SOCIETY OF ACTUARIES

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Report on the International Actuarial Association

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The most recent meeting of the IAA was held in Limassol, Cyprus this past November. The meeting took place against a backdrop of an ever-worsening global economy and public concerns that financial reporting, and what many perceive as unreasonable requirements of fair value measurement, may have contributed to the credit crisis. Although not a specific topic of discussion in the meeting sessions, the influence of current economic conditions on the discussions was apparent.

ACCOUNTING COMMITTEE DISCUSSIONS RELATED TO INTERNATIONAL FINANCIAL REPORTING STANDARDS

The liveliest discussions of the Accounting Committee related to topics on Phase II of the International Accounting Standards Board's (IASB or the Board) Insurance Project. The IASB intends to have a uniform global standard for accounting for insurance contracts issued by 2011 to be in effect soon thereafter, possibly 2013.

The Board's preliminary decisions regarding the insurance standard are presented in a Discussion Paper, in which the Board states its view that the measurement of insurance liabilities should be a current exit value (CEV), which, if it is not fair value, it is very close to fair value. A CEV may be estimated from current estimates of future cash flows, discounted at market rates and with a margin for risk.

The Accounting Committee of the IAA has organized a number of task forces on various topics related to the anticipated insurance standard, including discount rates, revenue recognition, and the boundary issue (about which more will later be discussed in this article).

DISCOUNT RATES

It was the discussion about discount rates that perhaps best illustrated the confluence of actuarial sensibilities, emerging accounting principles and the current economic environment. Many actuaries have concluded that the Phase II standard will require discounting at risk free rates with certain adjustments. Discussions on discount rates related to which adjustments to make to risk free rates and how to quantify them. Adjustments for credit standing and for liquidity were the most discussed.

Some actuaries believe that credit-standing has no role in the measurement of liabilities. It seems to them counterintuitive, if not simply inappropriate, that a company with a deteriorating credit situation would lower its liabilities and show more capital than it otherwise would. How can financial statements among insurers be comparable if the weaker companies get to report lower liabilities?

One can only imagine the effect on liabilities of the increase in credit spreads that has occurred in recent months. Nonetheless, US GAAP requires that credit standing, or the probability of nonperformance, be taken into account in fair value measurement, and the IASB, which is still deliberating about a uniform standard on fair value measurement, has not taken consideration of credit standing in the fair-value measurement of liabilities generally, or for insurance contracts specifically, off the table.

At the time of these discussions in Cyprus, there was no hotter topic among accountants than liquidity, centering around the extent to which the discount rates should reflect liquidity characteristics of the contracts being measured. Contracts that are not liquid, annuities for example, would have a larger factor than contracts that offer cash values. Illustrations of profit profiles for annuities demonstrate how significant the factor can be to emerging profit and loss at issue.

Much of the objection to fair value reporting in the current environment relates to liquidity. Previously deep and easily observed markets have suddenly frozen and provide little if any relevant observable data on values. Many accountants and others object to the use of a limited number of observable transactions as fair value indicators, on the grounds that they do not represent transactions in a normal market and are likely forced sales. So while many accountants are trying to dampen the influence of liquidity in the extreme on asset valuation, many actuaries are trying to get liquidity factored into liability measurement. These perspectives are reconciled by their desire to consider liquidity in discounting as it reflects an orderly, active market.

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REVENUE RECOGNITION

A presentation on revenue recognition by Kevin Griffith, an accountant from the London office of Ernst & Young, provoked much discussion as well. The presentation clarified why revenue recognition is important to liability measurement. It is apparent from the IASB deliberations on revenue recognition that without revenue there is no profit. The IASB is releasing its discussion paper on revenue recognition in December. The paper is expected to favor an approach called "customer consideration." Under customer consideration, the measurement of the obligation is calibrated to the value of the consideration and there is revenue as the liability for the obligation is decreased by performance or by delivery to the customer.

In the case of an insurer, it is not sufficient to collect a premium and record a liability for less than the amount of the premium in order to have a profit. What is necessary is that there be some performance under the contract, or delivery to the customer, that allows revenue to be recognized. It seems likely that revenues on contracts with long-tail liabilities will extend over the claims-payment period. In fact, it is not clear if there will be revenue before claims are settled. For there to be revenue during the exposure period, a case needs to be made that the insurer has performed under the contract by providing protection during the coverage period.

