Financial Reporting Quality within Business Groups

Using a unique dataset containing 958.759 firm-year observations of firms affiliated with European Business Groups, we study the financial reporting quality (FRQ) within business groups (BGs) and relate it to institutional and organizational factors such as organizational distance, minority ownership, and the institutional level of investor protection. We find that the level of unsigned discretionary accruals is positively related to the cash flow rights of the largest owners and the geographic and organizational distance to headquarters, while it is negatively related to the presence of co-owners and the regulatory quality of the affiliated company country. Also, some affiliate-level characteristics (such as the company size, the institutional setting, or the debt levels) influence the level of unsigned discretionary accruals. Our results are in line with the notion that insiders, in an attempt to protect their private control benefits, have incentives to provide financial information of lower quality, and suggest governance frictions that can be severe and, as a result, actions that are suboptimal for the group can occur. Also, our findings are consistent with the prediction that strong protection (like having minority owners at subsidiary levels, or country-level investor protection) limits insiders´ ability to acquire private control benefits

1-   Introduction

Business groups (BGs) are ubiquitous around the world. They contribute to a large part of the economic prosperity in emerging economies (Carney, M., Van Esse, M., Estrin, S., & Shapiro, D, 2018), and they are also relevant in more developed economies (Enriques, L. & Volpin, P., 2007).

There are clear financial, control, and organizational advantages to organizing economic activity into business groups (Masulis, Pham & Zein 2011). BGs benefit from synergies (and trust) between the companies and can utilize resources efficiently (Altomonte, Ottaviano, Rungi & Sonno, 2021); subsidiaries have access to capital (Almeida, Kim & Kim 2015), cash flow, supply chains, human resources, and know-how that can easily be transferred within the group (Huneeus, Larrain, Larrain & Prem 2021). Besides, BGs can mitigate market risks (Faccio, Morck & Yavuz 2021) so that their capital allocation decisions are more economically efficient.

Albeit powerful elements for growth, due to their complex organizational structure (Altomonte, Ottaviano, Rungi, & Sonno, 2021) and the concentration of power typical of business groups (Dau, Morck & Yeung, 2021), they can facilitate self-dealing transactions, that are difficult to

detect by outsiders. Having these motivations in mind, Khanna & Yafeh (2007) present the entrenchment/exploitation hypothesis that sees BGs as opaque structures designed to extract surplus from shareholders, government, and workers to the benefit of their owners (Carney, Van Esse, Estrin, & Shapiro, 2018).

We argue that financial reporting quality (FRQ) is key in reducing this organizational and informational distance, as the role of financial reporting is to reduce the asymmetry of information between inside and outside users of financial information (Bushee, Goodman, & Sunder 2019). Thus, financial reporting quality (FRQ) can be viewed as a key instrument to mitigate conflicts of interest within business groups and facilitate the efficient allocation of resources.

This research aims to study FRQ within business groups and relate it to ownership, institutional, and organizational factors such as cash flow rights of largest owners, minority ownership, organizational distance and the institutional level of investor protection. In our study, we try to answer two separate research questions: (1) how does FRQ vary within BGs (2) Is FRQ contingent on corporate governance, market, and /or institutional factors?

To answer these questions, we expand the classical principal-agent models to include the most relevant conflict, between controlling and noncontrolling shareholders (Enriques & Volpin 2007). We use a "principal-principal" model as described in the literature (Dharwadkar, George & Brandes, 2000; Young, Peng, Bruton, & Yi, 2008) to provide a theoretical framework for our work. Ultimately, we aim to shed light on how the different users of financial information interact, and how financial reporting quality can reduce the asymmetry of information (and thus mitigate conflict of interests) between controlling and smaller owners, and between the owners and the rest of stakeholders.

Following Bushee, Goodman, & Sunder (2019), we use accrual quality as a measure of a firm's FRQ. In our study, we use the amount of unsigned discretionary accruals as a proxy for poor FRQ.

Four key empirical regularities are found in our research. First, we find that the ownership structure (both at the company and at the group level) is significantly related to the financial reporting quality. We find a positive and significant -albeit very close to zero- relation between the proportion of cash flow rights at the hands of the largest group owner and the magnitude of unsigned discretionary accruals. More importantly, we find that having at least one additional owner at the affiliate level is significantly related to improvements in the quality of financial information.

 Second, we find that FRQ is related to the relative position of the affiliate firm within the BG. We find that the companies with the highest levels of discretionary accruals are the subsidiaries at the bottom of the organizational structure. We also find that the geographic distance (in thousands

of km) to the company headquarters also increases the level of unsigned discretionary accruals. This result holds irrespective of the size of the BG, the country where the affiliate company is incorporated, and the ownership structure at the group and firm level.

Thirdly, we find that overall group characteristics, such as the amount of unsigned discretionary accruals at the headquarters, are significantly related to the affiliate financial reporting quality, suggesting that the culture of the group (or some group characteristics) can be more relevant than individual firm characteristics at the affiliate level.

Finally, some affiliate-level characteristics (such as the company size, the institutional setting, or the debt levels) also influence the level of financial reporting quality.

In general, our results are in line with the notion that insiders, in an attempt to protect their private control benefits, have incentives to provide financial information of lower quality. In this case, the conflict of interest, and the asymmetry of information appear between the largest owners (insiders) and smaller owners (outsiders) at the BG level. Also, our findings are consistent with the prediction that strong protection (like having minority owners at subsidiary levels, or country-level investor protection) limits insiders' ability to acquire private control benefits.

The remainder of the paper is structured as follows. In Section 2 we present the testable hypotheses. In Section 3 we present the data and the methodology. In Section 4 we present the empirical results and Section 5 concludes.

