TESTIMONY OF

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Mr. Chairman, Members of the Subcommittee, good afternoon. I am Teri Yohn, Associate Professor of Accounting at Indiana University's Kelley School of Business. I appreciate the opportunity to appear before you today.

I have been asked to provide testimony on issues related to the international convergence of accounting standards and to the potential acceptance of the financial statements of foreign private issuers using international financial reporting standards (IFRS) without reconciliation of net income and shareholders' equity to U.S. generally accepted accounting principles (GAAP). Let me begin by saying that my views are primarily the result of an analysis of academic research on international accounting issues included in a comment letter submitted in response to the SEC's proposal to eliminate the required IFRS – U.S. GAAP reconciliation. The comment letter was prepared with Christine Botosan, Professor at University of Utah, and members of the

American Accounting Association's (AAA) Financial Accounting and Reporting Section's (FARS) Financial Reporting Policy Committee (FRPC), whose goal is to evaluate proposed accounting standards and reporting regulations and provide timely, substantive, and constructive written feedback that is grounded in relevant academic research.

As requested, my testimony will cover the following topics:

- the opportunities and challenges as the U.S. and international countries move toward convergence of IFRS with U.S. GAAP;
- the potential issues with the proposal to accept, in the filings of private issuers, financial statements prepared using IFRS without reconciliation to U.S. GAAP;
- the impact of these proposed efforts on stakeholders, including regulators, investors, auditors, and companies; and
- the differences that exist in the financial reporting results produced by U.S. GAAP compared to IFRS.

Because these four topics are interrelated, I will not address them separately. I will, instead, address the broad issues of the opportunities and challenges of international convergence of accounting standards and the potential issues related to the proposal to eliminate the 20-F reconciliation, including the potential impact of the reconciliation elimination on U.S. investors. I will conclude with a discussion of the competitiveness of the U.S. securities markets and the costs and benefits of foreign firms listing on the U.S. markets. Within these discussions, I will address the impact of the issues on stakeholders and the differences that exist between financial reporting results under IFRS versus U.S. GAAP.

In summary, my testimony that follows will provide evidence that, while the convergence of IFRS with U.S. GAAP is a worthwhile and beneficial goal, the elimination of the required IFRS - U.S. GAAP reconciliation is premature (at this point in time) and will cause U.S. investors to possess a significantly diminished set of relevant information for investment-related decision making.

Opportunities and Challenges of Convergence of IFRS and U.S. GAAP

It is my view that convergence of accounting standards is a laudable goal to which U.S. standard setters and regulators should strive. In general terms, the purpose of Regulation S-X is to provide U.S. investors with inter-temporally consistent information that is comparable across registrants, and internationally converged accounting standards will increase the comparability of financial information. The increased comparability will therefore, in the long run, allow investors to make improved investment decisions and/or reduce the cost of decision making. I note that some academics (Sunder 2002; Huddart, Hughes, and Brunnermeier 1999) argue that convergence may not the optimal solution for financial reporting and argue for competition among accounting standards across countries or markets. These academics argue that companies should be able to choose the accounting standard to adopt and that investors will gravitate to companies with preferred standards. In my opinion, this does not seem to be a realistic solution in that it reduces, rather than increases, comparability of financial information across companies and it assumes that investors are able to effectively evaluate the differential quality of standards. Even given this alternative scenario for financial reporting, I would argue that convergence of accounting standards is in the best interest of investors, companies and other stakeholders.

Convergence of standards is occurring through the joint standard-setting activities of the IASB and FASB, and academic evidence (Leuz 2003; Bartov, Goldberg and Kim 2005; and Daske 2006) suggests that IFRS appears to possess information attributes of a high quality set of standards. The research finds no significant difference in information asymmetries associated with or the value relevance of IFRS and U.S. GAAP for non-U.S. companies <u>in non-U.S. markets</u>. Therefore, it seems that most would agree that international convergence of accounting standards would be beneficial to the financial markets, that great strides have been taken in recent years in achieving convergence between U.S. GAAP and IFRS, and that both IFRS and U.S. GAAP reflect high quality standards.

An important issue that remains is whether it is possible to achieve "real" convergence in financial reporting across countries. Even while standard setters and regulators strive to attain international convergence of the codified set of rules and requirements, there is reason to question the feasibility of uniform financial reporting across international borders. Institutional differences between countries might well create differences in financial reporting practices even within an otherwise uniform set of standards. In addition, there is the concern that forced uniformity in accounting standards might mislead investors into thinking that financial reporting is uniform when it is not.

