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The Reexamination of Geographic Earnings Conservatism

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ABSTRACT

U. S. Multinational corporations are operated in many different countries. Their foreign and domestic earnings are separately reported in the annual report. This paper examined the difference between domestic and foreign earnings in terms of conservatism using a variety of model specifications for conservatism. I found that the degrees of conservatism of domestic earnings are much higher than foreign earnings in all the model specifications for conservatism, which is in line with prior literature (Hwang and Kim 2022). More importantly, I found that the higher financial leverage, the declining asset growth and the higher information asymmetry significantly increase the level of conservatism of domestic earnings rather than foreign earnings.

Keyword: domestic earnings, foreign earnings, accounting conservatism, persistence.

INTRODUCTION

To gain competitive advantages, U.S. corporations are increasingly under the influence of the internationalization of the U.S. economy, the globalization of the world's markets and the growth of emerging markets (e.g., Cateora and Graham 2007). Nonetheless, investigation on geographic segmental disclosures have been relatively less explored. This study investigated the accounting properties of geographic segmental disclosures using the sample of US multinational firms. Earnings conservatism plays important roles in benefiting information users in capital market through mitigating agency problems associated with managerial investment decisions, increasing debt and other contracts agreement efficiency, reducing information asymmetry between managers and equity investors, facilitating the monitoring of contracts (e.g., Watts 2003a, 2003b; Ball and Shivakumar 2005; LaFond and Watts 2008; Lara et al. 2009). Related to foreign operations compared to domestic operations, investors have more difficulties in monitoring management at distant, different foreign sites and also suffer from severe information asymmetry problems due to less public information available in foreign operations (e.g., Christophe 2002; Denis et al. 2002; Hope and Thomas 2008). Thus, it would be meaningful to test whether and how the roles of earnings conservatism work in foreign versus domestic operations in a variety of conservatism specifications.

The main research objective is to investigate the degree of conservatism between domestic and foreign earnings through employing a variety of research specifications of conservatism. Consistent with prior literature, I found that domestic earnings are significantly more conservative than foreign earnings, suggesting that the incremental speed of economic loss to be incorporated into earnings relative to economic gains are significantly much higher in domestic earnings than in foreign earnings. More importantly, this evidence was robust across

a variety of model specifications for conservatism including Basu (1997), Ball and Shivakumar (2006), Roychowdhury and Watts (2007), etc. In addition, I found that the higher financial leverage, the declining growth, and the higher information asymmetry (estimated by PIN measure) significantly increase the level of conservatism of domestic earnings rather than foreign earnings. The empirical findings suggest that agency cost hypothesis and operating leverage theory can explain the lower level of conservatism of foreign earnings but the information role of conservatism in foreign operations is not executed.

In sum, our findings of this study are important for the following reasons. First, it builds on the existing literature on domestic and foreign earnings (e.g., Bodnar and Weintrop 1997; Thomas 1999; Christophe 2002; Bodnar et al. 2003; Hwang and Kim 2022) by providing various evidence on conservatism of domestic and foreign earnings. Second, this paper begins to build more rigorous model testing what kinds of factors determine the properties of geographic earnings by considering a variety of economic characteristics of domestic and foreign operations. The remainder of this paper is organized as follows. Section II describes research designs used to test the research question. Section III presents the empirical results, Section IV shows additional analyses and Section V concludes the paper.

SAMPLE AND RESEARCH DESIGN

Data

The data covers the U.S. firms with domestic and foreign earnings and stock return data which was taken from Compustat annual industrial and Compustat Segment File and stock return data is taken from the CRSP files. The paper restricted firms to the firms which are domiciled in the United States. Also the financial firms and the 1% of extreme observations in each tail of each variable for each year were excluded.

Basu (1997)'s timeliness model

The primary focus of this paper is to investigate the conservatism of domestic earnings and foreign earnings. First of all, I employed Basu (1997)'s asymmetric timeliness model representing that firms asymmetrically incorporate good news or bad news in their earnings. Adjusting the Basu (1997)'s model, I used both domestic and foreign earnings as the dependent variables instead of total earnings below (Hwang and Kim, 2022).

$$DEPS_t = \beta_0 + \beta_1 DRET_t + \beta_2 RET_t + \beta_3 DRET_t * RET_t + \varepsilon_t \quad \text{..... (1a)}$$

$$FEPS_t = \gamma_0 + \gamma_1 DRET_t + \gamma_2 RET_t + \gamma_3 DRET_t * RET_t + \varepsilon_t \quad \text{..... (1b)}$$

Where *DEPS* (*FEPS*) is the domestic (foreign) pretax income divided by number of shares for firm i in fiscal year t, deflated by the market price per share at the beginning of year t; *RET* is the stock return on firm i from 9 months before fiscal year-end to the three months after fiscal year-end t or the stock return from 9 months before fiscal year-end to the three months after fiscal year-end t, less the corresponding CRSP equal weighted market return (*RET* or *ABRET*); DRET is a zero/one indicator variable if set equal to 1 if *RET* is less than 0;

The coefficients β_3 and γ_3 capture the incremental timeliness of bad news relative to good news in domestic and foreign earnings, respectively, thus contrasting the degree of conservatism of domestic earnings (β_3) and that of foreign earnings (γ_3).[1]

[1] To make the comparison possible, I followed Hwang and Kim (2022).

$DEPS_t$ or $FEPS_t = \beta_0 + \beta_1 D_DRET_t + \beta_2 D_RET_t + \beta_3 D_DRET_t * RET_t + \gamma_0 + \gamma_1 F_DRET_t + \gamma_2 F_RET_t + \gamma_3 F_DRET_t * RET_t + \sum YearDummy + \varepsilon_t$ .... (2)

Basu (1997)'s persistence model

I test the persistence of domestic and foreign earnings following Basu (1997) and Thomas (1999). More timeliness represents that more current value relevant news is recognized contemporaneously in earnings and more persistence means that less current value relevant news is reported in current earnings. Since earnings are predicted to be timelier for bad news, it is also predicted to be less persistent for bad news. The bad news reflected in current earnings will appear as a transitory shock or a one-time dip in the earnings process. In contrast, the effects of a current positive shock will be spread over several future periods' earnings as anticipated gains are realized. Thus good news events are likely to appear as persistent shocks to the earnings stream. Therefore, negative earnings changes tend to reverse in the following period more than positive earnings changes. In addition to Thomas (1999)'s model showing more persistence in foreign earnings than in domestic earnings, I decomposed each earnings changes into negative and positive earnings changes and test whether 1) negative earnings change is less persistent than positive earnings change in both domestic and foreign earnings and 2) that the less persistence of negative earnings change is significantly different from domestic and foreign earnings.

