To: Mr Gerrit Zalm

Chairman of the Trustees, International Accounting Standards Committee Foundation

30 Cannon Street, London EC4M 6XH, United Kingdom

Re: Comment Letter – IASC Foundation Constitution Review, Part 2

Dear Mr Zalm,

I appreciate the opportunity to comment on Part 2 of the ongoing Constitution Review of the IASC Foundation, including the consultation document titled *Proposals for Enhanced Public Accountability* and published by the Foundation on September 9, 2009. Furthermore I apologise for sending this letter a week later than the consultation deadline of 30 November, and am thankful for the extension that was granted to me in this.

I am a resident scholar at Bruegel, a European think tank which started operations in Brussels in 2005 with the support of a number of European member state governments (including, at the time, the Netherlands under your leadership of the Finance Ministry) and international companies. Bruegel's aim is to contribute to the quality of economic policymaking in Europe through open, fact-based and policy-relevant research, analysis and discussion. I am also a member of the CFA Institute's Corporate Disclosure Policy Council and of the International Corporate Governance Network's Accounting and Auditing Practices Committee. In the latter capacity I participated in the Constitution Review Round Table meeting organised by the Foundation in London on September 9, 2009, and expressed views on behalf of the ICGN. However, this letter represents my personal views and not those of the ICGN or, for that matter, those of Bruegel as an organisation.

Accounting standard-setting is a topic to which I have devoted significant attention since 2002. I believe that my Bruegel work, occasional private consulting activity, and nonprofit activities do not introduce any commercial or special-interest bias to my views nor do they impair the integrity of my research.

The Need for Strategic Readjustment

After a string of remarkable successes since 2000, the IASC Foundation has encountered mounting challenges in the ongoing financial crisis, which it has generally not met with apparent success. Beyond the very public controversy over fair value accounting, which is not specific to IFRS and has its echo in the domestic US context, a number of negative developments have occurred. They include, on the standard-setting side, the forced publication in October 2008 of a rule on reclassifications that is widely considered as decreasing reporting quality, and the failure to reach a joint approach with FASB on financial instruments in July 2009; on the international recognition side, the refusal of the European Commission to consider adoption of IFRS 9 in 2009, and in the US the likely delaying by the SEC of eventual IFRS adoption milestones; and on the governance side, the rushed creation in 2008-09 of a Monitoring Board whose design was widely criticised in the global investment community, then the refusal so far of the European Commission to participate in the Monitoring Group once created.

In this context, the confidence that the IASC Foundation attracts from its stakeholders and especially the global investment community appears to be at a low point, while the prospect of its capture by national or regional political interests has perhaps never seemed so threatening.

This challenging situation can be attributed both to the intrinsic political difficulty of the IFRS project, which the favourable market conditions of 2000-2007 had somewhat masked, and to specific decisions (or the absence thereof) by the Trustees and the IASB, both before and after the start of crisis. On the one hand, the crisis has revealed the magnitude of the strategic challenges faced by the Foundation. On the other hand, the Foundation's performance in meeting these challenges has been questionable, thus compounding its current difficulties, and in spite of a number of helpful initiatives such as the establishment of the Financial Crisis Advisory Group.

As a consequence, it is appropriate for the IASC Foundation to consider a strategic readjustment. This does not necessarily imply a dramatic change of course or a reversal of decisions made already. But the situation calls for the Foundation to chart a clear course to overcome the mounting obstacles it faces, and perhaps also envisage changes in leadership. Trying to just muddle through will lead to ever-larger problems which may eventually call into question the continued existence of the IFRS project itself.

As many of the current difficulties are of a primarily political nature, the Constitution Review is the right time to engineer such a strategic readjustment, and put IFRS standard-setting back on a sustainable track. However, Constitution changes only make sense as part of a broader, consistent vision. Two broad related themes, summarised under the labels 'Governance' and 'Convergence', are considered in the following comments, each of which has implications in terms of potential Constitutional changes. A number of recommendations are then drawn from this analysis, including specific comments on the IASC Foundation's consultation document.

Readjusting Governance

The IASC Foundation was set up without a clear indication of who its ultimate stakeholders are. Its first Trustees were appointed by an ad hoc committee and subsequent appointments were made by existing Trustees. Funding has been similarly ad hoc in the first years, and since 2006 has migrated towards a country-based system with wide variations among countries as to who the local funders are. The Constitution itself does not articulate specifically on whose behalf the Foundation is designed to work. The claims of "public accountability" in the Constitution Review consultation document are similarly vague.

