

IFRS – Insurance Newsletter

November 2009, **Issue 1**

This IFRS Insurance Newsletter highlights key developments relating to the joint International Accounting Standards Board (IASB) / U.S. Financial Accounting Standards Board (FASB) Insurance Contracts project, including the results of recent IASB and FASB discussions regarding the recognition and derecognition criteria for insurance contracts, and the accounting treatment of participating policies.

Additionally, the current status of the project and anticipated timeline are covered. The IASB and FASB (the “Boards”) are aiming to publish together insurance contracts exposure drafts in April 2010 with a view to finalising a joint standard by June 2011.

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KPMG’s monthly update on the joint IASB / FASB insurance project

Project Overview

With a start in 1997, the IFRS insurance contracts project was divided into two phases. Phase I of the project culminated with the IASB publishing IFRS 4 *Insurance Contracts* in 2004, which is currently in effect. The standard sought to bring limited improvements to accounting for insurance contracts, while minimising the amount of change required from pre-existing accounting policies and practices, and avoiding changes by insurers that may be reversed in the second phase of the insurance project. The second phase of the project picked up momentum with the IASB issuing a discussion paper in May 2007, which outlined a comprehensive “exit value” accounting model for insurance contracts. In October 2008 the FASB added a project on insurance to its agenda and the Boards agreed to continue the project jointly.

The speed of the project has accelerated in recent months. Several key tentative decisions were made at the September and October 2009 IASB and FASB meetings indicating an increased likelihood of convergence between the Boards. The treatment of acquisition costs had been a significant area of divergence between the Boards in previous meetings and at the 28 October 2009 joint meeting, the Boards jointly voted in favour of expensing acquisition costs

when incurred with no recognition of revenue to offset the costs incurred. Additionally, the FASB appears to be moving toward acceptance of adding an explicit risk or uncertainty element to the current fulfilment value model.

The measurement model candidates have received considerable focus over the past several months. The IASB and FASB models vary significantly from the “exit value” approach presented in the May 2007 discussion paper. The IAS 37 model, which the IASB voted in favour of adopting with an 8 to 7 vote during the 18 September 2009 meeting, continues to be revised and deliberated by the IASB in conjunction with their project to amend IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The definition and measurement of risk in the current IAS 37 model varies from the current fulfilment value model selected tentatively by the FASB. Discussions between the IASB and FASB during October 2009 reiterated the objective of a converged approach and the Boards plan to discuss the features of both measurement models in December 2009. They are aiming to clarify differences in the models before the release by the IASB of the limited re-exposure document on IAS 37 planned to be issued in December 2009.

Based on indications from recent meetings of the IASB and FASB and the reaffirmation of the Memorandum of Understanding (MOU) in early November 2009, the Boards announced their ongoing commitment to issuing a joint standard for insurance contracts. The Boards are aiming to publish together insurance contracts exposure drafts in April 2010 (delayed from the previously expected publish date of December 2009) with a view to finalising a joint standard by June 2011.

Recent Meetings

The IASB and FASB held separate meetings on 17 November and 24

November 2009, respectively to discuss recognition and derecognition of insurance contracts. In addition, the IASB and FASB held a joint meeting on 18 November 2009 to discuss the accounting treatment of participating contracts. A summary of the meetings are discussed below:

17 November 2009 IASB Meeting

The IASB considered the recognition and derecognition of insurance contracts. Specifically, whether an insurer should recognise insurance contracts when the insurer becomes party to the contract and derecognise an insurance liability when it no longer qualifies as a liability of the insurer; applying both the principles in IAS 39 *Financial Instruments: Recognition and Measurement* and its developing replacement IFRS 9 *Financial Instruments*.

Recognition – The IASB staff proposed that an insurer should recognise an insurance contract when it becomes party to the contract, which is consistent with the discussion paper *Preliminary Views on Insurance Contracts*. In the IASB agenda paper relating to this issue, two possible approaches were identified: 1) when an insurer becomes party to the contract; and 2) when the coverage period of the contract begins. IASB members requested further clarification from the IASB staff on when an insurer becomes “party” to the contract. There was discussion around jurisdictional differences as to when an insurer may recognise a contract which may be dependent on regulatory constraints. IASB members also raised the existence of a third possible approach for recognition – when an insurer makes an unconditional offer to the policyholder for coverage (in some countries referred to as “a binder”).

