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Financial Accounting and Reporting Section of the American Accounting Association

Financial Reporting Policy Committee

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Response to the SEC Release: ACCEPTANCE FROM FOREIGN PRIVATE ISSUERS OF FINANCIAL STATEMENTS PREPARED IN ACCORDANCE WITH INTERNATIONAL FINANCIAL REPORTING STANDARDS WITHOUT RECONCILIATION TO U.S. GAAP

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INTRODUCTION

The Financial Reporting Policy Committee (the Committee) of the Financial Accounting and Reporting Section of the American Accounting Association is charged with responding to discussion memoranda and exposure drafts on financial accounting and reporting issues.¹ The Committee is pleased to respond to the SEC's proposal to accept from foreign private issuers, financial statements prepared in accordance with International Financial Reporting Standards (IFRS) without reconciliation to United States (U.S.) GAAP.² The comments in this letter reflect the views of the individuals on the Committee and not those of the American Accounting Association or the Financial Accounting and Reporting Section of the American Accounting Association.

Our commentary is organized as follows. First, we provide an overview of the Committee's conclusion. We then discuss evidence on the extent to which securities prices reflect information contained in SEC-mandated reconciliations. We also review the literature on institutional factors that impact international financial reporting practice and the literature on compliance with international accounting standards. Next we discuss research concerning the costs and benefits U.S. listing for foreign firms and the literature pertaining to the competitive position of U.S. stock exchanges. Research on the costs and benefits of harmonization of accounting standards is discussed in the next section. The final section of our commentary offers a summary and conclusions.

¹ The Committee is independent of the Financial Accounting Standards Committee (FASC) of the American Accounting Association.

² International financial reporting standards have evolved over time. To mitigate confusion regarding the "version" of international standards examined in the studies, we employ the acronyms IAS, IFRS, or IAS/IFRS to refer to the period during which the International Accounting Standards Committee (IASC), the International Accounting Standards Board (IASB) or both organizations, respectively, promulgated international accounting rules. Some of the findings we discuss relate to older versions of IAS and might not apply to more recent IFRS.

OVERVIEW OF COMMITTEE'S CONCLUSIONS

In general terms, the purpose of Regulation S-X is to provide U.S. investors with inter-temporally consistent information that is comparable across registrants. Notwithstanding (1) certain exemptions and modified requirements based on registrant size and (2) the smaller number of required filings from foreign private issuers, all registrants are required to report a minimum of two financial-statement summary measures (i.e., net income and owners' equity) measured under U.S. generally accepted accounting principles (GAAP). U.S.-domiciled companies must conform to U.S.-GAAP for the entire set of financial statements, whereas foreign private issuers are required only to incrementally disclose the differences between home-country-GAAP and U.S.-GAAP measures of net income and owners' equity. Thus, conceptually, the 20-F reconciliation is a mechanism that allows U.S. investors to have access to a subset of potentially useful financial information that is inter-temporally consistent for each registrant and that is comparable across all registrants.

Logically, any proposal to eliminate the 20-F reconciliation requirement for a subset of foreign private issuers must be based on at least one of the following premises: (1) U.S. GAAP and IFRS are, at a minimum, informationally equivalent sets of accounting principles, or (2) investors can reconstruct consistent and comparable U.S.-GAAP-based summary accounting measures from IFRS financial statements. Note that neither of these conditions is dependent on the quality of U.S. reporting standards or IFRS. IFRS may very well be a high quality set of accounting standards based on the properties of reported information and prices in other countries, but also fail to provide information that U.S. investors find most relevant for investing decisions. As noted by Ball (2005, p. 29), "financial reporting occurs in a local, not global, context. Despite increased globalization, the clear majority of economic and political activity remains *intranational*, the implication being that the primary driving forces behind the majority of actual practices seem likely to remain domestic in nature..."

The SEC proposal requests responses to 49 separate questions, most of which ask for predictions about the assumed future behavior of investors and/or companies. Instead of speculating on these future actions or states, we provide a summary of academic research related to the central issue underlying the proposal – the proposed elimination of the 20-F reconciliation requirement for a subset of foreign private issuers.

Based on a review of the literature, the committee has concluded that eliminating the reconciliation requirement is premature. The committee offers the following main points based on our review of extant academic literature:

- Material reconciling items exist between U.S. GAAP and IFRS and the reconciliation currently reflects information that participants in U.S. stock markets appear to impound into stock prices.
- In international contexts, U.S. GAAP and IAS appear to possess information attributes of high-quality accounting standards (e.g., value

relevance or mitigation of information asymmetry); however, U.S. GAAP appears to be preferred by U.S. investors (i.e., there is a “home GAAP” preference).

- Cross-country institutional differences will likely result in differences in the implementation of any single set of standards. Thus, IFRS may be a high-quality set of reporting standards (pre-implementation) but the resulting, published financial-statement information could be of low quality given inconsistent cross-border implementation practices.
- Non-U.S. firms’ reporting compliance is an important factor the SEC appears to be ignoring. If there is no reliable enforcement mechanism and if implementation of standards varies widely in practice, then potential informational benefits of any high-quality set of reporting standards will be diminished.
- Despite the cost associated with preparing the reconciliation and satisfying the other listing requirements, evidence suggests that non-US firms garner financial benefits from listing on U.S. exchanges and that the net benefits of a U.S. listing have not been eroded in recent years.
- Harmonization of accounting standards could be beneficial to U.S. investors if it yields greater comparability and if IFRS provides information U.S. investors prefer for their investment decisions. Harmonization appears to be occurring via the joint standard-setting activities of the FASB and the IASB; thus, special, statutory intervention by the SEC does not appear to be necessary.

