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Do Accountants Listen?

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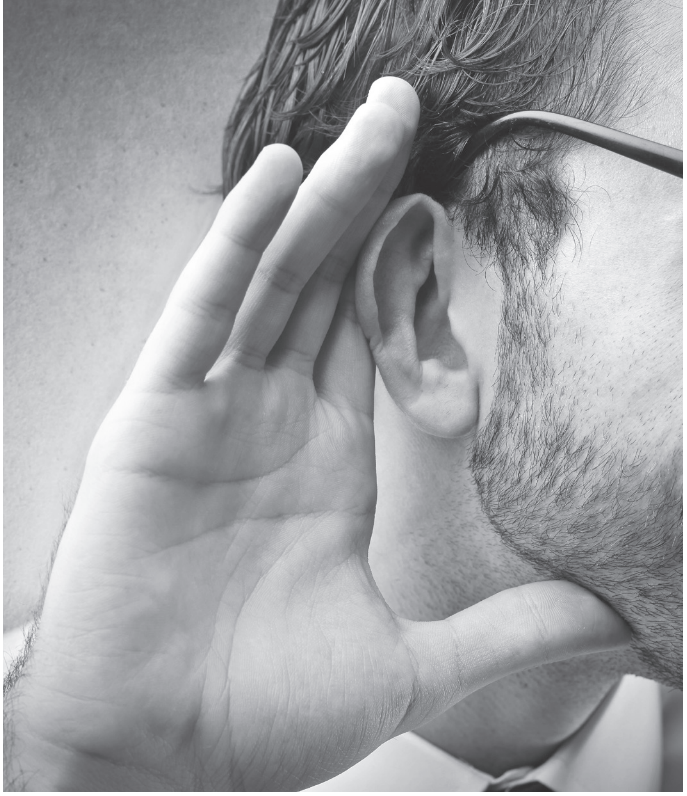

Do accountants listen to actuaries?

I won't keep you in suspense. The answer is "yes," and you probably suspected that. But the extent to which actuaries have influenced accounting concepts and financial reporting standards may surprise you.

Actuaries and accountants have enjoyed a cordial professional relationship for decades. There is a steady stream of communication between the two groups both formally and informally. Actuaries and accountants work together inside insurance companies, accounting firms employ actuaries, and actuarial firms sometimes employ accountants. The American Academy of Actuaries (Academy) meets regularly with the American Institute of Certified Public Accountants to discuss topics of common interest. The Academy comments on proposals of the Financial Accounting Standards Board (FASB) and of the International Accounting Standards Board (IASB) that affect insurers in United States. The formal communications are supplemented by many informal encounters, including face-to-face meetings, emails and calls. I can say from personal experience that IASB members and staff of the IASB sometimes read articles from *The Financial Reporter*.

The International Actuarial Association (IAA) has a memorandum of understanding with the IASB. This short document articulates the commitment of the intent of the two organizations to work together. In keeping with the intent, the IAA has a representative on the IFRS Advisory Council. This means that the IAA's formal involvement rightfully extends beyond strictly actuarial topics and that actuaries can do more than react to the activities of the IASB—they can help influence the direction of the IASB.

So we talk to each other, but does it make any difference? Again the answer is "yes." The history of the insurance project shows how actuaries have contributed to the proposed standard. I believe that the changes to accounting for financial instruments and the proposed changes to the *Conceptual Framework for Financial Reporting* (the CF) also illustrate how actuarial thinking has infected accounting concepts. Each of these is discussed further in the following paragraphs.

When I first became involved with the IAA, in 2001, and started closely following the IASB's activities related to insurance, I was shocked by what I learned about the IASB's views. The IASB did not want the measurement of long-duration contracts to consider future premiums that were not required to be paid. In their minds, including future premiums would be tantamount to recognizing an asset for a set of cash flows that do not meet the attributes for recognition. Furthermore, they did not want the liability to be reduced by the option to cancel the contract (i.e., they were uncomfortable with the effect of considering surrenders in projected cash flows), because a put option can't be an asset. They also wanted to unbundle and separately measure the investment components of whole life contracts. It goes without saying that the preliminary views of the IASB were not well received by the insurance industry. The industry argued strongly for a more holistic view of insurance contracts.

