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Dear Mr Zalm, Ms Oyre

Review of the constitution: identifying issues for Part 2 of the Review

This is the British Bankers' Association's ('BBA') response to the above due process document. We welcome the opportunity to comment.

The second part of the constitutional review takes place at a time of unprecedented volume of reform within the international regulatory framework in response to the financial crisis that has engulfed the world's financial markets. At the heart of this lies the G20 action plan aimed at coordinating as far as possible the international response to the crisis.

The review also coincides with the IASB Financial Crisis Advisory Group reviewing key issues related to the constitutional review and the governance structure:

- Objectives of financial reporting: who are the financial statements for?
- Should financial reporting have a financial stability objective?
- What are the priority issues for the IASB?
- What further changes are needed to the governance arrangements?

These issues are central to the constitutional review and we comment on each before turning to the specific questions raised in the December 2008 paper. At the heart of the discussion on these issues lies the fundamental question of whether the IASB should aim to coordinate its activity with other regulatory authorities within a structure aimed at enhancing financial stability or whether it should remain detached in order to maintain and protect the independence of accounting standard setting and the neutrality of accounts.

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While the BBA would not disagree with the proposition that financial reporting serves a purpose distinct from the regulatory regime, we believe that financial reporting and broader regulatory objectives are aligned and that the IASCF's constitution and governance arrangements need to reflect the IASB's place in the international regulatory framework.

◦ **Objectives of financial reporting: who are the financial statements for?**

The Financial Crisis Advisory Group has been asked to provide a view on who should be regarded as the primary users of financial statements. At one extreme some would say investors only; while at the other a long list of stakeholders could be provided and the IASB allocated socio-political objectives within a rigid financial stability framework.

From a BBA perspective, we would say that the current framework achieves an appropriate balance. This describes users as including "present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public". The perspective of investors is seen as providing the common denominator in that paragraph 10 states:

"While all of the information needs of these users cannot be met by financial statements, there are needs which are common to all users. As investors are providers of risk capital to the entity, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy."

While we have some sympathy with this, in modern, complex capital markets investors cannot be said to be a homogenous group and it is arguable that those operating purely within a trading environment have a different view of value generation and its assessment than those operating by reference to a longer time horizon. In discussion of the opening draft chapters of the IASB's conceptual framework, this manifested itself in a debate about the extent to which users place emphasis on their ability to assess the stewardship or accountability of management in respect of an entity's assets in assessing performance. It would seem to us that given the hard learnt lesson that market perfection rarely exists, we should be adopting a view of users that includes organisations that place value on the long term sustainability of a business entity.

We would, in any case, question the rationale of those who view investors' interests as being diametrically opposed to those of intergovernmental agencies and the regulatory authorities. For example, they would all wish the IASB to overcome the shortcomings in standards in respect of issues such as own credit and block discounts.

◦ **Should financial reporting have a financial stability objective?**

A key issue being debated by the Financial Crisis Advisory Group is whether the IASB should set itself a financial stability objective. On the one hand, it could be argued that the damage caused by the current crisis is of such a nature that preventing a similar occurrence should be an absolute priority for any regulator or standard setter. On the other, many involved in the standard setting process believe that a better contribution to financial stability is achieved through financial reporting delivering a neutral and transparent account of an entity's financial position unblemished by longer term considerations.

Debate so far has centred principally on whether regulators should seek to achieve their regulatory outcomes through financial reporting (e.g. on dynamic provisioning) or whether the objective should instead be for the financial statements to provide a means of disseminating information about regulatory actions in an open and transparent way. There is a further question in respect of financial stability, however, that appears to have attracted less attention and that is whether the IASB's standards themselves have contributed to pro-cyclicality and, if they have, whether the IASB should be placed under an obligation to give consideration to financial stability consequences in developing and/or reviewing its standards.

It is clear, for example, that the accounting regime (and Basel II for that matter) placed insufficient emphasis on the relevance of market liquidity to valuation and there is a strong belief within the banking industry that this has exaggerated reported losses. Recent events have also shed further light on concerns expressed in respect of proposals in hand on the process of calculating fair values. There is a legitimate question, therefore, about whether the IASB should have regard for financial stability considerations in evaluating reporting requirements, provided this can be said to be consistent with sound reporting on financial performance to investors. This is distinct from the suggestion that regulatory requirements should be met through financial reporting.

