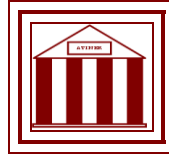


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**Foreign Ownership and Financial
Reporting Quality: Evidence from
Spanish Subsidiaries**

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Foreign Ownership and Financial Reporting Quality: Evidence from Spanish Subsidiaries

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Abstract

We provide empirical evidence on the relation between foreign shareholding and financial reporting quality in a sample of large private Spanish subsidiaries. We find that foreign controlled firms have poorer financial reporting quality than local group subsidiaries. Additionally, we observe that financial reporting quality improves with the tenure of the local controlling shareholder, while that is not the case of foreign group subsidiaries. Overall, results suggest that the informational disadvantage of foreign shareholders prevents them from playing an effective governance role.

Keywords: Audit opinion, Discretionary accruals, Financial reporting quality, foreign ownership.

Introduction

This paper examines the relation between foreign shareholding and financial reporting quality, which is not clear a priori. On the one hand, the literature documents that foreign shareholders have more incentives and better ability to monitor managerial actions (Ferreira and Matos, 2008). On the other hand, similar to foreign analysts, foreign investors face an informational disadvantage with regard to local shareholders, either because of the geographical distance (Malloy, 2005) or because of their poorer knowledge of local business culture and accounting standards and practices (Bae et al., 2008). From the perspective of their alleged superior ability to monitor managerial actions, the presence of foreign shareholders should be related to higher reporting quality, while the informational disadvantage faced by foreign shareholders would lead to the contrary effect.

We examine a sample of large private Spanish subsidiaries, where we argue that the informational disadvantage of foreign investors is particularly significant. The prevalence of earnings manipulation is documented to be higher in private companies (Ball and Shivakumar, 2005), where information disclosure is poorer than in public firms. Moreover, Spain is a code law country, where the literature documents a higher propensity to engage in earnings manipulation (Leuz et al., 2003). In this setting, the superior knowledge that local shareholders have regarding specific reporting incentives and accounting practices should result in a pronounced informational disadvantage for foreign shareholders.

We carry out our analyses in a sample of subsidiaries so as to avoid capturing the compound effect of foreign and controlling shareholding in determining the quality of the firm's financial reporting outcomes. Specifically, our research design allows us to maintain the impact of controlling shareholders constant and to focus on the effect of foreign versus local ownership. Thus, observed differences in the financial reporting quality of companies owned by local and foreign groups could not be attributed to the existence of a controlling shareholder.

We find that subsidiaries of foreign groups have poorer accounting quality than local group subsidiaries. Additionally, financial reporting quality of local group subsidiaries improves with the tenure of the controlling shareholder while that is not the case of foreign group subsidiaries. These results are robust to the use of several financial reporting quality proxies, alternative estimation techniques, and to the inclusion of a wide set of covariates.

This paper contributes to the literature on the ownership and governance structure as determinants of the firm's accounting quality (Xie et al., 2003). Our work is also related to the scarce literature concerned with the earnings quality of private companies (Ball and Shivakumar, 2005) and to the literature on the home bias phenomenon (Bradshaw et al., 2004).

Literature Review and Hypotheses Development

The Monitoring Role of Foreign Investors

A number of studies suggest that foreign shareholders have higher incentives and a superior ability to monitor managerial actions. For example, Fogel et al. (2013) find that the presence of foreign investors enhances the financial performance of public Swedish firms when they have an active management role, while Chang et al. (2013) show that firms acquired by foreign shareholders outperform local firms in China. Dahlquist and Robertsson (2001) posit that the role of foreign shareholders resembles that of institutional investors whose effectiveness in monitoring insiders is documented in academic research (e.g.: Koh, 2007); and Huang and Zhu (2014) argue that the presence of foreign institutional investors is associated with a significant decrease in the expropriation risk of minority shareholders.

The effective monitoring of foreign shareholders should reduce the ability of insiders to manipulate earnings for private purposes, and consequently the presence of foreign investors should result in higher earnings quality. Several studies provide evidence consistent with this prediction (Ben-Nasr et al., 2012; Khanna and Palepu, 2000).

Investors' Home Bias and the Informational Disadvantage of Foreign Investors

Despite the alleged benefits of diversifying into foreign equities, the literature documents a relatively low level of investment made outside domestic markets. This phenomenon is usually referred to as the “home bias puzzle” (see Karolyi and Stulz, 2003).