In the IASB agenda paper the IASB staff highlighted concerns expressed from respondents to the May 2007

discussion paper over the length of time that can exist between when a contract is entered into and the start of the coverage period. In some circumstances this time period can be substantial and an insurer could be exposed to the risk of loss during this period, depending on regulatory and legal requirements. Some IASB members supported a principle of recognising an insurance contract when coverage begins and treating the contract as fully executory until the start of the coverage period. Under this approach the insurer would treat any premium received before the start of the coverage period, as a deposit, with a liability adequacy test if the contract were onerous. Further research as to when coverage actually begins (i.e., before the contract is issued, when an unconditional offer is made, or at the date as stated in the contract), was requested and how this varied by jurisdiction.

Other considerations included recognising a derivative for future coverage until the coverage period starts and accounting for embedded options for future coverage.

No decision was made by the IASB regarding this subject. The IASB will continue to discuss it at a future meeting.

Derecognition – The IASB decided tentatively that an insurer should derecognise an insurance liability when it no longer qualifies as a liability applying the derecognition principles of IAS 39.

24 November 2009 FASB Meeting

The FASB continued deliberations on accounting for insurance contracts. The agenda for the FASB meeting mirrored that of the IASB’s meeting taking place on 17 November 2009. The FASB deliberated on the rights and obligations arising under insurance contracts, including the treatment of the insurance contract in the period

between entering into a contract and the start of the coverage period and derecognition of insurance liabilities.

Recognition – The FASB staff recommended that an insurer recognises insurance contracts when it becomes party to the contract. Similar to IASB discussions, there was significant emphasis placed on when an insurer becomes “party” to the insurance contract and clarifying this definition. In addition, considerable discussion focused on the potential of loss and the trigger for recognition when an insurer becomes *on risk* to provide coverage to the policyholder for an insured event. The *on risk* concept appears to capture the principle that recognition begins when an insurer enters into a firm arrangement with the policyholder.

The FASB also considered if it was appropriate for an insurer to recognise an insurance contract before the start of the coverage period. In a broad sense, there can be a change in conditions between the time the insurer enters into a contract and the start of the coverage period that can affect the future cash flows of the contract.

The FASB decided tentatively that an entity should recognise an insurance obligation at the earlier of (1) the entity being *on risk* to provide coverage to the policyholder for insured events and (2) the signing of the insurance contract.

Embedded Options for Future Coverage

– The FASB staff presented this issue for discussion purposes only. The key question posed by the FASB staff was whether the measurement of an insurance contract should include the expected present value of cash flows arising from an embedded policyholder option to buy additional coverage. The FASB did not appear to support the inclusion of cash flows related to the right to acquire

additional policy coverage, such as life insurance for a spouse, which would modify the existing provisions in the policy. The FASB expects to discuss this item, which is also related to contract boundaries / policyholder behaviour, in a future joint meeting between the Boards.

Derecognition – The FASB staff recommended that an insurer derecognise an insurance contract when it no longer qualifies as a liability of the insurer. The FASB staff proposed revisions to the existing guidance which are consistent with the current requirements in IAS 39. Respondents to the insurance contracts discussion paper on this topic expressed concern that, in some cases, claims are reported significantly after the end of the coverage period and an insurer may not know precisely whether a liability has been extinguished. The FASB staff highlighted that if an insurer has no information that a possible claim exists, the insurer will not measure the liability at a significant amount so there may be little difference between derecognition and measuring an insurance liability at a negligible amount. The FASB expressed a preference to include derecognition criteria in the standard to expressly convey that purchasing reinsurance does not trigger derecognition of an insurance liability.

The FASB decided tentatively on a principle that an insurance liability should be derecognised by an entity when that obligation no longer qualifies as a liability. The liability is eliminated when the entity is no longer on risk and no longer required to transfer any economic resources for that obligation.

18 November 2009 IASB / FASB Joint Meeting

The Boards continued to discuss the appropriate accounting treatment for insurance contracts with participating features referred to as “participating contracts.” Generally, insurance

products can be sold on a participating and non-participating basis. With participating contracts, the policyholder has both a guaranteed benefit (e.g., death benefit or coverage for loss of property) and a right to participate in the performance of the insurance entity or an underlying pool of insurance contracts (and sometimes related investments). The insurer has some discretion over the amount and timing of the resulting distributions (most commonly in the form of dividends or interest credits) to policyholders, but often the discretion is limited based on legislation, regulation or contract features.

