STATEMENT OF

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General Comments

The CFA Institute Centre for Financial Market Integrity welcomes this formal review of the governance of the IASB and IASC Foundation and particularly the decisions of the Trustees to provide opportunities for early-stage public input to the review process. As we have been reminded in the current global credit crisis, transparency and a high-quality financial reporting system are essential to the efficient and effective functioning of capital markets and the economies they serve. In this conjunction, and as we have stated on a number of occasions, we support the planned convergence of the diverse systems of national standards to a single set of internationally applicable standards.

We agree in general with the "operating premise" of the current IASC Foundation Constitution as stated in paragraph 2[1]:

> *…[A]ccounting standards should be set following an extensive and transparent due process by a highly professional, independent body, the IASB,* ***appropriately protected from particular national, sectoral or special interest pleading.*** [Emphasis added]

Given the importance of financial reporting to global markets, and the planned convergence of national standards to a single international standard, IFRS, we support the efforts of the Trustees to establish a governance system for the IASB that will ensure that this premise is met. A core part of this effort should be to develop a robust infrastructure to support the long-term *independent and sustainable* standard setting function of the IASB. In the sections that follow, we are pleased to offer some suggestions for consideration by the Trustees that we believe will strengthen the proposed governance framework and enhance the probability that the Trustees will succeed in achieving the stated objectives.

We agree in general with the new proposal to establish structures to ensure public accountability of the IASB and IASC Foundation to public organizations and authorities, and to continue to build upon and improve the steps already taken, such as those described in paragraphs 4 and 5[2]. The *Draft Proposals* provide the definition of public accountability as stated in the Constitution[3] in paragraph 14:

> *The objectives of the IASC Foundation are:*
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> *a. To develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that*

[1] *Draft—For the Purpose of the 19 June Round-Table.* IASC Foundation. London England. May 2008.
[2] Ibid.
[3] Ibid., para. 14.

require high quality, transparent and comparable information in financial statements and other financial reporting ***to help participants in the world's capital markets and other users make economic decisions****;*[4] [Emphasis added]

b. To promote the use and rigorous application of those standards;

c. In fulfilling the objectives associated with a and b, to take account of, as appropriate, the special needs of small and medium-sized entities and emerging economies; and

d. To bring about convergence of national accounting standards and International Accounting Standards and International Financial Reporting Standards to high quality solutions.

Paragraph 15 continues[5]:

> *In fulfilling those objectives, the Trustees are accountable not to a single group, but to the wide range of international stakeholders that have an interest in the IASC Foundation's efforts to achieve its objectives. To ensure the transparency of their work and public accountability to these broad interests, the Trustees have identified stakeholder groups with which they maintain regular contact and are establishing mechanisms to receive input outside the formal consultations. These stakeholder groups include official organizations, policymakers and private sector institutions around the world.*

While we agree with the broad responsibilities of the Trustees in monitoring and overseeing the financial reporting standard setting process, we believe that it is most important that the objective of these activities be made clear in defining the public accountability of the Foundation and the IASB. When all is said and done, the <u>ultimate</u> test of the standards is not whether preparers, large and small, found them easy to apply; nor whether auditors found them easy to audit; nor whether regulators found them easily enforced. Rather, the ultimate test is whether investors[6] who rely upon the information

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[4] We would question whether paragraph a. is a correct statement. It is the duty and obligation of the IASB, an independent standard setting body, rather than the IASC Foundation, to develop financial reporting standards. The role of the Trustees is to monitor the due process of the IASB, appoint the members, and secure funding in support of the activities of the Board. The roles of both bodies are necessary to achieve the objectives but they should not be blurred or confused. Indeed, we believe that a clear and inviolate distinction should be made between the functions of the two bodies.

[5] Ibid., para. 15.

