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SUGGESTIONS FOR REFORMING THE GOVERNANCE OF GLOBAL ACCOUNTING STANDARDS

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Highlights

- Public authorities overseeing the International Financial Reporting Standards (IFRS) Foundation, through the Monitoring Board in place since early 2009, should encourage the Foundation to make itself more directly accountable to the global investment community.
- The Monitoring Board should re-examine its own role, composition and processes in the same spirit, one option being its enlargement to include investor representatives, and transformation into a statutory body of the IFRS Foundation.
- The IFRS Foundation's funding framework should be better aligned with its governance and accountability arrangements.

This Policy Contribution is an adaptation of a letter sent on 12 April 2011 from the author to the Monitoring Board of the IFRS Foundation, whose members are public authorities including the European Commission, as a response to the public consultation on the Monitoring Board's Consultative Report on the review of the IFRS Foundation's governance.

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SUGGESTIONS FOR REFORMING THE GOVERNANCE OF GLOBAL ACCOUNTING STANDARDS

NICOLAS VÉRON, MAY 2011

THE MONITORING BOARD, which oversees the **International Financial Reporting Standards** (IFRS) Foundation, began in 2010 a review of the governance structure and processes underpinning IFRS standard setting. The review's stated aim is to establish if the governance structure "effectively promotes the standard-setter's primary mission of setting high quality, globally accepted standards as set forth in the Constitution of the IFRS Foundation, and whether the standard-setter is appropriately independent yet accountable". In February 2011, the Monitoring Board published a Consultative Report[1] setting out proposals for governance reform. This Policy Contribution is a response in the context of the Monitoring Board's public consultation.

A debate on the IFRS Foundation's governance is timely and necessary. Bruegel has previously published several papers in which it is argued that the IFRS Foundation needs a broad strategic readjustment if it is to make itself credibly accountable to the stakeholders whose needs it is primarily meant to serve, namely the global investment community[2]. This is the Foundation's core challenge at the current juncture.

In principle, the IFRS Foundation's Constitution and even more so the IASB (International Accounting Standards Board) Conceptual Framework are quite unambiguous about what this stakeholder orientation should be. So are the preamble of the Monitoring Board's Charter as signed by all its current members (first recital: "Whereas, the primary objective of general purpose financial reporting is to provide financial information about the issuer to capital providers"), and its statement of 22 September 2009 on Principles for Accounting Standards and Standard Setting[3].

However, the global investment community is very fragmented and has not organised itself into any broadly representative body, in spite of valuable contributions from organisations such as the CFA Institute or the International Corporate Governance Network. This problem of collective action makes it challenging to create a well-functioning governance framework for the IFRS Foundation.

In its first eight years of existence (2001-09), the IFRS Foundation (then named the IASC Foundation) was governed by a group of Trustees who were initially appointed by an ad hoc committee and then independently decided on their own reappointments and replacements. In early 2009 this framework was profoundly altered by the creation of the Monitoring Board, whose governance is set out in its own Charter, though without autonomous legal personality, as a separate body from the IFRS Foundation, and the agreement of a Memorandum of Understanding under which the Foundation's Trustees grant the Monitoring Board broad and explicit power over their own appointments and reappointments. This transfer of power implies that the role of the Monitoring Board goes well beyond mere monitoring – its name is a misnomer – and that it has become the IFRS Foundation's de facto highest body, even though it is not formally part of the Foundation[4].

The previous situation, in which the Trustees were essentially self-appointed, was unsatisfactory from an accountability perspective. This was recognised as such by most stakeholders. However, the post-2009 arrangement is not satisfactory either, for two main reasons. First, the Monitoring Board cannot be expected to consistently represent the global investment community, whose needs the IFRS Foundation is meant to serve, because of the diverse perspectives, mandates and governance patterns of its members. This assessment is amply supported by past

1. Consultative report available at: http://www.iosco.org/monitoring_board/pdf/Review_of_the_IFRS_Foundation_Governance_Report.pdf

2. See in particular Nicolas Véron, *The global accounting experiment*, Bruegel Blueprint, April 2007; 'Empower users of financial information as the IASC Foundation's stakeholders', Policy Contribution, July 2008; 'A US strategy for IFRS adoption', Policy Contribution, April 2009; and 'IFRS sustainability requires further governance reform', December 2009, all available at www.bruegel.org .

