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IFRS Foundation Monitoring Board
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Re: *IFRS Foundation Monitoring Board Consultative Report on the Review of* the IFRS Foundation's Governance

Dear Mr Kono,

The Monitoring Board published on 7 February 2011 its Consultative Report on the Review of the IFRS Foundation's Governance.

We appreciate the opportunity to provide input to the review of the IFRS Foundation's governance.

Our detailed comments on issues raised in the consultation paper are set out in the appendix to this letter. They represent the response from the European Commission services, with input from the European Parliament and Member States of the European Union.

I would be happy to discuss all or any of these issues further with you.

Yours sincerely,

Jonathan Faull

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Annex: Reply from the European Commission Services with the input from the European Parliament and Member States of the European Union

Monitoring Board Consultative Report on the review of the IFRS Foundation's Governance

Reply prepared by the European Commission Services with the input from the European Parliament and Member States of the European Union

1. Preliminary remarks

We very much welcome this broad and timely consultation on the review of the IFRS Foundation's Governance. Before responding to the specific remarks by the Monitoring Board, we would like to share a few general considerations of a more horizontal nature, in order to clarify the context of the subsequent more detailed remarks and responses.

(1) Overall assessment of the IFRS Foundation

All jurisdictions that have independent accounting standards setters have some means of creating independence but without removing accountability. The current governance model, institutional structure and procedures of the IFRS Foundation are based on those of the US Financial Accounting Foundation (FAF), the parent body of the US Financial Accounting Standards Board (FASB). In essence, this governance model is based on an independent standards-setting board composed primarily of full-time technical experts, overseen by a Board of Trustees whose primary purpose is to insulate the standards-setter from external pressure and hence maintain the quality of standards set. In addition, the Sarbanes-Oxley Act of 2002 introduced a stable, non-voluntary funding arrangement.

The FAF's governance model is primarily intended to guarantee the independence of the FASB, including full discretion over its technical agenda. However, there are both formal and informal constraints on the actions of the FAF and of the FASB. From a legal point of view, the SEC (and the US Congress) maintains its statutory authority to adopt accounting requirements. It may therefore reject or override standards adopted by the FASB. This is however a very unusual occurrence (as it is in other jurisdictions with independent standard setters), largely because the SEC and FASB have extensive informal interactions at staff and leadership level that, as a purely practical matter, inevitably influence the FASB's standards setting work; senior staff of the SEC and FASB has referred to the relationship between the two organisations as a policy of "no mutual surprises." These features, i.e. mainly informal cooperation backed by a credible threat of sanction, are essential – though partly uncodified – elements of the FASB's governance model and of its accountability towards US authorities.

The IFRS Foundation's governance model has adopted the formal aspects of the FAF's governance model. However, this model appears not to be fully suitable for the legal and political context in which an international standards-setter operates. First, as a growing number of countries adopt IFRS, the ability of individual jurisdictions to use an ex post override by not adopting an international accounting standard is constrained. Moreover, the partial or full rejection of an international accounting standard by individual jurisdictions is inconsistent with the objectives of a single set of international accounting standards, i.e. the creation of a global level playing field and the global integration of capital markets. Such an ex post override can therefore not act as the sole "safety valve" within an international system. Second, for purely practical reasons, the IASB cannot replicate the close informal cooperation that exists between the SEC and the FASB in its own relations with the multitude of jurisdictions that apply, or are converging towards, international accounting standards. The governance of the IASB has therefore not incorporated the uncodified elements of the FASB's governance model.

(2) Options for the future

This leads to two conclusions. First, from an institutional point of view, there should be a stronger formal accountability of the IASB and higher weight of public authorities in its governance and oversight. Second, the IASB's due process must incorporate more formal ex ante checks and balances. The latter should in particular ensure the participation of all relevant stakeholders, including relevant regulatory and supervisory authorities, in the agenda-setting and standards-setting process. However, this paper will focus on accountability and governance issues, and does not address questions related to the due process of the IASB, which have been covered by the ongoing Trustees' Strategy Review.

It is fully acknowledged that some reforms have been made over the last few years in response to concerns about public accountability, e.g. the establishment of the Monitoring Board. These changes are positive and should be seen as a first step towards more fundamental changes.

