

© 1996 American Accounting Association
Accounting Horizons
Vol. 10 No. 1
March 1996
pp. 95-109

COMMENTARY

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Foreign Companies and U.S. Securities Markets: Financial Reporting Policy Issues and Suggestions for Research

SYNOPSIS: This paper discusses several topics related to the debate over the SEC's financial reporting requirements for foreign issuers, focusing on the question of whether foreign issuers should be required to provide quantitative U.S. GAAP reconciliations. We summarize arguments presented by both supporters and opponents of the current requirements, and recent regulatory developments. Selected accounting research studies which provide relevant evidence are discussed, and suggestions for further research are presented.

I. INTRODUCTION

In this paper, prepared at the request of the Professional Practice Issues Committee of the American Accounting Association, we discuss the potential contribution of accounting research to the SEC's rulemaking on financial reporting requirements for foreign issuers. Although there is general support for the SEC's regulatory objectives, there is substantial disagreement about how well the SEC's current financial reporting requirements for foreign issuers meet the SEC's objectives.¹ Given the breadth of the topic, we do not provide an exhaustive survey of the literature, nor an in-depth review of existing research. Instead, we use specific papers as examples to illustrate broader points. To further focus the discussion, we concentrate on empirical archival research which addresses issues relevant for analyzing the SEC's requirement for quantitative reconciliations to U.S. GAAP.²

The appropriate level of required disclosure for foreign registrants is an issue about

which academic research potentially can provide insights. As with most normative questions, traditional research methods cannot resolve the issue of appropriate regulatory requirements, since the needs of investors, the relative importance of investor groups (such

¹ See SEC (1987, chapter IV) and Kosnik (1994) for discussions of the SEC's evolving philosophy on foreign issuers and, also, for a comprehensive review of the issues from a variety of perspectives see: Berton (1995), Choi et al. (1992), Raghavan and Sesit (1993), Freund (1993), Jarrell (1992), Gilpin (1994), Strauss (1992), Harris (1995), Wyatt and Yospe (1994), Falk (1994), Power and Salwen (1991) and Biddle and Saudagaran (1991).

² We consider studies that focus on non-U.S. corporations. A substantial body of research on U.S. corporations may provide indirect evidence relevant to the issues discussed in this paper.

We are indebted to Andrew Alford, Christine Botosan, Nick Dopuch, Trevor Harris, Bill Kinney, Jr., Kent Klein, Wayne Landsman, Charles Lee, Grace Pownall, Jim Shapiro and Art Wyatt for their many helpful comments and suggestions on this paper.

as retail vs. institutional investors), and the appropriate trade-offs among conflicting objectives are not known. As a result, the primary role of research is to provide descriptive evidence that the SEC might weigh in its deliberations.

The SEC generally requires foreign registrants to furnish financial information substantially similar to that required of domestic companies. However, foreign registrants' financial statements need not be prepared in accordance with U.S. GAAP if they are presented in accordance with another comprehensive body of accounting principles, and are accompanied by a quantitative reconciliation to U.S. GAAP of net income, shareholders' equity and earnings per share, if materially different (SEC 1995b).

Whether the reconciliation requirement helps or hinders the SEC in meeting its regulatory objectives is widely debated. As illustrated in figure 1, two main objectives in investor-oriented markets are investor protection and market quality.³ Generally, the SEC's reporting requirements are consistent with pursuing both objectives. However, stringent reporting requirements may satisfy the investor protection objective at the cost of reducing investors' investment opportunities or imposing high transaction costs on taking advantage of available opportunities.

Indeed, some commentators argue that the SEC's financial reporting requirements imposed on foreign companies are subject to this kind of market quality criticism, since they deter foreign companies from making their securities available in the U.S.⁴ As a result, it is claimed that U.S. investors are more likely to trade in markets such as the U.S. Over-the-Counter (OTC) market or overseas markets, where liquidity may be relatively low, transaction costs relatively high and investor protection less important. It is then argued that by relaxing the financial reporting requirements the SEC would provide U.S. investors with access to more investment opportunities within the regulated U.S. markets; this, in turn, would better balance the SEC's objectives of investor protection and market qual-

ity. Also, it is argued that the SEC's registration requirements may actually mislead U.S. investors by giving the appearance of comparability to foreign financial statements which may require a significantly different interpretation than U.S. statements.

Others counter that the current accounting and disclosure system both protects investors and ensures the quality of U.S. capital markets.⁵ Underlying this argument are the principles of full disclosure and equal treatment of foreign and domestic issuers. If investors in domestic securities require financial information based on U.S. GAAP to make informed decisions, then such information is at least as necessary for making informed decisions about non-U.S. securities with which they may be less familiar. Indeed, the competitive strength of U.S. capital markets, including their substantial liquidity and high level of investor confidence, is often attributed, at least in part, to the SEC's existing disclosure system and vigorous enforcement. It has also been argued that the SEC's reporting requirements are not the primary obstacles to foreign companies wishing to list securities in the U.S.