The paper prepared by IASB staff did not address measurement, presentation and disclosure, participating investment contracts, universal life contracts or unit-linked contracts (also known as variable contracts).

Two accounting approaches for participating contracts were presented:

View 1 – Measurement of the cash flows of an insurance contract includes probability weighted cash flows (expected value). Payments arising from participating features in an insurance contract would be cash flows of the contract and considered in the overall measurement of the liability.

View 2 – Components of the participating contract are bifurcated (split between guaranteed benefit and participating feature). The participating feature would be classified as liability or equity, either as a whole or by splitting it into components depending on the features of the contract.

Under both views, the guaranteed benefit would be classified as a liability.

In debating these views, a key point of discussion centred around the participating feature and whether it should be classified as a liability, as

equity or split into liability and equity components.

Considerations in support of a liability or split approach included the nature of the contractual relationship between the insurer and the policyholder, and differences in what could be viewed as a “constructive obligation” based on contractual or regulatory restrictions which can vary between jurisdictions. For instance, in the UK many participating features are contractually and legally established and determinations of benefits are specified so there is less discretion due to regulatory constraints. In other countries there is less regulation over these benefits and it is more difficult to interpret what is actually an enforceable legal obligation. Some of the members focused on the definition of “discretionary” and how this would be applied in different circumstances.

Board members supporting an approach to split the components, had

the view that if a benefit had to be paid based on legal requirements regardless of the timing of the distribution, this should be recorded as a liability and any remainder would be considered equity. Other considerations in support of this approach, included consistency with IAS 32 *Financial Instruments: Presentation*, which requires bifurcation of a compound financial instrument into equity and liability components.

Some Board members focused on the equity approach and thought that under view 2, the discretionary benefits would be treated as equity until they were declared, with a classification that indicated they were not available for shareholder distribution. Alternatively, there was a strong view by some that policyholders are not shareholders of the insurance entity and therefore benefits to policyholders should not be view as shareholders’ equity. The IASB staff highlighted that if the benefits arising from a participating feature were treated as equity, there may be a need

to bifurcate the premium to identify the portion that relates to a guarantee as opposed to discretionary benefit. This could lead to unnecessary complexity and difficulty for financial statement users.

Other general considerations included the timing and accounting for the expense associated with benefits.

One of the challenges in this area, regardless of the view that is adopted (View 1 or View 2) is that there can be varying impacts from the application of the guidance depending on how the individual product is structured and the nature of regulatory constraints that exist in the jurisdiction.

A joint tentative vote took place with the majority of IASB members voting (eleven to four) in favour of exploring View 1 and liability treatment, and the majority of FASB members voting (three to two) in favour of exploring View 2 and liability / equity bifurcation.

Current Status of the Project

The current status of the insurance contracts project and key decisions made to date are outlined in the table below:¹

