



# IFRS – Insurance Newsletter

August 2010, **Issue 9**

This IFRS Insurance Newsletter summarises the IASB's<sup>1</sup> exposure draft *ED/2010/8 Insurance Contracts* (the ED), which was published on 30 July 2010. Comments are due to the IASB by 30 November 2010.

The ED proposes a new standard on accounting for insurance contracts, which would replace IFRS 4 *Insurance Contracts*. The proposals represent the first comprehensive IFRS accounting model for insurance contracts and are expected to have a significant impact on the financial reporting of insurers. The ED does not propose an effective date for the new standard since the IASB plans an additional consultation on the effective dates of these proposals in conjunction with other proposed standards to be issued in 2011.

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**KPMG's update on the joint IASB/FASB insurance project**

## Background

In 2004 the IASB introduced IFRS 4, an interim standard, which represented the first phase of the insurance project. At the time, the IASB sought to minimise the amount of change required to current accounting policies and practices so as to avoid changes that might be reversed in the second phase of the insurance project and therefore allowed insurers to continue most of their current accounting policies for insurance contracts. The second phase of the insurance project was launched when the IASB published a discussion paper, *Preliminary Views on Insurance Contracts*, in May 2007, which focused on an "exit value" measurement approach for insurance contracts.

The proposals in the ED are the result of extensive deliberations following the publication of the discussion paper. These proposals are expected to significantly impact the financial reporting of all insurers.

In addition to the change in accounting policies and practices, the proposals also may significantly impact systems, data, and tax, reporting, and control processes. Early assessment of accounting and actuarial resources and training requirements will be essential in order for insurers to be properly prepared for implementation.

## Overview of proposals

The proposals contain one comprehensive measurement model for all types of insurance contracts issued by insurers with a modified approach for some short-duration contracts. The measurement model is based on a “fulfilment” objective, which reflects the fact that an insurer generally expects to fulfil its liabilities over time by paying benefits and claims to policyholders as they become due, rather than transferring the liabilities to a third party.

The measurement model is based on a principle that insurance contracts create a bundle of rights and obligations that work together to create a package of cash inflows (premiums) and outflows (benefits, claims and costs). The model, which applies to that package of cash flows, uses the following building blocks:

- a current estimate of future cash flows;
- a discount rate that adjusts those cash flows for the time value of money;
- an explicit risk adjustment; and
- a residual margin.

For short-duration contracts, a modified version of the measurement model applies. As a proxy for the measurement model the insurer measures the pre-claims liability by allocating premiums across the coverage period. For these contracts, the insurer would apply the building block measurement model to measure claim liabilities for insured events that already have occurred and for onerous contracts.

Insurers often incur significant costs to sell, underwrite and initiate a new insurance contract, generally referred to as “acquisition costs.” The ED proposes that an insurer includes incremental acquisition costs for contracts actually issued as part of the contract’s cash flows. As a result, those costs would

generally affect profit or loss over the coverage period rather than at inception. All other acquisition costs would be expensed when incurred.

The proposals also include:

- revised unbundling criteria for non-derivative components of an insurance contract;
- a revised presentation for the statement of financial position and statement of comprehensive income;
- a building block measurement model for reinsurance contracts;
- an expected loss model for credit risk of reinsurance assets;
- accounting guidance for investment contracts with a discretionary participation feature (DPF) including an expanded definition of a DPF compared to IFRS 4;
- revised accounting guidance for business combinations and portfolio transfers; and
- expanded disclosure requirements.

## Working with the FASB

The IASB developed the proposals jointly with the FASB. The IASB and the FASB (together, the Boards) reached the same conclusions in many areas, but reached different conclusions on some aspects of scope and the measurement model.

During the Boards’ deliberations, the FASB preferred a measurement model that did not include a separate risk adjustment and residual margin, but instead combined these in a single composite margin for recognition in profit or loss over the combination of the coverage and benefit paying periods of the insurance contract. The ED asks constituents which of these two approaches they prefer.

The FASB plans to publish a discussion paper to seek additional input from its constituents. The discussion paper is expected to present the

IASB’s proposals contained in the ED, the FASB’s tentative decisions, and a comparison of each of those with existing US GAAP for insurance reporting. The FASB expects to issue their discussion paper later this quarter with the comment period ending concurrently with the ED’s comment period, which ends 30 November 2010.

### The proposed insurance model

The table below summarises the key proposals outlined in the IASB's ED. Although the deliberations on the insurance project have been carried out jointly, the FASB plans to issue a separate discussion paper later this quarter. The tentative decisions made by the FASB to date that differ from the proposals contained in the ED are indicated in the boxes below.

Scope	
Definition of an insurance contract and financial guarantee contracts	<p>The proposals in the ED would apply to all insurance contracts (including reinsurance contracts) that an entity issues and reinsurance contracts that an entity holds.</p> <p>An <i>insurance contract</i> is 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. This definition is consistent with the current definition of an insurance contract in IFRS 4.</p> <p>The ED proposes to delete the separate definition of a financial guarantee contract contained in IFRS 4 and IAS 39 <i>Financial Instruments: Recognition and Measurement</i> and the related measurement guidance in IAS 39.</p> <p>Financial guarantee contracts issued by an entity that meet the definition of an insurance contract would be within the scope of the proposed IFRS on insurance contracts.</p> <p>The ED indicates that the proposed definition of an insurance contract does not capture credit-related contracts that pay out regardless of whether the counterparty holds the underlying debt instrument; or that pay out on a change in credit rating or change in credit index, rather than on the failure of a specified debtor to make payments when due. These contracts would continue to be accounted for as derivatives under IAS 39.</p>
Other points	<ul style="list-style-type: none"> <li>● In developing the proposals on the definition of an insurance contract, the IASB compared the existing definition in IFRS 4 with the current US GAAP requirements to identify possible improvements. Under current IFRS, an insurer is required to consider whether an insured event could require significant additional benefits in any scenario that has commercial substance. Under US GAAP, insurance risk is not considered to exist if there is not a scenario where the present value of net cash outflows exceed the present value of premiums. The IASB decided to include an additional test compared to IFRS 4 that insurance risk is not considered transferred unless there is a scenario that has commercial substance in which the present value of the net cash outflows of the insurer can exceed the present value of the premiums.</li> <li>● The proposals also include a change from the existing requirements of IFRS 4 to base the evaluation of risk transfer on present values rather than absolute amounts when analysing anticipated cash flows. This change could result in fewer contracts being classified as insurance contracts as compared to current practice.</li> <li>● Also, in determining whether significant insurance risk exists, the proposals incorporate the guidance from US GAAP that the insurer consider the effect of contractual terms that delay timely reimbursement to the policyholder.</li> </ul>

