

Commission services working paper on governance developments in the IASB (International Accounting Standards Board) and IASCF (International Accounting Standards Committee Foundation)

1. Introduction

At its meeting on 11 July 2006, the Economic and Financial Affairs Council (ECOFIN) adopted conclusions on funding of the International Accounting Standards Board (IASB). The Council welcomed the current private sector efforts to create a broad-based voluntary financing system for the IASB and recognized the need to finalise the financing system in order to prevent any disruption to the operations of the IASB.

In addition, ECOFIN stressed the importance of improvements in the IASB governance structure and encouraged the IASB to continue to:

- (1) strengthen its governance structure, with a view to ensuring that adequate account is taken of public interest issues, including financial stability aspects;
- (2) strengthen its due process with stakeholders - including work planning and setting of standards as well as their interpretations - in particular relating to consultation, so that views of all International Financial Reporting Standards (IFRS) users and investors are fully taken into account; in this context, impact assessments, field testing and reasoning behind any actions should be developed; and cooperation with other standard setting bodies should involve stakeholders using IFRS; as well as
- (3) ensure that stakeholders are adequately represented in the International Accounting Standards Committee Foundation (IASCF), IASB and International Financial Reporting Interpretations Committee (IFRIC) governing bodies;

ECOFIN invited the Commission to monitor the work of the IASB and report to the Council on a regular basis on effective progress on these issues. This is the first such report.

An overview of the IASCF organisational structure is included in Annex I of this report. The annex also contains background information on the current work programme, work on convergence and existing governance structures.

This report highlights the following main areas where further improvement is desirable:

- Firstly, concerning the **governance structure** of the IASCF/IASB, the Commission believes that further amendments would improve the accountability of the Board and of the Trustees to their constituents, in particular those jurisdictions which apply IFRS.
- Secondly, as regards the IASB's **due process with stakeholders**, strengthened consultation procedures are necessary, in particular for IFRIC. In particular, the IASB should explain, preferably in writing, the reasons for not taking into account comments made by stakeholders.

In addition, the credibility of standards would be further enhanced by impact assessment and field testing procedures.

It is important that the IASB evaluates the practical impact of new standards and the cost of possible changes in practice at an early stage of development in order to assess how the proposed standards or interpretations may affect businesses.

Meetings between world standard-setters and the IASB take place regularly. Certain projects are also carried out jointly by the IASB and national standard-setters. Nonetheless, the IASB could usefully intensify its informal liaison relationships with national standards setters and preparers.

Some projects are carried out jointly between standard setters. The IASB and FASB apply a so called "modified joint project" approach. Under this approach, one standard setter takes the lead and the other follows with consultation taking place once the main research is done. It is of the utmost importance that for joint and modified joint projects there is a proper consultation of all interested parties and jurisdictions and that any concerns which are raised are properly discussed and satisfactorily resolved before standards are finalised.

- Thirdly, on the issue of **adequate representation of stakeholders** in governing bodies of the IASCF/IASB, the composition of these bodies should ensure adequate representation and experience from countries and regions committed to use of IFRS.

2. Governance structure

Significant improvements have been made in the IASC/IASB governance structures, in particular:

- strengthening of the IASCF Constitution to define the involvement of Trustees in reviewing operating procedures, consultative arrangements and due process of the IASB,
- introduction of a formalised framework for evaluating the effectiveness of the oversight function of the IASCF Trustees including a specific section in the IASCF Annual Report on how the Trustees fulfil this function,
- more transparent election procedures for Trustees including a new Trustees Appointments Advisory Group,
- regular reviews of operating procedures and the Constitution, and
- strengthened role of the Standards Advisory Council.

On the other hand further improvement is needed in particular

- to take proper account of public interest considerations, including financial stability.

a) Result of the Constitutional review.

