



BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

Mr Tom Seidenstein
Director of Operations and Secretary
IASC Foundation
30 Cannon Street
London EC4M 6XH

11 February 2004

Reference: IASC Foundation Constitutional Review

Dear Mr Seidenstein

The Basel Committee on Banking Supervision welcomes the opportunity to comment on the consultation paper, *Identifying Issues for the IASC Foundation Constitution Review*, published for comment in November 2003. The Committee has a strong interest in promoting transparent and high quality financial reporting by banks. It therefore sees the work of the IASB, and the oversight thereof by the IASC Foundation Trustees, as of great importance. The Committee welcomes this review and looks forward to having the opportunity to discuss its views, in due course, with the Constitution Committee appointed to undertake the review.

Please find both our overview and detailed comments in the attached note. The Committee's Accounting Task Force, chaired by Prof Arnold Schilder, Executive Director of De Nederlandsche Bank, has assisted the Committee in developing this response.

If you have any questions regarding our comments, please feel free to contact Prof Schilder (+31 20 524 3360) or Mr Hirotaka Hideshima at the Basel Committee Secretariat (+41 61 280 8060).

Yours sincerely,

Jaime Caruana

Attachment



11 February 2004

Basel Committee Comments on the Consultation Paper "Identifying Issues for the IASC Foundation Constitution Review"

Introduction

For over a decade, the Basel Committee on Banking Supervision¹ (the Committee) has been issuing extensive guidance and policy papers on risk management activities of banks. In addition, in its work on the New Basel Capital Accord, the Committee is developing new rules and proposals for comprehensively relating capital adequacy to bank risk profiles. All of these efforts have involved extensive consultation with global banks and others, and have been designed to promote the adoption of sound risk management by banks around the world.

The Committee has long held that the transparency of banks – facilitated by sound accounting and disclosure – is a very important objective, and this has been the topic of a number of the Committee's policy papers, surveys and supervisory guidance documents in support of this objective. Most notably, the enhanced capital framework that the Committee has proposed recognises the important role of transparency in effecting market discipline as a complement to effective banking supervision. In addition, since 1998 the Committee has been actively involved in important projects, with the IASB and its predecessor, to enhance financial instruments accounting and disclosure. In all of these efforts, the Committee has been actively seeking to improve the overall quality of financial reporting in ways that will enhance transparency and market discipline, and facilitate financial stability. The IASB's work and the IASC Foundation's constitutional review are therefore viewed by the Committee as of major importance to banking supervisors and central banks.

This note presents our comments on the consultation paper in two sections. The first section provides our overview comments. The second section provides answers to the specific questions raised in the paper. The answers in this second section should be read in the context of our overview comments in the first section.

¹ The Basel Committee on Banking Supervision is a committee of banking supervisory authorities which was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent Secretariat is located.

Section 1 – Overview Comments

Independence of the standard-setting process

The Committee believes that the independence of the standard-setting process must be maintained and sees the constitutional review as an opportunity to further strengthen it. However, we also believe that the underlying cause of many of the concerns which have been raised regarding the IASB is a perceived lack of accountability for its decisions and actions. In our view, an independent standard-setting process must be accompanied by appropriate arrangements to ensure accountability if the resulting standards are to command widespread support and acceptance. This leads us to the conclusion that there is a need for more active ongoing oversight of the IASB than that currently provided by the Trustees in order to ensure that it is seen to undertake its work with due regard for the strong public interest in the quality of financial reporting.

Due process and transparency

The observance of due process and transparency are essential elements of the standard-setting process and we urge the Trustees to consider how to achieve improvements in both areas. We note that the Board has already made efforts to act transparently, for example through publishing summaries of its discussions on the IASB website and in monthly Updates, but believe that more can be done in this area. We believe that lessons need to be learnt from the protracted debates over the revision of International Accounting Standard (IAS) 39 in terms of how to demonstrate to stakeholders that the Board has fully understood and properly considered all the views expressed by them. A positive lesson is the potential value of public hearings on controversial issues. The Board should be made accountable for how it exercises its discretion in this respect. The length of time that elapsed between the publication of the IAS 39 Exposure Draft and the recent publication of a "final" text has highlighted the need for the Board to give greater attention to the issue of transparency in its processes for finalising standards once public consultation has closed. The Board could, for example, consider making some of the current working text of a proposed standard public before the standard as a whole has been finally agreed. We also believe that the value of opening Board meetings to the public is reduced if observers are denied access to the papers needed to properly follow the Board's discussions. We are therefore very pleased to learn that consideration is now being given to making Board papers available to observers. In our view, this would be a major step forward.