<b>Scope</b>		
Financial instruments with a discretionary participation feature (DPF)	<p><b>In scope (IASB preference)</b></p> <p>Financial instruments that contain a DPF are within the scope of the proposed standard on insurance contracts.</p> <p>A DPF is a contractual right to receive, as a supplement to guaranteed benefits, additional benefits:</p> <ul style="list-style-type: none"> <li>(a) that are likely to be a significant portion of the total contractual benefits;</li> <li>(b) whose amount or timing is contractually at the discretion of the issuer; and</li> <li>(c) that are contractually based on the following, provided that there also exist insurance contracts that provide similar contractual rights to participate in the performance of the same insurance contracts, the same pool of assets or the profit or loss of the same company, fund or other entity: <ul style="list-style-type: none"> <li>– the performance of a specified pool of insurance contracts or a specified type of insurance contract;</li> <li>– realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or</li> <li>– the profit or loss of the company, fund or other entity that issues the contract.</li> </ul> </li> </ul> <p>The condition relating to the existence of insurance contracts with similar participating rights is an addition to the definition in IFRS 4.</p> <p>In measurement, the boundaries of these contracts are defined as the point that the contract holder no longer has a contractual right to receive benefits arising from a DPF.</p>	<p><b>Out of scope (FASB preference)</b></p> <p>The FASB's approach scopes any financial instrument with a DPF into its proposed financial instruments standard.</p>

Scope	
Other points	<ul style="list-style-type: none"> <li>● Although these contracts do not transfer significant insurance risk, they are scoped into the proposals since participating investment and insurance contracts share many of the same features and commonly share the same pool of assets used to make distributions to participating policyholders (whether investment or insurance).</li> <li>● During the Boards' deliberations, many Board members were concerned about "scope creep" and that opportunities may arise to artificially structure contracts in order to qualify for insurance contract accounting, e.g. to get insurance accounting by adding one or two participating insurance contracts to share in the results of a pool of investment contracts with a DPF but no insurance risk.</li> <li>● During the Boards' deliberations, some members thought the staff needed to expand on the "pooling" concept to narrow this criterion to specify the degree or proportion of the pool of assets that had to be participating insurance vs participating investment contracts, and also to specify that the return on a pool of assets was dependent on mortality/morbidity risks. This criterion is not specified in the proposals.</li> <li>● The ED specifies how the proposed model for insurance contracts would be applied to insurance contracts with a DPF.</li> </ul>
Scope exclusions	<p>The proposals in the ED would apply to all insurance contracts <i>except</i>:</p> <ul style="list-style-type: none"> <li>● product warranties issued directly by a manufacturer, dealer or retailer;</li> <li>● residual value guarantees provided by a manufacturer, dealer or retailer, as well as a lessee's residual value guarantee embedded in a finance lease;</li> <li>● employers' assets and liabilities under employee benefit plans and retirement benefit obligations reported by defined benefit retirement plans;</li> <li>● contractual rights or contractual obligations that are contingent on future use of, or right to use, a non-financial item;</li> <li>● contingent consideration payable or receivable in a business combination;</li> <li>● fixed-fee service contracts that have as their primary purpose the provision of services, but that expose the service provider to risk because the level of service depends on an uncertain event; and</li> <li>● direct insurance contracts that an entity holds, i.e. direct insurance contracts in which an entity is the policyholder. This exemption does not apply to a reinsurance contract that an insurer holds.</li> </ul> <p>The proposed scope exclusions are similar to those in IFRS 4 except that there are additional exclusions for some types of fixed-fee contracts, e.g. maintenance contracts in which the service provider agrees to repair specified equipment after a malfunction, and for residual value guarantees provided by a manufacturer, retailer or dealer.</p>
Other points	<ul style="list-style-type: none"> <li>● During the Boards' deliberations, many Board members expressed some concerns in scoping fixed-fee contracts into the insurance standard since a large number of contracts may come into the scope of insurance measurement that are sold outside the insurance industry.</li> <li>● Scope exemptions are included in the proposals for warranties and residual value guarantees provided by a manufacturer, dealer or retailer because these products typically are issued in connection with the sale of the underlying goods.</li> <li>● As part of the proposals, warranties issued for short coverage periods to cover any defects that were undetected in the manufacturing of the product would not meet the definition of an insurance contract because they are intended to ensure that the seller satisfies the performance obligation rather than compensation for an uncertain future event.</li> </ul>

Recognition and derecognition	
Recognition	<p>Under the proposals, an insurer recognises an insurance contract liability or an insurance contract asset when the insurer becomes a party to the insurance contract, which is the earlier of:</p> <ul style="list-style-type: none"> <li>• the date when the insurer is bound by the terms of the insurance contract; and</li> <li>• the date when the insurer is first exposed to risk under the contract. This is when the insurer can no longer withdraw from its obligation to provide insurance coverage to the policyholder for insured events and no longer has the right to reassess the risk of the particular policyholder and, as a result, can no longer change the price to fully reflect that risk.</li> </ul>
Other points	<ul style="list-style-type: none"> <li>• Under the proposals, insurers should begin recognising the contract when they are bound to the coverage, which could be prior to the effective date or the date on which a contract is signed (i.e. when there is an unconditional offer extended for coverage).</li> <li>• The date on which the insurer recognises the insurance contract is particularly important in determining the residual margin an insurer can recognise. At recognition, the insurer measures the assets and liabilities arising from an insurance contract and determines a “locked in” residual margin, which is subsequently recognised over the contract’s life (see <i>The measurement model</i> below).</li> <li>• Under the proposals, an insurer should not recognise any liability or asset relating to possible claims under future contracts (catastrophe or equalisation provisions).</li> <li>• In principle, the FASB supported the concept that recognition begins when an insurer enters into an arrangement with the policyholder.</li> </ul>
Derecognition	<p>An insurance contract liability (or a part thereof) is derecognised from the statement of financial position when, and only when, it is extinguished, i.e. when the obligation specified in the insurance contract is discharged or cancelled or expires.</p>
Other point	<ul style="list-style-type: none"> <li>• The purchase of reinsurance does not trigger derecognition of an insurance liability unless the cedant’s obligations under underlying direct insurance contracts are extinguished.</li> </ul>