2- Hypotheses development

2.1. FRQ and the control of the largest owner (controlling power)

Disclosing financial information is costly for any organization (also for the subsidiaries within BGs, which are the object of our study). There are direct costs (the administrative costs of gathering and summarizing the information) and indirect costs (the informative advantage that this information gives to insiders) that increase with the quality of financial information. Disclosing financial information is therefore costly for the subsidiaries within BGs, but it allows the closure of the information gap between the company insiders (the largest owners that control the decision rights both at the apex of the BG and at the subsidiary level) 1 and the outside users of financial information

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[1] A major common feature of BGs -according to Dau et al.- is the presence of control-enhancing mechanisms, so that the controlling owners at the apex of the BG concentrate more on economic power than wealth alone. This excess of control rights means, from a practical viewpoint, that the controlling owner has a

(the rest of the owners, lenders, employers, general public, etc). The case in favor or against disclosure and reporting regulation is not ex-ante obvious and the relative magnitudes of various costs and benefits that arise from a mandate are largely an empirical matter (Leuz & Wysocki, 2016).

In the case of the BG, the insiders in a subsidiary are not only the managers within the subsidiary but also the ultimate owners at the BG level. The ultimate owner becomes an insider as they have control over the management of the company (Dau, Morck & Yeung, 2021; Schleifer, & Vishny, 1997; Laporta, Lopez de Silanes, & Shleifer, 1999). Because disclosing financial information is costly for the subsidiary, the ultimate owner has the economic incentives not to disclose financial information to outsiders, as long as this information is known to him via the BG´s internal control mechanisms (for economic justifications of disclosure and reporting regulation, see Seligman, 1983; Coffee 1984; Easterbrook and Fischel 1984; Mahoney 1995; Leuz and Wysocki 2008, Hart 2009, Zingales 2009; Bushman and Landsman 2010; Leuz 2010; Hermalin and Weisbach 2012). This is the case irrespective of whether the controlling owner's objective function is to maximize the benefits of the BG as a whole or to maximize its own personal (private) wealth.

As a result, the optimal equilibrium (from the controlling owner's viewpoint) is to have a disclosure threshold as low as possible (and the lowest possible level of FRQ). By contrast, an owner who has no control over the management will demand the highest possible level of accounting quality (as he/she is an external user of accounting information). Hence our first hypothesis:

H1.a We expect to find a negative relation between Financial Reporting Quality (FRQ) and the control of the ultimate owner over the subsidiary, measured by the proportion of cashflow rights of the ultimate owner over the subsidiary.

A large strand of the literature on BGs emphasizes the control motivations for the existence of BGs (Masulis, Pham & Zein, 2011; Laporta, Lopez de Silanes & Shleifer, 1999). This line of research aligns with the notion that the divergence between voting and cash flow rights encourages the expropriation of minority shareholders by a controlling owner (Dau, Morck, & Yeung, 2021; Johnson, LaPorta, Lopez-de-Silanes, & Shleifer, 2000; Bertrand, Mehta & Mullainathan, 2002; Baek, Kang, & Lee, 2006).

However, if that explanation is at the center of the creation of BGs, why would non-controlling investors hold stakes in subsidiaries of BGs? One plausible explanation is that BGs have financing advantages (He, Mao, Rui & Zha, 2013) and organizational choices (Masulis, Pham &

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strong decision power over the quality of the financial information disclosed at the subsidiary level. Thus, the controlling owner decides how much information is disclosed and when.

Zein, 2011) that compensate for the potential costs. Even when the potential benefits of belonging to a BG outweigh the chances of rent extracting, non-controlling rational investors could price such private control benefits and invest in group affiliates at a discount.

The quality of financial information helps thus to reduce the friction between insiders and outside stakeholders of the firms. He, Mao, Rui & Zha (2013) find that business groups in China help member firms overcome constraints in raising external capital and that the internal capital market within a business group is more likely to be an alternative financing channel among state-owned firms than among private firms.

Financial information impacts the investment decisions of non-controlling shareholders by reducing the information asymmetry between insiders and outsiders, mitigating the chances of extracting private rents by insiders. Thus, the need for external funding creates incentives for improved FRQ (Haw, Hu, Hwang & Wu 2004) at the subsidiary level.

H1.b We expect to find a positive relation between Financial Reporting Quality (FRQ) and the monitoring of the controlling owner at the subsidiary level, measured by the presence of controlling shareholders at the subsidiary level

2.2. FRQ and BG structure

The asymmetry of information within the BG is closely related to the organizational structure within the BG. Organizational distance from headquarters to subsidiaries implies lower control levels for the controlling owners at the headquarters (Belenzon, Hashai, & Patacconi, 2019). In this case, owners at the apex of the organization might demand higher FRQ to reduce the asymmetry of information between management at the subsidiary and decision-making at the HQ level, which would translate into a positive relationship between FRQ and organizational distance. On the other hand, this organizational distance might also imply asymmetry of information between the largest owners and the rest of the stakeholders, as the relative cost to gather information increases for the latter. The controlling owners that are far from subsidiaries might use this asymmetry of information to their advantage and disclose financial reports of lower quality to enjoy the private benefits of control, and a negative relation between FRQ and organizational distance would show. Thus, the direction of the relation between FRQ and the organizational distance will depend on which of the two mechanisms is stronger. We expect the second mechanism to be in place, as a major common feature of BGs (according to Dau et al.) is the presence of control-enhancing mechanisms.

H2. We expect a negative relation between FRQ and organizational distance within BGs.

3.   The data and empirical methodology

Company and financial data come from Orbis. We have merged Orbis data with data from World Bank estimates of countries' rule of law to characterize the institutional settings. From Orbis, we have collected detailed information on the ownership structure of every firm in the year 2020. From this initial effort, we have been able to identify and track ownership of 1.075.643 companies (listed and non-listed) that belonged to Business Groups headquartered in a set of twelve European countries. These countries are Austria, Belgium, Finland, France, Germany, Italy, Ireland, Luxembourg, Netherlands, Spain and the UK. For these listed and non-listed companies (the headquarters in Europe and all their subsidiaries worldwide) we compile financial data covering the years 2014-2021. In all, this initial panel data contains 3 191 643 observations. After having dropped companies within the financial and utilities sector, observations for which we do not have information to construct our measures of financial reporting quality, and companies that are headquartered in each of the BGs, we end up with a database containing 958.759 observations. The description of this sample is presented in Table 1.

