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**THE GOVERNANCE IMPACT OF A CHANGING INVESTOR LANDSCAPE:  
FOREIGN INVESTORS AND MANAGERIAL EARNINGS FORECASTS**

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**Abstract**

Within the backdrop of comparative corporate governance research, we draw on the managerial reporting and impression management literatures to examine how foreign shareholders infused with their own governance logic influence managerial earnings optimism and timely earnings guidance in a stakeholder oriented setting. Drawing on Japanese data, our results show that managers are more optimistic in their initial forecasts in the presence of foreign owners. We further explore the relevance of ownership type and portfolio turnover. In terms of earning guidance, we show that under the presence of foreign ownership, managers provide timely updates on the earnings forecast and avoid making last-minute adjustments.

## INTRODUCTION

Over the last decades, there has been a dramatic rise in financial globalization (Aggarwal, Erel, Ferreira, & Matos, 2011) coupled with demands for greater transparency and accountability by institutional investors (Boone & White, 2015) scattered all over the globe. As a result, local managers have become increasingly exposed to pressures from foreign investors, raising the need to better understand the influence of foreign investors across business systems. Contemporary corporate governance research concedes that national institutions such as culture, legal, and financial institutions matter a great deal in defining firms' corporate governance (Cumming & Walz, 2010; Dai & Nahata, 2016; Sugathan & George, 2015, to cite just a few), but the underlying mechanisms by which these institutions matter remains an ongoing research question (Aguilera, Desender, Bednar, & Lee, 2015).

International corporate governance research has shown that the Anglo-American shareholder-oriented economies are sharply different from the stakeholder-oriented economies such as Germany and Japan (Hall & Soskice, 2001; Kang & Moon, 2012; Shleifer & Vishny, 1997; Streeck & Yamamura, 2001). The core elements salient in shareholder oriented corporate governance systems such as strong minority shareholder rights protection, managerial incentives tied to performance, or market for corporate control often remain weak in stakeholder oriented countries, where alternative corporate governance mechanisms such as internal monitoring via concentrated ownership and tight (often informal) inter-firm relations tend to effectively substitute the above governance practices and display different sets of governance complementarities (Aguilera, Filatotchev, Gospel, & Jackson, 2008). We also know that the financial time horizons are longer in stakeholder oriented countries characterized by patient capital as opposed to short termism in shareholder oriented (Aguilera & Jackson, 2003). Moreover, the timeliness and conservatism across countries also show important discrepancies between shareholder- and stakeholder-oriented countries (Ball, Kothari and Robin (2000).

A related body of governance research examines how the heterogeneity of owners, and especially the now prominent shareholder-oriented institutional investors, influence a wide range of corporate governance practices such as CEO compensation (Geng, Yoshikawa &

Colpan, 2015; Zheng, 2010), disclosure practices (Bushee & Noe, 2000), CEO turnover (Aggarwal, et al., 2011), and corporate social engagement (Dyck, Lins, Roth, & Wagner, 2015; Graves & Waddock, 1994). In light of this research, the next pressing and relevant research question is to better understand how the combination of heterogeneous owners embedded in different national governance logics shapes managerial practices. Thus, in this article, we analyze whether and how foreign investors imprinted by their own country-level governance logics such as short-term shareholder oriented principles, introduce critical changes into domestic corporate governance and managerial disclosure practices when they invest in stakeholder oriented markets.

While some prior studies have looked at the impact of shareholder oriented foreign ownership on corporate restructuring, investment behavior and changes in corporate governance around the world (e.g., Aggarwal et al., 2011; Ahmadjian & Robbins, 2005; Bilinski, Cumming, Hass, Stathopoulos, & Walker 2015; David, O'Brien, Yoshikawa, & Delios, 2006), the effect of foreign ownership on accounting decisions in general, and managerial reporting behavior in particular, is still far from known, and has received scant attention from scholars, practitioners and policy makers. In this study, our outcome of interest is initial earnings optimism and the earnings guidance through the subsequent timely revision of earnings forecasts. Managerial earnings forecasts are managerial disclosures predicting firm earnings prior to the expected reporting date (King, Pownall, and Waymire, 1990).

The study of managerial earnings forecasts is especially interesting because it allows for the examination of the ample managerial discretion that managers strategically can deploy for impression management purposes (Pfarrer, Pollock, & Rindova, 2010). The management forecast literature has been largely developed in the U.S. context, where management earnings forecasts are voluntary. However, precisely because forecasts are voluntary, this research devotes a great deal of attention on the managerial incentives to disclose forecasts (e.g., Ajinkya, Bhojraj, & Sengupt, 2005; Karamanou & Vafeas, 2005; Skinner, 1994; Stocken, 2000; Verrecchia, 2001). Yet, we know a lot less about how management earnings forecasts vary across countries and how different firms across the globe adapt to pressures from shareholder

oriented foreign owners operating with certain shareholder value expectations and time horizons.

To fill in this gap in the current international business research, our study seeks to understand how domestic managers respond to foreign investor pressures for short term results and greater disclosure. We specifically examine how the presence of shareholder-oriented foreign investors influences managerial earnings optimism in their initial forecasts and earnings guidance in a quintessential stakeholder-oriented environment such as Japan.

The Japanese setting offers a number of advantages to address our research question. First, the Japanese system contrasts sharply with the Anglo-American system and Japanese firms have been resistant to change their corporate governance model towards the Anglo-American style (Aguilera & Jackson, 2003; Hall & Soskice, 2001; Yoshikawa & McGuire, 2008). In addition, the presence of foreign investors has increased dramatically since the 1990s. While foreign ownership accounted for less than 5 percent in 1990, it now constitutes the largest type of investor, holding an aggregate stake of 32 percent in 2015. Foreign investors in Japan generally originate from the Anglo-American governance context and collectively are sufficiently large to potentially exercise pressure for change.

Second, the Japanese setting allows us to investigate the strategic use of management forecasts in an economy where management earnings forecasts are effectively mandated, but managers have considerable latitude over the numbers they release. While management forecasts has long been a central issue in the disclosure literature (McNichols, 1989), most research has been conducted in settings where forecasts are voluntary and where there are clear legal sanctions for providing false or misleading disclosures and omissions. In Japan, managers are requested to disclose initial forecasts at the beginning of the fiscal year and can then revise those forecasts subsequently during the fiscal period.<sup>1</sup> Because forecasts in Japan are available for almost all firms, we can employ a large panel of firm-level forecasts, avoiding any selection bias, to analyze how foreign ownership influences managerial optimism in their initial earnings forecasts, as well as the strategic timing of subsequent adjustments.

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<sup>1</sup> Because the regulatory and legal costs of biasing forecasts are relatively low in Japan (Kato et al., 2009), managers can bias their initial forecasts but then revise their forecasts later in the fiscal period to avoid end of the year earnings surprises.

We build on the international corporate governance, impression management and managerial reporting behavior literature to establish whether Japanese firms follow a different strategic behavior when they are partially owned by short-term oriented foreign institutional investors. We also draw on Herrman, Inoue and Thomas (2003) and Kato, Skinner, and Kunimura (2009), who have looked at management forecast behavior in Japan to establish our base model.

Considering the universe of listed Japanese firms in the Tokyo Stock Exchange (TSE) over the period 2006-2013, our results show that Japanese managers are more optimistic in their initial forecasts in the presence of foreign owners. When we analyze the ownership structure in detail, we find that the main driver of this finding comes from foreign investment funds, who fall in the category of shareholder-oriented investors. Interestingly, foreign pension funds and domestic investors tend to exert an opposite effect. We also uncover stronger results for more active foreign investors compared to less active foreign investors. In terms of earning guidance, we show that under the presence of foreign ownership, managers provide subsequent timely updates on the earnings forecast and avoid making last-minute adjustments (i.e., timely earnings guidance). In addition, our findings reveal that firms' last earnings forecasts tend to fall just below the realized earnings (i.e., there is a small positive earnings surprise). Our findings are robust to different specifications and to the use of instruments to address endogeneity concerns.

In this study, which is anchored at the intersection of international accounting and international corporate governance, we contribute to the international business research in several ways. First, we shed light to international corporate governance research by arguing and empirically demonstrating that even though governance practices are heavily embedded within national boundaries, there is cross-pollination of practices as firms go abroad. Second, we engage with the current governance debate on the demands in attending to heterogeneous owners, and in particular, we address the puzzle of how to solve the tension of the divergent incentives and interests between foreign and domestic owners. Third, we illustrate that foreign investors are a channel through which country level governance changes but it does not lead to convergence of national governance systems as these changes tend to be within the boundaries

of each corporate governance system. They result in convergence of divergence into new hybrid governance forms. Fourth, drawing on impression management literature and managerial accounting research, we show that a governance tool within managerial discretion is the use of time to strategically disclose information towards remote investors. Our results also add to the accounting literature on forecast optimism and earnings guidance, as our findings provide new insights from a setting in which management earnings forecasts are effectively mandated. Finally, we present some key conclusions on the need to pay close attention to how managers respond to international pressures for greater compliance expectations within their own institutional constraints.

### **INSTITUTIONAL BACKGROUND**

Japan is categorized as a stakeholder-oriented system, characterized by tight networks of vertical and horizontal groupings known for their cross-shareholdings and financial, human, and transactional ties (Lincoln & Gerlach, 2004). Instead of owning stocks primarily as portfolio investments or for purely financial purposes, domestic investors are often business partners or commercial banks, both of which hold shares for the implicit purposes of business goodwill, information exchange, and mutual monitoring. Japanese investors typically fall under Aguilera and Jackson (2003)'s category of investors with strategic interests as opposed to financial interests. With stakeholders concerned about maintaining long-term relationships and achieving lasting returns, firms develop and implement strategies based on long-term goals, seeking to maximize mostly market share and growth rather than short-term profits.

The Stock Exchange Act governs disclosure and financial reporting practices for Japanese public companies. Regarding earnings forecasts, the Japanese stock exchanges request managers of listed companies to provide forecasts of annual earnings at the beginning of each annual earnings announcement period as well as revisions of these initial forecasts at interim earnings announcement dates (Kato, et al., 2009). More specifically, listed companies are expected to release point forecasts of annual of sales, earnings before extraordinary items and taxes (EBET), net income at each earnings announcement dates, as well as revisions of these forecasts at interim. Thus, managers provide initial forecasts for year  $t$  when year  $t-1$  earnings

are announced, and revisions (which include confirmations) when interim earnings are announced. There is no requirement that firms release interim forecasts.<sup>2</sup>

In addition, forecasts must be updated if there are significant changes in management estimates—defined as changes in sales estimates of 10 percent or more and/or changes in earnings estimates of 30 percent or more. The so-called Timely Disclosure Rules (*Kessan-Tannsin* or “summary of financial statements”) enforced by Japanese stock exchanges imposes more stringent legal guidelines regarding revisions of management forecasts.<sup>3</sup>

The legal costs of earnings forecasts disclosure are much lower in Japan than in the U.S., and securities litigation is not prevalent in Japan (Buchanan, Chai, & Deakin, 2012). Moreover, comparative accounting research (Ball et al., 2000) demonstrates that the degree of timeliness in accounting income is actually lower in Japan relative to the US or the UK. Thus, within the boundaries of complying with legal mandates, Japanese managers have ample managerial discretion to strategically manage (Edelman, 1992; Kato et al., 2009) the disclosure of both the initial forecast and subsequent adjustments contingent to performance expectations over time as well as different owners’ demands.

