



**ASSOCIATION ACTUARIELLE INTERNATIONALE
INTERNATIONAL ACTUARIAL ASSOCIATION**

July 28, 2008

Pro-Active Accounting Activities in Europe
c/o European Financial Reporting Advisory Group (EFRAG)
13-14 Avenue des Arts
1210 Brussels
Belgium

Dear Sir

Re: IAA comments on the Discussion Paper *Distinguishing between Liabilities and Equity*

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

These comments have been prepared by the Committee on Insurance Accounting of the IAA. If, upon reading these comments, you identify any points that you wish to pursue, please do not hesitate to contact the chairperson of that committee, Sam Gutterman, or any of the other members of the committee. The IAA will be pleased to develop these ideas further with you.

Yours sincerely

Yves Guérard
Secretary General

[Attachment](#): IAA comments

**A Commentary on the
DISCUSSION PAPER ON DISTINGUISHING BETWEEN LIABILITIES AND EQUITY
ISSUED BY THE PRO-ACTIVE ACCOUNTING ACTIVITIES IN EUROPE: JANUARY 2008**

International Actuarial Association

The International Actuarial Association (the “IAA”) represents the international actuarial profession. Our sixty 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 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 appreciates the opportunity to provide comments on this PAAinE discussion paper.

These comments have been prepared by the Committee on Insurance Accounting. Our comments are written from the perspective of actuaries involved in financial reporting for insurers around the world, with an emphasis on measurement of insurance liabilities and of reinsurance assets. Statements in this letter with respect to industry practices reflect the collective experience of the actuaries who participated in the preparation of this comment letter, which we believe represents an accurate and fairly comprehensive view of the insurance industry globally. The members of the task force and committee 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 web site.

The following paragraphs in this letter present our general comments regarding the DP, which in turn are followed by our responses to the questions posed in the DP.

General Comments

The interest of the IAA relates primarily to the implications of the proposed approach to distinguishing between liabilities and equity as it would be applied to insurance or other contracts offered by insurers, and in particular to contracts that contain participation features (PFs). PFs are contractual payments to policyholders that grant policyholders rights to share in specific surpluses achieved from the applicable business. Depending on the jurisdiction, holders of policies from mutual companies may also have membership rights that entitle them to share in some fashion in the residual interest under significantly restricted circumstances, for example, only in case of winding up the entity.

A policyholder pays a premium for a guaranteed benefit contingent on the occurrence of the insured event (the insured event is death in the case of a life insurance contract). Life insurance contracts in particular often have significant savings elements that are paid on cancellation or maturity of contracts. In the case of contracts with PFs, the net cash flows of a portfolio of contracts, which includes income from investments generated from positive contractual cash flows, is expected to be significantly more than needed to pay contractually guaranteed benefits.

The PF is a way to share this excess with the policyholders if in fact the cash flows are beneficial. The sharing of favorable experience lowers the policyholders' cost of insurance or enhances the contracts' values. Specific terms of PFs vary around the world, but they can all be said to be approaches to profit- or experience-sharing and hence in part serve some functions as loss-absorbing capital. There is clearly a buffer function to PFs. In addition, membership rights of mutual company policyholders may be similar to ownership rights to some extent.

The DP uses the criterion that “in order to qualify for as loss-absorbing capital, capital must absorb the ultimate accounting losses of the entity.” The reference to absorbing the ultimate accounting losses is important to insurers because it is this criterion that causes most PF features in stock companies to be characterized as liabilities, in keeping with current accounting and with the perspective of most insurers. While PFs are loss absorbing, they typically do not absorb the ultimate accounting losses of the entity. We note that the need for the reference to *ultimate* losses is acknowledgement that not all loss absorbing contracts are equity instruments.

As we see it, the use of the concept of loss absorbing capital fits well with the perspective of the insurance industry. Nevertheless there are some issues that must be resolved before the concept can be implemented.

Generally, PFs in a contract issued by a stock company do not absorb the ultimate losses of the company, but only the losses of its corresponding part of the business, with the absorption of losses limited by the requirement to pay at least the guaranteed benefits. While it is also common that contracts issued by mutual companies do not absorb the ultimate losses of the company, facts and circumstances vary among mutual companies depending on the company charter, the regulatory regime under which it operates and other factors. Hence it difficult to make a general conclusion about mutual companies. It is possible that a conclusion could be reached for some mutual insurers that contracts absorb ultimate losses if, for example, policyholders can be assessed to restore capital depleted by losses.

