

Attn. Elizabeth M. Murphy, Secretary U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers / File No. S7-27-08

Response by Nicolas Véron, Research Fellow, Bruegel

Executive Summary

It is in the U.S. interest to favor success of the “global accounting experiment”, the endeavor to set common accounting standards for the entire world. SEC decisions about U.S. recognition of IFRS will have a significant impact on this project. The SEC must articulate a clear long-term vision for IFRS, compatible with political and economic realities both in and outside the U.S. It must also implement its vision flexibly enough to accommodate the multiple tensions in this policy area, which have been emphasized and exacerbated by the financial crisis as illustrated in particular by the controversies over fair value accounting.

Specifically, clarity of purpose is needed in three broad areas:

1. Mandate, Governance, and Funding: The standard-setting organization needs a governance framework that suits its global responsibility. Its mandate must be clarified, with an unambiguous orientation towards investors’ information needs. The SEC should defend financial reporting transparency as contributive not detrimental to financial stability, including in the current crisis environment. The poorly designed “Monitoring Board” created earlier this year must be replaced by a broader governing body with fair representation of IFRS stakeholders in coherence with the mandate, which should entail strong representation and empowerment of global users of financial information. In parallel, the SEC should insist on a complete overhaul of the standard-setting organization’s funding framework.
2. Standards Content and Quality: Quality of standards, in compliance with the mandate of international standard-setting, must be the top priority, above convergence between IFRS and U.S. GAAP. A revamped agenda-setting process should also incorporate the aim of reducing the unnecessary complexity that has developed under IFRS, and improve the standards’ enforceability.
3. Enforcement: Switching from U.S. GAAP to IFRS can only be justified if the benefits of enhanced comparability are greater than the significant transition costs. As a consequence, international consistency of implementation and enforcement should be an integral part of the SEC’s strategy for IFRS recognition. The SEC should create strong coordination structures with the world’s accounting enforcement agencies to promote best practices and prevent local regulatory capture. In Europe, it should encourage the integration of enforcement capacities at European Union level.

Given the magnitude and complexity of these requirements, it will be difficult for the SEC at this stage to set a firm date for IFRS adoption in the U.S. However, it should exert significant pressure to ensure rapid progress in the three directions indicated above, so as to enable completion of U.S. adoption before the end of the next decade.

Dear Ms. Murphy and Commissioners:

I greatly appreciate the opportunity to comment on the SEC Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards (IFRS) by U.S. Issuers (File No. S7-27-08).

Bruegel is a European think tank devoted to international economics, which started operations in Brussels in 2005 with the support of a number of European member state governments and international companies. Its publications, research programme, and other detailed information are available on www.bruegel.org.

Bruegel's stated aim is to contribute to the quality of economic policymaking in Europe through open, fact-based and policy-relevant research, analysis and discussion. Global interdependence in accounting standard-setting is such that the present communication to the SEC falls under this mandate. As explained below, the impact of the SEC's future decisions on IFRS recognition will extend far beyond the U.S. borders and will affect European policymaking in a material way.

This note represents my personal views as a research fellow, not those of Bruegel as an organization. Accounting standard-setting is a topic to which I have devoted significant attention since 2002. I believe that my Bruegel work, private consulting activity, and nonprofit activities¹ do not introduce a commercial or special-interest bias to my views nor do they impair the integrity of my research in the debate about accounting standard-setting.

General Policy Orientation

Much is at stake in the debate on IFRS recognition in the U.S. The most immediate impact is that any decision will have **implications for U.S. companies, investors on U.S. capital markets, and U.S. financial competitiveness**. If it results in lower-quality financial reporting, or if the increase in financial reporting quality and/or comparability does not compensate for the cost of transition², then IFRS should not be endorsed by the SEC.

