

10-2010

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Recommended Citation

Marshall Geiger, Joyce van der Laan Smith; The Effect of Institutional and Cultural Factors on the Perceptions of Earnings Management. *Journal of International Accounting Research* 1 January 2010; 9 (2): 21–43. doi: <https://doi.org/10.2308/jiar.2010.9.2.21>

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The Effect of Institutional and Cultural Factors on the Perceptions of Earnings Management

Marshall Geiger and Joyce van der Laan Smith

ABSTRACT: In this study we examine the effect of stakeholder orientation versus shareholder orientation, and the level of cultural secrecy on individuals' perceptions of earnings management practices. Examining perceptions from 1,260 participants from 13 countries indicates that individuals from stakeholder-oriented institutional backgrounds were less accepting of earnings management, including both accounting earnings management and operating earnings management activities, than participants from shareholder-oriented institutional backgrounds, and that individuals from secretive cultures were more accepting of both types of earnings management activities. Our findings provide evidence of the anticipated perceptual differences across countries with respect to earnings management and suggest the need for further research linking perceptions to reported earnings management measures.

I. INTRODUCTION

A constant pressure in accounting and business across the globe is for companies to report stable, if not growing, financial position to stockholders, creditors, analysts, and other interested parties. With this strain comes the pressure on the firm's financial reporting executives to "manage" the company's reported financial results. In part, because of this financial reporting pressure, we seem to be bombarded with news of financial wrongdoing in a continual stream of announcements regarding someone, or some company, acting unethically in the context of financial reporting, not only in the United States (Hogan et al. 2008), but around the world (Reinstein et al. 2006; Goh 2008; Olive 2008; Kahn 2009). While not all earnings management leads to inappropriate financial reporting, it is important to examine these reporting practices from diverse perspectives. Accordingly, the evaluation of perceptions regarding earnings management behavior is a vital concern for business reporting worldwide. To the extent that perceptions lead to the practice of earnings management, an examination of these perceptions is particularly germane to the evaluation of the financial reporting climate in our growing international business community, and is of direct concern regarding the comparability of reported financial information across countries. Accordingly, it is critically important to examine the perceptions of individuals from different countries in an attempt to evaluate the climate for earnings management that may exist,

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Published Online: October 2010

and, therefore, the potential for biased financial information in different segments of our global financial marketplace, even after the adoption of a common set of worldwide financial reporting requirements (Jeanjean and Stolowy 2008; Zeff 2007).

Thus, the purpose of this study is to further our understanding of perceptions regarding the financial reporting practice of earnings management (i.e., income smoothing or manipulating income toward a desired goal) and to assess whether those perceptions may be influenced by institutional and cultural factors across countries. Prior research has found evidence of systematic cross-country variations in the perceptions of earnings management practices but has largely been unable to attribute these differences to cultural factors (Geiger et al. 2006). In addition, prior research has examined the qualities of financial reporting for companies operating in countries with either a stakeholder- or shareholder-oriented corporate governance model (Ball et al. 2000; Othman and Zeghal 2006), but has not examined individuals' perceptions of earnings management across this dimension. In this study, we combine and extend these areas of research by using a previously developed instrument (i.e., Merchant and Rockness 1994) to assess perceptions regarding the practice of earnings management of individuals from 13 countries. The studied countries are characterized as having either a stakeholder-oriented corporate governance model or a shareholder-oriented corporate governance model, and given that the objective of earnings management is to mask actual earnings, we examine countries that are different on the cultural dimension of secrecy (Hope et al. 2008).

We test our hypotheses by comparing the perceptions of 730 participants from seven countries having a shareholder-oriented corporate governance model (i.e., Australia, Hong Kong, Ireland, Malaysia, Singapore, U.K., and the United States) to the perceptions of 530 participants from six countries that have a stakeholder-oriented corporate governance model (i.e., Argentina, Belgium, Indonesia, Italy, Mexico, and Spain). In addition, the level of cultural secrecy for the 13 countries included in the study varies considerably and provides acceptable variation in order to examine this cultural dimension.

Our findings suggest that participants from all countries generally viewed accounting earnings management actions (i.e., changing reserve estimates, etc.) as less acceptable than operating earnings management actions (i.e., changing operating policies), and that participants from stakeholder-oriented countries were less tolerant of earnings management activities than participants from shareholder-oriented countries. We also find individuals from highly secretive cultures are more accepting of earnings management. Our perceptual findings provide evidence that differences in perceptions of earnings management across countries are significantly associated with the country's stakeholder/shareholder orientation and the level of cultural secrecy. Our findings also suggest the need for further research regarding the link between the perceptions of earnings management and the level and measurement of earnings management activities that may exist across countries, as well as the institutional and market factors that may account for these disparities (Ball et al. 2000; Othman and Zeghal 2006; Jeanjean and Stolowy 2008). Overall, our findings contribute to the ongoing cross-country debate regarding the complex relationship between institutions, culture, and financial reporting (Hope 2003; Zeff 2007).

The remainder of the paper is as follows. In the next section we provide a brief background, review the salient literature, and develop the hypotheses. We then discuss our methodology and provide a description of our sample and data in Section III. We present the results of the analyses in Section IV and offer conclusions from our study in the final section.

II. BACKGROUND, LITERATURE REVIEW, AND HYPOTHESES DEVELOPMENT

Earnings Management

Manipulating reported earnings, both internally and for external reporting purposes, is a very real temptation faced by all accountants and financial professionals (Guenther 1994; Healy and

Wahlen 1999; Matsumoto 2002; Moehrle 2002; Kinnunen and Koskela 2003; Tsakumis 2007; Francis and Wang 2008). Manipulating, or “managing,” one’s earnings takes a variety of forms and includes the practice of selectively choosing accounting estimates or timing operating or investment decisions to move reported earnings either upwards or downwards toward a desired goal (Schipper 1989; Merchant and Rockness 1994; Healy and Wahlen 1999). Prior research reveals considerable disagreement regarding the general ethical acceptability of the practice of managing earnings (Bruns and Merchant 1990; Merchant and Rockness 1994; Fischer and Rosenzweig 1995). While some individuals view these decisions as part of the typical set of financial reporting decisions and responsibilities, others view them as attempts to intentionally mislead the financial community (Mintz 1997; Xu et al. 2007).

