



**ASSOCIATION ACTUARIELLE INTERNATIONALE
INTERNATIONAL ACTUARIAL ASSOCIATION**

November 3, 2006

Ms. Li Li Lian
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International Accounting Standards Board
30 Cannon Street
London, EC4M 6XH
United Kingdom

Dear Ms Lian,

Re: IAA comments on *Preliminary Views on an improved Conceptual Framework for Financial Reporting*

In response to the request for comments on the Discussion Paper, *Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information*, I am pleased to transmit on behalf of the International Actuarial Association (IAA) our comments and recommendations.

These comments have been prepared by a task force of the Committee on Insurance Accounting of the IAA. If, upon reading these comments, you identify any points that you would wish to pursue, please do not hesitate to contact the chairperson of the Committee on Insurance Accounting, Sam Gutterman, or any of the other members of the committee. The IAA will be pleased to develop these ideas further with you.

Yours sincerely,

Yves Guérard
Secretary General

Attachment: Comments

A Commentary on the Discussion Paper
PRELIMINARY VIEWS ON AN IMPROVED CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING:
THE OBJECTIVE OF FINANCIAL REPORTING AND QUALITATIVE CHARACTERISTICS OF
DECISION-USEFUL FINANCIAL REPORTING INFORMATION
Released by the International Accounting Standards Board: July 2006

INTERNATIONAL ACTUARIAL ASSOCIATION

The International Actuarial Association (the "IAA") represents the international actuarial profession. Our fifty-five Full Member actuarial associations represent more than 95% of all actuaries practicing around the world. The Full Member associations of the IAA are listed in an Appendix to this statement. The IAA promotes high standards of actuarial professionalism across the globe and serves as the voice of the actuarial profession when dealing with other international bodies on matters falling within or likely to have an impact on the areas of expertise of actuaries. The IAA appreciates the opportunity to provide comments on this IASB document.

DUE PROCESS

These comments have been prepared by a task force of the Committee on Insurance Accounting. The members of the task force and committee are listed in an Appendix to this statement. It has also been subject to the due process required for it to constitute a formal view of the IAA, and will be posted to the IAA's official web site.

GENERAL COMMENTS

The IAA is pleased to be given the opportunity to provide input to the IASB in the development of these important matters. The success of the IASB in developing a robust and consistent set of international accounting standards based upon sound conceptual principles is dependent, to a greater extent than most realize, upon the construction of a consistent and well-constructed foundation, its conceptual framework.

We strongly support the goal of convergence between the conceptual frameworks underlying accounting standards worldwide. This is a necessary precondition for consistent accounting standards, which will ease the current burden of different and sometimes inconsistent reporting in different jurisdictions by entities that operate in more than one jurisdiction, and on those who advise them. (In another context of convergence, we also believe that, as far as possible, prudential and accounting principles and requirements should, if not identical, be consistent. By consistent, we mean, for example, that if different measurement conventions are adopted for setting general insurance claim liabilities, they should make use of a common set of expected cash flows. Further, different conventions should only be applied where there is an explicit reason for the difference and any differences between accounting and published statutory information should be disclosed.)

The IAA's interest in this project arises, not only from the roles played by its members in insurance and a wide range of other financial institutions that manage a wide range of products and benefits, but also from our members' involvement in the broad field of pension plans and other retirement planning. It is our belief that this perspective offers valuable insights into aspects of the framework that are not as clearly delineated from other contexts. In particular:

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- Uncertainty and risk lie at the heart of the businesses, products and services that actuaries deal with, including insurance, investments and employee benefits. As a result, our members have considerable experience in the practical analysis, assessment and reporting of uncertainty and the financial consequences of uncertainty. Based on this experience, we believe that it is particularly important that the accounting for insurance, financial instruments and employee benefits be based on a conceptual framework that incorporates stochastic concepts appropriately. A stochastic approach is one that considers a robust set representing the whole range of possible outcomes and their associated probabilities. Rather than concentrating wholly on a single point estimate, it gives due recognition to the range of variation around that estimate.
- In common with the customers of all financial institutions, insurance policyholders, owners of financial instruments and participants in employee benefit programs can have rather different needs for decision-useful information than those of many other users. It is important that the framework should establish an environment in which those needs can be met, as far as possible, without compromise in meeting the needs of investors. This will reduce the need for extra work to provide adequate information to those customers.
- Most insurance contracts require payment in advance of the delivery of the service of insurance protection. In some cases there are periodic payments over an extended period that, while nominally required under the policy, are, in reality, at the option of the policyholder. When these payments have a substantially different pattern from that of the consequential benefits and risks transferred, they present particular challenges in providing useful, meaningful and representationally faithful treatment of the associated cash flows.
- There are similar challenges relating to benefits in insurance contracts that are obligations of insurers, but whose amount, timing and even the recipient of the benefit payments of which may be subject to broad discretion of the insurer.

