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The Role of Financial Reporting in Reducing Financial Risks in the Market

S. P. Kothari*

Increased globalization of financial and product markets has raised the interest of both market participants and regulators in the quality of financial reporting worldwide. The rise in the volatility of stock returns across the globe in the past couple of years has also been a concern. Could greater transparency in financial statement information reduce volatility and produce more accurate stock valuations? Could more transparent financial statements of financial services firms (for example, banks) improve lending and credit evaluation decisions and contain the risks of a banking crisis? These issues are of central interest to all market participants and, in particular, to the U.S. Securities and Exchange Commission (SEC). The SEC is now considering whether to allow foreign corporations desirous of listing and raising capital in the United States to provide accounting reports prepared according to International Accounting Standards (IAS) instead of U.S. Generally Accepted Accounting Principles (GAAP).

Greater openness to international accounting standards and other foreign GAAP would reduce the costs to foreign firms seeking to list their stocks on the U.S. exchanges and raise capital here. This would enhance the competitiveness of the U.S. capital market, thus enabling it to attract a greater share of the global market for financial services. The trade-off is the risk that IAS or foreign GAAP disclosures might be of low quality, which potentially could weaken the stability of U.S. financial markets. Increased risk would make the U.S. capital market less attractive to

*Gordon Y Billard Professor of Accounting, Sloan School of Management, Massachusetts Institute of Technology.

investors, domestic and foreign alike, and also contribute to greater risk in financial markets globally.

In this paper I summarize the theoretical and empirical literature on the effects of disclosure of financial information on the risks of financial markets. Market participants seek high-quality financial information because it mitigates information asymmetry between the management of the firm and outside investors. Reduced information asymmetry has desirable effects on the cost of capital and the volatility of security prices. These benefits motivate regulators around the world to strive for high-quality accounting standards. The quality of reported financial information, however, is influenced not simply by the quality of accounting standards, but also by other institutional factors that affect the demand for and the supply of financial information. The salient institutional factors are the nature of corporate governance (diffuse shareholder model versus concentrated ownership, stakeholder model), the legal system, and the existence and enforcement of laws governing investor protection and disclosure standards.

Demand, and therefore supply, of quality financial information will be high if corporations are best described as owned by widely dispersed, individually atomistic shareholders. High-quality investor protection laws, good enforcement of these laws, and a common-law legal system collectively are conducive to diffusely owned corporations. Under these circumstances, regardless of whether the quality of financial reporting standards is high, disclosed financial statement numbers will be of a high quality. Cross-sectional variation is likely to exist in the demand for the quality of accounting information as a function of the nature of a firm's investments, financing, and operating activities. For this reason, I would expect cross-sectional variation in the quality of reported financial information but, overall, high-quality financial information will be available to market participants.

In contrast, corporations in countries with weak investor protection laws or countries with a weak law enforcement environment find it too costly to raise external finance from individually small, but collectively large debt and equity investors. Corporations tend to exhibit concentrated ownership by families and banks, and government agencies and labor unions typically play an important role in corporate governance. Often these countries also have a legal system with civil-law origins. In such an institutional setup, a stakeholder corporate governance model is more likely, placing less demand on high-quality, timely financial information, because internal communication among the stakeholders and the management resolves much of the information asymmetry. Reported financial statement numbers exhibit properties consistent with the prediction of the above analysis.

The next section defines disclosure quality and summarizes the effects of accounting standards and institutional factors on the variation

in the quality of financial reporting we observe internationally. Following is a discussion of the influence of investor protection laws and law enforcement on the nature of corporate governance and the quality of financial reporting. The final section lays out the implications for policy-makers and provides a summary of the paper.

Variation in the Quality of Financial Reporting

This section begins by defining disclosure quality. Accounting standards and the enforcement of those standards affect the quality of disclosed financial statement numbers. I will focus only on the standards. I discuss the costs and benefits of disclosure, which affect the demand and supply of disclosure. I conclude with a discussion of cross-country variation in the costs and benefits of disclosure, caused in part by such differences in institutional factors as the code-law and common-law legal systems.