Whether to engage in the practice of earnings management is one of the most important ethical and financial reporting issues accountants face in everyday practice around the world (Armstrong 1993; Kinnunen and Koskela 2003; Siregar and Utama 2008). Investors and creditors in every nation depend on accountants to provide fair and reliable financial information regardless of national orientation or institutional background. Financial statement users must be certain that companies report accurate information on which financial decisions must be based (Zeff 2007). Companies and individuals that engage in earnings management may misrepresent the true long-run economic profitability, and sustainability of their operations.

Although professional standards in all countries require accountants to present unbiased information (Zeff 2007), there are many facets to the earnings management issue, as well as potential ways to “manage” a company’s reported accounting earnings (Schipper 1989; Armstrong 1993; Xu et al. 2007). A large body of anecdotal and empirical evidence on publicly disclosed financial information suggests that individuals or companies practice earnings management (Burgstahler and Dichev 1997; Healy and Wahlen 1999; Brown 2001; Kinnunen and Koskela 2003). For example, Cahan (1992) found that companies use discretionary accruals to reduce their reported earnings during antitrust investigations. DeFond and Jiambalvo (1994) concluded that financially troubled companies appear to use accruals to increase their earnings to avoid violating debt covenants. Perry and Williams (1994) found evidence of income-reducing accruals just prior to management buyout offers, while Erickson and Wang (1999) found evidence of income-increasing accruals just prior to stock-for-stock mergers. Kinnunen and Koskela (2003) document the practice of upward rounding of net income disclosures across 18 countries, as managers attempt to present a more favorable economic picture of the company.

While these studies of publicly reported financial information suggest the practice of earnings management exists in many settings cross-nationally, there has been little research with respect to the perceptions of this practice and its acceptability. Consistent with this, Han et al. (2010) note that more recent research in accounting and finance has started to come to grips with the influence of the “softer dimension” of human values and their impact on cross-national capital markets. Continuing in this line of research, we examine the cross-national perceptions of earnings management and follow Merchant and Rockness (1994), who argue that there are generally two ways to engage in earnings management—accounting earnings management (AEM) and operating earnings management (OEM). AEM activities include the intentional manipulation of accounting numbers and include practices such as intentionally recording transactions in the wrong period, recording fictitious transactions, or artificially increasing/decreasing account balances or reserves to attain desired reporting goals (e.g., backdating sales invoices, or intentionally over- or understating inventory or the allowance for uncollectibles). In contrast, OEM activities pertain to the modification of operating policies and activities in order to attain the desired reporting results. OEM activities involve the timing or structuring of underlying business transactions. Xu et al. (2007) argue that these are the “real” earnings management practices, as they often include activities that may be inefficient or detrimental from the firm’s long-term perspective, such as not

performing regularly scheduled maintenance or increasing/decreasing current discretionary spending, but are performed in order to attain desired current reporting goals. While not misrepresenting the activities of the organization, these actions are undertaken with the intent of obtaining specific reporting goals that would not have otherwise been achieved in the normal course of operations (Ewert and Wagenhofer 2005; Xu et al. 2007).

Given the differences in the methods of accomplishing AEM and OEM, we expect that there will be differences in the perception of the type of manipulations for our study. Prior single country studies (Merchant and Rockness 1994) and cross-country studies (Geiger et al. 2006) have found that AEM is considered significantly less acceptable than OEM. Accordingly, we expect the same to hold true for our study across all countries, irrespective of institutional or cultural factors. Thus, in order to establish the equivalence of our sample with those of prior research, we first hypothesize that there will be differences in overall perceptions regarding OEM and AEM activities for all individuals regardless of country. Thus, our first hypothesis is:

H1: Participants from all countries will perceive AEM activities as significantly less acceptable than OEM activities.

Shareholder versus Stakeholder Orientation

An institutional factor that has been examined as an explanatory factor for cross-national differences in reported earnings management is the type of corporate governance model that is most prevalent in the reporting country. In this context, countries have been identified as either having a stakeholder or a shareholder orientation (Ball et al. 2000; Othman and Zeghal 2006). This distinction arises from the stakeholder theory literature that argues that successful firms are those which effectively manage their many stakeholder relationships (Freeman et al. 2007). Following the theory of stakeholder salience, the relationships a firm chooses to manage are based on the stakeholder attributes of power, legitimacy, and urgency (Mitchell et al. 1997). van der Laan Smith et al. (2005) argue that these stakeholder attributes are also affected by the institutional environment, which varies cross-nationally.

In comparison to shareholder-oriented countries, stakeholder-oriented countries are those with more of a communitarian perspective, which “holds that a corporation is a social organization that has social responsibilities that go beyond achieving economic efficiency” (van der Laan Smith et al. 2005, 130). Given this broader perspective, all stakeholders, and not only the company’s shareholders, are viewed as having a legitimate voice in corporate activities. Further, Ball et al. (2000) argue that in the stakeholder governance model, accounting income is viewed as a common “pie” divided up among stakeholders, such as dividends to shareholders, taxes to governments, bonuses to managers, and, possibly, pay increases to employees. This portfolio of interested stakeholders is all considered to share in success or failure of the company and are all impacted by financial reporting (Freeman et al. 2007).

In contrast, shareholder-oriented countries hold a contractarian perspective and view shareholder wealth maximization as the primary purpose of the corporation, resulting in less legitimacy accorded other stakeholder groups. In these shareholder-oriented countries, the needs and views of the corporate shareholders clearly dominate those of all other affected groups (Mitchell et al. 1997). Ball et al. (2000) and Leuz et al. (2003) argue that stakeholder-oriented countries are also typically code-law countries, and shareholder-oriented countries are typically common-law countries. They note that accounting information needs are different between these two types of countries with code-law countries maintaining relatively higher degrees of insiders who already have access to information, and being subject to comparatively stronger degrees of political influence from governments in the establishment of accounting regulations. For example, Ball et al. (2000) note that in a code-law country like Germany, the government sets both the accounting and tax

regulations, resulting in German financial reporting being almost identical to tax reporting. In addition, they argue that code-law and common-law countries have different institutional factors that bear on financial reporting outcomes, with common-law (shareholder-oriented) countries' financial reporting being more influenced by the need for public disclosure of information to the shareholders in the market, and code-law (stakeholder-oriented) countries being more influenced by the payout preferences of already reasonably well-informed stakeholders. In addition, because of the relatively higher need to inform shareholders, Ball et al. (2000) argue that shareholder-oriented countries are also ones with stronger financial market institutions and enforcements in place in order to aid in the dissemination of information to the company's owners.