The IASCF Constitution was revised with effect from 1 July 2005. This revision led to a number of governance improvements described below. The Trustees have indicated that they will conduct regular reviews of the IASB and IASCF governance structures. On 6 November 2006, the Board of Trustees presented a formalised framework for evaluating the effectiveness of their oversight function as well as the operational structures of the IASCF organisation.

These are welcome developments, but further action is needed in order to address fully the concerns expressed by ECOFIN and European stakeholders as regards public interest concerns including financial stability. This is particularly relevant where standards elaborated by the IASB are introduced in law and their application is mandatory.

b) Accountability of the Trustees.

The IASCF has put in place a formalised election process for Trustees, including the advertising of vacant positions and consultation with significant stakeholders, which should ensure their accountability to constituents and public oversight of their work. A Trustees Appointments Advisory Group was set up to give input into and oversee this process.

The Trustees have also stated their intention to seek comments regularly from constituents on IASCF operating procedures and the constitution. The inclusion of a specific section in the IASCF Annual Report on how the Trustees fulfil their oversight responsibilities is also helpful in ensuring their accountability.

c) Accountability of the Board to the Trustees.

The changes in the Constitution concerning the Trustees' consideration of the IASB's strategy, working programme and agenda, as well as their regular involvement in reviewing operating procedures, consultative arrangements and due process of the IASB are welcome. It is important that the Trustees follow the work of the IASB closely and provide effective oversight of its standard-setting activities. The foreseen annual review of the governing structure of the IASCF by the Trustees should be beneficial in achieving good governance.

The role of the Standards Advisory Council (SAC) has been strengthened, with a larger number of members and a part-time chair. The SAC has a special role in that it now provides advice on the working agenda of the IASB, and gives direction on the development of ongoing projects. The European Commission is an official observer in this Committee.

d) Public interest and financial stability

Public interest (including financial stability) aspects are currently not reflected in the governance structure or in the due process of the IASB. The potential impact of new accounting standards on markets', investors' and other stakeholders' behaviour should be analyzed before new standards are adopted. As the importance of the IASB as an international accounting standard-setter increases, and in particular where the standards it adopts are endorsed by law and are mandatory, it is crucial that these aspects are included in future discussions of the objectives of IASB and IASCF. The European Parliament and Member States are following these issues very closely.

Closer cooperation with the European Commission and respective European and International organisations (Committee of European Banking

Supervisors - CEBS, Committee of European Insurance and Occupational Pension Supervisors - CEIOPS, European Central Bank - ECB, Basel Committee on Banking Supervision - BCBS, International Association of Insurance Supervisors - IAIS, etc.) would help ensure that broader public interest considerations can be taken into account. Such co-operation should, of course, respect the independence of the IASB. But more contacts with public and private sector interests which have a stake in the output and work of the IASB would ensure that accounting standards take better account of market needs and business reality.

3. Due process with stakeholders

There have been improvements in the IASC/IASB due process procedures, in particular:

- the IASB's statement that it will extensively use more upstream and interactive consultative procedures with stakeholders,
- the yearly review of Due Process Handbooks by the Trustees including a consultative process.

On the other hand further improvement is needed in particular:

- in providing appropriate feedback on the specific reasons why the IASB does not follow comments received during the consultative process,
- in the decision-making process of the IFRIC related to its agenda, rejections or interpretations, including inputs from the Commission's Roundtable on consistent application of IFRS in the EU;
- consultation and due process related to convergence programme and projects between the IASB and the FASB.

The current due process rules of the IASB were revised in conjunction with the review of the Constitution. The new rules have improved consultation with stakeholders and transparency of the process, but constituents have called for further changes, in particular concerning how the IASB deals with comment letters on texts published for consultation and its reasoning when it decides not to take up comments. Numerous European stakeholders have expressed particular concern relating to the consultation process in relation to recent IASB projects, for example "Business Combinations II".