<INSERT TABLE 1 HERE>

For these companies, we collect company information, ownership and financial data. Company and ownership information allows us to create and map the business group structures. Financial data is useful for creating measures of financial reporting quality and firm-level controls. In Table 2 we present a definition of the key variables used in the analysis

<INSERT TABLE 2 HERE>

First,we construct our measure of FRQ. Our measure of financial reporting quality is based on discretionary accruals. We use the modified Jones model developed by Kohtari, Leone and Wasley (2005) to characterize discretionary accruals. Discretionary accruals are calculated using Equation 1

$$\frac{WC\_ACC_{it}}{AT_{t-1}} = \alpha_0 + \beta_0 \frac{1}{AT_{t-1}} + \beta_1 \frac{(\Delta Sales - AR)_{it}}{AT_{t-1}} + \beta_2 \frac{PPE_{it}}{AT_{t-1}} + \beta_3 \frac{ROA_{it}}{AT_{t-1}} + \varepsilon_{it}$$

We use this model specification as the Jones (1991) and modified Jones model developed by Dechow, Sloan, and Sweeney (1995) are the most extensively used in the literature (Bushee, Goodman, & Sunder, 2019). The only difference between them is the inclusion of changes in accounts receivables in the modified Jones model. In addition, following Kothari, Leone, and Wasley (2005), we include a performance measure, i.e., return on assets, to control for the impact of firm performance on unexpected accruals. We require at least 10 observations in the same industry year. This modified Jones model is estimated cross-sectionally, using all firm-year observations in the same industry. We use the residuals of this equation as an expression of discretionary accruals, DA. Larger values of discretionary accruals (in absolute value) indicate poorer FRQ.

Second, for every company in our dataset we collect the following information. The variable Level refers to the hierarchical level at which the company is located within the BG. As in Belenzon, Hashai, & Patacconi (2019), Level measures the distance of a focal subsidiary from headquarters (measured by the number of intermediate subsidiaries separating the subsidiary from headquarters). Headquarters are located at level zero. Companies directly owned by the headquarters are located at level one. Companies at level two are directly owned by companies at level one. Consequently, companies at level three are owned directly by companies at level two, etc etc. In all, we have tracked up to 17 levels of ownership. However, as most companies are located in levels zero, one, two, and three, our Level variable takes only 5 values, level 4 meaning that the company is located at the level 4th or beyond the corporate hierarchy. The variable CF is a continuous variable that measures the proportion of cash flow rights at the hands of the ultimate owner (at the apex of the business groups). It is calculated as the product of the cash flow rights of the largest owner across the ownership chain. The variable co_owned is a binary variable that takes the value one if the company has at least two different owners. For every company, we also measure the distance in km from the subsidiary to the headquarters (Geo_dist), and the distance in terms of industry sector (ind_distance).

The institutional context is also relevant for the FRQ at the subsidiary level. The "rules of the game" in each country or institutional setting, define how economic actors solve conflicts of interest among stakeholders (Aguilera, & Desender, 2021; Leuz, 2010; Leuz, Nanda, & Wysocki, 2003). Controlling owners and managers of firms from weak legal institutions have greater private benefits of control and may face higher proprietary costs when increasing transparency than those from strong legal institutions (Doidge et al., 2007; Durnev, Errunza, & Molchanov, 2009). One way to mitigate the capacity of large owners to extract rents (and thus reduce the control premia) is by providing high-quality financial information: increased monitoring, litigation, and reputational costs associated with disclosure curb controlling shareholders' opportunities to extract private benefits (Shi, Magnan & Kim 2012). We, therefore, expect that firms incorporated in countries with a strong legal regime will

have a greater propensity to disclose high-quality accounting information, irrespective of the power of controlling owners to extract private rents.

We characterize the institutional constraints- Regulatory quality- using the World wide governance indicators, 2022 update, issued by the World Bank Group and available at www.govindicators.org. These indicators are based on over 30 underlying data sources reporting the perceptions of governance of a large number of survey respondents and expert assessments worldwide. The methodology to produce these indicators can be found in Kaufmann, Kraay, & Mastruzzi (2010). We also include firm size measured as the total assets and leverage. As in Haw, Hu, Hwang, & Wu (2004) we expect both total asset and leverage to be negatively related to unsigned abnormal accruals.

To characterize the business groups, we use the following variables: HQ_country is a categorical variable that shows the country where the company is incorporated. #Subs is a continuous variable that shows the number of companies that belong to the BG. Finally, Family_Group is a binary variable that takes the value one if the ultimate shareholder of the BG is a family, according to Orbis shareholder type classification. All these variables are defined at BG level (they take the same value within the BG). We include information on the ultimate owner, as cash flow returns are not the only returns that the owners obtain from their ownership in BGs, and including the socio-emotional wealth that the company provides to their controlling owners, will help to map with more detail the conflict of interests between these controlling owners and the rest of the company stakeholders. Krishnam & Peytcheva (2019) show higher quality of financial information within family firms and attribute it to socio-emotional wealth, and Gomez-Mejia et al (2011) show that the socio-emotional wealth of family firms has a non-negligible impact of accounting information. Although is very difficult to quantify the socio-emotional wealth that each company provides to its controlling owners, we argue that families and private individuals will have more socio-emotional wealth invested in their controlled companies. Because the incentives to extract rent are moderated by the socio-emotional wealth of the controlling owner, we expect FRQ of lower quality when the ultimate owner is a private individual or a family firm.

