

# **A New Approach to Global Reporting Convergence: The Global Player Segment**

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International Financial Reporting Standards (IFRS) are set to become the global accounting language. Empirical evidence suggests, however, that IFRS adoption alone will not lead to global convergence of reporting practices and will not make comparing companies' financial statements as easy as many have hoped.<sup>2</sup> One reason is that substantial differences in countries' enforcement mechanisms remain. These and many other institutional differences across countries—in capital markets, securities regulation, investor protection and economic development, to name just a few—shape firms' reporting practices. These differences will continue to drive reporting variation, and thus non-comparability, for years to come, despite IFRS adoption around the world. True convergence in reporting practices would require a much broader convergence of countries' institutional frameworks, which is unrealistic in the near future (and probably not even desirable).

I therefore propose a different way forward that does not require convergence of regulatory approaches across countries (Leuz, 2010). The proposal is to create a “Global Player Segment” (GPS), in which firms would be required to use the same reporting rules (i.e., IFRS), face the same enforcement mechanisms, and have similar incentives for transparent reporting. Joining this segment should be attractive to firms that operate in many countries and raise (or seek to

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<sup>2</sup> See, e.g., research studies by Ball et al. (2000, 2003), Leuz et al. (2003), Burgstahler et al. (2006), Daske et al. (2008, 2009). For similar assessments, see also Ball (2006) and Hail et al. (2009).

raise) finance internationally. For these firms, comparability of reporting practices is important and real comparability would be easier to achieve.

Thus, my proposal recognizes that there appears to be a substantial demand from investors, analysts and regulators for more comparable corporate reporting by firms that operate and raise finance globally. It is designed to make such comparability much more likely to emerge than it would under IFRS adoption alone. There are two core ideas behind the proposed GPS and its approach towards reporting convergence.

### *Core Ideas behind the Global Player Segment*

The first core idea is to provide comparable enforcement across participating firms. Now that IFRS have been widely adopted around the world, reporting standards are no longer the main issue.<sup>3</sup> Instead, we need to shift attention towards differences in the enforcement of reporting and disclosure rules, which are still quite pronounced. But even harmonizing enforcement is not going to be sufficient. If the goal is to achieve comparable reporting, we also need to reduce differences in firms' reporting incentives.

The second core idea of the GPS, therefore, is to exploit the power of self-selection by letting firms opt into the segment. The GPS would provide a way for firms to show markets and investors that they are serious about transparency, because participating firms essentially commit to tough reporting regulation and enforcement. Such a commitment should be attractive to firms that have (or seek) an international shareholder base, raise finance internationally, operate in many countries, and hence would benefit from more comparable reporting. Moreover, for firms with substantial growth opportunities and external financing needs, a commitment to

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<sup>3</sup> Obviously, the U.S. is still an exception. But even if the U.S. decides not to adopt IFRS or not to permit U.S. firms to use IFRS, one can argue that IFRS and U.S. GAAP are close enough so that standards are not the issue.

transparency is important and beneficial, particularly if they come from jurisdictions with weaker institutions. This is the central message of the cross-listing literature: firms seek ways to make these commitments credibly, and markets reward them when they do (e.g., Reese and Weisbach, 2002; Doidge et al., 2004, 2008, 2009a and 2009b; Coffee, 2007; Hail and Leuz, 2009).<sup>4</sup>

If the rules and the enforcement in the GPS are strict and credible, only some firms will be willing to participate. This is an intended outcome. Self-selection is important, since it implies that participating firms are likely to have relatively similar reporting incentives in the first place.

To ensure and reinforce the selection effect, firms would not automatically become part of the new global segment upon application. They would have to be approved by the administrating body of the GPS. A formal approval process would allow for additional screening based on crucial firm characteristics (e.g., corporate governance, ownership structure), which in turn would further reduce differences in firms' reporting incentives among participating firms.

*Who could operate the Global Player Segment and how could it be organized?*

To have global reach and appeal, the GPS has to be operated by a supra-national body. One possibility is to have the International Organization of Securities Commissions (IOSCO) create the GPS at the global level. But in principle the proposal could also be implemented at the regional level. For instance, if the goal is to achieve greater convergence of reporting practices in the EU, the Committee of European Securities Regulators (CESR) would be a natural body to

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<sup>4</sup> Cross-listing in the U.S. is an alternative mechanism. However, U.S. cross-listings have been critically debated in recent years. There are concerns that private securities litigation is excessive in the U.S and that foreign firms may face new regulations that have been designed primarily with U.S. firms in mind. For this debate and some evidence see Committee on Capital Markets Regulation (2006), Doidge et al. (2008, 2009a).

create such a segment. Another possibility is to create a new independent body that privately operates the GPS and has an oversight board with trustees.

Membership in the GPS would be organized as a private contract between the participating firm and the administrative body. The contract would specify which jurisdiction would be used if there were a legal dispute. This private contracting solution does not involve cross-listing the participating firm's stock at a particular exchange. The advantage of this arrangement is that the GPS does not compete with stock exchanges or firms' extant listings. Thus, a firm could concentrate its liquidity and trading in one place (e.g., its home-country exchange) but still be part of the global segment.