Using this stakeholder/shareholder dichotomy, Ball et al. (2000) find that accounting income more quickly incorporates economic losses in common-law countries compared to code-law countries, which they argue proxies for the level of reported earnings management. Thus, they conclude that common-law (shareholder-oriented) countries exhibit lower levels of reported earnings management than code-law (stakeholder-oriented) countries. In addition, Leuz et al. (2003) find that "outsider economies with relatively dispersed ownership, strong investor protection, and large stock markets," as is primarily found in shareholder-oriented countries, exhibit less earnings management in their public financial reporting than "insider countries with relatively concentrated ownership, weak investor protection, and less developed stock markets," as is predominately found in stakeholder-oriented countries. Othman and Zeghal (2006) examine reporting in France (a stakeholder-oriented country) and Canada (a shareholder-oriented country) and find that earnings management activities are linked to specific and different incentives between the two countries. They find that earnings management activity is linked to contractual debt costs and effective tax rates in French firms, but is linked to issuing equity in Canadian firms.

As noted by these earlier researchers, companies operating in common-law countries generally have higher levels of regulation, and litigation, and the need for more transparent financial information compared to code-law countries. These differences result in different financial market forces and information needs by financial market participants. Accordingly, we cannot be certain whether their findings of differences in reported financial information are due to individuals' perceptions of the acceptability of earnings management practices, or the additional institutional and market forces impacting corporate financial reporting in these two different settings.

Based on the foundations of stakeholder theory (Freeman et al. 2007), however, we expect that individuals from stakeholder countries would perceive the practice of earnings management as more serious, and be less accepting of it due to the fact that, from this perspective, it affects many different interested stakeholder groups. Thus, notwithstanding some of the empirical findings of earlier researchers on financial reporting issues, we believe that the *perceptions* of the overall acceptability of earnings management will be lower (i.e., less accepting) for individuals from stakeholder-oriented countries than for individuals from shareholder-oriented countries. Accordingly, our second hypothesis:

H2: Participants from stakeholder-oriented countries will perceive earnings management to be less acceptable than participants from shareholder-oriented countries.

Cultural Secrecy

Othman and Zeghal (2006) note that, as with all human activities, accounting rules and practices, as well as the capital markets, are affected by culture. Accounting is a socio-technical activity involving an interaction between both human and non-human factions and, because the two interact, accounting cannot be culture-free. And as further asserted by Han et al. (2010) and Hussein (1996), there is an increasing awareness among many accounting researchers and standard setters of the social and cultural influences on accounting (Gray 1988; Beresford 1990).

In fact, culture has been found to influence the development of accounting systems (Gray 1988; Douplik and Salter 1995; Nobes 1983), the perceptions of the participants in those systems (Douplik and Tsakumis 2004), and the application of financial reporting rules within the accounting systems (Tsakumis 2007). With respect to earnings management, Braun and Rodriguez (2008) find a positive relationship between Gray's (1988) culturally derived accounting values of statutory control, uniformity, conservatism, secrecy, and earnings management. Further, Kinnunen and Koskela (2003) identify a positive relationship between earnings management and Hofstede's (1991, 2001) cultural value of power distance, which measures the extent to which individuals accept human authority inequality. Similarly, Nabar and Boonlert-U-Thai (2007) conclude that Hofstede's cultural values of uncertainty avoidance and masculinity were related to earnings management.

In the context of our study, since the objective of earnings management, whether AEM or OEM, is to conceal "unmanaged" results and to drive reported earnings toward a desired goal, we examine the cultural dimension of secrecy, developed by Hope et al. (2008). In their derivation of the cultural dimension of secrecy, Hope et al. (2008) incorporate a majority of Hofstede's (2001) five cultural dimensions to arrive at a country's secrecy score.¹ Hope et al. (2008) extend the earlier cultural work of Gray (1988) and Hofstede (1980, 1991, 2001), and argue that a composite measure of cultural secrecy is related to cross-cultural differences in financial reporting. Companies from countries that have more secretive cultures would tend to try and conceal or not fully disclose relevant financial information and be less financially transparent than companies from less secretive cultures. Accordingly, Hope et al. (2008) find, consistent with their secrecy expectations, that companies in more secretive cultures are less likely to engage a higher-quality Big 4 audit firm (who would be more likely to require full financial disclosures) than companies in less secretive cultures.

Based on these earlier works, we adopt the approach espoused in Hope et al. (2008) and examine the association of cultural secrecy with individual's perceptions of earnings management. We hypothesize that individuals from cultures that are more secretive will also be more tolerant of both types of earnings management compared to individuals from less secretive countries. Thus, our final hypothesis is:

H3: Participants from more secretive countries will perceive earnings management as more acceptable than participants from less secretive countries.

III. METHOD

Earnings Management Questionnaire

In order to capture perceptions of earnings management, participants answered a questionnaire that asked them to evaluate the ethical acceptability of 13 earnings management activities. The scenarios were originally developed by Bruns and Merchant (1990) and subsequently used by Merchant and Rockness (1994), Fischer and Rosenzweig (1995), and Geiger et al. (2006) to study perceptions regarding the practice of earnings management. The scenarios address relatively straightforward practices such as delaying or accelerating discretionary expenses or intentionally manipulating inventory reserves. A copy of the questionnaire items is included in the Appendix.

