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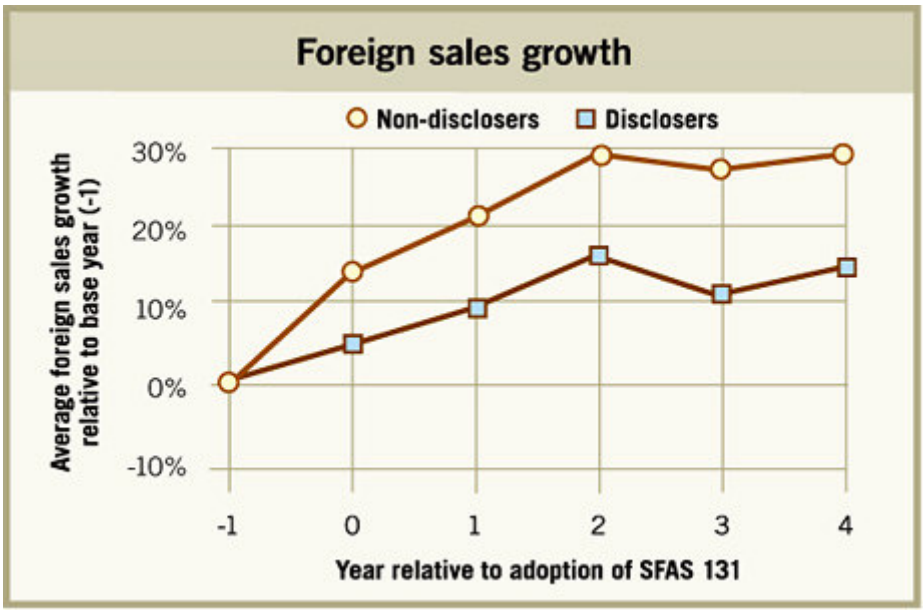
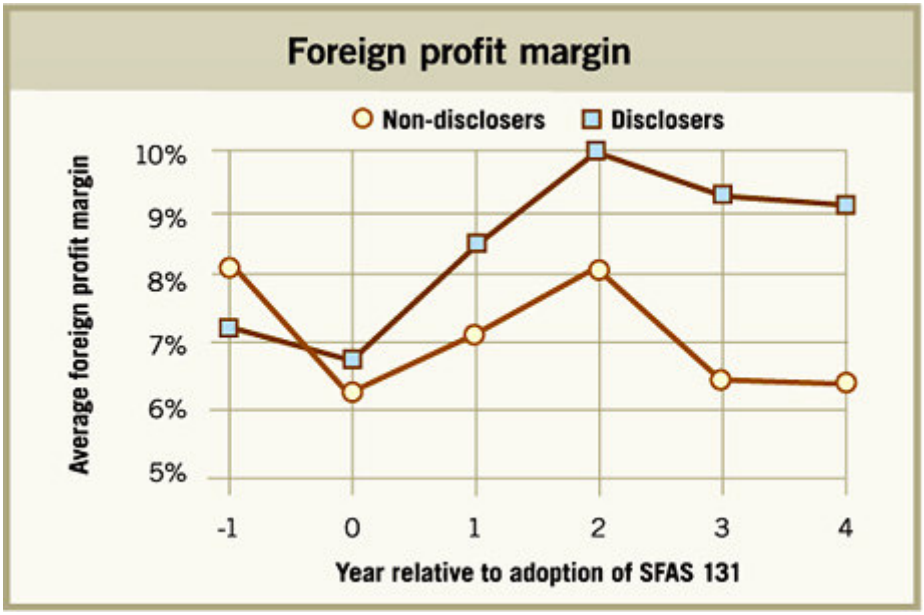
Geographic disclosures

By Ole-Kristian Hope

Thanks to globalization, nondisclosure of geographic earnings may result in a loss of important information

The International Accounting Standards Board (IASB) recently adopted the North American segment disclosure standard (SFAS 131/CICA Sec. 1701) almost verbatim as IFRS 8 Operating Segments. However, this standard has been met with strong opposition, especially in Europe. In November 2007, for example, the EU temporarily annulled its support for IFRS 8. The EU was concerned, among other things, about the new standard's potential to reduce disclosure levels related to firms' international operations and in particular the lack of requirement to disclose earnings for each geographic segment disclosed. Although it later reversed its annulment, this drastic action highlights the perceived importance of geographic segment disclosures and the role accounting standards play in informing investors and other users of financial statement information.





