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Does eliminating the Form 20-F reconciliation from IFRS to U.S. GAAP have capital market consequences? ☆

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This paper investigates the capital market consequences of the SEC's decision to eliminate the reconciliation requirement for cross-listed companies following International Financial Reporting Standards (IFRS). We find no evidence that the elimination has a negative impact on firms' market liquidity or probability of informed trading (PIN). We also find no evidence of a significant impact on cost of equity, analyst forecasts, institutional ownership, stock price efficiency and synchronicity. Moreover, IFRS users do not increase disclosure frequency nor supply the reconciliation voluntarily. Our results do not support the argument that eliminating the reconciliation results in information loss or greater information asymmetry.

1. Introduction

On November 15, 2007, the Securities and Exchange Commission (SEC) voted to eliminate the requirement for foreign cross-listed firms to provide reconciliation to U.S. Generally Accepted Accounting Principles (GAAP) if they prepare their financial statements in accordance with International Financial Reporting Standards (IFRS).[1] The SEC's move is welcomed by the International Accounting Standards Board (IASB), foreign IFRS-reporting firms, and major U.S. stock exchanges (Norris, 2007). The rule change has not been without controversy, however. Perhaps the debate can be best illustrated by the different views expressed by two committees of the American Accounting Association (AAA) in their respective comment letters submitted to the SEC.

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[1] The SEC expects this change to help promote the use of IFRS and facilitate the move towards a single set of globally accepted accounting standards (SEC, 2007a). In addition, the SEC believes that eliminating the reconciliation will reduce information preparation costs and consequently encourage foreign companies to enter or remain in U.S. capital markets (SEC, 2007a).

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The AAA's Financial Accounting Standards Committee expresses strong support for the SEC's decision to end the reconciliation requirement (AAA, 2007a). Committee members argue that extant accounting research suggests that both IFRS and U.S. GAAP "meet a minimum quality threshold." Moreover, they argue there is evidence that financial reports prepared under IFRS are of similar quality relative to those under U.S. GAAP (e.g., Leuz, 2003; Bartov et al., 2005), thus the elimination is unlikely to lead to a loss of valuable information.

In contrast, the Financial Reporting Policy Committee of the Financial Accounting and Reporting Section of the AAA considers the elimination of the reconciliation requirement "premature" (AAA, 2007b). Committee members argue that there are substantial differences between U.S. GAAP and IFRS, as reflected in the reconciliation items, and that the reconciliation provides value-relevant information to investors (e.g., Harris and Muller, 1999; Chen and Sami, 2008; Henry et al., 2009; Gordon et al., 2009). Thus, valuable information will be lost as a result of the rule change to end the reconciliation requirement. Moreover, the quality of financial information depends not only on accounting standards, but also on implementation of standards and enforcement mechanisms (e.g., Ball, 2001; Ball et al., 2003). Even if IFRS constitute a set of high-quality standards, the resulting financial reports could be of low quality because of inconsistent implementation and enforcement practices in different countries.

In this study, we attempt to provide evidence on the capital market impact of eliminating the reconciliation to U.S. GAAP for cross-listed foreign companies following IFRS. Specifically, we examine the effects of eliminating the reconciliation on stock market liquidity and the probability of informed trading (PIN). If reconciliation information is rarely used by investors, and investors do not perceive cross-listed firms' accounting numbers based on IFRS to be of inferior quality relative to those based on U.S. GAAP, then eliminating the reconciliation is unlikely to have a negative impact on the liquidity and PIN of foreign cross-listed firms. Supportive of this view, some studies suggest that the usefulness of the reconciliation has declined or may even diminish by 2006 due to the increased convergence between IFRS and U.S. GAAP and the improvements of IFRS in recent years (e.g., Plumlee and Plumlee, 2007; Chen and Sami, 2010; Jiang et al. 2010). Many practitioners also consider reconciliation an unnecessary and expensive practice (Edwards, 1993; Dzinkowski, 2007).[2]

If, however, eliminating the reconciliation results in a loss of useful information to investors and increases information asymmetries among investors of foreign issuers' stocks, then we would expect a decrease in market liquidity and an increase in PIN, after companies stop providing the reconciliation. In addition, eliminating the reconciliation may reduce the comparability of financial statements issued by foreign cross-listed and U.S. domestic companies. This may discourage U.S. investors from trading IFRS-reporting firms' shares cross-listed in the U.S. If so, these firms' market liquidity and PIN would also suffer.

Our sample of IFRS firms consists of 78 foreign firms that are cross-listed in the U.S. and prepare their financial statements using IFRS in 2006 and 2007, with 2006 (2007) being the pre- (post-) elimination year.[3] Our control sample consists of 162 U.S. cross-listed firms that do not use IFRS. We use a difference-in-differences design by comparing changes in market liquidity and PIN for IFRS firms before and after the elimination, relative to the corresponding changes for control firms. We find no evidence that eliminating the reconciliation has a significant impact on liquidity as measured by zero returns, price impact, bid-ask spread, and trading costs. We also find no evidence that IFRS firms experience a significant change in PIN after the elimination. Overall, our evidence does not suggest that eliminating the Form 20-F reconciliation has significantly negative capital market consequences. We conduct a battery of sensitivity tests and find that our results are robust.

We next investigate the cross-sectional variation of the effects of eliminating the 20-F reconciliation. We partition the sample based on: (1) the magnitude of the absolute difference between IFRS and U.S. GAAP earnings prior to the elimination, a proxy for the degree of potential information loss resulting from the elimination; and (2) institutional ownership, a proxy for investor sophistication. We continue to find no significant impact of the elimination on liquidity and PIN across different partitions of the sample.

In addition to market liquidity and PIN, we also explore other potential consequences of the elimination of the 20-F reconciliation. We investigate and find no evidence that the elimination has a significant impact on the cost of equity, analysts' forecast error, bias, and dispersion, institutional ownership, and stock price efficiency and synchronicity.

While our main analysis focuses on how the *users* of the reconciliation (i.e., investors) respond to the elimination, we also investigate whether the *preparers* of the reconciliation (i.e., cross-listed IFRS users) respond to the elimination by changing their voluntary disclosures. We find that none of the IFRS firms continue to provide the reconciliation in Form 20-Fs after the elimination. In addition, we examine these firms' press releases, and find that they do not change the frequency of voluntary disclosures after the elimination. Our findings are consistent with firms not perceiving the

[2] According to Dzinkowski (2007), experts attending a SEC roundtable on the Roadmap to IFRS in early 2007 agree that most investors, analysts, and rating agencies do not rely on reconciliation; instead they use IFRS or local accounting standards in their decisions regarding international firms. Similar views can be found in the comment letters submitted to the SEC. For example, Merrill Lynch states that "for issuers preparing financial statements in accordance with IFRS, [the reconciliation] provides no meaningful benefits to investors." Allianz SE argues that the reconciliation "is not relevant to the needs of investors and analysts… Analysts now use locally issued IFRS financial statements to perform their evaluation of foreign private issuers."

[3] The SEC's rule of eliminating the 20-F reconciliation applies to financial statements ending after November 15, 2007. For ease of exposition, we refer to the last year prior to the rule change as 2006, and the first year after the rule change as 2007. Note, however, that for a firm with fiscal year ending between July 1 and November 15, 2007, the pre- (post-) elimination year is actually 2007 (2008), but is still referred to as year 2006 (2007) in the paper.