We would also argue that it sits uncomfortably with the IASB's initiative to reduce complexity to view regulatory needs as being entirely divorced from the accounting regime and that the accounting framework should accommodate regulatory needs other than where their differing objectives necessitate divergence. IFRS financial statements are increasingly being relied upon to provide core accounting material for a variety of purposes, including regulatory and tax returns. While in some cases these require the adjustments or filters to the core data, these users are in a similar position to investors in wanting to ground their assessment of fundamental economic value in a set of figures drawn up on an understandable, comparable, relevant and reliable basis.

○ **What are the priority issues for the IASB?**

One of the reasons why the IASB found itself having to by-pass its consultative due process in October last year was that it failed to appreciate at a sufficiently early stage the action needed in response to the remit assigned to it by the Financial Stability Forum in April that year. We believe that for all its various consultative mechanisms and fora this points to an organisation that remains distant from the environment in which it operates and unresponsive to the needs of its inter-governmental sponsors and other constituents.

It would seem evident to us therefore that the IASB needs to engage in a much more interactive dialogue on its strategic agenda and short-to-medium term priorities. While some argue that this would constitute interference in the standard setting process and a threat to the independence of the Board, we see this more as a matter of the IASB engaging with the broad range of users to ensure that it devotes its time and energy in the areas where its activity will reap the greatest benefit. Engaging stakeholders in a strategic dialogue is an approach increasingly being given greater attention by standard setting, regulatory and governmental bodies. It is difficult to see why the IASCF should view engagement of this nature as being detrimental to the interests of the standard setting process.

Progress, of course, is being made in this regard and we are pleased to see that in addition to the establishment of the Monitoring Board of relevant public authorities, the IASB has invited both the reconstituted Standards Advisory Council and the recently formed Financial Crisis Advisory Group to comment on its priorities. For our part, we are highly supportive of the G20 initiative to put in place a coordinated response to the serious challenges facing the world economy and financial markets. In writing to each of the G20 members, the FSF and the IASB, the banking industry has supported the action already taken by the Board, but have additionally highlighted the need for the IASB to give priority to:

- Assessing whether further amendments to IFRS are needed in light of the financial turmoil. This includes reviewing standards to see whether there are detailed rules that in current market circumstances may be said to have had a pro-cyclical effect. This includes the valuation and impairment of Available-For-Sale financial assets, the inability to reclassify instruments subject to the fair value option and issues concerning embedded derivatives.
- Reviewing its position on *how* to calculate fair value to establish whether the current market paralysis sheds light on the relevance of exit values and the use of a market participant view; this

should also include a review of the guidance on valuation in illiquid markets issued last year and an assessment of whether elements should be built into a core standard.

- Pressing ahead with the follow up to the discussion paper '*Reducing Complexity in Financial Reporting*' with the aim of simplifying IAS 39 and dealing with some of the key concerns raised in the 160 comment letters on its proposals, including the rules attached to individual financial instrument categories, the need for hedge simplification and the vexed question of the fair valuation of own debt.
- Engaging in dialogue with regulators and industry to establish an appropriate way forward on dynamic provisioning that meets regulatory objectives without compromising IFRS principles.

In pursuing the above it would be appropriate for the IASB and FASB to conduct a review of the extent to which fair value may have played a part in the crisis and whether the valuations generated under IAS 39 are in any way pro-cyclical. We also urge the Boards to make an early announcement that the long term objective of full fair value set out in the reducing complexity discussion paper, and on occasions expressed as a principle, is no longer an option in view of the lessons learnt about the relevance and reliability of fair value in the absence of an intent and ability to trade or manage instruments on a fair value basis. We were disappointed that the IASB this month voted in favour of maintaining full fair value as the long term objective, but we welcome Board members confirmation that the short-term review of IAS 39 should proceed on the assumption of a mixed-attribute measurement model.

