INDEPENDENT AUDITOR'S REPORT

TO THE SHAREHOLDERS OF INSURANCE AUSTRALIA GROUP LIMITED

REPORT ON THE AUDIT OF THE FINANCIAL REPORT

Opinion

We have audited the Financial Report of Insurance Australia Group Limited (Company).

In our opinion, the accompanying Financial Report of the Company is in accordance with the *Corporations Act 2001*, including:

- giving a true and fair view of the Group's financial position as at 30 June 2017 and of its financial performance for the year ended on that date; and
- complying with *Australian Accounting Standards* and the *Corporations Regulations 2001*.

The Financial Report comprises:

- Consolidated balance sheet as at 30 June 2017;
- Consolidated statement of comprehensive income, Consolidated statement of changes in equity, and Consolidated cash flow statement for the year then ended;
- Notes including a summary of significant accounting policies; and
- Directors' declaration.

The Group consists of the Company and the entities it controlled at the year-end or from time to time during the financial year.

Basis for opinion

We conducted our audit in accordance with *Australian Auditing Standards*. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Our responsibilities under those standards are further described in the *Auditor's responsibilities for the audit of the Financial Report* section of our report.

We are independent of the Group in accordance with the *Corporations Act 2001* and the ethical requirements of the *Accounting Professional and Ethical Standards Board's APES 110 Code of Ethics for Professional Accountants* (the Code) that are relevant to our audit of the Financial Report in Australia. We have fulfilled our other ethical responsibilities in accordance with the Code.

Key Audit Matters

The Key Audit Matters we identified are:

- Valuation of Gross outstanding claims liability
- Valuation of Reinsurance and other recoveries on outstanding claims
- Valuation of Goodwill and Investment in joint venture and associates

Key Audit Matters are those matters that, in our professional judgement, were of most significance in our audit of the Financial Report of the current period.

These matters were addressed in the context of our audit of the Financial Report as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Valuation of Gross outstanding claims liability ($11,371 million)

Refer to Note 2.2 of the Financial Report

The key audit matter

Gross outstanding claims liability is a key audit matter as a result of significant complexity relating to:

Valuation of gross outstanding claims liability

The valuation of gross outstanding claims liability is significant to the Key Audit Matter as:

- judgement is required by us to consider the central estimate of the gross outstanding claims liability which is a significant estimate as the eventual outcomes of incurred but unsettled claims at the balance sheet date are inherently uncertain;
- there is a lower level of information available and a greater level of uncertainty inherent in assessing estimations of claims that have been incurred by the balance sheet date but have not yet been reported to the Group, including where there has been a recent natural catastrophe, such as the Kaikoura earthquake in November 2016 and Cyclone Debbie in late March 2017;
- judgement is required when considering the application of historical experience of claims development to determine current estimates, including the greater variability between the original estimation and the ultimate settlement of claims where there is a long time delay between the claim being incurred and the ultimate settlement. Examples include claims arising from Workers' Compensation, Liability, Compulsory Third Party (CTP) and the main Canterbury earthquakes of September 2010 and February 2011;
- the claims estimation uses an actuarial modelling process which involves complex and subjective actuarial methodologies, judgements and assumptions about future events and developments, both within and external to the Group, and for which small changes can have significant implications to the quantification, as outlined in Note 2.2(E);
- the Canterbury earthquake claims require judgement and technical actuarial expertise to evaluate the attribution of claims costs between the September 2010 and the February 2011 Canterbury earthquake events;
- judgement is required to assess the estimation of the periods the claims are expected to be settled in;
- the estimation of claims at year end relies on the integrity of the underlying data, including claim payments and individual estimates of unsettled claims, which is gathered from many different systems; and
- we involve senior resources, with deep industry experience, together with our actuarial specialists in evaluating the Group's estimations of outstanding claims.

How the matter was addressed in our audit

Our procedures included:

Valuation of gross outstanding claims liability

We adopted a risk based approach to determine which classes of business posed higher claims estimation risks. Factors that influenced the risk assessment included level of judgement required, higher degrees of uncertainty regarding the assumptions adopted, longer delays between claims being incurred, reported and expected settlement, greater relative magnitude in size, and more significant variations over prior estimates.

For the higher risk areas identified, such as Workers' Compensation, Liability, CTP and the main Canterbury earthquakes, we:

- compared the Group's actuarial methodologies with the methodologies applied in the industry and in prior periods;
- evaluated the Group's governance processes, including Management Reserving Committees and actuarial control cycles for the valuation of the outstanding claims liabilities;
- evaluated the appropriateness of the actuarial methodologies and the assumptions applied in the previous reporting period by comparing the actual claims development to the prior year claims liability estimate and considering their accuracy. We used the information to assess the adjustments made to the current year's actuarial methodologies and assumptions applied in the estimation;
- challenged key actuarial assumptions, including loss ratios, claim frequency and average size of claims, expected trends in court settlements and jury awards, and allowance for future claims inflation. Further we evaluated the attribution of losses to Canterbury earthquake events, by comparing these to our expectations based on the Group's historical experience, our industry knowledge and independently observable trends; and
- considered judgements required to estimate the period in which the claims will be settled by analysing historical payment patterns and assessing any significant changes.