Composition of the IASB

We believe that the current composition of the Board is not well-balanced in terms of both the balance among different accounting traditions and professional backgrounds. Of the 14 Board members, ten can be characterised as coming from an accounting tradition similar to that of the former G4 standard-setters group with just three from Continental Europe and one from Japan. The procedures for setting accounting standards in most of the latter group of countries have traditionally been more legalistic than those that operated in the former group. We consider that the lack of balance in this respect is not helpful in seeking to build widespread support and acceptance for the IASB's standards. We also have concerns about an imbalance in professional backgrounds with technical and standard-setting experience apparently being given greater weight in making appointments than other skills and experience needed by the Board. In particular, we recommend that the Board have a larger percentage of members that have professional experience in implementing accounting policies and procedures for financial instruments and related risk disclosures, including an understanding of the problems and practical issues associated with fair value accounting. We

believe that these imbalances in backgrounds, skills and experience need to be addressed even if it necessitates an increase in the size of the Board in the short-term.

Objectives of the IASB's work

The constitution refers to developing accounting standards that require high quality, transparent and comparable information in financial statements to help participants in the capital markets and other users make economic decisions. While we acknowledge that the needs of investors are a key consideration in setting accounting standards, the needs of other users also need to be given appropriate weight. We believe that the Board should always seek to develop standards that meet the needs of both investors and other user groups. In this regard, we believe that the information needs of central banks and banking supervisors should be given greater attention as part of the IASB's stated objectives and work programme. We comment below (Question D22) on the desirability of securing the involvement of both investors and other user groups in the standard-setting process.

Section 2 – Comments on Specific Questions in the Consultation Paper

Question A2 – Objectives

Should there be a specific objective to address the special challenges facing small and medium-sized entities (SMEs)?

We support the inclusion of a specific objective to address the special challenges facing SMEs. We believe that there is a tendency for the Board to focus on the application of IASs by listed/larger companies. A specific objective of this nature will help to ensure that appropriate attention is also given to the application of IASs by SMEs.

Moreover, we believe that it would be useful to also include a specific objective to address the special challenges of applying IAS in emerging markets, combined with an increased involvement of people with such backgrounds in the working groups and organisation of the IASCF and IASB.

Questions C4-8 – Trustees

Does the potential benefit of expanding the number of Trustees, possibly to accommodate a broader range of views, outweigh the risk that meetings would become more cumbersome and less effective if larger, potentially reducing a strong sense of commitment and participation by individual members?

The Trustees have a largely fixed geographical distribution. Is such a fixed distribution appropriate, or does the current distribution need review?

Although a broad distribution of professional backgrounds is clearly necessary, is the distribution enshrined in the Constitution appropriate?

We believe that consideration should be given to achieving a more balanced distribution of trustees between Europe/North America on the one hand and Asia/Pacific/other areas on the other. In particular, we would like to see emerging markets represented on the Trustees to give them a voice and strengthen their commitment to high quality accounting standards. We have reservations, however, about increasing the overall number of Trustees and would

prefer to see a reallocation within the existing numbers as the existing Trustees' terms of office come to an end.

We do not consider it appropriate or desirable for the Constitution to continue to mandate that five of the 19 Trustees be nominated by the International Federation of Accountants. We note that international organisations representing preparers, users and academics are required to be consulted for the purpose of ensuring representation from these groups. We believe that the same principle should apply in order to ensure appropriate representation from the accountancy profession (with IFAC and other relevant bodies being consulted). We also believe that a better balance should be struck between members with a background in the profession and members from other backgrounds.

Question C14 and 16 – Trustees' Duties

The intention of these provisions [contained in paragraph 14] is to protect the independence of the standard-setting process while ensuring sufficient due process and consultation. Does there need to be a specific requirement for the Trustees to review the strategy and the procedures of the IASB at intervals?

We believe that there is a need for more active ongoing public interest oversight of the IASB's work than that currently exercised by the Trustees. Such an oversight function should carry out regular reviews of matters such as major strategic decisions, the observance of due process in the standard-setting process, the overall performance of the Board and the adequacy of the resources available to the Board to meet the demands placed upon it.

