



AMERICAN ACADEMY *of* ACTUARIES

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International Accounting Standards Board
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United Kingdom

The Financial Reporting Committee of the American Academy of Actuaries¹ appreciates this opportunity to provide comments to the International Accounting Standards Board (IASB) concerning Exposure Draft 2009/5, “Fair Value Measurement” (FVM ED).

A major aspect of the actuarial profession’s expertise is the valuation of liabilities related to insurance contracts, defined benefit pension plans, and other postemployment benefit plans. In light of this, we have focused our comments on the implications of the FVM ED guidance for determining the fair value of these types of liabilities. Although we recognize that the IASB’s current Insurance Contracts project is no longer considering current exit value as a measurement attribute, there are still ample reasons to consider the applicability of the FVM ED in an insurance context; for example, reporting entities may choose to apply a Fair Value Option to certain insurance contract liabilities in order to achieve better matching between liabilities and assets. Similarly, while we understand that IASB intends to review employee benefit liability measurement issues under IAS 19 in a future project, we felt it was important to offer some comments at this time relating to the potential application of the FVM ED to these liabilities.

Additionally, a major area of focus for retirement actuaries (as contrasted with insurance actuaries) is providing disclosure information related to pension and other postemployment benefit plans, included in the postemployment benefit footnote of a company’s financial statements. In this capacity, we have provided our thoughts about the applicability of the proposed asset disclosure requirements in our response to Question 13 below.

Our specific comments are incorporated in our responses below to each of the questions posed by the Exposure Draft. Thank you again for this opportunity to provide input.

Sincerely yours,

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¹ The American Academy of Actuaries (“Academy”) is a 16,000-member professional association whose mission is to serve the public on behalf of the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

Question 1

The exposure draft proposed defining fair value as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date” (an exit price). This definition is relevant only when fair value is used in the IFRSs. Is this definition appropriate? Why or why not? If not, what would be a better definition and why?

In general, we agree with the Board’s proposed definition of fair value. We also believe that it is important to include details regarding how to address situations in which orderly transactions cannot be observed, which frequently occurs with respect to actuarial liabilities. The information included in Appendices B and C is helpful in this regard.

Question 2

In three contexts, IFRSs use the term ‘fair value’ in a way that does not reflect the Board’s intended measurement objective in those contexts: (a) In two of those contexts, the exposure draft proposes to replace the term ‘fair value’ (the measurement of share-based payment transactions in IFRS 2 *Share-based Payment* and reacquired rights in IFRS 3 *Business Combinations*) (see paragraph BC29 of the Basis for Conclusions). (b) The third context is the requirement in paragraph 49 of IAS 39 *Financial Instruments: Recognition and Measurement* that the fair value of a financial liability with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid (see paragraph 2 of the draft IFRS and paragraph BC29 of the Basis for Conclusions). The exposure draft proposes not to replace that use of the term ‘fair value’, but instead proposes to exclude that requirement from the scope of the IFRS. Is the proposed approach to these three issues appropriate? Why or why not? Should the Board consider similar approaches in any other contexts? If so, in which context and why?

Generally speaking, we believe a common definition of fair value across all IFRS pronouncements is a desirable goal, and therefore are supportive of the Board’s proposal. In particular, with respect to the third context above, we prefer the removal of the demand feature floor in determination of a fair value. There are circumstances in which the valuation of contracts issued by insurance companies includes a demand feature (i.e., cash surrender value) floor, e.g., under US Statutory Accounting Principles promulgated by insurance regulators. However, we do not believe that a demand feature floor is an appropriate basis for determining a fair value.

Question 3

The exposure draft proposes that a fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place in the most advantageous market to which the entity has access (see paragraphs 8–12 of the draft IFRS and paragraphs BC37–BC41 of the Basis for Conclusions). Is this approach appropriate? Why or why not?

From an insurance company perspective, it is unclear whether using the most advantageous market, as opposed to the principal market (as currently required under FAS 157 if it exists), results in any material difference in valuation. Since insurance contracts are rarely traded in an active market, it is common for the insurer making a fair value measurement of such contracts to have to make assumptions regarding either a principal or a most advantageous market. It would be helpful to have clarification as to whether the most advantageous market might be construed to be the policyholder market, to the extent that the value at which the insurer could settle the obligation to policyholders is more advantageous to the insurer than the values available in other markets (such as capital markets, reinsurance markets, or acquisitions by other insurance companies).