To motivate our discussion of research, we first present a background on SEC financial reporting requirements affecting foreign issuers. This is followed by a discussion of existing evidence from empirical studies, and a discussion of relevant questions on which relatively little research has been conducted. The final section presents conclusions.

³ Objectives and principles presented in figure 1 are from SEC (1995c, 1987) and Securities and Investment Board (1994). The concept of comparability is discussed further in the third section of this paper. Liquidity refers to the ability to trade quickly at prices that are reasonable in light of underlying demand/supply conditions (Schwartz 1991). Empirical measures of liquidity include an asset's average bid-ask spread, the frequency with which an asset trades, average trade size, trade volume and number of investors. (e.g., Schwartz 1991; NYSE 1994; Wells 1991, 1993)

⁴ See Cochrane (1994), Cochrane et al. (1995), Edwards (1993) and Baumol and Malkiel (1993) for further discussion.

⁵ See Breeden (1994), McConnell (1994) and Shapiro (1993).

FIGURE 1
Broad Objectives for the Regulation of Investor-Oriented Equity Markets¹

Objectives:

Investor Protection

Investors are provided with material information, and are protected through monitoring and enforcement.

Market Quality

Markets are fair, orderly, efficient and free from abuse and misconduct.

Specifically:

- | | |
|--|--|
| <ol style="list-style-type: none"> 1. Provide investors with material information. 2. Monitor and enforce market rules. 3. Inhibit fraud in the public offering, trading, voting and tendering of securities. 4. Seek comparability of financial information (allow investors to compare companies across industries and domiciles). | <ol style="list-style-type: none"> 1. Promote equitable access to information and trading opportunities (market fairness). 2. Enhance liquidity and reduce transaction costs (market efficiency). 3. Contribute to freedom from abuse through monitoring and enforcement. 4. Foster investor confidence. 5. Facilitate capital formation. 6. Seek conditions in which prices reflect investor perceptions of value without being arbitrary or capricious (market orderliness). |
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Principles

1. *Cost Effectiveness.* The cost of market regulation should be proportionate to the benefits it secures.
2. *Market Freedom and Flexibility.* Regulation should not impede competition and market evolution.
3. *Transparent Financial Reporting and Full and Complete Disclosure.*
4. *Equal Treatment of foreign and domestic firms.*

¹ See SEC (1995c, 1987) and Securities and Investment Board (1994) for further discussion.

II. BACKGROUND AND RECENT SEC DEVELOPMENTS

Under the Securities Exchange Act of 1934 (hereafter, the Exchange Act), a foreign issuer periodically must file information with the SEC once it has listed its securities on a national securities exchange or NASDAQ, or has registered a securities offering under the Se-

curities Act of 1933 (Brown & Wood 1994; SEC 1995b).⁶ Foreign issuers subject to the SEC filing requirement must file Form 20-F annual reports within six months of the fiscal year-

⁶ Registration under the Exchange Act is also required if the foreign issuer has assets greater than \$1,000,000 and a class of equity securities held by at least 500 shareholders.

end. Form 20-F financial statements need not be prepared in accordance with U.S. GAAP if they are presented in accordance with another comprehensive body of GAAP, and are accompanied by quantitative reconciliation to U.S. GAAP of the materially different items in the financial statements.⁷

Form 20-F has two sets of financial statement requirements, contained in Item 17 and Item 18. Item 17 contains the minimum disclosure requirements, and generally does not require U.S. GAAP disclosures if those disclosures are not required under the home country GAAP. Issuers are permitted to use Item 17 in annual reports filed under the Exchange Act for an exchange listing without raising new capital (SEC 1995b). Item 18 must generally be used in a public offering of securities and requires full compliance with material financial disclosures required by U.S. GAAP and Regulation S-X.

Recent SEC developments have occurred in two general areas: the streamlining of reporting requirements for foreign registrants, and the possible extension of financial reporting requirements to more foreign issuers. On the one hand, the SEC adopted initiatives in 1994 to streamline the registration, reporting and reconciliation requirements for foreign issuers reporting under the Exchange Act (SEC 1995b). The initiatives are intended to lower the barriers of entering the U.S. securities markets to foreign companies by reducing their financial reporting costs. For example, some of the initiatives: (1) permit first-time registrants to reconcile U.S. GAAP financial statements and selected financial data for only the most recent two (instead of five) fiscal years; (2) reduce reconciliation requirements for financial statements of acquired foreign businesses; and (3) expand the universe of foreign issuers eligible to use Item 17 financial statements in registration statements. Also, SEC staff use a flexible approach to obtain substantial compliance, rather than complete technical compliance with disclosure requirements (e.g., Kosnik 1994).

