

***PHIAC 2 Annual Returns***

***Audit Program Guidance***

***July 2008***



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# Section 1 - Audit program guidance for PHIAC 2 Annual Returns

- Exclusion Clause
- Introduction
- Adoption of Australian Equivalents to International Financial Reporting Standards
- Audit Approach
- Major Inherent Risk Areas

## Audit program guidance for PHIAC 2 Annual Returns

### Exclusion Clause

“Audit Program Guidance for PHIAC 2 Annual Returns” (“Returns”) is a publication produced by the Private Health Insurance Administration Council (PHIAC) to assist auditors of Registered Private Health Insurers (“Insurers”) in the audit of the PHIAC 2 Annual Returns of their clients. Auditors should, however, be aware that this program is not designed to be a complete set of procedures and is not a set of binding rules. As systems in Insurers vary, the program should be tailored to each insurer’s circumstances.

This guidance is not to be considered a stand alone document and under no circumstances should an auditor rely solely upon the program to the exclusion of their duties to perform audit procedures to arrive at their audit opinion on the PHIAC 2 Annual Returns.

It is the responsibility of the auditor to ensure that audit programs and processes are consistent with their internal methodology and are fully compliant with the requirements of Auditing and Assurance Standards Board (AUASB) Standards and Pronouncements. See Audit Approach below for more details.

This guidance is specific to the PHIAC 2 return and does not cover the audit requirements of the Private Health Insurance Act 2007 (Act) in respect of the PHIAC 1 returns.

### Introduction

The following guidelines and audit programs have been designed to assist the auditors of Insurers in Australia in their audit of the PHIAC 2 Annual Returns. As noted above, the programs are necessarily generic as the systems and processes found in Insurers vary and, where appropriate, the programs should be tailored to each Insurer’s circumstances.

The following guidance takes into account the arrangements contained in the Act and amendments thereon, and PHIAC Circulars.

Audit certification for the year to 30 June each year must be provided within three months of the end of the financial year. Please ensure that the certificate for the 2007-2008 year meets the deadlines as outlined in Circular 08/14. This deadline applies, regardless of when the Insurer’s financial year ends.

### Purpose of PHIAC 2 Annual Return

PHIAC established, under the Act, a two-tier regime of prudential reporting with each tier considering the capital requirements in a different set of circumstances.

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The first tier, addressed by the solvency standard contained in Schedule 2 of the Private Health Insurance (Health Benefits Fund Administration) Rules 2007 (the “Rules”), is intended to ensure the basic solvency of the health benefits Fund (the “Fund”) administered by the Insurer. The stated purpose of the solvency standard under Division 140 of the Act is:

*“to ensure as far as practicable that at any time the financial position of a fund conducted by an insurer is such that the insurer will be able to meet, out of the fund’s assets, all liabilities incurred for the purposes of the fund as those liabilities become due.”*

The second tier, covered by the capital adequacy standard contained in Schedule 3 of the Rules, is intended to secure the financial soundness of the Fund in a going concern sense and has a stated purpose under Division 143 of the Act:

*“to ensure, as far as practicable, that there are sufficient assets in a fund conducted by an insurer to provide adequate capital for the conduct of the fund in accordance with this Act and in the interests of the policy holders of the fund.”*

The purpose of the PHIAC 2 Annual Return is to enable both Insurers and PHIAC to monitor the solvency and capital adequacy of each Fund on an annual basis and, in doing so, allow PHIAC to prepare its report to Parliament in accordance with Section 264-15 of the Act.

### Scope of audit

The auditor of a Fund is required to determine whether the information contained in the PHIAC 2 Annual Return (containing Schedules 1 – 9) for the year to 30 June, or such other period, complies with the requirements of the solvency and capital adequacy standards.

In cases where the auditor is unable to provide an unqualified opinion that the PHIAC 2 Annual Return reflects the provisions of the above legislation, a qualified audit report should be provided to PHIAC that details the nature of the qualification.

## Adoption of Australian Equivalents to International Financial Reporting Standards

All Insurers are to apply the Australian Accounting Standards, which incorporate Australian Equivalents to International Financial Reporting Standards (“AIFRS”) to their *Corporations Act 2001* annual financial report (“Corporations Act accounts”) for periods beginning on or after 1 January 2005.

### Audit Approach

Due to the nature of the PHIAC 2 Annual Returns, a large proportion of the data will be extracted from already audited sources. Where possible, reliance should be placed on the work performed in forming an opinion on the Corporations Act accounts, other audited accounts and the audited PHIAC 1 returns.

Where the auditor of the PHIAC 2 Annual Returns is not the same as the auditor of the Corporations Act accounts, it is the responsibility of the PHIAC 2 auditor to ensure that they perform appropriate procedures in line with *ASA 600: Using the Work of Another Auditor*.

Where the Insurer is not subject to a statutory audit under the *Corporations Act 2001*, assurance should be gained over the source data used to prepare the PHIAC 2 return (such as the trial balance and underlying accounting records) by performing procedures necessary to gain sufficient appropriate evidence in order to form an opinion as to whether the PHIAC 2 return has been prepared in accordance with the Act. Such procedures should be completed with reference to the requirements of Auditing and Assurance Standards Board (AUASB) Standards and Pronouncements.

Note that PHIAC has the power to issue directives to individual Insurers under Sections 140-20 & 143-20 of the Act. Directions may affect the calculation of the solvency and capital adequacy requirements by prescribing certain actions to be undertaken by the Insurer. Prior to commencing audit procedures, the auditor should enquire as to whether any such directives have been received, and if so, assess the impact on the calculation, and the audit of the PHIAC 2 Annual Returns.

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## Major Inherent Risk Areas

Prior to commencing the audit of the PHIAC 2 Annual Returns, the auditor should gain an understanding of the major inherent risks associated with the information contained in the PHIAC return. Some general guidance on the inherent risks in auditing the Returns is given below but the auditor must obviously assess the specific risks for each of the Insurers for which they are responsible.

In order to appreciate the impact of any errors in the PHIAC 2 Annual Return, the auditor must understand the basis of the calculation that determines the solvency and capital adequacy of each Fund. The method of calculation is provided in the respective standards.

### Solvency Reserve – Completeness and Accuracy

#### *Outstanding Claims Liability*

The outstanding claims liability is a key component of the calculation that determines the outstanding claims components of the Solvency Reserve. The provisions relate to the various insurance activities conducted from the Fund (e.g., health insurance, overseas student health cover, overseas visitor cover, etc) and are calculated by employing actuarial methods and assumptions to arrive at a central estimate of claims that have been incurred at the balance sheet date but are yet to be presented, plus a provision for the cost of settling these claims. See Section 3 below for details of how the Solvency Reserve is calculated.

Given the level of judgement applied by the Insurer in determining the actuarial methodologies and assumptions, there is an inherent risk in the valuation of the outstanding claim liability, and hence the solvency requirement. It is expected that the auditor would use actuarial audit support experts to independently assess the reasonableness of the methodology and assumptions applied in arriving at the best estimate.

#### *Risk Equalisation Accrued Liability Component*

The risk equalisation accrued liability component (or asset) reflects the best estimate of the net amount of payments to, and recoveries from, the Risk Equalisation Trust Fund (“RETF”) in respect of the period up to the balance sheet date. This amount is not known in certainty, as the actual figure is dependent upon the benefit payments of all other Insurers and is not determined until after the balance sheet date. As this estimate is subject to significant levels of judgement by the Insurer, it is an area of inherent risk.

#### *Risk Equalisation Outstanding Claims Liability Component*

The risk equalisation outstanding claims liability component (or asset) reflects the central estimate of the net amount of payments to, and recoveries, from the RETF in respect of the outstanding claims liability. This amount is not known in certainty, as the calculation of this provision is dependent upon the inherent uncertainty in the valuation of the outstanding claims liability (as described above) and the ultimate recovery is dependent on the benefit payments of all other Insurers for a future period.

Given the level of judgement applied by the Insurer in determining the actuarial methodologies and assumptions, there is an inherent risk in the valuation of the risk equalisation outstanding claims liability component, and hence the Solvency Reserve. It is expected that the auditor would use actuarial audit support experts to independently assess the reasonableness of the methodology and assumptions applied in arriving at the best estimate.

#### *Unexpired Risk Amounts*

The Unexpired Risk Amounts are important components of the calculations that determine the unexpired risk components of the Solvency Amount. The component is calculated as the Contributions In Advance multiplied by a forecast loss ratio. The estimate of expected loss ratios is subject to actuarial methods and assumptions and, as it requires significant levels of judgement to be applied by the Insurer, is an area of inherent risk. It is expected that the auditor would use actuarial audit support experts to independently assess the reasonableness of the methodology and assumptions applied in arriving at the forecast loss ratios.

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See Section 3 below for details of how the Solvency Reserve is calculated and how the Unexpired Risk Component above is compared to that calculated for the Corporations Act accounts.

### **Capital Adequacy Reserve — Completeness and Accuracy**

#### *Renewal Option Amount*

The calculation to determine the renewal option amount is based on conservative business forecasts of the health insurance business and each health-related business for the twelve months following the balance sheet date. Due to the subjective nature of such forecasts, there is an inherent risk in the calculation of the renewal option amount.

Given the level of judgement applied by the Insurer in preparing business forecasts, there is an inherent risk in the calculation of the renewal option amount, and hence the Capital Adequacy Reserve.

#### *Business Funding Amount*

The business funding amount is determined solely by management and reflects their view of the future capital that will be required given the planned activities of the Fund over the next three years. Due to the subjective nature of such forecasts, there is an inherent risk in the calculation of the business funding amount.

Given the level of judgement applied by the Insurer in preparing business forecasts, there is an inherent risk in the calculation of the business funding amount, and hence the Capital Adequacy Reserve.

