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The role of national culture and corruption on managing earnings around the world

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ABSTRACT

Earnings management involves using managerial discretion to distort firm financial performance in order to mislead stakeholders. Drawing from institutional theory, we argue that national culture dimensions of power distance and institutional collectivism, which are related to how individuals view themselves with respect to others, serve as informal institutional forces that influence earnings management. We also propose that corruption, as an informal institution plays a significant role in explaining cross-national variation in earnings management. Using a sample of firms from 26 countries, we find support for both direct and interactive effects of these important informal aspects of the institutional context.

1. Introduction

Exercising managerial discretion to manipulate firm earnings is a common corporate practice around the world (Mahony, 2014). Indeed, a 2012 survey of 169 chief financial officers found that one in five firms manage earnings to misrepresent financial performance (Mahony, 2014). Earnings management involves having and using managerial discretion to make choices about how to treat certain financial items (e.g., accruals, depreciation, and asset write-offs), which may result in distorting the actual financial performance of the company (Klein, 2002). As noted by Healy and Wahlen (1999), earnings management is intended to mislead stakeholders, including current or potential providers of equity, debt and labor, suppliers and customers, as well as financial intermediaries (e.g., auditors, regulators, and analysts). Discretion, defined as the latitude of action that managers have, arises from contextual factors (Hambrick & Finkelstein, 1987; Finkelstein, Hambrick, & Cannella, 2009), including those associated with the national institutional context (Crossland & Hambrick, 2011). In this paper, we propose that aspects of the informal institutional context are important for understanding why managers exercise their discretion with respect to managing earnings in firms around the world.

According to institutional theory, firm decision makers are influenced by “common understandings of what is appropriate and, fundamentally, meaningful behavior” in the environment in which they are embedded (Zucker, 1983: 105). North (1990) describes these common understandings as informal institutions. Culture as an informal institution provides motivation and justification for types of behavior that

are consistent with beliefs, assumptions, values, and practices prevailing within a given country (Deephouse, Newbury, & Solemani, 2016; Licht, Goldschmidt, & Schwartz, 2007; North, 1990). Gray (1988) was one of the first to propose that a society’s culture has imprinting effects on the accounting values in a given country and therefore could be expected to influence accounting-type decisions, such as the choice to manage earnings. Exercising discretion to manipulate earnings is an opportunistic activity that is not necessarily in the best interest of other stakeholders. Therefore, we anticipate that cultural dimensions that are directly related to how individual decision-makers view themselves with respect to others will be influential with respect to whether managers engage in earnings management or not.

Power distance and individualism/collectivism are two cultural dimensions that reflect an individual’s relationships to other societal members (Hofstede, 2001; House, Javidan, Hanges, & Dorfman, 2002). Several relatively recent studies, based on Gray’s (1988) model have shown Hofstede’s individualism to be positively related to earnings management (Doupnik, 2008; Gray, Kang, Lin, & Tang, 2015; Han, Kang, Salter, & Yoo, 2010). Although Gray’s (1988) model included power distance, this cultural dimension has not been theoretically considered nor empirically tested. We believe this not only represents an empirical gap in the literature, but also subsequently leaves incomplete theoretical understanding about how culture may facilitate or hinder earnings management activity.

In addition, since corruption, as an informal institution is associated with individuals behaving in self-interested ways at the expense of others (Eden & Miller, 2004; Judge, Douglas, & Kutan, 2008), we

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propose that the level of corruption in a country will also influence how firm decision makers interpret the feasibility and legitimacy of managing earnings. When corruption is part of individuals' belief systems, it plays an important role in everyday economic and social life (Doh, Rodriguez, Uhlenbruck, Collins, & Eden, 2003). Indeed, previous research has suggested that in societies where corruption is pervasive, there are fewer constraints on viewing unethical or questionable behavior as illegitimate (Hoffman, Frederick, & Schwartz, 2013). Moreover, institutional scholars have suggested societal values that are relatively stable over time, such as national culture influence individuals' belief systems (Finch, Deephouse, & Varella, 2015; Lee, Pillutla, & Law, 2000). Therefore, we expect that the cultural dimensions as high-order institutions will moderate the relationship between corruption and earnings management.

We test our theoretical predictions in a multilevel analysis using a sample of 13,341 firms from 26 countries. We include firms from both developing and developed countries in our sample. In doing so, we not only address concerns that earnings management research has largely neglected developing economies (Wang & Yung, 2011), but are also better able to tease out the effects of the informal institutions we are studying. Developing countries in particular have been characterized as lacking formal regulatory frameworks, or having institutional voids (Khanna & Palepu, 1997). Scholars have highlighted that because of these voids, informal institutions may play an enhanced role in governing economic and social activity (Holmes, Miller, Hitt, & Salmador, 2013).