In addition, the SEC recognizes International Accounting Standards (IAS) on a lim-

ited basis. The Commission now accepts without reconciliation to U.S. GAAP a foreign registrant's cash flow statement prepared in conformance with IAS No. 7 ("Cash Flow Statements"), and has simplified reconciliation requirements for foreign registrants who comply with certain aspects of IAS No. 21 ("The Effects of Changes in Foreign Exchange Rates") and IAS No. 22 ("Business Combinations") (SEC 1995b). The SEC is far from accepting IAS as a whole, and the International Organization of Securities Commissions (IOSCO) has to date endorsed only a single IAS. However, IOSCO has stated that 14 of the IAS do not require additional improvement, providing that the other "core" standards are successfully completed.⁸

At the same time, the SEC is considering changes proposed by the National Association of Securities Dealers, Inc. (NASD) which, if adopted, will substantially expand the set of foreign companies required to register to include those with equities quoted on the Over-the-Counter Bulletin Board (OTCBB). The OTCBB is an electronic quotation system that was proposed by the NASD as a one-year pilot program in November 1988 (SEC 1990). In 1994, the NASD proposed to the SEC that the OTCBB be made permanent. As proposed, securities of foreign companies quoted on the

⁷ Effective July 1, 1991, the SEC adopted a multi-jurisdictional disclosure system (MJDS) for Canadian issuers (SEC 1995b). The MJDS allows eligible Canadian issuers to report under the Exchange Act using documents prepared largely in accordance with Canadian requirements. (However, like Form 20-F filers, these Form 40-F issuers are required to provide quantitative reconciliations to U.S. GAAP.) See SEC (1995b) and Brown & Wood (1994) for detailed discussions of the U.S.-Canada MJDS.

⁸ In November 1993, the IASC Board completed its Comparability and Improvements project with the approval of several revised IAS. The revised IAS include fewer allowable alternative accounting treatments, and implementation guidance has been improved so that requirements under IAS will be applied in the same way in different countries. See Purvis et al. (1991) for further discussion of the Comparability and Improvements project, and IASC (1995a, 1995b) for discussion of the IASC's progress in obtaining endorsement by securities commissions, and the recent agreement between the IASC and IOSCO concerning the IASC's work program that will result in a comprehensive core set of standards.

OTCBB as of July 1, 1994 would be "grandfathered," but any additional foreign issuers would be subject to reporting requirements under the Exchange Act.⁹ On July 7, 1994, the SEC extended the OTCBB "pilot" until September 28, 1995; the SEC has since postponed its decision until late June, 1996.

Thus, the SEC appears to be unwilling to relax the basic requirement for quantitative reconciliations in foreign registrants' Form 20-F financial statements, and willing to extend the requirement to foreign companies with equities quoted on the OTCBB. Therefore, empirical research on the reconciliation requirement is particularly timely.

III. EXISTING EMPIRICAL EVIDENCE

We organize our discussion of the research around major questions related to the SEC objectives of investor protection and market quality. Two factors should be kept in mind in interpreting our discussion. First, empirical research seldom produces definitive results which can extend beyond the samples analyzed in specific settings. Second, archival research is inherently limited because researchers can not control the causal variables. This leads to more than one potential interpretation of the results. Our focus is on the strengths and weaknesses we see in the various approaches, as a basis for identifying research questions which could provide a motivation for future studies in this area.

Investor Protection

Question 1: Are net income and shareholders' equity reported under non-U.S. accounting standards comparable to those prepared under U.S. accounting standards?

If accounting measures produced under principles other than U.S. GAAP are similar to U.S. GAAP-based measures, then reconciliations to U.S. GAAP may not be necessary.¹⁰ There are several ways to address comparability.¹¹ The first is to use reconciliation data currently disclosed by foreign issuers to directly compare financial measures under U.S.

and non-U.S. GAAP. An example of this approach is Amir et al. (1993) which, among other things, reports the extent of reconciling items for 101 firms from 20 countries during 1981-1991.¹² Amir et al. (1993) documents that the magnitude of reconciling items can be substantial, particularly for shareholders' equity and that the primary categories of reconciling items are for goodwill, asset revaluations, income taxes and pensions. The main advantage of this approach is that it controls for other factors because one can observe publicly-available data prepared for the same company under different sets of accounting principles. The main disadvantage is that while it is informative about non-U.S. SEC registrants who provide reconciliations, it is less informative about firms that do not list in the U.S. now

⁹ The grandfathering is available only to foreign issuers who have obtained a Rule 12g3-2(b) exemption (frequently called the information-supplying exemption) by December, 1994. Rule 12g3-2(b) of the Exchange Act requires that issuers furnish to the SEC whatever information (1) has been made public in the home jurisdiction, (2) has been filed with a stock exchange on which its securities are traded and which was made public by such exchange, or (3) has been distributed to its security holders. Instructions to Form 6-K, which Form 20-F filers are required to file as part of their continuing disclosure obligation, have a similar requirement (see SEC 1993a and SEC 1984). See Cochrane et al. (1995), SEC (1990, 1995a) and NASD (1994) for detailed discussions of the OTCBB.

