

IASB and FASB discuss significant issues to complete deliberations on insurance contract accounting

Overview

This month, the International Accounting Standards board (IASB) and Financial Accounting Standards Board (FASB) will devote a significant amount of time to the discussion of insurance contracts. They aim to resolve a number of significant issues in order to issue an exposure draft of the new standard in May 2010.

Discussions scheduled in March 2010 are as follows:

Monday, 15 March	Release of residual margins
Tuesday, 16 March	Acquisition costs (jointly with Revenue Recognition and Leases projects)
Wednesday, 17 March	Education session on determining the risk adjustment
Monday, 22 March	Definition of insurance, scope of a new standard, risk adjustments and participating contracts
Tuesday, 23 March	Continuation of previous discussions
Wednesday, 24 March	Disclosures

These discussions are likely to determine significant components of a new standard. The progress made in resolving open questions will determine whether the timetable for release of the exposure draft remains realistic. March 2010 is an important month for insurance reporting.

We summarise below the large volume of materials to be presented at the meetings.

The story so far

A summary of topics discussed and tentative decisions by the IASB and FASB to date, are set out in the table below.

Topic	IASB	FASB
Measurement approach	<p>The Boards decided tentatively that the measurement approach should portray a current assessment of the contract, using the following building blocks:</p> <ul style="list-style-type: none"> ▶ The unbiased, probability-weighted average of future cash flows expected to arise as the insurer fulfils the obligation. ▶ Incorporation of time value of money. ▶ A risk adjustment for the effects of uncertainty about the amount and timing of future cash flows. ▶ An amount that eliminates any gain at inception of the contract. <p>The Boards also tentatively decided that:</p> <ul style="list-style-type: none"> ▶ These building blocks should be used to measure the combination of rights and obligations arising from an insurance contract rather than to measure the rights separately from the obligations. That combination of rights and obligations should be presented on a net basis. ▶ The objective for measuring an insurance contract should refer to a value rather than cost. The Staff will refine the description of that objective. 	
Risk adjustment	<p>The Boards decided tentatively that the risk adjustment should measure the insurer's view of the uncertainty associated with the future cash flows and clarified that:</p> <ul style="list-style-type: none"> ▶ The risk adjustment should be the amount the insurer requires for bearing the uncertainty that arises from having to fulfil the net obligation arising from an insurance contract. The Staff will develop guidance on how to determine the risk adjustment. ▶ The risk adjustment should be updated (remeasured) each reporting period. 	
Non-performance risk	<p>The Boards decided tentatively that the measurement of an insurance liability should not be updated for changes in the risk of non-performance by the insurer.</p>	
Use of inputs	<p>The Boards decided tentatively that the measurement:</p> <ul style="list-style-type: none"> ▶ Consider all available information that represents the fulfilment of the insurance contract. All available information includes, but is not limited to, industry data, historical data of an entity's costs, and market inputs when those inputs are relevant to the fulfilment of the contract, ▶ Should use current estimates of financial market variables that are as consistent as possible with observable market prices. 	
Exclude discounting and margins in some instances?	<p>The IASB noted the arguments for and against an approach that uses an estimate of future cash flows with no margins and no discounting. The IASB also considered whether to use such an approach for non-life claims liabilities and tentatively decided not to add it to the list of candidates.</p>	<p>The FASB will consider at a future meeting whether, in certain instances, a measurement of insurance contracts would use future cash flows with no margins and no discounting.</p>
Unearned premium	<p>The IASB decided tentatively that:</p> <ul style="list-style-type: none"> ▶ An unearned premium approach would provide decision-useful information about pre-claims liabilities of short-duration insurance contracts. ▶ To require rather than permit the use of an unearned premium approach for those liabilities. 	<p>The FASB will discuss an unearned premium approach at a future meeting.</p>
Measurement of margins at inception	<p>In principle, the initial recognition of an insurance contract should not result in the recognition of an accounting profit. In the proposed accounting approach, a loss arises at inception if, after applying a risk adjustment, the expected present value of cash outflows exceeds the expected present value of cash inflows. The Boards tentatively decided that an entity should recognise that loss in profit or loss at inception.</p>	

