The Role of Foreign Shareholders in Disciplining Financial Reporting

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We investigate the role of foreign shareholders in improving the quality of accounting information provided by firms domiciled in countries with low de facto institutional quality. Using a sample of firms from four South-European countries (Portugal, Italy, Greece and Spain) for which we observe detailed ownership evolutions over the period 2002-2007, we find that firm-level earnings quality is positively associated with foreign shareholdings. More particularly, we show that increases in foreign ownership from firms domiciled in countries with strong institutional quality lead to a *subsequent* increase in firm-level earnings quality, while the opposite is not true. Further, we find that the improvement in earnings quality is more pronounced when we consider the effect of institutional investors. Finally, we find that the results hold before and after the introduction of the International Financial Reporting Standards (IFRS) in 2005. Combined, these results are consistent with the institutional environment and the presence of foreign ownership having a greater impact on earnings quality than a mandatory switch to superior reporting standards.