## **THEORETICAL FRAMEWORK AND HYPOTHESES**

We argue that the heterogeneity in shareholders’ logic and interests and their relative strength within the organization are critical to understand the influence of different types of owners over managerial reporting practices. Drawing on the idea that firms are embedded within a given governance logic and the literatures on impression management and managerial reporting, we examine how shareholder-oriented foreign investors influence initial managerial optimism in earnings forecasts as well as the timing of subsequent revisions.

Research on managerial earnings forecasts has been mostly conducted in the field of accounting, largely focusing on the U.S. setting, where management earnings forecasts are

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<sup>2</sup> A survey in 2006 reports that 3790 of the 3831 listed firms (98.9%) provided management forecasts (Ota, 2011). It is important to note that about 75 percent of all revisions happen at the interim earnings announcements, while about 25 percent correspond to stand alone announcements (Kato et al., 2009).

<sup>3</sup> If firms miss their net income forecasts by more than 30%, the firm is subject to potential insider trading investigations. To the extent firms follow the guidelines, they will not be held liable for missing their initial forecasts. Management can avoid potential insider trading investigations if reported earnings are maintained within 30% of the forecast.



voluntary. Because forecasts are voluntary in the US, research has focused on understanding managerial incentives towards forecasts (e.g., Skinner, 1994; Stocken, 2000; Verrecchia, 2001). For example, Ajinkya, et al. (2005) and Karamanou and Vafeas (2005) examine the relation of the board of directors and institutional ownership with the properties of management earnings forecasts. They both find that firms with more outside directors and greater institutional ownership are more likely to issue a forecast. In addition, Ajinkya et al. (2005) find evidence that outside directors and institutional ownership mitigate the bias in earnings forecasts, while Karamanou and Vafeas (2005) demonstrate that forecast updates are more likely to occur in firms with independent boards and where institutions own a higher fraction of equity.

In the Japanese setting, although earnings forecasts are effectively mandated, managers have considerable latitude over the initial earnings forecast as well as the subsequent revisions. Kato et al. (2009) are one of the first to study management forecasts in Japan. They describe how management can take one of three possible approaches to setting forecasts: (i) managers can set forecasts in an unbiased manner, based on their best estimates of earnings for the period, (ii) managers can make downward-biased (conservative) forecasts, or (iii) managers make upward-biased (optimistic) forecasts. They find that managers' initial earnings forecasts for a fiscal year are systematically upward-biased but that these forecasts are subsequently revised downward during the fiscal year so that at year end, earnings surprises are non-negative (i.e., close to the actual earnings). They also show that Japanese initial forecast optimism is inversely related to firm performance, and is more pronounced for firms with higher levels of insider ownership and for smaller firms. Kato et al. (2009) offer the following arguments for why Japanese managers are more likely to make upward-biased (optimistic) forecasts. First, if viewed as credible by capital market participants, optimistic forecasts increase stock prices, at least in the short term. Second, providing good news about the firm's future earnings prospects helps managers convince the firm's constituents that they are doing a good job, and deters stock exit. In addition, they suggest that managers' incentives to bias forecasts are also likely to depend on external discipline and monitoring.

Building on the arguments and findings by Kato et al. (2009), we propose that the

managerial incentives regarding optimism and the timing and magnitude of earnings adjustments are likely to be shaped by the level (and nature) of foreign ownership. In particular, when shareholder-oriented foreign ownership is high, we would expect greater levels of optimism in the initial forecast, combined with timely earnings guidance in the subsequent revisions. We discuss each of these two temporal steps in turn.

### **Foreign Investors and Initial Over Optimism**

The asymmetry of information between management and foreign investors is magnified by geographical and institutional distance (Berry, Guillen, & Zhou, 2010; Buckley, 1997) as well as lower level cross-national governance differences (Aguilera & Jackson, 2003; Guillen & Capron, 2015; La Porta, Lopez-De-Silanes, Shleifer, & Vishny, 2000). Foreign investors are less likely to have access to the informal governance practices employed by the domestic stakeholders. Given the importance of earnings forecasts in the shareholder-oriented context and the lack of access to domestic information channels, this managerial reporting instrument may become more relevant when foreign ownership is high. Against this backdrop, we argue that there are at least three reasons accounting for higher levels of earnings forecasts optimism when foreign ownership is high.

First, shareholder-oriented foreign investors place more attention on short-term movements than on long-term value (David et al., 2010; Geng et al., 2015), increasing the incentives for optimism. On the one hand, relative to domestic institutional owners, foreign investors lack means to gain benefit other than stock returns from their investment (David et al., 2010). On the other hand, Geng et al. (2015) find evidence from the annual reports of Japanese firms that top management is pressured by foreign owners with short-term interests to aim for higher stock prices. Similarly, Mamoru Shimode (chief strategist at Resona Bank)<sup>4</sup> states: "calls for a greater shareholder return are likely to continue in the future," in a response to foreign ownership reaching new heights in 2015. Hence, since foreign investors are likely to have a stronger focus on the short-term profits and managers are aware of it, this pressure may be

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<sup>4</sup> <http://asia.nikkei.com/Markets/Equities/Foreign-ownership-of-Japanese-stock-hits-record-for-third-year>

reflected in higher optimism in their initial earnings forecasts.

Second, foreign investors tend to hold, individually, relatively small stakes and rarely appear as strategic investors. This minority shareholding reduces their individual incentives of direct monitoring, thus potentially granting more discretion to managers. However, we observe that foreign investors tend to trade shares more frequently than domestic investors and their holdings disproportionately affect the share price of Japanese firms. For example, foreign investors accounted for more than 50% of the total trading in the Tokyo Stock Exchange in 2007 even though their total shareholding was only about 25% (TSE, 2008). This entails that if the earnings forecasts are below expectations, foreign investors can create a dramatic drop in the stock price by exiting the firm, which supports the argument of higher incentives for optimism in the presence of foreign investors. Tied to this, there is also an argument for an impression management strategy from the point of view of Japanese managers towards their foreign owners (Bundy, Shropshire, & Buchholtz, 2013; Elsbach, 1994). Given that there is a legitimate expectation from the market to anticipate certain level of optimism as suggested by Kato et al. (2009), managers might be penalized in the short term for adopting a conservative disclosing strategy in terms of the initial earnings forecasts.

Third, optimism may be used to signal managerial ability and to alleviate potential career advancement concerns. We know that optimism helps to convince the firm's constituents that managers are doing a good job as noted by Kato et al. (2009). This argument is likely to be strengthened when foreign ownership is high. Foreign investors may be more sensitive to the management earnings forecasts and managers may experience career threats as a result of foreign ownership exercising exit or voice. Taking these arguments together, we propose:

***Hypothesis 1.** The greater the percentage of a firm's shares held by foreign investors, the more likely managers are to make optimistic earnings forecasts.*

### **Foreign Investors and Guidance Quality**

In this section, we argue that the initial over-optimistic earnings forecasts in the presence of foreign owners (H1) are closely tied to the subsequent revisions offering more timely earnings guidance. Earnings guidance is important because it decreases information

asymmetries, between the firm and its investors, and potentially also between foreign and domestic investors, leading in turn to a lower cost of capital and enhanced corporate investment and growth (Houston, Lev, & Tucker, 2010). Furthermore, earnings guidance may enhance investor confidence in managers' ability. As previously stated, successful guiders are obviously "on top of things" (Trueman, 1986). Within the U.S., a large literature has developed on earnings guidance, providing evidence that firms engage in expectations management (i.e., Cotter, Tuna, & Wysocki, 2006; Matsumoto 2002; Richardson, Teoh, & Wysocki, 2004) to beat analysts' (quarterly) earnings targets. Another line of research within the U.S. setting has examined the causes and consequences of ending quarterly earnings guidance (e.g., Chen, Matsumoto & Rajgopal, 2011; Houston, et al., 2010).

In the Japanese context, earnings guidance is particularly sensitive because after the initial optimistic forecasts, managers need to decide on the timing and the magnitude of subsequent adjustments to avoid negative stock price reactions or reputational loss. In addition to investor concerns, if their initial earnings forecast are over- or understated by more than 30 percent, managers may face possible insider trading investigations. Kato et al. (2009) show that that earnings surprises tend to be very close to zero in Japan, and combined with optimism in the initial forecast, this means that managers need to decide how to guide the earnings expectations downwards.

The impression management literature is relevant here because it illustrates that managers have the ability to use time strategically in deciding how to disclose new information, in amending prior optimistic estimates, and in shaping investors' perceptions (Bundy & Pfarrer, 2015). Thus, during the fiscal period, there is again some degree of managerial discretion on how much and when to adjust the earnings forecasts. Earnings guidance is likely to be influenced by having foreign investors who are at arms-length, with wide information asymmetries, shareholder-oriented performance expectations, and with weak access and/or incentives to closely monitor.

From a managerial reporting perspective, managers have three broad options towards earnings revisions: (i) provide timely updates on the earnings forecast, i.e., timely earnings

guidance, (ii) wait until close the end of the year to provide any revisions, or (iii) make no adjustments which may lead to significant earnings surprises. We argue that managers will provide timely earnings guidance when foreign ownership is high, for at least three reasons.

First, international accounting research shows that differences in the demand for accounting income in different institutional contexts causes its properties, such as timeliness or conservatism, to vary cross-nationally. For example, Ball et al. (2000) compare the degrees of timeliness and (conditional) conservatism among seven countries (Australia, Canada, the UK, the U.S., France, Germany, and Japan) using 1985-1995 data, and show that discrepancies exist among countries: shareholder-oriented governance countries (i.e., Australia, Canada, the UK, and the U.S.) exhibit higher level of timeliness and (conditional) conservatism than stakeholder governance countries (i.e., France, Germany, and Japan). In fact, they uncover that accounting income in Japan exhibits the least timeliness. Compared to domestic investors, foreign investors face a disadvantage in terms of gaining access to managerial information. Therefore, as the impression management literature would suggest (Elsbach, 1994), making timely revisions of the earnings estimates, going against what is the norm in this accounting environment (low degree of timeliness), represents an earnings guidance channel that managers are aware of and willing to activate (Pfarrer, Smith, Bartol, Khanin, & Zhang, 2008). In addition, for foreign investors originating from the shareholder-oriented governance logic, timeliness is a key property of accounting income which they are used to and therefore they are likely to expect it (demand), particularly in a stakeholder-oriented setting.

