



Exploring the link between internationalization of top management and accounting quality: The CFO's international experience matters



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ABSTRACT

This study examines whether and how top management internationalization is associated with accounting quality. We combine upper echelons perspectives, agency theory, human capital theory and accounting research, and demonstrate that top management internationalization mitigates the level of managerial discretion in financial reporting. By decomposing the top management team, our analysis reveals that higher levels of accounting quality are associated with the internationalization of the CFO, not the internationalization of the CEO. In particular, we find that CFO's international education and international work experience are important factors in higher accounting quality.

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1. Introduction

Upper echelons literature has long investigated the link between top management characteristics and firm-level outcomes (Carpenter, Geletkanycz, & Sanders, 2004; Finkelstein, Hambrick, & Cannella, 2009; Rivas, 2012). More recently, scholars have also elaborated on the impact of top management internationalization. It has been argued that international top managers can better manage the complexity of geographically dispersed operations and cope with a multitude of different environments, such as different laws and regulations (Greve, Biemann & Ruigrok, 2015). In a similar vein, scholars have analyzed the relationship between top management internationalization and firm performance (Nielsen & Nielsen, 2012) or strategic decision making (Athanasios & Nigh, 2002).

The role and the impact of (international) upper echelons have become relevant fields of study not only in International Business (IB) literature but also in other academic disciplines. For instance,

accounting research has focused on investigating managerial discretion in financial reporting (Geiger & North, 2006; Healy & Wahlen, 1999). Several accounting decisions facilitate managerial discretion in choosing how to treat certain events, for example, through depreciation rates or accruals for bad debt. If these accounting decisions are conducted opportunistically, financial reporting might not always accurately reflect a firm's underlying economic situation; thus, accounting quality is considered to be impaired (Han, Kang, Salter, & Yoo, 2010; Healy & Wahlen, 1999). Multiple accounting studies have focused on identifying firm-specific characteristics, such as debt covenants or earnings targets, that can influence the level of managerial discretion in financial reporting (Krishnan & Parsons, 2008). Although the literature stresses that corporate governance mechanisms, such as board independence, audit committees, compensation committees, director ownerships or female representation on boards can increase accounting quality (Adams & Ferreira, 2009; Hwang & Kim, 2009; Klein, 2002; Kang, Leung, Morris & Gray, 2013), an increasing number of scholars also considers the characteristics of top managers and their impact on the financial accounting processes. These characteristics include, for instance, the age, qualification and tenure of top managers (Hu, Hao, Liu & Yao, 2015; Ali & Zhang, 2015).

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Despite the fact that top management initiatives directly affect the level of discretion in financial reporting, the role of top management in the financial reporting processes remains a relatively under-examined field of study (Naranjo-Gil, Maas, & Hartmann, 2009; Ge, Matsumoto, & Zhang, 2011; Demerjian, Lev, Lewis, & McVay, 2012). In this study, we aim to contribute to an increased understanding of managerial characteristics and analyze the role of top management internationalization in firms' financial reporting processes. We intend to portray a more precise picture of the association between top managers' demographics and accounting quality. In particular, our study asks the following questions:

- Is top management *internationalization* associated with accounting quality?
- Does the association between top management *internationalization* and accounting quality vary among corporate governance bodies?
- What is the influence of the *internationalization* of two relatively powerful board members, the CEO and the CFO, on accounting quality?