In common with the Standards Advisory Council, we view the IASB's conceptual framework project as important, but believe that some of the assumptions underlying it require review. We are also concerned about the burgeoning nature of the draft framework and the piecemeal fashion in which the IASB is seeking comment on individual draft chapters.

The priority for the IASB for the short and medium term, however, must be the review of standards relevant to the financial markets, including not only IAS 39 'Financial Instruments: Measurement and Recognition', but other crisis-related work and projects such as consolidation, derecognition and revenue recognition. Of lesser importance are plans to expand the scope of IFRS to include not-for-profit entities and the public sector. The IASB should give its full attention to fulfilling the remit under the G20 initiative in its broadest sense before turning to other tasks. If resource is an issue then longer term projects should be deferred in favour of addressing issues of immediate importance.

○ **What further changes are needed to the governance arrangements?**

Before examining the further changes needed to the IASB's governance structure, we should first acknowledge that there are many positive aspects to its governance arrangements in that:

- The IASCF and Board are overseen by independent trustees.
- Established due processes procedures for consultation are in place.
- The Board meets in public and makes good use of communications technology to enable global access.
- The IASCF has recently established a Monitoring Board to improve linkages with inter-governmental bodies.
- The IASCF has reconstituted its Standards Advisory Council and has augmented its six working groups with an Analyst Representative Group and the Financial Crisis Advisory Group.
- The Board holds open roundtables on key projects.

The IASB must also be credited with having gained wide global acceptance in its relatively short existence. Despite this, however, there is a widely held belief that the Board is insufficiently responsive to the needs of users – as broadly defined.

The review takes place within the context of the recommendation made by the G20 leaders in their declaration following the summit on financial markets and the world economy that the governance of the IASB should be further enhanced. This should be viewed as an opportunity rather than as a threat since it confirms that governments have recognised the IASB as an international standard setter and confirms its standing with more established international bodies, notably the Financial Stability Forum, the Basel Committee on Banking Supervision and the International Organization of Securities Commissions.

The G20 recommendation has been met, in part, through the establishment of the Monitoring Board scheduled to meet for the first time on 1st April. This will improve the IASB's relationship with inter-governmental bodies and the process of public oversight.

We can understand the concerns expressed about the need to ensure that the IASB remains independent of undue political interference and that it should act with and through appropriate due process. The dialogue on governance, however, so far suggests that it is not fully appreciated that IFRS play a central role in the global system of financial regulation and that their development should be taken forward within the context of other governmental and regulatory actions. The quality and strategic nature of the IASB's decision-making processes can only be enhanced through an informed and engaged dialogue with the full range of organisations involved in the establishment, application and use of regulatory requirements, including international accounting standards.

We therefore believe that Part 2 of the IASCF's constitutional review should be utilised to undertake a thorough review of the IASB's governance structure in the light of the principle that the constitution and the IASCF's processes should reflect fully the vital contribution that the IASB has to make to the international regulatory framework and the operation of global capital markets. The IASCF must be placed firmly within the structure of strategically important rule-setting and regulatory bodies and its governance arrangements and management processes must meet the standards expected of an internationally-recognised rule-setting body.

The BBA believes that this should include:

- **A review of the mission statement of the IASCF as set out in the foundation's primary objectives.** We do not agree that giving recognition to the IASCF's place within the international regulatory framework puts into question the independence of the accounting standard setting process; the IASCF constitution should be revised to set out the balance between broader intergovernmental and regulatory objectives for financial stability and the provision of transparent and neutral information in the financial statements.
- **A review of the processes by which the IASB's strategic agenda and priorities are set.** While the establishment of the Monitoring Group and the engagement with the Standards Advisory Council and Financial Crisis Advisory Group will help in this regard, the IASCF must engage in a more open and interactive dialogue on the priorities and direction for standard setting. This should involve a formal requirement for the IASCF to conduct an open consultation on its annual business plan and budget, including a forward-looking plan of its proposed priorities for the IASB's standards.
- **A review of the processes by which the Trustees fulfil their responsibility for overseeing standard setting and related activity.** While the Trustees have been successful in terms of building the IASB into a globally recognised standard setter, the quality and thoroughness of their oversight of the standard setting process is open to question. We therefore believe that in addition to operating in its own right, the recently established Monitoring Board should be charged with making recommendations on the way in which the trustees should discharge their responsibilities in this regard. There may be a question here about whether the oversight process is adequately resourced by a dedicated staff independent of those involved in the standard setting process.