The IASB responded to concerns and issued a press release in July 2006, indicating that it intends to make extensive use of consultative procedures, such as discussion papers (rather than directly issuing exposure drafts) and roundtables with stakeholders, in order to improve its due process. In 2006, the IASB already organised hearings or meetings with stakeholders on small and medium size enterprises (SMEs), as well as the Conceptual Framework and has also scheduled other meetings on IAS 37* (liabilities). These developments are welcome but further improvements can be made. In particular, it is important that the IASB explains, preferably in writing, the specific reasons why it does not intend to follow comments received during the consultative process.

Consultations with stakeholders are particularly important as regards the work included in the convergence plan between the IASB and the US Financial Accounting standards Board (FASB). More generally, the Commission has stressed the need for early and regular consultation on the convergence work programme. SAC has discussed this work programme and large convergence conferences are now planned for 2007 in Zurich and Singapore.

Joint convergence projects between the IASB and the FASB must be subject to full due process with stakeholders. In the case of fair value measurement, the FASB issued a final draft on the projects before the IASB had completed its own consultations. Such situations should be avoided and should not prevent the IASB respecting its own due process.

The initiative of the Trustees to review the Due Process Handbooks yearly for possible amendments should also provide more opportunities for constituents to put forward their views and review the effectiveness of latest amendments.

To further complement the current rules, the IASCF published in May 2006 a draft due process handbook for the IFRIC. The Commission is broadly supportive to the proposed changes, but have indicated concerns in a number of specific areas:

- *Composition and decision-making process of the IFRIC Agenda Committee:* It is important that the Agenda Committee operates under conditions of full transparency and that the meetings are held in public. The Committee should represent all stakeholders and be geographically balanced. Preparers and users should have a participation that is equal to that of the audit profession.

* International Accounting Standard 37 – Provisions, Contingent liabilities and Contingent Assets.

- *IFRIC agenda rejections:* The publishing of the reasons for not adding items to the IFRIC agenda has led to questions as to the status of these statements. It should be emphasised that IFRIC agenda rejections do not have the same status as IFRIC interpretations.
- *Timeliness of IFRIC interpretations:* The total time for issuing interpretations (15-20 months) needs to be shortened. Since IFRIC is now fully staffed, the frequency of meetings could perhaps be increased.

The European Commission has initiated a Roundtable on consistent application of IFRS in the EU containing all major stakeholders. The Roundtable will not issue interpretations, but will provide a forum for discussion of IFRS implementation issues. The Roundtable has met in May and September 2006 and a number of technical issues have been discussed, of which, certain issues have been submitted to the IASB and IFRIC. Comments from the Roundtable are particularly important for achieving a consistent application in the European Union and to work on convergence between IFRS and US GAAP. It is therefore of the utmost importance that they are taken into account in work of the IASB on standards and interpretations.

4. Adequate representation of stakeholders

Trustees

The geographical origin of the Trustees is set in the IASCF Constitution. There are currently 22 Trustees, seven of them from Europe.

The position of Chairman of the Board of Trustees is currently vacant. The Commission believes that the successor should be a European.

Board

The members of the Board are appointed by the Trustees. According to the Constitution, the selection of Board members shall not be based on geographical criteria, but the Trustees shall ensure that the IASB is not dominated by any particular constituency or geographical interest. As IFRS are now a part of the EU legal system, it is important that a sufficient number of Board members have an adequate knowledge of financial reporting needs in the EU.

The recent appointment of Philippe Danjou, formerly Director of Accounting Affairs at the French securities supervisor (AMF) and active member of the Committee of European Securities Regulators (CESR) as a new member of the Board, is a welcome development.

IFRIC

The composition of IFRIC should reflect a balanced representation of all stakeholders, in particular preparers. It is important that European issues and views are sufficiently considered. Furthermore, the appointment process should be more transparent.

