



**ASSOCIATION ACTUARIELLE INTERNATIONALE
INTERNATIONAL ACTUARIAL ASSOCIATION**

December 14, 1998

The Secretary-General
International Accounting Standards Committee
166 Fleet Street
London UK
EC4A 2DY

Subject: E62: Financial Instruments: Recognition and Measurement

Dear Sir Bryan:

Further to my letter to you of September 29, 1998 forwarding the International Actuarial Associations' (IAA) draft comments on the IASC's Exposure Draft E62 on *Financial Instruments: Recognition and Measurement*, I am pleased to confirm that the IAA's due process is now complete and the draft comments, as submitted, have been approved by the member associations for release as an IAA public statement.

Yours sincerely,

Jean Berthon
President

Final December 5, 1998

**International Actuarial Association Comments on the
International Accounting Standards Committee's
Exposure Draft E62
*Financial Instruments: Recognition and Measurement***

THE INTERNATIONAL ACTUARIAL ASSOCIATION

The International Actuarial Association (the "IAA") represents the international actuarial profession. Our member actuarial associations exceed forty in number, and 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 on the areas of expertise of actuaries.

The IAA's interest in the IASC's Exposure Draft E62: *Financial Instruments: Recognition and Measurement* ("Exposure Draft") is to assist the IASC in developing a high quality standard on this very important topic. The IAA appreciates the opportunity to provide comments on this Exposure Draft. We must note that the time provided for comments was quite short in view of its international scope and the need in our case to communicate with the various actuarial organizations in the world.

DUE PROCESS

This official statement of the IAA was prepared by the IASC Insurance Accounting Standards Committee of the IAA, the members of which are listed below by name and association. It has been circulated for approval to all the member associations of the IAA, a list of which is attached as an Appendix. Following the expiry of the prescribed 60 day notice period, the submission has accordingly been approved as a public statement of the IAA.

**MEMBERS OF THE IASC INSURANCE ACCOUNTING STANDARDS
COMMITTEE**

Sam Gutterman (Chair)
Clive Aaron
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The Institute of Actuaries of Australia
Institute of Actuaries
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Pascal Parant	Institut des Actuaire Français
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OVERVIEW AND MAJOR ISSUES

The IAA would prefer, as we believe does the IASC, to be discussing the exposure draft of the planned comprehensive standard for accounting for financial instruments, rather than an interim solution. However, recognizing the practical realities of the need for timely adoption of the core set of IASC standards, we understand the current need for such a standard. Although the IAA agrees in general with the overall approach to the methodology proposed to determine appropriate accounting values for financial instruments, we have a number of specific issues upon which we would like to comment.

The following are several major points with regard to the Exposure Draft, followed by responses to the questions posed in the Exposure Draft:

1. **Consistency in reporting asset and liability values.** As the IAA has indicated in previous comments regarding other IASC Exposure Drafts, we believe that it is important to report assets and liabilities in a reasonably consistent manner. In the case of an insurance enterprise, its business is, in essence, to sell future obligations. Its ability to fulfil these obligations depends upon the financial instruments that it owns. Because the principal fiduciary responsibility of directors of companies in drawing up their accounts is to their own shareholders and policyholders, the integrity of the company's balance sheet is therefore of preeminent importance. It would thus be quite wrong, particularly for a life insurer whose assets and liabilities may be intricately tied together, to introduce fair value reporting for that part of its assets that support its obligations, while at the same time permitting alternative methods of accounting for those obligations themselves.

Thus, since our strong preference is for the simultaneous implementation of fair value accounting for both assets and liabilities, we recommend the exclusion and deferral of these standards for insurance enterprises until successful completion of the current IASC insurance project.

The IASC recognizes the significance of this issue, as evidenced by its separate Steering Committee on Insurance Accounting Standards. However, because the results of the recommendations of this Steering Committee will not be implemented at the same time as the current Exposure Draft, a period of time will exist in which inconsistent standards will be in effect. As a result, it may be best if the provisions of the Exposure Draft with respect to insurance enterprises were deferred until standards with respect to insurance obligations are implemented.

We recognize that such a broad exclusion may create other difficulties, in particular, comparability of the valuation of certain assets held by different corporations. However, we believe that consistency in accounting standards within a firm is the more important objective in this instance.