As noted previously, earnings can be manipulated either by altering or misrepresenting the recording of existing transactions and events—an accounting earnings management manipulation, or by manipulating business activities near year-end to move revenues and expenses into desired

¹ Hofstede's (2001) five cultural dimensions are Individualism/Collectivism, Power Distance, Uncertainty Avoidance, Masculinity/Femininity, and Long-Term Orientation.

periods—an operating earnings management manipulation. Merchant and Rockness (1994) categorized the 13 scenarios according to whether they were AEM or OEM manipulations.² For example, scenario number 6, in which the manager misrepresents the division's inventory reserve, is an example of an AEM. Scenario number 2, in which a manager orders employees to defer discretionary expenditures until the next accounting period, is an example of an OEM.

In addition, the scenarios presented to the subjects were GAAP/IFRS context-free. Meaning, the scenarios were typical business activities and were not specifically addressed in either U.S. GAAP or international IFRS financial reporting standards. Further, we did not specify that the respondent apply any national or international financial reporting rules when completing the instrument. We simply asked them how ethical they believed the actions were. Accordingly, we have attempted to assess whether perceptions regarding the acceptability of earnings management techniques, in general, and with respect to AEM and OEM manipulations, are influenced by national culture and institutional factors, not whether the actions in the scenarios are necessarily prohibited or allowed under U.S. GAAP or IFRS.

As in Merchant and Rockness (1994), our subjects responded to each scenario using a five-point scale, ranging from a 1 for "Ethical practice." to a 5 for "Totally unethical. The manager should be fired." Thus, *higher scores* indicate that individuals perceived the action proposed in the scenario as *less ethical* than action perceptions represented by lower scores. Accordingly, high scores indicate how *unacceptable* the subject believed the action in question to be.

Country Selection

Stakeholder/Shareholder-Orientation Countries

The countries selected were chosen to enhance the distinction in the shareholder/stakeholder-oriented corporate governance structure, and to represent varying degrees of the cultural attribute of secrecy. Consistent with Ball et al. (2000), we use the classification of a country's legal system as a proxy for corporate governance structure, and we select countries from the common-law tradition and the French code-law tradition. La Porta et al. (1998, 1132, 1134) found that "shareholders in the two most widely spread legal regimes—common law and French civil law—operate in very different legal environments" and that "common-law countries have the relatively strongest and the French civil-law countries the weakest, protections of shareholders." Given this finding, we believe that the French code-law countries would be most likely to exhibit the least shareholder orientation and, therefore, the strongest stakeholder orientation and, accordingly, provide the greatest contrast to shareholder-oriented countries. We selected the common-law countries of Australia, Hong Kong, Ireland, Malaysia, Singapore, the U.K., and the United States to represent shareholder-oriented countries. We include Argentina, Belgium, Indonesia, Italy, Mexico, and Spain to represent stakeholder-oriented countries.

Secrecy Scores

Following Hope et al. (2008), we use their measure of cultural *Secrecy*, which combines Hofstede's (2001) uncertainty avoidance (*UA*), power distance (*POW*), and individualism (*IND*) dimensions into one composite secrecy score. Consistent with Gray (1988), Hope et al. (2008) argue that high uncertainty avoidance countries tend to restrict information disclosures to avoid conflict and preserve security, and high power distance countries tend to restrict information disclosures to preserve power inequalities, leading to higher secrecy. Further, higher preferences

² The questionnaire also includes scenarios that vary the direction (income increasing versus decreasing), and dollar amount (materiality) of the manipulation, as well as the intentions of the manager committing the manipulation. However, since the focus of our study is on national institutional and cultural differences, we focus our analyses on the overall types of manipulations and separately assess only the AEM and OEM measures.

for collectivism, as opposed to individualism, are also consistent with Gray's (1988) framework for reporting secrecy. Accordingly, a country's composite *Secrecy* score is calculated as their power distance (*POW*) score plus their uncertainty avoidance (*UA*) score minus their individualism (*IND*) score.

Participants

The participants in this study were 1,383 upper-level accounting students at several public and private universities in the 13 countries.³ Participation was voluntary and the responses to the questionnaire were anonymous. In order to ensure that the students understood the nature of the accounting scenarios, participation was limited to upper-level students who previously had at least one financial reporting course, and data was collected toward the end of the semester in all courses.⁴ When collecting demographic data, participants were also asked to indicate their home country. We used these responses and not the country location of participation to identify individual's country of nationality.⁵ Thirty-five students either did not provide all demographic data or did not answer all the questions, and 88 participants were eliminated because there were not at least 20 respondents from their country of origin. These data requirements resulted in 1,260 usable responses across the 13 countries.⁶

The use of students as surrogates for employed adults has long been an issue in business research (Dickhaut et al. 1972). However, several studies have suggested that the use of business students to proxy for professionals is appropriate when assessing basic traits or perceptions, but not for higher-order decision-making skills (Campbell 1986; Ward 1993). For example, Remus (1986) and Greenberg (1987) specifically addressed this student surrogate issue by studying both business students and employed adults simultaneously. Both these studies conclude that there were no differences between the business students and the employed adults. Therefore, Remus (1986) argues that the use of mature business students as surrogates for employed professionals is appropriate. Our study examines the perceptions of more mature, upper-level students—thus, meeting Remus' criteria.

In addition, numerous prior researchers have utilized accounting and business students in the assessment of ethical issues (Stanga and Turpen 1991; Morris and McDonald 1995; Snodgrass and Behling 1996; Roxas and Stoneback 1997). We also assess perceptions regarding fairly simple earnings management techniques, and assess differences across national, institutional, and cultural factors.

Model

In order to properly examine whether our variables of interest (*Stakeholder* and *Secrecy*) are significantly associated with individuals' perceptions of earnings management practices, we include several controls in our regression analyses that have been found in prior research to be associated with earnings management or differences in financial reporting across countries. Spe-

³ The instrument was translated into Spanish for administration in Mexico and Spain. All other courses were taught in English.

⁴ In our context, upper-level students refer to students that have completed at least one financial reporting course prior to their participation in the study, with most of the students in their last year of university study.

⁵ Students studying in countries other than their home country were most prevalent in Australian universities. In order to determine that location of data collection was not a factor (i.e., data collected when in their "home" country or whether they were "studying abroad"), we performed separate t-tests on all the variables of interest to the study and found no significant differences due to location of the participant. Thus, all country participants have been combined for analysis.

