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## **On the Role of Internationalization of Firm-Level Corporate Governance – The Case of Audit Committees**

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# On the role of internationalization of firm-level corporate governance – the case of audit committees

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**Abstract:** Motivated by agency theory and arguments from linguistic studies, we argue in this paper the internationalization of a firm's audit committee to be associated with weaker firm-level corporate governance. Based on 2,015 publicly traded European firms from 16 countries over 2000-2018, we find the presence of foreign directors on audit committees to have a significant negative impact on financial reporting quality (FRQ). The effect is found to be weaker in countries with strong investor protection. We find linguistic differences within audit committees an important explanation for the negative influence of foreign directors on FRQ. The results are robust to alternative FRQ measures and model specifications, including difference-in-differences and propensity score matching. While foreign directors on a corporate board may create value for the firm by boosting the advisory capacity of that board, recruiting a foreign director to that firm's audit committee may compromise the board's monitoring function and the firm's FRQ.

Keywords: Reporting Quality, Foreign Directors, Audit Committee, Investor Protection

JEL: F23, G34, K22, M16, M42

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# **On the role of internationalization of firm-level corporate governance**

## **– the case of audit committees**

### **INTRODUCTION**

Literature on board internationalization suggests that foreign directors (FDs) bring in specific knowledge, experience, and network ties that boost the advisory capability of corporate boards. The recruitment of FDs thus paves the way for firm internationalization (Maznevski, 1994; Oxelheim, Gregoric, Randøy, & Thomsen, 2013), better cross-border acquisitions (Masulis, Wang, & Xie, 2012), under the right conditions, increased firm value (Estélyi & Nisar, 2016; Miletkov, Poulsen, & Babajide Wintoki, 2017; Oxelheim & Randøy, 2003), and more CEO dismissals in underperforming firms (Oxelheim & Randøy, 2013). The presence of FDs on corporate boards is, however, also reported to be associated with lower board meeting attendance (Masulis et al., 2012), higher CEO compensation (Oxelheim & Randøy, 2005), and more room for earnings management (Hooghiemstra, Hermes, Oxelheim, & Randøy, 2019), indicating lower monitoring efficiency. Based on the apparent mixed impact of FDs on corporate boards, we see a knowledge gap yet to be filled. Therefore, we address how internationalization of an audit committee can add to the understanding of the mixed impact of board internationalization.

Our research question is motivated by the past research finding that top management commonly manipulates earnings in order to meet the financial market's earnings expectations (Bergstresser & Philippon, 2006). This is again driven by the fact that most top management teams in publicly traded firms have their compensation packages tied to a performance measure, be it the firm's stock market performance or accounting performance. The audit committee, as an internal corporate governance mechanism, plays an important role in curbing earnings management because the duty of the committee is to oversee financial reporting processes and ensure integrity in internal as well as external auditing (The European Parliament and the Council of the European Union, 2014). In line

with previous research - focusing on the relation between financial reporting quality (FRQ) and audit committee characteristics, including accounting and finance expertise, independence, and social capital – we subscribe to the idea that characteristics of audit committee members may be influential on reporting quality. In this study, we add to that strand of literature by analyzing the effect of an internationalized audit committee on reporting quality.

Our study is further motivated by the public demand for a more visible and effective role of the audit committee. For example, the European Union has issued two directives, with Article 39, §1, of the most recent one (Directive 2014/56/EU<sup>i</sup>) underlining the importance of the audit committee being composed of non-executives and independent directors appointed by the corporate board or shareholders. The Directive further requires the audit committee to be composed of at least one member with accounting or auditing competence. FDs are a major source of candidates for independent directorships. Firms recruit FDs not only to meet the regulatory requirements of having a major proportion of corporate boards composed of independent directors, but also to benefit from foreign institutional investments, foreign operations, and the recruitment of skilled FDs (see e.g., Chiu, Oxelheim, Wihlborg, & Zhang, 2016; Estélyi & Nisar, 2016; Miletkov et al., 2017).

We address our research question empirically by analyzing 2,015 non-financial firms from 16 European countries over the years 2000 to 2018. Our sample contains a total of 16,513 directors, including 2,870 FDs, 1,153 of whom were audit committee members during the sample period<sup>ii</sup>. We cover 12,771 firm-year observations, of which 3,294 (approximately 26 percent) contain a foreign audit committee member. As our dependent variable and proxy for FRQ, we use discretionary accrual measures developed by Jones (1991), Dechow and Dichev (2002), and Kothari, Leone, and Wasley (2005). In addition to these accrual measures, we also use a measure of conditional accounting conservatism (Basu, 1997) as a proxy for FRQ. We measure the presence of FDs on an audit committee as the relative number of FDs on that committee, and find – across our multiple measures of FRQ – a significant negative effect of the presence of foreign members of audit committees on

FRQ. To ensure that the results are mainly driven by the presence of FDs on the audit committee, we use propensity score matching (PSM) in which we compare firms whose audit committee is composed of FDs and locals with those whose audit committee is entirely made up of local directors. We match firms based on several variables, including firm-level governance and performance measures. The PSM results show that firms with foreign members of audit committees have lower FRQ than firms without foreign members of audit committees. We find linguistic differences within audit committees an important explanation for the negative influence of FDs on FRQ.

Measuring the impact of FDs provides several methodological challenges. Our starting premise is that the recruitment of FDs to the audit committee is endogenous because firms (by means of the shareholders' meeting) decide which individuals are appointed to their audit committee. Firms with low FRQ may prefer to recruit FDs to their audit committee. To address the reverse causality and endogeneity concerns, we use a difference-in-differences (DID) estimator. In the DID analysis, our treatment group consists of firms that recruit an FD to their audit committee for the first time during the sample period, while the control group consists of firms that replace their only foreign audit committee member. The results from the DID estimator show that the treatment group experiences lower FRQ after appointing a FD to their audit committee.

As a first contribution to the literature, our study adds to the growing literature on boards' internationalization and their internal and external communication processes (see e.g., Oxelheim, Gregorič, Randøy, & Thomsen, 2013), by addressing the role of foreign members of the audit committee. As a second contribution, our study adds to the literature on audit committee characteristics. Our findings support Klein (2002) by suggesting the internationalization of audit committees to be related to reporting quality as further evidence of the role of committee characteristics.

The rest of the paper is outlined as follows. In the next section, we discuss theory and formulate hypotheses. Thereafter, we present our research design and our sample. Then follows a section in which we present our results. The concluding section summarizes our findings.

## **BACKGROUND LITERATURE AND HYPOTHESES**

The literature on how corporate decisions and performance are shaped by the monitoring and advisory functions of corporate boards and their committees has attracted a long-standing scholarly interest (e.g., Brickley & Zimmerman, 2010; Hillier, Pindado, De Queiroz, & La Torre, 2011; Leksell & Lindgren, 1982; Miletkov et al., 2017). The monitoring duties of corporate directors include overseeing the financial reporting process, for which the audit committee is primarily accountable. Directive 2014/56/EU of the European Parliament and of the Council points out the importance of the audit committee's oversight role: "Audit committees, or bodies performing an equivalent function within the audited public-interest entity, have a decisive role to play in contributing to high-quality statutory audit" (The European Parliament and the Council of the European Union, 2014).<sup>iii</sup>

Considering the vital role of an audit committee in overseeing the financial reporting process, several studies have examined the relationship between audit committee characteristics and FRQ. These studies use FRQ measures, including accruals quality (e.g., Campbell, Hansen, Simon, & Smith, 2015; Dhaliwal, Naiker, & Navissi, 2010; Klein, 2002; Krishnan, Wen, & Zhao, 2011; Kusnadi, Leong, Suwardy, & Wang, 2016), going-concern reports (e.g., Carcello & Neal, 2000; Pomeroy & Thornton, 2008), restatements (Agrawal & Chadha, 2005; Cohen, Hoitash, Krishnamoorthy, & Wright, 2014; Ettredge, Guo, & Li, 2018), and fraudulent financial reporting (e.g., Beasley, Carcello, Hermanson, & Lapides, 2000), to establish a relationship between FRQ and audit committee characteristics (i.e., independence, and accounting, financial, and legal expertise). The findings in these studies provide a general conclusion that audit committee independence and expertise positively affect financial reporting and auditing quality.

