



**ASSOCIATION ACTUARIELLE INTERNATIONALE
INTERNATIONAL ACTUARIAL ASSOCIATION**

May 19, 2006

Director, Accounting Standards
Canadian Accounting Standards Board
277 Wellington Street West
Toronto, Ontario M5V 3H2
Canada

Dear Sir:

Re: IAA comments on the Discussion Paper: *Measurement Bases for Financial Accounting – Measurement on Initial Recognition*

In response to the request for comments to the Discussion Paper: *Measurement Bases for Financial Accounting – Measurement on Initial Recognition*, I am, on behalf of the International Actuarial Association (IAA), pleased to transmit our comments and recommendations. We hope that you find them to be of value.

These comments have been prepared by the Insurance Accounting Committee of the IAA, the members of which are listed by name and association in the Appendix to this submission. We would be pleased to respond to any questions you may have regarding these comments.

Yours sincerely,

Yves Guérard
Secretary General

Attachment: IAA comments

A Commentary on the Discussion Paper
MEASUREMENT BASES FOR FINANCIAL ACCOUNTING – MEASUREMENT ON INITIAL RECOGNITION
Released by the International Accounting Standards Board: November 2005

THE INTERNATIONAL ACTUARIAL ASSOCIATION

The International Actuarial Association (the “IAA”) represents the international actuarial profession. Our fifty-five Full Member actuarial associations represent more than 95% of all actuaries practicing around the world and are listed in an Appendix to these comments. The IAA promotes high standards of actuarial professionalism around 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 and practice of actuaries.

We are not a trade association and do not represent the interests of either clients or employers. As actuaries, we have developed significant experience and expertise in the assessment of the value of contingent cash flows. Using this experience, actuaries will continue to provide assistance to those involved in the enhancement of financial reporting standards to make them more useful to the users of financial statements. These comments have been prepared by our Insurance Accounting Committee, the members of which are listed by name and association in the Appendix to these comments. This document has also been subject to the due process required for it to constitute a formal view of the IAA, and will be posted to the IAA’s official web site.

IAA COMMENTS

Along with other responders to this document, the IAA appreciates this opportunity to provide input to the IASB regarding the Discussion Paper on *Measurement Bases for Financial Accounting – Measurement on Initial Recognition*. We commend the continuing, very worthwhile efforts of the IASB to develop globally-accepted international financial reporting standards.

General comments

We have the following general comments:

The IAA welcomes the IASB initiative prepared by the staff of the Canadian Accounting Standards Board to address the measurement objectives for assets and liabilities that are recognized in financial statements.

The IAA has previously commented on various aspects of measurement in the IASB conceptual thinking for insurance contracts and related financial instruments. We particularly agree with the statement in the summary of this paper that major developments have taken place since the IASB Framework was developed that have significant implications for accounting measurement. These include developments in finance theory, capital markets, behavioural economics, the application of present value and statistical probability principles, fair value measurement practices, technology and the availability of information.

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While the IAA appreciates the work undertaken, we note that probability, a matter of great importance for insurance products, is not addressed in sufficient detail in this paper. We encourage further research with respect to the application of probabilities to both recognition and measurement in financial reporting.

We suggest that the IASB accept this important paper, but at the same time start a follow-up project that deals with re-measurement considerations that includes in a rigorous manner probability concepts that are important for not only insurance contract liabilities and assets, but for other financial assets and financial liabilities as well. Although the analysis included in this paper addressing measurement on initial recognition is generally quite good, without an adequate and parallel examination of measurement of subsequent recognition, it is incomplete and cannot be implemented alone.

In addition, we note that measurement at initial recognition is only the first step in the measurement process. In fact, just as is the case for most financial products and instruments, measurement at initial recognition is not a practical concept, since recognition at issue rarely coincides with a reporting date. For insurance contracts, at each reporting date conditions (particularly in respect of the discount rates to be used in a measurement basis that applies present values) may have changed considerably from the prior report.

