

**CUE27 - DOES REPORTING REGULATION AFFECT EARNINGS
QUALITY? THE CASE OF FOREIGN FIRMS**

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Resumo

In this study we aim to investigate whether earnings quality varies accordingly the reporting regulation level stipulated by the SEC to U.S. and foreign firms listed in the U.S. market. Using abnormal accruals, earnings smoothness and managing towards earnings targets as earnings quality measures, and a sample containing U.S. and foreign firms listed in the U.S. market between 2000 and 2015, the results indicate that foreign firms complying with the full regulation tend to have more informative earnings than U.S. firms, while foreign firms with reporting regulation exemptions tend to have less informative earnings than U.S. firms. Concluding that the lower quality of foreign firms' earnings found on prior literature could be diminish if the SEC regulated all firms at the same extent.

DOES REPORTING REGULATION AFFECT EARNINGS QUALITY? THE CASE OF FOREIGN FIRMS

ABSTRACT

In this study we aim to investigate whether earnings quality varies accordingly the reporting regulation level stipulated by the SEC to U.S. and foreign firms listed in the U.S. market. Using abnormal accruals, earnings smoothness and managing towards earnings targets as earnings quality measures, and a sample containing U.S. and foreign firms listed in the U.S. market between 2000 and 2015, the results indicate that foreign firms complying with the full regulation tend to have more informative earnings than U.S. firms, while foreign firms with reporting regulation exemptions tend to have less informative earnings than U.S. firms. Concluding that the lower quality of foreign firms' earnings found on prior literature could be diminish if the SEC regulated all firms at the same extent.

Key-words: earnings quality; earnings informativeness; reporting regulation; foreign firms; foreign private issuer.

1 INTRODUCTION

The U.S. Securities and Exchange Commission (SEC) classifies foreign firms listed in the U.S. in two different groups and each group is subject to a different level of reporting regulation. This study aims to investigate whether the reporting regulation level stipulated by the SEC affects earnings quality, using abnormal accruals, earnings smoothing and management towards targets as earnings quality measures.

Dechow, Ge, and Schrand (2010, p.344) say that "higher quality earnings provide more information about the features of a firm's financial performance that are relevant to specific decision made by a specific decision-maker". Therefore, quality of earnings is related to the part of earnings attributable to the firm's financial performance rather than artificial earnings created by flexibility of accounting standard as the amount of depreciation and provisions, it could also be viewed as earnings informativeness.

Coffee Jr (2002) argues that firms with cross-listing shares in the U.S. market experience a premium compared to similar firms that are not cross-listed because they subject themselves to the enforcement powers of the SEC. However, the SEC classifies foreign firms listed on U.S. exchanges in two different groups: Foreign Private Issuers (FPIs) and Foreign Domestic Issuers (FDIs). While FDIs are subject to the same reporting regulation level as U.S. firms, FPIs are subject to a lower level of regulation. The reason for that is because foreign firms classified as FPIs have significant exemptions related to the timeliness, quality and frequency of financial statements, disclosure of private information and corporate governance practices.

Therefore, it is relevant to investigate whether foreign firms listed in the U.S. market with reporting exemptions (FPIs) present less informative earnings than U.S. firms compared to foreign firms listed in the U.S. with no reporting exemptions (FDIs). In other words, to investigate if SEC exemptions are related to less informative earnings.

Lang, Raedy, and Wilson (2006) compare earnings quality of cross-listed and U.S. firms using a matched sample based on past sales growth, industry and year. Their results indicate that foreign firms cross-listed in the U.S. have lower earnings quality than U.S. firms, but their cross-listed sample does not include FDIs. Moreover, their results suggest that cross-listed firms preparing their financial in full accordance to U.S. GAAP have higher earnings quality than cross-listed firms reconciling to U.S. GAAP. However, preparing a financial statement in full accordance with U.S. GAAP is a voluntary choice for FPIs, generating self-selection problems. In this case, it would be interesting to analyze if the behavior of FDIs are the same

as FPIs since both are cross-listed firms or if the behavior is different since they are subject to different disclosure regulation.

While there is a large amount of prior literature analyzing earnings quality between foreign firms listed in the U.S. and U.S. firms (Lang et al., 2006; Kang, Krishnan, Wolfe, & Yi, 2012; Chiu & Lee, 2013; Lail, 2014; Chen, Gotti, Herrmann, & Schumann, 2016) they do not consider whether the different regulation level within foreign firms might affect their results. They either define FPIs as the only group of foreign firms or do not distinguish between FPIs and FDIs assuming they are the same.

This paper fills this gap in the literature by creating a database of foreign firms, distinguishing between FPIs and FDIs and analyzing whether SEC reporting exemptions affect earnings informativeness of foreign firms when compared to U.S. firms. If the difference in earnings quality between foreign firms and similar U.S. firms found by Lang et al. (2006) was due to the lower level of regulation which FPIs are subject, we expect to see no difference in earnings quality of FDIs compared to U.S. firms, once FDIs are subject to the same level of reporting regulation that U.S. firms.

The final sample includes 6231 U.S. firms, 119 FDIs and 756 FPIs, with 46428, 931 and 4136 observations between 2000 and 2015, respectively. Using abnormal accruals as a proxy for earnings quality, we found that FPIs have more abnormal accruals than U.S. firms and similar FDIs, on average. Moreover, we did not find statistically difference in abnormal earnings between FDIs and U.S. firms either similar U.S. firms. While using earnings smoothness as a proxy for earnings quality we found a mix of results. Two measures of earnings smoothness indicate that FDIs and FPIs have more artificial smooth earnings than similar U.S. firms; and one measure indicates that FPIs have more artificial smooth earnings than similar U.S. firms while FDIs show less artificial earnings smoothing than similar U.S. firms. The last proxy used for earnings quality was earnings management to avoid reporting losses. FPIs showed more propensity to manage earnings to avoid losses than FDIs and similar U.S. firms; while FDIs are less likely to manage earnings to avoid losses than similar U.S. firms.

Overall, the results indicate that FPIs have lower quality of earnings than U.S. firms and FDIs have similar or better earnings quality than U.S. firms. Indicating that when the SEC demands foreign firms to comply with the same regulation that U.S. firms, their earnings are as informative or even more informative than U.S. firms earnings.

In this study we contribute to the prior cross-listed literature by creating a sample of foreign firms listed in the U.S. market distinguishing them by disclosure regulation level. In other words, we create a sample of foreign firms and identify which of them are classified as FPIs and which of them are classified as FDIs in each fiscal year between 2000 and 2015. Moreover, we extend Lang et al. (2006) work by analyzing whether the result found for them, that foreign firms classified as FPIs have lower earnings quality than similar U.S. firms, can be extended when comparing FDIs and U.S. firms or whether this difference in earnings quality between foreign firms and U.S. firms only exists when foreign firms do not follow the same disclosure regulation.

