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ONSTITUTION REVIEW

Empower Users of Financial Information as the IASC Foundation's Stakeholders

Presentation by Nicolas Véron, Research Fellow at Bruegel

Constitution Review Round Table held by the International Accounting Standards Committee (IASC) Foundation in London, 19 June 2008

Background Note

EXECUTIVE SUMMARY

The creation of a new body with authority over Trustee appointments and reappointments is a crucial step for the IASC Foundation. This body is likely to be granted more authority in the future over other key governance functions, including the Foundation's funding.

In this respect, the proposed Monitoring Group contains significant flaws, the primary one being its inability to credibly represent at global level the investors and other capital-market users which should be considered the Foundation's key stakeholders.

Moreover, the very short timetable proposed for the first part of the Foundation's Constitution Review is not warranted by the circumstances. The Foundation's Trustees should take a step back and consider a revised concept of oversight body as part of a one-phase Constitution Review to be completed in 2009.

This note is intended for use by the International Accounting Standards Committee (IASC) Foundation following the presentation I was invited to give on 19 June 2008 at the Constitution Review Round Table organised in London under the Chairmanship of Gerrit

Most of the following comments are devoted to the IASC Foundation's proposal to create a Monitoring Group as 'part one' of the envisaged Constitution Review. I also comment on the proposal to reform the size and composition of the International Accounting Standards Board (IASB), at the end of this text.

1. Constitution Review Background

International Financial Reporting Standards (IFRS) have met with extraordinary success since the creation of the IASB and IASC Foundation in the early 2000s and subsequent IFRS adoption by the European Union followed by a large number of jurisdictions around the world which either implement them or have announced a clear timetable leading to such implementation in the next 4-5 years. This worldwide success, including the recognition of IFRS use by non-US issuers decided by the US Securities and Exchange Commission (SEC) in November 2007, attests that IFRS as they currently stand are considered a broadly adequate response to the requirements of global capital markets for high-quality accounting standards.

At the same time, the IASB and IASC Foundation have faced criticism and received suggestions as to their governance, funding, and accountability. Based on a draft proposed by Alexander Radwan MEP on 24 September 2007, the European Parliament on 24 April agreed changes by June 2010 at the latest. The currently considered reform is proposed as a first part of the Constitution Review, the second part being scheduled for 2009.

On 6 November 2007, days before the SEC's decision on the reconciliation requirement, the IASC Foundation announced its intent to *'establish a link to a representative group of official institutions, including securities regulators'* that *'would approve Trustee appointments and review Trustee oversight activities.'* This proposal was refined when, on 11 February 2008, the Foundation announced its decision to *'accelerate consideration of their proposals on the size, composition and mandate of a monitoring group with the goal of reaching conclusions in the second half of 2008. Initial proposals will be published in the second quarter of 2008.'* On 8 April 2008, the Foundation announced the Trustees' intent *'to publish later this month for public comment their proposals regarding the Monitoring Group and the composition of the IASB.'* However, no document was released in April, and on 12 May the Foundation announced: *'A round-table discussion will be held in the coming weeks before the publication of the official consultation document.'* On 30 May 2008, the Foundation published a tentative document titled 'Proposals and Issues for the Constitution Review' (hereinafter 'the proposal') and simultaneously announced the date of 19 June for the round-table discussion.

2. A Crucial Step that Shapes the IASC Foundation's Future Governance

The importance of setting up the Monitoring Group should not be underestimated. For the first time, the Constitution would give an external party direct authority over the Foundation, through granting it the essential power to shape the composition of the Trustees.

The proposal gives the Monitoring Group the right to recommend candidates for Trustee positions, and to discretionarily approve or refuse Trustee appointments or reappointments (Proposed Section 5). Thus, the authority to appoint or reappoint Trustees would be effectively transferred from the Trustees, who currently hold it, to the Monitoring Group.

The statement made in the proposal (page 6, §18) that *'under the new arrangement, the governance of the IASC Foundation would remain with the Trustees, and the responsibilities of the Trustees and the independence of the standard-setting function (...) would remain unaltered'* is open to question. In reality, appointing and reappointing the trustees is a key governance function which would not 'remain with the Trustees' but on the contrary would be transferred to a third party not controlled by the Trustees, namely the Monitoring Group.

By doing this, the proposal if implemented would create the IASC Foundation's de facto highest body, i.e. a body that has formal authority over the Trustees through its control of their appointment and reappointment, as well as other rights to information and interaction with the Trustees and IASB as set out in the proposed new Section 19 of the Constitution. This is entirely different from consultative processes set up in the past, including the Trustee Appointments Advisory Group created in November 2005, in which the ultimate decision-making authority had always remained with the Trustees.

