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AMERICAN ACADEMY *of* ACTUARIES

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December 6, 2011

Mr. Patrick Finnegan

International Accounting Standards Board

30 Cannon Street

London, EC4M 6XH

Dear Patrick,

The American Academy of Actuaries’<sup>1</sup> International Accounting Standards Task Force has created the following brief white paper on the topic “what belongs in Other Comprehensive Income” and “How would you calculate it?” particularly with respect to insurance contracts. The paper expresses our understanding as actuaries in our roles as experts that support the preparation, analysis, and auditing of insurer financial statements. Section 4 of this paper, in which we articulate five potential principles for delineating the boundary of other comprehensive income, is likely to be of the greatest interest; the material preceding Section 4 is included for completeness and to provide sufficient context.

### **1. Accounting Basics**

Any accounting system has fundamental relationships between assets, liabilities and net worth. No matter what rules or principles exist for an accounting basis, the balance sheet item for net worth is always the difference between assets and liabilities.

The income statement is a measure of performance between two accounting periods. The change in net worth reflects the financial performance of the entity. This change in net worth is called Comprehensive Income (CI).

This CI can also be expressed by the summation of cash movement and changes in valuation of assets and liabilities. This CI is the ultimate bottom line of the income statement.

CI comprises two components, Profit/Loss (PL) and Other Comprehensive Income (OCI). A search of accounting literature has not revealed principles for assigning elements to either PL or

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<sup>1</sup> The American Academy of Actuaries is a 17,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

OCI. Items included in OCI have generally been unusual, non-recurring, or items outside the control of management.

## **2. Authoritative Accounting Literature**

We searched for OCI guidance in three popular accounting systems: US GAAP, IFRS and US statutory.

*US GAAP.* A September 30, 2010 letter from Ernst & Young states “there are no clear underlying principles for the recognition of OCI items or for the reclassification of such items through net income.

*IFRS.* From a June 2010 Ernst & Young industry newsletter we read “A number of respondents to the exposure draft requested that the IASB also address the issue of the lack of clear underlying principles for the recognition of OCI items (as well as for the reclassification of such items to profit or loss) within IFRS.”

*US Statutory.* Instructions for preparing the US statutory statement include a description of its OCI-like provision, the capital & surplus account: “the purpose of the capital & surplus account is to delineate certain charges and credits not included in operations such as net capital gains and items pertaining to prior years...”

We conclude that under the three accounting bases mentioned above, none articulate an underlying principle for recognizing items in OCI.

## **3. Uses of Profit Loss**

PL is used at by company management, by authorities and by investors.

### *Company management*

All insurance products are developed using models. The models produce results that display anticipated returns to policyholders, employees and to the company itself. The actual returns to the company itself are the PL. The anticipated PL can be neither too low (not enough return) nor too high (likely uncompetitive and unsalable). The actual PL as it emerges is tracked to the expected PL to evaluate the success of the product. It is rare, if at all, that expected OCI plays a part in the product development process.

PL can also play an important role in the determination of executive and employee bonus and incentive compensation. This helps align management actions with shareholder interests. Generally, it is thought that OCI is not a component of incentive plans.

Finally, PL is used to trumpet performance results. Each quarter, in print and through earnings conference calls, PL is the focal point of performance discussions. OCI is addressed and discussed in such communications, but in a more tangential manner.

### *Regulatory Authorities*

Insurance regulators tend to look at balance sheet adequacy on a current basis before looking at earnings. However, a string of successive negative CI's would cause alarm.

Insurance taxation bodies have a keen interest in the PL as that serves as the basis for taxable income. In the US, impacts of management-elected changes are often captured and re-spread over a specified number of years.

### *Investors*

Generally, the item that attracts investors' attention most is the PL. That seems to be the basis on which management is judged. PL is the numerator of a common benchmark, earnings per share. When a share value is expressed as a multiple of earnings, it is the PL that is used as the benchmark.

## **4. Recognizing events in either PL or OCI**

Should an OCI exist, performance impacts could be allocated to PL or OCI by either a blanket assignment or through principles.

