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Foreign ownership and financial reporting quality in private subsidiaries*

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Abstract

In a sample of large private Spanish subsidiaries, we find that the magnitude of discretionary accruals is significantly higher when the parent company is foreign than when it is local. Our tests support the thesis of recent research on earnings management strategies within multinational corporations (MNCs), suggesting that the parent company's incentives underlie the observed negative relation between foreign ownership and financial reporting quality at the subsidiary level. In particular, we observe that: (1) the tenure of the controlling shareholder has a negative incremental effect on financial reporting quality in firms under foreign control, but not in subsidiaries of local groups; and (2) the negative association between foreign ownership and financial reporting quality is mainly driven by the subsample of subsidiaries with parent companies located in countries with higher institutional quality than Spain.

Keywords: foreign ownership; private firms; subsidiaries; earnings management; discretionary accruals; institutional quality.
JEL Classification: F23, M41, M48.

Resumen

En una muestra de empresas subsidiarias españolas no cotizadas, este trabajo presenta evidencia empírica de que la magnitud de los ajustes por devengo discrecionales es significativamente mayor cuando la matriz es extranjera que cuando es local. Los resultados son consistentes con la tesis de algunos trabajos recientes sobre las estrategias de manipulación del resultado en las compañías multinacionales, sugiriendo que son los incentivos de la matriz los que subyacen a la relación negativa observada entre la propiedad extranjera y la calidad de la información contable de las subsidiarias. En particular, se observa que: (1) la experiencia de la matriz como accionista de control tiene un efecto incremental negativo sobre la calidad de la información contable en las subsidiarias controladas por un grupo extranjero pero no en las que tienen matriz local; y (2) la relación negativa observada entre la propiedad extranjera y la calidad de la información contable se debe fundamentalmente al grupo de subsidiarias cuya matriz está establecida en países con mejor calidad institucional que España.

Palabras clave: propiedad extranjera; empresas no cotizadas; subsidiarias; manipulación del resultado; ajustes por devengo discrecionales; calidad institucional.
Clasificación JEL: F23, M41, M48.

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1. Introduction

Despite that the economic effects of foreign direct investment (FDI) have been widely studied, there are still questions concerning the conditions and the channels through which FDI affects the host-country economies (Lipsey & Sjöholm, 2005). A related research stream studies the role of foreign investors in determining the quality of the invested firm's financial reporting. Our work builds upon this research and focuses on the scarcely analyzed setting of privately held companies, which are the main FDI recipients (e.g.: ECB, 2013, p. 66) and the source of a large portion of economic growth (e.g.: EcoDA, 2010, p. 6). In particular, we study how the presence of foreign controlling shareholders relates to earnings management in private firms.

In the setting of public companies, some studies document an effective governing role of foreign shareholders in constraining earnings management (e.g.: Beuselinck, Blanco, & García-Lara, 2017). However, these results cannot be extrapolated to private firms, which differ from public firms along a number of important dimensions that relate to financial reporting quality (Burgstahler, Hail, & Leuz, 2006). Moreover, research on samples of public companies typically associates foreign ownership with institutional investors, who tend to buy smaller stakes in their invested firms, as opposed to non-institutional investors who prefer to exert control (Fons-Rosen, Kalemli-Ozcan, Sorensen, Villegas-Sanchez, & Volosovych, 2013). We focus on non-institutional investors and analyze a sample of subsidiaries, where decision making is substantially influenced by the parent company (e.g.: Hsu, 2000; Robinson & Stocken, 2013), while that might not be the case at lower ownership rates. Focusing on subsidiaries helps to isolate the effect of foreign shareholding on financial reporting quality from that of another important correlated factor, namely controlling shareholding.

Assuming a significant influence of parent companies in their subsidiaries' accounting policies, financial reporting quality at the subsidiary level depends on the incentives and opportunities of the parent company (Beuselinck, Cascino, Deloof, & Vanstraelen, 2017). The incentives relate to both the benefits and costs of producing poor (or good) quality accounting information at the subsidiary level; and the opportunities mainly depend on the subsidiaries' institutional framework, including accounting standards and enforcement mechanisms.

In this study, the country-level characteristics that determine the subsidiaries' financial reporting quality are held constant. Spain is the Eurozone's fourth-largest economy and one of the main FDI receivers worldwide, ranking 14th in the top of countries by FDI inflows (CIA, 2016); and being the 8th most open country according to the OECD's FDI regulatory restrictiveness index (OECD, 2014, p. 91). Similar to other EU members, only 0.1 percent of

the Spanish companies are publicly traded (Chislett, 2015, p. 36; EcoDA, 2010, p. 6), and the accounts of private companies are public by law. This provides us with a representative setting to study how foreign shareholding affects financial reporting quality in private firms. Additionally, despite being a developed country, Spain has relatively low quality institutions (e.g.: Christensen, Hail, & Leuz, 2013; García-Osma, Gisbert, & de las Heras, 2016; La Porta, López-de-Silanes, Shleifer, & Vishny, 2000); and earnings management practices are more prevalent than in other developed countries (e.g.: Leuz, Nanda, & Wysocki, 2003).

Ceteris paribus opportunities, our predictions are based on the differential incentives of foreign and local controlling shareholders to produce high quality financial statements at the subsidiary level in the private setting. Several international studies suggest that multinational corporations (MNCs) prefer to manipulate earnings abroad, in order to avoid the pressure from the parent companies' local enforcers (e.g.: Durnev, Li, & Magnan, 2017; Fan, 2012). These studies have implications for the research question addressed in this paper, that is, how foreign ownership relates to financial reporting quality in private subsidiaries. We argue that if the incentives of foreign shareholders to manipulate their subsidiaries' earnings are on average stronger than those of their local counterparts, we should observe a negative association between foreign ownership and accounting quality at the subsidiary level.

We employ the magnitude of discretionary accruals to proxy for financial reporting quality and find that firms controlled by foreign groups report higher magnitudes of discretionary accruals. The association is not only statistically significant at conventional levels, but it is also economically important: keeping all controls constant, the magnitude of discretionary accruals represents, on average, between 0.3 and 0.5 percent more of total assets in the foreign group subsidiaries than in their locally-owned counterparts. This result is robust to including a wide set of covariates, to the use of several discretionary accruals measures, and to alternative model estimation procedures. Additionally, we observe that in the companies that during the sample period changed from local to foreign control or vice-versa the magnitude of discretionary accruals is significantly higher in the years under foreign control.

We additionally explore the effect of the parent company's tenure on the relation between foreign shareholding and financial reporting quality. Prior research suggests that foreign owners have a disadvantage with respect to local groups regarding their knowledge of local accounting standards and other related regulation (e.g.: Masulis, Wang, & Xie, 2012). Such informational disadvantage should be reduced as time passes because foreign controlling shareholders become more knowledgeable about the local accounting standards and practices. If the parent company had incentives to improve its subsidiaries' reporting quality, we should observe higher financial reporting quality as the parent company's tenure increases. On the contrary, if foreign owners had incentives to transfer earnings manipulation to their subsidiaries, the parent company's tenure would have a negative incremental effect on the

subsidiary's financial reporting quality. The results reveal that the owner's tenure negatively affects accounting quality only when the controlling shareholder is foreign, which is consistent with our predictions.

Literature also documents that the preference to manage earnings abroad has to do with the international differences in institutional quality. Earnings management, both at the consolidated level and at the subsidiary level, is more pervasive when the investment flows from parent companies established in strong institutional environments to subsidiaries located in settings with less stringent regulations and enforcement mechanisms (e.g.: Beuselinck, Cascino, et al., 2017; Dyreng, Hanlon, & Maydew, 2012). We therefore argue that the association between foreign shareholding and financial reporting quality depends on the relative institutional quality of the countries where the FDI comes from. In order to test this prediction, we make partitions of our sample of foreign controlled subsidiaries considering several institutional quality indexes identified in prior research that proxy for the level of investor protection and legal enforcement in the parent company's country of origin. We find that the negative association between foreign ownership and financial reporting quality is driven by the group of subsidiaries with parent companies located in countries that rank higher than Spain in several measures of institutional quality. These findings suggest that the observed lower financial reporting quality of companies controlled by foreign shareholders in Spain, a country with an institutional quality level relatively lower than that of the countries from which FDI is received, results from the incentives of MNCs to allocate earnings management in subsidiaries domiciled in countries with relatively weaker institutional environments than that of the parent company's home country.

This paper contributes to the literature in a number of ways. We add to the research concerned with the association between the company's ownership structure and its financial reporting quality (e.g.: Man & Wong, 2013). Specifically, we provide evidence on the role of foreign ownership in determining accounting quality in private subsidiaries, whereas prior research has mainly analyzed samples of stand-alone listed companies (e.g.: Beuselinck, Blanco, & García-Lara, 2017). Our results suggest that in the setting of private Spanish subsidiaries foreign shareholders do not play the effective monitoring role documented in public firms. In this sense, our work also relates to the literature concerned with the determinants of accounting quality in the private setting. Our results add to prior research indicating that these are not the same as in public firms (e.g.: Ball & Shivakumar, 2005; Burgstahler et al., 2006; Coppens & Peek, 2005; Hope, Thomas, & Vyas, 2011 & 2013).

We also contribute to the scant literature that focuses on financial reporting quality within MNCs. In line with Beuselinck, Cascino, et al. (2017), our results complement the evidence of the studies that focus on the quality of the parent company's consolidated earnings and document that the international differences in institutional quality underlie the incentives for

earnings management within MNCs (e.g.: Durnev et al., 2017; Dyreng et al., 2012), by looking at the subsidiaries' side. Our paper is closely related to Beuselinck, Cascino, et al. (2017), who study the location of earnings management within MNCs focusing on subsidiaries (both private and public firms) from 89 countries. Our study differs from Beuselinck, Cascino, et al. (2017) along three main aspects. First, we hold constant the country-level characteristics of the host country, ensuring that our findings are not driven by the differences in the quality of institutions or financial reporting practices across the different countries in which MNCs operate. Second, we focus on privately held subsidiaries, which allows us to hold constant the opportunities of the parent companies to allocate earnings management to their subsidiaries. Finally, we look at several dimensions of the institutional environment in the parent company's country of origin and construct and aggregate measure of institutional quality.