Disclosure Quality

There appears to be near unanimity among regulators and investors in their demand for high-quality financial reporting, because of the widespread belief that the quality of financial reporting directly affects capital markets. Arthur Levitt (1998, p. 80), Chairman of the SEC, says, "I firmly believe that the success of capital is directly dependent on the quality of accounting and disclosure systems. Disclosure systems that are founded on high-quality standards give investors confidence in the credibility of financial reporting—and without investor confidence, markets cannot thrive."

While "quality" of accounting information and "transparency" of a disclosure system or accounting standards are commonly and interchangeably used terms, a precise definition of quality or transparency that everyone agrees on has been elusive. Pownall and Schipper (1999, p. 262) define transparency as "standards that reveal the events, transactions, judgments, and estimates underlying the financial statements, and their implications." Levitt (1998, p. 80) defines good accounting standards as those that "produce financial statements that report events in the periods in which they occur, not before, and not after."

Ball, Kothari, and Robin (2000) and Ball, Robin, and Wu (1999) interpret transparency as a combination of the properties of timeliness and conservatism. Timeliness is the extent to which current-period financials incorporate current-period economic events, and conservatism is the greater speed with which financials reflect economic bad news than good news. The latter definition seeks to take into account management's asymmetric incentives such that its reporting of good news is not credible, but bad news reporting is credible. Notwithstanding the differ-

ences, a large overlap exists in the various definitions of quality and transparency of accounting information.

Quality of Standards versus the Quality of Reported Accounting Numbers

The quality of financial information users receive is a function of both the quality of (accounting) standards governing the disclosure of accounting information and the regulatory enforcement or corporate application of the standards in an economy. (The importance of this distinction will become apparent in the following sections.) Below, I first discuss the costs and benefits of high-quality standards, assuming complete enforcement or faithful application of the standards. Later on, I relax this assumption and examine the consequences of weak enforcement and poor protection of shareholders' rights.

Benefits of Disclosure

Benefits from financial disclosure explain the demand for high-quality accounting standards and disclosure systems. The theoretical literature shows that both mandated and voluntary disclosures reduce information asymmetries among informed and uninformed market participants (see Diamond and Verrecchia 1991). Reduced information asymmetry lowers (the information asymmetry component of) the cost of capital by shrinking bid-ask spreads, enhancing trading volume, and diminishing stock-return volatility (see Leuz and Verrecchia 2000). A link between all three of these effects and the cost of capital is developed theoretically and empirically in Stoll (1978), Glosten and Milgrom (1985), Admati and Pfleiderer (1988), and Amihud and Mendelson (1986 and 1989). Regulators appear to embrace the conclusion, notwithstanding the fact that empirical evidence on the effect of disclosure on the cost of capital is quite modest. Levitt (1998, p. 82) states, "The truth is, high standards lower the cost of capital. And that's a goal we share." Reduced information asymmetry is also consistent with another stated objective of regulatory bodies like the SEC—to level the playing field and thus protect investors.[1]

Costs of Disclosure

Despite the clear benefits from increased disclosure, a corner solution of maximum disclosure is not observed because of potential costs of

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[1] Improved disclosure is also argued to sharpen market participants' understanding of the costs and benefits of alternative investment opportunities and thus channel scarce capital to the most promising opportunities. This improvement in allocation efficiency can be interpreted as another manifestation of reduced cost of capital.

disclosure, which include direct costs, litigation costs, and proprietary costs. Disclosure entails direct costs. Disclosure of news about improved prospects that are uncertain and unverifiable at the time of disclosure exposes a firm to potential litigation, should the eventual outcome be unfavorable. Finally, because of the proprietary nature of information, disclosure can be competitively disadvantageous. For all these reasons, an interior solution to disclosure is optimal.

Diversity in Disclosure Quality: Variation in the Costs and Benefits of Disclosure[2]

Internationally, there is diversity in accounting standards and, therefore, in the properties of financial statement numbers. Ball, Kothari, and Robin (2000) hypothesize that international differences in legal and institutional factors contribute to differences in the demand for accounting information, and this causes predictable international variability in accounting standards and the properties of accounting numbers.