I employed the following equation. Similarly, coefficients of β_3 and γ_3 capture the incremental persistence of negative earnings change in domestic and foreign earnings, respectively. The dependent variable includes both domestic and foreign earnings change.[2]

ΔDE_{t+1} or $\Delta FE_{t+1} = \beta_0 + \beta_1 \Delta DE_t + \beta_2 D\Delta DE_t + \beta_3 D\Delta DE_t * \Delta DE_t + \gamma_0 + \gamma_1 \Delta FE_t + \gamma_2 D\Delta FE_t + \gamma_3 D\Delta FE_t * \Delta FE_t + \sum YearDummy + \varepsilon_t$ .... (3)

Where ΔDE_t (ΔFE_t) is change in domestic (foreign) pretax income from year t to year t-1, divided by total assets at year t-1; $D\Delta DE_t$ ($D\Delta FE_t$) is a zero/one indicator variable set equal to 1 if ΔDE_t (ΔFE_t)is less than 0.

Ball and Shivakumar (2006)'s accrual model

The next measure of conservatism is based on the approach by Ball and Shivakumar (2006) who use regressions based on accruals and cash flows. This approach presents the advantage of not relying on market measures, thereby reducing the risk of drawing incorrect inferences due to market inefficiencies (Dietrich et al. 2007). Economic gain and loss are regarded as the current period cash flow plus any revision in the present value of expected future cash flows. Timely recognition of revisions in expected future cash flows requires accruals, which thus are positively correlated with the shock to current cash flows. Ball and Shivakumar argue that asymmetrically timely gain and loss recognition introduces asymmetry in the relation between accruals and cash flows. Losses are more likely to be recognized on a timely basis, as accrued noncash charges against income, whereas gains are more likely to await their recognition until they are realized in cash. This asymmetry implies that the positive correlation between cash flows and accruals due to the timely recognition role of accruals is greater in periods with losses than with gains. I employed three accrual models incorporating the role of asymmetrically

[2] When domestic and foreign earnings changes are used as dependent variables, the dataset is reconstructed following the same procedures as the equation (2).

timely loss and gain recognition, using domestic and foreign earnings for dependent variables instead of accruals and thus they are adjusted as follows;

DD model:

$$DE_t \text{ or } FE_t = \beta_0 + \beta_1 CF_{t-1} + \beta_2 CF_t + \beta_3 CF_{t+1} + \beta_4 VAR_t + \beta_5 DVAR_t + \boldsymbol{\beta_6} DVAR_t * VAR_t + \sum YearDummy + \varepsilon_t \quad \ldots(4)$$

Jones model:

$$DE_t \text{ or } FE_t = \beta_0 + \beta_1 \Delta REV_t + \beta_2 GPPE_t + \beta_3 VAR_t + \beta_4 DVAR_t + \boldsymbol{\beta_5} DVAR_t * VAR_t + \sum YearDummy + \varepsilon_t \quad \ldots(5)$$

DD plus Jones model:

$$DE_t \text{ or } FE_t = \beta_0 + \beta_1 CF_{t-1} + \beta_2 CF_t + \beta_3 CF_{t+1} + \beta_4 \Delta REV_t + \beta_5 GPPE_t + \beta_6 VAR_t + \beta_7 DVAR_t + \boldsymbol{\beta_8} DVAR_t * VAR_t + \sum YearDummy + \varepsilon_t \quad \ldots(6)$$

DE_t = domestic pretax income in year t, divided by average total assets;
FE_t = foreign pretax income in year t, divided by average total assets;
CF_t = cash flow from operations in year t, taken from the cash flow statement;
REV_t = net revenue in year t.
ΔREV_t = change in revenue in year t, $REV_t - REV_{t-1}$;
$GPPE_t$ = gross property, plant, and equipment, divided by average total assets;

I employed five proxies of *VAR* for fiscal-year gains and losses. Three are financial reporting (book) measures and two are stock market returns as in Basu (1997):

	Economic Gain/Loss	Loss proxy DVAR*VAR	
Book-based measures	Level of cash flows	CF*DCF	CF_t= cash flow from operations in year t DCF_t = dummy variable = 1 iff $CF_t < 0$
	Change in cash flow	ΔCF *DΔCF	$\Delta CF_t = CF_t - CF_{t-1}$ $D\Delta CF_t$ = dummy variable = 1 iff $\Delta CF_t < 0$
	Industry adjusted cash flows	*Ind_CF * DInd_CF*	$Ind_CF_t = CF_t$ – Median of CF_t Median of CF = median CF_t in a three-digit SIC industry $DInd_CF_t$ = dummy variable = 1 iff $Ind_CF_t < 0$
Market-based Measures	Return	DRET * RET	RET_t = stock return from 9 months before fiscal year-end to the three months after fiscal year-end t $DRET_t$ = dummy variable = 1 iff RET_t <0
	Abnormal Return	DABNRET* ABNRET	$ABNRET_t = RET_t - MKTRET_t$ $MKTRET_t$ = CRSP equally weighted market return from 9 months before fiscal year-end to the three months after fiscal year-end t

Consistent with the previous data construction to make the coefficient comparison possible in different equations, the variables of domestic and foreign earnings are accumulated in one column as a new variable name but the independent variables are accumulated separately from

domestic and foreign earnings by putting zero value into all the other earnings variables. The new research models are developed as follows:

DD model:

$$DE_t \text{ or } FE_t = \alpha_0 + \beta_1 D_CF_{t-1} + \beta_2 D_CF_t + \beta_3 D_CF_{t+1} + \beta_4 D_VAR_t + \beta_5 D_DVAR_t + \boldsymbol{\beta_6} D_DVAR_t * VAR_t + \gamma_0 + \gamma_1 F_CF_{t-1} + \gamma_2 F_CF_t + \gamma_3 F_CF_{t+1} + \gamma_4 F_VAR_t + \gamma_5 F_DVAR_t + \boldsymbol{\gamma_6} F_DVAR_t * VAR_t + \sum YearDummy + \varepsilon_t \quad \ldots(7)$$

Jones model:

$$DE_t \text{ or } FE_t = \alpha_0 + \beta_1 D_\Delta REV_t + \beta_2 D_GPPE_t + \beta_3 D_VAR_t + \beta_4 D_DVAR_t + \boldsymbol{\beta_5} D_DVAR_t * VAR_t + \gamma_0 + \gamma_1 F_\Delta REV_t + \gamma_2 F_GPPE_t + \gamma_3 F_VAR_t + \gamma_4 F_DVAR_t + \boldsymbol{\gamma_5} F_DVAR_t * VAR_t + \sum YearDummy + \varepsilon_t \quad \ldots(8)$$