⁶ Where multiple sites in the same country were used to collect data (e.g., in Australia and the United States), an examination of differences between sites on all the variables of interest to the study were performed. These analyses indicate no significant differences due to location of the participant within the country. Thus, all country locations have been combined for analysis.

cifically, we control for a country's ownership concentration (*Own*) following Leuz (2006) who found that ownership concentration was associated with the level of earnings management. We control for the national level of shareholders rights (*Rights*) following Fonseca and Gonzalez (2008), Nabar and Boonlert-U-Thai (2007), and Leuz et al. (2003) who all found evidence of less earnings management in countries with strong investor protection. We control for the strength of the country's legal enforcement system (*Enforce*) following Leuz et al. (2003) who observed a negative relationship between legal enforcement and earnings management. We add a control for the country's level of per capita gross national income (*GNI*) since La Porta et al. (1998) found that a country's ability to enforce their system of law was influenced by their national wealth. In addition, we also control for the participants age (*Age*) and whether they were an accounting major (*Major*) or not, which might also affect their overall perceptions of earnings management (Merchant and Rockness 1994). In general, we would expect accounting majors to be less accepting of earnings management activities.

Accordingly, we estimate the following regression model:

$$AEM, OEM, TEM, TYPE = \beta_0 + \beta_1 Stakeholder + \beta_2 Secrecy + \beta_3 Own + \beta_4 Enforce + \beta_5 Rights + \beta_6 \text{Log}(GNI) + \beta_7 Age + \beta_8 Major + \varepsilon \quad (1)$$

where:

- AEM* = average score on the accounting earnings management items;
- OEM* = average score on the operating earnings management items;
- TEM* = average score on all earnings management items;
- TYPE* = difference between *AEM* and *OEM* (i.e., $AEM - OEM$);
- Stakeholder* = coded a 1 if from a stakeholder-oriented country, 0 otherwise;
- Secrecy* = cultural secrecy score ($UA + POW - IND$);
- Own* = ownership concentration, which is the mean ownership by the three largest shareholders of the ten largest nonfinancial domestic firms from La Porta et al. (1998);
- Enforce* = calculation following Leuz et al. (2003) as the mean score across three legal enforcement variables (efficiency of the judicial system, assessment of the rule of law, and the corruption index) from La Porta et al. (1998). All three component variables range from 0 to 10;
- Rights* = shareholder rights, the anti-director rights index from La Porta et al. (1998), and ranges from 0 to 5;
- $\text{Log}(GNI)$ = log of the average GNI per capita for 2004–2006 for all countries, except the United States, which is the average for 1999–2001, from the World Development Indicators database, World Bank;⁷
- Age* = age of the individual;
- Major* = 0 if an accounting major, 1 otherwise; and
- ε = an error term.

⁷ GNI is measured as the per capita average gross national income over the three years before and during the sample period, 2004–2006 for all countries except the United States. The U.S. sample was collected in 2001, so we use the 1999–2001 average for that sample.

IV. RESULTS

Descriptive Statistics

Table 1 indicates the number of participants from each country included in the study, as well as the mean age of participants; the country's *Secrecy* score, as well as the three cultural index scores from Hofstede (2001) that comprise the *Secrecy* score; and the country's stakeholder or shareholder orientation based on the classification as a French code-law or common-law country, respectively, from La Porta et al. (1998). As indicated in Table 1, the largest number of participants

TABLE 1
Descriptive Statistics for Sample

Shareholder Countries	Sample Size	Mean Age	Cultural Dimension Factors				Institutional Factors			GNI
			IND	POW	UA	Secrecy	Own	Rights	Enforce	
Australia	104	23.6	90	36	51	-3	.28	4	9.51	\$34,417
Hong Kong	43	22.7	25	68	29	72	.54	5	8.91	\$25,507
Ireland	114	19.5	70	28	35	-7	.39	4	8.36	\$41,564
Malaysia	22	20.9	26	104	36	114	.54	4	7.72	\$5,206
Singapore	20	22.7	20	74	8	62	.49	4	8.93	\$25,930
U.K.	52	21.6	89	35	35	-19	.19	5	9.22	\$38,345
United States	375	22.3	91	40	46	-5	.20	5	9.54	\$34,424
Total	730	22.0	—	—	—	—	—	—	—	—
Stakeholder Countries	Sample Size	Mean Age	Cultural Dimension Factors				Institutional Factors			GNI
			IND	POW	UA	Secrecy	Own	Rights	Enforce	
Argentina	42	NR	46	49	86	89	.53	4	5.79	\$4,556
Belgium	71	20.8	75	65	94	84	.54	0	9.44	\$36,631
Indonesia	30	21.0	14	78	48	112	.58	2	2.87	\$1,275
Italy	54	22.6	76	50	75	49	.58	1	7.07	\$30,268
Mexico	207	22.0	30	81	82	133	.64	1	5.37	\$7,200
Spain	126	19.1	51	57	86	92	.51	4	7.14	\$25,769
Total	530	19.4	—	—	—	—	—	—	—	—
Overall	1,260	20.9	—	—	—	—	—	—	—	—

Variable Definitions:

- NR = not reported;
IND = individualism index score from Hofstede (2001);
POW = power distance index from Hofstede (2001);
UA = uncertainty avoidance index from Hofstede (2001);
Secrecy = secrecy dimension calculated following Hope et al. (2008) from the Hofstede cultural scores as $UA + POW - IND$;
Own = ownership concentration, which is the mean ownership by the three largest shareholders of the 10 largest nonfinancial domestic firms from La Porta et al. (1998);
Rights = shareholder rights is the anti-director rights index from La Porta et al. (1998) and ranges from 0 to 5;
Enforce = calculation following Leuz et al. (2003) as the mean score across three legal enforcement variables (efficiency of the judicial system, assessment of the rule of law, and the corruption index) from La Porta et al. (1998). All three component variables range from 0 to 10; and
GNI = average GNI per capita for 2004–2006 for all countries, except the United States, which is the average for 1999–2001, from the World Development Indicators database, World Bank.

was from the United States, 375, followed by Mexico with 207 participants. Overall, we had 730 participants from shareholder-oriented countries and 530 participants from stakeholder-oriented countries for a total of 1,260 participants in the study. The participants ranged in age from 18 to 46 years with an overall median age of 20.9 years for all participants—reinforcing that we have included relatively mature participants in our study. This average age of the students is also reflective of our attempt to utilize upper-level students that would most likely be familiar with the accounting and business issues presented in the instrument, and also likely to fully reflect the national cultures and institutional orientations to which they belong. Further, the mean age of participants in shareholder countries was 22.0 years and was 19.4 years in stakeholder countries. An independent samples t-test of the mean ages revealed a significant difference between the shareholder and stakeholder groups ($p < .000$). Accordingly, when performing our analyses of differences between groups, as noted previously, we control for age of the participant in each of our models.