For certain classes of business, we independently projected the gross outstanding claims liability by applying our own actuarial methodologies and selecting assumptions for those methodologies. We used this re-projection to compare our results to the Group's estimates and challenge any significant differences.

We were assisted by KPMG actuarial specialists in interpreting and evaluating the Group's actuarial modelling processes and methodology for determining the level of provisions for gross outstanding claims liabilities. We also considered the work and findings of external, independent actuaries, engaged by the Group.

Our procedures around the financial records and controls included, amongst others:

- testing accounting and actuarial controls such as reconciliations of key data;
- testing key controls and a sample of claims case estimates and paid claims, by comparing the Group's estimations for individual claims to third party evidence; and

- using our IT specialists, we tested the general IT environment as well as tested the reconciliations between data on the claims systems (underlying data) and data used in the actuarial modelling processes by evaluating the Group's automated comparison programs which they apply to assess the consistency of the data.

Risk margins and Probability of Adequacy

The evaluation of the risk margins and Probability of Adequacy is significant to the Key Audit Matter as it is complex and necessitated a significant level of judgement by us in our audit.

Outstanding claims include statistically determined risk margins developed by the Group to make allowance for the inherent uncertainty in estimating ultimate claim settlements. The risk margins are included to achieve a specified Probability of Adequacy for the total outstanding claims reserves.

We involved senior resources and our actuarial specialists to focus on the complex statistical processes and parameters used by the Group to establish the risk margins.

Risk margins and Probability of Adequacy

With the assistance of our actuarial specialists we evaluated the appropriateness of the statistical processes to establish the Group's risk margins. In particular, our procedures included:

- assessing the statistical processes' suitability by critically studying these and comparing them to known industry practices, our industry knowledge and other observable trends in industry discussion forums and Actuaries Institute papers;
- assessing the risk margin parameters for significant portfolios by comparing these with external sources of data including published statistics (e.g. APRA-published data), prior periods and our industry knowledge;
- checking the central estimates of outstanding claims, that were tested in the valuation of gross outstanding claims liability processes, and which are a key input into the risk margin model, to the underlying financial records; and
- critically evaluating the Group's judgement in the execution of the statistical processes by comparing the judgements and overall results to our expectations based on the Group's historical experience, our industry knowledge and independent observable trends (e.g. listed competitors).

Valuation of Reinsurance and other recoveries on outstanding claims ($5,258 million)

Refer to Note 2.2 of the Financial Report

The key audit matter

Reinsurance and other recoveries on outstanding claims is a Key Audit Matter as:

- reinsurance and other recoveries, similar to the valuation of gross outstanding claims, are quantified from claims case estimates, paid claims data and estimates of ultimate claims settlement amounts. As such, the rationale for identifying it as a key audit matter is the same as that highlighted for valuation of gross outstanding claims;
- the Group has extensive reinsurance arrangements designed to protect its aggregate exposure to catastrophic claim events. Evaluating the reinsurance transactions accounting across the three reinsurance captive companies, and in the respective insurance companies within the Group requires significant consideration by our senior resources with deep industry knowledge and specialised technical skills; and
- the Group also has a range of significant reinsurance contracts, including the Whole of Account Quota Share, the Catastrophe excess of loss program, Adverse Development Covers in the form of excess of loss contracts, and other Quota Share arrangements, that form part of its capital management. Our consideration of the accounting treatment and recoverability of balances owed by the reinsurer counterparties requires our senior resources, deep industry experience and specialised technical skills.

How the matter was addressed in our audit

In addition to the audit procedures undertaken to assess the valuation of gross outstanding claims liability, our procedures included:

- testing, for a sample of contracts, how the reinsurance and other recoveries on outstanding claims were accounted for, including their processing through the Group's captive reinsurance companies. We referred to the terms of the captive reinsurance contracts, board meeting minutes, our expectations based on the Group's past experience, our industry knowledge, and the insurance accounting standard;
- independently evaluating a sample of reinsurance balances and other recoveries due to the Group arising from the Whole of Account Quota Share contract. We referred to the terms of the reinsurance contract, and applied it to the original underlying claims estimates and paid claims data to recalculate the reinsurance and other recoveries due. These independently generated results were compared to the amounts processed by the Group;
- evaluating a sample of the transactions processed relating to the reinsurance contracts. We tested the consistency of the contract terms to the criteria for the recognition of the transaction contained in those requirements; and
- assessing the recoverability of balances owed by reinsurer counterparties by considering their credit worthiness and capital strength, based on external sources of information, payment history of amounts and evaluation of information for indicators of disputes.

