

# NOTES TO THE FINANCIAL STATEMENTS

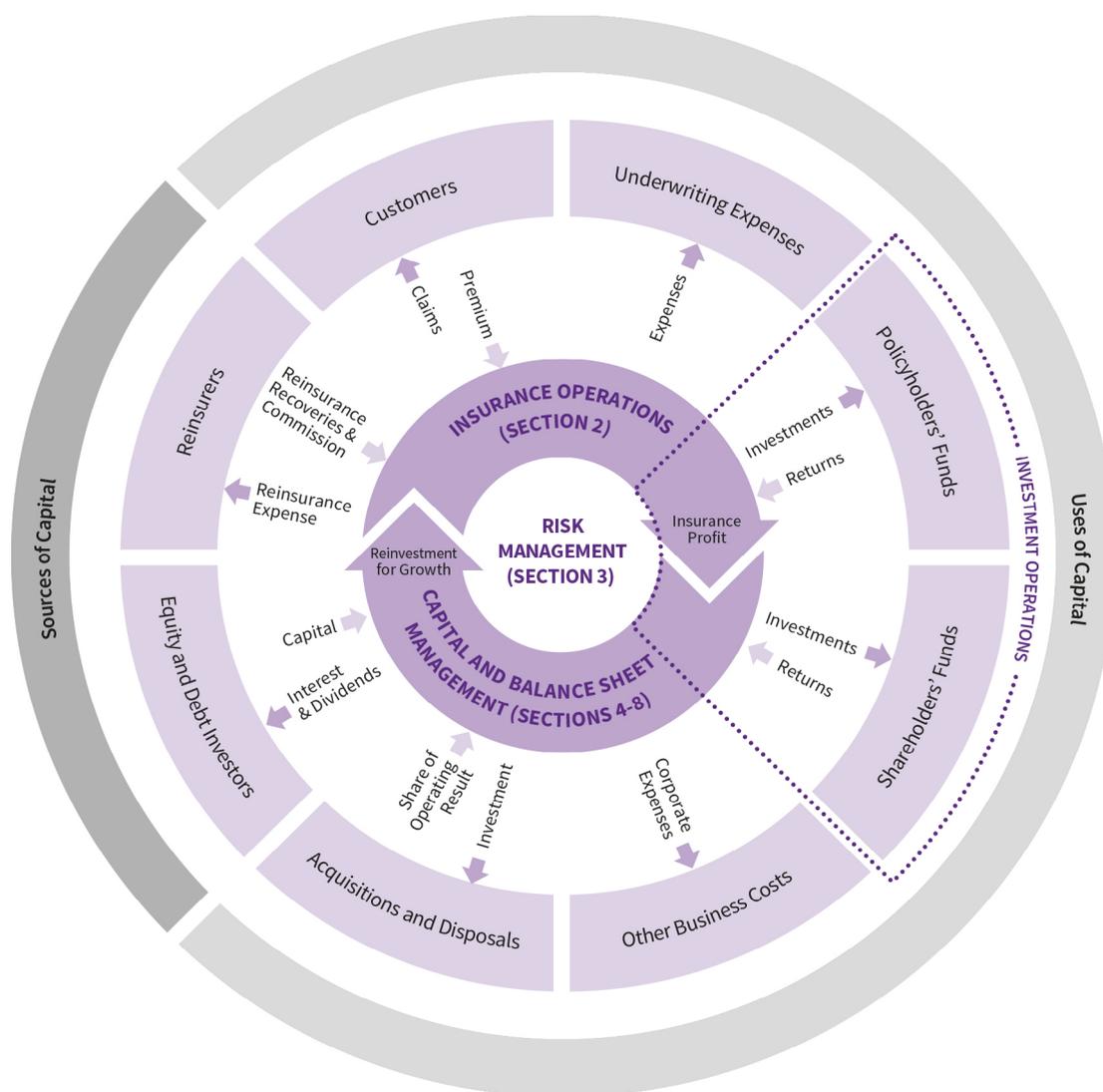
## 1. OVERVIEW

### NOTE 1.1 INTRODUCTION

The financial report is structured to provide prominence to the disclosures that are considered most relevant to the users' understanding of the operations, results and financial position of IAG.

The financial report has been organised into the following sections:

1. Overview – contains information that affects the financial report as a whole, as well as segment reporting disclosures.
2. Insurance disclosures – financial statement disclosures considered most relevant to the core insurance activities.
3. Risk – discusses IAG's exposure to various risks, explains how these affect IAG's financial position and performance and how IAG seeks to manage and mitigate these risks.
4. Capital structure – provides information about the capital management practices of IAG and related shareholder returns.
5. Other balance sheet disclosures – discusses other balance sheet items such as goodwill and intangible assets, as well as disclosures in relation to IAG's tax balances.
6. Group structure – provides a summary of IAG's controlled entities and includes acquisition and divestment disclosure.
7. Unrecognised items – disclosure of items not recognised in the financial statements at the balance date but which could potentially have a significant impact on IAG's financial position and performance going forward.
8. Additional disclosures – other disclosures required to comply with Australian Accounting Standards.



## **NOTE 1.2 ABOUT THIS REPORT**

### **A. CORPORATE INFORMATION**

Insurance Australia Group Limited (Company or Parent), the ultimate parent entity in the Group, is a for-profit company, incorporated and domiciled in Australia and limited by shares publicly traded on the Australian Securities Exchange (ASX). Its registered office and principal place of business is Level 13, Tower Two, Darling Park, 201 Sussex Street, Sydney, NSW 2000, Australia. This financial report covers the consolidated financial statements for the Company and its subsidiaries (IAG or Group) for the year ended 30 June 2018.

A description of the nature of IAG's operations and its principal activities is included in the Directors' Report.

### **B. STATEMENT OF COMPLIANCE**

This general purpose financial report was authorised by the Board of Directors for issue on 15 August 2018 and complies with International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB), the *Corporations Act 2001*, Australian Accounting Standards (AASBs) adopted by the Australian Accounting Standards Board (AASB), other authoritative pronouncements of the AASB and the ASX Listing Rules.

The current IFRS standard for insurance contracts does not include a comprehensive set of recognition and measurement criteria. The IASB has issued a new standard (*IFRS 17 Insurance Contracts* – adopted as *AASB 17 Insurance Contracts* in an Australian context) that does include such criteria, however this standard will not come into effect until 1 January 2021. Until this standard takes effect, the financial reports of insurers in different countries that comply with IFRS may not be comparable in terms of the recognition and measurement of insurance contracts.

### **C. BASIS OF PREPARATION**

The financial statements have been prepared on the basis of historical cost principles, as modified by certain exceptions noted in the financial report, with the principal exceptions being the measurement of all investments and derivatives at fair value and the measurement of the outstanding claims liability and related reinsurance and other recoveries at present value. All values are rounded to the nearest million dollars, unless otherwise stated, in accordance with ASIC Corporations Instrument 2016/191.

The balance sheet is prepared with the assets and liabilities presented broadly in order of liquidity. The assets and liabilities comprise both current amounts (expected to be recovered or settled within 12 months after the reporting date) and non-current amounts (expected to be recovered or settled more than 12 months after the reporting date).

#### **I. Basis of consolidation**

The consolidated financial statements incorporates the assets and liabilities of all entities controlled by the Company as at 30 June 2018. A list of significant controlled entities is set out in Note 6.1. IAG controls an investee if it has (i) power over the investee; (ii) exposure, or rights, to variable returns from its involvement with the investee; and (iii) the ability to use its power over the investee to affect the amount of those returns. Where an entity either began or ceased to be controlled during a financial year, the results are included from the date control commenced or up to the date control ceased. The financial information of all subsidiaries is prepared for consolidation for the same reporting year as the Parent. In preparing the consolidated financial statements, all inter-company balances and transactions, including income, expenses, and profits and losses resulting from intra-group transactions, have been eliminated.

Where a subsidiary is less than wholly owned, the equity interests held by external parties are presented separately as non-controlling interests on the consolidated balance sheet, except when presented as a liability where the subsidiary is a trust or similar entity. A change in ownership of a controlled entity that results in no gain or loss of control is accounted for as an equity transaction.

#### **II. Presentation and foreign currency**

The financial report is presented in Australian dollars, which is the functional currency of the Company. Foreign currency transactions are translated into Australian dollars using the exchange rates prevailing at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies at reporting date are translated to Australian dollars using reporting date exchange rates. Resulting exchange differences are recognised in profit or loss.

The assets and liabilities of foreign operations are translated to Australian dollars using reporting date exchange rates while equity items are translated using historical rates. The consolidated statement of comprehensive income and consolidated cash flow statement are translated using annual average rates for the reporting year. Exchange rate differences arising on translation are recorded directly in equity in the foreign currency translation reserve (FCTR). On the disposal of a foreign operation, the cumulative amount of exchange differences deferred in the FCTR relating to that foreign operation is recognised in profit or loss.

#### **III. Reclassification of comparatives**

Certain items have been reclassified from IAG's prior year financial report due to IAG'S consolidated Asian businesses now meeting the classification of discontinued operations. For further details, refer to Note 6.5.

## D. SIGNIFICANT ACCOUNTING POLICIES ADOPTED

The accounting policies adopted in the preparation of this financial report have been applied consistently by all entities in IAG and are the same as those applied for the previous reporting year, unless otherwise stated. The financial statements of entities operating outside Australia that maintain accounting records in accordance with overseas accounting principles are adjusted where necessary to comply with the significant accounting policies of IAG. The significant accounting policies adopted in the preparation of this financial report are set out within the relevant note.

### I. Changes in accounting policies

There were new Australian Accounting Standards and Interpretations applicable for the current reporting year, with no material financial impact to IAG on adoption. Refer to Note 8.5 for further details.

### II. Critical accounting estimates and judgements

In the process of applying the significant accounting policies, certain critical accounting estimates and assumptions are applied and judgements are made by management, the results of which affect the amounts recognised in the financial statements. The estimates and related assumptions are based on experience and other factors that are considered to be reasonable, and are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which they are revised, and future periods if relevant. Details of the material estimates and judgements are set out within the relevant note, as outlined below:

AREAS OF CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS	REFERENCE
Claims and reinsurance and other recoveries on outstanding claims	Note 2.2
Liability adequacy test	Note 2.4
Intangible assets and goodwill impairment testing, initial measurement and useful life	Note 5.1
Income tax and related assets and liabilities	Note 5.2
Investment in joint venture and associates impairment testing	Note 6.3

## NOTE 1.3 SEGMENT REPORTING

IAG has identified its operating segments based on the internal reports that are reviewed and used by the Chief Executive Officer (being the chief operating decision maker) in assessing performance and in determining the allocation of resources.

### A. REPORTABLE SEGMENTS

IAG has general insurance operations in Australia and New Zealand. Following the classification of IAG's consolidated businesses in Thailand, Vietnam and Indonesia as discontinued operations at 30 June 2018, Asia is no longer disclosed as a distinct operating segment. For further details refer to Note 6.5. IAG's ongoing interests in Malaysia and India continue to be treated as associates, but have been reclassified to Corporate and other within IAG's segment reporting.

The reportable segments for the period ended 30 June 2018 comprise the following business divisions:

#### I. Australia

The Australian division comprises two segments:

##### Consumer

This segment provides general insurance products to individuals and families throughout Australia, primarily under the NRMA Insurance, SGIO, SGIC and CGU brands, under the RACV brand in Victoria (via a distribution and underwriting relationship with RACV) and the Coles Insurance brand nationally (via a distribution agreement with Coles).

##### Business

This segment provides commercial insurance to businesses throughout Australia, predominantly under the CGU and WFI brands through intermediaries including brokers, authorised representatives and distribution partners

#### II. New Zealand

This segment provides general insurance products underwritten in New Zealand. Insurance products are sold directly to customers predominantly under the State and AMI brands, and through intermediaries (insurance brokers and authorised representatives) primarily using the NZI and Lumley Insurance brands. Personal and commercial products are also distributed by corporate partners, such as large financial institutions, using third party brands.

#### III. Corporate and other

This segment comprises other activities, including corporate services, capital management activity, shareholders' funds investment activities, inward reinsurance from associates, and investment in associates in Malaysia and India. IAG's captive reinsurance operation (captive) is a corporate function that acts as the interface between the external providers of reinsurance capital and the operating business divisions. IAG does not manage or view the captive as a separate business. Consequently, the operating results of the captive are systematically allocated to the operating business segments.

## B. FINANCIAL INFORMATION

	AUSTRALIA			NEW ZEALAND	CORPORATE AND OTHER	TOTAL
	CONSUMER	BUSINESS	TOTAL			
	\$m	\$m	\$m	\$m	\$m	\$m
<b>2018</b>						
<b>I. Financial performance</b>						
Total external revenue <sup>(1)</sup>	<u>8,434</u>	<u>4,473</u>	<u>12,907</u>	<u>3,267</u>	<u>237</u>	<u>16,411</u>
Underwriting profit/(loss)	<u>833</u>	<u>142</u>	<u>975</u>	<u>209</u>	<u>(7)</u>	<u>1,177</u>
Net investment income on assets backing insurance liabilities	<u>138</u>	<u>77</u>	<u>215</u>	<u>9</u>	<u>6</u>	<u>230</u>
Insurance profit/(loss)	<u>971</u>	<u>219</u>	<u>1,190</u>	<u>218</u>	<u>(1)</u>	<u>1,407</u>
Net investment income on shareholders' funds	-	-	-	-	<u>165</u>	<u>165</u>
Share of net profit of associates	-	<u>2</u>	<u>2</u>	-	<u>29</u>	<u>31</u>
Finance costs	-	-	-	-	<u>(82)</u>	<u>(82)</u>
Other net operating result	-	<u>(5)</u>	<u>(5)</u>	-	<u>(106)</u>	<u>(111)</u>
Total segment result from continuing operations	<u>971</u>	<u>216</u>	<u>1,187</u>	<u>218</u>	<u>5</u>	<u>1,410</u>
Income tax expense						<u>(384)</u>
Profit for the year from continuing operations						<u>1,026</u>
<b>II. Other segment information</b>						
Capital expenditure <sup>(2)</sup>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>155</u>	<u>155</u>
Depreciation and amortisation expense	<u>50</u>	<u>64</u>	<u>114</u>	<u>51</u>	<u>-</u>	<u>165</u>
<b>2017<sup>(3)</sup></b>						
<b>I. Financial performance</b>						
Total external revenue <sup>(1)</sup>	<u>8,162</u>	<u>4,241</u>	<u>12,403</u>	<u>3,276</u>	<u>313</u>	<u>15,992</u>
Underwriting profit	<u>816</u>	<u>141</u>	<u>957</u>	<u>80</u>	<u>1</u>	<u>1,038</u>
Net investment income/(expense) on assets backing insurance liabilities	<u>125</u>	<u>63</u>	<u>188</u>	<u>45</u>	<u>(1)</u>	<u>232</u>
Insurance profit	<u>941</u>	<u>204</u>	<u>1,145</u>	<u>125</u>	<u>-</u>	<u>1,270</u>
Net investment income on shareholders' funds	-	-	-	-	<u>246</u>	<u>246</u>
Share of net profit/(loss) of associates	-	<u>(1)</u>	<u>(1)</u>	-	<u>20</u>	<u>19</u>
Finance costs	-	-	-	-	<u>(93)</u>	<u>(93)</u>
Other net operating result	-	<u>(28)</u>	<u>(28)</u>	-	<u>(71)</u>	<u>(99)</u>
Total segment result from continuing operations	<u>941</u>	<u>175</u>	<u>1,116</u>	<u>125</u>	<u>102</u>	<u>1,343</u>
Income tax expense						<u>(328)</u>
Profit for the year from continuing operations						<u>1,015</u>
<b>II. Other segment information</b>						
Capital expenditure <sup>(2)</sup>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>109</u>	<u>109</u>
Depreciation and amortisation expense	<u>53</u>	<u>54</u>	<u>107</u>	<u>52</u>	<u>1</u>	<u>160</u>

(1) Total external revenue comprises gross earned premium, reinsurance and other recoveries, reinsurance commission revenue, investment income on assets backing insurance liabilities, investment income on shareholders' funds, fee and other income and share of net profit/(loss) of associates.

(2) Capital expenditure includes acquisitions of property and equipment, intangibles and other non-current segment assets.

(3) Prior year comparatives have been re-presented due to the discontinued operations. Refer to Note 6.5.

## 2. INSURANCE DISCLOSURES

### SECTION INTRODUCTION

This section provides an overview of IAG's general insurance operations, which are the main driver of IAG's overall performance and financial position.

IAG collects premium and recognises revenue for the insurance policies it underwrites. From this, IAG pays amounts to customers on settlement of insurance claims, with the claims expense representing the largest cost to IAG, as well as operating costs, which include the costs associated with obtaining and recording insurance contracts.

To mitigate IAG's overall risk and optimise its return profile, IAG passes some of its underwriting exposure to third parties (primarily reinsurance companies). The premiums paid to reinsurers are an expense to IAG, whereas recoveries under the reinsurance contracts are recognised as revenue. These recoveries can either be in relation to operating costs (reinsurance commission) or underwriting risk (reinsurance recoveries).

Investment activities are an integral part of the insurance business. The funds received from the collection of premium are invested as a key source of return for IAG under a sound investment philosophy. IAG starts investing insurance premiums as soon as they are collected and continues to generate returns until claims or other expenses are paid out.

The underwriting result measures the profit (or loss) generated from underwriting activities in a given period. The insurance result, which is a key performance metric, adds the net investment return to the underwriting result to derive the overall pre-tax profit (or loss) from insurance operations.

### NOTE 2.1 GENERAL INSURANCE REVENUE

	2018 \$m	2017* \$m
<b>A. COMPOSITION</b>		
Gross written premium	<b>11,647</b>	11,439
Movement in unearned premium liability	<b>(125)</b>	(118)
Gross earned premium	<b>11,522</b>	11,321
Reinsurance and other recoveries revenue	<b>3,388</b>	3,276
Reinsurance commission revenue	<b>880</b>	687
Total general insurance revenue	<b>15,790</b>	15,284

\* Prior year comparatives have been re-presented due to the discontinued operations. Refer to Note 6.5.

### B. RECOGNITION AND MEASUREMENT

#### I. Premium revenue

Premiums written are earned through the profit or loss in line with the incidence of the pattern of risk. The majority of premium is earned according to the passage of time (e.g. for a one-year policy, 1/365th of premium written will be earned each day).

#### II. Reinsurance and other recoveries

The recognition and measurement criteria for reinsurance and other recoveries revenue is referred to in Note 2.2.