3. Monitoring Board Charter and September 2009 statement available at http://www.iosco.org/monitoring_board/

4. The Foundation's revised Constitution has a section about the Monitoring Board (Articles 18-21); however, the Monitoring Board is not bound by the Constitution.

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experience. Second, the Monitoring Board, through its crucial power to appoint and reappoint the Trustees, has de facto control over the Foundation (at least on a medium-term basis) without being actually part of its institutional framework. Such 'backseat driving' can be expected to result in a harmful muddling of responsibilities, with the probable effect of further disempowerment of the Trustees without compensating by creating appropriate accountability channels for the Monitoring Board itself.

Two options for improvement

This situation can be improved in two ways. The first, preferable, option would be to recognise the central role of the Monitoring Board in the Foundation's governance, bring it into the fold of the Foundation itself, and make it more convincingly representative of the global investment community. Under this option, the governance of the Monitoring Board itself would be set by the Foundation's modified Constitution, and its Charter and Memorandum of Understanding with the Trustees would no longer exist. To be consistent with the commitment to serve the information needs of the global investment community, the membership of the Monitoring Board should be simultaneously enlarged to a number of investor representatives, which arguably should be at least as many as the representatives of public authorities within the Monitoring Board. How to select these investor representatives would be a thorny issue, but not an intractable one.

The other, less radical option would be to refocus the role of the Monitoring Board on monitoring, by ending its right of veto over Trustee appointments and reappointments and thus reducing the current confusion of responsibility and accountability. However, this should not simply be a return to the pre-2009 situation; additional accountability of the Trustees to the global investment community should be introduced. One possibility would be to complement the Monitoring Board with a parallel body composed of investor representatives and to require both bodies to express public opinions on proposed Trustee appointments as part of the Trustee appointment and reappointment process.

Just as importantly, the Foundation's funding framework requires reform that would make it better aligned with the aim of keeping the Foundation accountable to the global investment community. This should involve a re-examination of the principle that funding should be 'non-voluntary', which is practically incompatible with the aim of making the Foundation independent from national political interests.

These fundamental issues of accountability should be clarified as a priority for the Monitoring Board's reform efforts. Such an endeavour is politically difficult – but what is at stake is the mid-term sustainability of IFRS standard-setting with global authority, a crucial component of current policy commitments to efficient, globally connected capital markets. Thus, the Monitoring Board should consider bold options to fix what remains at this point a profoundly imbalanced, and potentially dysfunctional, governance framework.

Specific governance issues

This section makes specific recommendations based on issues raised in the Monitoring Board's Consultative Report of February 2011. The questions in italics are from the Consultative Report.

1. Should concrete efforts be made to deepen the pool of candidates for IASB membership from diverse geographical and professional backgrounds?

The IFRS Foundation has published a set of detailed criteria for the selection of IASB members,

as an Annex to its Constitution document. However, it has not always been seen as complying with these criteria. Specifically, by recently appointing Mr Hans Hoogervorst as Chairman of the IASB, the Trustees have chosen an individual of high reputation but whose prior accounting experience is limited, in apparent non-compliance with the first criterion set out in the Annex under which "All members of the IASB (...) should have demonstrated a high level of knowledge and technical competence in financial accounting and reporting". This remark is not meant as criticism of the decision to appoint Mr Hoogervorst, but rather of the value of adding criteria while the existing criteria arguably discourage compliance by being already too rigid.

The geographical criteria set out in the Constitution's current Article 26 should be relaxed, and replaced with a general requirement that the composition of the Board should not be materially imbalanced when measured against the realities of contemporary capital markets.

2. Should the roles of the IASB Chair and the CEO of the IFRS Foundation be separated, and if so, how should this be formalised?