### **Materiality — Application to PHIAC 2 Annual Returns**

As noted in Audit Approach above, reliance should be placed, wherever possible, on the work performed to support the auditor's opinion on the Corporations Act accounts.

It should be noted, however, that the level of materiality applied in performing this work may not be appropriate in the context of the audit of the PHIAC 2 Annual Returns. There is therefore a risk that a misstatement material to the PHIAC 2 Annual Returns may go undetected.

Due to their sensitive nature, materiality for the PHIAC 2 Annual Returns should be calculated independently of that applied for the purposes of the Corporations Act accounts. Guidance on the application of materiality is given in the solvency standard (Part 4, Clause 12), and the capital adequacy standard (Part 4, Clause 12). The auditor should also ensure that the application of materiality is compliant with *Australian Auditing Standard ASA 320 Materiality and Audit Adjustments*.

### **Taxation Implications — Accuracy and Existence of Tax Credits**

Where additional provisions or margins are applied to existing liabilities, there is the opportunity for management to claim additional tax credits. Due to both the complexity of the calculations and the structure of the PHI industry, there is an inherent risk that the tax rate applied may not be appropriate, and the tax credits recorded may not be recoverable.

### **Security of Spreadsheet — Integrity of Data and Formulae**

The PHIAC 2 Annual Returns are prepared in a Microsoft Excel workbook. The workbook contains key formulae and macros which are written in accordance with the solvency and capital adequacy standards. At present there is security in locks over the formulae, however there remains a risk that the formulae and macros may be deliberately or inadvertently amended thus compromising the integrity of the data in the spreadsheet.

The workbook's formulae and macros should not be tampered with.

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## Section 2 - Controls Testing Program

### Controls testing program

#### Introduction

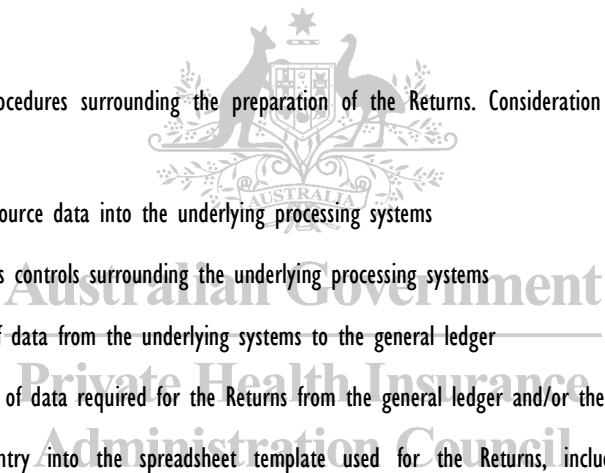
The auditor should perform an assessment of the processes, controls and procedures that the Insurer has in place to ensure compliance with the requirements of the Act. Where the auditor can independently validate that the controls over the preparation and review of the PHIAC 2 Annual Returns are operating effectively, reliance should be placed on them. The auditor may wish to consider the use of work performed by the internal auditor (*AUS 604 Considering Work of Internal Auditing*).

It is the responsibility of the auditor to ensure that audit programs and processes are consistent with their internal methodology and are fully compliant with the requirements of Auditing and Assurance Standards Board (AUASB) Standards and Pronouncements.

However, PHIAC anticipates that, due to the inherent risks described above, the sensitive nature of the Returns and after placing reliance on work performed in auditing the Corporations Act accounts or underlying accounting records the auditor will adopt a predominantly substantive approach in order to form an opinion on the Returns.

#### Areas of focus

Assess the processes, controls and procedures surrounding the preparation of the Returns. Consideration should be given, but not limited, to (where applicable):

- 
- controls over the input of source data into the underlying processing systems
  - general computer and access controls surrounding the underlying processing systems
  - controls over the transfer of data from the underlying systems to the general ledger
  - controls over the extraction of data required for the Returns from the general ledger and/or the underlying processing system
  - controls over the data entry into the spreadsheet template used for the Returns, including internal consistency checks and reconciliations to source data
  - monitoring controls over the preparation of the Returns including evidence of independent review, analytical review and data reasonableness checks, and
  - controls over the data integrity, including version control, limited access, password protection and final reasonableness review by the Officer signing the return.

The auditor should also consider, where applicable, the effectiveness and integrity of the governance, finance and compliance functions within the Insurer. Areas for focus may include, but are not limited to:

- integrity and level of oversight of senior management, the Board and the Audit Committee
- senior management's attitude towards controls and establishing a robust control environment
- the compliance culture within the Insurer and the processes in place to report and monitor breaches and non-compliance with laws and regulations, including any whistleblower policy
- the insurer's track record of corrective action in respect of identified breaches

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- the policies and procedures in place to ensure key staff are kept abreast of the laws and regulation applicable to their role within the Insurer
  - the historical accuracy of previous estimates, forecasts and budgets
  - the quality and depth of staff resources within the finance department.

### **Impact on testing**

Based on the results of the above testing, adjust the level of detailed substantive testing required in order to gain sufficient appropriate evidence to form an opinion on the PHIAC 2 Annual Returns.



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## Section 3 - Substantive testing program

*Schedule 1 – HIB Revenue & Expenses*

*Schedule 2 – HRB Revenue & Expenses*

*Schedule 3 – Insurer Income Statement Summary*

*Schedule 4 – Insurer Balance Sheet*

*Schedule 5 – Financial Instruments Sheet*

*Schedule 6 – HBF Renewal Option Amount*

*Schedule 7 – Resilience Amount*

*Schedule 8 – Components*

*Schedule 9 – Summary*

*Other Procedures*

### Substantive testing program

#### Schedule 1 – HIB Revenue & Expenses

##### *Overview*

Schedule 1 contains details of revenues and expenses associated with the health insurance business of the Fund. Schedule 1 includes:

- Dissemination of Premium Revenue and Fund Benefits Paid, by product and treatment type, at a state/territory level. Wherever possible, products that combine hospital and general treatment services should be split into their relevant service hospital/general treatment components.
- Costs attributable to the PHI activity are segregated into major cost types, and further disaggregated into costs associated with the handling and payment of health benefit claims, business acquisition costs and residual costs.

##### *Basis of Revenue Recognition*

The basis for attribution of Premium Revenue to the worksheet is determined by the underlying product and service types. Contribution Income is to be attributed on the product/service basis, irrespective of whether the underlying contract is treated as an insurance contract under *AASB 1023 General Insurance Contracts* (“AASB 1023”), or as a financial instrument under *AASB 139 Financial Instruments: Recognition and Measurement* (“AASB 139”).

The recognition criteria of AASB 1023 (and AASB 139 where appropriate) are to be applied for the purpose of attributing revenue amounts to the worksheet i.e. revenue must be determined by application of the applicable accounting standards.

##### *Overseas Student Health Cover (OSHC) and Overseas Apprentice Cover (OAC)*

People that are not eligible for Medicare, such as overseas students studying in Australia, overseas apprentices or other visitors to Australia may be required to be covered by health insurance contracts in a form different to the private health insurance arrangements, such as under a deed/contract with the Commonwealth. These non-PHI businesses are excluded from the scope of Health Insurance Business under the Act, but rather, falls within the definition of Health-Related Business. As a result, revenues and costs associated with OSHC and OAC business are not included in Schedule 1 and are to be reported as a Health-Related Activity in Schedule 2.

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### *Overseas Visitor Cover (OVC)*

Overseas visitors may also be required to be covered by health insurance contracts in a form different to usual private health insurance arrangements, but are covered under special transition arrangements such that OVC is considered to be Health Insurance Business for the purposes of the Act until 1 July 2008.<sup>1</sup> As a result, revenues and costs associated with OVC are to be included in Schedule 1 and are not to be reported as a Health-Related Activity in Schedule 2 for the 2008 Annual Return to PHIAC.

The inclusion of OVC in Schedule 2 anticipates the information collection necessary for OVC in the period on and after 1 July 2008.

### *Liability Movements*

Movements in the benefit component of the outstanding claims, unearned premium and unexpired risk liabilities are to be reported at the relevant Hospital Treatment, General Treatment or products covering ambulance items. This would include the application of a risk margin for the benefit component of the outstanding claims liability.

Movement in the RETF component of the outstanding claims liability is to be reported at the Net RETF item. This may include the application of a risk margin.

Movement in the Administration component of the outstanding claims liability should not be included at this schedule, but allocated in the Health Insurance Business — Administration Costs dissemination.

### *Health Insurance Business Administration Costs (by Type)*

The expenses of the Fund are to be allocated across those activities conducted by it on a consistent basis (i.e. using the same expense categories).

Costs attributable to the PHI activity are to be further segregated into costs associated with the handling and payment of health benefit claims, business acquisition costs and residual costs.

For the purposes of the Returns, costs and expenses should be recognised and measured on the basis consistent with that applied in the preparation of the Corporations Act accounts, unless stated otherwise.

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<sup>1</sup> The Government introduced the *Private Health Insurance Legislation Amendment Bill 2008* into the House of Representatives in May 2008. The Bill proposes amendments to the PHI Act from 1 July 2008, including insurance products where administered through an insurer's health benefits fund. This proposed amendment will see the removal of the dual regulation requirement for health related insurance activities conducted through health benefits funds post 1 July 2008, and as a result, the "health related business" will continue to be solely regulated by PHIAC.

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The segregation of PHI activity provides information relevant to the outstanding claims liabilities, deferred acquisition costs and the expense amount.

**Business Acquisition Costs** Identification of acquisition costs should be made in a consistent manner to that applied for the Corporations Act accounts. Per the AHIA guidance on adopting AASB 1023, acquisition costs may include, but are not limited to:

- fees and/or commissions paid to agents or brokers
- advertising, promotion and other sales costs where an identifiable link to new/continuing business is present
- administration costs of recording membership and policy details
- administration and transaction costs associated with the collection of premium.

These costs should be reported only where there is a clear nexus between these costs and particular insurance contracts.

