



**ASSOCIATION ACTUARIELLE INTERNATIONALE  
INTERNATIONAL ACTUARIAL ASSOCIATION**

April 29, 2013

Mr. Frank Bollmann, Vice Chairman  
International Valuation Standards Board  
68 Lombard Street  
London EC3V 9LJ  
United Kingdom

Dear Mr. Bollmann

**Re: IAA comments on the Discussion paper on Valuation of Liabilities**

In response to the request for comments on the Discussion Paper, I am pleased to transmit, on behalf of the International Actuarial Association (IAA), our comments and recommendations.

These comments have been prepared by the Insurance Accounting Committee of the IAA. If, upon reading these comments, you identify any points that you wish to discuss or obtain further insight regarding them, please do not hesitate to contact Francis Ruygt, chairperson of the Insurance Accounting Committee, care of the [IAA Secretariat](#). The IAA will be pleased to develop these ideas further with you.

Yours sincerely,

Kurt Wolfsdorf  
President

Attachment: IAA comments

**Comments by the International Actuarial Association on the Discussion Paper  
VALUATION OF LIABILITIES  
Released by the International Valuation Standards Council: February 2013**

**International Actuarial Association and its Due Process**

The International Actuarial Association (the “IAA”) represents the international actuarial profession. Our sixty-four Full Member actuarial associations, listed in an Appendix to this statement, 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 is pleased to have been given the opportunity to provide input to the IVSC on this Discussion Paper (the “DP”). These comments have been prepared by its Insurance Accounting Committee, the members of which are listed in an Appendix to this statement. It 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.

**General Comments**

Overall, the IAA supports the formulation of a set of principles for the valuation of liabilities as proposed in the DP. We note that the DP also refers to the development of standards and guidance, but at this stage we would suggest restricting the project to development of principles.

As actuaries, our expertise is the valuation of (inherently uncertain) future cash flows and as a result, the IAA (and, in particular, its Insurance Accounting Committee) has a keen interest in the project that the IVSC is proposing to undertake. We agree that the proper valuation of liabilities is an important aspect of financial reporting and is a vital element to improve investors’ confidence in the financial statements of entities. We also agree that the valuation of liabilities is a complex subject and one that is not well understood, even by some experienced valuation experts. Therefore, we offer our assistance and support to the IVSC to develop a general framework on how the value of different types of liability (other than insurance, pension and employee benefit) can best be determined and reported.

Our main objective is to ensure that uncertainty is measured in a conceptually clear and consistent manner.

We provide our initial thoughts on these topics and our response to the questions in the DP in the paragraphs that follow. We recognize that the creation of a general framework is a major project and we offer to meet with representatives of the IVSC to understand its objectives better, to discuss our comments further and to develop a way to work together on this important matter.

**Question 1**

**Do you agree with that the IVSC should produce a standard or guidance on the valuation of liabilities as defined above? If not please explain why.**

We agree that it is useful to formulate a set of sound basic principles for the valuation of liabilities for the purpose proposed in the DP.

## **Question 2**

**Do you agree that the possible definition of a liability given above is both clear and adequate? If not any alternative suggestions would be welcome.**

We believe the definition as stated is clear and adequate.

We note that a measurement approach to the valuation of uncertain cash flows is often best dealt with using expected present values in the statistical sense (i.e. the mean value of all possible probability-weighted outcomes). This type of measurement approach will also deal with potential outflows of resources that are either infrequent or remote.

## **Question 3**

**Do you agree with that liabilities arising under a financial instrument should be excluded from the scope of this project?**

We agree that it is appropriate to exclude liabilities resulting from financial instruments from the scope.

## **Question 4**

**Do you agree that other liabilities such as rental payments, pension liabilities, insurance liabilities and deferred tax should also be excluded?**

We agree that, due to their specialized nature, pension liabilities, insurance contract liabilities and deferred taxes should be excluded from the scope of this general project and are better addressed separately.

**On questions 3 and 4, a combined note;** We believe that the liability principles developed in the IVSC project should be consistent on an overall basis with the principles developed by others for reporting the liabilities excluded in questions 3 and 4. They should only diverge if sufficient justification for their divergence can be articulated.