Firms hire international directors (FDs) to meet the public demand for having a major proportion of corporate boards composed of independent directors. At the meanwhile, a growing literature on board internationalization suggests that, in order for directors to effectively monitor managerial activities, knowledge of local language and culture is highly beneficial (e.g., Hooghiemstra et al., 2019; Kassis, 2010; Miletkov et al., 2017; Piekkari, Oxelheim, & Randøy, 2015; Tenzer, Pudelko, & Harzing, 2014). Thus, we argue that FDs, who may bring language and culture differences to the audit committee, can restrain the corporate board to provide effective monitoring. This argument is based on past research that highlights how effective monitoring requires board directors to collect information, process the information and make a recommendation, share the decision with other directors as a group, and seek the implementation of the group decision (Boivie, Bednar, Aguilera, & Andrus, 2016; Forbes & Milliken, 1999).

Linguistic issues that arise due to board internationalization could, however, challenge the tendency for employing FDs. Research on the internationalization of corporate boards provides examples of communication problems that even force some firms to change the corporate language to English in an effort to cope with these problems and to be able to recruit an FD without exposing them to foreign language differences in the boardroom (Piekkari et al., 2015). Changing the corporate language to English could, however, further weaken communication quality, as English is in most cases not the mother tongue of all the directors serving on the company's board. Oxelheim et al. (2013) provide evidence that external and internal communication issues may generate different recruiting behavior with regards to FDs. We argue that some of these communication problems – such as lower reporting quality – may originate from the internationalization of the audit committee.

The auditing literature suggests that the financial reporting process is extremely technical and the many parties involved in processing financial reports necessitate a continuous communication flow for effective information processing (Beasley, Carcello, Hermanson, & Neal, 2009). Beasley et al.

(2009) stress that, to share information and decide upon financial-reporting-related issues, the audit committee, on average, meets approximately 10 times per year, with five face-to-face and five telephone meetings. In extreme cases, the audit committee could have up to 30 face-to-face and 20 telephone meetings. On average, the duration of an audit committee's face-to-face meetings (telephone meetings) is 197.5 minutes (85.0 minutes). Beasley et al. (2009) further add that most audit committee meetings take place in the presence of internal control and corporate managers. The committee also meets the audit firm to review corporate financial statements, the audit process, and internal control. Communication as a means for information processing is understood to be an essential part of the audit committee members' common routine. Like any other audit committee member, FDs need to have an advanced understanding of the firm's business and its environment to operate effectively. FDs are thus required to continuously obtain relevant information, process it, and share it with other committee members. However, given that FDs bring linguistic differences to the committee, we expect weaker social integration of FDs into the committee, and communication challenges among the committee members themselves, and between the committee and the management, the internal control, and the audit firm. This could further restrain FDs from obtaining sufficient information, processing it, and sharing it with local audit committee members.

To summarize, we expect linguistic differences to produce barriers to smooth communication between parties involved in the financial reporting process, hindering information processing and thereby leading to lower FRQ. We thus formulate the following hypothesis on the role of internationalization:

**Hypothesis 1:** The presence of foreign directors on a firm's audit committee has a negative impact on that firm's financial reporting quality.

Based on previous findings on language-generated corporate communication problems (Oxelheim et al., 2013; Piekkari et al., 2015), we argue that a major explanation for this result could be that the presence of FDs on the audit committee introduces language differences into the committee. These



differences potentially complicate communication and pose barriers to information processing that, in turn, curb cooperation between all sides involved in the financial reporting process, leading to lower FRQ. On the other hand, language similarity within the audit committee could lead to more effective information processing, mitigating the negative effect of the presence of FDs on the audit committee.

**Hypothesis 2:** There is a negative relationship between the degree of language differences among directors of the audit committee and the financial reporting quality.

There is empirical evidence that country-level governance and rule of law – framed as investor protection – have an influential role in determining corporate FRQ (DeFond, Hung, & Trezevant, 2007; Leuz, Nanda, & Wysocki, 2003). Leuz et al. (2003) argue that managers of firms operating in countries with high investor protection are less likely to manipulate earnings because they have a limited ability to accumulate private benefits of control and, therefore, fewer incentives to conceal firm performance. They find less earnings management in countries with higher quality of investor protection institutions. Based on this, we formulate the following hypothesis on the role of investor protection:

**Hypothesis 3:** The level of investor protection of a country moderates the negative impact the presence of foreign directors on a firm's audit committee has on that firm's financial reporting quality.

## DATA AND METHODOLOGY

The empirical analysis is based on a sample of 2,015 non-financial firms from 16 countries over the period 2000-2018. We obtained financials, stock data, and board data from Compustat Global, the Centre for Research in Security Prices (CRSP), and BoardEx, respectively. Further, we obtained country-level governance and rule-of-law measures from the World Bank.

Table 1 displays our sample selection criteria. First, we exclude from the sample firms with missing data on International Securities Identification Number (ISIN) and report date. Second, given that BoardEx provides data on the director level, we remove all the duplicates once the intended variables are created, to convert the data to the firm level. Third, we remove all firms with missing financial information. Fourth, we take out firms without Standard Industry Classification (SIC) codes. We further remove utility firms (SIC codes 4900–4999) and financial firms (SIC codes 6000–6999) because these industries tend to be regulated. Finally, we exclude firms with missing information on audit committee and FRQ measures<sup>iv</sup>. Our sample size for the main test is 12,771 firm-year observations.

[Insert Table 1 about here]

### ***Dependent Variable – Proxies for Financial Reporting Quality***

We use multiple proxies for FRQ to cover all facets of it and thereby have our results lend themselves to generalization. We use Jones (1991) as our first proxy for FRQ. We follow Ecker, Francis, Olsson, & Schipper (2013), and use firm size instead of industry as the criterion for selecting estimation samples. We exclude size deciles with less than 20 observations each year. We estimate the following regression:

$$ACCR_{it} = \beta_0 + \beta_1 1/Assets_{t-1} + \beta_2 \Delta Revenue_{it} + \beta_3 PPE_{it} + \varepsilon_{it} \quad (1)$$

where ACCR is total accruals, obtained as the change in non-cash current assets minus the change in current non-interest-bearing liabilities, minus depreciation and amortization expenses; Assets is total assets;  $\Delta\text{Revenue}$  is the annual change in revenue scaled by lagged total assets; and PPE is property, plant, and equipment scaled by lagged total assets. We then multiply the absolute values of the residuals from this regression by -1 (denoting them by DISTA) and use them to proxy for FRQ. A higher DISTA signifies higher FRQ.

To obtain our second proxy for FRQ, we follow Dechow and Dichev (2002) and estimate the following regression:

$$ACCR_{it} = \beta_0 + \beta_1 CFO_{it-1} + \beta_2 CFO_{it} + \beta_3 CFO_{it+1} + \beta_4 \Delta\text{Revenue}_{it} + \beta_5 PPE_{it} + \varepsilon_{it} \quad (2)$$

where ACCR is total accruals defined as for Equation 1; CFO is cash flow from operations scaled by lagged total assets;  $\Delta\text{Revenue}$  is the annual change in revenue scaled by lagged total assets; PPE is property, plant, and equipment scaled by lagged total assets. Further, we again multiply the absolute values of the residuals from this regression by -1 (denoting them by DD) and use them to proxy for FRQ. A higher DD represents higher FRQ.