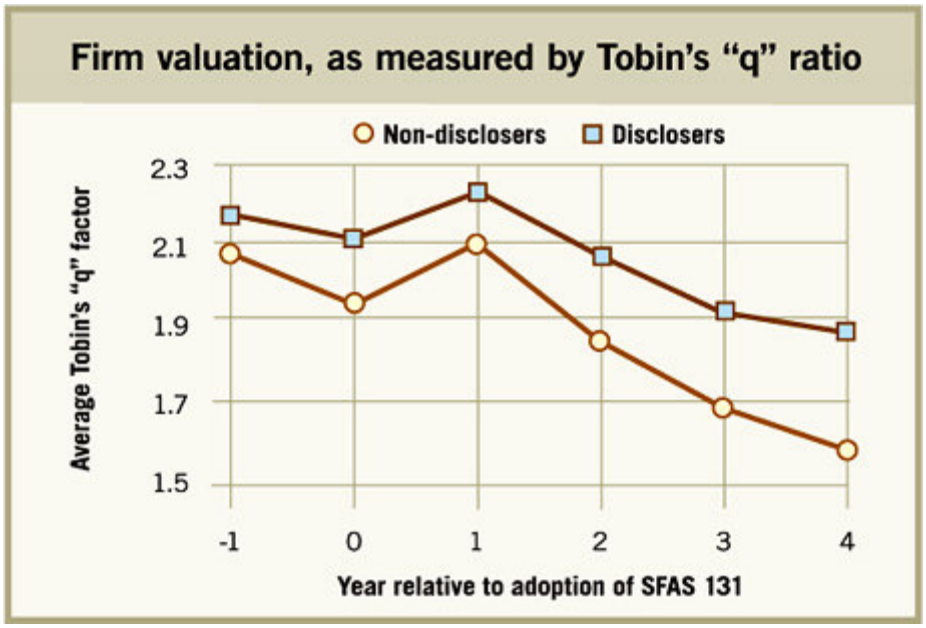
Geographic segment disclosures

In general, financial disclosures are potentially useful both for monitoring (i.e., the governance or stewardship role of accounting information) and for valuation purposes (i.e., the decision usefulness role of accounting information). Risk and growth opportunities vary considerably around the world, which creates a demand for information on firms' international operations. This demand is further enhanced by research evidence that suggests investors find it more difficult to assess firms' foreign operations as compared with domestic operations.[1] Possible reasons to explain the increased complexity of international operations include differences in cultures, growth opportunities, competition, governmental regulations, labour relations, tax laws, business practices and market conditions across countries, as well as generally lower disclosure levels related to foreign operations compared to domestic operations. In addition, as the proportion of foreign operations of US and Canadian companies continues to expand,

information related to these operations becomes increasingly important. For example, foreign earnings of US companies totaled US$315 billion in 2004, an increase of 78% over the past decade, and the growth of foreign earnings has far outpaced the growth of domestic earnings. Foreign operations are also important for Canadian firms: for Canadian firms with available data and with nonzero foreign income, the mean foreign pre-tax income as percentage of total pre-tax income for the 1990 to 2006 period was 38%.