We note that in certain countries, there are already processes for reporting fair value of liabilities (although they may or may not conform to what is eventually agreed to as the IASC insurance accounting standard). Where these exist and are sufficiently robust, we do not object to the adoption of E62 without any insurance exclusion. However, for most of the world, adoption with no exclusion may result in misleading financial presentations.

Two **alternatives** exist, neither of which are, to our mind, as satisfactory a short-term solution as the above, but which may be acceptable during the short period until successful implementation of the insurance standard resulting from the current IASC insurance project and the comprehensive financial instruments project:

- **Permit, but not obligate the application of this standard to insurance enterprises.** The advantage of such an approach would be to permit full implementation for insurers in nations in which liabilities are now determined on the basis of fair value and for insurers (such as most non-life insurers) whose obligations are not tied directly to asset performance. The disadvantage of this approach would be the possible lack of comparability between companies that adopt this requirement and those that do not adopt it for the period prior to the adoption of a new IAS covering insurance contracts. Thus, if a company is able to report its liabilities on a fair value basis or does not consider that application of the standard to its assets would produce materially misleading financial statements, it should adopt the standard; otherwise, it should not be required to do so until an IAS on insurance contracts is adopted.
- **Exclude contracts between an insurance enterprise and its policyholders,** in a manner similar to the new IAS on Provisions. This would effectively exclude the

obligations associated with insurance contracts, but include the assets that underlie and provide funding for them. The advantage of this approach is to defer application to such liabilities until the conclusions reached in the IASC insurance project are adopted, while providing for comparable asset values for financial instruments for all companies. The disadvantage is internally inconsistent financial statements for insurance enterprises subject to IASs, which may be significant as mentioned above, and as such, is not a preferable option. However, an **acceptable variation** of this approach would be to **exclude both such contracts and any financial instruments used to back the insurance liabilities recorded**. Since the rationale for this variation applies only to the assets underlying an insurer's obligations, the exclusion should only apply to assets supporting corresponding insurance obligations. However, it may be difficult in some cases to distinguish among these two classes of assets (those supporting contracts and others).

In any event, the requirements of the Exposure Draft should be required of insurance enterprises upon implementation of the IASC Insurance project. We hope that the period between the adoption of this new IAS, the IAS concerning insurance and the comprehensive standard on financial instruments is short.

1. **Reliably measurable criteria for fair valuation.** We are not comfortable with the definition of "reliably measured" being whether "the variability in the range of reasonable fair value estimates is not significant for that instrument", as provided for in the first sentence of paragraph 63. We note that the situations described in the remainder of paragraph 63 are quite good examples in which reasonable reliably measurable conditions are met; however, the definition does not seem consistent with the situations provided.

We do not believe that it is the range of reasonable fair values that should be the determining factor in such a case, although we note that "significant variability" is undefined. The primary use of financial models is to develop a value in situations of uncertainty as indicated in situation (c) in paragraph 63. Although the market tends to place a larger premium to compensate for risk associated with expected volatility, the simple existence of variability, even a significant degree of such variability, should not cause a financial instrument to be initially valued or subsequently revalued on the basis of amortized costs. Rather, alternative approaches should be used, including, as appropriate, the assignment of a fair value or the discounted value of expected cash flows from the instrument.

3. **Use of alternative accounting methods.** In general, we do not favor alternative methods of accounting being permitted for the same class of asset (or liability) within the same company. As a result, we favor the consistent application of a fair valuation method. This calls into question the appropriateness of a distinction between assets “held to maturity” and assets “held for trading”. The distinction is difficult to maintain and where currently used, typically one category is predominantly used.
4. **Encouragement of comprehensive financial instrument project.** We encourage the IASC in its effort to develop a comprehensive financial instrument standard, presumably geared to a more complete implementation of a fair value basis for accounting. One hopes that such an implementation will resolve several of the more significant issues raised in this Exposure Draft. Due to our particular concern with insurance, we expect that the conclusions reached in the comprehensive financial instrument project will be consistent with those reached in the IASC’s insurance project.

SPECIFIC QUESTIONS RAISED IN THE EXPOSURE DRAFT

The following questions and our comments correspond to the questions provided in the Exposure Draft and in some cases expand on the above.