RELEVANCE OF THE RECONCILIATION TO U.S. INVESTORS

IFRS has changed significantly since October 2002, when the IASB and FASB announced the issuance of a memorandum of understanding (i.e., the Norwalk Agreement) which formally recognized convergence as a goal of their standard-setting activities. Much of the research that focuses on the 20-F reconciliation was conducted prior to that time (e.g. Street, Nichols and Gray 2000; Harris and Muller 1999). Consequently, we focus on the reconciliation research conducted after issuance of the Agreement.

Haverty (2006) examines a sample of companies from the People’s Republic of China (PRC) from 1996 to 2002 that uses IFRS and provides reconciliations to U.S. GAAP. The author analyzes the reconciliation to assess the comparability of IFRS and U.S. GAAP net income and to determine the level of convergence in the standards over time. Haverty (2006) finds that 10 of the 11 PRC companies report net income under IFRS that is materially different (at a 5% materiality threshold) from net income under U.S. GAAP. The most significant differences result from revaluations of property, plant and equipment permitted under IFRS. In addition, the author finds some evidence of convergence over time.

While Haverty's (2006) results point to the existence of significant reconciling items between IFRS and U.S. GAAP, there are important caveats to keep in mind. The analysis is limited to 11 firms from the PRC that trade on the NSYE. Few firms are approved to trade abroad by the PRC government, suggesting that such firms might not be representative of the population. Moreover, the economic environment in the PRC is unique.³

Henry, Lin and Yang (2007) examine IFRS to U.S. GAAP reconciliations in 2004 and 2005 for 83 European Union companies that are cross listed in the U.S. and provide 20-F reconciliations. The authors analyze the materiality of the difference between U.S. GAAP and IFRS net income and shareholders' equity. The authors find that the mean (median) difference between IFRS and U.S. GAAP net income is -3.07 (-1.67) percent of IFRS equity and the mean (median) difference between IFRS and U.S. GAAP equity is 13.53 (7.70) percent of IFRS equity. These differences are larger than the differences reported in earlier work on IAS versus U.S. GAAP reconciliations (cf., Harris and Muller 1999) suggesting a questionable level of success for the convergence effort to date. In addition, the authors find that IFRS reported net income was on average 59 (29) percent higher than U.S. reported income in 2004 (2005). The authors also document that the most frequent reconciling items for net income (equity) relate to pension costs and investments (pension costs and goodwill). The authors note that the IASB and FASB plan to jointly work on these issues.

Henry, Lin and Yang (2007) also find that the income and equity reconciling items are incrementally important for explaining stock prices. Moreover, the change in the income-reconciling amount is incrementally value relevant over the change in IFRS net income in explaining annual stock returns. The authors' findings suggest "that significant differences exist between results reported using IFRS versus U.S. GAAP despite convergence efforts, that using IFRS allows most of the companies in the sample to report higher profitability than would be the case under U.S. GAAP and that the differences are value relevant" (Henry, Lin and Yang 2007, p. 7).

While significant value relevant differences might exist between U.S. GAAP and IFRS, the research discussed above does not demonstrate that the reconciliation itself is used by investors. To address this issue, Chen and Sami (2007), in an unpublished working paper, examine trading volume around 20-F reconciliation filing dates for reconciliations from IAS to U.S. GAAP. Their sample includes reconciliations filed from 1995 through 2004. The authors find a significant positive relation between the magnitude of the income-reconciling amount and abnormal trading volume. These results

³ In addition, endogeneity of exchange listing choice or accounting policy choice is a concern for most of the studies. For example, firms are not randomly assigned to U.S. GAAP or IAS "treatment" groups; instead firms implicitly choose which policy regime to follow. While much of the research attempts to deal with this issue using statistical techniques, the potential impact of endogeneity is a limitation of much of the research discussed in this response. Despite the potential limitation, we believe that the extant research produces results that should be of use to the SEC in its ongoing deliberations.

suggest that the reconciliation captures information that is also reflected in investors' decisions about their stock holdings.

These studies provide potentially important insights into whether the IFRS-U.S. GAAP 20-F reconciliation should be eliminated. The research indicates that significant reconciling items exist, and that the reconciliation appears to provide information incrementally useful to U.S. investors. Until greater convergence is achieved, eliminating the reconciliation runs the risk of diminishing the relevant information set available to U.S. investors. However, the research also indicates that convergence is occurring. As a consequence, the importance of the reconciliation should diminish through the ongoing joint standard-setting efforts of the IASB and the FASB.

THE QUALITY OF U.S. GAAP VERSUS IFRS AND INVESTORS' PREFERENCES

To obtain insight into the extent to which IFRS and U.S. GAAP provide "high quality" reporting standards (as reflected in capital market outcomes), we review research on the differential market effects of IFRS versus U.S. GAAP. After considering the relative quality of IFRS, we examine research suggestive of U.S. investors' relative preferences for IFRS and U.S. GAAP.

Ashbaugh and Olsson (2002) examine the valuation properties of the earnings and book values reported by 26 IAS firms, and 36 U.S. GAAP firms trading in London's Stock Exchange Automated Quotations International Equity Market. Using data for 1997, the authors investigate the explanatory power of three alternative valuation models: (1) an earnings capitalization model, which incorporates earnings alone; (2) a book value model, which incorporates book value alone; and the residual income valuation model, which incorporates book value as well as (abnormal) earnings.