For the third measure of FRQ, we follow Kothari et al. (2005) and estimate the following regression:

$$ACCR_{it} = \beta_1 1/\text{Assets}_{t-1} + \beta_2 \Delta\text{Revenue}_{it} + \beta_3 PPE_{it} + \beta_4 \text{ROA}_{it} + \varepsilon_{it} \quad (3)$$

where ACCR is total accruals defined as for Equation 1; Assets is total assets; CFO is cash flow from operations scaled by lagged total assets;  $\Delta\text{Revenue}$  is the annual change in revenue scaled by lagged total assets; PPE is property, plant, and equipment scaled by lagged total assets; ROA is net income before extraordinary items scaled by lagged total assets. We then multiply the absolute values of the

residuals from this regression by -1 (denoting them by DISACC) and use them to proxy for FRQ. A higher DISACC indicates higher FRQ. As our fourth FRQ measure, we use a measure of conditional conservatism as presented by Basu (1997).

### ***Main Explanatory Variable***

Our main explanatory variable is the number of FDs<sup>v</sup> on the audit committee divided by the total number of directors on the company's board (FD\_Audit).<sup>vi</sup> In our robustness tests in a later section, we use two additional measures of FDs on the audit committee: an indicator variable (FD\_Audit\_Dummy) that equals one if a firm has at least one FD on its audit committee in the given year, zero otherwise, and the number of foreign audit committee members (FD\_Audit\_Number).

### ***Main Empirical Model***

Using the OLS estimator, we examine whether the presence of FDs on the audit committee affects FRQ and estimate the following model:

$$FRQ_{it+1} = \beta_0 + \beta_1 FD\_Audit_{it} + \beta_2 X_{it} + c_{it} + u_{it} + v_{it} + \varepsilon_{it} \quad (4)$$

where FRQ is one of the three measures of financial reporting: DISTA – modified Jones (1991), DD – Dechow and Dichev (2002), and DISACC – Kothari et al. (2005); FD\_Audit is the number of foreign directors on the audit committee divided by the total number of directors on the company's board; the vector X is a set of control variables; c is a country dummy; u is an industry dummy; and v is a time dummy.

Further, we use Basu (1997)'s measure of conditional conservatism as a proxy for FRQ to examine whether FD\_Audit affects it. We estimate the following OLS regression:

$$\begin{aligned}
NI_{it} = & \beta_0 + \beta_1 Ret_{it} + \beta_2 D_{it} + \beta_3 FD\_Audit_{it} + \beta_4 Ret_{it} \times D_{it} \\
& + \beta_5 Ret_{it} \times FD\_Audit_{it} + \beta_6 D_{it} \times FD\_Audit_{it} \\
& + \beta_7 Ret_{it} \times D_{it} \times FD\_Audit_{it} + \beta_8 Z_{it} + c_{it} + u_{it} + v_{it} + \varepsilon_{it}
\end{aligned} \tag{5}$$

where NI is net income before extraordinary items scaled by the lagged total market value of equity; Ret is the annual buy and hold return beginning three months after the prior fiscal year end; D is an indicator that equals one if Ret is negative, zero otherwise; FD\_Audit is the number of FDs on the audit committee divided by the total number of directors on the company's board; the vector Z is a set of control variables (i.e., Size, Leverage, and MTB) and their interactions with D, Ret, and FD\_Audit; c is a country dummy; u is an industry dummy; and v is a time dummy.

In the regressions, we control for relevant firm-level performance and corporate governance variables identified as significant in explaining FRQ in previous research. We provide variable definitions in Appendix A.

## RESULTS

### *Descriptive Statistics and Univariate Analysis*

Table 2 presents the cross-sectional descriptive statistics for our final sample. The table shows that the mean (median) of FD\_Audit is 0.048 (0.000), meaning that the corporate boards of the sample firms are, on average, composed of 4.8 percent foreign audit committee members. Similarly, FD has a mean (median) of 0.115 (0.000), indicating that firms, on average, have 11.5 percent of their boards made up of FDs. The table further shows that firms, on average, have three audit committee members and 26 percent of firms have at least one female director on their audit committee.

[Insert Table 2 about here]

Table 3 displays the correlation matrix. As expected, the FRQ measures are positively correlated with each other. FD\_Audit is negatively correlated with all three measures of FRQ (DISTA, DD, and DISACC). The negative correlation between FD\_Audit and the FRQ measures supports our argument that FD\_Audit is negatively associated with FRQ. FD is also negatively correlated with some of the FRQ measures, though the correlation coefficients of FD are much smaller than those of FD\_Audit. The table also shows that FDs serve on gender-diversified audit committees of large firms. No multicollinearity issues are present as we obtain variance inflation factors (VIFs) that are all below four, meaning that the standard errors are not being inflated by a factor of two or more.

[Insert Table 3 about here]

#### ***Multivariate Analysis of Foreign Audit Committee Members and Financial Reporting Quality***

In columns 1 to 3 of Table 4, the coefficients of FD\_Audit from the OLS regressions are -0.026, -0.030, -0.025, significant at the 1.1%, 0.1%, and 0.2% level, respectively.. The results support Hypothesis 1 irrespective of how FRQ is measured (DISTA – Jones (1991), DD – Dechow & Dichev (2002), or DISACC – Kothari et al. (2005)).

To ensure that the results are mainly driven by FD\_Audit, we employ a PSM procedure. We create a closely matched sample and check whether firms with and without foreign audit committee members differ from one another in terms of FRQ. We match firms based on all the control variables in Table 4. The PSM results in columns 4 to 6 of Table 4 suggest that firms with FD\_Audit, on average, have lower FRQ than their counterparts without FD\_Audit, confirming the results from the OLS regressions. In an analysis<sup>vii</sup> not reported here, we find that the use of Abadie and Imbens (2006)'s nearest-neighbor matching or bias-corrected estimators for average treatment effects also support the conclusions reached using PSM.

[Insert Table 4 about here]

### *Endogeneity concerns*

Given that the hiring process of FDs is endogenous, firms with low FRQ may prefer to recruit FDs to their audit committee. In that case, `FD_Audit` would be correlated with the error term, and thus the OLS estimator would be inconsistent. To address this endogeneity and reverse causality concerns, we use a DID estimator and instrumental variable (IV) regression. In our DID approach, the treatment group consists of firms that hire an FD to their audit committee for the first time during the sample time period and the control group consists of firms that replace their only foreign audit committee member. `First_FD_Audit` is a dummy that equals one when a firm hires its first foreign audit committee member during the sample time period, zero otherwise, and `Post` is a year dummy that equals one after a firm has hired its first foreign audit committee member, zero otherwise. The interaction term between `First_FD_Audit` and `Post` shows the potential effect on FRQ of appointing the first FD to the audit committee.

Table 5 reports the DID estimator results. The coefficients of `First_FD_Audit × Post` are negative and statistically significant across the three measures of FRQ. The results indicate that, all things being equal, recruiting an FD to the audit committee leads to lower FRQ in the subsequent periods.

[Insert Table 5 about here]

We also employ IV methods to reduce the endogeneity concerns. We instrument `FD_Audit` with MSCI All Countries World Index (ACWI) additions (and deletions). The MSCI ACWI is a global index designed to reflect the performance of large- and mid-cap stocks from 23 developed and 26 emerging markets. The index covers approximately 85 percent of the free float-adjusted market capitalization in each market (MSCI, 2020).

MSCI, applied as an instrument in our study, is an indicator variable that equals one if a firm is added to MSCI ACWI, zero otherwise. Column 1 of Table 6 reports the first-stage regression results of the

IV model. The coefficient of MSCI in the first stage is 0.020, significant at the 0.1% level. The results indicate that members of MSCI ACWI, on average, have 2 percent higher FD\_Audit than non-members. Both the economic and statistical significance of MSCI satisfy the IV assumption that the instrument should be economically and statistically meaningful. The exclusion restriction of IV requires the covariates of the error term and the instrument to be zero. In other words, the instrument must not be correlated with the dependent variable. Given that FRQ plays no direct role in the additions (and deletions) of firms to (and from) MSCI ACWI – firm size is rather the only selection criterion of the index - our instrument satisfies the exclusion restriction.