The results found in this study also contribute to the regulation of the stock market. If foreign firms listed in the U.S. market present less informative earnings than U.S. firms due to disclosure exemptions and the SEC goal is to protect investors, they might consider applying the same regulation rules to all foreign firms listed in the U.S. market.

2 PRIOR LITERATURE AND HYPOTHESIS DEVELOPMENT

2.1. Foreign Firms Classification and Disclosure Regulation

The SEC classifies foreign firms who trade securities in the U.S. market in two different groups: Foreign Private Issuers (FPIs) and Foreign Domestic Issuers (FDIs), allowing exemptions from U.S security reporting and regulatory requirements for firms that qualify as

FPIs. Exemptions relate to the timeliness, quality and frequency of financial statements, disclosure of private information and corporate governance practices.

A foreign firm with shares listed in the U.S. market will be classified as Foreign Domestic Issuer (FDI) if:

- *More than 50% of the outstanding voting securities are held directly or indirectly of record by U.S. residents; and*

Any of the following applies:

- *The majority of the executive officers or directors are U.S. citizens or residents;*

or

- *more than 50% of the assets are located in the U.S.; or*

- *the business is administered principally in the United States.*

Otherwise, it will be classified as a foreign private issuer (FPI) and will enjoy some exemptions from U.S. security reporting and regulatory requirements exposed at Tables 1 and 2.

Table 1 contains foreign firms regulations related to financial statements. While FDIs must file their annual report using a 10-K Form FPIs can disclose their annual report using a 20-F Form (40-F for Canadian and Israeli firms). A 10-K Form must be filed within 60-90 days after the fiscal year end while a 20-F or 40-F can be filed within 4 months after the fiscal year end. Another exemption is related to the frequency of financial statements, FDIs must disclose quarterly reports using a 10-Q Form while FPIs are not required to disclose quarterly reports.

TABLE 1: FOREIGN FIRMS REGULATION RELATED TO FINANCIAL STATEMENTS

	FDIs	FPIs
Annual Reporting	Must file annual report using the Form 10-K. Form 10-K prescribes specific disclosures and must be filed within 60-90 days after the fiscal year end.	Do not have to file annual report using the Form 10-K, it can use the Form 20-F (or 40-F for Canadian and Israeli firms). Form 20-F prescribes specific disclosures and must be filed within 4 months after the fiscal year end.
Quarterly Reporting	Must file quarterly reports on Form 10-Q.	Not required.
Periodic Reporting	Must file Form 8-K generally within 4 business days of event to be reported. Prescribes specific disclosures to be made.	Form 6-K to be furnished promptly, after information is made public in home jurisdiction. No prescribed specific disclosures. FPIs that produce interim financial statements due to home country requirements disclose those statements in the US using Form 6-K.
Required Accounting Standards	Financial statements typically prepared in accordance with U.S. GAAP.	Must reconcile to U.S. GAAP, unless financial statements are prepared in accordance with IFRS.

Source: Produced by the author.

Financial statements exemptions also include the Financial Statement Accounting Standard. On November 15, 2007, the SEC approved a proposal allowing FPIs to prepare financial statements in accordance with International Financial Reporting Standards (IFRS) as published by the International Accounting Standards Board (IASB). Prior to this decision, the SEC required FPIs to disclose annual financial statements using the 20-F Form (40-F Form for Canadian firms) with reconciled earnings and stockholders' equity to U.S. GAAP if their

financial statements were prepared using any basis of accounting other than U.S. GAAP. After the SEC decision to approve the proposal, FPIs are no longer required to reconcile their financial statements in accordance with U.S. GAAP if their financial statements follow the IFRS. However, the elimination of the 20-F reconciliation from the IFRS to U.S. GAAP does not affect foreign firms classified as FDIs. One might think FPIs would keep reconciling to U.S. GAAP given the U.S. investors preference for U.S GAAP accounting standards and the valuation-relevance of the IFRS-to-U.S.-GAAP reconciliation (Harris & Muller III, 1999; Bradshaw, Bushee, & Miller, 2004; Gordon, Jorgensen, & Linthicum, 2009; Henry, Lin, & Yang, 2009). However, Kim, Li, & Li (2012) showed that foreign firms with financial statements following the IFRS do not supply the reconciliation to U.S. GAAP voluntarily.

Table 2 contains foreign firms regulation with regards to disclosure of private information and corporate governance. FDIs must file initial statements of beneficial ownership as well as changes in the beneficial ownership of executives and directors, among others, while FPIs are exempt from it. Exemptions related to disclosure of private information also include compliance with Regulation Fair Disclosure (Reg FD). The Reg FD says that all material non-public information disclosed by the company to a limited group of individuals must be disclosed publicly. Non-intentional sharing of such information must be promptly followed with public disclosures. FDIs must comply with Reg FD, while FPIs are exempt from it.

TABLE 2: FOREIGN FIRMS REGULATION RELATED TO DISCLOSURE OF INSIDER INFORMATION AND CORPORATE GOVERNANCE

	FDIs	FPIs
Disclosure of Beneficial Ownership	Must file initial statements of beneficial ownership as well as changes in the beneficial ownership of executives and directors, among others, and have to comply with Regulation FD.	Not required.
Regulation Fair Disclosure	When the company discloses any material nonpublic information to a limited group of individuals, it must make a public disclosure of that information. Non-intentional sharing of such information must be promptly followed with public disclosures.	Not required.
Proxy Rules	Must disclose voting procedure, nominated candidates for its board of directors, and compensation of directors and executives.	Not required.
U.S. stock exchange corporate governance requirements	Must comply with the stock exchange governance requirements when listed on NYSE or NASDAQ	NYSE and NASDAQ allow FPIs to follow their home country corporate governance practices.

Source: Produced by the author.

Corporate Governance exemptions include proxy rules and U.S. stock exchange corporate governance requirements. The NYSE and NASDAQ allow FPIs to follow their home country corporate governance practices, while FDIs must comply with the stock exchange governance requirements. Following the “bonding” hypothesis that firms choose to cross-list their shares in the U.S. market to bond themselves to a higher level of corporate governance, consequently increasing their value; one might think FPIs would voluntarily comply with the exchanges corporate governance requirements. However, with a sample of 439 FPIs from 2004 to 2008, Foley C., Goldsmith-Pinkham, Greenstein, and Zwick (2018) found that 80% of the

FPIs in their sample opt out of at least one exchange governance rule, instead committing to the stronger U.S. exchange corporate governance.