The measurement model	
Measurement model	<p>The proposals contain one comprehensive measurement model for all types of insurance contracts issued by insurers with a modified approach for some short-duration contracts. The measurement model is based on a “fulfilment” objective which reflects the fact that an insurer generally expects to fulfil its liabilities over time by paying benefits and claims to policyholders as they become due, rather than transferring the liabilities to a third party.</p> <p>The measurement model is based on a principle that insurance contracts create a bundle of rights and obligations that work together to create a package of cash inflows (premiums) and outflows (benefits, claims and costs). The model uses certain “building blocks” in measuring that package of cash flows.</p>
Other points	<ul style="list-style-type: none"> <li>• The measurement objective expresses a value rather than a cost notion. The measurement model focuses on “fulfilment cash flows” and is inclusive of a risk adjustment based on the amount the insurer would rationally pay to be relieved of the risk that the ultimate cash flows exceed those expected.</li> <li>• The rights (cash inflows) and obligations (cash outflows) arising from an insurance contract are considered collectively in determining the underlying margin for the contract. This treatment is consistent with the revenue recognition proposals, which treat the combination of rights and obligations as giving rise to a single contract asset or liability.</li> </ul>

## The measurement model

### Building blocks

#### Four building blocks (IASB preference)

At initial recognition, an insurer measures a contract as the sum of:

- the present value of the *fulfilment* cash flows, which is made up of:
  - an explicit, unbiased and probability-weighted estimate (i.e. expected value) of the future cash outflows less the future cash inflows that will arise as the insurer fulfils the insurance contract;
  - a discount rate that adjusts those cash flows for the time value of money; and
  - a risk adjustment being an explicit estimate of the effects of uncertainty about the amount and timing of those future cash flows; and
- a residual margin that eliminates any gain at inception of the contract.

If the initial measurement of an insurance contract results in a day one loss, then the insurer should recognise that day one loss in profit or loss.

The present value of the *fulfilment* cash flows are re-measured each reporting period.

#### Three building blocks (FASB preference)

At initial recognition, an insurer measures a contract as the sum of:

- the present value of the *fulfilment* cash flows, which is made up of:
  - an explicit, unbiased and probability-weighted estimate (i.e. expected value) of the future cash outflows less the future cash inflows that will arise as the insurer fulfils the insurance contract;
  - a discount rate that adjusts those cash flows for the time value of money; and
- a composite margin that eliminates any gain at inception of the contract.

In the FASB model, risk and uncertainty are reflected implicitly through a single composite margin rather than in a risk adjustment. This alternative approach does not give rise to differences at inception in most cases since both the residual and composite margin are calibrated to the consideration received for the insurance contract (premium received/receivable). However, differences arise in subsequent measurement of the insurance contract.

The FASB decided tentatively that the margin at inception (composite margin) should be measured by reference to the premium so as to eliminate day one gains. If the initial measurement of an insurance contract results in a day one loss, then the insurer should recognise that day one loss in profit or loss. For this purpose a day one loss would arise only if at inception, the expected present value of the outflows exceeds the expected present value of the premiums. In other words, no separate risk adjustment would be included in determining whether there is a day one loss under a composite margin approach.

The FASB decided tentatively that the composite margin should be presented with the insurance liability rather than as a separate liability outside the insurance liability and disclosed separately.

The measurement model	
Other points	<ul style="list-style-type: none"> <li>● The ED requests feedback from constituents on which of these two approaches is preferred.</li> <li>● Two IASB members dissented from the proposals. They disagreed with the four building block measurement approach for several reasons. In particular, they believe that it is not possible to objectively compute a risk adjustment or to expect any comparability from an estimate representing the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate cash flows exceed those expected. They consider that the risk adjustment is not the price of risk but rather a hypothetical amount that can be arbitrarily selected by each insurer.</li> <li>● The FASB's decision to adopt a composite margin was influenced heavily by concerns over clarity around measurement of the risk adjustment.</li> </ul>
Non-performance risk	The present value of the fulfilment cash flows does not reflect the risk of non-performance by the insurer, either at initial recognition or subsequently.
Other point	<ul style="list-style-type: none"> <li>● Exclusion of the insurer's own credit risk is a significant distinction between the proposed insurance measurement approach and fair value.</li> </ul>
Level of measurement (aggregation)	<p>Under, the proposals, an insurer would measure the present value of the fulfilment cash flows and the risk adjustment at a portfolio level of aggregation for insurance contracts.</p> <p><i>A portfolio of contracts</i> are contracts that are subject to broadly similar risks and managed together as a single pool. This definition is consistent with IFRS 4.</p> <p>The residual margin should be determined by grouping insurance contracts by portfolio and, within the same portfolio, by date of inception of the contract and by the coverage period of the contract.</p>
Other point	<ul style="list-style-type: none"> <li>● Part of the rationale for measuring the risk adjustment at a portfolio level as opposed to an individual contract basis, is to reflect "diversifiable" risks within the same portfolio. The IASB rejected an individual contract basis as it is inconsistent with the underlying economics of insurance, as an insurer often pools risks in order to receive the benefit of diversification.</li> </ul>
Contract boundaries (policyholder behaviour)	<p>For the purposes of measurement, the boundary of an insurance contract is the point at which the insurer either:</p> <ul style="list-style-type: none"> <li>● is no longer required to provide coverage; or</li> <li>● has the right or ability to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk.</li> </ul> <p>Options, forwards and guarantees that do not relate to the existing coverage under the insurance contract are not included within the boundary 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>
Other points	<ul style="list-style-type: none"> <li>● Applying the proposals on policyholder behaviour, no deposit floor applies to measurement.</li> <li>● Under the proposals, expected future cash flows related to options would involve considering all options and resulting future cash flows that fall within the boundary of the contract.</li> <li>● Currently, an insurer's accounting practices may not separately account for the full value of embedded options or guarantees in a life insurance contract. These proposals may result in some embedded options and guarantees being valued consistent with market prices.</li> <li>● A key consideration in the measurement approach is the boundary of a contract in terms of renewals (referred to as "policyholder behaviour"). For example, estimates of future renewals (and estimated expenses) are included in measurement if the insurer is required to provide future coverage at a fixed price.</li> </ul>

