



**ASSOCIATION ACTUARIELLE INTERNATIONALE
INTERNATIONAL ACTUARIAL ASSOCIATION**

October 3, 2008

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir

Re: IAA comments on the Exposure Draft of *An improved Conceptual Framework for Financial Reporting: Chapters 1 and 2*

In response to the request for comments on the Exposure Draft of *An improved Conceptual Framework for Financial Reporting: Chapter 1: The Objective of Financial Reporting and Chapter 2: Qualitative Characteristics and Constraints of Decision-useful Financial Reporting Information* (the ED), I am pleased to transmit on behalf of the International Actuarial Association (IAA) our comments and recommendations.

These comments have been prepared by the Committee on Insurance Accounting of the IAA. If, upon reading these comments, you identify any points that you wish to pursue, please do not hesitate to contact the chairperson of that Committee, 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](#): IAA comments

**A Commentary on the
EXPOSURE DRAFT ON AN IMPROVED CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING
CHAPTERS 1 AND 2
ISSUED BY THE INTERNATIONAL ACCOUNTING STANDARDS BOARD: MAY 2008**

International Actuarial Association

The International Actuarial Association (the “IAA”) represents the international actuarial profession. Our sixty full member actuarial associations represent more than 95% of all actuaries practicing around the world and are listed in an Appendix to these comments. 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 is pleased to be given the opportunity to provide input to the IASB in the development of these important matters. These comments have been prepared by the Committee on Insurance Accounting and the members of its task force on these issues, the members of which are listed in the Appendix.

IAA Commentary

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 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 what has sometimes been inconsistent reporting in different jurisdictions, especially important for 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 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 employee and retirement benefits. It is our belief that this perspective offers valuable insights into aspects of the framework that are not as clearly delineated from other contexts. Further, actuaries are the only profession organized on an international basis that applies statistical methods for accounting purposes. Important conceptual issues arise when measurement goes beyond simple counting and, because there is significant uncertainty, requires estimates based on statistical analysis of the available data. In particular:

- Uncertainty and risk lie at the heart of the businesses, products and services with which actuaries deal, including insurance, investments and employee benefits. Consequently, our members have considerable experience in the practical analysis, assessment and reporting of uncertainty, as well as in the measurement of 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. The stochastic approach, that is, the recognition of risk and uncertainty, which is now increasingly reflected in IFRSs, is one that considers the whole range of possible outcomes and their associated probabilities by applying suitable statistical techniques to derive both an “expected value” (mean or average) and a reflection of the surrounding uncertainty. Rather than concentrating wholly on a single (often the most likely) outcome, it gives due recognition to the range of variation. An appreciation of uncertainty is often crucial to making sound decisions by users of financial information.
- 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 a context within which those needs can be met as far as possible, without compromise in meeting the needs of investors. For financial institutions in particular, and to a lesser extent in other entities, it may be difficult to discern clear categories of stakeholders, such as investors, creditors etc. A narrower focus for general purpose financial reports would require an arbitrary borderline that would be very difficult to define in general terms. A broader definition of primary user in the Framework will facilitate the necessary flexibility in specific IFRSs.
- 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 to keep the contract in effect, 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. This may require the recognition of customer intangibles due to the inter-related nature of many longer-term insurance contracts.
- There are similar challenges relating to benefits in insurance contracts that are obligations of insurers but which that are subject to broad discretion of the insurer with respect to the timing, the amount and even the recipient of the benefit payments.

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 addressed in this paper. We do, however, intend to make comments on the other phases, particularly B – Elements and Recognition and C – Measurement, when such comments are sought. In particular, as foreshadowed above, there are some complex borderline issues that arise in the insurance industry that relate to the definition of reported items, in particular the definition of assets and liabilities, in the context of the long-term regulation and trust-based relationships existing often

between insurers and policyholders, rather than relationships based on precisely defined legal terms. Open issues such as formally non-enforceable but contractual premiums and formally discretionary but practically unavoidable benefits are well-known to the IASB Board. We offer the IASB our support in solving those issues in further stages of the conceptual framework project. Consequently, the members of the IAA Conceptual Framework Task Force, listed below, would welcome the opportunity to contribute to the development of views prepared in conjunction with 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.

Our comments in the balance of this submission are divided into three sections:

- general comments on what we believe to be the key issues;
- answers to the specific questions asked; and
- more detailed Specific Comments and suggestions on other substantive issues.

