



**ASSOCIATION ACTUARIELLE INTERNATIONALE
INTERNATIONAL ACTUARIAL ASSOCIATION**

April 17, 2002

Technical Director
International Federation of Accountants
535 Fifth Avenue, 26th floor
New York City, New York 10017
USA

Dear Sir or Madam:

Further to my predecessor's letter of December 17, 2001 forwarding the International Actuarial Association's (IAA) draft comments on the *Proposed International Public Sector Accounting Standard on Provisions, Contingent Liabilities and Contingent Assets*, I am pleased to confirm that the IAA's due process is now complete and that the draft comments, as submitted, have been approved by the member associations for release as an IAA public statement.

A copy of the final document is enclosed, for your files.

Yours sincerely,

Edward J. Levay
President, IAA

attachment

International Actuarial Association
Comments on the Proposed International Public Sector Accounting
Standard on *Provisions, Contingent Liabilities and Contingent Assets*
Prepared by the International Public Sector Accounting Committee of the
International Federation of Accountants

THE INTERNATIONAL ACTUARIAL ASSOCIATION

The International Actuarial Association (the “IAA”) represents the international actuarial profession. Our forty-six Full Member actuarial associations represent more than 95% of all actuaries practicing around the world. The IAA promotes high standards of actuarial professionalism across the globe and serves as the voice of the actuarial profession when dealing with other international bodies on matters falling within or likely to have an impact upon the areas of expertise of actuaries.

The IAA appreciates this and other opportunities to provide input to and assistance in the development of accounting standards. We commend the continuing efforts of the IFAC to enhance the accounting and auditing standards of the public sector.

DUE PROCESS

These comments have been prepared by a committee of the IAA, the members of which are listed below by name and association. These comments, which were circulated for approval to the member associations of the IAA as part of our due process procedures, have been approved as a public statement of the IAA.

**MEMBERS OF THE
IAA COMMITTEE ON INSURANCE ACCOUNTING**

Sam Gutterman	(Chairperson)
Francis Ruygt	(Vice-chairperson)
Paul McCrossan	(Vice-chairperson)
Clive Aaron	Institute of Actuaries of Australia
William Abbott	Institute of Actuaries
Yutaka Amino	Institute of Actuaries of Japan
Félix Arias Bergadá	Col.legi d’Actuaris de Catalunya
Dan Barron	Israel Association of Actuaries
Ralph Blanchard	Casualty Actuarial Society
Guy Castagnoli	Association Suisse des Actuaire
Morris W. Chambers	Canadian Institute of Actuaries
Paolo De Angelis	Istituto Italiano degli Attuari
Mariano Gongora Roman	Instituto de Actuarios Españoles
Eva Gustafson	Svenska Aktuarieföreningen
Steve Handler	Actuarial Society of South Africa
Eckhard Hütter	Deutsche Aktuarvereinigung e.V.

Tony Jeffery	Society of Actuaries in Ireland
Liyaquat Khan	Actuarial Society of India
Ad Kok	Het Actuarieel Genootschap
Jean-Pierre Lassus	Institut des Actuaire Français
Won How Lo	Actuarial Institute of the Republic of China
Jose Mendez	Colegio Nacional de Actuarios A. C.
Bruce D Moore	American Academy of Actuaries
Craig Murison	Faculty of Actuaries
Markku Paakkanen	Suomen Aktuaariyhdistys
Richard S Robertson	Society of Actuaries
Bjarni Thordarson	Félag Islenskra Triggastærðfræðinga
Gérard Vandenbosch	Association Royale des Actuaire Belges
Robert Wilcox	Conference of Consulting Actuaries

The IPSAC specifically asked for feedback on the following proposals:

a. Proposal to “exclude, from the scope of the Standard, provisions and contingent liabilities that arise from social benefits which the entity provides to the community and for which no or nominal consideration is expected directly in return from the recipients of those benefits [paragraph 1]. ... Comments are sought on whether the proposed scope exclusion is appropriate and any alternative approaches or strategies that respondents would support;”

IAA Response – We believe that provisions and contingent liabilities that arise from social benefits which the entity provides to the community and for which no or nominal consideration is expected directly in return from the recipients of those benefits, should be included in an accounting standard for the public sector standard. We agree with the committee that this may require further study and consideration. Nevertheless, we have a substantive concern with the usefulness of the resulting financial statements.