By addressing these questions, our work helps advance the research in several ways. First, we contribute to literature that investigates the outcomes of top management internationalization. To do so, we take an interdisciplinary stance and combine upper echelons perspectives, agency theory and human capital theory with accounting research. We argue that top managers with international exposure have weaker incentives to exert discretion in financial reporting, can better cope with the complexity of international accounting standards and can ultimately increase a firm's accounting quality. In this respect, our study can be regarded as an attempt to examine the association between managerial characteristics and the quality of financial reporting (Aier, Comprix, Gunlock, & Lee, 2005; Demerjian et al., 2012). Second, we provide a comprehensive view of the internationalization of top managers by drawing on four important dimensions to measure an individual's overall internationalization profile: foreign nationality, international education, international work experience, and international board appointments. Consequently, we respond to recent calls for more fine-grained and comprehensive measures of top management internationalization (Greve, Nielsen, & Ruigrok, 2009; Nielsen & Nielsen, 2012). Third, by focusing on a sample of German-listed firms, we complement investigations that primarily focus on top management characteristics in the Anglo-American context (see Oxelheim, Gregorič, Randøy, & Thomsen, 2013; Randøy, Thomsen, & Oxelheim, 2006; Six, Normann, Stock, & Schiereck, 2013, for notable exceptions) and account for the varieties of corporate governance systems that currently exist (Aguilera & Jackson, 2003). Our analysis adds empirical evidence with respect to the financial decision making capabilities of not only the two main boards in countries with a two-tier system (i.e., the management board and the supervisory board) but also the CEO and the CFO. To accomplish this, we follow Johnson, Schnatterly, and Hill (2012), who emphasize the importance of analyzing the role of top management subgroups and individual top managers within a firm. Along these lines, and to address research interests related to the role of individual top managers, we ask whether accounting quality is influenced by the internationalization of CEOs or CFOs.

Drawing on a sample of firms listed in the German DAX-30 index from 2005 to 2010 and using demographic data on more than 1800 individuals belonging to management boards or supervisory boards, our findings demonstrate that the internationalization of *management board members* increases accounting quality. However, the internationalization of *supervisory board members* is not

associated with the level of accounting quality. Additionally, our top management decomposition analysis reveals that the increase in accounting quality is primarily attributable to the internationalization of the CFO but not to the internationalization of the CEO. This finding complements existing research that emphasizes the general influence of CFOs on firms' financial reporting processes (Aier et al., 2005; Ge et al., 2011). Our additional analyses find that international education and the international work experience of CFOs, and not other dimensions of internationalization such as nationality or international mandates, are the strongest explanatory factors for increased accounting quality.

The remainder of the paper is structured as follows: the second section provides details about our theoretical argumentation and develops our hypotheses. The third section includes a description of the sample and outlines our research method. The results of our empirical investigation are presented in the fourth section, followed by a discussion and concluding remarks in section five. The paper ends with limitations and avenues for future research.

2. Literature and hypothesis development

2.1. The German corporate governance system

Several scholars emphasize important differences between Anglo-American and German accounting systems (e.g., Ernstberger & Vogler, 2008; Gray, 1988). Their investigations assert that institutional environments also affect firms' accounting quality (e.g., Gray, Kang, Lin, & Tang, 2015). Thus, before specifically addressing the association between top management internationalization and accounting quality in a German context, we must consider German particularities with respect to the corporate governance system. German stock corporations (*Aktiengesellschaften*) are typically characterized by a stakeholder orientation and a two-tier board structure that separates management and control (Quick & Warming-Rasmussen, 2009). In contrast to the Anglo-Saxon one-tier system, the management board (*Vorstand*) is responsible for strategic and operational decision making, whereas the supervisory board (*Aufsichtsrat*) monitors the actions of management board members and provides strategic guidance. Furthermore, the supervisory board represents employee interests through the concept of co-determination (Hopt, 1998; Tuschke & Sanders, 2003) and maintains networks with stakeholders. Fig. 1 provides an overview of the German corporate governance system, including the main roles of the management board and the supervisory board.

According to the German Corporate Governance Code (*Deutscher Corporate Governance Kodex*), consolidated financial statements of firms must be prepared by the members of the management board and examined by the auditor and the members of the supervisory board (CGCG, 2013). To account for the specifics of the German corporate governance system, we develop separate hypotheses for the management board and the supervisory board.

2.2. Accounting quality and managerial discretion in financial reporting

Accounting quality is generally defined as the degree to which understandable, relevant, reliable and comparable information about firm performance is provided to support the addressees' decision making processes (IASB Framework, 1989, para. 24). Because accounting standards do not provide any direct measures to help to make accounting quality observable, the accounting literature has developed empirical proxies for the quality in financial reporting (Francis et al., 2004). These proxies reflect accounting-based attributes of earnings on the one hand (i.e., persistence, predictability, quality of accruals, volatility and

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