The international accounting literature suggests that the main sources of the home bias phenomenon are related to the information asymmetries between countries, the information processing costs that foreign shareholders need to bear in order to understand local accounting standards, and the fact that foreign companies have less credible financial information. Previous research suggests that by improving the quality of financial information systems and reducing information asymmetries, foreign investment flows might be attracted into a country/firm (Bradshaw et al., 2004; Covrig et al., 2007). However, the opposite effect is not necessarily true (Ferreira and Matos, 2008).

The literature also suggests that local investors have an informational advantage, similar to the well-documented advantage of local analysts (Bae et al., 2008). This informational disadvantage of foreign investors should result in a less effective prevention of earnings management practices. The results of Bagaeva et al. (2008) support this prediction in a setting of non-listed Russian firms.

The Expected Role of Foreign Investors in Private Spanish Subsidiaries

Bae et al. (2008) find that the advantage of local analysts is higher in settings where there is less information disclosed by companies and earnings are manipulated more. Accordingly, we argue that the informational

disadvantage of foreign investors should be especially high in the context analyzed, since: (1) earnings manipulation is more prevalent in private companies, where information disclosure is poorer than in public firms (Ball and Shivakumar, 2005); and (2) Spain is a code law country, where the literature has documented a higher propensity to engage in earnings manipulation (Leuz et al., 2003) and a higher incidence of some specific incentives to manipulate earnings (García-Lara et al., 2005). In consequence, we expect that the alleged superior ability of foreign shareholders to monitor and constrain insiders' opportunistic actions is counteracted within this setting. We test the following hypothesis:

H1: financial reporting quality of foreign controlled firms is poorer than that of companies controlled by local shareholders.

The literature documents that the presence of large shareholders is beneficial for the firm since these investors monitor and discipline managers effectively, as well as focusing more on long-term performance (La Porta et al., 1999). Shleifer and Vishny (1986) argue that small shareholders do not play an active monitoring role due to the high associated costs, whereas large investors are forced to do so in order to protect their significant investment. Accordingly, as the experience of the controlling shareholder increases, financial reporting quality should improve. However, such improvements would be dissimilar for subsidiaries of foreign and local groups due to the different levels of information asymmetries they face. Therefore, we expect that improvements in the financial reporting quality associated with the tenure of the controlling shareholder will be higher for local group subsidiaries than for foreign controlled firms. Thus, our second hypothesis is the following:

H2: as the controlling shareholder's tenure increases the subsidiary's reporting quality improves more when the parent company is local than when it is foreign.

Research Design

Sample Selection

The primary source of data in our research is the SABI database.¹ We firstly identified non-financial private companies with full (i.e., not abbreviated) audited financial statements, which were subsidiaries of either a local or a foreign group at the end of 2011.² In this step we identified approximately 2,200 subsidiaries.

Since SABI does not provide historical ownership data, we completed the information manually using several other reliable sources: (1) the FACTIVE database;³ (2) acts officially registered by companies at the Spanish Trade

¹SABI is the database of the Bureau Van Dijk Group that covers Spanish companies.

²A firm is considered a subsidiary if there is a parent company which holds (directly or indirectly) at least 50.01 percent of the voting rights.

³FACTIVA is a Dow Jones database which provides access to top national and international newspapers, newswires, business journals etc.

Registry; and (3) corporate official websites of both subsidiaries and parent companies. We followed back in time each subsidiary identified in SABI and collected information on its controlling shareholders for the period 1997-2011.¹ We identified the country of origin of all the parent companies in the sample, as well as the date when each parent company became the controlling shareholder of the corresponding subsidiary.

Research Variables

We follow prior research and indirectly measure the quality of the firm's financial reporting system. In particular, we use two measures: (1) the magnitude of the abnormal component of accruals; and (2) the type of opinion issued by the auditor. Our first measure is frequently used to proxy for earnings management, and relies on the researcher's analysis of the firm's accounting numbers. In turn, the auditor's opinion provides an external evaluation of the firm's financial reporting quality, since the auditor passes judgment on whether the firm's financial statements comply with GAAP.

Discretionary Accruals

We split observed accruals into a normal and an abnormal component using the Jones (1991) model, presented in expression (1).

$$ACCRUALS_{i,t} = \alpha + \beta_1 \Delta SALES_{i,t} + \beta_2 PPE_{i,t} + \varepsilon_{i,t} \quad (1)$$

Where, for firm i in year t : $ACCRUALS_{i,t}$ are total accruals, calculated as the annual change in non-cash current assets less the annual change in current liabilities, and less annual depreciation expense; $\Delta SALES_{i,t}$ is the annual change in sales revenues; and $PPE_{i,t}$ is the level of property, plant and equipment. All variables are divided by lagged total assets.