Topic	IASB	FASB
Subsequent treatment of residual margins	<p>The proposed accounting approach eliminates any gain at inception by including a residual margin in the measurement of the combination of rights and obligations arising from the insurance contracts. The Boards tentatively decided:</p> <ul style="list-style-type: none"> ▶ To develop specific guidance on how the residual margin should be released to profit or loss over time. ▶ That the insurer should not adjust the residual margin in subsequent reporting periods for changes in estimates. 	
Discount rates	<p>The IASB decided tentatively that:</p> <ul style="list-style-type: none"> ▶ The discount rate for insurance liabilities should conceptually adjust estimated future cash flows for the time value of money in a way that captures the characteristics of that liability, rather than using a discount rate based on expected returns on actual assets backing those liabilities. ▶ The standard should not give detailed guidance on how to determine the discount rate. 	<p>The FASB will discuss this issue further at a future meeting.</p>
Acquisition costs	<p>The Boards decided tentatively that an insurer:</p> <ul style="list-style-type: none"> ▶ Should expense all acquisition costs when incurred. ▶ Should not recognise any revenue (or income) to offset those costs incurred. 	
Policyholder behaviour and contract boundaries	<p>The Boards decided tentatively that the policyholder options, as well as options, forwards and guarantees related to existing coverage should be included in the measurement of the insurance contract on a look through basis using the expected value of future cash flows (to the extent that those options are within the boundary of the existing contract). As a consequence, no deposit floor would apply. For a future discussion, the Staff will develop material to identify the boundary of an existing contract.</p> <p>The Staff will do additional analysis as to whether an option pricing model can be used to measure the contract. The Staff intends to provide that information at a future meeting as part of a discussion about risk adjustments.</p> <p>The Boards also discussed how to treat options, forwards, and guarantees that do not relate to the existing insurance contract coverage. The Boards tentatively decided to exclude such features from the measurement of that contract. Instead, those features should be recognised and measured as new insurance contracts or other stand-alone instruments, according to their nature.</p>	
Participating features in insurance contracts	<p>The IASB expressed an initial preference for an approach that includes all cash flows that arise from a participating feature in the measurement of the insurance liability on an expected present value basis.</p>	<p>The FASB expressed an initial preference for an approach that analyses cash flows expected to arise from a participating feature to determine whether those flows are required (e.g., by the contract or by a statute) or are discretionary. Required cash flows (if there are any) will be included in the measurement of the insurance liability. Discretionary cash flows will be recognised when the entity has an obligation to make payments.</p>
Recognition	<p>The IASB discussed the recognition of rights and obligations arising under insurance contracts, including the treatment of the contract in the period (if any) between entering into the contract and the start of the coverage period. No clear consensus emerged. The Boards will return to the topic of recognition at a future meeting.</p>	<p>The FASB tentatively decided that an entity should recognise an insurance obligation at the earlier of: (1) the entity being on risk to provide coverage to the policyholder for insured events; and (2) the signing of the insurance contract.</p>

The story so far (continued)

Topic	IASB	FASB
Derecognition	The IASB discussed derecognition of insurance liabilities and decided tentatively that an insurer should derecognise an insurance liability when it no longer qualifies as a liability of the insurer, applying the derecognition principle in IAS 39 <i>Financial Instruments: Recognition and Measurement</i> .	The FASB tentatively decided on a principle that an insurance liability should be derecognised by an entity when that obligation no longer qualifies as a liability. The liability is eliminated when the entity is no longer on risk and no longer required to transfer any economic resources for that obligation.
Presentation of the performance statement	The Boards decided tentatively that: <ul style="list-style-type: none"> ▶ The measurement approach should drive the presentation model for the performance statement. ▶ The Staff should further develop an expanded margin approach. 	
Other Comprehensive Income (OCI)	The IASB decided tentatively: <ul style="list-style-type: none"> ▶ Not to change the accounting for an insurer's assets. ▶ Not to permit or require the use of OCI for insurance contracts. 	The FASB will discuss OCI at a future meeting.
Assets associated with unit-linked contracts	The Boards decided tentatively that assets and related liabilities associated with unit-linked contracts, including those sometimes described as separate accounts, should be reported as the insurer's assets and liabilities in the statement of financial position. The Boards also decided tentatively not to address in this project issues involving the consolidation of investment funds associated with unit-linked contracts (including separate account contracts). Such issues are within the scope of the project on consolidation.	

