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Ms. Tamara Oyre
Assistant Corporate Secretary
IASC Foundation
30 Cannon Street
London EC4M 6XH
United Kingdom

Subject: IASCF constitution review – Part II

Dear Ms. Oyre,

I am writing to inform you about the European Commission's response to the IASCF's discussion document concerning Part 2 of the IASCF's constitution's review.

This response has been the subject of informal consultations with the European Parliament and with the Member States of the European Union. I would like to recall in this context the European Parliament's Resolution of 24 April 2008¹ and the conclusions agreed by the Economic and Monetary Affairs Council on 8 July 2008,² as well as the statement of the G20 Summits held in Washington on 15 November 2008 and London on 2 April 2009. The comments below and in the annex do not prejudice the Commission's position about broader aspects of the IASCF's governance or about the specific proposals to be presented at a later stage by the IASCF Trustees.

We support the Trustees' recent decisions to in the context of the IASCF's current constitutional review, which should however be seen as part of a medium term process to significantly enhance the governance of the IASCF. At this stage, there are a number of key issues that should in our view be addressed as part of the second phase of the IASCF Constitutional review:

- a key issue arising out the current financial crisis is the **link between accounting standards and the procyclical nature of financial markets**, which has implications for financial stability. We make specific suggestions about this point in the annex;

¹ <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+TA+P6-TA-2008-0183+0+DOC+WORD+V0//EN>

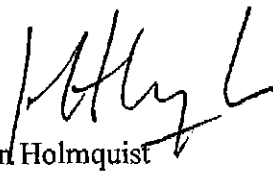
² http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ecofin/101742.pdf

- there needs to be greater **transparency about the IASB's agenda-setting**, including by ensuring public consultation and systematically submitting proposed changes to the Board's work programme to the Standards Advisory Council (SAC). Changes to the work programme should be adopted in a consolidated form on an annual basis and much better justification for agenda decisions should be provided. At the same time, some scope should be left for an accelerated procedure in cases of extreme urgency;
- the **effectiveness of the SAC** should be enhanced. The Commission welcomes the recent change to the composition of the SAC. However, the SAC continues to have too many members to function effectively. The SAC's role should be strengthened and its working methods improved (regarding the agenda-setting in particular). Consultation of the SAC about individual IASB projects should demonstrate added value over and above the public consultations that the Board carries out as part of its due process. The SAC's reporting requirements towards the Trustees should be strengthened to allow the latter to better monitor the SAC's effectiveness;
- the IASB's **due process** should be enhanced. The role of effects analyses as a mandatory part of the IASB's due process should be further developed and formalised. The role of field testing could also be developed. A fast-track procedure should nevertheless be foreseen for exceptional situations. Trustees should play a more active role by challenging the way in which the IASB responds to stakeholder input in order to ensure that due process amounts to more than going through the motions of formally applying a series of procedural steps;
- changes to the **terms of service of IASB members** should be adapted by abolishing the possibility to reappoint them for a second term. This would ensure that the Board is responsive to new accounting developments and contemporary business realities. We recognise that a balance needs to be struck between, on the one hand, avoiding excessive turnover that could destabilise the IASB's standard-setting process and, on the other hand, excessively long terms of office that prevent the infusion of new thinking. We make related proposals in the annex;
- the Commission also considers it important to review the **IASCF's funding arrangements**. While the European Commission welcomes the progress achieved by Trustees towards diversifying the IASCF's funding base, some aspects of the IASCF's current funding arrangements still give rise to concerns. In our view, these can only be remedied if the IASCF moves towards non-voluntary, stable and transparent funding arrangements with a broad geographic basis. In line with this objective, the European Union has recently agreed a legal basis that would allow the European Commission to provide a financial contribution towards the IASCF budget, subject to satisfactory progress being made to enhance the IASCF's governance.

Our detailed replies to the questions contained in the IASCF's consultation document are set out in the annex to this letter.

Finally, although we do not cover this issue in more detail in the annex, we consider that the role and procedures of IFRIC in the overall context of the IASB's standard-setting process needs to be enhanced. Overall procedures are too slow and IFRIC therefore does not fully fulfil its role in providing guidance or interpretation of the standards. This raises questions about the effectiveness of IFRIC's due process but may also raise constitutional issues (for example, concerning the transparency of IFRIC's agenda-setting process).

We look forward to commenting on the IASCF's specific proposals in due course. Do not hesitate to contact me if you have any questions about this letter.