4. Results

Based on the hypotheses presented in Section 2, we perform the following regression analysis:

$$FRQ_{it} = \alpha_0 + \alpha_1 CF_{it} + \alpha_2 HQ\_DA_{it} + \alpha_3 co\_owned_{it} + \alpha_4(Level_{it}) + \alpha_5(\# Subs_{it})$$
$$+ \alpha_6(Leverage_{it}) + \alpha_7(Ln\ Assets_{it}\ *) + \alpha_8(Geo\_dist_{it}) + \alpha_9(Ind\_dist_{it})$$
$$+ \alpha_{10}(Regulatory\ Quality_{it}) + \varepsilon_{it}$$

Where the dependent variable FRQ_{it} is measured using an accrual quality given by the presence of unsigned performance-matched discretionary accruals (Kohtari, Leone, & Wasley, 2005). Larger values of unsigned discretionary accruals (Abs_DA) indicate poorer FRQ.

We measure Poor_FRQ using the absolute value of performance-matched discretionary accruals. We use discretionary accruals because Jones, Krishnan, and Melendrez (2008) show that these accrual measures have the power to predict both small and large accounting frauds.

As key explanatory variables, we include the proportion of cash flow rights at the hand of shareholders, CF, a binary variable that takes the value one if the company is not fully owned by the subsidiary (co_owned) and a variable measuring the headquarters levels of DA (HQ_DA).

To characterize the position of the company within the BG we include three variables. First, the hierarchical level where the company is located within the BG (Level). Second, we include the distance in km to the company headquarters, and the industry distance, measured using nacerrevv industry indicators. To characterize the quality of institutions, we include a measure of the Rule of law in the country where the affiliated company is incorporated. Finally, we include as control variables firm size and leverage and year and HQ_country fixed effects.

Results from this model specification are presented in Table 4

<INSERT TABLE 4 HERE >

From Table 4, column 1 we observe that poor FRQ is more prevalent at lower levels of the organizational structure, and in companies that are geographically distant from the headquarters. This first empirical regularity holds for different model specifications and is robust to the inclusion of a battery of control variables. This way we find that including controls for ownership structure, such as the cash flow rights of the ultimate owner or the presence of co-owners at the affiliate level, do not alter the sign or significance of this first empirical regularity.

We include our key explanatory variables sequentially in columns 2, 3 and 4 of Table 4. From these regressions we observe that the ownership structure of the affiliated company is significantly related to the quality of financial information. We find a positive and significant relation between the cash flow rights at the hand of the largest owner and the amount of unsigned discretionary accruals, in line with the prediction that large owners have an incentive not to disclose proprietary information in a timely manner. In addition, having at least an additional co-owner at the affiliate level is related to higher FRQ. Finally, we find evidence suggesting that FRQ is set at the group level, as the amount of unsigned DA at the headquarters are positively related to the unsigned DA at the subsidiary.

Multiplicative variables are included in columns 5 to 8. From these columns we observe that these relations hold irrespective of the organizational level of the subsidiary. However, some mitigating relation appears in the case of companies that are co_owned (Table 4, column 6) suggesting that the limiting influence of co_owners lowers as we move down the business group organization.

In all our results are in line with the hypothesis that owners are reductant to disclose financial information, unless needed by their requirements for external funding, being FRQ higher in companies at the top of the business group organization.

In addition to this key result, we find that financial reporting is of higher quality when the costs of monitoring such information decrease such as bigger firms (measured by the logarithm of total assets), and more leveraged firms, and that the quality of financial information is related to the institutions of the country where the subsidiary is incorporated (measured by the Rule of Law index).

To rule out the possibility that some companies might be driving our results, we include Tables 5, 6 and 7, where we run regression 2 separately for different groups of companies.

For example, from Table 5 we split the sample into companies belonging to business groups with concentrated ownership (where the ultimate owner owns over 20% of the BG headquarters) and companies belonging to BGs with dispersed ownership (where the ultimate owner owns less than 20% of the BG headquarters). From Table 5 we observe that in firms where the largest owner owns more than 20% of the shares at the headquarters (Table 5, Column 2), both CF and co_owned are significant determinants of Poor_FRQ but turns not significant when the largest owner does not have significant proprietary rights over the hierarchical chain. In both sets of companies, level and distance are statistically significant variables, suggesting that the company position within the BG is key in determining FRQ. This result is in line with our hypothesis one, which states that controlling owners might be reluctant to disclose FRQ of high quality, in an attempt to retain the benefits of control. This is especially the case in Business Groups with concentrated ownership, where the ultimate owner has more decision-making power over the whole group strategy.

<INSERT TABLE 5 HERE>

From Table 6 we observe that the presence of co_owners at the affiliate level helps improve FRQ especially in Family firms and that the size of the Business Group (measured by the number of the group subsidiaries) is significantly related to FRQ only when the ultimate owner is a family or individual investor (what we code as Family Group). This later result reinforces our initial explanation, that the largest owners, when in control, might prefer to provide financial information of lower quality to retain private benefits of control, while having additional owners, might curtail their power to do so.

<INSERT TABLE 6 HERE>

From Table 7 we observe that the pattern of FRQ varies significantly depending on whether the affiliate is located in the same country as the BG headquarters (local) or is located abroad (Foreign). We find that CF is a significant determinant of FRQ in foreign (but not local) subsidiaries, while the coefficient of the variable Level (that measures the location of the affiliate within the BG) is larger in the case of local companies. Besides, we find that the corruption perception of the affiliate company is positively related to Poor FRQ in the case of foreign subsidiaries but negatively related in the case of foreign subsidiaries.

5. Conclusions

Financial Reporting Quality is key to alleviating the asymmetry of information between the decision-makers within a company and the rest of the stakeholders. In the case of Business Groups, the largest owners of the company at the apex of the organization have a disproportionate power over all the companies within the organization. Thus, the largest owners at the apex of the organization might have an interest to disclose financial information of lower quality to enjoy the benefits of control at group level.

