

## Insurance Accounting Alert

Special edition

# Proposal for accounting for insurance contracts

### Executive summary

The International Accounting Standards Board (IASB or the Board) is developing a new International Financial Reporting Standard (IFRS) on accounting for insurance contracts. The IASB's insurance contracts project has been split into two phases. Phase I culminated in 2004 with the publication of IFRS 4 *Insurance Contracts*, which permitted many existing international insurance contract accounting practices to be retained. On 30 July 2010, the Board issued its Exposure Draft<sup>1</sup> (ED) on phase II, which is intended to result in a single consistent recognition and measurement standard for insurance contracts internationally. If adopted, the ED will replace IFRS 4.

The IASB is proposing that an insurer should measure insurance liabilities using a model based on the 'present value of the fulfilment cash flows' plus a residual margin when required.

The release of the ED is a result of a joint project with the Financial Accounting Standard Board (FASB). The FASB decided to issue a Discussion Paper (DP) by the end of the third quarter. That DP will compare the IASB's proposed model, the FASB's tentative decisions reached to date and current US GAAP. It also will include preliminary views on possible improvements to current guidance.

This publication provides a high-level summary of the key components of the ED. Ernst & Young will publish a more comprehensive analysis of the ED and will hold a webcast in the coming months.

### Scope

The scope of the ED includes:

- ▶ Contracts that meet the definition of insurance that an insurer issues
- ▶ Reinsurance contracts that an insurer holds
- ▶ Financial instruments containing discretionary participating features (participating investment contracts) that an insurer issues and that share in the performance of the same pool of assets as participating insurance contracts

The exceptions to applying IFRS 4 are carried forward into the ED, with some modifications. The ED proposes to require financial guarantee contracts as defined in the ED into the scope of the insurance contracts standard.

<sup>1</sup> Exposure Draft, *Insurance Contracts*

Also, the ED proposes to exclude fixed-fee service contracts from the scope of the insurance contracts standard. Although the IASB acknowledged that these contracts meet the definition of an insurance contract, the IASB decided to exclude them from the proposed standard on the basis that the existing practice of accounting for fixed-fee service contracts as revenue contracts provides relevant information for the users of financial statements.

## Definition of an insurance contract

The IASB decided to continue to use the definition of an insurance contract set out in IFRS 4 in the ED, but they clarified how significant insurance risk in that definition should be evaluated.

The definition of an insurance contract in the ED is as follows:

“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.”

Based on this definition, a contract is an insurance contract only if it transfers 'significant insurance risk'. Insurance risk refers to the risk, other than financial risk, transferred from the holder of a contract to the issuer and is 'significant' if, and only if, an insured event could cause an insurer to pay significant additional benefits in any scenario, excluding scenarios that lack commercial substance. The clarification to how to interpret what is considered 'significant insurance risk' requires that the evaluation of additional benefits be on a present value basis and there is at least one scenario that the writer of the contract would be exposed to a loss.

The ED implies that a contract is an insurance contract if there is significant underwriting or timing risk.

### How we see it

The use of present value amounts to determine whether significant insurance risk has transferred may result in some contracts currently accounted for as insurance not qualifying as an insurance contract in the ED and thus having to apply other applicable IFRS.

## Unbundling

Insurance contracts may include multiple-elements, such as insurance coverage, investment (or financial) components and embedded derivatives. A key question in valuing insurance contracts is whether and how to separately identify and measure the components of the contract.

The ED requires entities to unbundle components of a contract that are not closely related to the insurance coverage specified in the contract. Examples included in the ED of components that should be unbundled are:

- ▶ Investment components that reflect an account balance which is credited with an explicit return and the crediting rate is based on the investment performance of the underlying investments
- ▶ Embedded derivatives that are required to be separated from the host contract in accordance with International Accounting Standard No. 39 *Financial Instruments: Recognition and Measurement* (IAS 39)
- ▶ Goods and services not closely related to the insurance coverage

Entities will be prohibited from unbundling if not required to do so by the standard.