Currently, employee benefits obligations are not subject to fair value measurement under IFRS. From an employee benefits plan perspective, we do not believe that an open market exists, since these obligations are rarely traded. The few trades that do exist occur through an insurance contract or through an acquisition with another company. In both cases the price and the substance of the obligation that was transferred is not easily determinable and rarely made public. As a result, it is not at all clear how this concept would apply to employee benefit plan obligations (if such obligations were required to be measured at fair value).

Question 4

The exposure draft proposes that an entity should determine fair value using the assumptions that market participants would use in pricing the asset or liability (see paragraphs 13 and 14 of the draft IFRS and paragraphs BC42–BC45 of the Basis for Conclusions). Is the description of market participants adequately described in the context of the definition? Why or why not?

Because there tends not to be an active, traded market for insurance contracts, further clarification on how to deal with multiple potential markets, and therefore market participants, would be helpful. While we believe the definition of market participants is adequate given a specified market, it is challenging with respect to items that are not actively traded to identify which market is most advantageous. Further guidance on the relative appropriateness of different markets for insurance obligations (e.g., reinsurance market, acquisition market, capital markets, and policyholder market) would be useful.

Since employee benefit plans also do not have an active traded market, we would require considerable clarification regarding how to apply fair value concepts to these obligations.

In short, identifying “market participants” (and the assumptions they would use) requires that there be a “market” in which those participants trade. In situations where there is no market, identifying its “participants” is at best problematic and perhaps virtually impossible.

Question 5

The exposure draft proposes that: (a) the fair value of an asset should consider a market participant’s ability to generate economic benefit by using the asset or by selling it to

another market participant who will use the asset in its highest and best use (see paragraphs 17–19 of the draft IFRS and paragraph BC60 of the Basis for Conclusions). (b) the highest and best use of an asset establishes the valuation premise, which may be either ‘in use’ or ‘in exchange’ (see paragraphs 22 and 23 of the draft IFRS and paragraphs BC56 and BC57 of the Basis for Conclusions). (c) the notions of highest and best use and valuation premise are not used for financial assets and are not relevant for liabilities (see paragraph 24 of the draft IFRS and paragraphs BC51 and BC52 of the Basis for Conclusions). Are these proposals appropriate? Why or why not?

Since these concepts would generally not be applicable to the valuation of insurance contracts or employee benefit plans, we have no comments.

Question 6

When an entity uses an asset together with other assets in a way that differs from the highest and best use of the asset, the exposure draft proposes that the entity should separate the fair value of the asset group into two components: (a) the value of the assets assuming their current use and (b) the amount by which that value differs from the fair value of the assets (ie their incremental value). The entity should recognise the incremental value together with the asset to which it relates (see paragraphs 20 and 21 of the draft IFRS and paragraphs BC54 and BC55 of the Basis for Conclusions). Is the proposed guidance sufficient and appropriate? If not, why?

We believe additional guidance regarding the types of situations in which other assets should be considered would be helpful, as well as clarification as to whether the guidance to consider instruments together would only apply in the case of assets, or whether it should be applied to liabilities as well.

Question 7

The exposure draft proposes that: (a) a fair value measurement assumes that the liability is transferred to a market participant at the measurement date (see paragraph 25 of the draft IFRS and paragraphs BC67 and BC68 of the Basis for Conclusions). (b) if there is an active market for transactions between parties who hold a financial instrument as an asset, the observed price in that market represents the fair value of the issuer’s liability. An entity adjusts the observed price for the asset for features that are present in the asset but not present in the liability or vice versa (see paragraph 27 of the draft IFRS and paragraph BC72 of the Basis for Conclusions). (c) if there is no corresponding asset for a liability (eg for a decommissioning liability assumed in a business combination), an entity estimates the price that market participants would demand to assume the liability using present value techniques or other valuation techniques. One of the main inputs to those techniques is an estimate of the cash flows that the entity would incur in fulfilling the obligation, adjusted for any differences between those cash flows and the cash flows that other market participants would incur (see paragraph 28 of the draft IFRS). Are these proposals appropriate? Why or why not? Are you aware of any circumstances in which the fair value

of a liability held by one party is not represented by the fair value of the financial instrument held as an asset by another party?