Table 1 also indicates a fairly wide dispersion of cultural index scores, and *Secrecy* scores in particular, across the 13 countries included in the study. Specifically, we find that *Secrecy* scores range from -19 to 133 in total, and from -19 to 114 for the shareholder-oriented countries and from 49 to 133 for the stakeholder-oriented countries. This dispersion of cultural secrecy scores allows us to perform a robust examination of this cultural factor on perceptions of earnings management across our study participants from the 13 countries.

Table 2 presents the mean responses to the 13 scenarios as well as the means for the total instrument (*TEM*), as well as means for *AEM* and *OEM* questionnaire items, the mean difference between the *AEM* and *OEM* items across participants (*TYPE*), by country and institutional orientation.⁸ As expected, the mean responses were higher in the stakeholder-oriented countries as compared to the shareholder-oriented countries for both *AEM* (3.02 versus 2.96) and *OEM* (2.34 versus 2.15) items ($p < 0.10$ and 0.01 , respectively), indicating that each type of practice was considered less acceptable in the stakeholder-oriented countries. In addition, the average overall mean response (*TEM*) for the shareholder countries of 2.58 was also significantly lower than that of the stakeholder countries of 2.71 ($p < 0.01$). The last column of Table 2 indicates the significant results of individual ANCOVAs conducted comparing shareholder countries to stakeholder countries for each question and the mean responses to the entire instrument (*TEM*), *AEM*, and *OEM* questions, as well as the differences between *AEM* and *OEM* questions (*TYPE*). Age (*Age*) and accounting major (*Major*) were treated as covariates in each of the analyses. Based on these analyses we identified significant ($p < .05$ or stronger) differences between shareholder- and stakeholder-oriented countries for questions 1, 3, 4a, 4b, 4c, and 5a. We also identified a significant difference between the two groups in the mean responses to the *OEM* questions ($p < 0.01$) and the *AEM* questions ($p < 0.10$), and for the *TEM* ($p < 0.01$) and *TYPE* ($p < 0.05$) analyses. As expected from stakeholder theory, these univariate comparisons indicate that participants from the stakeholder-oriented countries found both *AEM* and *OEM* to be less acceptable than the participants from shareholder-oriented countries.

Hypotheses Tests

Hypothesis 1 states that participants from all countries will perceive *AEM* as significantly less acceptable than *OEM* activities. We tested this hypothesis using a paired samples t-test of the

⁸ We calculated Cronbach's alpha for *AEM* and *OEM* items for shareholder countries (0.769 and 0.656, respectively) and stakeholder countries (0.735 and 0.594, respectively) indicating adequate internal consistency by country group.

TABLE 2
Earnings Management by Country and Institutional Orientation^a
Shareholder-Oriented Countries

Scenario	Australia (n = 104)	Hong Kong (n = 43)	Ireland (n = 114)	Malaysia (n = 22)	Singapore (n = 20)	U.K. (n = 52)	United States (n = 375)	Overall Total (n = 730)
1. Paint building early	1.29	1.44	1.23	1.64	1.20	1.17	1.14	1.21
2a. Defer expenditures for quarter	2.67	2.53	2.70	2.95	3.05	2.73	2.86	2.79
2b. Defer expenditures for year	3.02	3.05	3.23	3.27	3.50	3.13	3.47	3.31
3. Record supplies next year	3.07	2.84	3.26	3.14	3.15	2.85	3.22	3.15
4a. End-of-year sales program	1.88	2.12	2.07	2.00	2.65	1.88	2.04	2.03
4b. Overtime in December	1.79	1.88	1.71	1.86	1.75	1.96	1.73	1.77
4c. Sell unused assets	1.81	2.12	1.99	1.75	2.20	1.56	1.69	1.79
5a. Prepay \$60 K travel expenses	2.71	2.93	2.54	2.77	3.25	2.42	2.65	2.66
5b. Write down \$700 K inventory	2.96	2.98	2.93	2.81	3.25	3.18	3.20	3.10
6a. Write up inventory-product development	2.59	2.35	2.02	2.50	2.45	2.29	2.65	2.49
6b. Write up inventory-meet budget	2.79	2.32	2.53	2.50	2.70	2.79	3.22	2.93
7a. Delay recording \$30 K invoice	2.48	2.84	2.67	2.68	2.65	2.56	2.84	2.73
7b. Delay recording \$500 K invoice	3.41	3.44	3.47	3.41	3.80	3.38	3.82	3.64
Total (TEM)	2.49	2.53	2.49	2.58	2.74	2.45	2.66	2.58
Situation Factors								
AEM (3 + 5a + 5b + 6a + 6b + 7a + 7b)/7	2.85	2.81	2.77	2.83	3.04	2.78	3.08	2.96
OEM (1 + 2a + 2b + 4a + 4b + 4c)/6	2.07	2.19	2.16	2.28	2.39	2.07	2.15	2.15
TYPE (AEM – OEM)	.7816 ^{†††}	.6240 ^{†††}	.6295 ^{†††}	.5509 ^{†††}	.6440 ^{†††}	.7079 ^{†††}	.9317 ^{†††}	.8082 ^{†††}

(continued on next page)

