Date
31 March 2005

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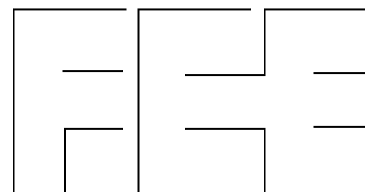

Mr. Yves Guérard
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Dear Sir,

Re: FEE Comments to IAA Drafts of International Actuarial Standards of Practice

Subject: Preliminary Exposure Drafts for Potential IAA Standard regarding International Financial Reporting Standards – second set

- Classification of Contracts
- Change in Accounting Policies
- Discretionary Participation Features
- Liability Adequacy Testing (LAT)

FEE (Federation of European Accountants, Fédération des Experts Comptables Européens) is pleased to submit its observations on the second set of preliminary exposure drafts for potential IAA Standards regarding IFRS. FEE is the representative organisation for the accountancy profession in Europe with membership of 44 professional institutes of accountants from 32 countries in total representing more than 500.000 accountants in Europe.

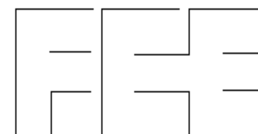
General comments

FEE acknowledges the benefits of the IAA developing guidance with a view to establishing globally consistent actuarial practice for its members when they are providing professional services to undertakings preparing financial statements in accordance with International Financial Reporting Standards – IFRSs. It is appropriate to consider the context within which financial statements are prepared and the different responsibilities in relation to their presentation and preparation.

As a number of our comments raise significant issues of principle and are generally applicable to each Exposure Draft, we address those in this covering letter. Further comments on particular provisions of individual Exposure Drafts are annexed hereto.

Status of Guidelines

We would like to reemphasize our significant concerns regarding the status of the guidelines set out in our earlier letter to you dated 20 January 2005. While we welcome the initiative to develop educational material, we do not consider it necessary or desirable to establish best practice in all areas covered by the proposed Practice Guidelines, and particularly not before a fair discussion has taken place between all concerned parties. There is a risk that the proposed guidelines would set a target standard which many actuaries will not in practice be able to sustain.



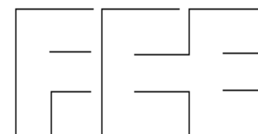
We note that you have given category 4 status to the majority of these papers. These guidelines are given a status (albeit at a low level) above that of purely educational material. There should be a clear distinction between guidelines which deal with actuarial methodology and which ought to be issued as standards and those that are educational material and deal with accounting matters. That would not undermine the value of issuing the material but would serve to avoid the material becoming de facto best practice with the inevitable attendant risks of either accidentally conflicting with other interpretations of IFRS or alternatively inappropriately increasing the threshold for compliance by companies might be required to jump to be in compliance.

We have considered whether the number of instances which we have identified as non compliance with IFRSs results in a need for more detailed review of these papers than we were able to do in the time available. Our suggestion is that the IAA formally engages accounting assistance to ensure compliance with IFRS material and total consistency of the guidance with IFRS. Please note that the attached comments are only examples of issues identified.

We would be pleased to discuss any aspect of this letter with you. We thank the IAA for the opportunity to comment on its proposals and would welcome the opportunity to comment on any future developments.

Yours sincerely,

David Devlin
President



APPENDIX

General questions

1. *Do these Preliminary EDs provide adequate and appropriate guidance for the application of IFRS 4 and related IFRSs?*

FEE supports the IAA initiative of providing educational material to the members of their associations, upon areas of actuarial practice that directly impacts financial reporting to ensure a common understanding of IFRS and to enhance the quality of actuarial work. However, the provision of guidance which may have the status of standards in due course and educational material are distinct matters and we are concerned that the distinction is not sufficiently clear in the Exposure Drafts. We would support the development of educational material on IFRS to the extent that it is described as such and not given the status of a professional standard. We refer also to the comments in our covering letter.

2. *In which areas do you recommend additional guidance to be provided? To what extent is the guidance included inappropriate or unnecessary? Please be as specific as possible.*

We recommend you reconsider the appropriateness and accuracy of the paper on Change in Accounting Policies. The consultation with accountants would substantially contribute to the quality of it, as it is not an area of expertise for actuaries. We believe that the paper demonstrates a lack of understanding of the difference between the definition of a change in accounting policy, a change in estimate and errors. IAS 8 is explicit on each of these and requires different accounting treatment for all of them. We believe educational material on this topic would be valuable for actuaries but must be exact.

