

The Effect on Financial Reporting Quality of an Exemption from the SEC Reporting Requirements for Foreign Private Issuers

Giorgio Gotti
University of Massachusetts Boston
giorgio.gotti@umb.edu

Stacy Mastrolia
University of Tennessee
smastrol@utk.edu

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Abstract

We test for differences in financial reporting quality between companies that are required to file periodically with the SEC and those that are exempted from filing reports with the SEC under Rule 12g3-2(b). We examine three earnings quality measures: conservatism, abnormal accruals, and the predictability of earnings. Our results, for all three measures, show improved financial reporting quality for companies that file with the SEC than for those that are exempt from filing requirements; this difference in financial reporting quality can lead investors to question why the SEC allows the exemption (and is currently discussing expanding the exemption) when one of the primary goals of the SEC is the protection of US investors.

Keywords: Exemption, 1934 Exchange Act, Rule 12g3-2(b), earnings quality, SEC, foreign private issuers

Data availability: The data are available from public sources identified in the text.

1. Introduction

Previous research has shown that foreign companies cross-list in the United States (U.S.) for several reasons: to signal their financial reporting quality by bonding their shares to a country with improved protection for minority shareholders, to access to the capital available in the United States market, and to lower their cost of capital (Biddle and Saudagaran 1991; Errunza and Miller 2000; La Porta et al. 1997). Foreign private issuers that cross-list in the United States are subject to registration under Section 12(g) of the Securities Exchange Act of 1934¹ and, therefore, certain filings are required with the Securities and Exchange Commission (SEC), including the annual Form 20-F. Foreign issuers may also be subject to the registration requirements of the 1934 Act if the company has securities listed on a national securities exchange in the United States. However, there are also foreign firms that are exempt from filing Form 20-F with the SEC. Under Rule 12g3-2(b), foreign private issuers can request an exemption if they have total assets of less than \$10 million, more than 500 owners worldwide and less than 300 owners in the United States. Foreign issuers benefit from the exemption because they are not required to make costly² periodic filings with the SEC when the issuer has only a marginal presence in the U.S. market. Interestingly, despite these initially strict thresholds, once a company has timely submitted its application and obtained the exemption, the company can exceed any of the shareholder, U.S. resident shareholder, or asset requirements that would otherwise trigger an obligation to register a class of

¹ Release No. 34-51893; International Series Release No. 1291.

² The SEC estimates that the average cost of preparing the U.S. GAAP reconciliation required in the form 20-F is \$4.6 million. This information is included in the Allianz Group comment letter to the SEC proposal on the 17 CFR parts 210, 230, 239, and 249 *Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards without Reconciliation to U.S. GAAP*, published on the SEC website.

securities under Section 12(g), as long as it maintains the exemption by submitting the required non-U.S. disclosure documents.

The SEC in the recent final rule that changes requirements and conditions for the “Exemption from Registration under Section 12(G) of the Securities Exchange Act of 1934 for Foreign Private Issuers”³ acknowledges that:

Investors will incur costs from the adopted rule amendments to the extent that the amendments encourage more foreign companies, which otherwise would be required to register their equity securities under the Exchange Act, to claim the Rule 12g3-2(b) exemption, where the information, enforcement remedies, and other effects of registration are valuable to investors

The SEC regularly published the foreign companies receiving a Rule 12g3-2(b) exemption with the last list being published on June 21, 2005.⁴

In this study, we will examine foreign issuers who are registered with the SEC under Section 12(g) and, therefore, are required to file Form 20-F and foreign issuers exempt from filing with the Commission under Rule 12g3-2(b) and, therefore, are not required to file Form 20-F. The goal of this paper is to determine whether registration with and reporting to the SEC is associated with improved financial reporting quality. Specifically, we measure, borrowing from prior literature, three earnings attributes—conservatism, abnormal accruals, and the predictability of earnings – to test for differences in financial reporting quality between exempted and non exempted foreign issuers. We hypothesize that reporting issuers have higher financial reporting quality than do exempt issuers. Our results for all three financial reporting quality measures provide consistent evidence that support our hypothesis. Interestingly, our univariate

³ 17 CFR Parts 239, 240, and 249, Sept. 10 2008

⁴ One of the authors contacted the SEC for a more updated list and was informed that an updated list is not and will not be available.

results indicated that exempt foreign private issuers are not smaller companies: they had, on average, higher net income and larger total assets than reporting foreign private issuers.

By examining differences between foreign firms that are registered under Section 12(g) and firms that are exempt from reporting requirements under Rule 12g3-2(b), this study can contribute to the existing literature in several ways.

First, it can provide evidence that foreign private issuers that are registered under Section 12(g) and that are filing periodic reporting with the SEC are associated with increased financial reporting quality.

Second, if reporting issuers are associated with improved financial reporting quality, investors may question why some foreign private issuers are allowed to exempt themselves from reporting to the SEC, especially as the exempt firms are larger - higher net income and higher assets, on average - than do reporting firms. As a result, when the SEC is considering expanding availability of the exemption⁵, this study may indicate that a Rule 12g3-2(b) exemption is not adequately protecting the U.S. investor.

Third, in light of the reporting changes for foreign private issuers related to the permissibility of reporting under International Financial Reporting Standards (IFRS), this study can inform the discussion related to possible effects of modifications to the 20-F reporting requirements and perhaps identify a potential negative consequence of reducing the SEC reporting requirements for foreign private issuers.

⁵ On February 13, 2008, the U.S. Securities and Exchange Commission proposed amendments to Rule 12g3-2(b) under the Securities Exchange Act of 1934 and to various other foreign issuer reporting requirements: Foreign Issuer Reporting Enhancements, Securities Act Release No. 33-8900, Exchange Act Release No. 34-57409 (Feb. 29, 2008), available at <http://www.sec.gov/rules/proposed/2008/33-8900.pdf>. Under the proposed amendments to Rule 12g3-2(b), paper submissions to the SEC would be eliminated and issuers would be allowed to claim the Rule 12g3-2(b) exemption without regard to the number of holders of the subject class of equity securities. The new Rule (Release No. 34-58465) has been approved on Sept. 5, 2008 with an effective date of October 10, 2008.

The paper continues as follows: Section 2 provides the background and previous literature; Section 3 describes our hypothesis; Section 4 describes our research design and model; Section 5 presents our results; Section 6 describes our sensitivity tests; and Section 7 provides our conclusions and recommendations for future research.

2. Background and Previous Research

2.1 Cross-listing literature

In the last ten years the number of companies that cross-list their shares in the U.S. market has increased tenfold⁶, with a peak in 1996 and a downturn at the beginning of this decade coinciding with regulatory changes⁷ that have made listing in the U.S. less attractive (Zhu et al. 2007). Finance, accounting, and legal literature provide different explanations and suggest different relevant factors for the development of the cross-listing activity.

