AMERICAN ACADEMY of ACTUARIES

Financial Reporting Committee comments on International Actuarial Association draft Practice Guideline:

Measurement of Investment Contracts and Service Contracts under International Financial Reporting Standards

The Financial Reporting Committee of the American Academy of Actuaries appreciates the opportunity to comment on the International Actuarial Associations' (IAA) draft Practice Guidelines. Members of the Financial Reporting Committee include: Ralph S. Blanchard, FCAS, MAAA, Chairperson; Henry W. Siegel, FSA, MAAA, Vice-Chairperson; Mark G. Beilke, ASA, MAAA; Rowen B. Bell, FSA, MAAA; Errol Cramer, FSA, MAAA; William C. Hines, FSA, MAAA; Darrell D. Knapp, FSA, MAAA; Ken A. LaSorella, FSA, MAAA; Jinn-Feng Lin, FSA, MCA, MAAA; Jay B. Morrow, FCAS, MAAA; Mark F. Oberholtzer, FSA, MAAA; William J. Sohn, FCA, FSA, MAAA; Stephen J. Strommen, FSA, MAAA; Andrea M. Sweeny, FCA, FCAS, MAAA; Nancy P. Watkins, FCAS, MAAA; James F. Verlautz, FCA, FSA, MAAA.

The Committee supports the effort of the IAA in creating guidance for actuaries working with international financial reporting standards and offers the following observations. We regret, however, that we were not able to suggest actual changes to the document because in several cases we were unclear as to the intent of the words.

4.1.2 Initial measurement of financial instruments

This is an area where we have the greatest concern. In this paragraph, IAS 39 is quoted, "When a financial asset or financial liability is recognized initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability" (IAS 39, Par 43). Not knowing exactly what the initial fair value is, it is difficult to add transaction costs and get the initial measurement. Also, IAS 39 seemed to focus on assets initially. Hence the reference to 'adding' transaction costs. The intent is likely not to add transaction costs to a liability. For example, commissions paid for a deferred annuity investment contract might be subtracted from considerations to get some initial value. Again, there seems to be an attempt to relate the fair value and/or initial value to consideration and transaction costs by further defining both; however, no linkage is provided to define either the fair value or initial measurement in terms of the consideration and transaction costs. As a result, just reading the words would leave one uncertain as to how to establish the initial liability for an investment contract that will not be carried at fair value.

To keep it simple, if the consideration (premium) received is $1000 and the commission paid to a broker by the company to acquire the contract is $50, how do we take the words of this section to arrive at $950 as the initial measurement? If $1000 (the consideration) is the fair value of the liability, then transaction costs of $50 would have to be subtracted (not added) to get $950.

4.1.4 Host investment contract with Embedded Derivative

The second paragraph makes reference to "...the fair value at inception of the host contract is the initial fair value, as described above..." As mentioned above, we do not see a clear definition of initial fair value in 4.1.2. Also, mention is made of non-option embedded derivatives having an initial fair value of zero. A quick mention of option-based embedded derivative treatment might be desirable here.

4.2.9. Determination of amortized cost

The last sentence of the third full paragraph starts, "The difference typically is amortized…" With this wording, it is difficult to determine exactly what difference is being referred to. The words give the impression that the difference is between the initial measurement and the maturity amount (this seems to be an asset focus). This might not be the same as the initial SFAS 91-type difference applied to a liability, where the difference would simply be the deferrable acquisition costs. Clarification here might be beneficial.

The statements in this section are all true, but if someone was not familiar with SFAS 91 or had not seen an example of the amortized cost method applied to a liability, it would be unlikely that one would walk away understanding the method. We suggest clarifying the words with a numerical example.

4.4.2 Fair value approach

In general, the last two paragraphs on page 13 (spilling onto 14) are correct but a bit vague. The approach is to use a model that appropriately reflects risk, calibrate to the market and, finally, apply accounting rules. The second step seems to indicate that the initial risk adjustment factors or assumptions were not derived from the market. If so, this might need some emphasis that risk adjustment is based on best-estimate assumptions or some basis other than market premiums. Hence, the need for the market calibration step.

Section 4.4.7.1 Margins for risk and uncertainty

This section mentions "material" assumptions. There is no definition, however, for what constitutes material. In Section 4.3.2 for example, materiality was specifically defined as the change in the present value of cash flows by at least ten percent.

4.4.7.2 Level of margins for risk and uncertainty

The second paragraph dealing with stochastic scenarios is unclear and could use an example. Some reference to how many runs are used might also be appropriate.

4.4.8.2 Calibration

Without a few simple references and possibly an example, it is difficult to know what calibration to the observable market actually means or how it is done. There are premiums being charged in the observable market and commissions paid in addition to prices of options to calibrate stochastic models. In short, what are we trying to calibrate to when we say calibrate to the observable market? From the language in this paragraph, the answer is not clear.

4.9 Criteria for model selection

The last paragraph refers to a separate educational note that could use a reference (i.e. which educational note?). [We realize it is possible that the educational note was not yet written at the time the exposure draft was produced.]

Finally, for investment contracts, references to the "policyholder," such as on page 4, should probably be changed to "contract holder," or some similar expression.

Again, we would like to commend the IAA for creating guidance for actuaries working with international financial reporting standards, and we appreciate the opportunity to provide comments. If you have any questions regarding these comments, please contact Ethan Sonnichsen, Risk Management & Financial Reporting Policy Analyst, at 202-223-8196 or sonnichsen@actuary.org.