The measurement model	
Future cash flows	<p>The estimates of cash flows for a portfolio of contracts include all incremental cash inflows (premium receipts from policyholders) and outflows such as claims and benefits paid to policyholders, claim handling expenses, persistency and surrender benefits, participation benefits, incremental acquisition costs, and other costs of servicing the contract arising from the portfolio. These cash flows should:</p> <ul style="list-style-type: none"> <li>● be explicit, i.e. separate from estimates of discount rates that adjust those cash flows for the time value of money and the risk adjustment that adjusts these cash flows for uncertainty about timing and amount of future cash flows;</li> <li>● reflect the perspective of the insurer;</li> <li>● reflect all available information that relates to the cash flows of the contract including, but not limited to, industry data, historical data of the insurer's costs, and market inputs when those inputs are relevant to the cash flows of the contract;</li> <li>● be current and consistent with market prices, i.e. use estimates of financial market variables such as interest rates; and</li> <li>● include only cash flows arising from existing contracts within the contracts' boundaries.</li> </ul> <p>For subsequent reporting periods, the measurement of cash flows should reflect updated estimates of the remaining future cash flows at that reporting date.</p>
Other points	<ul style="list-style-type: none"> <li>● The participating benefits an insurer expects to pay to policyholders of participating contracts are included in the cash flows.</li> <li>● Cash flow estimates are required to be updated each reporting period and changes in estimates are recognised in profit or loss. This proposal represents a significant change in practice for many insurers who currently use locked-in estimates of cash flows at inception.</li> <li>● General overhead costs and non-incremental acquisition costs are not included in measurement but are expensed as incurred.</li> </ul>
Acquisition costs	<p>Under the proposals, incremental acquisition costs, i.e. costs of selling, underwriting, and initiating an insurance contract that would not have been incurred if the insurer had not issued that particular contract, are included in the present value of the fulfilment cash flows of a contract.</p> <p>All other acquisition costs should be expensed when incurred in profit or loss.</p> <p>Unlike other cash flows, the determination as to whether acquisition costs are incremental and hence included in fulfilment cash flows is considered on an individual contract basis rather than at a portfolio level.</p>

## The measurement model

Other points	<ul style="list-style-type: none"> <li>● Incremental acquisition costs are limited to the costs of successfully selling a contract (i.e. not including costs for contracts that are not ultimately issued by the insurer) and exclude allocated costs. These costs are incremental at a contract level rather than the portfolio level. Under the proposals, an allocated cost such as salaries of employees in an underwriting department would not be included in measurement.</li> <li>● During the deliberations preceding the issuance of the ED, the IASB initially had leaned toward the approach that premium revenue includes recovery of acquisition costs and that revenue should be recognised to the extent of incremental acquisition costs. This also seemed to be the preferred approach of respondents to the field test questionnaires on this subject.</li> <li>● This approach for acquisition costs effectively excludes incremental acquisition costs from the determination of the residual and composite margins which are amortised in the statement of comprehensive income.</li> <li>● In June 2010 the FASB changed their previous tentative decision that acquisition costs should be expensed consistent with the revenue recognition project, based on the revised objective for the measurement of cash flows.</li> <li>● Some Board members were only supportive of including incremental acquisition costs in measurement if the proposals also included a summarised margin approach for the statement of comprehensive income (i.e. no revenue line presented).</li> <li>● Insurers that currently defer non-incremental acquisition costs under their current accounting policies may experience larger losses at inception.</li> </ul>
Discount rates	<p>Under the proposals, an insurer adjusts the future cash flows for the time value of money using a discount rate that is consistent with cash flows whose characteristics reflect those of the insurance contract liability (e.g. timing, currency and liquidity). The discount rate also should exclude any factors that influence the observed rates but are not relevant to the insurance contract liability, i.e. risks present in the instrument for which market prices are observed that are not relevant to the insurance contract liability.</p> <p>If the cash flows of a contract do not depend on the performance of specific assets, the discount rate would reflect the yield curve for instruments with no or negligible credit risk, adjusted for differences in liquidity between those instruments and the contract.</p>
Other points	<ul style="list-style-type: none"> <li>● The discount rate should capture characteristics of the cash flows including currency, duration and liquidity. The ED does not contain specific guidance on determining a discount rate (e.g. corporate bond rates, swap rates etc) or how an insurer might estimate a liquidity adjustment.</li> <li>● An insurer's own credit risk is not included in the discount rate.</li> <li>● Some constituents have raised the possibility of significant losses at the inception of some contracts (particularly long-duration non-participating insurance contracts) and possible accounting mismatches if the discount rate for insurance contracts does not change in response to changes in market credit spreads.</li> </ul>

## The measurement model

<p>Risk adjustment</p>	<p><b>Incorporating a risk adjustment (IASB preference)</b></p> <p>The risk adjustment, determined at the level of a portfolio of insurance contracts, reflects the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected.</p> <p>The ED includes application guidance that discusses the techniques for estimating the risk adjustment. These techniques are limited to three approaches (confidence level, conditional tail expectation (CTE) and cost of capital).</p> <p>In some cases, some or all of the cash flows of an insurance contract may be replicated by an asset with respect to their amount, timing and uncertainty. Notwithstanding the general requirement for separate estimates of future cash flows, discount rates and a risk adjustment, the ED indicates that a replicating asset approach based on the fair value of the replicating asset may be appropriate.</p> <p>The risk adjustment should be re-measured each reporting period. Changes in measurement of the risk adjustment should be recognised in profit or loss.</p>	<p><b>No risk adjustment (FASB preference)</b></p> <p>The FASB decided tentatively to eliminate an explicit risk adjustment from the measurement approach.</p>
<p>Other points</p>	<ul style="list-style-type: none"> <li>● The key difference between each Board’s preferred measurement approach is the incorporation of an explicit risk adjustment.</li> <li>● The proposals in the ED do not mandate a specific confidence level or CTE band for calibrating the risk adjustment.</li> <li>● The ED notes that the risk adjustment would generally decrease over time (as the insurer is released from risk) but could increase if new uncertainty emerges.</li> <li>● A loss at inception is more likely to occur with a measurement approach that incorporates a risk adjustment compared to the composite margin approach. For example, if the present value of policyholder inflows is 1,000, the present value of outflows is 900, and the risk adjustment is 150, then under the four building blocks approach, a loss of 50 is recognised at inception. If the three building blocks approach is applied then a composite margin of 100 is recorded at inception.</li> </ul>	