Jörgen Holmquist

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Enclosure: 1

c.c.: Ms. Pervenche Berès MEP, outgoing chair of the European
Parliament ECON Committee
Mr Vittorio GRILLI, Chairman of the Financial Services Committee,
Member State representatives in the Accounting Regulatory
Committee,
Mr. Lars SØRENSEN, European Parliament ECON Committee
secretariat,
Mr. Jean-Luc FILIPPINI, Financial Services Committee secretariat

OBJECTIVES OF THE ORGANISATION

1. Does the emphasis on helping 'participants in the world's capital markets and other users make economic decisions', with consideration of 'the special needs of small and medium-sized entities and emerging economies', remain appropriate?

The emphasis should remain as currently formulated. However, paragraph 2(a) of the IASCF Constitution states that the IASB develops standards in the public interest, while paragraph 19 of the IASB's Due Process Handbook states that the IASB "seeks to address a demand for better quality information that is of value to all users of financial statements [including] governments and their agencies." In spite of this, the Board has over the years been reluctant to actively engage with public authorities, apparently out of concern that this would undermine its independence. We consider that this concern is unfounded and has proved counterproductive.

In light of recent developments, including the recommendations emanating from the G20 process, the Board should step-up its efforts to take into account public interest objectives including financial stability. The IASCF should therefore come forward with detailed proposals to ensure that these considerations are fully taken into account, including practical arrangements to ensure ongoing co-operation with prudential regulators/supervisors and bodies responsible for financial stability. This should complement the role of the Monitoring Board by providing a more technical forum in which the IASB and the relevant public bodies can co-ordinate their work. This is without prejudice to the possible strengthening of the Basel Committee's role in the Monitoring Board.

We have no strong views about the reference to the special needs of Small and Medium-sized Entities (SMEs) and Emerging Market Economies (EMEs). In our view, a company's ownership structure (publicly-traded v. privately-held) can be of greater relevance to its reporting needs than its size per se. Similarly, a company's ownership structure can also be of greater relevance to its reporting needs than whether it is incorporated in a developing or emerging economy. This would certainly be the case for the growing number of companies from EMEs that operate internationally and that may be listed or subject to reporting requirements in both emerging and developed economies.

2. In the opinion of the Trustees, the commitment to drafting standards based upon clear principles remains vitally important and should be enshrined in the Constitution. Should the Constitution make specific reference to the emphasis on a principle-based approach?

The European Commission has for a long-time supported and continues to support principle-based standards, as this promotes the use of judgement, discourages "gaming the standard" and results in accounts that better reflect the economic substance of the underlying transactions. We could support the inclusion of a reference to a principles-based approach in the Constitution. However, accounting standards-setting must not become a theoretically-driven process and must remain firmly embedded in the needs of users of financial statements, including regulators. This inevitably implies that standards-setting involves pragmatic choices and that the distinction between "principles-based standards" and "rules-based standards" can sometimes be blurred.

3. The Constitution and the IASB's Framework place priority on developing financial reporting standards for listed companies. During the previous review of the Constitution some commentators recommended that the IASB should develop financial reporting standards for not-for-profit entities and the public sector. The Trustees and the IASB have limited their focus primarily to financial reporting by private sector companies, partly because of the need to set clear priorities in the early years of the organisation. The Trustees would appreciate views on this point and indeed whether the IASB should extend its remit beyond the current focus of the organisation.

We do not support extending the remit of the IASB to not-for-profit entities and the public sector, as this would divert the IASB's limited resources away from the Board's main objective as set out in paragraph 2(a) of the IASCF's Constitution. The need to set clear priorities remains valid, *a fortiori* in light of the Board's additional workload in the context of the ongoing financial crisis.

4. There are other organisations that establish standards that are either based upon or have a close relationship with IFRSs. The IASC Foundation already recognises the need to have close collaboration with accounting standard-setting bodies. Should the Constitution be amended to allow for the possibility of closer collaboration with a wider range of organisations, whose objectives are compatible with the IASC Foundation's objectives? If so, should there be any defined limitations?

We agree that the IASCF's Constitution should allow for closer collaboration with organisations other than standards-setters. The latter could include technical bodies with specific responsibilities to provide input to the IASB's standards-setting process such as the European Financial Reporting Advisory Group (EFRAG), as well as bodies charged with developing prudential or regulatory standards, e.g. the Basel Committee on Banking Supervision, and those with responsibilities for financial stability, e.g. IMF, ECB.

GOVERNANCE OF THE ORGANISATION

5. Trustees would welcome views on whether the language of Section 3 of the IASCF Constitution should be modified to reflect more accurately the creation of the Monitoring Group and its proposed role.