#### III. Reinsurance commission revenue

Reinsurance commission revenue includes reimbursements by reinsurers to cover a share of IAG's operating costs and, where applicable, fee income which reinsurers pay for accessing IAG's franchise. These income items are recognised broadly in line with the reference premium over the term of the reinsurance agreements. Where applicable, the reinsurance commission revenue also includes income which is based on the expected profitability of the covered business ceded to the reinsurer. The final value of the variable commission revenue recognised is subject to the achievement of a specified underlying profitability hurdle rate over time. This variable revenue is recognised over the term of the reinsurance contract on a straight-line, or other systematic basis, in accordance with the terms of the contract, and is reassessed at each reporting date.

## NOTE 2.2 CLAIMS AND REINSURANCE AND OTHER RECOVERIES ON OUTSTANDING CLAIMS

### A. NET CLAIMS EXPENSE

	Current year \$m	Prior years \$m	2018	Current year \$m	Prior years \$m	2017*
			Total \$m			Total \$m
Gross claims – undiscounted	8,585	(675)	7,910	9,364	(1,019)	8,345
Discount	(114)	209	95	(135)	148	13
Gross claims – discounted	8,471	(466)	8,005	9,229	(871)	8,358
Reinsurance and other recoveries – undiscounted	(3,304)	(18)	(3,322)	(3,355)	30	(3,325)
Discount	57	(123)	(66)	66	(17)	49
Reinsurance and other recoveries – discounted	(3,247)	(141)	(3,388)	(3,289)	13	(3,276)
Net claims expense	5,224	(607)	4,617	5,940	(858)	5,082

\* Prior year comparatives have been re-presented due to the discontinued operations. Refer to Note 6.5

### B. NET OUTSTANDING CLAIMS LIABILITY

#### I. Composition of net outstanding claims liability

	2018 \$m	2017 \$m
Gross central estimate – discounted	8,267	9,224
Reinsurance and other recoveries – discounted	(4,377)	(4,358)
Net central estimate – discounted	3,890	4,866
Claims handling costs – discounted	364	362
Risk margin	734	885
Net outstanding claims liability – discounted	4,988	6,113

The gross outstanding claims liability includes \$5,756 million (2017: \$6,488 million) which is expected to be settled more than 12 months from the reporting date.

The carrying value of reinsurance and other recoveries includes \$3,214 million (2017: \$3,151 million) which is expected to be settled more than 12 months from the reporting date.

#### II. Reconciliation of movements in net discounted outstanding claims liability

	2018 \$m	2017* \$m
Net outstanding claims liability at the beginning of the financial year	6,113	7,052
Movement in the prior year central estimate	(244)	(391)
Current year claims incurred, net of reinsurance and other recoveries	4,979	5,689
Claims paid, net of reinsurance and other recoveries received	(5,644)	(6,033)
Movement in discounting	67	40
Movement in risk margin	(143)	(247)
Transfers to liabilities held for sale	(105)	-
Net movement of discontinued operations	(8)	12
Net foreign currency movements	(27)	(9)
Net outstanding claims liability at the end of the financial year	4,988	6,113
Reinsurance and other recoveries on outstanding claims liability	5,422	5,258
Gross outstanding claims liability at the end of the financial year	10,410	11,371

\* Prior year comparatives have been re-presented due to the discontinued operations. Refer to Note 6.5.

#### III. Maturity analysis

Refer to Note 3.1 for details of the maturity profile of the estimated net discounted outstanding claims liability based on the remaining term to payment at the reporting date.

#### IV. Development table

Claims will often take a number of years to be settled from the date the original loss occurred. The following table shows the development of the net undiscounted ultimate claims estimate for the ten most recent accident years and a reconciliation to the net discounted outstanding claims liability. This table provides the user with an overview of how IAG's estimates of total claim amounts payable in relation to a given year have evolved over time. If the estimate of ultimate claims in relation to a given accident year declines over time, this suggests claims have developed more favourably than was anticipated at the time the original reserving assumptions were set.

Where an entity or business that includes an outstanding claims liability has been acquired, the claims for the acquired businesses are included in the claims development table from and including the year of acquisition. The outstanding claims liability includes international operations. For ease of comparison within the claims development table, all payments not denominated in Australian dollars have been converted to Australian dollars using the applicable exchange rates at the reporting dates. Therefore, the claims development table disclosed each reporting year cannot be reconciled directly to the equivalent tables presented in previous years' financial statements.

During the financial year, IAG announced the sale of its consolidated businesses in Thailand, Vietnam and Indonesia. The development table below includes claims related to these operations up to the 2018 accident year. Any outstanding claims relating to these businesses have been treated as paid in the table below within item (1).

	ACCIDENT YEAR											
	2008 and prior \$m	2009 \$m	2010 \$m	2011 \$m	2012 \$m	2013 \$m	2014 \$m	2015 \$m	2016 \$m	2017 \$m	2018 \$m	Total \$m
<b>NET ULTIMATE CLAIM PAYMENTS</b>												
Development												
At end of accident year		4,708	4,663	5,010	5,216	5,167	5,602	6,293	4,965	5,267	4,495	
One year later		4,746	4,637	5,123	5,290	5,090	5,606	6,219	4,917	5,211		
Two years later		4,680	4,535	5,162	5,231	5,010	5,519	6,156	4,858			
Three years later		4,673	4,485	5,193	5,142	4,930	5,378	6,040				
Four years later		4,587	4,432	5,390	5,090	4,850	5,309					
Five years later		4,534	4,379	5,457	5,027	4,831						
Six years later		4,489	4,344	5,475	5,020							
Seven years later		4,451	4,315	5,562								
Eight years later		4,447	4,306									
Nine years later		4,441										
Current estimate of net ultimate claim payments		4,441	4,306	5,562	5,020	4,831	5,309	6,040	4,858	5,211	4,495	
Cumulative payments made to date <sup>(1)</sup>		<u>4,400</u>	<u>4,260</u>	<u>5,357</u>	<u>4,911</u>	<u>4,653</u>	<u>5,036</u>	<u>5,632</u>	<u>4,375</u>	<u>4,604</u>	<u>2,896</u>	
Net undiscounted outstanding claims liability	104	41	46	205	109	178	273	408	483	607	1,599	4,053
Discount to present value	<u>(6)</u>	<u>(2)</u>	<u>(3)</u>	<u>(7)</u>	<u>(6)</u>	<u>(9)</u>	<u>(13)</u>	<u>(19)</u>	<u>(21)</u>	<u>(34)</u>	<u>(43)</u>	<u>(163)</u>
Net discounted outstanding claims liability	<u>98</u>	<u>39</u>	<u>43</u>	<u>198</u>	<u>103</u>	<u>169</u>	<u>260</u>	<u>389</u>	<u>462</u>	<u>573</u>	<u>1,556</u>	<u>3,890</u>
Reconciliation												
Claims handling costs												364
Risk margin												<u>734</u>
Net outstanding claims liability												<u><u>4,988</u></u>

#### C. RECOGNITION AND MEASUREMENT

##### I. Outstanding claims liability and claims expense

Claims expense represents claim payments and the movement in the closing outstanding claims liability from one financial period to the next. Current year claims relate to loss events that occurred during the current financial year. Prior year claims represent the movement on the estimates held for claims that occurred in all previous financial periods.

The outstanding claims liability is determined based on three building blocks:

- a central estimate of the future cash flows;
- discounting for the effect of the time value of money; and
- a risk margin for uncertainty.

#### a. CENTRAL ESTIMATE OF THE FUTURE CASH FLOWS

The outstanding claims liability is measured as the central estimate of the expected future payments relating to claims incurred prior to the reporting date including direct and indirect claims handling costs. The liability is measured based on the advice and/or valuations performed by, or under the direction of, the Appointed Actuary, and is intended to contain no deliberate or conscious bias toward over or under-estimation. Given the uncertainty in establishing the liability, it is likely that the final outcome will differ from the original liability established. Changes in claim estimates are recognised in profit or loss in the reporting year in which the estimates are changed.

#### b. DISCOUNTING

Projected future claim payments, both gross and net of reinsurance and other recoveries and associated claims handling costs, are discounted to a present value using risk free discount rates (derived from market yields on government securities) to reflect the time value of money.

#### c. RISK MARGIN

Given the uncertainty inherent in estimating future claim payments, it is considered appropriate to add a risk margin to the central estimate of expected future claim payments. The risk margin represents the amount by which the liability recognised in the financial statements is greater than the actuarial central estimate. IAG currently applies a 90% probability of adequacy to the outstanding claims liability. In effect this means there is approximately a 1-in-10 chance all future claim payments will exceed the overall reserve held.

Uncertainties surrounding the liability estimation process include those relating to the available data, actuarial models and assumptions, the statistical uncertainty associated with a general insurance claims run-off process, and risks external to IAG, for example the impact of future legislative reform. Uncertainty from these sources is examined for each class of business and expressed as a volatility measure relative to the net central estimate. The volatility measure for each class is derived after consideration of statistical modelling and benchmarking to industry analyses. Certain product classes may be subject to the emergence of new types of latent claims, and such uncertainties are considered when setting the volatility and hence the risk margin appropriate for those classes.

Long-tail classes of business generally have the highest volatilities for outstanding claims as the longer average time for claims to be reported and settled allows more time for sources of uncertainty to emerge. Short-tail classes generally have lower levels of volatility for outstanding claims.

IAG benefits from holding a portfolio diversified into many classes of business across different regions. The risk margin required to provide a given probability of adequacy for two or more classes of business or for two or more geographic locations combined is likely to be less than the sum of risk margins for the individual classes. This reflects the benefit of diversification. The level of diversification assumed between classes takes into account industry analysis, historical experience and the judgement of experienced and qualified actuaries.

The current risk margin and resultant overall probability of adequacy for the outstanding claims, which has been determined after assessing the inherent uncertainty in the central estimate, diversification and risks in the prevailing environment, is set out below:

	<b>2018</b>	2017
	%	%
The percentage risk margin applied to the net outstanding claims liability	<u><b>17</b></u>	<u>17</u>
The probability of adequacy of the risk margin	<u><b>90</b></u>	<u>90</u>

## II. Reinsurance and other recoveries on outstanding claims

Reinsurance and other recoveries on outstanding claims are recognised as income with the corresponding asset being recognised on the balance sheet. Reinsurance and other recoveries on outstanding claims are measured at the present value (discounted using appropriate risk free discount rates) of the expected future receipts due as a result of the reinsurance protection that IAG has in place. The reporting date balance also includes the net goods and services tax (GST) receivable on outstanding claims.

## D. SIGNIFICANT ACCOUNTING ESTIMATES AND JUDGEMENTS

### I. Outstanding claims liability

The estimation of the outstanding claims liability involves a number of key assumptions and is the most critical accounting estimate. The process involves using IAG's specific data, relevant industry data and more general economic data. Each class of business is usually examined separately, and the process involves consideration of a large number of factors, including the risks to which the business is exposed at a point in time, claim frequencies and average claim sizes, historical trends in the incidence and development of claims reported and finalised, as well as legal, social and economic factors that may affect each class of business.

The following ranges of key actuarial assumptions were used in the measurement of outstanding claims and recoveries, where appropriate, within the operating segments at the reporting date.

ASSUMPTION	AUSTRALIA		NEW ZEALAND	ASIA
	CONSUMER	BUSINESS		
<b>2018</b>				
Discounted average term to settlement	<b>1.9 years</b>	<b>2.0 years</b>	<b>1.0 year</b>	<b>n/a</b>
Inflation rate	<b>2.2%-3.9%</b>	<b>0.0%-4.3%</b>	<b>1.9%</b>	<b>n/a</b>
Superimposed inflation rate	<b>0.0%-5.0%</b>	<b>0.0%-5.0%</b>	<b>0.0%</b>	<b>n/a</b>
Discount rate	<b>1.5%-4.2%</b>	<b>1.5%-4.1%</b>	<b>1.8%-3.6%</b>	<b>n/a</b>
Claims handling costs ratio	<b>4.6%</b>	<b>4.3%</b>	<b>3.9%</b>	<b>n/a</b>
<b>2017</b>				
Discounted average term to settlement	2.1 years	2.0 years	1.0 year	0.4 year
Inflation rate	2.4%-4.1%	0.0%-4.3%	2.0%	0.0%-4.0%
Superimposed inflation rate	0.0%-5.0%	0.0%-5.0%	0.0%	0.0%
Discount rate	1.5%-4.5%	1.5%-4.4%	1.8%-3.5%	0.0%
Claims handling costs ratio	4.1%	4.4%	4.1%	1.6%

#### a. DISCOUNTED AVERAGE TERM TO SETTLEMENT

The discounted average term to settlement provides a summary indication of the expected future cash flow pattern for claims (inflated and discounted). It is calculated by class of business and is generally based on historic settlement patterns. A decrease in the discounted average term to settlement would reflect claims being paid sooner than anticipated and so would increase the claims expense. Note that this sensitivity test only extends or shortens the term of the payments assumed in the valuation, without changing the total nominal amount of the payments.

#### b. INFLATION RATE AND SUPERIMPOSED INFLATION

Payments of claims outstanding at the reporting date are to be made in the future and so need to take account of expected increases in the underlying cost of final claims settlements due to inflationary pressures. Economic inflation assumptions are set by reference to current economic indicators. Superimposed inflation tends to occur due to wider societal trends such as the cost of court settlements increasing at a faster rate than the economic inflation rate.

#### c. DISCOUNT RATE

An increase or decrease in the assumed discount rate will have a corresponding decrease or increase (respectively) on the claims expense recognised in the profit or loss.

#### d. CLAIMS HANDLING COSTS RATIO

This reflects the cost to administer future claims. The ratio is generally calculated with reference to the historical experience of claims handling costs as a percentage of past payments, together with budgeted future costs.

## II. Reinsurance and other recoveries on outstanding claims

The measurement of reinsurance and other recoveries on outstanding claims is an inherently uncertain process involving estimates. The amounts are generally calculated using actuarial assumptions and methods similar to those used for the outstanding claims liability, with appropriate consideration of the credit risk of the counterparty. Accordingly, the valuation of outstanding reinsurance recoveries is subject to largely similar risks and uncertainties as the valuation of the outstanding claims liability. Significant individual losses, for example those relating to catastrophe events, are analysed on a case-by-case basis.

## E. SENSITIVITY ANALYSIS

The impact on the divisional net outstanding claims liabilities (net of reinsurance recoveries) before income tax to changes in key actuarial assumptions is summarised below. Each change has been calculated in isolation of the other changes, and without regard to other balance sheet changes that may occur simultaneously. The movements are stated in absolute terms where the base assumption is a percentage or average term.

ASSUMPTION	MOVEMENT IN ASSUMPTION	AUSTRALIA		NEW ZEALAND	ASIA
		CONSUMER	BUSINESS		
		\$m	\$m	\$m	\$m
<b>2018</b>					
Discounted average term to settlement	<b>+10%</b>	<b>(11)</b>	<b>(9)</b>	<b>(1)</b>	<b>n/a</b>
	<b>-10%</b>	<b>11</b>	<b>9</b>	<b>1</b>	<b>n/a</b>
Inflation rate	<b>+1%</b>	<b>46</b>	<b>35</b>	<b>5</b>	<b>n/a</b>
	<b>-1%</b>	<b>(45)</b>	<b>(34)</b>	<b>(4)</b>	<b>n/a</b>
Discount rate	<b>+1%</b>	<b>(46)</b>	<b>(35)</b>	<b>(4)</b>	<b>n/a</b>
	<b>-1%</b>	<b>48</b>	<b>37</b>	<b>4</b>	<b>n/a</b>
Claims handling costs ratio	<b>+1%</b>	<b>48</b>	<b>41</b>	<b>9</b>	<b>n/a</b>
	<b>-1%</b>	<b>(48)</b>	<b>(41)</b>	<b>(9)</b>	<b>n/a</b>
<b>2017</b>					
Discounted average term to settlement	+10%	(14)	(9)	(1)	-
	-10%	14	9	1	-
Inflation rate	+1%	61	40	5	-
	-1%	(59)	(39)	(5)	-
Discount rate	+1%	(61)	(39)	(5)	-
	-1%	65	42	5	-
Claims handling costs ratio	+1%	53	41	7	2
	-1%	(53)	(41)	(7)	(2)

## NOTE 2.3 INVESTMENTS

	2018	2017*
	\$m	\$m
<b>A. INVESTMENT INCOME</b>		
Dividend revenue	42	45
Interest revenue	320	373
Trust revenue	37	18
Realised net (losses)/gains	(33)	74
Unrealised net gains/(losses)	60	(1)
Total investment income	<u>426</u>	<u>509</u>
<b>Represented by</b>		
Investment income on assets backing insurance liabilities	249	248
Investment income on shareholders' funds	177	261
	<u>426</u>	<u>509</u>

\* Prior year comparatives have been re-presented due to the discontinued operations. Refer to Note 6.5.

	2018	2017
	\$m	\$m
<b>B. INVESTMENT COMPOSITION</b>		
<b>I. Interest-bearing investments</b>		
Cash and short-term money	753	1,056
Government and semi-government bonds	933	1,034
Corporate bonds and notes	5,896	6,311
Subordinated securities	1,333	1,768
Other	253	199
	<u>9,168</u>	<u>10,368</u>
<b>II. Equity investments (includes exposure to convertible securities)</b>		
Listed	1,049	1,099
Unlisted	683	479
	<u>1,732</u>	<u>1,578</u>
<b>III. Other investments</b>		
Other trusts	107	158
Derivatives	-	32
	<u>107</u>	<u>190</u>
Total investments	<u>11,007</u>	<u>12,136</u>

### C. RECOGNITION AND MEASUREMENT

Investment revenue is brought to account on an accruals basis. Revenue on investments in equity securities and property trusts is deemed to accrue on the date the dividends/distributions are declared, which for listed equity securities is deemed to be the ex-dividend date.

Investments comprise assets held to back insurance liabilities (policyholder funds that represent assets available for future settlement of outstanding claims) and assets that represent shareholders' funds. The investment funds themselves are predominantly generated from the collection of insurance premiums. The allocation of investments between policyholder funds and shareholders' funds is regularly monitored and the portfolio rebalanced accordingly. To determine the allocation, IAG's investment funds under management are compared to the technical provisions of IAG, which includes insurance liabilities. The policyholder funds are allocated to back the technical provisions, with the excess representing shareholders' funds.

All investments are designated at fair value through profit or loss. Investments are recorded and subsequently remeasured to fair value at each reporting date. Changes in the fair value are recognised as realised or unrealised investment gains or losses in profit or loss. IAG recognises transfers into and transfers out of fair value hierarchy levels (described below) as at the end of the reporting year. Purchases and sales of investments are recognised on a trade date basis, being the date on which a commitment is made to purchase or sell the asset. Transaction costs for purchases of investments are expensed as incurred. Investments are derecognised when the rights to receive future cash flows from the assets have expired, or have been transferred, and substantially all the risks and rewards of ownership have transferred.

The inputs used to determine the fair value for securities recognised under each level of the fair value hierarchy is set out below.

#### I. Level 1 quoted prices

The fair value is determined by reference to quoted prices (mid-market) in active markets for identical assets and liabilities. For IAG, this category includes government securities and listed equities.