We feel that these social benefits should be included in some way in this standard. Their omission appears to be potentially significant, such that it could materially impair the completeness of the public entity’s financial reports. Paragraph 10 partially covers this issue, by requiring certain disclosures by entities that choose to accrue for such liabilities, but it does not make any disclosures mandatory for those that choose not to accrue a liability. Until the recommendations of the separate project to study further and consider these provisions and contingencies have been adopted, we recommend that this standard should include appropriate disclosure for these obligations. A likely place to make such a disclosure mandatory might be in paragraph 102.

b. Proposal to “include disclosure requirements for contingent assets, including those arising from non-exchange transactions and other events. The Committee would be interested in the views of respondents as to whether the identification and disclosure of contingent assets in the public sector raises significant issues that warrant further study and exploration;”

IAA response – We believe that the required disclosure of such contingent assets does not go far enough. Our concern relates to the apparent application of the asset recognition criteria (in paragraphs 39 through 43) to individual contingent assets and not to groups of similar contingent assets. While individual contingent assets in a group of similar items may not be

“reasonably certain” of producing economic benefits, a grouping of similar items may meet the “reasonably certain” criterion. In addition, the use of an asset-by-asset test could lead to potential manipulation of results and volatility caused more by judgment than true events would warrant. Such manipulation and questionable volatility should be reduced if the recognition criterion were based on groups of similar (contingent) assets.

As one example, consider a portfolio of overdue receivables. Such receivables have a market value greater than zero that could be achieved through a sale. The currently proposed recognition criterion could incent entities to engage in such sales, even on an uneconomic basis. Such sales would not be encouraged if the recognition standard allowed the grouping of similar receivables.

c. Proposal to “limit the application of provisions for onerous contracts in the Standard [paragraphs 1, 12, 76 – 80 and Appendix C Example 8] to contracts which were entered into with the expectation that the contract would provide approximately equal value to both parties. ... Comments are sought on whether the clarification of the provisions dealing with onerous contracts is helpful;”

IAA response – We have no comment.

d. Proposal to “require the present obligation arising from onerous contracts to be recognized as a provision. ... The Committee is concerned that it may not be clear whether the measurement of an onerous contract should be at the present obligation under the contract alone or whether it might comprise the net of that obligation and any recoveries. The Committee is of the view that the net amount is the appropriate measurement approach and is interested in whether respondents agree with this view and, if so, whether paragraph 76 should be amended to make this more explicit;”

IAA response – We agree that the net amount represents a more appropriate measurement of the obligation. However, we believe that the gross amount of the obligation and the amount of any recoveries should be separately disclosed in the notes. In addition, paragraph 76-79 should be amended, as these paragraphs do not make clear that there should be a netting of the obligation and the related recoveries.

e. Proposal to “include additional examples illustrating the application of the Exposure Draft to identification of provisions within the public sector [Appendix C]. Comments are sought on the usefulness of these examples. Respondents are also invited to provide additional public sector examples;”

IAA response – The examples presented appear to be reasonable. One additional potential example would be a provision for the decommissioning of a nuclear plant.

f. Proposal to “require that the discount rate (or rates) reflect(s) risks specific to the liability [paragraph 56]. This will require that governments and public sector entities make an assessment of the risks associated with a particular liability and the impact of those risks on the discount rate. The Committee is interested in how respondents will make such an assessment of risk for activities within the public sector. Respondents are asked to comment on any circumstances in which they have previously considered the impact of risk on the determination of discount rates used to calculate the present value of liabilities, and the factors that they considered in determining the appropriate discount rate. The Committee is particularly interested in whether the government bond

rate, the bond rate of another government, the incremental borrowing rate of the agency or other rate is factored into this calculation;”

