Board Duties and the Application of the IFRS – The Legal Perspective[1]

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With a listing at the SIX Swiss Exchange («SIX»), companies must apply a financial reporting standard providing a true and fair view of the financial situation of the company. Listed entities mainly have the choice between the application of the IFRS, the US GAAP, and the Swiss GAAP FER.

The choice of the financial reporting standard lies within the competence of the board of directors and impacts the board members' work on various levels. As the IFRS are the most applied reporting standard at the SIX this article focuses on the application of the IFRS.[2] Nevertheless, some considerations might be applicable to companies preparing their reports according to US GAAP or Swiss GAAP FER as well. The application of the IFRS has a significant effect on corporate governance and contrary to what one might expect, the application of the IFRS per se will not lead to a better corporate governance. To the contrary, only good corporate governance will mitigate risks arising from the application of the IFRS. This article therefore offers a legal perspective on the impacts of the application of the IFRS on board duties for the overall financial management of the company. The focus lies on the question whether the board of directors, being responsible for the overall financial management of the company, may base its decisions on an IFRS-report.

1 This contribution is based on the author's publication and dissertation published in 2021: Daniele Simoniello, The Influence of the IFRS on the Financial Management Duties of the Board of Directors under Swiss Law, SSHW 349, Zürich 2021. The author thanks Marisa Hunkeler, MLaw and Mirella Janett, MLaw for threir valuable inputs and critical review of this article.

2 <https://www.six-group.com/de/products-services/the-swiss-stock-exchange/market-data/shares/companies.html> (accessed on 29.03.2022).

1. Overall Financial Management: Duty to organize Accounting, Financial Control and Financial Planning

Based on the duty stipulated in Art. 716a para 1 Swiss Code of Obligations («CO»), the board of directors is required to prepare the financial report and to organise the entire accounting, financial control, and financial planning systems for the purpose of managing the company.

The duty of overall financial management is closely connected with the duty of overall strategic management. Members of the board must include in their overall strategy, which shall ultimately lead to the creation of shareholder value, long-term value management, the specification of financial goals and liquidity coordination, the capital structure policy, and how to maintain financial flexibility. To that end, the board of directors must set out a risk management framework, determine the basic risk orientation of the company and align the risk orientation with its capital structure policy.[3]

The primary guideline of overall financial management is to ensure the good financial performance of the company and the transformation of this performance into shareholder value, e.g. dividends or an increase in share value. A constant orientation towards creating shareholder value also helps to improve corporate governance.[4]

Financial reporting provides data that allows shareholders, tax authorities, and creditors to assess the financial situation of the company. However, financial reporting, but also accounting, financial control, and financial planning systems may serve internally to members of the board and the senior management. It is recognised amongst legal scholars that financial accounting and reporting should serve a board of directors as a management tool and only in the case in which financial reporting depicts the financial situation of the company as close to the reality as possible can board members make adequate decisions.[5]

To manage the company, a board of directors should receive (at least) monthly updates on costs, earnings, cash in- and outflows, as well as liquidity. Furthermore, financial indicators like the EBITDA, EBIT, ROA, or ROS might be required for the assessment of the financial situation of the company and to take adequate decisions.[6] Modern financial reporting standards, such as the IFRS, do, contrary to financial reports according to the CO, already offer a true and fair view, and they could therefore already offer to the members of the board of directors a basis on which they may rely their decisions without a separate management accounting system.[7]

The next paragraphs will present the positive and negative aspects of using the IFRS for decision making of the board, whether members of the board of directors may rely on an IFRS report and what considerations from a corporate governance perspective must be made by the board of directors. The analysis is based on international literature, mainly from Germany, where the context was similar as in Switzerland: German financial reporting was prudence driven and therefore unable to provide the board of directors and executive management with figures for decision making. Therefore, members of the board of directors and senior management had to rely on a second set of figures (controlling or management accounting). Several studies and contribution have shown the positive and negative aspects of the implementation of a convergent financial reporting system, meaning that the board of directors and the executive management may rely on a financial report according to the IFRS.[8]

3 Müller Roland/Lipp Lorenz/Plüss Adrian, Der Verwaltungsrat, 5th edn, Zürich 2021, p 192 et seq; Simoniello (fn 1), para 139 et seq.