Topic	IASB	FASB
Building Blocks	<p>The IASB decided tentatively that the measurement for insurance contracts should be based on three building blocks:</p> <ul style="list-style-type: none"> ● probability weighted future cash flows ● discounting (reflecting the time value of money) ● use of an explicit margin. 	<p>The FASB decided tentatively that the measurement for insurance contracts should be based on three building blocks:</p> <ul style="list-style-type: none"> ● probability weighted future cash flows ● discounting (reflecting the time value of money) ● use of an explicit margin.
KPMG Observations:	<ul style="list-style-type: none"> ● The Boards jointly agreed on the fundamental building blocks of the measurement model. ● A key consideration includes the boundary of a contract in terms of renewals (IASB refers to this as “policyholder behaviour”). The IASB would include cash flows where the amounts or timing depends on whether policyholders exercise options in the contracts. Whether the insurance company can cancel the contract or change the pricing or other terms, is the starting point for determining whether cash flows belong to an existing contract or a new contract. The IASB staff is developing additional guidance in this area. 	
Candidate Measurement Approaches	<ul style="list-style-type: none"> ● The IASB decided tentatively to select the IAS 37 model (following the project to amend or replace IAS 37) with modifications to exclude day one gains. ● It is important to note that a significant minority (seven of fifteen members) supported a fulfilment value approach and the exposure draft (ED) is currently planned to explain both approaches absent convergence of views. 	<p>The FASB tentatively selected a current fulfilment value approach with a composite margin as the measurement model.</p>
KPMG Observations:	<ul style="list-style-type: none"> ● Changes or clarifications may be made as deliberations on the IAS 37 measurement model continue prior to the limited re-exposure planned for December 2009. ● Key issues still being addressed with the IAS 37 model include whether both risk and service margins will be recognised, how the risk and service margins in the IAS 37 model compare to the composite margin of the fulfilment value model, and how the entity will treat its own credit risk. The current fulfilment value approach does not include an explicit risk margin (though that margin is implicitly included in the composite margin). ● At the October 2009 joint meeting there was considerable movement towards convergence in approach. At that meeting the FASB members appeared to be leaning toward accepting a separate risk or uncertainty element in the current fulfilment value approach. ● The Boards asked the staff to analyse the potential remaining differences between the current fulfilment value model and the IAS 37 model. In this analysis, the Boards asked the staff to draft language to clarify the measurement objective, including the role of an uncertainty adjustment under both measurement approaches. The goal of the analysis is to arrive at a converged tentative decision on measurement. ● It is important to note that significant volatility may be introduced in each of the proposed methods and there are variations as to whether all, or only a portion, of the volatility flows immediately through profit / (loss). 	

¹ These summaries of the IASB and FASB positions were derived from the November IASB staff agenda paper 10.

Topic	IASB	FASB
Exclude Discounting and Margins in some instances?	The IASB has discussed the arguments for and against selecting an approach that uses an estimate of future cash flows with no margins and no discounting. The IASB has also discussed when to use such an approach for non-life claims liabilities and decided tentatively not to add this to the list of measurement candidates.	The FASB has not yet discussed whether, in certain instances, the measurement of insurance contracts should include future cash flows with no margins and no discounting.
KPMG Observations:	<ul style="list-style-type: none"> Further discussion is expected by the Boards in this area. 	
Use of Inputs	<p>The measurement approach conceptually includes current estimates of financial market variables that are consistent with observable market prices when possible.</p> <p>The discount rate used in measurement of cash flows should be updated each reporting period.</p>	The measurement of cash flows should consider all available information including industry data, historical data of an entity's costs and market inputs when those inputs are relevant to fulfilling the contract.
KPMG Observations:	<ul style="list-style-type: none"> Generally, both approaches include measurement based on experience and input of the insurer and consistency with market variables when possible. 	
Measurement of Margins at Inception	<p>The margin at inception should be measured by reference to the premium. Therefore no day one gains should be recognised in profit or loss.</p> <p>If the initial measurement of an insurance contract results in a day one loss, the insurer should recognise this in profit or loss.</p>	<p>In principle the initial recognition of an insurance contract should not result in the recognition of an accounting profit.</p> <p>The FASB will continue to discuss the treatment of day-one losses at a future meeting.</p>
Discount Rates	<p>The IASB decided tentatively that the discount rate for insurance liabilities should conceptually adjust in a way that captures the characteristics of that liability rather than using a discount rate based on expected returns on assets backing the liability.</p> <p>The IASB may not be providing any detailed guidance on how to determine the discount rate.</p>	The FASB has not decided yet on this topic and will discuss at a future meeting.
KPMG Observations:	<ul style="list-style-type: none"> Based on the IASB discussion, the discount rate should capture characteristics of the cash flows including currency, duration and illiquidity. 	
Unearned Premium	The IASB decided tentatively that an unearned premium approach would be appropriate for pre-claim liabilities of short duration insurance contracts and to require rather than permit the use of an unearned premium for those liabilities.	The FASB has not decided yet on this topic and will discuss at a future meeting.