#### II. Level 2 other observable inputs

The fair value is determined by reference to quoted prices in active markets for similar assets or liabilities or by reference to other significant inputs that are not quoted prices but are based on observable market data, for example interest rate yield curves observable at commonly quoted intervals. For IAG, this category primarily includes corporate and other fixed interest securities where the market is considered to be lacking sufficient depth to be considered active.

#### III. Level 3 unobservable inputs

The fair value is determined using valuation techniques in which a number of the significant inputs are not based on observable market data. Level 3 investments are primarily unlisted private equity funds where the fair value of investments is determined on the basis of published redemption values of those funds. This category also includes IAG's unlisted equity interest in Bohai Property Insurance Company Limited (Bohai). The fair value of Bohai is supported by comparable transaction multiples observed in the local market.

The table below separates the total investment balance by hierarchy category:

	LEVEL 1 \$m	LEVEL 2 \$m	LEVEL 3 \$m	TOTAL \$m
<b>2018</b>				
Interest-bearing investments	<b>2,169</b>	<b>6,998</b>	<b>1</b>	<b>9,168</b>
Equity investments	<b>1,049</b>	<b>341</b>	<b>342</b>	<b>1,732</b>
Other investments	-	<b>107</b>	-	<b>107</b>
	<b>3,218</b>	<b>7,446</b>	<b>343</b>	<b>11,007</b>
<b>2017</b>				
Interest-bearing investments	2,085	8,282	1	10,368
Equity investments	1,076	340	162	1,578
Other investments	4	185	1	190
	<b>3,165</b>	<b>8,807</b>	<b>164</b>	<b>12,136</b>

## NOTE 2.4 UNEARNED PREMIUM LIABILITY

	2018 \$m	2017* \$m
<b>A. RECONCILIATION OF MOVEMENTS</b>		
Unearned premium liability at the beginning of the financial year	<b>6,331</b>	6,220
Deferral of premiums written during the financial year	<b>5,915</b>	5,748
Earning of premiums written in previous financial years	<b>(5,790)</b>	(5,630)
Net premiums earned and written on discontinued operations	<b>(3)</b>	(4)
Transfers to liabilities held for sale	<b>(206)</b>	-
Net foreign exchange movements	<b>(30)</b>	(3)
Unearned premium liability at the end of the financial year	<b>6,217</b>	<b>6,331</b>

\* Prior year comparatives have been re-presented due to the discontinued operations. Refer to Note 6.5.

The carrying value of unearned premium liability includes \$133 million (2017: \$172 million) which is expected to be earned more than 12 months from reporting date.

### B. RECOGNITION AND MEASUREMENT

Unearned premium is the portion of premium income that has yet to be recognised in the profit or loss (i.e. unexpired portion for risks underwritten) and is calculated based on the term of the risk and in accordance with the expected pattern of the incidence of risk underwritten, using an appropriate pro-rata method.

### C. ADEQUACY OF UNEARNED PREMIUM LIABILITY

#### I. Liability adequacy test (LAT)

The LAT assesses the adequacy of the carrying amount of the net unearned premium liability to settle future claims. To determine if any deficiency exists, estimates of future claim costs (premium liabilities net of reinsurance) are compared to the unearned premium liability (net of reinsurance and related deferred acquisition costs). If the future claim costs exceed the net premium liabilities, then a deficiency exists. Any deficiency is recognised immediately in profit or loss, with the corresponding impact on the balance sheet recognised first through the write-down of deferred acquisition costs for the relevant portfolio of contracts and then through the establishment of a provision (unexpired risk liability).

The LAT is required to be conducted at the level of a portfolio of contracts that are subject to broadly similar risks and that are managed together as a single portfolio. IAG defines 'broadly similar risks' at a level where policies are affected by one or more common risk factors, including natural peril events, general weather conditions, economic conditions, inflationary movements, legal and regulatory changes as well as legislative reforms, reinsurance cost changes and variation in other input costs. IAG defines 'managed together' at a segment level as the respective divisional CEOs collectively manage the entire portfolio within their control. The LAT is currently performed at the segment level for Australia (Australian Consumer division and Australian Business division) and New Zealand.

The LAT at reporting date resulted in a surplus for IAG (2017: surplus for IAG), with the table below providing details of the net premium liabilities (net of reinsurance and adjusted for appropriate risk margin) used in the LAT:

	2018 \$m	2017 \$m
Net central estimate of present value of expected cash flows on future claims	<b>2,718</b>	3,416
Risk margin of the present value of expected future cash flows	<b>66</b>	77
	<b>2,784</b>	<b>3,493</b>
Risk margin percentage	<b>2.4%</b>	2.3%
Probability of adequacy	<b>60.0%</b>	60.0%

## II. Significant accounting estimates and judgements

The LAT is conducted using the central estimate of the premium liabilities, applying a methodology consistent for reporting to APRA, which requires an estimation of the present value of future net cash flows (relating to future claims arising from the rights and obligations under current general insurance contracts) and adjusted for an appropriate risk margin for uncertainty in the central estimate for each portfolio of contracts. The test is based on prospective information and so is heavily dependent on assumptions and judgements.

The risk margin used in the LAT for individual portfolios is calculated by using a probability of adequacy (POA) methodology including diversification benefit, which is consistent with that used for the determination of the risk margin for the outstanding claims liability, based on assessments of the levels of risk in each portfolio. The 60% POA represented by the LAT differs from the 90% POA represented by the outstanding claims liability as the former is in effect an impairment test used only to test the sufficiency of net unearned premium liabilities, whereas the latter is a measurement accounting policy used in determining the carrying value of the outstanding claims liability. The process used to determine the risk margin, including the way in which diversification of risks has been allowed for, is explained in Note 2.2.

### NOTE 2.5 DEFERRED INSURANCE EXPENSES

	DEFERRED ACQUISITION COSTS <sup>(1)</sup>		DEFERRED OUTWARDS REINSURANCE EXPENSE <sup>(2)</sup>		TOTAL DEFERRED INSURANCE EXPENSES	
	2018	2017 <sup>(3)</sup>	2018	2017 <sup>(3)</sup>	2018	2017 <sup>(3)</sup>
	\$m	\$m	\$m	\$m	\$m	\$m
<b>A. RECONCILIATION OF MOVEMENTS</b>						
At the beginning of the financial year	<b>1,020</b>	1,051	<b>1,750</b>	1,727	<b>2,770</b>	2,778
Costs deferred	<b>1,809</b>	1,787	<b>4,662</b>	3,134	<b>6,471</b>	4,921
Amortisation charged to profit	<b>(1,835)</b>	(1,819)	<b>(3,851)</b>	(3,122)	<b>(5,686)</b>	(4,941)
Transfers to assets held for sale	<b>(37)</b>	-	<b>(74)</b>	-	<b>(111)</b>	-
Net costs earned and written on discontinued operations	<b>(2)</b>	2	<b>25</b>	12	<b>23</b>	14
Net foreign exchange movements	<b>(6)</b>	(1)	<b>(18)</b>	(1)	<b>(24)</b>	(2)
Deferred costs at the end of the financial year	<b>949</b>	<u>1,020</u>	<b>2,494</b>	<u>1,750</u>	<b>3,443</b>	<u>2,770</u>

(1) The carrying value of deferred acquisition costs includes \$27 million (2017: \$54 million) which is expected to be amortised more than 12 months from reporting date.

(2) The carrying value of deferred outwards reinsurance expense includes \$101 million (2017: \$42 million) which is expected to be amortised more than 12 months from reporting date.

(3) Prior year comparatives have been re-presented due to the discontinued operations. Refer to Note 6.5.

## B. RECOGNITION AND MEASUREMENT

### I. Acquisition costs

Acquisition costs are incurred in obtaining and recording general insurance contracts, which include advertising expenses, commission or brokerage paid to agents or brokers, premium collection costs, risk assessment costs and other administrative costs. These costs are initially capitalised and then expensed in line with the earning pattern of the related premium. Deferred acquisition costs at the reporting date represent the acquisition costs relating to unearned premium.

### II. Outwards reinsurance expense

Premium ceded to reinsurers is recognised as an expense in accordance with the pattern of reinsurance service received. The outwards reinsurance premium relating to unearned premium is treated as a prepayment at the reporting date.

### NOTE 2.6 TRADE AND OTHER RECEIVABLES

	2018	2017
	\$m	\$m
<b>A. COMPOSITION</b>		
<b>I. Premium receivable</b>		
Gross premium receivable	<b>3,622</b>	3,402
Provision for impairment	<b>(33)</b>	(39)
Net premium receivable	<b>3,589</b>	<u>3,363</u>
<b>II. Trade and other receivables<sup>(1)</sup></b>		
Reinsurance recoveries on paid claims	<b>92</b>	242
Loan to associates <sup>(2)</sup>	<b>99</b>	90
Investment-related receivables	<b>124</b>	280
Trade and other debtors	<b>181</b>	178
Trade and other receivables	<b>496</b>	790
	<b>4,085</b>	<u>4,153</u>

(1) Other than the loan to associates, receivables are non-interest bearing and are normally settled between 30 days and 12 months. The balance has not been discounted as the effect of the time value of money is not material. The net carrying amount of receivables is a reasonable approximation of the fair value of the assets due to the short-term nature of the assets.

(2) This loan is denominated in Malaysian ringgit and has a fixed term of 15 years. A cumulative preference dividend of 1% is payable annually. The loan relates to IAG's increased investment in AmGeneral to acquire Kurnia during the financial year ended 30 June 2013.

## B. RECOGNITION AND MEASUREMENT

Trade and other receivables are stated at the amounts to be received in the future, inclusive of GST and less any impairment losses. The amounts are discounted where the effect of the time value of money is material. The recoverability of debts is assessed on an ongoing basis and provision for impairment is made based on objective evidence for individual receivables and having regard to past default experience. The impairment charge is recognised in profit or loss. Debts which are known to be uncollectible are written-off.

## NOTE 2.7 TRADE AND OTHER PAYABLES

	2018	2017
	\$m	\$m
<b>A. COMPOSITION</b>		
<b>I. Reinsurance premium payable<sup>(1)</sup></b>	<b>1,157</b>	<b>712</b>
<b>II. Trade creditors<sup>(2)</sup></b>		
Commissions payable	275	268
Stamp duty payable	130	123
GST payable on premium receivable	175	157
Corporate treasury derivatives payable	14	-
Other <sup>(3)</sup>	321	472
	<b>915</b>	<b>1,020</b>
<b>III. Other payables<sup>(2)</sup></b>		
Other creditors and accruals	403	378
Investment creditors	113	310
Interest payable on interest-bearing liabilities	4	14
	<b>520</b>	<b>702</b>
	<b>2,592</b>	<b>2,434</b>

- (1) IAG has a right of offset and settles on a net basis under the agreement with National Indemnity Company (NICO), a Berkshire Hathaway (BH) company, and under the combined 12.5% quota share agreements. This balance includes reinsurance premium payable to BH of \$1,166 million (2017: \$1,166 million) and the combined 12.5% quota share agreements of \$727 million (2017: nil), which have been offset with receivables due from BH of \$650 million (2017: \$677 million) and the combined 12.5% quota share agreements of \$294 million (2017: nil), respectively. The relevant cash flows pertaining to the contracts have been presented on a gross basis within the cash flow statement.
- (2) Trade and other payables are unsecured, non-interest bearing and are normally settled within 30 days to 12 months. Amounts have not been discounted because the effect of the time value of money is not material. The carrying amount of payables is a reasonable approximation of the fair value of the liabilities because of the short-term nature of the liabilities.
- (3) Other trade creditors include \$4 million (2017: \$6 million) of reinsurance collateral arrangements with various reinsurers to secure the Group reinsurance recoveries. The balance is anticipated to reduce through the settlement of amounts from reinsurers as they fall due. This payable is interest bearing.

## B. RECOGNITION AND MEASUREMENT

Trade and other payables are stated at the fair value of the consideration to be paid in the future for goods and services received, inclusive of GST. The amounts are discounted where the effect of the time value of money is material.

# 3. RISK

## SECTION INTRODUCTION

This section provides an overview of IAG's approach to risk and capital management.

IAG is exposed to multiple risks relating to the conduct of its general insurance business. IAG does not seek to avoid all risks, but to optimally manage and/or price them. Management of those risks is an integral part of delivering IAG's strategy, decision-making and long-term sustainability. Risk management arrangements are designed to reflect the scope, scale and complexity of IAG's activities and where appropriate capital is held to support these activities.

IAG uses an enterprise-wide approach to risk that includes six risk categories:

- Strategic
- Insurance
- Reinsurance
- Financial
- Operational
- Regulatory Risk and Compliance

The risk categories, their definition and structured arrangements for their management are included in IAG's Risk Management Strategy (RMS). Risks rarely occur, or should be considered, in isolation. The interconnectivity of IAG's six risk categories and the key risks faced are understood and overseen. Key risks and their impact, likelihood, interconnectedness and velocity are considered in IAG's Enterprise Risk Profile (ERP).

## **NOTE 3.1 RISK AND CAPITAL MANAGEMENT**

### **A. RISK MANAGEMENT OVERVIEW**

The IAG Board has responsibility for setting risk strategy. The IAG Risk Committee (RC) assists the Board in fulfilling its risk management responsibilities, oversight of risk management, development of IAG's risk management framework (RMF) and policies and provides advice to the IAG Executives and Board. The RC monitors the effectiveness of the Risk Management function. The Group Chief Risk Officer (CRO) oversees risk management across IAG and is supported by a risk function. IAG's CRO and the risk function provide regular reports to the RC on the operation of IAG's RMF, the status of key risks, risk and compliance incidents and risk framework changes.

IAG's RMF is in place to assist the Board and senior executive management in managing risk. The RMF is the totality of systems, structures, policies and processes within IAG that identify, assess, treat, monitor, report and/or communicate all internal and external sources of risk that could have a material impact on IAG's operations. The RMF supports management by:

- ensuring clear roles and responsibilities for the management of risk;
- standardising risk management language, definitions and processes so risks can be accurately benchmarked and compared;
- establishing common reporting standards, tools and risk management information; and
- defining input for risk management reports as well as the ERP.

IAG's documented RMS describes the group-wide RMF and how it is implemented, including risk appetite (i.e. the levels, boundaries and nature of risk the organisation is willing to accept), the risk categories used, the major risk management processes, and the roles and responsibilities for managing risk. The RMS is a Board-approved policy which brings together consistent strategies and sets the minimum acceptable standards for managing the full spectrum of risks associated with pursuing corporate objectives and fulfilling IAG's purpose. IAG uses Group policies and other supporting documents to help ensure the risk management requirements are clear across IAG, and provide context to implement the risk management principles described in the RMS. The RMS must be adhered to, along with the legal, regulatory and prudential requirements in all countries in which the organisation has operations.

Other key documents within IAG's RMF include:

- Reinsurance Management Strategy (ReMS), which describes the systems, processes, procedures, controls and assurance to ensure IAG's reinsurance arrangements are prudently managed;
- Group Risk Appetite Statement (RAS), which articulates the levels, boundaries and nature of risk the Board is willing to accept in pursuit of IAG's strategic objectives; and
- Internal Capital Adequacy Assessment Process (ICAAP) and the ICAAP Summary Statement, which summarises IAG's risk assessment processes for capital management and describes the strategy for maintaining adequate capital over time.

The definitions of the risk categories and mitigation strategies are set out in the subsequent sections.

The RMS is supported by risk culture and behaviours that are the foundation for appropriate risk management and business sustainability. IAG is committed to conducting businesses in a manner aligned with IAG's purpose which is supported by principles developed in conjunction with the Ethics and Consumer Advisory Board which includes external representation.

### **B. STRATEGIC RISK**

Strategic risk is defined as the risk of not achieving corporate or strategic goals due to:

- poor business decisions regarding future business plans and strategies, and/or
- lack of responsiveness to changes in the business environment.

Strategic risk is managed by the IAG Group Leadership Team with Board oversight. Key elements in the management of strategy and strategic risk include a rigorous strategic planning program and associated oversight arrangements, with progress against strategic priorities regularly considered. IAG implements active portfolio management of its insurance operations. This involves robust and regular review of the portfolios that leads to informed decisions on the allocation of assets (scarce resources) in the most efficient and value-accretive way in order to achieve IAG's strategic objectives. Consideration of both current and future value is critical in the process. Portfolio management can involve the acquisition or divestment of other entities, for which IAG has implemented a Merger & Acquisitions Framework to help ensure the associated risks are appropriately managed. Strategic risk mitigation is further enhanced by the accountabilities of the Customer Labs function operated under the Chief Customer Officer. This function ensures IAG is accessing data-driven customer insights and reacting to such through the innovation of products, services and adjacencies.

### **C. INSURANCE RISK**

Insurance risk is defined as the risk that IAG is exposed to financial loss as a result of:

- inadequate or inappropriate underwriting;
- inadequate or inappropriate product design and pricing;
- inadequate or inappropriate reserving including unforeseen, unknown or unintended liabilities that may eventuate;
- inadequate or inappropriate claims management; and
- insurance concentration risk (e.g. by locality, segment, or distribution channel).

A fundamental part of IAG's overall risk management approach is the effective governance and management of the risks that affect the amount, timing and certainty of cash flows arising from insurance contracts. The level of insurance risk accepted by IAG is formally documented in its Insurance Business Licences, which are issued to each operating division. The Insurance Business Licence is prepared by the Group Chief Underwriting Officer in consultation with the customer-facing divisions and is approved by the Group CEO. The Insurance Business Licences are reviewed annually or more frequently if required. In addition to Insurance Business Licences, insurance risk is also managed through the implementation of the Insurance Risk Framework and supporting Insurance Risk Principles.

### I. Acceptance and pricing of risk

IAG adopts a disciplined approach to the underwriting of risks, rather than a premium volume or market share oriented approach. IAG believes this approach provides the greatest long-term likelihood of being able to meet the objectives of all stakeholders, including policyholders, regulators and shareholders. IAG's significant underwriting and pricing expertise, coupled with its data and analytics capability, allow IAG to effectively underwrite policies to the desired level of risk.

The underwriting by IAG of large numbers of less than fully correlated individual risks, predominantly short-tail business, across a range of classes of insurance businesses in different regions reduces the variability in overall claims experience over time. A risk still remains that the actual amount of claims paid is different to the amount estimated at the time an insurance product was designed and priced. IAG's effective claims management and provisioning, reinsurance and capital management further mitigate the impact of this risk to IAG.

As referenced above, business divisions underwrite within set criteria as contained in the Insurance Business Licence. Maximum limits are set for the acceptance of risk both on an individual insurance contract basis and for classes of business and specific risk groupings.

Management information systems are maintained to provide up to date, reliable data on the risks to which the business is exposed at any point in time. Statistical models that combine historical and projected data (pricing, claims and market conditions) are used to calculate premiums and monitor claims patterns for each class of business.