### *Blanket assignment*

Authoritative literature could merely state what measures do not belong in PL and should run through OCI. This would involve subjective determinations and could be the result of convenience, simplicity or political compromises. Any accounting authority can make such a list; without principles, there would be no way to evaluate its propriety.

### *Principles*

There are many viewpoints as to what can constitute "regular" or "normal" earnings (PL) in insurance, especially since there is so much unknown and so much variation around the unknown in insurance products and the investments and capital that support them. We identify and articulate several possible principles. We are not saying any one is the right answer. We are not saying that any one is practical. We are not saying that a single principle is adequate. The primary purpose of this section is to open the mind to different viewpoints and possibilities.

We offer perspectives, including advantages and disadvantages, on the following candidates for principles that could be used to distinguish OCI from PL:

1. Warranted vs. unwarranted volatility
2. Actions within vs. outside of management control
3. Ordinary (usual) vs. extraordinary (unusual) events
4. Regular results vs. those due to changes in methodologies or assumptions
5. Current year results vs. prior period adjustments

*1. Warranted vs. Unwarranted Volatility.* The first challenge is to develop a consensus viewpoint among participants as to what type of volatility would be considered unwarranted. We think there is a common perspective that effects imposed by accounting conventions that don't reflect the underlying economics of the business can be viewed as unwarranted. This is often called "accounting mismatch." We do understand that accounting literature needs to consider consistency across many industries and that compromises must be made.

One example of unwarranted volatility would be the component of CI arising from the fact that assets and liabilities are measured at discount rates that are determined on an inconsistent basis. Another example is the fact that one side of the balance sheet may be unlocked (fair value) while the other side may be locked in (amortized cost).

An example capturing the effects of accounting mismatch between fair value and fulfillment value is attached to this letter.

Advantages:

- Accounting mismatch is objective and relatively easy say whether or not it exists.

Disadvantages:

- It might involve two independent valuations at reporting time<sup>2</sup>.

*2. Actions within vs. outside control of management.* This can be a challenge to define. Possible examples of items outside of management's control would be introduction of a new catastrophe model that now dictates more capital is needed. Another example would be the use of market interest rates in determining the value of liabilities. A third example would be the introduction of legislation or an adverse judicial decision that is disruptive to the current business plan.

Advantages:

- This helps measure management performance by removing items that are beyond their control.

Disadvantages:

- Management is responsible for everything; why carve out certain items?
- It may be difficult to ascertain what is or is not within management's control.
- There might be a bias in classifying favorable events to be within management's control and unfavorable ones outside of their control, thus inviting manipulation.

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<sup>2</sup> For example, the "available-for-sale" treatment of assets requires valuation on both amortized cost and fair value bases. OCI is calculated as the change in the difference between the two valuations. Since that difference is zero when an asset is purchased and zero again after the asset is sold, this approach automatically recycles OCI amounts back through profit and loss (net income). Without dual valuation, some other means would be required to recycle OCI amounts back through profit and loss.

3. *Ordinary (usual) versus extraordinary (unusual) results.* Here again, defining extraordinary will be a challenge. To an individual, the arrival of a hurricane may be a life-changing extraordinary event. But to an insurer, this would be a regular component of day-to-day business. A major catastrophe for which benefits are payable under the terms of a contract is not an extraordinary, external event. Nor would a significant medical or technological breakthrough that dramatically reduces the cost of existing coverage be considered an extraordinary event.

Possible considerations for these external, extraordinary events might be a court case that establishes retroactive liabilities in contracts where no such exposure was anticipated (asbestos). Another possibility is the collapse of a counterparty (a reinsurer; a hedge provider) whose value is now dramatically diminished. Further candidates are the transfer of a large loss portfolio and the acquisition or sale of a block of business or company.

Advantages:

- This helps provide a better trend line of normal operations.
- This may help management make difficult decisions if there is a separate place in CI to report their impacts.