Stakeholder-Oriented Countries

Scenario	Argentina (n = 42)	Belgium (n = 71)	Indonesia (n = 30)	Italy (n = 54)	Mexico (n = 207)	Spain (n = 126)	Overall Total (n = 530)
1. Paint building early	1.40	1.25	1.63	2.15	1.60	1.48	1.57***
2a. Defer expenditures for quarter	2.62	2.61	2.83	3.11	2.58	2.81	2.71
2b. Defer expenditures for year	3.12	3.59	3.17	3.79	3.00	3.37	3.27
3. Record supplies next year	2.69	3.18	3.30	3.57	3.20	3.47	3.26**
4a. End-of-year sales program	1.69	2.00	2.97	2.42	2.17	2.14	2.17***
4b. Overtime in December	1.98	1.49	2.13	2.42	2.17	2.27	2.11***
4c. Sell unused assets	2.02	2.01	2.10	2.56	1.97	2.62	2.20***
5a. Prepay \$60 K travel expenses	2.50	3.10	2.90	3.59	2.72	2.77	2.86***
5b. Write down \$700 K inventory	3.00	3.56	2.57	3.44	2.94	3.26	3.13
6a. Write up inventory-product development	2.43	2.56	2.27	2.54	2.30	2.83	2.50
6b. Write up inventory-meet budget	2.95	3.22	2.67	3.41	2.39	3.12	2.84
7a. Delay recording \$30 K invoice	3.12	2.79	2.77	3.00	2.63	2.96	2.81
7b. Delay recording \$500 K invoice	4.09	3.97	3.80	4.07	3.40	3.90	3.74
Total (TEM)	2.59	2.72	2.70	3.08	2.54	2.85	2.71***
Situation Factors							
AEM (3 + 5a + 5b + 6a + 6b + 7a + 7b)/7	2.97	3.20	2.90	3.37	2.80	3.19	3.02*
OEM (1 + 2a + 2b + 4a + 4b + 4c)/6	2.14	2.16	2.47	2.74	2.25	2.45	2.34***
TYPE (AEM - OEM)	.8305 ^{†††}	1.0396 ^{†††}	.4230 ^{†††}	.6318 ^{†††}	.5491 ^{†††}	.7374 ^{†††}	.6832 ^{†††**}

*, **, *** Indicate significant differences between shareholder and stakeholder means at 0.10, 0.05, and 0.01 levels, respectively (two-tailed).

††† Indicates significant differences between AEM and OEM means at the 0.01 level (two-tailed).

^a This table presents the mean responses to the questions on earnings management scenarios measured using a five-point Likert scale anchored with 1 = "Ethical practice." and 5 = "Totally unethical. The manager should be fired." The last column reports p-values from the ANCOVA test of the differences in the means between shareholder and stakeholder countries. Age and whether the participant was an accounting major were treated as covariates in the analysis.

(continued on next page)

Variable Definitions:

TEM = total earnings management;

AEM = accounting earnings management manipulations;

OEM = operating earnings management manipulations; and

TYPE = $AEM - OEM$.

mean responses to the *AEM* and *OEM* scenarios separately for each of the countries. Consistent with the findings of Merchant and Rockness (1994) and Geiger et al. (2006) we find that *AEM* was considered significantly ($p < 0.01$) less acceptable than *OEM* in each of the 13 countries, as well as in the combined shareholder-oriented countries ($t = 31.140$, $df = 729$) and the combined stakeholder-oriented countries ($t = 22.669$, $df = 529$), and for the overall sample ($t = 38.286$, $df = 1,259$).

We also examine whether *TYPE*, the difference between *OEM* and *AEM*, is significantly different from zero, separately, for each of the countries. Results of these analyses indicate that *TYPE* was significantly different from zero ($p < 0.01$) for individuals in each of the 13 countries examined. These findings, along with the earlier analyses, provide consistent support for H1 and indicate that the participants reacted similarly to participants in prior research who also perceived *AEM* as significantly less acceptable than *OEM* activities (Merchant and Rockness 1994; Geiger et al. 2006), which also serves to reinforce the representativeness of our study participants with those of prior research.

Hypotheses 2 states that there will be a significant difference in the perception of earnings management between shareholder- and stakeholder-oriented countries with participants from stakeholder countries considering both *AEM* and *OEM*, as well as *TEM*, as less acceptable than participants from shareholder countries. To formally test this hypothesis, we use model 1 and ordinary least-squares regressions to examine the mean responses to *AEM*, *OEM*, *TYPE*, and *TEM* across differences in stakeholder-oriented countries. Further, H3 predicts that participants from more secretive countries will be more accepting of earnings management than participants from less secretive countries. To test this hypothesis we also include the *Secrecy* variable into our regression model in order to simultaneously examine the effects of *Secrecy* and *Stakeholder* on perceptions of earnings management.

Table 3 presents the results of our regression models. Results indicate that the coefficient on the *Stakeholder* variable is positive and significant at $p < 0.01$ for the *AEM*, *TYPE*, and *TEM* analyses, and is significant at $p < 0.05$ for the *OEM* analysis, after controlling for the other institutional, individual and country factors. Based on stakeholder theory we hypothesized in H2 that participants from stakeholder-oriented countries would be less accepting of earnings management than participants from shareholder-oriented countries. Results from these four analyses provide consistent support for H2 and suggest that participants from stakeholder-oriented countries were less accepting of all types of earnings management (*TEM*), as well as *AEM* and *OEM* actions, than participants from shareholder-oriented countries.

To examine H3 we assess the *Secrecy* variable in our regression models. Results for the *Secrecy* factor in the models indicate that the coefficient on the *Secrecy* variable is in the predicted direction for all regressions, and is significant at $p < 0.01$ for the *AEM* and *TEM* analyses, and at the $p < 0.10$ level for the *TYPE* analysis. However, level of cultural secrecy does not seem to impact individuals' perceptions of *OEM* activities, after controlling for the other institutional, individual, and country factors. These results provide general support for H3. The *TEM* results indicate that the more secretive the culture, the more tolerant individuals are, in general, of earnings management practices, and the significant *AEM* results coupled with the non-significant *OEM* results suggest that these overall perceptions are driven by differences in perceptions of the *AEM* activities. These two effects for *AEM* and *OEM* combine to produce a marginal significance ($p < 0.10$) for the differences reflected in the *TYPE* analysis. Our *Secrecy* results are also consistent with prior research. Specifically, our *AEM* results are consistent with those of Braun and Rodriguez (2008), who identified a positive relationship between *AEM* activities and cultural secrecy.