We note that the paper has not considered issues specific to particular industries. We feel it is important to recognise that many industries have specific issues that may influence the consideration of the measurement basis of their assets and liabilities. As might be expected, most, but not all, of our comments relate to liabilities and assets associated with financial products offered by insurance companies, primarily insurance contracts.

Exposure Draft – IAA Comments regarding questions raised:

Q1. Do you agree that the list of identified possible measurement bases (see paragraphs 33-51 of the condensed version and paragraphs 69-74 of the main discussion paper) sets out the bases that should be considered? If not, please indicate and explain any changes that you would make.

IAA Comments: We agree that the list provided sets forth reasonable bases that should be considered. However, we do not consider deprival value to be a measurement basis that needs to be considered separately. We believe such a value is adequately addressed technically by the other alternatives mentioned (i.e., replacement cost, net realizable value, and value in use), although conceptually it could be considered to be a different basis for financial reporting. We agree that the theory of management behaviour adds an important dimension to the three alternatives mentioned; however, we do not see this as an argument to distinguish this as a separate measurement basis.

Q2. Do you agree with the working terms and definitions, and supporting interpretations, of each of the identified measurement bases (see paragraphs 33-51 of the condensed version and paragraphs 77-96 of the main discussion paper)? If not, please explain what changes you would make. In particular, do you have any comments on the term “fair value” and its definition (in light of the discussion in paragraphs 46-48 of the condensed version and paragraphs 88-93 of the main discussion paper)?

IAA Comments: In general, we agree. However, we note that the FASB definition of fair value included in its March 15, 2006 Working Draft of its *Fair Value*

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Measurement standard is worded differently from the one in paragraph 46 of the condensed version. We encourage common definitions of such important terms – although convergence is useful, subtle differences or emphasis in definitions should be avoided. Wherever possible, definitions of important terms should be identical.

Q3. It is proposed that there are two fundamental sources of differences between the identified bases for measuring assets and liabilities on initial recognition:

- (a) market versus entity-specific measurement objectives, and
- (b) differences in defining the value-affecting properties of assets and liabilities.

(See paragraph 52 of the condensed version and paragraph 97 of the main discussion paper.) This proposal and its conceptual implications are the subject of chapters 4 and 5. Do you agree that these are the fundamental sources of differences between asset and liability measurement bases on initial recognition? If not, please indicate the fundamental sources of differences you have identified, and provide the basic reasons for your views. For any different fundamental sources you have identified, please indicate how these might be examined and tested.

IAA Comments: We agree. In using any source, the concepts of relevance and reliability are important characteristics to consider. We note that it may be appropriate to use portfolio-specific information that is not publicly available, at least to the extent that this information relates to the characteristics of the assets and liabilities and as long as there is no indication that market participants would not reflect that information.

Q4. The paper analyzes the market value measurement objective and the essential properties of market value.

- (a) Do you believe that the paper has reasonably defined the market value objective and the essential properties of market value for financial statement measurement purposes (see paragraphs 54-56 and 105-112 of the condensed version and paragraphs 99-110 and 236-241 of the main discussion paper)? If not, please explain why not, and what changes you would propose, or different or additional considerations that you think need to be addressed.
- (b) Do you agree with the proposed definition of “market” (see paragraphs 55-56 of the condensed version and paragraphs 107-110 of the main discussion paper)? If not, please explain why you disagree, and indicate any changes you would make and any issues that you believe should be given additional consideration.
- (c) Do you agree with the fair value measurement objective as proposed, and its derivation from the market value measurement objective (see paragraph 102 of the condensed version and paragraphs 111, 228 and 229 of the main discussion paper)?