We note that this set of preliminary views arises out of Phase A of an eight phase project. We therefore largely restrict our comments in this submission to the issues canvassed in this paper. We do, however, intend to make comments on the other phases, particularly B – Elements and Recognition and D – Measurement, when such comments are sought. In addition, the members of the IAA Conceptual Framework Task Force, listed below, welcome the opportunity to contribute to the development of views by the joint IASB/FASB project, by commenting on early drafts, particularly as they relate to the treatment of uncertainty in the definition, recognition and measurement of assets, liabilities, equity and revenue.

While the discussion of objectives in Chapter 1 does go some way towards better accommodation of the needs of a wide variety of users, we believe that it should go further. While the emphasis is rightly placed on the needs of *investors* and *creditors* (as defined), that emphasis should not be so strong as to ignore the needs of other significant groups of users, when those needs can reasonably be accommodated without compromising the needs of investors.

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In relation to the qualitative characteristics discussed in Chapter 2, our principle concern is, as might be expected from our background, with the way in which uncertainty is treated. This will emerge in more concrete form in relation to recognition and measurement, but it is important that the qualitative basis also properly reflect the reality of uncertainty. There are four main underlying themes involved.

- The first is that uncertainty is inherent both in the estimation of many economic and financial quantities and, in many cases, in the quantities themselves. This presents an inherent problem in a context where it is assumed that these quantities can each be represented by a single number. To do so suppresses an important quality of that quantity: its uncertainty.
- A related consideration is that uncertainty itself has an economic value and associated price. This may be seen clearly in the fact that individuals and corporations judge it worthwhile to insure against a wide range of perils and in the importance of insurance in commerce. It is also an important factor in the pricing, including market pricing, of most financial assets and liabilities. An important characteristic of the value of uncertainty and risk is that they are not generally additive. The insurance industry exists because the value of certain classes of pooled uncertainty is less than the sum of the values of the individual uncertainties in the pool.
- A further consequence is that it is seldom possible to specify a uniquely correct estimate of an uncertain quantity. This requires absolute knowledge of the underlying stochastic process. Although this is possible for certain theoretical constructs, such as the toss of a fair coin, but reality seldom, if ever, exactly mirrors such constructs. There will likely, for example, be manufacturing defects in a real coin.
- Due to the complex nature and linkages involved in many quantities, internal consistency in the parameters and assumptions inherent in related measurement of the cash flows being estimated is important.

Another major issue involves the nature of financial reporting. A financial report presents a perspective of financial position and performance and, inevitably, embodies a viewpoint. An important aspect of standard setting is to decide on the viewpoint that is most appropriate in the context of the users and the entities and transactions being reported on, and to select accounting conventions based on that viewpoint.

It is important to distinguish this selection of accounting conventions from the selection of a mathematical model or models as an aid in determining estimates. This latter is a pragmatic matter that should be largely left to those experts making the estimates. The framework and accounting conventions should specify the objectives of the mathematical model applied, but not the model itself or its parameters.

We are also concerned that the discussion of consistency does not extend to the way in which different elements are combined within financial reports, as when the value of plant and equipment is added to real estate and investments. This is particularly vital when one is to be

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subtracted from the other since small inconsistencies between the approaches used to value items of similar magnitude, can result in very large proportionate variations in the difference between them, as when liabilities are subtracted from assets to give net assets. Similarly, if their combination involves arbitrary decisions, the results provide potentially misleading results. (As an aside and in a somewhat lighter vein, it is well known that, if you add apples and oranges, the answer is a lemon; but if you subtract apples from oranges, the answer can be totally bananas.)

In the balance of this submission, we expand on these general points and offer specific comments in relation to the various sections of the discussion paper.