The coefficients of FD\_Audit in the IV models are -0.790, -0.571, -0.380, statistically significant at the 0.4%, 0.4%, and 1.4%, respectively. Consistent with the OLS and DID estimator results, the IV results also suggest that FD\_Audit negatively affects FRQ. The relatively larger coefficients of FD\_Audit in the IV models may indicate that its negative effect on FRQ is greater but the OLS estimator cannot appropriately capture it.

[Insert Table 6 about here]

### ***Robustness tests***

To ensure the results are robust to alternative measurements, we report in Panel A of Table 7 the use of two additional measures of FD\_Audit. More precisely, as our second measure of FD\_Audit, we use FD\_Audit\_Dummy (which is an indicator variable that equals one if a firm has at least one FD on its audit committee in the given year, zero otherwise). As our third measure of FD\_Audit, we use FD\_Audit\_Number (which is the number of FDs on the audit committee). The OLS regression results with the two alternative measures of FD\_Audit, across the different FRQ measures, are qualitatively similar to those presented in the earlier tables, implying that FD\_Audit negatively affects FRQ.



In Panel B of Table 7, we employ a subsample analysis to ensure our results are not driven by the inclusion or exclusion of a specific country. We divide our sample into non-UK and UK subsamples. The non-UK subsample contains all the European non-financial publicly listed firms, excluding those headquartered in the United Kingdom over the period 2000-2018, while the UK subsample only contains those firms headquartered in the United Kingdom over those years. The OLS results in Panel B of Table 7 show that *FD\_Audit* negatively affects *FRQ* in both subsamples, confirming that our results do not depend on the exclusion or inclusion of a specific country.

[Insert Table 7 about here]

### ***The presence of foreign directors on the audit committee and accounting conservatism***

Prior literature uses accounting conservatism as an alternative measure of *FRQ* (e.g., Givoly, Hayn, & Katz, 2010; Hope, Thomas, & Vyas, 2013). The argument is that conservative accounting potentially serves a governance role by alleviating agency problems related to delayed recognition of managers' poor decisions. Ball and Shivakumar (2005) provide evidence that managers of firms that pursue a highly conservative accounting approach are less likely to engage in loss-making projects. One possible explanation for this effect could be that managers are aware of the timely loss recognition that could potentially lead to managerial penalties relating to loss-making projects. A conservative accounting approach could also help creditors protect themselves more quickly from company default by imposing additional covenants. Knowing the extent to which a firm pursues conservative accounting, therefore, provides an alternative way to evaluate the demand that the firm's financial reports reflect governance and contracting information.

Consistent with the prior research, we use Basu (1997)'s conditional accounting conservatism as an alternative measure of *FRQ* (Table 8). The dependent variable in both column 1 and column 2 is net income before extraordinary items scaled by the lagged total market value of equity (*NI*). Column 1 contains the whole sample, whereas in column 2 we employ a stricter PSM procedure to create a more

closely matched sample composed of firms of a similar size, leverage, and market to book ratio. The coefficients of  $D \times Ret \times FD\_Audit$  in columns 1 and 2 are negative and statistically significant at the 2.1% and 4.4% level, respectively. The negative and statistically significant coefficients indicate that  $FD\_Audit$  leads to a lower degree of accounting conservatism. The results thus corroborate the conclusions reached using the accruals quality measures (i.e.,  $DISTA$ ,  $DD$ , and  $DISACC$ ).

[Insert Table 8 about here]

### *The role of linguistic differences*

All the results in our previous tabulated and untabulated tests confirm that  $FD\_Audit$  negatively affects  $FRQ$ . To test the role of language differences, we next create the indicator variable  $Similar\_Language$ , taking the value one if the foreign audit committee member speaks the same or similar language as that spoken in the firm's home country, zero otherwise. To empirically test this issue, we classify foreign audit committee members as speaking languages close to, respectively, English, French, German, and Scandinavian.  $Similar\_Language$ , for example, takes the value of one when a Swiss director sits on the audit committee of a German firm, assuming that the  $FD$  speaks German. The interaction term between  $Similar\_Language$  and  $FD\_Audit$  will indicate whether the negative effect of  $FD\_Audit$  on the  $FRQ$  measure is mitigated when the foreign audit committee member does not bring a language difference to the committee.

In Table 9, as expected, we see a positive and statistically significant association between  $FD\_Audit \times Similar\_Language$  and the different  $FRQ$  measures. The results show that the negative effect of the presence of foreign audit committee members on  $FRQ$  is mitigated when the foreign audit committee member speaks the same language as that spoken in the firm's home country. The result supports our hypothesis 2.

As a robustness test (unreported)<sup>viii</sup>, we use the standard deviation of the Ethnolinguistic Factorization index from Dražanova (2019) to measure linguistic differences at the audit committee and board level. Irrespective of how FRQ is measured, we find statistically significant evidence that linguistic differences in the audit committee lead to lower FRQ, while the same is not true for the corporate board. Hence, taken together, the results lend support to the argument that non-native-speaking audit committee members may create weaker communication and less coordination within the committee, leaving more room for executives to practice earnings management, and potentially gain higher compensation.

[Insert Table 9 about here]

#### ***On the influence of investor protection***

To test our Hypothesis 3, we follow previous research (e.g., Dou, Hope, & Thomas, 2013; Huang, Wu, Yu, & Zhang, 2020; Yu & Wahid, 2014), and use corporate governance and rule-of-law measures developed by Kaufmann, Kraay, and Mastruzzi (2004) and Kaufmann, Kraay, and Zoido (2005) as country-level investor protection proxies. In Table 10, we report the use of an interaction term between FD\_Audit and the investor protection variables to test whether investor protection mitigates the negative effect of FD\_Audit on FRQ. To proxy for FRQ, we use DISAVG, which is the average of DISTA – modified Jones (1992), DD – Dechow and Dichev (2002), and DISACC – Kothari et al. (2005). As expected, we observe statistically significant and positive coefficients on the interaction between FD\_Audit and the investor protection variables, indicating that the negative effect of FD\_Audit on FRQ is mitigated by investor protection instruments. Hence, we find support for Hypothesis 3.

[Insert Table 10 about here]

## CONCLUSION

In this paper, we examine whether the internationalization of a firm's audit committee affects the firm's financial reporting quality. We use multiple measures of financial reporting quality, including discretionary accruals quality and accounting conservatism. We provide evidence that the presence of foreign directors on a corporate audit committee leads to significantly lower financial reporting quality. Theoretically, we argue that foreign directors on audit committees are weaker monitors, and this produces higher agency costs – exhibited by more discretionary accruals.

The direction of causality between foreign directors on audit committees and financial reporting quality could be in question. Therefore, to mitigate the endogeneity issue, we employed difference-in-differences (DID) and instrumental variable (IV) regressions. Consistent with the OLS, the results from the DID and IV indicate that firms with foreign directors on the audit committee have relatively lower financial reporting quality.

In an unreported test<sup>ix</sup>, we find that the presence of foreign directors on committees other than the audit committee does not have any effect on financial reporting quality, confirming that the findings in this paper are primarily driven by the presence of foreign directors on audit committees. An explanation for this could be that committees in corporate boards are assigned with different duties, and the responsibilities of the audit committee for overseeing the financial reporting process could explain its close association with reporting quality.

To further explore the underlying explanation for the negative effect on reporting quality found for the presence of foreign directors on audit committees, we analyzed the role played by language differences within the audit committee. We argue that language differences create communication difficulties and a lack of social integration between foreign directors and other parties involved in overseeing the financial reporting process (i.e., management, internal control, and the audit firm), restraining the foreign directors from obtaining sufficient information, undertaking adequate

processing, and further sharing it with local audit committee members. These barriers will effectively hinder smooth communication between these parties, which will negatively affect financial reporting quality. The economic logic may mean that the management, being aware of the fact that the parties overseeing financial reporting activities lack proper communication and coordination ability due to linguistic differences, will exploit the opportunity to manipulate firm performance, which in turn means lower financial reporting quality.