## **Question 5**

**Do you consider that contingent liabilities as described above should be included? Please also indicate if there are any other types of contingent liability that should be included.**

We note that whether to include or exclude contingent liabilities is a question of recognition, not of valuation measurement. If a contingent liability is recognized, it should be valued as a liability in a manner consistent with those described paragraph 10 of the DP. Hence, we believe that it is appropriate to include contingent liabilities within the scope of this project, but note that external constraints or context may preclude their recognition. We also note that the definition of a liability using the expected value paradigm may reduce the need for explicit rules to determine when certain liabilities should be included or excluded from the scope of this project.

In addition, we note that much of the work done by actuaries is precisely the valuation of certain kinds of contingent liabilities. We suggest meeting with representatives of your organisation to discuss this and ensure we don't accidentally duplicate each other's efforts.

To add perspective, we note that a number of pensions and insurance contract liabilities involve contingent liabilities where the cost of the obligation is not defined. For example, relative to paragraph 10, property and casualty insurance (known as general insurance in some parts of the

world) often involves contingent liabilities (that is, contingent upon an accident) to repair or restore an asset, as part of a product warranty or even coverage of site remediation or decontamination.

### **Question 6**

**Please indicate whether you believe potential litigation liabilities can or should be valued and whether they should be included in this project.**

Whether litigation liabilities should be included within scope is a primarily a question that involves recognition rather than measurement. If a litigation is to be recognized it should be measured applying the same principles as for other liabilities. We believe that some (but not all) liabilities arising from litigation are subject to reliable estimation. We also note that the measurement of the financial effect of litigation liabilities is already being performed by those involved with the insured portion of such liabilities. Our experience indicates that such liabilities are more frequently reliably estimable when viewed as a portfolio of similar liabilities, not as individual claims on a reporting entity's assets. We also would be concerned if this project resulted in different measurement criteria when such liabilities are insured versus when not insured.

### **Question 7**

**For what purposes are you aware of liabilities being valued?**

The following is a non-exhaustive list of purposes for which liabilities are valued based on our experience with insurance:

- Financial and other reporting for public companies, to shareholders, to regulators and to tax authorities
- Product, benefit or service design and pricing, including assessing product options (e.g. surrender values, member options to take income or cash at retirement in a pension fund, etc)
- Internal group/management information and decision making. (This would also include input to asset-liability modelling, stress testing analysis and investment portfolio decisions)
- Mergers and acquisitions, including negotiation between parties involved in a proposed business combination
- Litigation including divorce proceedings
- Bankruptcy proceedings
- Settling of claims

### **Question 8**

**What basis or bases of value do you normally encounter?**

In our professional activities, actuaries encounter all of the valuation bases identified in the DP. Most often we encounter measurement approaches for liabilities that use a discounted cash flow technique any of which includes appropriate adjustments for risk and uncertainty associated with the cash flows being valued. This valuation model is often referred to as fair value although the value is not based on observation of market-based prices. Since liabilities are often not traded in markets, expected present values are more often used in their valuation than in valuations of assets.

We offer a further comment on terminology. We understand the term, “Base of Value”, to be equivalent to the IASB term “Measurement Attribute”. It determines whether the perspective of the valuation is based on the characteristics of the entity, the counterparty, the markets or other parties. The measurement attribute should be chosen depending on the objective of the valuation and the characteristics of the liability.

#### **Question 9**

**Do you agree that the bases that are appropriate objectives for a valuation of liabilities fall within one of the three categories described in the IVS Framework?**

We agree that the investment value is the value normally used for the type of liabilities that actuaries most commonly measure. We believe that the bases underlying the other methods as defined by the IVSC are heavily driven by asset valuation needs. It is important to note (as stated in paragraph 23 of the DP) that certain liabilities are generally not transferable, at least not without the consent of the counterparty. The counterparty would be expected to consent only if the transferee has at least the same credit standing as the holder of the liability. For that reason, there may not be markets for many of these liabilities (especially if financial liabilities are excluded).

#### **Question 10**

**Do you agree that it may be necessary modify some of valuation bases definitions in the Appendix in order for them to be applied to liabilities as opposed to assets? If so it would be helpful to indicate any changes you believe appropriate.**

The following are comments related to these definitions for liabilities.

- Investment Value - we suggest using "Fulfilment Value": The value of a liability to its holder, assuming that obligation will be fulfilled with the resources of the holder.
- Fair Value and Special Value could be applied to liabilities transferred with the consent of the entitled party (not a market price), as well as direct settlement with the entitled party. It might be useful to differentiate these.