Disadvantages:

- It is difficult, and getting more difficult, to define the dividing line between the ordinary and the extraordinary.
- There may be a tendency to classify adverse events as extraordinary and favorable events as ordinary, thus inviting manipulation.

4. *Results on a consistent basis vs. those where methodologies or assumptions have changed.*

Companies will frequently review methodologies in light of emerging developments and environments. Companies will often introduce new models or upgrade existing ones. These can be perceived as presenting a better indication of the future. Use of new methodologies can be viewed as a refinement rather than a correction.

Often, assumptions need to be changed. If an event occurs during the current period that dictates a prior assumption is no longer valid; the assumption should to be changed. OCI could be used to report the impact of the assumption change. However, one concern with using OCI for reporting impacts of changes in assumptions is that the prior assumptions applied to the current period produce meaningless, if not incorrect, results.

Advantages:

- This helps provide a better trend line of normal operations.
- This may help management make difficult decisions if there is a separate place in CI to report their impacts.

Disadvantages:

- Insurers should be changing their evaluation of the future constantly; why highlight activities that are part of normal operations?
- To quantify the impact of the assumption change, the company would need to quantify by using old assumptions at a new date or new (but premature) assumptions at the old date. Neither would reflect a valid representation of the balance sheet.

*5. Current year results vs. prior period adjustments.* Assumptions sometimes need to be changed. Sometimes what had appeared to be an aberration is now confirmed as a trend. This is a normal situation for the evaluation of mortality and sometimes voluntary terminations. Introduction of a new assumption is appropriate. With the benefit of hindsight, one could say that the change should have been implemented several periods earlier. One use of OCI would be to report the prior period effects in OCI and only the current period in PL.

Advantages:

- Items that have prior period impacts can usually be clearly identified as well as quantified.
- This helps provide a better trend line of normal operations.

Disadvantages:

- This might become painful for management to constantly address.
- This might become a source of litigation.

## **5. Conclusion**

It is a very appropriate time to consider articulating the principles behind distinguishing elements of PL and OCI. If accounting standard-setters desire to develop lists of what should be included in OCI, we would be happy to submit a proposed list with respect to insurance contracts. If instead standard-setters prefer to develop principles behind what belongs in OCI vs. PL, we are willing and able to assist. We do feel that addressing the warranted versus unwarranted volatility (which reveals the accounting mismatch) offers the most information to the user. It is possible that some combination of the above principles will offer the most valuable information to a user. Further, we think that quantification of the impacts of unusual or extraordinary events can be made in disclosures and not necessarily be assigned to OCI.

Sincerely,

A handwritten signature in black ink that reads "Stephen J. Strommen". The signature is written in a cursive style with a large, prominent initial "S".

Stephen J. Strommen FSA, CERA, MAAA  
Chair, International Accounting Standards Task Force  
American Academy of Actuaries

## Appendix: Discount rates and OCI – Life Annuity Example

This example illustrates the way accounting rules surrounding the discount rate and OCI could affect a block of lifetime annuity business where asset and liability cash flows are matched reasonably well.

Figures 1 and 2 below illustrate the following main points to be drawn from this example:

1. The expected financial results are a small and slowly declining profit.
2. Under the Canadian approach<sup>3</sup>, reported results fluctuate mainly due to the level of actual investment defaults during the reporting period.
3. Under the IASB / FASB approach, with all assets at fair value, reported earnings fluctuate very widely based on changes in the credit spreads in market interest rates. The fluctuations are so wide that they need to be shown on a graph with a vastly different vertical scale.