IAA Comments: Overall, we agree that the paper defines market value objectives and the essential properties of market value reasonably. We have the following additional comments:

Regarding paragraph 106 of the main paper, while we agree that market prices are relevant for accounting purposes, we believe further exploration of related issues is needed. This should address:

- 1. whether “price bubbles” or “underwriting cycles” are relevant for long term business like insurance contracts;**
- 2. how “price bubbles” that exist at the reporting date and have been self-corrected at the report publication date should be treated.**

Regarding paragraph 111 of the main paper, while in general we agree with the discussion of fair value in relation to market value, we do not understand the reference to “liquidity limitations” in the proposed fair value measurement objective in the case where no observable market price is available. We believe that

in such cases, by their very nature, there is no practical approach to assess the effect of illiquidity.

Regarding paragraph 139, footnote 53 applies a broader definition of the term “contractual” than commonly used in IFRS. While we understand the need for simplification, we believe it is important to recognise that constructive obligations may need to be treated differently from contractual obligations. This is particularly important in the insurance industry.

Further, in some jurisdictions there is a legal distinction between rights and obligations. While it is normally possible to transfer rights under a contract to a third party without consent of the obliged party under the contract, it is usually not possible to transfer obligations under a contract to a third party without the consent of the entitled party. This results in asymmetry in value. In addition, any other one-sided right, e.g., a unilateral cancellation right of one party, causes asymmetries that should be considered in measurement.

Q5. Do you agree with the definition and discussion of entity-specific measurement objectives (see paragraph 57 of the condensed version and paragraphs 112-116 of the main discussion paper) and their relationship to management intentions (see paragraph 58 of the condensed version and paragraphs 117-121 of the main discussion paper)? If not, please explain why you disagree.

IAA Comments: We agree with the definition and discussion. However, because there has been so much confusion over the term “entity-specific”, we suggest that, similar to the FASB’s current working draft on *Fair Value Measurement*, this concept should be relabelled if possible.

Q6. Do you agree with the comparison of market and entity-specific measurement objectives (see paragraph 59 of the condensed version and paragraph 122 of the main discussion paper) and with the proposed conclusion that the market value measurement objective has important qualities that make it more relevant than entity-specific measurement objectives for assets and liabilities on initial recognition (see paragraphs 60-61 of the condensed version and paragraphs 123-129 of the main discussion paper)? If not, please explain your views.

IAA Comments: We agree with the comparison and conclusion and believe that paragraph 128 provides an appropriate evaluation. In order for this comparison to be appropriate, the market value used has to be relevant to the asset or liability being measured. In addition, in the case such as insurance contracts in which market prices are unobservable, portfolio-specific risk characteristics of insureds should be reflected as an input even if they are not observable by market participants, as long as their experience would be reflected by market participants if they had such information available.

Q7. (a) It is reasoned that there can be only one market (fair) value for an asset or liability on a measurement date (see paragraph 62 of the condensed version and paragraphs 131-138 of the main discussion paper). Do you agree with this conclusion? If not, please explain why you disagree.

(b) It is proposed that differences between apparent market values for seemingly identical assets or liabilities on initial recognition may be attributable to:

- (i) differences between the value-affecting properties of assets or liabilities traded in different markets, or
- (ii) entity-specific charges or credits.

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(See paragraph 63 of the condensed version and paragraphs 131-138 of the main discussion paper.) However, the paper notes the existence of multiple markets for some assets and liabilities, and the possibility that they may be due to market access restrictions that require further investigation (see paragraphs 74-82 of the condensed version and paragraphs 95-109 of the main discussion paper).

Do you agree with these proposals, within the caveats and discussion presented? If not, please explain why you disagree.

IAA Comments: While we agree in general, we believe this requires further consideration in the context of insurance business. We believe the following should be noted:

- 1. The basis for the business of insurance is that an individual (person or entity) transfers insurance risk (e.g., mortality, morbidity, property damage and liability) to the insurer. The insurer then pools these risks, basically resulting in a reduced amount of uncertainty and volatility arising from the individual risks, the extent to which depends in part on the size of the pool. That implies that the individuals involved are willing to pay a price to participate in the pool – a price that may differ from the price that would be charged for the pool as a whole and lower than the resources needed individually to protect against the risk.**
- 2. Insurance liabilities are settled with the contract’s beneficiary by payment of (or providing payment in kind) the agreed benefit at occurrence of the event described in the contract or at contract maturity. This implies that there is no settlement market for the contract with the individual.**
- 3. As a result, we agree with the definition of market as given. Nevertheless, we believe this market is defined as a market between insurance companies transferring pools of risks. The transfer price should reflect the expected settlement price with the individuals.**

In addition, we believe there is a need to explore further the effect of information asymmetry. This concept is discussed briefly in paragraph 183 of the main paper. In addition, the effect of risk preference is also relevant here.

