

IASC Foundation constitution review

Submission by the Association of Investment Companies

Executive summary

The AIC supports the creation of global accounting standards but has been concerned that, on occasion, the standardisation of accounts has been achieved at the expense of the quality of information included.

This creates risks of detriment to investors and the wider public interest. Changes to the IASC's governance processes could substantially reduce these risks and enhance the utility of IAS to investors. In turn this will help increase overall standing and broaden the adoption of IAS.

Changes to the IASC's governance arrangements should adjust the IASC's constitution, including its objectives and the composition and role of the board of Trustees.

Changes to the IASC's objectives should include:

- Recognising more clearly the importance of investor needs in the standard setting process;
- Prioritising the delivery of high-quality information as the overriding goal of accounting standards;
- Greater recognition of diversity among issuers;
- Incorporating principles of good regulation in the standard setting process. This would include the need for standards, and the standard setting process, to be: proportionate, targeted, accountable, and consistent;
- Making an explicit commitment to evidence-based policy making, including the adoption of cost benefit analysis processes.

Changes relating to the Trustees should include:

- Adjusting the composition of the board of Trustees to focus more closely on their 'discipline' and ensuring that the majority of the board is drawn from those with an investment background;
- Reviewing processes to establish what scope there may be to broaden and deepen market input into the selection of Trustees;
- Giving the Trustees an explicit role in signing off standards and ensuring that proposals are only brought forward when there is an evidence-based case demonstrating the need for action.

The IASC' should not create the proposed Monitoring Group – the changes proposed above would result in better outcomes.

The AIC supports the expansion of the IASB to 16 members.

Overview

The Association of Investment Companies (AIC) welcomes the opportunity to comment on the International Accounting Standard's Committee Foundation (IASC) Trustees' review of the IASC constitution. This process is a very important one. If the Trustees are able to adapt the IASC's governance to more effectively encourage the provision of higher quality information to financial markets this would have widespread benefits in terms of market fairness and efficiency. This would in turn increase the standing of the IASC and allow it to build upon its achievements.

In principle the AIC supports the creation of global standards. However, setting standards is inevitably complex and, at times, can be controversial. One issue that has concerned the investment company sector, for example, is that standardisation of accounts for different types of business has at times been achieved at the expense of the quality of information included. This issue has been particularly clear to us because of the specialist nature of our sector.

Investment companies are collective investment vehicles. They are closed-ended (with shares listed or traded on a stock exchange) and hold a portfolio of assets with a view to spreading investment risk and delivering income and capital growth for their investors. They differ from trading companies in a variety of ways. For example, they have no customers in the traditional sense, they do not manufacture anything, or even provide a conventional service to a third party, most have no employees or offices etc. The 'one-size-fits-all' tendency of international accounting standards can sometimes lead to perverse outcomes for the investment company sector.

For example, when the investment company sector first came to apply the financial instrument standards, the AIC discovered that a significant proportion of its Members would have to present their accounts with their entire share capital accounted for as liabilities. As a result, technically these companies were presenting accounts showing a nil balance sheet, even though most were holding portfolios of liquid investments amounting to tens, or hundreds, of millions of pounds. This situation has been partially amended, but for a while it created huge problems for the sector. Indeed, had not changes to UK company law been secured at short notice, some of these companies would almost certainly have gone out of business on the basis that, having nil net assets, they would never have been allowed to pay dividends.

Anomalies of this nature should not be allowed to undermine the advantages of more consistent accounting treatments. The IASC constitution should create an environment which encourages vigilance by the Trustees and the IASB to ensure that standardised accounting treatments cannot inadvertently result in detriment to specific industries or markets. Such problems could arise where IFRS causes investors to receive information which fails to make clear the true position of a company they are trying to evaluate or, even worse, is confusing or actively misleading.

The AIC does not advocate undoing the work that has been done by the IASC and IASB to date. Rather, it **recommends** adjusting the IASC's governance to ensure that the benefits already achieved through introducing international accounting standards are consolidated. Adapting the IASC's governance should also be designed to better equip the IASC so it can help the IASB to avoid creating anomalies or unintended consequences in the future which might otherwise threaten the continued development and support for international accounting standards.