2.2. Hypothesis Development

Prior literature found that foreign firms with shares cross-listed in the U.S. market receive a valuation premium compared to similar firms in the home country that are not cross-listed (Coffee Jr, 2002). According Coffee Jr (2002), the premium is due to the lower level of information asymmetry. Analysts can monitor them closely once they cross-list, and institutional investors can negotiate minority protections if the firm wishes to make an initial public offering in the United States. Investors can exercise legal actions and they must provide more complete financial information following the U.S. accounting standard.

On the other hand, Lang et al. (2006) compares U.S. firms' earnings with reconciled earnings for cross-listed non-U.S. firms and their results indicate that non-U.S. firms' earnings are smoother with greater tendency to manage towards a target, lower association with share price and less timely recognition of losses. Concluding that FPIs have less informative earnings than similar U.S. firms, since Lang et al. (2006) sample of cross-listed firms is restricted to non-U.S. firms that file annual financial statements using a Form 20-F.

Most of prior literature looking at differences between U.S. firms and foreign firms earnings quality focus on only one group of foreign firms (FPIs) or assume all foreign firms as equal, not taking in place the differences between FPIs and FDIs (Lang et al., 2006; Kim et al., 2012; Hansen, Pownall, Prakash, & Vulcheva, 2014). However, results presented in Burnett, Jorgensen, and Pollard, (2017), indicate that the U.S. market sees foreign firms classified as FPIs as lower-value firms compared to FDIs and the value-difference varies within different requirement exemptions.

Thus, it is relevant to study whether FPIs lower-value is related to a lower quality of earnings compared to FDIs, and whether the SEC exemptions affect earnings quality of foreign firms compared to U.S. firms. In this research, we aim to amplify prior studies by creating a database of foreign firms distinguishing between FPIs and FDIs to investigate whether earnings quality varies within FDIs and FPIs compared to U.S. firms.

The Statement of Financial Accounting Concepts No. 1 (SFAC No. 1) issued by the Financial Accounting Standards Board (FASB) states that "Financial reporting should provide information about an enterprise's financial performance during a period." Based on this statement Dechow et al. (2010, p.344) define earnings quality as "higher quality earnings provide more information about the features of a firm's financial performance that are relevant to a specific decision made by a specific decision-maker". Therefore, earnings quality could be viewed as earnings informativeness, higher quality earnings provide more relevant information to stakeholders.

We expect that FDIs have as informative earnings as U.S. firm since FDIs must comply with the same reporting requirements than U.S. firms, disclosing financial reports with the same frequency and timeliness in full accordance with U.S. GAAP, initial and changes in the beneficial ownership, all material information disclosed to a limited group of individuals following Reg FD and same corporate governance rules. Resulting in the hypothesis H1:

H1: FDIs earnings have the same quality as U.S. firms earnings.

In the other hand, FPIs enjoy several exemptions, having more time to disclose their annual report which can be on a Form 20-F which does not have to be in full accordance with U.S. GAAP but reconciled to U.S. GAAP or IFRS, not having to disclose quarterly reports, beneficial ownership and do not have to comply with Reg FD. Thus, we expected FPIs earnings to be less informative than U.S. firms earnings, resulting in the hypothesis H2:

H2: FPIs earnings have lower quality than U.S. firms earnings.

3 RESEARCH DESIGN

3.1. Abnormal Accruals

According Dechow et al. (2010, p.358), “the normal accruals are meant to capture adjustments that reflect fundamental performance, while abnormal accruals are meant to capture distortions induced by application of accounting rules or earnings management”. Thus, higher levels of abnormal accruals indicate more artificial earnings, earnings with lower quality.

To measure abnormal accruals, we use the Modified Jones Model (Dechow, Sloan, & Sweeney, 1995) using two methods. The first method developed by Dechow et al. (1995) consists on estimating the Modified Jones Model by fiscal year and 2-Digit SIC Code using the OLS method¹:

$$\begin{aligned} TotalAccruals_{it} \\ = \alpha_1 \frac{1}{Assets_{i,t-1}} + \alpha_2 (\Delta REV_{it} - \Delta REC_{it}) + \alpha_3 PPE_{it} + \epsilon_{it} \end{aligned} \quad (1)$$

where **TotalAccruals** is calculated as income before extraordinary items less cash flow from operations plus extraordinary items and discontinued operations deflated by past total assets, **Assets_{t-1}** is the past total assets, **ΔREV_t** is the change in revenues, **ΔREC_t** is the change in receivables and **PPE_t** is property, plant and equipment. Therefore, the abnormal accruals obtained from the first method is defined as **Ab_acc_dechow_{it} = ê_{it}**, where **ê_{it}** is the estimated residual from the regression model (1).

The second method developed by Kothari, Leone, and Wasley (2005) consists on estimating the Modified Jones Model adjusting for a performance-matched firm’s discretionary accrual. Kothari et al. (2005) results show that the Modified Jones model adjusted for a performance-matched firm’s discretionary accrual tend to be the best specified measure of discretionary accruals. Therefore, before estimating the Modified Jones Model, we match each Foreign Firms with a U.S. Firms by fiscal year, 2-Digit SIC Code using the past return over assets (ROA), where ROA is calculated as $ROA_{it} = (Net\ Income_{it}) / (Assets_{i,t-1})$. Then, we estimate the Modified Jones Model using the past ROA matched sample. Therefore, the abnormal accruals obtained from the second method is defined as **Ab_acc_kothari = ê_{it}**, where **ê_{it}** is the estimated residual from the regression model (1) using the past ROA matched sample.

We adapted Ali and Zhang (2015) methodology to capture differences in abnormal accruals related to CEO tenure. To analyze whether abnormal accruals vary within U.S. firms, FDIs and FPIs; we estimate the following model using the OLS method with year and industry fixed effects:

$$\begin{aligned} AbnormalAccruals_{it} \\ = \beta_0 + \beta_1 FPI_{it} + \beta_2 FDI_{it} + \beta_3 MTB_{it} + \beta_4 Leverage_{it} + \beta_5 Loss_{it} \\ + \beta_6 CF_{it} + \beta_7 TotalAccruals_{i,t-1} + \beta_8 AssetsGrowth_{it} \\ + \beta_9 EmploymentGrowth_{it} + \beta_{10} Size_{it} + \beta_{11} LitigationRisk_{it} \\ + \beta_{12} FirmAge_{it} + \beta_{13} ReconciledGAAP_{it} + \beta_{14} IFRS_{it} + \epsilon_{it} \end{aligned} \quad (2)$$

where **AbnormalAccruals_{it}** is **Ab_acc_dechow_{it}** or **Ab_acc_kothari_{it}** for the firm *i* at fiscal year *t*, **FPI_{it}** is a dummy variable indicating if the foreign firm *i* is classified as FPI at the fiscal year *t*, **FDI_{it}** is a dummy variable indicating if the foreign firm *i* is classified as FDI at the fiscal year *t*. We included market-to-book ratio (**MTB_{it}**) to control for high growth prospects. **Leverage_{it}**—the ratio between the total debt and past total assets—is included to control for firm’s distress, because high leverage level is related distressed firms with more incentive to manage earnings (Becker, Defond, & Jiambalvo, 2010). Since Ashbaugh, LaFond, & Mayhew

¹ All variables were winsorized at 1% level.