## Contract boundaries

Contract boundaries are the key consideration in determining whether multiple-period insurance coverage might represent one or many insurance contract(s). The ED defines contract boundaries as the point at which the insurer either:

- ▶ Is no longer required to provide coverage
- or
- ▶ Has the right or practical ability to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk

The boundary principle should be applied at the individual contract level. In determining the contract boundary for a group contract, the specific contractual terms and conditions need to be considered to establish whether the unit of account is an individual contract with a single policyholder or a group plan where the contract may be with an employer who administers the plan on behalf of its employees.

## Recognition

The ED requires an entity to recognise an insurance obligation when it becomes a party to the contract which is defined by the ED as the earlier of when the insurer is:

- ▶ Bound by the contract
- and
- ▶ First exposed to risk

An insurer is on risk when it can no longer withdraw from its obligation to provide insurance coverage for insured events and is no longer free to re-underwrite the contract. Accordingly, an insurer could be a party to the contract prior to the start of the coverage period.

## Measurement

The ED indicates that insurance contracts are measured using the present value of the fulfilment cash flows. However, for certain contracts, a simplified model can be used for the pre-claim period. Furthermore, any insurance contract denominated in a foreign currency should be considered as a monetary item when applying IAS 21 *The Effects of Changes in Foreign Exchange Rates*.

The present value of the fulfilment cash flows is made up of the following components:

- ▶ Unbiased, probability-weighted average of future cash flows expected to arise as insurer fulfils the obligation
- ▶ Incorporation of time value of money (discount rate)
- ▶ A risk adjustment

### Future cash flows

The first component in valuing insurance contracts is the unbiased, probability-weighted average of future cash flows. The future cash flows should represent the net rights and obligations present in the contract as opposed to separately identifying the gross obligations and presenting separate gross assets and liabilities.

The ED provides guidance on estimating future cash flows arising from the fulfilment of an insurance contract. One of the principles in the ED for estimating future cash flows is that they should be explicit, meaning those cash flows directly related to the insurance contract should be used.

The future cash flows should reflect the manner in which the insurer expects to fulfil the contract. The ED requires that an entity incorporate, in an unbiased way, all available information about the amount, timing and uncertainty of all cash flows that will arise as the insurer fulfils the insurance contract. 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.

To the extent that the inputs used to calculate the estimated cash flows relate to observable market variables (for example, interest rates) the IASB requires these to be consistent with current observed market prices. However, for most insurance contracts, many significant variables (for example, mortality and specific expenses) will not be observable in the market. The IASB recognises that, for these assumptions, insurers will usually use internal data for estimation.

#### How we see it

Many entities may not have the capabilities today to capture this information. Therefore, insurers may have to change their internal controls and processes in order to include all future cash flows and to perform probability weighted scenarios. This change will have a significant effect on the information systems insurers use to maintain this information.

The ED requires that the cash flows be re-measured in each reporting period. Therefore, the information used to estimate the future cash flows should be current and correspond to conditions at the end of the reporting period. Any movements as a result of re-measurement should be recorded in profit or loss.

### Time value of money (discount rate)

The second component is the discount rate. The ED states that the discount rate should conceptually adjust estimated future cash flows for the time value of money in a way that captures the characteristics of that liability. The ED implies that the discount rate is based on the risk-free rate and adjusted for characteristics unique to the liability, for example, an adjustment for illiquidity. However, if the amount, timing or uncertainty of the cash flows depends, wholly or partly, on the performance of specific assets then the measurement of the insurance contract should reflect that fact. The ED states that own credit is explicitly excluded in determining a discount rate for insurance contracts.

The discount rate should be re-measured in each reporting period and changes should be recorded in profit or loss.

The ED provides a cross reference to estimate a discount rate included in the guidance on fair value measurements currently set out in IAS 39 (expected to be replaced by the end of 2010 with IFRS 9 *Financial Instruments*).

### Risk adjustment

The third component is the risk adjustment. This is an adjustment to capture the effects of uncertainty associated with the cash flows arising from the contract. The risk adjustment should be the maximum amount that the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows may exceed the expected cash flows.

The IASB decided to limit the number of permitted techniques used to measure the risk adjustment. The permitted techniques are listed as follows:

- ▶ Confidence level technique
- ▶ Conditional tail expectation
- ▶ Cost of capital

While the ED does not require the use of any one of these techniques for a specific situation, the application guidance includes a discussion of which technique the Board believes would be most suitable for certain circumstances. The ED indicates that considerable amount of judgment will have to be used by the insurer to determine which technique is most appropriate for their business.