### II. Claims management and provisioning

Once an incident has occurred, initial claim estimates are managed by claims officers with the requisite degree of experience and competence with the assistance, where appropriate, of a loss adjustor or other party with specialist knowledge of specific incidents. These case estimates are used to form part of the basis of the claims provisions. It is IAG's intention to respond to and settle all valid claims quickly whenever possible and to pay claims fairly, based on policyholders' full entitlements. Efforts are made, including plain language policy terms, to ensure there is no misalignment between policyholders' perceived benefits when a policy is initially sold and their actual entitlement when a claim is made.

Claims provisions are established using actuarial valuation models, including a risk margin to cover inherent uncertainty in the ultimate cost of the claims, to ensure adequate capital is allocated to settle the claims that have occurred. Refer to Note 2.2 for further details.

### III. Concentrations of insurance risk

Each year IAG sets its tolerance for concentration risk through the use of various models to estimate IAG's maximum exposure to potential natural disasters and other catastrophes. IAG mitigates its exposure to concentrations of insurance risk by holding a portfolio diversified into many classes of business across different regions and by the utilisation of reinsurance, taking into account the cost of reinsurance and capital efficiency. The reinsurance cover limits IAG's financial exposure to a single event with a given probability, and also protects capital. The catastrophe reinsurance cover purchased affects the Insurance Concentration Risk Charge (ICRC) in the APRA capital calculation.

Concentration risk is particularly relevant in the case of catastrophes, usually natural disasters including earthquakes, bushfires, hailstorms, tropical storms and high winds, which generally result in a concentration of policyholders being impacted by the same event. This aggregation of multiple claims arising from a single event creates the most material financial loss potential in the Group. IAG is also exposed to certain large man-made catastrophic events such as industrial accidents and building fires. Catastrophe losses are an inherent risk of the general insurance industry that contributes to potentially material year-to-year fluctuations in the results of operations and financial position. The nature and level of catastrophes in any period cannot be predicted accurately but can be estimated through the utilisation of predictive models. IAG actively monitors the aggregate exposure to catastrophe losses in all regions and limits exposure in regions that are subject to high levels of natural perils. Specific processes for monitoring identified key concentrations are set out below:

RISK	SOURCE OF CONCENTRATION	RISK MANAGEMENT MEASURES
An accumulation of risks arising from a natural peril/catastrophe	Insured property concentrations	Accumulation risk modelling and reinsurance protection
A large property loss	Fire or accident affecting one building or a group of adjacent buildings	Maximum per risk acceptance limits, property risk grading and reinsurance protection
Multiple liability retentions being involved in the same event	Response by a multitude of policies to the one event	Purchase of reinsurance clash protection

The tables below provide an analysis of gross written premium from continuing operations by both region and product, which demonstrates the diversity of IAG's operations and its relatively limited exposure to additional risks associated with long-tail classes of business (where there is increased uncertainty of the ultimate cost of claims due to the additional period of time to settlement):

	<b>2018</b>	2017*
	%	%
<b>a. REGION</b>		
Australia	<b>79</b>	80
New Zealand	<b>21</b>	20
	<b>100</b>	100
<b>b. PRODUCT</b>		
Motor	<b>32</b>	31
Home	<b>29</b>	28
Short-tail commercial	<b>22</b>	22
CTP (motor liability)	<b>7</b>	8
Liability	<b>6</b>	6
Other short-tail	<b>1</b>	2
Workers' compensation	<b>3</b>	3
	<b>100</b>	100

\* Prior year comparatives have been re-presented due to the discontinued operations. Refer to Note 6.5.

#### **D. REINSURANCE RISK**

Reinsurance risk is defined as the risk of:

- insufficient or inappropriate reinsurance coverage;
- inadequate underwriting and/or pricing of reinsurance exposures retained;
- inadequate or inappropriate reinsurance recovery management;
- reinsurance arrangements not being legally binding;
- reinsurance concentration risk; and
- credit counterparty concentration risk to reinsurers, which is covered under the credit risk section of financial risk.

IAG's reinsurance program is an important part of IAG's overall approach to risk and capital management. It is used to limit exposure to large single claims as well as an accumulation of claims that arise from the same or similar events in order to stabilise earnings and protect capital resources. IAG's ReMS outlines the reinsurance principles, including the requirement that IAG's reinsurance retention for catastrophe must not exceed 4% of net earned premium.

IAG purchases catastrophe reinsurance protection to the greater of:

- a 1-in-250 year return period for earthquake loss calculated on a whole-of-portfolio basis for Australia;
- a 1-in-1000 year return period for earthquake loss calculated on a whole-of-portfolio basis for New Zealand.

This is a more conservative view than APRA's prescribed minimum approach of 1-in-200 year return period loss calculated on a whole-of-portfolio, all perils basis.

Dynamic financial analysis modelling is used to determine the optimal level at which reinsurance should be purchased for capital efficiency, compared with the cost and benefits of covers available in the market.

The amount of reinsurance purchased is determined by reference to the modelled probable maximum loss (PML). Natural perils are inherently uncertain, which presents model risk. As a result, the loss from an actual event could exceed the modelled PML.

To facilitate the reinsurance process, manage counterparty exposure and create economies of scale, IAG has established a centralised reinsurance model across its operations. This is via captive reinsurance entities in Singapore and Labuan and a reinsurance department or virtual captive in Australia, collectively referred to as IAG Reinsurance. IAG Reinsurance acts as the interface between the external providers of reinsurance capital and the operating business divisions.

The use of reinsurance introduces credit risk. The management of credit risk includes the monitoring of reinsurers' credit ratings and controlling total exposures to limit counterparty default risk which is further explained in the financial risk section. IAG adopts a sound underwriting approach to the reinsurance program through the expertise provided by IAG Reinsurance. Retained exposures sit within the Board risk appetite and appropriate capital is maintained.

## **I. Current reinsurance program**

The external reinsurance program consists of a combination of the following reinsurance arrangements:

- a 32.5% whole-of-account quota share arrangements;
- a Group catastrophe cover which is placed in line with the strategy of buying to the level of a 1-in-250 year event on a whole-of-portfolio basis. IAG's catastrophe reinsurance protection runs to a calendar year and operates on an excess of loss basis, with IAG retaining the first \$250 million (\$169 million post-quota share) of each loss. It covers all territories in which IAG operates. The limit of catastrophe cover purchased effective 1 January 2018 was \$8 billion placed to 67.5%. Should a loss event occur that is greater than \$8 billion, IAG could potentially incur a net loss greater than the retention. IAG holds capital to mitigate the impact of this possibility;
- an aggregate sideways cover which protects against a frequency of attritional event losses in Australia, New Zealand and Asia, and operates below the Group catastrophe cover;
- excess of loss reinsurances which provide 'per risk' protection for retained exposures of the commercial property and engineering businesses in Australia, New Zealand, Thailand, Malaysia, Vietnam and Indonesia;
- excess of loss reinsurance for all casualty portfolios including CTP, public liability, workers' compensation and home owners warranty products;
- quota share protection for agency-distributed financial lines products including surety and trade credit;
- quota share protection for cyber;
- excess of loss reinsurance for all marine portfolios;
- excess of loss reinsurance cover for retained natural peril losses;
- crop quota share and stop loss;
- adverse development cover (ADC) and quota share protection on the CTP portfolio;
- ADC for the February 2011 Canterbury earthquake event; and
- ADC for policies issued prior to 31 December 2015 covering IAG's exposure to asbestos relating to legacy general liability and/or workers' compensation policies.

## **E. FINANCIAL RISK**

Financial risk is defined as the risk of:

- adverse movements in market prices (foreign exchange, equities, credit spreads, interest rates etc) or inappropriate concentration within the investment funds;
- a counterparty failing to meet its obligations (credit risk);
- inadequate liquidity; and
- inappropriate capital management.

Key aspects of the processes established by IAG to monitor and mitigate financial risks include:

- the Board Risk and Audit Committees with Non-Executive Directors as members;
- an Asset and Liability Committee (ALCo) comprising key Executives with relevant oversight responsibilities;
- value-at-risk analysis is performed, position limits are in place and monitored and monthly stress testing is undertaken to determine the impact of adverse market movements;
- maintenance of an approved Group Credit Risk Policy, Group Liquidity Policy, Group Foreign Exchange Policy and Group Investment Policy;
- Board-approved Strategic Asset Allocation and Investment Management Agreements;
- capital management activities – for further details refer to the capital management section (IV) of this note; and
- implementation of a Derivatives Risk Management Statement that considers the controls in the use of derivatives and sets out the permissible use of derivatives in relation to investment strategies.

## **I. Market risk**

### **a. FOREIGN EXCHANGE RISK**

IAG operates internationally and so is exposed to foreign exchange risk from various activities conducted in the normal course of business. Foreign exchange exposure is managed by IAG Asset Management and the Group Treasury function.

The key foreign exchange risk exposures and mitigation strategies are set out below:

EXPOSURE	RISK MANAGEMENT MEASURES
Net investment in foreign operations – through the translation of the financial position (recognised directly in equity) and performance (recognised in profit or loss) of foreign operations that have a functional currency other than the Australian dollar.	Designated hedging instruments – forward foreign exchange contracts (derivatives).
Translation of interest-bearing liabilities denominated in foreign currency.	Some designated as hedging instruments where the currency matches the functional currency of investments in foreign operations.
Translation of insurance liabilities denominated in currencies other than the Australian dollar (directly recognised in profit or loss).	Assets backing technical reserves are held in the same currency as the related insurance liabilities, mitigating any net foreign exchange exposure.
Translation of investments denominated in currencies other than Australian dollars.	Designated hedging instruments – forward foreign exchange contracts (derivatives).

The table below provides information regarding the impact on the measurement of net investments in foreign operations held at reporting date of an instantaneous 10% depreciation of the Australian dollar compared with selected currencies on equity, net of related derivatives. An appreciation of the Australian dollar would broadly have the opposite impact.

IMPACT OF 10% DEPRECIATION OF AUSTRALIAN DOLLAR	2018 \$m Impact directly to equity	2017 \$m Impact directly to equity
Net investments in foreign operations and related hedge arrangements		
New Zealand dollar	63	66
Malaysian ringgit	18	18
Other currencies where considered significant	5	13
	<b>86</b>	<b>97</b>

The sensitivity analysis demonstrates the effect of a change in one key assumption while other assumptions remain unchanged (isolated exchange rate movements).

#### b. PRICE RISK

IAG has exposure to equity price risk through its investments in equities (both directly and through certain trusts) and the use of equity-related derivative contracts. The impact on the measurement of the investments held at reporting date of a change in equity values by +10% or -10% on profit before tax, net of related derivatives, is shown in the table below:

IMPACT OF CHANGE IN EQUITY VALUE		2018 \$m Impact to profit	2017 \$m Impact to profit
Investments – equity and trust securities and related equity derivatives	+10%	108	108
	-10%	(105)	(107)

### c. INTEREST RATE RISK

Fixed interest rate assets and liabilities are exposed to changes in market value derived from mark-to-market revaluations. Financial assets and liabilities with floating interest rates create cash flow variability.

IAG's interest rate risk arises primarily from fluctuations in the valuation of investments in fixed interest-bearing securities recognised at fair value and from the underwriting of general insurance contracts, which creates exposure to the risk that interest rate movements materially impact the fair value of the insurance liabilities (the insurance liabilities are discounted with reference to the government yields). Movements in interest rates should have minimal impact on the insurance profit or loss due to IAG's policy of investing in assets backing insurance liabilities principally in fixed interest securities that are closely matched to the duration of the insurance liabilities (period to settlement). Therefore, movements in the fair value measurement of the assets broadly offset the impact of movements in the insurance liabilities from changes in interest rates.

The impact on the measurement of investments in fixed interest-bearing securities held at reporting date of a change in interest rates by +1% or -1% on profit before tax, net of related derivatives, is shown in the following table. The sensitivity analysis provided demonstrates the effect of a change in interest rates only, whilst other assumptions remain unchanged.

IMPACT OF CHANGE IN FIXED INTEREST-BEARING SECURITIES VALUE		2018	2017
		\$m	\$m
		Impact to profit	Impact to profit
Investments – interest-bearing securities and related interest rate derivatives	+1%	(159)	(200)
	-1%	167	213

Refer to Note 2.2 for details of the impact on the net outstanding claims liabilities before income tax to changes in key actuarial assumptions, including movements in discount rates.

### II. Credit risk

Concentrations of credit risk exist where a number of counterparties have similar economic characteristics. IAG's credit risk arises predominantly from investment activities, reinsurance activities, premium debtors and dealings with other intermediaries. IAG maintains a credit risk appetite, which is approved by the Board, and a Group Credit Risk Policy that is consistent with the Board's risk appetite. The policy outlines the framework and procedures in place to ensure an adequate and appropriate level of monitoring and management of credit quality throughout IAG with the Group Treasury function responsible for implementation. IAG maintains sufficiently diverse credit exposures to avoid a concentration charge added to the regulatory capital requirement.

The maximum exposure to credit risk loss as at reporting date is the carrying amount of the assets/receivables on the balance sheet as they are measured at fair value.

#### a. INVESTMENTS

IAG is exposed to credit risk from investments in third parties, for example debt or similar securities issued by those companies. At the reporting date, there are material concentrations of credit risk to the banking sector, in particular the four major Australian banks. The credit risk relating to investments is regularly monitored and assessed, with maximum exposures limited by credit rating, counterparty, industry and geography. The assets backing insurance liabilities include predominantly high credit quality investments, such as government securities and other investment grade securities, which reduce the risk of default.

The following table provides information regarding the credit risk relating to the interest-bearing investments based on Standard & Poor's counterparty credit ratings, which demonstrates the very strong overall credit quality of IAG's investment book:

CREDIT RATING OF INTEREST-BEARING INVESTMENTS	2018	2017
	\$m	\$m
AAA	3,520	3,794
AA	3,514	3,776
A	482	433
BBB and below	1,652	2,365
	<u>9,168</u>	<u>10,368</u>

#### b. REINSURANCE RECOVERIES ON PAID CLAIMS

Reinsurance arrangements mitigate insurance risk but expose IAG to credit risk. Reinsurance is placed with companies (reinsurers) based on an evaluation of their financial strength, terms of coverage and price. At the reporting date, there are material concentrations of credit risk in relation to reinsurance recoverables, in particular to large global reinsurers. IAG has clearly defined policies for the approval and management of credit risk in relation to reinsurers. IAG monitors the financial condition of its reinsurers on an ongoing basis and periodically reviews the reinsurers' ability to fulfil their obligations under respective existing and future reinsurance contracts. Some of the reinsurers are domiciled outside the jurisdictions in which IAG operates and so there is the potential for additional risk such as country risk and transfer risk.

It is IAG policy to only deal with reinsurers with credit ratings of at least Standard & Poor's BBB+ (or other rating agency equivalent) without collateralisation, other than a mandatory placement to meet local regulatory requirements. Where the credit rating of a reinsurer falls below the required quality during the period of risk a contractual right to replace the counterparty exists. Some of the reinsurance protection is purchased on a 'collateralised' basis, where reinsurers either deposit funds equivalent to their participation (trust or loss deposits) or provide other forms of collateral (letters of credit).

The following table provides IAG's exposure to reinsurance recoveries receivable on the outstanding claims balance, excluding other recoveries, by counterparty credit rating (Standard & Poor's) and the secured collateral:

CREDIT RATING OF REINSURANCE RECOVERIES ON OUTSTANDING CLAIMS	2018		2017	
	\$m	% of total	\$m	% of total
AA	3,667	89	3,367	86
A	456	11	526	14
BBB and below	11	-	12	-
Total	<u>4,134</u>	<u>100</u>	<u>3,905</u>	<u>100</u>

Of these, approximately \$1,025 million (2017: \$1,001 million) is secured directly as follows, reducing the credit risk:

- deposits held in trust: \$23 million (2017: \$144 million);
- letters of credit: \$1,000 million (2017: \$854 million); and
- loss deposits: \$2 million (2017: \$3 million).

An ageing analysis for reinsurance recoveries on paid claims is provided below:

	NOT OVERDUE		OVERDUE		TOTAL
	\$m	<30 days \$m	30-120 days \$m	>120 days \$m	
<b>2018</b>					
Reinsurance recoveries on paid claims	<u>70</u>	<u>8</u>	<u>3</u>	<u>11</u>	<u>92</u>
<b>2017</b>					
Reinsurance recoveries on paid claims	<u>128</u>	<u>11</u>	<u>44</u>	<u>59</u>	<u>242</u>

#### c. PREMIUM RECEIVABLE

The majority of the premium receivable balance relates to policies which are paid on a monthly instalment basis. The late payment of amounts due under such arrangements allows for the cancellation of the related insurance contract eliminating both the credit risk and insurance risk for the unpaid amounts. Upon cancellation of a policy the outstanding premium receivable and revenue is reversed. IAG is also exposed to the credit risk associated with brokers and other intermediaries when premium is collected via these intermediaries. IAG's exposure is regularly monitored by ALCo with reference to aggregated exposure, credit rating, internal credit limits and ageing of receivables by counterparty. Ageing analysis for premium receivable is provided below, with amounts aged according to their original due date, demonstrating IAG's limited exposure:

	NOT OVERDUE		OVERDUE		TOTAL
	\$m	<30 days \$m	30-120 days \$m	>120 days \$m	
<b>2018</b>					
Premium receivable	2,981	315	278	48	3,622
Provision for impairment	<u>(3)</u>	<u>(3)</u>	<u>(7)</u>	<u>(20)</u>	<u>(33)</u>
	<u>2,978</u>	<u>312</u>	<u>271</u>	<u>28</u>	<u>3,589</u>
<b>2017</b>					
Premium receivable	2,771	308	273	50	3,402
Provision for impairment	<u>(5)</u>	<u>(3)</u>	<u>(7)</u>	<u>(24)</u>	<u>(39)</u>
	<u>2,766</u>	<u>305</u>	<u>266</u>	<u>26</u>	<u>3,363</u>

### III. Liquidity risk

IAG's liquidity position is derived from operating cash flows, access to liquidity through related bodies corporate and interest-bearing liabilities (with some denominated in different currencies and with different maturities). IAG complies with its liquidity risk management practices, which include a Group policy, and has the framework and procedures in place to ensure an adequate and appropriate level of monitoring and management of liquidity.

#### a. OUTSTANDING CLAIMS LIABILITY AND INVESTMENTS

Underwriting insurance contracts expose IAG to liquidity risk through the obligation to make payment for claims of unknown amounts on unknown dates. The assets backing insurance liabilities can generally be readily sold or exchanged for cash to settle claims and are managed in accordance with the policy of broadly matching the overall maturity profile to the estimated pattern of claim payments.

A maturity analysis is provided below of the estimated net discounted outstanding claims liability (based on the remaining term to payment at the reporting date) and the investments that have a fixed term (provided by expected maturity). The timing of future claim payments is inherently uncertain. Actual maturities may differ from expected maturities because certain counterparties have the right to call or prepay certain obligations with or without penalties.

