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ScienceDirect
The British Accounting Review 40 (2008) 103–122
The British Accounting Review
www.elsevier.com/locate/bar

Familiarity, home bias and investors' reactions to 20-F reconciliation gains and losses and perceptions of the quality of accounting principles

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Received 31 July 2006; received in revised form 30 November 2007

Abstract

This paper examines whether financial statements based on home GAAP (Generally Accepted Accounting Principles) (Irish GAAP), versus non-home GAAP (US GAAP), have differential effects on Irish investors' financial assessments of a firm. The paper also extends Maroney and Ó hÓgartaigh's (2005) study by investigating whether perceptions of US GAAP and Irish GAAP financial statements and the gains and losses represented in 20-F reconciliations differ between non-US (Irish) and US users of financial statements. The paper adopts an experimental method involving 105 non-US (Irish) participants and 49 US participants. The current study provides evidence that non-US investors react very differently to reconciliation gains and losses than do US investors. In fact, the non-US investors react conversely to US investors in that they perceive the risk of firms filing 20-F reconciliations with reconciliation losses to be lower, and the quality of accounting principles higher, than firms filing 20-F reconciliations with reconciliation gains. Our study also finds that the non-US participants were more confident in making their quality assessment for the home GAAP (Irish GAAP) financial statements than for the non-home GAAP (US GAAP) financial statements. However, despite this difference in confidence level, the financial assessments of the firm preparing home GAAP (Irish GAAP) financial statements versus non-home GAAP (US GAAP) financial statements were not significantly higher. Together, these results help to shed light on the cause of what has been termed a 'home bias' phenomenon, whereby domestic investors exhibit a strong preference for domestic versus foreign markets suggesting in particular that 'home bias' derives in part from an increased confidence in 'home GAAP'.

Keywords: Foreign registrants on US exchanges; Framing of 20-F reconciliations; Home bias; International GAAP

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0890-8389/$ - see front matter
doi:10.1016/j.bar.2008.01.001

1. Introduction

IFRS (International Financial Reporting Standards)/US GAAP (US Generally Accepted Accounting Principles) convergence is a key objective of international accounting standard-setters and regulators (including the US Securities and Exchange Commission (SEC)). In that context, prior to 15 November 2007, foreign registrants on US stock exchanges were required by the SEC to file financial statements prepared under US GAAP or, alternatively, if their financial statements did not comply with US GAAP, they were required to reconcile (by way of a '20-F reconciliation') those financial statements with US GAAP (with some exceptions if complying with International GAAP). From 15 November 2007, after "extensive and informative public comment", the "financial statements of foreign private issuers in the US will be accepted without reconciliation with US GAAP only if they are prepared using IFRS as issued by the IASB" (SEC, 2007a).[3] Furthermore, the SEC is currently considering whether to allow US issuers to prepare their financial statements in accordance with the IFRSs of the IASB instead of US GAAP (SEC, 2007b). The debate surrounding this decision has been accompanied by assertions regarding the superior 'quality' of US GAAP and its status as a benchmark or 'gold standard' of accounting principles, "since the US is a leader in accounting standard-setting" as summarized by Dye and Sunder (2001, p. 265).

Maroney and Ó hÓgartaigh (2005) find that US subjects perceive the risk of firms filing 20-F reconciliations with reconciliation losses to be higher, and the quality of accounting principles lower, than firms complying with US GAAP or filing 20-F reconciliations with reconciliation gains. Krishnamoorthy et al. (2008) extended Maroney and Ó hÓgartaigh (2005) to determine if identical information with respect to US GAAP is evaluated differently by US financial professionals depending on whether the information is presented in a positive (20-F reconciliation gain) or negative (20-F reconciliation loss) way. A primary purpose of this paper is to further extend Maroney and Ó hÓgartaigh (2005) to assess whether such perceptions of the quality of accounting principles for financial statements based on US GAAP carry across cultural and regulatory boundaries or, alternatively, whether they are constructs of their context. We do this by examining whether financial statements based on home GAAP (Irish GAAP), versus non-home GAAP (US GAAP), have differential effects on Irish investors' assessment of the quality of accounting principles of a firm and their confidence in making this assessment. The second primary purpose is to further examine investors' perceptions of a firm's risk, financial performance and quality of accounting principles based on financial statements prepared under different GAAPs by assessing whether the 20-F reconciliation required by the SEC had differential effects on these perceptions depending upon the direction of the items included in the 20-F reconciliation (gain or loss) and the national background of the users (US or non-US) of the financial statements.

Maroney and Ó hÓgartaigh (2005) involved only US investors. The decisions of US investors may be shaped by familiarity with US GAAP and the use of US GAAP as a benchmark against which earnings and stockholders' equity are assessed. Global and US equity markets are increasingly populated by international, non-homogeneous categories of investors. Thus, the present study extends the Maroney and Ó hÓgartaigh (2005) study to include the reactions of groups of non-US (i.e. Irish) investors to reconciliation gains and losses between Irish GAAP and US GAAP. Using the same experimental instrument for non-US subjects as that employed by Maroney and Ó hÓgartaigh (2005) for their US subjects, this paper assesses whether the negative reaction to 20-F reconciliation losses found in Maroney and Ó hÓgartaigh (2005) extends beyond the US context to non-US subjects and non-US GAAP.[4] The paper, as a result, examines the extent to which decisions by US and non-US investors may be shaped by familiarity with US GAAP and the use of US GAAP and non-US GAAP (or 'home GAAP') as a benchmark against which earnings and stockholders' equity are assessed.

[3] While the SEC's requirement that foreign registrants preparing their financial statements under International GAAP changed with immediate effect from 15 November 2007, the experimental data reported in this study were collected prior to that date when such reconciliations were still required. On that basis, 20-F reconciliations provide a useful setting for the study of familiarity, 'home bias' and perceptions of the quality of accounting principles. This study is particularly opportune therefore, as it takes place in a setting that may not be available for future research on the phenomena reported in this paper.

[4] The data for the US subjects were obtained from the Maroney and Ó hÓgartaigh (2005) study. All the data in this study, from US and Irish subjects, were collected prior to the SEC's announcement with regard to 20-F reconciliations on 15 November 2007 (SEC, 2007a).