Second, as managerial earnings forecasts and realized performance are publicly disclosed, it is straightforward to figure out even at arms-length if by the end of the fiscal year, managers meet their earnings forecasts. If managers fail to meet publicly disclosed earnings forecasts, it means they did not fulfill their obligation to meet the shareholders' expectations. Missing expectations of earnings could result in lower compensation and loss of employment (Kaplan, 1994), but also it might cause undesirable social consequences for Japanese managers such as loss of face, damage to self-image as well as corporate image affiliated with them. This is particularly the case in the Japanese business environment (Gelfand, Nishii, Holcombe, Dyer,

Ohbuchi & Fukuno, 2001). For example, Herrmann, et al. (2003) argue that managers have incentives for meeting management forecasts to “save face.” While domestic owners may handle systematically missing earnings benchmarks in a manner that allows managers to “save face,” foreign investors are less likely to act in a subtle way, are known to have less patience, and might even engage in publicly questioning management.<sup>5</sup> In addition, earnings surprises or late substantial earnings revisions are also more likely to accentuate the information disadvantage of foreign investors, openly questioning management, and to affect the stock price significantly more compared to when managers engage in timely earnings guidance.

Third, there is also an argument for proactive shareholder engagement (Goranova & Ryan, 2014), even in the fairly dormant Japanese context. That is, Japanese governance regulators recognize that in the shareholder-oriented countries, there has been a rather vibrant movement to attend (or at least respond) to shareholders’ demands, given their growing repertoire of mechanisms to express their voice on company decisions. This effort has been incorporated within the managerial reporting recommendations. In particular, the TSE recently provided more flexibility for firms to choose which items to include in their initial forecasts, how to present items, which periods to cover, etc. In this revision of the Earnings Forecast Disclosure Rules, the TSE expressed that their view on disclosure of future estimates is to encourage listed companies to continue to proactively disclose future estimates so that firms can bridge the serious information gap between investors and listed companies (Yoshii, 2012). This effort is in the spirit to engage in a substantial dialog with investors in order to support fair and smooth price formation in the securities market. We argue that this regulatory initiative further encourages firms with large proportions of foreign investors to feel a greater need to engage with their investors by providing timely earnings guidance.

Taking these arguments together, we expect to find a significant relationship between foreign ownership and the timely disclosure of earnings adjustments. Therefore, we propose:

***Hypothesis 2.*** *The greater the percentage of a firm's shares held by foreign investors,*

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<sup>5</sup> The recent Olympus case illustrates how different domestic and foreign institutional investors reacted to this scandal.

*the more likely managers are to provide timely earnings guidance.*

## EMPIRICAL ANALYSIS

### Sample and Data Sources

To test our hypotheses, we consider all listed firms in the Tokyo Stock Exchange (TSE) for the period 2006-2013. We exclude financial firms because their accounts are significantly different. Our data comes from multiple data sources. The initial earnings forecast data were manually collected from the Japanese Company Handbook, while earnings revisions were obtained from Nikkei Financial Quest. The board and ownership structure data was manually collected from the companies' annual corporate governance reports on the TSE website. To gain detailed insights into the composition and nature of foreign ownership, we went further and collected from Thomson Eikon each investors' historical shareholdings for all firms in our sample over the last 15 years. Our data collection strategy reduces measurement error concerns as we draw on primary source. In addition, we gathered the accounting data to compute our control variables from the company financial statements and Thompson Worldscope. Finally, we obtained MSCI historical membership data which we employ as instrument for foreign ownership from Bloomberg. We winsorize all continuous variables at the top and bottom percentiles to avoid the effect of outliers. Our final sample contains 1,690 listed firms and 10,807 firm-year observations.

### Methodology

To assess the relationship between the presence of foreign ownership and earnings forecasts behavior, we estimate panel data regressions using annual data, building on Kato et al. (2009). The influence of foreign ownership on earnings forecasts behavior can be modeled as follows:

$$y_{it} = a_1 z_{it-1} + b_1 x_{it-1} + v_i \quad (1)$$

, where  $y_{it}$  represent our measures of earnings forecasts behavior,  $z_{it-1}$  is the vector of control variables,  $x_{it-1}$  represent our variables of interest, i.e., foreign ownership, and  $v_i$  is the vector of

heteroskedastic-robust standard errors. All explanatory variables are lagged by one period to mitigate possible simultaneity. The subindex  $i$  and  $t$  refers to firm and year, respectively.

### **Dependent Variables: Earnings Forecast Behavior**

To operationalize our measures of earnings forecast behavior, we focus on net income following Kato et al. (2009). Net income forecasts are likely to be of greater importance to investors than sales or operating income forecasts.<sup>6</sup> We define two measures of earnings forecast optimism (error and innovation), a measure of earnings surprise, and two measures related to the earnings revisions as follows:

- *Forecast Error* is defined as  $[\text{realized earnings for year } t - \text{initial management forecast of year } t \text{ earnings}] / [\text{total assets at } t-1 \text{ year-end}]$ . Greater optimism is reflected in larger negative forecast errors.
- *Forecast Innovation* is defined as  $[\text{initial management forecast of year } t \text{ earnings} - \text{realized earnings for year } t-1] / [\text{total assets at } t-1 \text{ year-end}]$ . This captures the forecasted growth in net income. Greater optimism is reflected in larger positive forecast innovations.
- *Earnings Surprise* is defined as  $[\text{realized earnings for year } t - \text{latest management forecast of year } t \text{ earnings}] / [\text{total assets at the end of prior year-end}]$ . Managers make revisions on their forecasts through the year, so the final forecast on net income is, on average, just below the realized net income, leading to a very small positive surprise. While managers may revise their forecast at any moment up until the approval of the financial statement, revisions on the (year-end) net income figure generally tend to coincide with quarterly earnings announcements.
- *Likelihood of a change in earnings revisions* is an indicator variable that equals one if there is a change in the forecasted net income with respect to the last forecast.
- *Magnitude of Earnings Revisions* is defined as  $[\text{revised management forecast of year } t \text{ earnings} - \text{previous management forecast of year } t \text{ earnings}] / \text{total assets at the end of prior year-end}$ .

### **Key Independent Variables: Foreign Ownership and Ownership Type**

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<sup>6</sup> We have repeated our main analysis using estimates on operating income, as well as sales, and find similar, but somewhat weaker results.



*Foreign ownership* reflects the percentage of total outstanding shares held by non-Japanese investors. The TSE requires firms to report the degree of foreign ownership in four categories: between 0 and 10 percent; between 10 and 20 percent; between 20 and 30 percent; and more than 30 percent. We use two main measures of foreign ownership. First, we employ the four categories as defined by the TSE, which allows us to test for non-linearity and avoid measurement errors. Second, we compute the total proportion of foreign ownership, as well as the proportion held by each type of foreign shareholder. The main types, i.e., those that represent at least one percent of all foreign shareholdings, are investment funds, corporations, sovereign wealth funds, pension funds and research firms. To compute these two continuous measures of foreign ownership we collected data from Thomson Eikon for the complete set of shareholders for every firm over the sample period. In total, we have analyzed close to five million individual shareholdings.

### **Control Variables**

We control for the determinants of optimism, following the approach in Kato et al. (2009). In particular, we introduce in equation (1), the following (one-period lagged) control variables:

*Firm Past Performance:* We include two controls for firm performance: Return on assets (ROA), computed as net income over total assets, and sales growth, which equals the change in annual sales scaled by previous year's sales. Past performance is likely to shape managerial forecasting behavior. Kato et al. (2009) find that optimism is higher for those firms with worse performance.

*Corporate Governance:* We include two relevant corporate governance mechanisms as control variables: board independence and quality of firm auditor. First, board independence operationalized as the proportion of outside board members (in the Japanese context, directors who have never served as executive director, executive officer, employee of the company or any of its subsidiaries) over the total board size, as reported in the companies' annual corporate governance report. Over the past decade, independent directors have become more prevalent in Japanese boardrooms (Yoshikawa & McGuire, 2008). We expect board independence to be

associated with lower levels of optimism because of the potential higher monitoring intensity. Second, quality of firm auditor is operationalized as a dummy variable (Big-4) that equals one if the client firm is working with one of the big 4 auditors, i.e., AZSA & Co. (KPMG), Tohmatsu (Deloitte Touche); Aarata (PwC) and ShinNihon (Ernst & Young) and 0 otherwise. We expect that high quality auditors may reduce the incentive of managers to report more optimistic earning forecasts.

*Domestic Ownership:* We measured domestic ownership concentration by type of domestic owners. To calculate the domestic ownership concentration by type, we primarily used the stakes of the 30 largest shareholders as reported by the company in their corporate governance reports, differentiating between individual/family, investment fund, company, employee and state ownership. Our results are unchanged if we calculate the domestic ownership variables from Thomson Eikon. Domestic ownership concentration is likely to shape managerial decision making (Kato et al. 2009).

Finally, we also control for firm size, measured as the natural log of total assets, firm leverage, measured as the ratio of total liabilities over total assets and low operating assets turnover measured as an indicator variable that equals one if the sales divided by net operating assets (i.e., shareholders' equity less cash and marketable securities and plus total debt) is below the median of the corresponding two-digit SIC industry-year, and zero otherwise. Firm size may be negatively related to forecast optimism since larger firms are subject to greater external discipline and/or are more likely to have managers who bear relatively larger reputational costs. Higher levels of leverage may be associated with more pressure to present optimistic forecasts, while low operating assets turnover has been related to lower likelihood of earnings surprises (Barton & Simko, 2002).

### **Empirical Strategy**

We begin our analysis using ordinary least squares (OLS) regressions, similar to Kato et al. (2009). However, there is a plausible concern that these regressions may suffer from endogenous selection bias. Our main concern is reverse causality, i.e., the possibility that foreign investors are more likely to invest in firms with optimistic forecasts, and that foreign

ownership could be related to an unobserved or uncontrolled factor. Endogeneity problems driven by measurement errors are less of a concern given that our data is derived mostly directly from the TSE or company files. Although it is difficult to completely solve the endogeneity problem, we attempt to address this concern by (1) estimating fixed effects regressions to account for heterogeneity induced by time-invariant factors and period effects, and (2) using instrumental variable techniques. Our instrument for foreign institutional ownership is the stock additions to the MSCI All Country World Index (MSCI ACWI), similar to Aggarwal, et al. (2011) and Bena, Ferreira, Matos, and Pires (2015).

## RESULTS

We report descriptive statistics for the regression variables, along with their correlations in Tables 1, 2 and 3. The descriptive statistics presented in Table 1 are generally consistent with prior findings (Kato et al., 2009). On average, forecast errors are negative, while the forecast innovations are positive, which point to optimism in the initial disclosure of earnings forecast. In addition, there is substantial variation in both measures reflecting significant managerial discretion in the earnings forecasts. The earnings surprise is positive, but very close to zero which is an indication that managers adjust their initial over optimistic forecast so that the final forecast falls very close to the realized earnings.

