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Strangers on the board: The impact of board internationalization on earnings management of Nordic firms

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ABSTRACT

The internationalization of firms has led to boards becoming more international as well. In this study, we investigate the consequences of board internationalization. In particular, by drawing on research on language and board dynamics, we identify theory-based reasons why board internationalization could increase, or decrease, earnings management practices. We use agency theory, stressing how board internationalization may positively or negatively affect monitoring quality of boards. Next to agency theory, we use theories explaining how language differences in the boardroom complicates communication and how differences in language structures (referred to as linguistic relativity in the literature) affect directors' perception and detection of earnings management practices. Using a sample of 3249 firm-year observations representing 586 non-financial listed Nordic firms during 2001–2008, we find that the presence of non-Nordic foreign directors on the board is associated with significantly higher levels of earnings management. Our analysis indicates that this effect is driven by language-related factors, as well as by the level of foreign board members' accounting knowledge.

1. Introduction

Both academics and practitioners agree that boards of directors have to ensure that management takes decisions that are in the interest of stakeholders. As such, boards are involved in the decision making process within organizations and can influence organizational actions. They therefore represent an important determinant of organization-level performance. Boards have three main roles. First, they monitor management by hiring, promoting, assessing and dismissing managers (Adams, Hermalin, & Weisbach, 2010). Second, they provide resources enabling organizational access to important resources and relevant information channels, as well as to resources that contribute to ensuring legitimacy (Pearce & Zahra, 1992; Pfeffer & Salancik, 1978). Finally, they provide advice to management in setting the strategy of the firm (Adams et al., 2010).

Over the last decades, firms have increasingly become internationalized, both in terms of their operations, as well as in terms of their financing (Oxelheim, Gregorič, Randøy, & Thomsen, 2013). This higher degree of internationalization of the firm not only increases the demand for information processing with respect to business operations and financial decision making, but also likely results in greater information asymmetry between managers and boards, which leads to higher monitoring costs (Sanders & Carpenter, 1998). One potential way of dealing with the increased demand for information processing and greater information asymmetry is to match the internationalization of the firm's activities with the internationalization of the board. Indeed, we have seen that the international nature of boards has become more prominent since the early 2000s (Estelyi & Nisar, 2016; Oxelheim et al., 2013; Miletkov, Poulsen, & Wintoki, 2017). At the same time, however, the few papers that have been published on the effects of the internationalization of boards show that increased internationalization of boards may have both positive and negative consequences (Masulis, Wang, & Xie, 2012; Miletkov et al., 2017; Oxelheim & Randøy, 2003). This triggers the question when these consequences may be positive or negative.

Our research aims at answering this question by zooming in on the monitoring role of boards.

We argue that the presence of foreign directors on a firm's board can be beneficial for, as well as detrimental to, boards' ability to effectively monitor management. On the one hand, it is possible that the presence

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of foreign directors benefits board monitoring, because these foreign directors are more independent from management and, hence, are more likely to critically scrutinize management. On the other hand, however, having foreign board members may potentially reduce the board's ability to monitor management. Specifically, we argue that foreign board members are more likely to suffer from a lack of knowledge of local rules and/or that their presence makes the board vulnerable to language issues, which hampers board effectiveness.

To test our ideas we focus on how international boards (that is, boards with at least one foreign member) influence earnings management at the firm level. Earnings management refers to choices made by corporate decision makers to use accounting methods offered by law and regulations to influence a firm's reported earnings (Chen, Luo, Tang, & Tong, 2015). As is clear from several renowned accounting fraud cases (e.g., Ahold, Enron, Tesco, and Toshiba), it is generally accepted that the quality of the firm's financial statements is compromised when corporate decision makers implement earnings management opportunistically. Accordingly, earnings management is frequently seen as an important manifestation of agency problems that should be obviated by effective monitoring of management by the board.

Our sample comprises 3249 firm-year observations representing 586 non-financial listed Nordic firms during 2001–2008. We suggest the Nordic region (i.e., Denmark, Finland, Norway, and Sweden) to be particularly useful as a context for our research, as the number of firms with an internationalized board is relatively high in Nordic firms, but with considerable variation across countries (Oxelheim et al., 2013). The Nordic firms are also well suited to the purpose of our study, as they have become much more international since the early 2000s as indicated by a range of measures including sales and production. At the same time, the Nordic countries comprise a relatively homogeneous region in terms of regulation (e.g., Caban-Garcia & He, 2013).

We find a significant positive relationship between the presence of at least one non-Nordic foreign director on the board and levels of earnings management (measured as discretionary accruals), as well as between the percentage of non-Nordic foreign directors on the board and the level of earnings management. Moreover, the presence of one or more foreign board members is found to be associated with income-*increasing*, but not associated with income-*decreasing* earnings management. These results support the argument that foreign directors are less effective monitors than home country recruited directors. We obtain qualitatively similar results when using alternative statistical techniques, such as OLS, an instrumental variables approach and propensity score matching.