3. *If you are an IAA member association, what are your plans regarding implementation of the proposed IASPs? Where IFRS is the required reporting basis in your jurisdiction, do you intend to introduce similar standards or use the resulting IASPs? What are your plans for members practicing in other jurisdictions?*

Not applicable.

4. *Any comments on the Glossary (sent with the first set of preliminary EDs) relative to this second set of preliminary EDs? Specifically, are any definitions missing that should be included or changes made to the definitions given?*

The selection of IFRSs mentioned in the Glossary is arbitrary and should refer to the whole set of IAS/IFRS Standards. The Glossary is incomplete and needs to be reviewed to ensure its consistency with IFRS.

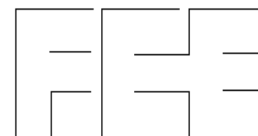
5. *Other comments.*

We have no other comments.

Classification of contracts

1. *In section 4.4.3, guidance is provided regarding the interpretation of the term “additional benefits”, as it was believed that paragraph B24c of IFRS 4 does not provide sufficient clarity. Do you believe that this additional guidance is helpful or do you believe that the guidance provided in IFRS 4, B24(c) is sufficient?*

Paragraph 2 of Section 4.4.3 looks at the significance of insurance risk in terms of the potential loss of the policyholder. The policyholder perspective is only one element of the consideration of additional benefits. The draft guidance appears more restrictive than IFRS 4. For example IFRS 4 B27 states “additional benefits could include a requirement to pay benefits earlier…”. The draft guidance also does not reflect that the significance of insurance risk will depend upon the circumstances of the contract.



We consider the example of the case of “new-for-old” coverage helpful as the amount paid or the benefit to the policyholder is clearly an indemnification of a loss. Whether paid in cash or kind, the loss is a necessary part of the terms of contract.

2. *The fifth and sixth paragraphs of section 4.4.7 argue that the pricing of annuities does not drive the assessment as to the extent of insurance risk. Do you agree with this? Is the guarantee of issuance of a life-contingent annuity at market-based rates sufficient to classify the original issue as an insurance contract? Is more guidance needed regarding the extent of the guarantee needed?*

We agree that the pricing of annuities does not drive the assessment of the extent of insurance risk. However we refer to our earlier comments on the danger of including interpretations in educational material. There is specific guidance in IFRS 4 on this category of embedded derivatives in IG Example 2.3. The IAA paper should refer to it.

The 5th paragraph of 4.4.7 is, in our opinion, a proper interpretation of IFRS. However, the 6th paragraph is unclear. It is true that if the market rate will certainly create an insurance risk on conversion and that conversion is mandatory then the contract can be argued to be insurance at inception – though it is questionable that the account balance would be supplemented by any reserve for insurance liability during the savings period. If the conversion is not mandatory and offers no advantage to the policyholder then it is questionable whether it really transfers insurance risk until the annuity is established. Therefore, we query the usefulness of this portion of the guidance

3. *In section 4.9.6, guidance is included that indicates that contracts that include optional features, such as the possibility of a contract being issued as unit-linked contract that can be subsequently switched by the policyholder to one that includes a DPF. Is the guidance provided regarding the criteria necessary to classify this type of contract sufficient or appropriate? If not, indicate what guidance should be provided?*

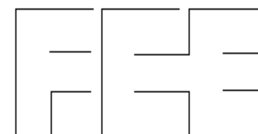
Sufficient guidance would require that all possible scenarios are mentioned and a clear guidance is given on how to classify the contracts in the different scenarios. Section 4.9.6 only mentions the scenario where there is an option to switch from an investment contract without DPF to an investment contract with DPF. On the other hand, there are also options to switch from a contract with DPF to one without, or from an investment contract to an insurance contract, and vice versa. Furthermore, there are also contracts with the option to switch back. Most companies accept that the mere existence of an option to switch is not sufficient to justify accounting for a contract initially written in “investment contract form” as if it were a contract with DPF. One has to demonstrate that there is actual switching activity between a unit-linked contract and a DPF contract.

We highlight again the danger of including interpretations in such guidance. Formal interpretation can only be given by the IFRIC. For example, on page 17, the last sentence on the page should read: “There has to exist a scenario of commercial substance that the policyholder will be provided with significant insurance risk under the contract *and* a reasonable likelihood that the policyholder will change the investment options…”

The guidance given in this section is not sufficient if it is to be used as practical guidance. The wording that the option to switch “makes contracts look like” is not precise enough. Depending on the option chosen contracts have to be classified as insurance contracts, investment contracts, or investment contracts with DPF.