(2003) argued that discretionary accruals models do not completely extract out nondiscretionary accruals that are negatively correlated with cash flows from operations, we included cash flow from operations scaled by past total assets (CF_{it}). Firms reporting losses are less likely to be engaged in earnings management (Brown, 2001), to control for that we included a variable to indicate if the firm i has a negative net income at the fiscal year t ($Loss_{it}$). Past total accruals ($TotalAccruals_{i,t-1}$) are included to control for past accruals level. Zhang (2007) argues that part of accruals measure investment in working capital accruals, which is part of firms' business growth, to control for it we include $AssetsGrowth_{it}$ —measured as the percentage change of total assets—and $EmploymentGrowth_{it}$ —measure as the percentage change of employees. Prior literature shows that larger firms are less likely to report aggressively given the greater political costs (Watts & Zimmerman, 1990), therefore, we included $Size_{it}$, measured as the natural log of past total assets. Following Ali and Zhang (2015), we included $LitigationRisk_{it}$, a dummy variable indicating when the firm operates in a high-litigation industry (SIC Codes 2833-2836; 3570-3577; 3600-3674; 5200-5961, and 7370-7374). $FirmAge_{it}$ is the number of years since the firm first appeared at CRSP, since older firms are likely to be well known with great value in the market and a reputation to protect, they are less likely to engage in earnings management given the reputation cost. We also included $ReconciledGAAP_{it}$, indicating if the firm foreign firm i disclosed its financial report reconciled with U.S. GAAP at the fiscal year t , and $IFRS_{it}$ indicating if the foreign firm i disclosed its financial report following IFRS at the fiscal year t , given that IFRS earnings are obtain using different metrics.

3.2. Earnings Smoothness

Graham, Harvey, and Rajgopal (2005) show that corporate executives are strongly willing to sacrifice long-term value to smooth earnings, holding cash flow volatility constant. The reason for such behavior is because the executives believe that investors perceive firms with smoother earnings as less risky for having more predictable earnings, leading to a lower risk premium or cost of equity capital. Therefore, artificial smoothness leads to less informative earnings; thus, lower quality earnings.

Prior research comparing cross-country earnings smoothing include Leuz, Nanda, and Wysocki (2003) and Lang et al. (2006). Examining earnings smoothing across 31 countries Leuz et al. (2003) show that smooth earnings are associated to low-quality country GAAP, less enforcement, or poor shareholder rights. Lang et al. (2006) analyzed whether foreign firms cross-listed in the U.S. manage earnings more than similar U.S. firms using various measures. In particular, they analyze whether cross-listed firms show more evidence of management than similar U.S. firms to present smoother earnings. Cross-listed firms showed more evidence of smoothing, greater tendency to manage towards earnings targets, lower association with share price and less timely recognition of losses.

Lang et al. (2006) developed their own measure of artificial smoothness controlling for smoothness of fundamental performance. Using a sample design with matched based on past sales growth and industry, they measure artificial smoothness as the variance of the residuals from a regression of annual changes in net income scaled by total assets on control variables for fundamental firm characteristics (**Variance of ΔNI**). Other measures include **Variance of ΔNI over ΔCF** and **Corr($TotalAccruals, CF$)**, where **Variance of ΔNI over ΔCF** is the variance of the residuals from a regression of changes in net income over the variance of the residuals from a regression of changes in cash flow on control variables for fundamental firm characteristics, and **Corr($TotalAccruals, CF$)** is the Spearman correlation between the residuals from a regression of total accruals and the residuals from a regression of cash flow on control variables for fundamental firm characteristics.

Following Lang et al. (2006) argue that other factors correlated with the decision of foreign firms to cross-list their shares in the U.S. might affect the characteristics of accounting

data. To address this problem, we follow their methodology and create a past sales growth matched sample, where for each foreign firm we match a U.S. firm in the same year and industry (2-Digit SIC Code) based on past sales growth.

Further, we estimated the regressions of annual changes in net income scaled by total assets, changes in cash flow scaled by total assets, total accruals and cash, respectively below, using the OLS model with country fixed effects:

$$\begin{aligned} \Delta NI_{it} = & \beta_0 + \beta_1 Size_{it} + \beta_2 SalesGrowth_{it} + \beta_3 EquityIssuance_{it} \\ & + \beta_4 Leverage_{it} + \beta_5 DebtIssuance_{it} + \beta_6 AssetTurnover_{it} \\ & + \beta_7 Profitability_{it} + \epsilon_{it} \end{aligned} \quad (3)$$

$$\begin{aligned} \Delta CF_{it} = & \beta_0 + \beta_1 Size_{it} + \beta_2 SalesGrowth_{it} + \beta_3 EquityIssuance_{it} \\ & + \beta_4 Leverage_{it} + \beta_5 DebtIssuance_{it} + \beta_6 AssetTurnover_{it} \\ & + \beta_7 Profitability_{it} + \epsilon_{it} \end{aligned} \quad (4)$$

$$\begin{aligned} TotalAccruals_{it} \\ = & \beta_0 + \beta_1 Size_{it} + \beta_2 SalesGrowth_{it} + \beta_3 EquityIssuance_{it} \\ & + \beta_4 Leverage_{it} + \beta_5 DebtIssuance_{it} + \beta_6 AssetTurnover_{it} + \epsilon_{it} \end{aligned} \quad (5)$$

$$\begin{aligned} CF_{it} = & \beta_0 + \beta_1 Size_{it} + \beta_2 SalesGrowth_{it} + \beta_3 EquityIssuance_{it} \\ & + \beta_4 Leverage_{it} + \beta_5 DebtIssuance_{it} + \beta_6 AssetTurnover_{it} + \epsilon_{it} \end{aligned} \quad (6)$$

where ΔNI is the annual change in the net income scaled by past total assets, ΔCF is the change in the cash flows from operations scaled by past total assets, $SalesGrowth$ is the percentage change on sales, $EquityIssuance$ is the percentage change in common stock, $DebtIssuance$ is the percentage change in total liabilities, $AssetTurnover$ is sales for the period divided by past total assets, $Profitability$ and CF are calculated as cash flows for the period divided by past total assets.