Valuation of Goodwill ($2,974 million) and Investment in joint venture and associates ($505 million)

Refer to Notes 5.1 and 6.3 of the Financial Report

The key audit matter

Valuation of goodwill and investment in joint venture and associates is a Key Audit Matter as:

- judgement is involved in considering the appropriateness of the cash generating units identified by the Group;
- the evaluation of potential impairment involves judgement in relation to forecast cash flows and key variables. Instances where judgement is required include interest rates, risk premium, growth rates, profit measures and terminal growth rates. We focused specifically on those cash generating units and associates where the valuation showed potential impairment indicators, or where there was a significant reduction in the valuation in the period;
- the assessment of the valuation of goodwill, and investment in joint venture and associates, requires the involvement of senior resources from the audit team together with our valuation specialists; and
- the Group uses complex models to perform their annual testing of goodwill for impairment. The models are largely internally developed, use adjusted historical performance, and a range of internal and external sources as inputs to the assumptions. Complex modelling, particularly those containing highly judgemental allocations of corporate assets and costs to cash generating units, using forward-looking assumptions tend to be prone to greater risk for potential bias, error and inconsistent application. These conditions necessitate additional scrutiny by us, in particular to address the objectivity of sources used for assumptions, and their consistent application.

How the matter was addressed in our audit

With the assistance of our valuation specialists, our procedures included:

- evaluating the Group's determination of their cash generating units based on our understanding of the industries in which the Group operates, and our knowledge of the business, including internal management reporting, against the accounting standard requirements;
- performing sensitivity testing, using the Group's models, to evaluate the impact of varying key assumptions. This enabled us to critically challenge the Group's quantification of assumptions and focus our testing to the most sensitive assumptions;
- assessing the Group's quantification of key variables by comparing them to external, observable metrics (e.g. GDP growth and inflation incl. forecasts provided by Oxford Economics and IBIS World), our knowledge of the markets, and current market practice;
- comparing the forecast cash flows to Board approved budgets and business plans, and performing an examination of the accuracy of past budgets to actual cash flows in order to challenge the Group's current forecasts;
- comparing the valuations for certain joint venture and associates to external, independent and observable valuations for broadly similar enterprises, and investigate significant outliers;
- assessing the Group's allocation of corporate assets to cash generating units for consistency based on the requirements of the accounting standards;
- assessing the Group's allocation of corporate costs to the forecasted cash flows contained in the value in use model, based on a reasonable and consistent basis using our understanding of the business; and
- involving our specialists, we evaluated the internally prepared discounted cash flow model. This included:
  - assessing the reasonableness of the valuation approach and methodology against market and industry practices and accounting standards; and
  - assessing the integrity of the models used, including the accuracy of the underlying calculation formulas.

Using our IT specialists, we tested the general IT environment as well as specific system controls in relation to the underlying data used in the valuation models to assess the consistency of the data.

Other Information

Other Information is financial and non-financial information in Insurance Australia Group Limited's annual reporting which is provided in addition to the Financial Report and the Auditor's Report. The Directors are responsible for the Other Information.

Our opinion on the Financial Report does not cover the Other Information and, accordingly, we do not express an audit opinion or any form of assurance conclusion thereon, with the exception of the Remuneration Report.

In connection with our audit of the Financial Report, our responsibility is to read the Other Information. In doing so, we consider whether the Other Information is materially inconsistent with the Financial Report or our knowledge obtained in the audit, or otherwise appears to be materially misstated.

We are required to report if we conclude that there is a material misstatement of this Other Information, and based on the work we have performed on the Other Information that we obtained prior to the date of this Auditor's Report we have nothing to report.

Responsibilities of the Directors for the Financial Report

The Directors are responsible for:

- preparing the Financial Report that gives a true and fair view in accordance with *Australian Accounting Standards* and the *Corporations Act 2001*;
- implementing necessary internal control to enable the preparation of a Financial Report that gives a true and fair view and is free from material misstatement, whether due to fraud or error; and
- assessing the Group's ability to continue as a going concern. This includes disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless they either intend to liquidate the Group or to cease operations, or have no realistic alternative but to do so.

Auditor's responsibilities for the audit of the Financial Report

Our objective is:

- to obtain reasonable assurance about whether the Financial Report as a whole is free from material misstatement, whether due to fraud or error; and
- to issue an Auditor's Report that includes our opinion.

Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with *Australian Auditing Standards* will always detect a material misstatement when it exists.

Misstatements can arise from fraud or error. They are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of this Financial Report.

A further description of our responsibilities for the Audit of the Financial Report is located at the Auditing and Assurance Standards Board website at www.auasb.gov.au/auditors_files/ar2.pdf. This description forms part of our Auditor's Report.

REPORT ON THE REMUNERATION REPORT

Opinion

In our opinion, the Remuneration Report of Insurance Australia Group Limited for the year ended 30 June 2017, complies with *Section 300A* of the *Corporations Act 2001*.

Directors' responsibilities

The Directors of the Company are responsible for the preparation and presentation of the Remuneration Report in accordance with *Section 300A* of the *Corporations Act 2001*.

Our responsibilities

We have audited the Remuneration Report included in pages 16 to 37 of the Directors' report for the year ended 30 June 2017.

Our responsibility is to express an opinion on the Remuneration Report, based on our Audit conducted in accordance with *Australian Auditing Standards*.

KPMG

KPMG

Andrew Yates
Partner

Sydney
23 August 2017

Ian Moyser
Partner