**Claims Handling Costs** These costs should be related directly to the claims handling function and should not include overhead allocations.

These will be included in the claims incurred figure per the Corporations Act accounts so will need to be separated out for the purposes of Schedules 1 and 2.

These also include an element in respect of the movement in the claims handling provision included in the outstanding claims liability - see Other Management Expenses below.

The types of expenses that PHIAC would expect are applicable to the claims handling function, include:

For dedicated claims processing staff and immediate managers:

- payroll & on costs
- recruitment & training
- accommodation/occupancy costs
- IT systems, software and hardware costs
- transactions fees such HICAPS and bank fees
- postage/stationery costs
- settlement costs such as clinical review, disputed claims resolution costs
- claims storage costs.

For Branch & Agency Operations, those costs above, to the extent that they are incurred in the handling

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of claims:

- movement in the Administration component of the outstanding claims liability, which may be reported as 'Other Management Expenses', and
- any other costs with a clear nexus to the handling of claims.

Commissions & Fees

Fees and/or commissions paid to agents or brokers.

Self Occupied Property Expenses

Costs associated with the fund-occupied component of property (including those relating to non-PHI activities) include:

- rent
- mortgage/lease amortisation
- fit-out costs
- depreciation
- building & office equipment maintenance costs
- cleaning, gas, electricity, etc.
- fair value losses on the revaluation of such property in excess of any balance on the associated revaluation reserve in equity.

Where the Fund occupies an owned space, allocation of costs to activities on a floor space, notional rent, or other allocation basis is acceptable, provided the internal revenue arising from such an allocation is also attributed to this line item.

Some Insurers own property of which they occupy/use only part. Costs attributed to this item relate only to the portion of the building/premises occupied by the Fund.

Costs associated with property not occupied by the Fund and held for commercial rental purposes should be netted from rental revenues earned from that property and reported at Net Interest, Dividends and Investment Gains (Losses).

Employee Costs

Includes recruitment, residual salary, wages, contractor and on costs, training etc.

IT & Computing	<p>May include, but not limited to:</p> <ul style="list-style-type: none"> <li>• equipment lease/rental costs</li> <li>• software licence costs — depreciation/amortisation</li> <li>• hardware depreciation &amp; amortisation</li> <li>• salaries/wages/contractor costs while engaged in the provision of IT services</li> <li>• IT/computer data transmission/communications costs</li> <li>• maintenance costs.</li> </ul>
Publications, Advertising, Sponsorship & Publicity	<p>Residual advertising production and distribution costs (where not acquisition costs).</p> <p>Costs associated with membership magazines and product/information brochures (where not acquisition costs).</p> <p>Sponsorship &amp; promotion activities (where not acquisition costs).</p>
Postage & Telephone	Residual telephony and postage costs.
Financial Charges (Non-Claims Related Fees, etc)	Residual bank fees & charges (but not Borrowing Costs, see Schedule 3 below) that are not claims related.
Accounting, Audit, Actuarial, Legal & Other Professional Fees	Costs associated with externally sourced professional services.
Share of Corporate Overheads	Overhead expenses of another entity borne by the Fund via management agreement.
Membership Subscriptions	Costs associated with membership of industry associations and other representative bodies e.g. AHIA, AHSA, HIRMAA, ARHG, IFHP, etc.
Health Maintenance & Promotion Programs	<p>May include:</p> <ul style="list-style-type: none"> <li>• costs directly associated to these programs not otherwise included as benefits</li> <li>• salaries &amp; wages costs directly associated with conducting programs (where not included elsewhere).</li> </ul>



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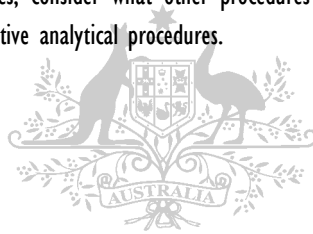
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Other Management Expenses May include:

- PHIAC, ACAC & PHIO levies
- movement in the claims handling component of the outstanding claims liability
- all other management expenses not covered elsewhere or not reported separately in Schedule 3.

### Audit Procedures

1. Agree the split by product, premium and benefit type by state/territory to the audited trial balance and audited underlying accounting records, where applicable. Where details cannot be agreed to audited sources, consider what other procedures will be required to achieve a sufficient level of audit assurance over the split e.g. substantive analytical procedures.
2. Agree the split of the Health Insurance Business Administration Costs, to audited underlying accounting records. Where details cannot be agreed to audited sources, consider what other procedures will be required to achieve a sufficient level of audit assurance over the split e.g. substantive analytical procedures.



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## Schedule 2 — HRB Revenue and Expenses

### *Overview*

Schedule 2 contains details of revenues and expenses associated with the Health-Related Business of the Fund. Schedule 2 includes segregation of revenues and expenses along major business lines, with a distinction between health-related insurance activities (such as OSHC) and health-related service provision activities (such as services provided by dental, optical, and medical centres).

The Health-Related Business subgroups refer to business activities that are conducted from within the Fund (i.e. not from subsidiary entities, joint ventures, nor those conducted by the Insurer but not within the Fund). The collection is intended to provide PHIAC with additional information regarding the nature and size of non-insurance business activities and the risk to the Fund from each.

Within the worksheet several types of business activities have been identified requiring discrete data entry. Within each, a number of data elements are to be completed.

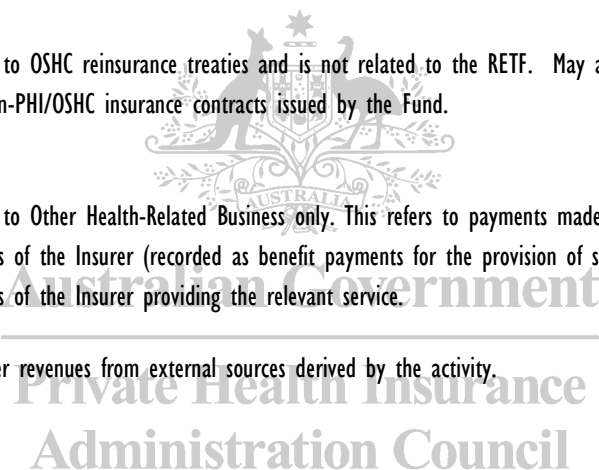
### *Health-Related Business Revenue (by Source & Activity)*

Health-Related Insurance Business - Premium Revenue Relates to revenue earned from non-HIB insurance activities.

Health-Related Insurance Business - Premium Ceded to Reinsurers Applies to OSHC reinsurance treaties and is not related to the RETF. May apply to "Other" activities if any Non-PHI/OSHC insurance contracts issued by the Fund.

Other Health-Related Business Revenue — From Health Insurance Business Applies to Other Health-Related Business only. This refers to payments made by the Health Insurance Business of the Insurer (recorded as benefit payments for the provision of services) to the Health-Related Business of the Insurer providing the relevant service.

Other Health-Related Business Revenue — From External Sources All other revenues from external sources derived by the activity.



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*Health-Related Business Expenses (by Type & Activity)*

The expenses of the Fund are to be allocated across those activities conducted by it on a consistent basis (i.e. using the same expense categories).

For the purposes of the Return, costs and expenses should be recognised and measured on basis consistent with that applied in the preparation of the Corporations Act accounts, unless stated otherwise.

The segregation of Health-Related Business activity also provides information relevant to the outstanding claims liabilities, deferred acquisition costs and the expense amount.

Health-Related Activities      Cost of materials and services acquired as inputs to the activity.

Cost of Goods/Services

Insurance Benefits              Benefits paid under contracts issued by the Insurer for Health-Related Insurance Business activities.

Benefit Recoveries  
(Reinsurance)                      Applies to Health-Related Insurance Business activities and is related to reinsurance treaties (not to the RETF).

Claims Handling Costs              These costs should be related only to the claims handling function and should not include overhead allocations.

These will be included in the claims incurred figure per the Corporations Act accounts so will need to be separated out for the purposes of Schedules 1 and 2.

They also include an element in respect of the movement in the claims handling provision included in the outstanding claims liability - see Other Management Expenses below.

The types of expenses that PHIAC would expect are applicable to the claims handling function are detailed in Schedule 1 – HIB Revenue and Expenses.

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The following expenses have the same meaning as per Schedule 1 – HIB Revenue and Expenses:

- Business Acquisition Costs
- Commissions & Fees
- Self Occupied Property Expenses
- Employee Costs
- IT & Computing
- Publications, Advertising, Sponsorship & Publicity
- Postage & Telephone
- Financial Charges (Non-Claims Related Fees, etc)
- Accounting, Audit, Actuarial, Legal & Other Professional Fees
- Share of Corporate Overheads
- Membership Subscriptions
- Health Maintenance & Promotion Programs
- Other Management Expenses

### Audit Procedures

1. Agree the amounts for Premium Revenue and Insurance Benefits paid in respect of both the Health Insurance Business (Schedule 1) and the Health-Related Insurance Businesses (Schedule 2) to the audited Corporations Act accounts of the Insurer. Discuss any differences with management and obtain support for any reconciling items.
2. Agree total amounts for Premium Ceded to Reinsurers, and Non-PHI Revenue to the audited Corporations Act accounts of the Insurer and/or audited underlying accounting records, where applicable. Discuss any differences with management and obtain support for any material reconciling items.
3. Agree the split of the types of revenues by activity, and the split of Other Health-Related Business revenue by Health Insurance Business and External, to audited underlying accounting records. Where details cannot be agreed to audited sources, consider what other procedures will be required to achieve a sufficient level of audit assurance over the split e.g. substantive analytical procedures.
4. Agree the split of Health-Related Business – Cost of Goods/Services by activity to audited underlying accounting records. Where details cannot be agreed to audited sources, consider what other procedures will be required to achieve a sufficient level of audit assurance over the split e.g. substantive analytical procedures.
5. Agree the split of Benefit Recoveries – Reinsurance; Claims Handling Costs and Business Acquisition Costs in respect of Health-Related Insurance Businesses to audited underlying accounting records, where applicable. Where details cannot be agreed to audited sources, consider what other procedures will be required to achieve a sufficient level of audit assurance over the split e.g. substantive analytical procedures.
6. Agree the amounts for Benefit Recoveries – Reinsurance; Claims Handling Costs and Business Acquisition Costs in respect of both the Health Insurance Business (Schedule 1) and the Health-Related Insurance Businesses (Schedule 2) to the audited Corporations Act accounts of the Insurer. Discuss any differences with management and obtain support for any reconciling items.
7. Ensure the total for Business Acquisition Costs agrees to the acquisition cost of the underwriting result disclosure per the Corporations Act accounts of the Insurer and/or audited underlying accounting records, where applicable. Discuss any differences with management and obtain support for any material reconciling items

