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Are 20-F reconciliations between IAS and US-GAAP value-relevant? A discussion[1]

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Abstract

Harris and Muller (1998) present some interesting evidence on the market valuation of accounting numbers under IAS and US-GAAP. I view this evidence as a first step in contributing to the debate on whether foreign firms following IAS should be allowed to list in the US without providing 20-F reconciliations. In my discussion, I evaluate the contribution and limitations of the study and suggest some extensions. © 1999 Published by Elsevier Science B.V. All rights reserved.

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1. Introduction

Harris and Muller (1998) address two interesting questions. (i) Whether the 20-F reconciliations between International Accounting Standards (IAS) and US-GAAP financial statement numbers (i.e., earnings and book value) are

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value-relevant. (ii) Whether US-GAAP earnings and book value are more value-relevant than their IAS counterparts. To address these questions, Harris and Muller use a sample of foreign firms listed in the US that prepare their home country financial statements using IAS and provide reconciliations to US-GAAP through Form 20-F. They find that the Form 20-F reconciliations from IAS earnings to US-GAAP earnings are incrementally value-relevant. Evidence is inconclusive on the relative importance (for valuation) of US-GAAP and IAS accounting measures. The paper is timely especially because the SEC is considering a proposal that will allow foreign registrants to file financial statements prepared under IAS without any reconciliations.

2. Motivation

The research questions addressed in the paper stem from the controversy and the debate over the potentially imposing reporting requirements, i.e., the 20-F reconciliations, for foreign companies listed in the US. Prior research (see Amir et al. (1993), Barth and Clinch (1996) for examples) has contributed to this debate by examining the incremental value-relevance of the 20-F reconciliations between US-GAAP and foreign GAAP measures. In general, the 20-F research finds the reconciliations to be incrementally value-relevant.

Recently, the SEC in co-ordination with the International Accounting Standards Committee is considering a proposal that waives the 20-F reconciliation requirements for foreign firms that prepare financial statements under IAS. Whether the SEC should allow financial statements presented under IAS as an acceptable alternative has been a contentious issue. The debate revolves around the quality of IAS and how this proposal could affect the information environment for foreign firms relative to US firms. The authors motivate their research questions by arguing that prior 20-F reconciliation studies cannot be used to address this debate because IAS is viewed as being closer to US-GAAP than other foreign GAAPs.

To make an incremental contribution to other 20-F reconciliation studies, it is imperative to demonstrate that IAS is substantially different from foreign GAAPs (non-US) in terms of accounting measurement choices. If compliance with IAS is feasible even when a firm follows its domestic GAAP, then the authors are essentially using the reconciliation amounts between US-GAAP and foreign GAAP under the garb of reconciliation between US-GAAP and IAS. In countries such as Canada, France, Italy and Switzerland, firms may be able to follow their respective domestic GAAPs and still comply with IAS. Over 50% of the sample observations used in the study are from these countries. Therefore, without some evidence on what these firms would report based on their respective domestic GAAPs as opposed to IAS, it is difficult to judge the incremental contribution of this paper.

Evidence on the differences between foreign GAAP and IAS for firms listing in the US, will also be very useful in demonstrating whether the differences between IAS and US-GAAP are smaller when compared to differences between foreign GAAP and US-GAAP. Unfortunately, such an analysis may not be possible because foreign firms are not required to provide reconciliations from foreign GAAP to IAS. The descriptive statistics reported in this study provide preliminary evidence on the differences between US-GAAP, IAS and foreign GAAP. In particular, Harris and Muller find that the mean and standard deviation of the difference between US-GAAP and IAS earnings for their sample firms are smaller than the mean and standard deviation of the difference between foreign and US-GAAP reported in Amir et al. (1993).

3. The Evidence

3.1. Incremental value-relevance

To address whether 20-F reconciliations are incrementally value-relevant, Harris and Muller conduct two tests. (i) They regress the market value of equity and price-per-share on earnings and book value under IAS and the related US-GAAP reconciliation amounts (hereafter, levels regression). (ii) They regress stock returns on IAS earnings and earnings changes and include the reconciliation amount and its change as additional variables (hereafter, returns regression).

The evidence from levels regressions suggests that both IAS earnings and IAS book value are value-relevant. However, they find that the reconciliation amount for only IAS earnings is incrementally value-relevant in the market value regressions. Their tests also reveal that the US-GAAP earnings are priced higher than IAS earnings in the undeflated model. They interpret this evidence as consistent with the market interpreting US-GAAP earnings to be more persistent than IAS earnings. It is not obvious why US-GAAP earnings should be more persistent than IAS earnings. Perhaps, future research could shed light on this issue by examining the time-series properties of IAS earnings and US-GAAP earnings. While the issue of appropriate deflator to control for scale differences and heteroskedasticity is unresolved, the different result obtained in the price per share model highlights the importance of considering alternative deflators for examining the robustness of results from levels regressions.