In this research, we study the quality of financial reporting within business groups and relate it to the conflict of interest that might appear between the largest owner at the apex of the business groups, and smaller owners, both at the Business group level and within each company. To answer

these questions, we expand the classical principal-agent models to include the most relevant conflict, between controlling and noncontrolling shareholders ((Enriques, L. & Volpin, P., 2007)).

We measure the principal-principal conflict of interest in BGs using the proportion of cash flow rights at the hands of the ultimate owners of the BG. This proportion is a measure of the concentration of power at the hands of the largest owner, and we relate this concentration of power to the quality of financial information. We base our analysis on the notion that insiders, in an attempt to protect their private control benefits, use poor FRQ to conceal firm information from outsiders (Leuz, Nanda, & Wysocki, 2003). We argue that, when providing financial information at the subsidiary level, the controlling owners must balance the costs of disclosing proprietary group information and the benefits of accessing the external capital markets (Fang & Wong, 2002; Jiang, Ma, Wang, 2020). Because the controlling owners have an incentive not to disclose proprietary information, we hypothesize that subsidiaries within BGs where the concentration of power (measured by the cash flow of the largest owners) is larger will provide financial information of lower quality. We also hypothesize that this (negative) relation can be moderated by institutional, market, and corporate governance factors.

Our empirical results are in line with this argumentation. We find a positive relation between the company's unsigned discretionary accruals (our proxy for poor financial quality) and the cash flow rights at the hands of the business group's largest owners. At the subsidiary level, we find that the presence of at least one additional owner is related to improved financial reported quality. As for organizational factors, we find more unsigned discretionary accruals in companies at lower levels of the organization, and companies that are located far from the business group's headquarters.

Understanding financial reporting quality at the group level is relevant to prevent rent extraction that might be very difficult to detect by analyzing a single company (or even group consolidated) reports alone. This rent extraction might lead to losses of millions to smaller owners and other stakeholders at the corporation (as the recent Grifols case in Spain, of the Wirecard collapse in Germany showed). More research is needed to provide insights into how Business Groups

orchestrate their Financial Reporting, and how to achieve more transparency at all layers of the

Business Group organization.

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TABLES

Table 1 Sample Selection

Sample Selection		
Sample Selection Process	# firm-year obs removed	# firm-year obs remaining
Sample with financial data from 2014 to 2021 for companies belonging to BGs with headquarters in our E-12 group [1]		3.191.643
After eliminating firms from the financial sector	(549.801)	2.641.842
After eliminating firms from the utility sector	(101.136)	2.540.706
After dropping observations with missing industry	(97.239)	2.443.467
After dropping observations with incomplete data to calculate earnings management measures	(1.268.818)	**1.174.649**
After dropping observations of headquarters	215.890	**958.759**
[1]Countries: Austria, Belgium, Germany, Denmark, Spain, Finland, France, UK, Ireland, Italy, Luxembourg, Netherlands		

Table 2. Variable Definition

Variable	Definition
Financial Reporting Quality	
DA	Discretionary Accruals (Accounting-based performance matched DA, See Kohtari et al., 2005)
Abs DA*	Discretionary accruals in absolute value
Business Groups Characterization	
HQ_abs_DA	Abs DA of the headquarters of the group
HQ_ country	Country of incorporation of the headquarters of the group
# Subs	Number of subsidiaries within the BG
Family group	=1 if the ultimate owner of the BG is a family (according to Orbis shareholder type classification)
BG with dispersed ownership	=1 if the ultimate owner owns more than 20% of the Headquarters´cash flow rights
Firm-Group Characteristics	
HQ	=1 if the firm is a headquarter in a Business Group; 0= if the firm is an affiliate
Level	The hierarchical level at which the company is located within the BG. Headquarters level is coded at zero. It measures the position of the company within the group
CF	Cash flow rights of the ultimate shareholder
Co-owned	=1 if the company has a minority owner
Geo_dist	Distance (in thousand km) between the headquarters and the affiliated company. It takes the value zero if the observation corresponds to a headquarters in a Business Group
Local	=1 if the compay is in the same country as the BG headquarters
Ind_dist	= 1 if the company is at the same 4-digit industry level as the headquarters in the BG; =2 if the company differs in the last digit of the 4 digit industry; =3 if the company differs in the second digit; =4 if the company differs in the fourth digit
Corruption	Reflects perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests.
Firm Level Controls	
Size	Total assets
Leverage	=(Short term debt + Long term debt)/ Total assets
Industry	2 digit Nacer rev 2 industry codes

Table 3. Descriptive Statistics

Variable	Observations	Mean	St Dev	Min	Max
Financial Reporting Quality					
Abs DA*	958.759	0.1211	0.1566	0.0007	1.7384

Business Groups Characterization					
# Subs	958.759	34.8755	118.1966	1	1313
Level*					
BG with dispersed ownership	732.102	62.71	31.99	0	100
Family group	958.759	0.4065964	0.4911	0	1
Firm-Group Characteristics					
HQ					
Level	958.759	1.6873	0.9758	1	4
CF	732.102	55.475	31.7544	0	100
Co-owned	958.759	0.3255	0.4685	0	1
HQ_absDA	330.370	0.0857812	0.1512	1.39e-17	12.13123
Geo_dist	958.759	0.0577	0.1653	0	1.9894
Ind_dist	958.759	3.27	1.34	0	4
Corruption	952.190	0.999	0.688	0	1
Firm Level Controls					
Size	958.759	32561.48	2300038	0.0006	4.40e07
Leverage	875.588	0.169	2.88	-0.0412	2651.33

Table 4. Regression analysis 1. Financial Reporting Quality within Business Groups