DD plus Jones model:

$$DE_t \text{ or } FE_t = \beta_0 + \beta_1 D_CF_{t-1} + \beta_2 D_CF_t + \beta_3 D_CF_{t+1} + \beta_4 D_\Delta REV_t + \beta_5 D_GPPE_t + \beta_6 D_VAR_t + \beta_7 D_DVAR_t + \boldsymbol{\beta_8} D_DVAR_t * VAR_t + \gamma_0 + \gamma_1 F_CF_{t-1} + \gamma_2 F_CF_t + \gamma_3 F_CF_{t+1} + \gamma_4 F_\Delta REV_t + \gamma_5 F_GPPE_t + \gamma_6 F_VAR_t + \gamma_7 F_DVAR_t + \boldsymbol{\gamma_8} F_DVAR_t * VAR_t + \sum YearDummy + \varepsilon_t \quad \ldots(9)$$

The interaction variables *D_DVAR*VAR* and *F_DVAR*VAR* in each model capture the incremental timeliness of loss recognition in domestic and foreign earnings, respectively. Since a majority of the sample firms are represented multiple times in the sample and there may be cross-sectional correlations among firms during a given time period, ordinary least square (OLS) estimates suffer from lack of independence of the observations. To address this problem (time effect), I ran yearly regression and obtain average parameter estimates following Fama-Macbeth (1973) approach[3]. In addition, I clustered the data by firm and estimate the cluster-adjusted standard errors to account for dependence across years for a given firm (firm effect). To prevent undue influences by outliers, I deleted the most extreme 1% of the cases at either end of the distribution each year. These empirical procedures are also applied to all regression reported in the rest of this paper.

EMPIRICAL RESULTS

Results on the Basu (1997)'s Timeliness model

Table 1 presents the descriptive statistics for variables employed in Basu's conservatism models explained in Section III. Mean domestic EPS is less than mean foreign EPS but median domestic EPS is greater than median foreign EPS, suggesting that domestic EPS is negatively skewed. As expected, the standard deviation (volatility) of domestic EPS is much greater than that of foreign EPS. The mean (median) change in domestic and foreign earnings (divided by total assets) is 0.007 (0.007) and 0.004 (0.001), respectively, implying that change in domestic earnings (*ΔDE*) is higher than foreign earnings change variable (*ΔFE*). Consistent with the level

[3] Petersen (2009) argue that in the presence of firm effect Fama-MacBeth standard errors are biased. However, since the Fama-MacBeth procedure is designed to address a time effect, the Fama-MacBeth standard errors are unbiased.

analysis, the volatility of domestic earnings change is greater than that of foreign earnings change.

Table 1 Descriptive statistics

Variable	Mean	Median	STD	Min	Q1	Q3	Max
$DEPS_t$	0.008	0.040	0.196	-7.127	-0.013	0.088	0.534
$FEPS_t$	0.021	0.012	0.054	-0.656	0.000	0.036	0.619
ΔDE_t	0.007	0.007	0.090	-0.551	-0.026	0.038	1.243
ΔFE_t	0.004	0.001	0.027	-0.227	-0.005	0.012	0.213
RET_t	0.133	0.065	0.546	-0.958	-0.191	0.346	7.987
$ABRET_t$	-0.019	-0.069	0.501	-1.282	-0.317	0.191	7.442

Variable descriptions

DEPS (FEPS) represents the domestic (foreign) pretax income divided by number of shares for firm i in fiscal year t, deflated by the stock price at the beginning of fiscal year t; *RET* represents the stock return on firm i from 9 months before fiscal year-end to the three months after fiscal year-end t; *ABRET* represents the stock return from 9 months before fiscal year-end to the three months after fiscal year-end t, less the corresponding CRSP equal weighted market return; ΔDE_t represents change in domestic pretax income from year t to year t-1, divided by total assets at year t-1; ΔFE_t represents change in foreign pretax income from year t to year t-1, divided by total assets at year t-1; $D\Delta DE_t$ represents a zero/one indicator variable set equal to 1 if ΔDE_t is less than 0; $D\Delta FE_t$ represents a zero/one indicator variable set equal to 1 if ΔFE_t is less than 0.

Table 2 presents the results of the conservatism of domestic and foreign earnings using Basu's timeliness model, which is consistent with Hwang and Kim (2022). I employed not only the Fama-Macbeth (1973) regression to control for cross-sectional dependence but also the robust regression using clustered standard error to control for time-series dependence as mentioned in Section III. The first three rows in Table 2 fall under the domestic earnings as the dependent variables and the next three rows fall under the foreign earnings. The interaction terms of each domestic (β_3) and foreign earnings (γ_3) capture the incremental timeliness of bad news recognition over good news recognition in domestic and foreign earnings. According to the Fama-Macbeth regression results, the domestic (β_3) and foreign (γ_3) slope coefficients in the first two columns using return (and abnormal return) as economic loss proxies are significantly positive 0.306 (0.251) and 0.040 (0.028), respectively. This suggests that both domestic and foreign earnings reflect bad news more quickly than good news and more importantly, the incremental speed of bad news recognition in domestic earnings is significantly greater than that of foreign earnings (0.306-0.040). In addition, the results of clustered standard error regressions in the next two columns are consistent with the results of Fama-MacBeth. The domestic (β_3) and foreign (γ_3) slope coefficients in the next two columns using return (abnormal return) as economic proxies are 0.300 (0.230) and 0.043 (0.034), respectively, which are significantly positive and the domestic coefficients (β_3) are significantly larger than foreign coefficients (γ_3). These results are consistent with Hwang and Kim (2022)'s result that 1) both domestic and foreign earnings are conservative and 2) domestic earnings are more conservative than foreign earnings.