MATURITY ANALYSIS	NET DISCOUNTED OUTSTANDING CLAIMS LIABILITY		INVESTMENTS	
	2018	2017	2018	2017
	\$m	\$m	\$m	\$m
Floating interest rate (at call)	-	-	755	944
Within 1 year or less	2,446	2,776	1,607	2,255
Within 1 to 2 years	920	1,182	773	880
Within 2 to 5 years	1,200	1,601	2,656	2,550
Over 5 years	422	554	3,377	3,739
Total	<u>4,988</u>	<u>6,113</u>	<u>9,168</u>	<u>10,368</u>

#### b. INTEREST-BEARING LIABILITIES

The following table provides information about the residual maturity periods of the interest-bearing liabilities of a capital nature based on the contractual maturity dates of cash flows:

	CARRYING VALUE	MATURITY DATES OF CONTRACTUAL UNDISCOUNTED CASH FLOWS					
		Within 1 year	1 - 2 years	2 - 5 years	Over 5 years	Perpetual	Total
		\$m	\$m	\$m	\$m	\$m	\$m
<b>2018</b>							
Principal repayments <sup>(1)</sup>	1,974	-	-	-	1,020	954	1,974
Contractual interest payments <sup>(1)</sup>		91	91	274	-	-	456
Total contractual undiscounted payments		<u>91</u>	<u>91</u>	<u>274</u>	<u>1,020</u>	<u>954</u>	<u>2,430</u>
<b>2017</b>							
Principal repayments <sup>(1)</sup>	1,638	-	-	-	684	954	1,638
Contractual interest payments <sup>(1)</sup>		73	73	220	-	-	366
Total contractual undiscounted payments		<u>73</u>	<u>73</u>	<u>220</u>	<u>684</u>	<u>954</u>	<u>2,004</u>

(1) All of the liabilities have call, reset or conversion dates which occur prior to any contractual maturity. Detailed descriptions of the instruments are provided in Note 4.1. The contractual interest payments are undiscounted and calculated based on underlying fixed interest rates or prevailing market floating rates as applicable at the reporting date. Interest payments have not been included beyond five years.

### IV. Capital management risk

IAG's capital management strategy plays a central role in managing risk to create shareholder value whilst meeting the objective of maintaining an appropriate level of capital to protect policyholders' and lenders' interests, and meet regulatory requirements.

IAG has a documented description of the capital management process (ICAAP) and reports annually on the operation of the ICAAP to the Board, together with a forward-looking estimate of expected capital utilisation (as represented in IAG's Capital Plan) and capital resilience (ICAAP Annual Report). Adequacy of IAG's capital position is judged relative to the Board's Capital RAS, with an internal capital model (ICM) used to assess the risks of breaching the minimum levels established in the Capital RAS. Scenario analysis and stress testing are important adjuncts to the ICM. The amount of capital required varies according to the business underwritten, extent of reinsurance and investment asset allocation.

The target level of capitalisation (risk appetite) for IAG is assessed by consideration of factors including:

- the probability of financial ruin over the next one to three years;
- the probability of falling below the APRA prescribed capital amount (PCA) over the next one to three years;
- other stakeholder perspectives on capitalisation, including rating agency capital models and associated ratings; and
- domestic and international levels of capitalisation.

#### a. REGULATORY CAPITAL

All insurers within IAG that carry on insurance business in Australia are registered with APRA and are subject to APRA's Prudential Standards. It is IAG's policy to ensure that each of the licenced insurers maintains an adequate capital position.

IAG's long-term target capital ranges set out below remain unchanged:

- a total regulatory capital position equivalent to 1.4 to 1.6 times the PCA, compared to a regulatory requirement of 1.0 times; and
- Common Equity Tier 1 capital of 0.9 to 1.1 times the PCA, compared to a regulatory requirement of 0.6 times.

Internal policies are in place to ensure significant deviations from the benchmarks are considered by the Board as to how any shortfall should be made good, or any surplus utilised.

IAG uses the standardised framework detailed in the relevant prudential standards (APRA Level 2 Insurance Group requirements) to calculate regulatory capital.

REGULATORY CAPITAL POSITION	<b>2018</b>	2017
	<b>\$m</b>	\$m
Common Equity Tier 1 capital (CET1 capital)	<b>3,114</b>	2,888
Additional Tier 1 capital	<b>624</b>	679
Total Tier 1 capital	<b>3,738</b>	3,567
Tier 2 capital	<b>1,280</b>	959
Total regulatory capital	<b>5,018</b>	4,526
Total PCA	<b>2,468</b>	2,661
PCA multiple	<b>2.03</b>	1.70
CET1 multiple	<b>1.26</b>	1.09

At 30 June 2018, IAG's Insurance Concentration Risk Charge (ICRC) from a catastrophe event was \$169 million (2017: \$200 million).

Consideration is given to the operational capital needs of the business. Targeting a capital multiple above the minimum regulatory requirement aims to ensure the ongoing strength and security of IAG, while suitably protecting policyholders and lenders.

The capital objectives are achieved through dynamic management of the balance sheet and capital mix, the use of a risk-based capital adequacy framework that relies on explicit quantification of uncertainty or risk and the use of modelling techniques that provide the capacity to understand the risk/return trade-off as well as valuable inputs to the capital management process. The influences on capital, such as product mix, reinsurance program design, catastrophe exposure, investment strategy, profit margins and capital structure, are all assessed using dynamic financial analysis modelling.

An important influence on IAG's capital level is the payment of dividends. IAG targets a dividend payout ratio, measured as a proportion of cash earnings, within a range approved by the Board (refer to Note 4.4).

#### b. CAPITAL COMPOSITION

The balance sheet capital mix at reporting date is shown in the table below:

CAPITAL MIX	<b>Target</b>	<b>2018</b>	2017
	%	%	%
Ordinary equity less goodwill and intangible assets	<b>60-70</b>	<b>65.7</b>	68.1
Interest-bearing liabilities – hybrid securities and debt	<b>30-40</b>	<b>34.3</b>	31.9
Total capitalisation		<b>100.0</b>	100.0

## F. OPERATIONAL RISK

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

When controls fail, an operational risk incident can cause injury, damage to reputation, have legal or regulatory implications or can lead to financial loss. IAG does not aim to eliminate all operational risks, but manages these by initiating an appropriate control framework and by monitoring and managing potential risks. The Board is responsible for oversight of the Operational Risk Framework and approval of the Operational Risk Management Policy, and any changes to it. The Board and Group Leadership Team believe an effective, documented and structured approach to operational risk is a key part of the broader RMF that is outlined in IAG's RMS.

IAG's Operational Risk Framework, inclusive of the Group Operational Risk Policy, operates within IAG's RMF. The Operational Risk Framework and supporting Operational Risk Policy and procedures aim to ensure that consistent governance mechanisms and practices are in place, and that activities undertaken which involve operational risk are continually assessed and managed with appropriate regard to the Group's RAS and the achievement of IAG's objectives. The Operational Risk Framework is supported by aligned frameworks, policies and procedures for key aspects of operational risk. For example, Fraud and Business Continuity Frameworks and policies are in place as are various other operational risk policies.

Management and staff are responsible for identifying, assessing and managing operational risks in accordance with their roles and responsibilities. IAG's Internal Audit function also reviews the effectiveness of controls and processes surrounding operational risk.

#### G. REGULATORY RISK AND COMPLIANCE

Regulatory Risk and Compliance is defined as failure or inability to comply with applicable laws, regulations or codes excluding failure of staff to adhere to internal policies/procedures and meeting contractual obligations. IAG works closely with regulators and regularly monitors developments across its international operations to assess potential impacts on its ongoing ability to meet the various regulatory requirements.

IAG acknowledges that a Royal Commission is the highest level of public inquiry in Australia. The Board, together with Management, is committed to cooperating fully with the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (the Royal Commission). IAG has provided submissions to the Royal Commission, and resources and expertise have been allocated to ensure any request arising from the Royal Commission is addressed with the appropriate consideration and importance. While it is likely the Royal Commission will make recommendations that could impact the broader financial services landscape in Australia, it remains too early to predict the nature and extent of these changes and any consequential impact these may have for IAG's businesses.

## 4. CAPITAL STRUCTURE

### SECTION INTRODUCTION

This section provides disclosures on the capital structure of IAG, which demonstrates how IAG finances its overall operations and growth through the use of different sources of funds, including ordinary equity and debt and hybrid instruments. Reinsurance is also an increasingly important source of long-term capital for IAG – reinsurance-specific disclosures are included in section 2 insurance disclosures.

The capital that IAG maintains provides financial security to its policyholders, whilst ensuring adherence to the capital adequacy requirements of industry regulators. IAG also seeks to maintain, and where possible enhance, the overall diversity and efficiency of its capital structure to support the delivery of targeted returns to shareholders. IAG measures its capital mix on a net tangible equity basis i.e. after deduction of goodwill and intangibles, giving it strong alignment with both regulatory and rating agency models. IAG's target is a capital mix of ordinary equity (net of goodwill and intangibles) at 60-70% and debt and hybrids at 30-40%.

### NOTE 4.1 INTEREST-BEARING LIABILITIES

Final Maturity Date	Principal Amount	Section	2018		2017	
			Carrying Value \$m	Fair Value \$m	Carrying Value \$m	Fair Value \$m
<b>A. COMPOSITION</b>						
<b>I. Capital nature<sup>(1)</sup></b>						
a. ADDITIONAL TIER 1 REGULATORY CAPITAL <sup>(2)</sup>						
Reset exchangeable securities						
No fixed date	\$550 million	B. I	<u>550</u>	<u>565</u>	<u>550</u>	569
Capital notes						
No fixed date	\$404 million	B. II	<u>404</u>	<u>423</u>	<u>404</u>	431
b. TIER 2 REGULATORY CAPITAL						
AUD subordinated convertible term notes						
19 March 2040	\$350 million	B. III	<u>350</u>	<u>354</u>	350	356
15 June 2044	\$350 million	B. IV	<u>350</u>	<u>353</u>	-	-
			<u>700</u>		<u>350</u>	
NZD subordinated convertible term notes <sup>(3)</sup>						
15 June 2043	NZ\$350 million	B. V	<u>320</u>	<u>332</u>	<u>334</u>	337
<b>II. Operational nature</b>						
Other interest-bearing liabilities			-	-	2	2
Less: capitalised transaction costs			<u>(14)</u>		<u>(16)</u>	
			<u><b>1,960</b></u>		<u><b>1,624</b></u>	

(1) Capital instruments above cannot be reconciled to the regulatory capital section of Note 3.1 due to APRA transitional arrangements.

(2) Instruments issued prior to 1 January 2013 are eligible for inclusion in the relevant category of regulatory capital up to limits prescribed by APRA under transitional arrangements. Any capital that is ineligible to be included in Tier 1 capital as a consequence may be included in Tier 2 capital to the extent there is residual capacity within Tier 2 transitional limits.

(3) At the reporting date, the Company recognised accrued interest of \$1 million (2017: \$1 million) which is presented within trade and other payables.

## **B. SIGNIFICANT TERMS AND CONDITIONS**

### **I. Reset exchangeable securities (RES)**

- face value of \$550 million and were issued by IAG Finance (New Zealand) Limited, a wholly-owned subsidiary of the Company;
- all remain outstanding as at the reporting date;
- non-cumulative floating rate distribution payable quarterly;
- distribution rate equals the sum of the three-month bank bill swap rate (BBSW) plus a margin of 4.00% per annum multiplied by (1-tax rate);
- if the distributions are not fully franked, the distribution rate is increased to compensate holders for the unfranked portion of the distribution, subject to no payment conditions existing;
- payments of distributions can only be made subject to meeting certain conditions. If no distribution is made, no dividends can be paid and no returns of capital can be made on ordinary shares unless IAG takes certain actions; and
- the RES may be exchanged by IAG or the holder on a reset date, or upon certain events. The next reset date is 16 December 2019. On exchange, IAG may convert RES into IAG ordinary shares, arrange a third party to acquire RES for their face value or redeem RES for their face value (subject to APRA approval).

### **II. Capital notes**

- face value of \$404 million and issued by the Company on 22 December 2016;
- all remain outstanding as at the reporting date;
- non-cumulative floating rate distribution payable quarterly;
- distribution rate equals the sum of three-month bank bill swap rate (BBSW) plus a margin of 4.70% per annum multiplied by (1-tax rate);
- if the distributions are not fully franked, the distribution rate is increased to compensate holders for the unfranked portion of the distribution, subject to no payment conditions existing;
- payments of distributions can only be made subject to meeting certain conditions. If no distribution is made, no dividends can be paid and no returns of capital can be made on ordinary shares until the next distribution payment date;
- IAG may convert, redeem or resell capital notes on 15 June 2023, or upon occurrence of certain events, subject to APRA approval;
- the capital notes are scheduled for conversion into a variable number of ordinary shares of the Company (subject to a maximum number of 140.6 million shares) on 16 June 2025 and at each subsequent distribution payment date provided the mandatory conversion conditions are satisfied; and
- the capital notes must be converted into a variable number of IAG ordinary shares (subject to a maximum of 351.1 million shares) or written-off if APRA determines the Company to be non-viable.

### **III. AUD subordinated convertible term notes due 2040**

- face value of \$350 million and issued by Insurance Australia Limited (IAL), a wholly-owned subsidiary of the Company on 19 March 2014;
- all remain outstanding as at the reporting date;
- floating interest rate equal to the three-month bank bill swap rate (BBSW) plus a margin of 2.80% per annum is payable quarterly;
- the notes mature on 19 March 2040 unless converted or redeemed earlier, subject to rights of conversion or redemption;
- IAL has an option to redeem the notes at face value between 19 March 2019 and 19 March 2020 and for certain tax and regulatory events (in each case subject to APRA's prior written approval);
- the notes can be converted into a variable number of ordinary shares of the Company (subject to a maximum of 128.0 million shares) at the option of holders from and including 19 March 2022 and at each subsequent interest payment date and the maturity date of 19 March 2040; and
- the notes must be converted into a variable number of ordinary shares of the Company (subject to a maximum of 319.9 million shares) or written-off if APRA determines the Company to be non-viable.

### **IV. AUD subordinated convertible term notes due 2044**

- face value of \$350 million and issued by the Company on 29 March 2018;
- all remain outstanding as at the reporting date;
- floating interest rate equal to the three-month bank bill swap rate (BBSW) plus a margin of 2.10% per annum is payable quarterly;
- the notes mature on 15 June 2044 unless converted or redeemed earlier, subject to rights of conversion or redemption;
- IAG has an option to redeem the notes at face value between 15 June 2024 and 15 June 2025 and for certain tax and regulatory events (in each case subject to APRA's prior written approval);
- the notes can be converted into a variable number of ordinary shares of the Company (subject to a maximum of 88.7 million shares) at the option of holders from and including 15 June 2027 and at each subsequent interest payment date and the maturity date of 15 June 2044; and
- the notes must be converted into a variable number of ordinary shares of the Company (subject to a maximum of 221.8 million shares) or written-off if APRA determines the Company to be non-viable.

## V. NZD subordinated convertible term notes

- face value of NZ\$350 million (equivalent to \$332 million at date of issue) and issued by the Company on 15 June 2016;
- all remain outstanding as at the reporting date;
- fixed interest rate of 5.15% per annum, payable quarterly;
- the notes mature on 15 June 2043 unless converted or redeemed earlier, subject to rights of conversion or redemption;
- IAG has an option to redeem the notes at face value between 15 June 2022 and 15 June 2023, and for certain tax and regulatory events (in each case subject to APRA's prior written approval);
- if the notes are not redeemed on 15 June 2022, the interest rate will become the applicable three-month bank bill benchmark rate (BKBM) plus a margin of 2.60% per annum;
- the notes can be converted into a variable number of ordinary shares of the Company (subject to a maximum of 114.0 million shares) at the option of holders from and including 15 June 2025 and at each subsequent interest payment date and the maturity date of 15 June 2043; and
- the notes must be converted into a variable number of ordinary shares of the Company (subject to a maximum of 284.9 million shares) or written-off if APRA determines the Company to be non-viable.

## C. RECOGNITION AND MEASUREMENT

The interest-bearing liabilities are initially measured at fair value (net of transaction costs) and subsequently measured at amortised cost. Based on market conditions at any point in time, the carrying value of the liabilities may not be representative of the fair value of the liabilities. The fair value for all interest-bearing liabilities is calculated using their quoted market price (fair value hierarchy level 1).

## NOTE 4.2 NOTES TO THE STATEMENT OF CHANGES IN EQUITY

	2018	2017	2018	2017
	Number of shares in millions	Number of shares in millions	\$m	\$m
<b>A. SHARE CAPITAL</b>				
Balance at the beginning of the financial year	2,367	2,431	7,082	7,275
Off-market share buy-back, including transaction costs	-	(64)	-	(193)
Balance at the end of the financial year	<u>2,367</u>	<u>2,367</u>	<u>7,082</u>	<u>7,082</u>

## B. STRATEGIC RELATIONSHIP WITH BERKSHIRE HATHAWAY (BH)

As part of the strategic relationship with BH, the Company and NICO entered into a subscription agreement dated 16 June 2015 (Subscription Agreement). The terms of the Subscription Agreement were released to the ASX on 16 June 2015 (attached to the Appendix 3B on that date).

### I. Anti-dilution right

On entry by the Company and NICO into the Subscription Agreement, the Company granted NICO a right to maintain, by way of a right to participate in any issue of shares or to subscribe for shares, its percentage interest in the issued share capital of the Company (Anti-dilution Right) in respect of a diluting event which occurs or is announced after 16 June 2015.

## C. NATURE AND PURPOSE OF EQUITY

### I. Ordinary shares

All ordinary shares on issue are fully paid and have no par value. Ordinary shares entitle the holder to a vote at a general meeting of the Company and to participate in the dividends and the proceeds on winding up of the Company in proportion to the number of, and amounts paid on, the shares held.

Shares are classified as equity when there is no obligation to transfer cash or other assets to the holder. Transaction costs directly attributable to the issue of equity instruments are shown in equity as a deduction from the proceeds, net of tax.

### II. Treasury shares held in trust

To satisfy obligations under the various share-based remuneration plans, shares are generally bought on-market at or near grant date of the relevant arrangement and are managed using in-house trusts, one for Australia and one for New Zealand, which are controlled by IAG. The shares are measured at cost and are presented as a deduction from equity. No gain or loss is recognised in profit or loss on the sale, cancellation or reissue of the shares. The shares are derecognised as treasury shares held in trust when the shares vest or are released to the participant. The total number of treasury shares acquired on-market during the financial year was 3 million (2017: 3 million) at an average price per share of \$6.20 (2017: \$5.47).

### III. Foreign currency translation reserve

The foreign currency translation reserve records the foreign currency differences arising from the translation of the financial position and performance of subsidiaries and investments in associates that have a functional currency other than Australian dollars.