We also argue that higher investor protection makes companies choose more qualified foreign directors for their audit committees, contributing to higher audit quality and thereby making internal oversight more efficient. Using country-level governance and rule of law as investor protection proxies, we find that high country-level investor protection mechanisms significantly mitigate the negative effect on financial reporting quality from having foreign directors on the audit committee.

Our study provides evidence that, while the presence of foreign directors on a corporate board may create value for a firm by boosting the advisory role of its corporate board (Oxelheim & Randøy, 2003), the firm may compromise its financial reporting quality by recruiting foreign directors to its audit committee. From a monitoring perspective, we conclude that the internationalization of the audit committee may lower the quality of firm-level corporate governance. On the policy-level it should be noted that our results stress that to the extent companies try to follow policy initiatives – like a recent EU-directive - encouraging recruitment of foreigner directors to the audit committee as a means to get more independent directors, this may come at a cost of lower average financial reporting standard.

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**Table 1**

Sample selection procedure.

All the European publicly listed firms	
All firm-year observations in BoardEx database	575,465
Less firms with missing data on ISIN and report date	73,224
Total number of observations from BoardEx	502,241
Less duplicates: the BoardEx data is at director-level	442,629
Less firms with missing financial information	26,588
Less financials, utilities, and missing industry	1,523
Less firms with missing data on FRQ measures	14,304
Total observations with board and financial information	17,197
Less firms with missing data on audit committee	4,426
Sample size for the main tests	12,771

**Table 2**

Sample statistics.

Variables are winsorized at the 1st and 99th percentile to adjust for potential outliers. All variables are defined in Appendix A.

Variables	Observations	Mean	Std. Dev.	P25	Median	P75
DISTA	12,297	-0.069	0.092	-0.082	-0.039	-0.017
DD	12,087	-0.050	0.066	-0.061	-0.028	-0.012
DISACC	12,087	-0.046	0.061	-0.055	-0.026	-0.011
DISAVG	11,900	-0.054	0.066	-0.064	-0.032	-0.017
FD_Audit	12,771	0.048	0.097	0.000	0.000	0.063
FD_Audit_Dummy	12,771	0.258	0.438	0.000	0.000	1.000
FD_Audit_Number	12,771	0.340	0.656	0.000	0.000	1.000
FD	12,771	0.115	0.176	0.000	0.000	0.167
Assets (in millions EUR)	12,767	1353.232	3868.645	35.795	158.116	751.743
Op_Cycle	11,821	307.284	7057.008	81.007	128.966	198.436
Size	12,767	5.124	2.156	3.578	5.063	6.622
Inventory	12,771	0.098	0.125	0.003	0.050	0.155
Loss	12,771	0.298	0.457	0.000	0.000	1.000
Growth	12,770	0.214	0.717	-0.037	0.053	0.199
Leverage	12,771	0.116	0.139	0.000	0.063	0.192
MTB	12,671	2.817	4.102	1.039	1.835	3.232
ROE	12,771	-0.018	0.564	-0.042	0.082	0.166
PPE	12,771	0.205	0.208	0.045	0.132	0.300
AC_Age	12,760	57.901	6.019	54.125	58.000	62.000
AC_Tenure	12,771	5.466	3.976	2.750	4.567	7.000
AC_Busyness	12,770	1.988	0.902	1.333	1.750	2.500
AC_Size	12,771	3.026	1.009	2.000	3.000	4.000
AC_Female	12,771	0.258	0.437	0.000	0.000	1.000
AC_Afin	12,771	0.352	0.478	0.000	0.000	1.000
Big4	12,771	0.622	0.485	0.000	1.000	1.000
ZScore	12,558	4.207	7.147	1.634	2.741	4.435
MSCI	12,771	0.087	0.283	0.000	0.000	0.000
RLE	12,235	1.692	0.156	1.627	1.705	1.764
RLR	12,235	93.420	2.722	92.488	93.301	94.554
MGOVR	12,235	3.296	0.293	3.193	3.266	3.388
MGOVE	12,235	3.608	0.390	3.456	3.607	3.801
GSCORE	12,235	4.827	0.478	4.645	4.822	5.002

**Table 3**

Pairwise correlation.

Variables are winsorized at the 1st and 99th percentile to adjust for potential outliers. All variables are defined in Appendix A.

Variables	[1]	[2]	[3]	[4]	[5]	[6]	[7]	[8]	[9]	[10]	[11]	[12]	[13]	[14]	[15]	[16]
[1] DISTA	1.00															
[2] DD	0.77	1.00														
[3] DISACC	0.75	0.88	1.00													
[4] FD_Audit	-0.02	-0.04	-0.05	1.00												
[5] FD	0.01	-0.01	-0.02	0.78	1.00											
[6] Size	0.30	0.30	0.26	0.01	0.10	1.00										
[7] Leverage	0.08	0.07	0.05	0.02	0.07	0.37	1.00									
[8] MTB	-0.06	-0.06	-0.04	0.03	0.04	-0.06	-0.04	1.00								
[9] AC_Age	0.08	0.04	0.05	-0.05	-0.03	0.05	-0.03	-0.05	1.00							
[10] AC_Tenure	0.12	0.08	0.09	-0.08	-0.09	0.02	-0.03	-0.08	0.37	1.00						
[11] AC_Busyness	0.01	0.03	0.01	0.03	0.04	0.17	0.06	0.04	0.00	-0.10	1.00					
[12] AC_Size	0.13	0.12	0.11	0.12	0.05	0.42	0.17	0.01	-0.04	-0.04	0.07	1.00				
[13] AC_Female	0.11	0.11	0.10	0.06	0.04	0.30	0.11	0.05	-0.17	-0.07	0.05	0.30	1.00			
[14] AC_Afin	0.04	0.03	0.03	0.04	0.04	0.06	-0.00	0.02	-0.07	-0.10	0.05	0.12	0.06	1.00		
[15] Big4	0.15	0.14	0.12	0.02	0.04	0.44	0.16	0.02	-0.01	-0.05	0.11	0.26	0.15	0.00	1.00	
[16] ZScore	-0.00	0.06	0.08	0.04	0.03	-0.15	-0.27	0.30	-0.03	-0.05	0.04	-0.05	-0.01	0.05	-0.06	1.00

**Table 4**

The presence of foreign directors on audit committee and financial reporting quality (FRQ).

This table reports the effect of FD\_Audit on FRQ. The sample consists of non-financial European publicly listed firms from the year 2000 to 2018. The dependent variable is one of a number of different FRQ measures. Columns 1, 2, and 3 include the OLS results for the FRQ measures on FD\_Audit. Columns 4, 5, and 6 present the propensity score matching (PSM) results in which we match firms with and without foreign directors on their audit committee based on all control variables. FD\_Audit is the number of foreign directors on the audit committee divided by the total number of directors on the company's board. All explanatory variables are lagged by one year. The standard errors are clustered at the firm level and p-values are reported in parentheses. All variables are defined in Appendix A.

