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The effect of globalization and legal environment on voluntary disclosure

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Abstract

We examine how interactions with foreign capital, product, and labor markets affect the disclosure practices of non-U.S. multinational firms. Drawing on literature related to multinationals, country-level legal institutions, and accounting disclosures, we expect that the relation between globalization and voluntary disclosure will be conditioned by the legal environment in a firm's home country. Specifically, while firms from countries with a strong legal environment (e.g., common-law countries) already face pressure for good disclosure, globalization can increase the benefits associated with good disclosure to firms from weak legal environments (e.g., civil-law countries). We use a self-constructed voluntary disclosure index and hand-collected disclosure and foreign activity data for 643 non-U.S. firms from 30 countries for 2003. We find a significant interaction between globalization and the legal environment. This indicates that for the same level of globalization, there is more voluntary disclosure for firms based in weak legal environments. Our results suggest that globalization is an important variable that has been overlooked in much of the previous cross-country research.

Keywords: Voluntary disclosure; Globalization; Legal environment

1. Introduction

There is an expanding literature that examines whether a country's legal and judicial institutions affect disclosures and other accounting properties across countries (e.g., Ball,

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Kothari, & Robin, 2000; Jaggi & Low, 2000; Hung, 2001; Ball, Robin, & Wu, 2003; Hope, 2003a, 2003b; Bushman, Piotroski, & Smith, 2004; Bushman & Piotroski, 2006). However, for the most part, these studies do not consider the role of globalization; i.e., they ignore the fact that many firms operate and raise funds in multiple countries. At the same time, a few studies (e.g., Gray, Meek, & Roberts, 1995; Cahan, Rahman, & Perera, 2005) find that voluntary disclosures increase with globalization, but these studies do not control for the fact that multinational firms operate in countries with different legal environments. This study provides the missing link by exploring the relationship between globalization and the legal environment as it relates to disclosure.

Specifically, we examine how a firm's voluntary disclosures are affected by its degree of international diversification and by the legal environment in its home country. We argue that globalization creates a demand for voluntary disclosure because multinational firms are likely to have greater information asymmetry as a result of their greater scope and complexity. However, in addition to increases in voluntary disclosures resulting from globalization, we expect that the effect will be larger for firms based in countries with weak legal environments than for firms based in countries with strong legal environments. That is, we expect that the former will provide more disclosures as a result of their weak legal and judicial institutions at home. Using a sample of 643 non-U.S. firms from 30 countries, a self-constructed index of voluntary disclosure, and hand-collected disclosure and foreign activity data, we find evidence that is consistent with our expectations—that the interaction between globalization and the legal environment is significantly associated with voluntary disclosures.

Our study contributes to several areas of research. First, we contribute to an emerging line of research that examines the accounting consequences of foreign firms interacting with the United States markets. For example, Lang, Raedy, and Yetman (2003) find that non-U.S. firms that are cross-listed in the U.S. have earnings properties that are more like U.S. firms compared to other firms in their home countries; Bradshaw, Bushee, and Miller (2004) find a positive relation between U.S. GAAP conformity of non-U.S. firms and ownership by U.S. institutions; and Khanna, Palepu, and Srinivasan (2004) find that non-U.S. firms are more likely to use U.S. disclosure practices as involvement with U.S. markets increases. Since we do not limit our tests to interactions with U.S. markets, we provide more general evidence on the effects of interacting with foreign markets.

Second, we add to the growing literature that uses country-level institutional features, such as legal origin or investor protection, to explain cross-country differences in accounting properties. For example, Jaggi and Low (2000), Hope (2003b), and Francis, Khurana, and Pereira (2005) find that country-level institutional factors matter in explaining disclosure levels. Further, Leuz, Nanda, and Wysocki (2003) find that earnings management is related to a country's investor protection. Ball et al., (2000) find that the accounting properties of timeliness and conservatism vary between common-law and civil-law countries. Ball et al. (2003) find that country-level institutional factors can dominate accounting standards, and Hope (2003a) finds that a measure of legal enforcement is related to analysts' forecast accuracy. However, none of the prior studies have considered how globalization affects their results. We suggest that globalization may be an omitted variable in these tests.

Third, we contribute to the voluntary disclosure literature. Most prior international studies have used the CIFAR scores or, more recently, the transparency and disclosure index developed by S&P. However, as Bushee (2004) suggests, these indexes are not without