The use of the term “accounting losses” introduces some conceptual difficulties. It means that distinguishing between liabilities and equity may be a function of the accounting principles, not solely of the nature of the capital or in this case the PFs involved. For example, if someone purchases an insurance contract from a mutual company for a premium of 100, the characterization of the contract depends on how the liability is measured. If the measurement principle that the IASB ultimate adopts is a current estimate of the guaranteed benefits plus a margin, then there are two possibilities depending on the determination of the margin. The first possibility is that the margin does *not* calibrate the liability to the premium. In the example, if the calculated margin is 15, then there is an amount of 5 that would be considered to be equity. The second possibility is that the margin *is* calibrated to the premium, in which case the margin in this example is 20 and there is no equity. The IASB is currently considering both possibilities. Furthermore, policyholders do not share generally in accounting losses but in those experience deviations that are recognized under the contract or the insurer's policy to provide participating benefits. Thus, adverse mortality results in a period might be shared by reduced participating benefits over several periods, causing a timing difference between the accounting loss and the policyholder's participation. In fact, adverse experience may not relate to accounting losses at

all, as the loss may only be economic or lost opportunity, i.e., earnings may be lower creating a lower return to the policyholder but not necessarily resulting in an accounting loss.

Another difficulty is reconciling the concept of loss-absorbing capital with the intuitive idea that equity relates to ownership or interest in the entity other than as a customer, an agent, a vendor or a lender. We have inferred that the use of the criterion that the capital must absorb ultimate losses of the entity is intended to address this point, since a customer, vendor or lender may absorb some specific losses without absorbing ultimate losses. How the reference to ultimate losses accomplishes the objective should be clarified. In particular, we wonder how ultimate losses differ from losses that are not ultimate and whether the differentiation can be made without a circular reference; that is, defining ultimate losses to be those that are incurred after liabilities have been considered implies that the liabilities have already been distinguished from equity. The discussion in Section 4 on circularity seems to take a practical position on the premise that the concept of absorbing the ultimate losses of the entity has sufficient merit to warrant bypassing the conceptual difficulties. We would prefer a stronger conceptual basis, perhaps revisiting the initial thinking of PAAinE that losses should be thought of in economic, not accounting, terms.

We also question whether the concept of equity can be reduced to the idea that it relates to absorbing losses. Many accounting losses are expenditures that are expected to benefit future periods and, therefore, should not be thought of as losses from an economic perspective, although in the period in which they are incurred they may create accounting losses. Similarly, entities sometimes seek equity capital in order to make an acquisition that does not involve accounting or economic losses. In such cases, equity capital provides capacity for growth. We believe that the concept of equity capital would be stated more strongly if it began with a discussion of the sources and uses of equity capital and then linked this discussion to a criterion that extends beyond loss absorption.

We have also considered the Preliminary Views of the Financial Accounting Standards Board (FASB), found in its publication *Financial Instruments with Characteristics of Equity*. We find that the use of an approach related to risk capital and loss absorption is not superior the use of the basic ownership approach found in FASB's Preliminary Views. We find the basic ownership approach to be more intuitive and more consistent with the idea that the owners' interest is constituted in the residual claims with no upper or lower limit other than the amount of assets. Our initial impression is that equity capital based on the basic ownership approach will encompass ultimate risk absorbing capital, and perhaps be equivalent to it or nearly so in the end, but the articulation of the concept of equity is superior.

We also recommend that the PAAinE consider how its recommended approach to distinguishing liabilities from equity relates to the Conceptual Framework as it is evolving, and to other standards. For example, the IASB has issued its Preliminary Views entitled *Conceptual Framework for Financial Reporting: The Reporting Entity* that is a product of a joint project with the FASB. In this document the IASB presents the view that the identification of the reporting entity should rest more on concepts of control than on legal ownership. It is not apparent how the concept of ultimate loss absorption would operate when an entity's financial reports consolidate companies under common entities that have different ownership. It may be

that there are no instruments that are ultimately loss absorbing for the consolidated companies, but only those that are loss absorbing for some but not all of the companies. In this case, there would be no equity in the consolidated financial statements. We believe that it is important to reconcile the conclusions in these preliminary views with the conclusions in the DP before the views of PAAinE are finalized.

Responses to Questions in the DP

Question 1

Do you believe that defining two different classes of capital on the credit side of the balance sheet does provide decision-useful information, even if the entity's capital structure is in fact multi-dimensional (the so-called "list claims"-approach, pars. 1.3 ff.)? If not, why?

IAA Response

We believe that the use of two classes of capital is common, intuitive and generally well understood. The issues related to classification do not stem from fundamental concerns about the concept of equity, but rather from issues related to classification of hybrid and nontraditional instruments. We prefer to see a resolution based on an attempt to clarify the meaning of liabilities and/or equity that will establish a better set of principles for distinguishing them than currently exists.