Research (Ball, Kothari and Robin 2001; Bushman and Piotroski 2006; Leuz, Nanda and Wysocki 2003; Ball, Robin and Wu 2003; and Henry, Lin and Yang 2007) has documented systematic differences in financial reporting outcomes (i.e., in terms of the timeliness and conservatism of reported earnings and earnings management) across countries based on legal origin (i.e., common versus code law), judicial system, enforcement system, risk of expropriation, equity market development, ownership structure, and investor protection. This area of research suggests that even if a uniform set of standards were adopted across countries, international differences in institutions could result in systematic cross-country differences in implementation of those standards.

Given the differences in economic and political forces across countries, enforcement of standards is also unlikely to be uniform. Like the FASB in the U.S., the IASB is an independent standard setter that does not have enforcement responsibilities. The U.S. has the reputation for providing the strictest enforcement of the securities markets; however, evidence on SEC enforcement of foreign firms cross-listed on U.S. markets suggests that enforcement remains an important issue even in U.S. markets. Research (Siegel 2005) has concluded that the SEC rarely acts effectively to enforce the law against cross-listed foreign firms. The academic studies also point out that there are legal and institutional obstacles to private litigators enforcing laws against cross-listed firms in the U.S. Therefore, while non-U.S. firms might have access to U.S. markets, they are not subject to the same scrutiny and oversight as U.S. firms. Consistent with this, research (Lang, Raedy and Wilson 2006) has documented that the reconciled earnings of non-U.S. firms listed on U.S. markets have characteristics that are more consistent with earnings management than earnings of U.S. firms. In addition, these results are more pronounced for firms from countries that are generally considered to have weaker local investor protection. This suggests that SEC oversight has not appeared to provide enough of a deterrent for non-U.S. firms and that the reconciled U.S. GAAP earnings are not comparable to U.S. GAAP earnings. These findings raise concern that even with U.S. GAAP reconciliations, there are underlying differences across financial reporting practices.

Academic evidence (Street and Gray 2002; Street and Bryant 2000; Glaum and Street 2003) also suggests that there is significant non-compliance with IFRS disclosure and measurement requirements and that the level of compliance is lower for IFRS than for U.S. GAAP firms. The research concludes that IFRS is less rigorously applied than U.S. GAAP and that cross-listing in the U.S. and being audited by a large firm can mitigate some of the non-compliance. These issues are important to consider because if there is no reliable enforcement mechanism and if implementation of standards varies widely in practice, then potential informational benefits of any high-quality set of reporting standards will be diminished. Taken together, the research discussed in the section also points to the likelihood that the SEC would become less effective if it was forced to monitor the financial reporting of foreign-private issuers that did not reconcile to U.S. GAAP.

The Proposal to Eliminate the IFRS - U.S. GAAP Reconciliation

Even given these challenges to achieving international convergence of financial reporting, it might be that the financial reporting outcomes of IFRS and U.S. GAAP are sufficiently similar to warrant elimination of the reconciliation Logically, any proposal to eliminate the 20-F reconciliation requirement must be based on the premise that U.S. GAAP and IFRS are informationally equivalent sets of accounting principles or that investors can reconstruct consistent and comparable U.S.-GAAP-based summary accounting measures from IFRS financial statements. Note that neither of these conditions is dependent on the quality of IFRS. IFRS may very well be a high quality set of accounting standards based on the properties of reported information and prices in other countries, but also fail to provide information that U.S. investors find most relevant for investing decisions.

While the IASB and FASB have been attempting to reduce the differences between IFRS and U.S. GAAP, academic studies (Henry, Lin ad Yang 2007) have documented that material reconciling items remain. An analysis (Henry, Lin and Yang 2007; Haverty 2006) of IFRS to U.S. GAAP 20-F reconciliations in 2004 and 2005 shows significant differences in net income and equity between IFRS and U.S. GAAP. In addition, the research documents that IFRS reported net income is higher on average than U.S. reported income, suggesting the existence of a systematic bias in the reconciling items.

The research (Henry, Lin and Yang 2007) also documents that the IFRS-U.S. GAAP reconciliation is value relevant and used by U.S. investors. That is, the income and equity reconciling items included in the reconciliation have been found to be incrementally informative for explaining stock prices, and the change in the income-reconciling amount has been found to be incrementally value relevant over the change in IFRS net income in explaining annual stock returns. In addition, a significant positive relation between the magnitude of the income-reconciling amount and abnormal trading volume has been documented (Chen and Sami 2007). These results suggest that U.S. investors use the IFRS-U.S. GAAP reconciliation and that elimination of the reconciliation could leave investors with less relevant information for making investing decisions.