Regarding foreign ownership, more than half of all firms have less than 10 percent foreign ownership, while about one fifth of our sample firms has more than 20 percent. When considering the Thomson Eikon data, the overall level of foreign ownership amounts to about 13 percent. Foreign portfolio investors are predominantly US and UK institutional investors. In Table 2, Panel A we decompose the total foreign ownership stake by country of origin of the investors, focusing on the ten countries with the largest stake of foreign investment, and decomposing it further by investor type. The US investors are by far the largest group with more than 58 percent of all foreign shareholdings, followed by UK investors with almost 15 percent. Firms from neighboring countries like, China or Korea only hold about 0.36 percent each. In addition, it is also worth noting the importance of investment funds, i.e., an investment firm who manages assets for private clients and institutions. More than 73 percent of all foreign

shareholdings pertain to this investor type. Corporations are the second more relevant investor type with almost 12 percent. Other relevant foreign investor types include sovereign wealth funds, pension funds and research firms (a sales side research firm that also has an investment banking side). The other investor types are not close to one percent of the total foreign shareholdings. While foreign investors are important as a group, the individual positions by foreign investors tend to be relatively small.

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 Insert Table 1 and 2 about here  
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To provide a better understanding of the different types of foreign investors, we have included the average shareholder investment horizon by investor type.<sup>7</sup> Following Bilinski et al. (2015), Gaspar, Massa, and Matos (2005), and Gaspar, Massa, Matos, Patgiri, and Rehman (2013), we measure shareholder horizons using investors' portfolio turnover (value weighted average), using the Churn Ratio measure. The churn ratio for each investor is calculated for every year, considering the investor's portfolio of Japanese firms as:

$$CR_{it} = \frac{\sum |N_{kit} * P_{kt} - N_{kit-1} * P_{kt-1} - N_{kit-1} * \Delta P_{kt}|}{\sum (N_{kit} * P_{kt} + N_{kit-1} * P_{kt-1}) / 2}$$

Where  $CR_{it}$  is the churn ratio of investor  $i$ ,  $N_{kit}$  is the number of shares in firm  $k$ , held by investor  $i$  in year  $t$ ;  $P_{kt}$  is the stock price of firm  $k$  at the end of year  $t$ ;  $\Delta$  denotes the yearly change operator. Table 2, Panel B reflects the average weighted churn ratios by investor type, separating between foreign and domestic investors. The average foreign investor turnover is 0.74, which means that 37 percent ( $0.74/2 = 0.37$ ) of the average investor's portfolio is turned over in a year, which is close to the 42.8 percent reported by Bilinski et al. (2015) for a sample of US institutional investors. The average investor turnover of 0.74 also entails that foreign investors hold an average stock in their portfolio for around 32 months ( $12/0.37 = 32.43$ ). Compared to foreign investors, the turnover ratio is about three times smaller for domestic

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<sup>7</sup> We would like to thank the editor, Douglas Cumming, our referees and Ameziane Lasfer for providing us with the suggestion to explore the investment horizon of foreign investors.

investors.

In terms of our control variables, about 80 of Japanese listed firms have a Big-4 auditor. The average return on assets ratio is just below two percent, while the average sales growth is just above two percent. Furthermore, about 10 percent of the board members are outsiders (the average board size is 8.5), a finding that is substantially lower compared to Anglo-American or Continental European boards. Notably, about half of all firms in our sample have a board composed with only insiders. When considering domestic ownership concentration, it is interesting to note that domestic banks and investment funds hold on average close to 11 percent, each, while family/individual investors hold almost 10 percent.

Table 3 shows our correlations. The forecast error is negatively correlated with forecast innovation and positively to the earnings surprise, which is in line with Kato et al. (2009), while it is positively related to firm size, profitability, having a Big-4 auditor and board independence and negatively related to firm leverage.

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Insert Tables 3 and 4 about here  
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Table 4 shows the regression results of earning optimism and the four levels of foreign ownership. Models (1) (3) and (5) estimate the base model with forecast error, forecast innovation and earning surprise as dependent variable, respectively. Model (2), (4) and (5) introduce the four levels of foreign ownership defined by the TSE into model (1), (3) and (5) respectively. When considering the forecast error in model (2), our results show a negative relationship between the levels of foreign ownership and the forecast error. The higher the level of foreign ownership, the more optimistic managers are with their earnings forecast. Similarly, model (4) shows that managers are more optimistic about the increase in net income relative to last years' realized net income (forecast innovation) in the presence of foreign ownership. Finally, the difference between the last forecast and the realized net income, i.e., the earnings surprise, shown in model 6 is only significantly more positive for firms with foreign ownership above 30%.

The regression results in all models of Table 4 indicate that our control variables are generally significantly related to earnings forecast optimism in the ways that we predicted. The forecast error is smaller (i.e., less negative) for large and profitable firms, with a low level of leverage and above industry operating assets turnover. The reverse is mostly the case when considering forecast innovation, which tends to be less positive for these firms. It is worth noting that while foreign ownership is positively related to firm size and profitability (see the correlation matrix in Table 3) and negatively related to firm leverage, these controls show opposite signs regarding their effect on earnings optimisms. This strengthens our results, as it suggests that the relationship between foreign ownership and size, leverage or profitability is not driving our findings between foreign ownership and managerial optimism. Taking these results together, our findings provide consistent support for our first hypothesis. Managers are generally optimistic, and they are even more so in the presence of foreign ownership. In addition, after the initial optimism, managers make forecast adjustments through the year so that the last forecast is close to or just below the realized net income.

To better understand the relationship between foreign ownership and managerial optimism, we decompose foreign investors by type as shown in Table 5. We also consider different types of domestic owners to gain further insight into the role of both foreign and domestic investors in managers' earnings forecasts behavior. Results in models (1) and (2) show that when the proportions of foreign investment funds are high, managers tend to be significantly, at the one percent level, more optimistic, i.e., the forecast error is more negative. Foreign corporations are also related to greater optimism, although the coefficient is only significant at the 10 level in model (2). Interestingly, we also show that the proportion of foreign pension funds seems to reduce the forecast error, in line with the idea that these type of investors tend to hold a longer investment horizon (David, Hitt & Gimeno, 2001; Neubaum & Zahra, 2006). The coefficients of foreign research firms and SWF are not significantly related to the forecast error. These findings provide further insight into the relationship between foreign ownership and the forecast error, as the negative relationship is mainly driven by foreign investment funds. Regarding the different types of domestic owners, our model (2) in Table 5

illustrates interesting results. Domestic ownership by families/ individuals, other firms, banks and even domestic investment funds significantly reduces the earnings forecast error. In line with our arguments developed to establish our first hypothesis, employees and banks are likely to have a longer time frame, trade less frequently and have access to multiple channels of information and therefore managers have lower incentives to be optimistic in their earnings forecasts. Interestingly, domestic investment funds do not seem to have the same influence as foreign investment funds, which again highlights the relevance of considering the institutional setting that different types of owners come from.

Next, we consider the results of models (3) and (4) which examines the forecast innovation. In line with our results on the forecast error, foreign investment funds and corporations are significantly related to more optimism. The sign of foreign pension funds is in line with lower optimism, but is not significant, while foreign SWF appear to have a positive relationship with the forecasted growth in net income. With respect to the domestic investors, only the proportion of domestic employees is significant and negative. Higher levels of employee stock participation seem to induce lower levels of managerial optimism. The results for the earnings surprises reflect positive coefficients for all types of foreign and domestic investors. However, only the coefficients for foreign corporations and pension funds, as well as domestic individual and employee participation are significant.

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Insert Table 5 about here  
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To this point, we have analyzed evidence on managers' initial forecasts for each fiscal year. To test our second hypothesis regarding the timing and magnitude of earning forecast revisions contingent on foreign ownership, our next set of tests uses data on management forecast revisions. From our previous analyses, we found that managers are generally optimistic at setting their initial forecast, and this is more pronounced in the presence of foreign investors. However, the earnings surprise, i.e., the difference between realized earnings and the last available forecast is positive, yet very close to zero, which means that managers make

significant revisions through the year to match the final realized earnings.<sup>8</sup> The central issue addressed in our second hypothesis relates to the timeliness of the earnings guidance, reflected in timely adjustments in the earnings forecasts.

We first provide descriptive statistics on the frequency and magnitude of earning forecast revisions in panel A of Table 6. We list the number of firm-year observations for each revision and the percentage of the total sample these revisions represent (it is important to note that revisions include forecasts that confirm the initial forecast). For example, 98.69 percent of the firms with initial forecasts (our full sample) engage in at least one revision. Managers provide a second revision in 90.40 percent of cases, a third revision in 81.82 percent of cases, a fourth revision in 43.73 percent of cases, and a fifth revision forecast in 14.71 percent of cases, with managers of a few firms revising more often than five times. Compared to Kato et al. (2009), who look at an earlier sample, the number of revisions seems to have increased in the most recent years. Next, we consider the mean value of each revision, together with the standard deviation, minimum and maximum. In general, earning forecast revisions are made downwards, and are especially substantial when it concerns second and subsequent revisions.

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Insert Table 6 about here  
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To understand better how these revisions differ depending on the firm's level of foreign ownership, panels B and C of Table 6 provide additional descriptive statistics. Panel B describes the average magnitude of the earnings revision for our four levels of foreign ownership. From the table, we can observe that while the first revision is generally downward biased for firms with very little foreign ownership, managers in firms with higher levels of foreign ownership tend to revise their net income slightly upwards in the first revision. Yet, in all subsequent revisions, the magnitude of the downward adjustment is larger for higher levels of foreign ownership.

Finally, panel C provides some insight into the timeliness of the earnings adjustments,

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<sup>8</sup> Revisions generally coincide with the end of quarter earnings announcement (Kato et al. 2009).



or the investor guidance, by looking at the likelihood of a change in the earnings forecast for each revision.<sup>9</sup> For firms with less than 10 percent of foreign ownership, the earnings forecast in the first revision is unchanged from the initial forecast in 85 percent of the cases, while this is substantially smaller for all other levels of foreign ownership. It is important to notice that for high levels of foreign ownership, the likelihood of making adjustments to the earnings forecast is substantially higher for all revisions, except for the fifth revision. For example, the likelihood of having a change in the second and third earnings revision is about 7 percent and 10 percent larger for firms with the two highest levels of foreign ownership compared to firms with the lowest level of foreign ownership. Taking the descriptive statistics from panel B and C together, larger levels of foreign ownership seem to be associated with higher probabilities of timely earnings guidance, through substantial revisions in the earlier stages of the fiscal year.

We next provide evidence on how managers revise their earnings forecasts in the presence of foreign ownership using a multivariate approach. Table 7 presents eleven models. Models (1), (3), (5), (7) and (9) estimate the likelihood of a change in the first, second, third, fourth or fifth revision using a logistic regression, while the models (2) (4), (6), (8) and (10) estimate the magnitude of adjustment with respect to the previous forecast, when it concerns the first, second, third, fourth or fifth revision. Finally, the last model (11) presents the results of a logistic regression where the probability of having more than 4 forecasts is estimated. To examine the effect of foreign ownership on earnings guidance it is better to interpret the models on the probability of having a change in the forecast together with the models that reflect the magnitude of any potential change.