We estimate model (1), where we also include industry and year controls, using the pool of observations included in the SABI database on companies which meet the size criteria required for our sample of subsidiaries. The absolute value of discretionary accruals ($|DAC|$) is our first proxy of the firm's financial reporting quality.

Auditor's Opinion

Auditors issue: a qualified report when they find any aspect which does not comply with GAAP; an adverse opinion, when they consider that the financial statements are materially misstated or false and, taken as a whole, not in line with GAAP; a disclaimer of opinion, when they are unable to perform their work and cannot issue an opinion on the financial statements; or a clean opinion, if the financial statements are in accordance with GAAP. With the exception of the disclaimer of opinion which could be triggered by reasons that do not suggest poor reporting quality -such as a late appointment of the

¹Before 1997 the availability of financial and auditing data necessary to calculate all the variables described in the following sections significantly decreases.

auditor-, the other types of unclean opinions indicate that the company did not comply with GAAP. Thus, we argue that an unclean audit report is an indicator of poor financial reporting quality. Therefore, our second measure of (poor) reporting quality is *OP*, a dummy variable that equals 1 if the firm receives an unclean audit report other than a disclaimer of opinion, and 0 otherwise.¹

Empirical Models

Tests of H1

We explore the relation between foreign shareholding and firm-level accounting quality using two baseline empirical models: the DAC model and the OP model.

The DAC model is presented in equation (2) and the OP model in equation (3), where coefficients are omitted for simplicity.

$$|DAC|_{i,t} = Foreignown_{i,t} + Big_{i,t} + Size_{i,t} + Lev_{i,t} + Loss_{i,t} + Salesgrowth_{i,t} + Opcycle_{i,t} + Industry\ Effects_{i,t} + Year\ Effects_{i,t} \quad (2)$$

$$OP_{i,t} = Foreignown_{i,t} + |DAC|_{i,t} + Lag_OP_{i,t} + Big_{i,t} + Size_{i,t} + Roa_{i,t} + Lev_{i,t} + Liq_{i,t} + Industry\ Effects_{i,t} + Period\ Effects_{i,t} \quad (3)$$

Detailed variable definitions are presented in the appendix.

To minimize the effect of outliers in our empirical tests we winsorize variables *|DAC|*, *Size*, *Lev*, *Salesgrowth*, *Opcycle*, *Roa* and *Liq* at 1% and 99%. We use ordinary least squares (OLS) and logistic regression to estimate models (2) and (3) respectively, where we follow Cameron et al. (2011) and correct standard errors by clustering on both firm and year.

Tests of H2

To test our second hypothesis, we estimate two additional models for each financial reporting quality proxy, where we add two regressors to models (2) and (3): *Tenure_control* (or *Longtenure*), and its interaction with *Foreignown*. The resulting models are presented in expressions (4a), (4b), (5a) and (5b) (coefficients and control variables omitted for simplicity):

$$|DAC|_{i,t} = Foreignown_{i,t} + Tenure_control_{i,t} + Tenure_control*Foreignown_{i,t} + Control\ Variables_{i,t} \quad (4a)$$

$$|DAC|_{i,t} = Foreignown_{i,t} + Longtenure_{i,t} + Longtenure*Foreignown_{i,t} + Control\ Variables_{i,t} \quad (4b)$$

$$OP_{i,t} = Foreignown_{i,t} + Tenure_control_{i,t} + Tenure_control*Foreignown_{i,t} + Control\ Variables_{i,t} \quad (5a)$$

$$OP_{i,t} = Foreignown_{i,t} + Longtenure_{i,t} + Longtenure*Foreignown_{i,t} + Control\ Variables_{i,t} \quad (5b)$$

¹The few observations with disclaimer of opinion are eliminated. Including them in the analysis (as unclean reports) does not change the results.

Where: the coefficient of *Tenure_control* (or *Longtenure*) indicates how the controlling shareholder's tenure affects local group subsidiaries, while the coefficient of the interaction term *Tenure_control*Foreignown* (or *Longtenure*Foreignown*) captures the incremental effect of foreign shareholding on the corresponding financial reporting quality proxy due to the controlling shareholder's tenure. Finally, the sum of the coefficients of *Tenure_control* (or *Longtenure*) and its interaction with *Foreignown* indicates how the controlling shareholder's tenure affects financial reporting quality in the sample of foreign group subsidiaries.

