# Governance Tensions in MNCs’ Financial Reporting Quality

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*Journal of International Business Studies, 2022*

**Cross-listings, offshore financial centres and the impact on MNC accounting quality**

Multinational corporations (MNCs) that cross-list in the U.S. — and which use offshore financial centres (OFCs) — have a greater likelihood that their financial reporting quality will be lower than cross-listing counterparts that don’t resort to such structures, according to a recent accounting study from a group of business professors.

It’s noteworthy research that examines the impact that the complex and opaque world of offshore financial centres has on the quality of financial reporting and should attract the attention not only of retail and institutional investors, but accounting and security market regulators.

**The Study**

Entitled *Governance Tension in Financial Reporting Quality*, the study by professors Tiemi Li at the Telfer School of Management at the University of Ottawa, Michael Magnan, at the John Molson School of Business at Concordia University and Yaqi Shi of the Ivey Business School at Western University, tests both the corporate governance bonding theory and corporate governance arbitrage theory to investigate how offshore financial centres impact financial accounting quality.

Corporate governance bonding theory surmises that a U.S. cross-listing benefits a corporation by reducing opaque information asymmetry and contributes to higher accounting quality, thanks to an enhanced legal and regulatory regime, and more transparent practices.

Contrast that with corporate governance arbitrage theory, which surmises that companies look to gain an edge by utilizing less stringent legal or financial regimes to avoid governance requirements.

The academics wanted to examine whether accounting quality was impacted by cross-listing and whether the use of an OFC had any impact on accounting quality.

To do so, they turned to the comprehensive OSIRIS data service, which tracks more than 80,000 listed (and de-listed) companies from around the world to draw a sample of multinational corporations.

They stripped out companies from countries that were considered an offshore financial centre, as well as those in the financial sector. They limited their search to companies that had information on all measures of accounting quality (and control variables), and they chose those that had at least 10 years’ worth of observations, covering the period 2002-2013, which began with the adoption of the Sarbanes-Oxley Act in the U.S.

They ended up with a sample of 3,236 multinational corporations that operated subsidiaries or affiliates in OFCs during that time period. That included 2,946 non-cross-listed companies and 290 cross-listed companies.

They represented 31 countries, with the U.K., Germany, France, Japan and Taiwan accounting for 63 per cent of the observations that they studied. (Canadian MNCs were excluded from the primary sample because most list their shares directly in the U.S. and are excluded from many disclosure requirements under the multijurisdictional disclosure system between the U.S. and Canada.)

Companies in the materials, industrial and telecom sectors dominated, with slightly more than 80 per cent of the sample size.

When assessing the 40 OFCs that the multinational corporations used, the academics turned to the offshore attitude index. It is a zero to five scale that takes into consideration characteristics of an OFC and includes things like political stability, regulations enforcement, the presence of crime, and whether it falls on a blacklist, such as the Financial Action Tasks Force’s list of Non- Co-operative Countries and Territories, which concerns itself with money laundering, or the OECD’s list of tax havens. The higher the score, the lower the level of transparency and oversight associated with the OFC.

**The Results**

The report found that “MNCs cross-listing in the U.S., exhibit lower abnormal accruals, higher accruals quality and more persistent earnings patterns compared to MNCs not-cross-listing in the U.S.,” which the academics said supported the corporate governance bonding theory. They determined that a cross-listing in the U.S. was associated with a 20.93% reduction in the absolute value of abnormal accruals.

However, they also found that “the positive association between cross-listing and accounting quality is negatively moderated by a MNC’s choice of OFC subsidiaries or affiliates, thereby suggesting that the internal institutions underlying foreign subsidiaries do relate to the accounting quality of the parent firm.”

For example, they found that higher offshore attitude index scores for cross-listed MNCs were associated with higher absolute values of abnormal accruals, higher positive abnormal accruals and lower accruals quality, lower modified accruals quality and lower earnings persistence.

“Moreover, a MNC’s OFC choice also negatively moderates the relation between home country governance and accounting quality, thus lending further support to *corporate governance arbitrage theory*.”

The academics also conducted similar tests on MNCs that did not register subsidiaries or affiliates in an OFC and compared them to those that do and concluded that “the mobility of bad governance, i.e., setting up subsidiaries in OFCs, does impact the overall accounting quality of MNCs, thus lending further credence to the *corporate governance arbitrage theory*.”

**Implications**

The study is notable for three reasons. First, it adds to the literature involving corporate governance around MNCs. Academics have called for more study on the parent-subsidiary relationship. By examining the accounting quality of MNCs that have an OFC structure, the authors say they heed that call, and show the need to have “effective” co-operation between of MNCs regulators in home and host countries to “enhance accounting quality.”

Second, the study advances the literature on foreign firms listing in the U.S. Past research has focused on the parent companies’ legal and institutional environment. This study examines how an MNC’s underlying internal legal institutions interact with their cross-listing status and how that impacts accounting quality.

Third the study adds to the literature on OFCs and how their use can reduce the benefit of cross-listing and home-country governance on accounting quality.

 “Our study underscores, to regulators and investors, the co-existence of international mobility of good governance and bad governance for MNCs. Therefore, it is important to enhance monitoring efforts for MNCs with opaque and complex structures, to better detect opportunistic earnings management,” the study concludes.

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