SPECIFIC COMMENTS

Introduction

While we agree that (IN5) the Framework should not override more specific standards, standards should be consistent with the framework. If there appears to be a need for an individual standard to be inconsistent, this is an indication either that the standard has not been properly crafted or that the Framework is not sufficiently general to accommodate the circumstances in which the standard must operate. In the latter case, there is a danger that, if similar circumstances apply under standards that do comply, they will lead to inappropriate financial reporting under those other standards. We accept that, in an imperfect world, such inconsistencies are inevitable, but where they do arise, they should be accorded attention on a priority basis.

If this is not done, inconsistencies are likely to arise between the accounting treatment of similar transactions or quantities, subject to different standards. For example, there is considerable scope for such tensions and arbitrage opportunities to arise in the measurement of insurance contracts and other financial instruments.

In IN1, third sentence, we prefer the term "describes" rather than "identifies".

Chapter 1

We feel that, as in previous versions, the narrowing of the focus to general purpose financial reporting is not given sufficiently immediate prominence. Perhaps this might be accomplished by changing the title to *Conceptual Framework for General Purpose Financial Reporting* and incorporating part of OB11 in OB2. The chapter name could then become, simply, *Objectives*.

Likewise, it could be helpful to bring forward, from OB26, the idea that general purpose financial statements have a limited scope.

OB2 might then read:

The objective of financial reporting is to provide information that is useful in making investment, credit, and similar resource allocation decisions. Some users of such information are able to specify the information that they require from an entity by requiring special purpose financial reports that are outside the scope of this framework. Likewise, there are specialised tasks, such as an estimate of the value of an entity, that require more detailed and extensive information, including relevant information about external conditions. General purpose financial reporting is intended to meet the general

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needs of potential users who must rely on the information provided in general purpose financial reports. In this framework, unless explicitly qualified, the term user should be restricted to such users. (Paragraphs OB6–OB9 discuss the potential users of financial reporting information.)

We also suggest that it would be desirable to introduce the concept of an accounting convention at this point. This might be done by adding a paragraph after OB2 in the following manner.

Financial information can be presented in a variety of ways. For example, the spare parts inventory of a repair shop might be recorded at cost, replacement value or market value. If individual instances of a particular item are not traced, there is a choice between FIFO and LIFO. These are all accounting conventions. The choice of accounting convention, in the context of a particular accounting standard, should reflect the needs of the users considered in the context of the financial reports taken as a whole.

In OB6, the use of the term *creditor* is not given its intuitive meaning. In general usage, creditors include all those to whom the entity owes money, so that categories a, c, d, e, f and g all include creditors from time to time and to a greater or lesser degree. One solution that might address this concern is to substitute the word *debt investor*. Similarly, the use of the term *investor* as restricted to equity investors is likely to cause misunderstanding. Given that it is often used in the phrase *investors and creditors* which, as defined, coincides with the normal usage of investor, it would be helpful to substitute *investor* for this phrase. This would require consequential simplifications to subsequent paragraphs.

OB7 might then read:

As used in the framework, the term investors refers to equity and debt investors. Equity investors include present and potential holders of equity securities, holders of partnership interests, and other owners; as well as their advisors. Debt investors include present and potential institutional and individual lenders and their advisors. (Investors include both those who obtain their interests from the entity and those who obtain their interests from other holders of the entity's equity or debt instruments. In other words, a party may become an entity's investor or creditor either directly or indirectly.)

In OB6c, it should be noted that suppliers also have an interest in whether the entity is likely to continue to want the goods and services that they provide. This could be accommodated by adding a few words:

...and that it will continue to be in the market as a potential customer.

In OB6e, we would like to point out that customers can be divided into two groups: those who receive their goods and services at or before the time of payment and those who pre-pay and, therefore, become creditors (in the broad sense) until delivery or later. A suggested additional sentence is:

Where payment is made before delivery, customers stand to suffer a loss if the entity cannot deliver.

Another important category of creditors (in the broad sense) is (insurance) claimants. These include those with a valid claim (for example, arising from a breach of a duty of care or, in the

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case of a claim against an insurer, as a policy beneficiary) against the entity. Again, the concern is the entity's ability to pay. It is probably not necessary to add this as a separate item or as second example in OB6g, as it is not intended that the list of users should be exhaustive, but this group is important in the context of insurance, where their interests overlap heavily with those of customers (policyholders).

In the case of financial service entities, the distinction between customers and investors is not clear-cut. It is also, perhaps, confusing to refer to tax, when taxation authorities almost always demand special purpose financial reports. This, and the changes suggested above, might be accommodated by rewriting OB8 as follows.