Additionally, we contribute to a better understanding of the effects of FDI on the host-country companies, and specifically in a relatively low institutional quality setting. As far as financial reporting quality of privately held subsidiaries is concerned, we do not find FDI spillover benefits. On the contrary, foreign direct investment relates to higher earnings manipulation in this setting. Finally, this paper relates to the studies on the effects of the institutional environment on accounting outcomes (e.g.: Burgstahler et al., 2006; Leuz, et al., 2003). Our results suggest that, in the context of MNCs, strong institutions do not eliminate the incentives to carry out earnings management, but result in the transfer of the manipulation towards subsidiaries domiciled in countries with more lenient institutions.

2. Related literature and hypotheses development

A number of studies suggest that foreign shareholders have higher incentives and a superior ability to monitor managerial actions. For instance, Dahlquist and Robertsson (2001) posit that the role of foreign shareholders resembles that of institutional investors, whose effectiveness in monitoring insiders is documented in the literature (e.g.: Koh, 2007). Aggarwal, Erel, Ferreira, and Matos (2011) find that foreign investors play a decisive role in improving the governance of non-US companies, while Ferreira and Matos (2008) provide evidence that foreign institutional ownership has a positive impact on the valuation and performance of non-US firms. One potential outcome of the effective role of foreign shareholders in disciplining insiders is an increase in accounting quality. The empirical results of some studies conducted in the setting of listed firms are consistent with this prediction. For example, Khanna and Palepu (2000) find that foreign investors reduce the opportunities for discretionary accounting choices in a sample of listed Indian firms; and An (2015) shows that foreign shareholding in Korea is positively related to conservatism, which in turn is associated with reduced managerial opportunism. Closer to our study, Beuselinck,

Blanco, and García-Lara (2017) examine a sample of listed firms from the four countries known under the derogatory acronym of PIGS (Portugal, Italy, Greece, and Spain) and find a negative association between changes in foreign ownership from shareholders located in countries with strong institutional quality and changes in the magnitude of discretionary accruals.

Our study shares the geographical setting described by Beuselinck, Blanco, and García-Lara (2017). However, we focus on private subsidiaries, whose specificities impede extrapolating the arguments and results of the studies carried out in the public setting. On the one hand, the conflict between managers and shareholders is not a major problem in the private subsidiaries setting where, if any, the agency problems arise from the conflict between the majority and the minority owners (La Porta, López-de-Silanes, Shleifer, & Vishny, 1999). Indeed, public firms are usually stand-alone companies where the influence of the foreign investor on the accounting policy is limited. In contrast, there is evidence that controlling shareholders significantly influence the firm's reporting activity (e.g.: Hedlund, 1981; Robinson & Stocken, 2013). Since the consolidated financial statements are obtained from the individual annual reports of all the firms within the consolidation perimeter, a parent company might manipulate the group's consolidated earnings via its subsidiaries. Additionally, looking at subsidiaries avoids capturing the compound effect of foreign and controlling shareholding on the quality of the firm's financial reporting outcomes.[1] Both effects would be mixed in a non-restricted sample, since investors tend to acquire majority stakes in their foreign invested firms (e.g.: Erramilli, 1996; Gatignon & Anderson, 1988); especially in settings where the legal framework does not provide sufficient protection, and foreign investors compensate this deficiency by taking large positions in their invested firms (La Porta et al., 2000).

On the other hand, literature suggests that private and public firms respond differently to some factors that determine financial reporting quality such as tax alignment, minority-shareholder rights or disclosure requirements (Burgstahler et al., 2006, p. 986). The lower demand and the weaker internal and external enforcement mechanisms make the cost-benefit relation of reporting good quality accounting information less positive in private than in public firms. Accordingly, several studies document lower reporting quality in the private setting: Ball and Shivakumar (2005) in the UK; Hope et al. (2013) in the US; Burgstahler et al. (2006) in a set of European countries; Goncharov and Zimmerman (2006) in Russia; or Arnedo, Lizarraga, and Sánchez-Alegría (2007) in Spain. There is also evidence that public companies use their private subsidiaries to manage the group's consolidated earnings in order

[1] Literature on ownership concentration and financial reporting quality is extensive, and offers conflicting results (Fan & Wong, 2002; Firth, Fung, & Rui, 2007; Francis, Schipper, & Vincent, 2005; Shleifer & Vishny, 1986 & 1997; Yeo, Tan, & Chen, 2002).

to overcome the restrictions imposed by capital markets (Bonacchi, Cipollini, & Zarowin, 2017).

Despite the relative lower quality of accounting information with regard to the public setting, accounting quality plays a role also in private companies (e.g.: Chen, Hope, Li, & Wang, 2011). This is also the case in Spain, where Gill-de-Albornoz and Illueca (2007) observe that, when private firms are large enough, higher accruals quality is associated with lower cost of debt. Therefore, specifically studying the determinants of financial reporting in this setting deserves attention. We are interested in the role of foreign shareholding, and more precisely in that of non-institutional investors (i.e., manufacturing and service firms).

We keep constant the country-level factors that determine the opportunities of the parent company to influence the quality of its subsidiaries' reporting policies, such as the accounting standards or the audit enforcement regulations. Ceteris paribus opportunities, our predictions are based on the incentives of the controlling shareholders.

Prior research indicates a preference for earnings manipulation away from enforcers. For example, Kedia and Rajgopal (2011) argue and find that the firm's proximity to a SEC's office is negatively associated with the likelihood of misreporting; and DeFond, Francis, and Hallman (2015) obtain evidence that receiving a modified audit opinion is more likely as the distance from a SEC's office increases. There is also evidence that firms manage earnings less when they are near to their investors (e.g.: Ayers, Ramalingegowda, & Yeung, 2011). Other studies document a higher prevalence of earnings management in companies whose auditors are located far away from their corporate headquarters. For instance, Brooks and Yu (2016) conclude that firms which tend to manage earnings are more likely to hire a big auditor located far away, while Choi, Kim, Qiu, and Zang (2012) and Jensen, Kim, and Yi (2015) find a negative association between local auditors and the absolute value of discretionary accruals. Building on this evidence, Fan (2012) finds that US MNCs manipulate foreign earnings more often than domestic earnings to avoid losses.

Given prior evidence on the firms' tendency to manage earnings away from their local monitors, in the context of MNCs earnings management should be more prevalent in foreign jurisdictions than in the home country of the parent company. Therefore, we expect that the incentives of parent companies to transfer earnings management to their subsidiaries are stronger when the parent is foreign. In other words, we expect that earnings manipulation is more prevalent in subsidiaries of foreign groups than in subsidiaries of local groups. We therefore state the following hypothesis:

H1: financial reporting quality of foreign group subsidiaries is poorer than that of companies controlled by local groups.

Similar to foreign analysts (e.g.: Bae, Stulz, & Tan, 2008), foreign investors have a poorer knowledge of local accounting standards and practices, at least during the first years after investment (Masulis et al., 2012).[2] Consequently, unless the incentives to produce high quality accounting information at the subsidiary level differ between foreign and local parent companies, accounting quality of foreign group subsidiaries should improve as the tenure of the controlling shareholder increases and the differences in accounting quality between foreign and local group subsidiaries should be reduced because of the foreign controlling shareholders' gain of knowledge about the local accounting standards and practices. In turn, if, as predicted, foreign parent companies have greater incentives to manipulate earnings, the controlling shareholder's tenure would affect foreign and local group subsidiaries differently. Thus, we argue that, as opposed to locally owned subsidiaries, the owner's tenure has a negative effect on reporting quality of foreign group subsidiaries. Accordingly, we state our second hypothesis as follows:

H2: the parent company's tenure has a negative effect on financial reporting quality of foreign group subsidiaries.

A number of studies show that strong institutions relate to higher earnings quality over and above firm-level characteristics. For example, Ball, Kothari, and Robin (2000) document that the timeliness of accounting income in common law countries is greater than in code law jurisdictions. Similarly, Bushman and Piotroski (2006) find that conservatism is on average lower in countries with weak shareholder protection. There is also evidence that strong investor protection regulations result in less pervasive earnings management activity (e.g.: Burgstahler et al., 2006; Dyck & Zingales, 2004; Fonseca & Gonzalez, 2008; Francis & Wang, 2008; Kanagaretnam, Lim, & Lobo, 2014; Leuz et al., 2003); and Han, Kang, Salter, and Yoo (2010) argue that both national culture and institutional features have explanatory power for earnings management around the world.

The evidence on the financial reporting implications of cross-country differences in institutional quality for MNCs is scarce. Two studies provide evidence that the institutional environment in the countries where the foreign subsidiaries are located is relevant to the quality of the groups' consolidated earnings (i.e., at the parent company level). Specifically, Durnev et al. (2017) investigate whether having subsidiaries in offshore financial centers is related to the parent companies' reporting quality. Using a sample of listed parent companies

[2] Indeed, foreign investors typically appoint managers from the parent company's country because they better serve the group's interests (e.g.: Edström & Galbraith, 1977; Harzing, 2001; Kopp, 1994; Tung, 1982 & 1987).

domiciled in 15 countries with relatively high institutional quality, they observe that financial reporting quality is lower when MNCs have subsidiaries in offshore financial centers and that the effect on earnings quality extends beyond tax avoidance. They also find that among MNCs with subsidiaries in offshore financial centers, non-US firms have less poor financial reporting quality than US firms, suggesting that the incentives for earnings management are greater for US-based firms. Dyreng et al. (2012) compare the level of earnings management in US MNCs and document that parent firms with a high proportion of subsidiaries located in weak rule of law countries or tax havens manage their earnings more than those with a high proportion of subsidiaries from countries with strong institutions or jurisdictions that are not tax havens. Additionally, they show that the effect of the subsidiaries' institutional quality is concentrated in foreign earnings. Only one study addresses the relation between institutional quality and earnings management from the subsidiaries' perspective, Beuselinck, Cascino, et al. (2017), which focuses on majority-owned subsidiaries (both public and private companies) located in 89 countries and provides evidence that MNCs headquartered in countries with more restrictive regulations manage earnings through subsidiaries established in jurisdictions with weak institutions. Our study adds to that of Beuselinck, Cascino, et al. (2017), where we hold constant two main factors that determine the opportunities of the parent companies to manipulate earnings at the subsidiary level, namely the host-country institutional characteristics and the pressures imposed by the capital market since we focus on privately held Spanish subsidiaries.

