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Statement of the Shadow Financial Regulatory Committee

**Strengthening Transparency and Global Reporting Convergence**

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The G20 recently renewed its call for global convergence of reporting practices. The debate has so far focused on adopting the same set of accounting standards around the world. However, empirical evidence suggests that even a worldwide adoption of International Financial Reporting Standards (IFRS) alone would not lead to global convergence of reporting practices. A chief 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 impair comparability, for years to come. True convergence in reporting practices would require a much broader convergence of countries' institutional frameworks, which is unrealistic in the near future.

To strengthen transparency and global reporting convergence, the Shadow Financial Regulatory Committee proposes that a “Global Segment” (GS) be established, in which all companies that choose to join are required to use the same set of reporting rules (e.g., IFRS), face the same enforcement mechanism, and, importantly, have similar incentives for transparent reporting.<sup>1</sup> The GS would be aimed at firms that operate in many countries and raise or seek to raise funds internationally. These firms face substantial demand from investors, analysts and regulators for more comparable corporate reporting.

<sup>1</sup> This proposal is based on C. Leuz, Different Approaches to Corporate Reporting Regulation: How Jurisdictions Differ and Why, *Accounting and Business Research*, 2010, Forthcoming. See this paper for further details, such as the funding of the proposed segment.

The GS creates incentives for more transparent reporting built on two core ideas. The first is to provide comparable enforcement across participating firms. Now that IFRS have been widely adopted around the world and US GAAP and IFRS are moving closer together, we need to shift attention towards differences in the enforcement of reporting rules. But even harmonizing enforcement is not going to be sufficient. If the goal is to achieve comparable reporting in practice, we also need to reduce differences in how firms implement and use the discretion in the rules. This implies a need to provide firms with incentives to be transparent.

Therefore, our second core idea is to exploit the power of self-selection by letting firms opt into the Global Segment. If the rules and the enforcement in the GS are strict and credible, not all firms would be willing to participate. This is an intended outcome. Self-selection is important because it would provide a way for firms to distinguish themselves and to show markets and investors that they are serious in their commitment to transparency. It also makes it easier to achieve comparable reporting as participating firms are more likely to have similar reporting incentives in the first place. Based on empirical research, such a commitment likely has capital-market benefits for firms that have substantial external financing needs, seek an international shareholder base, or operate in many countries around the world. To reinforce the selection effect, firms would not automatically become part of the GS upon application. Their membership would have to be approved by the GS. 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.

Membership in the GS 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. The 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 GS would 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.

The GS could impose additional disclosure requirements beyond prevailing standards. Key areas to consider are disclosures about related-party transactions, compensation policies, internal controls, risk-management practices and off-balance sheet arrangements. Credible disclosure requirements in these areas would make the GS less attractive to firms in which controlling insiders pursue practices that are at the expense of or even expropriating outside investors. Such firms have a tendency to engage in opaque reporting practices and hence would likely shy away from a market segment that requires and enforces tough disclosures. Disclosure requirements in these key areas would also ensure that firms adhere to their entry criteria and investors can monitor these firms effectively.

The GS would be tightening enforcement relative to what many participating firms would have faced in their home countries. In doing so, the GS 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 higher market liquidity and a lower cost of capital. It would include the following elements:

- GS firms would be required to use a GS-approved auditor. Not all auditors would be eligible to audit participating firms. To be approved, 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.
- GS enforcement staff would monitor compliance with its additional disclosure. 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 obligated to respond to such requests for further information. Such a review would be mandatory, if there is no adequate review process for financial statements in a firm's home country.
- The GS contract would give GS enforcement staff the right to on-site inspections and to seize certain documents in the event GS staff have serious concerns about a firm's reporting practices.
- The GS would publish its enforcement actions against a participating firm.
- The GS would have the right to expel firms from the segment if they do not comply with its requirements.

To have global reach and appeal, the GS has to be operated by a supra-national body. One possibility is to build on existing organizations, such as the International Accounting Standards Setting Board (IASB) or the International Organization of Securities Commissions (IOSCO). An alternative, and perhaps preferable, approach is to create a new independent body that privately operates the GS. This body would have an oversight board with large representation from institutional investors that are heavy users of financial statements, such as mutual funds, insurance companies, pension funds, and endowments. The providers of capital have a strong interest in comparability of reporting practices and also know the kind of information that they would like to have in order to have greater confidence in the value of firms.

In sum, the GS proposes a way to strengthen transparency and reporting comparability. It uses market forces to produce an incentive-compatible enforcement mechanism. This approach does not require convergence of countries' institutional frameworks. While not being perfect, it promises greater convergence of reporting practices for those firms that wish to distinguish themselves by meeting market demand for transparency and comparability. The Committee's proposal also turns the spotlight on the shortcomings of the current convergence approach, which is too narrowly focused on the accounting rules alone.