¹⁰ For example, one assumption implicit in the SEC's adoption of the U.S.-Canada MJDS was that many Canadian accounting principles are similar to or the same as U.S. accounting principles. In proposing the MJDS, the SEC asked for empirical evidence on differences between U.S. and Canadian GAAP (SEC 1989).

¹¹ Comparability refers to the extent to which accounting systems vary in how they capture economic reality, and can be evaluated along two dimensions—bias and "noise." Bias refers to the extent to which accounting systems vary in terms of conservatism (e.g., German accounting is alleged to be more conservative than U.S. accounting). Noise refers to the association between accounting systems and economic reality. While bias may be mitigated by simply adjusting valuation multiples, noise is of more concern because it may result in less information about the firm. We focus on the comparability of data prepared under non-U.S. and U.S. GAAP. However, it should be recognized that comparability is also an issue within accounting systems, as well as across accounting systems.

¹² Also, see Bandyopadhyay et al. (1994), SEC (1993b) and Harris (1993).

but which might list if requirements were reduced.¹³

A closely-related (not strictly archival) approach is for the researcher to perform the reconciliation to U.S. GAAP using information supplied by the companies being studied. A recent example of this approach is Harris (1995), which restates shareholders' equity data for companies from Sweden (Atlas Copco), Germany (Bayer), Australia (Broken Hill Proprietary), France (Cap Gemini Sogeti and Valeo), New Zealand (Fletcher Challenge), Switzerland (Holderbank) and Italy (Olivetti) from the company's accounting practice to U.S. GAAP. Consistent with the results from Form 20-F reconciliations, Harris finds that substantial adjustments related to acquisitions, asset re-valuations, income taxes and postemployment benefits are sometimes necessary.

Although the above approach allows one to extend analysis beyond firms that currently file Form 20-F, the sample firms are still not likely to be representative. Because the approach is so labor intensive, sample sizes are likely to be small. The companies which are willing to expend time and resources to participate may be those which are contemplating a U.S. listing and, so, are not representative of firms in general. Further, many firms do not have ready access to all the information (e.g., income tax and pension data) to allow a full reconciliation.

A third approach uses stock price analysis to infer whether financial measures produced under different reporting systems or environments are comparable. An example of this approach is Harris et al. (1994), which uses the coefficients from regressions of stock prices and returns on net income and shareholders' equity for a matched sample of 230 U.S. and German firms to infer whether the stock market valuation of German net income and shareholders' equity is similar to that in the U.S.¹⁴ The study provides evidence that coefficients applied in valuing net income and shareholders' equity are generally higher for German firms, consistent with conservative bias in German reporting. However, the de-

gree of correlation between stock returns and earnings data in Germany is comparable to that in the U.S., suggesting that German earnings data are no less value-relevant than U.S. data.¹⁵

An advantage of the above approach is that it lends itself to large sample inference with publicly available data. A disadvantage is the range of other possible explanations for differences in pricing multiples, including differences in expected growth and risk across countries, market inefficiencies and the effects of other information.

Question 2: Is the information in reconciliation disclosures value-relevant?

The preceding discussion suggests that non-U.S. GAAP accounting measures vary from U.S. GAAP accounting measures, but there is little evidence that the association between accounting data and share prices is higher under U.S. GAAP. This raises the issue of whether reconciliations to U.S. GAAP are decision-relevant given non-U.S. GAAP data. Because decision-relevance is hard to measure empirically, most research has relied on the degree of incremental association between stock prices or returns and reconciling items (after controlling for non-U.S. GAAP earnings). One approach is to esti-

¹³ Differences are likely to exist between these two groups of firms for two reasons. First, the fact that these firms choose not to list under current requirements suggests that they differ systematically in terms of either the costs or benefits of listing. For example, if the cost of preparing the reconciliation information is increasing in tandem with the extent to which non-U.S. GAAP differs from U.S. GAAP, then the firms which do not currently list may be those for which the reconciliation would be most extensive and, thus, most informative. Second, there is anecdotal evidence that firms listing under current requirements change their non-U.S. GAAP accounting methods to be more consistent with U.S. GAAP (e.g. Warbrick 1994).

¹⁴ Also, see Alford et al. (1993) and Joos and Lang (1994).