Topic	IASB	FASB
KPMG Observations:	<ul style="list-style-type: none"> The total liability under an unearned premium model would be the sum of the unearned premiums for the coverage period, any liability from the liability adequacy test and a claims liability. While this approach sounds similar to the current model for short-duration contracts in U.S. GAAP, there will likely be some striking differences. Most notably the use of a risk margin / uncertainty element and discounting in the claim liability. There are still many questions to be addressed about the application of this approach. 	
Acquisition Costs	Acquisition costs are expensed when incurred and the insurer should not recognise any revenue (or income) to offset those costs incurred.	Acquisition costs are expensed when incurred and the insurer should not recognise any revenue (or income) to offset those costs incurred.
KPMG Observations:	<ul style="list-style-type: none"> The IASB initially leaned toward the concept that the 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 preference indicated by respondents to the field test questionnaires on this subject. The IASB (eight to six) and the FASB (five to zero) voted at the October joint meeting that no revenue should be recognised at inception maintaining consistency with the revenue recognition project. 	
Policyholder Behaviour (Contract Boundaries)	<p>The measurement should include probability weighted cash flows (i.e., future premiums and cash flows resulting from those premiums such as benefits and claims) including cash flows which the amount or timing is dependent on whether policyholders exercise options in the contracts.</p> <p>The staff is currently developing proposals for identifying the “boundary” of the contract. A proposed starting point to identify a boundary between an existing contract and a new contract could be the right for the insurer to cancel the contract or change the pricing or other terms.</p>	The FASB has not decided yet on this topic and will continue to discuss at a future meeting.
KPMG Observations:	<ul style="list-style-type: none"> The Boards are currently discussing whether the accounting model should incorporate expectations about cash flows that are a consequence of policyholder renewals or cancellations. Additionally, there will be further discussion on how to distinguish new contracts from existing contracts. 	
Deposit Floor	Applying the tentative decisions made regarding policyholder behaviour, the IASB confirmed that no deposit floor applies to measurement.	The FASB has not decided yet on this topic and will discuss at a future meeting.

Topic	IASB	FASB
Policyholder Accounting	<p>The IASB has not decided yet on this topic and will continue to discuss this further at a future meeting.</p> <p>The IASB asked the staff to provide additional analysis around policyholder accounting including further detail around:</p> <ul style="list-style-type: none"> ● possible issues arising from lack of symmetry between policyholder accounting and the accounting by the issuer of the insurance contract. ● any similarities with accounting for reinsurance contracts from the perspective of the policyholder. 	<p>The FASB has not decided yet on this topic and will continue to discuss this further at a future meeting.</p> <p>The FASB asked the staff to prepare an analysis of policyholder accounting including further detail around:</p> <ul style="list-style-type: none"> ● possible issues arising from lack of symmetry between policyholder accounting and the accounting by the issuer of the insurance contract ● any similarities with accounting for reinsurance contracts from the perspective of the policyholder.
KPMG Observations:	<ul style="list-style-type: none"> ● Reinsurance accounting by both ceding and assuming companies are proposed to be included in the standard. 	
Subsequent Treatment of Margins	<p>The IASB decided tentatively that:</p> <ul style="list-style-type: none"> ● The driver for the residual margin should result in recognising margins in income systematically in the manner that best demonstrates the insurer's performance under the contract. ● The residual margin should be released over the coverage period. ● The residual margin should not be adjusted in subsequent reporting periods for changes in estimates. 	<p>The FASB has not decided yet on this topic and will continue to discuss at a future meeting.</p>
KPMG Observations:	<ul style="list-style-type: none"> ● The IASB's tentative decision to recognise the residual margin over the coverage period was made on the assumption that the IAS 37 model would be the measurement approach. If a fulfilment value approach was adopted, the Board may reconsider the tentative decision. ● While the broader conceptual conclusion of the IASB is to recognise the residual margin for insurance contracts over the coverage period, under the IAS 37 approach the separate margins for risk and potentially service would likely be recognised over the period to settle the claims. ● The length of the coverage period in the IASB model becomes a key driver for recognising the margin in profit or loss. ● The guidance set forth in the IAS 37 model is being deliberated currently and will be re-exposed outside of the Insurance Contracts project in December 2009. ● There has not be a decision on "how" the residual margin is determined, i.e., based on what underlying "drivers." The IASB is still considering a broad principle on considerations for the driver(s) or specifying the driver(s) to be utilised. ● The current fulfilment value approach does not include an explicit risk margin (though that margin is implicitly included in the composite margin). ● Further discussion of the margin is planned for January 2010. 	