[6] By "investor" we mean all of those capital providers who lend money or purchase securities in the open markets. Such investors, by definition, do not have access to private information, such as bank lending officers may be in a position to demand, but

contained in financial statements prepared according to IFRS, and who directly bear risk as a result of their reliance, are willing to provide capital to borrowers and issuers of securities at the lowest possible cost of capital, and whether they are willing to provide as much capital as businesses both large and small need to grow, flourish, and benefit the economies in which they operate.[7]

Consequently, while we recognize that the Foundation has a variety of responsibilities and corresponding accountabilities we believe that the highest public interest accountability should be to the capital markets and investors and that this accountability should be made explicit in the Constitution and clearly reflected in the activities and actions taken by the Foundation. In this regard, we were gratified to learn of the position taken by U.S. SEC Chairman Christopher Cox in a recent address delivered to an IOSCO meeting.[8] Chairman Cox states:

> *In order for IFRS to fulfill the promise it holds to be a uniter of the world's capital markets and a powerful tool for investors everywhere, there are a handful of principles that are critical to its success. Everyone of us here today needs to see to it that these principles are applied.*
>
> *The first key success factor for IFRS is that the* ***standards be crafted in the interest of investors. That has to be their overarching purpose.***

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must rely solely on the public information provided in financial statements and the notes and other attendant disclosures.

[7] It is worth noting in this context that the reports of the Financial Stability Forum to the G7 finance ministers and central bank governors, "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience," (7 April 2008), and the report of the U.S. President's Working Group on Financial Markets "Policy Statement on Financial Market Developments," (March 2008), both of which examined the current market credit and liquidity crises, determined that a profound lack of transparency in the sub-prime mortgage and related securitization markets, combined with a degree of regulatory forbearance, created the conditions that allowed these instruments and investment practices to develop and grow unchecked for a period of several years. The result was exponential growth in these poor quality securities that spread to a number of major markets and resulted in investor and institutional losses to date of hundreds of billions of euros and a loss of market liquidity as investors removed some or all of their capital from most credit markets. Both reports call for a full restoration of transparency to the credit markets, including a requirement that clear, complete, and up-to-date information and valuations, measured as accurately as current market information will allow, be reported for all such instruments.

[8] "International Financial Reporting Standards: The Promise of Transparency and Comparability for the Benefit of Investors Around the Globe," address to the Annual Conference of the International Organization of Securities Commissions. Paris, France. 28 May 2008.

> *The second is that the standard setting process be transparent. That is essential not only to maintain investor confidence, but to ensure the integrity and quality of the standards.*
>
> *The third is* ***that the standard setter must be independent. That means independent from special pleaders, from the political process, from favored industries or industry players, and from national or regional biases.***
>
> *Fourth,* ***the standard setter must be accountable. This means ensuring that IFRS actually meet the needs of investors and other stakeholders****, and that they are updated in a timely way.*
>
> *And fifth and finally,* ***it is vitally important that all of the stakeholders themselves participate in the standard setting process in order to ensure the continued success of IFRS.***[9] [Emphasis added]

We fully agree with these principles and believe it is helpful to understand the rationale that underlies and informs them. Chairman Cox explains[10]:

> *What does it mean to say the investor's interest must be paramount in standard setting? We all know that a business's financial reports are relied upon not just by investors, but by many other people in addition, and for many purposes. Financial statements are used by the managers of the business as an important tool in making decisions. They are relied upon by many outside parties, such as commercial lenders who extend credit to the business. And of course financial reports are important to analysts of all kinds for purposes that go far beyond investing, as for example when economists use them as a basis for reporting about an industry's size and other aggregate statistics.*
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> ***But above all, a public company's financial reports represent a direct communication between the company and its investors. And from the investor's standpoint, accounting standards should promote both clarity and comparability. In these respects, both the IASB and the IASC Foundation, its governing body, are working hard to ensure that investors' interests remain the primary concern in the continuing development of IFRS. This is particularly important today, as the IASB reviews its standards in light of the experience of the recent period of market turmoil.*** [Emphasis added]

We agree and encourage the Foundation to take this opportunity of the Review to make this ultimate objective, investor's interest, clear and explicit in the Constitution. If this

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[9] Ibid., p. 3.
[10] Ibid, pp. 3 ff.

objective is clearly stated, then investors will have greater confidence that their interests will be addressed in the actions taken by the Foundation, and that their information needs will be met in the standards developed by the IASB. As Chairman Cox states, such investor confidence will be a critical factor in determining the success of IFRS as the single international standard for financial reporting.