Table 2: Conservatism of domestic and foreign earnings using Basu's timeliness model

	Fama-MacBeth		Clustered standard error	
Economic loss proxy	RET	ABRET	RET	ABRET
D_DRET_t	0.002	0.016	-0.008	-0.005
	(0.34)	(3.78)***	(-2.00)**	(-1.57)
D_RET_t	0.003	0.007	-0.023	-0.026
	(0.32)	(0.77)	(-4.71)***	(-4.47)***
$D_DRET*RET_t$	0.306	0.251	0.300	0.230
	(9.21)***	(10.66)***	(19.24)***	(20.29)***
F_DRET_t	0.000	0.001	0.006	-0.001
	(0.15)	(0.83)	(4.11)	(-0.90)
F_RET_t	0.007	0.008	-0.002	-0.002
	(3.25)***	(3.58)***	(-1.85)	(-1.69)
$F_DRET*RET_t$	0.040	0.028	0.043	0.034
	(9.38)***	(9.52)***	(10.83)***	(11.51)***
$(\beta_3 - \gamma_3)$	0.266	0.223	0.257	0.196
Difference test	(8.25)***	(9.67)***	(16.42)***	(17.41)***
Adj. R^2	0.145	0.143	0.090	0.082

This table reports the regression results using Fama-Macbeth regressions and clustered standard errors (by firm). The sample covers a period of 22 years, including total 48,245 observations of 3,357 firms. T-statistics are reported in parentheses: ***Significant at the 1% level, **significant at the 5% level, * significant at the 10% level. Refer to Section II for Variable descriptions.

Results on Roychowdhury and Watts (2007)'s model

Prior studies have questioned the validity of asymmetric timeliness as an empirical measure of conservatism, specifically arguing the negative correlation between the Basu measure and other conservatism measures, market-to-book ratio (MTB). This negative association has been evidence against the Basu coefficient capturing conservatism. To address this, Roychowdhury and Watts (2007) find that the negative association between Basu's asymmetrical timeliness measure and MTB becomes positive over longer horizons since Basu estimates are dependent on the composition of MTB at the beginning of the estimation period. Following Roychowdhury and Watts, I used longer horizons (two years, three years and up to four years) to measure Basu's coefficients.

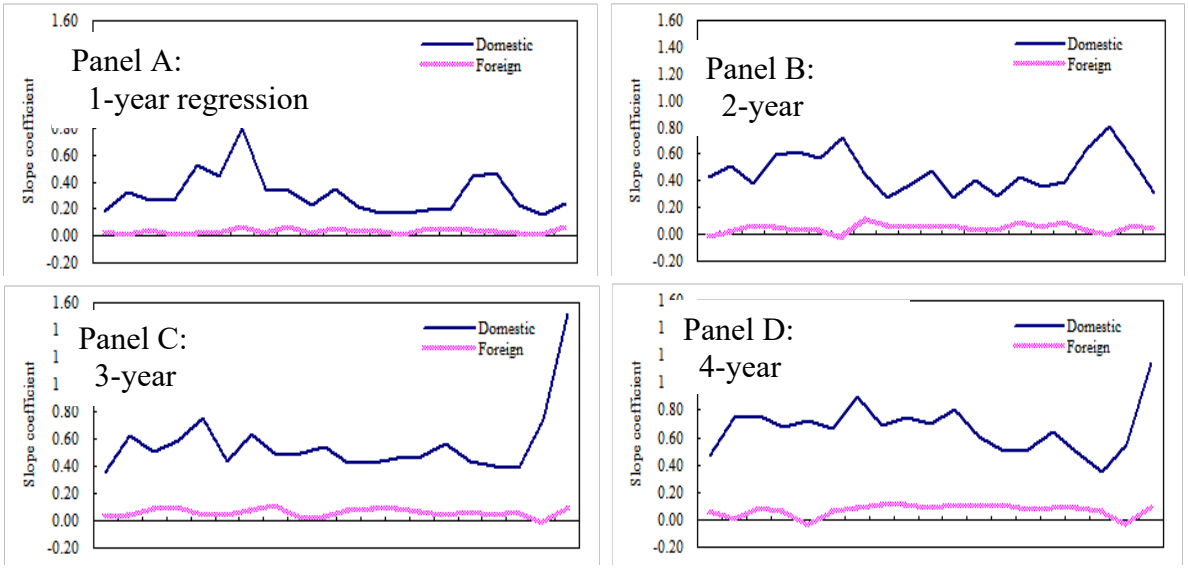


Figure 1: Time-series pattern of conservatism measures using Roychowdhury and Watts (2007)

Figure 1 graphs the yearly Basu's asymmetric timeliness of various horizons, one year through four years. The results using various horizons are consistent with the previous results of annual regression. More interestingly, the gap in conservatism between domestic and foreign earnings is increasing as the aggregation period increases. The empirical results following Roychowdhury and Watts (2007) also supported the evidence of Hwang and Kim (2022).

Results on the Basu (1997)'s persistence model

Table 3 reports the results on the persistence of negative earnings changes in both domestic and foreign earnings using Fama-Macbeth and clustered standard errors. The interaction variable of $D\Delta DE^{*}\Delta DE$ capturing the incremental persistence of negative earnings change in domestic earnings shows significantly negative in both columns, -0.530 (t-value: -9.49) and -0.541 (t value: -15.67), respectively. Similarly, the coefficients on $D\Delta FE^{*}\Delta FE$ are significantly negative in both columns. These results suggest that both negative earnings changes show less persistence and more mean-reversal than positive earnings changes, respectively.

Comparing β_3 and γ_3 representing the incremental persistence of positive over negative earnings changes in both domestic and foreign earnings, I found that the incremental mean-reversal of negative earnings changes in domestic earnings (β_3) are on average significantly larger than that in foreign earnings (γ_3) as a result of difference test. This suggests that the evidence that negative domestic earnings changes are less persistent than negative foreign earnings changes supports higher level of conservatism in domestic earnings than in foreign earnings.

Table 3: Conservatism of domestic and foreign earnings using Basu's persistence model

Variables	Fama-MacBeth	Clustered standard errors
ΔDE_t	-0.005	0.039
	(-0.18)	(1.82)*
$D\Delta DE_t$	-0.011	-0.009
	(-5.85)***	(-4.63)***
$D\Delta DE_t * \Delta DE_t$	-0.530	-0.541
	(-9.49)***	(-15.67)***
ΔFE_t	0.069	0.046
	(2.27)**	(2.23)**
$D\Delta FE_t$	-0.001	-0.001
	(-1.34)	(-1.95)*
$D\Delta FE_t * \Delta FE_t$	-0.385	-0.423
	(-6.29)***	(-10.75)***
$(\beta_3 - \gamma_3)$	-0.145	-0.118
Difference t-test	(-2.36)**	(1.22)
Adj.R^2	0.104	0.093
N	34,942	34,942
Years	21	21

This table reports the two regression results of Basu's persistence model using the methodology of Fama-MacBeth and clustered standard errors (by firm): T-statistics are reported in parentheses.