1 General Comments

OB – Objectives

The discussion of the main user included here has confused us; as a result, we believe that additional clarification is needed. The principle in OB2 refers to “present and potential equity investors, lenders and other creditors in making decisions in their capacity as capital providers”, while OB5 refers to “all capital providers (those with a claim on the entity’s resources)”. We are concerned that, while BC1.22 in its reference to *the full range of capital providers* suggests that this difference may be unintended, OB2 refers only to examples implying a current claim while OB5 implies that capital providers are restricted to *those with a claim on the entity’s resources*. Further, OB6 refers to “An entity obtains economic resources from capital providers in exchange for claims on those resources.” As a result, it is unclear to some of us whether the Board intends to restrict the main users to capital providers with an actual claim to the entity’s resources (i.e. users which are present or potential both capital providers and creditors), or whether it intends to include *all capital providers*, as in OB5, and does not recognise that there might be other capital providers. We suggest that this be clarified and made consistent.

In our view, unless the restriction is intentional, in which case this point should be explicitly made, it would be preferable to list either *equity investors, lenders and other capital providers* or *equity investors, lenders, creditors and other capital providers*. The point is that, particularly in the field of financial services, substantial amounts of capital are provided by customers (depositors and policyholders) and, in the case of insurance contracts, claimants. While these customers arguably serve in a creditor function, it is desirable that their status as capital providers should not be excluded from acknowledgment in the respective IFRS. Capital can also be provided by borrowers if the value of the collateral given exceeds the amount borrowed and by suppliers, to the extent that they provide resources that the entity would otherwise have to fund itself.

We note that, in either case, the focus of general purpose financial reporting is toward capital providers in their capacity as capital providers and not to interests that they might have in other capacities.

We are also concerned that, while uncertainty is mentioned in a number of places, these references do not adequately reflect the crucial role that a proper assessment of uncertainty plays in the decisions to be made by present and potential capital providers. That is of particular concern in cases, such as insurance, where that uncertainty can be one of the most important considerations in making soundly based decisions (i.e., as indicated in many IASB Board discussions, value is rarely a summation of future checks payable or receivable). This is a major weakness in the current *Framework* and has been, therefore, a major source of difficulty in framing accounting standards for insurance contracts that are consistent with that *Framework*. While detailed discussion of uncertainty belongs properly in later sections of the new *Framework*, this discussion needs to be properly introduced in the discussion of Objectives. In section 3 below, we suggest how this might be accomplished.

QC – Qualitative Characteristics and Constraints

We are in broad agreement with that discussion of qualitative characteristics in chapter 2. Our primary 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 reflect the reality of uncertainty properly. There are four main underlying themes involved:

1. Uncertainty is inherent both in the estimation of many economic and financial quantities and, in many cases, in the quantities themselves. This presents a fundamental 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.
2. Related to (1) 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 values of uncertainty and risk is that they are not generally additive. The insurance industry exists because the value placed on certain classes of pooled uncertainty is less than the sum of the values of the individual uncertainties in the pool. This fact does not sit comfortably within the current *Framework* that implicitly assumes that the whole is equal to the sum of the parts and fails to properly reflect the need for information about the value of uncertainty and the need for business techniques to cope with uncertainty.
3. In practice, it is rarely, if ever, possible to specify a uniquely correct expected value (mean) 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, reality seldom, if ever, exactly mirrors such constructs. For example, coins are typically asymmetrical and not uniformly weighted, with different designs for heads and tails.
4. Due to the complex nature and linkages involved in many quantities, internal consistency in the parameters and inputs inherent in related measurement of the cash flows being estimated is important.

Where there is material uncertainty, this has implications for verifiability. In this context, *measurement* actually means *estimation*. While this may not have been intended, many of those who prepare actuarial and statistical estimates might interpret the current description of verification literally, as implying a requirement to reproduce a particular estimate exactly, using the same data, inputs (assumptions) and methods. While this is one possible approach, it is not always the most appropriate form of verification. It may be preferable to consider alternative assumptions and methods, in which case the estimate adopted can be considered to be verified, if it lies within the range of each of the reasonable alternatives. We therefore suggest that this description be clarified to make it clear that, while the same accounting approach must be followed, different ways of applying that approach can be acceptable.

Another concern relates to the status of the Bases for Conclusions, in particular BC2.21, where there is reference to *selecting an amount from the midpoint of a range if a point estimate is required*. There is a danger that this could be interpreted too literally, as a universal requirement, rather than one of a number of possibilities whose merits depend on particular circumstances. If, for example, the weight of probability is concentrated at one end of the range, i.e., in the case of an asymmetric probability distribution, choosing the midpoint could be highly misleading. It would be preferable to refer to the *average, mean or expected value*, in cases where there is material uncertainty. Where there is material uncertainty as to what this mean is, further information is needed. In such circumstances, the ends of a range, and hence its midpoint, will also usually be vague.