The analysis set-out below is based on the premise that all major jurisdictions will make a clear commitment – within a reasonable timeframe – to apply IFRS and to contribute on a proportionate basis to the funding of the IFRS Foundation. Should this commitment fail to materialise, the participation of jurisdictions not applying IFRS would need to be reexamined, including the implications for the overall governance framework of the IASB. As a general principle, participation in the governance of the IFRS Foundation should be linked both to funding and to the legal application of international accounting standards.

2. Detailed comments

Q1: Do you agree with the proposal to urge concrete efforts to deepen the pool of candidates for IASB membership from diverse geographical and professional backgrounds?

We support the proposal to intensify the efforts to ensure that the IASB reflects a balance of all interested parties both geographically and professionally (users, preparers, auditors, regulators). This should be complemented by a new provision in the IFRS Foundation's Constitution stating that the IASB's composition should reflect a balance of all interested parties (users, preparers, auditors, regulators including prudential authorities) – the Constitution currently refers to a "diversity of international business and market experience." This provision should however remain a principle rather than a hard-and-fast rule requiring specific numbers of representatives from each category. In addition, a greater number of Board members could be appointed on a part-time basis, e.g. up to six (as opposed to the current maximum of three). This would ensure that the Board has a more direct awareness of current financial reporting practice. More intensive use of expert groups to support the Board's deliberations could also help to achieve this required diversity and awareness of practical considerations: some recent experiences, such as the Expert Advisory Panel on impairment, have been positive, although in other cases expert groups have been constituted but little used by the Board.

Finally, when selecting Board members, priority should be given to nationals of countries applying IFRS or having a firm commitment to do so in the short- to medium-term. In case of non-compliance with the commitment to apply the standards, membership of the IASB could be reviewed in order to align it with the effective implementation of standards by the respective jurisdictions.

Q2: Do you agree with the proposal to separate the roles of the IASB Chair and the CEO of the IFRS Foundation, and if so would you have suggestions on how to formalize this?

We support the proposal to establish, separately from the IASB Chair position, a position of IFRS Foundation's Chief Executive Officer who would be responsible for managing human and material resources of the Foundation. There are two reasons to support this change.

First, maintaining the current "double hat" implies that the IASB Chair effectively controls the resources made available to the Board of Trustees to whom that person is accountable. This does not reflect best corporate governance practice.

In addition, the growing number of countries using or converging towards IFRS has over recent years placed a heavy demand on the IASB's Chair to participate in events around the world, adding to the considerable workload associated with the IASB's standard-setting role per se and with the administrative function of running the Foundation. This may not be compatible with the increasing size of the IASB organisation (in terms of personnel and budget), which suggests a need for a separate CEO function.

The separation of the two roles would address both concerns. It is worth noting that this separation is already practiced by the US Financial Accounting Foundation and there appears to be no reason why this solution cannot be applied in an international context.

Q3: Do you agree that clearer division of responsibility between staff dedicated to the IASB operations and to the Foundation's administrative and oversight functions should be considered, and if so would you have suggestions on how to formalize this?

Yes. Mirroring the separation of the IASB Chairman from the CEO of the IFRS Foundation, there should be a clearer division of responsibility between staff dedicated to the IASB's technical work and those dedicated to the Foundation's administrative and oversight functions.

Q4: Please provide comments on any aspects of Trustees composition or appointments that you believe the Monitoring Board should consider.

In the same manner as for the IASB Board, it is important that the Trustees represent faithfully the diversity of the IASB's stakeholders as set-out in the IFRS Foundation's constitution.

In addition, we note that the IFRS Foundation's Constitution stipulates that "Normally, two of the Trustees shall be senior partners of prominent international accounting firms." This provision may have been justified in the past and reflects the fact that the largest audit firms are still significant contributors to the budget of the Foundation. However, in light of our proposals concerning the funding of the Foundation (see Q12), we consider that the voluntary funding provided by the audit profession should progressively be phased out. Therefore, the reservation of seats for the major international audit firms should be reviewed in parallel with the introduction of a new funding system.

Q5: Do you agree with the proposal to provide increased transparency into the process for Trustee nominations? To what extent should the Monitoring Board be involved in the nomination process?
Do you agree that further clarification of criteria for the Trustees' candidacy would help support confidence of the stakeholders?