The words "who shall also be the Chief Executive of the IFRS Foundation" in the Constitution's Article 30 should be deleted, and a separate provision should be introduced for the appointment of the Foundation's CEO by the Trustees, replacing the current Article 47, thus allowing for the appointment of a separate CEO if the Trustees so decide.

3. Should there be a clearer division of responsibility between staff dedicated to the IASB operations and staff dedicated to the Foundation's administrative and oversight functions? If so, how should this be formalised?

An operational separation of the two organisations would be welcome. Ideally, they should be physically separated by moving the main office location of the Foundation's staff (as opposed to the IASB's staff) to either the Americas or Asia (in a country widely seen as strongly committed to the rule of law), thus making the Foundation less London-centric and better reflecting the global diversity of its stakeholders than is currently the case. This proposal is also practical given the current small size of the Foundation's staff.

4. Are there other aspects of Trustee composition or appointments that the Monitoring Board should consider?

In addition to the comments provided in the introductory section, the position of Chair of the Trustees should be a full-time (or at least half-time) job, thus allowing for actual leadership and commitment that in general has not been sufficiently noticeable in the past half-decade or so.

5. Should increased transparency be provided into the process for Trustee nominations? To what extent should the Monitoring Board be involved in the nomination process? Would further clarification of criteria for the Trustees' candidacy help support confidence of the stakeholders?

There is an inherent limit to the extent of the transparency of recruitment processes, short of making them subject to actual elections by a broad base of voters, which does not appear appropriate at this stage of the development of the IFRS Foundation. Thus, there is not much scope at present for additional transparency. As noted in the introductory section, the involvement of the Monitoring Board should be reduced by no longer giving it a veto over Trustee appointments, unless the Monitoring Board is itself fully brought into the scope of the Foundation's Constitution and is made in effect a body of the Foundation.

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As for recruitment criteria, a provision should be added to Article 6 of the Constitution that each new Trustee's professional background should give credence to his/her commitment to high-quality standards that serve the needs of capital providers. Furthermore, the unnecessary and distortive provision in Article 7 that "Normally, two of the Trustees shall be senior partners of prominent international accounting firms," could be deleted.

6. Should the membership of the Monitoring Board continue to be confined to capital markets authorities responsible for setting the form and content of financial reporting in respective jurisdictions? Should the Monitoring Board's membership be expanded by adding a mix of permanent members representing primarily major emerging markets and rotating members from all other markets? How should the major markets be selected? Should a jurisdiction's application of IFRS and financial contribution to standard-setting play a role? Should rotating members be selected through the International Organisation of Securities Commissions (IOSCO)?

There are two broad options for the improvement of the Monitoring Board's position and role, as set out above. In the first, which is the preferable option, the Monitoring Board should be transformed into a body of the Foundation that would credibly represent the global investment community whose needs the Foundation is meant to serve. In the second, less radical, option, the Monitoring Board should see its formal power to appoint the Trustees scaled down in order to make it more likely that the Trustees see themselves as accountable and committed primarily to the global investment community.

In both options, as well as in the (less desirable) assumption of status quo in the form and role of the Monitoring Board, the choice of public authorities as members of the Monitoring Board should be confined to those that, in view of their mandate and governance framework, have the most credible alignment of priorities with the global investment community as regards financial reporting standard setting, in their respective jurisdictions. This criterion should be preferred to the formal responsibility "for setting the form and content of financial reporting", whose importance is set to decline in those jurisdictions that have already made the firm decision to adopt IFRS. In the three jurisdictions that currently enjoy a permanent representation in the Monitoring Board, the above suggested criterion would arguably lead to the inclusion as members of, respectively, the US Securities and Exchange Commission, the Japanese Financial Services Agency, and the European Securities and Markets Authority.