	OLS			PSM		
	(1) DISTA	(2) DD	(3) DISACC	(4) DISTA	(5) DD	(6) DISACC
FD_Audit	-0.026 (0.011)	-0.030 (0.001)	-0.025 (0.002)	-0.033 (0.036)	-0.038 (0.005)	-0.026 (0.032)
Op_Cycle	0.000 (0.363)	0.000 (0.106)	0.000 (0.084)	0.000 (0.014)	0.000 (0.005)	0.000 (0.028)
Size	0.012 (0.000)	0.008 (0.000)	0.006 (0.000)	0.010 (0.000)	0.007 (0.000)	0.005 (0.000)
Inventory	-0.048 (0.000)	-0.049 (0.000)	-0.028 (0.000)	-0.043 (0.034)	-0.036 (0.040)	-0.020 (0.217)
Loss	-0.009 (0.000)	-0.010 (0.000)	-0.010 (0.000)	-0.004 (0.355)	-0.010 (0.007)	-0.010 (0.002)
Growth	-0.003 (0.038)	-0.002 (0.045)	-0.001 (0.184)	-0.005 (0.066)	-0.001 (0.495)	-0.003 (0.117)
Leverage	-0.012 (0.269)	-0.000 (0.983)	-0.001 (0.879)	-0.021 (0.273)	-0.005 (0.761)	-0.013 (0.361)
MTB	-0.001 (0.000)	-0.001 (0.003)	-0.000 (0.144)	-0.001 (0.142)	-0.000 (0.390)	-0.000 (0.992)
ROE	0.002 (0.367)	0.003 (0.136)	0.005 (0.016)	0.003 (0.590)	0.006 (0.176)	0.007 (0.064)
PPE	0.020 (0.000)	0.023 (0.000)	0.024 (0.000)	0.027 (0.007)	0.031 (0.000)	0.030 (0.000)
haAC_Age	0.000 (0.911)	-0.000 (0.667)	-0.000 (0.855)	0.000 (0.524)	0.000 (0.603)	0.000 (0.790)
AC_Tenure	0.001 (0.003)	0.000 (0.013)	0.000 (0.046)	-0.000 (0.752)	-0.000 (0.974)	-0.000 (0.858)
AC_Busyness	-0.002 (0.019)	-0.001 (0.116)	-0.001 (0.067)	-0.002 (0.229)	-0.000 (0.872)	-0.000 (0.955)
AC_Size	-0.001 (0.240)	-0.001 (0.268)	-0.000 (0.664)	-0.002 (0.335)	-0.001 (0.645)	-0.001 (0.485)
AC_Female	0.000 (0.809)	0.000 (0.861)	0.000 (0.840)	0.006 (0.068)	0.003 (0.306)	0.002 (0.461)
AC_Afin	-0.000 (0.795)	-0.001 (0.380)	-0.001 (0.673)	-0.002 (0.534)	-0.000 (0.909)	0.001 (0.728)
Big4	0.001 (0.577)	0.001 (0.537)	0.001 (0.624)	0.003 (0.553)	-0.000 (0.996)	0.000 (0.949)
Z-score	0.001 (0.000)	0.001 (0.001)	0.001 (0.000)	0.001 (0.023)	0.000 (0.056)	0.000 (0.021)
Intercept	-0.133 (0.000)	-0.072 (0.000)	-0.063 (0.000)	-0.098 (0.000)	-0.076 (0.000)	-0.060 (0.001)
Industry and year fixed effects	Y	Y	Y	Y	Y	Y
Country fixed effects	Y	Y	Y	Y	Y	Y
Adjusted R <sup>2</sup>	0.148	0.146	0.126	0.118	0.118	0.108
Observations	11,653	11,653	11,653	2,688	2,688	2,688

**Table 5**

Financial reporting quality post hiring of the first foreign audit committee member.

This table reports DID estimator results in which the treatment group is firms that appoint a foreign director to their audit committee and the control group is those that replace their only foreign audit committee member. The sample consists of non-financial European publicly listed firms from the year 2000 to 2018. The dependent variable is one of a number of different FRQ measures. First\_FD\_Audit is a dummy that equals one when a firm hires its first foreign audit committee member during the sample time period, zero otherwise; Post is a year dummy that equals one after a firm hires its first foreign audit committee member, zero otherwise. All explanatory variables are lagged by one year. The standard errors are clustered at the firm level and p-values are reported in parentheses. All variables are defined in Appendix A.

	(1) DISTA	(2) DD	(3) DISACC
First_FD_Audit	0.008 (0.223)	0.007 (0.173)	0.007 (0.116)
Post	0.012 (0.045)	0.009 (0.045)	0.010 (0.015)
First_FD_Audit × Post	-0.016 (0.022)	-0.011 (0.028)	-0.013 (0.007)
Op_Cycle	0.000 (0.002)	0.000 (0.055)	0.000 (0.001)
Size	0.010 (0.000)	0.008 (0.000)	0.006 (0.000)
Inventory	0.003 (0.913)	-0.001 (0.949)	0.015 (0.471)
Loss	-0.003 (0.490)	-0.005 (0.188)	-0.005 (0.095)
Growth	-0.001 (0.750)	0.001 (0.799)	0.003 (0.200)
Leverage	0.014 (0.448)	0.031 (0.001)	0.019 (0.064)
MTB	-0.001 (0.070)	-0.000 (0.201)	-0.000 (0.324)
ROE	0.002 (0.677)	0.006 (0.157)	0.007 (0.051)
PPE	0.004 (0.825)	0.004 (0.754)	0.012 (0.279)
AC_Age	-0.000 (0.466)	-0.000 (0.241)	-0.000 (0.119)
AC_Tenure	0.001 (0.034)	0.001 (0.001)	0.001 (0.009)
AC_Busyness	0.003 (0.194)	0.003 (0.092)	0.003 (0.063)
AC_Size	0.002 (0.228)	-0.001 (0.679)	0.000 (0.759)
AC_Female	-0.002 (0.618)	-0.002 (0.462)	-0.002 (0.343)
AC_Afin	-0.002 (0.555)	-0.001 (0.823)	-0.001 (0.684)
Big4	0.004 (0.342)	0.004 (0.216)	0.003 (0.370)
Z-score	0.001 (0.012)	0.001 (0.015)	0.001 (0.006)
Intercept	-0.166 (0.000)	-0.120 (0.000)	-0.112 (0.000)
Industry and year fixed effects	Y	Y	Y
Country fixed effects	Y	Y	Y
Adjusted $R^2$	0.164	0.185	0.163
Observations	2,426	2,426	2,426

**Table 6**

The presence of foreign directors on the audit committee and financial reporting quality: two-stage least squares.

This table contains the IV regression results for financial reporting quality (FRQ) on FD\_Audit. The sample consists of non-financial European publicly listed firms from the year 2000 to 2018. The first column shows the OLS first-stage regression results of FD\_Audit on MSCI addition (MSCI). Columns 2, 3, and 4 include the IV results for the FRQ measures on FD\_Audit, which is instrumented with MSCI. FD\_Audit is the number of foreign directors on the audit committee divided by the total number of directors on the company's board. MSCI is a dummy that takes the value one if a firm is included in MSCI ACWI, zero otherwise. All explanatory variables are lagged by one year. The standard errors are clustered at the firm level and p-values are reported in parentheses. All variables are defined in Appendix A.

	(OLS) FD_Audit	(IV) DISTA	(IV) DD	(IV) DISACC
FD_Audit		-0.790 (0.004)	-0.571 (0.004)	-0.380 (0.014)
Op_Cycle	-0.000 (0.936)	0.000 (0.394)	0.000 (0.180)	0.000 (0.126)
Size	-0.005 (0.004)	0.009 (0.000)	0.006 (0.000)	0.004 (0.000)
Inventory	-0.019 (0.272)	-0.063 (0.001)	-0.060 (0.000)	-0.035 (0.000)
Loss	0.006 (0.084)	-0.004 (0.296)	-0.007 (0.012)	-0.008 (0.000)
Growth	0.001 (0.538)	-0.003 (0.172)	-0.002 (0.228)	-0.001 (0.364)
Leverage	0.016 (0.218)	-0.000 (0.993)	0.008 (0.457)	0.004 (0.623)
MTB	0.000 (0.336)	-0.001 (0.124)	-0.000 (0.361)	-0.000 (0.766)
ROE	0.001 (0.678)	0.003 (0.340)	0.003 (0.142)	0.005 (0.015)
PPE	-0.002 (0.895)	0.018 (0.082)	0.021 (0.006)	0.023 (0.000)
AC_Age	-0.000 (0.535)	-0.000 (0.673)	-0.000 (0.473)	-0.000 (0.588)
AC_Tenure	-0.002 (0.000)	-0.001 (0.395)	-0.000 (0.360)	-0.000 (0.517)
AC_Busyness	0.003 (0.073)	0.000 (0.858)	0.001 (0.571)	0.000 (0.939)
AC_Size	0.016 (0.000)	0.012 (0.016)	0.008 (0.021)	0.006 (0.040)
AC_Female	0.001 (0.864)	0.001 (0.764)	0.001 (0.791)	0.001 (0.775)
AC_Afin	0.000 (0.897)	0.000 (0.998)	-0.001 (0.718)	-0.000 (0.870)
Big4	0.003 (0.451)	0.003 (0.464)	0.002 (0.430)	0.002 (0.470)
Z-score	-0.000 (0.668)	0.001 (0.028)	0.000 (0.052)	0.001 (0.004)
MSCI	0.020 (0.001)			
Intercept	0.104 (0.084)	-0.066 (0.233)	-0.024 (0.519)	-0.032 (0.242)
Industry and year fixed effects	Y	Y	Y	Y
Country fixed effects	Y	Y	Y	Y
Adjusted R <sup>2</sup>	0.169	.	.	.
Observations	11,653	11,653	11,653	11,653