From the regression models (3), (4), (5) and (6) we obtain the estimated residuals $\hat{\epsilon}_{\Delta NI}$, $\hat{\epsilon}_{\Delta CF}$, $\hat{\epsilon}_{TotalAccruals}$ and $\hat{\epsilon}_{CF}$, respectively. Therefore, the measures for artificial earnings smoothing are calculated as **Variance of ΔNI** = $\hat{\epsilon}_{\Delta NI}$, **Variance of ΔNI over ΔCF** = $\hat{\epsilon}_{\Delta NI} / \hat{\epsilon}_{\Delta CF}$, **Corr(TotalAccruals, CF)** = $Corr(\hat{\epsilon}_{TotalAccruals}, \hat{\epsilon}_{CF})$.

Firms with artificially smoother earnings are expected to show a lower **Variance of ΔNI** . Because firms with more volatile cash flows will naturally have more volatile net income the second measure, **Variance of ΔNI over ΔCF** , adjusts for cash flows variability. According Myers, Myers, and Skinner (2007) and Land and Lang (2002), a more negative correlation between $\hat{\epsilon}_{TotalAccruals}$ and $\hat{\epsilon}_{CF}$ is an indicator of earnings smoothing, because managers respond to poor cash flow outcomes by increasing accruals.

According the hypothesis 2 (H2), we expect that FPI are going to show lower **Variance of ΔNI** , lower **Variance of ΔNI over ΔCF** and a more negative **Corr(TotalAccruals, CF)** than similar U.S. firms. Indicating that FPIs have lower quality of earnings compared to similar U.S. firms. Following hypothesis 1 (H1), we do not expect to find statistically different between **Variance of ΔNI** , **Variance of ΔNI over ΔCF** and **Corr(TotalAccruals, CF)** between FDI and U.S. firms.

3.3. Managing Earnings Targets

Prior literature found that firms have a tendency to manage earnings to avoid reporting earnings losses (Burgstahler & Dichev, 1997; Beaver, McNichols, & Nelson, 2003; Phillips, Pincus, & Rego, 2003; Altamuro, Beatty, & Weber, 2005; Kerstein & Rai, 2007; Jacob & Jorgensen, 2007; Caramanis & Lennox, 2008).

Burgstahler & Dichev (1997) show that firms tend to manage earnings to achieve a small positive net income scaled by total assets instead reporting a loss, making their earnings less

informative. Thus, small positive net income scaled by total assets indicates a lower quality earning.

Following Lang et al. (2006), we use the matched sample based on past sales growth defined at section 3.2 and consider small positive earnings when net income scaled by past total assets is between 0 and 0.01.

To test whether FDIs are more likely to report small positive earnings than U.S. firms, we exclude FPIs from the sample and estimate the following regression model using the Logit model:

$$FDI_{it} = \beta_0 + \beta_1 SmallPositiveNI_{it} + \beta_2 Size_{it} + \beta_3 Sales_Growth_{it} + \beta_4 Equity_Issuance_{it} + \beta_5 Leverage_{it} + \beta_6 Debt_Issuance_{it} + \beta_7 Asset_Turnover_{it} + \beta_8 Profitability_{it} + \epsilon_{it} \quad (7)$$

where FDI_{it} is a dummy variable equals to 1 if the foreign firm i is classified as a FDI at the fiscal year t , and 0 if firm i is a U.S. firm; $SmallPositiveNI_{it}$ is a dummy variable equals to 1 if firm i 's net income scaled by past total assets is between 0 and 0.01 at the fiscal year t , and 0 otherwise. Thus, if FDIs are equally likely to report small positive earnings than matched U.S. firms the coefficient β_1 is going to be statistically insignificant.

Succeeding, to test whether FPIs are more likely to report small positive earnings than U.S. firms, we exclude FDIs from the sample and estimate the following regression model using the Logit model:

$$FPI_{it} = \beta_0 + \beta_1 SmallPositiveNI_{it} + \beta_2 Size_{it} + \beta_3 Sales_Growth_{it} + \beta_4 Equity_Issuance_{it} + \beta_5 Leverage_{it} + \beta_6 Debt_Issuance_{it} + \beta_7 Asset_Turnover_{it} + \beta_8 Profitability_{it} + \epsilon_{it} \quad (8)$$

where FPI_{it} is a dummy variable equals to 1 if the foreign firm i is classified as a FPI at the fiscal year t , and 0 if the firm i is a U.S. firm. Consequently, if FPIs are more likely to report small positive earnings than U.S. firms the coefficient β_1 is going to be positive and statistically significant.

To compare FDIs and FPIs we exclude U.S. firms from the sample and estimate the following regression model using the Logit model:

$$FPI_{it} = \beta_0 + \beta_1 SmallPositiveNI_{it} + \beta_2 Size_{it} + \beta_3 Sales_Growth_{it} + \beta_4 Equity_Issuance_{it} + \beta_5 Leverage_{it} + \beta_6 Debt_Issuance_{it} + \beta_7 Asset_Turnover_{it} + \beta_8 Profitability_{it} + \epsilon_{it} \quad (9)$$

where FPI_{it} is a dummy variable equals to 1 if the foreign firm i is classified as a FPI at the fiscal year t , and 0 if the foreign firm i is classified as a FDI at the fiscal year t . Therefore, if FPIs are more likely to report small positive earnings than FDIs the coefficient β_1 is going to be positive and statistically significant.

4 RESULTS

4.1. Sample

We collected FPIs information on the SEC's website. The SEC makes available annually FPIs lists from 2000 to 2015. Then, we matched the names at the SEC lists with CRSP historical names and received a CRSP and COMPUSTAT id information for that firm (permno and gvkey). The left names of foreign firms on the SEC FPI lists that we could not match using CRSP historical names we hand checked one-by-one using COMPUSTAT and CRSP firms' names. Out of 17530 firms-years observations from 2000 to 2015, we identified 15559 firms-years observations. 51.14% of the 1971 observations left are classified as OTC Market, 40.48% are classified as Debt (NYSE-Debt or OTC-Debt), 2.83% are classified as preferred (AMEX-Preferred, NYSE-Preferred or OTC-Preferred), 4.01% is classified as NYSE Market and the left 1.54% as distributed within AMEX, Capital Market, Global Market, and NMS.