In the discussion document for Part 1 of the Constitution Review (July 2008), it is mentioned that the Trustees "implemented regular meetings with various interested external parties, including public officials and business, investor and accountancy organisations" (page 6); that "the Trustees met prominent stakeholders from around the wor[l]d with an interest in accounting standard-setting, including regulators, accounting and business organisations, and the Standards Advisory Council" (page 7); and that "the Trustees have identified stakeholder groups with which they maintain regular contact and are establishing mechanisms to receive input outside formal consultations. These stakeholder groups include official organisations, policymakers, investor groups and private sector institutions from around the world" (page 9). The consultation document for Part 2 of the Consultation Review refers to "the need to demonstrate the organisation's public accountability and to be open to dialogue with all stakeholders" (page 4) but is even less specific than in Part 1 about who these stakeholders may be.

This question of stakeholder identification is becoming crucial as IFRS gain ground and are increasingly endorsed around the world, a consequence of which is that the IASB finds itself subject to much more pressure from competing special interests than was the case before 2002, and that the need to differentiate among these competing interests becomes more pressing.

On the face of it, investors would seem to be the natural "priority stakeholders" for the Foundation. In a Statement on Principles of 22 September 2009, the IASCF's Monitoring Board wrote: "We view the primary objective of financial reporting as being to provide information on an entity's financial performance in a way that is useful for decision-making for present and potential investors". The IASB's own conceptual framework, in its current wording dating from the late 1980s, states that "While all of the information needs of these users [as previously listed: investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies, and the public] cannot be met by financial statements, there are needs which are common to all users. As investors are providers of risk capital to the enterprise, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy" (Section 10).

There are however obstacles to the empowerment of investors, or more generally of users of financial information, as the Foundation's primary stakeholders. The global investment community is very fragmented and is not as well represented by industry bodies as are other business categories, in spite of the constructive efforts played in that sense by, among others, the CFA Institute, the International Corporate Governance Network, and, in the US, the Council of Institutional Investors. In many jurisdictions, including several major EU countries, a critical number of large investment players are themselves a part of diversified financial services firms whose interests as issuers may prevail over their views as investors in accounting debates. Meanwhile, many firms with investment arms, including many mutual fund managers, insurance companies, or investment banks, often have large issuers as major clients and are therefore wary of expressing views in public discussions that may run counter to those clients' policy positions. Thus, the representation of the global investment community remains underdeveloped in accounting policy debates.

But this does not imply that the IASC Foundation should renounce putting investors (and other users) at the centre of its governance framework. On the contrary, being investor-centric is the only way for the Foundation to ensure the sustainability of IFRS, much the same way as companies have to be customer-centric in order to compete successfully. However, it does mean that the IASC Foundation has itself to organise representation of the global investment community for the purposes of its own governance, rather than relying on existing representative bodies. So far the Foundation's efforts in this have been extremely modest and have sometimes appeared half-hearted. Putting investors (back) at the core should be the starting point of the Foundation's needed governance adjustment.

In individual jurisdictions, the representation of investors and other users can be partly exercised through public authorities that oversee standard-setters and intervene in their governance on behalf of the investing public. This is typically the case in the US (through the Securities and Exchange Commission), Japan (through the Financial Services Agency), or the UK (through the Financial Reporting Council). However, no such arrangement is possible at global level as there is no global public authority that could credibly play a similar role. The claim in the current Constitution (Article 18) that the relationship between the Foundation and the newly established Monitoring Board "seeks to replicate, on an international basis, the link between accounting standard-setters and those public authorities that have generally overseen accounting standard-setters" fails to adequately recognise the simple and fundamental difference between national environments and the global level, namely that there is no such thing as a global government.

By reorienting its funding since 2006 towards a country-based model in which funding decisions are ultimately made by national governments (and the European Union), and by empowering in early 2009 a Monitoring Board composed of national (or in the case of the European Commission, regional) authorities, the Foundation is following a track that may lead it ultimately to be governed as a traditional treaty-based international organisation, such as the specialised agencies of the United Nations. However, for the same reasons that have led most developed countries to outsource accounting standard-setting to specialised bodies that rely largely on private-sector resources, the gradual introduction of an "UN-like" funding and governance framework for IFRS standard-setting involves a significant risk of political capture and poor technical outcomes. In any case, it is highly unlikely that such a framework for oversight of IFRS standard-setting could adequately represent the global investment community in a sustainable manner.