The authors find that when firms report under IAS, the earnings capitalization model and the residual income valuation model demonstrate similar explanatory power, and both dominate the book value model. That is, IAS earnings alone or IAS earnings and book values together, explain more of the cross-sectional variation in price than IAS book value alone. In contrast, when firms report under U.S. GAAP, the residual income valuation model dominates the alternatives.

Taken together, Ashbaugh and Olsson's (2002) findings suggest that U.S. GAAP earnings, on their own, have less explanatory power than IAS earnings. The authors suggest, but do not test, the conjecture that their findings reflect the fact that U.S. GAAP is more likely to charge to income, expenditures such as research and development costs, which create long-term value.

Bradshaw, Bushee and Miller (2004) examine whether U.S. institutional investors prefer to invest in non-U.S. firms whose accounting methods conform more closely to U.S. GAAP (hereafter, "U.S. GAAP conformers"). Their sample period spans 1989

through 1999. The authors find that U.S. GAAP conformers experience greater U.S. institutional ownership, and that this relation is magnified when the firm lists as an American depository receipt (ADR) in the U.S. Moreover, increases in U.S. GAAP conformity precede increases in U.S. institutional investment, suggesting a causal relationship between accounting choice and foreign investment decisions.⁴ Bradshaw, Bushee and Miller (2004) conjecture that U.S. institutional investors might prefer greater U.S. GAAP conformity because it reduces their information processing costs. Alternatively, they may prefer to invest in U.S. GAAP conformers because they consider U.S. GAAP standards to be of higher quality.

This study does not focus on firms employing IAS versus U.S. GAAP. Moreover, the study focuses on U.S. institutional investment outside of U.S. capital markets. Accordingly the implications drawn from it regarding the effect of the SEC's proposed regulatory change on U.S. institutional ownership in non-U.S. firms listed in the U.S. are speculative. Nevertheless, the study documents a "home-GAAP" preference that impacts investment decisions.

Covrig, Defond and Hung (2007) also examine firms trading outside the U.S. capital markets. Their sample period spans 1999 – 2002 and includes firms domiciled in 29 countries. The authors find that foreign mutual fund ownership is higher among firms using IAS compared to firms using local standards. In addition, foreign mutual fund ownership increases following IAS adoption. In contrast, domestic mutual fund ownership is invariant to the choice of IAS or local standards. These findings are consistent with a home-GAAP preference among domestic stock exchange participants.

In a recent unpublished working paper, Plumlee and Plumlee (2007) provide evidence of a home-GAAP preference within U.S. capital markets. The authors' sample is comprised of Form 20-F filers and spans 2002 – 2006. The authors document greater abnormal trading volume in response to earnings announcements, as well as greater trading volume in general, for firms using U.S. GAAP versus IFRS/IAS or other foreign GAAP. These results suggest a positive relation between the use of U.S. GAAP and stock market liquidity for cross-listed firms on U.S. exchanges.

Leuz (2003) investigates whether firms using U.S. GAAP versus IAS exhibit differences in information asymmetry. Institutional factors are held constant by limiting the sample to firms trading in Germany's New Market. The sample is comprised of 69 (195) firms with data for 1999 (2000). Leuz finds that differences in the bid-ask spread, share turnover, analyst forecast dispersion, and initial public offering underpricing between U.S. GAAP and IAS firms are statistically (and economically) insignificant. Leuz concludes that IAS versus U.S. GAAP is inconsequential for information asymmetry and market liquidity.

⁴ Interestingly, decreases in U.S. GAAP conformity do not precede decrease in U.S. institutional investment suggesting that U.S. GAAP conformity is an important factor in choosing to invest in a firm, but sales decisions are based on factors other than accounting choice.

Bartov, Goldberg and Kim (2005) employ much the same setting as Leuz to investigate the value relevance, as measured by the association between earnings and stock returns, of U.S. GAAP, IAS and German GAAP. The authors document a stronger earnings/returns relation for U.S. GAAP and IAS over German GAAP, but fail to find any significant difference in the strength of the relation between U.S. GAAP and IAS. Consistent with Leuz (2003), Bartov, Goldberg and Kim (2005) conclude that U.S. GAAP does not dominate IAS in terms of value relevance. However, the conclusions drawn from both studies may not generalize to the U.S. capital market where U.S. GAAP is a high-quality set of accountings standards that enjoys the home-GAAP preference discussed above.

Daske (2006) examines the relation between accounting policy choice (i.e. IAS/IFRS, U.S. GAAP or German GAAP) and cost of equity capital for a sample of firms trading on the German Stock Exchange. His sample spans 1993 through 2002. Daske finds no evidence of a lower cost of equity capital for firms using IAS/IFRS or U.S. GAAP versus firms employing German GAAP. He finds some evidence that IAS/IFRS firms have a higher cost of equity capital than U.S. or German GAAP firms but, this finding is not corroborated by an analysis of the change in cost of equity capital of firms switching from German GAAP to IAS/IFRS. However, the changes analysis may suffer from a lack of statistical power due to the small sample size.