The legal and institutional factors are related to whether the country has a code-law or a common-law system in place, which also affects corporate forms and corporate governance mechanisms in those countries (also see LaPorta, Lopez-de-Silanes, Shleifer, and Vishny 1997). The Romans introduced code law, also referred to as civil law, and it has undergone German, Scandinavian, and French adaptations. Countries with code-law systems typically exert high political influence on accounting standard-setting and accounting practices. For example, Japan's Business Accounting Deliberation Council (which advises the Ministry of Finance) promulgates code-law accounting standards. The code prescribes regulations ranging from abstract principles to detailed procedures with respect to the application of accounting standards. The government enforces the code law, and criminal penalties can be assessed for code-law violation.

Common law has English origins. It differs from code law in that common law evolves in the private sector through legal precedents and practices that become generally accepted and assume the status of a law. Accounting standards in a common-law regime arise in an accounting market, not in government. The contracting demands in an economy influence the evolution of the common-law disclosure standards. Common law is enforced privately, through civil litigation.

The role of code law is not limited to its influence on accounting standards; it also affects the corporate governance model that has evolved simultaneously with accounting standards and disclosure systems in

[2] This subsection draws heavily from Ball, Kothari, and Robin (2000) and essentially summarizes their sections 1 and 4.

these countries. Ball, Kothari, and Robin (2000) argue that in code-law countries, a "stakeholder" governance model is likely to be observed, with shareholders, managers and employees, the government, and banks (as shareholders or debtholders) as major stakeholders. In the stakeholder governance model, demand for public disclosure of (accounting) information is diminished because the stakeholders' agents participate in corporate governance. The agents are generally informed because of their access to inside information. This solves much of the information asymmetry problem that typically arises because of the superior knowledge of a firm's managers vis-à-vis other claimholders. While the demand for public disclosure is reduced, financial statement numbers in a stakeholder governance system are likely influenced by the payout preferences of the agents for labor, capital, and government. In particular, greater earnings smoothing and earnings management can be expected. The latter demand arises in part because stakeholders, in particular managers and employees, may hold a relatively undiversified portfolio.

In common-law countries, a "shareholder" governance model is more likely. In this model, diffuse ownership and a separation of ownership from control are frequently encountered. Management and the board of directors generally are not large blockholders of debt or equity, so they represent management without large ownership. Moreover, employees and the government also do not have large ownership stakes and are rarely represented on the board. This creates a demand for timely public disclosure of financial information, to mitigate the information asymmetry between managers and current and potential owners and for monitoring the performance of the managers.

Ball, Kothari, and Robin (2000) present evidence from 25 common-law and code-law countries from 1985 to 1995 for over 40,000 firm-years. The evidence is consistent with the hypothesis that the shareholder governance model in common-law countries encourages more timely disclosure of accounting information compared to code-law countries with a stakeholder governance model. Of particular importance from the standpoint of mitigating financial risks in markets, Ball, Kothari, and Robin find that disclosure of bad news is especially timely in the common-law environment. One reason is that disclosure of bad news by managers is more credible and thus serves as useful information to external suppliers of capital. In addition, failure to disclose material bad news on a timely basis can spark shareholder litigation. Shareholder litigation is far more likely to be successful if plaintiffs can attribute their losses (or damages) to management's withholding of bad news, rather than arguing that they suffered an opportunity loss because management withheld good news.

Summary

Mandated and voluntary disclosures reduce information asymmetry among market participants, which in turn lowers the cost of capital and facilitates the channeling of investment into the most productive projects. However, a corner solution of maximum disclosure is not observed because direct, proprietary, and litigation costs of disclosure and benefits of disclosure vary across countries. Institutional factors like the code-law and common-law legal systems and the stakeholder and shareholder corporate governance models create differential demands for public disclosure of financial information. Thus, systematic international variation in accounting standards and information disclosure is observed.