Biddle and Saudagaran (1991) identify both the costs and benefits of listing on a foreign stock exchange. They identify several financial benefits to cross-listing including: a reduction in the firm's cost of capital, lower transaction costs, lower systematic risk, and lower required rate of return by investors. Moreover, companies listing on a foreign stock exchange gain marketing, public relations, and political benefits. The costs include the accounting and regulatory costs of foreign listing, specifically: compliance with foreign accounting reporting requirements (in the U.S., generally accepted accounting principles or GAAP), modification of auditing procedures, changing the frequency of

⁶ Non-U.S. companies listing or issuing their shares on the United States market through the American Depository Receipts (ADR) program went from 158 in the early '90 to 2172 at July 2007 (data from Bank of New York ADR website: www.adrbny.com).

⁷ US Congress enacted the Sarbanes-Oxley Act on July 30, 2002 (Pub. L. No. 107-204, 116 Stat. 745).

financial reporting, increasing financial disclosure⁸, and the upfront costs of the initial registration.

The market segmentation hypothesis emphasizes that world markets are separated by cultural, financial, legal, language, and fiscal barriers. Capital market integration theories (Alexander et al. 1987) argue that removing those barriers would help to share the risk among investors, thereby reducing the expected returns demanded by investors and the transaction costs, while increasing the stock prices. Non-U.S. companies can remove these investment barriers by cross-listing on a U.S. exchange. Indeed, empirical research has found a significant decrease in the cost of capital for cross-listing companies (Errunza and Miller 2000).

Some other researchers suggest increased liquidity as another explanation for the decision to cross-list. The U.S. market is more liquid, and thus can alleviate capital constraints that may exist in a domestic market thereby making capital available to firms at a lower cost. In a single-country study, Davis-Friday (2005) provides evidence that Mexican companies cross-listed in the U.S. in order to overcome the capital constraints that existed in Mexico following the devaluation of that currency in 1995.

Another stream of research, in the law and finance disciplines, identifies the bonding hypothesis as a motivation for cross-listing in order to signal the “quality” of a firm. Where the legal protection of minority shareholders is weak, it is more difficult for companies to raise external capital (La Porta et al. 1997). To alleviate this problem, firms that desire external capital can bond themselves to a higher investor protection system by

⁸ Licht (2004) notes that in the United States, current reporting rules require that companies disclose potentially sensitive information such as remuneration, related party transaction, stock-option data, and names of shareholders with more than 5% of the issuer’s voting securities. These rules can reduce managers’ control and financial and non-financial benefits.

cross-listing their shares in the U.S., because of mandatory high quality disclosure requirements, SEC enforcement actions, and shareholder litigation law, all of which make expropriation of minority shareholders by dominant shareholders and/or by management more difficult (Coffee 1999). Empirical research has consistently supported the bonding hypothesis. Doidge et al. (2004) provide evidence that at the end of 1997, foreign companies with shares cross-listed on major U.S. exchanges have Tobin's Q ratios significantly higher than companies that do not cross-list. These authors suggest that cross-listing in the U.S. reduces the opportunities for dominant shareholders and management to expropriate private benefits, thereby enhancing the value of the firm. This effect is more pronounced for firms that are based in countries with weaker investor protection laws.

Within this line of research, analytical models consider the decision to cross-list as both a signal from dominant shareholders and managers of private information about their firm's "quality" to outside investors, and as an action designed to bond the firm to a higher quality disclosure environment.

Our study will include all companies that cross-list in the U.S. (for which the necessary data is available), comparing financial reporting quality for foreign private issuers that are registered with and report to the SEC to those that are exempt from reporting. If cross-listing reduces information asymmetry and signals the "quality" of a company, we will test if issuers that provide more information to the market (reporting issuers) have an incentive to provide better financial reporting quality than do issuers that provide less information to the market (exempt issuers).

2.3 SEC Rule Sections 12(g)

In 1964, Congress adopted Section 12(g) of the Exchange Act in order to provide investors trading in over-the-counter securities, for which significant public interest existed, with the same fundamental disclosure protections provided to investors trading in securities that were listed on a national securities exchange.⁹ Section 12(g) requires an issuer to comply with the reporting requirements of Section 13 of the Exchange Act of 1934.

2.4 SEC Rule Exception 12g3-2(b)

Rule 12g3-2(b) provides an exemption from the periodic reporting requirements of the Section 13 of the Exchange Act of 1934 for certain foreign private issuers. Foreign private issuers are eligible for this exemption if (1) they establish a Level I ADR facility or a Rule 144A offering to qualified investors; and (2) if all the following conditions are met (i) the company has less than \$10 million in assets, (ii) the company has at least 500 shareholders worldwide, and (iii) the company has less than 300 shareholders with addresses in the U.S.

Either compliance with the exemption rule or the periodic reporting requirement is required by law when the company is establishing a sponsored Level I ADR facility to trade its shares on a United States stock market.¹⁰ Exempt companies solicit investment from U.S. investors (their shares are exchanged over-the-counter through the Pink Sheets) but do not provide investors either (a) the reconciliation between annual financial

⁹ Securities and Exchange Commission. Federal Register, Part II, Monday, February 25, 2008.

¹⁰ It is important to note here that the classification in this paper is based on the legal status of exemption with the SEC of the foreign firm. This is not equivalent to the usual classification Level I vs. Level II and III ADRs. Indeed, foreign private issuers with Level I ADRs listen in US stock exchanges can either be exempted, in compliance with the exemption rule when the required thresholds are met, or subject to the periodic reporting requirement mandated under Section 13 of the Exchange Act of 1934.

statements in local GAAP or IFRS and U.S. GAAP, as required by all the other private foreign issuers, or (b) all the other pieces of information required by the SEC in the 20-F form. Also, before an offering in the United States under Rule 144A, the observance of the requirements of the rule simplifies the compliance with Rule 144A provisions.

To qualify for an exemption from the securities laws while establishing a trading market in the U.S. over-the-counter market, the company must provide the SEC with all the documents made available to the public under the laws of the country where the company is incorporated and all the documents made public according to the regulations of any stock exchange on which the company's stock is listed. Furthermore, the company must provide to the SEC all the documents containing information of interest to investors otherwise made available to the public by the company (annual reports, announcements of meetings of shareholders, press releases relating to dividends, etc.).¹¹

To establish the exemption under this rule, the company must supply the SEC with a copy of all the required documents (as described above) made public or distributed since the beginning of the company's last fiscal year. Furthermore, the company must deliver to the SEC a description of the documents that the company makes public or distributes during the course of a year and the dates or time periods when it is required to do so. Finally, the company should inform the SEC of the number of shareholders of the company resident in the U.S., the amount and percentage of shares they hold, the circumstances under which they acquired the shares (e.g., ordinary trading, exempt offering, etc.) and the date of the most recent distribution of securities by the company.