- **Placing greater emphasis on the IASB Board and staff adopting a balanced approach in setting out issues relating to the development of particular standards.** All too often the analysis in support of particular proposals is too one sided or even downright dismissive of alternative approaches to those favoured by the Board. This is not only undisciplined, it has contributed significantly to a loss of trust and confidence in the Board on the part of many of its constituents at a senior level.
- **The urgent formalisation of the criteria for, and rules governing, a permanent fast track procedure.** While an absence of any due process is clearly not the answer, there are clearly instances in which there is a need to introduce or amend standards without an extended consultative process over a period of many months. This is a major gap in the IASB's toolbox and it would seem unnecessary for the introduction of such a facility to await the outcome of the constitutional review. The Board variously used 15 and 25 day comment periods during the second half of 2008 for urgent measures and we would suggest that there are circumstances in which the need for action outweighs the need for lengthy deliberation.

We have addressed the specific questions raised in the December 2008 review paper in the enclosed appendix and would be happy to expand on any of the issues raised in this letter if that would be helpful.

Yours sincerely



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Appendix on the specific questions raised in the December 2008 discussion document on Part 2 of the IASCF's review of the constitution

The following answers to the specific questions raised in the discussion document should be read within the context of the points made in the covering letter. There are cross referenced where appropriate.

Objectives of the organisation

- 1. The constitution defines the organisation's primary objective in the following manner: to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions**

In fulfilling that objective, the organisation is: to take account of, as appropriate, the special needs of small and medium-sized entities and emerging economies

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?

We support the emphasis on capital markets but believe that the reference to other users should be expanded in the primary objective. There should also be reference to the place of global accounting standards in the international regulatory framework. We support the IASB taking account of the needs of emerging economies but are unsure about the reference to SMEs since we do not subscribe to the belief that standards designed principally with large multinationals in mind can be condensed for application to SMEs. Better regulation suggests that an altogether lighter touch approach is needed for SME accounting and we believe that further work is needed before IFRS could be applied to the smallest entities.

- 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 principles-based approach?**

We agree that the emphasis on a principles-based approach should be enshrined in the constitution. We would also observe that the question is appropriately expressed given that the standards and guidance drawn up under this mantle now stretch to over 2,500 pages of detailed technical accounting. This suggests a need for further thought on the balance between accounting principle and detailed, technical provision.

- 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.**

While the IASB should be mindful of the fact that its standards are gaining acceptance in circumstances beyond those originally envisaged, we would not see the development of standards for not-for-profit entities and the public sector as an immediate priority. A better

approach may be for it to be left to regional and national standard setters, possibly in coordination, to develop regimes for these (and SMEs) in light of the broad principles of IFRS without the investment of large amounts of IASB Board and staff resource.

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?**

As explained in our covering letter, we consider that the IASCF must recognise the role that the IASB and its standards play within the broader financial regulation framework. We therefore believe that it should establish appropriate relationships with relevant inter-governmental and regulatory authorities and that these relationships, and the responsibilities they bring, should be enshrined in the IASCF constitution, together with any agreed countervailing factors, such as the need to maintain independence in standard setting and economic neutrality in the output of the standard setting process.

Governance of the organisation

5. **The first part of the review of the constitution proposed the establishment of a formal link to a Monitoring Group. Under this arrangement, the governance of the organisation would still primarily rest with the Trustees. Although the first part of the review has not yet been completed, the Trustees would welcome views on whether the language of Section 3 should be modified to reflect more accurately the creation of the Monitoring Group and its proposed role.**

While we would agree with the Trustees remaining primarily responsible for the governance of the organisation, we see the establishment of the Monitoring Group as a significant enhancement in the IASCF's public oversight and accountability arrangements. We believe it merits both specific reference within Section 3 of the constitution and, as mentioned in our covering letter, consider that the Monitoring Group should be charged with making recommendations on how the trustees can improve the discharge of their oversight of the IASB and its processes for standard setting and related activity.