We recommend that a new body, working alongside the Trustees, be created for this purpose (or that a committee of the Trustees able to provide active public interest oversight of this nature be established). Moreover, we recommend that the Trustees and any new oversight body have an in-depth meeting at least annually with the Standards Advisory Council to receive its views about the IASB and its agenda, proposals and standards on a confidential basis (i.e., without the IASB in attendance).

Question C18 – Review of Constitution

Should the language of the constitution be changed to require a review of the Constitution "at least every ten years" rather than every five years?

We can see no good reason to change this requirement at present and note that no arguments in support of a change are set out in the paper.

Questions D19 and 22 – IASB Members

Should the number of IASB members be reduced to make the Board more workable?

Should the part-time positions be eliminated in recognition that the workload of IASB members is heavy and requires substantial time for consultation with interested parties?

Should the requirement for this distribution of professional backgrounds be relaxed in light of the desirability of attracting the best-qualified individuals?

We are not in a position to assess either how large the Board needs to be or how heavy a workload is carried by individual Board members. We do believe, however, that the Trustees

need to gather the necessary information during the review to enable such an assessment to be made.

There are advantages and disadvantages associated with having part-time Board members as well as full-time members. One advantage can be that part-time members may bring to the Board a useful direct contact with the application of the standards in practice. Against this, there is the risk that this may detract from the perceived independence of the Board.. We believe that the Trustees need to weigh carefully, in the light of experience with the existing part-time positions, whether or not the overall effectiveness of the Board is likely to be enhanced by continuing to appoint some Board members on a part-time basis. If the conclusion is that some part-time positions should be retained, we recommend that consideration be given to allowing the Trustees some flexibility in deciding how many part-time members should be appointed at any one time.

While the Trustees need to ensure that a variety of professional backgrounds are represented on the Board, we do not believe that it is necessary or desirable for the Constitution to specify quotas for particular backgrounds. We also consider that the current arrangements appear to have resulted in practice in too few members with recent business experience. The problems encountered recently with standards that will have a significant impact on the banking and insurance sectors have, in our view, highlighted the importance of the Board having sufficient business and industry expertise amongst its members. We consider that the process would get more buy in if the skill sets of members included more people with business and industry expertise and with knowledge of the practical issues and problems associated with financial instruments accounting (including fair value accounting, particularly when active markets do not exist). The Trustees should therefore work to ensure that the composition of the Board reflects a balanced appreciation of both the conceptual and practical aspects of the significant accounting issues on the IASB's agenda (for example, as the Trustees consider new Board members for appointment or decide whether to renew the terms of existing Board members). Furthermore, the Trustees should be responsible for ensuring that the Board as a whole has the necessary diversity of expertise, skills and professional backgrounds without being constrained by arbitrary quotas. It should be noted that, even if the Board's skill base is strengthened, consultation and collaboration with external experts as appropriate should remain an important part of the IASB's due process.

Question D22 – User Involvement

The IASC Foundation (like other standard-setting organizations) has experienced difficulty in securing the involvement of the analyst and investment community (“users”). Is there any way to encourage that group to increase its involvement?

We believe it is wrong to equate the term "users" with the analyst and investment community. Central bankers, fiscal authorities, banking supervisors and other prudential regulators are all major users of general purpose financial statements and this is reflected in the significant resources the Basel Committee and others devote to analysing and commenting on the IASB's proposals. In addition, banks themselves and other financial services institutions make extensive use of financial statements in making lending and other decisions. We believe that the Foundation needs to focus on securing the involvement of users in this wider sense rather than merely focusing on investors and analysts. We note, in this context, that the analyst representatives have been very vocal and active in providing advice to the IASB at the Standards Advisory Council meetings.

Questions D23 – Liaison Responsibilities

Does this kind of formal liaison relationship seem important for ensuring convergence of accounting standards? Should special consideration be given to liaison with emerging economies, not currently represented by the existing liaison relationships?

We believe that the existing liaison relationships should be continued and extended to include emerging economies. However, we consider that limiting liaison relationships to national standard-setters (whose future role in some jurisdictions is likely to be reduced due to the adoption of IASs) may not be the best approach. In most jurisdictions there are a number of other bodies with a major interest in the financial reporting process who should also be included (eg banking and insurance regulators, securities regulators, bodies responsible for enforcing compliance with accounting standards and auditor oversight bodies). We recognise that it may not be feasible for IASB Board members to personally undertake wider liaison responsibilities of this nature. However, we see no reason why senior members of staff should not do so on their behalf.