Monitoring Group Proposals

We support in general the Trustees' proposal in paragraph 17 to create a Monitoring Group with accountability to public authorities. We believe that it will be very helpful to have a high level, highly knowledgeable, and respected body of members who can both (1) conduct liaison activities with governmental and other organizations, and (2) monitor and oversee the functioning of the IASB and the Trustees to ensure that the objectives of these two bodies are being met.

As we have discussed above, we believe that if IFRS have the primary objective of serving investor interests, then the ultimate accountability of the Monitoring Group must be to the capital markets and investors who rely on IFRS. That is, the Monitoring Group must ensure that the standards are of sufficient quality and comprehensiveness to permit markets to function efficiently and effectively, and to allow investors relying on statements prepared according to IFRS to properly allocate their capital and determine the terms on which that capital should be provided.

We agree that the members of the Monitoring Group as proposed in the *Draft Proposals* would be appropriate for monitoring and overseeing the activities of the IASB and the Foundation and for ascertaining that these are activities are being conducted with the interests of investors and the world's capital markets in mind. These proposed members would include[11]:

a. The responsible member of the European Commission

b. The managing director of the International Monetary Fund

c. The chair of the IOSCO Emerging Markets Committee

d. The chair of the IOSCO Technical Committee (or vice chair or designated securities commission chair in cases where either the chairman of an EU securities regulator, commissioner of the Japan Financial Services Agency, or chairman of the US Securities and Exchange Commission is the chair of the IOSCO Technical Committee)

e. The commissioner of the Japan Financial Services Agency

[11] *Draft.* IASC Foundation. May 2008. Paragraphs 20 and 21

f. The chairman of the US Securities and Exchange Commission, and

g. The President of the World Bank

The five regulators are officials appointed by their respective governmental bodies to serve in the public interest and to monitor and oversee their capital markets. They do so in order to ensure fair and orderly markets, and to promote stability in those markets so that capital users and capital providers will be able to contract on fair and equitable terms, resulting in the lowest possible cost of capital and adequate liquidity. The distribution of the proposed regulators reflects major concentrations of global capital, regional differences, and a concern for the world's emerging markets and their needs. We believe that the aggregate knowledge and experience of these regulators gleaned from their regulatory responsibilities will be an important success factor for IFRS in and of itself. They understand the importance of financial reporting to the markets and will be in a position to make certain that IFRS meet the needs of investors. They also have experience with and understand the importance of providing for an effective and *independent* standard setter to craft the standards, as Chairman Cox makes clear in his third principle.

Similarly, the managing director of the International Monetary Fund (IMF) will bring a wealth of knowledge based upon the IMF's decades of experience in funding major projects that promote the public interest, and that support the development of critical infrastructure and the like. High quality financial information is fundamental to their own contracting activities in support of projects, and they have a long history of promoting the development and use of such standards. Hence, we believe that the director of the IMF will be in a position to provide a valuable perspective to the Monitoring Group.

For six decades, the World Bank has invested in projects to help the world's developing countries by funding the most basic infrastructure projects designed to improve the lot of the countries' citizens. As with the IMF, the World Bank has devoted substantial resources to encouraging and supporting the adoption and implementation of high quality financial reporting and general financial literacy among governments and officials so that these projects not only can be initiated but will ultimately succeed. The president of the World Bank will be able to contribute this specialized knowledge and experience to the Monitoring Group.

We do, however, find one notable omission in the proposed membership of the Monitoring Group, one that could affect the ultimate success of the body. This is the absence of any representation from investors in the capital markets, those who directly commit their own or their clients' capital and bear risk based upon financial reports, and as we and Chairman Cox have argued, should be the ultimate target of financial reporting standard setting. Like regulators, investors in the capital markets must constantly monitor the markets and track developments in those markets. However, those who invest their own wealth and/or that of their clients are constantly apprised of new developments including structured finance strategies and securities, of strengths and weaknesses, of new and emerging sources of risk, and, of greatest importance for the purposes at hand, of the adequacy or lack thereof of the financial information available to investors. In a sense, investors are the early-warning system for deficiencies in the financial reporting system and the need for new or revised standard setting.