Table 3 shows the sample construction. Merging COMPUSTAT, CRSP and FPIs' lists. The final sample contains 2703 U.S. firms, 931 FDIs and 756 FPIs, extending the sample used

by Lang et al. (2006), which had 181 FPIs between 1991 and 2002. The past ROA matched sample used to calculate the abnormal accruals measure following Kothari et al. (2005) methodology described at section 3.1 contains 5043 U.S. firms, 931 FDIs and 756 FPIs. The past sales growth matched sample used to calculate earnings smoothing measures and target beating describe at sections 3.2 and 3.3, respectively, contains 5043 U.S. firms, 931 FDIs and 756 FPIs.

TABLE 3: SAMPLE CONSTRUCTION

	U.S. Firms		FDIs		FPIs	
	Nº. Of Firms-Years Obs.	Nº. Of Firms	Nº. Of Firms-Years Obs.	Nº. Of Firms	Nº. Of Firms-Years Obs.	Nº. Of Firms
Merged COMPUSTAT, CRSP and FPIs' Lists (2000-2015) with available information	74457	10225	1624	228	7739	1161
Deleted FPIs voluntarily disclosing 10-K Form	0	0	-157	-17	-904	-126
Deleted financial institutions	-14573	-1934	-360	-57	-1945	-271
Delete industries with less than 10 obs. by year	-762	-49	-8	0	-43	-8
Delete obs. with no available information for control variables	-12694	-2011	-168	-35	-711	0
FULL SAMPLE	46428	6231	931	119	4136	756
PAST ROA MATCHED SAMPLE	5043	2585	931	119	4112	756
PAST SALES GROWTH MATCHED SAMPLE	5043	2703	931	119	4112	756

Source: Produced by the author.

Table 4 shows the number of firm-year observations by country—Current ISO Country Code – Incorporation (FIC), displaying the top 10 predominant country by group. FDIs observations are concentrated at Israel, Great Britain, Bermuda, the Netherlands, Cayman Islands and Switzerland; and FPIs observations are concentrated mainly at Cayman Islands, Israel, Great Britain, the British Virgin Island and Canada.

TABLE 4: FOREIGN FIRMS COUNTRY FREQUENCY

FDIs			FPIs		
Country Code	Freq	%	Country Code	Freq	%
IRL	255	27.39%	CYM	715	17.29%
GBR	143	15.36%	ISR	643	15.55%
BMU	112	12.03%	GBR	215	5.20%
NLD	89	9.56%	VGB	211	5.10%
CYM	74	7.95%	CAN	207	5.00%
CHE	52	5.59%	NLD	202	4.88%
ISR	34	3.65%	JPN	201	4.86%
SGP	27	2.90%	FRA	160	3.87%
CAN	22	2.36%	MEX	109	2.64%
BHS	20	2.15%	DEU	107	2.59%
Total	828	88.94%	Total	2770	66.97%

Source: Produced by the author.

4.2. Descriptive Statistics

Table 5 contains the descriptive statistics of variables for U.S. firms at column (1), FDIs at column (2) and FPIs at column (3). The last three columns show the p-value of the mean tests; where the columns **US-FDI**, **US-FPI** and **FDI-FPI** contain the p-value of the hypothesis

TABLE 5: DESCRIPTIVE STATISTICS

	US FIRMS			FDIs			FPIs			Mean Test Pr(T > t)		
	N	MEAN	STD	N	MEAN	STD	N	MEAN	STD	US-FDI	US-FPI	FDI-FPI
Full Sample												
<i>Ab_Acc_Dechow</i>	46428	-0.0004	0.1554	931	-0.0026	0.1399	4136	0.0138	0.1400	0.6399	0.0000	0.0013
<i>TotalAccruals</i>	46428	-0.0832	0.1386	931	-0.0652	0.1103	4136	-0.0626	0.1193	0.0000	0.0000	0.5149
<i>1/Assets_{t-1}</i>	46428	0.0159	0.0318	931	0.0062	0.0211	4136	0.0096	0.0246	0.0000	0.0000	0.0000
<i>ΔREV-ΔREC</i>	46428	0.0754	0.2666	931	0.0722	0.2255	4136	0.0691	0.2301	0.6705	0.0969	0.7097
<i>PPE</i>	46428	0.5110	0.4200	931	0.4478	0.3605	4136	0.5228	0.4386	0.0000	0.0975	0.0000
<i>MTB</i>	46428	2.9082	4.5893	931	3.4097	5.1272	4136	2.4873	3.6311	0.0031	0.0000	0.0000
<i>Leverage</i>	46428	0.2188	0.2470	931	0.2667	0.2568	4136	0.1967	0.2094	0.0000	0.0000	0.0000
<i>CF</i>	46428	0.0366	0.2156	931	0.0985	0.1676	4136	0.0643	0.1793	0.0000	0.0000	0.0000
<i>TotalAccruals_{t-1}</i>	46428	-0.0864	0.1680	931	-0.0657	0.1365	4136	-0.0655	0.1440	0.0000	0.0000	0.9622
<i>AssetsGrowth</i>	46428	0.1312	0.4681	931	0.1799	0.4386	4136	0.1677	0.4758	0.0008	0.0000	0.4520
<i>EmploymentGrowth</i>	46428	0.0660	0.2930	931	0.1084	0.3060	4136	0.0842	0.2919	0.0000	0.0001	0.0282
<i>Size</i>	46428	5.6952	1.9959	931	7.3895	2.0228	4136	6.8503	2.4014	0.0000	0.0000	0.0000
<i>NI</i>	46428	-0.0478	0.2704	931	0.0323	0.1924	4136	0.0041	0.2051	0.0000	0.0000	0.0001
<i>FirmAge</i>	46428	15.3004	12.7337	931	15.6359	14.1986	4136	9.3540	8.2903	0.4746	0.0000	0.0000
Past Roa Matched Sample												
<i>Ab_Acc_Kothari</i>	5043	0.0033	0.1340	931	-0.00166	0.133017	4112	0.0139	0.1333	0.3012	0.0002	0.0013
Past Sales Growth Matched Sample												
<i>ΔNI</i>	5043	-0.0038	0.2019	931	-0.00158	0.17643	4112	-0.0107	0.1730	0.7270	0.0792	0.1475
<i>ΔCF</i>	5043	0.0796	0.2028	931	0.064828	0.176444	4112	0.0513	0.1797	0.0225	0.0000	0.0381
<i>SalesGrowth</i>	5043	0.1364	0.4268	931	0.164956	0.39973	4112	0.1660	0.4565	0.0479	0.0015	0.9448
<i>EquityIssuance</i>	5043	0.1249	0.5139	931	0.128677	0.50582	4112	0.1273	0.5307	0.8361	0.8244	0.9422
<i>DebtIssuance</i>	5043	0.1892	0.6302	931	0.24252	0.676956	4112	0.2029	0.5905	0.0259	0.2852	0.0991
<i>AssetTurnover</i>	5043	1.1050	0.8078	931	0.944881	0.578213	4112	0.8526	0.5815	0.0000	0.0000	0.0000
<i>Profitability</i>	5043	0.0375	0.2095	931	0.099196	0.165711	4112	0.0652	0.1769	0.0000	0.0000	0.0000

All variables were winsorized at 1% level.