*****Significant at the 1% level, **significant at the 5% level, * significant at the 10% level. Refer to Section II for research models and variable descriptions.**

In sum, negative changes in domestic and foreign earnings are less persistent than positive changes in both earnings and the incremental persistence of negative changes in domestic earnings are less than that of foreign earnings, suggesting that domestic earnings are more conservative than foreign earnings.

Results on the Ball and Shivakumar (2006)'s accrual model

Table 4 presents the results of Fama-Macbeth (1973) regression of the adjusted accrual models incorporating asymmetrically timelier loss recognition in equation (7), (8) and (9). This analysis employs the three models (DD, Jones and DD plus Jones models) and the two market-based loss dummies using the return (RET) and the market-adjusted return (ABRET) as proxies for economic gain and loss, as in Basu (1997).

Table 4: Economic loss proxy: Market-based measures

Economic proxy	Section A: RET			Section B: ABRET		
Model	DD	Jones	DD-Jones	DD	Jones	DD-Jones
D_CF_{t-1}	0.197		0.227	0.199		0.228
	(13.25)***		(16.70)***	(12.75)***		(16.58)***
D_CF_{t}	0.431		0.427	0.434		0.431
	(19.37)***		(22.02)***	(19.74)***		(21.69)***
D_CF_{t+1}	0.146		0.138	0.144		0.137
	(12.76)***		(13.32)***	(12.07)***		(12.45)***
$D_\Delta REV_{t}$		0.147	0.117		0.146	0.116
		(22.47)***	(21.36)***		(23.11)***	(21.13)***
D_GPPE_{t}		0.000	-0.042		0.001	-0.041
		(0.10)	(-12.85)***		(0.34)	(-12.44)***
D_RET_{t}	0.002	-0.013	-0.008	0.003	-0.013	-0.006
	(0.96)	(-3.73)***	(-2.76)**	(1.12)	(-4.32)***	(-1.63)
D_DRET_{t}	0.009	0.008	0.008	0.010	0.012	0.011
	(3.02)***	(1.78)*	(2.27)**	(2.89)**	(3.60)***	(3.12)***
$D_DRET_{t}*RET_{t}$ (a)	0.122	0.230	0.131	0.091	0.186	0.098
	(11.22)***	(24.23)***	(12.41)***	(7.61)***	(10.47)***	(8.66)***
F_CF_{t-1}	0.041		0.047	0.042		0.047
	(11.31)***		(12.07)***	(11.27)***		(12.12)***
F_CF_{t}	0.081		0.079	0.080		0.079
	(8.49)***		(9.37)***	(8.37)***		(9.41)***
F_CF_{t+1}	0.035		0.032	0.035		0.031
	(5.47)***		(5.26)***	(5.42)***		(5.25)***
$F_\Delta REV_{t}$		0.026	0.022		0.026	0.022
		(9.58)***	(7.82)***		(9.68)***	(7.87)***
F_GPPE_{t}		0.002	-0.006		0.002	-0.006
		(2.55)**	(-6.12)***		(2.58)**	(-5.78)***
F_RET_{t}	0.000	0.002	-0.001	0.000	0.002	-0.001
	(0.25)	(0.52)	(-0.92)	(0.25)	(0.54)	(-0.86)
F_DRET_{t}	-0.001	-0.001	-0.001	0.000	0.001	0.000
	(-0.72)	(-0.63)	(-0.88)	(-0.32)	(0.40)	(-0.32)
$F_DRET_{t}*RET_{t}$ (b)	0.019	0.035	0.021	0.015	0.027	0.016
	(5.70) ***	(6.74)***	(6.00)***	(4.20)***	(5.78)***	(4.66)***
(a)-(b)	0.103	0.195	0.110	0.076	0.159	0.082
Difference t-test	(10.21)***	(21.52)***	(11.36)***	(7.18)***	(7.73)***	(8.07)***
Adj.R^2	0.443	0.271	0.504	0.443	0.267	0.503
N	33,558	40,602	33,486	33,558	40,602	33,486

This table presents the results of Fama-Macbeth (1973) regression of the adjusted accrual models incorporating asymmetrically timelier loss recognition in equation (7), (8) and (9) in Section II. Refer to section II for variable definitions. T-statistics are reported in parentheses: ***Significant at the 1% level, **significant at the 5% level, * significant at the 10% level.

The result shows that the incremental loss coefficients for domestic earnings *D_DRET*RET* in all 6 specifications are positive and significant, ranging from 0.091 to 0.230 while those for foreign earnings *F_DRET*RET* are positive and significant, ranging from 0.015 to 0.035, demonstrating that both domestic and foreign earnings are conservative. The main research question is to compare the level of the incremental loss recognition in domestic earnings and those in foreign earnings. All 6 specification results using the three models and two economic loss proxies show that the loss recognition in domestic earnings are significantly timelier than those in foreign earnings; for example, 0.122 vs. 0.019 in DD model, 0.230 vs. 0.035 in Jones model and 0.131 vs. 0.021 in DD plus Jones model when the return is used for economic loss proxy, and 0.091 vs. 0.015 in DD model, 0.186 vs. 0.027 in Jones model and 0.098 vs. 0.016 in DD plus Jones model when abnormal return is used for economic loss proxy.

Table 5 presents the results using the three different models (DD, Jones and DD plus Jones models) and the three book-based loss dummies (CF, ΔCF and IND_CF). The asymmetry implies positive coefficients on the cash flow variables interacted with the three loss dummies in both domestic and foreign earnings regressions. The incremental loss coefficients in domestic earnings are significantly different from zero across all specifications, ranging from 0.162 (t-value; 3.40) to 0.178 (t-value 4.65) in section A (cash flows are used for economic loss proxy), from 0.215 (t-value 8.01) to 0.634 (t-value 18.52) in section B (change in cash flows are used for economic loss proxy), and from 0.142 (t-value 5.38) to 0.257 (t-value 9.73) in section C (industry adjusted cash flows are used for economic loss proxy). All the coefficients are significant and positive, suggesting that domestic earnings are incorporating economic loss timelier than economic gain. For foreign earnings, the loss coefficients (*F_DCF*CF*) seem to have different patterns. For the section A, the coefficients are significantly negative, -0.068 (-5.70), -0.048(-3.96) and -0.063 (-5.48), suggesting that foreign earnings show aggressive accounting rather than conservative accounting. For the section B, the coefficients are all positive but not all significant. For the section C, the coefficients are all negative but not all significant. Making the comparison between the two loss dummies, *D_DCF*CF* and *F_DCF*CF*, the interaction variables for domestic earnings are significantly greater than those for foreign earnings. In sum, our findings show that domestic earnings are more conservative than foreign earnings when employing the adjusted accrual models. Furthermore, the adjusted R^2s across all the specifications are quite high ranging from 0.205 to 0.480, suggesting that the adjusted Ball and Shivakumar model have very high explanatory power compared with the methods employed in previous analyses. Thus, the empirical evidence strongly supports the evidence of Hwang and Kim (2022) that domestic earnings are more conservative than foreign earnings in all the accrual specifications.