2 Answers to Questions

OB – Objectives

- 1 The boards decided that an entity’s financial reporting should be prepared from the perspective of the entity (entity perspective) rather than the perspective of its owners or a particular class of owners (proprietary perspective). (See paragraphs OB5–OB8 and paragraphs BC1.11–BC1.17.) Do you agree with the boards’ conclusion and the basis for it? If not, why?

IAA response. We agree with this conclusion.

- 2 The boards decided to identify present and potential capital providers as the primary user group for general purpose financial reporting. (See paragraphs OB5–OB8 and paragraphs BC1.18–BC1.24.) Do you agree with the boards’ conclusion and the basis for it? If not, why?

IAA response. Please refer to our general and specific comments.

- 3 The boards decided that the objective should be broad enough to encompass all the decisions that equity investors, lenders and other creditors make in their capacity as capital providers, including resource allocation decisions as well as decisions made to protect and enhance their investments. (See paragraphs OB9–OB12 and paragraphs BC1.24–BC1.30.) Do you agree with that objective and the boards’ basis for it? If not, why? Please provide any alternative objective that you think the boards should consider.

IAA response. We agree with the decision that general purpose financial reporting should focus on the needs of all capital providers, but consider that the current restriction of this to holders of present claims on entity’s resources is neither necessary nor desirable. We refer to our proposals in our general comments above.

QC – Qualitative Characteristics and Constraints

- 1 Do you agree that:
 - (a) *relevance* and *faithful representation* are fundamental qualitative characteristics? (See paragraphs QC2–QC15 and BC2.3–BC2.24.) If not, why?
 - (b) *comparability*, *verifiability*, *timeliness* and *understandability* are enhancing qualitative characteristics? (See paragraphs QC17–QC35 and BC2.25–BC2.35.) If not, why?
 - (c) *materiality* and *cost* are pervasive constraints? (See QC29–QC32 and BC2.60–2.66.) If not, why? Is the importance of the pervasive constraints relative to the qualitative characteristics appropriately represented in Chapter 2?

IAA response. In each case, we agree.

- 2 The boards have identified two fundamental qualitative characteristics—*relevance* and *faithful representation*:

- (a) Financial reporting information that has *predictive value* or *confirmatory value* is relevant.
- (b) Financial reporting information that is *complete, free from material error* and *neutral* is said to be a faithful representation of an economic phenomenon.
 - (i) Are the fundamental qualitative characteristics appropriately identified and sufficiently defined for them to be consistently understood? If not, why?
 - (ii) Are the components of the fundamental qualitative characteristics appropriately identified and sufficiently defined for them to be consistently understood? If not, why?

IAA response. In general, we agree. In relation to faithful representation, however, we believe that some further discussion is required in respect of uncertainty.

In addition, it needs to be made clear that faithful representation is required for the entity as a whole, particularly when there are interactions between items that could render the values of those items, assessed in isolation, misleading. Examples of this include hedging or, in the insurance context, asset/liability matching and reinsurance, and uncertainty, where the uncertainty of the whole is typically less than the sum of the uncertainties of the parts, if those parts are considered in isolation.

- 3 Are the enhancing qualitative characteristics (*comparability, verifiability, timeliness* and *understandability*) appropriately identified and sufficiently defined for them to be consistently understood and useful? If not, why?

IAA response. Overall, yes. Again, some further discussion may be appropriate, in relation to comparability between interacting or interdependent elements as a necessary condition for faithful representation, and in relation to verifiability of uncertain results to avoid misleading guidance.

- 4 Are the pervasive constraints (*materiality* and *cost*) appropriately identified and sufficiently defined for them to be consistently understood and useful? If not, why?

IAA response. Yes.

3 Specific Comments

OB – Objectives

Capital Provider

As noted above, we are concerned that, in the attempt to clarify the concept of *capital provider*, it may have become unintentionally restricted. This could be avoided by replacing the phrase “*those with a claim to the entity’s resources*” in OB5 with “*those with a **current or potential claim on the entity’s resources***”, and replacing “*equity investors, lenders and other creditors*” in OB2 with either “*equity investors, lenders and **other capital providers***” or “*equity investors, lenders, creditors **and other capital providers***”. This would leave it open to the IASB to consider, in the context of an individual IFRS, whether it is appropriate to regard particular classes of potential users as capital providers.