The AIC strongly supports the current review and is confident that revisions could be made to IASC's governance structures to strengthen its oversight and improve the quality of the IASC Foundation's output.

Refining the IASC's objectives

The Trustees should re-assess and revise the IASC's objectives to ensure the continued effectiveness, relevance and quality of the IASC's work. The AIC **recommends** that the revised objectives should:

- **Place investors at the heart of the standard setting process:** The current objectives prioritise the 'public interest'. The provision of accurate financial statements will, of course, provide wider public benefits but this is a by-product of their primary function – which is to inform investors. It is unfortunate that the current objectives (as set out in Paragraph 2 of the IASC constitution) make no explicit mention of investors, whose needs should be central to the process of setting standards. Investors have a direct and clear financial interest in the content of accounts and place significant value on their accuracy. Their interests face real and significant damage if corporate accounting is not of sufficient quality. This interest should be formally recognised and prioritised within the IASC constitution.

Placing investor interests at the centre of the standards setting process could drive real changes in the way that standard setting is approached. For example, one by-product of recent IFRS developments has been to increase the length of annual statements. To name just one example, HSBC's financial report for 2007 was nearly 500 pages long. Investment company reports have also increased markedly in length in recent years. Feedback from our Members (who are investors as well as issuers) is that much of this increased information is of little or no value. Indeed, it may be that increasing the amount of information disclosed actually obscures the true picture for investors who are less able to sift the more important facts from extraneous detail. The sensitivity analyses required by IFRS 7 are an example of requirements that have added considerable length and confusion to the accounts of investment companies, with virtually no benefits to investors (many of whom have privately admitted to the AIC that they never look at these disclosures).

Indeed, professional analysts of the investment company sector (i.e. users who might be deemed capable of making use of the additional, complex, information required by IFRS) have frequently commented to the AIC that,

since the introduction of IFRS in the UK, they have tended to move their focus away from the financial statements to the 'front end' of the accounts to find the information they need to make an informed assessment of the company's prospects. If such professional analysts are not using the information mandated by IFRS, it begs the question as to whether anyone is and, even if a few are, whether this can justify the wholesale imposition of such requirements on every company.

There is a risk that company reporting is overly driven by technical accounting considerations rather than 'real world' needs. Placing investors at the centre of the IASC's priorities will help remove this risk.

Once investor needs have been satisfied this will inevitably create wider public benefits as the published information will help potential investors assess investment opportunities. This will lead to the promotion of fair and efficient markets – with all the knock-on benefits that implies in terms of capital efficiency etc. These benefits will only arise if investors are based at the centre of the system, as it is investors who are the primary participants in, and drivers of, financial markets.

- **Prioritise the delivery of high-quality information as the overriding goal of accounting standards:** The current objectives (Paragraph 2(a) of the constitution) recognise the importance of high-quality information, but do not explicitly give primacy to this objective over other outcomes (such as comparability).

That fact that securing high-quality information has not been given sufficient primacy over other issues is reflected in various ways within the existing standards. For example, the concept of 'true and fair' or 'fair representation' has not been sufficiently developed in the standards. Instead, the focus has been on mechanistic compliance with detailed rules – whether that produces the right result for investors or not. Whether or not this is the intention of the IASC/IASB, this has been the outcome as accountants and auditors have become increasingly risk averse in relation to compliance. The perspective has increasingly become that implementing the detail of the rules – regardless of the outcome – creates less risk than applying judgement. The view that 'true and fair' still has precedence in the preparation of accounts is becoming an increasingly academic one.

For example, the AIC has recently been debating whether 'C' shares issued by investment companies should be classified as liabilities (an issue where the IFRS and UK standards are identical). Without going into the detail of the issue, investors, preparers and auditors are all united in the view that the presentation of 'C' shares in this way is nonsensical and extremely misleading to investors. Even the UK standards setters have expressed sympathy with the industry's concerns on this matter. However, as the terms of the 'C' share issue do not meet the precise terms of the detail of the relevant standard, it appears that a nonsensical and misleading accounts presentation must be forced through. There is no realistic chance that audit firms will be prevailed upon to agree to a 'true and fair' override.