<b>The measurement model</b>		
Treatment of margins	<p><b>Residual margin (IASB preference)</b></p> <p>A residual margin arises at inception when the present value of the fulfilment cash flows is less than zero. If the present value of the fulfilment cash flows at inception is positive, i.e. the expected present value of cash outflows plus the risk adjustment is greater than the expected present value of cash inflows, then this amount is recognised immediately as a loss in profit or loss.</p> <p>The residual margin is determined on initial recognition at a portfolio level for contracts with a similar inception date and coverage period. This residual margin amount is locked-in at inception.</p> <p>The residual margin is recognised in profit or loss over the coverage period in a systematic way that best reflects the exposure from providing insurance coverage, either on the basis of the passage of time or of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time.</p>	<p><b>Composite margin (FASB preference)</b></p> <p>A composite margin arises at inception when the expected present value of the future cash outflows less future cash inflows is less than zero. If the expected present value of cash outflows is greater than the future cash inflows, then this amount is recognised immediately as a loss in profit or loss.</p> <p>The composite margin is not remeasured to reflect increases in risk, uncertainty or changes in the price for bearing risk.</p> <p>The composite margin should be released over both the coverage period (during which the insurer provides insurance coverage) and the benefit paying period (during which the insurer is exposed to uncertainty of ultimate cash outflows).</p> <p>The composite margin should be amortised using two factors:</p> <ul style="list-style-type: none"> <li>● the insurer's exposure from the provision of insurance coverage; and</li> <li>● the insurer's exposure from uncertainties related to future cash flows.</li> <li>● The specific method to determine current period amortisation could be characterised as a percentage of completion method (reflecting the pattern of the decline of risk) calculated as follows:</li> </ul> $\frac{\text{(Premium allocated to current period + current period claims and benefits)}}{\text{(Total contract premium + total claims and benefits)}}$
Other points	<ul style="list-style-type: none"> <li>● The residual and composite margins are measured at inception and are not subsequently remeasured; however, the residual and composite margins are amortised.</li> <li>● The residual margin is recognised systematically over the coverage period (subject to the criteria above) as opposed to the composite margin which is recognised over <i>both</i> the coverage period and the benefit paying period.</li> <li>● Both the residual and composite margins exclude incremental acquisition costs.</li> <li>● Specific guidance was added in respect of the expectation of incurring benefits and claims in a pattern that differs significantly from the passage of time, to capture some types of insurance contracts in which the exposures from insurance coverage may be seasonal or unevenly spread throughout the term of the contract coverage (e.g. hurricane coverage).</li> <li>● The expected contractual cash flows are a key driver in amortising the composite margin.</li> <li>● The FASB decided tentatively that an insurer should not adjust the composite margin for changes in cash flow estimates.</li> </ul>	

The measurement model		
Interest accretion on margins	<p><b>Accrete interest (IASB preference)</b></p> <p>The insurer accretes interest on the carrying amount of the residual margin using the discount rate determined on initial recognition to reflect the time value of money.</p>	<p><b>Do not accrete interest (FASB preference)</b></p> <p>The FASB has decided tentatively that interest should not be accreted on the composite margin.</p>
Other points	<ul style="list-style-type: none"> <li>● Supporters of accreting interest on the residual and composite margins point out that these margins are the difference between discounted balances at inception and believe that each should be adjusted for the time value of money consistent with the other building blocks of the measurement approach.</li> <li>● Opponents of accreting interest on the residual and composite margins believe that the margins are a mixture of different components, and therefore accreting interest may provide additional complexity and cost for minimal benefit.</li> <li>● Under the IASB's proposals, interest is accreted at a locked-in rather than a current rate.</li> </ul>	

Modified measurement or "premium allocation " approach	
Unearned premium	<p>The proposals contain a modified measurement approach for pre-claim liabilities of short duration contracts. This model is intended to be a proxy for the building block measurement model in the pre-claims period. Under the proposals, <i>short-duration</i> contracts are insurance contracts with a coverage period of approximately 12 months or less that do not contain any embedded options or derivatives that significantly affect the variability of cash flows.</p> <p>Under this measurement approach, an insurer is required to measure its pre-claims obligation at inception as premiums received at initial recognition plus the expected present value of future premiums within the boundary of the contract less incremental acquisition costs.</p> <p>This pre-claims obligation is reduced over the coverage period in a systematic way that best reflects the exposure from providing insurance coverage, either on the basis of the passage of time or the expected timing of incurred claims and benefits if this pattern differs significantly from the passage of time.</p> <p>The pre-claims liability is the pre-claims obligation less the present value of future premiums within the boundary of the contract. The insurer also is required to accrete interest on the carrying amount of the pre-claims liabilities. If a contract is onerous based on a comparison of the expected present value of the fulfilment cash flows for future claims and the pre-claim obligations for contracts in a portfolio with similar inception dates, the excess of the present value of the fulfilment cash flows over the carrying amount of the pre-claims obligation is recognised as an additional liability and expense.</p> <p>Liabilities for claims incurred are measured at the present value of fulfilment cash flows in accordance with the general measurement model.</p>