Question D29-32 – Due Process

The Constitution describes the principles and elements of required due process for the IASB. The IASB's procedures are listed in more detail in the Preface to IFRS. If respondents do not believe the procedures laid out in the Constitution are sufficient, what should be added?

The process followed by the IASB in developing new standards allows for public comment on published exposure drafts. The IASB provides feedback on major points made by commentators by explaining its reasons for accepting or rejecting them. The regular Board meetings are public and information is provided regularly on IASB's decisions through various publications. Each exposure draft and final standard is accompanied by a Basis for Conclusions to help readers understand the reasons for the Board's decisions. These procedures should, in theory, ensure that due process is followed in the standard-setting process.

In practice, however, the process would run more smoothly and achieve greater buy-in if there was more opportunity to input at an earlier stage. We often hear a concern that the IASB has already carefully examined the significant accounting issues involved in a project, and come to a considered view about them, before the start of public consultation. In order to improve the due process and the efficiency of the consultations, it would be highly desirable if public consultation was initiated at an earlier stage of the discussions, in order to make the debate on the more significant accounting options more open-ended. The due process makes it possible, but not compulsory, to publish, and invite comments on, discussion papers at an earlier stage in the standard-setting process. We recommend that the IASB extend the use of such discussion papers and be required to specifically consider their use in relation to all of its projects.

The consideration of public comments by the IASB should also be improved. We believe that the public roundtables held early in 2003 on IAS 32 and IAS 39 helped the Board reach a better understanding of a number of the concerns raised by commentators. We therefore recommend that the IASB consider making greater use of such public hearings in future.

While recognising the unique challenges the Board has faced in seeking to finalise key standards in time for their adoption in the European Union from 2005, we also believe that the Board needs to be more rigorous in assessing the need for re-exposure when it is proposing to adopt major changes from the proposals set out in the Exposure Draft issued for public comment.

The IASB sometimes works alongside a national standard-setter on specific projects. Although this is a way to improve the efficiency of the process, it can result in too much importance being attached to the views of the national standard-setter concerned at the expense of a more diversified exchange of views. In addition, the objective to seek convergence with US GAAP, however desirable, could be perceived (by some) to result in a single national standard-setter having a disproportionate influence on certain projects. We consider that the Board needs to strengthen its procedures to ensure that no one national standard-setter is able, or perceived to be able, to exercise undue influence on the outcome of individual projects.

Questions F38-40 – Standards Advisory Council (SAC)

Are the current procedures and composition, in terms of numbers and professional backgrounds, of the SAC satisfactory? Is the SAC able to accomplish its objectives as defined in Section 38?

Is the manner of selection of the SAC Chairman appropriate?

We support the need for SAC members to be drawn from a wide range of backgrounds. However, we believe that all members should act in the public interest and that this requirement should be explicitly stated in the Constitution. We recommend that the Trustees seek direct feedback from SAC members as to how the SAC can more effectively meet its stated objectives in future. In our view, the SAC could be operated more effectively by ensuring that sufficient time is given to key topics, such as financial instruments accounting and risk disclosure, so as to allow for better discussions at SAC meetings and the opportunity for the SAC to give clearer advice to the IASB. We note that the large number of SAC members (currently around 50) may not be helpful in terms of achieving effective discussions. We therefore recommend that the size of the SAC be reconsidered and/or the use of other discussion techniques (for example, smaller discussion groups of SAC members) be considered. We also believe that the SAC should select its own Chair going forward, rather than the IASB Chair continuing in the role, as it needs to be seen as independent of the IASB. We also recommend, as mentioned above, that the Trustees have an in-depth meeting with the SAC at least annually, on a confidential basis without the IASB being present, to obtain the SAC's candid views and advice on the IASB's agenda, proposals and standards.

Other Comments – IFRIC

We believe that, in the context of the implementation of IAS in a number of countries in the near future, many questions are likely to arise on interpretation issues. We are concerned that IFRIC will not be able to address all these questions in a timely manner. We note that the only output from IFRIC to date is a small number of draft interpretations. We therefore believe that there is an urgent need to review the working practices of IFRIC and the resources available to it to meet the important responsibilities it has taken on.