IAA response –

a) In response to the question as to how an assessment of risk may be made, the IAA and several of its member actuarial associations have written numerous papers on this issue, although recent ones have focused on insurance. Examples include the following:

- *Section D of the Casualty Actuarial Society “White Paper on Fair Valuing Property/Casualty Insurance Liabilities”, attached, is also available at <http://www.casact.org/research/tffvl/index.htm>.*
- *The IAA submission to the December 1999 IASC Insurance Issues paper entitled “Insurance Liabilities – Valuation & Capital Requirements, General Overview of a Possible Approach,” also attached, is available at http://www.actuaries.org/public/en/publications/submissions_e.cfm.*

If you seek additional sources, please let us know and we will happy to provide them.

There are several general approaches to quantifying a risk adjustment. One category of approaches estimates the probability distribution for the possible outcomes for the item at risk, and uses this to determine the risk adjustment. This could be done by adding an amount to the otherwise calculated valuation based on a factor times the outcome distribution's standard deviation, i.e., booking more than the mean (expected value) of the amount or setting the risk charge based on a factor times the market risk premium times the correlation of the item's outcome distribution with overall market risk. The difficulty in these approaches, assuming an outcomes distribution is estimable, is in calibrating the risk charge to the market.

Another category of approaches utilizes actual market data for a total or summarized result, backs out components of that total that have directly observable or reliably estimable market values to back into a market value for the remainder, then relates the indirectly determined market value to the estimation process at hand. For example, the market value for a company's liabilities, including a risk margin, might be estimated by taking its publicly available market equity value, backing out financial assets and liabilities and other assets and liabilities for which market values are observable, backing out estimates of intangible values, to arrive at an estimated market value for the remainder. This estimated market value could then be allocated to the individual items making up the remainder. To the extent that the entity doing the estimation has no public value, it potentially could utilize data from publicly traded companies with similar assets or liabilities in developing its market value estimations. The risk adjustment is the excess of the estimated market value over the present value of the applicable expected cash flows. The difficulty in these approaches is in finding market data for an entity or situation close enough to the estimation task at hand to allow determining a relevant market value.

As can be seen from the above discussion, some judgment is unavoidable in estimating the risk adjustment for many situations. Concerns over excessive reliance on judgment can be handled by disclosures of estimation assumptions, reliance on experts practicing under suitable professional standards of practice, or by prescribing detailed estimation procedures. The latter option may be the least desirable, however, since that procedure can be the most expensive to maintain (given the speed with which circumstances and situations can change) and the least flexible in reacting to unusual facts & circumstances.

b) The selection of an appropriate discount rate can be an important factor in measurement the value of a provision. In this situation, the use of the federal government rate or in some rare instances the lowest level of interest rate in the country in question. Note that in the private sector, it is not uncommon to use the rate of a high quality corporate bond for this purpose. For application to a public entity, a central government rate might be appropriate.

g. Proposal to “exclude provisions arising from employee benefits and income taxes (where an entity is subject to pay income tax under a tax equivalents regime) from the scope of the Standard [paragraph 1]. ... Respondents are asked to comment on whether they support this exclusion and, if not, what alternative approach they would recommend;”

IAA response – This exclusion is reasonable if suitable alternative standards are in effect to provide guidance for appropriate provisions for employee benefits or to provide provisions for

any future taxes. If no such standards are available, we suggest referring to standards adopted on these topics by the IASB.

h. Proposal to “specify the ‘obligating event’ for an obligation arising from legislation as the point when it is ‘virtually certain to be enacted as drafted’ [paragraphs 30 and 60]. This treatment is consistent with IAS 37. Respondents are asked to comment on whether they agree with this guidance or whether they consider that it would be more appropriate to provide more restrictive guidance, such as waiting until the legislation is enacted.”