Strong institutional environments act as deterrents to earnings management. This means that firms located in countries with high quality institutions have less opportunities to manage their accounting numbers than those domiciled in countries with more lenient regulations. MNCs operate in multiple jurisdictions with different institutional environments which implies that parent companies whose earnings management practices are constrained by the legal institutions in their country of origin have incentives to transfer earnings management to their foreign subsidiaries located in countries with weaker institutions. Research suggests that the international differences in institutional quality underlie the incentives for earnings management within MNCs. Accordingly, we predict that the relation between foreign shareholding and financial reporting quality depends on the institutional quality of the country where the FDI comes from. Therefore, our third hypothesis states as follows:

H3: the relation between foreign ownership and financial reporting quality is sensitive to the institutional quality in the parent company's country of origin.

3. Research design

3.1. Sample

Our sample consists of 2,055 large private Spanish subsidiaries owned by local or foreign groups during the period 1997-2013. We consider that a firm is a subsidiary if there is a parent company which holds, directly or indirectly, at least 50.01 percent of the voting rights. Our primary source of data is SABI, a database by Bureau van Dijk covering a large number of Spanish companies. As a first step in the sample selection process, we used SABI's ownership files to select non-financial private subsidiaries that presented full financial statements in 2011.[3] As far as the information on a company's ownership structure is concerned, SABI does not provide historical ownership data but offers only the most recent information available at a given point in time; and 2011 was the year for which the database provided this information at the moment we began the sample selection process. For this reason we had to hand-collect the information on the controlling shareholder/s of each subsidiary for the period analyzed (1997-2013). Specifically, we used FACTIVA, an international news database produced by Dow Jones, to identify the date when each parent company gained control of the corresponding subsidiary. We also examined both the group's and the subsidiary's corporate websites to obtain information regarding the ownership changes. Additionally, we identified the country of origin of all the controlling shareholders in the sample, as well as the listing status of the parent firms during the sample period.

After obtaining the date/s of the change/s in control, we made the following assumptions: (1) a company is part of a given group during the period comprised between the date when that group's parent company became its controlling shareholder and (a) the date when a new group took over the company, (b) the date when it became a stand-alone company (i.e., a company that is not a subsidiary), or (c) 2013, if no other control change occurred after the last one identified; and (2) a company is controlled by the same group during the entire sample period when the controlling shareholder took control before 1997 and no control change was identified later on. For a better understanding of the hand-collecting process, we provide some examples in the Appendix.

We discarded observations of companies where the controlling shareholder, either local or foreign, is a financial or an institutional investor (i.e., private equity firms, banks, insurance companies, investment companies, mutual funds, hedge funds etc.) because these type of

[3] Spanish standards require companies to present full financial statements (i.e., detailed formats of both balance sheet and income statement, as well as cash flow and changes in equity statements) when they are large enough. In 2011, full financial statements were compulsory for all firms that had met two out of these criteria during two consecutive years: total assets more than 11,400 thousand Euros; net sales revenue higher than 22,800 thousand Euros; and average number of employees higher than 250. These companies must also have their annual accounts audited.

investors do not consolidate their invested companies' accounts. The sample period starts in 1997 because the availability of financial data necessary to calculate all the research variables significantly decreases before that year. Observations of year 2008 were dropped because some of the variables of the empirical analyses require comparable accounting information of two consecutive years, and the accounting standards applied by the sample firms changed in 2007 to harmonize with IFRS.[4] The new local standards have to be applied to prepare the financial statements since year 2008; and, despite the requirement to report the prior year information restated for comparability purposes, for the vast majority of the companies SABI provides the information of year 2007 prepared only under the old standards.

The final sample consists of 20,959 firm-year observations. Table 1 presents the distribution of the sample by the home country of the parent company (Panel A), and by industry (Panel B). About 53 percent of the sample observations correspond to subsidiaries with foreign controlling shareholders, which are headquartered in thirty nine countries. The countries with a higher presence are: France (10.76 percent of the whole sample), the US (10.59 percent), Germany (8.26 percent), the UK (3.79 percent), Italy (3.22 percent), Switzerland (3.00 percent), the Netherlands (2.81 percent), Japan (2.22 percent), Sweden (1.49 percent), and Belgium (1.06 percent). The rest of the countries represent individually less than one percent of the whole sample.[5] Subsidiaries included in our sample operate in six industry divisions based on the standard industrial classification of economic activities (SIC); the most represented industry in both subsamples is manufacturing, with 32.35 and 41.17 percent of the local and foreign group subsidiaries respectively. However, there are differences in the industry distribution between the two subsamples. Since financial reporting quality might also differ across industries, this indicates the need to control for industry affiliation in our subsequent tests.

[4] The companies analyzed have to prepare their financial statements under the standards established in the General Accounting Plan, which is part of the Spanish corporate law. The Spanish local GAAP were harmonized with the International Financial Reporting Standards (IFRS) by the Royal Decree 1514/2007. However, there are still differences between the Spanish local GAAP and IFRS (see Deloitte, 2011).

[5] The other home countries of foreign parent companies are (ordered by frequency): Portugal, Luxembourg, Ireland, Denmark, Finland, Austria, South Korea, United Arab Emirates, Bermuda, Norway, Canada, South Africa, Israel, Mexico, Australia, China, Kuwait, India, Brazil, Turkey, Hong Kong, Taiwan, Kazakhstan, Russia, New Zealand, Lithuania, Saudi Arabia, Algeria, and Colombia.

Table 1: Sample composition.

This table presents the composition of the sample by the parent company's country of origin (Panel A) and by industry (Panel B).

Panel A: Sample composition by the country of origin of the parent company

Country of origin	**Freq.**	**%**
Spain	9,756	46.55
France	2,256	10.76
United States	2,219	10.59
Germany	1,731	8.26
United Kingdom	794	3.79
Italy	674	3.22
Switzerland	628	3.00
Netherlands	588	2.81
Japan	466	2.22
Sweden	312	1.49
Belgium	222	1.06
Other	1,313	6.25
Total	**20,959**	**100.00**

Panel B: Sample composition by industry

	Local control		**Foreign control**	
Industry	**Freq.**	**%**	**Freq.**	**%**
Agriculture, Forestry & Fishing	118	1.21	76	0.68
Mining & Construction	1,219	12.49	330	2.95
Manufacturing	3,156	32.35	4,612	41.17
Transportation & Public Utilities	1,334	13.67	714	6.37
Wholesale & Retail Trade	1,817	18.62	3,436	30.67
Services	2,112	21.65	2,035	18.16
Total	**9,756**	**100.00**	**11,203**	**100.00**

3.2. Research variables

Financial reporting quality

An empirical assessment of financial reporting quality is difficult because of its context-specificity (Dechow, Ge, & Schrand, 2010, p. 344). We follow prior studies and use the magnitude of the discretionary (or abnormal) component of accruals, which is frequently used to proxy for the firm's earnings management behavior (García-Osma, Gill-de-Albornoz, & Gisbert, 2005).

Earnings are the sum of cash flows and accruals. Accrual accounting requires a great deal of professional judgment, allowing management to make discretionary choices. There is plenty of evidence suggesting that managers use such discretion to alter accounting numbers and give an interest-based image of the company (for a review see Dechow et al., 2010). Given that not all the observed accruals are opportunistic, the literature frequently uses an expectations model to split them into a non-discretionary (or normal) and a discretionary (or abnormal) component. In particular, we use two models: (1) the modified version of the Jones model proposed by Dechow, Sloan, and Sweeney (1995), which we estimate both in its total accruals and working capital accruals versions; and (2) the Dechow and Dichev (2002) model.

To calculate discretionary accruals with the modified Jones model (*DAC*) we first estimate the model proposed by Jones (1991), as presented in expression (1a), where for firm *i* in year *t*: *Accruals* are total accruals, calculated as the annual change in non-cash current assets less the annual change in current liabilities, less the annual depreciation expense; Δ*Sales* is the annual change in sales revenue, and *PPE* is the level of property, plant and equipment; and then use the estimated coefficients to calculate *DAC* as indicated in expression (1b), where Δ*Rec* is the annual change in accounts receivable.

$$Accruals_{i,t} = \alpha + \beta_1 \Delta Sales_{i,t} + \beta_2 PPE_{i,t} + \varepsilon_{i,t} \quad (1a)$$

$$DAC_{i,t} = Accruals_{i,t} - [\hat{\alpha} + \hat{\beta}_1 (\Delta Sales_{i,t} - \Delta Rec_{i,t}) + \hat{\beta}_2 PPE_{i,t}] \quad (1b)$$

The discretionary accruals from the working capital accruals version of the modified Jones model (*WCDAC*) are calculated similarly but using working capital accruals (*WCAccruals*) instead of *Accruals*[6] as the dependent variable and excluding *PPE* from the right hand side of the model.

[6] Working capital accruals are calculated as the annual change in non-cash current assets less the annual change in current liabilities.

Additionally, we use an accruals quality measure derived from the model proposed by Dechow and Dichev (2002) (*DD*). This model assesses the degree to which working capital accruals (*WCAccruals*) map into the past, current, and future cash flows from operations (*CFO*). In particular, we use the residuals of the estimation of model (2) to proxy for discretionary accruals.

$$WCAccruals_{i,t} = \alpha + \beta_1 CFO_{i,t-1} + \beta_2 CFO_{i,t} + \beta_3 CFO_{i,t+1} + \varepsilon_{i,t} \quad (2)$$

All the variables in models (1a), (1b) and (2) are scaled by lagged total assets. The models (1a) and (2) are estimated using the pool of observations that meet the size criteria required for our sample of subsidiaries, where we include industry and year controls.[7] Our proxies of the firm's financial reporting quality are the absolute value of the discretionary accruals measures estimated (i.e., |*DAC*|, |*WCDAC*|, and |*DD*|).