ADDITIONAL ANALYSES

Special Items

Testing *special items* provides additional evidence supporting the previous empirical results of differential conservatism between domestic and foreign earnings. To be consistent with previous results, it is predictable that the effects of special items are more pronounced in domestic than in foreign earnings.

Table 6 presents the estimated slope coefficients on DRET*RET as results of Fama-MacBeth regressions, using two economic loss proxies, RET and ABRET. As shown in Panel A of Table 6, I divide the sample into the two groups of negative and non-negative values of the special items

and then re-divide them into the two subgroups, *High* and *Low*, respectively. The coefficients on *DRET***RET* using the *RET* proxy have 0.357 for *High* and 0.182 for *Low* in domestic earnings and 0.063 for *High* and 0.027 for *Low* in foreign earnings. The results are also consistent when using the *ABRET* proxy. As expected, *High Negative* shows higher conservatism than *Low Negative* in both domestic and foreign earnings. That is, recognition of more negative special items is more likely to be associated with the higher level of conservatism of domestic earnings than foreign earnings. The findings suggest that negative special items are primarily hitting the domestic earnings rather than foreign earnings. In other words, negative special items are directly incorporated into the domestic earnings component rather than into the foreign earnings component. In addition, the explanatory power of *High Negative* special items is much higher than that of *Low Negative*, implying that Basu (1997)'s conservatism model is fitted better when more negative special items are recognized.

Table 5: Conservatism of domestic and foreign earnings using Ball and Shivakumar (2006)'s accrual model Economic loss proxy: accounting-based measures

Economic proxy	Section A: CF			Section B: ΔCF			Section C: IND_CF		
Model	DD	Jones	DD-Jones	DD	Jones	DD-Jones	DD	Jones	DD-Jones
D_CF_{t-1}	0.200 (11.50)***		0.233 (13.77)***	0.298 (9.66)***		0.295 (10.48)***	0.200 (11.00)***		0.233 (13.21)***
D_CF_{t}	0.442 (25.33)***	0.634 (42.01)***	0.415 (22.41)***	0.360 (10.99)***	-0.168 (-5.58)***	0.389 (13.30)***	0.398 (16.42)**	0.489 (26.02)***	0.404 (16.28)***
D_CF_{t+1}	0.163 (12.13)***		0.149 (12.27)***	0.163 (12.24)***		0.152 (12.33)***	0.169 (13.96)***		0.154 (13.77)***
$D_\Delta REV_{t}$		0.120 (20.31)***	0.120 (21.88)***		0.153 (27.94)***	0.117 (20.73)***		0.123 (21.65)***	0.119 (21.64)***
D_GPPE_{t}		-0.028 (-10.98)***	-0.037 (-11.39)***		0.003 (0.90)	-0.038 (-11.69)***		-0.014 (-5.58)***	-0.036 (-11.43)***
D_DCF_{t}	0.002 (0.37)	0.002 (0.48)	-0.001 (-0.34)	-0.001 (-0.21)	-0.006 (-2.76)**	0.006 (1.86)*	0.001 (0.25)	-0.003 (-1.29)	0.004 (1.33)
$D_DCF_{t}*CF_{t}$ (a)	0.162 (3.40)**	0.178 (4.63)***	0.176 (3.65)***	0.244 (7.85)***	0.634 (18.52)***	0.215 (8.01)***	0.155 (5.10)***	0.257 (9.73)***	0.142 (5.38)***
F_CF_{t-1}	0.040 (11.18)***		0.047 (11.66)***	0.053 (2.76)**		0.054 (2.95)***	0.040 (11.59)***		0.047 (12.26)***
F_CF_{t}	0.107	0.149	0.101	0.072	-0.027	0.076	0.094	0.119	0.094

	(13.44)***	(24.68)***	(13.10)***	(4.33)***	(-2.14)**	(4.59)***	(15.05)***	(15.03)***	(14.18)***
F_CF_{t+1}	0.037 (7.52)***		0.034 (7.40)***	0.039 (6.73)***		0.036 (7.23)***	0.037 (7.41)***		0.034 (7.19)***
$F_\Delta REV_t$		0.021 (11.59)***	0.023 (9.29)***		0.030 (10.47)***	0.023 (8.60)***		0.022 (11.59)***	0.023 (9.27)***
F_GPPE_t		-0.005 (-6.36)***	-0.007 (-7.41)***		0.003 (2.32)**	-0.007 (-7.67)***		-0.002 (-2.62)***	-0.007 (-6.65)***
F_DCF_t	-0.002 (-1.30)	0.000 (-0.36)	-0.002 (-1.83)	-0.002 (-1.24)	-0.002 (-1.82)*	0.000 (-0.26)	-0.003 (-4.73)***	-0.003 (-3.63)***	-0.002 (-3.55)***
$F_DCF_t*CF_t$ (b)	-0.068 (-5.70)***	-0.048 (-3.96)***	-0.063 (-5.48)***	0.027 (1.09)	0.104 (4.91)***	0.025 (1.27)	-0.025 (-2.24)**	-0.002 (-0.21)	-0.025 (-2.45)**
(a) -(b) Difference t-test	0.229 (4.61)***	0.226 (5.73)***	0.239 (4.66)***	0.217 (5.98)***	0.531 (17.15)***	0.190 (5.34)***	0.180 (6.24)***	0.259 (10.67)***	0.167 (6.51)***
Adj.R^2	0.418	0.429	0.480	0.420	0.205	0.480	0.418	0.403	0.479
N	36,464	45,046	36,298	36,464	42,888	36,298	36,464	45,046	36,298

This table presents the results using the three different models (DD, Jones and DD plus Jones models) and the three book-based loss dummies (CF, ΔCF and IND_CF), using equation (7), (8) and (9). Refer to section II for research models and variable definitions. T-statistics are reported in parentheses. ***Significant at the 1% level, **significant at the 5% level, * significant at the 10% level

Regarding the *Non-negative* special item subsample, the *Zero* group represents firms reporting zero values of special items, approximately consisting of 44% of the total sample. The level of conservatism of the *Zero* special item subsample is not significantly different from that of the *Positive* special item subsample, suggesting that only negative special items are likely the explanation for the differential level of conservatism between domestic and foreign earnings. When only three main special items are considered for the analysis such as goodwill impairment, restructuring costs and write-down, the results strongly support the previous results of the total special items.