Current standards for segment disclosures

The US Financial Accounting Standards Board (FASB) and the Canadian Accounting Standards Board (AcSB) jointly wrote the current segment standard. In contrast to the previous segment rules, firms are now required to report operating segments according to the internal organization of the company. In general, prior research finds that the implementation of SFAS 131 has made substantial improvements to the overall disclosure environment of US firms. SFAS 131 has resulted in less aggregation of segments and more information per operating segment being disclosed. Extant research also suggests that these segment disclosure improvements are responsible for a greater precision in analysts' forecasts and greater information to the market about future earnings.[2] However, these studies focus primarily on business segment disclosures. Although the importance of understanding information related to firms' foreign operations is becoming increasingly apparent, there has been limited research on the informativeness of geographic segment data.



Under SFAS 131, firms that choose to define operating segments on any basis other than geographic area (e.g., products or services) are no longer required to disclose geographic earnings (e.g., net income in Mexico or net income in East Asia). Specifically, disclosure of geographic earnings is voluntary when operating segments are defined on any basis other than geographic area, and most firms opt not to disclose. These firms must, however, continue to report sales and long-lived assets for each geographic segment disclosed.

To understand the setting better, consider Texas-based Diamond Offshore Drilling Inc. From 1997 to 1998, the deep water drilling contractor reported growth in domestic sales of 14% and growth in foreign sales of nearly 50%. By the end of 1998, foreign sales totaled 43% of the company's total operations. What effect did implementation of SFAS 131 in 1998 have on the company's geographic segment reporting? In 1997 Diamond Offshore reported sales and earnings for three foreign geographic segments: Europe/Africa; Australia/Southeast Asia; and South America/other. Sales for each segment were US$201.9 million, US$94 million and US$50.8 million respectively. Operating income for each segment was US$38.2 million, (US$3.8 million), and US$18.4 million, respectively. Notice the difference in profit margins across the three segments: 0.19 versus (0.04) versus 0.36. In 1998 (after implementation of SFAS 131), the company no longer disclosed geographic earnings but continued to report the same geographic segments with sales of US$292.6 million, US$139.1 million, and US$84.5 million, respectively. Was the decision to continue to grow its Australia/Southeast Asia segment a good one or did growth in this segment contribute greater losses to overall operations? Was the company able to maintain its high profit margin in South America/other? When analysts are preparing their earnings forecasts, to what extent should they expect the foreign portion of total earnings to grow? Nondisclosure of geographic earnings makes answers to these questions more difficult. In other words, if geographic earnings are useful in assessing managerial actions and firm value, then the absence of such disclosures could significantly impact the information set used by investors to value the firm.

The reduction in mandated geographic segment disclosures was likely a result of the political process of accounting standard-setting, which involves a number of trade-offs. The standard-setters focused primarily on increasing line of business disclosures and gaining acceptance for the so-called "management approach" to operating segment disclosures. FASB and AcSB board members have indicated that the decision not to require geographic earnings was a concession to preparers who argued that the increase in line of business disclosures was too onerous. In other words, to get more line of business information, standard-setters were willing to cede other information, such as geographic earnings.

Monitoring role of geographic earnings disclosures

Agency theory describes the natural conflict between shareholders and managers.[3] The conflict arises because individuals choose actions to maximize their own utility, suggesting that managers will not always act in the best interest of shareholders. One way to resolve this conflict is through monitoring, and one obvious monitoring system is financial disclosures by the firm. To the extent that disclosures serve as a monitoring mechanism, managers are disciplined to act in the best interest of shareholders. However, when disclosure quality reduces, the agency cost hypothesis predicts that managers can make (suboptimal) self-maximizing decisions. These suboptimal decisions include empire building, which decreases operating performance and reduces firm value. In other words, as the ability of shareholders to monitor managers diminishes because of inadequate disclosure, managers are more willing to expand their operations (i.e., build an empire), even though such actions lead to lower firm performance. Managers are able to behave this way because investors are less capable of linking managerial decisions to firm performance when the quality of monitoring mechanisms, such as financial disclosures, is reduced.