As the Monitoring Board has its own Charter and is independent of the IASCF, the latter's Constitution cannot determine the Monitoring Board's role. At most, it should reflect the way in which the Monitoring Board affects and interacts with the IASCF's governance and internal procedures. We therefore consider that the Constitution, read together with the Memorandum of Understanding concluded between the Monitoring Board and the IASCF, is sufficient to reflect the creation of the Monitoring Board and its proposed role. This is without prejudice to any changes that may be needed in the future to reflect any changes in the Monitoring Board's mandate.

TRUSTEES

6. The Trustees are appointed according to a largely fixed geographical distribution. Is such a fixed distribution appropriate, or does the current distribution need review?

We agree that a broad geographical balance is appropriate, premised on the assumption that all major jurisdictions remain committed to the objective of global accounting convergence. Jurisdictions that do not make a credible commitment to convergence with and, ultimately, adoption of IFRS would not have a strong claim for fixed representation in the Board of Trustees.

We note that paragraph 6(d) of the IASCF Constitution provides some flexibility that should be used to recognise the specific role of those jurisdictions that already apply IFRS.

We also take this opportunity to comment on two aspects of paragraph 7 of the IASCF Constitution:

- this paragraph states that "[n]ormally, two of the Trustees shall be senior partners of prominent international accounting firms." While we recognise that the major international audit networks currently still make a significant financial contribution to the IASCF's budget (about which see our response to question 8) and that the auditing profession has historically made an important contribution to accounting standards-setting, we question whether the explicit reference to the representation of major international audit networks in the Board of Trustees continues to be appropriate. The previous sentence in paragraph 7 of the Constitution already refers to "an appropriate balance of professional backgrounds, including auditors", which seems sufficient;
- according to paragraph 7, "Trustees should be selected after consultation with national and international organisations of auditors (including the International Federation of Accountants), preparers, users and academics." Notwithstanding the new role of the Monitoring Board in the selection and appointment of Trustees, we consider that it would be important to also explicitly refer to regulators and supervisors in paragraph 7 of the Constitution.

7. The Trustees would welcome comments on Sections 13 and 15 of the IASCF Constitution, and more generally on the effectiveness of their oversight activities.

Sections 13 to 15 of the IASCF Constitution give broad scope to the Trustees to oversee the work of the IASB. However, there is room to enhance the use that Trustees make of these provisions, in particular paragraphs 15(c) and 15(e), to review the IASB's agenda and priorities in light of "broad strategic issues affecting accounting standards" and the resources available to the IASB. The independence of the IASB should not preclude scrutiny of the appropriateness of its agenda-setting, in terms both of process and substance, by the Trustees. Given the broader societal implications of the accounting standards, a case could be made that the ultimate decision-making authority over the Board's agenda should rest with the Trustees, as technical accounting expertise (the defining characteristic of the IASB members) is not necessarily sufficient to judge the merits of agenda-decisions. We consider that Trustees should further explore this possibility.

8. The Trustees would welcome comments on the progress and the future of the organisation's financing.

Trustees have over recent years achieved considerable progress to diversify the IASCF's funding sources. This is welcome. Nevertheless, further progress is required to guarantee the stability of the IASCF's funding arrangements and to ensure that the latter enhance the IASB's independence from private parties with a direct interest in accounting standards.

The establishment of the Monitoring Board provides a mechanism for closer co-operation between the IASCF and relevant public authorities to jointly review the former's funding arrangements. In line with the Memorandum of Understanding concluded between the Monitoring Board and the IASCF Trustees, this review should focus on ensuring that the IASCF's funding arrangements become wholly or primarily based on non-voluntary, stable and transparent sources of financing.

In line with this objective, the European Union has recently agreed a legal basis to allow the European Commission to make a grant towards the IASCF's funding from the European Union's budget. We consider that other major jurisdictions, in particular those represented in the Monitoring Board, should in due course also make a proportionate contribution to the IASCF's budget, both to support the latter's stability and the IASB's independence, as well as to signal their support for global accounting convergence.

The IASCF Trustees may therefore wish to consider incorporating a reference in the Constitution to the objective of achieving non-voluntary, stable and transparent funding arrangements with a broad geographic basis.

INTERNATIONAL ACCOUNTING STANDARDS BOARD

9. Trustees would welcome views on the IASB's agenda-setting process and would appreciate it if, in setting out views, respondents would discuss any potential impact on the IASB's independence.