In this table, we present the results from a set of random effects regressions, with the total amount of unsigned discretionary accrual as a proxy for poor financial reporting quality and standard errors clustered by firm. The explanatory variables are the proportion of cash flow rights of the ultimate owner (*CF*); a dummy for whether the affiliate has more than one owner (*co_owned*); the total amount of unsigned discretionary accruals of the BG headquarter (HQ_DA); the position of the company within hierarchical structure of the BG (*Level*); the number of affiliated companies within the BG (*#Subs*); company size (*Ln_assets*) and total debt divided by total assets (*Leverage*). *Geo_dist* measures the distance (in thousands of km) to the BG headquarters, and *Ind_dist* measures the industry distance between the headquarters and the affiliate company; *Corr* is the affiliated country corruption index provided by the World Bank. Finally, we include year dummies and a dummy for the country where the BG is incorporated. p-values in parentheses. * p < 0.05, ** p < 0.01, *** p < 0.001

	Expected sign	(1) abs DA	(2) abs DA	(3) abs DA	(4) absDA	(5) abs DA	(6) abs DA	(7) abs DA	(8) abs DA
CF	+/-		0.000016* (0.037)			0.0022 (0.137)			0.0001** (0.002)
Co_owned	-			-0.00653*** (0.000)			-0.00841*** (0.000)		-0.0081*** (0.000)
HQ_DA	+				0.166*** (0.000)			0.144*** (0.000)	0.149*** (0.000)
Level*CF						-0.000 (0.656)			0.00001*** (0.000)
Level*co_owned							0.00119* (0.014)		0.00124 (0.297)
Level* HQ_DA								0.0142 (0.050)	0.0159* (0.044)
Level	+	0.006*** (0.000)	0.00615*** (0.000)	0.00575*** (0.000)	0.00816*** (0.000)	0.006*** (0.000)	0.00544*** (0.000)	0.00678*** (0.000)	0.0100*** (0.000)
# Subs	+/-	-0.0000104*** (0.000)	-0.0000105*** (0.000)	-0.0000100*** (0.000)	-0.00000947*** (0.000)	-0.0000105*** (0.000)	-0.0000101*** (0.000)	-0.0000100*** (0.000)	-0.000011*** (0.000)
Ln assets	-	-0.0137*** (0.000)	-0.0137*** (0.000)	-0.0137*** (0.000)	-0.0138*** (0.000)	-0.0137*** (0.000)	-0.0137*** (0.000)	-0.0138*** (0.000)	-0.0138*** (0.000)
ROA	+/-	-4.5e-09* (0.019)	-4.5e-09* (0.019)	-4.5e-09* (0.018)	0.000 (0.559)	-4.5e-09* (0.019)	-4.5e-09* (0.018)	0.000 (0.560)	0.000 (0.6060)
Leverage	-	0.0002 (0.075)	0.000143*** (0.056)	0.000161 (0.076)	0.000938*** (0.000)	0.00014 (0.056)	0.000161 (0.076)	0.000093*** (0.000)	0.0000935*** (0.000)

	Expected sign	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Geo_dist	+	0.0412***	0.0392***	0.0407***	0.0445***	0.0392***	0.0392***	0.0443***	0.0393***
		(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
Ind_dist	-	-0.000745	-0.000672	-0.0000774	-0.000620	-0.000673	-0.000746***	-0.000369	-0.000351
		(0.000)	(0.000)	(0.852)	(0.209)	(0.000)	(0.000)	(0.067)	(0.131)
Corruption	+	0.0208***	0.0237***	0.00187***	0.00210*	0.0237***	0.00191***	0.00210*	0.00239*
		(0.000)	(0.003)	(0.000)	(0.025)	(0.000)	(0.000)	(0.026)	(0.024)
Constant		0.215***	0.248***	0.253***	0.194***	0.247***	0.254***	0.196***	0.193***
		(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
Year FE		Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
HQ_Country FE		Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
N		851023	650879	851023	306826	851023	851023	306826	234581
R2-within		0.0290	0.0552	0.0539	0.0486	0.0552	0.0539	0.0486	0.0552
R2-between		0.0760	0.1442	0.1434	0.1445	0.1442	0.1434	0.1445	0.1442
R2-overall		0.0454	0.1277	0.1237	0.1017	0.1277	0.1237	0.1017	0.1277

Table 5. Regression analysis II. Business Groups with concentrated/dispersed ownership

In this table we present the results from a set of random effects regressions, with proxies for poor financial reporting quality as explanatory variables. We split the sample in two groups: BG with concentrated ownership where the ultimate owners owns at least 20% of CF Headquarters , and BG with dispersed ownership where the ultimate owner owns strictly less than 20 % of the CF rights of the HQ.

As explanatory variables we include the proportion of cash flow rights of the largest owner (*CF*), a dummy for whether there is a divergence between the cash flow rights and ownership rights of the ultimate owner (D*iv. dummy*); a dummy for whether the company is co-owned (*Co_owned*) and a set of multiplicative variables. We a also include *HQ*, an indicator variable that takes the value one if the company is a headquarter; *Level* measures the position of the company within the hierarchical structure of the BG; *#Subs* measures the number of affiliated companies within the BG; *Ln_assets* measures company size and *Leverage* is total debt divided by total assets. *Geo_dist* measures the distance (in km) to the BG headquarter, and *Ind_dist* measures the industry distance between the headquarter and the affiliate company.. Finally, we include year, industry, and (BG) country fixed effects. -pvalues in parentheses. * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

	Expected sign	BG with concentrated ownership (1)	BG with concentrated ownership (2)	BG with concentrated ownership (3)	BG with concentrated ownership (4)	BG with dispersed ownership (5)	BG with dispersed ownership (6)	BG with dispersed ownership (7)	BG with dispersed ownership (8)
		abs DA	abs DA	abs DA	abs DA	abs DA	abs DA	abs DA	abs DA
CF	+/-		0.0000454**				0.000344		
			(0.005)				(0.168)		