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Insert Table 7 about here

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Regarding the revisions, our results show, in line with our descriptive statistics, that there is a higher likelihood of a change in the earnings forecast in the first revision (model (1)),

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<sup>9</sup> It is important to note that about 75 percent of all revisions happen at the interim earnings announcements, which help to explain why a proportion of revisions, carry an unchanged net income number, while 25 percent relate to stand-alone revisions.

and on average is slightly upwards for intermediate levels of foreign ownership (model (2)) although, the magnitude of the adjustments is very small. More importantly, Models (3) to (6) show that the likelihood of adjustments are significantly higher in the second and third revision for higher levels of foreign ownership, while models (4) and (6) show that these adjustments are especially downward in the presence of foreign ownership relative to firms with little or no foreign ownership, which provide support to our second hypothesis. For the second revision, the probability of an adjustment in the earnings forecast is 14 percent higher when the foreign ownership is between 20 and 30 percent and 29 percent higher when the foreign ownership is above 30 percent, compared firms with less than 10 percent of foreign ownership. Equally important, the magnitude of the second and third revisions for high foreign ownership levels is substantial, as they represent adjustments to the ROA of around 0.2 percent. Given that the average forecasted ROA is around 1.7 percent, a 0.2 percent adjustment represents a 12 percent change. These results provide strong evidence to our support our second hypothesis.

When we consider firms that make four or five revisions, the sample size is dramatically reduced. The results for the fourth revision are not substantially different across firms with different foreign ownership levels. However, when we consider the fifth revision, we find consistent evidence that managers try to avoid delivering last minute adjustments when foreign ownership is high. As shown in model (10) in Table 7, the probability of having changes in the forecast in a fifth revision are 55 percent lower for firms with foreign ownership between 10 and 20 percent, 52 percent lower for firms with foreign ownership between 20 and 30 percent and 44 percent lower for firms with foreign ownership above 30 percent. However, if these firms make any adjustments they tend to make stronger downward adjustments compared to firms with low levels of foreign ownership.

Finally, to gain further insight into the likelihood of delivering late adjustments, we use a logistic regression model that estimates the probability of issuing a stand-alone earnings revision past the third quarter earnings announcements, i.e., late adjustments (model 11 in Table 7). The results show that it is far less likely that managers issue stand-alone reports past the third quarter's earnings announcements. The effect of foreign ownership becomes stronger as

the importance of foreign ownership increases. The probability of making earnings adjustments past the third quarter are 19 percent lower for firms with foreign ownership between 10 and 20 percent, 30 percent lower for firms with foreign ownership between 20 and 30 percent and 33 percent lower for firms with foreign ownership above 30 percent. Taking these results together, we find strong support for our argument that managers provide more timely and substantial adjustments in their earnings forecasts, i.e., better earnings guidance, when foreign ownership is high. The likelihood of offering adjustments in the earnings forecasts in the earlier revisions is substantially higher for higher levels of foreign ownership, while the likelihood of making last-minute adjustments is substantially lower.

### **Additional Analyses**

We perform a number of additional analyses targeted to (1) mitigate endogeneity concerns, and (2) provide further evidence of the underlying factors that drive the link between foreign ownership and optimism, focusing on the investors' investment time horizon.

First, it is plausible that foreign investors may choose to invest in firms with better long-term growth prospects or in more optimistic firms. To control for unobserved variables that may affect our results, we run our regression introducing firm-fixed effects. In addition, we include dummies for the time periods in our FE estimator to control for systematic shocks that might lead to increases in forecast optimism in all firms. Moreover, we further address endogeneity concerns related to reverse causality and omitted variables using instrumental variable (IV) methods that isolate exogenous variation in foreign institutional ownership. To this end, we define a vector of instrumental variables that are correlated with the explanatory variable, but are uncorrelated with the error term in the regression (1). Our instrument for foreign institutional ownership is the stock additions to the MSCI All Country World Index (MSCI ACWI).

Table 8, models (1), (3) and (5) replicate our main analyses to test our first hypothesis when considering four levels of foreign ownership, using FE estimations. In line with our first hypothesis and our previous findings, the results show more negative forecast errors in the presence of foreign ownership and larger earnings innovations for high levels of foreign

ownership. The presence of foreign ownership is thus positively related to management earning forecast optimism. The coefficient of foreign ownership on the earnings surprise is positive but non-significant. Models (2), (4) and (6) present our results when decomposing foreign and domestic ownership by investor type, using FE estimations. We find consistent evidence of higher levels of optimism when foreign investment funds are salient and lower levels when foreign pension funds become larger. Again, domestic investment funds have an opposite sign, compared to foreign investment funds, with respect to the earnings forecast error.

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Insert Table 8 about here  
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We also implement an instrumental variables (IV) approach using a two-stage least squares (2SLS) regression. We employ the stock membership in the MSCI ACWI as an instrument for foreign ownership. In particular to Aggarwal et al. (2011)<sup>10</sup>, we define our instrument as a dummy variable (MSCI) that equals one if a firm is included in the MSCI ACWI in a given year, and zero otherwise. We exploit the exogenous variation in foreign institutional ownership around the cutoff point that is used to determine the stock membership in the index. The index methodology follows the rule that its coverage should be 85% of the free float-adjusted market capitalization within each country (MSCI 2015). Specifically, stocks are included in the index in descending order of their free float until the cumulative free float reaches 85% of the total free float in each country. The 85% rule means that firms are added mechanically depending on their relative ranking, which implies some randomness in index membership. We do not expect that the stock membership in the MSCI ACWI to affect directly our measures of managerial forecast behavior, thus the exclusion restriction assumption is likely to be satisfied, as stocks are added to the MSCI ACWI because they represent a country's investable equities, not because of their level of managerial optimism. Consistent with this logic

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<sup>10</sup> The MSCI ACWI captures large and mid-cap equities across 23 developed markets and 23 emerging markets countries so it encompasses all of the MSCI indices that are the most commonly used benchmarks by foreign portfolio investors (e.g., MSCI World, MSCI Emerging Markets). At the end of 2015, MSCI ACWI had 2,480 constituents, 318 of which stem from Japan, and the index covered approximately 85% of the global investable equity opportunity set (Bena et al., 2015).

MSCI membership does not seem to be correlated with our measures of managerial forecast optimism as their correlations are not significant. Firms that are MSCI member have an average forecast error of -0.0067, while non-MSCI members have an average forecast error of -0.0069. In contrast, we expect the stock membership in the MSCI ACWI to influence directly the level of foreign ownership. Empirically, Ferreira and Matos (2008) and Leuz, Lins, and Warnock (2009) find that MSCI membership increases the probability that a firm attracts foreign capital.

Table 9 presents the results of the first-stage regression of the IV estimator. The first-stage tests whether the instrument is correlated with foreign ownership. Model (1) presents the results of the specification including industry, and year fixed effects, and model (2) presents the results using firm and year fixed effects. The coefficient on the MSCI instrument is positive and statistically significant in both cases. In model (1), the MSCI coefficient is 0.0706, with an *F*-statistic of 439.70. The *F*-statistic is well above the conventional threshold, confirming that the instrument provides explanatory power for the variation in foreign ownership. Foreign investors hold about 7.06 percent more of the stock in firms that are included in the MSCI ACWI. In model (2) we add firm fixed effects to further examine the link between MSCI and foreign ownership. The MSCI coefficient is 0.0238 indicating that a change in MSCI is related to change in foreign ownership by 2.38 percent.

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Insert Tables 9 and 10 about here

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As a placebo test, we also run a first-stage regression of domestic institutional ownership on the instrument MSCI. Models (3) and (4) of Table 9 show the results. The coefficients on MSCI are statistically insignificant in models (3) and (4). Since domestic institutions do not increase (decrease) their holdings following stock additions (deletions) to the MSCI ACWI, this result suggests that these events do not reveal new information to investors about the firms that are being added or deleted (such as information about the firms' future growth prospects) to the index. This result thus lends further support to the validity of our instrument.

Table 10 presents the IV estimates using MSCI as an instrument for foreign ownership on managerial optimism. Model (1) focuses on the earnings forecast error, and the coefficient of foreign ownership is negative and significant at the 1 percent level. In line with our previous results, higher levels of foreign ownership are related to larger levels of managerial optimism. The results for forecast innovation, presented in model (2), show a similar picture. These results provide strong evidence to our first hypothesis, suggesting that managers respond to foreign investors by issuing more optimistic initial earnings forecasts. Finally, we also present our IV estimates for foreign ownership on earnings surprise in model (3). The coefficient of foreign ownership is not significant, similar to our previous findings, indicating that there are no significant differences in the final earnings surprise when foreign ownership is high or low.

Lastly, we aim to provide further insight into the nature of the foreign investors, in addition to the type of foreign owners. Our theoretical arguments highlight the investment horizon of foreign investors as one of the relevant factors. While our analysis on decomposition of foreign investors by type lends support to our argument, there is likely to be some heterogeneity within each group of investors. Thus, we have classified all foreign investments into those that have an above median turnover rate (more active) and those that have a below median turnover rate (less active). To establish the median turnover rate, we have calculated the weighted turnover rate for the entire set of each foreign investor in our sample, where the weight is determined by the dollar value of each foreign stake held by the investor compared to the total value of his/her portfolio of Japanese firms, for each year. Next, we take the median turnover rate from the set of all foreign investor per year, to separate investors into more and less active. Finally, we calculated the total foreign ownership stake in the hands of more and less active investors for each firm, per year.

In Table 11, we present our results for our two main variables of managerial optimism, i.e., forecast error and forecast innovation, using OLS and FE estimations. For all four models the effect of foreign ownership on managerial optimism is higher for larger proportions of foreign ownership, and this effect is especially strong for foreign ownership held by more active investors. The effect of foreign ownership in the hands of less active investors is still significant,

but weaker.<sup>11</sup> These results are in line with our theoretical arguments and suggest that the time horizon of foreign investors is a critical factor in explaining the relationship between foreign ownership and managerial optimism.

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Insert Table 11 about here  
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## DISCUSSION

In this paper, we bring forward the view that shareholder oriented foreign investors have a significant impact on management reporting practices as they invest around the world, and particularly in very different corporate governance settings. Within the backdrop of comparative corporate governance research, we draw on the managerial reporting and impression management literatures to examine how foreign shareholders infused with their own governance logic influence managerial decision making regarding financial disclosure in a new and dramatically different governance environment. We specifically ask how shareholder-oriented, foreign institutional investors affect initial managerial optimism in earnings forecasts and the timing of subsequent earnings adjustments in a stakeholder oriented governance context. We maintain that the managerial incentives regarding optimisms and the timing of earnings adjustments are likely to be shaped by the level, type and nature (active vs. passive) of foreign ownership. In particular, when short-term shareholder-oriented foreign ownership is high, we would expect greater levels of optimism in the initial forecast, followed by timely earnings guidance in the subsequent revisions through timely adjustments of the earnings forecasts.

We conduct an empirical, longitudinal analysis of Japanese TSE corporations over the period 2006-2013. Our results demonstrate that Japanese managers in general are optimistic, yet they are even more optimistic in the presence of foreign owners. When we analyze the ownership structure in detail, we find that foreign investment funds are the main drivers of this finding, while, consistent with our logic, foreign pension funds and domestic investors tend to

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<sup>11</sup> It is important to recall that the average turnover ratio for foreign investors is substantially larger than the turnover ratio for domestic investors. Our split separates the most active foreign investors from the less active foreign investors.

reduce the level of optimism in the initial forecasts. In addition, when we separate the foreign investors by their portfolio turnover, we find stronger results for more active foreign investors compared to less active foreign investors, in line with our argument that short term shareholder orientation is an important trigger.