### Modified measurement or “premium allocation” approach

#### Other points

- Some FASB members supported the application of a modified measurement and presentation approach for certain insurance contracts. However, the FASB had a number of questions about certain aspects of a modified measurement and presentation approach and about which insurance contracts should follow that approach rather than the general approach. The FASB has not indicated in their tentative decisions whether they plan to adopt the modified measurement model. The FASB’s discussion paper is expected to solicit further feedback from constituents.
- During the Boards’ deliberations, many members were not in favour of drawing a “bright line” at 12 months, although they agreed that limiting use of the modified model to contracts with a shorter length would be preferred.
- Based on the criteria set forth in the ED, many property and casualty contracts and some life contracts would be subject to this modified model.
- The FASB staff is researching whether the model would be appropriate for longer tail coverages (i.e. those with extended claim settlement periods).
- While the modified approach appears similar to the current accounting model for short-duration contracts under US GAAP and models used by many insurers under IFRS 4, there likely will be some striking differences, most notably the use of a risk adjustment and discounting for measuring the claims liabilities. Also, future premiums would be discounted and netted against the pre-claims liabilities.
- Consistent with the general measurement model, a current market discount rate would be used in discounting the pre-claims obligation and claims liability.
- Although the original intent of the model was to simplify the measurement, some constituents and FASB members have raised concerns on the complexities embedded in the approach given the inclusion of discounting and accretion of interest.
- Several questions remain whether and how the modified approach would be applied if a composite margin approach is used for measurement.

### Participating contracts

#### Participating insurance contracts

Payments to policyholders arising from participating features in insurance contracts are cash flows from the contract like any other and are included in the expected present value of fulfilment cash flows in measuring an insurance contract.

#### Other points

- One of the challenges in this area is the varying impacts from the application of the guidance depending on how products are structured and what regulatory constraints exist in different jurisdictions.
- The revised unbundling criteria may further impact how these contracts are presented.

Unbundling and embedded derivatives	
Unbundling	<p>Some insurance contracts contain one or more components that would be within the scope of another IFRS if the insurer accounted for those components as if they were separate contracts, e.g. an investment (financial) component or a service component.</p> <p>If a component is not closely related to the insurance coverage specified in a contract, the ED proposes that an insurer unbundle and account separately for that component.</p> <p>The ED contains the following most common examples of components that are not closely related to the insurance coverage and that would result in unbundling:</p> <ul style="list-style-type: none"> <li>● an investment component reflecting an account balance that is credited with an explicit return at a rate based on the investment performance of a pool of underlying investments. The rate should pass on all investment performance but may be subject to a minimum guarantee;</li> <li>● an embedded derivative that is separated from its host contract under IAS 39; and</li> <li>● contractual terms relating to goods and services that are not closely related to the insurance coverage but have been combined in a contract with that coverage for reasons that have no commercial substance.</li> </ul>
Other points	<ul style="list-style-type: none"> <li>● Other investment and service components of insurance contracts would be subject to the refined unbundling principle. An unbundled service component generally would be accounted for under IAS 18 <i>Revenue</i> or, in time, a new standard on revenue recognition and an unbundled investment component would be accounted for under IFRS 9 <i>Financial Instruments</i> or IAS 39.</li> <li>● In unbundling an account balance that is credited with an explicit return at a rate based on the investment performance of a pool of underlying investments, an insurer shall regard all fees and charges assessed on the account balance, as well as cross-subsidy effects included in the crediting rate, as part of the insurance component or another component of the contract and not as part of the investment balance.</li> <li>● During the Boards' deliberations, one proposed driver in determining whether components should be unbundled was "interdependency". Many of the Board members agreed that the notion of significant interdependence is too broad and would result in little to no unbundling.</li> </ul>
Embedded derivatives	<p>Under the proposals, IAS 39 applies to an embedded derivative in an insurance contract unless the embedded derivative itself is an insurance contract. If the economic characteristics and risks of the embedded derivative are not closely related to those of the host insurance contract, the insurer is required to separate the embedded derivative and measure it at fair value with recognition of changes in fair value in profit or loss.</p>
Other points	<ul style="list-style-type: none"> <li>● The proposals are generally consistent with the current practice for accounting for embedded derivatives under IAS 39. However, unlike under IFRS 4, an insurer could not have a policy of separately accounting for embedded derivatives that do not meet the IAS 39 criteria for separation. Conversely, the ED would not permit an insurer to avoid separation under IAS 39 by having a policy of accounting for the whole of an insurance contract at fair value through profit or loss.</li> <li>● IFRS 4 contains an exception to the requirements of IAS 39 for a policyholder's option to surrender an insurance contract for a fixed amount. As stated in the basis of conclusions in the ED, surrendering an insurance contract generally leads to cancellation of the entire contract and therefore is often interdependent with other components. Applying the guidance in paragraph AG33(h) of IAS 39, an insurer would need to determine whether the surrender option is closely related to the host contract.</li> </ul>

<b>Presentation and disclosure</b>	
Presentation of the statement of comprehensive income and financial position	<p>The ED proposes that an insurer present each portfolio of insurance contracts as a single item within insurance contract assets or insurance contract liabilities. It also proposes that an insurer present a pool of assets underlying unit-linked contracts as a single line item separate from the insurer's other assets and that the portion of the liabilities linked to the pool be presented as a single line item separate from the insurer's other liabilities. Reinsurance assets are not offset against insurance contract liabilities.</p> <p>Under the ED, all income and expense from insurance contracts is presented in profit or loss. The ED proposes a new presentation for the statement of comprehensive income which follows the proposed measurement model. The underwriting margin is subject to disaggregation requirements (in the notes or on the face of the statement of comprehensive income), disclosing the change in risk adjustment and release of the residual margin.</p> <p>Other items to be presented in the statement of comprehensive income include:</p> <ul style="list-style-type: none"> <li>● gains and losses at initial recognition, further disaggregated on the face of the statement of comprehensive income or in the notes into losses at initial recognition of an insurance contract, losses on insurance contracts acquired in a portfolio transfer, and gains on reinsurance contracts bought by a cedant;</li> <li>● acquisition costs that are not incremental at the level of an individual contract;</li> <li>● experience adjustments and changes in estimates, further disaggregated on the face or in the notes into experience adjustments, changes in estimates of cash flows and discount rates, and impairment losses on reinsurance assets; and</li> <li>● interest on insurance contract liabilities.</li> </ul> <p>Income and expense from unit-linked contracts are presented as a separate single line item.</p> <p>Premiums and claims generally are not presented in the statement of comprehensive income on the basis that they represent settlements of insurance contract assets or liabilities rather than revenues or expenses. However, related information must be provided in the notes.</p> <p>For short-duration contracts subject to the alternative measurement approach for pre-claims liabilities, the underwriting margin is disaggregated into line items reflecting each of premium revenues, claims and other expenses, amortisation of incremental acquisition costs and changes in additional liabilities for onerous contracts.</p>
Other point	<ul style="list-style-type: none"> <li>● During the deliberations on the presentation model, many Board members supported a summarised margin approach for the statement of comprehensive income as they believed that revenue should not be a derived amount solely based on the margin, as would have been the case in the expanded margin presentation model that was also discussed by the Boards, and there should be a rationale behind the amount being recognised as revenue.</li> </ul>
Disclosures	<p>Under the proposals, an insurer is required to disclose quantitative and qualitative information in respect of:</p> <ul style="list-style-type: none"> <li>● the amounts arising from insurance contracts recognised in the financial statements; and</li> <li>● the nature and extent of risks arising from insurance contracts.</li> </ul> <p>An insurer is required to consider the level of detail necessary to satisfy the disclosure requirements, including how information is aggregated or disaggregated. Aggregation levels for disclosures which may be appropriate are type of contract and geography, but information may not be aggregated across different reportable segments as defined in IFRS 8 <i>Operating Segments</i>. Sufficient information should be provided to allow reconciliation to the line items in the statement of financial position.</p>