Source: IASB Staff Paper 6, Ernst & Young

Release of residual margins and recognition of revenue

The measurement model for insurance contracts proposes using four building blocks:

- ▶ Unbiased, probability-weighted average of expected future cash flows
- ▶ Time value of money
- ▶ A risk adjustment for the effects of uncertainty about the amount and timing of future cash flows; and
- ▶ An amount that eliminates any gain at inception of the contract (residual margins)

Residual margins are in place to eliminate day one differences between: a) expected premiums; and b) expected claims and expenses plus a risk adjustment. These differences are primarily related to acquisition costs, but also result from differences in markets, insurer pricing and the insurance cycle itself. Based on tentative conclusions to date, the residual margins will: a) not be re-measured; b) not be adjusted for changes in estimates; and c) accrete interest due to the time value of money.

Although the Staff recognises that there are alternatives to releasing residual margins into profit and loss, the Staff will recommend that insurers release them over the coverage period

using the expected value of claims and benefits to be incurred in determining the amount and timing of release. The Staff will ask the Boards whether they agree with this recommendation.

Paper 6F sets out the basis for the recommendation above and primarily focuses on consistency with the revenue recognition project, in which, the Boards propose to allocate consideration based on performance under the contract. The Staff believe that 'performance' in the context of an insurance company is the provision of insurance coverage. Therefore, they conclude that revenue should be recognised over the coverage period.

However, the Staff also recognise that, although the period of the contract may be fixed, the exposure for which coverage is provided may vary during that period. Paper 6F uses the example of hurricane coverage in Florida, which may be for an annual period, but the related exposure is not the same throughout. Paper 6F states that an obvious way of estimating exposure is through the expected claims and benefits related to the contract and will recommend this approach to the Boards. The Staff identify alternative treatments for subsequent changes in projected release patterns (update the impact over the whole period vs. over the remaining period), but will re-visit this issue at a later meeting.

In Agenda Paper 6G, the Staff present five worked examples of the release of residual margins under different approaches identified.

Acquisition costs

In paper 6H, the Staff will revisit the topic of the treatment of acquisition costs. Whilst the Boards have tentatively concluded that acquisition costs should be expensed as incurred, subsequent decisions and responses to field testing have indicated to the Staff that the topic should be revisited. The Staff will not present a recommendation due to conflicting views among them.

In addition to the current tentative decision to recognise all costs as an expense when incurred and not recognise a part of the premium as revenue (or income) at inception equal to acquisition costs, the Staff will propose consideration of three potential approaches:

- ▶ Calibrating the contract liability to premiums excluding incremental acquisition costs (i.e., the insurance liability is reduced for incremental acquisition costs)
- ▶ Inclusion of incremental acquisition costs in contractual cash flows to determine residual margin at inception (i.e., the insurance liability is reduced on payment for incremental acquisition costs that were included in the calculation of the liability)
- ▶ Recognition of an intangible asset measured at the amount of incremental acquisition costs and amortised into expense over the life of the contract

The Staff will also raise the question of whether all directly-related and incremental costs would be a better definition of acquisition costs than the present tentative decision to only include the incremental costs of issuing an insurance contract, although no recommendation is given.

Risk adjustment

Paper 6D *Risk adjustment* provides information about the objective of a risk adjustment, as well as an analysis of the numerous methods that may be used to calculate it.

The Staff will ask the Boards to reiterate an earlier decision that the risk adjustment should be the amount the insurer requires for bearing the uncertainty that arises from having to fulfil the net obligation from an insurance contract.

After describing different options (and current practice) for measuring risk adjustments (and similar concepts such as risk margins), the Staff recommend that the future measurement model should not require a particular method for determining a risk adjustment. The Staff believe that the wide range of insurance contracts necessitates flexibility in selecting the best approach for determining a risk adjustment as does the rapid pace of development and the continued advances in the techniques used to estimate uncertainty.

They also recommend that disclosures be required describing: how the risk adjustment is calculated; the sensitivity of the risk adjustment to different assumptions; and a roll-forward of the

opening and closing balance of the risk adjustment (similar to the disclosures required by other standards to accompany fair values measured with unobservable inputs). The purpose of these disclosures is to provide a way to deal with the variety and complexity of the various methods which can be used to determine a risk adjustment.