Source: Produced by the author

tests $H_0: US\ mean - FDI\ mean = 0$, test $H_0: US\ mean - FPI\ mean = 0$ and $H_0: FDI\ mean - FPI\ mean = 0$, respectively.

The means and mean tests indicate that FDIs are bigger than U.S. firms on average, with average size—measured as the logarithm of total assets—of 7.3895 against 5.6952. The same is observed for FPIs, FPIs have average size of 6.8503, statistically different from U.S. firms size mean. Consistent with results found by Lang et al. (2006), where FPIs showed a average size of 8.39 against 5.88 for similar U.S. firms.

The MTB mean of U.S. firms is 2.9082, indicating U.S. firms are overvalued, on average. However, FDIs presented a higher MTB mean than U.S. firms, suggesting that FDIs are even more overvalued than U.S. firms, on average. FDIs also presented higher leverage than U.S. firms, while FPIs presented less leverage than U.S. firms.

Using the full sample, U.S. firms, FDIs and FPIs presented average abnormal accruals (Ab_Acc_Dechow) of -0.0004, -0.0026 and 0.0138, respectively. Using the past ROA matched sample U.S. firms, FDIs and FPIs presented average abnormal accruals ($Ab_Acc_Kothari$) of 0.0033, -0.0017 and 0.0139, respectively. While FPIs presented more abnormal accruals than U.S. firms, on average, we cannot reject the hypothesis that U.S. firms and FDIs have the same level of abnormal accruals, on average—using both samples. Indicating that FPIs manage earnings more than U.S. firms to report higher earnings, while FDIs and U.S. firms have the same level of earnings management than U.S. firms. Going in the direction of my hypothesis **H1** and **H2** that FDIs and U.S. firms have similar earnings quality and FPIs have lower earnings quality than U.S. firms.

FDIs also have similar age, changes in net income, and equity issuance than U.S. firms, while FPIs presented just statistically similar equity issuance and debt issuance than U.S. firms, on average. Comparing the two groups of foreign firms, we can say that FDIs presented evidences of less abnormal accruals, more overvalue, more leverage, more cash flow, more employment growth, more assets, more net income, older and more changes in cash flows than FPIs.

4.3. Abnormal Accruals

The results using abnormal accruals measures as earnings quality are at Table 6. Using both samples the coefficient of the variable *FPI* was positive and statistically significant at 1% and the *FDI* coefficient was statistically insignificant. Indicating that FPIs manage earnings more than U.S. firms, on average, to inflate earnings; and FDIs and U.S. firms have the same level of earnings management, on average. Supporting my both hypothesis **H1** and **H2**. Table 6 also included a test comparing the coefficients of the variables *FDI* and *FPI*. Using both samples the coefficient tests were statistically significant, indicating that FPIs have more abnormal accruals than FDIs, on average.

Consistent with results found by Ali and Zhang (2015), higher abnormal accruals are related to higher MTB, lower leverage, non-negative earnings, lower cash flow level, higher past accruals, higher growth of assets, lower growth of employment and lower size.

4.4. Earnings Smoothness

The second proxy used for earnings quality was artificial earnings smoothing, capture by *Variance of ANI*, *Variance of ANI over ΔCF* and *Corr(TotalAccruals, CF)*. The results are presented at Table 7. Table 7 Panel B shows the coefficients estimated from the regression models (3), (4), (5) e (6) defined at Section 3.2. Their estimated residuals were winsorized at 1% level generating the measures of earnings smoothing. Recording that higher *Variance of ANI*, higher *Variance of ANI over ΔCF* and more negative *Corr(TotalAccruals, CF)* indicate more artificial smooth earnings.

TABLE 6: ABNORMAL ACCRUALS

Variables	Ab_Acc_Dechow		Ab_Acc_Kothari	
	Coef.	t-Stat.	Coef.	t-Stat.
<i>FPI</i>	0.0220	(6.1)***	0.013	(3.1)***
<i>FDI</i>	0.0046	(-0.98)	-3.70E-04	(-0.74)
<i>MTB</i>	-0.0003	(-1.1)	-1.60E-04	(-2.9)
<i>Leverage</i>	-0.0140	(-3.2)***	-0.028	(-3.3)***
<i>Loss</i>	-0.1100	(-59)***	-0.12	(-32)***
<i>CF</i>	-0.1800	(-24)***	-0.31	(-18)***
<i>TotalAccruals_{t-1}</i>	0.1400	(19)***	0.11	(6.8)***
<i>AssetsGrowth</i>	-0.0084	(-2.4)**	0.012	(1.7)*
<i>EmploymentGrowth</i>	0.0009	(-0.21)	-0.013	(-1.7)*
<i>Size</i>	-0.0085	(-20)***	-0.0069	(-8.5)***
<i>LitigationRisk</i>	-0.0100	(-3.8)***	-0.0072	(-1.5)
<i>FirmAge</i>	0.0006	(12)***	3.80E-04	(3.6)***
<i>Reconciled to US GAAP</i>	0.0057	(-1.4)	0.0062	(-1.5)
<i>IFRS</i>	0.0053	(-0.96)	0.0074	(-1.3)
<i>Constant</i>	0.12	(18)***	0.12	(7.5)***
Year Dummies		Yes		Yes
Industry Dummies		Yes		Yes
Observations		51495		10086
Adj. R-squared		0.134		0.194
Test on coefficients			F-Stat.	
<i>FPI - FDI</i>		(12.49)***		(7.27)***

* Statistical significance at the 10% level based on robust standard errors (two-tailed p-values in parenthesis).

** Statistical significance at the 5% level based on robust standard errors (two-tailed p-values in parenthesis).

*** Statistical significance at the 1% level based on robust standard errors (two-tailed p-values in parenthesis).

winsorized at 1% level.

Source: Produced by the author.

Table 7 Panel A presents the artificial earnings smoothing measures. U.S. firms, FDIs and FPIs showed a 0.03382, 0.02439 and 0.02442 *Variance of ΔNI* , respectively. The p-value for the variance test comparing U.S. firms and FDIs rejected the hypothesis of equal variance, concluding that FDIs have smaller *Variance of ΔNI* than similar U.S. firms. The same is observed comparing FPIs and U.S. firms variance of the estimated residuals from the regression model (3), FPIs show smaller *Variance of ΔNI* than similar U.S. Indicating that there is no statically difference between FPIs and FDIs artificial earnings smoothing level, while both FDIs and FPIs have statistically more evidence of management to achieve smoother earnings than similar U.S. firms.

