AMERICAN ACADEMY of ACTUARIES

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Technical Director—File Reference 1235-001
Financial Accounting Standards Board
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To Whom It May Concern:

The American Academy of Actuaries'[1] Financial Reporting Committee appreciates the opportunity to respond to the Financial Accounting Standards Board's invitation to comment, "Selected Issues Related to Assets and Liabilities with Uncertainties." The document addresses what we think are core elements, axioms even, of the project to redefine financial reporting through a consistent conceptual framework. We believe general actuarial concepts and practices have direct relevance on several crosscutting issues, as described herein.

We support the ultimate goal of including probability and uncertainty in defining, recognizing, and measuring assets and liabilities. However, the proposed amendments to IAS 37 appear to hinge on the concept of reliable measurement. Standards that articulate how and why certain measurements are reliable, and distinguish them from other inappropriate measurements, appear to be a prerequisite to general acceptance of this change in accounting practice.

For your consideration, our responses to the questions asked in the invitation to comment are below:

Question 1: Do you agree with eliminating the notion of contingent asset? If not, why not?

Although we agree that there are problems with the notion of contingent asset, we see significant practical problems with implementing the proposed definitions. Explicit standards for reliability are needed. Specifically, measuring the value of an "unconditional right" entails some probabilistic calculations, by way of a "model", that may be extremely subjective. Some models may be more reliable than others. For this measurement to be

[1] The American Academy of Actuaries is the public policy organization for 15,000 actuaries practicing in all specialties within the United States. A major purpose of the Academy is to act as the public information organization for the actuarial profession. The Academy is non-partisan and assists the public policy process through the presentation of clear and objective actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials, comments on proposed federal regulations, and works closely with state officials on issues related to insurance. The Academy also supports the development and enforcement of actuarial standards of conduct, qualification and practice and the Code of Professional Conduct for all actuaries practicing in the United States.

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reliable and valid, the model should be based on current credible estimates of observable inputs, and rational consistent relationships. Probabilistic models will often produce a range of potential outcomes, so standards for choosing an appropriate point estimate for use in financial statements may also be required.

Question 2: Do you agree with the IASB's analysis of unconditional and conditional rights in contractual settings, as summarized in paragraphs 30 and 31 of this Invitation to Comment and paragraphs BC10−BC13 of the IASB Exposure Draft? If not, why not?

No, we do not.

We believe that it is important to use probabilistic models to measure groups of similar risks rather than individual risks.

Consider, for example, a product warranty. From the perspective of the customer who buys one computer, it may be highly unreliable to estimate the time to failure of that computer. However, from the perspective of the manufacturer who sells a large volume of identical equipment, it should be possible to estimate the value of the warranty obligation reliably.

The actuarial concept required here is the notion of a fair risk classification. It is appropriate for the manufacturer to group individual contracts together because all generate basically the same exposure to loss under the warranty. On the other hand, it would reduce the reliability of the measurement for the manufacturer to group quite dissimilar risk exposures. That could create hidden subsidies and reduce representational faithfulness. Actuarial practice with regard to risk classification could be useful for setting guidance for this work.

Question 3: If you answer yes to Question 2, do you agree that the IASB has appropriately applied the notion and supporting reasoning referred to therein in the analysis of Examples 1–3 in paragraphs 33−35 of this Invitation to Comment? If not, why not?

Example 3 of paragraph 35, in which an entity apparently would book a receivable based on the fact that it is negotiating a contract with a new customer, illustrates potential problems. Guidance would be needed to ensure reliable and useful measurement of the current value of the marketing activity. Even good-faith estimates of the value created by marketing activity may show measurement bias through systematic overconfidence.

Question 4: Do you agree with the IASB's proposal to classify as intangible assets those unconditional rights that are associated with conditional rights and that satisfy the definition of an asset, without shifting the consideration of the uncertainty surrounding the conditional rights from recognition to measurement?

We have no specific comment on this issue.

Question 5: Do you agree with eliminating the notion of contingent liability? If not, why not?

We have no specific comment on this issue.

Question 6: Do you agree with the IASB's analysis of unconditional and conditional obligations in contractual settings, as summarized in paragraphs 39 and 40 of this Invitation to Comment and paragraphs BC24–BC28 of the IASB Exposure Draft? If not, why not?

We have no specific comment on this issue.

Question 7: If you answer yes to Question 5, do you agree that the IASB has appropriately applied the notion and supporting reasoning referred to therein in the analysis of the example in paragraph 41 of this Invitation to Comment? If not, why not?

We have no specific comment on this issue.

Question 8: Do you agree with omitting the probability criterion for recognition of nonfinancial liabilities? If not, why not?

Our comments on these questions are similar to those on assets. We note that measuring the particular assets or liabilities will be subject to considerable subjectivity for which guidance is not available.

Question 9: Do you agree with the proposed measurement requirements for nonfinancial liabilities? If not, why not?

We support the proposal to use probabilistic tools to measure the value of future uncertain cash flows. We would point out, however, that there are many types of such tools, ranging from simple deterministic models to very complicated stochastic models. Determining which model to use will vary depending on the situation.

There are currently Actuarial Standards of Practice that guide our professionals in performing such probabilistic measurement, including the development of credible assumptions, constructing appropriate models, inferring reliable conclusions, communicating to stakeholders, and revising estimates with new information. Many of these practices may have relevance for this purpose.

We see immediate application for the actuarial concept of "credibility". For example, the death of one member of a group life plan is an event that can be easily verified. Whether or not that event constitutes credible evidence on the mortality assumption for remaining and future participants in the plan, however, is important for providing a fair representation of that liability.

We also believe that a discussion of the use of point estimates would be appropriate. Not all point estimates are equally useful to a financial statement user. For example, the range of potential error and subjectivity inherent in point estimates for pension liabilities is far greater than for cash on hand. Yet sometimes these amounts are shown on the balance sheet with no differentiation as to the likely variance of the amounts. Discussion of the risk factors involved in making those point estimates would help the user understand them better.

We appreciate the opportunity to comment on this document. We recognize that the formal comment period has closed, but we hope you will still find our perspective useful as FASB considers these important issues. If you have any questions concerning our comments, please contact Ethan Sonnichsen, staff liaison to the Financial Reporting Committee, at (202) 223-8196 or sonnichsen@actuary.org.

Sincerely,

Henry Siegel

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