AMERICAN ACADEMY *of* ACTUARIES

October 22, 2004

Andrea Pryde
Assistant Project Manager
International Accounting Standards Board
30 Cannon Street, London EC4M 6XH, United Kingdom

Exposure Draft: ED7 Financial Instruments: Disclosures

Dear Ms. Pryde,

The Financial Reporting Committee of the American Academy of Actuaries[1] (AAA) is pleased to review and comment on the IASB exposure draft: *ED7 Financial Instruments: Disclosures*. Attached are our responses to the specific questions asked by the Board; however, we have a general concern with the exposure draft that we would like to highlight.

With the work that is currently starting on Phase II of the Insurance Contracts project, we question whether this is the proper time to be discussing changing disclosures for insurance liabilities. While we recognize that changes are needed to reflect the replacement of IAS 32 by this IFRS, the imposition of changes to the overall disclosures for insurance liabilities is ill timed. In particular, as we note in our comments, some of the proposed disclosures would either be extremely burdensome to provide or would require disclosure of otherwise proprietary company information that would potentially restrict competition in the industry. For these reasons, we urge that the changes to IFRS simply be to recognize the new Standard and not to make any fundamental changes to insurance disclosures.

Should you wish to discuss these comments, please contact Ethan Sonnichsen at 202-223-8196 or sonnichsen@actuary.org

Sincerely,

Ralph S. Blanchard

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Chair, Financial Reporting Committee
American Academy of Actuaries

[1] The Academy is the public policy organization for actuaries of all specialties within the United States. In addition to setting qualification and practice standards, a major purpose of the Academy is to act as the public information organization for the profession. The Academy is nonpartisan and assists the public policy process through the presentation of objective analysis. The Academy regularly prepares comments on proposed federal regulations, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualification and practice, and the Code of Professional Conduct for all actuaries practicing in the United States.

American Academy of Actuaries – Financial Reporting Committee
Response to IASB on
ED7 Financial Instruments; Disclosures

Question 1 – Disclosures relating to the significance of financial instruments to financial position and performance

The draft IFRS incorporates disclosures at present contained in IAS 32 *Financial Instruments: Disclosure and Presentation* so that all disclosures about financial instruments are located in one Standard. It also proposes to add the following disclosure requirements:

> **(a) financial assets and financial liabilities by classification (see paragraphs 10 and BC13).**
> **(b) information about any allowance account (see paragraphs 17 and BC14).**
> **(c) income statement amounts by classification (see paragraphs 21(a), BC15 and BC16).**
> **(d) fee income and expense (see paragraphs 21(d) and BC17).**

Are these proposals appropriate? If not, why not? What alternative disclosures would you propose?

Academy Response:
The AAA believes the proposal to put all disclosures in one Standard is appropriate. As a clarification, we wonder whether Deferred Costs as defined in IAS 18, and particularly Deferred Acquisition Costs as defined in many Insurance Accounting Standards, would qualify as a financial asset, and if so, where it would be disclosed? We would recommend that it be shown separately.

Question 2 – Disclosure of the fair value of collateral and other credit enhancements

For an entity's exposure to credit risk, the draft IFRS proposes to require disclosure of the fair value of collateral pledged as security and other credit enhancements unless impracticable (see paragraphs 39, 40, BC27 and BC28).

Is this proposal appropriate? If not, why not? What, if any, alternative disclosures would you propose to meet the stated objective?

Academy Response:
The AAA believes the proposal is appropriate for financial assets. However, we believe it is not appropriate to apply the proposal to insurance or reinsurance contracts.

IAS 32 requires disclosures related to credit risk for financial assets. IFRS 4 requires these same disclosures for financial assets arising from insurance contracts. The draft IFRS extends the disclosure requirement in IAS 32 to all financial instruments and proposes to amend IFRS 4 to use the same expanded scope. The AAA thinks it is impractical and not useful to users to include disclosures on credit risk of insurance contract liabilities. We therefore suggest the IASB add language clarifying this point.

One of the principal difficulties with applying these requirements to insurance contracts is the difference in units of account. The unit of account typically involved in financial instrument valuation is the individual contract. In such a case, the proposed disclosures are feasible. But for insurance contracts, the unit of account is more typically a portfolio of contracts. This adds complexities (theoretical and practical) not envisioned in the exposure draft when attempting to produce the proposed disclosures. This complexity beyond the norm for exchange-traded financial instruments is one of the reasons a separate accounting standard for insurance contracts is being developed, and is also a reason to address disclosures for such contract assets and liabilities separately (and not in ED7).

Question 3 – Disclosure of a sensitivity analysis

For an entity that has an exposure to market risk arising from financial instruments, the draft IFRS proposes to require disclosure of a sensitivity analysis (see paragraphs 43, 44 and BC36-BC39).

Is the proposed disclosure of a sensitivity analysis practicable for all entities?

If not, why not and what, if any, alternative disclosures of market risk would you propose to meet the stated objective of enabling users to evaluate the nature and extent of market risk?