The Staff note that the concept of a risk adjustment is similar to the concepts currently used for reporting, including:

- ▶ The provision for adverse deviations (PAD) required for long-duration insurance contracts under current US GAAP
- ▶ The risk adjustment and margin for adverse deviations required in Australian and Canadian reporting
- ▶ The risk margin required for Swiss regulatory reporting, and proposed for European regulatory reporting under Solvency II
- ▶ The adjustment for non-hedgeable risks required for Market Consistent Embedded Value reporting

Some Board members previously raised concerns about the discipline and rigor surrounding the proposed insurance measurement (specifically the cohesiveness of the risk adjustment with the probability-weighted cash flows). Consequently, those Board members directed the Staff to perform an analysis of the applicability of an option pricing model in the context of measuring an insurance contract. The Staff will, therefore, present a paper on option pricing and risk in the context of insurance contracts.

Option pricing and risk

Using Agenda Paper 6E, the Staff intends to walk the Boards through a discussion of risk adjustments using a detailed worked example of a lattice pricing model for a very basic option and discussion of the formula for the Black-Scholes pricing model. Ultimately, the Paper states that inclusion of a risk adjustment in an insurance contract is consistent with the valuation of options, though the difficulty lies in determining what techniques to use and deriving unobservable inputs. This discussion is meant to provide the Boards with background only and will not present recommendations.

Definition of an insurance contract

The Staff will present a paper entitled 6A: *Definition of an insurance contract* to the Boards seeking decisions with respect to certain aspects of the definition of an insurance contract. The Staff propose to use the definition of an insurance contract from *IFRS 4 Insurance Contracts*, which defines an insurance contract as:

“A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.”

IFRS 4 also specifically defines insurance risk as “other than financial risk”.

While there is no set definition in US GAAP for an insurance contract, guidance is set out in paragraph 944-20-05-40 of the FASB *Accounting Standards Codification*TM. The three key differences that exist between this guidance and the definition above are summarised in the following paragraphs. The Staff will ask the Boards to conclude on their recommendations related to the first and third differences and will provide a separate paper for the second.

Compensation vs. indemnification – IFRS 4 refers to compensation where US GAAP refers to compensation and indemnification. The Staff state that compensation is a broader term than indemnification and therefore encompasses the fact that policyholders can benefit from an insurance contract and not just be made whole through replacement or its monetary equivalent. When presented in the context of the terms “significant risk” and “a specified uncertain future event that adversely affects the policyholder”, the Staff believe that compensation is very closely related to indemnification. The distinction between the two is clarified by the Staff using the examples of a death benefit – where the agreed-upon value is not necessarily a good measure of a human life – and a business interruption claim where the policyholder profits as compared with a scenario where the insured event had not occurred.

The Staff recommend that the definition of an insurance contract utilise the term “compensation” alone (as per the definition quoted above).

Financial risk – IFRS 4 defines insurance risk by excluding financial risk, while US GAAP defines insurance risk as “underwriting and timing risk”. This exclusion of financial risk was incorporated in IFRS 4 in order to more easily distinguish insurance contracts from derivatives. No similar exclusion exists in US GAAP. However, US GAAP specifically requires the presence of both timing and underwriting risk to qualify for insurance risk.

The Staff acknowledge the challenge it faces in drafting the exposure draft to address these discrepancies. The Staff will also provide a separate paper on timing risk and the potential need for its inclusion in the upcoming exposure draft.

Significant insurance risk – IFRS 4 defines “significant” by the requirement of “an insurer to pay significant additional benefits in any scenario, excluding scenarios that lack commercial substance”. In US GAAP, the term “significant” is not defined as rules of thumb have developed, but there is no specific rule.

The Staff will recommend that the definition of “significant insurance risk” as included in IFRS 4 be carried forward to the exposure draft.