What happens with life insurance is also unclear. In particular it is not clear how revenue is recognized when there are future premiums. Is there revenue recognition as deaths occur in each premium period, or is there a guarantee of future insurability that must be considered in revenue recognition? If so, is there performance when the guarantee is sold (on premium payment) because the guarantee is delivered or is there revenue only as the guarantee plays out over time?

THE BOUNDARY PROBLEM

The boundary problem relates to the difficulty some Board members have in distinguishing between renewal premiums—for example, the renewal of an automobile policy—and recurring premiums on, for example, level term insurance. Many Board members see future premiums as an asset for which recognition is dubious, but they see the need to recognize a liability for guaranteed insurability. The preliminary decision of the Board is that future premiums are not considered in the measurement of insurance liabilities unless they must be paid in order to maintain insurability or if the contract liability is greater if they are considered. It seems that revenue recognition and consideration of future premiums in the measurement of liabilities are linked and that the Board's insurance projects and revenue recognition projects are interdependent and the projects will need to be synchronized.

CONCEPTUAL FRAMEWORK

Another Board activity that raises issues relevant to the measurement of insurance liabilities is its project on the conceptual framework that comprises the fundamental concepts that underlie the principles found in the standards and other pronouncements. A part of this project is a review and possible revision of the concepts related to elements of financial reporting and recognition of the elements. Elements include assets and liabilities. The definitions of assets and liabilities, both those within the existing framework and those being used by the Board for discussion purposes, are found in the following table.

	CURRENT DEFINITION	DISCUSSION DEFINITION
Asset	An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.	An asset of an entity is a present economic resource to which the entity has a right or other access that others do not have.
Liability	A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.	A liability of an entity is a present economic obligation for which the entity is the obligor.

The working definition of an asset that emphasizes access that others do not have rather than control may make the Board more receptive to seeing future premiums as an asset that can be recognized, although to be sure, recognition is a set of considerations apart from the definition. The proposed definition of a liability may make it easier for the Board to accept future dividends on participating contracts as part of liabilities, something it has been reluctant to do except when dividends are a clear legal or constructive obligation.

OTHER ACTIVITIES

The space remaining does not allow for an exhaustive report on other activities, but three items of note must be mentioned.

STOCHASTIC MODELING

With the support of the Financial Reporting Section and others, the Accounting Committee has sponsored the development of a monograph on applications of stochastic modeling in insurance. With the likely need to use stochastic modeling to comply with the international insurance standard when it is adopted, this will be a timely and useful publication. The monograph is being written by experts from Milliman and reviewed by a select group of members of the Accounting Committee. It should be available sometime in 2009.

INTERNAL MODELS

The Solvency Subcommittee of the Regulatory Committee has nearly completed a *Guidance Paper on the Use of Internal Models for Risk and Capital Management purposes by Insurers*. The guidance should help actuaries build and maintain models in a proper control environment and prevent models from becoming "black boxes." The guidance may apply equally to financial reporting when, as expected, internal models will be the basis for measurement of liabilities. This paper is also expected in 2009.

RISK MARGINS

The long awaited paper on risk margins should be released before year end. In fact, it covers much more than risk margins. Its title is *Measurement of Liabilities for Insurance Contracts: Current Estimates and Risk Margins*. The paper has been a major undertaking and will be a valuable primer to actuaries seeking an introduction to setting assumptions, selecting discount rates and quantifying risk margins.

NEXT MEETING

The next council and committee meetings of the IAA are scheduled for the end of May in Tallinn, Estonia. There will be much to report on following that meeting. ■

A NOTE FROM THE AUTHOR

I appreciate the opportunity that the Financial Reporting Section has given me to continue my involvement with the International Accounting Association and to report to you on the activities of the IAA. In my reports I will focus on topics of particular interest to actuaries involved in financial reporting. These are primarily, but not exclusively, the activities of the Accounting Committee of the IAA. I have chosen to write the reporting topically, allowing the reports to reflect my perspective on the activities. These reports can be seen as expanding the reporting that has previously been included in Henry Siegel's articles on international financial reporting.

This issue of the Financial Reporter *contains the first report, with additional reports to follow as least semiannually, corresponding to meetings of the IAA. Readers whose interest is piqued by the reports can request elaboration of topics touched on in the reports, which may form the basis for additional articles from me or from a colleague involved with the IAA.*