#### IV. Share-based remuneration reserve

The share-based remuneration reserve is used to recognise the fair value of equity-settled share-based remuneration obligations issued to employees. The total amount expensed over the vesting period through the consolidated statement of comprehensive income is calculated by reference to the fair value of the rights at grant date. The fair value of the rights is calculated at the grant date using a Black-Scholes valuation model and Monte Carlo simulation. The volatility assumption has been set considering the Company's historic share price. Some of the assumptions are based on historical data which is not necessarily indicative of future trends. Reasonable changes in these assumptions would not have a material impact on the amounts recognised in the financial statements.

The Company provides benefits to employees (including senior management and Executives) through share-based incentives to create a link between shareholder value creation and rewarding employees, and assist with retention of key personnel. The senior management and Executive share plan arrangements consist of two separate arrangements working together. These two arrangements are the Deferred Award Rights Plan (DAR Plan) and Executive Performance Rights Plan (EPR Plan). PARC approves the participation of each individual in the plans.

The obligations under share-based payment arrangements are covered by the on-market purchase of ordinary shares of the Company which are held in trust. The number of shares purchased to cover each allocation of rights is determined by the trustee based on independent actuarial advice.

#### NOTE 4.3 EARNINGS PER SHARE

	<b>2018</b>	2017 <sup>(3)</sup>
	<b>cents</b>	cents
<b>A. REPORTING PERIOD VALUES</b>		
<b>Continuing and discontinued operations</b>		
Basic earnings per ordinary share <sup>(1)</sup>	<u><b>39.06</b></u>	<u>39.03</u>
Diluted earnings per ordinary share <sup>(2)</sup>	<u><b>38.30</b></u>	<u>37.72</u>
<b>Continuing operations</b>		
Basic earnings per ordinary share <sup>(1)</sup>	<u><b>40.08</b></u>	<u>39.41</u>
Diluted earnings per ordinary share <sup>(2)</sup>	<u><b>39.26</b></u>	<u>38.07</u>
(1) The basic earnings per ordinary share is determined by dividing the profit or loss attributable to shareholders of the Parent by the weighted average number of shares of the Parent on issue during the reporting year. The treasury shares held in trust are deducted, but earnings attributable to those shares are included.		
(2) Diluted earnings per share is determined by dividing the profit or loss attributable to shareholders of the Parent, adjusted for the finance costs of dilutive convertible instruments, by the weighted average number of ordinary shares and dilutive potential ordinary shares, primarily as a result of debt instruments that possess a conversion feature.		
(3) Prior year comparatives have been re-presented due to the discontinued operations. Refer to Note 6.5.		
	<b>2018</b>	2017
	<b>\$m</b>	\$m
<b>B. RECONCILIATION OF EARNINGS USED IN CALCULATING EARNINGS PER SHARE</b>		
Profit attributable to shareholders of the Parent which is used in calculating basic and diluted earnings per share	<u><b>923</b></u>	929
Finance costs of convertible securities, net of tax	<u><b>38</b></u>	37
Profit attributable to shareholders of the Parent which is used in calculating diluted earnings per share	<u><b>961</b></u>	966
Profit from continuing operations attributable to shareholders of the Parent	<u><b>947</b></u>	938
Loss from discontinued operations attributable to shareholders of the Parent	<u><b>(24)</b></u>	(9)
	<b>2018</b>	2017
	<b>Number of shares in millions</b>	Number of shares in millions
<b>C. RECONCILIATION OF WEIGHTED AVERAGE NUMBER OF ORDINARY SHARES USED IN CALCULATING EARNINGS PER SHARE</b>		
Weighted average number of ordinary shares on issue (adjusted for treasury shares held in trust) used in the calculation of basic earnings per share	<u><b>2,363</b></u>	2,380
<b>Weighted average number of dilutive potential ordinary shares relating to:</b>		
Convertible securities	<u><b>142</b></u>	175
Unvested share-based remuneration rights supported by treasury shares held in trust	<u><b>4</b></u>	6
	<u><b>2,509</b></u>	<u>2,561</u>

## NOTE 4.4 DIVIDENDS

	2018		2017
	Cents per share		Cents per share
	\$m		\$m
<b>A. ORDINARY SHARES</b>			
2018 interim dividend paid on 29 March 2018 (2017: 2017 interim dividend) fully franked at 30% <sup>(1)</sup>	14.0	330	13.0 307
Dividend component of off-market share buy-back fully franked at 30%	-	-	192.0 123
2017 final dividend paid on 9 October 2017 (2017: 2016 final dividend) fully franked at 30% <sup>(2)</sup>	20.0	473	13.0 316
		<u>803</u>	<u>746</u>
<b>B. DIVIDEND NOT RECOGNISED AT REPORTING DATE</b>			
2018 final dividend (2017: 2017 final dividend) fully franked at 30% to be paid on 27 September 2018 <sup>(2)</sup>	20.0	474	20.0 474

- (1) Of the total 2018 interim dividend declared of \$331 million, right and entitlement of \$1 million (2017 interim dividend: \$1 million) to dividends on unallocated treasury shares was waived during the year by the trustee of the IAG Share and Rights Plans Trust.
- (2) Of the total 2017 final dividend declared of \$474 million, right and entitlement of \$1 million (2016 final dividend: nil) to dividends on unallocated treasury shares was waived during the year by the trustee of the IAG Share and Rights Plans Trust.

	2018		2017
	\$m		\$m
<b>C. DIVIDEND FRANKING AMOUNT</b>			
Franking credits available for subsequent financial periods based on a tax rate of 30%		<u>100</u>	<u>115</u>

The consolidated amounts above are calculated from the balance of the franking account as at the end of the reporting period, adjusted for franking credits that will arise from the settlement, after the end of the reporting date, of liabilities or receivables for income tax and dividends and the franking credits that will be utilised for dividends determined but not recognised at the reporting date.

The Company, immediately after payment of the final dividend, will have no further franking credits available for distribution.

### D. DIVIDEND REINVESTMENT

A Dividend Reinvestment Plan (DRP) operates which allows shareholders with ordinary shares to elect to receive their dividend entitlement in the form of ordinary shares of the Company. The price of DRP shares is the VWAP, less a discount if determined by the Directors, calculated over the pricing period (which is at least five trading days) as determined by the Directors for each dividend payment date.

A copy of the terms and conditions for the DRP is available at [www.iag.com.au/shareholder-centre/dividends/reinvestment](http://www.iag.com.au/shareholder-centre/dividends/reinvestment). The DRP for the 2018 interim dividend paid on 29 March 2018 was settled with the on-market purchase of 6.6 million shares priced at \$8.09 per share (based on a VWAP for 10 trading days from 26 February 2018 to 9 March 2018 inclusive, with no discount applied).

### E. RESTRICTIONS THAT MAY LIMIT THE PAYMENT OF DIVIDENDS

There are currently no restrictions on the payment of dividends by the Parent other than:

- the payment of dividends is subject to the provisions of the *Corporations Act 2001* and IAG's constitution;
- the payment of dividends generally being limited to profits, subject to ongoing solvency obligations, and under the APRA Level 2 Insurance Group supervision requirements, IAG is required to obtain approval from APRA before payment of dividends on ordinary shares that exceed the Group's after tax earnings as defined by APRA; and
- no dividends can be paid and no returns of capital can be made on ordinary shares if distributions are not paid on the capital notes or reset exchangeable securities, unless certain actions are taken by IAG. For further details, refer to Note 4.1.

### F. RECOGNITION AND MEASUREMENT

Provision for dividends is made in respect of ordinary shares where the dividends are declared on or before the reporting date, but have not yet been distributed at that date.

**NOTE 4.5 DERIVATIVES**  
**A. REPORTING DATE POSITIONS**

	<b>2018</b>			2017		
	<b>Notional contract amount</b>	<b>Fair value asset</b>	<b>Fair value liability</b>	Notional contract amount	Fair value asset	Fair value liability
	\$m	\$m	\$m	\$m	\$m	\$m
<b>I. Net investment hedges (hedge accounting applied)</b>						
Forward foreign exchange contracts	<b>1,223</b>	<b>11</b>	<b>(15)</b>	922	14	(3)
<b>II. Investment-related derivatives (derivatives without hedge accounting applied)</b>						
Bond futures	<b>2,559</b>	-	-	2,913	-	-
Share price index futures	<b>(28)</b>	-	-	(44)	-	-
Forward foreign exchange contracts	<b>3,394</b>	-	<b>(53)</b>	2,827	29	-
Options	-	-	-	(48)	3	(1)
<b>III. Treasury-related derivatives (derivatives without hedge accounting applied)</b>						
Forward foreign exchange contracts	<b>754</b>	<b>6</b>	<b>(8)</b>	1,160	11	(4)
Interest rate swaps	<b>320</b>	<b>1</b>	-	334	-	(5)

All derivative contracts are expected to be settled within 12 months, except for interest rate swaps which mature in more than three years.

**B. RECOGNITION AND MEASUREMENT**

Derivatives are initially recognised at trade date at fair value, which is determined by reference to current market quotes or generally accepted valuation principles. The investment-related derivatives are presented together with the underlying investments or as payables when the fair value is negative. The treasury-related derivatives are presented as receivables when the fair value is positive or as payables when the fair value is negative.

**I. Hedge accounting**

Hedge accounting may be applied to derivatives designated as hedging instruments provided certain criteria are met. To qualify for hedge accounting, at the inception of the hedge and throughout its life, each hedge must be expected to be highly effective. Actual effectiveness in the range of 80% to 125% must also be demonstrated on an ongoing basis. When it is determined that a derivative for which hedge accounting has been designated is not (or ceases to be) effective, hedge accounting is discontinued prospectively from the date of ineffectiveness. The hedging relationships have been effective throughout the current financial year, or since inception.

The foreign currency exposures arising on translation of net investments in foreign operations are hedged (net investment hedge) using forward exchange contracts and the designation of certain foreign currency borrowings as hedging instruments. The fair value is determined using observable inputs (level 2 in the fair value hierarchy).

Any gain or loss on the net investment hedges relating to the effective portion of the hedge is recognised in equity, while the gain or loss relating to the ineffective portion is immediately recognised in profit or loss. Gains and losses accumulated in the equity reserve are recognised in profit or loss upon the disposal of the foreign operation.

**II. Derivatives without hedge accounting applied**

For derivatives that do not qualify for hedge accounting, the changes in fair value are immediately recognised in profit or loss. Transaction costs for purchases of derivatives are expensed as incurred.

The fair value of the bond futures and share price index futures are measured using a quoted price in an active market (level 1 in the fair value hierarchy), whilst the fair value of the interest rate swaps and forward foreign exchange contracts are determined using observable inputs (level 2 in the fair value hierarchy).

# 5. OTHER BALANCE SHEET DISCLOSURES

## SECTION INTRODUCTION

This section provides disclosures on other components of IAG's financial position, including:

- Goodwill and intangible assets – these balances primarily relate to the difference between the total consideration paid and the net tangible assets acquired in relation to past business acquisitions as well as internally developed capitalised software. These assets support the generation of future earnings and are subject to impairment testing, with finite useful life intangible assets also subject to amortisation. For example, an impairment will arise if future earnings can no longer support the carrying value of the assets in question.
- Income tax – the note summarises both the comprehensive income (profit or loss and other comprehensive income) and balance sheet items related to income tax. The profit or loss disclosure includes a reconciliation between the income tax expense reported and the prima facie amount when applying the Australian company tax rate (30%). The balance sheet disclosure focuses on deferred tax balances, which arise due to timing differences between the accounting treatment of taxable income or expenses and the treatment adopted by the relevant tax authority. For example, IAG recognises a deferred tax asset in relation to the earthquake losses incurred by its New Zealand operations since the 2011 financial year. This asset is expected to unwind over time as the tax benefit recognised for accounting purposes is used to offset future taxable income.
- Provisions – this balance primarily includes employee-related costs, for example an annual leave entitlement representing amounts owing to employees at the balance date based on past service.

## NOTE 5.1 GOODWILL AND INTANGIBLE ASSETS

	GOODWILL	SOFTWARE DEVELOPMENT EXPENDITURE	DISTRIBUTION CHANNELS	CUSTOMER RELATIONSHIPS	BRANDS AND OTHER	TOTAL
	\$m	\$m	\$m	\$m	\$m	\$m
<b>2018</b>						
<b>A. COMPOSITION</b>						
Cost	2,870	872	157	192	125	4,216
Accumulated amortisation and impairment	-	(743)	(122)	(131)	(42)	(1,038)
Net foreign exchange movements	5	(8)	1	4	3	5
Balance at the end of the financial year	<u>2,875</u>	<u>121</u>	<u>36</u>	<u>65</u>	<u>86</u>	<u>3,183</u>
<b>B. RECONCILIATION OF MOVEMENTS</b>						
Balance at the beginning of the financial year	2,974	99	66	90	103	3,332
Additions acquired and developed	-	81	-	3	-	84
Disposal through sale of businesses	(15)	-	-	(1)	-	(16)
Net movement in discontinued operations	-	2	-	-	(1)	1
Transfers to assets held for sale	(62)	(3)	-	-	-	(65)
Amortisation	-	(58)	(29)	(25)	-	(112)
Amortisation and impairment charged to discontinued operations	-	(1)	-	-	(14)	(15)
Net foreign exchange movements	(22)	1	(1)	(2)	(2)	(26)
Balance at the end of the financial year	<u>2,875</u>	<u>121</u>	<u>36</u>	<u>65</u>	<u>86</u>	<u>3,183</u>
<b>2017</b>						
<b>C. COMPOSITION</b>						
Cost	2,947	798	157	190	125	4,217
Accumulated amortisation and impairment	-	(690)	(93)	(105)	(29)	(917)
Net foreign exchange movements	27	(9)	2	5	7	32
Balance at the end of the financial year	<u>2,974</u>	<u>99</u>	<u>66</u>	<u>90</u>	<u>103</u>	<u>3,332</u>
<b>D. RECONCILIATION OF MOVEMENTS</b>						
Balance at the beginning of the financial year	2,982	132	96	93	107	3,410
Additions acquired and developed	20	22	-	21	-	63
Disposal through sale of businesses	(26)	-	(1)	-	-	(27)
Amortisation	-	(54)	(29)	(24)	(4)	(111)
Net foreign exchange movements	(2)	(1)	-	-	-	(3)
Balance at the end of the financial year	<u>2,974</u>	<u>99</u>	<u>66</u>	<u>90</u>	<u>103</u>	<u>3,332</u>

## E. IMPAIRMENT

An impairment charge is recognised in profit or loss when the carrying value of the asset, or Cash Generating Unit (CGU), exceeds the calculated recoverable amount. The impairment charge for goodwill cannot be subsequently reversed, whereas for identified intangibles the charge can be reversed where estimates used to determine the recoverable amount have changed. For assets with indefinite useful lives, which include goodwill, the recoverability of the carrying value of the assets is reviewed for impairment at each reporting date, or more frequently if events or changes in circumstances indicate that it might be impaired. The carrying amounts of intangible assets with finite useful lives are reviewed at each reporting date by determining whether there is an indication that the carrying values may be impaired. If any such indication exists, the asset is tested for impairment.

### I. Impairment testing of goodwill

For the purpose of impairment testing goodwill is allocated to CGUs. The recoverable amount of goodwill is determined by value-in-use calculations, which estimate the present value of future cash flows by using a post-tax discount rate that reflects current market assessment of the risks specific to the CGUs. The carrying value of identified intangible assets is deducted from the value generated from the cash flow projections to arrive at a recoverable value for goodwill which is then compared with the carrying value of goodwill. Where an impairment is determined, impairment losses relating to CGUs are allocated first to reduce goodwill and then to other CGU assets on a pro-rata basis.

Goodwill is allocated to the following CGUs:

	2018	2017
	\$m	\$m
Australian Consumer division	756	771
Australian Business division	1,479	1,479
New Zealand	640	667
Asia	-	57
	<u>2,875</u>	<u>2,974</u>

The following describes the key assumptions on which management based its cash flow projections to undertake the impairment testing:

- Cash flow forecasts are based on ten-year valuation forecasts for growth and profitability. Twenty-year periods are used only in emerging markets, to enable appropriate phasing to terminal values. The forecast durations reflect the insurance business life cycle and the growth trajectories of portfolios within each of the established and emerging markets.
- Terminal value is calculated using a perpetuity growth formula based on the cash flow forecast at the end of the relevant valuation forecast period, terminal growth rate in profit or premium and, where appropriate, terminal insurance margin. Terminal growth rates and insurance margins are based on past performance and management's expectations for future performance in each segment and country. The terminal growth rate assumptions used in IAG's impairment assessment for significant CGUs as at 30 June 2018 are: Australian Consumer division 4.8% (2017: 4.5%), Australian Business division 4.0% (2017: 4.5%) and New Zealand 3.7% (2017: 3.5%).
- Discount rates reflect a beta and equity risk premium appropriate to IAG, with risk adjustments for individual segments and countries where applicable. The post-tax discount rates used for significant CGUs as at 30 June 2018 are: Australian Consumer division 9.5% (2017: 9.7%), Australian Business division 9.5% (2017: 9.7%) and New Zealand 10.1% (2017: 10.3%).

### II. Impairment testing of identified intangible assets

Where the recoverable amount is determined by a value-in-use calculation, it involves the use of accounting estimates and assumptions to determine the projected net cash flows, which are discounted using an appropriate discount rate to reflect current market assessment of the risk associated with the assets or CGU. A description of the nature of significant intangible assets is provided below:

- The value of distribution channels is derived from future revenue expected to be generated as a result of the existing relationships with the broker networks.
- Customer relationships represent the present value of future profits expected to arise from existing customer relationships (developed prior to acquisition of the business). The assumptions for the useful life and customer attrition rates are determined based on historical information.
- Brands represent the revenue-generating value of the acquired brand and is determined using the relief from royalty method.
- An impairment charge for capitalised software is incurred if there is evidence of obsolescence or significant changes impacting the manner in which an asset is used or expected to be used or evidence indicating the economic performance of the asset is not as intended by management.

## F. RECOGNITION AND MEASUREMENT

All of the goodwill and intangible assets, other than components of capitalised software development expenditure (internally generated), have been acquired.

Intangible assets are initially recorded at cost at the date of acquisition, being the fair value of the consideration. Internally generated intangible assets comprise all directly attributable costs necessary to create, produce and prepare the asset to be capable of operating in the manner intended by management. Goodwill is generated as a result of business acquisition and is initially measured as the excess of the purchase consideration over the fair value of the net identifiable assets and liabilities acquired. At the date of disposal of a business, attributed goodwill is used to calculate the gain or loss on disposal.