¹⁵ For a related approach, see Chan and Seow (1995), which examine the associations between annual stock returns and earnings measures as reported under local GAAP and U.S. GAAP for 45 firms that filed Forms 20-F between 1987 and 1992. The study provides evidence that returns are more highly correlated with non-U.S. GAAP earnings than with U.S. GAAP earnings, which they interpret as casting doubt on the desirability of reconciliation.

mate a regression of share price level or annual returns on shareholders' equity data and earnings data as originally reported, and on the reconciliation amounts. While this approach yields evidence on the association between share prices and the information disclosed in reconciliation footnotes, it does not provide evidence on whether the reconciliation disclosures are timely, or whether they convey information that is directly used by investors for valuation.

A second approach is to examine the association between reconciliation information and stock returns computed over short intervals surrounding the initial date of reconciliation disclosures. The advantage of this approach is that any observed relation is likely to have been the result of the disclosure of interest rather than other variables. A major problem with this approach, however, is that the difficulty in determining when the reconciliation information reaches the market may result in weak tests.

Amir et al. (1993), using both approaches, examines the incremental explanatory power of reconciling items for stock price levels, annual returns and five-day returns around Form 20-F filing dates.¹⁶ Evidence from regressions of stock price on earnings, book value, shareholders' equity and reconciling items suggest some explanatory power for the shareholders' equity reconciling items, driven primarily by goodwill and asset revaluations. The regressions of annual returns on earnings levels, earnings changes and reconciling items provide only weak evidence that information in reconciliation disclosures has incremental explanatory power.

Amir et al.'s (1993) analysis of stock returns computed over short intervals surrounding the Form 20-F filing dates does not support the hypothesis that reconciliation disclosures convey value-relevant information. However, other studies report that reconciliation information has incremental explanatory power in regressions of short-horizon stock returns on accounting data.¹⁷

Evidence on the extent to which U.S. investors can interpret non-U.S. GAAP disclosures is also relevant for assessing the incre-

mental value of reconciliations. For example, Meek (1983) finds that the U.S. market responds to earnings announced under non-U.S. GAAP by 26 foreign issuers during 1968 through early 1979.¹⁸ Further, evidence from Meek (1983) and other studies (see footnote 18) indicates that the U.S. response is not significantly different from the response to U.S. firms' earnings disclosures and, that for U.K. firms listed in both the U.S. and the U.K., the U.S. market response is not significantly different from the U.K. market response. However, the results are difficult to interpret because the stock price reaction to an earnings announcement is a function of both the reported earnings and the market's expectation. For example, if less pre-announcement information is available for non-U.S. firms, a larger stock price response to earnings might be expected, even if non-U.S. firms' earnings were less informative. The evidence suggests, though, that U.S. investors use financial information based on non-U.S. GAAP in valuation and that reconciliations might not be necessary.

Market Quality

Question 3: Do SEC disclosure requirements deter foreign companies from listing in U.S. markets?

It is difficult to directly observe the effects of SEC disclosure requirements on the listing decisions of potential registrants. While there may be substantial costs of complying with

¹⁶ Also, see Bandyopadhyay et al. (1994), McQueen (1993), Barth and Clinch (1995) and Pope and Rees (1994). Frost and Kinney (1996), using a different but related approach, compare foreign registrants' reconciled-to-U.S.-GAAP earnings/returns correlations with correlations of U.S. firms matched on size and industry. They find that the foreign firm and U.S. firm correlations are similar and have similar significance levels, consistent with the view that foreign registrants' reconciled-to-U.S.-GAAP earnings are as value-relevant as U.S. firms' U.S. GAAP earnings.

¹⁷ For example, see McQueen (1993) and Frost and Pownall (1996). Results in Meek (1983) are consistent with Amir et al. (1993).

¹⁸ Also, see Meek (1985, 1991), Frost and Pownall (1994b, 1995, 1996) and Lee (1995).

SEC requirements which deter firms from listing, the benefits of trading in a closely regulated market may outweigh the costs. One way to assess whether SEC disclosure requirements impair the competitiveness of U.S. capital markets is to examine the listing choices of foreign issuers, which reflect the perceived benefits, net of any costs.

Direct evidence on the numbers of foreign firms listed on major world equity markets suggests that U.S. markets have been more successful than the London, Tokyo, Paris and Frankfurt markets in attracting foreign listings since 1990. Specifically, between December 31, 1990 and December 31, 1994, the numbers of foreign companies listed on each of the four non-U.S. stock exchanges have steadily fallen, but the numbers of foreign listed companies have risen on the NYSE, the American Stock Exchange, and NASDAQ.¹⁹ The London Stock Exchange has been criticized for not being stringent in monitoring and disciplining market abuses, and its difficulty in curbing insider trading may harm its ability to attract foreign issuers (e.g., Dwyer 1995). These facts suggest that the SEC requirements have not been a significant deterrent to foreign firms. However, the growth in the number of foreign companies quoted OTC has been the most dramatic of all, suggesting that the growth of firms listing on the exchanges could have been even greater, absent the SEC requirements.²⁰

An example of academic research on the topic is Saudagaran and Biddle (1992), which examines the listing patterns of 302 internationally-listed firms in 1987, and changes in listings between 1981 and 1987. The results suggest that the probability a firm will list on a given foreign stock exchange is inversely related to the exchange's disclosure level.²¹ However, the data predate the recent trends in listing patterns discussed above. Further, because listing choices reflect both perceived benefits and costs of listings, it is difficult to infer which of the two drives the results.