Investors generally provide cash to an entity with the expectation of receiving a return on, as well as a return of, the cash provided; in other words, they expect to receive more cash than they provided. Other potential users also often have claims to cash payment by the entity. For example, at a given date, a supplier might have a right to payment for goods delivered, a customer might have a right to a cash refund, or an employee will usually have a right to accrued pay and other entitlements. However, such parties are not included in the category of investors because those entitlements arise out of their primary role, which is not as a provider of funds to the entity. For instance, customers' rights to receive goods or services may be more important to them than any right to receive a cash refund or other cash payment. Nevertheless, information that satisfies the needs of investors is likely to be useful to those parties as well.

In the case of some customers of financial service providers, this distinction is far less clear. Bank depositors and life insurance policyholders, in particular, may place greater value on the investment aspects of their relationship with the financial institution or distributor more than the service they receive.

While the assertion in OB12, that *investors and creditors* are the most prominent external groups, is commonly true, it is not universally so. For insurance companies and banks, the dominant group includes customers – policyholders (and claimants) and depositors respectively, and insurance regulators.

The assertion in OB13 that the information needs of others will be satisfied by the information tailored to the needs of *investors and creditors*, is not universally true. An example of this is given by the standard practice of recording debt liabilities discounted at a rate that includes an allowance for default. Although this meets the information needs of equity investors, it is less explicit regarding the risk of default for creditors. If the same treatment is applied to insurance liabilities, it again may meet the information needs of equity investors, but can be seriously misleading for policyholders and claimants. It would be useful to further explore examples of the different types of interest of these two types of users so that users of the framework could more easily gain insight regarding the relative perspectives and interest that they are likely to have.

The proper approach is, where such conflicts exist in relation to a significant class of general users, to provide supplementary information. This issue is mentioned, in a way, in BC1.27, but

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should be brought forward into the standard itself. This could be done by substituting the following for the final sentence of OB13.

Where such information does not satisfactorily meet the needs of a major group of other users, consideration should be given to whether supplementary information to address those needs can be provided without undue cost or loss of clarity.

Although performance measurement is mentioned in OB22 and OB23, we do not feel that it has been given adequate prominence here. In fact, the only reference to it is with respect to accrual accounting (OB22) and cash flows (OB23). We feel that the income statement, performance report and supplementary information provide information that is useful to users. Indeed, in some cases, including insurance, cash flow information is of limited value in assessing financial performance, and can prove misleading. The principles underlying such reports should be given far more emphasis in the framework.

It could be noted, in OB25 or in a new paragraph, that an entity's assets and liabilities can also change in value independent of an explicit financial transaction due to circumstances outside the entity's control. Examples include the occurrence of an insurance claim, reassessment of mineral reserves, the failure of a creditor and changes in market values of investments. Depending on the measurement attributes adopted, not all of these will affect the values shown. In some cases, the entity may not even be aware of the change.

Chapter 2

QC4 makes the point that users of financial information should not need the degree of expertise that is needed to prepare that information. There is, however, a degree of expertise, which varies according to the nature of the information presented, needed to properly interpret the information. These different degrees of expertise may not be immediately apparent to all users. Due to the nature of the information involved, some users may need to seek expert advice in order to be able to make sound economic decisions on the basis of the information presented, although we agree that every effort should be made to use language that would facilitate broad understandability.

Regarding QC5, which refers to the level of care expected of those who prepare financial reports, an important aspect of that duty of care is the use of appropriate experts, where such expertise is required. These points could, perhaps both be encompassed by expanding QC5 as follows:

... Proper application includes the use of appropriate experts where special expertise is required. Where special expertise has been applied, it is desirable that this should be explicitly indicated, to indicate to users that they, too, may need expert guidance to fully understand the information provided.

It may be desirable to extend the definition of timeliness, to encompass the concern that out-of-date information can inappropriately influence decisions. This might be done by rewording the last sentence of QC8.

... Timeliness — making information available to decision makers before it loses its capacity to support sound decisions — is another aspect of relevance.

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We believe that the concept of expectation must be distinguished from that of prediction. If the expectation is that the outcome of rolling a die is 3.5, nobody expects the one actual result to be 3.5. This possible confusion emerges in QC13, where the second sentence should read:

... Information that confirms past expectations decreases the uncertainty (increases the likelihood) that the results will be consistent with the previous expectation.