Intangible assets with an indefinite useful life, including goodwill and certain brands, are not subject to amortisation but to impairment testing. Intangible assets with finite useful lives are amortised on a straight-line basis over the period in which the related economic benefits are expected to be realised. Amortisation rates and residual values are reviewed annually and any changes are accounted for prospectively. Amortisation is recognised within fee-based, corporate and other expenses in the consolidated statement of comprehensive income, whilst the amortisation of capitalised software is recognised within the insurance profit. The useful lives for each category of intangible assets are as follows:

- capitalised software: up to 3 years;
- distribution channels: 5 to 10 years;
- customer relationships: 5 to 10 years; and
- brands and other: up to 20 years.

## NOTE 5.2 INCOME TAX

	2018 \$m	2017* \$m
<b>A. INCOME TAX EXPENSE</b>		
Current tax	393	350
Deferred tax	(11)	14
Under/(over) provided in prior year	2	(36)
Income tax expense	<u>384</u>	<u>328</u>
<b>Deferred income tax expense/(credit) included in income tax comprises</b>		
Decrease in deferred tax assets	5	55
Decrease in deferred tax liabilities	(16)	(41)
	<u>(11)</u>	<u>14</u>
<b>B. RECONCILIATION OF PRIMA FACIE TAX TO INCOME TAX EXPENSE</b>		
Profit for the year before income tax	<u>1,410</u>	<u>1,343</u>
Income tax calculated at 30% (2017: 30%)	423	403
<b>Amounts which are not deductible/(taxable) in calculating taxable income</b>		
Difference in tax rate	(48)	(31)
Impairment not subject to income tax	11	-
Rebatable dividends	(4)	(5)
Interest on capital notes and convertible preference shares	6	6
Other	(6)	(9)
Income tax expense applicable to current year	382	364
Adjustment relating to prior year	2	(36)
Income tax expense attributable to profit for the year from continuing operations after impact of tax consolidation	<u>384</u>	<u>328</u>
<b>C. DEFERRED TAX ASSETS</b>		
<b>I. Composition</b>		
a. AMOUNTS RECOGNISED IN PROFIT		
Property and equipment	106	88
Employee benefits	78	85
Insurance provisions	113	119
Investments	30	31
Provisions	6	4
Tax losses	396	433
	<u>729</u>	<u>760</u>
b. AMOUNTS RECOGNISED DIRECTLY IN OTHER COMPREHENSIVE INCOME		
Defined benefit superannuation plans	11	12
	<u>740</u>	<u>772</u>
c. AMOUNTS SET-OFF AGAINST DEFERRED TAX LIABILITIES		
	<u>(196)</u>	<u>(227)</u>
	<u>544</u>	<u>545</u>
<b>II. Reconciliation of movements</b>		
Balance at the beginning of the financial year	772	861
Charged to profit or loss	(5)	(55)
Charged to equity	(1)	(11)
Adjustments relating to prior year	11	(23)
Transfers to assets held for sale	(25)	-
Charged to discontinued operations	2	1
Foreign exchange differences	(14)	(1)
Balance at the end of the financial year prior to set-off	<u>740</u>	<u>772</u>

\* Prior year comparatives have been re-presented due to the discontinued operations. Refer to Note 6.5.

### III. Tax losses

The deferred tax assets from tax losses primarily relate to those incurred in IAG's New Zealand business as a result of the Christchurch earthquake events that occurred in 2010 and 2011 and the 2016 Kaikoura earthquake. In the context of the New Zealand Income Tax Act, tax losses carried forward do not expire after a particular period and remain available to offset against future income tax liabilities, provided the 49% continuity of shareholding requirement is met at the listed holding company level.

	2018	2017*
	\$m	\$m
<b>D. DEFERRED TAX LIABILITIES</b>		
<b>I. Composition</b>		
a. AMOUNTS RECOGNISED IN PROFIT		
Investments	67	80
Intangible assets	18	26
Other	<u>108</u>	<u>114</u>
	<b>193</b>	<b>220</b>
b. AMOUNTS RECOGNISED DIRECTLY IN OTHER COMPREHENSIVE INCOME		
Hedges	<u>3</u>	<u>7</u>
	<b>196</b>	<b>227</b>
c. AMOUNTS SET-OFF AGAINST DEFERRED TAX ASSETS		
	<u>(196)</u>	<u>(227)</u>
	<u>-</u>	<u>-</u>
<b>II. Reconciliation of movements</b>		
Balance at the beginning of the financial year	227	258
Credited to profit or loss	(16)	(41)
(Credited)/charged to equity	(4)	2
Adjustments relating to prior year	-	8
Transfers to liabilities held for sale	(12)	-
Charged to discontinued operations	<u>1</u>	<u>-</u>
Balance at the end of the financial year prior to set-off	<u><b>196</b></u>	<u><b>227</b></u>

\* Prior year comparatives have been re-presented due to the discontinued operations. Refer to Note 6.5.

### E. RECOGNITION AND MEASUREMENT

#### I. Income tax

Income tax expense for a reporting year comprises current and deferred tax. Income tax is recognised in profit or loss, except to the extent that it relates to items recognised directly in either equity or other comprehensive income.

#### II. Current tax

Current tax assets and liabilities are the expected tax recoverable or payable on the taxable income for the year, using tax rates for each jurisdiction, and any adjustment to tax payable in respect of previous financial periods. These include any rates or laws enacted or substantially enacted at the balance sheet date.

#### III. Deferred tax

Deferred tax liabilities are recognised for all taxable temporary differences between the carrying amount and tax bases. Deferred tax assets (deductible temporary differences, carried forward unused tax assets and unused tax losses) are recognised to the extent it is probable that future taxable profit will be available to utilise them before the unused tax losses or credits expire. In making this assessment, IAG considers historical trends of profit generation.

The following demonstrates other circumstances when no deferred tax asset or liability is recognised:

- temporary differences if they arose in a transaction, other than a business combination, that at the time of the transaction did not affect either accounting profit or taxable profit or loss;
- temporary differences between the carrying amount and tax bases of investments in subsidiaries where it is probable that the differences will not reverse in the foreseeable future; and
- temporary differences relating to the initial recognition of goodwill.

#### IV. Tax consolidation

The Company and its Australian resident wholly-owned subsidiaries adopted the tax consolidation legislation with effect from 1 July 2002 and are therefore taxed as a single entity from that date. The Company is the head entity within the tax-consolidated group.

## NOTE 5.3 PROVISIONS

	2018	2017*
	\$m	\$m
<b>A. EMPLOYEE BENEFITS</b>		
<b>I. Expense recognised in the consolidated statement of comprehensive income</b>		
Defined contribution superannuation plans	106	111
Defined benefit superannuation plans	6	1
Share-based remuneration	32	22
Salaries and other employee benefits expense	<u>1,472</u>	<u>1,464</u>
	<u>1,616</u>	<u>1,598</u>
<b>II. Provision recognised on the consolidated balance sheet</b>		
Annual leave	87	92
Long service leave	88	91
Cash-based incentive arrangements	97	98
Defined benefit superannuation plans	17	18
Executive performance rights	16	-
Other employee benefits	<u>4</u>	<u>7</u>
	<u>309</u>	<u>306</u>

\* Prior year comparatives have been re-presented due to the discontinued operations. Refer to Note 6.5.

The employee benefits provision includes \$80 million (2017: \$76 million) which is expected to be settled after more than 12 months from reporting date.

	2018	2017
	\$m	\$m
<b>B. RESTRUCTURING PROVISION</b>		
Balance at the beginning of the financial year	23	26
Additions	29	25
Amounts settled	<u>(34)</u>	<u>(28)</u>
Balance at the end of the financial year	<u>18</u>	<u>23</u>

The provision primarily comprises restructuring costs in respect of the operating model changes in Australia. All provision outstanding at the reporting date is expected to be settled within 12 months (2017: all).

## C. RECOGNITION AND MEASUREMENT

### I. Annual leave

Liability for annual leave is recognised at the nominal amounts unpaid at the reporting date using remuneration rates that are expected to be paid when the liability is settled, including on-costs.

### II. Long service leave

A liability for long service leave is recognised as the present value of estimated future cash outflows to be made in respect of services provided by employees up to the reporting date. The estimated future cash outflows are discounted using corporate bond yields which have terms to maturity that match, as closely as possible, the estimated future cash outflows. Factors which affect the estimated future cash outflows such as expected future salary increases, experience of employee departures and period of service, are incorporated in the measurement.

### III. Short-term incentive plan

The short-term incentive plan continued in operation during the current reporting year. Under the plan, eligible employees have the capacity to earn an incentive, calculated as a proportion of their base salary, which is paid in cash each year. The incentive opportunity is set depending on an employee's role and responsibilities. The majority of employees are on a 10%, 15% or 20% plan. The incentive payments are determined based on an assessment of individual performance and achievement of a range of Group, business unit and individual goals.

### IV. Superannuation

For defined benefit superannuation plans, the net financial position of the plans is recognised on the balance sheet and the movement in the net financial position is recognised in profit or loss, except for remeasurements of defined benefit plans (experience adjustments and changes in actuarial assumptions), which are recognised directly in retained earnings. For defined contribution superannuation plans, obligations for contributions are recognised in profit or loss as they become payable.

### V. Executive performance rights

Executive performance rights (EPRs) issued after July 2013 are indeterminate rights in that they can be cash-settled or equity-settled. The choice of settlement is with the Board. Liabilities for the EPRs that are cash-settled are recognised as employee benefit expense over the relevant service period. The liabilities are remeasured to fair value at each reporting date and are presented as employee benefit obligations in the balance sheet.

## VI. Restructuring provision

A restructuring provision is recognised for the expected costs associated with restructuring where there is a detailed formal plan for restructure and a valid expectation has been raised in those persons expected to be affected. The provision is based on the direct expenditure to be incurred which is both directly and necessarily caused by the restructuring and may include termination benefits. It does not include costs associated with ongoing activities. The adequacy of the provision is reviewed regularly and adjusted if required. Revisions to the estimated amount of a restructuring provision are reported in the period in which the revision to the estimate occurs.

# 6. GROUP STRUCTURE

## SECTION INTRODUCTION

This section provides disclosures on the Group structure, including details of the significant controlled entities and equity accounted investments. It also provides details of the significant acquisitions and divestments during the year.

### NOTE 6.1 DETAILS OF SUBSIDIARIES

The following table details IAG's general insurance operations and other significant controlled entities:

	COUNTRY OF INCORPORATION/FORMATION	EXTENT OF BENEFICIAL INTEREST IF NOT 100%	
		2018 %	2017 %
<b>A. ULTIMATE PARENT</b>			
Insurance Australia Group Limited	Australia		
<b>B. SUBSIDIARIES</b>			
<b>I. Australian general insurance operations</b>			
CGU Insurance Limited <sup>(1),(3)</sup>	Australia		
CGU-VACC Insurance Limited <sup>(1),(2)</sup>	Australia		
HBF Insurance Pty Ltd <sup>(1),(2)</sup>	Australia		
IAG Re Australia Limited <sup>(1),(2)</sup>	Australia		
Insurance Australia Limited	Australia		
Insurance Manufacturers of Australia Pty Limited	Australia	<b>70.00</b>	70.00
Mutual Community General Insurance Proprietary Limited <sup>(1),(2)</sup>	Australia	-	
Swann Insurance (Aust) Pty Ltd <sup>(1),(3)</sup>	Australia		
WFI Insurance Limited <sup>(1),(3)</sup>	Australia		
<b>II. New Zealand general insurance operations</b>			
AMI Insurance Limited	New Zealand		
IAG New Zealand Limited	New Zealand		
Lumley General Insurance (NZ) Limited	New Zealand		
<b>III. International insurance operations</b>			
AAA Assurance Corporation <sup>(4)</sup>	Vietnam	<b>73.07</b>	63.17
IAG Re Labuan (L) Berhad	Malaysia		
IAG Re Singapore Pte Ltd	Singapore		
PT Asuransi Parolamas <sup>(4)</sup>	Indonesia	<b>80.00</b>	80.00
Safety Insurance Public Company Limited <sup>(4)</sup>	Thailand	<b>98.61</b>	98.61
<b>IV. Corporate operations</b>			
IAG Finance (New Zealand) Limited	Australia		

(1) On 1 August 2017, all the insurance assets and liabilities of these entities were transferred into a related business, Insurance Australia Limited.

(2) Mutual Community General Insurance Proprietary Limited was deregistered in April 2018, and CGU-VACC Insurance Limited, HBF Insurance Pty Ltd and IAG Re Australia Limited were deregistered in July 2018.

(3) These entities are targeted for deregistration.

(4) On 19 June 2018, IAG announced the sale of its businesses in Thailand, Vietnam and Indonesia. Refer to Note 6.5.

## NOTE 6.2 NON-CONTROLLING INTERESTS

### A. SUMMARISED FINANCIAL INFORMATION

Set out below is summarised financial information (before intercompany eliminations) of controlled entities where significant non-controlling interests exist, being Insurance Manufacturers of Australia Pty Limited of which IAG's beneficial interest is 70%.

	INSURANCE MANUFACTURERS OF AUSTRALIA PTY LIMITED	
	2018	2017
	\$m	\$m
<b>I. Summarised statement of comprehensive income</b>		
Net premium revenue	<u>3,085</u>	<u>2,935</u>
Profit after tax attributable to the Parent entity	<u>186</u>	179
Profit after tax attributable to non-controlling interest	<u>79</u>	77
Other comprehensive income	<u>1</u>	3
Total comprehensive income	<u>266</u>	<u>259</u>
<b>II. Summarised balance sheet</b>		
Total assets	<u>4,136</u>	3,791
Total liabilities	<u>(3,237)</u>	<u>(3,039)</u>
Net assets	<u>899</u>	<u>752</u>
Carrying amount of non-controlling interest	<u>270</u>	<u>226</u>
<b>III. Summarised cash flow</b>		
Net cash flows from operating and investing activities	<u>34</u>	217
Dividends paid to other IAG entities	<u>(83)</u>	(163)
Dividends paid to non-controlling interest	<u>(36)</u>	<u>(68)</u>
Total net cash flows	<u>(85)</u>	<u>(14)</u>

## NOTE 6.3 INVESTMENT IN JOINT VENTURE AND ASSOCIATES

### A. INTERESTS IN JOINT VENTURE AND ASSOCIATES

Summarised information of interests in material associates and joint venture accounted for on an equity basis is as follows:

	COUNTRY OF INCORPORATION/ FORMATION	PRINCIPAL ACTIVITY	CARRYING VALUE		OWNERSHIP INTEREST	
			2018	2017	2018	2017
			\$m	\$m	%	%
AmGeneral Holdings Berhad (AmGeneral)	Malaysia	Insurance underwriting	<u>392</u>	353	<u>49.00</u>	49.00
SBI General Insurance Company Limited (SBI General)	India	Insurance underwriting	<u>139</u>	138	<u>26.00</u>	26.00
Other			<u>26</u>	<u>14</u>		
			<u>557</u>	<u>505</u>		

During the reporting period, IAG has undertaken an assessment of the recoverable amount of its Asian assets. In aggregate, this has given rise to a write-down totalling \$50 million. The write-down reflects updated assumptions and forecasts in relation to the current operating landscape affecting both the investment in associates and select identifiable intangibles. The related expense has been presented within 'Fee-based, corporate and other expenses' and 'Loss after income tax from discontinued operations' in the statement of comprehensive income. Where applicable, in addition to the impact of the write-down, the movement in carrying values shown above also includes the net impact of current period earnings and changes in exchange rates. The post-tax discount rates applied for valuation purposes have remained unchanged since 30 June 2017.

## B. SUMMARISED FINANCIAL INFORMATION

Summarised financial information of material associates is provided below. The summarised financial information represents the financial position and performance of the entities as a whole (100% stand-alone basis) and not just IAG's share. The financial statements below are for the year ended 31 March 2018.

	<b>AmGeneral Holdings Berhad \$m</b>	<b>2018 SBI General Insurance Company Limited \$m</b>	AmGeneral Holdings Berhad \$m	2017 SBI General Insurance Company Limited \$m
<b>I. Summarised statement of comprehensive income</b>				
Revenue	<u>519</u>	<u>784</u>	<u>543</u>	<u>580</u>
Profit after tax	<u>74</u>	<u>79</u>	<u>53</u>	<u>30</u>
Other comprehensive (expense)/income	<u>(1)</u>	<u>-</u>	<u>1</u>	<u>-</u>
Total comprehensive income	<u><u>73</u></u>	<u><u>79</u></u>	<u><u>54</u></u>	<u><u>30</u></u>
<b>II. Summarised balance sheet</b>				
Total assets	<u>1,982</u>	<u>1,185</u>	<u>1,643</u>	<u>957</u>
Total liabilities	<u>(1,198)</u>	<u>(887)</u>	<u>(1,024)</u>	<u>(736)</u>
Net assets as at reporting date	<u><u>784</u></u>	<u><u>298</u></u>	<u><u>619</u></u>	<u><u>221</u></u>
IAG's ownership interest	<u>384</u>	<u>77</u>	<u>303</u>	<u>58</u>
Other adjustments*	<u>8</u>	<u>62</u>	<u>50</u>	<u>80</u>
Carrying value as at 30 June	<u><u>392</u></u>	<u><u>139</u></u>	<u><u>353</u></u>	<u><u>138</u></u>

\* Other adjustments include IFRS adjustments, foreign exchange revaluations, goodwill, intangibles and share of profit/(loss) from financial statement date to 30 June.

None of the associates are listed on a stock exchange. Those entities that do not have a 30 June financial year end are equity accounted using financial information for the reporting year to 30 June which includes, at least in part, unaudited management results.

## C. RECOGNITION AND MEASUREMENT

IAG's investments in its associates and joint ventures are accounted for using the equity method and are those entities over which it exercises significant influence or joint control, generally reflecting a shareholding of between 20% and 50% of the voting rights of an entity. The investment in associates is initially recognised at cost (fair value of consideration provided plus directly attributable costs) and subsequently adjusted for the post-acquisition change in the investor's share of net assets of the investee. The investor's share of the profit or loss of the investee is included in the profit or loss of IAG and disclosed as a separate line in the consolidated statement of comprehensive income. Distributions received reduce the carrying amount of the investment and are not included as dividend revenue of IAG. Movements in the total equity of the investee that are not recognised in the profit or loss of the investee are recognised directly in equity of IAG and disclosed in the statement of changes in equity. The carrying values of the investments are reviewed annually for impairment.

Where an entity either began or ceased to be an associate during the current financial reporting year, the investment is equity accounted from the date significant influence commenced or up to the date significant influence ceased.

The financial statements of associates are adjusted where necessary to comply with the significant accounting policies of IAG.

When the investor's share of losses exceeds its interest in the investee, the carrying amount of the investment is reduced to nil and recognition of further losses is discontinued except to the extent that the investor has incurred obligations or made payments on behalf of the investee.

## NOTE 6.4 PARENT ENTITY DISCLOSURES

The ultimate Parent entity in the Group is Insurance Australia Group Limited, which is incorporated in Australia. The following information of the Parent entity is disclosed as required by the current regulatory requirements in Australia.