Scope of the exposure draft

The Staff recommend that the following contracts are excluded from the exposure draft on insurance contracts:

1. Residual guarantees embedded in a lease
2. Employers’ assets and liabilities under employee benefit plans and retirement benefit obligations reported by defined benefit retirement plans

3. Contingent consideration payable or receivable in a business combination

The following topics are already excluded from the exposure draft based on prior decisions:

4. Insurance contract accounting by the policyholder (except related to reinsurance)
5. Warranties issued to cover defects undetected during manufacturing

The Staff believe that items 2 and 3 should be brought forward without further consideration. However, paper 6B presents discussion of the following areas and asks the Boards to conclude on their recommendations.

Warranties – the revenue recognition project identified two categories of warranty:

1. Warranties for short coverage periods to cover any defects that were undetected during the manufacture of the product, which do not meet the definition of an insurance contract.
2. Warranties that provide coverage for the customer for faults that arises after the product is transferred to the customer, which do meet the definition of an insurance contract.

The Staff believe that the conclusions above are appropriate and intends to exclude item 1 above from the exposure draft, while including item 2.

Fixed-fee service contracts – after deliberations as set out in paper 6B, the Staff conclude that fixed-fee service contracts, in which the level of service depends on an uncertain event, should remain in the scope of the exposure draft. The primary justification for this is the applicability of the insurance contract model to longer-duration contracts and the potential likely availability of a simplified measurement basis for short-duration service contracts, for which the Staff believe the building block model is likely to be burdensome. If this simplified measurement basis were to be excluded, the Staff would likely have to revisit this conclusion.

Residual value guarantees – residual value guarantees embedded in a lease are covered by the Boards’ project on Leases and the Staff recommend that they are not covered in the exposure draft, noting that stand-alone guarantees are not excluded from the scope of IFRS 4 and should not be excluded from the exposure draft.

Timing risk

The Staff will present a paper on timing risk, noting that US GAAP requires the presence of both significant timing and underwriting risk in order for a contract to meet the definition of insurance. The risk arising from uncertainties about the timing of the receipt and payments of the net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract.

Timing risk is treated as a “disqualifying characteristic” of an insurance contract. They propose doing this by including the following sentence: “Contractual provisions that delay timely reimbursement to the policyholder can eliminate or significantly reduce uncertainty because they prevent the insurer’s payments from directly varying with the claims settled under the reinsured

contracts. This would mean that timing risk would have to be taken into account if it reduces the significance of insurance risk in a contract.”

In addition, the Staff propose basing the assessment of insurance risk on present values rather than absolute amounts. Therefore, the present value of possible benefits which could be paid to policyholders as a result of an uncertain future event would need to be significant in order to qualify as insurance. The current definition of insurance risk in IFRS 4 bases the assessment of insurance risk on absolute (undiscounted) amounts.

Participating contracts

The Staff will bring to the Boards an issue on which divergent views have previously been expressed. The question relates to which cash flows should be taken into account in determining the liability for participating contracts. The Staff will not discuss whether participating dividends allocated to policyholders should be presented as a reduction of policyholder premiums or as an expense akin to policyholder benefits.

Participating contracts generally contain a guaranteed element as well as a participating feature, which gives rise to payments to the policyholder from a distinct share of surpluses after providing guaranteed benefits.

Some Staff members will recommend, that all future cash flows arising from a participating feature in an insurance contract should be taken into accounting in determining liabilities in the same way as all other cash flows arising from the contract. Therefore, all cash flows expected from the contracts (including those that are at the discretion of management) should be taken into account.

Other Staff members will recommend, that only cash flows resulting in a legal or constructive obligation to pay those benefits should be taken into account in determining the liability. Cash flows not representing a legal or constructive obligation should be regarded as being part of shareholders’ equity.

In addition, the Staff provides a summary of potential disclosure requirements, including specific disclosures to capture the nature of the participating contracts and bridge the gap between the two views above.

Disclosures

In Agenda Paper 6J, the Staff discusses their proposed approach to disclosures on insurance contracts, recommending that they be principles-based, but also require specific minimum disclosure requirements. The identified principles being disclosure of information that:

- ▶ Explains the characteristics of the insurance contracts (e.g., contractual terms with customers in sufficient detail to enable users to understand types of typical contracts with customers)
- ▶ Identifies and explains the amounts in the financial statements arising from insurance contracts (e.g., reconciliations - roll forwards - of changes), and
- ▶ Helps the users of the financial statements to evaluate the

nature and extent of risks arising from insurance contracts (consistent with the requirements of IFRS 7).