As for the geographical coverage, objective criteria for representation in the Monitoring Board would be preferable to discretionary powers for IOSCO. One option would be to weight jurisdictions by their share of the aggregate market value of listed companies' free float, based on the location of such companies' operational headquarters. Under this criterion it can be expected, subject to more precise calculation, that 11 jurisdictions have consistently occupied the first ranks in the past few years and together represent more than nine-tenths of the global total: Australia, Brazil, Canada, China, the European Union, Hong Kong, India, Japan, Russia, Switzerland and the US. The membership of the Monitoring Board (again, as far as public authorities are concerned) could thus be based on this list. Alternatively, the inclusion of GDP as part of the weighting of jurisdictions could be considered. The criterion of free float is imperfect, particularly as it directly relates to issuers rather than to the investor community, but it is comparably easy to define and understand, and directly related to the use and usefulness of financial reporting standards, which is why its use is recommended here for lack of a better alternative.

As the Monitoring Board should primarily serve the needs of the investor community rather than issuers, there is no compelling case for making inclusion of a public authority in the Monitoring Board directly dependent on whether the corresponding jurisdiction mandates or permits the use of IFRS for local issuers.

It is not clear that rotating memberships are necessary or even desirable in this context, but a

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revision of the membership at regular intervals (say, every five years) can be recommended, together with a principle that the number of jurisdictions represented should not exceed a reasonable total, say twelve, in order for the Monitoring Board not to become too unwieldy. One implication would be that jurisdictions could have to leave the Monitoring Board if their relative share in global free float drops, assuming the above proposed weighting criterion is adopted. Thus, rotation would mirror the transformations of the global financial landscape.

7. Should the Monitoring Board continue to make its decisions by consensus? Are there any types of decisions taken by the Monitoring Board for which voting other than by consensus (for example, by qualified majority) may be appropriate? If so, what would be an appropriate voting mechanism?

If the Monitoring Board's role was essentially consultative, as it would become in the event of suppression of its veto right over Trustee appointments, then consensus could arguably be kept as a decision-making principle.

However, if the Monitoring Board has direct decision-making power in respect of the Foundation, as is currently the case and as would also be the case if it were to become an integral body of the Foundation as recommended above, then the consensus rule is likely to lead to harmful deadlock, in the current configuration and even more so if Monitoring Board membership is extended to additional jurisdictions and/or enlarged to investor representatives.

In this case there should be a qualified majority voting principle using the same weighting as noted in response to the previous question, eg share of the aggregate market value of listed companies' free float in the global total. The majority threshold could be set at different levels (say, from simple majority to four-fifths) depending of the type of decision considered.

8. To ensure increased involvement of public authorities and other international organizations in Monitoring Board activities, should the Monitoring Board (a) expand the number of Monitoring Board observers, (b) hold more formalised dialogues, or (c) establish an advisory body, and on what basis? What should be the criteria for selecting participants?

The usefulness and role of observers in the Monitoring Board is unclear. It would be preferable to favour a commitment by the Monitoring Board to consult with relevant global bodies with a clear and broad role in supporting economic and financial policymaking at global level, including the Financial Stability Board and the International Monetary Fund and depending of the nature of the decision(s) to be made.

As IFRS are unambiguously meant not to be sector-specific, there is no compelling case for giving a privileged position to sectoral regulators, be they of banks or insurance companies or telecom firms or electric utilities, in the general framework of the Monitoring Board. The obvious importance of financial sector accounting justifies a frequent dialogue between the IASB and the Basel Committee, but not a formal representation of bank supervisors as such in the Monitoring Board.

The establishment of a new advisory body, which would further complicate the already fairly complex set of bodies surrounding IFRS standard setting, should not be a preferred option.

9. Do the current arrangements for the standard-setting process adequately ensure the appropriate involvement of all relevant stakeholders and

that all relevant public policy objectives are taken into account?

As a specialised organisation that primarily serves the needs of a specific base of stakeholders, first and foremost the global investment community, the IFRS Foundation cannot and should be expected to give all possible public policy objectives the same level of priority.

This is echoed by the fact that most jurisdictions that have adopted IFRS have included safeguard clauses in their endorsement mechanisms, such as the provision in EU Regulation 1606-2002 (Article 3.2) that IFRS can only be adopted if they "are conducive to the European public good". Such clauses should be used with utmost restraint but are appropriate to ensure that individual jurisdictions can opt out of standards they judge to be incompatible with vital public interests.