But this is not the only dimension that the SEC should consider. Seen in a global context, future SEC decisions about IFRS recognition will have a significant impact beyond the U.S.:

- To a large extent, **the SEC's attitude will determine the future of the International Accounting Standards Board (IASB)**. SEC endorsement has arguably been the central strategic objective of the IASB since its creation in 2001, and of the International Accounting Standards Committee (IASC) for several years before. If only for this reason, an outright rejection of IFRS by the SEC would severely impair the IASB's credibility. Absent the prospect of future U.S. adoption of IFRS, existing strains could develop to undermine the ability of the IASB to lead international accounting standard-setting. It is imaginable that IFRS would then gradually unravel: non-U.S. jurisdictions, including those which

¹ These include participation in the Accounting and Auditing Practices Committee of the International Corporate Governance Network since 2004, and in the CFA Institute's Corporate Disclosure Policy Council since 2008.

² See Luzi Hail, Christian Leuz and Peter Wysocki, "Global Accounting Convergence and the Potential Adoption of IFRS by the United States: An Analysis of Economic and Policy Factors", February 2009, available at <http://ssrn.com/abstract=1357331>

have already adopted IFRS, may entrust future standard-setting to regional or national bodies, or alternative global standards issued by other standard-setting entities may supersede IFRS.

- Beyond accounting, the outcome will have **implications for global financial governance** more generally. Though perhaps not the most visible to the general public, international accounting standards-setting is one of the most advanced experiments in financial and even economic policymaking on a global scale. Failure of this experiment may negatively impact the prospect of other comparable endeavors in the future.
- This point is given additional importance by the **current crisis context**, which considerably amplifies the potential effects of regulatory choices. We are close to a bifurcation point between global financial market fragmentation and the creation of stronger international financial policy frameworks³. Decisions by the SEC on IFRS recognition will be part of the balance of forces that determine the eventual outcome.

Given this, I recommend the following policy orientations:

- The SEC should **reaffirm the aim of a single set of high-quality accounting standards applied throughout the globe** as a guiding principle of its policy in this area – as agreed upon by the U.S. in successive G20 summit declarations, on 15 November 2008 and 2 April 2009. In spite of the formal G20 agreement, temptations exist in jurisdictions which have adopted IFRS or variations thereof, including the European Union, to shift back to regional standard-setting in view of the tensions experienced with the IASB. The U.S., and the SEC on its behalf, has a responsibility to make credible the prospect of complete global accounting standards harmonization.
- The SEC should **confirm conditional support for the IASB as global standard-setter**. Under Chairman Christopher Cox, such support was expressed with clarity but the relative absence of conditionality met strong and legitimate resistance inside the U.S. The SEC's support should be maintained, but it should be conditional to ensure sustainability. The IASB and IASCF Foundation (IASCF) currently remain the world's, and the SEC's, best hope to attain the aim mentioned in the previous paragraph in a reasonable timeframe. Their achievements towards this aim in the past decade have been remarkable, in spite of recent decisions which have to some extent jeopardized their role and authority, including the rushed change brought to accounting for financial instruments under pressure from the European Union in October 2008. IFRS have been adopted or are being adopted in many jurisdictions, and their implementation in the European Union and other jurisdictions has led to generally higher-quality financial reporting from the point of view of users⁴, at a manageable transition cost. Thus, the SEC should specify conditions for IFRS recognition while allowing for future policy flexibility, especially on timing (see below), in a spirit not unlike that of the initial roadmap document⁵.

In the next sections I outline suggested conditions for IFRS recognition in three key areas: the mandate, governance and funding of the IASCF and IASB; the content of the standards they produce; and the adoption and enforcement framework. The first and second items are within the decision-making remit of the IASCF and IASB, while the third one depends on individual jurisdictions and international bodies other than the IASCF/IASB.

³ See for example the *Financial Times* editorial, "Lessons learnt for capitalism's future", 14 April 2009: "The current mismatch of globalised finance and national governance is unsustainable. Either governance becomes more globalised or finance less globalised".