The ED requires that the risk adjustment be determined for a portfolio of insurance contracts without any credit for diversification or negative correlation between portfolios. The risk adjustment should be re-measured each reporting period and any movements as a result of re-measurement should be recorded in profit or loss.

## Residual margins

In addition to the present value of the fulfilment cash flows, the ED requires that the measurement of an insurance contract include a residual margin that eliminates any gain at the inception of the contract. The residual margin represents a calibration that eliminates the positive day-one difference between: a) the expected premiums, and b) the expected claims, benefits and claims handling expenses and incremental acquisition costs. If the expected claims, benefits and claims handling expenses and incremental acquisition costs results in a negative day-one difference, then the insurer should recognise that difference immediately in the profit or loss.

The residual margin is to be released over the coverage period (during which the insurer provides insurance coverage) based on either the passage of time or the timing of expected claims and benefits incurred if the insurer expects to incur claims and benefits in a pattern that is significantly different than the passage of time. Also, an insurer should accrete interest on the carrying amount of the residual margin.

The ED indicates that an insurer should not adjust the residual margin in subsequent reporting periods for changes in cash flow estimates. Therefore, the residual margin is only adjusted for amortisation.

## Unit of account

Unit of account refers to the question of whether the residual margin should be determined for a portfolio of insurance contracts or for individual contracts. Although some of the components in the present value of the fulfilment cash flows are calculated at an individual contract or portfolio level, the ED requires the residual margin be determined at a level that aggregates contracts into a portfolio of insurance contracts. The ED requires that each portfolio of insurance contracts should be grouped by inception date and by length (or life) of the contract. The ED defines a portfolio of insurance contracts as 'contracts that are subject to broadly similar risks and managed together as a single portfolio.'

## Simplified model

Notwithstanding that the ED has a measurement model based on the present value of the fulfilment cash flows plus a residual margin, it requires for certain contracts in the pre-claim period the use of a simplified measurement model. The ED requires an insurer to measure insurance contracts using the simplified model if the contract meets both of the following criteria:

- ▶ Coverage period is approximately one year or less
- ▶ Does not contain embedded options or other derivatives that significantly affect the variability of cash flows

The simplified model measures the pre-claim obligation as the premium, if any, received at inception plus the expected present value of future premiums less the incremental acquisition costs. The pre-claim obligation is released over the coverage period based on the passage of time or the timing of expected claims and benefits incurred if the insurer expects to incur claims and

benefits in a pattern that is significantly different than the passage of time. An insurer should accrete interest on the pre-claim obligation.

The ED requires an insurer, initially and subsequently, to assess whether an insurance contract measured under the simplified model is onerous. An insurance contract is onerous if the pre-claim obligation is lower than the present value of the fulfilment cash flows. If determined onerous, the insurer should recognise an additional liability and recognise the loss in profit and loss. The additional liability should be re-measured each reporting period and reversed when the pre-claim obligation is above the present value of the fulfilment cash flows.

### How we see it

While the Board has provided what might appear to be relief from requiring insurers to determine the present value of the fulfilment cash flows in the pre-claim period, those that use this approach will have to perform an onerous contract test. This test requires the use of the present value of the fulfilment cash flows to determine whether the insurance contract is onerous.

## Portfolio transfers

A portfolio transfer of insurance contracts should be measured at the higher of either the consideration received or the present value of the fulfilment cash flows. If the consideration is higher then the difference is recognised as the residual margin. However, if the present value of the fulfilment cash flows is higher, the difference results in a loss that the insurer should recognise immediately in the profit and loss.

## Business combinations

The ED requires that a portfolio of insurance contracts acquired in a business combination should be measured at the higher of the fair value of the portfolio or the present value of the fulfilment cash flows. If the fair value is higher then the difference is recognised as the residual margin. However, if the present value of the fulfilment cash flows is higher, then the difference is recognised as additional goodwill.