In addition to suggesting that investors use the IFRS-U.S. GAAP reconciliation in making investment decisions, research (Bradshaw, Bushee and Miller 2004; Plumlee and Plumlee 2007) also suggests that U.S. investors prefer U.S. GAAP over IFRS or other foreign GAAPs. U.S. institutional investors appear to prefer to invest in non-U.S. firms whose accounting methods conform more closely to U.S. GAAP and, as evidenced by trading volume, U.S. investors appear to react more to earnings reported under U.S. GAAP than under IFRS or other foreign GAAP. The preference for U.S. GAAP and the greater trading activity related to U.S. GAAP might occur because U.S. GAAP familiarity reduces U.S. investors' information processing costs or because U.S. investors consider U.S. GAAP standards to be of higher quality. In either case, the results suggest that U.S. investors prefer U.S. GAAP over IFRS in making investment decisions. Together, these results suggest that while convergence is occurring, there are currently significant differences between IFRS and U.S. GAAP and that U.S. investors use the information in the 20-F reconciliation in making investment decisions. Therefore, U.S. investors do not appear to view IFRS and U.S. GAAP as substitutes.

Of course, the elimination of the reconciliation would not be problematic if investors could obtain the information necessary to determine the differences between IFRS and U.S. GAAP from information in the financial reports and if U.S. investors had the expertise to understand the differences between the two sets of standards. Without the reconciliation, it would be very difficult if not impossible for an accounting expert to reconstruct U.S. GAAP income and equity from IFRS-based financial statements and footnotes. In addition, at this point in time, U.S. investors do not have the necessary expertise in IFRS to understand the differences in financial reporting under IFRS versus U.S. GAAP. Universities are attempting to increase coverage of IFRS in their curricula; however, they are far from fully integrating international standards into the courses and accounting programs and are still attempting to determine the best way to do so. Thus, given the substantial differences that exist between IFRS and U.S. GAAP, U.S. investors must have an understanding of the two sets of standards. They do not.

In addition, if the reconciliation is eliminated for a subset of firms that participate in U.S. capital markets, it might lead U.S.–based companies to request permission to use IFRS instead of U.S. GAAP. At this point in time, it does not appear that U.S. stakeholders, including companies, auditors, analysts and investors, have sufficient expertise in IFRS to allow this to happen. For example, recent conversations with top executives from the largest auditing firms reveals that one of their biggest concerns is the lack of current expertise in IFRS within their domestic professional staff. This suggests that even our most expert stakeholders in the U.S. capital markets (i.e., auditors) recognize the continuing convergence of worldwide accounting standards but that that they do not yet possess sufficient IFRS-related expertise within domestic offices.

The existence of significant reconciling items, the value relevance and use of the reconciliations by U.S. investors, the preference for U.S. GAAP over IFRS by U.S. investors, the lack of expertise in IFRS by auditors and analysts, and the work that still needs to be done to incorporate IFRS into accounting education suggest that elimination of the 20-F reconciliation for IFRS-reporting foreign private issuers is premature. It would perhaps be prudent to revisit the issue of the reconciling items and the use of the reconciliation by U.S. investors on a regular basis. In my opinion, it would be appropriate to consider eliminating the reconciliation when the reconciling items are immaterial and when U.S. investors appear to view IFRS and U.S. GAAP to be informationally equivalent. Without informationally equivalent standards or the reconciliation, it is essential that investors be proficient in IFRS and that the necessary information is available to create U.S. GAAP comparable income and equity measures. Neither of these criteria hold at this point in time.

<u>The Competitiveness of U.S. Markets</u>

I note that the above discussion focused on the benefits of the reconciliation to U.S. investors. It did not address the costs of the reconciliation to the companies cross-listed on the U.S. markets. A concern exists that the U.S. markets are losing their competitiveness because of the onerous reporting requirements and that eliminating the reconciliation could help to reduce these costs. Central to this concern is the issue of whether the costs are so significant as to effectively offset or exceed the benefits received from registration in the U.S. securities markets.

Research has addressed the issue of the net benefits of foreign firms listing on U.S. markets and the issue of whether the U.S. has lost its competitiveness with respect to the securities markets. The research (Reese and Weisbach 2002; Lins, Strickland, and Zenner 2005) suggests that listing on U.S. markets improves access to capital, especially for emerging market firms. Research (Doidge 2004; Doidge, Karolyi and Stulz 2004) also suggests that listing on U.S. markets provides greater investor protection and results in a premium for firms that list in the U.S. Specifically, cross-listed firms appear to be valued higher than foreign firms that do not list in the U.S. and the magnitude of the premium appears to be negatively associated with the level of home-country investor protection. The academic evidence (Lang, Raedy and Yetman 2003) also suggests that listing in the U.S. provides improved financial reporting quality to shareholders and that cross-listed firms are less aggressive in terms of earnings management, convey bad news in a more timely fashion, and have earnings that are more strongly associated with share price. In addition, research (Baker, Nofsinger and Weaver 2002; Lang, Lins and Miller 2003) finds that when non-U.S. firms cross-list in the U.S., their information environment improves. Firms that cross-list on U.S. exchanges have greater analyst coverage and forecast accuracy compared to firms that are not cross-listed. Accordingly, the research concludes that cross-listing improves the firm's information environment, which yields a higher stock valuation.