Institutional quality

Institutional quality is a broad concept and prior research in international accounting documents multiple characteristics of a country's institutional environment that explain the differences in financial reporting quality around the world. However, as noted by Leuz and Wysocki (2016), it is difficult to isolate the impact of an individual institutional attribute on reporting outcomes. Accordingly, we use six measures that proxy for the quality of institutions in the parent company's home country and construct an aggregate measure of institutional quality (*IQ*). In particular, we consider the following measures of institutional quality: (1) the anti-self-dealing index of Djankov, La Porta, López-de-Silanes, and Shleifer (2008), which focuses on private enforcement mechanisms; (2) the index of shareholder protection through securities laws of La Porta, López-de-Silanes, and Shleifer (2006); (3) the anti-director index of La Porta, López-de-Silanes, Shleifer, and Vishny (1998); (4) the aggregate earnings management score of Leuz et al. (2003); (5) the mean premium paid for the controlling block of Dyck and Zingales (2004), which proxies for private control benefits; and (6) the index for public enforcement of La Porta et al. (2006). Except for the earnings management score and the block premium, which are inverse measures, the rest are direct measures of institutional quality. These metrics have been frequently used as proxies for two fundamental dimensions of a country's institutional environment, namely the level of legal protection of minority shareholders and the quality of the enforcement mechanisms. Investor protection relates to the insiders' ability to consume private control benefits, strong outsider rights acting as a deterrent to earnings management (Leuz et al., 2003). On the other hand, legal enforcement plays a major role for the quality of reporting regulation given that the

[7] Results are qualitatively the same when estimating the models in each year and 2-digit SIC combination requiring a minimum of 10 observations per regression as in DeFond and Jiambalvo (1994), although the sample size is considerably reduced.

accounting standards may remain ineffective in the absence of strong enforcement mechanisms (e.g.: Burgstahler et al., 2006; Byard, Li, & Yu, 2011; Daske, Hail, Leuz, & Verdi, 2008; Holthausen, 2009; La Porta et al., 1998; Landsman, Maydew, & Thornock, 2011; Leuz, 2010).

To calculate our aggregate measure of institutional quality (*IQ*) we consider only the countries for which all the individual institutional quality measures are available. This leaves us with twenty one countries out of the forty included in our sample.[8] Firstly, we rank the parent companies' home countries (Spain included) based on each individual measure of institutional quality, and then we calculate *IQ* as the mean rank by country. Given that all the individual measures are static (i.e., they are obtained at a certain moment in time), each country has the same *IQ* during the entire sample period. We observe that the US ranks first in institutional quality which means that, of all the MNCs in our sample, US MNCs are subject to the highest institutional pressure in their country of origin. This is consistent with prior literature documenting the US superiority in terms of institutional quality (e.g.: Clarkson & Simunic, 1994; Jackson, 2006 & 2007; Leuz, 2010; Hope, 2003). Other countries with strong institutions are Australia, Canada, Hong Kong, and the UK, whereas South Korea, Switzerland, Italy, Germany, and Austria have the lowest institutional quality in our sample. Spain ranks eleventh out of the twenty one countries included in this analysis.

3.3. Empirical models

Tests of H1

We explore the relation between foreign shareholding and accruals quality by estimating model (3), where we omit coefficients for simplicity, and subscripts *i* and *t* represent firm and year respectively.

$$\begin{aligned} FRQ_{i,t} = {} & Foreignown_{i,t} + Size_{i,t} + Lev_{i,t} + |Roa|_{i,t} + |CFO|_{i,t} + Loss_{i,t} \\ & + Salesgrowth_{i,t} + Big_{i,t} + NBanksA_{i,t} + ListedP_{i,t} \\ & + Year\ Effects_{i,t} + Industry\ Effects_{i,t} \end{aligned} \quad (3)$$

The definitions of all the variables are in Table 2. *FRQ* is financial reporting quality and stands for |*DAC*|, |*WCDAC*| or |*DD*|. The main experimental variable is *Foreignown*, a dummy that equals 1 if the parent company is foreign, and 0 if it is local. In H1 we predict that the financial reporting quality of foreign group subsidiaries is poorer than that of

[8] Even though the number of countries is substantially reduced, the number of observations is not since we lose only 835 firm-year observations in this analysis (i.e., less than 5 percent of the initial sample).

subsidiaries controlled by local groups. Accordingly, the coefficient of *Foreignown* is expected to be significantly positive. The model includes a set of control variables, since we are interested in the effect of foreign shareholding on financial reporting quality above and beyond the effect of other factors. We include several firm characteristics in which subsidiaries of local and foreign groups potentially differ and that prior studies relate to discretionary accruals. We control for firm size using the logarithm of total sales (*Size*). Foreign group subsidiaries are potentially larger than those of local groups, while the previously documented relation of firm size with our proxies of accounting quality is unclear. Larger firms have higher political costs and better internal control procedures over financial reporting, and therefore exhibit lower levels of discretionary accruals (e.g.: Ball & Foster, 1982; Hribar & Nichols, 2007); although larger firms have also greater incentives to incur in income smoothing (e.g.: Craig & Walsh, 1989; Michelson, Jordan-Wagner, & Wootton, 1995 & 2000; Moses, 1987). The company's leverage, calculated as total debt over total assets (*Lev*), proxies for the firm's financial constraints and is expected to be positively associated with the prevalence of earnings manipulation since higher bankruptcy risk is related to higher discretionary accruals (e.g.: DeAngelo, DeAngelo, & Skinner, 1994; DeFond & Jiambalvo, 1994). Firm performance is another determinant of reporting quality that in turn has been related to foreign ownership. There is evidence that firms with extreme performance and loss-making firms have higher discretionary accruals (e.g.: Dechow & Dichev, 2002; Dechow et al., 1995), so that we control for performance with the absolute value of the return on assets ratio (|*Roa*|), the absolute value of the cash flow from operations (|*CFO*|), and a dummy variable equaling 1 if the firm reports losses, and 0 otherwise (*Loss*).[9] The model also includes the annual rate of sales growth (*Salesgrowth*), since previous studies show that growing firms tend to report higher levels of discretionary accruals (e.g.: Menon & Williams, 2004).

[9] We use the absolute values of ROA and CFO because the discretionary accruals variables are also unsigned. Results are similar whether we use signed ROA and CFO instead.

Table 2: Variable definitions.

Variable	Description
Accruals	Total accruals, calculated as the annual change in non-cash current assets less the annual change in current liabilities, and less the annual depreciation expense.
Big	Dummy variable that equals 1 if the firm is audited by a multinational audit firm, 0 otherwise.
CFO	Cash flow from operations, calculated as earnings before taxes less total accruals (*Accruals*).
DAC	Discretionary accruals obtained from the total accruals version of the modified Jones model (Dechow et al., 1995).
DD	Discretionary accruals calculated as de residuals of the Dechow and Dichev (2002) model.
Foreignjyr (*j = 2* or *3*)	Dummy variables that equal 1 in the *j* years after (before) the takeover by a foreign (local) shareholder, and 0 in the *j* years before (after) the takeover by a foreign (local) shareholder.
Foreignown	Dummy variable that equals 1 if the parent company is foreign, 0 if it is local.
IQ	Aggregate measure of institutional quality calculated as the mean rank by country based on six institutional quality indexes.
Lev	Ratio of total debt to total assets.
ListedP	Dummy variable that equals 1 whether the parent company is listed, 0 otherwise.
Loss	Dummy variable that equals 1 if net income is negative, 0 otherwise.
NBanks	Number of banks the company works with.
NBanksA	*NBanks* over total assets. This variable is multiplied by 1,000 for expositional convenience.
PPE	Property, plant and equipment.
Rec	Accounts receivable.
Roa	Ratio of net income over total assets.
Sales	Total sales.
Salesgrowth	Annual growth rate in sales.
Size	Natural logarithm of *Sales*.
TenureP	Number of years since the parent company became the firm's controlling shareholder.
Treat	Dummy variable that equals 1 for observations of firms that change from local to foreign control during the sample period, and 0 for observations of firms that are under local control during the entire sample period.
WCAccruals	Working capital accruals, calculated as the annual change in non-cash current assets less the annual change in current liabilities.
WCDAC	Discretionary accruals obtained from the working capital accruals version of the modified Jones model proposed by Dechow et al. (1995).
$\|X\|$	Absolute value of the variable *X*.
ΔX	Annual change of the variable *X*.

A potentially important confounding factor affecting both financial reporting quality and foreign ownership is the auditor's size, which we proxy with a dummy variable equaling 1 if the firm is audited by a multinational audit firm, and 0 otherwise (*Big*). Foreign investors are more likely to choose one of the internationally renowned audit firms, and auditor size is in turn a determinant of financial reporting quality. US-based research finds that companies audited by big auditors have lower discretionary accruals (Becker, DeFond, Jiambalvo, & Subramanyam, 1998; Francis & Krishnan, 1999). However, there is also evidence that large auditors are less conservative and have lower incentives to constrain earnings management in settings with less restrictive regulation and lenient audit environment (e.g.: Francis & Wang, 2008; Maijoor & Vanstraelen, 2006; Van Tendeloo & Vanstraelen, 2008). Additionally, the role of auditor reputation as determinant of financial reporting quality in the private setting, where the risk of reputation loss is lower than in public firms, has been scarcely explored (Hope & Langli, 2010).

We control for the firm's dependence on bank financing with the variable *NBanksA*, calculated as the number of banks the company works with over total assets. Banks are the most important users of financial statements in the private setting, and financial reporting quality is related to loan terms (Armstrong, Guay, & Weber, 2010; Chen, He, Ma, & Stice, 2016; Karjalainen, 2011). The higher the dependence on bank financing the more important the incentives of debt contracting for financial reporting quality. Thus, given that subsidiaries of foreign groups are documented to be more financially dependent on the parent company than subsidiaries of local groups (e.g.: Chowdhry & Coval, 1998; Huizinga, Laeven, & Nicodeme, 2008), [10] the observed relation between foreign shareholding and financial reporting quality could be due to different debt contracting incentives.

Similarly, we control for the listing status of the parent company (*ListedP*), since the capital markets' pressure generates incentives for parent companies to manipulate their subsidiaries' accounts (Bonacchi et al., 2017), and in our sample the rate of listed parent companies is substantially higher among foreign investors, which is as expected because the rate of public companies in Spain is much lower than in many of the countries where the FDI comes from.