Specifically, the primary responsibility for assessing the financial stability consequences of accounting standards, a matter that generally involves a significant dimension of judgement and for which there is little globally-agreed analytical base, should be kept at the level of individual jurisdictions rather than granted to the IASB or IFRS Foundation.

As for involvement of relevant stakeholders, the priority for the IFRS Foundation should be to increase and strengthen the involvement of investors at all levels of its governance and operations.

10. What are the appropriate means and venues for the Monitoring Board to enhance the visibility and public understanding of its activities?

This depends on the future form and role of the Monitoring Board. A good starting point would be to align the name of the body with its actual role. As argued already, the fact that the Monitoring Board currently controls the process of Trustee appointments/reappointments implies that its role goes well beyond mere monitoring. To the extent that this remains the case, a change of name would enhance the public understanding of its function and activities.

11. Are the current arrangements for the Monitoring Board involvement in the IASB's agenda setting appropriate? Or should the Monitoring Board have an explicit ability to place an item on the agenda, or should other alternatives that would enhance the Monitoring Board involvement in the IASB agenda setting be considered?

As the Consultative Report rightly notes (page 19), "the oversight role of both the Monitoring Board and Trustees must be designed to promote – and never undermine, either substantively or in appearance – the independence of the IASB and its standard-setting process." In this context, granting the Monitoring Board an explicit ability to place an item on the IASB's agenda does not appear advisable. More generally, there is not a strong case for formally enhancing the Monitoring Board's involvement in the IASB's agenda setting.

12. How could the Monitoring Board or the Trustees encourage a move towards a more stable and independent funding model?

As mentioned in the introductory section, the Trustees' current principles for the Foundation's funding are flawed, and do not work well in practice. In particular, it seems that the consequences of the principle that funding should be non-voluntary have not been sufficiently thought through and that this principle should be re-examined, as it is bound to lead to excessive dependence of the Foundation on national/jurisdictional political interests. This is a key item in the debate on IFRS Foundation reform.

13. Should the Monitoring Board have a more prominent role in the selection of the IASB Chair? Should its role include involvement in establishing a set of publicly disclosed criteria for the Chair, and assessment of a short list of candidates against those criteria? Should the Monitoring Board be given any further, specific role in the selection of the IASB Chair? In particular, should the Monitoring Board approve the Trustees' final selection?

As argued already, current powers of the Monitoring Board over Trustee appointments are too extensive, as long as the Monitoring Board is not transformed into a body of the IFRS Foundation. As long as this remains the case, there should be no extension of such powers to the appointment or vetting of the IASB Chair, including establishing a set of publicly disclosed criteria.

14. Should the Monitoring Board's responsibilities explicitly include consultation with the Trustees as they further develop the framework to ensure proper balance in the composition of the IASB?

In line with previous comments, there is no compelling case for making this a formal responsibility of the Monitoring Board while it exists outside of the IFRS Foundation.

15. Should a permanent secretariat be established to support the Monitoring Board's increasing roles in overseeing the governance of the standard-setter, even if this would require additional financial contributions from stakeholders?

Establishing a small permanent secretariat could be beneficial to the operation of the Monitoring Board and to its role of oversight of the IFRS Foundation. It would have a number of consequences though, including possibly the need to establish the Monitoring Board as a separate legal entity.

As noted already, the staff of the Foundation could be located in Asia and the secretariat of the Monitoring Board in the Americas, or conversely, to reflect the global stakeholder base of IFRS standard-setting, while taking into account the fact that it would be impractical to move the bulk of IASB staff from London.

The funding of the permanent secretariat should come from the members of the Monitoring Board and not from other stakeholders, particularly while the Monitoring Board exists as a separate entity from the IFRS Foundation.

16. Is there a need for regular reviews, and is the interval of five years appropriate as a benchmark? Should the reviews be aligned with the timing of the Foundation's mandated Constitution reviews?

To the extent that the governance of the IFRS Foundation has not achieved a stable balance, which is the case at this point, more frequent reviews may be warranted. This need is illustrated by the sequence of the last few years, with partial changes brought to the IFRS Foundation's Constitution in 2005, 2007, 2009 and 2010.