Another approach for inferring the magnitude of the costs associated with SEC requirements is to examine compliance with

SEC reporting requirements. For example, Frost and Kinney (1996) report substantial noncompliance with SEC segment and reconciliation disclosure requirements in a study of 156 foreign registrants traded on major U.S. stock exchanges during 1990.²² This evidence suggests that some foreign registrants view the costs of meeting SEC reporting requirements as greater than the expected costs of noncompliance. However, one can not infer whether the results reflect high compliance costs or low noncompliance penalties. Survey evidence also suggests that compliance costs can be substantial. Choi and Levich (1990) report that several of 15 non-U.S. issuers interviewed, primarily those domiciled in Japan and Germany, reported that regulatory requirements in international capital markets pose problems.²³

IV. SOME QUESTIONS TO ADDRESS IN FUTURE RESEARCH

In this section we pose several questions relevant for the policy debate on which there has been less research. The questions focus on the appropriate financial reporting policy requirements for foreign issuers, but they also spill over to more general disclosure and equity market issues.

Question 4: Are International Accounting Standards (IAS) a viable substitute for reconciliation to U.S. GAAP?

Several alternatives to the U.S. GAAP reconciliation requirement have been proposed that might provide an acceptable level of fi-

¹⁹ Data are from the London Stock Exchange (1992, 1993, 1995). Also see Breeden (1994), Shapiro (1993) and *The Economist* (1995a).

²⁰ The non-NASDAQ OTC equity market is the fastest growing public market in terms of number of foreign quoted equities in the U.S. (Cochrane et al. 1995, Bank of New York 1995). Most of the OTC foreign equities are currently exempt from SEC registration under the Exchange Act.

²¹ Also, see Biddle and Saudagaran (1989) and Meek and Saudagaran (1990).

²² Also, Frost and Pownall (1994a) report substantial noncompliance with SEC annual and interim reporting rules by 53 foreign issuers in the U.S. during 1989.

²³ See Decker (1994) and Rader (1994) for discussions of disclosure costs from practitioners' perspectives.

financial statement comparability, and at the same time offer several advantages over the reconciliation requirement. One widely-discussed alternative is for the SEC to accept financial statements prepared in conformance with IAS.²⁴ Acceptance of IAS could overcome two primary objections to U.S. GAAP reconciliations. First, it would mitigate the view that the SEC is imperialistic in mandating reconciliation to U.S. GAAP when non-U.S. regulators do not have similar requirements for U.S. companies. IAS provide a universal benchmark which could be used as a basis for listing in all markets. Second, IAS allow some latitude in the choice of accounting standards, so that firms might be able, by choosing the appropriate accounting methods, to satisfy both local and IAS requirements with one set of statements. Under current requirements, many registrants are forced to maintain two sets of accounts because use of U.S. GAAP is not permitted for their local reporting.

Many questions about IAS remain unresolved, including whether financial statements prepared in conformance with IAS are comparable, and whether allowing foreign issuers to report using IAS would violate the principle of equal treatment of foreign and domestic issuers. Current research on these issues is quite limited due to data constraints. First, the revised IAS came into effect for financial statements covering periods beginning on or after January 1, 1995 (IASC 1994). Therefore, for most companies reporting under IAS, fiscal 1995 (or later, depending on fiscal year-end) will be the first year for which they prepare financial statements under the new standards. While IAS have existed for a number of years, results for periods preceding revised IAS adoption probably do not represent the current environment, since recent IAS revisions have been substantial. Second, few companies have prepared financial statements in conformance with IAS. Only recently have enough companies adopted IAS to allow for large sample studies.²⁵ These factors are now less restrictive, suggesting that IAS financial reporting issues comprise an important area for additional research.

An example of recent research investigating IAS is Harris (1995), discussed above in conjunction with question 1, which recomputes net income and shareholders' equity under IAS (using company-supplied data). This study suggests that, subject to the choice of accounting methods under IAS, accounting data prepared under IAS are very similar to those prepared under U.S. GAAP.

Question 5: Should other disclosures currently included in the Form 20-F continue to be required?