¹¹ The company is not required to furnish documents such as product catalogs and price lists, and an English translation is not required for all documents. However, press releases and any documents that are given to shareholders of the company, not merely made available to the public, must be in English. An exact translation is not required; an English language version that contains the same information or a summary of the document's contents in English is acceptable.

To maintain the exemption under the rule, once the SEC has approved the company's establishment of the exemption, the company should send the SEC a copy of each required document soon after it is made public or distributed. At various intervals (last time on June 21, 2005) the SEC publishes a list of companies that have established and maintained the exemption. Once a company has timely submitted its application and obtained the exemption, the company can exceed any of the shareholder, U.S. resident shareholder, or asset thresholds that would otherwise trigger an obligation to register a class of securities under Section 12(g), as long as it maintains the exemption by submitting the required non-U.S. disclosure documents.

The exemption under the rule is not available to companies that are subject to the periodic reporting requirements or have been subject to those requirements in the past 18 months, to companies that have acquired another company (U.S. or non-U.S.) that was subject to the periodic reporting requirements, to companies with securities listed on a U.S. stock exchange or quoted in NASDAQ, or to Canadian companies.

The rule specifically exempts the documents furnished under the exemption from some of the provisions of the U.S. securities laws relating to liability for disclosure: indeed, the company could be liable to investors or the SEC if the documents are false or misleading. However, since the rule was adopted in 1967 the SEC has never sued any company for false or misleading disclosure in documents furnished under the rule and no investor has successfully sued a company under the rule.

2.5 Contents of 20-F Filing

Foreign private issuers that are subject to reporting under Section 13 of the Exchange Act of 1934 (reporting issuers) are required to file a Form 20-F with the SEC within 120 days¹² of the company's fiscal year end. A Form 20-F contains a great deal of financial and operational information about the company for investors to use in their decision making; by comparison, exempt firms do not file a Form 20-F and are not required to make that same financial and operational information available to investors. As a result, more information is readily available to U.S. investors for reporting issuers than is available for exempt issuers. For example, we looked on a popular broker's website for investor information for Cadbury PLC. (a reporting issuer listed on the NYSE) and Nestle S.A. (an exempt issuer listed on the Pink Sheets). While we would have been able to invest in either company through the broker's website, only Cadbury PLC provided any financial information on the broker's website. We further went to the SEC EDGAR website (www.sec.gov) to research both issuers and found a Form 20-F for Cadbury PLC (with 155 pages of information) and no financial or operational information for Nestle S.A. In *Appendix 1*, we have included a copy of the Table of Contents for Cadbury PLC's 2007 Form 20-F to show the breadth and scope of the information that is available for a reporting issuer when making an investment decision.

3. Hypothesis

According to previous literature, if cross-listing reduces information asymmetry and signals the "quality" of a company, we hypothesize that issuers that provide more

¹² It was 180 days until the recent ruling by the SEC. The new Rule (Release No. 34-58465) has been approved on Sept. 5, 2008 with an effective date of October 10, 2008.

information to the market (reporting issuers) will have higher financial reporting quality than do issuers that provide less information to the market (exempt issuers). Our hypothesis is as follows (in the alternative form):

Hypothesis: Issuers that are subject to SEC Rule 12(g) will have higher financial reporting quality than do issuers that apply for (and receive) an exemption under Rule 12g3-2(b).

4. Research Design and Model

To test our hypothesis, we examine three measures of earnings quality in order to determine if there are systematic financial reporting quality differences between foreign private issuers that are required to report under Section 13 of the Exchange Act of 1934 and those that are exempt from this reporting. Similar to previous research, we use the following three proxies for earnings quality: timeliness of earnings (or accounting conservatism), accruals quality, and earnings predictability (Van der Meulen et al. 2007).

Our test period is from 2000 to 2005. We use this time period because the SEC published the list of exempt issuers in 1999, 2002, 2003, 2004 and 2005. To avoid the confound of issuers that were both reporting and exempt issuers during our sample period, our sample only includes reporting issuers and exempt issuers that were in either group for the entire period. We adopt a binary variable equal to 1 for companies that are continuously exempted from SEC filing and 0 for companies that file continuously with the SEC from 2000 to 2005. We then compare the financial reporting quality measures between the two sub-samples, controlling for country-level variables (La Porta et al. 1998; La Porta et al. 2006; Hope 2003) and firm-level variables that previous literature

identifies as relevant in order to identify only differences in earnings quality between reporting and exempt companies, without regard for legal, cultural, economical, or development differences between the individual countries of origin.

4.1 Timeliness

First, we test for earnings timeliness (accounting conservatism) using a measure consistent with previous research (Van der Meulen et al. 2007). Timely earnings recognize expected (future) changes in cash flows in the reported financial statements. Conservative, high quality, financial reporting recognizes bad news (defined as expected losses) more quickly than good news in reported earnings. For a more in depth review of the literature dedicated to conditional conservatism, its causes, and its determinants, we direct the reader to two review papers by Watts (2003a, 2003b)

To test whether there is a systematic difference in the timely recognition of future gains vs. losses between exempt and reporting companies in our sample, we use a model similar to Basu (1997):

$$\begin{aligned}
 Net\ Income_{it} = & a_0 + a_1 RET_{it} + a_2 DR + a_3 Exempt + a_4 RET_{it} * DR + \\
 & a_5 RET_{it} * Exempt + a_6 Exempt * DR + a_7 Exempt * DR * RET_{it} + \\
 & a_8 Size_{it} + \beta \Gamma_{it}
 \end{aligned} \tag{1}$$

Net Income is calculated as the firm's net income (DATA32) divided by the firm's lagged market value. *RET* is equal to the return to investors (including dividends)¹³, *DR* is a binary variable equal to 1 for issuers with negative annual returns (a proxy for bad news about future cash flow) and 0 otherwise. To test for systematic differences between the

¹³ Return (with dividends) is calculated as the end of the period firm's stock price minus beginning of the period plus dividends, divided by beginning of the period stock price.

two sub-samples in our study, we add to the original Basu (1997) model a binary variable (*Exempt*) that is equal to 1 when the foreign private issuer is exempt from SEC filings, 0 otherwise, and the related two-way and three-way interaction terms.

We control for both firm and country characteristics that are indicated by previous research and by our univariate testing. At the firm level, we control for *Size* (the natural log of total assets). At the country level we control for factors - Γ_{it} - that previous literature (La Porta et al. 1998; La Porta et al. 2006; Djankov et al. 2008; Hope 2003) found important in explaining country-level differences in financial reporting quality. In particular, as in La Porta et al. (1998), we control for the legal origin of the issuer, Debt/GNP ratio, Equity/GNP ratio, Rule of Law, level of corruption (Corruption), Creditor Rights protection (La Porta 1998), and CIFAR score (Hope 2003).

In this model the coefficient of interest is a_7 : a negative and significant coefficient indicates that companies filing with the SEC are characterized by more conservative financial reporting than are exempt issuers, lending evidence to support our hypothesis: reporting issuers have higher financial reporting quality than exempt issuers.