Consistency is only beneficial where it also delivers accuracy. Information which is consistent but misleading or inaccurate has no value whatsoever and may even be damaging.

- **Recognise diversity among issuers:** The IASC's current objectives do have some regard to diversity as they make reference to the size of companies (Paragraph 2(c) of the constitution). However, this recognition is insufficient given the breadth of issuers which apply IFRS. Although there are many areas where the same standards can and should apply to issuers in different commercial sectors, this is not always the case.

Investors do not necessarily want companies in sectors ranging from regulated utilities, international oil exploration, pharmaceuticals research development and manufacturing, retailing, and banking – let alone investment companies – to report in exactly the same way. The potential for differences of this kind should be formally recognised in the IASC's objectives.

For example, the IASB has been investigating the possibility of radically extending the use of consolidation, on the basis that this will provide the users of the accounts with the information that they need. This may be true of traditional trading companies, but is not the case for passive investment vehicles such as investment companies. Nonetheless, the IASB has indicated that there will be no exemptions or special treatment for investment vehicles. However, the AIC has not yet encountered an investor who believes that an extension of consolidation to the investee companies would improve the quality of the information in the accounts of investment companies – the consistent view is that it would result in poorer corporate reporting.

- **Incorporate principles of good regulation:** The IASC's overall ability to develop effective standards would be significantly enhanced if the constitution set out clear principles designed to achieve effective regulation. In particular, it should require that, in pursuing its activities, the IASB should be:
 - **Proportionate.** The IASB should only intervene when necessary. Interventions should be proportionate to the problem or risk. Assessing the need for intervention should always include a cost benefit analysis (see 'evidence-based policy-making' below).
 - **Targeted.** This would require the IASB to ensure that standards are focussed on particular, identified problems. These problems should be ones that are of real concern to the market – not simply areas of technical or academic concern. The IASB's obligation to target its activities should also involve reviewing the impact of existing standards to test whether they are necessary and effective. If they are not necessary and effective they should be modified or deleted.

- **Accountable.** The IASB should be prepared to justify decisions, explaining how and why a final view has been reached. This would, of course, include maintaining existing commitments to consultation as well as explaining policy decisions and specific aspects of standards.
- **Consistent.** This would involve the IASB ensuring that its standards were consistent with one another and worked in a joined up way. It would also require the IASB to ensure that its standards were consistent with its objectives – which should include, as the highest priority, a commitment to supporting the preparation of high-quality information which serves the needs of investors.

The Trustees should review the extent to which the IASB has achieved these outcomes in its annual review of the strategy of the IASB and its effectiveness.

- **Make an explicit commitment to evidence based policy-making:** This should include consultations with investors to find out what areas of accounting are causing concern and what problems need to be remedied. It is not clear that this approach is always adopted at present.

For example, on the issue of an extension of consolidation the IASB has stated:

'The board affirmed that investment companies (such as private equity entities and venture capital organisations) should not be excluded from the scope of the proposed standard. The board concluded that the information needs of users are best served by financial statements that consolidate investments under the control of the reporting entity.'

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The AIC does not agree with the contention that this approach will serve the best interests of users and believes its view is shared across the market (by both preparers and investors). This is a prime example of the sort of statement that the Trustees should be in a position to challenge and ask for the evidence which supports them.

Key questions which should be asked are:

- How many investors in investment companies have been pressing for a change to the basis of consolidation, who are they and what are their reasons?
- How many investors in investment companies have opposed the basis of consolidation, or had reservations with it? Who are they and what are their reasons?
- What is the balance of opinion for and against the proposal?

- In the light of the evidence gathered (which should include an assessment of costs and benefits, see below) how did the board reach the conclusion that user needs would be best served by this change?

The AIC believes that questions of this nature would expose shortcomings in the IASB's conclusions and that it could not show it had sufficient evidence to say that the needs of users of investment companies are, as a matter of fact, best served by such changes.