Over the course of many years, the arguments of the insurance industry eventually prevailed. Insurers were able to convince the IASB that insurance contracts could only be faithfully represented as a bundle of cash flows. Actuaries were everywhere to be found in the discussions and deliberations. Actuarial input was most apparent in comment letters by actuarial organizations and presentations to the IASB by actuaries. Actuaries were involved in nearly all industry responses to the preliminary views of the IASB, although to the casual observer their involvement may not have been as apparent.

Actuaries' influence on accounting for insurance is not surprising. But the influence of actuaries extends beyond insurance related topics. It is interesting to observe the evolution of accounting concepts over the period of time that actuaries have been actively providing input to accountants. The accounting for impairments of financial assets found in IFRS 9 *Financial Instruments* (IFRS 9) provides an example. IFRS 9, which will be effective in 2018, supplants much of the guidance found in existing accounting standards and will eventually become the single accounting standard on financial instruments.

In the current guidance, impairment losses are recognized when incurred; i.e., when the impairment occurs. After IFRS 9 is effective, the expected loss model will apply when a company acquires a financial asset and measures it at amortized cost. The company must estimate expected credit losses over a 12 months period and recognize a loss allowance, which creates an immediate impairment loss in the income statement. The period over which the company looks for expected losses extends to the remaining lifetime of the asset if the credit standing of the asset significantly deteriorates or if it is in fact impaired. The effective yield is not affected by the loss allowance.

The expected credit loss is measured "in a way that reflects … an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes."[1] This sounds very actuarial to me.

So I take the accounting guidance for expected losses in IFRS 9 as evidence that accountants are increasingly thinking like actuaries. I believe that it is a result of actuaries working with accountants.

It is also evident that accountants have not come around completely to actuarial thinking. An actuary would naturally estimate expected losses over the life of the assets and reduce the effective yield to a net effective yield, or at least build the provision out of the revenue; i.e., actuaries would build a liability out of a part of investment income.

The FASB is making similar changes to accounting for financial instruments. The FASB will require a loss allowance based on the expected losses over the lifetime of the asset. So maybe FASB thinks a little bit more like actuaries than the IASB. I wonder if the FASB would take this as a compliment.

The influence of actuaries can also be seen in the deliberations of the IASB as it reconsiders its *Conceptual Framework for Financial Reporting (CF)*. This document accompanies, and in effect precedes, the accounting standards. It is not itself a standard, and hence not accounting guidance, but rather "… it describes the objective of, and the concepts for, general purpose financial reporting."[2] The thoughts expressed in the CF permeate the accounting standards. They can also directly significantly influence reporting entities' accounting policies, especially in situations that are not specifically addressed by any accounting standard.

To show how actuarial thinking has infected the IASB, even in its most fundamental thinking about accounting concepts, I point to how the definition of "asset" is changing. In the current CF, 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."[3]

In the May 2015 exposure draft for a revised conceptual framework (EDRCF), an asset:

> "… is a present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits."[4]

Ordinarily actuaries would like accountants to make more use of expected values, especially as contrasted to best-estimates. In the context of the current CF, however, the word "expected" can be construed to mean that a resource is not an asset unless it is more-likely-than-not to be realized. This definition is prejudicial to recognition, as it could be construed that something that has less than 50 percent probability of being realized is not an asset. The revision to the definition is meant to be an improvement in the articulation of the concept, not a change in thinking about what constitutes an asset. It is nonetheless a change that actuaries welcome.

I could go on, but I think I have made the point. Accountants listen to actuaries and actuaries influence accounting concepts.

Is the reverse true? Do actuaries listen to accountants? In the next edition of *The Financial Reporter*, I will point out important ways that actuaries should think more like accountants. ■

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ENDNOTES

1 *http://eifrs.ifrs.org/eifrs/bnstandards/en/2015/ifrs09.pdf*

2 *http://www.ifrs.org/Current-Projects/IASB-Projects/Conceptual-Framework/Pages/Conceptual-Framework-Summary.aspx*

3 http://eifrs.ifrs.org/eifrs/bnstandards/en/2015/framework.pdf

4 *http://www.ifrs.org/Current-Projects/IASB-Projects/Conceptual-Framework/Documents/May%202015/ED_CF_MAY%202015.pdf*