#### **General comment on questions 11-15**

**The issues raised in these questions are important. However, it seems to us that at this stage they are merely focussing on standards and guidance and, as stated in our General Comments above, we believe the first aim of the project is a general framework for valuation principles. Nevertheless, we have provided our views from the perspective of principles.**

#### **Question 11**

**If you have experience of using the market approach to value liabilities, please indicate the nature and types of liabilities where this is used.**

No comment.

#### **Question 12**

**Please give an example of a type of liability where you have encountered or used a DCF method and indicate the purpose for which the valuation was required.**

We use DCF using mean (expected value in a statistical sense) values in the vast majority of our work.

### **Question 13**

**For the example given for question 12, please indicate the source of the projected financial information used in the cash flow forecast.**

The entity estimates fulfilment cost based on its own past experience, adjusted for expected changes in the future (such as, in some estimates, from inflation). In the case of product warranties, there is often sufficient experience data available to enable a statistical estimate of the future fulfilment cost to be developed.

### **Question 14**

**For the example given for question 12, indicate what risk factors you reflected and whether these were reflected by probability weighting the cash flows or the discount rate.**

We refer to our commentary on question 15.

### **Question 15**

**Do you consider that a “risk free” rate should be used when estimating the current value of a future liability? If not please indicate how you derive the rate and the rationale to support it.**

We believe that the discount rate should reflect the characteristics of the liability being measured. When a provision for risk is to be used, either implicitly, through adjusting the discount rate (i.e., using a risk adjusted interest rate) or explicitly by adjusting the estimate of the cash flows (i.e., through a conservative estimate of the cash flows), the discount rate should be derived in a consistent manner. If all of the provision for risk has been reflected by adjusting the probabilities or cash flows and the cash flows do not depend on the performance of assets or the level of interest rates, then a “risk free” rate (potentially also adjusted for illiquidity) may be appropriate for discounting. However, when the provision for risk is to be reflected in the discount rate or when liability cash flows depend on the performance of assets or interest rates in general, a risk-free discount rate may not be appropriate.

### **Question 16**

**Please indicate if you have used or encountered option pricing in estimating the value of liabilities. If so please indicate the nature of the liability and the purpose for which the valuation was required.**

We believe it is only appropriate to apply option pricing when the risks born are traded in markets. Most non-financial liabilities will not include such risks. In those cases, it is necessary to apply a valuation technique based on discounted cash flows with a provision for the risk related thereto, reflecting the expected variability in the cash flows.

### **Question 17**

**Please indicate whether you agree that in calculating the value of a liability based on the cost of fulfilment at a future date a “profit margin” (or risk premium) should be included to reflect the risks to the holder of the cost estimate proving inadequate. If so, please give an example.**

We believe that the valuation of a liability should reflect the risks and uncertainties inherent in the cash flows (both in terms of their amount and timing aspects). Such reflection of risk and uncertainty can be viewed as an opportunity cost, which reflects the risk-equivalent to the cost without considering risk and uncertainty. Without a provision for risk, a risky liability would appear to be the same as a liability without risk, losing important information about the risk.

### **Question 18**

**If you use or are familiar with the Cost Approach, please indicate in your experience how the cost of fulfilling, transferring or settling/cancelling an equivalent liability is determined.**

As stated in the DP, the cost approach is not suitable for the measurement of most liabilities. But it can be expressed in a way that could be applied to liabilities, such as: “A valuation approach based on the economic principle that a holder will pay no more for a liability than the cost to transfer, settle or fulfil the liability.”

### **Question 19**

**Do you agree with the Board’s proposed approach?**

We agree. We also believe that it would be appropriate to develop a general framework to measure both assets and liabilities, which describes corresponding Bases of Value and corresponding Valuation Methods. Fundamental differences in conceptual and practical measurement between assets and liabilities mean that a framework for the valuation of assets needs to be translated into the world of liabilities. Further, in the absence of observable market prices, based on our experience with insurance liabilities, we support the use of discounted value of expected cash flows, with a risk-free and illiquid discount rate, plus a risk adjustment for the value of risk and uncertainty of deviations of the actual value from the estimated expected value. However, in simpler cases, simplifications may be appropriate; for example, application of no discounting for items of short duration, allowing for risk and uncertainty implicitly in the cash flows or discount rate, and the use of expert assessment.

We would welcome the opportunity to work with the IVSC in developing such a framework for valuation.

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