The European Commission has concerns about three aspects of the IASB's agenda-setting process:

1. neither the IASCF Constitution or the IASB's Due Process Handbook require public consultation about the IASB's agenda decisions. We consider that this should be remedied by introducing greater transparency and stakeholder input to the IASB's agenda-setting process. In practice, we recommend that the IASB should on a yearly basis issue its proposed agenda for public comment and that, when it finalises the agenda in the light of the comments received, the IASB should be required to summarise the views expressed and explain the decisions it has taken. That published proposed agenda should include a preliminary effects analysis (see also our response to question 10), including rationale, objectives, options available, and an initial summary of the perceived costs and benefits, to demonstrate that there is a genuine justification for the project. The proposed agenda should also include a detailed calendar setting out the key milestones for each project;

2. while paragraph 59 of the IASCF Constitution states that the IASB should consult the Standards Advisory Council (SAC) about taking agenda-decisions, this is not always done. Trustees oversight should be stepped-up to ensure the full and timely involvement of the SAC in the IASB's agenda-setting process, subject to the possibility to invoke a fast-track procedure in exceptional circumstances (see our answer to question 11);
3. decisions about the prioritisation of IASB projects, such as those linked to the IASB-FASB convergence agenda, should also be subject to due process including public consultation.

The resulting greater transparency would in our view in no way affect the independence of the Board. See also our reply to question 7. The key issue is to demonstrate why a particular item should be included on the Board's agenda, in the sense of showing what real-world problem exists that requires an accounting solution, not just showing that a particular accounting issue should be explored because it would advance the practice of accounting.

10. The Constitution describes the principles and elements of required due process for the IASB. The IASB's procedures are set out in more detail in the IASB Due Process Handbook. If respondents do not believe the procedures laid out in the Constitution are sufficient, what should be added? If respondents believe that the procedures require too much time, what part of the existing procedures should be shortened or eliminated? The Trustees would also welcome comments on recent enhancements in the IASB's due process (such as post-implementation reviews, feedback statements, and effect analyses) and on the IASB Due Process Handbook.

The IASCF Constitution and the IASB's Due Process Handbook provide for extensive due process. On paper, notwithstanding our comments about agenda-setting discussed under preceding questions and the effects analyses discussed below, these are quite good and reflect the importance of accounting standards for the functioning of capital markets and the broader economy. We welcome the recent additions to the IASB's due process, which partly address the requests formulated by the EU for some time.

We nevertheless believe that the effects analyses should play a much more important role in the IASB's due process, akin to the impact assessments carried out by the European Commission.¹ This is one of the key issues highlighted by the EU's Economic and Monetary Affairs (ECOFIN) Council in its conclusions of 8 July 2008:

- first, as noted in our reply to question 9, a preliminary effects analysis should inform the IASB's agenda-setting process;
- second, all major projects should be accompanied by a full effects analysis that should be developed as early as possible in the life-cycle of the project to allow consideration by stakeholders. The full effects analysis should therefore be published at the latest when the Board issues an exposure draft.

¹ See Communication from the Commission on Impact Assessments, COM(2002)276 final of 5 June 2002. Further information about the European Commission's impact assessments, including guidelines and evaluation reports, are available on the following web page: http://ec.europa.eu/governance/impact/index_en.htm.

These requirements should be formalised in the IASCF's Constitution and in the IASB's Due Process Handbook. The quality of effects analyses could be enhanced by providing for *ex ante* review of draft effects analyses, such as by a board consisting of independent experts (or by the SAC). This would complement the *ex post* oversight of due process carried out by the Trustee Due Process Oversight Committee.

We also consider that more use of field-testing could make a valuable contribution to ensure the quality and relevance of IFRS. The Board could co-operate with national or regional bodies (national standards-setters, EFRAG) to identify panels of preparers to test draft standards as soon as a stable proposal is available. The results of such field tests could be reflected in the full effects analysis published together with exposure drafts.

In addition, due process is only as good as its implementation: due process must amount to more than going through the motions of formally applying a series of procedural steps. In particular, input from stakeholders to the IASB public consultations, roundtables, etc. should be given genuine and serious consideration. There is a concern that the Board too easily dismisses or ignores input that challenge its preferred views. This situation is difficult to address through formal procedural requirements, but Trustees oversight of the IASB could play a stronger role to challenge the way in which the Board responds to stakeholder input.

11. Should a separate 'fast track' procedure be created for changes in IFRSs in cases of great urgency? What elements should be part of a 'fast track' procedure?