Question 1 (Paragraph 1)

This Exposure Draft would apply only to enterprises whose securities are publicly traded (paragraph 1). In the past, the Board has limited the application of disclosure requirements to public companies (for example segment reporting and earnings per share). But the Board has always held non- public enterprises to the same recognition and measurement standards as public enterprises. Should the Board:

- (a) retain the proposed scope of applicability only to publicly traded enterprises;
- (b) expand the scope to include non- public enterprises; or
- (c) further restrict the scope, for example, to financial statements issued in connection with cross- border securities sales?

Comments: Based on the information provided, (b) would be preferable. This conclusion has been reached to satisfy the need for consistency in the basis of financial reporting – that the financial statements of two otherwise similar entities should be reported in a consistent manner. We believe that, consistent with historical practice, IASC standards should apply across all affected companies. An example in the U.S. is the recent extension of GAAP to mutual insurers, for whom purchasers of insurance contracts now benefit from consistent accounting rules. Comparability between enterprises is important,

independent of whether they are public or non-public companies. A competitive advantage resulting from the use of different accounting standards is not appropriate. Since no reason has been advanced to justify its inconsistent application, we cannot determine whether such reason, if it exists, justifies the inconsistency.

Question 2 (Paragraph 3(c))

Rights and obligations under insurance contracts are excluded from the scope of this Exposure Draft (paragraph 3(c)). Those financial assets and financial liabilities are unique to insurance enterprises and are being addressed in a separate IASC project on accounting by insurance enterprises. However, that project will not address the non-unique financial assets and liabilities of insurance enterprises that are covered by this Standard, such as investments in financial instruments. Some people have suggested that the effective date of this Standard should be deferred for insurance enterprises pending completion of IASC's insurance project, so that the insurance Standard and this one can take effect at the same time. The Board has tentatively concluded, however, that the need is urgent for recognition and measurement standards for the non-unique financial instruments of insurance companies. Accordingly, they are included in the scope of this Exposure Draft. Should the effective date of this Standard be:

- (a) applicable to insurance enterprises as well as to other enterprises; or
- (b) deferred for insurance enterprises pending completion of the insurance project?

Comments: Problems involving inconsistent financial reporting can be associated with each of the above approaches. If the proposed standard does not apply to insurance enterprises, inconsistent reporting treatment across the financial services industry may result, possibly resulting in certain assets moving from one subsidiary to another within a financial services conglomerate. On the other hand, if the proposed standard applies to insurance enterprises (but excludes insurance obligations), then the assets and liabilities of insurance enterprises would be based on internally inconsistent methodologies, which can produce internally inconsistent earnings and financial statements at best, and misleading information for investors at worst. As a practical matter, we believe that the latter type of problem is likely to be more common.

If this proposed standard were the final version of this statement, we would be of the firm opinion that inconsistent and potentially significantly misleading financial information should be avoided at all costs. However, based on the understanding that this problem will be addressed within a short period of time by the IASC's insurance project and the IASC's comprehensive financial instrument project, possibly another interim approach might be acceptable.

See General Issue (1) above for further discussion of this issue. Whatever approach is adopted, appropriate disclosure will be called for. In any event, the Exposure Draft, or more appropriately the comprehensive financial instrument standard should be required of insurance enterprises upon implementation of the IASC insurance project.

Question 3 (Paragraph 7)

In a few countries, it is common for an enterprise to make what it views as a strategic investment in equity securities issued by another enterprise, with the intent of establishing or maintaining a long- term operating relationship (see paragraph 7). Such strategic equity investments would not qualify as ‘held- to- maturity’ investments for which amortized cost is appropriate under this Exposure Draft because they are not fixed maturity securities. Sometimes, the percentage of ownership is too small or the nature of the relationship is too passive to qualify for the equity method of accounting because the investor does not have significant influence over the enterprise in which the investment is made. Should the Board:

- (a) retain the proposed applicability of this Exposure Draft to strategic equity investments if the equity method is not appropriate; or
- (b) require the amortized cost method for such equity investments even if fair value can be reliably measured and, if so, how should ‘strategic equity investments’ be operationally defined?

Comments: We agree that proposed approach (a) is a reasonable one at this time, primarily as a result of a concern for consistency in reporting. The fair value of a financial instrument, or a partial share in equity ownership in another company in which a transaction has just occurred, is the market price paid. However, as soon as market conditions change, the fair value of the ownership interest changes as well. Historical costs should only be relied upon if the fair value is not reliably measurable.