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 are not aware of any particular concerns with the geographical distribution of the trustees.

7. **Sections 13 and 15 set out the responsibilities of the Trustees. The intention of these provisions is to protect the independence of the standard-setting process while ensuring sufficient due process and consultation – the fundamental operating principle of the organisation. In addition to these constitutional provisions, the Trustees have taken steps to enhance their oversight function over the IASB and other IASC Foundation activities. The Trustees would welcome comments on Sections 13 to 15, and more generally on the effectiveness of their oversight activities.**

As explained in both our covering letter and our response to question 9 below, we believe that Section 15(c) should be amended to give the Trustees a preponderant role in overseeing the IASB's strategic agenda and priority setting.

- 8. The Trustees are responsible for ensuring the financing of the IASC Foundation and the IASB. Since the completion of the previous review of the Constitution, the Trustees have made progress towards the establishment of a broad-based funding system that helps to ensure the independence and sustainability of the standard-setting process. However, the Trustees have no authority to impose a funding system on users of IFRSs. The Trustees would welcome comments on the progress and the future of the organisation's financing.**

We support the four principles for the funding of the IASC Foundation which were put in place last year and welcome the progress made by the Trustees towards establishing national funding regimes consistent with the principles in a number of countries. As the question observes, however, the Trustees have no authority to impose a system of funding on users. The corporate contribution to the IASB's budget is, in our view, better arranged through levies on listed companies than individual contribution, and for this the IASB is reliant upon the cooperation of governmental agencies. This underlines the relevance of the IASCF's activities to the broader regulatory framework and the appropriateness of public oversight and accountability.

International Accounting Standards Board

- 9. Commentators have raised issues related to the IASB's agenda-setting process. The Constitution gives the IASB 'full discretion in developing and pursuing its technical agenda'. The Trustees have regularly reaffirmed that position as an essential element of preserving the independence of the standard-setting process. However, they 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.**

As explained in our covering letter, we see a vital need for the IASB to consult more widely on its strategic agenda and priority setting and believe that this should be drawn more formally into the remit of the oversight process of both the Trustees and the Monitoring Board. We believe the IASB should engage in an open, constructive and interactive dialogue on its agenda and priorities with all constituents perhaps using the framework of an annual consultation on its business plan and budget. We do not believe that this need impede the independence of the standard setting process and, to the contrary, believe it can be argued that investing in an early, strategic debate will serve to minimise the prospect of heavy handed interference later in the process.

- 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 existing 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*.**

We believe that the problem lies with the execution of the procedures and policies as opposed to the way in which they are set out in the *IASB Due Process Handbook*. As explained elsewhere we believe that the Monitoring Group should be asked to lead a review of the relevant arrangements. On a specific note, we would see merit in a more definitive commitment being given in paragraph 51 of the Handbook on post-implementation reviews.

- 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?**

Most would find it surprising that a body such as the IASB does not already have in place a facility for introducing or revising its requirements without an extended consultative process over a period of many months. This is a major gap in the IASB's toolbox and it would seem unnecessary for the introduction of such a facility to await the outcome of the constitutional review. The Board variously used 15 and 25 day comment periods during the second half of 2008 for the resolution urgent measures and we would agree that there are circumstances in which the need for action outweighs the need for lengthy deliberation.

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?

We are broadly content with the procedures and composition of the Standards Advisory Council as written in the constitution. The question is more about whether the IASB is influenced by the views brought to it by the SAC.

13. Attached to this 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?

We have no further comments to make on the SAC.

Other issues

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

We would conclude that we view it as vitally important that the Trustees reflect upon the expectation within the regulatory, political and business field that the IASCF will give firmer direction to the IASB's strategic agenda and priority setting. We believe that the Trustees should place weight on ensuring that Board aligns its priorities with those of intergovernmental agencies, other regulators and the business community.