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8. As described above, claims handling costs are included within the claims incurred figure per the Corporations Act accounts. AASB 1023 paragraph 17.6.3(h) requires a separate disclosure of total underwriting expenses (including the claims handling costs recognised in claims). Therefore if the claims handling costs figure is not explicitly disclosed, it can be calculated by taking the total underwriting expenses per the paragraph 17.6.3(h) disclosure from the total underwriting expenses of the underwriting result.
  9. Agree the split of the types of expense by activity, and the split of Administration Costs, to audited underlying accounting records. Where details cannot be agreed to audited sources, consider what other procedures will be required to achieve a sufficient level of audit assurance over the split. e.g. substantive analytical procedures.
  10. Agree total amounts for Administration Costs in respect of both the Health Insurance Business (Schedule 1) and the Health-Related Insurance Businesses (Schedule 2) to the audited Corporations Act accounts of the Insurer and/or audited underlying accounting records, where applicable. Discuss any differences with management and obtain support for any material reconciling items.



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## Schedule 3 — Insurer Income Statement Summary

### *Overview*

Schedule 3 is a modified Income Statement of the Insurer for the year to 30 June. Most of the information regarding the operations of the Fund is drawn directly from Schedules 1 and 2 but some data entry may be required where:

- the Fund has other items of expense or revenue, borrowing costs or is subject to taxation, and
- the Insurer conducts activities other than those of the Fund.

### *Finance Revenue Attributable to the Fund*

Earnings from the investment of the Fund's assets that are themselves considered assets of the Fund are reported at this item.

### *All Other Revenue Attributable to the Fund*

Any revenue attributed to the Fund but not otherwise disclosed is to be reported at this item.

### *Borrowing Costs*

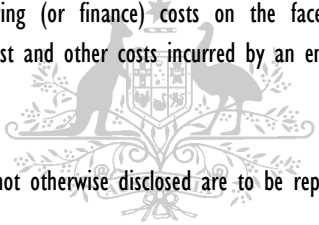
AIFRS requires entities to separately disclose borrowing (or finance) costs on the face of the income statement for the purposes of the Corporations Act accounts. These are defined as interest and other costs incurred by an entity in connection with the borrowing of Funds.

### *Other Expenses paid/payable from the Fund*

Any items of expense paid or payable from the Fund not otherwise disclosed are to be reported at this item.

### *Income Tax*

The amount of income tax paid or payable from the Fund (whether or not the liability for tax stems from the operations of the Fund) is reported at this item.



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## Audit Procedures

1. Ensure that the following cross references from Schedule 3 to Schedules 1 & 2 are correct:
  - Cell D5 agrees to cell J12 of Schedule 1
  - Cell D6 agrees to the sum of cells D10:F10 of Schedule 2
  - Cell D7 agrees to the sum of cells H9:L9 of Schedule 2
  - Cell C13 agrees to cell J24 of Schedule 1
  - Cell C14 agrees to cell I44 of Schedule 1
  - Cell C15 agrees to cell H44 of Schedule 1
  - Cell C16 agrees to cell G44 of Schedule 1
  - Cell D16 agrees to the sum of cells C13:C16
  - Cell C18 agrees to the sum of cells D15:F15 of Schedule 2 less the sum of cells D16:F16 of Schedule 2
  - Cell C19 agrees to the sum of cells D17: F17 of Schedule 2
  - Cell C20 agrees to the sum of cells D18:F18 of Schedule 2
  - Cell D21 agrees to the sum of cells D20:F31 of Schedule 2
  - Cell C23 agrees to the sum of cells H14:L14 of Schedule 2
  - Cell C24 agrees to the sum of all cells H20:L31 of Schedule 2
  - Cell C25 agrees to the sum of cells H8:L8 of Schedule 2
2. Ensure cell D10 agrees to the sum of cells D5:D9
3. Ensure cell D16 agrees to the sum of cells C13:C16
4. Ensure cell D21 agrees to the sum of cells C18:C21
5. Ensure cell D25 agrees to the sum of cells C23:C25
6. Where amounts have been included at all other expenses, discuss the nature of the items with management.
7. Agree all amounts disclosed in Column D per Schedule 3 to the signed Corporations Act accounts of the Insurer, taking into account the work on reconciling items performed for the purposes of Schedule 1 and Schedule 2. Discuss any differences with management and obtain support for any material reconciling items. Where details cannot be agreed to audited sources, consider what procedures will be required to achieve a satisfactory level of assurance.

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## Schedule 4 — Insurer Balance Sheet

### *Overview*

Schedule 4 contains items from the Balance Sheet of the Insurer and principally the Fund conducted by it as at 30 June and these items should agree to the audited Corporations Act accounts. It also includes a split of certain Balance Sheet items into greater detail for the purposes of calculating the inadmissible assets amount which counts towards the Solvency and Capital Adequacy Reserves.

### *Unclosed Business*

Unclosed Business is disclosed separately for the Health Insurance and the Health-Related Insurance Business of the Fund. Unclosed Business arises from two sources, see table below:

Unclosed Business Contributions - Earned	This represents premiums in arrears, including those collected by third parties, measured up to the balance sheet date only
Unclosed Business Contributions - Unearned	The health insurance equivalent of the Unearned Premium Liability (“UPL”) per AASB 1023 consists of two balances: <ul style="list-style-type: none"><li>• actual cash premium receipts for periods in advance of the balance sheet date, plus</li><li>• forecasted premiums receivable from balance sheet date to the expiry of the contract period in respect of current health insurance contracts represents the Unclosed Business Contributions – Unearned balance.</li></ul>

### *Deferred Acquisition Costs*

Deferred acquisition costs are to be reported together with intangibles at cell I59.

### *Holdings in Associated and Subsidiary Entities*

Where the valuation methodology applied to the investment in a prudentially regulated subsidiary of the Fund conducted by an Insurer is anything other than fair value, the value of the net tangible assets of the subsidiary may be used as the investment’s prescribed value for the purpose of completing the Returns.

This applies even where the value of the net tangible assets exceeds the book value of the entity in the Corporations Act accounts of the Insurer.

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Common errors:

- ADIs not recorded in the correct location, i.e. not split correctly per the \$50m threshold. To ensure the correct classification, the Insurer needs to check the latest public financial report of each institution. It is not uncommon, for ADI's to change their asset holdings.
- Cash on hand is not in the correct location. This should be included in other assets as it is not held in an ADI.
- Cash in transit is not in the correct location. This should be included in other assets as it is not held in an ADI.

The following table is intended to assist the auditor regarding correct classification in the balance sheet for prudential requirements.

Cash	Cash held in trading accounts needs to be recorded in the cash section.  Cash needs to be split up according to where it is held. The capital standards separate cash held in banks depending whether it is held in ADIs with net assets over or less than \$50m.
Interest Bearing Assets	Cash held in an ADI that is not a trading account. Examples include, term deposits, bank bills, cash deposits.
Indexed Bond Assets	A bond where the payments are linked to an index, for example, consumer price index (CPI). These bonds are issued by ADIs.
Other Indexed Bond Assets	A bond where the payments are linked to an index. These bonds are not issued by ADIs.
Other Interest Bearing Assets	Other interest bearing assets encompasses a wide range of assets, including, but not limited, to: <ul style="list-style-type: none"><li>• term deposits not held in ADIs</li><li>• cash trusts or cash that is held as part of a unit trust</li><li>• collateral debt obligations (CDOs)</li></ul>

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Assets Guaranteed by a National Government This should include:

- amounts receivable from the Risk Equalisation Trust Fund (RETF)
- the 30% PHI Contributions Rebate.

Equities This includes shares and securities traded through brokers (over the counter) and on the securities exchange. Examples include, but are not limited, to:

- shares, options, futures and other derivatives relating directly to equities
- property trusts should not be recorded here, but under the Property Sub-section of the PHIAC 2 return.

#### *Reporting of Pooled Assets/Managed Investments*

Many pooled investment arrangements do not provide counterparty or concentration information at the balance sheet date. Where Insurer have invested Fund monies in pooled investment arrangements and specific asset allocations are not known to the Fund at the balance sheet date, it is desirable for the purpose of completing the Returns that these pooled investments are split consistent with the investment mandates of the investment manager, and allocated to the corresponding investment type in Schedule 4.

#### *Insurance Liabilities*

The insurance liabilities of the Fund are disclosed separately for each major insurance activity:

- Health Insurance liabilities
- Overseas Students and Overseas Apprentice Cover
- Overseas Visitor Cover and Other Insurance activities (Overseas Visitor Cover not required for 2008 Annual Return)

Below is a summary of the changes in the valuation of the insurance liabilities for the purposes of the Returns arising from the adoption of AIFRS.

Unearned Premium & Unexpired Risk Liability:

Unearned Premium – Closed Business

Contributions in Advance Liability (“CIA”) The liability for CIA is the amount of contributions actually received prior to the valuation date for insurance cover to be provided for periods after the valuation date.

Unexpired Risk Liability – CIA Component Amount calculated in accordance with AASB 1023 in relation to the CIA component i.e. loss recognition in respect of unexpired risk portion of health insurance contracts current at the balance sheet date.