The Staff will recommend that the specific disclosure requirements should include, at a minimum, the requirements currently included in IFRS 4. The Staff will also assess whether sections of IFRS 4 Implementation Guidance, US GAAP and any other additional disclosures should be required. In developing requirements, the Staff will also consider the level of disaggregation to be required (e.g., by line of business).

Providing further information on current disclosure requirements, Appendix A to Agenda Paper 6J compares the principles set out above to the current IFRS 4 and certain IFRS 7 disclosure requirements (and includes other drafting changes to reflect tentative decisions by the Boards), while Appendix B compares current US GAAP and IFRS 4 disclosure requirements.

Detailed specific disclosures related to risk adjustments and participating contracts are covered separately and the discount rate will be discussed at a later date.

Timetable for Boards discussion

The insurance exposure draft is scheduled to be published in May 2010, with comments due by September 2010. The majority of open issues will be discussed by the Boards at their joint meetings in March and April.

Follow the discussion

Accounting for insurance contracts is scheduled to be discussed by the IASB and FASB on the following dates and times in March:

- ▶ Monday, 15 March – 16:30-18:00 GMT
- ▶ Tuesday, 16 March – 13:00-15:15 GMT
- ▶ Wednesday, 17 March – 13:00-14:30 GMT
- ▶ Monday, 22 March – 14:15-15:45 and 16:00-18:00 GMT
- ▶ Tuesday, 23 March – 15:45-17:45 GMT
- ▶ Wednesday, 24 March – 09:00-10:00 GMT

Some of these discussions will have concluded by the time you receive this newsletter. Summaries of Board discussions are posted on the IASB website at www.iasb.org. You can also register to follow any of the future discussions via webcast at the same address.

Area IFRS insurance contacts

We welcome your feedback on *Insurance Accounting Alert*.

Please get in touch with your local Ernst & Young insurance contact with any enquiries.

Global Centre of Excellence

James Dean
+44 20 7951 1404
jdean1@uk.ey.com

Kevin Griffith
+44 20 7951 0905
kgriffith@uk.ey.com

Christine Holmes
+31 88 407 3876
christine.holmes@nl.ey.com

Americas

Jennifer Weiner
+1 617 585 0347
jennifer.weiner@ey.com

Richard Lynch
+1 212 773 5601
richard.lynch@ey.com

Actuarial

Jim Christie (Property and Casualty)
+1 416 943 3468
jim.k.christie@ca.ey.com

Mark Freedman (Life)
+1 215 448 5012
mark.freedman@ey.com

Far East

Kieren Cummings
+82 2 3787 6517
kieren.cummings@kr.ey.com

Japan

Kenji Usukura
+81 3 3503 1191
usukura-knj@shinnihon.or.jp

Peter Gaydon
+81 3 3503 2998
gaydon-ptr@shinnihon.or.jp

Oceania

Christina Habal
+61 3 9288 8192
christina.habal@au.ey.com

Europe, Middle East, India and Africa

Cornea De Villiers (South Africa)
+27 21 443 0364
cornea.devilliers@za.ey.com

Gabriele Pieragnoli (Italy)
+39 027 221 2434
gabriele.pieragnoli@it.ey.com

James Lenton (UK)
+44 20 7951 1993
jlenton@uk.ey.com

Loic Moan (France)
+33 1 46 93 42 02
loic.moan@fr.ey.com

Nicole Verheyen (Belgium)
+32 3 270 1394
nicole.verheyen@be.ey.com

Niek de Jager (The Netherlands)
+31 88 407 3849
niek.de.jager@nl.ey.com

Pedro Garcia Langa (Spain)
+34 915 727 812
pedro.garcialanga@es.ey.com

Ralf Widmann (Germany)
+49 711 9881 15142
ralf.widmann@de.ey.com

Rohan Sachdev (India)
+91 22 4035 6300
rohan.sachdev@in.ey.com

Rolf Bächler (Switzerland)
+41 58 286 44 95
rolf.baechler@ch.ey.com

Actuarial

Alex Lee (Property and Casualty)
+44 20 7951 1047
alee6@uk.ey.com

Brian Edey (Life)
+41 58 286 4224
brian.edey@ch.ey.com

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EYG no. AU0473

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