Question 4 (Paragraph 14)

This Exposure Draft would allow non-derivatives to be designated as hedging instruments (see the definition of a hedging instrument in paragraph 14) if the criteria for hedge accounting otherwise are met (see, in particular, the conditions in paragraph 86). While derivatives generally are acquired for hedging purposes, the link between a non-derivative and a hedged item is often harder to demonstrate – or disprove – leading, in the view of some, to too much flexibility on the part of enterprises in designating hedges. Should non-derivatives:

- (a) be allowed to be hedging instruments if the criteria for hedge accounting otherwise are met, as proposed; or
- (b) not be allowed as hedging instruments?

Comments: There does not appear to be a material difference in the overall financial impact between the use of a hedge using an explicit derivative and an effective hedge relying on non-derivative financial instruments satisfying all of the conditions in paragraph 86. Thus, we prefer alternative (a). However, before such hedge accounting is permitted, several practical issues should be clearly addressed. An example of such an issue is whether to reflect the impact of the effective hedges differently than that of any part of the non-derivative hedge that is deemed to be non-effective.

Question 5 (Paragraphs 17- 21)

This Exposure Draft would require that a derivative embedded in another contract, such as a lease or an insurance contract, be accounted for as a separate derivative financial instrument in certain circumstances (see paragraphs 3(b), 3(c), and 17- 21). Do you concur that:

- (a) at least some embedded derivatives should be recognized and measured separately and, if so, do you believe that paragraphs 17- 21 define the embedded derivatives that should be separately recognized and measured; or
- (b) embedded derivatives should never be recognized and measured separately?

Comments: If a financial instrument is reported at other than at its fair value, it is appropriate that embedded derivatives that can be reliably measured and can significantly alter their cash flows or fair values be recognized and reported separately. In certain cases, it may be possible to add to a non-derivative contract (or one for which hedge accounting can be applied) an embedded derivative to circumvent the impact of the proposed accounting standard.

Conceptually, bifurcation of such a contract would be appropriate as long as it is practical to separate such elements, such embedded derivatives (hedges) are a material part of the host contract, and a fair value is reliably measurable.

However, since from a practical viewpoint this is a very complex issue, we believe that for insurance products, it should be addressed as part of the IASC insurance project, rather than as part of this interim standard, as making such a separation without further guidance may prove inappropriate. For instance, an a consensus has not been reached as to how to separately value many embedded options such as a non-forfeiture option or the equity-indexed feature

of equity indexed annuity and life insurance products. In addition, no market exists from which to derive fair values of such embedded options.

As of this time, we recommend excluding embedded derivatives in insurance contracts. Attempting to handle this one aspect of embedded options here without a significant amount of guidance may only lead to confusion and inconsistent application.

Question 6 (Paragraphs 25- 29)

A securitisation is the process of transforming a group of similar financial assets into an asset- based security. An example is a bank ‘securitising’ a group of residential mortgages and selling the new asset- backed security to another enterprise. Usually the seller retains certain obligations or rights. Some persons view the criteria for derecognition in paragraphs 27 and 29 as prohibiting derecognition when traditional securitisations occur. That is not the Board’s intent. Do you believe that:

- (a) the derecognition criteria paragraphs 25- 29, and particularly paragraphs 27 and 29, are appropriate; or,
- (b) paragraphs 25- 29 require substantive modification and, if so, how?

Comments: No comment, other than posing the question as to whether derecognition is possible in the situation of an embedded option.

Question 7 (Paragraph 44)

Paragraph 44 provides that transaction costs should be included in the initial measurement of held-to-maturity investments, which will be carried at amortized cost subsequent to acquisition, but should be excluded from the initial measurement of financial assets and liabilities that will be remeasured to fair value subsequent to initial acquisition. Do you:

- (a) concur with this distinction;
- (b) believe that transaction costs should be excluded from the initial measurement of all financial assets; or
- (c) believe that transaction costs should be included in the initial measurement of all financial assets.

Comments: There does not appear to be a justification for inconsistent measurement of transaction costs in any system, as both valuation

measurement systems should focus on future cash flows. Thus, we do not believe that (a) is appropriate. We believe that (b) is more consistent with a fair valuation method, because in such a system, it would not be appropriate to reflect historical transaction costs.