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Risk Margin % Applied to CIA      The risk margin adopted by the Insurer for the purposes of undertaking the liability adequacy test.

Discount Rate % Applied to CIA      The rate used to discount the closed business liabilities to their present value, if applicable.

Unearned Premium – Unclosed Business:

Unclosed Business Contributions Liability      The amount of unclosed business premiums in arrears for the period between the balance sheet date and the contract end.

This would usually be equal to the amount reported as receivable in respect of the unclosed business and a default formula equates the value of the liability to that of the amount receivable.

Unexpired Risk Liability – Unclosed Business Liability Component      Amount calculated in accordance with AASB 1023 in relation to the unclosed business liability component i.e. loss recognition in respect of contracts with risk periods incepting after the balance sheet date, covering the period up to the contract renewal date.

Risk Margin % Applied to Unclosed Business Liability Component      The risk margin adopted by the Insurer for the purposes of undertaking the liability adequacy test.



Discount Rate % Applied to Unclosed Business Liability Component      The rate used to discount the unclosed business liabilities to their present value, if applicable.

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Unexpired Risk Liability – Expected Contract Renewals (Renewal Option Liability):

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Unexpired Risk Liability – Renewal Option Liability Component      Amount calculated in accordance with AASB 1023 in relation to the renewal option liability component i.e. loss recognition in respect of contracts expected to renew after the balance sheet date, covering the period up to the date of the next expected pricing review.

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Risk Margin % Applied to Renewal Option Liability Component      The risk margin adopted by the Insurer for the purposes of undertaking the liability adequacy test.

Discount Rate % Applied to Renewal Option Liability Component      The rate used to discount the renewal option liability to present value, if applicable.

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Unpresented & Outstanding Claims:

Benefit Component	Benefits payable for: <ul style="list-style-type: none"><li>• claims that have been reported, but are not yet settled at balance date;</li><li>• claims that have been incurred, but not yet reported (IBNR); and</li><li>• claims that have been administratively settled, but which may be reopened.</li></ul>
Administration Component	Allowance for claims handling expenses associated with those claims included within the provision for Unpresented & Outstanding Claims.
RETF Component	The value of any amount payable or receivable under the RETF arrangements arising from run-off of claims included within the provision for Unpresented & Outstanding Claims.
Outstanding Claims ("OSC") Margin for Risk	Dollar value of the risk margin applied to the OSC liability.
Risk Margin % Applied to OSC Liability	The risk margin percentage applied by the Insurer to the OSC liability.
Discount Rate % Applied to OSC Liability	The rate used to discount the OSC liability to present value, if applicable.
RETF:	
RETF Liability	Amounts unpaid at balance date arising from the operation of the RETF arrangements.
RETF Margin for Risk	If the Insurer has determined that a risk margin is held in relation to the RETF liability, the dollar value of the risk margin is to be reported.  Note that AASB 1023 does not require the recognition of a risk margin in relation to the RETF liability.
Risk Margin % Applied to OSC Liability	The risk margin percentage applied by the Insurer to the RETF liability, if applicable.
Discount Rate % Applied to OSC Liability	The rate used to discount the RETF liability to present value, if applicable.
Loyalty Bonus:	
Loyalty Bonus Liability	The value of accrued loyalty bonus entitlements is to be reported here. This item relates to run-off of pre-PHI Act liabilities.  Loyalty bonus liabilities are required to be reported separately as these liabilities have the potential

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to be long lived and have a run-off experience different to that of other health insurance liabilities.

Loyalty Bonus Margin for Risk	If the Insurer has determined that a risk margin is held in relation to the loyalty bonus liability, the dollar value of the risk margin is to be reported.
Risk Margin % Applied to OSC Liability	The risk margin percentage applied by the Insurer to the loyalty bonus liability, if applicable
Discount Rate % Applied to OSC Liability	The rate used to discount the loyalty bonus liability to present value, if applicable.



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## Audit Procedures

1. Agree the amounts per Schedule 4 to the Balance Sheet and accompanying notes of the Corporations Act accounts. Discuss any differences with management and obtain support for any material reconciling items. Ensure that the balance sheet balances.
2. Where necessary, agree additional detail to the audited trial balance and audited underlying accounting records. Emphasis should be given to the classification of investments as this directly impacts the Solvency and Capital Adequacy Reserves. Where details cannot be agreed to audited sources, consider what procedures will be required to achieve a satisfactory level of assurance.

### *Assets Used in the Conduct of Business*

3. Review loans to directors, employees, advisers and related parties and, where possible, agree details to the audited related party note in the Corporations Act accounts. Where this cannot be performed, agree totals to the audited underlying accounting records and discuss with management their classification. Note: All loans should be considered unsecured unless proven otherwise.
4. Where the Insurer has claimed any recoverable amounts in cells M15 to M58 check that this complies with requirements of Clause 21 of the solvency standard.
5. Recalculate the maximum admissible amount for each asset and check for compliance with Clause 23 of the solvency standard.

### *Holdings in Associated & Subsidiary Entities which are prudentially regulated institutions*

6. Identify any associated or subsidiary entities which are prudentially regulated institutions.
7. Agree the fair value of the holdings in the above entities to the audited trial balance or audited underlying accounting records.
8. Where the regulated entity requires a minimum capital amount to be maintained, this is required to be disclosed. Agree this amount to the relevant audited regulatory returns.
9. Recalculate the maximum admissible amount for each asset and check for compliance with Clause 23 of the solvency standard and Clause 30 of the capital adequacy standard.

### *Asset Concentration Risk*

10. Recalculate the maximum admissible amount for each asset and check for compliance with Clause 23 of the solvency standard and Clause 30 of capital adequacy standard.
11. Recalculate the % of total for each asset.
12. Recalculate the maximum level prescribed and check compliance with Clause 23 of the solvency standard and Clause 30 of the capital adequacy standard.
13. Ensure that all assets are appropriately dissected and in accordance with Clause 23 of the solvency standard and Clause 30 of the capital adequacy standard.

### *Total Inadmissible Assets*

14. Recalculate the Assets Value for Prudential Standards Purposes on a total basis.

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15. Recalculate the solvency inadmissible asset amount. This is calculated as the addition of the inadmissible amounts of “Assets Used to Conduct Business”, “Holdings in Associated & Subsidiary Entities which are Prudentially Regulated” and “Asset Concentration Risk”.
  16. Recalculate the capital adequacy inadmissible asset amount. This is calculated as the addition of the inadmissible amounts of “Holdings in Associated & Subsidiary Entities which are Prudentially Regulated” and “Asset Concentration Risk”.



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## Schedule 5 – Financial Instruments Sheet

### Overview

Schedule 5 is a new schedule in the PHIAC 2 return. This schedule provides PHIAC with additional information regarding the nature of a Fund's investment portfolio and financial instruments therein. This Schedule has been inserted into the template. The Renewal Option Amount Schedule is now located at Schedule 6.

The following table is intended to assist the Fund in completing this schedule.

Financial Instrument	A financial instrument is any contract that gives rise to a financial asset of one entity, and a financial liability or equity instrument of another entity.
Name of Investment	This is the name of the investment or product. In the event that an entry in the Schedule 4 (Balance Sheet) is an amalgamation of various assets, it is important that the name of each investment is independently stated. PHIAC needs to be able to link each line item back to each line item on Schedule 4.
PHIAC 2 Balance Sheet Category	These are the same categories as found in Schedule 4. PHIAC has created a pull down list to complete this item. This means that other financial instruments that do not fall into the categories do not need to be included in Schedule 5.
Value	This is the value as stated in Schedule 4. Should an entry in Schedule 4 show the aggregated value of various investments, then the value of each investment should be separately identified.
Valuation Methodology	This is how the investment was valued at reporting date. Some examples include fair value, cost, and face value.
Manager	This is the institutional investment manager that the Fund uses to manage the particular investment, e.g. PIMCO, Grange, etc.
Nature of Investment	PHIAC is interested in the type and nature of the underlying investment. A wide range of investments and financial instruments are used. PHIAC is interested in obtaining an understanding of this range. The nature of investment may include, but not limited to:

Cash in the bank (trading accounts)	Term deposits
Cash management trust	Debentures
Unsecured notes	Managed funds or trusts
Options	Warrants
Swaps	CDOs
Futures	Hedged fund

Counterparty	Counterparty is both a legal and financial term that refers to the other individual or institution to an
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agreement or contract.

**Product Type — Off the Shelf** Off the Shelf products are also known as over the counter markets (“OTC”) can generally be described as financial instruments that are available to the general public rather than specifically for the use of the Fund. Possible indications of Off the Shelf products include but not limited to the existence of a Product Disclosure Statement, Product Information, and regular performance update that is available to the public.

**Product Type — Tailored** These products are tailored to meet the Fund’s individual financial needs and goals. Ongoing performance updates of these products are generally not made publicly available.

**Counterparty Grade** A summary table has been included in the worksheet. PHIAAC does not require the credit rating, but requires the relevant Grade 1-6 as per the table. Investments without a grade must be classified as Grade 6. The table in the worksheet has been duplicated here:

Counterparty Grades				
Grade	Standard & Poor's	Moody's	AM Best	Fitch
1	AAA	Aaa	A++	AAA
2	AA+	Aa1	A+	AA+
	AA	Aa2		AA
	AA-	Aa3		AA-
3	A+	A1	A	A+
	A	A2		A
	A-	A3		A-
4	BBB+	Baa1	B++	BBB+
	BBB	Baa2	B+	BBB
	BBB-	Baa3		BBB-
5	BB+ or below	Ba1 or below	B or below	BB+ or below
6	Unrated assets or exposures			

If a financial instrument has a number of grades, the Insurer needs to record the rating attached to the largest value attributable to the grade. In the example below, the correct grade to be recorded in the Return would be 4, as the largest component in the financial instrument has an S&P rating of BBB+.

