Accounting Procedures Act Changing How Foreign Firms Converge Toward U.S. Regulations, Study Finds

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Finance research has demonstrated that in the global economy, non-U.S. firms benefit from convergence toward U.S. market and legal regulations. University of Arkansas researchers have examined the relative advantages of the two convergence methods - cross-listing and acquisition by a U.S. firm - and determined that passage of the 2002 Sarbanes-Oxley Act, which tightened reporting and accounting procedures in response to major corporate scandals, is changing the way foreign firms converge.

"Convergence is much more than opening an office in the United States or gaining a share of the U.S. consumer market," said Tomas Jandik, associate professor of finance in the Sam M. Walton College of Business. "It really has more to do with greater access to U.S. capital markets. Foreign companies want to attract more investors and shareholders, and the way to do that is to make themselves subject to superior corporate governance and disclosure requirements. In effect, by cross-listing or getting acquired by a U.S. firm, non-U.S. firms are 'renting' U.S. regulations."

Non U.S. firms cross-list by registering with a U.S. exchange, such as the New York Stock Exchange or Nasdaq, while remaining an independent company in their home country. As Jandik mentioned, it is advantageous for these companies to cross-list because they are held to a higher standard of accountability and thus are viewed to provide superior

investment opportunities at lower risk.

Jandik and Dobrina Georgieva, a Walton College graduate student, studied 188 foreign companies that cross-listed and 109 that were acquired during the period of 1999 to 2004. They found that firms from countries with legal systems based on civil law were more likely to cross-list than be acquired by a U.S. firm. On the other hand, companies high in capital and those with lower growth opportunities - firms more likely to be located in countries with legal systems based on common law - tended to get acquired. In global finance, the distinction between legal systems is important because common-law is generally regarded as stronger and more efficient in protecting shareholder interests.

"Countries differ in terms of shareholder and creditor rights, judicial efficiency, liquidity of capital markets and the extent of accounting disclosure," Jandik said. "In general, countries based on Anglo-American common law provide stronger investor protection, better enforcement of law and stricter disclosure requirements. They are also associated with bigger, more liquid capital markets. Consequently, firms from civil-law companies have more to gain by cross-listing, despite its associated costs."

However, adoption of the Sarbanes-Oxley Act has caused an apparent shift in the way foreign companies pursue convergence toward U.S. standards, Jandik found. A significant and perhaps unintended consequence of the law is that its more rigorous standards created obstacles to foreign firms wanting to cross-list. Their study demonstrates that adoption of the law has led to an increase in the propensity of firms from civil-law countries to seek convergence though acquisition.

"This is consistent with increases in costs of compliance with U.S. regulations after the passage of Sarbanes-Oxley," Jandik said. "Previous finance research has already shown that listing rates of foreign firms

have decreased since the act was passed, and some companies have threatened to de-list. We find that this decline in cross-listing activities might have actually led to an increase in the frequency of cross-border takeovers. Acquisition by a U.S. bidder brings foreign assets 'under the roof' of an established U.S. corporation. It thus allows foreign entities to reap benefits associated with being subject to strict U.S. laws and regulations - without the substantial costs of compliance with Sarbanes-Oxley provisions that firms cross-listing independently are forced to incur."

Conversely, Jandik and Georgieva also found that firms from common-law countries with greater capital needs tended to cross-list more after the passage of Sarbanes-Oxley in 2002. Therefore, it appears that the legislation may generate extra benefits for firms needing access to capital.

The researchers go one step further by suggesting optimal convergence choices for foreign firms. They discovered economic losses by foreign and U.S. firms when the foreign firms acted counter to the above trend. In other words, in situations that suggested acquisition as the optimal route of access to U.S. market and regulations, U.S. and foreign firms suffered economically by cross-listing. On other hand, firms that followed the anticipated route, based on their model of trends following the enactment of Sarbanes Oxley, experienced better economic performance.

"Overall, these findings show which firms should list on their own and which should be acquired," Jandik said.

Jandik will discuss their findings at the 2007 Financial Management Association Annual Meeting Oct. 17-20 in Orlando, Fla.

Source: University of Arkansas

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