Figure 1

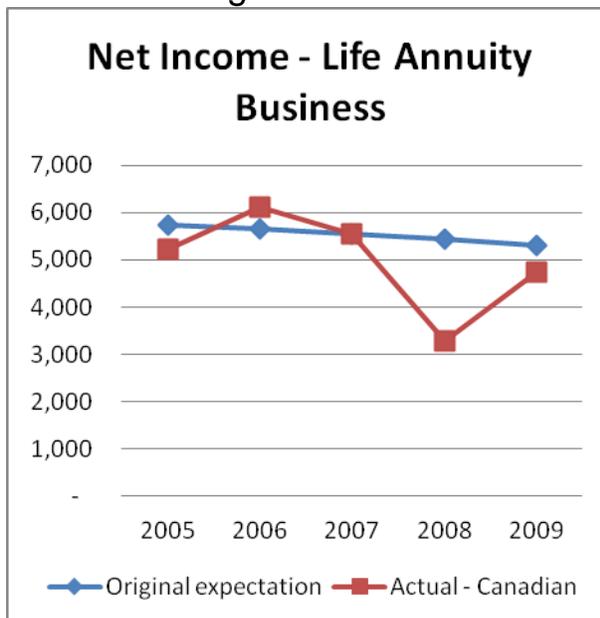
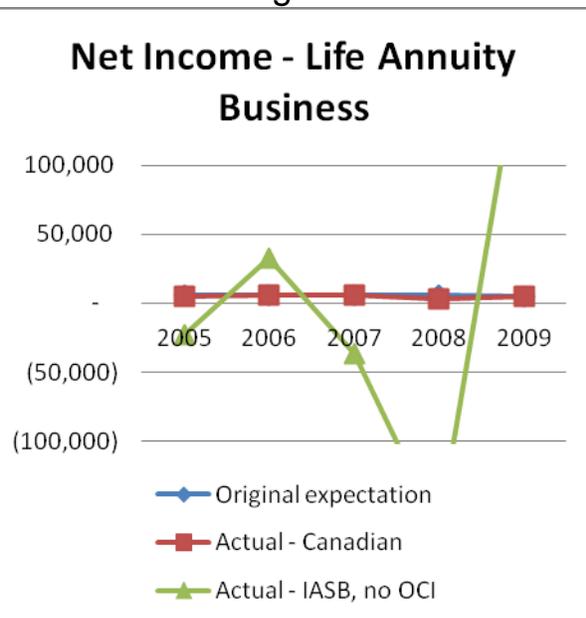


Figure 2



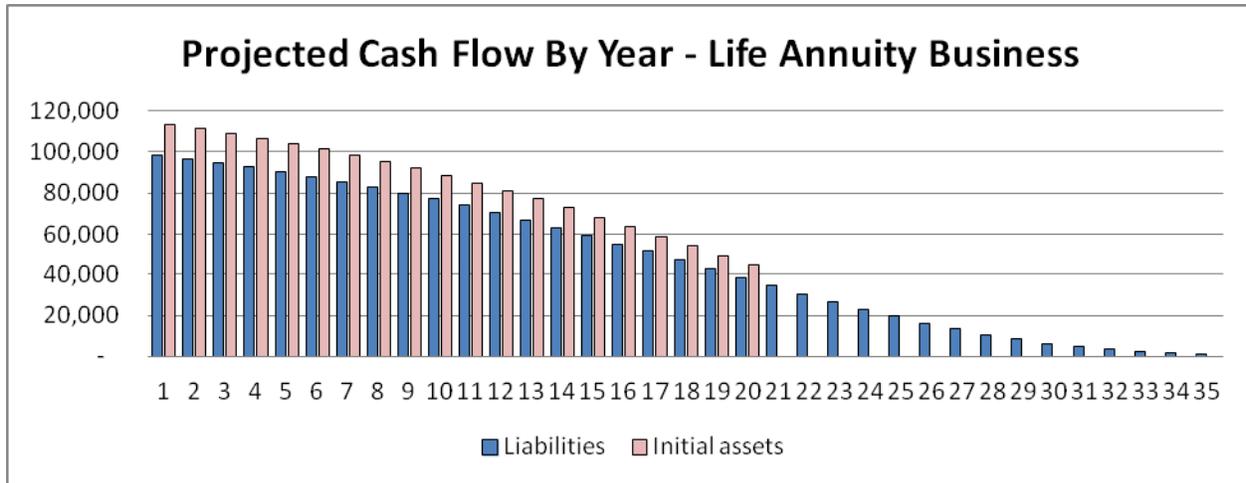
Though not labeled explicitly in the graphs, if OCI is used to capture the effect of changes in interest rates, then reported net income under the IASB / FASB approach is comparable with that under the Canadian approach, and OCI captures the wide fluctuations shown.