Daske (2006) suggests that the lack of robust findings in his study may be the result of accounting diversity created by the co-existence of three alternative reporting regimes in the German Stock Market. Daske (2006) states, “this variety and speed of the ‘accounting revolution’, together with the lack of available accounting information for comparable periods may have affected the apparent uncertainty among investors during the transition period” (Daske 2006, p. 369). This interpretation is consistent with German financial press articles discussing investors’ difficulties adapting to the new standards. The author argues that this uncertainty may explain the lack of a decline in cost of equity capital following the adoption of IAS/IFRS or U.S. GAAP. It is worth noting that such accounting diversity will also characterize the U.S. market should the SEC proposal be adopted.

The evidence from non-U.S. markets suggests that non-U.S. investors do not prefer U.S. GAAP to IAS (in terms of value relevance or mitigation of information asymmetry). However, U.S. GAAP appears to have a home-GAAP preference on the part of U.S. investors.

THE IMPACT OF INSTITUTIONAL FACTORS ON FINANCIAL REPORTING

Even while standard setters and regulators strive to achieve convergence, there is reason to question the feasibility of any given set of uniform, global accounting standards. Institutional differences across countries might well create a need for differences in financial reporting practices even within an otherwise uniform set of standards. This is consistent with the country-specific versions of IFRS that we observe

in practice. There is also the concern that given the differences in institutional structures, forced uniformity in accounting standards might result in differences in implementation, which could mislead investors into thinking that financial reporting is uniform when it is not (Ball 2005). In the following paragraphs, we discuss research that examines the interplay between institutional structures and financial reporting.

Ball, Kothari and Robin (2001) suggest that the application of accounting standards could differ across countries because of differences in enforcement as well as differences in managers' real business decisions made in direct response to accounting standards (e.g. transaction structuring). The authors examine differences in the timeliness and conservatism of income for companies from seven countries based on whether the company is domiciled in a code law or common law country. Using a sample that spans 1985 to 1995, the authors find that firms domiciled in common law countries recognize economic losses in income more quickly (i.e., timelier) than firms domiciled in other countries. This finding suggests that institutional structures impact accounting standards, and potentially the application of accounting standards. However, it is not clear that the results would hold if the sample were limited to firms employing uniform standards.

Bushman and Piotroski (2006) also examine accounting conservatism; however, they examine differences not only across common law and code law countries but also across other institutional characteristics such as the impartiality of the judicial system, the strength of securities laws, the extent of state ownership, the risk of expropriation, and the tax regime. The authors examine firms from 38 countries from 1992 through 2001, and conclude that accounting conservatism is greater for firms in countries with high quality judicial systems, strong public enforcement, and a low risk of expropriation. These results suggest that institutional factors beyond common law and code law origins are important in explaining accounting conservatism, and that institutional differences are associated with differences in accounting standards. However, like Ball, Kothari and Robin (2001), this study does not yield insight into whether these differences would parlay into implementation differences if one set of international accounting standards were required. In addition, the authors' assertion that more conservative financial information is a proxy for higher quality information is subject to debate (e.g., Holthausen 2003).

Leuz, Nanda and Wysocki (2003) use an alternative proxy for the quality of accounting information by examining the relation between earnings management at the country level and institutional factors. Specifically, the authors examine the relation between earnings management and institutional factors from 1990 to 1999 for over 8,000 firms from 31 countries. They conclude that firms in countries with developed equity markets, dispersed ownership structures, strong investor rights, and legal enforcement engage in less earnings management. These results suggest that cross-country differences in investor protection have a significant impact on earnings quality. Like the previous papers, the countries in the sample have not only different institutional characteristics, but also different accounting methods. The authors note this and find that the importance of the institutional factors is robust to the inclusion of variables that capture the type of accounting standards. Accordingly, this study provides some evidence that even holding

accounting standards constant differences in implementation could subvert the goal of convergence.

Ball, Robin and Wu (2003) attempt to control for the quality of the accounting standards in their analysis of the effect of institutional factors on financial reporting quality by examining four East Asian countries (Hong Kong, Malaysia, Singapore and Thailand) that are thought to have high quality accounting standards. The authors consider the accounting standards in these countries to be high quality because they are substantially influenced by existing standards with common law origins (i.e. U.S., UK and IAS standards). Nonetheless, with respect to financial reporting quality incentives, the countries exhibit characteristics more consistent with code law than common law.

The authors' sample consists of 2,726 earnings announcements made during 1984 to 1996 by firms domiciled in the four East Asian countries. They compare the timeliness of earnings announced by companies in their sample to the timeliness of earnings announced by companies that comprise two benchmark samples. Their benchmark samples consist of pure common law countries versus pure code law countries. The authors hypothesize that the timeliness of the accounting information for their sample companies will be more similar to that of the code law countries even though their standards have common law origins. They conclude that "incentives appear to dominate accounting standards as a determinant of financial reporting" and that one must give substantial weight to the institutional influences on preparer's actual financial reporting incentives.

While Ball, Robin and Wu (2003) attempt to control for the quality of the accounting standards, Holthausen (2003) raises concerns about the inferences that can be made from the study. He questions the assumption that the IAS standards adopted by the East Asian countries are of high quality. If the standards are not of high quality, then it is not clear that the low quality financial reporting is a result of institutional features as opposed to the standards themselves. He argues that IAS was evolving and that the "Core Standards Project" which led to substantial revisions was not completed until after the time period studied. Holthausen (2003) also questions the use of timeliness and conservatism as proxies for financial reporting quality. While the results suggest that institutional factors can affect the attributes of the financial reporting process, it is not clear which attributes represent a higher quality outcome.