Why domestic earnings are more conservative than foreign earnings?

Up to now, I found significant empirical results using a variety of specification models for conservatism that domestic earnings are more conservative than foreign earnings. In this section, I explore which factors induce the differential levels of conservatism between domestic and foreign earnings. Watts (2003a) presents the four main factors affecting conservatism

including debt contract efficiency, litigation, tax and regulation. In addition, LaFond and Watts (2008) show information role of conservatism using PIN[4] measure as a proxy for information asymmetry. Also, I consider financial leverage as a proxy for debt-contract efficiency. Debtholders demand more conservative accounting and firms may supply conservative accounting to lower the cost of debts. In addition, I include litigation dichotomized by industry group (Francis et al. 1994), asset growth as a proxy for growing firm and market-to-book ratio for growth options (LaFond and Watts 2008). The regression model is as follows:

$$
\begin{aligned}
DEPS \text{ or } FEPS = {} & \text{Domestic} \left[\begin{array}{l} \beta_0 + \beta_1 DRET + \beta_2 RET + \beta_3 RET * DRET \\ + \beta_{41} LEV + \beta_{42} LEV * DRET + \beta_{43} LEV * RET + \beta_{44} DRET * RET * LEV \\ + \beta_{51} AGRW + \beta_{52} AGRW * DRET + \beta_{53} AGRW * RET + \beta_{54} DRET * RET * AGRW \\ + \beta_{61} MTB + \beta_{62} MTB * DRET + \beta_{63} MTB * RET + \beta_{64} DRET * RET * MTB \\ + \beta_{71} LIT + \beta_{72} LIT * DRET + \beta_{73} LIT * RET + \beta_{74} DRET * RET * LIT \\ + \beta_{81} PIN + \beta_{82} PIN * DRET + \beta_{83} PIN * RET + \beta_{84} DRET * RET * PIN \end{array} \right] + \\
& \text{Foreign} \left[\begin{array}{l} \gamma_0 + \gamma_1 DRET + \gamma_2 RET + \gamma_3 RET * DRET \\ + \gamma_{41} LEV + \gamma_{42} LEV * DRET + \gamma_{43} LEV * RET + \gamma_{44} DRET * RET * LEV \\ + \gamma_{51} AGRW + \gamma_{52} AGRW * DRET + \gamma_{53} AGRW * RET + \gamma_{54} DRET * RET * AGRW \\ + \gamma_{61} MTB + \gamma_{62} MTB * DRET + \gamma_{63} MTB * RET + \gamma_{64} DRET * RET * MTB \\ + \gamma_{71} LIT + \gamma_{72} LIT * DRET + \gamma_{73} LIT * RET + \gamma_{74} DRET * RET * LIT \\ + \gamma_{81} PIN + \gamma_{82} PIN * DRET + \gamma_{83} PIN * RET + \gamma_{84} DRET * RET * PIN + \varepsilon_t \end{array} \right] \qquad \text{....(10)}
\end{aligned}
$$

The regression model above examines 1) whether domestic earnings are still more conservative than foreign earnings even after controlling for all the factors and 2) which factors primarily affect the differential levels of conservatism, including financial leverage, asset growth, market-to-book ratio, litigation risk, and PIN measure. Table 7 shows the regression results including only financial leverage (LEV), asset growth (AGRW) and MTB(market-to-book ratio) as additional regressors. First of all, the coefficients of *DRET*RET* in domestic earnings (0.342; t-value 5.13) and foreign earnings (0.031; t-value 2.90) support our previous findings even after controlling for other factors affecting conservatism. The interaction term of *LEV*DRET*RET* captures how financial leverage affects the levels of conservatism in both domestic and foreign earnings, and the coefficients show 0.114 (t=3.29) and 0.026 (t=2.82) in domestic and foreign earnings, respectively. This indicates that the financial leverage significantly increases conservatism and the leverage effects are much more pronounced in domestic than in foreign earnings, thus increasing the gap between both earnings.

[4] PIN is a function of the abnormal order flow. PIN score is the arrival rate of information-based orders divided by the arrival rate of all orders. Thus, higher PIN scores represent higher probabilities of information based trading, greater information asymmetries.

Table 6: Conservatism by the levels of special items

					RET			ABRET			
Variable			Mea	Medi	Domes	Foreig	Adj.	Domes	Foreig	Adj.	N
Special	Negati	High	-	-	0.357	0.063	0.2	0.290	0.038	0.2	9,50
					(18.92	(3.34*		(18.35	(2.39*		
		Low	-	-	0.182	0.027	0.0	0.129	0.024	0.0	9,50
					(13.15	(1.99*		(12.51	(2.32*		
	Non-	Zero	0.00	0.00	0.212	0.035	0.1	0.160	0.026	0.1	20,0
					(22.58	(3.71*		(22.54	(3.65*		
		Positi	0.06	0.00	0.234	0.054	0.1	0.173	0.033	0.1	6,80
					(12.42	(2.87*		(12.39	(2.38*		
Sum of Goodwill Impairmen + + Write-	Negati	High	-	-	0.463	0.051	0.1	0.363	0.031	0.1	2,97
					(12.03	(1.32)		(11.48	(0.99)		
		Low	-	-	0.250	0.012	0.0	0.144	0.016	0.0	2,97
					(10.95	(0.50)		(9.27**	(1.02)		
	Non-	Zero	0.00	0.00	0.221	0.046	0.0	0.160	0.037	0.0	13,3
					(20.86	(4.34*		(18.56	(4.26*		
		Positi	0.01	0.00	0.060	0.019	0.0	0.077	-0.009	0.0	506
					(0.99)	(0.31)		(1.63*)	(0.18)		

1. This table presents the results of the Fama-MacBeth regression using Basu (1997)'s model. The regression is performed on the subsamples based on the levels of Special items. Special items are first divided into the two groups of Negative and Non-negative and then into High and Low (Zero and Positive), respectively, within each group. The sum of goodwill impairment, restructuring charge and write-down are used to create four subsamples in the same way as Special items are.
2. *Variable definition*: Special items = special items pretax divided by net sales; Goodwill impairment = impairment of goodwill pretax divided by net sales; Restructuring Cost = restructuring costs pretax divided by net sales; Write-down =write-down pretax divided by net sales:

Table 7: Multiple regression including financial leverage, asset growth, and market-to-book ratios

