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Do Foreign Directors Mitigate Earnings Management? Evidence From China☆

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ABSTRACT

In this study, we use a sample of Chinese companies to examine the monitoring role of foreign directors in deterring earnings management. Our findings show that earnings management is significantly negatively associated with the presence and ratio of foreign directors on corporate boards. We further find that, under these conditions, earnings management is less pronounced in state-owned enterprises as compared to others. These findings are robust to various specifications of earnings management as well as to the approach used in matching the treatment and control samples. Interestingly, the negative impact of board membership of foreign directors on earnings management varies with audit quality, IFRS convergence, investor protection and the similarity or difference of the time zones of the foreign directors and China.

1. Introduction

Nowadays, along with corporate internationalization, the globalization of corporate boards is increasingly popular. Multinational corporations are the bellwethers that lead the revolution because business transnational expansion evokes the demand for foreign top executives. Staples (2007) finds an increasing tendency for foreign directors, from 36.3% in 1993 to 75% in 2005, in the 80 largest multinational corporations. Moreover, recommendations from regulators also accelerate this evolution. Regulators in some developed countries suggest that public firms should take the benefit of board nationality diversity into account. For example, the Securities and Exchange Commission in the United States requires public companies to provide disclosure regarding the consideration of board diversity in the process of nomination (Securities and Exchange Commission [SEC], 2009).

Most of the benefits of board diversity are attributed to the cognitive and information diversity that diverse members bring into the upper echelons of firms (Kim & Rasheed, 2014). Diverse groups have superior cognitive skills to homogenous groups, as they can reduce the risk of "group think" and improve the quality of decision-making. Board members from other countries usually have different educational backgrounds and working experiences from local board members. Also, their logic and intuition are highly affected by some long-standing cultural and institutional factors in their own homelands. Consequently, when foreign directors enter the boardroom, they can help solve the problem of narrow-mindedness. Moreover, foreign directors provide some crucial resources for the organization, such as access to international capital and a linkage to some business elites with other nationalities

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(Walt & Ingley, 2003). Several extant studies document that ethnic or nationality diversity does improve corporate performance in developed countries (Carter, Simkins, & Simpson, 2003; Erhardt, Werbel, & Shrader, 2003; Oxelheim & Randøy, 2003), echoing the above proposition.

It is well accepted that advising and monitoring are two basic functions of the board of directors (Hillman & Dalziel, 2003). The question of whether foreign directors contribute to firm performance and shareholder value primarily through the advising role, monitoring role, or both, is an under-researched problem. Masulis, Wang, and Xie (2012) document that foreign directors bring in some advisory benefits to firms headquartered in the United States. However, they find that foreign directors are less effective monitors due to geographic distance, cultural barriers, and information unavailability. In addition to acknowledging their eminent contributions, we argue that the U.S. context limits the generalization of findings in Masulis et al. (2012). Specifically, we should not neglect the differentiation in institutional settings between developed countries and developing countries, as well as firms' motivations for hiring foreign directors.

First, in developed countries, when firms select foreign directors, they are apt to "lock" directors to those from equivalently developed areas. For instance, Van Veen and Elbertsen (2008) find that for corporations in the Netherlands, most foreign directors come from the United Kingdom, United States, France, Belgium, and Germany. In contrast, firms in emerging markets historically lag behind their counterparts in developed economies in a variety of aspects such as business operation, corporate governance, and internal control. As a response, when firms in emerging markets hire foreign directors, they tend to look for talented persons from more advanced areas, as these candidates are assumed to have more knowledge and experience. In addition, foreign directors from developed economies play a larger role beyond consulting. Actually, some foreign directors serve as mentors or instructors in China. Second, it is worth noting that the monitoring role of corporate boards is especially important for firms in emerging markets. Some international comparative studies shed light on the typical institutional features in emerging markets, such as concentrated ownership, poor legal system, and weak investor protection (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000; Leuz, Nanda, & Wysocki, 2003). If the board of directors is captured by managers, its monitoring role is less effective. Therefore, to constrain insider control and managerial entrenchment, the monitoring role of the board of directors should be emphasized. Foreign directors are more independent from top managers than locally based directors. Higher independence enables foreign directors to better oversee managers. Moreover, the reputation effect boosts foreign directors' sense of responsibility, and their specialized knowledge ensures their professional judgment during the process of monitoring. As a result, we argue that foreign directors improve the monitoring level of the board of directors in firms from developing countries.

Based on the context of China, we investigate whether the globalizing boardroom and foreign directors help enhance financial reporting monitoring and thus mitigate earnings management. We employ the Chinese context not only because China has the largest emerging market and the second-largest economy in the world, but also because the Chinese context is suitable for our research question. Earnings management is rampant in Chinese listed firms, as legal investor protection is weak (Chen, Chen, Lobo, & Wang, 2011; Chen & Yuan, 2004; Haw, Qi, Wu, Wu, & Clinch, 2005). The board of directors is a crucial internal control mechanism in constraining earnings management and financial statement fraud (Beasley, 1996; Klein, 2002; Xie, Davidson, & DaDalt, 2003). Thus, when foreign directors, who usually serve as independent directors and audit committee members, sit in the boardrooms, they transmit their knowledge and experience in monitoring. More importantly, they strike the innate balance of the characteristics referred to as *Guanxi* (connection, ties, connectedness), *Renqing* (favor), and *Mianzi* (face) among the local Chinese. As a result, foreign directors enhance the overall independence of corporate boards, which thus results in a higher likelihood of deterring managers' financial reporting irregularities.

Using a sample of 11,529 firm-year observations from the Chinese stock market for the period 2004–2012, we show that both the presence and percentage of foreign directors are significantly negatively associated with earnings management, suggesting that foreign directors enhance financial report monitoring. In addition, the role of foreign directors in constraining earnings management is less pronounced for state-owned enterprises (SOEs) than for non-SOEs, revealing that the impact of foreign directors competes with political forces in government-controlled enterprises. The above findings are robust to alternative measures of earnings management and foreign directors. Furthermore, our conclusions are still valid after controlling for the endogeneity issue. In additional tests, we find that the negative effect of foreign directors on earnings management varies with: (1) whether a firm is audited by a Big10 auditor; (2) convergence between the 2007 Chinese Accounting Standards (CAS) and International Financial Reporting Standards (IFRSs); (3) the time zones of countries that foreign directors come from; (4) the level of investor protection in the country that the foreign directors come from; and (5) the extent of convergence between national accounting standards where the foreign directors come from and IFRSs. Additionally, our additional tests also show that foreign directors are significantly negatively related to the likelihood (magnitude) of financial restatement (overstatement).

Our study makes several contributions to prior literature as follows. First, the existing literature on board nationality diversity is mostly based on the context of developed countries, where firms tend to hire foreign directors from other developed countries (Masulis et al., 2012). In contrast, firms in developing countries follow the "best practice" from those in developed countries, and thus they take in foreign directors from more developed regions, with the expectation that foreign directors can also serve as the monitors. Differences in governance systems make it hard to generalize conclusions based on developed countries to other countries, and thus it is arguable whether findings in Masulis et al. (2012) are valid and transferable to firms in developing countries. Our empirical tests are conducted using a sample of Chinese listed firms, which have some different features in terms of foreign directors compared to firms in the United States. We find that foreign directors mitigate earnings management, which does not repute findings in Masulis et al. (2012) because of the different contexts. Specifically, we contend that the role of foreign director is conditional on various contexts, depending on country-specific institutions, incentives of "importing" foreign directors, and some local factors such as the nature of the ultimate owner, board size, board composition, and tones at the top (managerial style).

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