In an unpublished working paper, Henry, Lin and Yang (2007) address the issue of accounting standard quality by examining only those firms that use IFRS in 2004 and 2005. Specifically, they examine differences in reconciling items from IFRS to U.S. GAAP for 83 European Union (EU) firms based on whether the country's legal origin is common law or civil law and based on the country's major legal family (i.e., English, French, German and Scandinavian). If cross-country institutional differences result in different applied version of IFRS, we would expect to observe relations between the reconciling items and country characteristics. The authors find that convergence of net income is generally homogeneous across partitions; however, in contrast, the authors find that the convergence of shareholders equity differs between common law and civil law

countries and across countries based on legal family. This provides evidence that the adoption of IFRS is not standard across countries.

In summary, this area of research suggests that one set of uniform global accounting standards may not be feasible (or desirable) because differences in institutional factors across countries will lead to inevitable tinkering and/or wholesale changes to the centrally promulgated set of standards. Moreover, even if a uniform set of standards were adopted across countries, international differences in institutions could result in systematic cross-firm differences in implementation.

EVIDENCE ON COMPLIANCE WITH ACCOUNTING STANDARDS

The discussion of differences across countries in the implementation of standards suggests that compliance with the standards is also an important issue. Like the FASB in the U.S., the IASB is an independent standard setter that does not have enforcement responsibilities. Given the differences in economic and political forces across countries, enforcement of standards is unlikely to be uniform. The U.S. has the reputation for providing the strictest enforcement of the securities markets; however, research on SEC enforcement of foreign firms cross-listed on U.S. markets suggests that enforcement remains an important issue even in U.S. markets.

Siegel (2005) examines U.S. listed Mexican firms that were accused of engaging in illegal asset taking around the 1994-1995 economic downturn. He finds that the SEC took “no action to recover any of the billions of dollars taken from U.S. investors in U.S. listed Mexican firms” and that “the SEC has rarely acted effectively to enforce the law against any cross-listed foreign firm” (Siegel 2005, p. 335). In addition, Siegel (2005) argues that there are legal and institutional obstacles faced by private plaintiffs attempting to enforce laws against cross-listed firms in the U.S. He notes that the plaintiff often must produce internal company documents showing that the company acted willfully and deceptively, but that the Private Securities Litigation Reform Act of 1995 makes it difficult for plaintiffs to obtain access to the necessary documents. When the plaintiffs do succeed, the settlements are generally a fraction of the investor losses. Siegel’s (2005) findings suggest that while non-U.S. firms might have access to U.S. markets, they are not subject to the same scrutiny and oversight as U.S. firms. This suggests that reconciliations to U.S. GAAP do not necessarily ensure compliance to IFRS or to U.S. GAAP, given the lax enforcement by the SEC of foreign firms.

Lang, Raedy and Wilson (2006) argue that if there are greater incentives to manage earnings in other countries relative to the U.S. and if there is relatively lax oversight of non-U.S. firms by the SEC, then the reconciled earnings of non-U.S. firms might differ from the earnings of U.S. firms. The authors examine 181 non-U.S. firms with 20-F reconciliations from 1991 through 2002. The authors analyze earnings for smoothing, the tendency to manage earnings to a target, time loss recognition, and the relation with share price. The authors find that “relative to U.S. firms, cross-listed firms reported reconciled earnings that are smoother compared to cash flows, show more of a tendency to use accruals to smooth cash flow volatility, report a higher proportion of

small positive earnings, are less likely to recognize losses in a timely manner and generally report reconciled earnings and shareholders' equity data that are less highly correlated with share price, especially in case of bad news" (Lang, Raedy and Wilson 2006, p. 258). They also find that these results are more pronounced for firms from countries that are generally considered to have weaker local investor protection. These results suggest that SEC oversight has not appeared to provide enough of a deterrent for non-U.S. firms and that the reconciled U.S. GAAP earnings are not comparable to U.S. GAAP earnings. These findings provide more concern that U.S. GAAP reconciliations may not be resolving some of the underlying issues regarding differences across financial reporting practices.

Research has also examined the compliance with IFRS and whether the compliance differs across firm and country characteristics. Street and Gray (2002) examine the extent of compliance with IAS disclosure and measurement requirements for 279 companies using IAS in their 1998 financial statements. The authors conclude that "there is a significant extent of non-compliance, especially in respect of IAS disclosures, and that key factors associated with the level of compliance include listing status, being audited by a Big 5+2 firm, the type of reference to IAS, and country of domicile." This suggests that compliance with IAS is an issue and that cross-listing and being audited by a large firm can mitigate some of the non-compliance. A caveat with respect to the implications of this study is that the authors examined IAS compliance in the year prior to the ruling that companies can only state they use IAS if they comply with each IAS standard. Therefore, the study could overstate the non-compliance with IFRS in more recent years.

Street and Bryant (2000) examine whether the disclosures associated with companies using IAS standards differ depending on whether the company lists or files in the U.S. Specifically, the authors calculate a disclosure index for each company in 1998 and examine whether the disclosure index differs for companies using IAS with a U.S. listing or filing and for companies using IAS with no U.S. listing or filing. The authors find that the overall level of disclosure is greater for companies with U.S. listings and that the extent of compliance with IAS mandatory disclosures is greater for companies with U.S. listings or filings. The authors also find that the extent of compliance with IAS disclosure requirements is greater for companies with an audit opinion that states that the statements are in accordance with IAS and that the ISAs were followed when conducting the audit. The authors conclude that their results suggest that "enforcement of IASs may be less of an issue for companies with listings and filings in the U.S. However, for companies without U.S. listings and filings, compliance is indeed of great concern" (Street and Bryant 2000, p 326). These results suggest that while being listed in the U.S. has not resulted in SEC enforcement, U.S. listing does appear to result in better compliance with the accounting standards. Whether or not the required reconciliation contributed to the improved compliance is an open question. It is important to note, however, that as with Street and Gray (2002), the authors perform analyses on financial statements prior to 1999, the year in which companies were no longer permitted to refer to the use of IAS unless they comply with each and every IAS.