For insurance contracts, insurers utilize underwriting (selection) techniques that consider the risks transferred by the individuals that apply for coverage to determine whether they are sufficiently homogenous to constitute a single pool. However, individuals may have information that they have not shared with the insurer that might significantly impact their individual risk and that will only become observable by the insurer after it has committed itself and is then obligated to fulfil its contractual promises. Such risk is not priced for in the premium (the entry value) and may significantly affect the price an insurer has to pay to another knowledgeable insurer in case of a transfer of the pool of risks.

Furthermore, we believe that “policyholder behaviour” is an important concept that has to be considered in the measurement of insurance contracts. In fact, some observed policyholder behaviour may appear to be irrational in the context of public market information, but may be perfectly rational from the perspective of the individual policyholder. As an example, it may seem financially rational that a

policyholder should cancel an insurance contract in case of increasing interest rates (the rational action being to purchase a new policy with the proceeds that can provide a higher benefit). However, not only are many such policyholders loyal to the producer or insurer and convinced that the needs for which the contract was purchased still exist, but a cancellation of the contract may mean that the policyholder no longer has access to an insurance pool and thus cannot purchase another such contract.

Since insurance contracts are frequently complex bundles of rights and obligations that can be highly related, both policyholder and insurer behaviour should be considered in both initial and subsequent measurement.

Q8. Do you agree that a promise to pay has the same fair value on initial recognition whether it is an asset or a liability, and that the credit risk associated with a promise to pay enters into the determination of that fair value with the same effect whether it is an asset or liability (see paragraph 65 of the condensed version and paragraphs 142-147 of the main discussion paper)? If you do not agree, please explain the basis for your disagreement.

IAA Comments: Many actuaries do not agree with reflecting “own credit risk” in the fair value measurement of the liability. They believe this does not represent the value that would arise from individual settlement of the contract. In addition, for almost all insurance and annuity contracts, credit risk plays a relatively minor role in prices of these contracts (particularly due to the existence in many jurisdictions of regulatory sponsored guarantee programs). The difficulty of measuring this risk after issuance of an insurance contract (in contrast with most debt instruments) and the problems that can arise if the insurer’s credit standing changes after issue have convinced these actuaries that its application could lead to misleading results after issue, which would thus make it undesirable to reflect at issue as well.

In any case, these actuaries believe reflecting own credit risk results may, looked at in isolation, represent a potentially misleading factor, as a decrease in credit rating is (partly) compensated by lowering the liabilities. They believe that these results do not constitute an understandable measurement basis. They also believe that the practical difficulties with the measurement of such an adjustment overwhelm any theoretical advantage.

Many actuaries believe that, in this case, decision making usefulness should be seen as more important than the theoretical considerations of clean market approaches. In any case, if “own credit risk” is considered in measuring liabilities, we suggest that the effect be recognised separately in the balance sheet and the income statement.

Q9. The paper makes the following proposals with respect to defining the unit of account of the asset or liability to be measured on initial recognition:

- (a) The appropriate individual item or portfolio unit of account on initial recognition is generally the unit of account in which the reporting entity has acquired the asset or incurred the liability (see paragraphs 67-70 of the condensed version and paragraphs 149-154 of the main discussion paper).
- (b) The appropriate level of aggregation for non-contractual assets on initial recognition is the lowest level of aggregation at which an identifiable asset is ready to contribute to the generation of future cash flows

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through its sale or use (see paragraphs 71-73 of the condensed version and paragraphs 157-161 of the main discussion paper).