In order to guarantee the legitimacy of the IFRS Foundation and of the Trustees, it is particularly important that the application criteria are clearly defined and the selection of candidates is based on a robust due process in order to identify and select the best profiles. In this context, greater transparency about the process and criteria for the selection and appointment of Trustees would be helpful. A description of the process and criteria could for example be published by the Monitoring Board ex ante, while a summary of the results (such as the number and geographical distribution of candidates) could be published ex post whilst respecting the right to personal data protection and the privacy of the persons concerned.

Q6: 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?

The composition of the Monitoring Board should be defined in order to strengthen the accountability of the IASB towards the relevant public authorities, including in particular those with legal responsibility for setting the form and content of financial reporting requirements.

Furthermore, each jurisdiction should be responsible for selecting its representative in the Monitoring Board, based on its own national or regional context and circumstances. Securities market authorities would then not automatically become the Monitoring Board member representing participating jurisdictions if the legal responsibility for setting the form and content of financial reporting requirements rests with another authority, e.g. Ministry or other public body. This approach would also contribute towards enhanced diversity of the Monitoring Board.

Representatives in the Monitoring Board should be of an appropriately high level in order to ensure political accountability.

Do you agree with the proposal to expand the Monitoring Board's membership by adding a mix of permanent members ([four]) representing primarily major emerging markets and rotating members ([two]) from all other markets? How should the major markets be selected?

Should a jurisdiction's application of IFRSs and financial contribution to standard-setting play a role?

Do you agree that rotating members should be selected through IOSCO?

The composition of the Monitoring Board should strike the right balance between the need for an appropriate geographical representation of stakeholders and efficiency. Consequently, there would appear to be a need for a wider range of countries, particularly emerging countries, to engage in the governance of the IFRS Foundation, including at the level of the Monitoring Board. This should contribute to improved accountability and an increased diversity of views presented. In practical terms, we agree that four major emerging economies could become full members of the Monitoring Board, subject to the application of or clear progress towards the adoption of IFRS in those jurisdictions.

As a general rule, participation by a representative of a country or jurisdiction in the governance of the IASB, including membership of the Monitoring Board, should be conditional on (i) the application of the IFRS or at least a firm commitment to this end within a reasonable timeframe, such as in 5 years and (ii) participation in the funding of the IFRS Foundation.

Q7: Do you agree that the Monitoring Board should 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 please describe why and suggest an appropriate voting mechanism

A careful balance needs to be struck between the legitimacy and the effectiveness of the decisions taken by the Monitoring Board. Certain decisions, such as the selection of the Monitoring Board's Chairman, may require consensus and could remain subject to unanimity. However, other decisions could be subject to qualified majority voting. Weighting of votes based on market capitalization should be considered in this respect to ensure that decisions reflect a broad support across the world's capital markets.

Q8 : To ensure increased involvement of public authorities and other international organizations in Monitoring Board activities, do you support the Monitoring Board (a) expanding the number of Monitoring Board observers, (b) holding more formalized

dialogue, or (c) establishing an advisory body, and on what basis? What should be the criteria for selecting participants?

Consistently with the answers provided to questions 6 (which refer to the geographical representation) and 9 (regarding the inclusion of all relevant public policy objectives), we are of the view that the composition of the Monitoring Board should fairly reflect the diversity of public authorities dealing with accounting issues. Therefore, the appointment of the Basel Committee as a full member should be supported. Similarly, membership of other relevant bodies with responsibilities for prudential regulation or financial stability, such as the IAIS, could be explored, provided the efficiency of the Monitoring Board is not endangered by a too large number of participants.

Q9: Do you believe that 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?

We support in particular the addition of economic analyses / impact assessments at an early stage of the IASB's standard setting due process. This should help IFRS constituents to evaluate the consequence of the technical choices proposed by the standard setter and provide the IASB with more substantial feedback on its proposals.

We also consider that legitimate public policy objectives must be given appropriate consideration in the standards-setting process. While recognising that the primary objective of accounting standards is to deliver decision-relevant information to investors, there are other important participants in the world's capital markets and other users of financial information. A key challenge is to ensure that the IASB's mission of producing high-quality accounting standards should not undermine other important policy objectives. These include prudential regulation or financial stability. For example, accounting standards should not induce excessive risk taking behaviour and must provide an accurate representation of preparers' business models. This may imply a revision of the respective provisions in both the IFRS Foundation's constitution and in the IASB's conceptual framework in order to give due consideration to legitimate public policy objectives, including a revision of the current definition of the public interest within the Constitution of the IFRS Foundation.