## Reinsurance

A reinsurance contract is an insurance contract issued by one insurer (the reinsurer) to compensate another insurer (the cedant) for losses on one or more contracts issued by the cedant. The ED requires that a cedant measure the reinsurance contract initially at the present value of the fulfilment cash flows including the risk of non-performance by the reinsurer. The cedant should estimate the present value of the fulfilment cash flows for the reinsurance contract in the same manner as the corresponding part of the present value of the fulfilment cash flows for the underlying insurance contract. If the present value of the fulfilment cash flows for the reinsurance contract is greater than zero (that is, future cash inflows plus the risk adjustment [reinsurance recoverable] exceed the future cash outflows [premiums minus ceding commission]), then a gain should be recognised in the profit or loss. However, if the present value of the fulfilment cash

flows for the reinsurance contract is less than zero (that is, future cash inflows plus the risk adjustment [reinsurance recoverable] is less than the future cash outflows [premiums minus ceding commission]), then the cedant should record the difference as a residual margin.

#### How we see it

The ED proposes different ways that the residual margin should be determined depending on how the insurance contracts are acquired. Also, the ED does not address how to amortise the residual margin for insurance or reinsurance contracts that are beyond the coverage period but were acquired in a business combination or a portfolio transfer. These issues will need to be addressed when the final standard on insurance contracts is issued.

## Acquisition costs

Acquisition costs are expenses insurers incur to secure contracts with policyholders. The ED requires an insurer to include in the present value of the fulfilment cash flows only those acquisition costs that are incremental at the individual contract level. Incremental acquisition costs are the costs of selling, underwriting and initiating an insurance contract that the insurer would not have incurred if it had not issued the insurance contract. The incremental acquisition costs increase the present value of the fulfilment cash flows thereby decreasing the residual margin.

All non-incremental costs should be expensed in the profit and loss when the insurer incurs them.

#### How we see it

Currently, many entities capitalise acquisition costs as an asset on the balance sheet and recognise them in the income statement over the period of the insurance contract to which they relate. The ED proposes a significant change to the accounting for acquisition costs because it requires that only incremental acquisition costs be included in the present value of the fulfilment cash flows.

## Participating features

Participation contracts are contracts in which part of the benefits paid to policyholders is dependent on the performance of an underlying pool of insurance contracts or other related investments.

The ED requires that all payments arising from discretionary participating features should be included in the measurement of account-driven insurance contracts in the same way as any other contractual cash flows (that is, on an expected present value basis). The Board believes that discretionary participating features represent an integral part of the contract, rather than an individual item that should be considered separately for recognition and measurement.

## Policyholder behaviour

Certain contractual features permit a policyholder to take actions that change the cash flows resulting from an insurance contract, such as an option that allows the policyholder to suspend or terminate the payment of premiums under the policy.

The ED requires that policyholder options, forwards and guarantees related to existing coverage, should be measured on a look-through basis using the expected value of future cash flows (to the extent that they are within the boundary of the existing contract). As a result, no deposit floor should be applied. Policyholder options, forwards and guarantees that do not relate to the existing insurance coverage should be excluded from the measurement of the contract, instead being recognised and measured as either new insurance contracts or other stand-alone instruments, according to their nature.

## Participating investment contracts

The ED requires that certain investment contracts with discretionary participation features be measured using the same measurement model as insurance contracts, with some modifications.

The contract boundary of a participating investment contract is the point at which the contract holder no longer has a contractual right to receive benefits arising from the participating contract. Also, the residual margin is released over the life of the contract based on either the passage of time or, if the insurer expects to provide asset management services, in a pattern that differs significantly from the passage of time.

## Presentation

### Statement of financial position

The ED requires that net insurance contract assets or liabilities and net reinsurance contract assets or liabilities are presented in the statement of financial position.

The ED requires that assets and related liabilities associated with unit-linked contracts (that is, account balances based on net asset values) should be presented in the statement of financial position of the insurance entity that owns the assets and is contractually obligated to pay the liabilities.

### Statement of comprehensive income

The ED includes a presentation model that focuses on margins and other key performance information. The Board selected this model because it believes that the measurement approach should determine the presentation. The margin presentation requires insurers to treat all premiums as deposits and all claims and benefits as repayments to the policyholder. An insurer is expected to present at a minimum the following items:

- ▶ Change in the risk adjustment
- ▶ The release of the residual margin during the period
- ▶ The difference between the expected and the actual cash flows

- ▶ Changes in estimates
- ▶ Interest on insurance liabilities

Any additional performance information related to the insurance contracts should be disclosed.