Question 8 (Paragraph 46)

Paragraph 46 provides that transaction costs should always be excluded from the measurement of financial assets and liabilities at fair value subsequent to initial acquisition. Do you:

- (a) concur that transaction costs should not be deducted in determining fair value; or
- (b) believe that transaction costs should be deducted in determining fair value?

Comments: As indicated in the answer to question (7), in a fair value environment, it is not appropriate to reflect historical transaction costs. However, since fair value is the amount for which an asset could be exchanged in the future, netting expected future transaction costs (e.g., disposal costs in the case of an asset or salvage/subrogation values in the case of certain liabilities) would be appropriate if reliably measurable. We recognize that such an approach can result in a lack of symmetry between creditors and debtors.

Note that Paragraph 46 and subsequent paragraphs only refer to financial assets while this question refers to both financial assets and financial liabilities. We presume that it is the intent of these paragraphs to refer to both financial assets and liabilities.

In addition, it may be appropriate to clarify paragraph 46 and associated paragraphs to distinguish between historical transaction costs (incurred when acquired) and subsequent transaction costs.

Question 9 (Paragraph 46)

This Exposure Draft requires that financial assets that otherwise would be measured at fair value be measured at amortized cost if fair value cannot be reliably measured (paragraph 46(b)). Because reliability is somewhat subjective, the Board is concerned that paragraph 46(b) could be invoked inappropriately by an enterprise that does not wish to follow fair value measurement of financial assets. Therefore, the Board has provided guidance in paragraphs 63- 66 as to when fair value can be reliably measured. Do you believe that:

- (a) the guidance in paragraphs 46(b) and 63- 66 is appropriate, clear, and sufficient; or

(b) the guidance in paragraphs 46(b) and 63- 66 should be modified, and if so, how?

Comments: See General Issue (2) above

Question 10 (Paragraph 46)

Paragraph 46(b) provides that any financial asset whose fair value cannot be reliably measured should be measured at amortized cost, rather than fair value, subsequent to initial acquisition. Some have suggested that this provision be modified to require that all financial assets other than held- to- maturity investments must be measured at fair value but to acknowledge that, in some cases, cost or amortized cost may be the best indicator of fair value.

Do you favor:

- (a) the approach in this Exposure Draft that, sometimes, fair value may not be reliably measurable; or
- (b) the alternative that cost or amortized cost may be the best indicator of fair value?

Comments: In some cases, fair value may not be reliably measurable. In most such cases, it would be appropriate to reflect an alternative approach to measurement. Although in certain cases cost or amortized cost may be an appropriate measure, an alternate methodology may be more appropriate.

Question 11 (Paragraph 51)

Paragraph 51(b) says that an enterprise does not have the positive intent to hold an investment to maturity if it stands ready to sell the asset in response to liquidity needs. Some people suggest that this condition is too strict, because every asset is likely to be available for sale in the case of severe liquidity needs. Do you believe that:

- (a) paragraph 51(b) is appropriate as drafted; or
- (b) paragraph 51(b) should be modified and, if so, how?

Comments: In general, we do not favor alternative methods of accounting being permitted for the same class of asset (or liability) within the same company. As a result, we favor the consistent application of a fair valuation method. Section (b) of paragraph 51 as currently stated seems to cover all assets, as under significant liquidity conditions, a company may dispose of many assets that under normal conditions it would hold to maturity. If this section remains, it may make a held-to-maturity category difficult to maintain.

We would favor a somewhat less restrictive condition, with appropriate guidance in order that consistent application is practical.

Question 12 (Paragraph 51- 52)

Because classification of a held- to- maturity investment is based on intent (see the definition in paragraph 14), paragraphs 51- 52 contain criteria for assessing intent, including a condition that sale of more than an insignificant amount of such investments calls into question the enterprise's intent to hold the rest to maturity. Paragraph 52 permits that test to be applied to major categories of investments, rather than to an enterprise's investment portfolio in its entirety. Do you believe that:

- (a) the sale of more than an insignificant amount of any held-to-maturity investment should call into question the enterprise's intent to hold its entire portfolio to maturity; or
- (a) the grouping permitted by paragraph 52 is appropriate?