Do you agree with these proposals within the caveats and discussion presented? If not, please explain why, and in what respects, you disagree.

IAA Comments: As stated in our response to Q7, the business of insurance is to pool risks that are transferred to the pool by individuals. The risk arising from pooling these individual risks is managed by the insurer. The impact of pooling the risk is that the volatility of the financial effect of an occurrence of the risk covered is lower than it would be for an individual risk.

Note that this does not imply that the long-term uncertainty of occurrence of the risk is diminished. As a result, we do not agree with the conclusion reached in paragraph 150 of the main paper that insurance risk can be diversified away in an efficient market. Only the volatility risk can be reduced by organizing a sufficiently large pool.

As an example, we are not aware of the transfer of longevity risk (for example by securitisation) at a price that does not include a margin for risk and uncertainty. In other words, the market includes a price for risk and uncertainty in transaction prices.

The definition as provided in paragraph 152 of the main paper implies that for insurance contracts the unit of account is the individual policy. This is a workable concept if and only if the probability concept of occurrence of risk is applied in full (i.e., on the individual contract basis). We note this is similar to considering risk margins after reduction of the pooling effect, since this implies that the unit of account for measurement is the pool.

An individual contract is reasonable to use if the contracts are essentially identical. One share of a company is like any other and the value of the share is the number of shares times the value of one share. There is no adjustment for portfolio size; e.g., small portfolios are not discounted because they may be difficult to sell and large portfolios do not receive the benefit associated with a control premium. Even when there are identical contract terms, insurance contracts differ because the insured risks differ.

In fact, the value of a single contract is determined by reference to the average expectations of market participants relating to the inputs affecting the entire portfolio and is not, in isolation, a meaningful value.

In addition, we believe the concepts of portfolio creation and aggregation need further consideration, particularly in the context of diversification.

The paper seems to indicate that portfolio creation refers to similar, but individually still identifiable, items being collected (i.e., the pooling concept that we described

above), while aggregation refers to similar or dissimilar items being put together in a manner that they are not longer individually distinguishable.

The economic effect of portfolio creation is referred to as being the “diversification effect”. However, “diversification” as referred to in financial theory means risk mitigation among dissimilar, but independent risks. As a result, we believe the effects described in 150 are not diversification effects but are effects of similar but independent risks resulting from the application of the Central Limit Theorem of mathematical probability theory. The application of the diversification concept in this manner also makes it arguable that finance theory does not consider any price for a diversifiable risk.

This, in our view, is different from pooling of similar risks, since this requires significant effort in searching for and investigating risks, and construction and managing of the pool. Therefore, we recommend distinguishing creation of portfolios of diversified risks from collection of similar risks in a pool. In respect of paragraphs 149 to 154, this would imply replacing the term “portfolio” by “pool” and “diversification” by “pooling”.

Such a strict distinction between diversifiable risk and poolable risk would also address the apparent anomaly that the risks associated with insurance and loan defaults do not have a price. These risks do have a price because they cannot be diversified effectively but can only be pooled, while pooling reduces those risks in a mathematically describable manner under the Central Limit Theorem (but will not eliminate them entirely).

Q10. It is suggested that, in many cases, the best market source on initial recognition is the market in which the asset or liability being measured was acquired or issued. However, some significant situations are noted in which a different source may be appropriate, and research is proposed into possible multiple markets (see paragraphs 75-82 of the condensed version and paragraphs 162-182 of the main discussion paper). Do you agree that the paper provides a reasonable analysis of market sources and their implications on initial recognition? If not, please provide reasons for disagreeing, and indicate any additional analysis or research you would think should be carried out.

IAA Comments: We agree in general with the analysis provided. However, in respect of demand deposits (paragraph 172 of the main paper) we note that an exit market price may also be influenced by reflecting “own credit standing”.