Effect of Enforcement on the Quality of Financial Reporting and Security Markets

In addition to financial accounting standards and securities laws that affect disclosure, other important determinants of the quality of disclosure are observed internationally. An emerging literature (see La Porta et al. 1997; Ball, Robin, and Wu 1999; and Bhattacharya and Daouk 2000) suggests enforcement of shareholder protection laws and threat of litigation are just as important as the disclosure standards, if not more important. That is, if enforcement of shareholder rights and disclosure standards is weak, then the quality of disclosure tends to be poor, regardless of the disclosure standards.

The impact of weak enforcement on disclosure quality works in two ways. First, weak shareholder protection has a negative impact on the growth of capital markets and makes corporations with a shareholder-governance model unattractive to investors. Both of these phenomena reduce the demand for timely public disclosure of financial information, regardless of the quality of disclosure standards. Lack of demand for public disclosure coupled with weak enforcement means that the quality of financial disclosure in such economies will be poor. Second, if accounting standards are not enforced vigorously and if private avenues of inducing compliance with disclosure standards through shareholder litigation are not easily available, then disclosure quality is likely to suffer.

Investor Protection

A literature is emerging on the interplay between the effectiveness of legal systems in protecting shareholder and creditor rights and corporate

finance, as well as the development of capital markets in an economy.[3] Firms raise external finance in the form of debt and equity supplied by outside (that is, non-management) investors. The management, however, acts in its own interest. This creates a demand for the protection of shareholder and creditor interests against expropriation by the controlling shareholders, the management. Certain rights empower shareholders in that they can replace directors, and creditors have the right to repossess collateral (see La Porta et al. 1998). Alternatively, a well-functioning legal system can also protect investor interests by enforcing their rights through shareholder litigation against the management and directors who are expropriating their wealth. Potential shareholders and creditors are more willing to provide external finance to firms if the legal system protects their rights than if investor protection laws and enforcement of those laws are lax. Recent evidence documents a link between investor protection and the extent of external finance and ownership patterns. I summarize this evidence below.

Variation in Investor Protection Laws

La Porta et al. (1998) find that international variation in legal protections of investors is related to international differences in the financing and ownership of firms. They study investor protection laws and the quality of enforcement of those laws in 49 countries, along with their relation to corporate ownership and external financing internationally. They find considerable international variation in investor protection laws, which is tied to differences in legal origins of the laws. Investor protection is stronger in common-law countries (for example, the United States, the United Kingdom, and Australia) than in civil-law countries (for example, France and Germany). The quality of enforcement is high in Scandinavian and German civil-law countries but low in French civil-law countries, and it is somewhere in between for the common-law countries.

La Porta et al. (1998) find that international variation in legal systems and quality of enforcement statistically maps into the variation in ownership concentration. They find "a strong negative correlation between concentration of ownership, as measured by the combined stake of the three largest shareholders, and the quality of legal protection of investors. Poor investor protection in French civil-law countries is associated with extremely concentrated ownership. The data on ownership concentration thus support the idea that legal systems matter for corpo-

[3] See Hart (1995); La Porta, Silanes, and Shleifer (1999); La Porta, Silanes, Shleifer, and Vishny (1997, 1998, 1999a, 1999b, and 2000); and Bhattacharya and Daouk (2000). The discussion in this section draws extensively from these papers.

rate governance, and that firms have to adapt to the limitations of the legal systems that they operate in."

Variation in the Enforcement of Insider Trading Laws

Bhattacharya and Daouk (2000) is another study that offers evidence on the effect of investor protection through the enforcement of insider trading laws on financial markets. In particular, the authors study the impact of the quality of enforcement of insider trading laws on corporate cost of capital. If the absence of insider trading laws or the weak enforcement of insider trading laws reduces the quality of disclosure in an economy, a negative relation between insider trading laws and cost of capital is predicted, assuming disclosure quality measurably influences cost of capital.