When we examine the earnings surprise at year end (i.e., difference between forecasted and realized earnings), our results reveal that the last forecast of Japanese firm in general tends to fall just below the realized earnings, which means that managers make significant strategic adjustments of their forecasts through the fiscal year. Considering the timing of these adjustments in detail, our findings show that the likelihood of making changes to the earnings forecast in the earlier revisions is substantially higher for firm with higher levels of foreign ownership, while the likelihood of making last-minute adjustments is substantially lower. This lends support for the idea that managers provide timely earnings guidance when foreign ownership is high. Our findings are robust to different specifications and to the use of instruments to address endogeneity concerns.

Our study contributes to the international corporate governance literature by providing insights into the role of foreign shareholders in influencing governance practices in different institutional environments as well as in companies with heterogeneous shareholders. Drawing from a cross-national institutional perspective, we argue that managerial earning disclosure practices are likely to be interpreted and adopted in various ways by Japanese managers contingent on the different interests and pressures exerted by heterogeneous owners, including foreign ones. Then, we examine how foreign owners investing in Japan, having a shareholder oriented governance logic, influence Japanese managerial reporting practices and how Japanese managers strategically respond to foreign shareholders through their earnings forecast behavior. We uncover that in Japan, a setting that has been very resistant to formal governance changes (Yoshikawa & McGuire, 2008), the influence of shareholder-oriented foreign investors is manifested through the strategic deployment of managerial reporting practices. In this sense, our analysis reveals that change in managerial reporting, e.g., timely reporting, is at work within the boundaries of the existing corporate governance system (Edelman, 1992). Our findings uncover



the possibility of hybrid systems, in which Japanese corporations with a high degree of foreign ownership combine elements common to both the Japanese CG context and the Anglo-American context, and as result they embrace a hybrid corporate governance system.

Furthermore, our study contributes to a better understanding of the mechanisms through which foreign ownership shapes local organizational practices. While prior research on the effects of foreign ownership has mainly focused on outcomes (e.g., Ahmadjian & Robbins, 2005, Ahmadjian & Robinson, 2001; David et al., 2006; Yoshikawa, Phan, & David, 2005), or on changes in the governance structure (Chizema & Shinozawa, 2012), our study focuses on a directly observable measure of managerial decision making.

Our research also has implications for policymakers, and in particular for the current debate on the rules for listed firms' earnings forecasts. Following a debate that started in 2010 on how earnings forecasts are presented on stock exchanges as a priority element of the financial strategy, on the 23<sup>rd</sup> of March, 2012, the Tokyo Stock Exchange relaxed the rules for listed firms' earnings forecasts, introducing more flexibility in the items and time horizon of earnings forecast disclosure, while encouraging systematic engagement with investors. Our results speak to the relevance of the earnings forecasts for foreign investors and the significance of receiving timely updates on the earnings forecasts, as a means to more effectively involve and inform them.

Our study also opens interesting venues for future research. First, it would be worthwhile to investigate the influence of foreign ownership on other aspects of financial reporting, such as earnings management or accounting conservatism. Second, it would be intriguing to examine whether the introduction of timely managerial reporting triggered by foreign investors creates spill-over effects, over time, in firms without large levels of foreign ownership. That is, is there an isomorphic trend because these practices get legitimated even within a corporate governance environment that initially resisted shareholder-oriented governance practices? Finally, while we study the influence of foreign ownership on initial optimism and the timing of subsequent earnings revisions, future research may explore whether

the consequences of the initial earnings optimism, as well as missing earnings target, in terms of stock price reactions or managerial turnover, is contingent on foreign ownership.

In sum, our study explores how the rise of financial globalization has led to the spread of governance practices across the world. We show that even resistant environments to introduce foreign practices such as the Japan, tend to cope with foreign pressures strategically within the boundaries of the existing governance practices.

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**Table 1. Descriptive statistics**

Variable	Mean	St.Dev.	Min	Max
Forecast error	-0.0072	0.0299	-0.1971	0.0992
Forecast innovation	0.0096	0.0331	-0.1000	0.2938
Earnings Surprise	0.0007	0.0055	-0.0299	0.0492
Foreign <10%	0.5844	0.4928	0.0000	1.0000
Foreign 10%-20%	0.2210	0.4149	0.0000	1.0000
Foreign 20%-30%	0.1220	0.3273	0.0000	1.0000
Foreign >30%	0.0726	0.2595	0.0000	1.0000
Foreign_Corporations	0.0058	0.0351	0.0000	0.6520
Foreign_Investment Funds	0.1037	0.0838	0.0000	0.7360
Foreign_Pension Funds	0.0060	0.0119	0.0000	0.1853
Foreign_Research Firms	0.0020	0.0134	0.0000	0.2754
Foreign_SWF	0.0103	0.0211	0.0000	0.3474
Domestic_family/individuals	0.0974	0.1525	0.0000	0.9379
Domestic_firms	0.2091	0.1881	0.0000	1.0000
Domestic_employees	0.0227	0.0303	0.0000	0.2437
Domestic_banks	0.1117	0.0877	0.0000	0.6565
Domestic_investment funds	0.1068	0.0920	0.0000	0.6565
Domestic_government	0.0034	0.0209	0.0000	0.5001
Big-4 Auditor	0.7980	0.4015	0.0000	1.0000
Firm Size	11.0258	1.6010	4.6539	17.3846
Leverage	0.1953	0.1777	0.0000	2.0204
Return on Assets	0.0170	0.0955	-2.6841	0.5578
Sales growth	0.0203	0.0620	-0.5938	0.2971
Low Op. Assets Turnover	0.4907	0.4999	0.0000	1.0000
Board independence	0.1045	0.1456	0.0000	1.0000

**Table 2: Foreign Ownership – decomposition by country and type of owner**

<b>Panel A</b>											
country	Stake of Foreign Ownership	Banks	Corporations	Hedge Funds	Holding Companies	Individual Investors	Investment Funds	Pension Funds	Private Equity	Research Firms	SWFs
United States	58.53%	0.31%	3.64%	0.21%	0.02%	0.12%	51.22%	1.88%	0.29%	0.83%	0.00%
United Kingdom	14.88%	0.00%	1.00%	0.00%	0.22%	0.00%	11.86%	0.00%	0.00%	1.79%	0.00%
Norway	6.44%	0.00%	0.00%	0.00%	0.00%	0.00%	0.12%	0.00%	0.00%	0.00%	6.32%
Singapore	3.22%	0.00%	0.71%	0.12%	0.00%	0.00%	2.38%	0.00%	0.00%	0.00%	0.01%
Germany	1.80%	0.04%	0.99%	0.00%	0.00%	0.00%	0.76%	0.00%	0.00%	0.00%	0.00%
Netherlands	1.70%	0.00%	0.77%	0.00%	0.00%	0.02%	0.29%	0.61%	0.00%	0.00%	0.00%
Hong Kong	1.64%	0.00%	1.04%	0.00%	0.00%	0.00%	0.38%	0.00%	0.20%	0.00%	0.00%
Canada	1.62%	0.00%	0.09%	0.00%	0.00%	0.00%	0.74%	0.79%	0.00%	0.00%	0.00%
France	1.49%	0.00%	0.62%	0.00%	0.02%	0.00%	0.86%	0.00%	0.00%	0.00%	0.00%
Switzerland	1.49%	0.12%	0.09%	0.00%	0.00%	0.00%	1.28%	0.00%	0.00%	0.00%	0.00%
Top 10 Countries	92.81%	0.47%	8.95%	0.33%	0.26%	0.14%	69.89%	3.28%	0.49%	2.62%	6.33%
Full Sample	100.00%	0.61%	11.83%	0.36%	0.26%	0.51%	73.17%	3.40%	0.51%	2.62%	6.32%

<b>Panel B</b>											
	Total sample	Banks	Corporations	Hedge Funds	Holding Companies	Individual Investors	Investment Funds	Pension Funds	Private Equity	Research Firms	SWFs
Av. Churn ratio – Foreign investors	0.74	0.86	0.15	1.37	0.62	0.08	0.86	0.73	0.82	0.98	0.62
Av. Churn ratio – domestic investors	0.23	0.26	0.22	0.49	0.11	0.19	0.41	0.09	0.47	0.44	

**Table 3. Correlation matrix**

	1	2	3	4	5	6	7	8	9	10	11	12
1 Forecast error	1											
2 Forecast innovation	-0.13	1										
3 Earnings Surprise	0.22	-0.01	1									
4 Foreign 10%-20%	0.01	-0.03	0.01	1								
5 Foreign 20%-30%	0.00	-0.03	0.03	-0.22	1							
6 Foreign >30%	0.00	0.00	0.04	-0.15	-0.11	1						
7 Big-4 Auditor	0.03	-0.04	0.01	0.08	0.08	0.03	1					
8 Firm Size	0.07	-0.13	0.02	0.20	0.31	0.26	0.17	1				
9 Leverage	-0.11	0.08	-0.05	-0.04	-0.06	-0.08	-0.07	0.17	1			
10 Return on Assets	0.06	-0.53	-0.01	0.07	0.08	0.08	0.11	0.11	-0.23	1		
11 Sales growth	-0.02	-0.15	0.00	0.02	0.02	0.03	0.02	0.00	-0.02	0.24	1	
12 Low Op. Assets Turnover	-0.04	0.03	-0.03	0.03	0.00	0.02	-0.02	0.08	0.15	-0.07	-0.04	1
13 Board independence	0.00	0.05	0.05	-0.01	0.05	0.10	0.07	0.04	0.02	-0.07	0.01	-0.01

**Table 4: Regression results of Earnings optimism and four levels of foreign ownership (n= 10807)**

Dependent variable:	Forecast error		Forecast Innovation		Earnings Surprise	
	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
Foreign Own: 10%-20%		-0.0015** (0.0008)		0.0021** (0.0010)		0.0001 (0.0002)
Foreign Own: 20%-30%		-0.0038*** (0.0010)		0.0054*** (0.0014)		0.0003 (0.0002)
Foreign Own >30%		-0.0045*** (0.0013)		0.0080*** (0.0018)		0.0006** (0.0003)
Big4-Auditor	0.0003 (0.0007)	0.0003 (0.0007)	-0.0006 (0.0011)	-0.0005 (0.0011)	-0.0001 (0.0002)	-0.0001 (0.0002)
Firm Size	0.0014*** (0.0002)	0.0020*** (0.0003)	-0.0028*** (0.0003)	-0.0037*** (0.0004)	-0.0001* (0.0001)	-0.0001* (0.0001)
Leverage	-0.0195*** (0.0019)	-0.0216*** (0.0019)	0.0203*** (0.0028)	0.0229*** (0.0029)	-0.0008* (0.0005)	-0.0007 (0.0005)
Return on Assets	0.0236*** (0.0039)	0.0236*** (0.0039)	-0.0684*** (0.0048)	-0.0680*** (0.0048)	0.0059*** (0.0007)	0.0059*** (0.0007)
Sales Growth	-0.0008 (0.0013)	-0.0007 (0.0013)	0.0168*** (0.0015)	0.0168*** (0.0015)	0.0005*** (0.0002)	0.0005*** (0.0002)
Low Op. Assets Turnover	-0.0012** (0.0006)	-0.0011* (0.0006)	0.0001 (0.0008)	0.0000 (0.0008)	-0.0002* (0.0001)	-0.0002* (0.0001)
Board Independence	0.0004 (0.0021)	0.0016 (0.0021)	0.0095*** (0.0031)	0.0078** (0.0031)	0.0017*** (0.0005)	0.0016*** (0.0005)
Constant	-0.01882** (0.01072)	-0.0227** (0.0108)	0.0376*** (0.0038)	0.0452*** (0.0041)	0.0026*** (0.0006)	0.0031*** (0.0007)
Year dummies	Yes	Yes	Yes	Yes	Yes	Yes
Industry dummies	Yes	Yes	Yes	Yes	Yes	Yes
Firm dummies	No	No	No	No	No	No
R2	0.1330	0.1367	0.2923	0.2977	0.0284	0.0292

\*\*\* p < 0.01; \*\* p < 0.05; \* p < 0.10, based on two-tailed tests, robust standard errors, clustered at the firm level in parentheses. All independent variables are lagged by one term.