Topic	IASB	FASB
Recognition of Insurance Contracts	The IASB has not decided yet on this topic and will discuss again at a future meeting.	The FASB decided tentatively that an entity should recognise an insurance obligation at the earlier of (1) the entity being <i>on risk</i> to provide coverage to the policyholder for insured events and (2) the signing of the insurance contract.
KPMG Observations:	<ul style="list-style-type: none"> ● When to begin recognising the contract (i.e., effective date, date the contract is entered into / signed or when there is an unconditional offer extended for coverage) is a significant consideration. ● When an insurer is <i>on risk</i> to provide coverage is a key consideration by the FASB. ● The FASB supported, in principle, that recognition begins when an insurer enters into an arrangement with the policyholder. 	
Derecognition of Insurance Contracts	The IASB decided tentatively that an insurer should derecognise an insurance liability when it no longer qualifies as a liability, applying the derecognition principles of IAS 39.	The FASB decided tentatively on a principle that an insurance liability should be derecognised by an entity when that obligation no longer qualifies as a liability. The liability is eliminated when the entity is no longer on risk and no longer required to transfer any economic resources for that obligation.
KPMG Observations:	<ul style="list-style-type: none"> ● The FASB expressly conveyed that purchasing reinsurance does not trigger derecognition of an insurance liability. 	
Participating Contracts	The IASB decided tentatively to explore a model where the measurement of an insurance contract includes expected value (i.e., probability-weighted) cash flows. For this purpose, the payments to the policyholders arising from participating features in insurance contracts would be cash flows from the contract like any other; those cash flows should be included in the expected present value basis and treated as a liability.	The FASB decided tentatively to explore a model in which the components of a participating contract have to be bifurcated between the guaranteed feature and the participating feature. The participating feature should then be classified as a liability or equity, either as a whole or by splitting it into components. The cash flows from those participating features that result in a liability (if any) will be included on the basis of expected cash flows. Discretionary cash flows will be recognised when the entity has an obligation to make payments.
KPMG Observations:	<ul style="list-style-type: none"> ● Due to the current difference in views, it is possible that both options will be presented in the exposure drafts. ● One of the challenges in this area, regardless of the view that is adopted, is that there could be varying impacts from the application of the guidance depending on how products are structured and what regulatory constraints exist in the jurisdiction. ● Although there is an aim by some to stay consistent with the financial instruments project and require bifurcation, this would be difficult to implement in practice for some types of contracts due to the inherent complexity in isolating cash flows from the guaranteed and discretionary features. 	

Timeline for Completion

The IASB published a revised timetable for the insurance contracts project with an anticipated release of the final standard in June 2011. The revised timeline aims for issuing an exposure draft in April 2010. Key milestones and timelines are set forth below:

Timeline	Topic for Discussion
December 2009	<p>Measurement:</p> <ul style="list-style-type: none"> ● Objective of measurement ● Margins ● Embedded derivatives <p>Related projects include revenue recognition, financial instruments, liabilities</p> <p>Unbundling Related projects include revenue recognition and financial instruments</p> <p>Financial Statement Presentation Related projects include revenue recognition, employee benefits, financial instruments</p> <p>Policyholder Participation – measurement issues Related projects include concepts (i.e., elements, recognition) and financial instruments with characteristics of equity</p>
January 2010	<p>Participating, unit-linked and index-linked insurance contracts and investment contracts and universal life contracts Related projects include financial instruments, consolidation, derecognition, concepts (reporting entity)</p> <p>Business Combinations – including definition and scope Related projects include financial instruments and revenue recognition</p> <p>Margins (follow-up from December 2009 meeting)</p>
January / February 2010	<p>Disclosures Related projects include financial statement presentation</p>
February 2010	<p>Summary of Field Testing Reinsurance</p>
February / March 2010	<p>Pre balloting and Sweep Issues</p>
April 2010	<p>Publication of the ED</p>
August 2010	<p>Comments due on ED</p>
September 2010 - February 2011	<p>Summary of comments and discussion on issues raised in the comment letters</p>
March - May 2011	<p>Pre Balloting and Sweep</p>
June 2011	<p>Publication of final standard</p>

The activities on this project may be monitored through the IASB website at <http://www.iasb.org> and the FASB website at <http://www.fasb.org>, where summaries of the Board meetings, meeting materials, and project summaries and status are available.

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