⁴ See for example AFG and FFSA, *Investor Perspectives on IFRS Implementation*, Paris, December 2007

⁵ Donald Nicolaisen, "A Securities Regulator Looks at Convergence", *Northwestern University Journal of International Law and Business*, April 2005

IASCF/IASB Mandate, Governance and Funding

- The SEC should foster **clarity of the IASCF's mandate**. "Quality" of accounting standards, as referred to in the IASCF's Constitution⁶, does not exist in a vacuum, and must be assessed against collective-interest objectives and prioritization of stakeholders. Consistent with its recently issued report on the impact of mark-to-market accounting⁷, the SEC should affirm its commitment to **accounting standards designed to serve as a priority the needs of capital providers**. Furthermore, it should ensure that this vision is not only the SEC's and that it is shared throughout the U.S. government, including prudential supervisors. Many voices, though not all, in the global supervisory and central banking community concur that investor-oriented accounting standards are not only compatible with the aim of financial stability, but also can contribute to it⁸. The SEC should make it clear that the obvious need for the IASB to appropriately liaise with prudential supervisors, as has been emphasized in the declaration of the London Summit on 2 April, should not be interpreted as a dilution of standard-setting's orientation towards investors' needs. It should see to it that the long overdue revision of the IASB's conceptual framework does not introduce ambiguity on this point.
- The SEC should also foster **a comprehensive overhaul of the IASCF's governance framework**, which does not currently correspond to the IASCF's global responsibilities. The Monitoring Board established earlier this year is inherently dysfunctional, and marginal changes to its design cannot correct its fundamental flaws. The central idea of the Monitoring Board, which is to replicate the accountability channels of national standard-setters vis-à-vis national governments⁹, remains impractical as long as humankind does not submit itself to a global government. Furthermore, the concern to keep the Monitoring Board very small has led to key stakeholders being left out without apparent justification, and an absence of clarity of the criteria which led to the Board members' selection¹⁰. The SEC should promote a **transformation of the Monitoring Board into a broader Governing Body that would better represent the global stakeholders of IFRS**. This governing body should specifically entail a high degree of accountability to representatives of the investment community, in coherence with the previous paragraph about the organization's mandate, and also include representation of other stakeholder categories such as analysts, auditors, preparers, alongside national and regional regulators and political authorities. It should be governed by the IASCF's Constitution¹¹. It should also put an end to the fiction that the Monitoring Board's task can

⁶ The Constitution currently refers to "a single set of high quality, understandable and enforceable global accounting standards that 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" (Article 2)

⁷ Office of the SEC Chief Accountant and SEC Division of Corporation Finance, "Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting", December 2008

⁸ See Claudio Borio and Kostas Tsatsaronis, "Risk in financial reporting: status, challenges and suggested directions", Bank for International Settlements Working Paper No 213, August 2006

⁹ Press release of the IASCF, 29 January 2009: "This basic approach to the architecture of governance is similar to that in place in many national jurisdictions for accounting standard-setters".

¹⁰ For a more in-depth analysis, see my testimony in the IASCF's Constitution Review Round Table of 19 June 2008, subsequently published as "Empower Users of Financial Information as the IASC Foundation's Stakeholders", Bruegel Policy Contribution series, July 2008.

¹¹ By contrast, the Charter of the Monitoring Board, adopted on 1 April 2009, is outside the remit of the IASCF Constitution. In my view this is incompatible with the autonomy of the IASB. See the comment letter by Deloitte in response to the IASCF's consultation on the establishment of the Monitoring Board (Review of the IASCF

be artificially limited to Trustee appointments and reappointments (let alone to actual monitoring), which is contradicted by the present Monitoring Board's already sweeping prerogatives¹². The governing body should, in particular, be sole competent to amend the IASCF's Constitution. These recommendations are not trivial to implement. They entail a degree of organizational complexity, and require a spirit of institutional innovativeness that the IASCF has not much displayed in recent years. But reform along such lines is the only sustainable way to ensure the desired legitimacy, independence and authority.

- Finally, the SEC should foster a **rethink of the IASCF's funding structure**, which is currently built on an underlying concept of taxation without representation¹³ and is therefore neither sound nor sustainable. The SEC should encourage the IASCF to align the funding structure with the representation of global stakeholders as outlined in the previous paragraph, as opposed to country-based funding schemes as have been developed since 2006.