Our results show that cultural dimensions of power distance and institutional collectivism along with the informal institution of corruption have significant effects on the magnitude of earnings management. Our study contributes to international business literature in several ways. First, research studying the role of informal institutions and in particular their interactive effects on firm-level phenomena are notably limited (Ang, Benischke, & Doh, 2015). Therefore, our study helps address this limitation and subsequently provides a more comprehensive understanding of what drives firm-level earnings management around the world. Relatedly, our finding that power distance significantly moderates the relationship between corruption and earnings management highlights the complexities and contingent nature of how values and norms of behavior influence firm-level activities. Second, while there is a vast body of research on national-level outcomes of corruption, relationships between corruption and firm-level outcomes are relatively unexplored and thus not fully understood (De Jong & van Ees, 2014; De Jong, Phan, & van Ees, 2012; Doh et al., 2003). This study is a modest attempt to help address this issue. Third, while earnings management is a very particular manifestation of managerial discretion, our findings add to research that shows the non-random role national culture plays in affecting managerial discretion across countries (e.g., Crossland & Hambrick, 2011). Finally, our focus on how three important informal institutions shape the legitimacy and acceptance of certain types of firm-level behaviors enhances research grounded in institutional theory by underscoring how and why the institutional environment in which firms are embedded matters.

In the following sections, we develop theoretical arguments about why the level of power distance, institutional collectivism, and corruption pervasiveness in a country influence the magnitude of firm-level earnings management. This is followed by an explanation of the methodology we use to test the hypotheses and the presentation of results. We conclude with a discussion of our findings and their implications for international business theory and practice.

2. Theory and hypotheses

In firms around the world, managers use judgment in structuring financial transactions to arrive at desired earnings reports (Han et al., 2010). These practices are referred to as earnings management and are reflective of the level of discretion managers have and are willing to use

with respect to choices about accurate reporting of financial information (Bergstresser & Philippon, 2006; Dechow & Skinner, 2000). Managers derive their discretion from individual and firm-level sources, but also from the external environment (Finkelstein et al., 2009). From an institutional theory perspective, firm-level decisions resulting from managerial discretion, such as managing earnings, are shaped by the broad set of institutions prevailing within a country (North, 1990).

Previous cross-national research has shown that a country's formal institutions, legal and regulatory conditions influence the prevalence of earnings management (Han et al., 2010; Leuz, Nanda, & Wysocki, 2003). Yet a country's institutional environment also includes informal institutions, which "may do the enabling and constraining that is widely attributed to formal institutions." (Helmke & Levitsky, 2004:726). Further, when formal institutions are underdeveloped and their outcomes uncertain, such that institutional voids occur, informal institutions take on greater relevance for those involved in business transactions (North, 1990; Puffer & McCarthy, 2011).

Research has shown that national level informal institutions "elicit shared cognitive and normative frameworks among economic agents" (Abdi & Aulakh, 2012: 491) suggesting that whether and how managers choose to use their discretion with respect to managing earnings will be subjectively influenced by the values, norms, beliefs, and assumptions associated with the institutional context in which they are embedded. Since choosing to exert discretion to manage earnings is viewed as acting in a self-interested manner at the expense of other stakeholders, we expect that cultural dimensions associated with how individuals view themselves with respect to others will be particularly relevant. Specifically, we evaluate the effect of power distance since it is associated with relations between individuals embedded in hierarchies, and that of institutional collectivism, which deals with relationships between individuals and groups.

Culture defines what is legitimate, right and desirable in a given society (Deephouse et al., 2016; North, 1990). Therefore, it influences individuals' preferences and justifications (Chai, Liu, & Kim, 2009). Indeed, culture has been shown to play an important role in managerial perceptions regarding ethical decisions (e.g., Parboteeah, Bronson, & Cullen, 2005; Sims & Gegez, 2004; Thorne & Sauders, 2002; Sims & Gegez, 2004; Thorne & Sauders, 2002) and with respect to the level of discretion managers are able to develop and use in organizations (e.g., Crossland & Hambrick, 2011). We expect that both power distance and institutional collectivism will influence the availability of managerial discretion as well as the motivation to exert it.

From an institutional theory perspective, scholars (e.g., Eden & Miller, 2004; Judge et al., 2008; Parto, 2008) have suggested corruption serves as an informal institution as it is "rooted in societal beliefs and norms" and influences expectations about legitimate behavior (Xu & Shenkar, 2002: 610). Thus, we anticipate that differences in the level of corruption pervasiveness across countries will also shape variation in the use of discretion to manipulate earnings.

2.1. Earnings management and power distance

Power Distance is the degree to which power and authority are expected to be distributed and expressed equitably or inequitably within society (Carl, Gupta, & Javidan, 2004; Hofstede 1980; House, Hanges, Javidan, Dorfman, & Gupta, 2004). In high power distance cultures, members of a society expect and agree that power should be stratified and concentrated at higher levels of an organization or government (House et al., 2004).

Several recent empirical earnings management studies, while not explicitly hypothesizing effects of power distance, do include the dimension in their regression models and provide mixed findings. There are studies showing non-significant positive relationships (e.g., Guan, Pourjalali, Sengupta, & Teruya, 2005), non-significant negative relationships (e.g., Desender, Castro, & De León, 2011) or both (e.g., Douppnik, 2008; Nabar & Boonlert-U-Thai, 2007). Results by Han et al.

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