Our fear is that, in fact, the decision over this matter was motivated primarily by a desire not to give any 'special treatment' for fear of where this might lead, rather than from what the users of the accounts actually want or need. However, where 'special treatment' results in better information for users of the accounts, and can be justified, it should be embraced rather than resisted. The key to making decisions of this nature should be related to evidence about the real market impact.

The evidence based approach should also involve a commitment to cost benefit analysis which considers the costs of implementing standards (both initial and ongoing) against the benefit which will be delivered to the market.

It is clear that the costs of introducing IAS across the European Union to date have been substantial, and may even run into billions of pounds. For the IASC to maintain its reputation and support, it will be important that in future these costs are clearly balanced against identified, costed benefits.

No standard, or change to a standard, should be capable of being issued simply on the basis that it will improve corporate reporting for some users. What must be demonstrated is the benefits delivered clearly outweigh any additional costs incurred by preparers of accounts, and any other attendant costs.

Incorporating these elements into the IASC's objectives will provide a clear framework for its activities and provide the Trustees with an effective yardstick against which to judge the work of the IASB. The eventual outcome will be higher quality financial statements, with all the public benefits that implies.

Developing the IASC's oversight mechanisms

The AIC supports the continued role of the Trustees in overseeing the work of the IASC. It **recommends** that the IASC should not create a Monitoring Group as proposed and should instead consider other options to enhance the IASC's oversight function.

The 'proposals and issues' paper suggests that a Monitoring Group should be established because the IASB has no authority or powers to impose its standards on countries and that it does not have a direct reporting mechanism to governments. It also notes that the IASB is different in many ways from other standard setting bodies - for example, it is not comprised of regulatory officials from different countries. A Monitoring Group is therefore proposed as

a way to enhance the IASC's accountability and provide a means to assess the impact of the standards and their application.

We do not agree that imposing a body over and above the Trustees is the way forward. Creating formal links to Government and other official bodies is not the best way to increase the authority and demand for take-up of IFRS. This should be done by creating better targeted and effective standards – and this can be achieved by enhancing the governance of the IASC in different ways. In the first instance we **recommend** that this can be achieved by refining the objectives of the IASC (see discussion above).

Second, we **recommend** that the board of Trustees itself should be reconfigured to achieve governance arrangements that will ultimately support the creation of more authoritative standards. This reconfiguration will be most effective where it connects the perspective of the IASC more closely to the needs of users of accounts - not to official institutions. The priority of the Trustees should be to get the current arrangements right, not simply to impose another layer of oversight on top.

To ensure appropriate accountability of the IASC, the composition of the Trustees should be revised with the following principles in mind:

- **The composition of the Trustees should be dictated by their 'discipline' and should include a majority of investors and investor representatives.** Investors are the key users of accounts. Trustees with an investor's perspective will have the clearest insight into what information the market requires to function effectively. This, in turn, will ensure that the output of the IASC delivers the greatest public benefit. Trustees with this background are also likely to be well attuned to the need to balance competing issues such as cost vs. benefit.

The IASC constitution currently embeds geographical distribution into the composition of the board of Trustees (Paragraph 6 of the constitution). The AIC **recommends** that it should also specify the disciplines of Trustees. We **recommend** that it should require that:

- **Eleven** of the twenty-two individuals must be investors or investor representatives. These would primarily be shareholder representatives, but there might also be some role for holders of debt.

The recommended number of investor representatives set out above assumes the current complement of 22 Trustees is maintained. If the number is changed the principle would be that investors should represent either half of the total or a majority if there are an odd number of Trustees.

- **four** of the twenty-two individuals must be issuers or issuer representatives

- **four** of the twenty-two individuals would be auditors or accountants or their representatives
- **three** of the twenty-two individuals would be representatives of relevant regulatory authorities.

Clearly, all of the individuals appointed to be Trustees would also have to have suitable experience of accounts and accounting issues.

If the Trustees felt it desirable, the requirement to achieve a suitable breakdown of disciplines could be additionally further broken down according to the relevant geographical distinctions as required. So, of the six North American Trustees, three would be investors, one would represent issuers, one auditors/accountants and one the relevant regulatory authorities etc.