We believe that the Foundation, in its governance review, and the creation of the Monitoring Group has an opportunity to avoid, or at least mitigate the probabilities of financial reporting problems occurring in the future by making certain that those who work and invest their capital in the markets are well-represented on the Monitoring Group. This could be done in several ways, but we will suggest two approaches for consideration by the Trustees. The first would be to provide for the appointment to the Monitoring Group of several investors who have deep and direct experience analyzing and investing in the various major market sectors, including credit securities, derivatives and structured finance products, and equity securities. A second approach would be to provide for the appointment of a dozen or so investors to an Investor Sub-committee of the Monitoring Group. In this second alternative, the chairperson and vice-chair of the Sub-committee would serve as designated full members of the Monitoring Group with the ability to report the findings and concerns of the Sub-Committee members directly to the Group and, conversely, to serve as liaison from the Monitoring Group to the members of the Sub-Committee. The larger size of the Sub-Committee would allow much broader representation of technical market sectors as well as geographic representation.

Regardless of the approach chosen, we believe it will enhance the chances of success of the Monitoring Group if it has the benefit of the knowledge and experience of the primary constituency that IFRS must serve as the single financial reporting standard. However, for this to occur, the relationship be a direct one, i.e., full membership, so that investors will be able to contribute to the deliberations of the Group as they are being held rather than indirect involvement through advisory committees which necessarily must operate at a distance and with limited access to the body they are advising. Also, such direct membership would enhance the confidence of the markets in the quality of the standards and the comprehensiveness of financial reporting. The confidence of investors in the standards is one of the five critical success factors cited by Chairman Cox.

As an aside, given that the governance review in its second phase will address issues with the Foundation as well, we believe that substantial and direct representation by investors would enhance the effectiveness of the Trustees as well and contribute to public confidence in their oversight of the IASB. Currently, investor representation among the Trustees is limited at best.

We believe generally that the proposed functions of the Monitoring Group, approval of the appointments of Trustees, overseeing the functioning of the Trustees, and serving as the interface between the IASB and public authorities and other organizations, are reasonable and appropriate to such a body. However, we believe that both the Trustee nomination and oversight processes must be fully open and transparent. For example, actions taken by the Monitoring Group should be documented and these documents should be released for public review and consideration. The documents should contain sufficient detail for interested reviewers to be able to determine the complete nature of the issue, what alternatives were considered, and the rationale for the action decided upon.

We believe that a Monitoring Group is an important component of an efficient and effective governance system for the IASB. But, we also believe that the Group be designed so as to act solely in the public interest for the benefit of investors and the world's capital markets. In this regard, although individual members will be appointed by various governments, public organizations such as the IMF, and, as we have proposed investors who actively invest their own or their clients' money, a threat to the success of the Monitoring Group as both the oversight body for the Trustees and the IASB and the primary linkage with governments and other public and private organizations, is the risk that members could tend to act in their own best interest or that of those governments or organizations they represent. This is a well-recognized threat of self-regulatory organizations and has been examined and described in the capital markets context.[12] Although any self-regulatory body is subject to the threat, the risk is particularly apparent in the context of global capital markets in which the investment of large amounts of capital, and the profitability of that capital, can be affected by decisions that drive either the information available to the markets or the regulation and enforcement of compliance with the standards by participants in the markets.

Consequently, when the charter for the Monitoring Group is being developed, we recommend that due consideration be given to the self-interest threat, and to steps that can be taken to mitigate it, as well as to ensure that the Monitoring Group itself remains free of the threats explicitly listed in the operating premise of the Constitution. In fact, we believe that it would benefit the Group and the Trustees to submit the charter to public comment before it is finalized. Such a step may well bring to light significant omissions and other difficulties that the Trustees and Monitoring Group could address in timely fashion. In addition, it would enhance the public's and investors' confidence in the Monitoring Group and its activities.

