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International accounting harmonization and global equity markets[1]

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Abstract

We show harmonizing domestic GAAP with foreign GAAP can have deleterious effects on security market performance, specifically price informativeness and trading volume. Harmonization effects result from interaction between two forces. Direct informational effects depend on whether harmonization increases or decreases GAAP precision. Expertise acquisition effects depend on benefits and costs to foreign investors of becoming domestic GAAP experts. These countervailing forces can result in harmonization to more (less) precise GAAP increasing (decreasing) or, unexpectedly, decreasing (increasing) price informativeness and trading volume. We also observe this for a cost of capital metric. Thus, harmonization is not necessarily a desirable singular goal.

JEL classification: D82; G15; M41

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1. Introduction

Generally accepted accounting principles (GAAP) vary across countries and currently efforts are underway by regulators of national securities markets to harmonize their country's GAAP with GAAP of other countries, potentially leading to the common application of International Accounting Standards. These efforts presumably reflect some regulators' beliefs that harmonizing their country's GAAP to GAAP of other countries will improve the performance of their national capital markets. Other regulators are concerned that if harmonization involves lowering the quality of their accounting standards, the performance of their equity market will decline. The objective of this paper is to investigate how harmonization affects securities market performance. We adopt an investor perspective on the effects of international accounting differences and seek to provide insights potentially relevant to regulators and accounting standard-setters who are concerned with effects of international accounting differences on equity markets.

We model country-specific GAAP systems as providing public reports of value-relevant information containing measurement error. Our model assumes traders are risk averse and, thus, have incentives to trade in the equity of both domestic and foreign firms. We operationalize harmonization as changes in domestic GAAP that reduce the variance of the difference between domestic and foreign GAAP applied to the same firm. Thus, changes in the precision of domestic GAAP and/or correlation between domestic and foreign GAAP can lead to harmonization. Although domestic traders are endowed with expertise in domestic GAAP that foreign traders do not possess, foreign traders can become experts in domestic GAAP at a cost that is decreasing in the extent of GAAP harmonization across the countries.

Because there is no widely agreed upon objective function for securities market regulators, we focus on various measures of securities market performance that are likely to be of interest to regulators. Specifically, we focus on the effects of harmonization on the informativeness of domestic stock prices about either firm value or information available in the economy and on domestic trading volume. Our various price informativeness measures are indicators that capture different dimensions of market performance that likely are relevant to regulators' goal of reducing market informational asymmetries, in part to reduce the cost of capital for new productive investments and in part to maintain a 'level playing field' for all investors, particularly those who are less informed and trade for liquidity reasons (see, e.g., Diamond and Verrecchia, 1991; Verrecchia, 1996). We study trading volume to explore the potential impact of accounting differences on the flow of equity trade across global markets.

Our model demonstrates that the effect of harmonizing accounting standards on market performance depends on the interaction between two important forces. First, harmonization can be accomplished by increasing or decreasing the