4 Böckli Peter, Schweizer Aktienrecht, 4th edn, Zürich 2009, § 14 para 36; cf the discussion in Bühler Christoph B., Regulierung im Bereich der Corporate Governance, Zürich 2009, para 343 et seq; Simoniello (fn 1) para 135.

5 Böckli (fn 4) § 13 para 344; Müller/Lipp/Plüss (fn 3) p 200 et seq.

6 Bühler Christoph B., In: Handschin Lukas (Ed), Zürcher Kommentar Obligationenrecht, Art 698-726 und 731b OR, Die Aktiengesellschaft Generalversammlung und Verwaltungsrat Mängel in der Organisation, 3th edn, Zürich 2018 (ZK-Bühler), Art 716a CO para 61; Müller/Lipp/Plüss (fn 3), p 196.

7 However, it is to be noted that in Switzerland, companies are still required to present their statutory financial reports in accordance with the CO for tax purposes and dividend payments and it still serves as basis for the assessment of a company in financial crisis and e.g. the determination of over-indebtedness and the therewith relating duties of the board to notify the competent court. See Simoniello (fn 1) para 696 et seq.

8 Brandau Michael/Endenich Christoph/Luther Robert/Trapp Rouven, Separation - integration - and now...? A historical perspective on the relationship between German management accounting and financial accounting, Accounting History 22 (2017), p 67 et seq. See also Simoniello (fn 1) para 333 et seq.

2. Use of IFRS for Decision Making of the Board – Positive Aspects

2.1 Shareholder Value Orientation

From a shareholders' perspective what counts is in the financial report. The core communication medium for financial information of a company is therefore the external financial report.[9] Communication between a company and the capital market improves if the same financial data is used internally as well as externally, because internal and external communication are aligned. Generally, if internal communication improves in quality so does external communication. At the same time, there is an alignment of aims of shareholders, board of directors and management, and the managers will aim to maximize the figures of the IFRS-report, which ultimately benefits the shareholders.[10]

2.2 Reduction of Divergences in the Financial Results

When using two separate financial accounts, externally and internally, it is possible that the board of directors receives divergent financial results, which obviously raises the question of which result the board of directors and managers should trust.[11] Therefore, when the board of directors bases its decisions on the report communicated externally there will be no unexplainable divergences, which helps the board of directors, to make the right decisions.[12]

A further advantage is that if a company decides to make decisions based on external results, the objectivity of the internal management system is enhanced. Managers must act within the regulations set by the standard setting body. Furthermore, the external financial report is audited in contrast to a separate internal report, leaving a minimal margin for managers to cover up any failures with extensive use of subjective estimates. Finally, audited reports improve the internal credibility of an accounting and reporting system.[13]

2.3 Improvement of International Clarity and Transparency of Accounting

Especially in an international context, the use of the IFRS allows for a clear and transparent understanding of accounting for managers all over the world, as in an international group there might be different views and understandings of financial accounting and controlling within the group. Different accounting standards, reconciliation accounts, and further internal reports are additional sources of error, which can be reduced by using a single set of figures.[14]

2.4 Effectiveness and Efficiency

Several scholars have also pointed out the improved effectiveness and efficiency when using one set of figures mainly due to the waiving of imputed costs, and the therefore obsolete reconciliation accounts between internal and external accounting, which are particularly time-consuming. Consequently, it is possible to obtain a financial report faster («fast close») and controllers have more time to look after their core competences and act as business partners with senior management.[15]

9 Trapp Rouven, Konvergenz des Rechnungswesens: Eine Inhaltsanalyse der Diskussion um eine Annäherung des internen und externen Rechnungswesens in deutschsprachigen Fachzeitschriften, Diss Dortmund 2011, Wiesbaden 2012, p 175 et seq; Weissenberger Barbara E., IFRS für Controller, 2nd edn, Freiburg 2011, p 206.