Finally, model (3) includes year and industry effects, where the latter are built based on the SIC classification. We winsorize all the continuous variables at the 1 percent and 99 percent levels to minimize the effect of outliers,[11] and use ordinary least squares (OLS) to estimate

[10] MNCs' subsidiaries are frequently funded with the parent company's loans since *MNCs can exploit the tax advantage of debt more aggressively than national companies* (e.g.: Møen, Schindler, Schjelderup, & Tropina, 2011).

[11] Our conclusions remain unchanged whether we truncate the sample below percentile 1 and above percentile 99 of the variables |*DAC*|, |*WCDAC*|, |*DD*|, *Size*, *Lev,* |*Roa*|, |*CFO*|, *Salesgrowth*, and *NBanksA*.

model (3) and the rest of the models presented later on, where we correct standard errors by clustering on both firm and year following Cameron, Gelbach, and Miller (2011).

Tests of H2

In H2 we state that the tenure of the foreign owner is expected to have a negative incremental effect on the subsidiary's reporting quality. To test this prediction, we estimate the model presented in equation (4), where we extend model (3) with two additional regressors: *TenureP* is the number of years since the parent company became the controlling shareholder; and *TenureP_Foreignown*, is the interaction of *TenureP* with *Foreignown*. The coefficient of *TenureP* indicates how the controlling shareholder's tenure relates to the reporting quality of firms under local control, while the coefficient of the interaction term *TenureP_Foreignown* captures the incremental effect of foreign shareholding on the relation between the controlling shareholder's tenure and the magnitude of discretionary accruals. Finally, the sum of the coefficients of *TenureP* and *TenureP_Foreignown* indicates how the controlling shareholder's tenure relates to financial reporting quality in the sample of foreign group subsidiaries.

$$FRQ_{i,t} = Foreignown_{i,t} + TenureP_{i,t} + TenureP\_Foreignown_{i,t} + Control\ Variables_{i,t} \quad (4)$$

Given our predictions, we expect a positive and significant coefficient of the interaction term *TenureP_Foreignown*. In other words, we expect that as the tenure of foreign owners increases, they become more knowledgeable about the local accounting regulation which enables them to transfer earnings manipulation to their subsidiaries.

Tests of H3

In H3 we aim to provide evidence on the role of the institutional quality of the parent companies' home country in the relation between foreign shareholding and financial reporting quality. For this purpose, we partition the sample of foreign-owned subsidiaries in two subsamples depending on the level of institutional quality in the parent company's country of origin with reference to that in Spain. We use an aggregate measure of institutional quality (*IQ)* which we construct based on several country-level institutional quality proxies suggested in the literature (see section 3.2.). Subsequently, we estimate model (3) in the subsamples where the parent company is located in a country that ranks higher or lower than Spain in *IQ*. Consistent with our predictions, we expect that the coefficient of *Foreignown* is significantly more positive in the subsample where the foreign group subsidiaries' owners are headquartered in countries with higher quality institutions than Spain.

4. Descriptive statistics, univariate tests and correlations

Table 3 reports the descriptive statistics of the research variables by type of parent company, local (N = 9,756, except for variables *DAC* and *DD* where the sample is reduced) and foreign (N = 11,203, except for variables *DAC* and *DD*), as well as the statistics for the corresponding tests to compare means, distributions, or proportions between the two groups. Table 4 presents Pearson pair wise correlations.

Both the descriptive statistics and the correlations are consistent with our main prediction, that is, financial reporting of foreign controlled firms is of lower quality than that of firms under local control. Subsidiaries of foreign groups report significantly higher levels of discretionary accruals (mean |*DAC*| of 0.109 vs. 0.103; mean |*WCDAC*| of 0.107 vs. 0.101; mean |*DD*| of 0.066 vs. 0.058). However, the two groups of subsidiaries also exhibit significant differences in other variables that in turn are related to financial reporting quality. On average, firms with foreign controlling shareholders are larger (*Sales*) and less leveraged (*Lev*), have higher return on sales (|*Roa*|) and cash flows from operations (|*CFO*|), are more likely to incur in losses (*Loss*), and have lower sales growth rates (*Salesgrowth*) than companies under local control.[12] Additionally, as expected, the proportion of international auditors (*Big*) and listed parent companies (*ListedP*) is significantly higher in the subsidiaries of foreign groups, and the dependence on bank financing (*NBanksA*) is significantly higher in subsidiaries of local groups. Also as expected, all these variables are significantly correlated to our financial reporting quality measures. Therefore, the observed positive association at the univariate level between foreign shareholding and our discretionary accruals measures could be just reflecting some confounding effect/s. This calls for carrying out multivariate analysis in order to get any meaningful insights on the relation between foreign shareholding and our financial reporting quality proxies.

[12] For the sake of comparability, we provide some references of our sample characteristics with regard to other studies using Spanish data. As expected, our sample firms are smaller and less leveraged than listed Spanish firms included in the sample of Beuselinck, Blanco, and García-Lara (2017). As compared to the private firms with audited financial statements used in Cano-Rodríguez and Sánchez-Alegría (2012), our sample firms are larger, and have higher growth rates, while they are similar in terms of leverage and profitability. Finally, compared to SMEs with audited accounts studied in Huguet and Gandía (2016), the firms included in our sample are larger, more leveraged and profitable, and have higher growth rates.

Table 3: Descriptive statistics of research variables.

This table presents the descriptive statistics of the variables included in our baseline model for the two subsamples of subsidiaries (with local or foreign control), as well as the tests that compare the characteristics of the two subsamples. Variable definitions are in Table 2. The last three columns show respectively the *t*-statistics, $\chi 2$-statistics and *z*-statistics of the tests where the null hypothesis is that the two groups have identical means, distributions or proportions. Statistical significance is indicated by *** for p < 0.01, ** for p < 0.05, and * for p < 0.1.

	Local control				Foreign control				Means diff.	Kruskal Wallis	Proportions diff.
Variable	**N**	**Mean**	**Median**	**Stddev**	**N**	**Mean**	**Median**	**Stddev**			
|*DAC*|	9,733	0.103	0.059	0.134	11,174	0.109	0.063	0.139	-2.81***	8.37***	
|*WCDAC*|	9,756	0.101	0.058	0.129	11,203	0.107	0.062	0.134	-3.30***	16.75***	
|*DD*|	8,337	0.058	0.038	0.072	9,516	0.066	0.043	0.079	-6.98***	60.58***	
Sales (million €)	9,756	209.755	59.960	526.213	11,203	265.639	104.839	531.716	-7.63***	895.61***	
Lev	9,756	0.653	0.674	0.239	11,203	0.646	0.663	0.263	1.87*	8.06***	
|*Roa*|	9,756	0.066	0.044	0.072	11,203	0.079	0.053	0.083	-11.79***	142.55***	
|*CFO*|	9,756	0.119	0.081	0.125	11,203	0.127	0.084	0.133	-4.37***	8.08***	
Loss	9,756	0.206	0.000	0.404	11,203	0.253	0.000	0.434			-8.04***
Salesgrowth	9,756	0.216	0.063	0.944	11,203	0.182	0.054	0.810	2.82***	2.98*	
Big	9,756	0.791	1.000	0.407	11,203	0.907	1.000	0.291			-23.60***
NBanksA	9,756	0.091	0.044	0.188	11,203	0.055	0.027	0.107	17.02***	531.32***	
ListedP	9,756	0.465	0.000	0.499	11,203	0.755	1.000	0.430			-43.15***

Table 4: Correlations.

This table presents Pearson pair wise correlations of the research variables. Variable definitions are in Table 2. Statistical significance is indicated by *** for p < 0.01, ** for p < 0.05, and * for p < 0.1.

		(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*	*(7)*	*(8)*	*(9)*	*(10)*	*(11)*	*(12)*	*(13)*
(1)	***|DAC|***	**1.00**												
(2)	***|WCDAC|***	0.96***	**1.00**											
(3)	***|DD|***	0.57***	0.57***	**1.00**										
(4)	***Foreignown***	0.02***	0.02***	0.05***	**1.00**									
(5)	***Size***	-0.12***	-0.12***	-0.11***	0.18***	**1.00**								
(6)	***Lev***	0.11***	0.10***	0.07***	-0.01*	0.03***	**1.00**							
(7)	***|Roa|***	0.19***	0.20***	0.45***	0.08***	-0.06***	-0.04***	**1.00**						
(8)	***|CFO|***	0.59***	0.58***	0.30***	0.03***	-0.06***	0.03***	0.42***	**1.00**					
(9)	***Loss***	0.11***	0.10***	0.18***	0.06***	-0.08***	0.27***	0.07***	0.02***	**1.00**				
(10)	***Salesgrowth***	0.26***	0.25***	0.25***	-0.02***	-0.03***	0.08***	-0.01	0.04***	-0.001	**1.00**			
(11)	***Big***	0.03***	0.03***	0.03***	0.16***	0.14***	-0.004	0.05***	0.05***	0.03***	0.01*	**1.00**		
(12)	***NBanksA***	0.04***	0.04***	0.05***	-0.12***	-0.40***	0.06***	0.06***	0.03***	0.01	0.01**	-0.13***	**1.00**	
(13)	***ListedP***	0.03***	0.03***	0.04***	0.30***	0.13***	-0.004	0.06***	0.04***	0.002	0.01	0.27***	-0.10***	**1.00**

5. Regression results

Table 5 presents the results of the estimation of model (3). The coefficient of *Foreignown* is positive and statistically significant at conventional levels regardless of the accruals quality measure employed. Thus, above and beyond the effect of the rest of the explanatory variables included in our model, the magnitude of the discretionary accruals is significantly higher for the firms controlled by foreign groups. This result is consistent with the evidence obtained at the univariate level and supports our prediction in H1: earnings management practices are more pervasive, and therefore financial reporting quality is poorer, in foreign group subsidiaries than in local group subsidiaries. The results are not only statistically significant but also economically important: the coefficient of *Foreignown* ranges between 0.003 and 0.005, meaning that, keeping the rest of controls constant at their means, the magnitude of discretionary accruals in the foreign group subsidiaries represents on average between 0.3 and 0.5 percent more of total assets than in the subsidiaries of local groups.