The remainder of this document provides additional details regarding this example.

### Description of the business activity

<sup>3</sup> The Canadian approach bases the discount rate for insurance liabilities on the projected book yield of the supporting assets.

The example is based on a block of lifetime annuity business issued by an insurer at the end of 2004. The insurer collects a single premium for these benefits when the annuities are issued, and invests that money in fixed-income investments that roughly match the timing of the first 20 years of annuity payments. The insurer would ideally match the timing of all expected payments, but finds that no desirable investments are available with terms longer than 20 years. The graph below illustrates the expected pattern of future cash flows after the initial premium is collected and the funds are invested:



Note that in the first 20 years, asset cash flows will exceed the payments on the annuities. Part of the excess is profit that will be paid as dividends to stockholders, and part needs to be re-invested to fund the annuity payments after 20 years.

For purposes of simplifying this example, we will assume the following:

1. There are no expenses.
2. Mortality experience on the annuities is exactly as expected.

We will also include a small amount of assets in excess of liabilities, as if the insurer allocated some capital to this business. Therefore the initial assets are slightly greater than the premium paid.

Expected results

Based on the expected cash flows the insurer can project its “expected” financial results for this business assuming interest rates do not change. The table below gives highlights of the expected income and balance sheet.

	2004	2005	2006	2007	2008	2009
Net income		5,748	5,652	5,548	5,437	5,320
Other comprehensive income		-	-	-	-	-
Total comprehensive income		5,748	5,652	5,548	5,437	5,320
Dividends to stockholders		5,000	5,000	5,000	5,000	5,000
Total assets	1,042,750	998,603	953,739	908,264	862,283	815,909
Total liabilities	1,003,375	958,478	912,963	866,941	820,522	773,828
Capital and surplus	39,376	40,124	40,776	41,324	41,761	42,081

For purposes of illustrating actual results, we assume that both interest rates and defaults fluctuate in a manner based on the 2004-2009 period. We will assume all annuity payments are made exactly as expected, so all variances from expectation are related to interest rates and defaults. The table below shows actual and expected levels of interest rates and asset defaults. Note that the interest rates shown in the table are meant to be representative of the level of the yield curve, but in practice a full yield curve may be used for discounting.

The relationship between the corporate bond rate and the liability discount rate is important in this example. The liability discount rate is always greater than the US Treasury rate by 0.50%, a hypothetical estimate of the spread attributable to the lack of liquidity in a life annuity contract. The spread between corporate bonds and the liability discount rate is largely due to credit risk that is not characteristic of the annuity contract, and that spread fluctuates in a wide range during this period.