Other points	<ul style="list-style-type: none"> <li>● The disclosure requirements of IFRS 4 (including the disclosure requirements in IFRS 7 <i>Financial Instruments: Disclosures</i> that are incorporated in IFRS 4 by reference) were retained in the proposals with supplemental disclosures as a result of the proposed presentation for the statement of comprehensive income and the statement of financial position.</li> <li>● Required disclosures include: reconciliation of contract balances; methods and inputs used to develop the measurements, including a measurement uncertainty analysis; the nature and extent of risks arising from insurance contracts; a risk sensitivity analysis; and claims development information.</li> </ul>
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Reinsurance	
Reinsurance	<p>A reinsurer accounts for reinsurance contracts it issues using the recognition and measurement approach for insurance contracts.</p> <p>At initial recognition, a cedant measures a reinsurance contract as the sum of:</p> <ul style="list-style-type: none"> <li>● the present value of the <i>fulfilment</i> cash flows, which is made up of the expected present value of the cedant's future cash inflows plus a risk adjustment less the expected present value of the cedant's future cash outflows; and</li> <li>● a residual margin that eliminates any loss at inception of the contract.</li> </ul> <p>The cedant estimates the present value of fulfilment cash flows in the same manner as the corresponding part of the present value of fulfilment cash flows for the underlying insurance contract, after remeasuring the underlying insurance contract on initial recognition of the reinsurance contract.</p> <p>The cedant considers the risk of non-performance by the reinsurer on an expected value basis when estimating the present value of fulfilment cash flows and also updates for any change in the risk of non-performance by the reinsurer in subsequent measurement.</p> <p>The residual margin determined at inception cannot be negative. If the present value of the fulfilment cash flows is:</p> <ul style="list-style-type: none"> <li>● less than zero, i.e. the expected present value of future cash inflows plus the risk adjustment is less than the expected present value of future cash outflows, the cedant recognises this amount as the residual margin at initial recognition of the contract.</li> <li>● greater than zero, i.e. the expected present value of future cash inflows plus the risk adjustment exceed the expected present value of future cash outflows, the cedant recognises that amount as a gain in profit or loss at initial recognition of the contract.</li> </ul> <p>Any ceding commissions a cedant receives should be recognised as a reduction of the premium ceded to the reinsurer.</p>
Other points	<ul style="list-style-type: none"> <li>● Reinsurance balances should not be offset against related direct insurance balances either in the statement of financial position or the statement of comprehensive. However, a cedant would derecognise an insurance contract liability if the obligation is (legally) discharged, cancelled or expired (see Derecognition section).</li> <li>● The expected present value of losses from default by the reinsurer or coverage disputes are incorporated in the measurement of reinsurance assets.</li> <li>● During the deliberations on the measurement model, the Boards discussed the asymmetries that may practically arise in accounting for risk margins (which may differ between a cedant and reinsurer).</li> </ul>

### Insurance contracts acquired in a business combinations and portfolio transfer

Business combinations	<p>An insurer shall measure a portfolio of insurance contracts initially at the higher of the fair value or the present value of the fulfilment cash flows of the assumed contracts.</p> <p>This treatment is an exception from the general requirements in IFRS 3 <i>Business Combinations</i> and ASC Topic 805 <i>Business Combinations</i>, which require an entity to measure assets acquired and liabilities assumed in a business combination at fair value.</p> <p>If the present value of the fulfilment cash flows is higher than the fair value, the difference results in an increase in the initial carrying amount of goodwill. If the fair value is higher than the present value of fulfilment cash flows, the difference should be treated as the residual margin at initial recognition.</p>
Portfolio transfers	<p>For each portfolio of insurance contracts acquired in a portfolio transfer, an insurer should determine the expected present value of the fulfilment cash flows and compare that amount with the consideration received for those contracts, after adjusting the consideration for any other assets and liabilities acquired in the same transaction, such as financial assets and customer relationships treating the difference as follows:</p> <ul style="list-style-type: none"> <li>● if the consideration is the higher amount, the difference is established as the residual margin at that date; and</li> <li>● if the consideration is the lower amount, the difference is recognised immediately as an expense.</li> </ul>