4.2 Accruals Quality

In recent years, the SEC has made a connection between earnings management and restatements or improper accounting (Public Accounting Report 1998). Additionally, in a 1998 speech, then SEC Chairman Levitt made a direct connection between earnings management, earnings quality and the quality of financial reporting (Chairman Levitt Speech 1998). Previous research has used accruals quality as a proxy for earnings management and financial reporting quality and this paper does the same. Most of this

research indicates that managers use discretionary accruals to intentionally manage earnings to their benefit.

A cross-sectional Jones model (Jones 1991) is commonly used to evaluate earnings management in the U.S. but it is not practical for the calculation of abnormal accruals with international data (Francis and Wang 2008). When calculating abnormal accruals for international data, the number of observations in each industry and in each country can be small, thereby reducing the reliability of the results of abnormal accruals calculated with the Jones model (Wysocki 2004; Meuwissen et al. 2007). To avoid this problem, we adopt a linear expectation model adapted from DeFond and Park (2001) that uses a firm's own prior year accruals in calculating the expectation benchmark. Expected accruals are based on a firm's prior year ratio of current accruals to sales, and the prior year's ratio of depreciation expense to gross property, plant, and equipment (PPE). An additional benefit of this approach is that it controls for cross-country differences in accounting standards and in country characteristics by using a firm as its own control to compute abnormal accruals. For example, Francis and Wang (2008) assume that the ratio current accruals to sales is equal to 0.15 for a firm in year $t-1$, based on sales of \$100 and current accruals of \$15 in $t-1$. If sales in year t are \$140, then predicted current accruals in year t would be $\$140 \times 0.15 = \21 . The same procedure is used for predicted depreciation expense, which is based on the prior year's ratio of depreciation expense to gross PPE.

As Francis and Wang (2008) point out, this model is not a random walk expectation model in which current accruals are simply expected to be the same dollar amount as last year's accruals. Rather, accruals are assumed to have a constant linear relationship over time with sales (for current accruals) and gross PPE (for depreciation) that can be used to

predict current period accruals for a given level of sales and gross PPE. See *Appendix 3* for a detailed explanation of the estimation of abnormal accruals (ABNACC) and the related data definitions.

We test for accruals quality with the following model:

$$ABNACC_{it} = a_0 + a_1 Exempt_{it} + a_2 Size_{it} + a_3 Net\ Income_{it} + a_4 Net\ Income_{it} * Size + \beta \Gamma_{it} \quad (2)$$

ABNACC is equal to the firm's abnormal accruals (total/positive/negative) for the year as calculated in *Appendix 3*. We calculate abnormal accruals for the sample in total and separately for positive and negative abnormal accruals. Positive abnormal accruals are income-increasing abnormal accruals and negative abnormal accruals are income decreasing abnormal accruals. As in previous studies, we identify lower abnormal accruals in total and for each of the positive and negative accrual subsets as higher financial reporting quality.

Exempt is a binary variable equal to 1 when the foreign private issuer is exempt from SEC filings, 0 otherwise. We control for both firm and country characteristics. At the firm level we control for *Size* (the natural log of the total assets) and *Net Income*, since our univariate analysis suggests that there is a statistically significant difference in the means of these two variables between exempt and reporting firms. At the country level we control for all the factors - Γ_{it} - that previous literature (La Porta et al. 1998; La Porta et al. 2006; Djankov et al. 2008; Hope 2003) has found important in explaining country-level differences in financial reporting quality. In particular, conforming to La Porta et al.

(1998), we control for the legal origin of the firm, Debt/GNP ratio, Equity/GNP ratio, Rule of Law, level of corruption (Corruption), Creditor Rights protection (defined as in La Porta 1998), and CIFAR score (Hope 2003). We run the model for the entire sample, and separately for positive (income increasing) abnormal accruals, and for negative (income decreasing) abnormal accruals.

A positive and significant coefficient a_1 indicates that exempt issuers have higher abnormal accruals (total/positive/negative) than reporting issuers, even after controlling for firm-level and country-level differences, . As hypothesized, a positive coefficient a_1 would, therefore, provide evidence in support of our hypothesis that reporting issuers have higher earnings quality than exempt issuers.

4.3 Predictability

The U.S. Financial Accounting Standard Board (FASB) Statement of Financial Accounting Concepts No. 1 explicitly states that “Investors, creditors, and others often use reported earnings and information [...] to help them [...] predict future earnings.” Better quality financial statements, then, will help users of financial reporting to better predict the firm’s future earnings. Hence, we adopt earnings predictability as a measure of earnings quality and we measure the association between current and future earnings with an autoregressive model (Van der Meulen et al. 2007):

$$\begin{aligned}
 & \text{Net Income}_{it} = \\
 & a_0 + a_1 \text{Exempt} + a_2 \text{Net Income}_{it-1} + a_3 \text{Exempt} * \text{Net Income}_{it-1} + a_4 \text{Size} \quad (3)
 \end{aligned}$$

Net Income equal to the firm's net income over market lagged value, *Exempt* is a binary variable equal to 1 if the firm is an exempt issuer from 2000 to 2005 and zero otherwise. We control for *Size* (the natural log of total assets) since our univariate analysis suggests that there is a statistically significant difference in the means of the variable between exempt and reporting issuers.¹⁴

A negative and significant coefficient for the interaction term a_3 indicates that exempt issuers display a weaker association between current and future earnings than do reporting issuers. This would provide evidence that reporting issuers provide higher earnings quality than do exempt issuers, in the sense that information in their current earnings will help investors to better forecast future earnings and, therefore, future cash flow and dividends, thereby reducing the information risk that investors are exposed to.

5. Sample and Descriptive Statistics

In the past, the SEC regularly published the list of foreign private issuers with a Rule 12g3-2(b) exemption.¹⁵ The list was published in 1999, 2002, 2003, 2004 and 2005¹⁶ (the last list was published on June 21, 2005.¹⁷) Due to the availability of the list of exempt issuers, our sample includes all issuers that either continuously report to the SEC from 2000 to 2005 or are continuously exempt from filing with the SEC from 2000 to 2005.

¹⁴ We do not control for *Net Income* at time t in this model since this variable is on the left-hand side of the equation and lagged *Net Income* is included in the autoregressive model.

¹⁵ The most recent list (2005) is available on the SEC website:
<http://www.sec.gov/divisions/corpfin/international/foreignalpha2005.pdf>

¹⁶ The last list of the series has been: SEC Release No. 34-51893; International Series Release No. 1291. June 21, 2005: List of Foreign Issuers That Have Submitted Information Under the Exemption Relating to Certain Foreign Securities. The list of foreign private issuer exempted from filing with the SEC is available on the SEC website. After the release on June 21, 2005 there have not been updates to the list.