Regarding the coefficients of the control variables, although the sign of the coefficient of |*Roa*| differs depending on the discretionary accruals measure considered, both |*CFO*| and *Loss* are positively and significantly associated with the magnitude of discretionary accruals, which is consistent with prior research indicating that firms with extreme performance have higher discretionary accruals. Additionally, the magnitude of discretionary accruals significantly increases with leverage (*Lev*) and sales growth (*Salesgrowth*), and decreases with firm size (*Size*). The variable measuring bank financing dependence (*NBanksA*) is negative and marginally significant, which suggests that debt contracting incentives increase the need for companies to have better accruals quality. Finally, the coefficients of *Big* (auditor size) and *ListedP* (the listing status of the parent company) are positive although not statistically significant.

Table 5: Foreign control and financial reporting quality. Regression analysis.

This table presents the results of the estimation of model (3). Variable definitions are in Table 2. We report *t*-statistics adjusted for clustering on both firm and year. Statistical levels are indicated by *** for p < 0.01, ** for p < 0.05, and * for p < 0.1.

Variables	***|DAC|***	***|WCDAC|***	***|DD|***
Constant	0.121***	0.090***	0.061***
	[10.21]	[8.53]	[7.44]
Foreignown	0.005***	0.005**	0.003**
	[2.63]	[2.55]	[2.15]
Size	-0.008***	-0.008***	-0.005***
	[-8.81]	[-8.52]	[-6.61]
Lev	0.024***	0.021***	0.012***
	[5.28]	[4.44]	[3.34]
|Roa|	-0.114***	-0.091***	0.390***
	[-3.57]	[-3.24]	[24.41]
|CFO|	0.634***	0.595***	0.074***
	[45.24]	[38.62]	[8.18]
Loss	0.029***	0.024***	0.027***
	[11.54]	[10.37]	[7.72]
Salesgrowth	0.036***	0.033***	0.022***
	[15.43]	[15.51]	[13.50]
Big	0.002	0.002	0.001
	[0.91]	[0.77]	[0.61]
NBanksA	-0.008	-0.008	-0.010*
	[-1.34]	[-1.32]	[-1.69]
ListedP	0.003	0.003	0.002
	[1.44]	[1.46]	[1.26]
Year and industry effects	Yes	Yes	Yes
No. observations	20,907	20,959	17,853
R-squared	0.426	0.404	0.314
F-statistic	144.30***	143.67***	70.08***

Table 6 provides the results of the estimation of model (4). The coefficient of *TenureP* is negative and significant at the 1 percent level, suggesting that accruals quality improves with the tenure of the parent company when subsidiaries are owned by local groups. Most important, and consistent with our predictions in H2, the coefficient of the interaction term (*TenureP_Foreignown*) is positive and significant, indicating that when the parent company is foreign the controlling shareholder's tenure has a negative incremental effect on the subsidiary's reporting quality. Finally, the sum of the coefficients of *TenureP* and *TenureP_Foreignown* is not significantly different from zero, which means that accruals quality does not significantly change as the parent company's tenure increases in the case of foreign group subsidiaries.

In sum, the subsidiaries' reporting quality does not improve as the foreign parent company's tenure increases. On the contrary, the incremental effect of the controlling shareholder's tenure on the subsidiaries' financial reporting quality is significantly negative when the parent company is foreign. These results are compatible with the explanation that, over time, foreign owners gain a richer knowledge of local accounting standards and practices which enables them to transfer earnings management to their subsidiaries located in countries with low quality institutions. Overall, results support the thesis that the lower quality of the accounting numbers reported by firms under foreign control is driven by the parent company's incentives.

The results of the analysis on the role of the institutional quality of the parent company's home country are reported in Table 7. The coefficient of *Foreignown* is positive and statistically significant only when we consider the subsample of foreign group subsidiaries with parent companies located in relatively high institutional quality countries.[13] This evidence supports our predictions in H3. Thus, the positive association between foreign shareholding and earnings management practices is driven by the group of subsidiaries where the parent companies come from countries with stronger institutional environments than Spain.

[13] Results (untabulated) are qualitatively the same when the sample is partitioned using each individual measure of institutional quality or considering the two underlying factors obtained from applying a factor analysis procedure.

Table 6: Parent company's tenure and financial reporting quality.

This table presents the results of the estimation of model (4). Variable definitions are in Table 2. We report *t*-statistics adjusted for clustering on both firm and year. We also report the *F*-statistic of the Wald test whose null hypothesis is that the sum of the two coefficients is not significantly different from zero. Statistical levels are indicated by *** for p < 0.01, ** for p < 0.05, and * for p < 0.1.

Variables	***|DAC|***	***|WCDAC|***	***|DD|***
Constant	0.124***	0.095***	0.062***
	[10.39]	[8.73]	[7.43]
(1) Foreignown	-0.001	-0.000	-0.000
	[-0.37]	[-0.08]	[-0.02]
(2) TenureP	-0.0006***	-0.0006***	-0.0003***
	[-2.84]	[-3.02]	[-2.71]
(3) TenureP_Foreignown	0.0006***	0.0006***	0.0003**
	[2.91]	[2.74]	[2.44]
(2) + (3)	0.0000	0.0000	0.0000
F-statistic test (2) + (3) = 0	[0.01]	[0.31]	[0.27]
Size	-0.008***	-0.008***	-0.005***
	[-8.70]	[-8.46]	[-6.44]
Lev	0.024***	0.020***	0.011***
	[5.21]	[4.32]	[3.32]
|Roa|	-0.113***	-0.090***	0.390***
	[-3.54]	[-3.22]	[24.49]
|CFO|	0.633***	0.595***	0.074***
	[45.32]	[38.71]	[8.15]
Loss	0.029***	0.023***	0.027***
	[11.57]	[10.33]	[7.72]
Salesgrowth	0.036***	0.033***	0.022***
	[15.39]	[15.41]	[13.39]
Big	0.002	0.002	0.001
	[0.88]	[0.73]	[0.57]
NBanksA	-0.008	-0.008	-0.010*
	[-1.37]	[-1.35]	[-1.71]
ListedP	0.004*	0.004*	0.002
	[1.65]	[1.68]	[1.46]
Year and industry effects	Yes	Yes	Yes
No. observations	20,907	20,959	17,853
R-squared	0.426	0.404	0.314
F-statistic	136.02***	135.64***	66.02***

Table 7: Foreign control and financial reporting quality: The role of the institutional quality in the parent company's home country.

This table presents the results of the estimation of model (3) in the subsamples where the observations of the foreign controlled firms are partitioned according to the level of institutional quality in the parent company's home country with respect to that in Spain. Variable definitions are in Table 2. We report *t*-statistics adjusted for clustering on both firm and year. We also report the *χ2* for the difference in the coefficient of *Foreignown* of the two estimations. Statistical levels are indicated by *** for p < 0.01, ** for p < 0.05, and * for p < 0.1.

	|DAC|		***|WCDAC|***		***|DD|***	
Variables	**HigherIQ vs Local**	**LowerIQ vs Local**	**HigherIQ vs Local**	**LowerIQ vs Local**	**HigherIQ vs Local**	**LowerIQ vs Local**
Constant	0.090***	0.125***	0.118***	0.092***	0.052***	0.047***
	[6.93]	[8.78]	[7.91]	[7.23]	[10.82]	[5.18]
Foreignown	0.009***	0.003	0.009***	0.003	0.004**	0.001
	[4.45]	[1.12]	[4.50]	[1.20]	[2.48]	[0.54]
Size	-0.009***	-0.008***	-0.008***	-0.008***	-0.005***	-0.004***
	[-9.48]	[-7.47]	[-7.93]	[-6.85]	[-6.20]	[-5.80]
Lev	0.021***	0.028***	0.020***	0.024***	0.009**	0.016***
	[3.89]	[4.89]	[3.44]	[3.94]	[2.22]	[3.35]
|Roa|	-0.116***	-0.133***	-0.092***	-0.114***	0.373***	0.386***
	[-3.00]	[-3.45]	[-2.66]	[-3.41]	[19.12]	[17.54]
|CFO|	0.645***	0.624***	0.607***	0.589***	0.083***	0.069***
	[41.05]	[34.35]	[35.96]	[30.94]	[9.19]	[4.97]
Loss	0.028***	0.027***	0.023***	0.022***	0.027***	0.027***
	[11.20]	[9.13]	[9.93]	[8.05]	[7.61]	[6.32]
Salesgrowth	0.036***	0.035***	0.032***	0.032***	0.024***	0.022***
	[12.29]	[14.08]	[12.82]	[15.06]	[11.30]	[13.22]
Big	0.004	0.000	0.003	-0.000	-0.000	0.001
	[1.59]	[0.22]	[1.46]	[-0.08]	[-0.01]	[0.59]
NBanksA	-0.009	-0.008	-0.008	-0.009	-0.010**	-0.009
	[-1.62]	[-1.28]	[-1.20]	[-1.28]	[-2.05]	[-1.61]
ListedP	0.002	0.000	0.001	-0.000	0.004**	0.000
	[0.78]	[0.14]	[0.46]	[-0.01]	[2.10]	[0.30]
Test for the difference in Foreignown (χ2 HigherIQ *vs* LowerIQ):						
	7.57***		8.04***		5.41**	
Year and industry effects	Yes	Yes	Yes	Yes	Yes	Yes
No. observations	15,213	14,595	15,252	14,628	13,012	12,495
R-squared	0.434	0.420	0.412	0.399	0.305	0.315
F-statistic	109.12***	95.16***	108.74***	94.78***	47.01***	44.42***

6. Control changes and financial reporting quality

Inferring causality in the reported relation between foreign shareholding and financial reporting quality is challenging. We intend to further address this issue by exploring the sample of subsidiaries where we observe changes of control (i.e., firms that during the sample period changed from a foreign to a local parent company and vice versa). Specifically, we identify 160 takeovers where the subsidiary changes from a local to a foreign controlling shareholder and 42 takeovers where the subsidiary changes from a foreign to a local controlling shareholder.