Models (4a) and (4b) are estimated by OLS and models (5a) and (5b) using logistic regression. We follow Cameron et al. (2011) and correct standard errors by clustering on both firm and year. In addition, since we acknowledge the problems to calculate and interpret the interaction effects in non-linear models,¹ for models 5(a) and 5(b) we use the procedure suggested by Norton et al. (2004) to estimate the magnitude, standard errors and z-statistics of the interaction effects.

Descriptive Statistics And Univariate Tests

Descriptive Statistics

Table 1 reports the descriptive statistics of the research variables for the common sample of 14,484 firm-year observations.

The mean (median) value of $|DAC|$ is 0.104 (0.062), while the statistics of *OP* indicate that 25.3% of the observations received an unclean audit report. Approximately half of the sample corresponds to subsidiaries with foreign control (mean *Foreignown* equals 0.544), with the average tenure of the controlling shareholder (*Tenure_control*) being 12.5 years.

¹In non-linear models the interaction effect differs across observations, a positive interaction effect being possible for some observations and a negative one for others.

Table 1. Descriptive Statistics of Research Variables

Variable	Mean	Median	Stddev	Min	P25	P75	Max
 DAC 	0.104	0.062	0.131	0.001	0.026	0.127	0.848
OP	0.253	0	0.435	0	0	1	1
Foreignown	0.544	1	0.498	0	0	1	1
Tenure_control	12.526	10	11.111	1	6	15	103
Big	0.842	1	0.365	0	1	1	1
Assets (million €)	98.926	53.018	136.509	0.063	21.314	116.084	822.613
Roa	0.039	0.035	0.093	-0.382	0.004	0.079	0.346
Lev	0.648	0.670	0.241	0.016	0.485	0.815	1.411
Loss	0.214	0	0.410	0	0	0	1
Salesgrowth	0.194	0.063	1.153	-0.955	-0.038	0.182	17.834
Opcycle(days)	281.331	219.825	297.834	24.641	134.395	330.140	2599.323
Liq	1.441	1.191	1.142	0.127	0.944	1.615	14.700

Source: Author's Fieldwork Survey Data

Univariate Tests

Table 2 presents the results of the univariate tests. Panel A shows the mean and median values of $|DAC|$ for the subsidiaries of local and foreign companies. Additionally, we present the results partitioning the sample by the parent company's tenure: ten years or more (LT: long tenure) or lower than ten years (ST: short tenure). The results indicate that subsidiaries of foreign groups report higher levels of discretionary accruals than subsidiaries of Spanish groups, the difference being statistically significant at 1%. This result only holds in the subsample with long tenure, whereas in the subsample where the controlling shareholder's tenure is lower than 10 years there is no significant difference in the magnitude of discretionary accruals between subsidiaries of foreign and local groups.

Panel B of Table 2 provides evidence consistent with that of Panel A for our second proxy of financial reporting quality. The proportion of unclean audit reports in subsidiaries of foreign groups is 31.2 percent, significantly higher than the 17.4 percent of the local group subsidiaries. This result holds irrespective of how long the tenure of the controlling shareholder is. However, the difference is more pronounced when the controlling shareholder's tenure is long.

Table 2. Foreign Control and Financial Reporting Quality. Univariate Tests

Panel A: Foreign Control and Discretionary Accruals

	N	<i>Local control</i>			<i>Foreign control</i>			Means difference	Kruskal Wallis
		N	Mean DAC	Median DAC	N	Mean DAC	Median DAC		
All	16,547	7,730	0.104	0.061	8,817	0.111	0.065	-3.05***	7.09***
LT	8,599	3,284	0.090	0.053	5,315	0.106	0.063	-5.78***	38.80***
ST	7,948	4,446	0.115	0.068	3,502	0.118	0.066	-0.97	0.37

Panel B: Foreign control and audit opinion

	N	<i>Local control</i>		<i>Foreign control</i>		Proportions difference
		N	Mean OP	N	Mean OP	
All	16,800	7,583	0.174	9,217	0.312	-20.46***
LT	8,821	3,218	0.142	5,603	0.336	-19.86***
ST	7,979	4,365	0.199	3,614	0.275	-8.04***

Statistical significance is indicated by *** for p<0.01, ** for p<0.05, and * for p<0.1.