	DEPS Para. Est.	t-valu		FEPS Para. Est.	t-valu		Dom - For Diff.	t-value
DRET	-0.003	-		0.015	3.20	***		
RET	-0.008	-		-0.001	-0.17			
DRET * RET	0.342	5.13	**	0.031	2.90	***		
LEV	-0.044	-	**	0.012	6.02			
LEV * RET	0.000	-		0.006	1.13			
LEV * DRET	0.025	1.36		0.002	0.47			
LEV * DRET * RET	0.114	3.29	**	0.026	2.82	***	0.08	2.27**
AGRW	0.098	8.86	**	0.014	4.38	***		
AGRW * RET	0.011	0.97		-0.002	-0.58			
AGRW * DRET	0.068	1.88	*	-0.002	-0.49			
AGRW * DRET * RET	-0.328	-	**	-0.027	-1.86	**	-	-4.35***
MTB	0.014	1.25		-0.008	-3.54	***		
MTB * RET	-0.012	-		-0.003	-0.84			
MTB * DRET	-0.073	-	**	-0.011	-2.5	**		
MTB * DRET * RET	-0.065	-		-0.001	-0.06		-	-0.60
ADJ. R^2	0.244							
N	48,048							
Years	22							

This table examines how financial leverage and asset growth affect the level of conservatism in domestic and foreign earnings, after controlling for size, market-to-book ratio, PIN, litigation costs. This is the result of the Fama-MacBeth (1973) regression using the following equation. Refer to Section II for variable definition. T-statistics are reported in parentheses. ***Significant at the 1% level, **significant at the 5% level, * significant at the 10% level.

Next, the inclusion of asset growth variable is to examine how the conservatism changes as the asset growth changes. Specifically, I investigated whether earnings incorporate the negative shocks to the company when asset growth is declining. As presented in Table 8, the coefficients of *AGRW*DRET*RET* are -0.328 (t=-4.77) and -0.027 (t=-1.86) in domestic and foreign earnings, respectively. This negative association suggests that the declining asset growth is likely to increase the level of conservatism in both domestic and foreign earnings and more importantly, the effect of asset growth is primarily reflected in domestic earnings rather than foreign earnings.

Table 8 shows the results of regression augmented by litigation costs and information asymmetry measure (PIN) using equation (10). This result suggests that financial leverage (LEV) is positively associated with conservatism, showing coefficients of 0.172 (t=1.85) and 0.014 (t=0.71) for domestic and foreign earnings, respectively. In addition, asset growth is negatively associated with conservatism with coefficients of -0.432 (t=-3.54) and -0.087 (t=-2.68) for domestic and foreign earnings, respectively. More importantly, the effects of both financial leverage and asset growth variables are more pronounced in domestic earnings than foreign earnings. PIN measures interacted with DRET*RET are 0.154 (t-value 1.98) and -0.042 (-2.00) for domestic and foreign earnings, respectively, suggesting that higher information asymmetry increases level of conservatism only in domestic earnings, and rather decreases in

foreign earnings. Therefore, information asymmetry explanation for the differential conservatism between domestic and foreign earnings is not valid in domestic versus foreign operation.

Table 8: Multiple regression including financial leverage, asset growth, market-to-book ratios, litigation, and PIN

	Domestic			Foreign			Do - For	
	Para. Est.	t-value		Para. Est.	t-value		Diff.	t-value
DRET	0.030	1.35		-0.006	-0.64			
RET	0.066	1.79	*	-0.009	-0.59			
DRET * RET	0.320	3.14	**	0.084	3.55	***		
LEV	-0.048	-5.69	**	0.010	2.76	**		
LEV * RET	-0.014	-1.01		0.001	0.14			
LEV * DRET	-0.012	-0.35		-0.006	-0.56			
LEV * DRET * RET	0.172	1.85	*	0.014	0.71		0.1	1.73
AGRW	0.067	7.51	**	0.007	1.92	*		
AGRW * RET	0.020	1.25		-0.012	-1.45			
AGRW * DRET	0.069	1.94	*	0.000	-0.05			
AGRW * DRET * RET	-0.432	-3.54	**	-0.087	-2.68	**	-	-
MTB	0.032	1.69		-0.020	-3.72	***		
MTB * RET	-0.042	-1.66		0.008	1.53			
MTB * DRET	-0.091	-2.12	**	0.016	1.47			
MTB * DRET * RET	-0.131	-1.83	*	-0.031	-1.22		-	-1.35
PIN	0.007	1.09	**	-0.018	-3.65	***		
PIN * RET	-0.010	-0.86		0.012	1.49			
PIN * DRET	-0.029	-1.74		0.034	2.57	**		
PIN * DRET * RET	0.154	1.98	*	-0.042	-2.00	**	0.1	2.25**
LITI	-0.015	-3.27	**	-0.002	-0.81			
LITI * RET	-0.020	-1.66		0.001	0.28			
LITI * DRET	-0.014	-0.97		-0.005	-0.72			
LITI * DRET * RET	-0.089	-1.36		0.020	1.04		0.1	-1.54
ADJ. R^2	0.307							
N	21,429							
Years	18							

This table examines how financial leverage and asset growth affect the levels of conservatism in domestic and foreign earnings, after controlling for size, market-to-book ratio, PIN, litigation costs. This is the result of the Fama-MacBeth (1973) regression using the following equation. T-statistics are reported in parentheses. ***Significant at the 1% level, **significant at the 5% level, * significant at the 10% level.

In sum, this analysis controlling for the factors affecting conservatism shows the consistent results with our main findings that domestic earnings are more conservative than foreign earnings. In addition, the higher level of conservatism in domestic earnings is likely induced by higher financial leverage, lower asset growth and higher information asymmetry.

CONCLUSION

This study tests earnings conservatism of domestic and foreign earnings disclosed under the geographic segment reporting. I found that domestic earnings are significantly more conservative than foreign earnings using a variety of specification models for conservatism available in prior research (Basu 1997; Ball and Shivakumar 2006; Roychowdhury and Watts 2007, etc.). More importantly, I found that higher financial leverage, firms' declining growth, and higher information asymmetry significantly induce the differential level of conservatism between both earnings.

This study takes additional step to show the differential levels of conservatism between domestic and foreign earnings. Nonetheless, I believe that there remains a fundamental question, as yet unresolved rigorously, about why domestic earnings are more conservative than foreign earnings. Hence, the factors affecting the levels of conservatism in domestic and foreign earnings need to be investigated more rigorously and then the question why domestic earnings are more conservative than foreign earnings should be more addressed.

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