IAA response – We believe that the description provided by this standard calls for disclosure, whether or not recognition is required. Any pending legislation, no matter how likely to be passed, is still subject to uncertainty. To the extent that it can materially affect the entity’s position, this uncertainty should be disclosed. Note that we do not recommend such disclosure for all possible or proposed legislation – we recommend it only for that legislation with a high probability of enactment based on information as of the reporting date. Overall, the “virtually certain” language is more appropriate, providing the users of financial statements more relevant information.

Additional comments by the IAA on items not addressed in the above questions:

1. **Paragraph 4, exclusion relative to financial instruments**

This paragraph says that the standard applies to “financial instruments (including guarantees) that are not carried at fair value. We believe this statement is too general and subject to different interpretations and thus to inconsistent values when applied to multiple companies. The manner in which paragraph 4 is worded implies that any financial instrument which is not carried at fair value falls under the scope of this standard, even if projects are underway that address the accounting for these financial instruments. We believe several financial instruments are not currently valued at fair value. Paragraph 1.d specifically excludes “those [provisions, contingent liabilities and contingent assets] arising in insurance entities from contracts with policyholders.”

2. **Paragraphs 23-25, treatment of constructive obligations**

We concur with the proposed definition of obligations, especially with respect to the implications for constructive obligations. The proposed treatment of obligations is based on whether economic performance is more likely than not, for the group of similar obligations. This would include obligations that may be unavoidable, even though they are not directly written into a contract, which we believe is a more appropriate accounting standard than the wording used in the Joint Working Group’s recent draft standard for the fair value of financial instruments, which appears only to recognize purely contractual obligations.

3. **Paragraph 32, grouping of similar obligations for the purposes of applying recognition criteria**

We agree with the concept of applying the recognition criteria to the group of similar obligations, rather than to each individual potential claimant or payee. We feel that more clarification should be provided. The concept emphasizes that recognition should be based on the probability that an obligation arises. As an example, our concern is that the example in paragraph 32 focuses only on multiple claimants or beneficiaries from a single “event”. No mention is made of similar obligations from similar events. For example, if a public sector entity does not buy insurance to protect itself from liability arising from employee-

caused accidents, then the obligation from the individual accidents may not pass the recognition test, but the aggregate obligation over all such accidents may be sufficient to meet the recognition criteria (if such a calculation is allowed under the standard).

4. Paragraphs 44 through 48, Best estimate measurement standard

We support the focus on a more entity-specific value for an obligation, rather than an immediate exit value reflecting current market conditions at the valuation date. This is consistent with the portion of the current version of the draft statement of principles underlying a probable IASB insurance contracts accounting standard with regard to liability estimates. In general, the approach suggested by these paragraphs seem reasonable to us.

Nevertheless, we believe that the use of the term “best estimate” is inappropriate and may result in misunderstanding. Rather, the term used should recognize the expected value plus an appropriate risk margin, i.e., greater than the best estimate, which is consistent with paragraph 45 which states that the ‘amount that an entity would rationally pay to settle the obligation at the reporting date or to transfer it to a third party at that time’ and can be considered as the best estimate plus an appropriate risk margin. This represents the reward the market requires to assume the risk. We refer to the current IASB Draft Statement of Principles for accounting for insurance contracts, chapter 4, paragraphs 11 and following, for further deliberations on this issue.

5. Paragraphs 50-51, Risk and Uncertainty

While we understand the concept being expressed here, we believe more clarification is needed regarding the purpose and role of the risk adjustment. We suggest clearly stating that exchange and transaction values of uncertain items almost always include some risk adjustment or risk premium. These risk premiums are not considered to be simply conservative (prudent) provisions, but instead reflect what the market price requires. Hence, provisions that ignore these risk premiums will understate the liability. Again, we note here the use of the word ‘best estimate’, which seems to be used here to include a risk adjustment, whereas in general, best estimate is defined in a different way. In this regard, we refer to our previous comments.