5. Conclusion

In conclusion, the Commission acknowledges the improvements that the IASB has made in addressing some of the concerns expressed by European stakeholders, in particular in the area of its governance structure and due process, but on the other hand it feels that further improvement is needed in order to:

- enhance the accountability of the Board and of the Trustees to jurisdictions which apply IFRS, in particular by improving co-operation and intensifying liaison relationships with those jurisdictions;
- strengthen the IASB's consultation procedures, in particular in providing appropriate feedbacks to respondents, improving IFRIC due process and in putting in place proper implementation assessment and field testing procedures in order to evaluate the practical impact of new requirements and the cost of possible changes in practice;
- ensure that there is adequate representation of stakeholders in governing bodies of the IASCF/IASB in particular from countries applying IFRS and strengthen consultation and due process on convergence activities.

Annex I: About the IASB structure

The International Accounting Standards Committee Foundation (IASCF) was formed as a not-for-profit organisation incorporated in the State of Delaware, US. IASCF is an independent body that oversees the International Accounting Standards Board (IASB).

The IASCF is an independent organisation having two main bodies, the Trustees and the IASB, as well as a Standards Advisory Council and the International Financial Reporting Interpretations Committee.

IASCF Trustees comprise twenty-two individuals. Current Trustees select and appoint all subsequent Trustees. According to the IASCF Foundation Constitution, there are currently six Trustees from North America, Europe, Asia/Oceania region and four Trustees appointed from any area, subject to establishing overall geographical balance. The governance of the IASB and its related bodies is ultimately in the hands of the Trustees of the IASCF.

The IASC Foundation's Constitution provides that the Trustees must show a firm commitment to the IASC Foundation and the IASB as a high quality global standard-setter, to be financially knowledgeable, and to have an ability to meet the time commitment. Each Trustee shall have an understanding of, and be sensitive to, international issues relevant to the success of an international organisation responsible for the development of high quality global accounting standards for use in the World's capital markets and by other users.

The Trustees appoint the members of the IASB, the International Financial Reporting Interpretations Committee (IFRIC) and the Standards Advisory Council. In addition they:

- review annually the strategy of the IASB and its effectiveness,
- approve annually the budget of the IASB and determine the basis for funding,
- review broad strategic issues affecting accounting standards, promote the IASB and its work and promote the objective of rigorous application of International Financial Reporting Standards (however, they are excluded from involvement in technical matters relating to the standards),
- establish and amend operating procedures for the IASB, the IFRIC and the Standards Advisory Council; approve amendments to the Constitution after following a due process, including consultation with the Standards Advisory Council and publication of an Exposure Draft for public comment,
- exercise all powers of the IASC Foundation except those expressly reserved to the IASB, the IFRIC and the Standards Advisory Council.

The Trustees are not responsible for setting International Financial Reporting Standards. That responsibility rests solely with the IASB.

The International Accounting Standards Board (IASB) is an independent, privately-funded accounting standard-setter based in London, UK. The Board members come from nine countries and have a variety of functional backgrounds. Five members come from the EU and the US and there is one member from Japan, China, Canada and South Africa.

The IASB is committed to developing, in the public interest, a single set of high quality, understandable and enforceable global accounting standards (known as International Financial Reporting Standards - IFRSs) that require transparent and comparable information in general purpose financial statements. In addition, the IASB co-operates with national accounting standard-setters to achieve convergence in accounting standards around the world.

There are 14 Board members, each with one vote. The Trustees appoint the Board members. The IASCF Constitution provides that the Trustees shall:

"[...] select members of the IASB so that it will comprise a group of people representing, within that group, the best available combination of technical skills and background experience of relevant international business and market conditions in order to contribute to the development of high quality, global accounting standards." [Paragraph 20]

The Standards Advisory Council (SAC) of the IASB provides a forum where the IASB consults individuals, and representatives of organisations affected by its work, that are committed to the development of high quality IFRSs. It is composed of a Chairman from Brazil and 40 Members coming from Africa: 2, Asia-Oceania: 9, European Union: 14, Latin America: 3, Middle East: 1, North America: 4 and 7 Members are representatives of various International organisations (Basel Committee of Banking Supervisors, International Association of Insurance Supervisors, International Federation of Accountants, International Monetary Fund, International Organization of Securities Commissions, United Nations Conference for Trade and Development and World Bank).