We agree that further research would be appropriate in the area of the “demand deposit floor” mentioned in paragraph 173 of the main paper. Although we recognize the concern with recognizing profits at issue (as evidenced by recent discussion regarding revenue recognition), we also believe that to be consistent with fair value, the use of an accounting constraint of an application of such a minimum value does not appear consistent with market-consistent values.

Note that if the definition of fair value is the amount to settle immediately, the demand deposit floor may be relevant as the policyholder would not settle for less than the surrender value which then would be the demand deposit floor. However,

if the definition is the amount paid to transfer the obligations to a third party, then the unit of account is the portfolio and the demand deposit floor is not a constraint.

Q11. The paper concludes that transaction costs, as defined, are not part of the fair value of an asset or liability on initial recognition (see paragraphs 86-87 of the condensed version and paragraphs 193-200 of the main discussion paper). Do you agree with the proposed definition of transaction costs? Do you agree with the above conclusion? If you disagree, please explain your reasons and what you believe the implications of your different view would be for fair value measurement of assets and liabilities on initial recognition.

IAA Comments: We agree to the extent that “transaction costs” that can be recovered in the market should be reflected. We understand that the paper defines this type of cost to be included as a transaction cost. However, in paragraph 193 transaction costs are defined to include commissions. Insurance contracts often include ongoing commissions (payable each year to the sales representative as long as the contracts are in force) which would be included in the exit value if the pool of liabilities is transferred to another party. The wording used in the paper may result in excluding these commissions from the measurement of the liability. In particular, we believe the reference to “not recoverable in the marketplace” is somewhat circular, since the measurement approach should consider everything that would be considered by market participants. Especially if market prices have to be estimated by a valuation technique, this expression is not clear regarding whether the specific costs are recoverable in the marketplace or not. As a result, we believe there is a need for clarification and possible rewording.

We also note that the paper’s position is based on the presumption that transaction costs are not a function of the value of the asset or liability, but rather only a function of the transaction itself. In many cases, the transaction cost or commission is very much a function of both the size and other characteristics of what is being transferred. Thus, we suggest that this concept be rethought to reflect better the true principles underlying the characterisation of this price.

Q12. Do you agree with the proposal that, when more than one measurement basis achieves an acceptable level of reliability, the most relevant of these bases should be selected (see paragraph 89 of the condensed version and paragraph 202 of the main discussion paper)? If not, please explain why you disagree, and indicate how you would settle trade-offs between the relevance and reliability of alternative measurement bases.

IAA Comments: We agree.

Q13. Do you agree with the two proposed sources of limitations on measurement reliability — estimation uncertainty and economic indeterminacy — and supporting discussion (see paragraphs 90-100 of the condensed version and paragraphs 204-216 of the main discussion paper)? If not, please explain your view.

IAA Comments: We agree that the two proposed sources provide appropriate reflection of the limitations on measurement. Nevertheless, we have four observations:

- 1.** We believe there is a need to clarify the distinction between an “accounting estimate” and the technical term “estimate”. An accounting estimate is applied whenever the value of an accounting item is not certain. There is a variety of approaches to take in developing such “accounting estimates” that are not necessarily “estimates” in a technical, i.e. statistical, sense.

2. We suggest that statements like “accounting measurement cannot avoid some degree of estimation uncertainty” be clarified further. Such a statement provides the impression that “estimation uncertainty” is just a minor issue in financial reports. For business accepting uncertain risks (like insurance), “estimation uncertainty” can often be quite large. In that respect, the last sentence of paragraph 220 states “it is proposed that a measurement basis should not be considered unreliable solely because it has a wide range of measurement uncertainty, if relevant and reliable information can be provided that enables users to understand the basis for determining the single point estimate and the nature, size and shape of the range of possible values around that point.” For insurance contracts, the needed volume to provide “relevant and reliable information” can be quite large and even if available may not be “relevant”. We believe that if such information cannot be provided, e.g., for practical reasons, it would not be appropriate for the item to be ignored, since there might be lower and upper limits that are reliably determinable.
3. We appreciate the discussion in paragraphs 207 and 208 of the main paper on the distinction between estimation uncertainty from risk related volatility. However, we believe this distinction can be made clearer by not referring to the “volatility of the value over time” as included in the first sentence of paragraph 208. We believe this would be clearer if it were referred to as “uncertainty of the value over time”. As an example, for a multi-year term insurance contract (covering mortality risk), the insurer bases its valuation on assumptions regarding the expectation of the occurrence of death in the portfolio (a pool of similar/homogenous risks). Even if this assumption is developed on a reasonable basis (i.e., taking into account all relevant information), the number of deaths from the pool and the amount of insurance benefits payable on them will fluctuate each year. This concept is known as volatility and is as defined in paragraph 207 of the main paper.