¹⁷ One of the authors contacted the SEC for a more updated list and was informed that an updated list is not and will not be available.

For each year, from 2000 to 2005, we manually collect from the SEC website the list of foreign private issuers that are exempt from filing periodically with the SEC. Then we collect the available accounting and market information from Compustat Global Vantage (Industrial/Commercial and Global Issue files) for reporting issuers and for exempt issuers. For the last year of our sample, 2005, we have 690 exempt issuers and 1,236 reporting issuers. Finally, we gather analysts' EPS forecast and adjusted actual EPS from I/B/E/S database.

See *Appendix 2* for variables definitions and *Appendix 3* for the model to calculate abnormal accruals adapted for international companies.

Table 1 lists the country of origin for each firm-year observation in our sample, and separately for reporting and exempt issuers.

[Insert Table 1 about here]

4.1 Descriptive Statistics

[Insert Table 2 about here]

Table 2 presents the descriptive statistics for our sample. Panel A includes all of the companies that are exempt or reporting but is not limited to companies that are in one subset or the other continuously during the test period (2000-2005).¹⁸ Panel B includes companies that are continuously exempted from filing with the SEC during the test period, and Panel C includes companies that continuously file with the SEC during the test period.

¹⁸ This panel includes issuers that were in both the exempt and the reporting subsamples for at least one year during the test period, but not continuously from 2000-2005.

The table does not include variables coming directly from the Compustat Global Vantage database because accounting data for companies from different countries are presented in the database in different currencies and with a different scale. Instead we calculate relative values of each issuer's accounting results for comparison purposes – for example, we calculate net income over market value and returns to investors as relative measures for comparison.

On average, companies in our sample have a rate of return to investors equal to 18%, an average size of annual net income over lagged market value of 12%, 7.68 is the average issuer size (natural log of total assets), and finally abnormal accruals scaled by firm's total assets are, on average, negative (income reducing) and equal to 12% of the firm's total assets. Details on the calculation of abnormal accruals are included in *Appendix 3*.

5. Results

5.1 Univariate Analysis

[Insert Table 3 about here]

As the univariate tests of means shows (Table 3), the reporting and the exempt issuers are statistically different in both *Net Income* and *Size*. Exempt issuers (counter-intuitively) have, on average, twice the net income of reporting issuers (0.16 vs. 0.08, difference significant at 1% confidence level) and are, on average, larger (8.4 vs. 7.8 average log of total assets value, difference significant at 1% confidence level) during our test period.

Because of these statistically significant differences between the samples, we control for these two variables – *Net Income* and *Size* - in our main statistical tests of our hypothesis.

5.2 Multivariate Results

5.2.1. Timeliness

[Insert Table 4 about here]

First we test for differences in financial reporting quality between exempt and reporting companies using earnings timeliness (conservatism) as a proxy for financial reporting quality; higher conservatism is considered to be higher financial reporting quality. Our results in Table 4 show that the interaction coefficient of model (1) a_7 , as expected, is negative (-0.5862) and strongly statistically significant (t value of 4.07, significant at 1% of confidence level). The sign of the three-way interaction coefficient a_7 , together with the significant and positive sign of the two-way interaction coefficient a_4 , provide evidence in support of our hypothesis that exempt issuers are less conservative (report less timely negative news about future cash flow) than reporting issuers, even after controlling for factors that previous literature has found significant in explaining difference in earnings quality between countries.

5.2.2 Accruals Quality

[Insert Table 5 about here]

Our second test for differences in financial reporting quality between exempt and reporting issuers uses abnormal accruals as a proxy for financial reporting quality; lower

abnormal accruals is considered to be associated with higher financial reporting quality. We run model (2) for total accruals and separately for positive (income-increasing) and negative (income-decreasing) accruals.

For our total accruals measure, our results in Table 5 show a positive (0.0263) and significant at 5% confidence level coefficient for our test variable, indicating that exempt issuers have higher abnormal accruals (lower financial reporting quality) than reporting issuers. For the sample of firms with negative (income-decreasing) abnormal accruals, we find similar results: a positive association between negative abnormal accruals and our test variable (coefficient of 0.0216, significant at the 5% confident level). Similarly, these results provide evidence of a higher level of negative abnormal accruals (lower financial reporting quality) for exempt issuers than reporting issuers. For our sample of firms with positive (income-increasing) abnormal accruals, we find no significant difference between exempt and reporting issuers, indicating no difference in financial reporting quality between the two groups of issuers on this dimension.

In all three analyses, we control for two firm-level variables (*Size* and *Net Income*) and country-level variables that previous literature identifies as relevant in explaining financial reporting quality: the legal origin of the company, the level of Debt/GNP, the level of Equity/GNP, the Rule of Law, the corruption level, the creditor rights level of the country of origin (La Porta et al. 1998), and the CIFAR score (Hope 2003).

5.2.3 Predictability

[Insert Table 6 about here]

Our third test for differences in financial reporting quality between exempt and reporting issuers uses earnings predictability as a proxy for financial reporting quality; higher earnings predictability is considered to be associated with higher financial reporting quality. Our results in Table 6 show a negative value of the coefficient a_3 for the interaction term (*Exempt*Net Income*) and a positive value of the coefficient a_2 (*Net Income*); both coefficient values are significant at the 1% confidence level. These results indicate that exempt issuers have significant less predictability of earnings (lower financial reporting quality) than reporting issuers and provide evidence consistent with our hypothesis: there is a positive association between previous year and current year net income, but this association is lower (weaker) for exempt issuers. Stated in other words, exempt issuers exhibit a lower predictability of future earnings based on present earnings (lower financial reporting quality).

6. Sensitivity Tests

Our sample includes multiple observations for each issuer introducing serial correlation of the error terms. To address this issue, we also run panel regressions instead of OLS regressions for models (1), (2), and (3).¹⁹ Our main results and inferences for models (1) and (3) do not change. Panel regressions for model (2) provide an estimated coefficient for the binary test variable (*Exempt*) that is still positive but only significant at the 10% confidence level for the total abnormal accruals sample, while the coefficient becomes insignificant when we limit the sample to positive or negative abnormal accruals.

¹⁹ The results are untabulated and available from the authors.

7. Conclusions and Future Research

In this paper, we use a unique sample of foreign private issuers that are exempt from filing with the SEC, in order to test whether reporting to the SEC is associated with improved financial reporting quality. We compare the financial reporting quality of cross-listed firms that are required to file with the SEC and cross-listed firms that are exempt from filing information with the SEC. We use three proxies for financial reporting quality to compare the exempt and reporting issuers: conservatism, abnormal accruals, and the predictability of earnings.

Our results indicate that for all three measures of earnings quality exempt issuers exhibit lower financial reporting quality than do reporting issuers. These results indicate that the reporting requirements of Section 12(g) of the 1934 Exchange Act are associated with higher financial reporting quality. These results should be of interest to investors and regulators as they may indicate that a Rule 12g3-2(b) exemption may not be in the best interest of U.S. shareholders. This study is very timely as the SEC is currently considering expanding the availability of the exemption to more foreign private issuers, which this study indicates, may result in lower financial reporting quality.