Q10: What are the appropriate means and venues for the Monitoring Board to enhance the visibility and public understanding of its activities?

Increased transparency regarding the work, decision process and conclusions adopted by the Monitoring Board, are important elements that could help strengthening credibility. That said, it is recognized that the transparency may need to be balanced against the efficiency of the functioning of the Monitoring Board.

Q11: Do you believe that the current arrangements for Monitoring Board involvement in the IASB's agenda-setting are appropriate, or should the Monitoring Board have an explicit ability to place an item on the agenda, or would you consider other alternatives that would enhance the Monitoring Board involvement in the IASB agenda setting?

The Monitoring Board currently has the possibility to refer issues of broad public interest related to financial reporting for consideration by the IASB through the IFRS Foundation. This possibility should be further developed by requiring for instance that the IASB submits its work programme for consideration by the Monitoring Board on a periodic basis before its formal adoption, coordinated with the public consultation currently required by the Constitution of the IFRS Foundation. In addition, any substantial modification of the work programme occurring between these public consultations should be submitted to the Monitoring Board. The Monitoring Board should also have the possibility of requesting the IASB to reconsider its work programme. It is clear that this possibility would only be used in exceptional circumstances and should not be allowed to jeopardize the IASB's independence.

Q12: Do you have concrete suggestions on how the Monitoring Board or the Trustees could encourage a move towards a more stable and independent funding model?

One possibility could be to link participation in the IASB governance, including membership of the Monitoring Board, to its funding. The relative contribution of each participant should be proportionate and could for example be based on each jurisdiction's relative market capitalization. This obligation could be included in the Charter of the Monitoring Board. More generally, each jurisdiction should be free to determine how to collect the necessary funds (public budget, statutory levy on issuers, etc.) since the different constitutional, legal and administrative constraints prevailing in participating jurisdictions are unlikely to allow a single approach.

Q13: Do you believe that the Monitoring Board should have a more prominent role in the selection of the IASB Chair? Do you agree with the proposal that the 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?
Do you believe that the Monitoring Board should be given any further, specific role in the selection of the IASB Chair? In particular, should the Monitoring Board approve the Trustees' final selection?

Given the political dimension of the appointment of the IASB Chair, public authorities represented in the Monitoring Board should be involved in the selection of the IASB Chair and properly consulted at an early stage.

In our view, the Trustees should remain responsible for the appointment, but it should be considered to give the Monitoring Board a more prominent role than it has today. Consequently, the Monitoring Board should approve the profile/job description before the launch of the selection process and should be consulted on the basis of a substantive list of candidates before the submission of the preferred candidate for consideration by the full Board of Trustees.

Q14: Do you agree that the Monitoring Board's responsibilities should explicitly include consultation with the Trustees as they further develop the framework to ensure proper balance in the composition of the IASB?

As stated in the answer to question 1, the diversity of IFRS constituents should be considered when defining the composition of the IASB. Even if the appointment of IASB Members is less sensitive than the nomination of the Chair and Vice Chair, it remains nevertheless important. Therefore, the Monitoring Board should at least be kept informed during the appointment process, i.e. before a formal decision is taken by Trustees.

Q15: Do you agree with the proposal to consider establishing a permanent secretariat for the Monitoring Board to support its increasing roles in overseeing the governance of the standard-setter? Would you support this proposal even if it would require additional financial contributions from stakeholders?

In our view, the current arrangements (i.e. the group's secretariat services are provided by the Chair of the Monitoring Board) seem adequate.

We acknowledge that the establishment of an independent secretariat may be necessary for practical reasons. However, the quantity of work to be performed should be closely assessed in order to ensure that the cost and resources of such a permanent secretariat are justified.

Q16: Do you agree with the need for regular reviews, and the interval of five years as a benchmark? Should the reviews be aligned with the timing of the Foundation's mandated Constitution reviews?

We agree with the proposed approach. In particular, close coordination with the Trustees regarding any review of the Constitution is essential to avoid incoherent piece-meal changes to the Constitution.