**Table 5: Regression results of Earnings optimism and Foreign and Domestic Ownership Types (n= 9407)**

Dependent variable:	Forecast error		Forecast Innovation		Earnings Surprise	
	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
Foreign_Corporations	-0.0254*** (0.0097)	-0.0179* (0.0098)	0.0546*** (0.0094)	0.0538*** (0.0095)	0.0045** (0.0019)	0.0046** (0.0019)
Foreign_Investment Funds	-0.0193*** (0.0041)	-0.0173*** (0.0043)	0.0429*** (0.0039)	0.0397*** (0.0041)	0.0003 (0.0008)	0.0002 (0.0009)
Foreign_Pension Funds	0.0774*** (0.0277)	0.0763*** (0.0279)	-0.0021 (0.0264)	-0.0166 (0.0265)	0.0110** (0.0055)	0.0097* (0.0055)
Foreign_Research Firms	-0.0302 (0.0233)	-0.0289 (0.0233)	0.0332 (0.0218)	0.0278 (0.0218)	0.0013 (0.0046)	0.0009 (0.0046)
Foreign_SWF	-0.0156 (0.0140)	-0.0225 (0.0142)	0.0696*** (0.0134)	0.0617*** (0.0136)	0.0018 (0.0028)	0.0012 (0.0028)
Domestic_Family/Individuals		0.0064** (0.0032)		0.0133*** (0.0031)		0.0013** (0.0006)
Domestic_Corporations		0.0092*** (0.0021)		0.0011 (0.0020)		0.0006 (0.0004)
Domestic_Employees		0.0118 (0.0107)		-0.0355*** (0.0101)		0.0041* (0.0021)
Domestic_Banks		0.0202*** (0.0066)		0.0072 (0.0063)		0.0003 (0.0013)
Domestic_Investment Funds		0.0108* (0.0061)		0.0008 (0.0057)		0.0011 (0.0012)
Domestic_Government		0.0116 (0.0182)		-0.0042 (0.0182)		0.0015 (0.0036)
Big4-Auditor	-0.0002 (0.0007)	-0.0002 (0.0007)	0.0024*** (0.0007)	0.0023*** (0.0007)	0.0001 (0.0001)	0.0001 (0.0001)
Firm Size	0.0012*** (0.0003)	0.0008*** (0.0003)	-0.0022*** (0.0003)	-0.0019*** (0.0003)	0.0000 (0.0001)	0.0000 (0.0001)
Leverage	-0.0207*** (0.0021)	-0.0199*** (0.0021)	-0.0036* (0.0020)	-0.0042** (0.0020)	-0.0013*** (0.0004)	-0.0013** (0.0004)
Return on Assets	0.0296*** (0.0053)	0.0256*** (0.0054)	-0.3514*** (0.0056)	-0.3550*** (0.0057)	0.0019** (0.0009)	0.0016* (0.0009)
Sales Growth	0.0018 (0.0013)	0.0020 (0.0013)	0.0049*** (0.0009)	0.0049*** (0.0009)	0.0001 (0.0002)	0.0001 (0.0002)
Low Op. Assets Turnover	-0.0008 (0.0006)	-0.0008 (0.0006)	-0.0019*** (0.0006)	-0.0020*** (0.0006)	-0.0002 (0.0001)	-0.0002 (0.0001)
Board Independence	0.0008 (0.0022)	0.0016 (0.0022)	-0.0038* (0.0021)	-0.0036* (0.0021)	0.0014*** (0.0004)	0.0014*** (0.0004)
Constant	-0.0112 (0.0101)	-0.0169* (0.0103)	0.0335** (0.0140)	0.0306** (0.0140)	-0.0028 (0.0020)	-0.0034* (0.0021)
Year dummies	Yes	Yes	Yes	Yes	Yes	Yes
Industry dummies	Yes	Yes	Yes	Yes	Yes	Yes
Firm dummies	No	No	No	No	No	No
R2	0.147	0.152	0.367	0.370	0.301	0.032

\*\*\* p < 0.01; \*\* p < 0.05; \* p < 0.10, based on two-tailed tests, robust standard errors, clustered at the firm level in parentheses. All independent variables are lagged by one term.

**Table 6: Descriptive statistics on the likelihood and magnitude of earnings revisions**

Panel A: Descriptive statistics on the likelihood and magnitude of earnings revisions – Full sample

Variable	N	% of total sample	Mean	St.Dev.	Min	Max
First revision	10665	98.69%	-0.00004	0.00445	-0.03119	0.03117
Second Revision	9769	90.40%	-0.00252	0.01415	-0.11131	0.11892
Third Revision	8842	81.82%	-0.00256	0.01219	-0.11402	0.10802
Fourth Revision	4726	43.73%	-0.00313	0.01639	-0.11289	0.11013
Fifth Revision	1590	14.71%	-0.00404	0.01962	-0.10583	0.09525

Panel B: Descriptive statistics on the average magnitude of earnings revisions – for different levels of foreign ownership

Foreign Ownership	<10%	10%-20%	20%-30%	>30%
First revision	-0.00017	0.00007	0.0002	0.00011
Second Revision	-0.00246	-0.00242	-0.00234	-0.0029
Third Revision	-0.00222	-0.00248	-0.00374	-0.00349
Fourth Revision	-0.00297	-0.00302	-0.00381	-0.00416
Fifth Revision	-0.00287	-0.00609	-0.00571	-0.00484

Panel C: Descriptive statistics on the likelihood of having a **change in earnings revisions**– for different levels of foreign ownership

Foreign Ownership	<10%	10%-20%	20%-30%	>30%
First revision	15.04%	18.48%	24.54%	20.36%
Second Revision	52.97%	56.45%	59.26%	60.81%
Third Revision	27.64%	31.85%	39.08%	35.78%
Fourth Revision	61.57%	64.76%	60.70%	67.75%
Fifth Revision	86.49%	78.89%	75.14%	77.33%

**Table 7: Regression Analyses considering revisions and foreign ownership**

Dependent Variable: Revision	P(change in First)	Magnitude of First	P(change in Second)	Magnitude of Second	P(change in Third)	Magnitude of Third	P(change in Forth)	Magnitude of Forth	P(change in Fifth)	Magnitude of Fifth	P(Revision past Q3)
	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8	Model 9	Model 10	Model 11
Foreign Own: 10%-20%	0.0705 (0.0681)	0.0003** (0.0001)	0.0368 (0.0539)	-0.0007** (0.0004)	0.1021* (0.0616)	-0.0006* (0.0003)	0.1587* (0.0813)	-0.0001 (0.0006)	-0.8104*** (0.1698)	-0.0040*** (0.0012)	-0.2102*** (0.0555)
Foreign Own: 20%-30%	0.5065*** (0.0799)	0.0004*** (0.0002)	0.1373** (0.0688)	-0.0011** (0.0005)	0.3707*** (0.0753)	-0.0021*** (0.0004)	-0.1177 (0.1054)	-0.0010 (0.0008)	-0.7241*** (0.2184)	-0.0041** (0.0017)	-0.3619*** (0.0745)
Foreign Own >30%	0.1319* (0.0751)	0.0002 (0.0002)	0.2551*** (0.0919)	-0.0012** (0.0006)	0.2278*** (0.1005)	-0.0018*** (0.0006)	0.2177 (0.1466)	-0.0016 (0.0011)	-0.5863* (0.3174)	-0.0047** (0.0024)	-0.3943*** (0.0932)
Big4-Auditor	-0.0357 (0.0651)	0.0002 (0.0001)	0.0096 (0.0513)	-0.0004 (0.0003)	-0.0519 (0.0594)	-0.0003 (0.0003)	0.0561 (0.0737)	-0.0010* (0.0006)	0.1986 (0.1586)	0.0011 (0.0011)	0.0336 (0.0524)
Firm Size	0.0842*** (0.0213)	-0.0000 (0.0000)	0.0506*** (0.0172)	0.0003*** (0.0001)	0.1107*** (0.0197)	0.0002** (0.0001)	0.0268 (0.0258)	-0.0001 (0.0002)	0.0110 (0.0564)	-0.0000 (0.0004)	-0.0428** (0.0184)
Leverage	0.1485 (0.1567)	-0.0001 (0.0003)	0.2486** (0.1251)	-0.0007 (0.0009)	0.5748*** (0.1409)	-0.0014 (0.0009)	0.2093 (0.1793)	-0.0037** (0.0015)	-0.0161 (0.3900)	-0.0049 (0.0029)	0.9740*** (0.1367)
Return on Assets	-0.1872 (0.3106)	0.0031*** (0.0005)	-0.7228*** (0.2772)	0.0479*** (0.0019)	-0.8759*** (0.3070)	0.0232*** (0.0017)	-0.3450 (0.3968)	0.0768*** (0.0035)	0.1276 (0.5786)	0.1156*** (0.0065)	-0.9895*** (0.2563)
Sales Growth	-0.0860 (0.1143)	0.0010*** (0.0002)	-0.0489 (0.0687)	0.0046*** (0.0006)	-0.1824 (0.1185)	0.0046*** (0.0006)	0.0785 (0.1018)	0.0054*** (0.0009)	-0.4856* (0.2869)	0.0032 (0.0020)	-0.1339 (0.0966)
Low Op. Assets Turnover	-0.0109 (0.0512)	-0.0001* (0.0001)	-0.0094 (0.0407)	-0.0005** (0.0003)	-0.0494 (0.0465)	0.0002 (0.0003)	-0.0839 (0.0594)	-0.0002 (0.0004)	0.0855 (0.1315)	-0.0002 (0.0009)	-0.0864** (0.0421)
Board Independence	0.3245* (0.1867)	0.0005 (0.0003)	-0.0021 (0.1526)	0.0017* (0.0010)	0.4458** (0.1746)	-0.0009 (0.0010)	0.2341 (0.2307)	0.0005 (0.0018)	-0.7203 (0.4763)	0.0049 (0.0036)	-0.5876*** (0.1613)
Constant	-3.2224*** (0.2336)	0.0027 (0.0031)	-0.7567*** (0.1838)	-0.0000 (0.0092)	-2.3511*** (0.2122)	-0.0084 (0.0067)	-0.0542 (0.2741)	-0.0023 (0.0088)	1.5846*** (0.6012)	0.0016 (0.0179)	1.0657*** (0.1984)
Year dummies	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Industry dummies	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
N	10665	10665	9769	9769	8842	8842	4726	4726	1590	1590	10807
(Pseudo) R2	0.0281	0.0328	0.0162	0.1267	0.0354	0.1100	0.0119	0.1759	0.0369	0.2452	0.0578

\*\*\* p < 0.01; \*\* p < 0.05; \* p < 0.10, based on two-tailed tests, robust standard errors, clustered at the firm level in parentheses. All independent variables are lagged by one term.