Economists differ on the desirability of insider trading laws on the basis of their assessments of the potential costs and benefits of such laws. Since insider trading reveals information to outside market participants through the insiders' trades, some economists argue that insider trading improves the informational efficiency of securities markets and therefore should not be banned (see Manne 1966). In contrast, many economic arguments favor a ban on insider trading; they are summarized in Bhattacharya and Daouk (2000, p. 1) and include reduced adverse selection costs and increased liquidity, greater confidence in the market, improved investments and welfare, and greater incentive to large shareholders to monitor management instead of seeking to profit from inside information. The legal rationale against insider trading appears to be that insider information is corporate property, and trading on that is theft. If the frequency with which insider trading is illegal under securities laws internationally is any indication, perceived costs of insider trading appear to far outweigh any benefits of legalizing insider trading.

Bhattacharya and Daouk study all 103 countries that had stock markets at the end of 1998. Of these, 87 countries proscribe insider trading. All developed countries prohibit insider trading, whereas 80 percent of the developing countries have laws against insider trading. However, in only 38 countries did insider trading laws appear to be enforced. In many of the remaining countries, even though the law appears on the books, no prosecution has ever taken place, which Bhattacharya and Daouk interpret as weak enforcement. Enforcement is far more common in developed countries: 78 percent, compared to only 23 percent of developing countries.

Bhattacharya and Daouk find that the enforcement of insider trading laws is a significant determinant of liquidity and cost of capital, over and beyond the existence of insider trading laws (also see Bhattacharya, Daouk, Jorgenson, and Kehr 2000). The increment to the country cost of capital associated with the lack of enforcement of insider trading laws

raises a country's cost of capital by a staggering 5 percent per annum. In contrast, they find that "the mere existence of insider trading regulations without their enforcement does not affect the cost of equity." They also find that credit ratings are lower for the countries that have lax enforcement of insider trading laws.

Since countries that enforce insider-trading laws are also likely to be developed countries and those with lax enforcement are almost certain to be developing countries, the Bhattacharya and Daouk (2000) evidence cannot be unambiguously interpreted as weak enforcement causing an increase in the cost of capital. However, it is quite likely that weak enforcement coexists with poor shareholder and investor protection laws (that is, potential for investor wealth expropriation by management), concentrated ownership, illiquid markets, and poor disclosure. Collectively, these institutional characteristics contribute to high cost of capital and might, in part, be driving the findings in Bhattacharya and Daouk.

Enforcement and Disclosure Quality[4]

Ball, Robin, and Wu (1999) study the influence of institutional factors on the properties of reported accounting numbers when enforcement of standards is weak. Four East Asian countries have common-law standard-setting: Hong Kong, Malaysia, Singapore, and Thailand. Their recent standards closely resemble International Accounting Standards. However, Ball, Robin, and Wu (1999, abstract) find that "earnings reported in the four East Asian countries, taken as a whole, exhibit properties that are typical of code-law accounting."

These four East Asian countries have a mix of code-law and common-law attributes when it comes to standard-setting and corporate governance. Standard-setting is similar to that in a common-law country in that the government is not directly involved in standard-setting, and tax codes do not significantly influence financial reporting. Corporate governance reflects a mix of common-law and code-law characteristics; while labor is not an important stakeholder, concentrated family ownership and bank financing are the norm.

Equity ownership in the four East Asian countries is typically through a series of Chinese family cross-holdings. This has led to the emergence of dominant family business groups. In addition, private loans from banks constitute a major source of financing instead of public debt and equity. In the absence of diffuse ownership accounting for large fractions of debt and equity financing, liquidity in the securities is limited. In this type of institutional setup, Ball, Robin, and Wu (1999, p. 9)

[4] This subsection summarizes main findings from Ball, Robin, and Wu (1999).

conclude that "information asymmetry is resolved more through the channels of private communication than through public disclosures."

The evidence in Ball, Robin, and Wu suggests that the lack of demand for public disclosure of information affects the properties of reported accounting information. In particular, accounting numbers in the four East Asian countries are not transparent (that is, timely in disclosing information or conservative in reporting bad news quickly) to the same extent as those for a typical corporation in a common-law country like the United Kingdom or the United States. Thus, in spite of high-quality, common-law accounting standards, the lack of users' demand for timely public disclosure of accounting information appears to determine the properties of accounting disclosure in the four East Asian countries. Weak enforcement of accounting standards enables companies in these countries to deviate from the standards in their application. Shareholder litigation against corporations and auditors is infrequent: There have been no judicial actions against auditors in Malaysia and Thailand (see Diga and Saudagaran 1998), and lawsuits against auditors are not common in Singapore and Hong Kong (see Ball, Robin, and Wu 1999).