The break-down suggested above does not challenge the current number of Trustees which make up the board. In the absence of the number of Trustees being revised to create the potential for a 'true' majority of investor representatives, the AIC **recommends** that the Chairman of the Trustees should always be drawn from among the investor representatives. This requirement should be added to the provisions related to the appointment of the Chairman already set out in constitution (in Paragraph 10).

Determining the Trustees in this way would automatically make the IASC more accountable and attractive across jurisdictions – particularly if introduced in combination with the recommended adjustments to the IASC's objectives.

- **Existing processes for selecting Trustees should be bolstered:** It is unlikely that the proposed Monitoring Group, particularly as currently envisaged, would result in the selection of a more effective group of Trustees than would be possible under the model proposed above (i.e. where a more defined balance of disciplines was required and where Trustees have a more appropriate set of objectives).

The IASC should not seek to secure its authority by reliance on appointments made by representatives of international regulatory bodies (as currently envisaged). Instead it should secure its authority – and ultimately the adoption of IFRS – by creating, and being seen to create, standards which really do deliver what investors want. This offers a far better prospect of creating a high-quality, respected and internationally adopted accounting regime.

In rejecting the proposed Monitoring Group, we **recommend** the Trustees should instead review the arrangements by which the various geographic regions nominate and appoint Trustees, with a view to increasing stakeholder involvement. In some geographical regions there may be scope to establish processes with a greater degree of engagement from

stakeholders (investors, issuers etc). This could include wider consultation, input into the range of candidates put forward for consideration, perhaps even some form of voting process. Precise arrangements would no doubt differ from region to region, but there is no reason in principle why institutional representatives appointed to a Monitoring Group should be uniquely, or better, able to put forward suitable candidates. In fact, they may have less scope to make successful appointments as they may not be as close to the needs of the markets as other stakeholders.

At the very least, consultative processes should be developed to provide stakeholder influenced lists of nominees which the Trustees would use to select new recruits to the Board. We are confident that processes of this kind would be able to secure Trustees of suitable authority and expertise, without the need for the proposed Monitoring Group.

- **Role of Trustees.** If the objectives set out in the constitution and the composition of the Trustees are revised as recommended, there is no reason why the Trustees themselves should not fulfil all the functions envisaged for the Monitoring Group. Indeed, they are likely to be better able to review the strategy of the IASC and IASB and deliver an effective review of procedures and consultative arrangements etc.

One critical function of the Trustees is to promote IFRS. We are confident that the reforms discussed above would help this process as they would inevitably increase investor input into the development of standards. This will in turn increase pressure on issuers and regulatory authorities to adopt them as appropriate. (If investors are not content with the standards it provides a reason for national and other authorities to reject IFRS.) The ideal outcome will be for the further take-up of IFRS to be demand-led. This would be the ultimate prize and something that a reconfigured board of Trustees, alongside a revised constitution, would be well placed to deliver.

The AIC also **recommends** that the Trustees should increase their direct oversight of the preparation of IFRS. At the moment their oversight function of the standards themselves concentrates on reviewing the strategy of the IASB and its effectiveness and considering broad issues affecting accounting standards. The AIC **recommends** that the Trustees should be required to approve/sign-off standards (although we do not envisage that they would have powers of amendment). They should also act as a final forum for the IASB to justify its decisions regarding specific standards (i.e. the Trustees should test the evidence base, including the cost-benefit analysis, which justifies proposed standards and changes to standards). This will significantly increase the accountability of the IASB and radically improve the process of standards setting.

While the AIC does not support the creation of a Monitoring Group as proposed, it recognises that there may be scope to increase the liaison between the IASC Foundation and the institutions which would have made up

the membership of that body. To this end, we **recommend** the creation of a forum to discuss issues of strategic interest.

Size and composition of the IASB

In principle, the AIC supports the expansion of the IASB from 14 to 16 members. However, in light of the AIC's proposals to revise the IASC's objectives, we would identify reasons for this in addition to those identified (in Paragraph 26 of the 'proposals and issues' paper).