4. *Other comments.*

The draft standard draws closely on the wording of IFRS 4 (guidance on insurance/reinsurance contracts and investment contracts with discretionary participation features), IAS 32 (guidance on contracts which are financial instruments), IAS 39 (guidance on financial instruments as a derivative or an embedded derivative and measurement of financial instruments), IAS 18 (guidance on requirements for revenue from rendering services) and seems to be widely a repetition of these standards. It should be made clear in the text when IFRSs are quoted. There are some simplifications or paraphrasing which are sometimes inconsistent with IFRS. Formal guidance like this should use the identical language as in the IFRS. We suggest that, whenever possible, direct quotation from the IFRS be



encouraged. The paper could be structured to start with the IFRS quotation, followed by educational guidance for actuaries.

4.3.3 contains a suggestion that an agreement between two group companies becomes different on consolidation. This is a misunderstanding of the principle of consolidation. The contract remains a contract but, for accounting purposes, the separate companies in the group are accounted for as if a single entity. This principle should be made clear and consistent with accounting practice.

Change in Accounting Policies

1. *Would further guidance regarding the permitted introduction of current market interest rates (IFRS 4, par. 24) in the measurement of designated liabilities be useful? If so, please indicate the issue(s) that would be helpful to address here.*

No further guidance is needed. The guidance given in section 4.2 seems to be sufficient.

2. *Are there any types of situations in which a liability can be changed on a contract-by-contract basis other than in IFRS 4, par. 24 and par. 25(c)? If so, is further guidance needed to describe these situations?*

We believe no further guidance is needed.

3. *Would further guidance regarding shadow accounting (IFRS 4, par. 30) be useful? If so, please indicate the issue(s) that would be helpful to address here.*

The requirements in IFRS 4 are sufficiently clear. No additional guidance is necessary.

4. *Other comments.*

We refer to our answer to the general questions. We support the initiative to issue educational material for actuaries, but are concerned that the level of misunderstanding might increase if it is not exact. It was not possible for us in the time available to identify all the possible inconsistencies in the paper. However, we note that the examples on page 5 are not all changes in accounting policies according to IAS 8. We recommend the paper be reviewed in consultation with accountants.

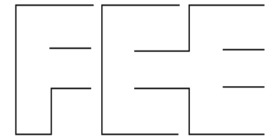
Discretionary Participation Features

1. *The Subcommittee has had long deliberations on this preliminary ED, as globally there is a very wide range of discretionary participating features. Do you believe that this preliminary ED provides sufficient guidance for those DPFs that are provided by contracts issued in your country? If not, do you believe that this preliminary ED should be expanded or modified to cover those DPFs as well? If so, we would appreciate receipt of a description of the DPFs for which you are looking for further guidance and the guidance that you believe appropriate.*

We refer to our answer to question 5.

2. *In certain countries, a contract that includes a DPF has discretion with regards to the timing, but not the amount, to be paid. In those countries, for example, this amount may be due to the current level of unrealised capital gains. Is it appropriate to include as a liability or equity the effect of the DPF corresponding to these gains based on the percentage guaranteed by contract or law, or the percentage currently declared by the company's Board? Is there additional guidance that should be provided relating to this situation?*

We refer to our answer to question 5.



3. *Is further guidance needed to identify separated or combined recognition approaches? Are the consequences of a combined recognition approach clear? If you believe that an example would be helpful, could you describe the issue to which the example would add clarity?*

The fourth paragraph suggests that in the case of a separated consideration of a DPF, the DPF might not or not completely be considered in the liability adequacy test in contrast to a non-separated consideration. In all cases, IFRS 4 requires that a current estimate of all contractual cash flows is the basis of the liability adequacy test. There are no further requirements for the non-separated consideration of the DPF. Any estimated future payment under a DPF is a contractual cash flow, hence to be considered in the test. It is important to clarify that the liability adequacy test does not distinguish between the accounting approaches. All future cash flows are considered, regardless of how they are accounted for.

4. *Is further guidance regarding the effect of shadow accounting on participating business needed? If so, in what area? For example, in regards to deferred unrealised capital gains that can arise in some countries?*

The requirements in IFRS 4 regarding shadow accounting are sufficiently clear. No additional guidance is necessary.