10 Engelen Christian/Pelger Christoph, Determinanten der Integration von externer und interner Unternehmensrechnung – Eine empirische Analyse anhand der Segmentberichterstattung nach IFRS 8, in: zfbf 66 (2014), p 178 et seq, p 186; Trapp (fn 9) p 176 et seq; Weissenberger (fn 9) p 206 et seq. See Simoniello (fn 1) para 333 et seq.

11 Trapp (fn 9) p 143 et seq; Weissenberger (fn 9) p 206.

12 Cf Angelkort Hendrik, Integration des Rechnungswesens als Erfolgsfaktor für die Controllerarbeit, Diss Giessen/ Frankfurt am Main 2010, pp 1, 28.

13 Engelen/Pelger (fn 10) p 186; Trapp (fn 9) p 179 et seq.

14 Beissel Jörg/Steinke Karl-Heinz, Integriertes Reporting unter IFRS bei der Lufthansa, in: ZfCM 2/2004, p 63 et seq, p 65.

15 Beissel/Steinke (fn 14) p 65; Belohuby Richard, Kundenwertcontrolling und IFRS Rechnungslegung, Wiesbaden 2014, p 20 et seq; Trapp (fn 9) p 171 et seq, 175.

3. Use of IFRS for Decision Making of the Board – Negative Aspects

3.1 Dependance on International Standard-Setters

One disadvantage when using a single set of figures pointed out by several scholars is the dependency on international standard-setters.[16] Instruments of decision making and management accounting should be implemented because of their benefit for its purpose and not because of other, possibly political, reasons. Furthermore, the decision making system cannot be personalised to suit a company's unique needs, and new standards that are introduced over the years can hinder the aim of comparability across years.[17]

3.2 Inferior Fulfilment of Controlling Requirements

It has also been argued that the IFRS are not entirely appropriate for controlling requirements. In particular, because the IFRS are designed to meet the requirements of aiding the decision-making of external investors, which does not necessarily meet the internal requirements of for incentive setting. Furthermore, fair value measurement might impede the correct valuation of performance because financial results become more volatile if they are dependent on, for example, discount rates. Finally, the earnings management policy for external reporting automatically and directly influences internal reporting, which leads to a loss of accuracy in the management reporting system.[18]

4. A Partially Integrated Reporting System as State of the Art

Because of certain negative aspects of using the IFRS for decision making, a partially integrated reporting system might be more suitable for a company applying the IFRS. Partially integrated means that for the purpose of managing the entity, senior management as well as the board of directors rely on the figures of financial reporting, possibly with some adjustments. However, for operational management (for example, for «make or buy» decisions), management accounting figures are used, including e.g. opportunity costs, on lower management levels.[19]

Therefore, for the purpose of performance measurement in a company reporting according to the IFRS, the following should be considered:

- At the highest levels of the management hierarchy, internal and external financial reporting must be fully converged. The highest levels of the hierarchy include the management of group and segment levels.
- The IFRS standards, which are not appropriate for performance measurement, should be eliminated or adjusted when necessary. However, these bridging positions should always be comprehensible and transparent.
- At an operational level, and for the purpose of process management, it must be possible to rely on internal figures, which might be adjusted for cost calculations.[20]

16 Beissel/Steinke (fn 14) p 70; Dais Martin/Watterott Richard, Umstellung des externen und internen Rechnungswesens der Bosch-Gruppe auf IFRS, in: Controlling 8/9 2006, p 465 et seq, p 472 et seq; Weissenberger (fn 9) p 212.

17 Cf Angelkort (fn 12) p 30; cf Belohuby (fn 15) p 42.

18 Beissel/Steinke (fn 14) p 70; Belohuby (fn 15) p 43; Weissenberger (fn 9) p 212; Dais/Watterott (fn 16) p 472 et seq; Trapp (fn 9) p 184 et seq.

19 Weissenberger (fn 9) p 212 et seq

20 Weissenberger Barbara E., Ergebnisrechnung nach IFRS und interne Performancemessung, in: Wagenhofer Alfred (Ed), Controlling und IFRS Rechnungslegung, Berlin 2006, p 49 et seq, p 72; cf also Angelkort (fn 12) p 31 et seq.