These studies all suggest that there are important benefits to listing in the U.S.; however, some have expressed concerns as to whether the U.S. has lost its competitiveness because of the significant costs of complying with SEC requirements and that the benefits of listing in the U.S. are offset by the costs. Research (Doidge, Karolyi, and Stulz 2007) has investigated the accepted wisdom that the decrease in flow of new listings in New York and the increase in flow of new listings in London is evidence that New York has become less popular due to the passage of the

Sarbanes-Oxley Act of 2002 (SOX). While the three major New York exchanges have not experienced changes in market share in recent years, London's share has increased. The research suggests that growth in the London exchange relative to the U.S. exchanges is explained by the changing mix of firms seeking cross-listing. The research documents no significant change in the characteristics of firms listing on U.S. markets since the adoption of SOX, and that the firms that cross-list on London exchange tend to be small and unlikely candidates to cross-list on U.S. markets. In addition, cross-listing on a U.S. exchange appears to result in a valuation premium, which has not declined over time, while cross-listing in London results in no premium. Based on these results, the authors conclude that SOX has not eroded the benefits of listing on a U.S. exchange and the benefits cannot be replicated through a London listing.

In summary, extant research suggests that cross-listing in the U.S. market improves access to capital, increases investor protection, and improves the firm's information environment. The implications for firm value are both direct and indirect. Firm value is enhanced directly because improved shareholder protection lowers the expected wealth transfers and is enhanced indirectly because improved access to capital allows managers to undertake more positive net present value projects. The evidence suggests that these benefits are greatest for firms domiciled in emerging markets and/or in countries with weak shareholder protection. Finally, the extant evidence suggests that SOX has not eroded the benefits of listing on a U.S. exchange, and that the benefits offered by such a listing are unique to the U.S.

Conclusion

While convergence is a laudable goal to which U.S. standard setters and regulators should strive, at this time the academic literature <u>does not</u> support the SEC's proposal to eliminate the U.S. GAAP – IFRS reconciliation requirement for foreign private issuers. While research on IFRS versus U.S. GAAP for non-U.S. companies in non-U.S. investment markets finds no significant difference in the value relevance or levels of information asymmetries between the two sets of standards in foreign markets, the research on the IFRS - U.S. GAAP reconciliation suggests that material differences between IFRS and U.S. GAAP exist and that information contained in the reconciliations are reflected in investment decisions made by U.S. investors. Until greater convergence is achieved, eliminating the reconciliation runs the risk of diminishing the relevant information set available to U.S. investors. However, the FASB and IASB continue to work jointly to achieve greater convergence. As a consequence, the importance of the reconciliation should diminish through the ongoing joint standard-setting efforts. Over time, standard setters and regulators should periodically revisit the question of the materiality of the reconciling items and the usefulness of the reconciliation to U.S. investors. When the difference between the two sets of standards becomes immaterial and when the reconciliation is no longer useful to U.S. investors, the SEC should reconsider eliminating the reconciliation requirement. However, we are not currently at that point. Thus, in the meantime, it will be important for the U.S. to focus on educating stakeholders, including auditors, investors, analysts and companies, on IFRS.

Deferring the elimination of the IFRS – U.S. GAAP reconciliation will also allow regulators to address some of the major challenges of convergence. Specifically, differences in the implementation of uniform standards across countries and issues with respect to compliance to the standards by foreign firms are important concerns that deserve attention. Whether the reconciliation requirement reduces the implementation differences and compliance issues remains an open question. However, before eliminating the reconciliation, the SEC should attempt to understand the role of the reconciliation in mitigating these issues.

While the costs of the reconciliation and of listing on the U.S. exchanges has been a concern, research suggests that foreign firms that list on U.S. exchanges benefit from greater access to capital and a richer information environment. In addition, U.S. requirements, including Sarbanes-Oxley-related reporting, do not appear to make the U.S. market less attractive to foreign firms.

Based on this evidence, I conclude that the elimination of the IFRS - U.S. GAAP reconciliation requirement is premature. Until the U.S. is willing either to adopt IFRS, or to require U.S. firms to reconcile to IFRS, elimination of the reconciliations will reduce comparability while significant differences in financial reporting remain.

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