Summary

Enforcement of investor protection laws and disclosure standards is an important determinant of corporate ownership patterns, corporate governance, and disclosure quality. Weak investor protection laws or weak enforcement of those laws reduces the likelihood of diffusely owned and externally financed corporations. Instead, concentrated family ownership or bank financing with a strong involvement in the management is more likely. Demand for public disclosure is high in the case of diffuse-ownership corporations, whereas demand for disclosure is muted in the presence of concentrated ownership. The evidence supports these predictions.

Implications and Summary

The analysis and evidence summarized in previous sections suggest a simple policy implication. With or without good enforcement of investor protection laws and disclosure standards, the case for high-quality, mandated disclosure standards is surprisingly weak. This sounds counterintuitive, so let me explain. I explain the rationale underlying the policy implication, first assuming good law enforcement, and then under the assumption of a weak enforcement regime.

Countries with good law enforcement might have common law or civil law. In common-law countries, investor ownership is likely to be diffuse and ownership separated from management control. The demand

for disclosure is high. Common law and good enforcement also imply that investor rights are well protected through shareholder litigation and bankruptcy laws. Under these circumstances, regardless of the disclosure standards, disclosure quality is expected to be high. Should the standards not be of high quality, corporations will engage in voluntary disclosure to meet the demand for public disclosure.

The advantage of not mandating high disclosure stems from the fact that there is likely to be cross-sectional variation in the demand for public disclosure of financial information, as a function of the nature of the investment and financing decisions of a corporation. For example, the demand for information might be greater for high-growth, high technology, and R&D-intensive firms than for other firms. Corporations can fine-tune their supply of voluntary disclosure to supplement mandated disclosure in order to meet investors' demand. It might be costly and impractical for standard-setters to have a range of standards tailored to capture the cross-sectional variation in demand for disclosure, and a one-size-fits-all, high-quality disclosure standard might impose unnecessary costs on a subset of the firms.

There is evidence that high-quality accounting information has been forthcoming from a subset of the firms in an economy that many claim does not have particularly high-quality disclosure standards, but where enforcement is not weak. Germany's Neuer Markt at the Frankfurt Stock Exchange, which targets technology firms raising new capital, requires firms to provide better-quality disclosures, following IAS or U.S. GAAP (see Johnson 2000; Leuz 1999; Leuz and Verrecchia 2000). In addition, many German firms seeking to raise capital have voluntarily adopted IAS or U.S. GAAP (see Leuz and Verrecchia 2000; Ball 1998). The remaining German firms are likely to be have concentrated investor holdings; they probably do not experience a high degree of information asymmetry and thus do not perceive a need to actively reduce information asymmetry through increased disclosure. Stated differently, these firms do not face high demand for public disclosure. The upshot is that we observe a peaceful coexistence of firms with high-quality and low-quality public disclosure in one economy, because their disclosure strategies respond to differences in the demand for public disclosure facing these firms.

Turning attention to economies characterized by weak law enforcement, I do not believe mandating high-quality disclosure is desirable, for at least two reasons. First, the logic and evidence in Ball, Robin, and Wu (1999) suggest that, with weak law enforcement, the properties of reported financial disclosures may not conform to the high-quality standards. Second, capital market development with diffuse shareholder ownership is stunted in economies with weak law enforcement and investor protection. This reduces the demand for high-quality public disclosure. So, high-quality standards might impose unnecessary costs on firms that choose to comply with the mandated disclosure standards.

In summary, institutional factors such as investor protection laws, corporate governance structures, and the quality of law enforcement jointly influence the demand for accounting information. These factors and mandated standards determine properties of reported financial information. Therefore, standard-setting decisions should take into account institutional factors and the quality of law enforcement in an economy, rather than be taken on standards in isolation. A simultaneous push for greater shareholder protection and transparent accounting standards is warranted.

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