As described previously, it is likely that most contracts issued by insurance companies and to which FVM is relevant would fall under (c) above, and require use of a present value technique. The guidance provided appears appropriate in theory. However, because of the lack of an active market for insurance liabilities and the subjectivity of the multiple valuation inputs, two knowledgeable, independent parties (one holding the liability, the other holding the asset) likely will end up with different but equally reasonable values for the same contractual obligation. An example of this in today's market would be reinsurance of embedded derivatives in insurance contracts, which in US GAAP are measured at fair value under FAS 157. There are instances in which the liability (asset) held by the reinsurer differs from the asset (liability) for the reinsurance recoverable of the direct writer, due to differences in the subjective judgment of the two parties' respective valuation experts. However we agree that in theory, and absent any bid/ask spread differences, these two values should be equal in active markets.

Question 8

The exposure draft proposes that: (a) the fair value of a liability reflects non-performance risk, ie the risk that an entity will not fulfill the obligation (see paragraphs 29 and 30 of the draft IFRS and paragraphs BC73 and BC74 of the Basis for Conclusions). (b) the fair value of a liability is not affected by a restriction on an entity's ability to transfer the liability (see paragraph 31 of the draft IFRS and paragraph BC75 of the Basis for conclusions). Are these proposals appropriate? Why or why not?

In our committee's recent response to the IASB staff paper on "Credit Risk in Liability Measurement" (see http://www.actuary.org/pdf/finreport/iasb_sep09.pdf) we asserted that, whether or not the reported fair value of a liability includes a discount for non-performance, the amount of the discount for non-performance should also be reported. Both bases carry decision useful information and are needed to provide a full picture of the liability and the entity that reports it. One should also note that an entity which transfers a liability generally remains liable in the event of non-performance by the transferee. Thus transferability should affect neither the undiscounted value nor, by inference, the discounted value.

We suggest that the Board consider providing further clarification regarding the appropriate treatment of third party credit guarantees on fair value. Examples of this arising in the US would include Federal Deposit Insurance Corporation (FDIC) guarantees on bank deposits, Pension Benefit Guaranty Corporation (PBGC) guarantees on pensions, and state guaranty fund guarantees on certain types of insurance contracts. To the extent such guarantees are funded by the issuing entity, and provide a payment guarantee in the event of nonpayment by the contract issuer, should such guarantees be considered in a fair value measurement of the liabilities? If not, should they be considered a separate asset and valued as such?

Question 9

The exposure draft lists four cases in which the fair value of an asset or liability at initial recognition might differ from the transaction price. An entity would recognise any resulting gain or loss unless the relevant IFRS for the asset or liability requires otherwise. For example, as already required by IAS 39, on initial recognition of a financial instrument, an entity would recognise the difference between the transaction price and the fair value as a gain or loss only if that fair value is evidenced by observable market prices or, when using a valuation technique, solely by observable market data (see paragraphs 36 and 37 of the draft IFRS, paragraphs D27 and D32 of Appendix D and paragraphs BC76–BC79 of the Basis for Conclusions). Is this proposal appropriate? In which situation(s) would it not be appropriate and why?

To the extent that an asset or liability is going to be measured at fair value at subsequent measurement dates, consistency requires the recognition of a gain or loss if the transaction price and the fair value are not the same at the initiation date, regardless of how fair value is measured. For example, if the fair value determined for an insurance contract by following the guidance outlined in the ED produces a liability less than the entry price for the contract, we believe that a gain at issue is appropriate. (This statement should not be construed as an endorsement of the notion that fair value is an appropriate measurement attribute for insurance contracts.) We do not believe such a gain should be restricted to instances in which the fair value is evidenced by observable market prices or when using a valuation technique solely by observable market data.

Question 10

The exposure draft proposes guidance on valuation techniques, including specific guidance on markets that are no longer active (see paragraphs 38–55 of the draft IFRS, paragraphs B5–B18 of Appendix B, paragraphs BC80–BC97 of the Basis for Conclusions and paragraphs IE10–IE21 and IE28–IE38 of the draft illustrative examples). Is this proposed guidance appropriate and sufficient? Why or why not?

We believe these additional clarifications are useful, relevant, and appropriate. We suggest adding further clarification on methods for determining a margin for risk when observable market data is not available.

Question 11

The exposure draft proposes disclosure requirements to enable users of financial statements to assess the methods and inputs used to develop fair value measurements and, for fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on profit or loss or other comprehensive income for the period (see paragraphs 56–61 of the draft IFRS and paragraphs BC98–BC106 of the Basis for Conclusions). Are these proposals appropriate? Why or why not?