7.1 Future research

This paper provides evidence that financial reporting quality is different for companies that are required to report to the SEC and those that are exempt from reporting to the SEC. We believe the next logical question is: does the market perceive and price the difference in financial reporting quality? Specifically, do U.S. investors penalize exempt issuers for not providing the same information (transparency) as reporting foreign

private issuers? Do U.S. investors impound the differences in information into the stock prices of these companies, thus requiring the exempt issuers to deliver a higher return to investors, or, said otherwise, do the exempt issuers incur in a higher cost of equity capital? Also, do financial analysts impound the lower level of information provided by exempt issuers by providing forecasts that are less precise than forecasts for reporting foreign private issuers? We start to address these questions in a follow up paper (Gotti and Mastrolia 2009) that examines the market reactions to the U.S. foreign private issuers exempt from filing with the SEC under Rule 12g3-2(b).

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Appendix 1: Sample Table of Contents for Cadbury PLC Form 20-F²⁰

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²⁰ Publically available through the Securities and Exchange Commission website :
<http://www.sec.gov/Archives/edgar/data/744473/000115697308000420/u55102e20vf.htm>.

Appendix 2: Variables Definition

To compute the variables used in the model, we retrieve from the Global Vantage database the following information for each company:

- Total sales (DATA1),
- Depreciation and amortization total (DATA11),
- Depreciation of fixed assets (DATA12),
- Amortization of intangibles (DATA13),
- Operating income (DATA14),
- Minority interests (DATA27),
- Net income (DATA32),
- Dividends to common shares (DATA36),
- Cash and short term investments (DATA60) ,
- Treasury stock (DATA73) ,
- Total current assets (DATA75),
- Debt in current liabilities (DATA94),
- Dividends (DATA102),
- Current liabilities (DATA104),
- Deferred taxes (DATA105),
- Reserves (DATA108),
- Other liabilities (DATA109).

We calculate:

- Market value as number of share outstanding (adjusted²¹) times the price (adjusted) at the beginning of the period.
- Net income as the net income (DATA32) divided by lagged market value.
- Change in net income as DATA32 – lagged DATA32 divided by market value.
- Size is the natural log of total assets (DATA89).

²¹ In order to make shares and stock prices directly comparable through time we use Cumulative Adjustment Factors (CAF) from Wharton Research Data Services (WRDS). We calculate adjusted stock price and adjusted shares outstanding by multiplying numbers from the Global Vantage Global Issue database with the CAF provided by WRDS.

Finally, we compute returns with dividends (RET) as price (adjusted) plus dividends to common shares (DATA36) times shares outstanding (adjusted) minus the lagged price (adjusted) divided by the lagged price (adjusted).

Appendix 3: Abnormal Accruals Modeling for International Companies

Following previous literature (Francis and Wang 2008) we calculate current accruals using data from COMPUSTAT Global Industrial and Commercial file. We calculate predicted accruals as:

$$\text{Predicted accruals} = \{[\text{Sales (DATA1) in year } t * (\text{current accruals in year } t-1 / \text{sales in year } t-1)] - [\text{gross PPE (DATA77) in year } t * (\text{depreciation in year } t-1 (\text{DATA11}-\text{DATA13}) / \text{gross PPE in year } t-1 (\text{DATA77}))]\} / \text{total assets (DATA89) in year } t-1.$$

Abnormal accruals are defined as the firm's actual total accruals in year t , minus predicted total accruals for year t as defined above. Total accruals in year t are calculated as follows:

$$\text{Total accruals} = (\text{Earnings before extraordinary items} - \text{Operating cash flows}) / \text{total assets (DATA89) in year } t-1, \text{ where:}$$

$$\begin{aligned} \text{Earnings before extraordinary items} &= \text{net income (DATA32)} - \text{extraordinary items (DATA33)}; \\ \text{Operating cash flows} &= \text{Earnings before extraordinary items} + \\ &\text{Depreciation and Amortization (DATA11)} + \text{change in deferred income tax (DATA105)} \\ &+ \text{change in untaxed reserve (DATA108)} + \text{change in other liabilities (DATA109)} \\ &+ \text{minority interest (DATA27)} - \text{current accruals (as defined below)}. \end{aligned}$$

$$\begin{aligned} \text{Current accruals} &= \text{change in non-cash working capital} = \Delta[\text{total current assets (DATA75)} \\ &- \text{cash and short term investments (DATA60)} - \text{treasury stock shown as current assets (DATA73)}] - \Delta[\text{total current liabilities (DATA104)} - \text{total amount of debt in current liabilities (DATA94)} - \text{proposed dividends (DATA102)}]. \end{aligned}$$

Abnormal accruals are calculated each year for the firms in the sample using data from 2000 to 2005. Because we need data for three consecutive years to calculate abnormal accruals, we collected accounting and market information starting from 1997 so that we can compute abnormal accruals for the period 2000-2005. Abnormal accruals are scaled by a firm's lagged total assets.

In more formal notation:

Predicted Accrual =

$$\frac{\left\{ \left[Sales_t * \left(CA_{t-1} / Sales_{t-1} \right) \right] - \left[gross\ PPE_t * \left(depr_{t-1} / gross\ PPE_{t-1} \right) \right] \right\}}{TA_{t-1}}$$

All the variables are defined above.

Table 1: Firm-year observations by country of origin (2000-2005)

Country	SEC filing Issuers (Exemption= 0)	Exempt Issuers (Exemption= 1)
ANT (Netherlands Antilles)		10
ARG (Argentina)	30	
AUS (Australia)	41	47
AUT (Austria)	7	10
BMU (Bermuda)	25	44
BRA (Brazil)	130	1
CAN (Canada)	914	53
CHE (Switzerland)	42	10
CHL (Chile)	67	
CHN (China)	69	8
CYM (Cayman Islands)	17	10
DEU (Germany)	51	39
ESP (Spain)	30	8
FIN (Finland)	2	
FRA (France)	41	
GBR (Great Britain)	221	28
GRC (Greece)	10	
HKG (Hong Kong)	49	58
IND (India)	18	9
IRL (Ireland)	35	
ISR (Israel)	81	
ITA (Italy)	52	29
JPN (Japan)	146	111
KOR (Korea)	27	15
LUX (Luxembourg)	14	
MEX (Mexico)	55	30
MYS (Malaysia)		18
NLD (Netherlands)	82	20

NOR (Norway)	26	
NZL (New Zealand)		7
PER (Peru)		7
PHL (Philippines)	15	10
PNG (Papua New Guinea)	10	
POL (Poland)		14
PRT (Portugal)	10	
RUS (Russia)	7	
SGP (Singapore)	10	19
SVK (Slovak Republic)		10
SWE (Sweden)	10	
THA (Thailand)		19
TUR (Turkey)	6	10
TWN (Taiwan)	30	10
ZAF (South Africa)	36	48
Totals	2416	712