Form 20-F includes numerous disclosures, other than reconciliations, which may impose significant costs on foreign issuers and may, therefore, deter foreign companies from listing in the U.S. Form 20-F. Item 18, in particular, requires disclosures considered particularly difficult for foreign issuers, including disclosures about geographic and industry segments, pension and income tax liabilities, loss contingencies and related party transactions (Rader 1994; Kosnik 1994; SEC 1987, ch. IV). At the same time, some of the Item 18 disclosures are among the items cited as being especially relevant to financial statement users.²⁶ However, there is only limited evidence on this issue.

Question 6: What financial information do foreign issuers disclose when not reporting under the Exchange Act?

Evidence on the financial reporting and disclosure choices of non-U.S. issuers making U.S. placements of securities under Rule 144A of the Securities Act of 1933 would be useful.²⁷

²⁴ A second alternative is mutual recognition, which for financial reporting, is the acceptance in an overseas jurisdiction of financial information prepared in conformance with home market requirements, perhaps with some minimum standards. See Cochrane (1994) and Karmel (1993) for discussion of these and other alternative approaches.

²⁵ The IASC reports that as of June 28, 1995, over 200 companies disclosed that their financial statements conform with IAS (IASC 1995c).

²⁶ For example, see AICPA (1993).

²⁷ Rule 144A provides a non-exclusive safe harbor exemption from Securities Act registration for resales of certain restricted securities to Qualified Institutional Buyers (see SEC 1995b). See Harris (1995) for a discussion of the limited evidence currently available.

Such evidence would be relevant for assessing what companies disclose in response to demand by institutional investors, in the absence of reporting requirements under the Exchange Act. Such evidence would be subject to two limitations. First, the number of such offerings is relatively low (see SEC 1995b); second, because the use of Rule 144A is at the issuer's option, Rule 144A firms are probably not representative of foreign issuers in general. Since most OTCBB firms are also exempt from Exchange Act reporting, analysis of their disclosures would also shed light on this issue.

Evidence from the above analyses would help clarify whether Exchange Act reporting requirements are indeed necessary to ensure that material information is disclosed to the market. The greater the gap between disclosures by firms reporting under the Exchange Act and firms not reporting under the Exchange Act, the more likely Exchange Act rules are required to secure disclosure of material information.²⁸

Question 7: How do the SEC's financial reporting requirements affect the liquidity, transaction costs, investor confidence and investor access to trading opportunities in U.S. equity markets?

Little direct evidence is available on the effect of SEC financial reporting requirements on U.S. capital markets. Tests of causal factors are difficult to design, since many inter-related factors affect equity market characteristics. For example, while foreign issuers vary in terms of continuing reporting obligations, they also vary along other dimensions, including domicile, U.S. equity market, reason for entering the U.S. equity markets and, possibly, disclosure incentives.²⁹ Therefore, it is difficult to attribute differences in market characteristics (such as transaction costs) to financial reporting differences among firms in different disclosure classes.

Several types of evidence would be relevant to the policy debate. Evidence on the characteristics of companies that choose to list, and companies that choose not to list, in U.S. equity markets is potentially relevant for ad-

ressing market quality issues because it would provide insight into the benefits to U.S. investors of having firms listed on U.S. exchanges which are deterred from registering under current requirements. For example, current requirements may exclude certain industries or geographic regions and, thus, limit low-cost access by U.S. investors to entire classes of securities. An observation that such firms have substantial U.S. investor following, despite not registering with the SEC, would suggest that there are no close substitutes among firms currently registered in the U.S.

Evidence on which foreign companies list in U.S. equity markets may also provide insight into what is attractive about U.S. markets. Foreign companies might be attracted to U.S. markets because U.S. markets are considered to be of high quality (e.g., see Grundfest 1990). If lowering disclosure standards impairs the perceived quality of U.S. markets, then they may be less attractive to foreign companies, creating an adverse effect on actual market quality. A related issue concerns the influence of perceived market quality on investor confidence. Relaxed disclosure requirements might lower investors' confidence in the market. These investors may become less active, thus reducing market liquidity.

Additional comparative evidence on financial reporting and disclosure practices, transaction costs, liquidity and trading opportunities worldwide would also be useful in the policy debate. Current U.S. regulatory policy assumes that full disclosure, transparent financial reporting and vigorous enforcement enhance market efficiency, fairness and liquidity (e.g., Breeden 1994). However, there is little empirical evidence for determining whether the present disclosure policies are

²⁸ This reasoning assumes that the additional disclosures required by the SEC are useful.