Question 2

Do you believe that listing all claims to the entity's assets, ranking those claims by a certain criterion and providing additional information on all other characteristics of the claims in the Notes to the financial statements would have merit (pars. 1.3 ff.)? Why? If not, why?

IAA Response

We do not do not believe that a multiple listing resolves the concerns relating to distinguishing liabilities and equity, but rather it appears to circumvent the issues. Our initial impression of a listing of claims is that it is likely to be confusing to users and to require multiple decisions about classification. We suspect that, in the end, entities will attempt to list claims in order of priority in bankruptcy, a listing that provides limited decision-useful information about an entity that is a going concern.

Note: The following questions are based on our view that defining two different classes of capital on the credit side of the balance sheet does provide decision-useful information (i.e. you disagree with question 1.)

Question 3

Do you agree with the analysis of the different characteristics of capital as the basis for distinguishing between equity and liabilities (pars. 1.14 ff.)? If not, why? Do you think that any other characteristics should be considered? If yes, which?

IAA Response

We find the analysis thoughtful and insightful. We do not offer any additional considerations.

In our view, the notion that equity = assets – liabilities and that equity capital is the value of equity instruments should be the same. Distinguishing between liabilities and equity means not only identifying which capital has the nature of liabilities but also being sure that the characterization of these leaves no room for a middle ground or for ambiguity. As a practical matter, the process of distinguishing between the two is likely to require identification of one, with classification as the other being the default. The process in the DP, as illustrated in Section 6, is to consider whether capital is equity and then, if it does not qualify as equity capital, to conclude by default that it is debt. Hence the essential characteristic of debt capital is that it is not equity capital. This reverses the current practice that equity is capital that is not debt. We do not disagree with this approach, but we would like to see this position, that debt capital is capital that does not qualify as equity capital, articulated more explicitly. We do wonder how the classification of debt as credits that are not equity can be reconciled to the concepts of debt and the guidance related to recognition and measurement of debt found in the Fundamental Concepts and in the standards, in particular in IAS 39 *Financial Instruments: Recognition and Measurement*. It is not apparent that all capital that is not equity will meet the criteria for recognition as debt, which seems incongruous.

Question 4

Do you agree with the analysis in the paper on whether to base a capital distinction on one or more than one criterion (pars. 1.33 ff.)?

IAA Response

We agree with the analysis, but while we agree that it would be preferable to have a single criterion for making the distinction, we find that, in fact, the suggested process has two criteria, namely,

1. that it is loss absorbing, and
2. that it absorbs the ultimate losses of the entity.

Many contracts, such as those with incentives or experience participation features, provide buffers that can be loss absorbing but do not absorb the losses of the entity.

We also note that similar instruments, such as PFs in life insurance, may be classified differently for a stock company than a mutual company. The result would be a characterization of mutual company PFs as equity rather than liabilities. We believe that this possibility should be discussed further and the PAAinE should decide whether this is the intended and desirable result of its proposal. We hold the view that the measurement of liabilities for a mutual company should not differ from the measurement for a stock company. We are aware of some mutual companies for which membership rights could be classified as equity under the given definition, although we believe these cases are rare.

While we appreciate the difficulties associated with more than one criterion, we do not believe the objective of having a single criterion should drive the concepts. As stated earlier, the objective should be to have a distinction based on the nature of equity, even if this cannot be reduced to a single criterion.

Question 5

Do you agree with the analysis in this paper that, in order to classify capital, either an entity view or a proprietary view has to be applied (pars. 1.40 ff.)? If not, why not?

Do you agree with the paper's description of the implications of each approach (pars. 2.35 ff., 3.22 ff.)? If not, why?

IAA Response

We do not agree with the analysis. We note that the FASB has used an ownership, or proprietary approach, and has reached a characterization of equity that, in our view, will result in a classification of capital as liabilities or equity that is likely to be no different from what would result from the use of the entity view and the loss absorbing concept. The basic ownership approach is a superior concept because it does not rely on the accounting concept of losses to make the determination and avoids the circularity indicated in the DP.

Question 6

Do you agree with the analysis of the needs of the users of financial statements in the context of classifying capital (pars. 3.1 ff.)?

IAA Response

We find that the conclusion that risk capacity and loss absorption meets the needs of users better than alternatives has not been supported. While we generally agree with the analysis of needs, the conclusions are a significant leap from this analysis. There needs to be a bridge between the analysis of needs and the proposed approach.

Question 7

Do you agree that basing the distinction between equity and liabilities on risk capital would provide decision-useful information to a wide range of users of financial statements about entities in different legal forms (pars. 3.5 ff.)? If not, why?

Is there any other basis for the distinction that you would consider providing more useful information? If yes, which and why?