	2018	PARENT 2017
	\$m	\$m
<b>A. FINANCIAL RESULTS</b>		
Profit for the year	<u>1,428</u>	<u>467</u>
Total comprehensive income for the year, net of tax	<u>1,428</u>	<u>467</u>
<b>B. FINANCIAL POSITION</b>		
Current assets	12	16
Total assets	10,789	12,221
Current liabilities	159	171
Total liabilities	<u>1,563</u>	<u>3,619</u>
<b>C. SHAREHOLDERS' EQUITY</b>		
Share capital	7,082	7,082
Retained earnings	<u>2,144</u>	<u>1,520</u>
Total shareholders' equity	<u>9,226</u>	<u>8,602</u>

The Group's consolidation of its nine Australian insurance licences into two, which occurred on 1 August 2017, had the combined effect on the Parent entity of a reduction in both non-current assets and non-current liabilities resulting from the return of capital from its seven subsidiary entities whose operations ceased on completion of the transfer of their insurance assets and liabilities to a related entity, Insurance Australia Limited. The restructure has also caused the upstreaming of material dividends, which largely explains the increase in the profit for the Parent entity during the year. The consolidation of insurance licences had no impact to the Group's consolidated financial performance or position.

### D. CONTINGENT LIABILITIES

There are no known material exposures to the Parent or events that would require it to satisfy the guarantees or take action under a support agreement (2017: nil).

#### Recognition and measurement

Contingent liabilities are not recognised on the balance sheet but are disclosed where the possibility of settlement is less than probable but more than remote. Provisions are not required with respect to these matters as it is not probable that a future sacrifice of economic benefits will be required or the amount is not reliably measurable. If settlement becomes probable, a provision is recognised. The best estimate of the settlement amount is used in measuring a contingent liability for disclosure.

### E. COMMITMENTS

The Parent has no material commitments (2017: nil).

## NOTE 6.5 DISCONTINUED OPERATIONS

On 19 June 2018, IAG announced it had entered into a sale agreement with Tokio Marine & Nichido Fire Insurance Co., Ltd (Tokio Marine) for IAG's operations in Thailand and Indonesia. Separate to the transactions with Tokio Marine, IAG has reached an agreement to sell its interest in AAA Assurance Corporation, based in Vietnam. All transactions are expected to conclude in the financial year ending 30 June 2019, subject to regulatory approvals or notifications. As a result of the sale agreements, these consolidated Asian businesses have been identified as discontinued operations in the current financial year and comparative figures have been re-presented accordingly.

	2018	2017
	\$m	\$m
<b>A. RESULTS OF DISCONTINUED OPERATIONS</b>		
Revenue	493	510
Expenses	<u>(516)</u>	<u>(519)</u>
Loss before income tax	(23)	(9)
Income tax expense	<u>(2)</u>	<u>(1)</u>
Loss for the year from discontinued operations	<u>(25)</u>	<u>(10)</u>
Other comprehensive income, net of tax	<u>1</u>	<u>1</u>
Total comprehensive loss from discontinued operations	<u>(24)</u>	<u>(9)</u>
Loss for the year attributable to shareholders of the Parent	(24)	(9)
Loss for the year attributable to non-controlling interests	<u>(1)</u>	<u>(1)</u>
Loss for the year from discontinued operations	<u>(25)</u>	<u>(10)</u>
Total comprehensive loss for the year attributable shareholders of the Parent	(23)	(8)
Total comprehensive loss for the year attributable non-controlling interests	<u>(1)</u>	<u>(1)</u>
Total comprehensive loss from discontinued operations	<u>(24)</u>	<u>(9)</u>
<b>B. EARNINGS PER SHARE FROM DISCONTINUED OPERATIONS</b>		
Basic earnings per share, from discontinued operations – cents per share	<u>(1.02)</u>	<u>(0.38)</u>
Diluted earnings per share, from discontinued operations – cents per share	<u>(0.96)</u>	<u>(0.35)</u>
<b>C. CASH FLOW FROM DISCONTINUED OPERATIONS</b>		
Net cash flows from operating activities	(47)	7
Net cash flows from investing activities	34	16
Net cash flows from financing activities	<u>(4)</u>	<u>(4)</u>
Net cash flows for the year from discontinued operations	<u>(17)</u>	<u>19</u>

## D. ASSETS AND LIABILITIES HELD FOR SALE

Assets and liabilities related to the Group's consolidated businesses in Thailand, Vietnam and Indonesia, that have been classified as held for sale are included in the table below:

	2018
	\$m
Cash held for operational purposes	32
Investments	282
Trade and other receivables	72
Reinsurance and other recoveries on outstanding claims	52
Deferred insurance expenses	111
Other assets	41
Goodwill and intangible assets	<u>65</u>
Total assets held for sale	<u>655</u>
Trade and other payables	65
Outstanding claims liability	157
Unearned premium liability	206
Other liabilities	<u>16</u>
Total liabilities held for sale	<u>444</u>

# 7. UNRECOGNISED ITEMS

## SECTION INTRODUCTION

This section provides an overview of those items that are not required to be recognised in the financial statements, but may have informative content in relation to IAG's performance or financial position and are required to be disclosed under the accounting standards. These include:

- contingencies – these primarily relate to contingent liabilities that are only recognised in the financial statements when their settlement becomes probable or the amount to be settled can be reliably measured;
- commitments – this note provides information on IAG's future contractual obligations, which includes those in relation to signed property lease agreements; and
- events subsequent to reporting date – information is included on non-adjusting events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue. For example, disclosure of the final dividend in relation to a financial year as it is declared to be paid by the Board subsequent to the reporting date.

## NOTE 7.1 CONTINGENCIES

In the normal course of business, transactions are entered into that may generate a range of contingent liabilities. These include litigation arising out of insurance policies and IAG's undertakings for maintenance of net worth and liquidity support to subsidiaries. Such undertakings constitute a statement of present intent only and are not intended to give rise to any binding legal obligation. The Directors are of the opinion that provisions are not required in respect of these matters, as it is either not probable that a future sacrifice of economic benefits will be required or the amount is not capable of reliable measurement.

IAG conducts fiduciary activities in the form of investment management as it operates as manager, custodian or trustee for a number of investments and trusts. The funds managed on behalf of third parties which are not included in IAG's balance sheet had a fair value as at the reporting date of \$335 million (2017: \$335 million).

## NOTE 7.2 COMMITMENTS

	2018	2017
	\$m	\$m
<b>A. OPERATING LEASE COMMITMENTS</b>		
<b>I. Property</b>		
Due within 1 year	84	120
Due within 1 to 2 years	89	104
Due within 2 to 5 years	237	257
Due after 5 years	<u>559</u>	<u>642</u>
	<b>969</b>	<b>1,123</b>
<b>II. Equipment</b>		
Due within 1 year	25	31
Due within 1 to 2 years	13	22
Due within 2 to 5 years	<u>32</u>	<u>6</u>
	<b>70</b>	<b>59</b>
	<b><u>1,039</u></b>	<b><u>1,182</u></b>

## B. RECOGNITION AND MEASUREMENT

Certain properties, motor vehicles and computer equipment are leased under non-cancellable operating leases. Most leases are subject to annual review and, where appropriate, a right of renewal has been incorporated into the lease agreements. There are no options to purchase the relevant assets on expiry of the lease.

Operating lease payments are recognised as an expense in the consolidated statement of comprehensive income on a straight-line basis over the term of the lease. The operating lease incentives received are initially recognised as a liability, presented as trade and other payables and are subsequently reduced through recognition in profit or loss on a straight-line basis over the period of the lease.

## NOTE 7.3 EVENTS SUBSEQUENT TO REPORTING DATE

As the following events occurred after reporting date and did not relate to conditions existing at reporting date, no account has been taken of them in the financial statements for the current reporting year ended 30 June 2018. These include:

- On 15 August 2018, the Board determined to pay a final dividend of 20.0 cents per share, 100% franked. The dividend will be paid on 27 September 2018. The DRP will operate by acquiring shares on-market for participants with no discount applied.
- On 15 August 2018, IAG announced a capital management initiative amounting to 25.0 cents per ordinary share, or \$592 million, expected to comprise a 19.5 cents capital return and a 5.5 cents fully franked special dividend, with a share consolidation which would reduce IAG's ordinary issued shares by approximately 2.4% and preserve consistency of EPS calculation. The capital return and share consolidation are subject to shareholder approval at the AGM, and IAG has made payment of the special dividend conditional on approval being obtained. If approved, the capital management initiative is expected to occur on or around 26 November 2018.

# 8. ADDITIONAL DISCLOSURES

## SECTION INTRODUCTION

This section includes other information that must be disclosed to comply with the Accounting Standards, Corporations Act and ASX Listing Rules, but which are considered less relevant to understanding IAG's performance or financial position.

### NOTE 8.1 NOTES TO THE CONSOLIDATED CASH FLOW STATEMENT

	2018	2017
	\$m	\$m
<b>A. COMPOSITION OF CASH AND CASH EQUIVALENTS</b>		
Cash held for operational purposes	448	424
Cash and short-term money held in investments	753	1,056
Cash and cash equivalents in discontinued operations	144	-
Cash and cash equivalents	<u>1,345</u>	<u>1,480</u>
<b>B. RECONCILIATION OF PROFIT FOR THE YEAR TO NET CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Profit for the year	1,001	1,005
<b>I. Non-cash items</b>		
Net gains on investments	(31)	(76)
Amortisation of intangible assets and impairment	161	111
Depreciation of property and equipment	58	52
Other non-cash items	(1)	11
<b>II. Movement in operating assets and liabilities</b>		
Insurance assets	(1,335)	(577)
Insurance liabilities	(70)	(411)
Net movement in other operating assets and liabilities	174	352
Net movement in tax assets and liabilities	(9)	210
Provisions	(1)	(41)
Net cash flows from operating activities	<u>(53)</u>	<u>636</u>

### C. SIGNIFICANT NON-CASH TRANSACTIONS RELATING TO FINANCING AND INVESTING TRANSACTIONS

There were no financing or investing transactions during the year which have had a material effect on the assets and liabilities that did not involve cash flows.

### D. RECOGNITION AND MEASUREMENT

Cash and cash equivalents represent cash at bank and on hand, deposits at call and short-term money held in investments, net of any bank overdraft. Money held in investments is readily convertible to cash within two working days and subject to insignificant risk of change in value. The majority of the amounts bear variable rates of interest based on daily bank deposit rates. Those balances bearing a fixed rate of interest mature in less than one year.

### NOTE 8.2 RELATED PARTY DISCLOSURES

#### A. KEY MANAGEMENT PERSONNEL

##### I. Details of compensation

Key management personnel (KMP) are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any Director (whether Executive or otherwise) of that entity. It is important to note that the Company's Non-Executive Directors are specifically required to be included as KMP in accordance with AASB 124 *Related Party Disclosures*. However, the Non-Executive Directors do not consider that they are part of 'management'. The aggregate compensation disclosed in the table below represents the KMP's estimated compensation received from IAG in relation to their involvement in the activities within the Group.

	2018	2017
	\$000	\$000
Short-term employee benefits	14,098	19,074
Post-employment benefits	326	533
Other long-term benefits	89	145
Termination benefits	810	600
Share-based payments	8,769	8,974
	<u>24,092</u>	<u>29,326</u>

The reduction in KMP compensation compared to the prior financial year reflects the lower number of individuals that met the refined KMP definition, as outlined in the Remuneration Report.

## II. Other benefits

Remuneration does not include premiums paid by IAG for an insurance contract covering current and former Non-Executive Directors' and Executives' liabilities and legal expenses incurred in respect of the relevant office, as the insurance policies do not specify premiums paid on behalf of specific individual Non-Executive Directors and Executives and the terms of the contract specifically prohibit the disclosure of the premium paid. Insurance products provided by IAG are available to all Non-Executive Directors and Executives on the same terms and conditions available to other employees.

### NOTE 8.3 REMUNERATION OF AUDITORS

	2018	2017
	\$000	\$000
<b>A. KPMG</b>		
Audit of the financial statements prepared for the Parent and subsidiaries	7,762	8,098
Audit of statutory returns in accordance with regulatory requirements	585	1,059
Other assurance services	121	126
Advisory services	2,620	1,233
Total remuneration of auditors	<u>11,088</u>	<u>10,516</u>

In relation to the Royal Commission, IAG has engaged external legal advisors. As part of this engagement, the legal advisors have appointed IAG's auditors, KPMG, to provide project administration, documentation and preparation assistance, process and control review and testing and general assistance. During the 2018 financial year, the costs incurred for this engagement relating to KPMG totalled \$1,503 thousand, which have been presented within advisory services costs above.

### NOTE 8.4 NET TANGIBLE ASSETS

	2018	2017
	\$	\$
Net tangible assets per ordinary share	<u>1.47</u>	<u>1.36</u>

Net tangible assets per ordinary share have been determined using the net assets on the balance sheet adjusted for non-controlling interests, intangible assets and goodwill.

### NOTE 8.5 IMPACT OF NEW AUSTRALIAN ACCOUNTING STANDARDS ISSUED

#### A. ISSUED AND EFFECTIVE

The new Australian Accounting Standards and Interpretations applicable for the current reporting year are given below. The adoption of these standards did not have a material financial impact:

TITLE	DESCRIPTION
AASB 2016-1	Amendments to Australian Accounting Standards – Recognition of Deferred Tax Assets for Unrealised Losses [AASB 112]
AASB 2016-2	Amendments to Australian Accounting Standards – Disclosure Initiative: Amendments to AASB 107
AASB 2017-2	Amendments to Australian Accounting Standards – Further Annual Improvements 2014-2016 Cycle
AASB 1048	Interpretation of Standards

#### B. ISSUED BUT NOT YET EFFECTIVE

As at the date of this financial report, there are a number of new and revised accounting standards published by the Australian Accounting Standards Board for which the mandatory application dates fall after the end of this current reporting year.

None of these standards have been early adopted and applied in the current reporting year.

TITLE	DESCRIPTION	OPERATIVE DATE	NOTE
AASB 9	Financial Instruments	1 January 2018	A
AASB 15	Revenue from Contracts with Customers	1 January 2018	A
AASB 16	Leases	1 January 2019	A
AASB 17	Insurance	1 January 2021	B
AASB 2010-7	Amendments to Australian Accounting Standards arising from AASB 9	1 January 2018	A
AASB 2014-1 (Part E)	Amendments to Australian Accounting Standards – Financial Instruments	1 January 2018	A
AASB 2014-7	Amendments to Australian Accounting Standards arising from AASB 9 (December 2014)	1 January 2018	A
AASB 2014-10	Amendments to Australian Accounting Standards – Sale or Contribution of Assets between an Investor and its Associate	1 January 2022	A
AASB 2015-8	Amendments to Australian Accounting Standards – Effective Date of AASB 15	1 January 2022	A
AASB 2015-10	Amendments to Australian Accounting Standards – Effective Date of Amendments to AASB 10 and AASB 128	1 January 2022	A
AASB 2016-3	Amendments to Australian Accounting Standards – Clarifications to AASB 15	1 January 2018	A

TITLE	DESCRIPTION	OPERATIVE DATE	NOTE
AASB 2016-5	Classification and Measurement of Share-based Payment Transactions	1 January 2018	A
AASB 2016-6	Applying AASB 9 Financial Instruments with AASB 4 Insurance Contracts	1 January 2018	A
AASB 2017-3	Amendments to Australian Accounting Standards – Clarifications to AASB 4	1 January 2018	A
AASB 2017-6	Amendments to Australian Accounting Standards – Prepayment Features with Negative Compensation	1 January 2019	A
AASB 2017-7	Amendments to Australian Accounting Standards – Long-term Interests in Associates and Joint Ventures	1 January 2019	A
AASB 2018-1	Amendments to Australian Accounting Standards – Annual Improvements 2015–2017 Cycle	1 January 2019	A
AASB 2018-2	Amendments to Australian Accounting Standards – Plan Amendment, Curtailment or Settlement	1 January 2019	A
AASB Interpretation 22	Foreign Currency Transactions and Advance Consideration	1 January 2018	A
AASB Interpretation 23	Uncertainty over Income Tax Treatments, and relevant amending standards	1 January 2019	A
Conceptual Framework	Amendments to standards to apply the new definition and recognition criteria in the Conceptual Framework for Financial Reporting	1 January 2020	A

#### TABLE NOTE

A These changes are not expected to have a significant, if any, financial and disclosure impact.

B The changes may have financial impact, however the assessment has not been completed yet.

The Australian Accounting Standards and amendments detailed in the table above are not mandatory for IAG until the operative dates stated, however, early adoption is permitted. IAG currently plans to apply the standards and amendments detailed above for the reporting periods beginning on or after the operative dates set out above.

AASB 9 was issued during 2014 and will replace existing accounting requirements for financial instruments. Currently, IAG's investments are designated as at fair value through profit or loss on initial recognition and are subsequently remeasured to fair value at each reporting date, reflecting the business model applied by IAG to manage and evaluate its investment portfolio. Under this business model, the adoption of AASB 9 is not expected to result in significant changes to accounting for investments. Other changes to the accounting for IAG's financial instruments arising from the application of AASB 9 are expected to be minimal.

AASB 15 introduces a single model for the recognition of revenue based on when control of goods and services transfers to a customer. It does not apply to insurance contracts and financial instruments. Hence the majority of IAG's revenue is not impacted by this change.

AASB 16 was issued during 2016 and will replace existing accounting requirements for leases. Under current requirements, leases are classified based on their nature as either finance leases, which are recognised on the balance sheet, or operating leases, which are not recognised on the balance sheet. The application of AASB 16 will result in the recognition of all leases on the balance sheet in the form of a right-of-use asset and a corresponding lease liability, except for leases of low value assets and leases with a term of 12 months or less. As a result, the new standard is expected to impact leases which are currently classified by IAG as operating leases, primarily, leases over premises and equipment. Based on preliminary assessments, the resulting amount to be recognised, in effect as a gross up to the balance sheet, is expected to be approximately \$775 million. This is based on lease commitments and discount rates as at 30 June 2018.

AASB 17, a new accounting standard for insurance contracts, was adopted by the Australian Accounting Standards Board on 19 July 2017 subsequent to being issued by the International Accounting Standards Board on 18 May 2017. The standard is effective for periods beginning 1 January 2021. The first applicable reporting period for IAG will be for the year ending 30 June 2022, with the comparative period for the year ending 30 June 2021. The standard introduces a new general measurement model for accounting for insurance contracts, with the application of a simplified approach (similar to AASB 1023) permitted in certain circumstances. IAG is currently undertaking a detailed impact assessment of the new standard. There are changes in the presentation of the financial statements and disclosures anticipated. Due to the complexity of the requirements within the standard the final impact of certain requirements may not be determined until global interpretations and regulatory responses to the new standard are developed.