**EXAMPLE:** Financial Instrument A has a total value of \$100 000, which consists of the following credit rating by S&P:

\$20 000 A+

\$50 000 BBB+

\$30 000 AAA

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Maturity (months) The term to maturity, in months, at the end of the reporting period (end of each quarter and annually). PHIAC is not interested in the duration or the full investment term.

Where the financial instrument has more than one maturity date, then the weighted average maturity must be recorded.

For financial instruments with no defined maturity date and is perpetual in nature (eg; shares, trading account), this cell can be left blank.

### Audit Procedures

1. Agree each line item in Schedule 4 with each line in Schedule 5. In the event that an entry in the Schedule 4 (Balance Sheet) is an amalgamation of various assets, it is important that the name of each investment is independently stated. PHIAC needs to be able to link each line item from Schedule 5 to each line item on Schedule 4. Any discrepancies should be discussed with management and sufficient audit evidence obtained for material reconciling items.
2. Agree the totals for each balance sheet category from Schedule 4 and ensure that they agree with each balance sheet category in Schedule 5. Any discrepancies should be discussed with management and sufficient audit evidence obtained for material reconciling items.
3. Discuss and confirm the investment manager. Ensure that the nature of investment is correctly disclosed in the Schedule.
4. Confirm that the valuation methodology and the value are correct. Agree details back to the audited trial balance or audited underlying accounting records.
5. Agree the name of the investment to audited underlying accounting records.
6. Discuss the counterparty arrangements. Agree the counterparty to audited underlying accounting records.
7. Discuss the type of product and confirm that the type of product is correct.
8. Agree the credit rating grade to audited underlying accounting records. Any discrepancies should be discussed with management and sufficient audit evidence obtained for material reconciling items.

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9. Agree the maturity to source documentation. Any discrepancies should be discussed with management and sufficient audit evidence obtained for material reconciling items.
  10. Terms of maturity should link to the Schedule 7 - Resilience Amounts. Enquire of management as to how they calculated the term to maturity. Review logic for reasonableness and agree details back to the audited trial balance or audited underlying accounting records. The maturity should be the weighted average.



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## Schedule 6 — Renewal Option Amount

### *Overview*

Clause 19 of the capital adequacy standard describes the renewal option amount as follows:

The renewal option amount must make provision for the risks and potential costs in providing the right of renewal to policy holders. The renewal option amount is determined based on a separate projection of each health insurance business, health-related insurance business and health-related other business over the 12-month period subsequent to the valuation date.

The renewal option amount reflects the risks associated with the ability of the Insurer, through the Fund conducted by it, to write new policies with an appropriate degree of premium stability.

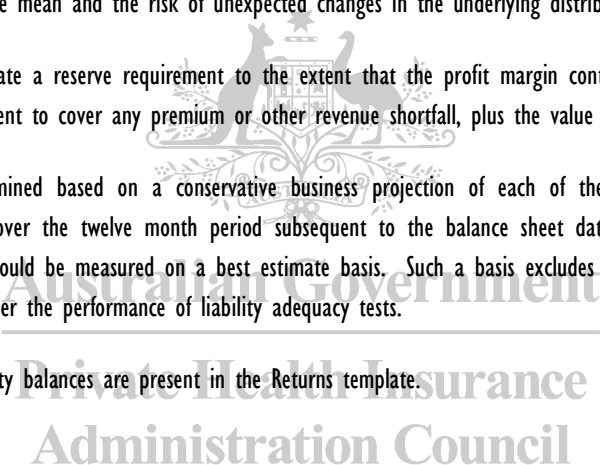
Policyholders have an expectation to maintain and renew their membership in the future. To the extent that current premiums may prove inadequate to cover future insurance benefits, related expenses and other costs of service provision, some prospective renewal option amount is needed. This would reflect the time taken to identify any adverse emerging experience trends and for appropriate corrective action to be taken.

The risks pertaining to each element include the risk of miss-estimation of the mean, the risk of deterioration of the assumed mean, the risk of adverse statistical fluctuations about the mean and the risk of unexpected changes in the underlying distribution of experience.

The renewal option amount will generate a reserve requirement to the extent that the profit margin contained within the prospective premiums or other revenue cash flows is insufficient to cover any premium or other revenue shortfall, plus the value of the risks evaluated.

The renewal option amount is determined based on a conservative business projection of each of the Health Insurance and Health-Related Businesses conducted from the Fund over the twelve month period subsequent to the balance sheet date. Hence liability amounts (which go toward notional investment income) should be measured on a best estimate basis. Such a basis excludes amounts recognised by the addition of risk margins or amounts recognised after the performance of liability adequacy tests.

Default formulas for the opening liability balances are present in the Returns template.



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## Audit Procedures

1. All Income Statement items are to be included on an accrual basis. Some accrual items have been dissected into their component parts e.g. Premium Revenue has been dissected into cash received, movement in CIA liability and movement in contributions in arrears asset. These component parts, when summed together, provide an accrual based total. Emphasis should be given to check that this has been performed. Where exceptions occur, assess their impact on the Solvency and Capital Adequacy Reserves in light of materiality.
2. Obtain an understanding of the sources of data management have used as a basis for their projected cash flows. Such sources could include, but are not limited to:
  - strategic / business plans
  - budgets
  - company forecasts
  - Financial Condition Reports.
3. Consider the appropriateness of the source and the level of scrutiny it has been subject to. For example, consider management's review and/or Board approval of the source.

The renewal option amount may also be prepared by an external actuary. Where such a practice occurs, and reliance is to be placed on the work performed by the external actuary, consider the requirements of ASA 620: Using the Work of an Expert. The auditor may also use internal audit support actuaries to review the methodologies and assumptions applied in calculating the renewal option amount.

4. Agree key numbers used in the projection back to source documentation. Discuss any differences with management and obtain support for any material adjusting items.
5. Agree the opening balance for the 12-month period for CIA, contributions in arrears and outstanding claims and risk equalisation liability/asset to Schedule 4.
6. Agree the discount rate used to the rate advised by PHIAC.
7. Ensure the correct tax status has been applied in the template.
8. Perform overall reasonableness review of the projections by calculating key performance indicators ("KPIs") for each 12-month projection and compare these to the prior year after taking into account client and industry developments. Such KPIs include, but are not limited to:
  - claims ratio (benefits paid / contributions received)
  - expense ratio (expenses paid / contributions received)
  - loss ratio (addition of above 2 ratios)
  - premium growth rate
  - medical expense growth rate.
9. Recalculate the Incurred Payments & Costs after application of the capital adequacy margin (e.g. for the Health Insurance Business projection: for State Levies & Management Expenses, Pre Adjusted Cash flows x (1+(Capital Adequacy Margin/2)) and for all other expenses, Pre Adjusted Cash flows x (1+Capital Adequacy Margin)).

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10. Recalculate the renewal option amount as: the sum of the Total Discounted Inflows less Total Discounted Capital Margin Adjusted Outflows for the Health Insurance Business and each Health-Related Business.



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## Schedule 7 - Resilience Amount

### *Overview*

The resilience amount is an intermediate component in the determination of the Solvency Reserve and the Capital Adequacy Reserve, which reflects the risks of the Fund in respect of any mismatching of asset and liability exposures.

To the extent that the value of liabilities is not directly linked to the value of the underlying assets, an adverse movement in the day to day value of the assets effectively reduces the level of reserves supporting the liabilities.

An Insurer must recognise the risk associated with such asset valuation volatility and hold an amount such that the obligation of each Fund would still be able to be met following an adverse systemic market movement.

### *Default Asset Allocation*

Schedule 7 has been designed to collect information from Schedule 4. This collection makes some assumption as to the type of resilience or market risks that attach to particular assets e.g. subsidiary entities are included as equities in the resilience amount worksheet.

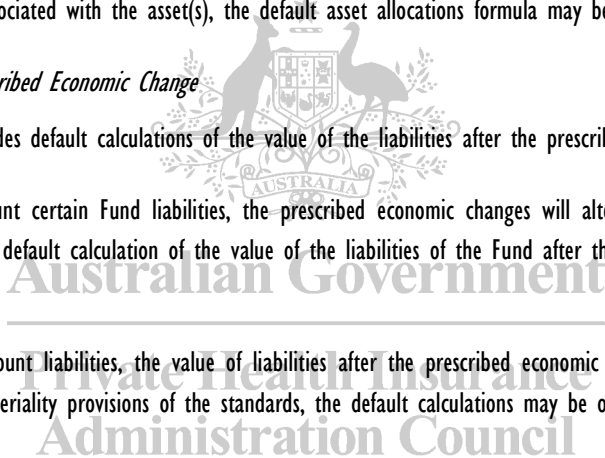
Where the Insurer determines that the default allocation of assets in the resilience amount worksheet does not appropriately match the type or extent of resilience or market risk associated with the asset(s), the default asset allocations formula may be over-written.

### *Determination of Liabilities after Prescribed Economic Change*

The resilience amount worksheet includes default calculations of the value of the liabilities after the prescribed economic changes.

Where Insurers have chosen to discount certain Fund liabilities, the prescribed economic changes will alter the relevant discount rate for those liabilities. In these circumstances the default calculation of the value of the liabilities of the Fund after the prescribed economic changes may be incorrect.

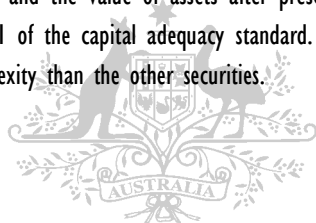
Where an Insurer has chosen to discount liabilities, the value of liabilities after the prescribed economic changes should be recalculated by the Insurer and, having regard to the materiality provisions of the standards, the default calculations may be over-written.