Glaum and Street (2003) compare compliance with IAS and U.S. GAAP disclosure requirements for companies listed on Germany's New Market. Specifically, the authors calculate a disclosure compliance index for a sample of 100 companies in 2000 that prepared their financial statements according to IAS and 100 companies that used U.S. GAAP. The authors find that disclosure compliance for both sets of standards was positively related to the use of a Big 5 auditor and to being cross listing on a U.S. exchange. The authors also find that the average level of compliance is lower for IAS than for U.S. GAAP firms, even after controlling for the compliance factors. The authors conclude that the results "provide some support for the widespread belief that IAS, although by now a comprehensive and high quality set of accounting standards, suffers from an enforceability problem and that IAS is less rigorously applied than U.S. GAAP" (Glaum and Street 2003, p. 86). They also suggest that the "results unveil a considerable extent of non-compliance in the application of U.S. GAAP" (Glaum and Street 2003, p. 92). and that the enforcement of U.S. GAAP absent SEC regulation is an important problem. This study provides insights into the issues related to the compliance of U.S. GAAP and IAS; however, as pointed out by the authors, it is important to note that the study includes young and small growth firms in the New Market and that the study does not examine compliance with measurement and presentation standards.

In an unpublished working paper, Bradshaw and Miller (2007) compare compliance with U.S. GAAP for foreign firms that voluntarily adopt U.S. GAAP to compliance with U.S. GAAP for U.S. firms. Specifically, they compare 178 non-U.S. firms from 27 countries in 1999/2000 that have voluntarily adopted U.S. GAAP to U.S. firms that report under U.S. GAAP. They also examine the earnings properties of the foreign firms that voluntarily adopt U.S. GAAP to the earnings properties of non-U.S. firms in the same country that report under local accounting standards, matched on industry and size. The authors examine whether the U.S. GAAP adopters are compliant in implementing U.S. GAAP, whether the U.S. GAAP adopters exhibit accounting conservatism that is closer to that of U.S. firms, and whether regulatory oversight or capital market incentives impact the level of compliance with U.S. GAAP. They argue that firms that cross-list in the U.S. face greater regulatory oversight and should exhibit a higher level of compliance with U.S. GAAP. On In contrast, the authors also argue that accounting conservatism is not part of regulatory oversight since it is driven by litigation and contracting. Given Siegel's (2005) observation that U.S. cross-listed firms are seldom subject to U.S. litigation, they do not expect that regulatory oversight will impact conservatism. They also examine characteristics related to capital market incentives and suggest that compliance and accounting conservatism should be greater for firms with greater market incentives. The authors conclude that "properties of accounting outputs for U.S. GAAP adopters converge substantially towards those of U.S. firms (and away from the domestic matched firms), but that convergence is not complete" (Bradshaw and Miller 2007, p. 3). They also conclude that "regulation generally increases compliance in disclosed accounting choices and generates accrual relations similar to U.S. firms but has little impact on measures of conservatism" (Bradshaw and Miller 2007, p. 3). They find no support for capital market incentives being a primary driver of compliance. The analysis provides insight into the issue of compliance with standards; however, the generalizability of the results is a concern given that the sample firms voluntarily adopted

U.S. GAAP, given the analysis focused on the compliance with U.S. GAAP which is more prescriptive than IFRS, and given that many disclosures were unavailable to the authors to determine compliance.

The results of these studies suggest that enforcement of IFRS and U.S. GAAP for non-U.S. firms is a significant issue that regulators should consider. As the reliability of enforcement mechanisms decrease, the quality of the standards themselves becomes increasingly irrelevant. The SEC should consider the long-term implications of lax enforcement of regulations for a subset of registrants (i.e., foreign private issuers). In addition, the SEC should be careful to not mischaracterize—as evidence of high quality implementation—the relative absence of enforcement-related activities against foreign private issuers.

RESEARCH ON THE COMPETITIVENESS OF U.S. STOCK EXCHANGES

A concern related to the IFRS-U.S. GAAP reconciliation requirement is the incremental cost incurred by foreign private issuers in preparing and disclosing reconciliation information for U.S. filings. Central to this concern is the issue of whether the costs are so significant as to effectively offset or exceed the benefits received from registration in the U.S. securities market. In the paragraphs that follow, we review literature that provides some evidence on the relative costs and benefits

Lins, Strickland, and Zenner (2005) investigate whether an ADR listing improves access to capital. Their sample comprises firms with Level II or III ADR listings on the NYSE or NASDAQ between 1986 and 1996. The authors find that dependence on internally generated cash for investment declines following an ADR listing for emerging market firms, but not for developed market firms. In the post-ADR listing period, the authors document a significant increase in the proportion of firms issuing debt or equity, the number of debt or equity issues per firm, and the amount of capital raised. Such increases are observed for both the emerging market firms and the developed market firms, but the increases are more pronounced for the emerging market firms. Lins, Strickland and Zenner (2005) conclude that greater access to capital is an important benefit for emerging market firms, but less so for developed market firms.