In relation to QC21, it may be helpful to distinguish between estimation and the choice of accounting convention. This relates to the discussion currently in QC18, where the choice of accounting convention is discussed. Historical cost approaches, such as amortisation schedules, typically do allow exact measurement, but do not necessarily provide the most relevant or useful information. Attempts to discern current value almost invariably involve estimation.

We feel that it is important to emphasise that a faithful representation of an uncertain quantity must, indeed, represent that uncertainty faithfully. (This point is, of course, recursive in nature. If the degree of uncertainty is uncertain, then the uncertainty of the uncertainty needs to be faithfully represented. But we believe that this further enhancement need not be stated explicitly.) Certainly, if uncertainty is material, then it needs to be disclosed. Uncertainty also has a value that, if material, must be represented appropriately.

In QC21, it should be noted that accuracy and precision are not the same thing. Precision is a technical term and can be expressed in terms of the number of significant digits or in terms of a standard error around an estimate with a greater number of significant digits than would otherwise be justifiable. It would be preferable to use a term such as *exact* or *exactness* in QC21 and QC22.

While accurate estimates are desirable (QC21), it is not helpful to state that there is a minimum level of accuracy required for faithful representation of an economic phenomenon. The accuracy of the estimate has an upper bound that is a function of the uncertainty of the quantity being estimated. An estimate that purports greater accuracy is not necessarily a faithful representation of an item, any more than one that grossly overstates the uncertainty.

In the case of extreme uncertainty, it is possible that a faithful representation of an economic phenomenon should focus on the uncertainty involved, rather than the estimate. This requires a different form of presentation, but does not imply that the phenomenon cannot be faithfully represented. Indeed, failure to present material uncertainty violates the requirement for faithful representation. Sound decisions cannot be made in ignorance of uncertainties that are likely to affect outcomes materially.

Suggested changes to QC21 are as follows.

Economic activities take place under conditions of uncertainty, and most financial reporting measures involve estimates of various types, some of which incorporate management judgment. With the possible exception of the amount of cash that an entity controls, it rarely is possible to develop a current measure of an economic phenomenon that does not involve some degree of uncertainty. For instance, an entity's receivables could be represented as the sum of the legal claims embodied in the receivables; however, a more relevant representation would be the estimated amount of cash inflows that will

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result from the receivable that requires reflection of the effects of uncertainty about whether the receivables are collectible. An estimate of receivables that are collectible at a point in time may be a faithful representation, at the time the estimate is made, even though the amount eventually collected differs from the previous estimate. To represent an economic phenomenon faithfully, an estimate must be based on the appropriate inputs, and each input must reflect the best available information. Although accuracy of estimates is desirable, faithful representation implies neither exactness in the estimate nor certainty about the outcome. To imply a degree of exactness or certainty of information that it does not possess would diminish the extent to which the information represents faithfully the economic phenomena that it purports to represent.

It would be worthwhile to add a comment about relevance to QC22.

QC22. Some financial reporting measures that are often thought of as exact, or at least more exact than the alternatives, prove not necessarily to be so precise upon closer inspection. For example, measures based on original cost have long been regarded as highly precise representations of economic phenomena, and it is true that the cost of acquiring assets can often be determined unambiguously. However, if a collection of assets is bought for a specified amount, the cost of each individual item may be impossible to ascertain. The problem of determining cost becomes more difficult if assets are fungible. If an entity has made several purchases at different prices and a number of disposals at different dates, only by the adoption of some convention (such as first-in, first out [FIFO]) can a cost be allocated to the assets on hand at a particular date. The result is that what is shown as the assets' cost is only one of several possible values, and it is difficult to verify that the chosen amount faithfully represents the economic phenomenon in question, that is, the purchase price of the assets. Even if such an accounting convention does lead to an exact measure, however, it is also necessary to consider whether that measure is the most relevant in the context.

The description of verifiability, as given in QC23-26, is of concern in the context of uncertain economic phenomena. In the face of material uncertainty, direct verification (as defined) of an estimate is not possible. If the obvious interpretation is adopted, indirect verification, by recalculation using the same method may not be the only, or even the best, alternative. It is often preferable, in the face of complexity, to apply a variety of methods of estimation (such as different actuarial models) to obtain a range of results, each with its own estimate of uncertainty. Using this approach, it is not necessary to reproduce the result exactly. The chosen result is considered verified if it is statistically consistent with the results coming from the other models.