Source: Author's Fieldwork Survey Data

In sum, the results presented in this section are consistent with our predictions. In support of H1, financial reporting of foreign group subsidiaries is of lower quality than that of local group subsidiaries. Additionally, the difference in financial reporting quality between foreign and local group subsidiaries is higher as the controlling shareholder's tenure increases, which supports H2.

Regression Analysis

Foreign Control and Accruals Quality

Table 3 shows the results of the estimation of models (2), (4a) and (4b). As observed in the first column, the coefficient of *Foreignown* is positive and significant. This result supports H1, indicating that foreign shareholding significantly relates to lower accruals quality.

The second and third columns of Table 3 provide the results of models (4a) and (4b). The coefficients of *Tenure_control* and *Longtenure* are negative and significant, confirming that as their experience increases, local controlling shareholders play an effective monitoring role and better constrain earnings management practices. The coefficient of the interaction between *Tenure_control* (or *Longtenure*) and *Foreignown* is positive and significant, indicating that the controlling shareholder's tenure has a positive incremental effect on the magnitude of the subsidiary's discretionary accruals when the controlling shareholder is a foreign group. Finally, the sum of the coefficients of *Tenure_control* (or *Longtenure*) and its interaction with *Foreignown* is not significantly different from zero, suggesting that accruals quality does not significantly change as tenure increases in the case of foreign group subsidiaries. These results are in line with H2, and suggest that tenure translates into better monitoring of insiders only for local parent companies.

Table 3. Foreign Control and Discretionary Accruals. Regression Analysis

Variables	Model (2)	Model (4a)	Model (4b)
	DAC	DAC	DAC
Constant	0.097 [1.57]	0.108* [1.75]	0.099 [1.62]
(1) Foreignown	0.010*** [3.51]	-0.005 [-0.94]	0.003 [0.57]
(2) Tenure_control		-0.002*** [-4.77]	
(3) Tenure_control*Foreignown		0.002*** [4.20]	
(2) + (3)		0.000	
F-statistic test (2) + (3) = 0		[0.10]	
(4) Longtenure			-0.014*** [-3.75]
(5) Longtenure*Foreignown			0.015** [2.23]
(4) + (5)			0.001 [0.09]
F-statistic test (4) + (5) = 0			
Big	0.008** [2.12]	0.009** [2.30]	0.008** [2.19]
Size	-0.002 [-1.57]	-0.002 [-1.50]	-0.002 [-1.52]
Lev	0.041*** [5.92]	0.040*** [5.63]	0.040*** [5.72]
Loss	0.029*** [5.42]	0.029*** [5.40]	0.029*** [5.41]
Salesgrowth	0.027*** [12.42]	0.026*** [12.11]	0.026*** [12.37]
Opcycle	0.007*** [3.28]	0.007*** [3.39]	0.007*** [3.36]
Year and industry effects	yes	yes	yes
No. observations	16,547	16,547	16,547
R-squared	0.114	0.116	0.115
F-statistic	18.95***	18.78***	18.55***

Statistical levels are indicated by *** for $p < 0.01$, ** for $p < 0.05$, and * for $p < 0.1$.

Source: Author's Fieldwork Survey Data

Several untabulated robustness tests enhance the results of the DAC model. Results are robust: (1) in a firm-fixed effects estimation, which controls for unobserved firm heterogeneity; and to the Fama-Macbeth (1973) estimation technique; (2) if we use alternative discretionary accruals measures, such as those proposed by Dechow and Dichev (2002), Carey and Simnett (2006) and Francis and Wang (2008); (3) in the subsamples with positive and negative discretionary accruals, which is as expected since the information asymmetries preventing foreign investors from playing an effective governance role exist independently of the type of incentives underlying accrual manipulation.

Foreign Control and Audit Opinion

The results of the logistic estimation of models (3), (5a) and (5b) are reported in Table 4. As observed in the first column, *Foreignown* is positively and significantly related to *OP*, indicating that the probability of receiving an unclean audit report is significantly higher for the subsidiaries of foreign groups than for subsidiaries of local groups. This supports our prediction in H1.