For example, if the IASC constitution is adjusted so that the work of the IASB is required to recognise greater diversity among issuers this is likely to create demand for a more diverse skills base within the IASB.

In particular, the AIC **recommends** that there should be formal recognition in the IASC's constitutional documents of a need for appropriate investor experience to be represented on the IASB. It is notable that the current discussion of relevant disciplines (Paragraph 21 of the current constitution) makes reference to 'users' rather than investors. Even this, somewhat ambiguous, reference to investors is third on the list of relevant experience – a position indicative of the importance that is placed on arguably the most important stakeholders of all. Increasing the membership of the IASB to include two additional members with experience from the investor perspective would be an invaluable enhancement of the skills base, and should be pursued as a priority.

Also, embedding evidence based policy making more clearly into the IASC's constitution may lead to new processes being developed – particularly in relation to cost-benefit analysis – which could require a different profile of expertise to be incorporated into the IASB.

(Notwithstanding the need to explicitly refer to investor experience in the overall composition of the IASB) the AIC agrees that the 'Criteria for IASB Members' as set out in the annex to the constitution remains relevant and should be retained.

The AIC also accepts the proposal (Paragraph 27 of the 'proposals and issues' paper) to include geographical criteria in respect of the composition of the IASB, as this reflects the current reality of selection and will simply formalise existing arrangements.

Questions relating to the Monitoring Group

a) Do you support the creation of a Monitoring Group in order to create a direct link of public accountability to official institutions? No (see above for discussion).

b) The Trustees will remain responsible for the governance of the organisation and the oversight of the IASB. Their responsibility to a Monitoring Group will enable regulatory and other authorities responsible for the adoption of IFRSs to review the Trustees' fulfilment of their constitutional duties. Does the formulation of the Monitoring Group's mandate, as described in the proposed Section 19, appropriately provide that link, while maintaining the operational independence of the IASC Foundation of the IASB? No. The proposals do not create a proper basis for overseeing the work of the IASC. The Trustees should be autonomous in fulfilling their duty to oversee the work of the IASC Foundation and IASB. Including a formal oversight link to other authorities will provide little value and could even be damaging insofar as it distracts from the preferred approach of increasing investor involvement in the IASC and orientating its activities more clearly to recognise their interests.

There is already a danger that bureaucratic and administrative priorities (such as targeting levels of adoption of IFRS reporting rather than the quality) will dominate the oversight and goals of the IASC. Creating a Monitoring Group as envisaged will simply increase these risks.

The proposal to create a Monitoring Group should not be adopted as it will not enhance the governance of the IASC in a desirable fashion. Other options (as discussed above) are far more preferable.

c) Given the proposed creation of a Monitoring Group, would there be a continued need for the Trustee Appointments Advisory Group in the selection of Trustees? The Monitoring Group should not be created. However, the way in which Trustees are appointed should be reviewed. Options for widening and deepening (and if possible democratising) the process of consultation on the appointment of Trustees should be examined.

Whatever reforms are introduced, we envisage that the Trustee Appointment Advisory Group is likely to play a role in any revised process. (See discussion above.)

d) The Trustees would welcome any additional comments related to a Monitoring Group proposal. See above.

Questions related to IASB composition

a) Do you support the principle behind expanding the IASB's membership to 16 members in order to ensure its diversity, its ability to consult, liaise and communicate properly across the world, and its legitimacy? Yes (see comments above).

b) Do you agree with the geographical formulation suggested by the Trustees? Yes (see comments above).

c) The Trustees are suggesting that the Constitution provide flexibility on the matter of part-time membership. Do you support that recommendation? The AIC supports the proposals on part-time membership.

d) The Trustees would welcome additional comments on the proposals.
See discussion above.

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For more information on the issues raised in this note please contact:

Ian Sayers, Deputy Director General, The Association of Investment Companies. ian.sayers@theaic.co.uk

or

Guy Rainbird, Public Affairs Director, The Association of Investment Companies. guy.rainbird@theaic.co.uk