6. Paragraph 55, need for editorial correction

The second half currently reads:

“Paragraph 97(e) of this Standard requires disclosure of the increase [in the discounted provision] during the period in the discounted amount arising from the passage of time.”

Perhaps it could say something close to:

“Paragraph 97(e) of this Standard requires disclosure of the increase [in the discounted provision] arising from the passage of time during the period in which that increase occurs.”

7. Paragraphs 58 and 59, Reflection of future events

Paragraphs 58 and 59 seem to be inconsistent with paragraph 47 (which describes an “expected value” approach reflecting the various possible outcomes and their probability). Paragraph 47 requires the entity to reflect a future possible event to the extent that it is reasonably measurable (i.e., by weighting its financial result with other possible events based on the probability of those events). Paragraph 58 seems to preclude reflecting

possible events at all, and instead requires evidence that the event “will” happen. We suggest changing paragraph 58 to make it consistent with paragraph 47, possibly by requiring recognition of future events in measurement calculations only to the extent that they are possible, through a probability weighting approach (although a “virtually certain” standard may still be appropriate for future legislative changes.)

Please let us know if the IFAC would like elaboration or clarification of any of the comments we have presented. We hope to continue to provide objective assistance to the IFAC in the future.

IAA FULL MEMBER ASSOCIATIONS

Consejo Profesional de Ciencias Económicas de La Ciudad Autónoma de Buenos Aires (Argentina)
Institute of Actuaries of Australia (Australia)
Aktuarvereinigung Österreichs (AVÖ) (Austria)
Association Royale des Actuaire Belges (Belgique)
Instituto Brasileiro de Atuária (IBA) (Brazil)
Canadian Institute of Actuaries (Canada)
Cyprus Association of Actuaries (Cyprus)
Česká Společnost Aktuárů (Czech Republic)
Den Danske Aktuarforening (Denmark)
Egyptian Society of Actuaries (Egypt)
Estonian Actuarial Society (Estonia)
Suomen Aktuaariyhdistys (Finland)
Institut des Actuaire (France)
Deutsche Aktuarvereinigung e. V. (DAV) (Germany)
Hellenic Actuarial Society (Greece)
Actuarial Society of Hong Kong (Hong Kong)
Hungarian Actuarial Society (Hungary)
Félag Íslenskra Tryggingastærðfræðinga (Iceland)
Actuarial Society of India (India)
Society of Actuaries in Ireland (Ireland)
Israel Association of Actuaries (Israel)
Istituto Italiano degli Attuari (Italy)
Institute of Actuaries of Japan (Japan)
Japanese Society of Certified Pension Actuaries (Japan)
Lebanese Association of Actuaries (Lebanon)
Colegio Nacional de Actuarios A. C. (Mexico)
Het Actuarieel Genootschap (Netherlands)
New Zealand Society of Actuaries (New Zealand)
Den Norske Aktuarforening (Norway)
Actuarial Society of the Philippines (Philippines)
Instituto dos Actuários Portugueses (Portugal)
Academia de Actuarios de Puerto Rico (Puerto Rico)
Actuarial Society of South Africa (South Africa)
Col.legi d'Actuaris de Catalunya (Spain)
Instituto de Actuarios Españoles (Spain)
Svenska Aktuarieföreningen (Sweden)
Association Suisse des Actuaire (Switzerland)
Actuarial Institute of the Republic of China (Taiwan R.O.C.)
Faculty of Actuaries (United Kingdom)
Institute of Actuaries (United Kingdom)
American Academy of Actuaries (United States)
American Society of Pension Actuaries (United States)
Casualty Actuarial Society (United States)
Conference of Consulting Actuaries (United States)
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