Effective date and transition	
Effective date and transition	<p>The ED does not include an effective date for the proposals or state whether they may be adopted early. The IASB plans an additional consultation, in conjunction with the FASB, on the effective dates of these proposals and other proposed standards to be issued in 2011. The Board will consider delaying the effective date of IFRS 9 (currently effective for annual periods beginning on or after 1 January 2013) if the new IFRS on insurance contracts has a mandatorily effective date later than 2013 so that an insurer would not have to face two major rounds of change in a short period.</p> <p>With respect to transition, the ED proposes that at the beginning of the earliest period presented, an insurer would, with a corresponding adjustment to retained earnings:</p> <ul style="list-style-type: none"> <li>● measure its existing portfolios of insurance contracts at the present value of the fulfilment cash flows. Measurement both at transition and subsequently does not include a residual margin for those contracts since the Board believes that requiring insurers to estimate a transitional balance may be costly and subject to bias through the use of hindsight;</li> <li>● derecognise any existing deferred acquisition costs; and</li> <li>● derecognise any intangible assets arising from insurance contracts assumed in previously recognised business combinations (excluding intangible assets such as customer relationships and customer lists which relate to possible future contracts).</li> </ul> <p>An insurer is permitted, but not required, to redesignate a financial asset as measured at fair value through profit or loss at the start of the earliest period presented when it adopts the proposals if doing so would reduce a measurement or recognition inconsistency. The reclassification is a change in accounting policy in accordance with IAS 8 <i>Accounting Policies, Changes in Accounting Estimates and Errors</i>. The insurer should recognise the cumulative effect of that redesignation as an adjustment to opening retained earnings of the earliest period presented and remove any balances from accumulated other comprehensive income.</p> <p>Additionally, an insurer is exempt from disclosing previously unpublished information about claims development that occurred earlier than five years before the end of the first financial year in which it applies the proposals. An insurer is required to disclose if it is impracticable to prepare information about claims development that occurred before the beginning of the earliest period presented.</p> <p>The transition requirements apply both to a first-time adopter of IFRS and to an insurer currently reporting under IFRS.</p>
Other points	<ul style="list-style-type: none"> <li>● Under this approach, at transition an insurer recognises a risk adjustment for the portfolio of insurance contracts but does not recognise any residual margin. The effect of not recognising a residual margin for contracts in existence at transition would be to depress the net income reported for those contracts in periods post-transition compared to a full retrospective application with recognition of a transitional residual margin balance. If a composite margin approach were applied to measurement, the composite margin would be set equal to the risk adjustment and would not be subsequently remeasured but released into income in the same way as any other composite margin.</li> <li>● IAS 8 prohibits the retrospective application of an accounting policy to the extent that it would be impracticable as defined in IAS 8. The IASB concluded that retrospective determination of a residual margin may be impracticable and the costs of applying a full retrospective approach would outweigh the benefits for users.</li> <li>● During their deliberations on the ED, some Board members expressed concern that a mandatory 2013 effective date consistent with IFRS 9 might not allow insurers sufficient time to put systems in place to enable full prospective measurement of their insurance contract liabilities from the start of the comparative period. Some of the staff and Board members thought that this may result in a need to defer the effective date of IFRS 9.</li> </ul>

Other topics	
Use of other comprehensive income	Under the ED, all income and expense from insurance contracts is included in profit or loss. Remeasurement of insurance contracts through other comprehensive income would not be permitted or required.
Other point	<ul style="list-style-type: none"> <li>Under the proposals, the current use of “shadow accounting” would be eliminated.</li> </ul>
Foreign currency cash flows	Insurance contracts that result in foreign currency cash flows are treated as monetary items in accordance with IAS 21 <i>The Effects of Changes in Foreign Exchange Rates</i> .
Other points	<ul style="list-style-type: none"> <li>Since premiums and liabilities usually are settled in cash, balances arising from insurance contracts, including the present value of cash flows, the risk adjustment, the residual margin and any pre-claim liability for a short-duration contract, are treated as monetary items.</li> <li>This might represent a significant change for insurers that currently treat deferred revenue balances related to unearned premiums denominated in a foreign currency as non-monetary items. It would also reduce the mismatch that occurs when such premiums are held as cash or invested in other monetary assets denominated in the foreign currency.</li> </ul>
Assets associated with unit-linked contracts	<p>The Boards decided 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 consolidation project.</p> <p>Accounting mismatches can arise with unit-linked contracts, being contracts for which some or all of the benefits are determined by the price of units in internal or external funds. In some jurisdictions these contracts are referred to as variable contracts.</p> <p>In some cases, the asset portfolios associated with unit-linked contracts include property, including owner-occupied property. Although owner-occupied property can be revalued under IAS 16 <i>Property, Plant and Equipment</i>, the resulting change in carrying amount is not recognised in profit or loss but rather in revaluation surplus, which is never reclassified to profit or loss.</p> <p>The proposals introduce a requirement to measure property owned and occupied by the insurer that is part of a pool of assets underlying unit-linked contracts at fair value through profit or loss to the extent the changes in the property relate to the interest of unit-linked contract holders in a pool of assets. Changes in the fair value of the insurer’s own interest in property would be recognised as a revaluation in other comprehensive income.</p> <p>In addition, some asset portfolios associated with unit-linked contracts hold investments in the insurer’s own shares, which are not recognised as assets under IAS 32 <i>Financial Instruments: Presentation</i>.</p> <p>The proposals also require that for insurer’s own shares underlying unit-linked contracts, an insurer recognise the shares as assets and measure the shares at fair value through profit or loss to the extent those changes relate to the interest of unit-linked contract holders in the pool of assets. If the insurer also has its own interest in the same fund, the insurer would measure those assets at fair value through profit or loss.</p>
Other points	<ul style="list-style-type: none"> <li>An amendment is proposed to IAS 16 to introduce a requirement to measure property owned and occupied by an insurer that is part of a pool of assets underlying unit-linked assets at fair value through profit or loss.</li> <li>Amendments are also proposed to IFRS 9 and IAS 32 to require an insurer to recognise and measure shares it has issued at fair value through profit or loss if these shares are held as part of a pool of assets underlying unit-linked assets.</li> </ul>

**Timeline for completion**

Proposed timelines are as follows:

Timeline	Topic for discussion
Third quarter 2010	Publication of the FASB discussion paper (targeted end of August 2010)
30 November 2010	Comments due on the ED and FASB discussion paper.
December 2010 – March 2011	Summary of comments and discussion on issues raised in the comment letters
April – May 2011	Pre-balloting and sweep issues
June 2011	Publication of final standard by the IASB
Third quarter 2011	Publication of an exposure draft by the FASB
2012	Publication of final standard by FASB

Summaries of the activities on this project and a copy of the ED can be accessed at the IASB website at <http://www.ifrs.org> and the FASB website at <http://www.fasb.org>.

**Abbreviations**

- 1 IASB: International Accounting Standards Board
- 2 FASB: US Financial Accounting Standards Board

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