Reese and Weisbach (2002) also provide evidence of greater access to capital following an ADR listing. The authors document a significant increase in the number and value of equity offerings post cross-listing. Moreover, firms with weak home-country shareholder protection are more likely to issue equity and in larger quantities than firms with strong shareholder protection. This result is consistent with the finding above, that greater access to capital is an important benefit for emerging market firms, but less so for developed market firms.

Majority shareholders are able to reap private benefits from control when poor local legal protection is afforded to minority shareholders. This situation imposes costs on the firm including difficulty in raising capital and a higher cost of capital. Doidge

(2004) tests the hypothesis that cross-listing on a U.S. exchange reduces the private benefits from control. The author uses the percentage difference between the prices of high-voting and low-voting shares of non-U.S. firms with dual-classes of stock (i.e. a voting premium) to proxy for the private benefits of control. Doidge (2004) finds that the average voting premium of firms that do not cross-list on a U.S. exchange is 21%. For firms that cross-list with a Level II or Level III ADR, the average voting premium is significantly less at about 12%. The reduction in voting premium does not extend to firms creating Level I ADR or Rule 144a programs. The author's results hold after controlling for firm-level and country-level factors that explain cross-sectional variation in voting premiums.

Doidge (2004) also provides evidence that explains why controlling shareholders would want to list on a U.S. exchange and constrain their private benefits from control. He finds that the prices of both classes of stock increase around the announcement of a U.S. listing. The voting premium declines because the price of the low-voting stock increases more than the price of the high-voting stock. Moreover, the magnitude of the decline in the voting premium is associated with the degree of investor protection in the firm's home country. Taken together the results of this study suggest that listing on a U.S. exchange benefits firms by constraining the private benefits from control, and such benefits are greater for firms domiciled in countries with poor legal protection for minority shareholders.

Doidge, Karolyi and Stulz (2004) document results that also support the contention that a U.S. exchange listing delivers financial benefits to foreign firms by constraining the private benefits of control. The authors find that cross-listed firms are valued higher than foreign firms that do not list in the U.S. and the magnitude of the value difference is negatively associated with the level of home-country investor protection. The cross-listing premium documented by the authors is robust to controlling for firm and country characteristics. These results are consistent with Foerster and Karolyi (1999) and Miller (1999) who document positive abnormal announcement-period returns for non-U.S. firms that issue an exchange-listed ADR, and Foerster and Karolyi (2000) who document positive long-horizon returns for such firms that raise capital.

Lang, Raedy, and Yetman (2003) provide evidence that suggests that the "bonding" cross-listing promulgates extends beyond the legal bonding that results in enhanced minority investor protection to include financial reporting and disclosure bonding. The authors show that cross-listed firms are less aggressive in terms of earnings management, convey bad news in a more timely fashion, and have earnings that are more strongly associated with share price.

Consistent with informational bonding, Lang, Lins and Miller (2003) find that when non-U.S. firms cross-list in the U.S. their information environment improves. The authors show that firms that cross list on U.S. exchanges have greater analyst coverage and forecast accuracy than firms that are not cross listed. Moreover, cross-listing is associated with an increase in analyst coverage and forecast accuracy as measured over a long-window, both of which are associated with greater firm value. The authors' results

are robust to controlling for the endogeneity of the listing decision. Accordingly, Lang, Lins and Miller (2003) conclude that cross-listing improves the firm's information environment, which yields a higher stock valuation.

Baker, Nofsinger and Weaver (2002) also provide evidence of an improvement in the information environment for foreign firms listing their shares on the NYSE or London Stock Exchange. The authors document a significant increase in firm visibility as proxied by analyst following and print media attention. Although the results are statistically significant for firms listing on either exchange, the results are stronger for NYSE listing firms.

Siegel (2005) examines the legal bonding hypothesis, which proposes that foreign firms list equities in the U.S. to overcome the detrimental effects of weak home country legal institutions. Using a sample of Mexican firms he finds no evidence that having an ADR deters corporate insiders from illegal asset taking. Moreover, he finds little evidence of effective regulatory enforcement of U.S. securities laws or of regulatory or private litigation penalties imposed against such firms. Altogether, Siegel's results provide little empirical support for the legal bonding hypothesis. However, proponents of the legal bonding hypothesis argue that notwithstanding the fact that the SEC might be less likely to prosecute foreign firms, it is sufficient for the validity of the hypothesis if foreign issuers' and market participants believe that cross-listing engenders increased risk of liability.

In an unpublished working paper, Doidge, Karolyi, and Stulz (2007) investigate the accepted wisdom that the decrease in flow of new listings in New York and the increase in flow of new listings in London is evidence that New York has become less popular due to the passage of the Sarbanes-Oxley Act of 2002 (SOX). The authors address the question, "Has New York become less competitive?" by investigating whether New York now fails to attract listings it would have attracted in the past? The authors show that the three major New York exchanges account for 30% of the market for global listings in 2005; unchanged from their 1998 market share. In contrast, London's share has increased from 16% (1998) to 19% (2005). However, all of the increase is attributable to growth in London's Alternative Investment Market (AIM). AIM's share of the market increased from less than 1% in 1998 to 8% in 2005, while the share of London's Main Market declined from 15% to 11%.