We fully recognize that the Trustees are at an early stage in their development of plans for the institution of the Monitoring Group, their revision and reforms of their own Foundation governance and procedures, and the development of a fully robust governance structure for the IASB that can ensure its long-term sustainability and independence. Given the early stage of development, much ambiguity remains to be resolved regarding the distinct duties, obligations and functions of the Monitoring Group and the Trustees. At this stage, the potential would appear to exist for a good bit of overlap between the duties of the two bodies, and the proposals do not yet resolve either the ambiguity or the possible conflicts. For example, a much clearer division of responsibilities, duties, and obligations should be established between the Monitoring Group and the Trustees. We are aware from the *Draft Proposals* that a Memorandum of

[12] See for example, *Self-Regulation in Today's Securities Markets: Outdated System or Work in Progress*? CFA Institute Centre for Financial Market Integrity Publications. September 2007.

Understanding will be developed, and, as with the Monitoring Group charter and for the same reasons, we would encourage the Trustees to submit the MOU for public comment. We believe that this MOU could be particularly important to the success of the IASB and the Trustees.

Finally, regarding the establishment of the Monitoring Group and the development of the charter and the MOU, we believe that explicit provision should be made for ensuring the independence of the IASB and its standard setting function from either the Monitoring Group or the Trustees. That is, neither of the latter two bodies should have any authority over the standard-setting agenda of the Board or the standards themselves. This concern is closely related to the issue of the self-regulatory threat. Furthermore, the Monitoring Group and Trustees should make certain that no other authority or organization gains such power, either directly or indirectly. Although the Board can and should seek the views of a wide range of constituencies, in the final analysis, they should be guided by the ultimate objective of their standard setting activities and should remain entirely free of any pressures that do not serve that objective.

Expanding the IASB and Making Explicit a Geographic Component

We agree with the proposals in paragraph 23-30 that an expansion of the IASB from twelve full time and two part time members to sixteen will better enable the IASB to efficiently and effectively meet its objectives. We believe that the members should be full time with no remaining responsibilities or obligations to any other bodies or organizations. The appearance of independence, as well as independence in fact, will be a major determinant of the future success of IFRS as the single global financial reporting standard as Chairman Cox asserted in his third principle.

We concur with the proposal to provide for four members from Europe, four from North America, four from Asia/Pacific and four additional members selected at-large and believe this will promote investor confidence in, and global compliance, with the standards. Such a regional representation will also provide a platform for full due process and reception of views in the setting of standards.

However, despite the objective of the standards stated in the IASB Framework[13] to create standards that meet the needs of investors, part a of paragraph 14 of the Constitution, and the principles outlined in Chairman Cox's address with which we agree, only one part-time member, or 1/26th of the current membership weight (4%), is devoted to the *direct* participation of investors. Indeed, this representation weight *declined* in 2007 from one full time member. This circumstance raises questions about the commitment of the Trustees to develop a single global set of financial reporting standards that will meet the needs of investors in the world's financial markets.

[13] *Framework for the Preparation and Presentation of Financial Statements*, International Accounting Standards Committee (1989), adopted by the IASB in 2001. Paragraph F–9.

As is widely observed, financial markets and investment strategies and securities are becoming increasingly complex and specialized. This complexity demands that the Board have the benefit of expert knowledge regarding these instruments *at the table* when Board members are deliberating how best to proceed, and ongoing and fundamental decisions are being made about the agenda, prioritization of projects, and the details of the standards themselves.

Thus, we recommend that the Trustees take the opportunity of the expansion of the IASB to at the same time mandate a significant increase in the representation of investors on the IASB. The representation should be sufficiently large and broad that major sectors of the financial markets and securities can be represented. Given the proposed expansion of the Board to sixteen members, all of which we believe should be fulltime, we would recommend that a minimum of five of the members possess direct and extensive experience in at-risk investment decision making.

Again, we appreciate the opportunity to offer our perspective on the proposed changes to the IASB and IASCF.