The main advantage of such system is that at the senior management and board level, it is possible for the entity to benefit from improved communication possibilities with capital markets. Internal and external goals can be compared, even if some adjustments for the reasons set out above are made.[21] On the other hand, management at the profit-centre level can still work with internal calculations, which do not need to be compared with the figures communicated to external investors. Many German companies have adapted the system of partial integration, and it is therefore considered as state of the art among scholars and practitioners.[22] Therefore, in the opinion of the author, from a legal perspective, a board of directors may rely on an IFRS report, possibly with some adjustments. However, it must ensure good corporate governance and mitigate certain risks, some of which are outlined in the following paragraphs.

5. Impact of IFRS on Corporate Governance and the Board's Duties

5.1 Determine Effects of Fair Value Measurement

According to IFRS 13, a fair value is the price that market participants would pay in an orderly transaction to transfer an asset or liability. The price is therefore an exit price under current market conditions. At initial recognition, a fair value is usually the purchase price. For subsequent valuations, the preparer of the financial report might use valuations methods such as the DCF method. However, IFRS 13 sets forth three different levels of inputs to assess the fair value of an asset. Fair values according to level 1 inputs are assessed by means of quoted prices in an active market. With level 2 inputs, prices can be observed directly or indirectly, however, no active market exists. For level 3 inputs in the fair value hierarchy, no prices are observable for the asset or liability.

Fair value measurement, therefore, leaves a great deal of discretion to managers. To decide which inputs should be used for valuation, managers must assess whether an active market exists. In the case in which no active market exists and inputs categorised in level 3 are unobservable, managers need to use inputs that reflect assumptions and considerations that a market participant would use when pricing an asset or liability. These assumptions include risk rates.[23]

The board of directors must therefore ensure that discretion is applied fairly and not in such a way that managers are unduly benefitted. One way of doing so is ensuring that the board of directors itself is composed in such a way that it ensures control over senior management. One author found that a strong board is able to mitigate the risks arising from level 3 fair values. He determined that a strong board is independent, small with respect to the size of the company, and gender diverse.[24]

A board of directors could enhance internal control by introducing an independent valuation committee outside of the board of directors. The valuation committee should be independent from the board of directors, the treasury, and senior management. Furthermore, members of that committee should not receive any variable remuneration based on financial figures.[25]

A strong audit can further enhance corporate governance in general, specifically in that fair values are applied correctly. Auditors should use their own programs and parameters to determine fair values and control the end results with the results of the company. Fair values are considered to be applied correctly, if the difference in valuation is within a threshold determined by the auditor in advance.[26]

21 Weissenberger (fn 20) p 72 et seq.

22 Brandau/Endenich/Luther/Trapp (fn 8) p 80 et seq; cf also for convergence in general Prochazka David, The Development of Financial and Management Accounting after the IFRS adoption: A Case from the Czech Republic, May 2010, available at: <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1660122> (accessed on 29.03.2022), p 19.

23 For an overview see Simoniello (fn 1) para 441 et seq.

24 Siekkinen Jimi, Board characteristics and the value relevance of fair values, in: J Manag Gov 21 (2017), p 435 et seq.

25 See, the example of Leonteq, Annual Report 2021, p 208, available at: <https://ch.leonteq.com/investor-relations/fyr-2021/leonteq+ag-full+year+report-2021-en.pdf> (accessed on 29.03.2022).

26 See, the example of Leonteq, Annual Report 2017, p 146, available at: <https://ch.leonteq.com/investor-relations/fyr-2021/leonteq+ag-full+year+report-2021-en.pdf> (accessed on 29.03.2022).