As part of that consultative process the SAC gives advice to the IASB on a range of issues which includes, but is not limited to, the following:

- input on the IASB's agenda;
- input on the IASB's project timetable (work programme) including project priorities, and consultation on any changes in agenda and priorities; and
- advice on projects, with particular emphasis on practical application and implementation issues, including matters relating to existing standards that may warrant consideration by the IFRIC.

The International Financial Reporting Interpretations Committee (IFRIC) is composed of a non-voting chairman from South Africa and twelve voting members coming from United States: 3, Canada:1, Australia:1, New Zealand:1, European Union: 4, Argentina:1 and Japan:1.

The IFRIC reviews, on a timely basis within the context of current IFRSs and the IASB Framework, accounting issues that are likely to receive divergent or unacceptable treatment in the absence of authoritative guidance, with a view to reaching consensus on the appropriate accounting treatment. In developing interpretations, the IFRIC works closely with similar national committees.

The IFRIC meets about every six weeks. All technical decisions are taken at sessions that are open to public observation.

The IFRIC addresses issues of reasonably widespread importance, not issues that are of concern to only a small minority of entities.

Convergence project

The IASB and the US FASB published a Memorandum of Understanding (MoU) in February 2006 that outlines a work programme for convergence between US Generally Accepted Accounting Practices (GAAP) and International Financial Reporting Standards (IFRS). This convergence programme is an important step in bringing about mutual recognition of accounting standards between the EU and the US, and reflects comments made by Committee of European Securities Regulators (CESR) concerning equivalence between GAAP and IFRS. The convergence work covers those areas that the Securities Exchange Commission (SEC) has identified in its Roadmap as important for lifting the GAAP reconciliation requirement in 2009, at the latest.

The MoU balances amendments to current standards with longer-term considerations and focusses on areas where there is a clear business case for improved accounting standards. It also gives the EU a period of stability to get used to the new standards which have been applicable since 1 January 2005.

Annex II: Due process of the IASB

IFRSs are developed through an "international due" process that involves accountants, financial analysts and other users of financial statements, the business community, stock exchanges, regulatory and legal authorities, academics and other interested individuals and organisations from around the world. The IASB consults, in public meetings, the SAC on major projects, agenda decisions and work priorities, and discusses technical matters in meetings that are open to public observation. Formal due process for projects normally, but not necessarily, involves the following steps (the steps that are required under the terms of the IASC Foundation Constitution are indicated by an asterisk*):

- (a) the staff are asked to identify and review all the issues associated with the topic and to consider the application of the **Framework** to the issues;
- (b) study of national accounting requirements and practice and an exchange of views about the issues with national standard-setters;
- (c) consulting the SAC about the advisability of adding the topic to the IASB's agenda;*
- (d) formation of an advisory group to give advice to the IASB on the project;
- (e) publishing for public comment a discussion document;
- (f) publishing for public comment an exposure draft approved by at least eight[†] votes of the IASB, including any dissenting opinions held by IASB members;*(The IASB normally allows a period of 120 days for comment on a discussion paper or an exposure draft)
- (g) publishing within an exposure draft a basis for conclusions;
- (h) consideration of all comments received within the comment period on discussion documents and exposure drafts;*
- (i) consideration of the desirability of holding a public hearing and of the desirability of conducting field tests and, if considered desirable, holding such hearings and conducting such tests;
- (j) approval of a standard by at least eight[†] votes of the IASB and inclusion in the published standard of any dissenting opinions;*and
- (k) publishing within a standard a basis for conclusions, explaining, among other things, the steps in the IASB's due process and how the IASB dealt with public comments on the exposure draft.

[†] Under the revised Constitution (July 2005), the requirement was raised to nine votes.