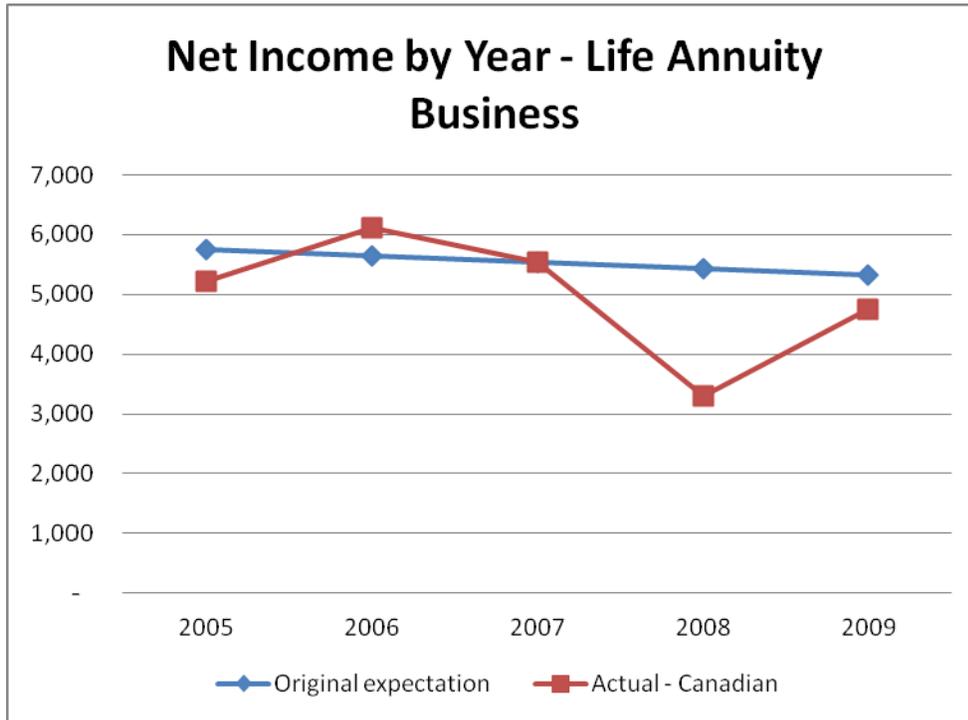
	Expected	Actual				
		2005	2006	2007	2008	2009
US Treasury Rate	4.83%	4.53%	4.81%	4.45%	2.68%	4.64%
Liability Discount Rate	5.33%	5.03%	5.31%	4.95%	3.18%	5.14%
Corporate Bond Rate	5.93%	6.00%	5.92%	6.26%	7.31%	6.00%
Default Rate	0.25%	0.30%	0.20%	0.25%	0.50%	0.35%

It is worth considering in advance what changes in experience will drive financial results for this business over the long term. We assume mortality experience and expenses are exactly as expected, so there is no source of variance there. Changes in interest rates will affect results because some money needs to be re-invested. But since only a small portion of assets will ever be re-invested, changes in interest rates should not drive wide fluctuations in results over the long term. Changes from expected defaults, however, directly drive fluctuations in earnings in every reporting period.

Reported results under the Canadian approach, no OCI

Under the Canadian approach, fluctuations in reported income are largely due to fluctuations in defaults. Changes in interest rates have very little effect because:

- Assets are held at amortized cost so their book yield is stable
- The asset book yield is used as the basis of the discount rate for liabilities, so it is stable and matched to assets
- Asset and liability cash flows are reasonably well-matched so very little cash is re-invested at current market interest rates each year.