Academy Response:

The AAA does not believe the sensitivity analysis is always appropriate for non-market traded liabilities such as insurance contract liabilities. Not all insurance contract liabilities may be conducive to such disclosures or "relatively easy to understand and calculate", yet the proposed language would make no exceptions. For example, claim liabilities resulting from a heterogeneous mix of tort liability coverages may not be amenable to such disclosures, yet the proposed language would require the creation and disclosure of sensitivity analyses anyway. Such reported claim liabilities may represent the aggregation of dozens or more separate product and/or coverage components subject to separate analysis with separate sets of drivers affecting their ultimate level. The separate drivers of the liability estimation risk may also be subject to synergies and may not be subject to reliable quantification for the purposes of a sensitivity analysis (e.g., changes in jury views on fairness or the "deep pocket" theory of liability are not easily quantified). (Note that the current IFRS 4 language only requires discussion of sensitivity, which can range from qualitative discussion to full sensitivity analysis where appropriate.)

We believe the issues associated with insurance liabilities are complex, and are best handled in a focused manner - during the phase II discussion - and not in this draft IFRS.

Question 4 – Capital disclosures

The draft IFRS proposes disclosure of information that enables users of an entity's financial statements to evaluate the nature and extent of its capital. This includes a proposed requirement to disclose qualitative information about the entity's objectives, policies and processes for managing capital; quantitative data about what the entity regards as capital; whether during the period it complied with any capital targets set by management and any externally imposed capital requirements; and if it has not complied, the consequences of such non-compliance (see paragraphs 46-48 and BC45-BC54).

Is this proposal appropriate? If not, why not? Should it be limited to only externally imposed capital requirements? What, if any, alternative disclosures would you propose?

Academy Response:
The AAA is concerned about the requirement to disclose externally imposed capital requirements as proposed within the exposure draft and suggest that it be removed. Consistent with arguments presented in the Basis for Conclusions, the AAA believes that disclosure of externally imposed capital requirements could lead users of the financial statements to inappropriately rely on the provided capital disclosures rather than consider all appropriate facets of the entity's financials. The AAA also believes that requiring the proposed capital disclosures could result in adverse business consequences for a company; the very consequences that the rating agency or regulator is attempting to avoid with their recommendations to management. The separately published reports of rating agencies and regulators give the user enough information about whether the company has met its external capital requirements.

Insurance rating agencies and regulators perform comprehensive reviews of insurers to determine the entity's capital adequacy or solvency position. These reviews are typically based on a multitude of factors including internal management capital assessments. Any attempt to simplify such analyses through disclosure of one or a few factors, such as a particular capital target, is subject to undue emphasis and scrutiny – positively or negatively – by a user of the financial statements. It is important to note that in the United States, state regulators recognize the importance of propriety capital management data, and maintain confidentiality over the details of a company's regulatory Risk-Based Capital analysis. Additionally, information requested by and distributed to rating agencies is done so under a strict confidentiality agreement. We suggest, therefore, that the requirement to disclose such information be eliminated.

Question 5 – Effective date and transition

The proposed effective date is for periods beginning on or after 1 January 2007 with earlier adoption encouraged (see paragraphs 49 and BC62-BC67).

Entities adopting IFRSs and the draft IFRS for the first time before 1 January 2006 would be exempt from providing comparative disclosures for the draft IFRS in the first year of adoption (see Appendix B, paragraph B9).

Are the proposed effective date and transition requirements appropriate? If not, why not? What alternative would you propose?

Academy Response:
We believe the effective dates are appropriate in general but, as noted elsewhere, we believe the changes for insurance liabilities should be tied to the implementation of Phase II of the Insurance liability project.

Question 6 – Location of disclosures of risks arising from financial instruments

The disclosure of risks arising from financial instruments proposed by the draft IFRS would be part of the financial statements prepared in accordance with International Financial Reporting Standards (see paragraph BC41). Some believe that disclosures about risks should not be part of financial statements prepared in accordance with IFRSs; rather they should be part of the information provided by management outside the financial statements.

Do you agree that the disclosures proposed by the draft IFRS should be part of the financial statements? If not, why not?

Academy Response:
The AAA agrees that disclosures of sensitivities to risks arising from financial instruments are valuable to readers of the financial statements and accompanying information. However, we do not agree that the sensitivity analysis should be part of the financial statements.

Requiring analysis of reasonable possible changes in the relevant risk variables within the financial statements may cause a significant burden for all reporting entities. Auditors must provide an opinion, taken as a whole, on the fairness of the financial statements. In providing this opinion, auditors must attest that the notes to the financial statements are also fairly stated. By requiring disclosures of risks and uncertainties and the impact of reasonable possible changes to risk variables within the financial statement notes, auditors will be required to test and verify these disclosures. Not only would these disclosure requirements increase the cost of this audit work, it is unclear that a quantitative analysis will be useful to readers of the financial statements in the case of certain insurance liabilities (see our response to question 3). In addition, auditors may be concerned with additional liability repercussions if they endorse financial statements containing these types of disclosures.

We think disclosures of risks and uncertainties including the impact of reasonable possible changes in relevant risk variables, other future assumptions and other sources of management uncertainty are more appropriately discussed in the Management, Discussion and Analysis or in a similar section that accompanies, but is not considered part of, the financial statements and does not require the opinion of an auditor.