I am aware that the recommendations in the two previous paragraphs would lead to a framework of governance and accountability which has no obvious precedents among existing global organizations. But the task that the IASCF has given itself, the autonomous setting at global level of norms with as much economic impact as accounting standards, is also without precedent. Thus, the IASCF cannot escape the need to find innovative institutional responses to this largely unprecedented challenge.

Content of IFRS

Even though the IASCF's identity and governance will be a key determinant of the future quality of IFRS, the SEC should also ground its future decisions on the content of the standards themselves and on the characteristics of the process under which they are prepared and adopted. Under this objective:

- The SEC should insist on **standards quality above convergence**. The convergence process between IFRS and U.S. GAAP, initiated under the Norwalk Agreement of 2002 between the IASB and FASB and the subsequent Memorandum of Understanding of February 2006, has not always been conducive to an enhancement of standards quality, and in some cases can be specifically identified as a cause of decrease in quality of IFRS¹⁴. Such developments are doubly detrimental, through the direct impact on financial reporting but also because they tend to undermine the acceptance of IFRS outside the U.S., by making standard-setting appear as dominated by U.S. special interests as opposed to the interests of users of financial information prepared using IFRS. Convergence between IFRS and U.S. GAAP is a legitimate aim for the SEC, as it potentially lowers the cost of transition to IFRS for U.S. issuers, but it should not be allowed to supersede the more important objective of standards quality.
- Consistent with the previous point, the SEC should encourage **improvement of the IASB's agenda-setting process** which has been excessively dominated by the convergence objective since 2002 and

Constitution), 19 September 2008: "Agreeing to the creation of a monitoring group without knowing exactly what its powers or terms of reference are to be, and where within (or out-with) the governance system of the IASC Foundation it is to fit would represent a 'leap of faith' on behalf of the IFRS community".

¹² As set out in the Memorandum of Understanding to Strengthen the Institutional Framework of the IASCF of 1 April, which establishes the Trustees' relationship with the Monitoring Board.

¹³ The IASCF's euphemism for taxation is "non-voluntary funding", in the Preamble of the Memorandum of Understanding referred to in the previous note.

¹⁴ One such case is the adoption in 2006 of the IFRS 8 standard on operating segments. See my note for the European Parliament's Economic and Monetary Affairs (ECON) Committee, published as "EU Adoption of the IFRS8 Standard on Operating Segments", Bruegel Policy Contribution series, September 2007.

especially since 2006. Agenda-setting should instead be based on an autonomous assessment of IFRS' gaps and shortcomings, such as currently on insurance liabilities or the conceptual framework. Alignment of IFRS on U.S. GAAP should be reserved to cases where the latter offer unambiguously superior solutions.

- In the interest of users, the SEC should encourage the IASB to **reduce the complexity** of the current IFRS. There is a widespread assessment in the user community that some of the present complexity is not justified by the requirement of high-quality financial reporting¹⁵.
- In a similar vein, the SEC should encourage the IASB to ensure a better **enforceability of IFRS** by reducing the degree of discretion granted to companies in cases where such discretion is not generally conducive to higher-quality reporting. High-visibility developments such as the booking in 2007 by Société Générale of a trading loss incurred in January 2008, invoking the "true and fair view override" under IAS 1, and other less visible cases, have reinforced the perception that there is significant room for improvement of IFRS from that viewpoint. This debate cannot and should not be reduced to the largely misleading, though often heard, black-and-white opposition between "principles-based" and "rules-based" standards.

Consistent Adoption and Enforcement

Comparability is a crucial promise of IFRS, and is one of the parameters which the SEC needs to assess in considering their future recognition in the U.S. As mentioned in the previous paragraph, comparability can be enhanced by the content of IFRS and the extent to which the standards limit companies' discretion in their financial reporting. Even more important for comparability is the consistency of adoption and enforcement practices across jurisdictions. I do not include here a specific development about audit quality, but it is a significant dimension from this point of view.