In a recent study, Ole-Kristian Hope and Wayne Thomas test the agency cost hypothesis in the context of firms' decisions on whether to disclose geographic earnings in the annual report following adoption of SFAS 131.[4] Their sample firms have extensive foreign operations, with foreign sales on average being almost 37% of total sales in the post-SFAS 131 period. Whereas all firms disclosed geographic earnings under SFAS 14 (as required), 74% of the firms discontinued disclosure following implementation of SFAS 131.

The research findings are consistent with the theory and with the monitoring role of geographic disclosures. Specifically, after controlling for factors related to alternative corporate governance mechanisms, the information environment, and firm performance, Hope and Thomas document that nondisclosure of geographic earnings is associated with a significant increase in foreign sales growth and foreign fixed assets and a significant decrease in foreign profit margin and total return on assets. In other words, as the ability of shareholders to monitor managers diminishes because of nondisclosure of geographic earnings, managers are more willing to expand their international operations (i.e., build an empire), even though such actions lead to lower firm performance. They also find that overall firm values and excess stock returns are significantly lower for nondisclosers than for disclosers in the post-SFAS 131 period. The lower firm value for nondisclosers is consistent with investors detecting the value reducing decisions of managers of nondisclosing firms. These findings are robust to a large number of sensitivity analyses.

Evidence on the valuation role of geographic segment disclosures

In a separate but related study, Hope, Kang, Thomas and Vasvari investigate whether the market's valuation of foreign earnings (i.e., the price-to-earnings multiplier for foreign earnings) is a function of the firm's geographic segment disclosures.[5] All US firms are required to separately disclose total domestic and total foreign earnings as per SEC requirements (§210.4-08(h)).

SFAS 131 introduces two important changes to the disclosure of geographic information. First, in an attempt to provide more disaggregated disclosure, SFAS 131 encourages firms to disclose country-level geographic information for material countries. Prior to SFAS 131, most firms disaggregated their foreign operations into a couple of broad regions (e.g., Western Europe) or continents (e.g., Asia). Thus, implementation of SFAS 131 may result in more disaggregation (i.e., higher-quality disclosure) for firms that claim to have material countries or less disaggregation for companies that claim individual countries are not material. Second, as discussed, SFAS 131 allows firms to no longer disclose earnings for secondary segments.

To the extent that changes in geographic disclosures coinciding with SFAS 131 improve or worsen the ability of investors to assess foreign operations, one would expect the valuation of foreign earnings to increase or decrease. Prior theoretical and empirical research provides support for higher quality disclosures leading to a higher valuation multiplier for earnings.[6]

Consistent with this research, Hope et al. find strong evidence that geographic segment disclosure practices relate to the pricing of foreign earnings. Firms that increase their number of reported geographic segments or that continue to disclose geographic earnings have foreign earnings that are priced higher than those of firms that do not

increase the number of geographic segments or that discontinue the reporting of geographic earnings. The results suggest that higher-quality geographic segment disclosures allow investors to better relate reported performance to underlying foreign operations.

Other recent research finds that geographic segment disclosures have the potential to mitigate the previously documented mispricing of firms' foreign earnings.[7] Finally, a current study examines trading volume around quarterly earnings announcements for disclosers versus nondisclosers of geographic earnings.[8] This study documents that because nondisclosure of geographic earnings reduces the amount of publicly available information prior to the earnings announcements, investors have less information available for interpreting the earnings announcement. As a result, firms that discontinue disclosing geographic earnings after the rule change experience a significant decline in trading volume around subsequent quarterly earnings announcements. In sum, these studies show significant valuation effects of variations in geographic disclosures.

Conclusion

Because of increasing globalization, nondisclosure of geographic earnings may result in investors losing important information for both monitoring managers' actions and valuing the firm. Although the above findings are based on samples of US firms, they should be of interest to Canadian and international standard-setters, investors and managers as well.

Ole-Kristian Hope, PhD, CFA, CPA, CMA, is the Deloitte professor of accounting and associate professor at the Rotman School of Management, University of Toronto

Technical editor: Christine Wiedman, PhD, FCA, associate professor and co-director, PhD program, School of Accounting and Finance, University of Waterloo

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