Question 7 – Consequential amendments to IFRS 4 (paragraph B10 of Appendix B)

Paragraph B10 of Appendix B proposes amendments to the risk disclosures in IFRS 4 *Insurance Contracts* to make them consistent with the requirements proposed in the draft IFRS. The requirements in IFRS 4 were based on disclosure requirements in IAS 32 that would be amended by the draft IFRS. The Board's reasons for proposing these amendments are set out in paragraphs BC57-BC61.

Do you agree that the risk disclosures in IFRS 4 should be amended to make them consistent with the requirements proposed in the draft IFRS? If not, why not and what amendments would you make pending the outcome of phase II of the Board's Insurance project?

Academy Response:
The AAA disagrees with the proposed amendment to make changes to the disclosure requirements of IFRS 4 so that it is fully consistent with ED 7. Phase II of the Insurance Contracts Project has begun, and the IASB has committed to completion of Phase II as soon as possible. When IFRS 4 was implemented, it was expected that there would be no additional revisions until Phase II was completed. Disclosure revisions should be deliberated during the development of the Phase II insurance standard rather than be included as an appendix to another standard on which there has not been proper deliberation. We support the alternative suggestion included in the Basis for Conclusions to make only minimum essential changes to IFRS 4 in response to ED7 and conduct a fuller review of the disclosures in IFRS 4 as part of Phase II of the insurance project.

ED 7 indicates that changes to other standards will be applied for annual periods beginning on or after Jan. 1, 2007. With this implementation date, insurers will be required to make significant system changes twice within two years (IFRS 4 in 2005 and ED 7 in 2007), and a third time, as soon as Phase II is released. This is an unreasonable burden on the insurance industry.

Question 8 – Implementation Guidance

The draft Implementation Guidance accompanying the draft IFRS suggests possible ways to apply the risk disclosure requirements in paragraphs 32-45 (see paragraphs BC19, BC20 and BC42-BC44).

Is the Implementation Guidance sufficient? If not, what additional guidance would you propose?

Academy Response:
The AAA does not believe the Implementation Guidance is sufficient. It seems open to too much interpretation. For example, does "profit and loss" refer to the profit and loss for the reporting period or to future periods? Also, would a "reasonably possible change" be a one-time change with future periods showing a return to previous levels, or would this change remain for future periods?

Question 9 – Differences from the Exposure Draft of Proposed Statement of Financial Accounting Standards *Fair Value Measurements* published by the US Financial Accounting Standards Board (FASB).

The FASB's Proposed Statement of Financial Accounting Standards *Fair Value Measurements*, which is open for public comment at the same time as this Exposure Draft, proposes guidance on how to measure fair value that would apply broadly to financial and non-financial assets and liabilities that are measured at fair value in accordance with other FASB pronouncements. That Exposure Draft proposes disclosure of information about the use of fair value in measuring assets and liabilities as follows:

- **(a) For assets and liabilities that are remeasured at fair value on a recurring (or ongoing) basis during the period (for example, trading securities)**
  - **(i) the fair value amounts at the end of the period, in total and as a percentage of total assets and liabilities,**
  - **(ii) how those fair value amounts were determined (whether based on quoted prices in active markets or on the results of other valuation techniques, indicating the extent to which market inputs were used), and**
  - **(iii) the effect of the remeasurements on earnings for the period (unrealised gains or losses) relating to those assets and liabilities still held at the reporting date.**
- **(b) For assets and liabilities that are remeasured at fair value on a non-recurring (or periodic) basis during the period (for example, impaired assets), a description of**
  - **(i) the reason for remeasurements,**
  - **(ii) the fair value amounts,**
  - **(iii) how those fair value amounts were determined (whether based on quoted prices in active markets or on the results of other valuation techniques, indicating the extent to which market inputs were used), and**
  - **(iv) the effect of the remeasurements on earnings for the period relating to those assets and liabilities still held at the reporting date.**

Disclosures similar to (a)(ii) above are proposed in paragraph 31 of the draft IFRS (and are currently required by paragraph 92 of IAS 32) and disclosures similar to (a)(iii) are proposed in paragraph 21(a).

Do you agree that the requirements in the draft IFRS provide adequate disclosure of fair value compared with those proposed in the FASB's Exposure Draft? If not, why not, and what changes to the draft IFRS would you propose?

Academy Response:
The AAA agrees that the suggested disclosures provide adequate disclosure of fair value in accordance with the proposed guidance of the FASB.

Question 10 – Other comments

Do you have any other comments on the draft IFRS, Implementation Guidance and Illustrative Examples?

Academy Response:
As previously noted, the AAA is concerned with the continued changes being made to IFRS 4. Insurers are well into the implementation of IFRS 4 for 2005. These continuing changes cause resource and financial burdens to the companies as they strive to prepare for the upcoming year. Additionally, these immediate changes are viewed as unnecessary as the IASB has committed to completing phase II quickly.

Also, the requirement of the modified IG 62A for IFRS 4 to split cash flows between those of the next 12 months and those later seems not useful for insurers due to the longer-term nature of their liabilities.