In addition, there is a risk that the insurer will experience a deviation from the assumed long-term mortality trend (e.g., mortality rates can decrease more or less than assumed). We believe this part of the deviation risk should be defined as “uncertainty” rather than as “volatility.”
4. For insurance risks, a deep and liquid market does not usually exist. As a result, this risk is subject to the concept of “a reasonable estimate”. This issue is discussed further in our response to Q15.

Q14. Do you agree that fair value is the most relevant measure of assets and liabilities on initial recognition of assets and liabilities, and therefore should be used when it can be estimated with acceptable reliability (see analyses of fair value and alternative bases in chapter 7, and discussion of measurement date on initial recognition in paragraphs 179-180 of the condensed version and paragraphs 410-415 of the main discussion paper)? If not, please explain why.

IAA Comments: We are not convinced that the discussion in paragraphs 410-415 is helpful in the consideration of establishing liabilities for insurance contracts. For insurance contracts, initial recognition is not a meaningful concept since this basically refers to recognition at issue, which usually does not coincide with a

reporting date. For insurance contracts at a reporting date, circumstances, particularly with respect to the discount rates applied in a measurement basis that applies present values, may have changed considerably.

We note that value at inception may be useful for model calibration purposes. This is a topic that should be considered further in the evaluation of reliable estimates. A reliable estimate is produced by a model that is validated by calibration to observable inputs or where observable inputs are not available, unobservable inputs can be used if calibrated to other relevant factors.

Q15. Do you agree that fair value is not capable of reliable estimation in some common situations on initial recognition (see paragraph 104 of the condensed version and paragraphs 232-277 of the main discussion paper)? More specifically, do you agree that:

- (a) A single transaction exchange price should not be accepted to be equal to fair value unless there is persuasive evidence that it is (see paragraphs 106-114 of the condensed version and paragraphs 243-252 of the main discussion paper), and
- (b) A measurement model or technique cannot be considered to achieve a reliable estimation of the fair value of an asset or liability when the estimate depends significantly on entity-specific expectations that cannot be demonstrated to be consistent with market expectations (see paragraphs 115-118 of the condensed version and paragraphs 263-268 of the main discussion paper)?

Please provide explanations for your views on these questions if they differ significantly from the conclusions and supporting arguments presented in the paper.

IAA Comments: We agree with the analysis. However, we note that there is considerable debate regarding the proper measurement of insurance risk and whether or not a fair value objective can be estimated reliably. We believe a need exists for further guidance on the interpretation of the wording “reliably estimated” in the context of liabilities arising from insurance contracts.

This may be particularly useful in the context of approaches that bifurcate the measurement of the liabilities into their components, where one component can be measured by reference to observable market prices and another component (where no observable market prices exist) has to be measured by means of a valuation technique that refers to the specifics of the risks in the portfolio.

In addition, we believe there is a need to clarify the difference between an entity-specific concept and a portfolio-specific concept. In some cases these concepts are used interchangeably meaning the same thing, while we believe they are not the same. In fact, we believe that it is appropriate for another word be used in place of “entity-specific” since it has been used to refer to several different concepts (e.g., characteristics of the item being measured, the entity’s risk preference, and using data only available to the entity). In the context of insurance contracts, the concept that is more appropriate is portfolio-specific data (i.e., as observed in the specific portfolio to be measured, subject to generally the same underwriting and settlement procedures, acquired in generally the same target market consisting of reasonably homogeneous insurance risks and with the same sales approach, portfolio mortality, claims ratios, etc.). Such data would not be affected if the portfolio would be transferred to another entity.