**Table 8: Robustness testing - Regression results (using FE) of Earnings optimism and Foreign and Domestic Ownership Types**

	Forecast error		Forecast Innovation		Earnings Surprise	
	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
Foreign Own: 10%-20%	-0.0052*** (0.0013)		0.0019 (0.0017)		0.0001 (0.0003)	
Foreign Own: 20%-30%	-0.0104*** (0.0019)		0.0050** (0.0025)		0.0001 (0.0005)	
Foreign Own: 10%-20%	-0.0052*** (0.0013)		0.0019 (0.0017)		0.0001 (0.0003)	
Foreign_Corporations		-0.0110 (0.0296)		-0.0141 (0.0421)		-0.0006 (0.0044)
Foreign_Investment Funds		-0.0242** (0.0101)		0.0226*** (0.0072)		-0.0012 (0.0020)
Foreign_Pension Funds		0.1025** (0.0351)		-0.0394 (0.0558)		0.0114 (0.0088)
Foreign_Research Firms		-0.0372 (0.0456)		-0.0186 (0.0296)		-0.0035 (0.0080)
Foreign_SWF		-0.0285 (0.0251)		0.0494* (0.0264)		-0.0031 (0.0048)
Domestic_Family/Individuals		0.0000 (0.0002)		0.0000 (0.0002)		0.0000 (0.0000)
Domestic_Corporations		0.0001 (0.0001)		0.0000 (0.0001)		0.0000 (0.0000)
Domestic_Employees		-0.0001 (0.0005)		-0.0003 (0.0003)		-0.0001 (0.0001)
Domestic_Banks		0.0001 (0.0002)		0.0002 (0.0002)		0.0000 (0.0000)
Domestic_Investment Funds		0.0006*** (0.0002)		0.0000 (0.0002)		0.0000 (0.0000)
Domestic_Government		-0.0007 (0.0007)		0.0006 (0.0005)		-0.0002* (0.0001)
Big4-Auditor	0.0053 (0.0073)	0.0193 (0.0165)	-0.0115 (0.0147)	0.0058 (0.0043)	-0.0008 (0.0022)	0.0014 (0.0015)
Firm Size	-0.0109* (0.0045)	0.0171*** (0.0033)	-0.0290*** (0.0043)	0.0022 (0.0034)	-0.0021** (0.0008)	-0.0010 (0.0008)
Leverage	-0.0051 (0.0128)	-0.1052*** (0.0107)	0.0907*** (0.0114)	-0.0236** (0.0102)	0.0001 (0.0017)	-0.0036** (0.0017)
Return on Assets	0.2890*** (0.0460)	-0.0889*** (0.0161)	-0.0086 (0.0151)	-0.5961*** (0.0435)	0.0081*** (0.0022)	-0.0032* (0.0018)
Sales Growth	0.0145*** (0.0034)	-0.0003 (0.0018)	0.0208*** (0.0031)	0.0063 (0.0045)	0.0004 (0.0004)	-0.0003 (0.0002)
Low Op. Assets Turnover	0.0003 (0.0014)	-0.0013 (0.0014)	0.0012 (0.0015)	-0.0027** (0.0011)	0.0001 (0.0002)	0.0001 (0.0002)
Board Independence	0.0236** (0.0090)	-0.0056 (0.0072)	0.0136 (0.0099)	0.0100 (0.0063)	-0.0009 (0.0013)	-0.0006 (0.0012)
Constant	0.1061* (0.0516)	-0.2010*** (0.0412)	0.3183*** (0.0491)	-0.0083 (0.0389)	0.0235** (0.0085)	0.0125 (0.0096)
Year dummies	Yes	Yes	Yes	Yes	Yes	Yes
Industry dummies	No	No	No	No	No	No
Firm dummies	Yes	Yes	Yes	Yes	Yes	Yes
R2 - within	0.0698	0.1995	0.2870	0.5506	0.0135	0.0297
R2 - overall	0.0385	0.0358	0.1093	0.3312	0.0003	0.0032

\*\*\* p < 0.01; \*\* p < 0.05; \* p < 0.10, based on two-tailed tests, robust standard errors, clustered at the firm level in parentheses. All independent variables are lagged by one term.

**Table 9: Foreign Ownership and MSCI ACWI Membership: First Stage**

	First stage: Foreign ownership		Placebo: Domestic institutional ownership	
	Model 1	Model 2	Model 3	Model 4
MSCI	0.0706*** (0.0026)	0.0238*** (0.0052)	0.0025 (0.0026)	-0.0004 (0.0044)
Big4-Auditor	-0.0011 (0.0017)	0.0103 (0.0199)	-0.0022 (0.0017)	0.0044 (0.0074)
Firm Size	0.0248*** (0.0006)	0.0264*** (0.0063)	0.0296*** (0.0006)	-0.0088*** (0.0029)
Leverage	-0.1114*** (0.0044)	-0.0497*** (0.0119)	-0.0213*** (0.0044)	-0.0245*** (0.0071)
Return on Assets	-0.0097 (0.0079)	0.0043 (0.0092)	0.0106 (0.0079)	0.0107** (0.0044)
Sales Growth	0.0101*** (0.0023)	-0.0003 (0.0018)	-0.0002 (0.0023)	0.0011 (0.0008)
Low Op. Assets Turnover	-0.0001 (0.0014)	-0.0031* (0.0018)	-0.0017 (0.0014)	0.0003 (0.0013)
Board Independence	0.0669*** (0.0050)	0.0207 (0.0174)	-0.0175*** (0.0050)	-0.0205*** (0.0072)
Constant	-0.0224 (0.0284)	-0.1800** (0.0711)	-0.0969 (0.0283)	0.2143*** (0.0329)
Year dummies	Yes	Yes	Yes	Yes
Industry dummies	Yes	No	Yes	No
Firm dummies	No	Yes	No	Yes
R2 - overall	0.4225	0.3506	0.3639	0.0989

\*\*\* p < 0.01; \*\* p < 0.05; \* p < 0.10, based on two-tailed tests, robust standard errors, clustered at the firm level in parentheses. All independent variables are lagged by one term.

**Table 10: Foreign Ownership and Earnings optimism: Second stage**

Dependent Variable	Forecast error	Forecast Innovation	Earnings Surprise
	Model 1	Model 2	Model 3
Foreign ownership	-0.0890*** (0.0157)	0.1424*** (0.0196)	0.0046 (0.0030)
Big4-Auditor	0.0005 (0.0007)	0.0015** (0.0008)	0.0001 (0.0001)
Firm Size	0.0050*** (0.0007)	-0.0069*** (0.0008)	-0.0001 (0.0001)
Leverage	-0.0294*** (0.0029)	0.0156*** (0.0034)	-0.0010** (0.0005)
Return on Assets	0.0247** (0.0112)	-0.2755*** (0.0405)	-0.0011 (0.0013)
Sales Growth	0.0011 (0.0019)	0.0029 (0.0040)	-0.0002 (0.0002)
Low Op. Assets Turnover	-0.0013** (0.0006)	0.0002 (0.0007)	-0.0004*** (0.0001)
Board Independence	0.0056** (0.0028)	-0.0056* (0.0034)	0.0007 (0.0005)
Constant	-0.0437*** (0.0055)	0.0716*** (0.0072)	0.0020* (0.0011)
Year dummies	Yes	Yes	Yes
Industry dummies	Yes	Yes	Yes
Wald Chi2	371.201	356.667	392.900
p-value	0.0000	0.0000	0.0000
Centered R2	0.0921	0.2346	0.0215

\*\*\* p < 0.01; \*\* p < 0.05; \* p < 0.10, based on two-tailed tests, robust standard errors, clustered at the firm level in parentheses. All independent variables are lagged by one term.

**Table 11: Robustness testing - Regression results of Earnings optimism and Foreign ownership for higher and lower Turnover rates**

Dependent Variable	Forecast error		Forecast Innovation	
	Model 1	Model 2	Model 3	Model 4
FO_Higher Turnover	-0.0276*** (0.0060)	-0.0321*** (0.0111)	0.0713*** (0.0056)	0.0430*** (0.0100)
FO_Lower Turnover	-0.0155*** (0.0044)	-0.0200* (0.0105)	0.0430*** (0.0041)	0.0197* (0.0102)
Big4-Auditor	0.0002 (0.0008)	-0.0012 (0.0028)	0.0017** (0.0007)	0.0032 (0.0075)
Firm Size	0.0014*** (0.0003)	0.0203*** (0.0047)	-0.0027*** (0.0003)	0.0002 (0.0046)
Leverage	-0.0216*** (0.0022)	-0.1160*** (0.0126)	-0.0013 (0.0021)	-0.0280*** (0.0087)
Return on Assets	0.0347*** (0.0058)	-0.0946*** (0.0184)	-0.3740*** (0.0062)	-0.5819*** (0.0456)
Sales Growth	0.0012 (0.0014)	0.0010 (0.0015)	0.0046*** (0.0009)	0.0058 (0.0051)
Low Op. Assets Turnover	-0.0007 (0.0006)	-0.0019 (0.0015)	-0.0017** (0.0006)	-0.0035*** (0.0013)
Board Independence	0.0008 (0.0023)	-0.0060 (0.0084)	-0.0038*** (0.0022)	0.0144** (0.0066)
Constant	-0.0042 (0.0108)	-0.2139*** (0.0530)	0.0469** (0.0231)	0.0207 (0.0529)
Year dummies	Yes	Yes	Yes	Yes
Industry dummies	Yes	No	Yes	No
Firm dummies	No	Yes	No	Yes
R2 -within		0.2057		0.5194
R2 -overall	0.1479	0.0384	0.3778	0.3466

\*\*\* p < 0.01; \*\* p < 0.05; \* p < 0.10, based on two-tailed tests, robust standard errors, clustered at the firm level in parentheses. All independent variables are lagged by one term.