Readjusting Convergence

The objective to develop “a single set of high quality, understandable and enforceable global accounting standards” (Article 2(a) of the current Constitution) has given rise to efforts to seek ‘convergence’ between IFRS and the most important and influential sets of national accounting standards. Convergence is specifically mentioned as an objective in itself in Article 2(d) of the current Constitution. In practice, convergence efforts have been essentially focused on the United States, with a minor secondary focus on Japan. Convergence with US GAAP has been enshrined in the so-called Norwalk Agreement of September 2002 between FASB and the IASB and in consecutive Memorandums of Understanding (MoUs) in 2006 and 2008, as well as a recent joint statement issued in November 2009. The aim of convergence was solemnly reaffirmed and endorsed in the Pittsburgh summit statement of G20 country leaders, whose section relating to accounting standard-setting (item 14) reads as follows: “We call on our international accounting bodies to redouble their efforts to achieve a single set of high quality, global accounting standards within the context of their independent standard setting process, and complete their convergence project by June 2011. The International Accounting Standards Board’s (IASB) institutional framework should further enhance the involvement of various stakeholders”.

However, there are worrying signs that the convergence effort between IFRS and US GAAP, as currently practiced, may have become counterproductive from the point of view of standards quality, and of long-term IFRS acceptance. My assessment is that a growing number of observers in the policy, auditing and investment communities are viewing the current IFRS-US GAAP convergence process as increasingly akin to a race to the bottom rather than to the top. Specifically, the IFRS 8 standard on operating segments, one of the first to follow the February 2006 MoU, was adopted by the IASB (and subsequently by the EU) against considerable opposition from the global investment community[1]. Later, the emphasis placed on a convergent approach for the crucial issue of financial instruments accounting (which in IFRS terms corresponds to the replacement of IAS 39) was called into question by the rushed adoption on 13 October 2008 of an amendment to IAS 39 permitting reclassifications, without apparent coordination with FASB and against the near-unanimous opposition of the global investment community, and by the publication in July 2009 of divergent visions on financial instruments accounting by the IASB and FASB respectively. Simultaneously, the prospect of US adoption of IFRS for domestic issuers, which may have seemed tantalisingly close in 2008 when the SEC was chaired by Christopher Cox, is now becoming more remote, and the same is true of Japan as regards mandatory IFRS adoption.

In the light of these developments and the current dynamics in key jurisdictions, the IASC Foundation should seriously explore to what extent convergence as currently practised is compatible with its other objectives. It seems natural for the Foundation to continue seeking eventual IFRS adoption by the US and Japan as a key aim. However, IFRS adoption for the US is not directly comparable to what it has been or is in other jurisdictions, in which IFRS were widely seen as of generally equal or higher quality than the local standards they were to replace. While Enron and other accounting scandals have raised doubts about the reliability of US GAAP, there are indications that many stakeholders of the US investment community are concerned that IFRS adoption may carry the risk of a decrease in quality, both in terms of the content of existing standards and, perhaps even more importantly, in terms of the future standard-setting process. Thus, it may be the case that the bar to be reached for IFRS adoption to become possible in the US is higher than the milestones set by the current convergence programme under the FASB-IASB MoUs, which may themselves prove impractical and unachievable within the G20-endorsed completion deadline of mid-2011.

[1] This point is specifically documented in “EU Adoption of the IFRS 8 Standard on Operating Segments”, Note for the ECON Committee of the European Parliament, 21 September 2007, published in the Bruegel Policy Contribution series and available on www.bruegel.org.

Thus, the Foundation may consider adjusting its strategy for enabling eventual IFRS adoption in the US, Japan, and other jurisdictions which have not yet (or not fully) adopted them. Instead of an alignment between IFRS and US GAAP (or Japanese standards), which may have become unrealistic and counterproductive, the aim would be to make IFRS of sufficiently high intrinsic quality so that key US and Japanese constituents, first and foremost the investment community, would no longer resist but on the contrary would advocate their mandatory use.

Recommendations to the Trustees

These recommendations follow the above developed analysis.

- Timing and process: the changes envisaged in Part 2 of the Constitution Review are not ambitious enough to meet the expectations and requirements of the current moment of IFRS development. Thus, the Trustees should open a Part 3 of the Constitution Review immediately after the completion of Part 2 (just as Part 2 followed Part 1, or to be more accurate was started just before the completion of Part 1). This Part 3 should be primarily about how to make the IFRS Foundation (if this new name is adopted) more investor-centric and should include the consideration of significant changes to both the Monitoring Board and the funding framework.