We believe that for insurance contracts specifically, the lack of observable market data, the long duration of the liabilities, and the significant subjectivity associated with the fair valuation make

the disclosures critical for financial statement users. In particular, paragraph 57(g), which requires sensitivity disclosures for Level 3 measurements, will be useful to readers.

We also suggest requiring explicit disclosures of methods, inputs, and assumptions used to determine risk margins for Level 3 measurements.

Finally, we have substantive concerns over the wisdom of proceeding with these disclosures in the special case of assets backing postemployment benefit plans. Please see our response to Question 13 below for further discussion of this issue.

Question 12

The exposure draft differs from Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157) in some respects (see paragraph BC110 of the Basis for Conclusions). The Board believes that these differences result in improvements over SFAS 157. Do you agree that the approach that the exposure draft proposes for those issues is more appropriate than the approach in SFAS 157? Why or why not? Are there other differences that have not been identified and could result in significant differences in practice?

As described above, it is unclear how the change from principal market to most advantageous market will impact the valuation of contracts issued by insurance companies. Therefore it is difficult to comment on whether this is an improvement.

We believe some of the other differences, including guidance on measurement methods and guidance related to inactive markets, are useful.

Question 13

Do you have any other comments on the proposals in the exposure draft?

IFRS does not currently require liabilities for pensions and other postemployment benefits to be measured at fair value. Nevertheless, we wanted to use the issuance of the FVM ED as an opportunity to discuss some issues that should be considered before potentially applying fair value measurements to these areas. The comments below are divided into two sections: measurement issues; and asset disclosure issues.

Measurement Issues

IAS 19 does not require the use of fair value measurements, but instead requires that the defined benefit obligation (DBO) for such benefits be determined by: (1) estimating the future benefits that employees will receive under a plan; (2) allocating those benefits to past, current, and future service using the Projected Unit Credit Method; and (3) discounting the benefits allocated to past service to the measurement date using an assumed discount rate based on the yields available on high-quality corporate bonds.

We believe that the current IAS 19 requirement that postemployment benefit liabilities not be measured at fair value remains appropriate. In most countries, there is not a significant market in which employee benefit liabilities may be transferred from one entity to another, due to significant regulation and restrictions on an entity's ability to transfer the liability. Also, there are almost no traded assets or liabilities with similar characteristics that could provide a reference point for determining fair value.

While the guidance in the FVM ED would not impact the measurement of postemployment benefit liabilities under the current provisions of IAS 19, we understand that in the next few years the IASB will undertake a project to reassess the fundamental concepts underlying the accounting for postemployment benefits. It is possible that fair value measurement of postemployment benefit liabilities could be considered as part of this project. As a result, we have drafted these comments in light of this possibility.

With postemployment benefit liabilities, there is generally not a corresponding asset in the same sense that there would be an asset corresponding to a corporate debt obligation. For example, a retiree in a defined benefit pension plan effectively holds a promise to receive a certain level of income for the remainder of his or her lifetime. However, the retiree generally does not have the ability to transfer this promise to another party or otherwise immediately realize the value of the promise, other than by direct settlement with the plan sponsor. As a result, we believe that paragraph 28 and Appendix C of the FVM ED would apply, but that additional guidance on applying the valuation techniques to employee benefit liabilities would be needed. .

If at some future date the IASB determines that fair value accounting is appropriate for postemployment benefit liabilities, then we believe it will be critical for the IASB to provide clear, practical guidance on how to implement fair value measurement in the context of IAS 19. Among other issues, this guidance would need to address how to account for uncertainty in future cash flows, how to reflect liability- and entity-specific credit risk, and how the presence or lack of guaranty agencies (such as the PBGC in the US and the Pension Protection Fund in the UK) should influence the measurement of liability-specific credit risk.

More broadly, we believe the IASB should articulate a clear set of guiding principles to determine under what circumstances fair value accounting is appropriate and under what circumstances it is not. As noted earlier, we believe it is appropriate that IAS 19 does not currently require postemployment benefit liabilities to be measured at fair value for several reasons. Whether fair value accounting should eventually apply to postemployment benefit liabilities is an issue that the IASB will need to evaluate in future deliberations regarding IAS 19. We believe that a clear set of guiding principles for when to apply fair value accounting should be articulated prior to these deliberations, and that all corporate liabilities should be evaluated using this same set of principles in order to ensure consistency and comparability of financial statements.