²⁹ Disclosure classes include Form 20-F filers (Item 17 and Item 18), eligible Canadian issuers filing Form 40-F under the Exchange Act using the MJDS, issuers exempt from Exchange Act reporting under Rule 12g3-2(a) and issuers exempt under Rule 12g3-2(b). For discussion, see SEC (1995b).

near the optimum.³⁰ Early research in this area includes Alford and Jones (1995), which analyzes share liquidity and other equity and information characteristics of a sample of NASDAQ-traded U.S. firms, foreign firms filing Forms 20-F and foreign firms exempt from registration under the Exchange Act. The study finds no evidence of significant differences in bid-ask spreads across the three classes of securities. There is some basis for the claims of Breeden (1994) and others that U.S. capital markets are the most liquid in the world, but this may result from deficiencies in non-U.S. markets, and does not mean that U.S. markets cannot be substantially improved.³¹

Question 8: Are global equity markets informationally efficient?

In informationally efficient global equity markets, information disclosed in one location is immediately reflected in equity market prices worldwide.³² Evidence on global efficiency may be relevant for considering what information disclosed in the home market should also be directly disclosed in the U.S.

The SEC currently requires that both Form 20-F filers and firms electing the information-supplying exemption (under Rule 12g3-2(b)) disclose, in the U.S., any material information disclosed in their home market or other markets where their equities trade. However, if global equity markets are informationally efficient, these conformity-of-disclosure requirements might not be necessary for U.S. investors.³³ Also, recent evidence indicates substantial noncompliance by foreign issuers with SEC conformity-of-disclosure requirements, suggesting that, at least for some issuers, compliance costs are material.³⁴ Therefore, relaxing these rules may reduce disclosure costs for some foreign issuers, with minimal adverse effects on investor protection.

Question 9: What do some recent developments in global equity markets imply for the effectiveness of SEC's current rules?

Recent trends in world equity markets have important implications for how the SEC might best achieve its objectives. These trends

include technological progress, internationalization and the increasingly dominant role of institutional investors.³⁵ Some commentators predict that the SEC's traditional approach to promulgating rules will probably not survive, since market participants who object to SEC rules will increasingly find non-SEC-regulated substitute markets at reasonable cost (e.g., Grundfest 1992). Furthermore, if U.S. institutional investors and non-U.S. companies increasingly use overseas equity markets because of dissatisfaction with SEC regulation, the access of U.S. investors to investment opportunities and the liquidity of U.S. equity markets may be impaired. However, empirical research is just beginning to address such important issues as the extent to which U.S. institutional and retail investors trade in overseas equity markets, the financial information available in those markets and equity market characteristics worldwide.³⁶

³⁰ In fact, The London Business School (1995, sect. 4) expresses the view that equity markets with the lowest regulatory burden attract the most business, and that the accommodating regulatory framework in the U.K. (in contrast to regulatory systems in the U.S. and Japan) has given the London financial center a competitive advantage.

³¹ See London Stock Exchange (1995), London Business School (1995) and Cochrane et al. (1995) for comparative evidence.

³² See Fama (1970) and Fama and Miller (1972) for discussions of market efficiency. Market efficiency ensures that U.S. stock prices reflect all information released worldwide so that investors can rely on prices as accurately reflecting value. However, U.S. investors may still be disadvantaged if they do not have timely access to information and, hence, can not earn trading profits from short-term mispricings at the time of information release.

³³ For example, Frost and Pownall (1995) report that the stock prices of non-U.S. firms listed in the U.S. respond significantly to earnings announcements released in the U.K. (before public release in the U.S.), consistent with either rapid worldwide dissemination of firm-specific news at the time of release in the U.K., or with U.S. stock prices impounding information released in the U.K. but not yet in the U.S. In addition, they do not observe a U.S. stock price response when these non-U.S. firms subsequently disclose the same news to U.S. capital market participants.

³⁴ See Frost and Pownall (1994a).

³⁵ See Scarlata (1993), Grundfest (1992), *The Economist* (1995b) and Frankel (1994) for discussion of these trends and implications for regulation.

³⁶ See Frankel (1994) for several relevant studies.

V. CONCLUSIONS

This paper discusses the debate over the SEC's financial reporting requirements for foreign issuers, emphasizing the question of whether quantitative U.S. GAAP reconciliations should continue to be required. Selected accounting research studies which provide relevant evidence are discussed, and suggestions for further research are presented.

Several conclusions can be based on the preceding discussion. First, the issue of SEC financial reporting requirements for foreign registrants is important, especially as the SEC is relaxing some requirements while requiring more companies to register under the Exchange Act. Second, while there is some rel-

evant research evidence, much remains to be done.

While most research to date has focused on the comparability of accounting data under different reporting systems, substantial questions remain largely unanswered, especially concerning such matters as International Accounting Standards. Research investigating the effects of SEC requirements on the functioning of capital markets (e.g., investor access, transaction costs, liquidity, etc.) is still in its infancy. Given the need and demand for such research, and the increasing availability of data, this is a very promising area for continuing work.

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