Comments: Regardless of our doubts regarding the appropriateness of a held-to-maturity category, we do not understand the logic of a split being by major category of asset (such as all bonds or all mortgages). For example, a segment of a bond portfolio may have been obtained for the purposes of matching, exactly or approximately, a corresponding set of liabilities, which may or may not be accounted for by hedge accounting. An alternative approach would be to reflect the intent of management with respect to a specified grouping of instruments; however, the application of this approach may result in practical difficulties. For example, in insurance enterprises, asset portfolios are often segmented to match specific sets of assets (not necessarily identified by a specific class or type) with suitable liabilities; in such cases, we agree that the existence of a non-material amount of such sales would require the intent to be validated.

Question 13 (Paragraph 58)

If an enterprise changes its measurement of a financial asset from fair value to amortized cost, paragraph 58 requires that any prior gain or loss relating to that asset that was reported directly in equity, through the statement of changes in equity, should be amortized over the remaining period to maturity. The Board adopted the approach in paragraph 58, rather than requiring that the amount in equity be immediately reported in net profit or loss, to prevent enterprises from making selective reclassifications such that they can effectively put 'unrealized' gains in income at will. Do you:

- (a) concur with the amortization approach in paragraph 58; or

- (b) believe that paragraph 58 should be changed to require that the amount in equity be immediately reported in net profit or loss when reclassification takes place?

Comments: The possible management of reported earnings through bringing unrealized gains into income may distort financial results. At the same time, we suspect that in many cases, financial engineering may be employed to achieve the same effect, which will not always add economic value to the company. The use of amortization of such unrealized gains may minimize such activity, even though it is inconsistent with fair value measurement; thus, we would prefer approach (a). A more comprehensive fair value system would minimize such potential manipulation or incentive for non-economic behavior. In general, changes in measurement methodology should be discouraged, because of the potential for such manipulation.

Question 14 (Paragraph 59)

Paragraph 59 requires that derivatives and trading liabilities be reported at fair value subsequent to acquisition and that all other liabilities be reported at amortized cost. The Board considered whether to permit, though not require, the other financial liabilities to be reported at fair value but concluded that optional measurement standards can cause confusion among users of financial statements. Do you:

- (a) concur that a single method, amortized cost, should be the only requirement for financial liabilities other than derivative and trading liabilities; or
- (b) believe that the Standard should permit, though not require, other financial liabilities to be reported at fair value?

Comments: In general, we do not favor an approach that provides for the use of alternative methods, due to concern with lack of comparability. As a result, we favor a minimization of such options. Because of a need for consistency in the valuation of assets and liabilities, it may be most appropriate to require liabilities to be valued at fair value, assuming that most assets will be valued in the same manner. If an alternative were to be provided, one that might be acceptable would reflect fair value computations conducted by experts in

accordance with professional guidelines that have due regard to the definition of reliable measurement in the accounting standard. Although excluded from the Exposure Draft, it may be useful to note that the application of amortized costs in the determination of insurance liabilities would be particularly inappropriate.

Question 15 (Paragraph 68)

Paragraph 68(b) allows enterprises to make a one- time, enterprise- wide election regarding how to report a gain or loss resulting from an adjustment to fair value of a non- trading financial asset. The options are:

- (a) include the adjustment in net profit or loss for the period in which it arises; or
- (b) recognize it directly in equity, through the statement of changes in equity, until the financial asset is sold, collected, impaired or otherwise disposed of, at which time the gain or loss should be included in net profit or loss for the period.

It is the Board's intent, in the Standard resulting from the comprehensive financial instruments project currently under way, to adopt a single policy for all enterprises, not to provide an option. At this stage, however, the Board believes that allowing the option with appropriate disclosure of any amounts reported directly in equity is as far as it should go pending further study of fair value measurement, performance reporting, and user needs. Those studies are now under way by the Board. The approach proposed in this Exposure Draft accomplishes an important objective of fair valuation of financial assets on the balance sheet. Further, it provides sufficient information to let users of financial statements take the value change into account in assessing performance, if they wish. Do you:

- (a) concur with allowing these alternatives (pending further study of fair value measurement, performance reporting, and user needs) with full disclosure of the effect;
- (b) disagree with allowing alternatives and, instead, would require that the fair value adjustment for non- trading financial assets and liabilities always be included in net profit or loss; or
- (c) disagree with allowing alternatives and, instead, would require that the fair value adjustment for non- trading financial assets and liabilities always be recognized directly in equity until the asset is sold, collected, or otherwise disposed of or the liability is extinguished?