Finally, the board of directors might decide to restrict the application of fair values by opting for the cost model where possible (for example, IAS 16 for property, plant, and equipment). A study showed that most companies use the cost model for plant and equipment as well as for intangible assets. Fair values are mostly used for property and investment property, especially where it enhances performance measurement and the asset is part of the primary activities of the company.[27]

5.2 Determine Effects on Incentive Setting and Executive Pay

A board of directors is required to decide on compensation plans for senior management since it has the non-transferable duty to appoint and supervise senior management according to Art. 716a para 1 CO. Appointing managers involves determining the terms of their employment and compensation.[28]

Executive compensation plans are an important aspect of corporate governance because incentives must be set in such a way that the company and shareholders benefit and that principal-agent problems are mitigated. However, compensation plans based only on financial figures might lead to results that are contrary to the overall strategic targets.[29] This is especially true since financial reporting according to the IFRS is complex and results are difficult to foresee, which is why boards of directors must determine adverse effects that might arise with incentive plans based on IFRS results.

Furthermore, the board should address whether fair values should be included in compensation plans. Fair values might be included when the asset that is valued based on fair values is a primary activity, e.g. financial instruments for banks. In all other cases, results should be adjusted by fair values because they include external effects, like interest rate changes, in the results. Thus, it is not possible to measure the performance of the managers in a reliable manner.[30]

Nevertheless, these problems might be eliminated by a value-oriented management system (e.g., by using the CVA method) and further adjustments.[31] Furthermore, members of the board might come to the conclusion that relative performance evaluation with foreign peers is an adequate solution for incentivising managers because accounting earnings are more cross-country comparable with IFRS-based reports than with reports according to local GAAP.[32]

Finally, because of the complexity and profound differences between the different sectors, boards of directors are required to establish a compensation committee within the board and seek external advice. The compensation committee must consider that senior management compensation must be understandable from a shareholder's perspective and, therefore, be transparent.[33]

5.3 Maintain an Internal Control System

The internal control system is an important tool for ensuring the efficient management of the company, its assets, and its corporate governance as well as to ensure a trustworthy and complete accounting system. The understanding of the internal control system is derived from the concept of the COSO.[34]

5.4 Prepare a Reporting Handbook

To ensure the uniform application of the IFRS in the whole company, the board of directors should (in close collaboration with finance and accounting departments) establish a financial reporting handbook.[35]

27 Christensen Hans B./Nikolaev Valeri V., Does Fair Value Accounting for Non-Financial Assets Pass the Market Test?, November 2012, available at: <https://ssrn.com/abstract=1269515> (accessed on 29.03.2022), p 4 et seq.

28 ZK-Bühler (fn 6) vor Art 707-726 CO para 172.

29 Bühler (fn 4) paras 380 et seq, 511 et seq.

30 Trapp (fn 9) p 282. See also Simoniello (fn 1) para 674 et seq.

31 Cf the examples in: Dais/Watterott (fn 16) pp 466, 568, 472.

32 Ozkan Neslihan/Singer Zvi/You Haifeng, Mandatory IFRS Adoption and the Contractual Usefulness of Accounting Information in Executive Compensation, February 2012, available at: <https://ssrn.com/abstract=1999898> (accessed on 29.03.2022), p 4.

33 Swiss Code of Best Practice for Corporate Governance, Economiesuisse, February 2016, available at: <https://www.economiesuisse.ch/sites/default/files/publications/economiesuisse_swisscode_e_web_2.pdf> (accessed on 29.03.2022), appendix 1.

34 Böckli (fn 4) § 15 para 248; Müller/Lipp/Plüss (fn 3) p 277 et seq.

35 Dais/Watterott (fn 16) p 467; Engelbrechtsmüller Christian, Bilanzpolitik und IFRS-Umstellung im Zuge eines Unternehmenserwerbes, in: Engelbrechtsmüller Christian, Losbichler Heimo (Ed), CFO-Schlüssel-Know-how unter IFRS, Wien 2010, p 163 et seq. See also Simoniello (fn 1) para 672.

A manager might not violate any reporting duties when using the great margin of financial reporting regulations. However, it is possible that such managers could violate internal corporate governance norms, and therefore be liable to the company.

5.5 Establish Board Committees

This contribution demonstrates that the work of a board of directors can be very complex and demanding. It is therefore uncontested that a board of directors must split different tasks and delegate them to specialised committees within the board. In the context of the present contribution the focus lies on the audit committee and compensation committee.