The ability to appoint and reappoint Trustees is one of the most essential governance functions in an organisation such as the IASC

Thus, the proposal if implemented would probably pave the road for a Monitoring Group that not only would ultimately control the composition of the Trustees, but could acquire other direct governance tasks as well. Trustees should keep these future consequences in mind when considering the current proposals.

3. Identifying the IFRS' Stakeholders

The proposal presents the creation of the Monitoring Group as an initiative to 'enhance public accountability' (page 5) of the IASC Foundation. However, accountability can only be defined with reference to one or several groups of stakeholders to which the Foundation would be made accountable.

The IASC Foundation is a private-sector organisation tasked with an economic policymaking responsibility, accounting standard-setting, at global level – or, as the proposal puts it, *'de facto setting law in many jurisdictions'* (page 6, §16). This unique situation means that the question of who its key stakeholders are exactly is far from straightforward. In national environments, accounting standards are set in reference to a sovereign authority, which in democratic jurisdictions belongs to the people. In the context of the European Union, that authority is shared between the people and member states, all of which are themselves democracies, with a common legal basis for EU matters. But there is no comparable setting at global level. Specifically, many of the countries in which IFRS are now implemented are not themselves democracies, and there is no overarching global framework of law. Thus, the accountability framework that exists in national democratic environments cannot effectively be replicated or emulated by the IASC Foundation at global level. From that point of view, it would be hazardous to describe the Monitoring Group, as did a joint communication by regulators on 18 June, as *'a mechanism (...) that approximates the historical relationship between securities authorities and national standard setters'*[3].

The proposal specifically makes the point that *'the Trustees are accountable not to a single group, but to the wide range of international stakeholders that have an interest in the IASC Foundation's efforts to achieve its objectives.'* However, this language does not provide much clarity on who such stakeholders actually are or should be. It is a truism that different stakeholders may have different demands on financial reporting standards, and therefore the recognition of key stakeholders is bound to have a significant influence on the standard-setting process and eventually the content of the standards themselves.

Article 2 of the Constitution, which specifies the objectives of the IASC Foundation, mentions as its first aim *'to help participants in the world's capital markets and other users make economic decisions'.* Since the 2005 revision, it also introduces consideration for *'the special needs of small and medium-sized entities and emerging economies'*. This is as close as exists to a constitutional definition of the organisation's stakeholders. Furthermore, the IASB's Framework for the Preparation and Presentation of Financial Statements (adopted by the IASC in 1989 and readopted by the IASB in 2001) indicates that *'While all of the information needs of these users* [as previously listed: investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies, and the Public] *cannot be met by financial statements, there are needs which are common to all users. As investors are providers of risk capital to the enterprise, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy'* (Section 10). A new text for the Framework is being considered (as part of a revision project that started in 2004, an exposure draft was published on 29 May 2008 and is currently undergoing consultation), with a new description of the objective of financial reporting including the following text: *'The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to present and potential equity investors, lenders and other creditors in making decisions in their capacity as capital providers. Capital*

[3] Joint press release of SEC Chairman Christopher Cox, IOSCO Executive Committee Chair Jane Diplock, Japanese Financial Services Agency Commissioner Takafumi Sato and European Commissioner Charlie McCreevy, 18 June 2008, available on www.ec.europa.eu.

providers are the primary users of financial reporting.' It would appear from these indications that investors and creditors, and more generally users of financial information

(FASB) since 1973, and to enforce them. In the EU, the European Commission is responsible for the IFRS endorsement process (with input from the Council and European Parliament), while public enforcement is left to national authorities. These involve to varying degrees securities regulators (though not in all EU countries), other public or semi-public bodies (such as the Financial Reporting Review Panel, which is part of the UK Financial Reporting Council, or the German Financial Reporting Enforcement Panel), and the courts, while EU-level coordination is brought by the Committee of European Securities regulators (CESR). The proposal ignores this diversity when it states that '*The Monitoring Group would include regulatory and other official bodies generally charged with the establishment and enforcement of financial reporting standards*'. Referring to the proposal for the Monitoring Group, the chairman of CESR specifically pointed out that the European Commission has no role in the enforcement of IFRS[6].

Neither is the geographical rationale straightforward. Among other potentially contentious points, the absence of major jurisdictions such as China (whose large listed companies, investors, but many have many other missions as well; more importantly, such a mandate is not enough to create universally accepted legitimacy, and it is well known that in most jurisdictions the investor community does not consider the local securities regulator to be its only or even its main advocate, if it is considered an advocate at all.