We support the introduction of a 'fast-track' procedure in cases of great urgency, including the possibility to amend the Board's work programme. The use of such a procedure by the IASB should be subject to prior approval by the Board of Trustees and minimum requirements in terms of due process should be foreseen.

The use of a fast-track procedure should be reserved for exceptional circumstances and would therefore be extremely rare. The best way to avoid the need to invoke such a procedure is for the Board to address emerging issues in a proactive and open manner so they can be addressed in the normal course of its business.

STANDARDS ADVISORY COUNCIL

12. Are the current procedures and composition, in terms of numbers and professional backgrounds, of the Standards Advisory Council (SAC) satisfactory? Is the SAC able to accomplish its objectives as defined in Section 38?

The Commission has long-held the view that the large size of the SAC is an impediment to its effectiveness and we made this point in our written contributions to the previous constitutional review. We welcome the recent changes in the composition of the SAC such that its members no longer represent only their personal point of view. However, the size of the SAC (currently close to 50 members) remains far too large to allow it to discharge its mandate and to provide effective and coherent advice to the IASB.

While we recognise the importance of ensuring balanced geographic (including from emerging market economies converging towards or using IFRS) and sectoral representation of stakeholders in the SAC, we urge the Trustees to consider significantly reducing the size of the SAC as part of the current constitutional review. One possible approach would be to foresee representation on the basis of "colleges" drawn from key stakeholder groups, e.g. preparers, investors, auditors, regulators, standards-setters/technical bodies and academia. Each college could consist of no more than 4 members (resulting in a maximum of 24 members using the stakeholders groups listed in the previous sentence) and would have responsibility to seek input from its peers. Such an approach would allow a balanced geographic and sectoral representation of stakeholders in the SAC while enhancing the latter's effectiveness.

13. Attached to this discussion document are the terms of reference for the SAC, which describe the procedures in greater detail. Are there elements of the terms of reference that should be changed?

As noted in our reply to question 9, the SAC is in practice not always consulted about IASB agenda decisions. This raises a more general issue: while paragraph 1 of the SAC's terms of reference and operating procedure refers to the SAC's role in providing advice to the IASB about (i) the IASB's agenda; and (ii) the IASB's project timetable (work programme) including project priorities, our experience is that the SAC devotes most of its meetings to advice on individual projects, the third item mention in paragraph 1. Moreover, this advice tends to duplicate the IASB's public consultations by focusing on technical aspects of projects rather than, as stated in the SAC's terms of reference, emphasising "practical application and implementation issues." This further undermines the added value that the SAC brings to the IASB.

The responsibility for redressing the situation rests primarily with the Chairman of the SAC. In order to ensure that Trustees can better monitor the effectiveness of the SAC, we suggest that the Chairman of the SAC should be required to report the SAC's main conclusions in writing to the Trustees after each meeting and to provide the Trustees with an annual report, approved by the SAC, at the end of each calendar year. In addition, the SAC needs to review some of its procedural working methods in order to enhance its independence from IASB members and staff.

OTHER ISSUES

14. Should the Trustees consider any other issues as part of this stage of their review of the Constitution?

The effectiveness of the Board is determined as much by formal governance and due process requirements as by the background and experience of its members. In order to ensure that the Board is responsive to new accounting developments and contemporary business realities, it is important to ensure regular renewal of its members. Moreover, preference should be given to Board members with direct practical experience in the application of IFRS. We are therefore struck by the fact that the tenure of IASB members can be extremely long and that no less than seven members – half the Board's complement – have served since the IASB's establishment in 2001. Prior to that, several current members were involved in the work of the IASC, in one case as Board member since 1995 (making a total of fourteen continuous years as a member of the body developing IAS/IFRS). Such long tenures in our view discourage critical thinking about the existing IFRS literature.

The IASCF Constitution encourages this situation by allowing the reappointment of Board members pursuant to paragraph 31. In order to ensure the regular infusion of "new blood" into the IASB, the possibility to reappoint Board members should be abolished. This could be accompanied by an extension of the term of office to six years. Appointments to the Board could be staggered, e.g. half the Board to be replaced every three years or one third every two years, to ensure a measure of continuity. We would also support more frequent rotation of the Chairperson of the IASB.

Trustees should also ensure diversity in the Board's composition. Paragraph 25 of the IASCF Constitution refers to the "best available combination of technical expertise and diversity of international business and market experience." This can in our view best be achieved by ensuring that the Board includes a balanced sectoral membership drawn from investors, preparers, auditors, regulators, academia, standards-setters, etc. without any one group having more than 3 members on the Board.