In terms of rules, the GPS could impose additional disclosure requirements beyond those in IFRS. To create the right reporting incentives, disclosures about related-party transactions, compensation policies, internal controls, risk-management practices and off-balance sheet arrangements are particularly relevant and should be considered. Credible disclosure requirements in these areas would make the GPS less attractive to firms in which controlling insiders engage in investor expropriation and private benefit consumption. Such firms tend to have weaker reporting incentives (Leuz et al., 2003). Such disclosure requirements would thus help to further align the reporting incentives of participating firms.<sup>5</sup> Similarly, the GPS could impose governance requirements that are likely to reassure outside investors with respect to the quality of corporate reporting: firms in the global segment could be required to have audit committees with independent directors, for example.

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<sup>5</sup> Such requirements could also become an important tool to the extent that future IFRS become more of a political "compromise" as more countries adopt IFRS and try to influence the standard setting process. See Hail et al. (2009) for a discussion of the political risks in the IFRS standard setting process.

On the enforcement side, the GPS's aim would be to harmonize the enforcement of IFRS for participating firms, thus helping firms that join to overcome widespread differences in legal and enforcement systems around the world. Moreover, by tightening enforcement relative to what many participating firms face in their home countries, the GPS would not only align, but also improve firms' reporting incentives and provide a credible commitment to transparency, which in turn would have tangible benefits, such as a lower cost of capital. Towards these goals, the GPS would use a number of enforcement mechanisms.

First, GPS firms would be required to use a GPS-approved auditor. Not all auditors would be eligible to audit participating firms. The GPS administrating body would approve audit firms. To be approved by the GPS, auditors would themselves have to meet important reporting requirements: for example, by disclosing new staff disciplinary actions, or legal actions against the audit firm. These reporting requirements could be modeled after existing rules of the U.S. Public Company Accounting Oversight Board.

Second, GPS enforcement staff would monitor compliance with its additional disclosure (and governance) requirements. In addition, it would have the right to review firms' financial statements and disclosures as well as the right to seek further information and clarification on these documents. Firms would be required to respond to such requests for further information. Such a review would be mandatory (and not just an option) if there is no review process for financial statements in a firm's home country.

Third, the GPS contract would give GPS enforcement staff the right to on-site inspections and to seize certain documents in the event GPS staff have serious concerns about a firm's reporting practices. Fourth, the GPS would publish its enforcement actions against a participating firm. Finally, it would have the right to expel firms from the segment if they do not

comply with its requirements. The last two mechanisms would essentially rely on adverse publicity and market reactions as a way to enforce GPS rules. Those should provide powerful incentives. To the extent that these enforcement mechanisms are viewed as insufficient, however, the GPS framework could require each firm to post a monetary bond in an (interest-bearing) escrow account upon becoming a GPS member. This bond would be forfeited if a firm is expelled from the GPS or leaves the GPS after violating its rules. This arrangement would increase the commitment value of the GPS even further.

### *Funding of the Global Player Segment*

A key question is obviously how the operation of the GPS could be financed. Among other things, the GPS would need well-qualified enforcement staff in sufficient numbers to perform its monitoring and compliance role. Membership fees are an obvious source of funding. That is, GPS firms would be asked to pay an annual fee. Participating firms are the primary beneficiaries and to the extent that the GPS provides a credible commitment to transparency firms should receive tangible benefits (see Leuz and Wysocki, 2008). Asking participating firms to pay for GPS membership amounts to an important “market test” and provides incentives to design and operate the GPS in a way that adds value to firms. If firms were unwilling to pay for a segment that is designed to achieve greater comparability of firms’ reporting practices (and to overcome the issue of externalities), then this would be a clear sign that we need to re-think the case for global convergence of reporting practices in the first place.

However, using corporate funding alone also has drawbacks. For instance, it can create conflicting interests when the time comes for the GPS staff to be tough on a particular firm. Therefore, it will be important for the GPS to have further funding sources. There are several options. First, exchanges that list GPS member firms could pay a fee, since they benefit from the

certification and assurance that the GPS provides. Second, audit firms that are approved to audit GPS firms could pay an annual fee. Third, some funding could come via the IASC Foundation, since the GPS contributes to the reputation of IFRS. Fourth, the G20 have called for more progress towards global reporting convergence. If they are serious about this goal, then they should consider providing financial support for steps in this direction. Finally, the GPS could raise royalty fees from financial service firms that use the GPS to create new products. For instance, the GPS could ask for a licensing fee when a financial firm creates an index based on securities from firms that participate in the GPS.

### *Conclusion*

In sum, the Global Player Segment proposes a new approach to comparable reporting and global reporting convergence. It relies on market forces but also on a robust regulatory framework, including IFRS. This approach does not require convergence of reporting regulation and enforcement across countries, which is unrealistic in the near future, and it promises greater convergence of reporting practices for those firms for which there is a strong market demand for comparability. The current approach to global reporting convergence relies primarily on IFRS adoption, in the face of major institutional and enforcement differences around the world, which is unlikely to bring true comparability of firms' reporting practices. Thus, even if the GPS proposal is not successful, it turns the spotlight on the shortcomings of the current convergence approach. My hope is that this proposal at least contributes to a more rigorous debate about what it takes to achieve global reporting convergence.

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