IAA Response

We do not disagree with the DP, but we find that the distinction in the FASB's preliminary views is more useful. The concept of basic ownership instruments is a more intuitive approach because it links the equity to the economic consequences of ownership. We also do not see it as more difficult to apply and we believe that the use of the basic ownership approach fits better with mutual company financial statements.

Question 8

Do you agree with the analysis of losses as either economic losses or accounting losses in the context of classifying capital as equity or liabilities (pars. 4.1 ff.)? If not, why? Would you agree that the Loss Absorption Approach should focus on accounting losses?

IAA Response

We find the use of accounting losses introduces circularity, acknowledged in the DP, with which we are very uncomfortable. The distinction that capital may depend on measurement principles rather than on the nature of the capital is a consequence that we believe is unintended and undesirable. At the same time it is not apparent that use of economic losses offers a better solution, as the classification then may depend on effects that are not recognized in financial statements.

Question 9

Do you think that the Loss Absorption Approach is explained sufficiently clear in this paper (Section 4)? Do you agree with the definition of loss-absorbing capital in par. 4.16? If not, why? How could this definition be improved?

IAA Response

We have no difficulty understanding the definition and concept. However, for reasons stated elsewhere, we do not find the arguments for the Loss Absorption Approach compelling.

Question 10

Do you agree that classification of an instrument as equity or liability should be based on the terms and conditions inherent in the instrument? Do you agree that the passage of time should not be the trigger for reclassification of an instrument (pars. 4.22 ff)? If not, why?

IAA Response

We agree on both points, but as we have stated elsewhere, the approach is, in fact, dependent not only on the nature of the instrument but on the measurement principles as well. Moreover, a reference to purely legal terms might be insufficient for those cases where significant constructive obligations exist. If the character of the instrument changes simply by passage of time, the instrument can be bifurcated on a time basis.

Question 11

Do you agree with the discussion on linkage (pars. 4.13 ff.)?

IAA Response

We agree with the discussion.

Question 12

Do you agree with the discussion on split accounting (pars. 4.36 ff.)?

IAA Response

We agree with the discussion.

Question 13

Do you agree with the discussion of the different approaches to distinguish equity from liabilities within a group context in general and with regard to the Loss Absorption Approach in particular (section 5)? If not, why? Would you prefer the approach set out in par 5.1(a) or the approach in par. 5.1 (b)? Why?

IAA Response

We prefer approach 5.1 (b). Insurers often are capitalized at a subsidiary level through debt of the parent. We believe that it would be misleading to characterize loss absorbing capacity of the entity level as debt at the subsidiary level.

Question 14

Do the examples in section 6 illustrate the loss-absorption principle well? Would you have reached a different conclusion (or classification)? Why? Are there any other aspects of the Loss Absorption Approach that need to be illustrated?

IAA Response

The examples are informative. Given our focus on insurance contracts, we hope that the implications of the Loss Absorption Approach to insurers, both stock and mutual, will be specifically considered before such an approach is adopted. We are available to assist in these considerations if further analysis beyond what is offered in our comment letter is desired.

*Questions on the loss absorption approach in general***Question 15**

Do you believe that the Loss Absorption Approach is sufficiently robust to be prescribed in an accounting standard? If not, why? If you are concerned about structuring opportunities what would be your suggestion to limit the structuring opportunities?

IAA Response

Notwithstanding our concerns with the approach, we find that the concepts as articulated are sufficiently robust.

Question 16

Do you think the Loss Absorption Approach should be simplified? If yes, how could the Loss Absorption Approach be simplified?

IAA Response

Our concerns do not relate to the complexity of the approach, but rather to the conceptual issues that we have identified and to the possible implication for mutual insurers.

Question 17

This Discussion Paper is based on the view that the current IFRS approach to distinguish equity from liabilities has shortcomings.

Do you agree with the analysis of the current IFRS approach to distinguish equity from liabilities (section 2)? Do you agree that the current approach has shortcomings as identified in this paper (pars. 2.17 ff.)? If not, why? Do you see any other shortcomings?

Do you see advantages of the current approach?

IAA Response

We agree that there are shortcomings to the current approach in distinguishing liabilities from equity as described in the DP. We do not see any other shortcomings. We appreciate that the IASB is considering ways to overcome the shortcomings.

Question 18

Do you believe that the Loss Absorption Approach would represent an improvement in financial reporting over the current IFRS approach? Do you think that the distinction based on this approach provides decision-useful information? If not, why? Do you have any other comments?

IAA Response

While we can agree that the Loss Absorption Approach would represent an improvement over the current IFRS approach, we do not see that it is better than the improvements being suggested by the IASB itself.

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