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Are foreign earnings disclosures value-relevant? Disaggregation solves the puzzle

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ABSTRACT

This study examines whether foreign region- and country-specific performance disclosures relate differentially to shareholder wealth compared to domestic performance disclosures. Bearing in mind the fact that, in previous literature, empirical findings regarding the value-relevance of geographic performance disparities have been surprisingly conflicting and puzzling, we question in this paper prior sample selection procedures and data treatments. Using an extensive international company-level database, we distinguish between foreign 'region-' and 'country-'specific performance disclosures and find that (1) the use of disaggregated foreign earnings information increases significantly the precision and significance of the value-relevance of foreign performance; (2) the disclosure of positive earnings movements generated in Latin American countries has a consistently negative value impact and (3) the value-relevance of foreign segment disclosures is particularly perceptible for Asian Pacific countries and the United Kingdom, confirming the attractiveness of these areas for foreign direct investment.

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1. Introduction

With the ongoing internationalization of trade and capital flows, the pricing impact of disclosed foreign operations performance has grown to one of the most interesting and exciting debates in accounting, business and international finance. The last three decades have indeed witnessed an impressive surge in companies' foreign operations and assets all over the world. Corporate rationales for geographic diversification include economies of scale, access to larger customer bases, proximity of natural resources, operational flexibility and the ability to arbitrage institutional as well as financial restrictions and regulations. Value-based studies seem to suggest that investors are willing to pay a premium for shares of internationally diversified companies, as they represent a claim on a collection of diversified profit streams generated in various areas of the world. Empirically, however, the link between firms' foreign activities and shareholder value remains ambiguous and puzzling.

While in earlier years, empirical studies fairly unanimously supported the theoretical concept that geographic diversification enhances firm value (Caves, 1971; Kogut, 1983; Errunza and Senbet, 1981; Hines and Rice, 1994) by showing that disclosed foreign operations resulted in positive valuation effects (Errunza and Senbet, 1984; Kim and Lyn, 1986), later evidence is mixed and conflicting. While Denis et al. (2002) report evidence on the negative value impact of international

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diversification, Morck and Yeung (1991), Garrod and Rees (1998), Bodnar et al. (2003b) and Dos Santos et al. (2008) suggest that geographic diversification is positively related to firm value. On the other hand, focusing on disclosed foreign activities, Boatsman et al. (1993), Christophe (1997) and Christophe and Pfeiffer (2002) show that investors do not value foreign operations as highly as they value domestic operations, while Bodnar and Weintrop (1997) and Bodnar et al. (2003a) report that firm value is more strongly affected by changes in foreign earnings than by changes in domestic earnings.

The purpose of this study is to address this puzzle and the key issues related to the impact of foreign operations performance disclosures on shareholder wealth. It also aims to fill the gap left by previous research in performing a comprehensive and detailed analysis of the impact of geographic earnings disparities. The basic idea is simple: given the increasing number of companies providing country-specific disclosures of their foreign operations, it is surprising that no existing study has yet investigated the value-relevance of detailed foreign performance disclosures. As country-specific disclosures have the most easily identifiable economic characteristics relative to domestic operations disclosures, they are the most informative in terms of differential value-relevance—they are the most appropriate means of telling us whether and why investors conjecture either a stronger or weaker value impact of foreign operations relative to the value impact of domestic activities.

We investigate, using a sample of 390 European, Canadian, Australian, New Zealand and U.S companies, how foreign versus domestic operations are reflected in shareholder wealth, how the disclosures of foreign earnings in *specific regions* constitute incremental value-relevant news for investors and how the disaggregation of this region-specific performance information into *country-specific* performance information provides shareholders with additional value-relevant information above and beyond the information contained in more commonly investigated aggregated disclosures.

We conduct four major tests of the relationship between foreign performance disclosures and firm value. The following key points have emerged from our empirical findings:

(i) Both domestic and foreign performance disclosures have a significant positive impact on firm value. While valuation effects seem to depend on the country where the company is located, evidence on the differential impact of domestic *versus* foreign performance remains inconclusive—region, respectively country-specific information is needed.
(ii) Disaggregated foreign *country-specific* earnings are statistically significantly reflected in firm value. The comparison between the value-relevance of *country-specific* versus *region-specific* profit disclosures confirms, moreover, that previous empirical designs based on the aggregation of foreign country-level performance disclosures into foreign region-specific disclosures lead to an important loss of value-relevant information for investors and are hence misspecified.
(iii) In contrast with the positive value impact of domestic performance, most authors (Rask et al., 1998; Wurgler, 2000; Durnev et al., 2004; Wet, 2004) anticipate that when the foreign performance disclosures relate to a vulnerable or less transparent market, they will have a relatively weaker – or even negative[1] – value impact on firm value. Our study finds support for a negative link between firms' disclosed earnings in specific Latin American markets and shareholder value.
(iv) Results show that investors perceive positive changes in foreign earnings related to Asia Pacific and the United Kingdom as outstandingly good news. They associate relative higher responses to these foreign performance disclosures—hence confirming the attractiveness of these countries for foreign direct investment.

The outline of the remainder of this paper is as follows. In the next section, we discuss the background and motivation of this paper. Section 2 describes the selection procedure used to form the sample of multinationals analyzed. It details carefully various sample characteristics. In section 3, we describe the empirical design used to measure the value-relevance of geographic earnings disclosures. The estimates obtained from alternative specifications are presented and the results analyzed. Section 4 concludes.

2. Background and motivation

The purpose of this study is to investigate the relative value-relevance of foreign earnings disclosures with respect to domestic earnings disclosures. Following Francis and Schipper (1999), Core et al. (2003) and Kothari and Shanken (2003), we regard the value-relevance of this accounting information as the degree to which domestic versus foreign earnings disclosures are reflected in shareholder wealth. Recent evidence describes extensively how firms manage financial reporting practices to provide support for superior managerial ability (Iatridis and Valahi, 2010) to influence their stock price (Graham et al., 2005). They show that earnings matter more to managers than cash flows for financial reporting purposes. Investors are hence expected to assess the value of a firm based on its earnings information, basing their assessment less on its cash flow information. The underlying question is whether and how investors use geographical segmented earnings disclosures when establishing the value of a company.

[1] Given that a firm's foreign *region*- and *country-specific* performance is usually publicly announced after the disclosure of its overall consolidated earnings, foreign earnings disclosures constitute 'additional' relevant signals for investors. This is consistent with the functional fixation theory, which states that investors respond to bottom line accounting numbers without fully reflecting on the valuation implications of the different components of earnings. Subsequent price adjustments occur when the information contained in the financial statements is unscrambled (Hand, 1990; Tiniç, 1990; Sloan, 1996; Harris and Nissim, 2006).

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