	Sign	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Co_owned	-				-0.00678*** (0.000)				-0.00295 (0.180)
HQ_DA	+				0.166*** (0.000)				0.166*** (0.000)
Level	+	**0.00621*** (0.000)**	**0.00661*** (0.000)**	**0.00594*** (0.000)**	**0.00803*** (0.000)**	**0.00323* (0.016)**	**0.00340* (0.013)**	**0.00315* (0.019)**	**0.00670** (0.008)**
# Subs	+/-	0.0000104 (0.298)	0.0000104 (0.324)	0.00001000 (0.331)	0.00000977 (0.334)	-0.00000960 (0.684)	-0.00000407 (0.864)	-0.00000954 (0.689)	0.000113 (0.207)
Ln assets	-	-0.0139*** (0.000)	-0.0138*** (0.000)	-0.0138*** (0.000)	-0.0140*** (0.000)	-0.0129*** (0.000)	-0.0129*** (0.000)	-0.0129*** (0.000)	-0.0123*** (0.000)
ROA	+/-	-4.57e-09* (0.019)	-4.54e-09* (0.018)	-4.61e-09* (0.018)	0.0000835 (0.581)	-0.00000380* (0.037)	-0.00000380* (0.036)	-0.00000380* (0.034)	0.0124 (0.300)
Leverage	-	0.000151 (0.063)	0.000133* (0.044)	0.000151 (0.064)	0.0000928*** (0.000)	0.00875** (0.002)	0.00869** (0.002)	0.00869** (0.002)	0.0139 (0.074)
Geo_dist	+	**0.0437*** (0.000)**	**0.0418*** (0.000)**	**0.0430*** (0.000)**	**0.0478*** (0.000)**	**0.0276*** (0.000)**	**0.0281*** (0.000)**	**0.0274*** (0.000)**	**0.0215** (0.004)**
Ind_dist	-	-0.000600* (0.026)	-0.000497 (0.135)	-0.000597* (0.027)	-0.000338 (0.352)	-0.00199 (0.073)	-0.00194 (0.076)	-0.00201 (0.070)	-0.000525 (0.676)
Corruption	+	0.00221*** (0.001)	0.00256*** (0.000)	0.00199** (0.003)	0.00237 (0.066)	0.00124 (0.484)	0.00132 (0.456)	0.00112 (0.531)	-0.000284 (0.926)
Constant		0.251*** (0.000)	0.245*** (0.000)	0.253*** (0.000)	0.195*** (0.000)	0.257*** (0.000)	0.253*** (0.000)	0.258*** (0.000)	0.215*** (0.000)
Year FE		Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
HQ_Country FE		Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
N		788627	588483	788627	288257	62396	62396	62396	18569
R2-within		0.0289	0.0281	0.0289	0.0584	0.06161	0.0296	0.0296	0.0667
R2-between		0.0775	0.0731	0.0775	0.1037	0.1471	0.0793	0.0792	0.0624
R2-overall		0.0458	0.0439	0.0458	0.0736	0.1490	0.0481	0.0480	0.0762

Table 6. Regression analysis II1. Financial Reporting Quality within Business Groups. Family versus nonfamily groups

In this table, we present the results from a set of random effects regressions, with the total amount of unsigned discretionary accrual as a proxy for poor financial reporting quality and standard errors clustered by firm. The explanatory variables are the proportion of cash flow rights of the ultimate owner (*CF*); a dummy for whether the affiliate has more than one owner (*co_owned*); the total amount of unsigned discretionary accruals of the BG headquarter (HQ_DA); the position of the company within hierarchical structure of the BG (*Level*); the number of affiliated companies within the BG (*#Subs*); company size (*Ln_assets*) and total debt divided by total assets (*Leverage*). *Geo_dist* measures the distance (in thousands of km) to the BG headquarters, and *Ind_dist* measures the industry distance between the headquarters and the affiliate company; *Corr* is the affiliated country corruption index provided by the World Bank. Finally, we include year dummies and a dummy for the country where the BG is incorporated. In columns 1, 2 and 3 we include observations where the ultimate owner is of the type "One or more individuals or family". p-values in parentheses. * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

	Expected sign	(1) Family Group	(2) Family Group	(3) Family group	(4) Family group	(5) Non family Group	(6) Non family group	(7) Non family group	(8) Non family group
		abs DA	abs DA	abs DA	abs DA	abs DA	abs DA	abs DA	abs DA
CF	+/-		**0.000019**				**0.00000**		
			(0.290)				**(0.821)**		
Co_owned	-			**-0.00551*****				**-0.00649**	
				(0.000)				**(0.000)**	
HQ_DA	+				**0.174*****				**0.161*****
					(0.000)				**(0.000)**
Level	+	**0.00593*****	**0.00559*****	**0.00560****	**0.00426*****	**0.00516*****	**0.00467*****	**0.00499*****	**0.00715*****
		(0.000)	**(0.000)**	**(0.000)**	**(0.000)**	**(0.000)**	**(0.000)**	**(0.000)**	**(0.000)**
# Subs	+/-	0.0000***	0.0000***	0.00000391	-0.0000338***	0.0000	0.00000	0.0000105	0.0000
		(0.000)	(0.110)	(0.293)	(0.000)	(0.057)	(0.974)	(0.705)	(0.742)
Ln assets	-	-0.0159***	-0.0160***	-0.0138***	-0.0164***	-0.0132***	-0.0132***	-0.0137***	-0.0129***
		(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
ROA	+/-	0.0003	0.0002	0.000	0.000	-4.6e-09*	-4.5e-09*	-4.6e-09*	-4.5e-09*
		(0.321)	(0.384)	(0.322)	(0.507)	(0.019)	(0.019)	(0.018)	(0.018)
Leverage	-	0.0131***	0.0138***	0.00131***	0.0143***	0.00124*	0.0001*	0.0000**	0.000161
		(0.000)	(0.000)	(0.000)	(0.000)	(0.024)	(0.011)	(0.000)	(0.076)
Geo_dist	+	**0.0396*****	**0.0401*****	**0.0390*****	**0.0489*****	**0.0399*****	**0.0361*****	**0.0394*****	**0.0392*****
		(0.000)	**(0.000)**	**(0.000)**	**(0.000)**	**(0.0000)**	**(0.000)**	**(0.000)**	**(0.000)**