- Representation and participation of the global investment community: In Part 3, the Trustees should aim at the building of appropriate mechanisms for the representation and participation of the global investment community and of other users of financial information, both within a transformed Monitoring Board (or a body or bodies to which the Trustees would become accountable and that would replace the Monitoring Board) and in the Foundation's funding framework, for which the Trustees may return to an at least partly transnational (as opposed to country-based) approach. As no obvious precedent exists, the Trustees may adopt an experimental and perhaps phased approach to reach the aim of making their organisation ultimately accountable to the global investment community, while simultaneously keeping or developing accountability channels towards national governments and the EU. Specifically, the Trustees may consider integrating the relevant provisions relating to funding in the framework of the Constitution.

- Part 2 amendments: as previously stated, Part 2 as outlined in the consultation document is not ambitious enough to provide an appropriate response to current challenges as regards the Foundation's Constitution. However, some of the proposed changes could be adopted by the Trustees in this phase:
  - The suggested changes of names (IFRS, IFRS Board, IFRS Foundation; **Questions 1 and 2** of the consultation document) represent a significant and helpful streamlining of the current terminology, and should be adopted expeditiously. The sometimes heard argument that 'IASB' is an established brand whose value should not be lost fails to recognise how confusing the current 'alphabet soup' is for third parties which are not familiar with accounting standard-setting intricacies.
  - The changes to the Foundation's objectives as expressed in the Constitution's Article 2 (**Question 3**) merit further debate and this topic should be shifted to Part 3 in order to be made consistent with the broader strategic readjustment advocated above, as well as with the still ongoing rewriting of the IASB's conceptual framework. As regards the proposed changes, the following three remarks apply. First, in (a), the adjective 'acceptable' should be preferred to 'accepted' as this item should not refer to the actual adoption of the standards, only to their development by the IASB. Second, in (c), the notion of 'emerging economies' as a distinct category is arguably outdated and should be replaced by a broader reference to the diversity of the world's economies. Third, consistent with the above remarks on convergence, the entire item (d) could be deleted as convergence should not be an objective of the same order as (a), (b) and (c).

- The reference to the Trustees as the body where the Foundation's governance rests 'primarily' (**Question 4**) is of doubtful significance, as it is arguably incompatible with the currently applicable MoU between the Foundation and the Monitoring Board. The suggested amendment is therefore not 'clarifying' and should not be adopted.
- The widening of the geographical scope on the basis of which the Trustees shall be selected (**Question 5**) is welcome. However, it remains ad hoc, with no clarity as to the underlying principles of representation. A better alternative would be to specify according to which objective criteria the geographical balance within the Trustees should be established and regularly updated. Such criteria may include, for example, a combination of respective regions' population and measures of GDP and/or savings and/or market capitalization.
- The proposed accelerated due process (**Question 11**) rests on no compelling case and is likely to lead to a decrease in the quality of standards and a diminution of trust in IFRS on the part of the global investment community, as was the case in October 2008. The proposed amendment should be rejected by the Trustees.
- I have no particular comments on the other questions raised in the consultation document.

▪ Trustee engagement in the public debate: Irrespective of what changes are made to the Constitution, it would be in the interest of the Foundation and of the IFRS project that Trustees engage much more in the public debate than has been the case since the beginning of the crisis. The spirit of the Foundation's constitutional framework that has been in place since 2001 is that the Trustees should protect the integrity and independence of the standard-setting process by taking the lead as regards the governance and funding of the entire standard-setting organisation. Instead, in the past two years it has been the Chairman of the IASB, rather than the Trustees, who has been most visibly present in meetings with policymakers as well as in the public debate to explain and defend the Foundation's governance framework and accountability. Though the IASB Chairman is a widely recognised and respected figure, this is an unsustainable pattern that should be remedied through significantly enhanced public engagement by the Trustees themselves.

  In this spirit, the Trustees may also consider whether the position of their Chair should become a full-time assignment, as is the case in many comparable organisations. The same considerations would justify further clarifying the respective scope of the Foundation and the IASB by removing the mention in the Constitution that the IASB Chair should simultaneously be chief executive of the Foundation, as has been advocated by other respondents.

Yours sincerely,

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