Doidge, Karolyi, and Stulz (2007) suggest that growth in AIM relative to the U.S. exchanges and London's Main Market is explained by the changing mix of firms seeking cross-listing. That certain types of firms prefer to list on certain types of exchanges is demonstrated in Pagano, Röell, and Zechner (2002). These authors focus on European firms, and find that the U.S. exchanges tend to attract European firms that are large, high-growth, export-oriented, high-tech firms. Doidge, Karolyi, and Stulz (2007) document no significant change in the characteristics of firms listing on U.S. exchanges since the adoption of SOX, and that the firms that cross-list on AIM tend to be small, and unlikely candidates to cross-list on U.S. exchanges.

In addition, Doidge, Karolyi, and Stulz (2007) document a listing premium for firms cross-listed on a U.S. exchange, which has not declined significantly over time, but no listing premium for firms cross-listed in London.⁵ Based on these results, the authors conclude that SOX has not eroded the benefits of listing on a U.S. exchange and the benefits cannot be replicated through a London listing.

In summary, extant research suggests that cross-listing on a U.S. exchange (1) improves access to capital, (2) reduces private benefits of control, and (3) improves the information environment. The implications for firm value are both direct and indirect. Firm value is enhanced directly because improved shareholder protection lowers the expected wealth transfers. Firm value is enhanced indirectly because improved access to capital allows managers to undertake more positive net present value projects.

The evidence suggests that these benefits are greatest for firms domiciled in emerging markets and/or in countries with weak shareholder protection. Moreover, many of the studies discussed above examine firms that trade on less-regulated U.S. markets (such as the OTC and PORTAL market), and document no significant benefits to foreign firms cross-listing on these markets, providing further support for the bonding hypothesis. Finally, the extant evidence suggests that SOX has not eroded the benefits of listing on a U.S. exchange, and that the benefits offered by such a listing are unique to the U.S.

The notion of accounting and regulatory bonding is a central theme of this literature. The weight of the evidence suggests that the benefits of cross-listing on a U.S. exchange stem from the commitment to adhere to more stringent legal and financial accounting and disclosure requirements than required in their home countries. The committee recommends that the SEC consider the link between accounting and regulatory bonding and cross-listing benefits in their deliberations by evaluating the extent to which the proposed change might impact the bonding benefits that research suggests play a critical role in attracting foreign firms to U.S. exchanges. Reese and Weisbach (2002) speak directly to this point stating, “The impact of these laws is mitigated somewhat by the fact that the SEC is probably less likely to prosecute foreign companies than U.S. ones, and by any potential future decisions that limit the degree to which these rules apply to foreign companies” (Reese and Weisbach 2002, pg. 77).

THE COSTS, BENEFITS AND NEED FOR HARMONIZATION

An important issue that underlies the question of whether the SEC should eliminate the IFRS-U.S. GAAP reconciliation requirement is whether harmonization of accounting standards is a desired goal. Harmonization is concerned with reducing diversity between accounting practices in order to improve the comparability of financial

⁵ The authors measure the listing premium using the ratio of the book value of non-equity claims plus the market value of equity to the book value of total assets. The authors do not control for differences in accounting policy choice. Systematic differences in accounting policies across markets, if they exist, could confound the results of this analysis.

reports prepared by companies from different countries (Murphy 2000). There are significant costs and benefits to harmonization (Ball 2005), which can be examined from a global perspective or from the perspective of individual countries or firms.

Sunder (2002) argues for competition among accounting standards. A regime that allows all companies to choose freely between U.S. GAAP and IFRS is consistent with the type of competitive environment Sunder envisions. The crux of Sunder's argument is that investors will place a higher value on the securities of firms that choose to adopt better reporting rules. Because optimal reporting minimizes the cost of capital for the firm, managers will choose to adopt the standards that investors favor. Managers' observed preference for a particular set of standards enhances the reputation and support afforded the "winning" standard setting organization, and this in turn impacts the standard-setting bodies' choices among standards.

Huddart, Hughes, and Brunnermeier (1999) model a somewhat different structure, but reach a similar conclusion. In their setting, stock exchanges choose the required accounting standards, and managers choose the exchange on which to list their shares. In contrast to Sunder (2002), the setting depicted by Huddart et al. (1999) does not allow for competition among accounting standards within an exchange, but does allow for competition among accounting standards across exchanges. Liquidity traders are attracted to the stock exchange that provides the least informational advantage to insiders. This results in migration to the high disclosure exchange. Thus, even though high disclosure reduces the insiders' informational advantage, it also attracts more liquidity, and it is the latter effect that dominates. This results in a "race to the top" in terms of disclosure quality.

Empirical evidence is consistent with the predications of Huddart et al.'s (1999) model. Pagano, Röell, and Zechner (2002) find that European exchanges with the highest trading costs, lowest accounting standards, and worst shareholder protection fared worst in attracting or retaining foreign listings. The authors conclude that since firms compete to attract liquidity traders, and liquidity traders migrate to firms providing greater disclosure, there is less need for concern about differences in disclosure standards between foreign and domestic firms. What is not clear, however, is whether Pagano et al.'s (2002) findings are driven by trading costs, accounting standards, shareholder protection laws, or some combination thereof.

Presenting a more balanced perspective, Ball (2005) highlights the benefits of harmonization along with likely impediments and costs. He identifies at least three major advantages of uniform standards: scale economies such that the rules need be only invented once, protection from managers choosing more favorable rules, and comparability. Ball (2005) suggests that relative to the national standards for many countries, widespread adoption of IFRS could lead to more accurate, comprehensive and timely financial information and greater comparability of financial statements across countries. However, this is not necessarily the case for countries that already have an endogenously determined set of high quality accounting standards.

