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Cross listing, bonding and firms' reporting incentives: A discussion of Lang, Raedy and Wilson (2006)☆

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Abstract

Lang, Raedy and Wilson (henceforth LRW) (2006) compare the properties of U.S. GAAP accounting numbers across cross-listed and U.S. firms. Using a wide range of properties, LRW show that accounting data are not comparable, even though sample firms use the same accounting standards. I discuss how these findings advance the literature and what they imply for the effectiveness of cross listing as a bonding mechanism. My discussion highlights that documented differences cannot be solely attributed to weak U.S. legal enforcement. I emphasize that accounting standards provide discretion and that cross-listed and U.S. firms are likely to have differential incentives to use this discretion. To illustrate, I document that cross-listed and U.S. firms differ in ownership concentration and that these differences are associated with the level of earnings management. I also provide evidence that home-country institutions continue to influence cross-listed firms' reporting behavior.

JEL classification: G15; G32; K22; M41; M43; M44

Keywords: Cross listing; Earnings quality; Enforcement; Ownership structure; Bonding; U.S. GAAP; Reconciliation

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1. Introduction

Concerns about the quality of foreign firms' financial statements have been a primary motivation for the SEC to require cross-listed firms to either provide U.S. GAAP financial statements or reconciliations of net income and shareholders' equity to U.S. GAAP (e.g., Breeden, 1994; Sutton, 1997). While this debate has sparked a fairly extensive literature on whether reconciliations are useful to investors (see Pownall and Schipper, 1999), there is little evidence on the (relative) quality of financial statements of foreign firms with cross listings on U.S. exchanges.

To address this gap, Lang, Raedy and Wilson (2006) (henceforth LRW) examine the properties of U.S. GAAP accounting numbers provided by cross-listed firms and compare them to those of U.S. firms. They analyze a wide range of important properties related to earnings management, timely loss recognition, and value relevance, given the difficulty in measuring accounting quality. The sample comprises firms from 34 countries with cross listings on NYSE, NASDAQ and AMEX, all of which require that firms file Form 20-F with the SEC and report reconciliations from home-country GAAP to U.S. GAAP. Matching this sample to U.S. firms by industry and sales growth (or alternatively size), LRW document that U.S. GAAP numbers of cross-listed firms are not comparable to those of their U.S. counterparts.

Accounting data for cross-listed firms exhibit more earnings management, less timely loss recognition, and lower value relevance than data for U.S. firms, despite the fact that both sets of companies use U.S. GAAP. In addition, LRW provide results suggesting that earnings quality is lower for cross-listed firms from countries with weaker local investor protection. They also show that the general thrust of their findings continues to hold for cross-listed firms that use U.S. GAAP in their local financial statements, although the differences to U.S. firms are smaller and less significant than for cross-listed firms providing merely U.S. GAAP reconciliations.

The question whether cross-listed firms provide accounting numbers that are comparable to those of U.S. firms and the authors' findings are interesting for (at least) three reasons. First, cross listing in the U.S. has been suggested as a mechanism by which firms from countries with weak legal institutions can subject themselves to stricter U.S. investor protection and thereby reassure outside investors (e.g., Coffee, 1999; Stulz, 1999). While there is evidence consistent with the notion of bonding, most of it is indirect.[1] Moreover, Licht (2003) and Siegel (2005) have questioned the effectiveness of U.S. securities regulation and SEC enforcement when it comes to foreign firms (see also Frost and Pownall, 1994). Given this debate, analyzing the impact of specific SEC requirements (such as GAAP reconciliations) is useful as this analysis may shed light on how well bonding works in practice. LRW view their study in this vein and highlight that weak SEC enforcement could be one explanation for their findings.

Second, while cross-listed firms have to follow the same accounting standards as U.S. firms, they continue to face different reporting incentives. That is, firms are still subject to different institutional arrangements and market forces in their home countries, which in turn provides managers and owners with differential incentives to use discretion when applying accounting standards. In exploiting this feature, LRW also contribute to the debate on the role of accounting standards for the quality of financial statements. Several recent studies

[1] See, e.g., Reese and Weisbach (2002) and Doidge et al. (2004). An exception is Doidge (2004).