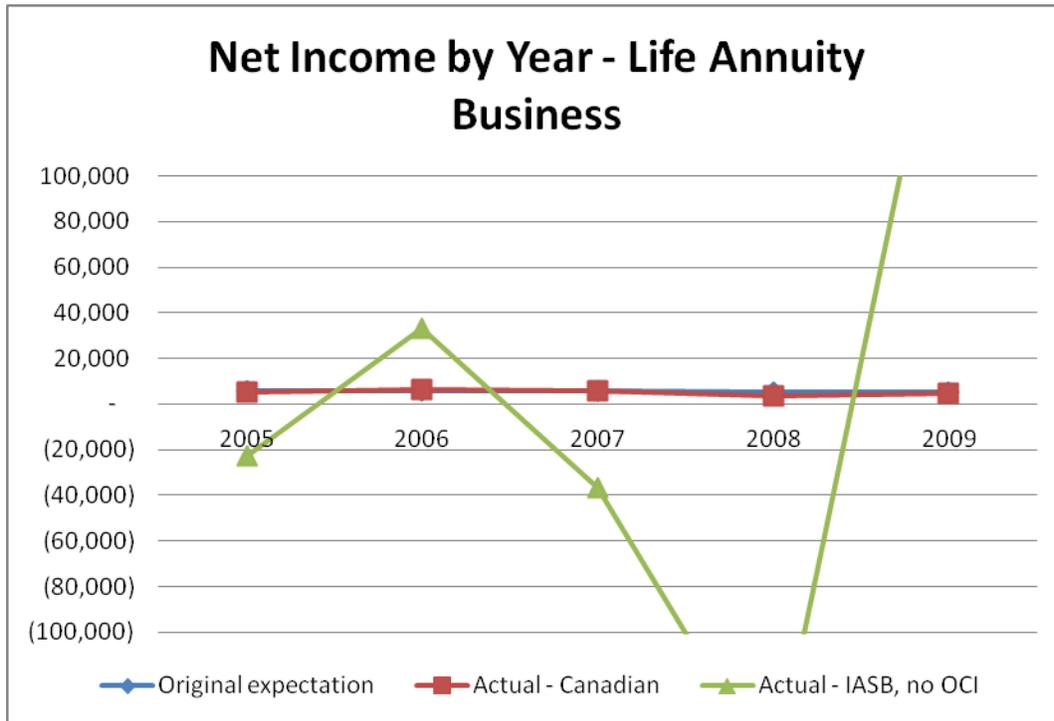


	2004	2005	2006	2007	2008	2009
Net income		5,227	6,121	5,543	3,292	4,745
Other comprehensive income		-	-	-	-	-
Total comprehensive income		5,227	6,121	5,543	3,292	4,745
Dividends to stockholders		5,000	5,000	5,000	5,000	5,000
Total assets	1,042,750	998,081	953,687	908,208	860,082	813,133
Total liabilities	1,003,375	958,478	912,963	866,941	820,522	773,828
Capital and surplus	39,376	39,603	40,724	41,267	39,560	39,305

Reported results under the IASB / FASB approach with all assets at fair value and no OCI

Under the IASB / FASB approach, changes in interest rates drive wide fluctuations in income. This may be unexpected because the timing of asset and liability cash flows is reasonably well-matched. However, changes in credit spreads affect the valuation of assets held at fair value to a much greater degree than liabilities, which are at fulfillment value.

The changes in credit spreads during 2008-2009 were well outside the normal range. Nevertheless they really happened, and could lead to the kind of fluctuations in reported financial results shown here. Insurers have suggested that this kind of volatility is not meaningful given the nature of the underlying business.



	2004	2005	2006	2007	2008	2009
Net income		(22,523)	33,082	(36,673)	(164,016)	201,563
Other comprehensive income		-	-	-	-	-
Total comprehensive income		(22,523)	33,082	(36,673)	(164,016)	201,563
Dividends to stockholders		5,000	5,000	5,000	5,000	5,000
Total assets	1,042,750	993,415	954,297	890,291	795,900	810,047
Total liabilities	1,003,375	981,563	914,362	892,029	966,654	784,238
Capital and surplus	39,376	11,852	39,935	(1,738)	(170,754)	25,809

Reported results under the IASB / FASB approach with “current-current through OCI”

When OCI is used to capture changes in asset and liability value due to changes in interest rates (current-current through OCI) then the reported net income under the IASB / FASB approach behaves in the same way as under the Canadian approach, while fluctuations in current value remain reflected in the balance sheet.

	2004	2005	2006	2007	2008	2009
Net income		5,227	6,121	5,543	3,292	4,745
Other comprehensive income		(27,750)	26,961	(42,216)	(167,309)	196,818
Total comprehensive income		(22,523)	33,082	(36,673)	(164,016)	201,563
Dividends to stockholders		5,000	5,000	5,000	5,000	5,000
Total assets	1,042,750	993,415	954,297	890,291	795,900	810,047
Total liabilities	1,003,375	981,563	914,362	892,029	966,654	784,238
Capital and surplus	39,376	11,852	39,935	(1,738)	(170,754)	25,809

The volatility in capital and surplus created by market valuation of asset credit risk remains a concern to insurers, even if net income is stabilized as shown here. To prevent the negative capital positions shown in 2007 and 2008 from occurring, an insurer would need to dedicate substantially more capital to this business. The added cost of capital would make new lifetime annuity contracts more expensive and could make existing contracts difficult to support.