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On the Issues

XBRL and U.S. Financial Market Leadership

By Peter J. Wallison

To remain competitive internationally, U.S. companies need to accelerate the development and use of XBRL, a financial reporting system that enables investors and analysts to compare company performance.

In December, the London Stock Exchange celebrated a record year for foreign company new issues, with 129 new listings by companies from twenty-nine different countries. In contrast, the New York Stock Exchange registered a net gain of six foreign listings (a gain of nineteen and a loss of thirteen) in 2005, and NASDAQ gained a net of fourteen. According to a press report by the London Stock Exchange on its success, "about 38 per cent of the international companies surveyed said they had considered floating in the United States. Of those, 90 per cent said the onerous demands of the new Sarbanes-Oxley corporate governance law had made London listing more attractive." By now, it is well-known what harm Sarbanes-Oxley has done to the attractiveness of the U.S. securities markets, but what is not well-known is that the lack of resources available to a relatively obscure accounting group—engaged in the development of a technical-sounding disclosure system called XBRL—may also threaten not only the current primacy of the U.S. financial markets, but also the future competitiveness of U.S. companies.

Since 1998, the American Institute of Certified Public Accountants (AICPA) and a few other organizations have sponsored the development of a taxonomy for extensible business reporting language (XBRL), a derivation of the computer language XML that has the ability to tag individual words and numbers so that they can be understood in a particular context. The tagging facility permits financial statements, and even text such as footnotes, to be translated into a common language that can be read by computer applications. Thus, an analyst or investor who is interested in comparing, for example, the oil reserves of all publicly reporting energy companies would be able—using XBRL—to search a database containing the financial statements or 10K reports of these companies and pull out the relevant data in seconds. Because XBRL tags each term with contextual meaning, it allows the search engine to ignore "reserves" for bad debts or other purposes and to extract only the data on oil reserves. Without this facility, the same information would have to be developed through a time-consuming page-by-page search through the disclosure materials filed with the Securities and Exchange Commission (SEC).

XBRL represents a huge advance in the information potentially available to investors and analysts, and its significance has not been lost on the new chairman of the SEC, Christopher Cox. Since taking office, Cox has made the implementation of XBRL—which he calls "interactive data" in order to avoid the techie connotation of XBRL—one of his key priorities, devoting attention to it in almost a third of all his public speeches. Under his prodding, the SEC is doing what it can to encourage the use of XBRL by public companies, most recently offering expedited review of securities

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registrations for those companies that file in the interactive data format.

But there is a problem. The development of the XBRL taxonomy—the definitions and classifications that enable contextual tags to be applied to every item in a company's financial statements—is going slowly. As Cox explains, "the development of taxonomies lacks resources. Believe it or not, the awesome global challenge of fashioning a new way for billions of people to exchange financial data is currently dependent on the success of one solitary man who labors in anonymity at XBRL-US," the coalition of U.S. firms that has overall responsibility for developing the XBRL taxonomy. Indeed, it's true: only one person is currently employed full time on this task; the others are volunteers who believe in the value of XBRL but are employed elsewhere and help out when they can. This bizarre situation—in which the chairman of the SEC sees great value in a technological advance that is limping along in a state of resource privation—is the result of the traditional American view that the private sector, and not the government, ought to lead in the development of market innovations. But this approach, ordinarily so successful, does not work when no private sector company or group sees an immediate economic benefit from an investment. Up to now, the AICPA has mostly been footing the bill, and the organization deserves applause for doing so, but even the accounting industry cannot afford to devote substantial resources to the development of a disclosure system that will mostly be of use to analysts. It is likely, in fact, that the XBRL project will separate from the AICPA this year.

And why is this a problem? For the same reason that the growth of the London Stock Exchange is a problem. The EU is also aware of the power and significance of XBRL, but its officials have not relegated it to a private, voluntary initiative. In typical European fashion, the governments have funded and pushed XBRL through to completion. Now, the EU's new common financial reporting system, known as International Financial Reporting Standards (IFRS), can be stated fully in XBRL. The United States lags behind. Before Chairman Cox, the SEC would not even acknowledge the significance of XBRL, and its development has been slow and uneven. Now that the value of the system has been officially recognized, it is far behind in its development.

Here, then, we come to the crux of the issue: in the future, companies that want their financial statements to be more accessible to investors and analysts will have another reason, apart from Sarbanes-Oxley, to offer their securities in the EU, particularly London, and to report their financial results in IFRS. And, even worse, in the globalized capital market of today, capital will flow to the companies whose financial statements are most easily analyzed and understood, giving those companies that state their financials in IFRS an important competitive advantage over the U.S. companies that use generally accepted accounting principles (U.S.-GAAP).

To be sure, at the moment, the U.S. financial reporting system is the preferred financial reporting system for most businesses, but IFRS is not far behind. According to the latest data available, U.S.-GAAP is used by companies comprising 53 percent of the capitalization of all markets, while IFRS is used by 35 percent. The balance, 12 percent, use other financial reporting systems but will likely convert to either U.S.-GAAP or IFRS as the capital markets continue to globalize. As shown by the growth of the London stock market, however, and the corresponding decline in foreign listings on the U.S. markets, IFRS is closing the gap and will continue to do so.

So what we have is a competition in two distinct areas, all revolving around the development of XBRL. The first is competition between the U.S. and EU securities markets for dominance in the global financial markets of the future. The EU, which has now put in place the XBRL taxonomies that are necessary to make financial reports stated in IFRS more accessible to investors and analysts than those stated in U.S.-GAAP, is in a position to take advantage of this resource in attracting new listings and encouraging the use of IFRS. But the second area of competition may be even more important in the long run. Unless the XBRL taxonomies can be completed soon, U.S. companies that report in U.S.-GAAP may find themselves at a disadvantage in attracting capital vis-à-vis foreign competitors that use IFRS. The long-run consequences for the competitiveness of the U.S. economy as a whole could thus be adversely affected.

What to do? Now that XBRL has the full endorsement of the SEC, there can be no reason for U.S. companies to hold back. XBRL is coming—the only question is whether it will be sooner or later. The competition between the United States and the EU for financial dominance and the competition among companies for scarce capital argue strongly for the U.S. financial and industrial communities to get behind the XBRL effort. This means providing the financial resources to increase the personnel available to the XBRL-US consortium. It does not take much to join (www.xbrl.org/us), and there is a lot at stake.

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