ACCOUNTING AND REGULATORY ISSUES

The Economic Consequences of Increased Disclosure

Christian Leuz and Robert E. Verrecchia
Journal of Accounting Research
vol. 38, Supplement (2000):91–124

Companies can voluntarily adopt international accounting standards for international reporting, whether in addition to or sometimes instead of their domestic standards. International reporting standards typically require increased levels of disclosure, which is likely to be valued by investors. Significant reductions in bid–ask spreads and increases in daily turnover result from voluntary adoptions. These changes should lead to a reduction in the company's cost of capital.

Companies often have a choice in the selection of their international reporting regime. For example, an international company may adopt International Accounting Standards (IAS) or U.S. Generally Accepted Accounting Principles (U.S. GAAP) rather than its domestic GAAP. Compared with the accounting standards of most countries, a switch to IAS or U.S. GAAP mandates a significant increase in disclosure levels. Furthermore, most research suggests that *increases* in disclosure increase the overall *quality* of disclosure. If that hypothesis is true, then the voluntary commitment of a company to greater disclosure should lower the cost of capital arising from information asymmetries between the company and its shareholders. The rationale for this reduction is that greater disclosure should decrease adverse selection, thus increasing liquidity and leading to a decrease in the cost of capital.

Christian Leuz and Robert E. Verrecchia are at the University of Pennsylvania. The summary was prepared by William H. Sackley, CFA, University of North Carolina at Wilmington.

The authors examine German companies that switched from German GAAP to either IAS or U.S. GAAP to determine whether reductions in the bid–ask spread, increases in turnover, or decreases in price volatility occur in a manner that can be attributed to the voluntary decision to increase disclosure. Previous studies have reported insignificant changes in bid–ask spreads, turnover, and volatility. The previous research, however, focused on companies with securities already registered in the United States. As such, their level and quality of disclosure was already high, and any voluntary change in reporting regime may have provided little in the way of additional disclosure.

The bid–ask spread provides a direct measure of the information asymmetry between a company and its shareholders. As additional information is disclosed, adverse selection will diminish and bid–ask spreads should be tighter. Trading volume is a reflection of the liquidity surrounding the investment. Once again, greater disclosure should reduce adverse selection and thus provide greater liquidity. Price volatility also can reflect adverse selection, although volatility is also affected by many additional factors.

The results indicate that the choice of an international reporting strategy reduces the bid–ask spread by an average of 35 percent in the sample of German companies. Daily turnover in shares increases by 50 percent for German companies voluntarily switching to an international reporting strategy. Only the price volatility proxy for cost of capital is unaffected overall by the selection of an international reporting strategy. Companies within the sample that were less frequently traded actually witnessed an increase in price volatility.

The results are tested for robustness by controlling for a number of company characteristics, including performance, company size, and foreign listings. The choice of IAS or U.S. GAAP does not affect the results among those companies that selected an international reporting strategy. The authors note that this finding strongly suggests that what matters is the commitment to disclosure, not the particular standard chosen for the disclosure. Companies making a voluntary decision to provide greater levels of disclosure experience increases in liquidity that should lead to a reduction in the cost of capital.

Keywords: Corporate Finance; Financial Statement Analysis: accounting and financial reporting issues

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