Table 2: Descriptive Statistics*Panel A: All companies from 2000 to 2005²²*

<i>Variable</i>	<i>n</i>	<i>Mean</i>	<i>S.D.</i>	<i>Min</i>	<i>.25</i>	<i>Mdn</i>	<i>.75</i>	<i>Max</i>
Net Income	8857	0.12	0.78	-1.3	0.00	0.03	0.09	6.8
RET	7844	0.18	0.70	-0.92	-0.22	0.07	0.40	3.75
Size	8915	7.68	2.29	-0.35	6.18	7.77	9.25	13.54
ABNACCR	6121	-0.12	0.23	-1.06	-0.19	-0.11	-0.05	1.38

Panel B: Companies that from 2000 to 2005 are continuously exempted from filing with the SEC

<i>Variable</i>	<i>n</i>	<i>Mean</i>	<i>S.D.</i>	<i>Min</i>	<i>.25</i>	<i>Mdn</i>	<i>.75</i>	<i>Max</i>
Net Income	703	0.16	0.76	-1.26	0.00	0.06	0.12	6.81
RET	644	0.20	0.62	-0.92	-0.14	0.09	0.39	3.75
Size	712	8.40	1.87	2.25	7.26	8.41	9.49	12.81
ABNACCR	534	-0.08	0.21	-1.06	-0.15	-0.09	-0.04	1.38

Panel C: Companies that from 2000 to 2005 continuously file with the SEC

<i>Variable</i>	<i>n</i>	<i>Mean</i>	<i>S.D.</i>	<i>Min</i>	<i>.25</i>	<i>Mdn</i>	<i>.75</i>	<i>Max</i>
Net Income	2398	0.08	0.65	-1.26	-0.00	0.02	0.07	6.81
RET	2161	0.18	0.71	-0.92	-0.21	0.05	0.37	3.75
Size	2416	7.76	2.22	0.48	6.31	7.94	9.33	13.07
ABNACCR	1709	-0.13	0.20	-1.06	-0.20	-0.12	-0.06	1.38

Where *Net Income* is the winsorized (1%) measure of net income, calculated as firm's net income (DATA32) divided firm's lagged market value, *SALES* is the winsorized measure (1%) of the natural log of total sales (DATA1), *RET* is the winsorized measure (1%) of the with dividends returns to investors, calculated as price (adjusted) plus dividends to common shares (DATA36) times share outstanding minus the lagged price divided by the lagged price, *Size* is the natural log of the total assets (DATA89), and

²² All companies includes not only companies that are exempted or file with the SEC continuously from 2000 to 2005, but also companies that are exempted or file with the Commission for one or more year, but not continuously, over the sample period.

ABNACCR is the value of abnormal accruals. Following previous literature (Francis and Wang 2008) we calculate current accruals using data from COMPUSTAT Global Industrial and Commercial file. Predicted accruals are calculated as: predicted accruals = {[Sales (DATA1) in year t *(current accruals in year $t-1$ /sales in year $t-1$)] - [gross PPE (DATA77) in year t *(depreciation in year $t-1$ (DATA11-DATA13)/gross PPE in year $t-1$ (DATA77))]/total assets (DATA89) in year $t-1$. Abnormal accruals are defined as the firm's actual total accruals in year t , minus predicted total accruals for year t as defined above. Total accruals in year t are calculated as follows: total accruals = (Earnings before extraordinary items - Operating cash flows)/total assets (DATA89) in year $t-1$, where: earnings before extraordinary items = net income (DATA32) - extraordinary items (DATA33); Operating cash flows = Earnings before extraordinary items + Depreciation and Amortization (DATA11) + change of deferred income tax (DATA105) + change of untaxed reserve (DATA108) + change in other liabilities (DATA109) + minority interest (DATA27) - current accruals (as defined below). Current accruals = change in non-cash working capital = Δ [total current assets (DATA75) - cash and short term investments (DATA60) - treasury stock shown as current assets (DATA73)]- Δ [total current liabilities (DATA104) - total amount of debt in current liabilities (DATA94) - proposed dividends (DATA102)].

Abnormal accruals are calculated each year for the firms in the sample using data from 2000 to 2005. Because we need data for three consecutive years are to calculate abnormal accruals, we collected accounting and market information starting from 1997 so that we can compute abnormal accruals for the period 2000-2005. Abnormal accruals are scaled by a firm's lagged total assets.

Table 3: Univariate Tests

Panel A: Net Income

<i>Group</i>	<i>Obs</i>	<i>Mean</i>	<i>Std. Err.</i>	<i>Std. Dev.</i>	<i>[95% Conf. Interval]</i>
Non Exempt	2398	0.075	0.013	0.651	0.049 0.101
Exempt	703	0.159	0.029	0.761	0.103 0.216

Ho: mean (Non Exempt) – mean (Exempt) = 0; Ha: diff < 0.

t = -2.902; P < t = 0.0019

Where *Net Income* is calculated as the firm's net income (DATA32) divided by the firm's lagged market value.

Panel B: Size

<i>Group</i>	<i>Obs</i>	<i>Mean</i>	<i>Std. Err.</i>	<i>Std. Dev.</i>	<i>[95% Conf. Interval]</i>
Non Exempt	2416	7.767	0.045	2.220	7.676 7.853
Exempt	712	8.397	0.070	1.868	8.259 8.534

Ho: mean (Non Exempt) – mean (Exempt) = 0; Ha: diff < 0

t = -6.910; P < t = 0.0000

Where *Size* is the natural log of the total assets (DATA89).

Table 4: Timeliness Measure

$$\begin{aligned}
 \text{Net Income}_{it} = & a_0 + a_1 \text{RET}_{it} + a_2 \text{DR} + a_3 \text{Exempt} + a_4 \text{RET}_{it} * \text{DR} + \\
 & a_5 \text{RET}_{it} * \text{Exempt} + a_6 \text{Exempt} * \text{DR} + a_7 \text{Exempt} * \text{DR} * \text{RET}_{it} + \\
 & a_8 \text{Size}_{it} + \beta \Gamma_{it}
 \end{aligned}
 \tag{1}$$