- On adoption, the SEC should tailor the necessary safeguards of U.S. national sovereignty so as to preserve the vision of a single global set of standards. As part of the responsibility granted to it by U.S. legislation, the SEC should keep a **domestic safeguard mechanism similar to the European Union's endorsement mechanism** introduced in 2002 as a key component of the decision to adopt IFRS there¹⁶. As in the original EU regulation, this should allow the SEC to adopt or reject any given IFRS standard or IFRIC interpretation, but not to rewrite them or amend their content including through the use of "carve-outs"¹⁷. However, the SEC should simultaneously **establish IFRS as issued in English by the IASB as the sole standard for cross-border mutual recognition**. Unlike the current practice of the European Commission, the SEC should not grant "equivalent status" to accounting standards other than "full IFRS", in order to avoid further fragmentation.
- On enforcement, the SEC should promote **strong coordination mechanisms, which may include binding arrangements, in order to ensure international consistency**. One aspect of this would be to foster a reduction of international divergence by encouraging the European Union to centralize enforcement of IFRS among its member states through the establishment of a "European Chief Accountant" who would be delegated enforcement authority by most, or ideally all, EU national

¹⁵ See for example Moody's Global Corporate Finance Special Comment, "Are We Better Off Under IFRS?", November 2008

¹⁶ Regulation of the European Parliament and the Council 1606/2002 of 17 July 2002.

¹⁷ My understanding is that the carve-out of IAS 39, as set out in the European Commission Regulation (EC) 2086/2004 of 19 November 2004, is not compliant with Regulation 1606/2002.

relevant public authorities¹⁸. Beyond the European Union, the SEC should expand on existing efforts by the International Organization of Securities Commissions to coordinate IFRS enforcement.

Timing

To implement these recommendations, the SEC will need to implement a difficult balancing act. On the one hand, it should actively foster a consensus about reform not only with the IASCF and IASB but also with other authorities including the members of the Monitoring Board as well as U.S. (and likewise non-U.S.) prudential supervisors. On the other hand, it should not indefinitely postpone decisions on IFRS recognition under the pretext of conditionality, which would carry a serious risk of undermining the IASB's credibility as argued above. I recommend that the SEC clearly signal its desire to **adopt an improved set of IFRS under a reformed IASCF/IASB in the second half of the next decade**. Obviously, many issuers would prefer to immediately know a "date certain" and adjust their planning accordingly¹⁹. But setting a firm target date for IFRS adoption at this stage would in my opinion be incompatible with the flexibility that will be required to manage the complex set of policy developments which will inevitably unfold in the meantime. It may be appropriate for the SEC to set up a formal yearly progress review towards this objective, perhaps in conjunction with the U.S. Congress, with the aim of making rapid progress that will eventually allow the announcement of a firmer schedule.

I do not recommend allowing the optional use of IFRS by U.S. issuers in the meantime, especially not in the very short term as is envisaged in the proposed rule. Such a "two-GAAP" situation would inevitably lead to regulatory arbitrage by some companies and may thus negatively impact both the quality of financial reporting, and the reputation of both IFRS and U.S. GAAP.

I am neutral as to whether the eventual adoption of IFRS should occur over several years depending on the size of issuers, as envisaged in the proposal rule.

I am grateful to the SEC for giving me the opportunity to offer my views on the proposed rule and the broader debate about IFRS recognition in the U.S. Of course, I would be delighted to develop the items outlined in this letter if you or your staff have questions or seek further elaboration of them.

Yours sincerely,



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¹⁸ A sketchy proposal for such a reform is outlined in my 2007 essay *The Global Accounting Experiment*, Bruegel Blueprint series, April 2007, in which I refer to a "European Accounting Authority" – but "European Chief Accountant" better capture the nature of the enforcement mandate, especially with reference to the role of the SEC Chief Accountant. It is to be noted that in some EU member states, including the United Kingdom and Germany, the public authority in charge of IFRS enforcement is distinct from the securities regulator.

¹⁹ See for example Deloitte, "2009 IFRS Survey Results", March 2009