	Exp. sign	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Ind_dist	-	-0.000 (0.480)	-0.0000 (0.876)	-0.00019 (0.512)	-0.00003 (0.926)	-0.00085*** (0.000)	-0.000762 (0.156)	-0.000843 (0.038)	-0.000317*** (0.607)
Corruption	+	-0.0000364 (0.969)	0.000332*** (0.793)	0.00210* (0.025)	0.00174 (0.480)	0.00293*** (0.0000)	0.00346*** (0.000)	0.00270*** (0.000)	0.00316** (0.023)
Constant		0.266*** (0.000)	0.262*** (0.000)	0.268*** (0.000)	0.007*** (0.000)	0.248*** (0.0000)	0.248*** (0.000)	0.249*** (0.000)	0.185*** (0.000)
Year FE		Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
HQ_Country FE		Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
N		354923	305827	354923	179433	496100	345052	496100	157393
R2-within		0.0275	0.0271	0.0275	0.0532	0.0301	0.0293	0.0301	0.0638
R2-between		0.0850	0.0838	0.0859	0.1266	0.0740	0.0708	0.0751	0.0891
R2-overall		0.0464	0.0458	0.0467	0.0752	0.0456	0.0440	0.0459	0.0743

Table 7. Regression analysis II1. Financial Reporting Quality within Business Groups. Local versus foreign firms

In this table, we present the results from a set of random effects regressions, with the total amount of unsigned discretionary accrual as a proxy for poor financial reporting quality and standard errors clustered by firm. The explanatory variables are the proportion of cash flow rights of the ultimate owner (*CF*); a dummy for whether the affiliate has more than one owner (*co_owned*); the total amount of unsigned discretionary accruals of the BG headquarter (HQ_DA); the position of the company within hierarchical structure of the BG (*Level*); the number of affiliated companies within the BG (*#Subs*); company size (*Ln_assets*) and total debt divided by total assets (*Leverage*). *Geo_dist* measures the distance (in thousands of km) to the BG headquarters, and *Ind_dist* measures the industry distance between the headquarters and the affiliate company; *Corr* is the affiliated country corruption index provided by the World Bank. Finally, we include year dummies and a dummy for the country where the BG is incorporated. In columns 1, 2 and 3 we include observations where the ultimate owner is of the type "One or more individuals or family". p-values in parentheses. * p < 0.05, ** p < 0.01, *** p < 0.001

	Expected sign	(1) Local	(2) Local	(3) Local	(4) Local	(5) Foreign	(6) Foreign	(7) Foreign	(8) Foreign
		abs DA	abs DA	abs DA	abs DA	abs DA	abs DA	abs DA	abs DA
CF	+/-		0.00000795 (0.380)				0.0000470** (0.002)		
Co_owned	-			-0.00708*** (0.000)				-0.00429*** (0.000)	
HQ_DA	+				0.177*** (0.000)				0.127*** (0.000)
Level	+	0.00853*** (0.000)	0.00864*** (0.000)	0.00824*** (0.000)	0.00941*** (0.000)	0.00291*** (0.000)	0.00331*** (0.000)	0.00282*** (0.000)	0.00464*** (0.000)

# Subs	+/-	0.00000418[*]	0.00000447[*]	0.00000357[*]	0.00000371	0.0000189[***]	0.0000180[***]	0.0000191[***]	0.0000289[***]
		(0.015)	(0.011)	(0.040)	(0.053)	(0.000)	(0.000)	(0.000)	(0.000)
Ln assets	-	-0.0135[***]	-0.0135[***]	-0.0135[***]	-0.0135[***]	-0.0145[***]	-0.0145[***]	-0.0145[***]	-0.0149[***]
		(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
ROA	+/-	0.000276	0.000193	0.000276	0.0000134	-4.54e-09[*]	-4.55e-09[*]	-4.56e-09[*]	0.000415
		(0.382)	(0.495)	(0.383)	(0.893)	(0.019)	(0.020)	(0.018)	(0.429)
Leverage	-	0.00252	0.00215	0.00254	0.000579	0.0000933[**]	0.0000875[***]	0.0000932[**]	0.0000760[***]
		(0.202)	(0.239)	(0.203)	(0.521)	(0.002)	(0.001)	(0.002)	(0.000)
Geo_dist	+	0	0	0	0	0.0392[***]	0.0376[***]	0.0391[***]	0.0378[***]
		(.)	(.)	(.)	(.)	(0.000)	(0.000)	(0.000)	(0.000)
Ind_dist	-	-0.000133	-0.0000745	-0.000158	0.0000395	-0.00275[***]	-0.00288[***]	-0.00273[***]	-0.00236[***]
		(0.430)	(0.702)	(0.347)	(0.851)	(0.000)	(0.000)	(0.000)	(0.000)
Corruption	+	-0.0129[***]	-0.0141[***]	-0.0129[***]	-0.00355	0.00204[***]	0.00218[***]	0.00184[**]	0.00228
		(0.000)	(0.000)	(0.000)	(0.115)	(0.000)	(0.001)	(0.001)	(0.060)
Constant		0.272[***]	0.255[***]	0.272[***]	0.115	0.278[***]	0.275[***]	0.279[***]	0.227[***]
		(0.000)	(0.000)	(0.000)	(0.709)	(0.000)	(0.000)	(0.000)	(0.000)
Year FE		Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
HQ_Country FE		Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
N		600750	453461	600750	253575	250273	197418	250273	53251
R2-within		0.0313	0.0305	0.0313	0.0219	0.0247	0.0247	0.0247	0.0464
R2-between		0.0752	0.0733	0.0766	0.1091	0.0751	0.0737	0.0755	0.0739
R2-overall		0.0452	0.0441	0.0457	0.0761	0.0444	0.0441	0.0445	0.0607