When looking at *Variance of ΔNI over ΔCF* , FDIs have bigger variance than similar U.S. firms and FPIs have smaller variance than similar U.S. firms. Indicating that FDIs have less evidence of earnings smoothing than similar U.S. firms and FPI have smoother earnings than similar U.S. firms, on average.

Looking at the third measure for earnings smoothness, *Corr(TotalAccruals,CF)*, the conclusion is similar than for the first measure, once FPIs have more negative correlation than similar U.S. firms and FDIs also presented more negative earnings than similar U.S. firms.

4.5. Managing Earnings Targets

Table 8 shows the coefficients estimated from the regression models (7), (8) and (9) described at Section 3.3. The coefficient of *Small Positive NI* is negative and statistically significant when estimating the regression model (7), using a sample with only FDIs and U.S. firms, indicating that U.S. firms are more likely to manage earnings to avoid reporting losses than FDIs.

TABLE 7: EARNINGS SMOOTHING Earnings Smoothing

PANEL A: EARNINGS SMOOTHING MEASURES

	Variance of ΔNI^a	Variance of ΔNI over ΔCF^b	Corr(TotalAccruals,CF) ^c
<i>U.S. Firms</i>	0.03382	1.0040	-0.1346***
<i>FDIs</i>	0.02439	1.0528	-0.2031***
<i>FPIs</i>	0.02442	0.9685	-0.2043***
Group Test	P-Value of Variance Test		
<i>U.S. Firms vs. FDIs</i>	0.0000		
<i>U.S. Firms vs. FPIs</i>	0.0000		
<i>FDI vs. FPIs</i>	0.9862		

PANEL B: COEFFICIENT ESTIMATES FROM THE REGRESSION MODELS (3), (4), (5) and (6)

<i>Variables^d</i>	<i>Sample Size</i>	<i>Independent Variables^e</i>								<i>Significant Country Fixed Effects</i>
		<i>Constant</i>	<i>Size</i>	<i>Sales Growth</i>	<i>Equity Issuance</i>	<i>Leverage</i>	<i>Debt Issuance</i>	<i>Asset Turnover</i>	<i>Profitability</i>	
<i>ΔNI</i>	10086	0.0298***	-0.0058***	0.1056***	-0.0023	0.0168	-0.0509***	-0.0004	0.1293***	11/48
<i>ΔCF</i>	10086	0.1436***	-0.0147***	0.1003***	0.0157**	0.0405***	-0.0262***	-0.0210***	0.2144***	26/48
<i>TotalAccruals</i>	10086	-0.1079***	0.0061***	0.0077	-0.0146***	-0.0176**	-0.0263***	0.0174***		23/48
<i>CF</i>	10086	-0.1340***	0.0387***	0.0073	-0.0296***	-0.1035***	0.0092*	0.0781***		44/48

* Statistical significance at the 10% level based on robust standard errors (two-tailed p-values in parenthesis).

** Statistical significance at the 5% level based on robust standard errors (two-tailed p-values in parenthesis).

*** Statistical significance at the 1% level based on robust standard errors (two-tailed p-values in parenthesis).

All variables were winsorized at 1% level.

Source: Produced by the author.

TABLE 8: TARGET BEATING

Variables ^a	Sample: FDIs and U.S. FDI ^b		Sample: FPIs and U.S. FPI ^c		Sample: FPIs and FDIs FPI ^d	
	Coef.	t-Stat.	Coef.	t-Stat.	Coef.	t-Stat.
<i>Small Positive NI</i>	-0.44	(-2)**	0.22	(2.1)**	0.69	(3.3)***
<i>Size</i>	0.35	(16)***	0.23	(20)***	-0.04	(-2.5)**
<i>Sales Growth</i>	0.31	(3)***	0.36	(6.1)***	0.17	(-1.5)
<i>Equity Issuance</i>	0.16	(2)**	0.11	(2.5)**	0.026	(-0.36)
<i>Leverage</i>	0.31	(1.7)*	-0.84	(-7.1)***	-1.4	(-7.6)***
<i>Debt Issuance</i>	0.15	(2.1)**	0.15	(3.7)***	0.023	(-0.29)
<i>Asset Turnover</i>	-0.36	(-7.1)***	-0.59	(-15)***	-0.22	(-3.6)***
<i>Profitability</i>	1.2	(3.5)***	0.29	(2.1)**	-1	(-3.3)***
<i>Constant</i>	-3.8	(-24)***	-1.1	(-13)***	2.3	(18)***
<i>Sample Size</i>	5974		9155		5043	
Pseudo R-Squared	0.103		0.0721		0.0279	

* Statistical significance at the 10% level based on robust standard errors (two-tailed p-values in parenthesis).

** Statistical significance at the 5% level based on robust standard errors (two-tailed p-values in parenthesis).

*** Statistical significance at the 1% level based on robust standard errors (two-tailed p-values in parenthesis).

All variables were winsorized at 1% level.

Source: Produced by the author.

When using a sample containing FPIs and U.S. firms and estimating the regression model (8) the coefficient of *Small Positive NI* is positive and statistically significant, suggesting that FPIs are more likely to manage earnings to avoid reporting losses than similar U.S. firms. The last two columns of Table 8 contain the estimation results of the regression model (9), using only FDIs and FPIs. The *Small Positive NI* coefficient is positive and statistically significant, indicating that FPIs are more likely to manage earnings to avoid reporting losses than FDIs.

Therefore, when using managing earnings targets as a measure of earnings quality, the results indicate that FDIs have higher quality of earnings than U.S. firms and FPIs have lower earnings quality than similar U.S. firms.

5 CONCLUSION

In this study we aimed to analyze whether the difference in earnings quality between foreign firms listed in the U.S. market and U.S. firms exists due to the different level of regulation. In other words, to investigate whether the lower earnings quality of foreign firms classified as FPIs are due to their disclosure regulation exemption.

Using abnormal earnings, earnings smoothness and managing towards earnings targets as proxies for earnings quality the results show that foreign firms classified as FPIs have lower earnings quality than U.S. firms and foreign firms classified as FDIs. Moreover, FDIs showed similar or better quality of earnings than U.S. firms. Concluding that foreign firms complying with the full reporting regulation have earnings as informative as U.S. firms.

For future research we intend to use a difference-in-difference model to investigate whether earnings quality of foreign firms vary when they change status, since the FPI status of foreign firms is reviewed every year. To analyze whether there is a decline in earnings quality when a foreign firm changes from FDI to FPI and whether there is an increase in earnings quality when a foreign firm changes from FPI to FDI.

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