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## Audit Procedures

1. Note: focus should be given to classification of investments as incorrect allocation will directly affect both the Solvency and Capital Adequacy Reserves. Agree all amounts in cells in B6:B17 to the corresponding balance on Schedule 4, where they will have been agreed back to the audited trial balance or audited underlying accounting records.
2. Recalculate the inadmissible asset amounts for solvency and capital adequacy in total and for the individual asset classes, per cells C6:D17, by reference to the formulas in Schedule 4. Additional emphasis should be given to the calculation of bonds as this is higher in complexity than the other securities.
3. Ensure the formulas in cells E6:F17 are correctly calculating the admissible asset amount before prescribed economic change both in total and for the individual asset classes.
4. Enquire of management as to how they calculated the average term to maturity. Review logic for reasonableness and agree details back to the audited trial balance or audited underlying accounting records.
5. Where management have over-written the default allocation of assets in the resilience amount worksheet, discuss the reasoning and confirm whether this is reasonable given the auditor's understanding of the market and the Insurers business.
6. Recalculate the diversification factor and the value of assets after prescribed change for each asset class as per Clause 24 of the solvency standard and Clause 31 of the capital adequacy standard. Additional emphasis should be given to the calculation of bonds, as this is higher in complexity than the other securities.



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## Schedule 8 - Components Calculation

### *Section 1: Solvency Reserve*

The Solvency Reserve requires the following elements for calculation:

- Management Capital Amount — the management capital amount reflects the need for a minimum dollar amount in respect of the business risks that are not proportional to the size of the Fund and is a fixed amount of \$1 million (from 1 April 2007).
- Expense Amount - the purpose of the expense amount is to reflect the provision for expenses needed to cover a run-off situation in respect of the Fund. This is calculated as 40% of the “Non-Claim Expenses” of the Fund for the year ending on the balance sheet date.
- Solvency Insurance Liabilities Amount — the purpose of the solvency insurance liabilities amount is to assess, on a conservative valuation basis, the insurance liabilities of the Fund as per Schedule 4, and determine whether any additional capital requirement is necessary having regard to the stated values of those liabilities.
- Inadmissible Assets Amount - the inadmissible assets amount is referenced directly to Schedule 4 and includes:
  - assets used for the conduct of business
  - holdings in associated and subsidiary entities including prudentially regulated entities, and
  - asset concentration amount.
- Resilience Amount - the resilience amount is referenced directly to Schedule 7.

### *Section 2: Capital Adequacy Reserve*

The Capital Adequacy Reserve requires the following elements for calculation:

- Capital Adequacy Insurance Liabilities Amount — the purpose of the capital adequacy insurance liabilities amount is to assess, on a conservative valuation basis, the insurance liabilities of the Fund as per Schedule 4, and determine whether any additional capital requirement is necessary having regard to the stated values of those liabilities.
- Renewal Option Amount - the renewal option amount is referenced directly to Schedule 6
- Business Funding Amount - the purpose for the inclusion of the business funding amount in the determination of the HBFCAR is to reflect the additional capital that will be required for any planned business growth or development over the next three years.
- Inadmissible Assets Amount - the inadmissible assets amount is referenced directly to Schedule 4 and includes:
  - holdings in associated and subsidiary entities including prudentially regulated entities, and
  - asset concentration amount.
- Resilience Amount - the resilience amount per Section 4 is referenced directly to Schedule 7.

The minimum Capital Adequacy Reserve is \$1,500,000. If the Capital Adequacy Reserve by the addition of the above components is less than \$1,500,000 then the amount is taken to be \$1,500,000.

### *Subordinated Debt*

PHIAC allows Insurers to fund the capital requirements of the Fund through the use of subordinated debt, subject to approval of PHIAC. For the purposes of the solvency and capital adequacy standards subordinated debt is deducted from the liabilities of the Fund.

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*Risk Equalisation Outstanding Claims Liability Component*

The risk equalisation outstanding claims liability component reflects the best estimate of the net amount payable or receivable in respect of recoveries from and payments to the RETF in respect of the outstanding claims liability. The net amount is determined as the difference between the relevant Calculated Deficit and the relevant Gross Deficit.

*Risk Equalisation Accrued Liability Component*

The risk equalisation accrued liability component reflects the best estimate of net amount payable to or receivable from the RETF in respect of the period ending at the balance sheet and not payable until after the balance date. The net amount is determined as the difference between the relevant Calculated Deficit and the relevant Gross Deficit.



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## Audit Procedures

### *Solvency Reserve*

1. Subordinated Debt
  - Review the level of subordinated debt used by management to fund its capital requirements and confirm that this is in line with the auditor's understanding of the business of the Insurer.
  - Where subordinated debt has been used, sight appropriate approval from PHIAC for the current year Returns and sight the subordinated debt contract focussing on (but not limiting procedures to) the amount per the contract, the parties involved in the contract and that the debt is subordinate in obligation to all other liabilities.
2. Risk Equalisation Outstanding Claims Liability Component
  - Where possible agree the risk equalisation outstanding claims liability component to the Corporations Act accounts, audited trial balance or the audited underlying accounting records.
  - Review the calculation of the Calculated and Gross Deficit and check for compliance with Clause 18 of both the solvency and capital adequacy standards. Where possible agree amount per Single Equivalent Unit (or member) to third party confirmation from the Health Benefits Risk Equalisation Trust Fund and recalculate totals based on membership.
  - Reconcile the total risk equalisation outstanding claims liability amount to the audited Schedule 4.
3. Risk Equalisation Accrued Liability Component
  - Where possible agree the risk equalisation accrued liability component to the signed Corporations Act accounts, audited trial balance or the audited underlying accounting records.
  - Review the calculation of the Calculated and Gross Deficit and check for compliance with Subclause 15(4) of both the Solvency and Capital Adequacy Standards. Where possible agree these amounts to third party confirmation from the Health Benefits Risk Equalisation Trust Fund.
  - Reconcile the total risk equalisation accrued liability component to audited Schedule 4.
4. Expense Amount
  - Check the calculation of the expense amount is in compliance with Clause 13 of the solvency standard and equals 40% of the "Total Non-Claims Expense."
  - Reconcile the Total Non-Claims Expense to the audited Schedules 1 & 2 and ensure the amount includes all non claim related income statement expenses for the 12 months ending on the balance sheet date.
  - Confirm, via reference to the Audit Procedures performed on Schedule 3 that the Total Non-Claims Expense figure agrees to the signed Corporations Act accounts and Schedules 1 & 2.
5. Solvency Insurance Liabilities Amount
  - For the solvency health insurance liabilities component
    - Agree the best estimate of the outstanding claims liability to the sum of the Benefit and Administration components of the unrepresented and outstanding claims within the Health Insurance Liabilities of the audited Schedule 4.

- Agree the best estimate of the risk equalisation outstanding claims liability to the RETF component of the unrepresented and outstanding claims within the Health Insurance Liabilities of the audited Schedule 4.
- Agree the outstanding claims margin for risk to the risk margin component of the unrepresented and outstanding claims within the Health Insurance Liabilities of the audited Schedule 4.
- Agree the value of the calculated deficit to the previously audited risk equalisation accrued liability component.
- Agree the CIA and unexpired risk liability components to the closed and unclosed business components of the health insurance unearned premium liability.
- Ensure the calculation of the solvency health insurance liability component is in accordance with Clause 15 of the solvency standard by checking the formulae in the cells arrive at the appropriate answer and that all cross references to Schedule 4 are correct.
- For the Solvency Health Related Insurance Liabilities Component
  - Agree the best estimates of the outstanding claims liability to the sum of the benefit and administration components of the relevant unrepresented and outstanding claims amounts within the Health-Related Insurance Liabilities of the audited Schedule 4.
  - Agree the outstanding claims margin for risk to the risk margin component of the relevant unrepresented and outstanding claims within the Health-Related Insurance Liabilities of the audited Schedule 4.
  - Agree the CIA and unexpired risk liability components to the relevant closed and unclosed business components of the health-related insurance unearned premium liability.
- Ensure the calculation of the solvency health-related insurance liability is in accordance with Clause 16 of the Solvency Standard by checking the formulae in the cells arrive at the appropriate answer and that all cross references to Schedule 4 are correct.

#### 6. Contributions In Advance & Unexpired Risk Liability

- Agree CIA liabilities to the audited Schedule 4.
- If the loss ratios are calculated by reference to Schedule 6, agree the cross references to the audited Schedule 6.
- If the default loss ratios per Schedule 6 is not considered as the best estimates, obtain managements explanation for the reasons why and assess for reasonableness.
- If the default loss ratio is not applied assess the appropriateness of the loss ratio consider (but not limited to) the following:
  - agree the amounts per claims and expense ratios to underlying source data and estimation models;
  - discuss the methodologies and assumptions applied by management and determine whether these are in line with the auditor's expectations given knowledge of the client and the industry;
  - where actuarial methods and assumptions have been employed, consider the use of actuarial audit support actuary to review the methods and assumptions for reasonableness;

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- confirm the mathematical accuracy of the underlying model and the correct application of stated assumptions; and
  - compare the estimate to historical performance and previous loss ratio estimates.
- Recalculate the unexpired risk amount as the loss ratio applied to CIA.
  - Consider the appropriateness of any tax credits by assessing (amongst other items) the ability of the Insurer to utilise such tax credits in the future.
7. Inadmissible Assets Amount
- Agree, both in total and by type, the inadmissible assets for the Solvency Reserve to the audited Schedule 4.
8. Resilience Amount
- Agree the resilience amount for the Solvency Reserve to the audited Schedule 7.
9. Recalculate the Total Solvency Reserve as follows:
- Solvency: \$1,000,000 + Expense Amount + Solvency Insurance Liabilities Amount + Inadmissible Assets Amount + Resilience Amount



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*Capital Adequacy Reserve*

10. Capital Adequacy Margin

- Ensure the calculation of the capital adequacy margin is in accordance with Clause 13 of the capital adequacy standard by checking the formulae in the cells arrive at the appropriate answer.
- Agree the “Funds Size” figure per cell D120 to audited underlying accounting records, where applicable. Where details cannot be agreed to audited sources, consider what other procedures will be required to achieve a sufficient level of audit assurance.
- Review reasonableness of management’s discretionary margin by considering, but not limiting consideration to, the following:
  - level of margin – minimum 0%, high 10%. No upper limit has been prescribed
  - authorisation of the margin by those charged with governance of the Insurer
  - membership numbers – stability supports a low margin, variable membership indicates high margin may be appropriate
  - utilisation rates and unit costs (allowing for expected seasonal fluctuations) - stability supports a low margin, variable membership indicates high margin may be appropriate
  - loss ratios – stable or falling loss ratios support a low margin, volatile or increasing loss ratios indicate a high margin may be appropriate, and
  - new products – the existence of those expected to have a material financial effect, that have limited or unreliable utilisation and unit cost experience data, and where there is a high degree of uncertainty, indicate the need for a high margin.