On the whole, we prefer *equity investors, lenders and other capital providers*, in which case OB6c would refer to *capital providers* rather than *other creditors*. As this sub-paragraph does not pretend to be exhaustive, it may not be necessary to extend the examples given there, but in order to illustrate the source of our concern the following are some examples that might not be (or might be commonly thought not to be) considered to be creditors.

- An 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 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 a second example in OB6g, since 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), and also because the ability to pay is a concern of all capital providers.
- Another important source of capital for insurers is reinsurance. Reinsurers, in effect, provide a substantial source of capital, particularly in general insurance, where reinsurance enables individual insurers to cover much larger risks than they could support with their own capital resources.
- Implied capital is also provided, in many cases, by suppliers, who need to be able to assess the continued viability of their customers.

Priority

An important implication of the decision to target a wide range of capital providers is that different capital providers stand in different positions in a hierarchy of claims on the resources of the entity. Ostensibly, this hierarchy is determined by their respective contractual and legal relationships. In practice, timing can be a significant factor. If a particular group of capital providers is to make properly informed decisions, it needs to know its place in this hierarchy and the extent of any higher priority interests. This is a generalisation of the concept of gearing.

While the main requirements arising from this relate to disclosure, it is sufficiently important to be noted in the discussion of objectives. This might, for example, be done at the end of OB17 by adding the sentence:

Information about an entity's capital structure helps particular classes of capital providers to assess their place in the hierarchy of claims on the entity's economic resources.

or, in OB10, by changing the first two sentences to read:

An entity's capital providers are directly interested in the amount, timing and uncertainty of cash flows from dividends and interest, the sale, redemption or maturity of securities or loans and other payments as they fall due. However, the prospects for those cash flows depend on the entity's existing cash resources and, of more importance, on its ability to generate enough cash to pay its employees and suppliers and satisfy its other operating needs, to meet higher priority and earlier obligations when due, and to reinvest in operations. ...

Uncertainty

While uncertainty is mentioned in a number of places in this chapter, the discussion is limited and no mention is made of the fact that uncertainty, in itself, has an economic value, as evidenced by market pricing of uncertain cash flows. While this point emerges mainly in relation to Recognition, Measurement and Disclosure, it should be introduced in relation to both Objectives and Qualitative Characteristics. A suitable place in this Chapter might be after OB14 where we suggest the addition of the following:

By the nature, estimates contain uncertainty. This is typically a combination of uncertainty arising from the estimation process and uncertainty inherent in what is being estimated. This uncertainty has an economic value that can modify the value of what is being estimated and its extent is, therefore, information needed by capital providers.

A rather more pedantic point is that variability is not the sole source of uncertainty. Uncertainty arises from lack of knowledge as well as from the inherent variability of outcomes. This can be accommodated by adding some words to the third sentence of OB19, such as:

The uncertainty and variability of that return is also important, especially in assessing the uncertainty of future cash flows, as is information about the components of that return.

QC – Qualitative Characteristics and Constraints

Uncertainty

We believe that it is important to emphasise that a faithful representation of an uncertain quantity must 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 information about that uncertainty should be provided. Uncertainty also has a value that, if significant, should be represented faithfully. This point is made in the last sentence of QC12. However, what is not mentioned there is the economic value of uncertainty and how that relates to the concept of neutrality. This could be dealt with in a short new paragraph, following QC11, as follows:

Uncertainty also has an economic value. Markets typically place a lower price on an uncertain income stream than on a fixed income stream with the same expected value (average or mean). Likewise, the value of cash outflows is increased by uncertainty. To ignore this value is a violation of both completeness and neutrality. Any measurement that purports to reflect economic value must incorporate the value of any uncertainty.

Another concern relates to the Basis for Conclusions, in particular BC2.21, where there is reference to “*selecting an amount from the midpoint of a range if a point estimate is required.*” There is a danger that this could be interpreted too literally as a universal requirement, rather than one of a number of possibilities whose merits depend on particular circumstances. If, for example, the weight of probability is concentrated at one end of the range (an asymmetric distribution), choosing the midpoint could be highly misleading. We suggest that first sentence of this paragraph be re-written as follows:

Being careful in the presence of uncertainty includes searching for additional information to reduce uncertainty, reflecting the uncertainty of a range of potential amounts in making an estimate, or selecting an amount intended to reflect the expected value (average or mean), adjusted for the value of uncertainty, if a point estimate is required.