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Data relating to experience of the entity (i.e., data observed in the reporting entity and specific to that entity, including factors such as underwriting cost, administration cost, settlement speed, available capital, etc.) may change if the portfolio would be transferred to another entity, but would continue to apply if the entire entity is sold.

Q16. Do you agree with the paper’s analyses and conclusions with respect to the comparative relevance and reliability of:

- (a) historical cost (see paragraphs 120-137 of the condensed version and paragraphs 281-319 of the main discussion paper);
- (b) current cost – reproduction cost and replacement cost (see paragraphs 138-154 of the condensed version and paragraphs 320-361 of the main discussion paper);
- (c) net realizable value (see paragraphs 155-161 of the condensed version and paragraphs 362-375 of the main discussion paper);
- (d) value in use (see paragraphs 162-169 of the condensed version and paragraphs 376-392 of the main discussion paper); and
- (e) deprival value (see paragraphs 170-178 of the condensed version and paragraphs 393-409 of the main discussion paper)?

Please provide reasons for any disagreements, and any advice you may have as to additional analysis or research that you believe should be carried out.

IAA Comments: We agree with the overall analysis described. Regarding deprival value, we believe the analysis is appropriate; however, as stated in our response to Q1, we do not consider deprival value to be a separate measurement basis.

Q17. The paper discusses substitutes for fair value when the fair value of an asset or liability cannot be reliably estimated on initial recognition. Do you agree that, when other measurement bases are used as substitutes for fair value on initial recognition, they should be applied on bases as consistent as possible with the fair value measurement objective (see paragraph 186 of the condensed version and paragraph 417 of the main discussion paper)? If not, please explain why.

IAA Comments: We agree.

Q18. Do you agree with the proposed hierarchy for the measurement of assets and liabilities on initial recognition (see chapter 8)? If not, please explain your reasons for disagreeing and what alternatives you might propose.

IAA Comments: We have some concern regarding the categorization of insurance contract liabilities as a level 3 substitute: “a liability should be measured on initial recognition at its current consideration amount, provided that this amount can be reliably estimated and can be reasonably expected to represent the amount owed.” We refer to earlier comments that the initial market is between an individual and the insurer, which may include the effect of pooling advantages in the price set (historical cost value). That market is not similar to the market as defined in this paper.

In addition, we believe that prices charged at issue for taking on the obligation may be subject to competitive pricing rather than the cost as estimated by an insurer to whom the risk would be transferred after issue and, as a result, would not necessarily represent a fair value price. In other words, the initial price may not be

consistent with expected costs, or consistent with transaction prices in a resale market.

Furthermore, we have some difficulty understanding the discussion in Appendix C (paragraph C11) that seems to argue that historic cost is an entity-specific concept, which seems to contradict the notion expressed in paragraphs 431 and following in the main paper.

Q19. Do you have comments on any other issues or proposals, including the proposals for further research (see paragraph 189 of the condensed version and paragraph 441 of the main discussion paper)? If so, please provide them.

IAA Comments: We agree with the recommendations for further research, particularly regarding the further study of issues relating to the unit of account (c) – preferably in the context of a discussion on probability concepts; and further theoretical and empirical research into the application of finance theory. In addition, we believe that additional references to the liabilities of insurance contract liabilities are warranted and particularly with respect to the interpretation of “reliably estimated”.

We also believe that, although the analysis included this paper addressing measurement on initial recognition is generally quite good, without an adequate and parallel examination of measurement of subsequent recognition, it is incomplete and cannot be implemented alone.

We have no further comments.

IAA Comments on the Discussion Paper
Measurement Bases for Financial Accounting – Measurement on Initial Recognition

APPENDIX A

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