5. *Other comments.*

We welcome the way this paper deals with the issue of discretionary participation features. It is appropriate for educational material to expose an issue, discuss it and not conclude on one solution or the other. The paper addresses difficult matters on DPF and is helpful.

Within the “Background” information it is said that “IFRS 4 and IAS 39 provide guidance for the recognition and measurement of insurance and investment contracts with DPFs, while IAS 32 provides guidance for the disclosure of these instruments.” The wording should be more precise as IAS 32 provides guidance for the disclosures of investment contracts with DPF while IFRS 4 provides guidance for insurance contracts with such features.

Future voluntary payments which are not based on rights of policyholders, i.e. those not based upon legal obligations of the insurer or constructive obligations, do not qualify as a liability. Hence, the sentence “may not be necessary to recognise a liability” in section 4.6, last paragraph addresses the issue incorrectly. If the existing accounting policy allows reporting such amounts as a liability this accounting policy can be continued. On the other hand, it is not permissible to change to that accounting policy.

Direct references to specific countries, such as the one to Switzerland in section 4.6.3, should be avoided. Furthermore, it implies that the approach described is a very specific one whereas it exists in a large number of countries and is a common approach there. The text might be reworded to read “in a number of jurisdictions, the first step…”.

<u>Liability Adequacy Testing</u>

1. *The test for liability adequacy is a comparison of the net carrying value to future cash flows. Possible considerations for future cash flows are listed in section 4.2 when applying an existing accounting policy, with additional considerations given in section 4.4.1 when applying an IAS 37 approach. Do you agree with these lists of considerations? What factors would you add to or delete from these lists?*

The main purpose of the liability adequacy test is that insurance risk is considered. Scenario analysis is merely applicable to investment scenarios and development of market conditions which depend on factors like surrender rates. It is most important, especially in the case of claim liabilities, that insurance risk is properly reflected and guidance is need in this respect. As educational material, the IAA draft practice guideline could give examples of the most relevant approaches to consider for the liability adequacy test, but should not refer to specific ones as reference material.

The intention of Section 4.2 is unclear to us. In our opinion, the practitioner does not need to consider all those requirements when evaluating the accounting policies. Section 4.2 as currently phrased risks creating a box-ticking approach to any considerations. The list should be considered only as examples. The last sentence of the second paragraph in section 4.2 could be rephrased "could consider factors such as the examples below when evaluating…"

2. *In section 4.1 of this preliminary ED, insurance assets are discussed. It is mentioned that it may be appropriate to include some of these insurance assets in the liability adequacy test. Do you agree with this, and if not, why not? If you agree, do you believe the guidance provided is sufficient or should the guidance be expanded? If you believe that such additional guidance is needed, what should be its nature?*

The IAA standard extends the application of the liability adequacy test of IFRS 4 to assets other than those referred to in IFRS 4. If assets are not subject to the liability adequacy test in IFRS 4, they are subject to the impairment test under IAS 36. IFRS 4 does not grant any exemption from IAS 36. Furthermore, IAS 36 requires a more conservative measurement of assets than IFRS 4 does. A reference to IAS 36 as applicable guidance for insurance assets would be helpful. See also par. 4.7. We wonder whether the reference to Zillmer assets in section 4.1 is adequate, since they are contractual assets under insurance contracts but not considered in the wording of IFRS 4 concerning the liability adequacy test.

3. *When applying the IAS 18 approach to the measurement of the servicing element of investment contracts, the deferred costs must be tested for recoverability and the servicing contract must be tested for the possibility of a provision for an onerous contract. Is the guidance given in section 4.8 sufficient for this purpose? What clarification, if any, would you prefer to make the guidance more useful?*

The guidance given seems to be sufficient.

4. *Other comments.*

The standard remarks in section 3.1.1 that IFRS 4 does not specify whether or how the cash flows should be discounted or how they should be adjusted for risk and uncertainty, and if the adequacy testing indicates that net carrying amounts are sufficient at the present reporting date. The IAA standard concludes that consistent with existing measurement practices the measurement focuses on *net carrying amounts*. The wording should be closer to IFRS 4, referring to insurance liabilities net of related intangible assets rather than to net carrying amounts. The exact terminology of the IFRS should be used instead of introducing new terms.

The section 3.2.7 deals with the "Recoverability of deferred transaction costs and accounting for onerous contracts". The commentary should reflect the application guidance in IAS 39 which indicates how to determine the fair value which can also be relevant for determination of value in use.