January 3, 2006

Technical Director File Reference No. 1235-001 Financial Accounting Standards Board of the Financial Accounting Foundation 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116 1166 Avenue of the Americas New York, NY 10036-2708 212 345 7000 Fax 212 345 7414 www.mercerHR.com

Letter of Comment No: 1/4File Reference: 1235-001 Date Received: 1-3-16

#### Subject:

# Invitation to Comment: Selected Issues Relating to Assets and Liabilities with Uncertainties

Dear Sir or Madam:

On behalf of Mercer Human Resource Consulting, we thank you for the opportunity to comment on certain issues raised in the Invitation to Comment, Selected Issues Relating to Assets and Liabilities with Uncertainties. We offer our thoughts as actuaries whose primary training and expertise are in the measurement of contingent events, and have limited our comments to matters in the Invitation related to that expertise.

- 1. One thrust of the IASB seems to be the general concept that "uncertainty" and "contingency" (as well as similar constructs such as "likelihood," "probability," or "risk") are measurement, and not definition or recognition issues for assets and liabilities. We agree with this in concept. While we have no opinion as to the correct terminology, we believe some type of recognition of contingent assets and liabilities is crucial. Very little in our world is guaranteed, and anything not guaranteed is contingent. Acknowledging the contingent nature of assets and liabilities, and highlighting the likelihood of the contingency, would generally improve the usefulness of information in the financial statements.
- 2. Accounting literature also uses the term "probable." We believe this term causes confusion on occasions, because one definition of probable is "more likely than not," while another definition is "not completely certain," which includes any contingency no matter how remote. Consistently clarifying the intended meaning of this term would be useful. For example, rather than using "probable" as a threshold criterion for recognition, it is more useful to describe the possible outcomes and assess the *degree* of probability or likelihood that each will occur.



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3. The probabilities associated with uncertain events span a broad range of reliability. At one end are one-time, unprecedented events (for example a catastrophic natural disaster or a potential future significant lawsuit). Applying probabilities to these types of risks adds very little or no value as compared to management's best estimate. At the other end of the spectrum are events or transactions that may have a high degree of individual variation, but

which exist (or are anticipated to exist) in sufficient numbers over a sufficient period of time that reliable probability distributions are available for aggregate results. Mortality would be an example from our own area of expertise – while it is nearly impossible to predict whether one individual will die during the year, the total number of deaths in a large group of people can be estimated with much greater reliability. In between these two extremes are uncertain events for which there may not be enough numbers (a small employer, for example) or for which the past may bear a lesser relationship to the future (option analysis or the rate of increase in retiree medical claims, for example).

A significant consequence of this reasoning is that the uncertainties faced by an entity, typically as a collection of individual events will be different, than the collected uncertainties of those individual events.

4. In evaluating assets or liabilities associated with contingencies subject to probability distributions, some consideration should be given to the concept of confidence intervals or other measures based on degree of likelihood. Historical cost accounting is typically based on actually or hypothetically completed transactions or events for which specific pricing information (or its close analogue – the single point estimate of expected present value) is available. However, the hypothetical value of an asset or liabilities with embedded uncertainties is, in and of itself, an uncertain amount; single point estimates are incomplete, because they provide no information about this uncertainty, and can, in some circumstances, be extremely misleading. For example, some pension plans provide a floor of benefits which

is only paid if the benefits under an accompanying defined contribution (DC) plan do not reach a minimum level. In the case of such a plan where the DC benefit is expected to exceed the floor, the liability for the plan, as determined under current accounting rules, is zero. However, the economic value of the plan (and thus the employer's economic liability) is greater than zero because the actual results of comparing the DC benefit with the floor will probably be somewhat different than the expected (most likely) results, and in some cases will result in a floor benefit being payable. The stochastic confidence interval approach would convey this economic value to the financial statement reader, while the current deterministic approach does not.

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As the Board considers the extent to which contingent amounts should be valued in a probabilistic manner, they should also consider whether the more useful disclosure is a point estimate or a range with a confidence interval. We acknowledge the significant difficulties inherent in reporting ranges and confidence intervals. However, as the recognition model becomes more assumption-dependent (for example, because of the incorporation of probability analysis), the disclosure and reporting model may need to adapt to more accurately depict the inherent uncertainties. If the Board believes that more sophisticated measurement techniques than historical cost are warranted, then using the more sophisticated techniques in reporting those measurements may also be necessary.

- 5. Paragraph 54 notes that the proposed language of IAS 37 precludes recognition of liabilities where liabilities cannot be measured reliably. We concur with that statement, but note that reliability is a statistical measure. We believe that further elaboration of the use and/or definition of reliability is important.
- 6. With regard to question 9, we agree that contingency (actuarial) mathematics should be used to measure contingencies where appropriate. As noted above, contingency mathematics may not be appropriate in valuing one of a kind transactions. Also, probability analysis typically assumes that various events are independent, or at least have reliable co-variances. But for events that are under control of management, the independence vanishes and the use of contingency mathematics becomes far more problematic. In addition, the effectiveness of these requirements will depend on the implementation details, some of which will prove to be very complex. For example:
  - A. In reflecting probabilities, what types of probabilities should be reflected?
    - Potential company bankruptcy
    - Company growth/shrinkage
    - Segment disposal

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- Reinsurance of a block of business (or closing it to new customers)
- Product obsolescence
- Employee obsolescence (layoffs)
- Pension plan termination/freeze
- B. To what extent should the assumptions behind the probability measurement be disclosed? How can the disclosures be made without disclosing proprietary information about anticipated company operations? Is disclosure of a percentage likelihood of bankruptcy a good idea?

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C. How does one audit a projection of future company operational decisions?

Once again, we appreciate your consideration of these thoughts. If you have any questions regarding this information, please contact Steve Alpert at 212 345 8566 or Jim Verlautz at 612 642 8819.

Yours truly,

Ethe E. K.

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Ethan E. Kra, F.S.A. Worldwide Partner and Chief Actuary – Retirement

Copy: Steve Alpert, F.S.A. James F. Verlautz, F.S.A., C.P.A. (Inactive)

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