The ED requires that those contracts applying the simplified measurement should use a different presentation model. An insurer applying the simplified measurement model is expected to present at a minimum the following items:

- ▶ Premium revenue
- ▶ Claims incurred
- ▶ Expenses incurred
- ▶ Incremental acquisition costs incurred

## Disclosures

The ED proposes a high-level principle for its disclosure requirements, supplemented with some specific disclosures to meet the principle. Some of the specific disclosures required by the ED are as follows:

- ▶ Reconciliation from the opening and the closing aggregate contract balances
- ▶ The methods and inputs used to develop the measurements
- ▶ Sensitivity information quantifying the impact of significant assumptions used by management in determining revenue

## Transition

The ED requires that an insurer should measure each portfolio of insurance contracts at the present value of the fulfilment cash flows, starting at the beginning of the earliest period presented. If there is a difference between the new measurement amount and the amount under the insurer's previous accounting policies, that difference should be recognised in retained earnings.

The insurer should derecognise any existing balances of deferred acquisition costs and any intangible assets arising from insurance contracts assumed in previously recognised business combinations.

## Transition for financial assets

IFRS 9 *Financial Instruments* allows entities to classify some financial assets at amortised cost if the financial asset meets specific criteria. However, the ED uses a current value and, as such, all re-measurements of the liability should be recognised in profit or loss. The ED does not permit or require the use of other comprehensive income in equity for insurance contracts. The different accounting treatment for financial assets and insurance liabilities could cause 'accounting mismatches'. Therefore, the ED allows an insurer to re-designate financial assets to fair value through profit or loss at the start of the earliest period presented when adopting the new insurance contracts standard, if it eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise from measuring assets and liabilities or recognising the gains and losses on them on different accounting bases. The entity should recognise the cumulative effect of the re-designation as an adjustment to opening retained earnings of the earliest period presented and remove any related balances from accumulated other comprehensive income.

## Effective date

The ED does not include a proposed effective date. Instead, the effective date will be considered when the Board meets to discuss the effective dates for all of the major joint projects currently under way and expected to be completed in 2011.

Comments on the Exposure Draft are due by 30 November 2010.

## IASB and FASB differences

The IASB and FASB have agreed on a number of decisions relating to the insurance contracts project. However, the IASB and FASB have reached different decisions in some areas. The main differences are as follows:

- ▶ FASB has tentatively decided to use a single composite margin instead of a risk adjustment plus residual margin
- ▶ FASB has tentatively decided not to include participating investment contracts in the scope of the standard

The ED includes the following summary of similarities and differences between a composite margin and a risk adjustment plus a residual margin.

	IASB: Risk adjustment plus residual margin	FASB: Composite (single) margin
Gain possible at inception	No	No
Loss possible at inception	Yes	Yes (but less likely, see paragraph BC115)
Risk adjustment included in determining whether a loss arises at inception, and measuring any such loss	Yes	No
Explicit remeasurement for risk each period	Yes	No
Does risk adjustment decline over time	Generally, yes, but could increase, for example if a new uncertainty emerges.	N/A
Can risk adjustment increase after initial recognition	Yes, but this is likely to be rare in practice.	N/A
Can residual or composite margin increase after initial recognition	No	No
How does risk adjustment run-off over time	Explicit measurement, reflecting reduction in remaining risk.	N/A
How does residual or composite margin run-off over time	Over the coverage period on the basis of passage of time or, if significantly different, on the basis of the pattern of claims and benefits, as expected at inception.	On the basis of reduction in exposure from both: <ul style="list-style-type: none"> <li>▶ The provision of insurance coverage over the coverage period</li> </ul> and <ul style="list-style-type: none"> <li>▶ Uncertainties related to future cash flows during the claims handling period (for life contracts usually similar to the coverage period)</li> </ul>
Is release from risk one possible driver of the residual margin or composite margin	No. The risk adjustment accounts for risk.	Yes.
What margin is included on transition	The risk adjustment only. The residual margin would be set at zero.	The composite margin would be set equal to the risk adjustment determined in the other approach. That adjustment would not be remeasured subsequently, it would simply be released to income in the same way as any other composite margin.  This is the only purpose for which a risk adjustment would be used in the composite margin approach.

Source: IASB Insurance Contracts Exposure Draft

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