Next, our findings support the hypothesis that foreign directors due to lack the specific knowledge of national accounting rules and laws are less able to curb earnings management. In addition, we find support for the notion that language-related factors may reduce the quality of communication in the boardroom, leading to less effective monitoring, thus facilitating higher levels of earnings management. Our results favor the interpretation that appointing a foreign director to the board of directors can reduce the board's ability to discipline managers as far as earnings management is concerned. We note, however, that our analysis of the contribution foreign board members can make to the firm's performance is partial. These board members may also be beneficial for the firm by, for example, their supply of advice and/or their experience in exploring new and foreign markets resulting in a net positive value from the internationalization of the board.[1]

Our study is part of an emerging field that focuses on the antecedents and consequences of the internationalization of the board of directors (Estelyi & Nisar, 2016; Masulis et al., 2012; Miletkov et al., 2017; Oxelheim & Randøy, 2005; Oxelheim et al., 2013; Piekkari, Oxelheim, & Randøy, 2015). It contributes to this literature in two ways. First, notwithstanding the increasing popularity of foreigners on firms' boards of directors, the academic research on the consequences of these directors on firm outcomes is still in its infancy. Prior studies looked at the effects on firm financial performance (Masulis et al., 2012; Miletkov et al., 2017; Oxelheim & Randøy, 2003), with mixed results. In this study, we focus on the effects of foreign board members on earnings management. The focus on earnings management is important not only because executive directors may resort to earnings management practices for self-serving reasons (e.g., Chen et al., 2015), but also because earnings management can be extremely value destroying (e.g., Dechow, Sloan, & Sweeney, 1996; Hennes, Leone, & Miller, 2008; Karpoff, Lee, & Martin, 2008; Palmrose, Richardson, & Scholz, 2004). In addition, the immediate effect of monitoring activities of boards on earnings management is likely to be greater than is their immediate impact on firm performance. While earnings management is more likely to reflect deliberate decision-makers' choices, firm performance is a more distant outcome measure in the sense that it is, at least partially, also the outcome of circumstances beyond decision-makers' control (e.g., general economic conditions, industry competition, and other external circumstances).

Second, our study allows us to provide a more nuanced view of how the presence of foreign directors affects firm outcomes. By considering the nationalities of foreign directors on boards of Scandinavian firms, we take apart the domestic-foreign dichotomy frequently used in prior research on boards. More specifically, we show how a lack of knowledge of local accounting rules may impair foreign directors' effectiveness on boards. In addition, we consider the role of language to show how language affects the internal workings of boards. We show that both language proficiency and differences in language structures may influence the quality of boards' monitoring. As such, our study may be an important extension of recent papers on the consequences of foreign directors on firm outcomes (Masulis et al., 2012; Miletkov et al., 2017; Oxelheim et al., 2013) by integrating international corporate governance research with literature about language issues (Tenzer, Terjesen, & Harzing, 2017) and research about board expertise (e.g., Dhaliwal, Naiker, & Navissi, 2010; Krishnan & Visvanathan, 2008).

The remainder of the paper is organized as follows. Section 2 reviews the relevant literature and states the hypothesis. The third section presents the research design, and the fourth section provides the empirical analyses and results. The last section gives the concluding remarks.

2. Literature review and hypothesis development

One of the key roles of boards is monitoring management (Adams et al., 2010). Following agency theory, the board of directors is a crucial mechanism to constrain managers' opportunistic behavior. A key premise of agency theory is that firms characterized by a separation of ownership and control are fraught with agency problems between managers and shareholders (Fama & Jensen, 1983; Jensen & Meckling, 1976). Information asymmetry between managers and shareholders provides self-interested managers with the opportunity to behave opportunistically and to increase their personal wealth at the expense of shareholders. Efficient board monitoring should help reducing self-serving behavior of managers. Given the trend of increased operational complexity following the internationalization of firms on the one hand, and the internationalization of boards accompanying this trend on the other hand, the question is how effective board monitoring is influenced by bringing more foreigners to the board.

An interesting example to study this question is to focus on the occurrence of earnings management at the firm level. Earnings management may be seen as a manifestation of agency problems as it leads to lower earnings quality. In its most basic form, earnings management

[1] For papers taking a broader perspective on the potential costs and benefits of having foreign board members, see, among others, Oxelheim and Randøy (2003); Masulis et al. (2012); García-Meca, García-Sánchez, and Martínez-Ferrero, (2015); Estelyi and Nisar (2016) and Miletkov et al. (2017).