Comments: Again, we are reluctant to recommend an approach that provides for the ability to choose between alternative accounting methods. However, we agree that it may currently be appropriate, at least prior to the implementation of the IASC's comprehensive financial instruments project, to select the best alternative, particularly reflecting practicality, thus disagreeing with (a). The most appropriate answer provided would be (b), as it should minimize possible manipulation, but we realize that this may not be practical at the current time. Thus, we are left with (c) as the best of the lot. We note that, particularly as we wait for the comprehensive financial instrument project to be implemented, in general we do not favor one-time choices, as such choices tend to result in other difficulties in the future. We assume that the impact of such an election will be disclosed.

Question 16 (Paragraph 73)

Paragraph 73 provides that an impairment loss should be recognized for a held-to-maturity investment if its carrying amount exceeds the present value of expected future cash flows discounted at the financial instrument's original effective interest rate. The Board rejected discounting at the current market rate of interest because that rate would, in effect, impose fair-value measurement on financial assets that this Standard would otherwise measure at amortized cost (held-to-maturity investments). Discounting using the financial instrument's original effective interest rate is consistent with an amortized cost measurement basis. Do you:

- (a) concur with use of the original effective interest rate in this case; or
- (b) favor discounting at the current market rate of interest?

Comments: First, it is inappropriate to reflect the amortized cost of an asset if the resulting value is greater than the fair value of the asset. We note that in the determination of an expected value of future payments, the risk of default would be reflected. It would seem that consistency would require the use of the original interest rate, as it is still a held-to-maturity investment, in which case it would be inappropriate to switch interest rates. In this case, we would favor (a). However, wherever possible, it would be appropriate to use fair values in a consistent manner within financial statements, which would result in approach (b); such an approach, which would result in a lower of amortized and fair value method, may not be consistent with the intent of having a hold-to-maturity method of valuation, although it would be more appropriate. An approach consistent with the IAS covering Impairment of Assets would not be inappropriate.

Question 17 (Paragraph 73)

Paragraph 73 requires recognition of an impairment loss if an enterprise does not expect to collect all amounts due on a held- to- maturity investment. The guidance in paragraph 74 makes clear that impairment may be measured and recognized on a portfolio basis for a group of similar financial assets such as trade receivables or a loan portfolio. While paragraph 73 focuses on impairment, some people believe that the Standard should address uncollectibility of financial assets in general. They would either broaden the scope of the principle in paragraph 73, or create an additional principle, that would require recognition of general provisions for uncollectible receivables and loan losses from the time of acquisition of those assets through maturity based on an enterprise's experience as to probability of collection. IAS 18, Revenue, includes brief guidance, but not a principle, on recognition of bad debt expense. Do you:

- a) favor including a principle that addresses uncollectibility of a portfolio of financial assets in general as part of a Standard on recognition and measurement of financial instruments; or
- b) disagree with including such a principle?

Comments: In the case of an asset not held at fair value (which should reflect any expected uncollectible receivables), a provision to reflect estimated uncollectibles would be appropriate. The impaired value should be determined in a manner consistent with the separate IAS on Impairment of Assets. Thus, we agree with (a).

Question 18 (Paragraph 76)

Paragraph 76 requires an impairment test for a financial asset that is not carried at fair value because its fair value cannot be reliably measured. Some people say that if fair value cannot be reliably measured then the impairment calculation cannot be made. The Board believes, however, that the calculation under paragraph 76 can be made by applying the current market rate of interest for a similar financial asset to estimated cash flows. Do you:

- (a) concur with paragraph 76;
- (b) believe that paragraph 76 should be revised and, if so, how; or
- (c) believe that paragraph 76 should be deleted as inoperable?

Comments: We note that paragraph 76 may be difficult to apply in practice and that in some cases of extreme uncertainty a zero value would be appropriate. We suggest that paragraph 76 be modified to provide more guidance.

Question 19 (Paragraph 85(b))

Paragraph 85(b) states that a hedge of an unrecognized firm commitment to buy an asset at a fixed price is a cash flow hedge. The Board's reasoning in reaching this conclusion is that if it is considered appropriate not to recognize such a commitment standing alone (that is, in the absence of a hedge), then that commitment should not be subject to 'backhanded' recognition as a result of hedge accounting adjustments. The alternative would be to treat the hedge of an unrecognized commitment as a fair value hedge, which would, in effect, result in recognizing the commitment when the fair value of the hedging instrument changes even though accounting would not otherwise recognize such commitments. Do you:

(a) concur that a hedge of an unrecognized firm commitment to buy an asset is a cash flow hedge; or

(a) favor treating it as a fair value hedge?