Consistency

The discussion of comparability in QC16-19 does not consider the need for internal consistency within the financial reporting for an entity in a single period. In practice, while capital providers are interested in the individual elements in an entity’s accounts, most decision making relies heavily on an assessment of the accounts as a whole. While general purpose financial reports have traditionally focused on their component elements, more recent developments, such as hedge accounting, reflect this need for a more holistic view. Two key derived figures are net assets and net profit. Both are derived as differences, assets minus liabilities and revenue minus expenditure, respectively. If incompatible accounting conventions are adopted for assets and liabilities or for revenue and expenditure, the usefulness of their respective differences is diminished. If the difference is small relative to its components, it can render the accounts to be totally meaningless.

If, for example, financial assets are valued at market or fair value and financial liabilities are amortised using historical discount rates, any change in interest rates introduces an element of distortion that militates against a faithful representation of the entity as a whole. For example, consider a liability of face value 100, payable in 10 years, backed by an asset, also with a face value of 100 and payable in 10 year, the net position, assuming no risk, at any time over those 11 years, is neither surplus nor deficit. If the asset is classified as held to maturity and amortised at the current discount rate of 5% per annum, its value after one year will be 64.46. If, however, the liability is valued at fair value and the market discount rate halves, to 2.5% p.a., its fair value would be 80.07, a “loss” over the year of 15.61. If the market discount rate doubles, to 10% per annum, fair value would be 42.41, a “profit” over the year of 22.05.

There are similar, but less severe, issues when incompatible accounting conventions are applied to quantities that are to be added together.

A new paragraph should be added after QC19, as follows:

It is also essential that the individual elements of an entity's accounts should combine to give a faithful representation of the entity as a whole. This demands consistency, or at least compatibility, between the accounting conventions adopted for those elements. Changes in circumstances should neither generate material spurious movements in the differences between the values of assets and liabilities, nor should genuine movements in those differences be hidden.

Verifiability

As discussed in our general comments above, the description of verifiability, as given in QC20-21, is of concern in the context of uncertain economic phenomena. While it may not have been intended, the third sentence of QC21 is likely to be understood by many as requiring the same technical methods, as well as the same accounting convention. This confusion arises because the word *methodology* appears to be used as a redundant synonym for *convention*, while actuaries and statisticians think of methodology as a particular way of applying techniques (methods).

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 for example conducting recalculation using the same technical 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 would be considered verified if it is statistically consistent with the results coming from the other models. This approach, while not wholly satisfactory if the range of results is material in accounting terms, is a consequence of the uncertainty itself. If the uncertainty cannot be reduced by better analysis or by gathering more information, it has to be accepted as a feature of reality.

While we see this as a technical, rather than a Framework issue, we believe that this *multiple model* approach is a preferable approach to both the original estimate and to verification where there is material uncertainty. Under this approach, the selected model should be either one that produces a result near the middle of the range of results generated by the various models or one that is thought to better reflect 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 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-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.

Paragraph QC21 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. We suggest the following:

Verification may be either direct or indirect. With direct verification, an amount or other representation is itself 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 accounting convention and the same or a different technical 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).

The associated guidance, which might be used in the Basis for Conclusions or, probably more appropriately, in IFRSs dealing with the issue of verification in specific cases, might be as follows:

If the second approach referred to in QC21 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 fifty percent in both directions, then few would dispute that the results are mutually consistent. If it is low, say less than 0.5%, then mutual consistency should normally be rejected. In between these lies a 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.

Materiality is also a consideration. A low level of likelihood is acceptable if the range is not material.

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 usual, in statistical practice, to rely on it

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 in the Exposure Draft. We believe some discussion of this issue, possibly in the Basis for Conclusions, is appropriate, such as the following:

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 previous estimates. Conversely, real changes can be masked by offsetting random variation, or can even 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 that 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.

Confidentiality

The constraint *cost* on financial reporting includes, for some industries, the issue of confidentiality. This might be covered in a new paragraph, with its own heading, perhaps after QC31. The examples, provided in square brackets in the following suggested wording, could perhaps be omitted or included in the Basis for Conclusions:

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 users about the financial condition of the entity and damage that financial condition and, as a result, simultaneously benefit and damage the interests of its capital providers. Such costs need to be recognised as a part of the cost/benefit analysis when deciding what information should be included in general purpose financial statements. There is also the point that excessive disclosure requirements may encourage concealment of sensitive matters. [An 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. Another example, in insurance, 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.]

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