When applying this *multiple model* approach, the selected model should be either one that produces a result near the middle of the range of probable results or the one that is thought to reflect best the reality being modelled: preferably both. While this approach does not guarantee the appropriateness of the result either, it does provide a greater degree of assurance than a total reliance on a single model. It also contributes to the understanding of uncertainty, particularly if the model results include explicit estimates of uncertainty.

The use of a single model should be restricted to cases where there is a strong consensus that a particular model is appropriate or where the use of multiple models is judged not to be cost-

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effective. In such cases, the estimated uncertainty of the resulting estimate should reflect any doubts about the relationship of the model to reality. This, however, should be left as a technical judgement, as over-prescription of methods is likely to inhibit new and better ways of estimating uncertain quantities.

It is, however, possible to adopt a different interpretation, that is, the use of *multiple models* can be considered to be a single method. The confusion, that the existence of these alternative interpretations causes, could be avoided if the word *approach* were used. We suggest that QC23 be changed as follows.

To assure users that information faithfully represents the economic phenomena that it purports to represent, the information must be verifiable. Verifiability implies that different knowledgeable and independent observers would reach general consensus, although not necessarily complete agreement, either:

- a. that the information represents the economic phenomena that it purports to represent without material error or bias (by direct verification); or*
- b. that the chosen recognition or measurement approach has been applied without material error or bias (by indirect verification).*

To be verifiable, information need not be of the form of a single point estimate. A range of possible amounts and the related probabilities can also be verified. In this case, unless an identical approach is used, it is unlikely that an identical set of numbers will result. In this context, the requirement is that the answers must be mutually consistent (as discussed in paragraph QC25).

Paragraph QC25 should be modified to remove the implication that indirect verification is restricted to the duplicate application of a single method and to provide guidance as to what is meant by mutually consistent. Consideration could be given to splitting this paragraph in the following way.

Verification may be either direct or indirect. With direct verification, an amount or other representation itself is verified, such as by counting cash or observing marketable securities and the quoted prices for them. With indirect verification, the amount or other representation may be verified by checking the inputs and recalculating the outputs, using the same or a different method or methods and observing that the results are either mutually consistent or not materially different. An example of the first approach is verifying the carrying amount of inventory by checking the inputs (quantities and costs) and recalculating the ending inventory using the same cost flow assumption (for example, average cost or FIFO). If the second approach is adopted and the difference is material, it is necessary to define mutual consistency.

Two estimates are mutually consistent if each is a reasonably likely outcome of the probability distribution underlying the other. Being probabilistic, this inherently requires a judgement as to how much freedom is given by reasonably likely. If the underlying probability distributions are explicit, it is possible to quantify the likelihood that a particular estimate, or one less likely, would have resulted by random chance. If this probability is reasonably high, say greater than 50%, in both directions, then few would dispute that the results are mutually consistent. If it is low, say less than 0.5%, then mutual

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consistency should normally be rejected. In between these is the grey area. A common standard is that consistency should be questioned if the likelihood is less than 5%, but this is a matter of judgement. It should also be noted that, if twenty such comparisons are made, one is expected to have a likelihood less than 5%. In this intermediate range, say between 1% and 25%, it may be more satisfactory to disclose the likelihood, rather than either accept or reject mutual consistency.

More often, one or both of the probability distributions will not be sufficiently well known to perform such calculations. In such cases, judgement is applied. If this judgement is applied by professionals with suitable experience and expertise, then it is reasonable to rely on it. The evaluation of the experience and expertise of the professionals is, itself, a matter of judgement.

We are also uncomfortable with QC26 which unjustifiably assumes that indirect verification is unable to provide any help in reducing model errors. Although referred to in QC18, it ignores the importance of an appropriate accounting convention. We suggest:

Direct verification is desirable because it gives assurance that information faithfully represents the economic phenomena in accordance with the chosen accounting convention. In contrast, indirect verification using a single model tends to minimize only application bias. Even though different verifiers reach consensus, an indirectly verified amount may not faithfully represent the economic phenomena that it purports to represent because the method used may give rise to material error by failing to reflect aspects of the real world adequately. This shortcoming can be reduced, but not eliminated, if the approach adopted in estimation and verification involves models that incorporate different aspects of reality and/or the same aspects of reality in different ways. This helps to reduce the errors that arise because models are approximations to reality, but can do nothing about the fact that past experience, on which all models must be based, is unlikely to match expected future experience exactly. Even though indirect verification does not guarantee the appropriateness of the method used, it does provide some assurance that the method used was applied carefully and without error or personal bias on the part of the one applying it. In many situations, knowledgeable and independent observers may need to apply both direct and indirect verification. It should be noted that, in either case, the use of an appropriate accounting convention is vital. While it is desirable to minimise the exercise of judgement, it is better to have a useful estimate based on the application of judgement within an appropriate accounting convention, than a measure that cannot be used as a basis for sound decisions because the accounting convention is inappropriate.

Another consequence of uncertainty is that random fluctuations are to be expected. As a result, if successive estimates of the same quantity are made *ab initio*, they can be expected to vary, even in the absence of any real change. This can result in meaningless variation, generating spurious profits and losses. This issue is not addressed here. We believe that an additional paragraph is required, either after QC26 or in the discussion of consistency (QC35-38).

When estimates are based on observation of uncertain phenomena, those observations are subject to random variation. Unless a very large body of observations is available, this uncertainty flows through to the estimates. As a result, even if nothing has changed, successive estimates, based on the latest available data, are likely to be different from

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previous estimates. Conversely, real changes can be masked by offsetting random variation, or can be exaggerated. If successive estimates of the same or comparable quantities are made independently of each other, this can lead to spurious variation. In some cases, this spurious variation can be substantially greater than the real underlying change from period to period.

In such circumstances, it is desirable to make successive estimates in a way which strikes an appropriate balance between stability in the face of random variation and sensitivity to real change. Once an estimate has been made on the basis of data that embodies random variation, it should only be changed to the extent that later data provides evidence that the previous estimate should be changed.

The requirement for neutrality might be read as a requirement that estimates should not be adjusted for risk. In the case of an accounting convention that focuses on economic value or price, this is incorrect, since risk and uncertainty have economic value. One way of reflecting this would be to extend QC28 with the following sentences.

... This does not, however, mean that risk should be not be recognised. Risk and uncertainty do have an economic value, as evidenced by the fact that individuals and corporations judge it worthwhile to insure against a wide range of perils. This value is also an important factor in observable prices of most other financial instruments. Where the focus of the accounting convention is on market or economic value, ignoring uncertainty would not be a faithful representation and would introduce bias by violating the requirement for completeness.

This also relates to BC2.22, which should be extended in a similar manner.

The discussion of comparability and consistency in QC35-38 omits an important point – that there is also a need for internal consistency among the accounting conventions applied in a single period within a single entity. This is important when quantities are to be added or compared and absolutely vital when important decisions are to be based on their difference. This could be accommodated by amending QC35 as follows.

Comparability, including consistency, enhances the usefulness of financial reporting information in making investment, credit, and similar resource allocation decisions. Comparability is the quality of information that enables users to identify similarities in and differences between two sets of economic phenomena. Consistency refers to the use of the same accounting policies and procedures from period to period within an entity, in a single period across entities or, in a single period for a single entity. Comparability is the goal; consistency is a means to an end that helps to achieve that goal.

This should be complemented by an extension to QC36.

... This is particularly important when one quantity is likely to be subtracted from another. If, for example, an insurance company shows its assets at market value and its liabilities as the undiscounted sum of expected cash flows, it is difficult to ascribe any meaning to the resulting net asset calculation. Further, a change in market interest rates will result in a profit or loss that bears no relationship to economic reality.

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Another constraint on financial reporting that should be mentioned is confidentiality. This might be covered in a new paragraph, perhaps after QC57.

Some information, such as information involving business or production secrets, may be relevant for users but might endanger the future success of the entity or compromise its position in negotiations or litigation. Reporting that information may simultaneously inform about the financial condition of the entity and damage that financial condition. In insurance, for example, information about claim probabilities and costs is vital business knowledge, as well as being potentially useful financial information. Detailed information regarding a business segment might enable competitors to deduce information that a market leader has spent years accumulating and provide entry to that market without the costs that the market leader has had to carry. Another example is the situation of an entity involved in a single large legal dispute. Disclosing the entity's assessment of the economic impact of that dispute may compromise its ability to negotiate a satisfactory resolution.

Editorially, note that the construction *claims to* appears in a number of places. More common usage is *claims on*.

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