**Table 7**

Foreign directors on the audit committee and financial reporting quality (FRQ): Alternative measure of foreign directors on the audit committee and subsample analysis.

This table reports the effect of FD\_Audit on FRQ. The sample consists of non-financial European publicly listed firms from the year 2000 to 2018. The dependent variable is one of a number of different FRQ measures. In Panel A, FD\_Audit\_Dummy is an indicator variable that equals one if a firm has at least one foreign director on its audit committee in the given year, zero otherwise; FD\_Audit\_Number is the number of foreign directors on the audit committee. In Panel B, we divide the full sample into two parts: the full sample excluding firms headquartered in the UK, and the UK-based firms. Controls refers to all the control variables in Table 4. All explanatory variables are lagged by one year. The standard errors are clustered at the firm level and p-values are reported in parentheses. All variables are defined in Appendix A.

Panel A: Alternative measures of FD_Audit						
Variables	(1) DISTA	(2) DD	(3) DISACC	(4) DISTA	(5) DD	(6) DISACC
FD_Audit_Dummy	-0.006 (0.002)	-0.007 (0.000)	-0.005 (0.000)			
FD_Audit_Number				-0.004 (0.003)	-0.004 (0.000)	-0.004 (0.001)
Intercept	-0.135 (0.000)	-0.074 (0.000)	-0.065 (0.000)	-0.135 (0.000)	-0.074 (0.000)	-0.065 (0.000)
Controls	Y	Y	Y	Y	Y	Y
Industry and year fixed effects	Y	Y	Y	Y	Y	Y
Country fixed effects	Y	Y	Y	Y	Y	Y
Adjusted $R^2$	0.148	0.147	0.126	0.148	0.146	0.126
Observations	11,653	11,653	11,653	11,653	11,653	11,653
Panel B: Subsample analysis						
Variables	(1) DISTA	(2) DD	(3) DISACC	(4) DISTA	(5) DD	(6) DISACC
FD_Audit	-0.026 (0.071)	-0.038 (0.008)	-0.032 (0.011)	-0.035 (0.012)	-0.035 (0.002)	-0.028 (0.006)
Intercept	-0.106 (0.000)	-0.084 (0.000)	-0.074 (0.000)	-0.151 (0.000)	-0.084 (0.000)	-0.078 (0.000)
Study sample	Non-UK	Non-UK	Non-UK	UK	UK	UK
Controls	Y	Y	Y	Y	Y	Y
Industry and year fixed effects	Y	Y	Y	Y	Y	Y
Country fixed effects	Y	Y	Y	N	N	N
Adjusted $R^2$	0.163	0.153	0.137	0.140	0.141	0.117
Observations	3,436	3,436	3,436	8,217	8,217	8,217

**Table 8**

Foreign directors on the audit committee and accounting conservatism: An alternative measure of FRQ.

This table reports the effect of FD\_Audit on accounting conservatism. The sample consists of non-financial European publicly listed firms from the year 2000 to 2018. The dependent variable is NI, measured as net income before extraordinary items divided by the lagged total market value of equity; Ret is the annual buy-and-hold stock return, beginning three months after the prior fiscal year end; D is an indicator equal to one if the return is negative, zero otherwise; MTB is the market value of equity divided by the book value of equity; Leverage is long-term debt divided by total assets; Size is the natural log of total assets. Column 1 is for the full sample; in column 2 we employ a stricter PSM procedure to create a more closely matched sample.

The standard errors are clustered at the firm level and p-values are reported in parentheses. All variables are defined in Appendix A.

Variables	Full sample		PSM	
	NI		NI	
	Coefficient	p-values	Coefficient	p-values
D	0.026	(0.412)	0.033	(0.491)
Ret	0.008	(0.150)	-0.006	(0.716)
D × Ret	0.265	(0.001)	0.305	(0.007)
FD_Audit	-0.045	(0.131)	-0.042	(0.231)
D × FD_Audit	-0.066	(0.190)	-0.038	(0.551)
Ret × FD_Audit	0.008	(0.233)	0.003	(0.733)
D × Ret × FD_Audit	-0.321	(0.021)	-0.382	(0.044)
MTB	0.010	(0.000)	0.011	(0.000)
D × MTB	-0.001	(0.644)	-0.001	(0.858)
Ret × MTB	-0.001	(0.001)	-0.000	(0.837)
D × Ret × MTB	-0.016	(0.046)	-0.009	(0.392)
Leverage	-0.004	(0.002)	-0.004	(0.035)
D × Leverage	-0.003	(0.212)	-0.000	(0.929)
Ret × Leverage	-0.001	(0.140)	0.000	(0.621)
D × Ret × Leverage	-0.009	(0.222)	-0.008	(0.370)
Size	0.016	(0.000)	0.015	(0.000)
D × Size	0.002	(0.521)	-0.002	(0.688)
Ret × Size	0.000	(0.691)	0.001	(0.511)
D × Ret × Size	0.012	(0.115)	0.004	(0.658)
Intercept	0.054	(0.274)	0.087	(0.267)
Industry and year fixed effects		Y		Y
Country fixed effects		Y		Y
Adjusted $R^2$		0.186		0.205
Observations		7,996		2,778



**Table 9**

Language similarity in a nationality-diversified audit committee and financial reporting quality (FRQ).

This table presents the OLS results of regressions examining whether language similarity of foreign directors with that of the firm's home country mitigates the potential negative effect of foreign audit committee members on FRQ. The sample consists of non-financial European publicly listed firms from the year 2000 to 2018. The dependent variable is one of three different FRQ measures. *Similar\_Language* is an indicator variable that equals one if the foreign audit committee member speaks the same language as that spoken in the firm's home country, zero otherwise. All explanatory variables are lagged by one year. The standard errors are clustered at the firm level and p-values are reported in parentheses. All variables are defined in Appendix A.