The proposed Monitoring Group seems likely to be welcomed by the European Commission, SEC and JFSA, which play a central role in the endorsement of IFRS in their respective jurisdictions. But there is a high risk that this proves far from sufficient to create broad acceptance and legitimacy.

5. Timing Considerations

The proposal (page 1, Introduction) asserts that as regards the creation of the Monitoring Group, *'delay in implementation to 2010 is not appropriate'*. This assertion is unsubstantiated and highly debatable.

The stated desire to complete the creation of the Monitoring Group before the end of 2008 has led the Trustees to envisage a very short consultation phase for the Monitoring Group. Even though the intent was announced in November 2007, an actual proposal was only made public on 30 May 2008. The final document open to consultation is expected to be published in July, for response possibly before 15 September 2008 as the proposal suggests (page 1). This means that a large part of the consultation period, which itself is unusually short, willTfsomot(t4(()g.8(e).7( )-6llTf2-8.6(h)e week(is)-s2(on of)]4 Tc212947 0 TD-.0006 formal governance arrangements. The proposal, which reduces the public debate phase to an extremely short summertime period, is not of a nature to assuage these concerns, which could only be satisfied with a more substantive public consultation and deliberation process.

In the United States, the SEC has consulted market participants about the possible adoption of a roadmap towards endorsement of IFRS for domestic issuers. Since large US business organisations such as the US Chamber of Commerce have started advocating a shift to IFRS in the past few years, eventual adoption of IFRS now seems a near-certainty. However, there is bound to be an animated debate as to the modalities of the transition. This debate is likely to involve close congressional attention at some point, in which the concerns expressed in the above quoted letter of Senators Dodd and Reed could feature highly, and to include a discussion about the accountability of the IASB and the alignment of its objectives with investors' interest.

In order to meet this challenge successfully, the IASC Foundation's interest is to build a broad and bipartisan base of acceptance and, crucially, to win backing from key US institutional investors and their representatives, including large public pension funds. There is every indication that many such stakeholders are not satisfied with the current proposal for the Monitoring Group[10]. The proposal (page 3, §7) states that *'a clear organisational objective'* for *'the IASB is to become the world's accounting standard-setter'*, implying the recognition of IFRS in all significant jurisdictions including the US. With this strategic objective in mind, the IASC Foundation should consider the risks of implementing a major governance reform with a base of acceptance which does not include key US constituents. The likelihood of the US adopting IFRS in the next few years is very high, but provided it is not derailed by an unnecessary backlash that could be caused by too narrow an approach to force a decision this year.

Nor is there any public indication that a specific deadline in 2008 serves the Foundation's interest in other key jurisdictions such as Canada, China, India, Japan, or Russia.

6. Size and Composition of the IASB

The intent to rebalance the geographical composition of the IASB is welcome and has already triggered remarkable progress in the last few years through well-thought-out appointments of highly respected individuals. However, this rebalancing in itself does not require a change in the Constitution and can be implemented by the Trustees under the current Constitution, including when several mandates expire towards the end of 2008. Therefore, from the point of view of geographical balance there is no need to implement changes to the Constitution this year.

The proposed increase in the size of the Board is a matter of mild concern. Experience suggests that the optimal size of a group of Board members to enable unity of action and substantial internal debate is around 10-13 members, which is reflected by widespread corporate practice. From that perspective, the current IASB with 14 members is already on the high side.

In order to maximise the quality of individuals appointed to the IASB, the geographical balance should be governed by principles rather than narrow rules. Assigning only one geographical zone to each Board member does not fit well with the fact that many of the relevant individuals have had highly international careers which give them a sensitivity and knowledge of different parts of the world.

In consistency with the general recommendation that capital-market users be recognised as the key stakeholders of IFRS standard-setting, one could rather imagine a broad principle that the combined experiences of the IASB members remain representative of the geography of global capital markets as measured by countries' market capitalisations. By contrast, rather rigid rules such as the one proposed risk become obsolete very quickly.

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[10] See for example the International Corporate Governance Network's successive comment letters of 19 March and 18 June 2008, on www.icgn.org.

One may keep in mind that Japan represented over a third of global market capitalisation in the late 1980s, and that Asia could well overtake either North America or Europe by this criterion in the decade to come. Rather than having to change the geographical rule at each Constitution Review to adapt it to such market developments, a more flexible principle would appear advisable.

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