In the estimation of models (5a) and (5b), the coefficients of *Tenure_control* and *Longtenure* are negative and significant, indicating that as the tenure of the controlling shareholder increases the probability of receiving an unclean audit report decreases for firms controlled by local shareholders. This again suggests that local shareholding is related to higher financial reporting quality as the controlling shareholder's tenure increases. The coefficient of the interaction term between *Tenure_control* (or *Longtenure*) and *Foreignown* indicates a positive incremental effect of tenure on the probability of receiving a qualified audit opinion in firms with foreign parent companies.¹ This result is again consistent with H2, and suggests that information asymmetries faced by foreign shareholders are more pronounced than for local shareholders. In fact, the sum of the coefficients of *Tenure_control* and *Tenure_control*Foreignown* is positive and significant. For firms with foreign controlling shareholders the probability of having a qualified audit report even increases with the ownership tenure.

¹The mean interaction effect estimated using the Norton et al.'s (2004) procedure is positive and statistically significant at 1%. In addition, the interaction effect is positive for all the observations and is statistically significant at 5% in more than 99 percent of the sample observations.

Table 4. *Foreign Control and Audit Opinion. Regression Analysis*

Variables	Model (3) <i>OP</i>	Model (5a) <i>OP</i>	Model (5b) <i>OP</i>
Constant	-3.671*** [-5.66]	-3.545*** [-5.39]	-3.609*** [-5.61]
(1) Foreignown	0.520*** [8.09]	0.176** [2.12]	0.315*** [4.14]
(2) Tenure_control		-0.025*** [-2.85]	
(3) Tenure_control*Foreignown		0.033*** [3.69]	
(2)+(3) χ^2-statistic test (2) + (3) = 0		0.008*** [18.08]	
(4) Longtenure			-0.302*** [-2.88]
(5) Longtenure*Foreignown			0.444*** [4.41]
(4)+(5) χ^2-statistic test (4) + (5) = 0			0.142 [2.49]
 DAC 	0.075 [0.56]	0.055 [0.42]	0.059 [0.45]
Lag_OP	3.633*** [24.91]	3.620*** [24.83]	3.620*** [24.83]
Big	0.299*** [3.95]	0.310*** [4.15]	0.304*** [4.06]
Size	0.025* [1.95]	0.029** [2.25]	0.026** [2.04]
Roa	-2.530*** [-5.05]	-2.531*** [-5.05]	-2.524*** [-4.97]
Lev	-0.111 [-0.88]	-0.078 [-0.60]	-0.097 [-0.74]
Liq	0.025 [1.07]	0.026 [1.08]	0.025 [1.04]
Period2	0.263*** [2.88]	0.281*** [3.07]	0.285*** [3.17]
Period3	0.174 [1.48]	0.213* [1.91]	0.212* [1.78]
Industry effects	yes	yes	yes
No. observations	16,800	16,800	16,800
Pseudo R ²	0.415	0.416	0.415
Wald χ^2	5,323***	5,309***	5,311***

Statistical levels are indicated by *** for p<0.01, ** for p<0.05, and * for p<0.1.

Source: Author's Fieldwork Survey Data

In order to validate the results of the OP model, we used two alternative estimation techniques, whose results are untabulated for the sake of brevity. Results are robust to: (1) the Fama-Macbeth (1973) estimation procedure; and (2) a random effects estimation following the constrained version of

Wooldridge's (2005) approach proposed by Rabe-Hesketh and Skrondal (2013).

An additional robustness test reveals that our results hold when the three models from Table 4 are estimated after eliminating financially distressed firms - firms with two consecutive years of net losses (Kaplan and Williams, 2013). Financially distressed companies potentially deserve a GC qualification, which indicates poor financial performance, and not necessarily poor reporting quality.

Conclusions

We provide evidence on the relation between foreign shareholding and financial reporting quality. We find that firms controlled by foreign shareholders have both lower accruals quality and higher probability of receiving an unclear audit report than locally controlled firms. We also observe that as the tenure of the controlling shareholder increases, the firm's reporting quality improves when the controlling shareholder is local, while that is not the case when there is a foreign parent company. Overall, our results suggest that in the setting of private companies within a code law country, such as Spain, the informational disadvantage of foreign shareholders counteracts their alleged superiority in monitoring managerial actions.

Our research has implications for policy makers. The results suggest that implementing policies which help to reduce the informational disadvantage of foreign investors would most likely contribute to improving the reporting quality of private companies controlled by foreign investors. The harmonization of accounting standards and practices could be one way to do so. Further research on the cross-sectional differences in the reporting quality of foreign controlled private firms is needed, so as to shed light on how the differences in the accounting standards applied by the parent companies and the subsidiaries affect the monitoring role of foreign shareholders. Results would contribute to inform the debate on the current accounting convergence process towards IFRS, which is restricted to public companies in many jurisdictions while most FDI receivers are private firms.

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