	(1) DISTA	(2) DD	(3) DISAC
FD_Audit	-0.037 (0.022)	-0.039 (0.003)	-0.027 (0.018)
Similar_Language	-0.025 (0.033)	-0.018 (0.073)	-0.007 (0.469)
FD_Audit × Similar_Language	0.300 (0.002)	0.213 (0.019)	0.099 (0.295)
Op_Cycle	0.000 (0.335)	0.000 (0.096)	0.000 (0.075)
Size	0.012 (0.000)	0.008 (0.000)	0.006 (0.000)
Inventory	-0.051 (0.000)	-0.051 (0.000)	-0.029 (0.000)
Loss	-0.009 (0.001)	-0.010 (0.000)	-0.010 (0.000)
Growth	-0.004 (0.032)	-0.003 (0.019)	-0.002 (0.110)
Leverage	-0.013 (0.260)	-0.002 (0.828)	-0.002 (0.823)
MTB	-0.001 (0.000)	-0.001 (0.002)	-0.000 (0.138)
ROE	0.002 (0.489)	0.003 (0.222)	0.004 (0.053)
PPE	0.020 (0.000)	0.023 (0.000)	0.024 (0.000)
AC_Age	0.000 (0.872)	-0.000 (0.646)	-0.000 (0.685)
AC_Tenure	0.001 (0.014)	0.000 (0.035)	0.000 (0.089)
AC_Busyness	-0.003 (0.013)	-0.001 (0.066)	-0.001 (0.037)
AC_Size	-0.001 (0.293)	-0.001 (0.214)	-0.000 (0.665)
AC_Female	-0.000 (0.846)	-0.001 (0.732)	-0.001 (0.670)
AC_Afin	-0.001 (0.634)	-0.001 (0.300)	-0.001 (0.584)
Big4	0.001 (0.508)	0.001 (0.455)	0.001 (0.518)
Z-score	0.001 (0.001)	0.001 (0.003)	0.001 (0.000)
Intercept	-0.138 (0.000)	-0.072 (0.000)	-0.062 (0.000)
Industry and year fixed effects	Y	Y	Y
Country fixed effects	Y	Y	Y
Adjusted $R^2$	0.144	0.140	0.116
Observations	10,930	10,930	10,930

**Table 10**

The effect of FD\_Audit on financial reporting quality (FRQ) in the presence of investor protection mechanisms.

This table presents the effect of FD\_Audit on FRQ in the presence of country-level investor protection mechanisms. The sample consists of non-financial European publicly listed firms from the year 2000 to 2018. The columns show the OLS results for DISAVG – an FRQ measure – on FD\_Audit and the interaction term between FD\_Audit and investor protection indicators developed by Kaufmann et al. (2004, 2005). DISAVG is the average of the FRQ measures: DISTA – modified Jones (1991), DD – Dechow and Dichev (2002), and DISACC – Kothari et al. (2005); FD\_Audit is the number of foreign directors on the audit committee divided by the total number of directors on the company's board; RLE is the estimated rule of law; RLR is the percentile rank rule of law; MGOVR is the percentile rank governance score; MGOVE is the estimated governance score, GOVS is the governance score. Controls refers to all the control variables in Table 4 and the additional variables FD\_Audit, RLE, RLR, MGOVR, MGOVE, and GOVS. All explanatory variables are lagged by one year. The standard errors are clustered at the firm level and p-values are reported in parentheses. All variables are defined in Appendix A.

	(1)	(2)	(3)	(4)	(5)
	DISAVG	DISAVG	DISAVG	DISAVG	DISAVG
FD_Audit × RLE	0.059 (0.042)				
FD_Audit × RLR		0.004 (0.083)			
FD_Audit × MGOVR			0.032 (0.070)		
FD_Audit × MGOVE				0.023 (0.068)	
FD_Audit × GOVS					0.019 (0.066)
Intercept	-0.065 (0.001)	0.007 (0.828)	-0.054 (0.006)	-0.058 (0.001)	-0.055 (0.003)
Controls	Y	Y	Y	Y	Y
Industry and year fixed effects	Y	Y	Y	Y	Y
Country fixed effects	Y	Y	Y	Y	Y
Adjusted $R^2$	0.164	0.164	0.164	0.164	0.164
Observations	11,205	11,205	11,205	11,205	11,205

**Appendix A: Variable Definitions**

FD	number of foreign directors divided by total number of directors on company's board
FD_Audit	number of foreign directors on audit committee divided by total number of directors on company's board
FD_Audit_Dummy	indicator variable that equals one if a firm has at least one foreign director on its audit committee in the given year, zero otherwise
FD_Audit_Number	number of foreign audit committee members
Op_Cycle	measured as $[\text{Inventory} / (\text{Cost of Sales} / 365)] + [\text{Receivables} / (\text{Sales} / 365)]$
Sales	total sales in the given year
Cost of sales	total cost of goods sold
Receivables	total receivables of a firm in the given year
Size	natural log of total assets
Inventory	total inventory divided by total assets
Loss	indicator variable that equals one if a firm reports a loss in terms of income before extraordinary items in the given year, zero otherwise
Growth	percentage change in total assets
Leverage	long-term debt divided by total assets
MTB	total market value of equity divided by total book value of equity
ROE	income before extraordinary items divided by shareholders' equity
PPE	property, plant, and equipment divided by total assets
AC_Age	mean age of all directors sitting on a firm's audit committee
AC_Tenure	average number of years directors sit on a firm's audit committee
AC_Size	number of directors sitting on a firm's audit committee in the given year
AC_Female	indicator variable that takes the value one if the audit committee of a firm has at least one female, zero otherwise
AC_Business	mean of total number of corporate boards the audit committee members sit on

AC_Afin	dummy that equals one if a firm has at least one audit committee member with accounting or auditing competence, zero otherwise
Big4	indicator that takes the value one if a firm is audited by one of the four largest accounting firms, i.e., Deloitte, KPMG, PWC, or Ernst & Young
First_FD_Audit	indicator variable that equals one when a firm hires its first foreign audit committee member during the sample time period, zero otherwise
Post	indicator variable that equals one after a firm has hired its first foreign audit committee member, zero otherwise.
MSCI	indicator variable that equals one if a firm is added to MSCI ACWI Index in the given year, zero otherwise
ROA	income before extraordinary items divided by total assets
Ret	annual buy-and-hold return, beginning three months after prior fiscal year end
D	indicator equal to one if Ret is negative, zero otherwise
Similar_Language	indicator variable that takes the value one if the foreign audit committee member speaks the same or a similar language as that spoken in the firm's home country, zero otherwise
EFindex	Ethnic Fractionalization index, reflects the likelihood that two people chosen at random within a given country will be from different ethnic groups. The EFindex ranges from zero, when there is no ethnic difference and all individuals belong to the same ethnic group, to one, where everyone is a member of his or her own ethnic group.
RLE	estimated rule of law
RLR	percentile rank rule of law
MGOVR	percentile rank governance score
MGOVE	estimated governance score
MGOVS	governance score

### Appendix B: Frequency Distribution by Country

This table reports the distribution of observations by country.

Country	Observations	Percent	Cumulative
Belgium	42	0.33	0.33
Denmark	42	0.33	0.66
Finland	47	0.37	1.03
France	1,733	13.57	14.60
Germany	659	5.16	19.76
Greece	18	0.14	19.90
Israel	5	0.04	19.94
Italy	6	0.05	19.98
Luxembourg	26	0.20	20.19
Netherlands	49	0.38	20.57
Norway	85	0.67	21.24
Ireland	31	0.24	21.48
Spain	17	0.13	21.61
Sweden	611	4.78	26.40
Switzerland	385	3.01	29.41
United Kingdom	9,015	70.59	100.00

## Endnotes

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- <sup>i</sup> It amends Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts.
- <sup>ii</sup> Foreign audit committee members primarily come from the United States, United Kingdom, Germany, France, the Netherlands, and Sweden, with 215, 137, 100, 67, 63, and 63 directors, respectively.
- <sup>iii</sup> Article 39, §3, of Directive 2014/56/EU summarizes the duty of an audit committee as being to inform the corporate board of the outcome of the statutory audit; oversee the financial reporting process; monitor the effectiveness of internal control; review and monitor the statutory audit of financial reports and auditors' independence; and recommend the auditor and be accountable for their selection process (The European Parliament and the Council of the European Union, 2014).
- <sup>iv</sup> No systematic pattern is found among the missing observations.
- <sup>v</sup> We define FDs as directors who are citizens of countries other than that of the firm's home-country.
- <sup>vi</sup> We also use a measure where we relate the number of FDs on the audit committee to the total number of members of that committee. Since the results are qualitatively similar to those where we use `FD_Audit`, we do not - for space reasons - report them here.
- <sup>vii</sup> Available upon request.
- <sup>viii</sup> Available upon request.
- <sup>ix</sup> Available upon request.