Comments: We do not understand how a firm commitment to purchase an asset could constitute a cash flow hedge.

Question 20 (Paragraph 92)

With respect to hedges of forecasted transactions, this Exposure Draft includes two alternative treatments for hedges of forecasted asset and liability acquisitions (paragraphs A92- A96 and B92- B95). The difference concerns what to do, when the forecasted asset or liability acquisition actually occurs, with the amount of recognized gain or loss on the hedging instrument that initially had been reported directly in equity, through the statement of changes in equity. The two versions are: Version A: Remove the amount from equity and include it as part of the measurement of the initial acquisition cost or other carrying amount of the asset or liability. Thereafter, the gain or loss on the hedging instrument is automatically included in net profit or loss in the same period or periods as the acquired asset or liability affects net profit or loss through recognition of depreciation expense, interest income or expense, or cost of sales. Version B: Keep the amount in equity. Thereafter, the gain or loss on the hedging instrument is amortized to net profit or loss in the same period or periods as the acquired asset or liability affects net profit or loss, such as in the periods that depreciation expense, interest income or expense, or cost of sales is recognized. Because the initial carrying amount of the asset or liability is adjusted under version A, that approach is sometimes called 'basis adjustment'. The amount of net profit or loss reported after the asset or liability is acquired is the same under either approach. The difference relates to balance sheet presentation and, possibly, the line item on the income statement. At this stage some Board members prefer Version A (Basis Adjustment), and others prefer Version B (No

Basis Adjustment). The Board will consider comments received on this Exposure draft and intends to then eliminate either Version A or Version B in the final Standard. The Board asks commentators to indicate whether and why they:

- (a) prefer Version A (Basis Adjustment);
- (b) prefer Version B (No Basis Adjustment); or
- (c) prefer some other alternative.

Comments: No comment.

Question 21 (Matters Not Covered by a Specific Question)

The foregoing questions do not deal with all of the principles proposed in this Exposure Draft. If you disagree with a proposed principle, we particularly invite you to explain the reasons for your disagreement and to propose and defend an alternative principle that the IASC Board should consider.

Comments:

- 1. Paragraph 3 (f). Although acceptable under an interim standard, the exclusion of “conventional mortgage insurance contracts, letters of credit, and similar financial guarantee contracts” should be re-evaluated within the context of both the IASC project on insurance and the comprehensive financial instruments project. Some of the same concerns for consistency in reporting raised in question 2 above apply to these contracts, but to a somewhat lesser extent because of a lower level of correlation between valuation methodologies of assets and liabilities for these products.*
- 2. Paragraph 13(b). We do not understand why a financial guarantee contract would not be considered a financial instrument. It seems that a financial guarantee contract is similar to an insurance contract and their treatment should be consistent. However, based on the exclusion in paragraph 3(f), this distinction would not make a difference in the current case.*
- 3. Paragraph 21. This paragraph indicates that if an embedded derivative cannot be separately measured, the entire host contract should be treated as a derivative. We believe that a number of preconditions are appropriate for such treatment: (1) it should not be closely related to the other aspects of the host contract and (2) its value should be significant in comparison with the value of the host contract. Of course, its value should also be material in order for this type of reporting to be required.*

4. Paragraphs 38 and 41. The examples in these paragraphs refer to what appears to be financial guarantees. Note that in paragraph 13(b), financial guarantee contracts are not considered to be financial instruments and as a result, for consistency sake, should not be included as examples in this Statement. Also note our comment (2) just above concerning paragraph 13(b).

5. Paragraph 46. The measurement of fair value does not address the alternative methodology of whether to reflect bid, asked or other method of valuation. The use of mid-market valuation is a reasonable method, if applicable.

6. Paragraph 81. We are not certain whether the proposed treatment of a loan stock convertible into its own stock has been made sufficiently clear. This is a loan stock with an embedded derivative. Is the whole instrument an equity security? Why would the purchase of a matching option not reduce risk and thus be a hedging instrument?

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