In a first set of tests, we restrict the sample to the firm-years around these 202 takeovers, and compare the accruals quality of years under foreign and local control. In particular, we estimate the model specified in expression (5), where the coefficients and control variables are omitted for simplicity; and $Foreignjyr_{i,t}$ is a dummy variable that equals 1 in the j years after (before) the takeover by a foreign (local) shareholder, and 0 in the j years before (after) the takeover by a foreign (local) shareholder, with j equaling 2 or 3. The rest of the control variables are as defined in model (3).

$$FRQ_{i,t} = Foreignjyr_{i,t} + Control\ Variables_{i,t} \quad (5)$$

Results of this additional analysis are reported in Panel A of Table 8. The coefficients of *Foreign2yr* and *Foreign3yr* are positive and statistically significant at conventional levels in five out of the six estimations carried out. This indicates that the magnitude of discretionary accruals is higher in the years when the owner of the company is a foreign group, suggesting that the deterioration (improvement) of accruals quality is a consequence of changing from local (foreign) to foreign (local) control.

In a second set of tests, we use a differences-in-differences design where companies that are controlled by a local group during the entire sample period are used as the control sample; and the treatment sample is composed of firms that during the sample period change from local to foreign control. We define a dummy variable, *Treat*, that equals 1 for observations belonging to the treatment sample, and 0 for the control sample; and estimate the model specified in equation (6), where the coefficients and control variables are omitted for simplicity. The coefficient of *Treat* captures the differences in financial reporting quality between the control and the treatment samples other than those related to foreign shareholding while *Foreignown* captures the effect of foreign takeovers on financial reporting quality.

$$FRQ_{i,t} = Treat_{i,t} + Foreignown_{i,t} + Control\ Variables_{i,t} \quad (6)$$

We report the results of this analysis in Panel B of Table 8. The first three columns show the results of the estimation of model (6) in the entire control and treatment

samples, while in the last three columns we report the results of the estimation where we restrict the treatment sample to the three years around the takeover. Irrespective of the accruals quality measure and treatment sample employed, the coefficients of *Foreignown* are positive and statistically significant at conventional levels, indicating that foreign shareholding increases earnings manipulation, and therefore reduces reporting quality.

Table 8: Control changes and financial reporting quality.

Panel A presents the results of the estimation of model (5) while Panel B presents the results of the estimation of model (6). We report *t*-statistics adjusted for clustering on both firm and year. Variable definitions are in Table 2. Statistical levels are indicated by *** for p < 0.01, ** for p < 0.05, and * for p < 0.1.

Panel A: Comparing years around takeovers under local and foreign control

	Two years around takeovers			***Three years around takeovers***		
Variables	***|DAC|***	***|WCDAC|***	***|DD|***	***|DAC|***	***|WCDAC|***	***|DD|***
Constant	0.162*	0.014	0.155***	0.067	0.067	0.052
	[1.70]	[0.31]	[3.47]	[1.47]	[1.58]	[0.62]
Foreign2yr	0.031**	0.031**	0.011			
	[2.08]	[2.10]	[1.48]			
Foreign3yr				0.026**	0.025**	0.015**
				[2.30]	[2.30]	[2.39]
Size	-0.004	-0.005	-0.001	-0.004	-0.005	-0.001
	[-1.03]	[-1.11]	[-0.29]	[-1.27]	[-1.33]	[-0.31]
Lev	0.036	0.036	0.034*	0.046	0.043	0.037**
	[0.94]	[1.10]	[1.96]	[1.42]	[1.51]	[2.47]
|Roa|	0.192	0.137	0.690***	0.181	0.149	0.585***
	[1.22]	[0.82]	[12.07]	[1.39]	[1.09]	[10.16]
|CFO|	0.462***	0.456***	-0.056	0.417***	0.416***	-0.049
	[4.85]	[4.94]	[-0.88]	[5.61]	[6.34]	[-1.63]
Loss	0.023*	0.024*	0.027***	0.003	0.004	0.016**
	[1.80]	[1.91]	[4.79]	[0.54]	[0.70]	[2.45]
Salesgrowth	0.009	0.009	0.014**	0.021**	0.020**	0.020***
	[1.31]	[1.25]	[2.18]	[2.19]	[2.11]	[2.77]
Big	0.017	0.018	0.003	-0.000	0.002	-0.004
	[1.37]	[1.47]	[0.42]	[-0.02]	[0.21]	[-0.52]
NBanksA	0.037	0.029	0.048	-0.014***	-0.008**	0.031*
	[0.78]	[0.54]	[1.53]	[-5.61]	[-2.06]	[1.72]
ListedP	0.003	0.006	0.007	-0.001	0.001	0.002
	[0.22]	[0.54]	[1.39]	[-0.13]	[0.10]	[0.51]
Year and industry effects	Yes	Yes	Yes	Yes	Yes	Yes
No. observations	421	427	370	554	562	482
R-squared	0.410	0.384	0.518	0.360	0.352	0.468
F-statistic	4.13***	3.41***	4.22***	4.65***	4.11***	4.39***

Table 8: Control changes and financial reporting quality (Cont'd).

Panel B: Differences-in-differences design

	All years			***Three years around takeover***		
Variables	***|DAC|***	***|WCDAC|***	***|DD|***	***|DAC|***	***|WCDAC|***	***|DD|***
Constant	0.102***	0.098***	0.054***	0.110***	0.107***	0.054***
	[5.48]	[3.26]	[4.12]	[5.58]	[5.53]	[4.14]
Treat	-0.002	-0.005	-0.002	-0.013	-0.010	-0.009**
	[-0.28]	[-0.72]	[-0.61]	[-1.62]	[-1.21]	[-2.56]
Foreignown	0.013**	0.016**	0.010**	0.028***	0.025***	0.022***
	[2.19]	[2.42]	[2.13]	[3.39]	[2.69]	[3.23]
Size	-0.008***	-0.007***	-0.004***	-0.009***	-0.008***	-0.004***
	[-5.73]	[-4.91]	[-3.30]	[-5.65]	[-4.95]	[-3.72]
Lev	0.028***	0.028***	0.012**	0.026***	0.027***	0.010*
	[3.80]	[3.68]	[2.44]	[3.19]	[3.11]	[1.91]
|Roa|	-0.157***	-0.136***	0.345***	-0.184***	-0.166***	0.334***
	[-3.26]	[-2.91]	[13.55]	[-3.81]	[-3.47]	[12.39]
|CFO|	0.649***	0.615***	0.086***	0.647***	0.618***	0.081***
	[27.12]	[24.73]	[4.45]	[24.83]	[23.75]	[4.04]
Loss	0.027***	0.023***	0.026***	0.025***	0.022***	0.026***
	[8.98]	[7.10]	[5.74]	[8.12]	[6.94]	[5.59]
Salesgrowth	0.036***	0.033***	0.025***	0.033***	0.030***	0.024***
	[11.54]	[11.19]	[14.01]	[9.34]	[10.15]	[9.32]
Big	0.002	0.001	-0.001	0.003	0.002	-0.001
	[0.77]	[0.46]	[-0.29]	[0.99]	[0.64]	[-0.29]
NBanksA	0.003	0.005	0.000	0.000	0.002	-0.002
	[0.36]	[0.45]	[0.01]	[0.03]	[0.14]	[-0.30]
ListedP	0.000	-0.002	0.004*	-0.001	-0.003	0.003
	[0.07]	[-0.72]	[1.85]	[-0.39]	[-1.16]	[1.51]
Year and industry effects	Yes	Yes	Yes	Yes	Yes	Yes
No. observations	8,847	8,870	7,538	7,927	7,949	6,754
R-squared	0.439	0.422	0.305	0.436	0.421	0.296
F-statistic	58.18***	57.95***	22.22***	53.06***	53.19***	19.23***

7. Robustness tests

Following, we summarize the results of several robustness tests carried out to enhance our main findings. The results reported in Table 5 are robust in a firm-fixed effects estimation, which controls for unobserved firm heterogeneity. We also implement the coarsened exact matching (CEM) procedure (Blackwell, Iacus, King, & Porro, 2009) to match subsidiaries controlled by foreign MNCs with locally owned subsidiaries by size, year and industry, and obtain results consistent with those in Table 5.

We confirm the results using several additional discretionary accrual measures. The association between foreign shareholding and the magnitude of discretionary accruals is also positive: when adjusting the modified Jones model for performance as suggested in Kothari, Leone, and Wasley (2005), and for timely loss and gain recognition as suggested in Ball and Shivakumar (2006); and when using the discretionary accruals model proposed by Francis and Wang (2008).

The results are also robust when we estimate model (3) in the subsample with big audit firms, and after excluding the observations of subsidiaries whose parent companies come from countries with less than 10 observations. Finally, the positive relation between foreign ownership and the magnitude of earnings management is also observed when extending the baseline model with several control variables, whose calculation reduces the sample size considerably, such as: the rolling 5-year standard deviation of cash flow from operations from year t to t - 4, the rolling 5-year standard deviation of sales going from t to t - 4, and lagged discretionary accruals.

8. Conclusions

We provide evidence on the relation between foreign shareholding and financial reporting quality in a sample of large private Spanish subsidiaries. We find that firms controlled by foreign shareholders have poorer accruals quality than locally controlled firms. We also observe that, as opposed to local controlling shareholders, the tenure of the foreign controlling shareholders has a positive impact on the subsidiaries' earnings management practices, suggesting that the foreign owners gain a richer knowledge of the local accounting regulations over time which they use to manipulate their subsidiaries' accounting numbers. This finding enhances the explanation of the parent companies' incentives to opportunistically manage their foreign subsidiaries' accounts. Furthermore, the negative relation between foreign shareholding and accounting quality is driven by the subsidiaries of groups where the parent company comes from countries with higher institutional quality than Spain.

Our results suggest that (1) the incentives of the foreign parent companies to carry out earnings management practices at the subsidiary level are significantly stronger than those of their local counterparts; and (2) foreign shareholding from high institutional quality countries not only does not result into positive spill-overs for the financial reporting quality outcome, but it has a negative effect on the accounting quality of subsidiaries located in countries with weaker institutional quality.

Our research has implications for policy makers, who should be aware of the potential negative effects that institutional differences between countries have for financial reporting quality. Our results support the view that reducing the international differences in institutional quality may help to improve the quality of financial reporting worldwide.

Our research also has limitations, since the causality issues are always challenging and our data constraints do not allow us to rule out some omitted variables problems; for instance, we are unable to control for some characteristics of the parent companies. Additionally, the majority of the firms included in our sample are under local or foreign control during the entire sample period, so that the tests where we look at control changes (section 6) are based on a limited number of takeovers.