5.5.1 Audit Committee

The tasks of the audit committee can be summarised into three areas of responsibility: dealing with the external audit, the internal control system, and financial reporting. The requirement for an audit committee is primarily targeted at listed companies. However, depending on a company's size and the complexity of its situation, an audit committee might be recommended even for non-listed companies.[36]

Some of the IFRS standards give managers and boards of directors a substantial margin of discretion and therefore need close control. Furthermore, decisions concerning impairment (e.g. regarding goodwill) or decisions regarding provisions can have a major influence on the financial results of a company.[37] In the opinion of the author, it is therefore inevitable that companies applying the IFRS establish an audit committee within the board of directors. The complexity of the IFRS and the required collaboration of the board of directors with internal controllers, and external auditors often exceed the expertise of most board members, and it would also require too much time for the entire board to handle this task.[38]

The audit committee should be composed of a minimum of three members, all of which are required to be independent board members, since even non-executive members that are not independent can have a considerable influence in a small committee. Furthermore, members of the audit committee should be financially literate and be able to understand a report and raise important questions about it.[39] The audit committee should represent a counterbalance to the managers and executive members of the board of directors, which will usually have more insights and greater knowledge than independent board members.[40]

5.5.2 Compensation Committee

The compensation committee is responsible for the entire compensation policy of the company, especially the compensation of senior management. The committee submits the proposal for the compensation policy to the entire board of directors for final approval.[41] As the salary of senior management could be controversial among shareholders as well as stakeholders, it should be supported by the entire board of directors.

The compensation committee should be composed of non-executive and independent members of the board of directors.[42] If remuneration is based on IFRS-based figures, it is important that the compensation committee understands the potential impacts of incentives. Incentive setting using IFRS-based figures can become highly complex, which should be considered when nominating members of the compensation committee. It might be helpful if a member of the audit committee is at the same time part of the compensation committee.[43]

36 Böckli Peter, Audit Committee, Zürich 2005, para 7, 146 et seq; Simoniello (fn 1) para 685.

37 Regarding goodwill impairment, Kabir Humayun/Rahman Asheq, The role of corporate governance in accounting discretion under IFRS: goodwill impairment in Australia, in: Journal of Contemporary Accounting & Economics 12 (2016), p 290 et seq.

38 Cf Böckli (fn 4) § 13 para 391; Böckli (fn 36) para 35.

39 Böckli (fn 4) § 13 para 391; Böckli (fn 36) para 26 et seq; Böckli Peter, Einführung in die IFRS/IAS, 2nd edn, Zürich 2005, para 6 et seq; Simoniello (fn 1) para 685 et seq.

40 According to Kabir and Rahman, the audit committee's expertise has a direct influence on corporate governance, which was assessed by analysing the association between economic indicators and impairment decisions of the company. Kabir/Rahman (fn 37) p 291.

41 Müller/Lipp/Plüss (fn 3) p 74.

42 Müller/Lipp/Plüss (fn 3) p 74.

43 Simoniello (fn 1) para 692 et seq.

6. Conclusion

This article has shown that the application of the IFRS impacts the members of the board on many levels. Even though members of the board of directors may rely on a report according to the IFRS for their decision making process they have to ensure good corporate governance, as the application of the IFRS itself does not lead to a better corporate governance of a company.

To do so the board of directors must ensure that valuations are executed fairly and in the interest of the company, determine the effects of the IFRS and especially of fair values in general and on incentive setting and executive pay.

Additionally, the board of directors must implement an appropriate internal control system and consider implementing an independent valuation committee outside of the board of directors that is responsible for fair values, which could reduce the risk that managers use fair values in an opportunistic manner. A strong audit further enhances corporate governance and the correct application of the IFRS.

Furthermore, the board of directors should establish an audit and a compensation committee within the board of directors, and, if necessary, seek expert advice externally.

However, if a company has a strong corporate governance and the board of directors takes into account the impact of the IFRS on issues as e.g. incentive setting, the IFRS report can serve the board of directors as an important management tool. Particularly, will the IFRS report provide the board of directors with valuable financial information, which will enable the board to take adequate decisions, ultimately supporting the board of directors to fulfill its financial management duties according to the Swiss Code of Obligations.