Asset Disclosure Issues

Assets for postemployment benefit plans differ from other company assets in a number of unique ways:

- In most situations, these assets do not belong directly to the company, but rather are held in a trust on behalf of plan participants.
- The company does not always directly control how these assets are invested. For example, investment decisions may be delegated to a third-party investment manager. Even when company representatives do directly control how the assets are invested, they are typically acting as a plan fiduciary and are required to act on behalf of the plan’s participants.
 - As a result, the company is rarely responsible for selecting the specific securities in which plan assets are invested and instead sets broad investment guidelines and selects investment managers or funds (collectively referred to as “investment experts” in this comment letter) to make the actual investment decisions. These hired investment experts are responsible for valuing the plan’s asset holdings and providing information about these holdings to the plan sponsor. As a result, companies will generally need to rely on these investment experts to provide all of the asset disclosure information that the IASB would require under the types of disclosures contained in the FVM ED. Most companies do not have the in-house expertise to challenge the asset valuation information provided by these investment experts.
- In many countries, fiduciary requirements are such that the investment policy for a postemployment benefit plan requires the use of a broadly diversified portfolio.
 - As a result, many investment decisions made by a company or its investment experts expose the plan to a broad range of investments that could be using a multitude of complex asset valuation inputs and techniques. For example, a single “fund of funds” investment could easily be invested in 50 different private equity managers, each with a portfolio of 10 complex, Level 3 type investments. Applying the disclosure requirements in paragraphs 57(d), (e), and (g) to such an investment would likely result in a footnote that is quite voluminous while being of limited use to investors. Even more commonly, a single investment with a fixed income manager using a broad array fixed income securities could result in a complicated collection of Level 1, 2, and 3 assets using a variety of valuation techniques and inputs, making the disclosure requirements under paragraphs 57(c) and (d) quite complicated.
- Postretirement benefit plan assets are not directly reflected on a company’s balance sheet; only the net difference between the plan’s obligation and the assets is recognized.² This net measure is not a fair value measurement, since postretirement benefit obligations are not measured at fair value. In addition, there may be further adjustments

² This statement assumes the use of either the immediate recognition method for recognizing gains and losses or the SoRIE/OCI method, as permitted under IAS 19. Current US accounting standards also require balance sheet recognition of the net unfunded obligation.

to the balance sheet in the event a plan has deferred actuarial gains/losses or prior service costs.

As a result of these differences, we do not believe that it would be appropriate for all of the fair value measurement disclosure items listed in paragraph 57 of the FVM ED to apply to postemployment benefit plan assets. Instead, we think that any changes to the asset disclosure requirements under IAS 19 should be made in conjunction with the IASB's Phase 1 project to amend IAS 19. This project is already underway, and is expected to make significant changes to the disclosure requirements under IAS 19. We believe all changes to the disclosure requirements under IAS 19 should be effective at the same time, and be considered within the context of the Phase 1 project. Note that this would be consistent with the FASB's decision to exempt employer reporting of pensions and other postemployment benefit plans from the disclosure requirements of FAS 157, and instead issue separate guidance on asset disclosure requirements for these plans in FSP FAS 132(R)-1.

We understand and appreciate the desire to require companies to disclose more information about their postemployment benefit plan asset holdings. However, we caution the IASB to carefully consider any new disclosure requirements for these plans to ensure that the disclosures can be readily prepared and are useful to investors. Specifically, we are concerned that requiring all of the disclosure items in paragraph 57 for postemployment benefit plan assets would create an undue burden on plan sponsors and provide limited value to investors when all of the details are aggregated into general, broad-based statements.

Also, as noted earlier, access to detailed asset information is often dependent on third parties, who will need to perform additional work to provide this information and assess additional fees on plan sponsors to do so. In addition, the time available to collect, analyze, and disclose this information will be very short, and companies' finance departments will need to do this at a time when they are already fully absorbed in other year-end activities.

Therefore, we recommend that the IASB follow an approach consistent with that taken by the FASB, and explicitly exempt postemployment benefit plan assets from the asset disclosure requirements in the FVM ED while proposing disclosure requirements identical to those under FSP FAS 132(R)-1 as part of its Phase 1 project to amend IAS 19. Alternatively, a subset of those requirements could be considered. This would allow investment experts to prepare a single set of asset information under US GAAP and IFRS, while still allowing for the disclosure of significantly more information about postemployment benefit plan assets.

Further, we believe that much can be learned from the initial implementation of the FASB's new asset disclosure requirements under FSP FAS 132(R)-1, and it would be unfortunate to require additional disclosure information without first understanding the effectiveness of the new FASB requirements and whether they meet investor needs.