	<i>Net Income</i>	<i>Net Income</i>	<i>Net Income</i>
RET	0.0321 (2.22)*	0.0493 (3.42)**	0.0510 (3.07)**
DR	0.0249 (1.07)	0.0320 (1.39)	0.5063 (2.01)*
Exempt	-0.0820 (3.00)**	-0.0852 (3.15)**	-0.1436 (4.35)**
RET*DR	0.2806 (5.32)**	0.2074 (3.92)**	0.2140 (3.71)**
RET*Exempt	0.2906 (8.69)**	0.2786 (8.42)**	0.4705 (10.94)**
Exempt*DR	0.0867 (1.78)*	0.0785 (1.63)*	0.1438 (2.52)**
Exempt*DR*RET	-0.4013 (3.33)**	-0.3521 (2.95)**	-0.5862 (4.07)**
Size		0.0265 (5.86)**	0.0256 (6.22)**
Legal Origin			0.0023 (0.15)
Debt/GNP			-0.1398 (2.29)*
Equity/GNP			-0.1975 (3.12)**
Rule of Law			0.0074 (0.54)
Corruption			-0.0185 (1.88)*
Creditor Rights			0.0536 (3.91)**
CIFAR Score			0.0040 (1.49)
Constant	0.4479 (3.38)**	0.4479 (3.38)**	-0.2702 (1.85)*
Observations	2805	2805	2084
Adjusted R-squared	0.0706	0.0918	0.1416

Absolute value of t statistics in parentheses

* significant at 5%; ** significant at 1%

Where: *Net Income* is calculated as the firm's net income (DATA32) divided by the firm's lagged market value. *RET* is equal to the returns to investors (including dividends), *DR* is a binary variable equal to 1 for companies with negative annual returns (proxy for a bad news about future cash flow) and 0 otherwise. To test for systematic differences between the two sub-samples in our study, we add to the original Basu (1997) model a binary variable *Exempt* that is equal to 1 when the foreign private issuer is exempt from SEC filings from 2000 to 2005, 0 otherwise, and the related two-way and three-way interaction terms. Moreover, we control for *Size*, the natural log of the total asset (DATA89), *Legal Origin* of the firm conforming to La Porta et al. (1998): Legal origin=1 if the firm is from Australia, Canada, Malaysia, Singapore, South Africa, Thailand, UK, United States, Hong Kong, India, Ireland, Israel, New Zealand, and British Virgin Islands. Legal origin=2 if the firm is from Brazil, Chile, France, Indonesia, Italy, Netherland, Spain, Netherlands Antilles, Argentina, Belgium, Greece, Mexico, Peru, Philippines, Portugal, Turkey. Legal origin=3 if the firm is from Germany, Japan, Korea, Austria, Swiss, Taiwan. Legal origin=4 if the firm is from Denmark, Finland, Norway, Sweden. We also control for the ratio *Debt/GNP*, *Equity/GNP*, the *Rule of Law*, *Corruption* (level of corruption), and *Creditor Rights* (defined as in La Porta 1998). Finally, we control for *CIFAR* Score that is used as a proxy for Corporate governance disclosure index by previous literature (Hope 2003).

There are 43 repeated observations in the sample, for companies with more than one stock program. After dropping these observations, results are qualitatively similar and our inferences do not change.

Table 5: Accruals Quality

$$ABNACC_{it} = a_0 + a_1 Exempt_{it} + a_2 Size_{it} + a_3 Net\ Income_{it} + a_4 Net\ Income_{it} * Size + \beta \Gamma_{it} \quad (2)$$

	ABNACC	Positive ABNACC	Negative ABNACC
Exempt	0.0263 (2.16)*	-0.0007 (0.01)	0.0216 (2.29)*
Size	-0.0042 (1.68)*	0.0309 (2.57)**	0.0021 (1.07)
Net Income	0.1368 (2.23)*	0.0455 (0.14)	0.0730 (1.54)
Net Income*Size	-0.0145 (2.09)*	0.0023 (0.04)	-0.0072 (1.35)
Legal Origin	0.0263 (2.88)**	0.0079 (0.22)	0.0083 (1.14)
Debt/GNP	0.0044 (0.12)	-0.1699 (1.25)	0.0335 (1.15)
Equity/GNP	0.0173 (0.47)	0.3625 (2.47)**	0.1379 (4.57)**
Rule of Law	0.0003 (0.03)	-0.0511 (1.71)*	0.0216 (3.16)**
Corruption	-0.0080 (1.38)	-0.0071 (0.31)	-0.0134 (2.90)**
Creditor Rights	-0.0110 (1.35)	-0.0216 (0.64)	-0.0161 (2.47)**
CIFAR	0.0032 (1.98)*	0.015 (2.14)*	-0.0020 (1.50)
Constant	-0.3002 (3.42)**	-0.2728 (0.64)	-0.1901 (2.81)**
Observations	1647	171	1476
Adjusted R-squared	0.0147	0.0775	0.0401

Absolute value of t statistics in parentheses
 * significant at 5%; ** significant at 1%

Where *ABNACC* is equal to the firm's abnormal accrual for the year as calculated in *Appendix 3*, *Exempt* is a binary variable equal to 1 when the foreign private issuer is exempt from SEC filings from 2000 to 2005, 0 otherwise. *Size* is the natural log of total assets (DATA89), *Net Income* is equal to DATA32 from COMPSUTAT, and the vector Γ_{it} includes all of the country variables that previous literature found important in explaining country-level differences in financial reporting quality.

In particular, we control for *Legal Origin* of the firm conforming to La Porta et al. (1998): Legal origin=1 if the firm is from Australia, Canada, Malaysia, Singapore, South Africa, Thailand, UK, United States, Hong Kong, India, Ireland, Israel, New Zealand, and British Virgin Islands. Legal origin=2 if the firm is from Brazil, Chile, France, Indonesia, Italy, Netherland, Spain, Netherlands Antilles, Argentina, Belgium, Greece, Mexico, Peru, Philippines, Portugal, Turkey. Legal origin=3 if the firm is from Germany, Japan, Korea, Austria, Swiss, Taiwan. Legal origin=4 if the firm is from Denmark, Finland, Norway, Sweden. We also control for the ratio *Debt/GNP*, *Equity/GNP*, the *Rule of Law*, *Corruption* (level of corruption), and *Creditor Rights* (defined as in La Porta 1998). Finally, we control for *CIFAR* Score that is used as a proxy for Corporate governance disclosure index by previous literature (Hope 2003).

Table 6: Predictability

$Net\ Income_{it} =$

$$a_0 + a_1 Exempt + a_2 Net\ Income_{it-1} + a_3 Exempt * Net\ Income_{it-1} + a_4 Size \quad (3)$$

	Net Income _t
Exempt	0.0514 (3.06)**
Net Income_{t-1}	0.1105 (9.40)**
Exempt * Net Income_{t-1}	-0.0952 (4.48)**
Size	0.247 (7.57)**
Constant	-0.1771 (6.67)**

Observations 2790

Adjusted R-squared 0.0591

Absolute value of t statistics in parentheses

* significant at 5%; ** significant at 1%

Where: *Net Income* is calculated as the firm's net income (DATA32) divided by the firm's lagged market value. *Exempt* is equal to 1 when the foreign private issuer is exempt from SEC filings from 2000 to 2005, 0 otherwise. *Size* is the natural log of total assets (DATA89)