11. Subordinated Debt

- Review the level of subordinated debt used by management to fund its capital requirements and confirm that this is in line with the auditor’s understanding of the business of the Insurer.
- Where subordinated debt has been used, sight appropriate approval from PHIAC for the current year Returns and sight the subordinated debt contract focussing on (but not limiting procedures to) the amount per the contract, the parties involved in the contract and that the debt is subordinate in obligation to all other liabilities.

12. Capital Adequacy Insurance Liabilities Amount

- Agree the value of liability components to the audited values of the solvency insurance liabilities above.
- Ensure the calculation of the capital adequacy insurance liabilities amount is in accordance with Part 6 of the capital adequacy standard by checking the formulae in the cells arrive at the appropriate answer and that all cross references to Schedule 4 are correct.
- Consider the appropriateness of any tax credits by assessing (amongst other items) the ability of the Insurer to utilise such tax credits in the future.

13. Renewal Option Amount

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- Agree the renewal option amount to the audited Schedule 6.

14. Business Funding Amount

- Due to its subjective nature, the consideration of a business funding amount will be at the discretion of management. When assessing the appropriateness of the reserve booked by management, consider (but do not limit the procedures to) the following:
  - agree the amounts per Section E to underlying source data and estimation models e.g. forecasts, strategic plans and budgets for the next three years
  - discuss the methodologies and assumptions applied by management, including their anticipated growth in membership base. Determine whether this is in line with the auditor's expectations given knowledge of the client and the industry
  - review for consistency with figures reported in Schedule 6
  - where actuarial methods and assumptions have been employed, consider the use of actuarial audit support actuary to review the methods and assumptions for reasonableness
  - confirm the mathematical accuracy of the underlying model and the correct application of stated assumptions, and
  - ensure that the calculation has been approved by a senior member of management.

15. Inadmissible Assets Amount

- Agree, both in total and by type, the inadmissible assets for the Capital Adequacy Reserve to the audited Schedule 4.

16. Resilience Amount

- Agree both the solvency and capital adequacy amounts of the resilience amount to the audited Schedule 7.

17. Recalculate the Total Capital Adequacy Reserve as follows:

- Capital Adequacy Insurance Liabilities Amount + Renewal Option Amount + Business Funding Amount + Inadmissible Assets Amount + Resilience Amount.

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## Schedule 9 - Summary

### *Overview*

Schedule 9 presents the final solvency and capital adequacy calculations by bringing together the details prepared on the other Schedules. It is this Schedule that determines whether the Insurer is technically solvent and capially adequate.

### **Audit Procedures**

Agree the details from Schedule 9 to the preceding audited Schedules. Any discrepancies should be discussed with management and sufficient audit evidence obtained for material reconciling items.

Review the calculation of the solvency and capital adequacy position and check for compliance with the standards by ensuring all cell references and formulae arrive at the correct result.



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## Section 4 - Completion Program

- Pro forma audit opinion
- Management representation



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## Completion program

### Pro forma audit opinion

[TO BE PREPARED ON AUDIT FIRM LETTERHEAD]

## INDEPENDENT AUDITOR'S REPORT

### Insurer Name and Address

cc: Private Health Insurance Administration Council (PHIAC)

### Report pursuant to PHIAC Circular no 08/14

We have audited the schedules of the PHIAC 2 Annual Return ("the Return") of [enter name of Insurer], which is used by PHIAC for the purpose of providing an Annual Report to Parliament for the financial year ended 30 June 2008.

#### The Director's Responsibility

The directors of [enter name of Insurer] are responsible for the ensuring compliance with the accounting and financial reporting matters contained in the PHIAC Circular no 08/14. This responsibility includes the preparation of the Return and the information contained therein and ensuring that the report is prepared in accordance with the requirements of the requirements of the *Private Health Insurance Act 2007* and the *Solvency and Capital Adequacy Standards* contained within the *Private Health Insurance (Health Benefits Fund Administration) Rules 2007* ("the PHIAC Requirements").

#### Auditor's Responsibility

Our responsibility is to express an opinion to PHIAC on whether the report is prepared in accordance with the requirements of the *Private Health Insurance Act 2007* and the *Solvency and Capital Adequacy Standards* contained within the *Private Health Insurance (Health Benefits Fund Administration) Rules 2007* ("the PHIAC Requirements").

The Return has been prepared to fulfil the requirements of Circular No. 08/14. We disclaim any assumption of responsibility for any reliance on this report or on the Return to which our report relates, to any person other than PHIAC or for any purpose other than that for which it was prepared.

A. For Schedules 1, 2, 3, 4, 6, 7, 8 (excluding Capital Adequacy Reserve Section C), and 9, our audit has been conducted in accordance with Australian Auditing Standards. Our procedures included examination, on a test basis, of evidence supporting the amounts and other disclosures in the Return and the evaluation of significant accounting estimates. These procedures have been undertaken to form an opinion as to whether, in all material respects, the Return has been prepared in accordance with the PHIAC Requirements.

B. In relation to Schedule 6 and Section C of the Capital Adequacy Reserve of Schedule 8, we have performed procedures agreed with PHIAC and described below. These procedures were undertaken in accordance with Australian Auditing Standards applicable to agreed-upon procedures engagements. The responsibility for determining the adequacy or otherwise of the procedures agreed to be performed is that of PHIAC.

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The procedures were performed solely to assist PHIAC in determining the appropriateness of the information disclosed in Schedule 6 and Section C of the Capital Adequacy Reserve of Schedule 8 and are summarised as follows:

#### Schedule 6

- We obtained an understanding of the source of management's projected cash flows and ensured that sign-off from an appropriately senior body or individual was obtained
- We agreed all amounts to source documentation
- We agreed that the discount rate used is either the 1 year Commonwealth Treasury Rate less 1%; or a rate advised by PHIAC
- We recalculated the total cash outflows after inflation by the capital adequacy margin
- We recalculated the renewal option amount as the net cash inflows less outflows discounted to present value

#### Section C of Schedule 8

- We obtained an understanding of the processes undertaken by management to determine an appropriate business funding amount and ensured that sign-off from an appropriately senior body or individual was obtained

Because the above procedures do not constitute either an audit in accordance with Australian Auditing Standards or a review in accordance with Australian Auditing Standards applicable to review engagements, we do not express any assurance or opinion on the appropriateness of the information disclosed in Schedule 6 and Section C of the Capital Adequacy Reserve of Schedule 8.

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#### Auditor's Opinions

#### A. Audit Opinion on schedules 1 to 5, 7, 8 (excluding Section C of the Capital Adequacy Reserve), and 9

In our opinion, schedules 1 to 5, 7, 8 (excluding Section C of the Capital Adequacy Reserve), and 9 of the PHIAC 2 Annual Return of *[enter name of Insurer]* for the financial year ended 30 June 2008 have been prepared in accordance with the requirements of the *Private Health Insurance Act 2007* and the *Solvency and Capital Adequacy Standards* contained within the *Private Health Insurance (Health Benefits Fund Administration) Rules 2007*.

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B. Findings on schedules 6 and 8 (Section C of the Capital Adequacy Reserve)

For the procedures performed in relation to Schedule 6 and Section C of Schedule 8, we report as follows:

[provide a description of the findings, including sufficient details of errors and exceptions found]

[provide a description of the findings, including sufficient details of errors and exceptions found]

[provide a description of the findings, including sufficient details of errors and exceptions found]

[provide a description of the findings, including sufficient details of errors and exceptions found]

[provide a description of the findings, including sufficient details of errors and exceptions found]

[provide a description of the findings, including sufficient details of errors and exceptions found]



[Name of Audit Firm]

Chartered Accountants

by [Name of Partner]

Partner

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**Private Health Insurance Administration Council**

[Location]

[Date]

[Note - It is the responsibility of the auditor to ensure that their opinion is in compliance with any additional internal risk management policies and procedures.]

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## Letter of representation

Throughout the PHIAC 2 Annual Returns there are several areas where management have exercised their judgement. Consider items for which management representations may be obtained. Such items may include, but are not limited to:

- management's forecasts in the renewal option amount
- assumptions used in the calculation of the expected loss ratio
- assumptions used in the decision of the capital adequacy margin
- management's intentions and forecasts in light of the business funding amount, and
- completeness and accuracy of disclosure of all related-party loans.



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## Private Health Insurance Administration Council

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## Section 5 - Appendix A: Copies of Prudential Standards

Copy of the **solvency standard** (as an extract of the *Private Health Insurance (Health Benefits Fund Administration) Rules 2007*) is located on the PHIAC website under the reference:

<http://www.phiac.gov.au/standardsguides/scastandards/solvency.pdf>

Copy of the **capital adequacy standard** (as an extract of the *Private Health Insurance (Health Benefits Fund Administration) Rules 2007*) is located on the PHIAC website under the reference:

<http://www.phiac.gov.au/standardsguides/scastandards/capad.pdf>



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