Appendix: Data collection process

In this Appendix we describe how we hand-collected the information on the subsidiaries' ownership structure. We provide three examples of subsidiaries where the controlling shareholder changed during the period analyzed (1997-2013). Specifically, the data collection process consists in identifying the dates of the control changes from the newspaper articles retrieved from the FACTIVA database. Subsequently, we assume that a company is owned by a given group since the date when the group's parent company became the subsidiary's controlling shareholder until (a) the date when a new group gains control of the subsidiary or (b) 2013, if no control changes take place after the last one identified. For expositional purposes, we provide a timeline with the milestones in each company's life (Figures 1-3). For each article retrieved we give the name of the newspaper/news agency, the date of publication, the news headline and overview of the article.

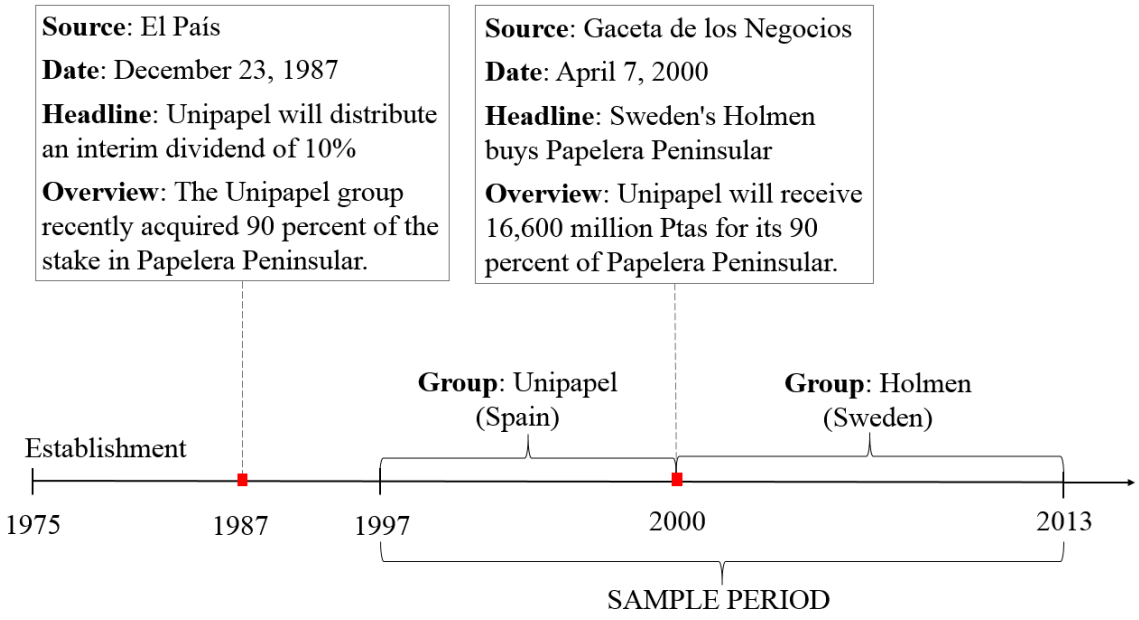
Example 1: HOLMEN PAPER MADRID, S.L. (NIF B28388197)

This company was previously called Papelera Peninsular, S.L. (which is the name that is alluded in the two cited articles) and was established in 1975. We identified two controlling shareholders during the period analyzed:

(a) From 1997 until 1999: the Unipapel group, which acquired 90 percent of the company's shares in 1987. Its parent company is located in Spain and was floated on the Madrid Stock Exchange in 1986.

(b) From 2000 until 2013: the Holmen group, which bought Papelera Peninsular from Unipapel in 2000. The Holmen group is headquartered in Sweden and publicly traded on the Stockholm Stock Exchange since 1936.

Figure 1: Timeline for the ownership changes of Holmen Paper Madrid, S.L. (previously called Papelera Peninsular, S.L.)



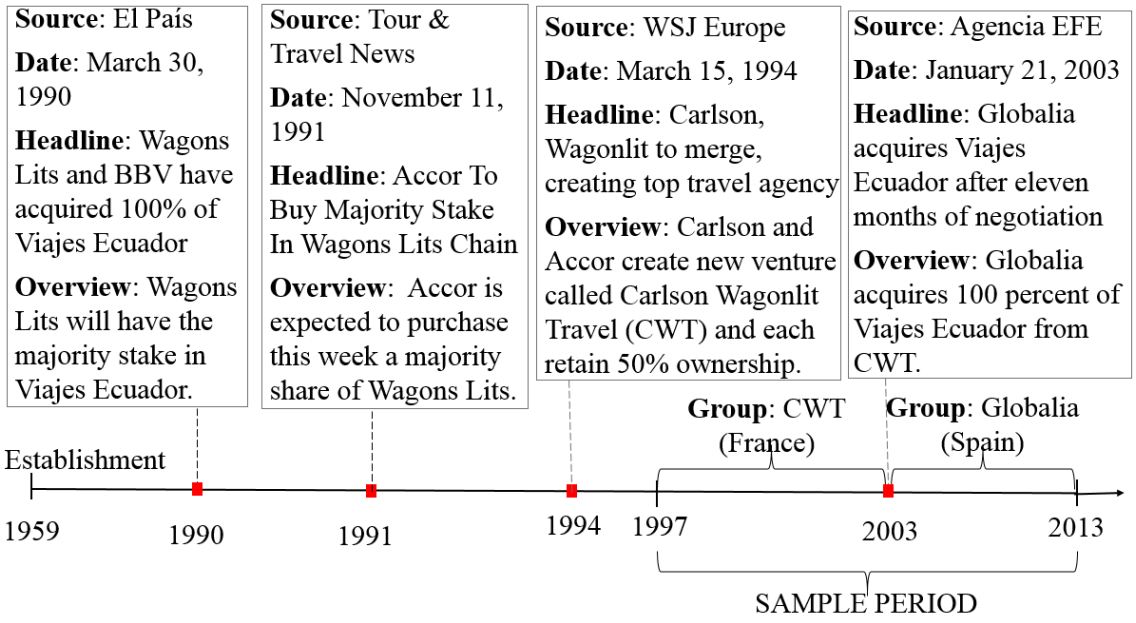
Example 2: VIAJES ECUADOR, S.A. (NIF A48028179)

This company was established in 1959 and during the period 1997-2013 was part of two different groups:

(a) From 1997 to 2002: Carlson Wagonlit Travel (CWT), headquartered in France. Viajes Ecuador was acquired by the Wagons Lits group (Belgium) in 1990. In 1991, the Wagons Lits group was bought by the Accor group (France), and in 1994 Carlson Travel Network and Wagons Lits merged, forming a new privately held group called Carlson Wagonlit Travel.

(b) From 2003 to 2013: Globalia, a privately held group headquartered in Spain, bought 100 percent of Viajes Ecuador from the CWT group in 2003.

Figure 2: Timeline for the ownership changes of Viajes Ecuador, S.A.

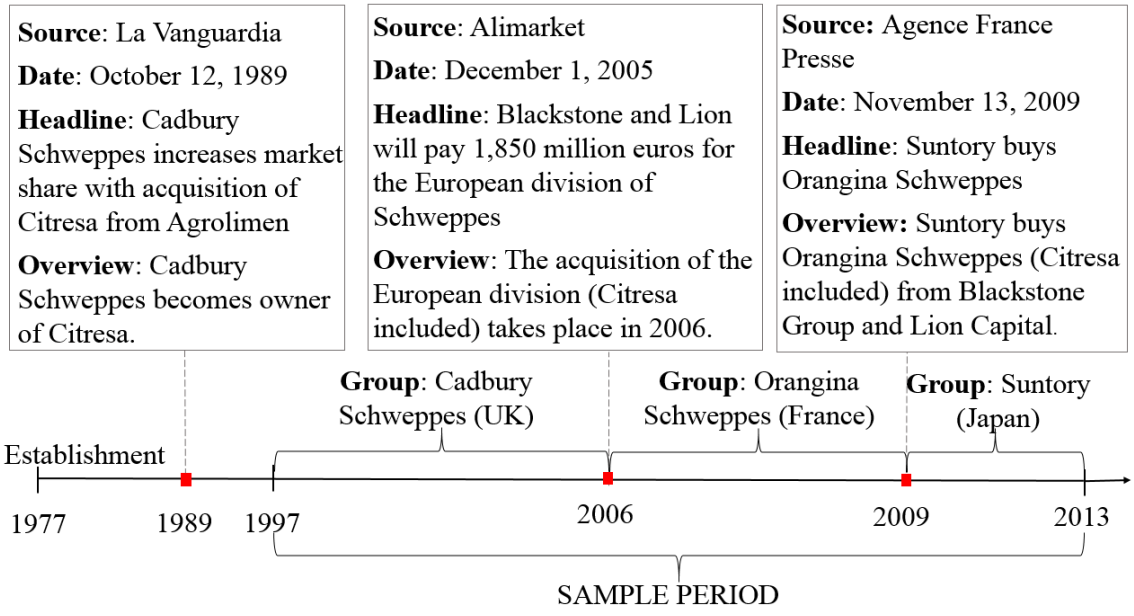


Example 3: CITRICOS Y REFRESCANTES, S.A. (Citresa, NIF A46106613)

Citresa was established in 1977 and was a subsidiary of several groups. We identified the following controlling shareholders during the period analyzed:

(a) From 1997 to 2005: the Cadbury Schweppes group acquired the company in 1989 from the Spanish group Agrolimen. The parent company of the Cadbury Schweppes group is located in the UK and is listed on the London Stock Exchange since 1969.
(b) From 2006 to 2008: the Orangina Schweppes group, headquartered in France and privately held by two private equity firms since 2006 (The Blackstone Group International and Lion Capital LLP). Orangina Schweppes is the former European Beverages Division of Cadbury Schweppes Plc – CSEB (which included Citresa).
(c) From 2009 to 2013: the Suntory group, headquartered in Japan, whose parent company was floated on the Tokyo Stock Exchange in 2013. In 2009 Suntory bought the Orangina Schweppes group (Citresa included) from the two private equity firms.

Figure 3: Timeline for the ownership changes of Citricos y Refrescantes, S.A. (Citresa)



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