The lack of significant coefficient estimates for book value adjustments are open to two interpretations. One, reconciliations in book value may be predictable based on past reconciliations resulting in dependence in observations over time and, inefficiencies in the pooled regressions. Two, conference participants suggested that only some components of the book value reconciliations may be value-relevant. Conference participants felt that such an analysis may be worthwhile because foreign firms that use IAS may be more inclined to drive the net reconciliation amount to be small. However, given the lack of a large sample size, component analysis may not be feasible, at least for now.

In the returns regression analysis, Harris and Muller find that both IAS earnings and earnings changes are value-irrelevant. Together, the earnings and earnings changes variables explain only 1.47% of the cross-sectional variation in returns. Based on this result, it is not clear what one can conclude about the importance of IAS variables for valuation. At one extreme, it is tempting to conclude that IAS earnings do not capture any of the value-relevant information impounded by market participants. However, it is more likely that the return window used in the study captures only part of the time period for which the IAS earnings information pertains to. Harris and Muller use a 12-month window ending six months after the fiscal year end to coincide with the time period allowed for the filing of 20-F reconciliations. Because the study follows an 'association' approach as opposed to an 'information content' approach and market efficiency is assumed, perhaps the appropriate event window is twelve months ending with the fiscal year as opposed to six months following the fiscal year.

The inclusion of reconciliation variables in the returns regression estimation improves the explanatory power of the returns regression by about 16% and the earnings change variable, which was previously negative and insignificant, is now positive and statistically significant. This implies that IAS earnings are value-relevant only after conditioning on information contained in reconciliation amounts. In addition, one can also infer that US-GAAP earnings are incrementally value-relevant to IAS earnings. Taken together, the evidence from levels and returns regressions are broadly consistent with the value-relevance of reconciliation amounts. However, conference participants felt that (and the authors acknowledge that) the results do not imply that market participants use the 20-F reconciliation amounts in determining share prices or that such reconciliation is necessary. To assess the usefulness of the reconciliation amounts, short-window tests surrounding the 20-F filings are more appropriate. But, short window analysis has shortcomings of its own. Problems include (i) identifying the 20-F filing date and, (ii) determining the unexpected component in the reconciliations especially because of the long time period allowed for filing the reconciliations.

3.2. Relative value-relevance

Examining relative value-relevance is particularly useful in answering questions that relate to the choice among alternative measurement methods. Because the SEC is considering a proposal to waive the 20-F reconciliation requirements, it represents a choice between summary measurements based on

IAS and US-GAAP. Harris and Muller examine the relative value-relevance by investigating which set of accounting numbers, (i.e., IAS or US-GAAP) is more highly associated with stock prices and returns. The results are inconclusive. While the results from levels regressions suggest that neither IAS nor US-GAAP dominate one another, the results from returns regressions suggest that US-GAAP earnings are more highly associated with returns than IAS earnings. The result from returns regressions is not surprising given the lack of explanatory power of either IAS earnings or earnings changes in explaining returns.

4. Concluding remarks

Overall, the paper by Harris and Muller presents some interesting evidence on a very topical issue. However, as with other 'value-relevance' studies, it is difficult to draw any policy implications because evidence on incremental or relative value-relevance of 20-F reconciliations does not imply that investors use such reconciliation amounts or that they are necessary. Further, if reconciliation amounts are reflected in stock prices, it is reasonable to conjecture that such disclosures will be associated with information about future earnings. Perhaps, more direct tests of whether such reconciliation amounts help improve earnings' predictive ability or whether analysts revise their forecasts based on the reconciled numbers would be useful. Recent work by Ashbaugh and Pincus (1998) provides some evidence on this issue by documenting a significant improvement in analysts' forecast accuracy in the year following adoption of IAS. Nonetheless, documenting value-relevance can be considered a starting point for further inquiries on the usefulness of such reconciliation amounts.

Besides the reconciliation requirements for earnings and book value, some foreign registrants are required, as part of Form 20-F, to supply additional footnote disclosures, e.g., segment information. Even though such additional disclosures in Form 20-F are likely to be relevant to US investors, extant research has not examined this issue. Evidence on the 20-F reconciliations alone is insufficient to determine whether financial statements prepared in conformance with IAS are comparable to US-GAAP based financial statements. Hence, examining the value implications of additional disclosures included in Form 20-F may be an interesting area for future inquiry.

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