TABLE 3
Regression Results for Perceptions of Earnings Management

	Exp. Sign	AEM	OEM	TYPE (AEM – OEM)	Total (TEM)
<i>Stakeholder</i>	+	.679 *** (6.609)	.227 ** (2.196)	.489 *** (4.784)	.574 *** (5.547)
<i>Secrecy</i>	–	–.395 *** (–2.876)	–.191 (–1.382)	–.234 * (–1.710)	–.363 *** (–2.626)
<i>Own</i>	–	.222 * (1.798)	.215 * (1.731)	.039 (.314)	.258 ** (2.073)
<i>Enforce</i>	+	.419 *** (3.686)	–.098 (–.854)	.507 *** (4.479)	.236 ** (2.061)
<i>Rights</i>	+	.280 *** (3.930)	.138 * (1.931)	.163 ** (2.300)	.258 *** (3.610)
<i>GNI</i>	+	–.204 ** (–2.008)	.078 (.763)	–.273 *** (–2.701)	–.100 (–.975)
<i>Age</i>	?	.124 *** (3.267)	.030 (.795)	.099 *** (2.617)	.099 *** (2.598)
<i>Major</i>	–	–.084 ** (–2.567)	–.005 (–.163)	–.080 ** (–2.459)	–.059* (–1.812)
Intercept		1.692 *** (3.654)	1.355 *** (3.255)	.803 * (1.680)	1.787 *** (4.622)
Adjusted R ²		.044	.029	.054	.032
n		1,260	1,260	1,260	1,260

*, **, *** Indicate significance at 0.10, 0.05, and 0.01 levels, respectively, (two-tailed).

Variables definitions:

Stakeholder = 1 if from a stakeholder-oriented country, 0 otherwise.

Age = age of the individual; and

Major = 0 if an accounting major, 1 otherwise.

All other variables are defined in Table 1 and Table 2.

We also find that our control variables of *Enforce* and *Rights* in our regression models are generally significant and in the expected directions, indicating that the stronger the legal enforcement and shareholder rights in a country, the less accepting the participants are of earnings management attempts. These results are consistent with those reported in Leuz et al. (2003). In addition, we find that *Age* and *Major* are also generally significant and in our models indicating that older participants and accounting majors are less accepting of earnings management activities than younger participants or non-accounting major participants. We also find that *Own* is generally positive and significant and *GNI* is negative and significant in our analyses indicating that countries with greater ownership concentrations and countries with lower GNI are less accepting of earnings management activities.

In sum, our findings indicate that participants from stakeholder-oriented countries are less tolerant of earnings management, including both AEM and OEM activities, than participants from shareholder-oriented countries. We also find that individuals from more secretive countries are significantly more tolerant of earnings management activities, particularly with respect to AEM activities. However, the level of cultural secrecy does not appear to be significantly related to

perceptions of OEM activities for our participants. Overall, our regression results support our main hypotheses regarding the institutional and cultural factors effecting perceptions of earnings management cross-nationally.⁹

Additional Analyses

Following prior research, we use a country's legal system as our proxy for the shareholder/stakeholder orientation. However, we recognize that this is a rough measure as it does not capture all of the cross-national institutional differences, which may influence perceptions of financial reporting and earnings management. For example, Ball et al. (2003) in their study of four East Asian countries whose legal systems are classified as following a common-law or shareholder model, concluded that manager and auditor incentives, identified as closely reflecting a code-law or stakeholder model, were more important in determining earnings quality than was the legal system classification. Three of the countries considered by Ball et al. (2003) were included in our study and classified as shareholder countries: Hong Kong, Malaysia, and Singapore. Accordingly, as a robustness test of our results, we re-estimate our regression models excluding these three countries from the analyses.

The results for these analyses are consistent with and even stronger than our reported findings in Table 3. Specifically, the *Stakeholder* variable is positive and significant at the $p < 0.001$ level for both *AEM* and *OEM* regressions and the *Secrecy* factor being negative and significant at the $p < 0.001$ level for *AEM* and at the $p < 0.05$ level for *OEM* regression. Further, if we reclassify Hong Kong, Malaysia, and Singapore as stakeholder countries and re-estimate the, we find substantively the same results and significance levels for the *Stakeholder* and *Secrecy* variables in the *TEM* and both the *AEM* and *OEM* regressions as originally reported in Table 3. The consistency of these re-estimated results suggest that even though these East Asian countries may exhibit certain stakeholder traits, our overall results are generally robust to their shareholder/stakeholder identification or to their exclusion.

In addition, although we test for differences between participants in their native country and those "studying abroad" and find no significant univariate differences, in order to help assure that our results are not confounded by participants misclassified as to country of origin, we eliminate participants completing the instrument in Australia. We do this test because Australian universities have a fairly high percentage of visiting non-national students studying on student visas. Most of the other countries included in our study had no or very few visiting non-national students. Results of our re-estimated models using all non-Australian participants are substantively the same as those presented in Table 3. We found the same significance levels for the *Stakeholder* and *Secrecy* factors for the *AEM*, *TEM*, and *TYPE* regressions, and the *OEM* regression revealed even stronger results with the *Stakeholder* factor significant at the $p < 0.01$ level and the *Secrecy* factor significant at the $p < 0.05$ level. Thus, our results do not appear to be confounded by the possible misclassification of visiting non-national students.

Another area of possible bias arising from the cross-national survey methodology employed in our study is the risk of a culture-related response bias. Prior research has identified bias in the way in which participants from different cultures respond to Likert-type rating scales (Stening and Everett 1984; Culpepper and Zimmerman 2006). For example, Stening and Everett (1984) in their

⁹ Our examination of 13 countries effectively precludes a meaningful analysis of the interaction of our two main independent variables due to the difficulty with interpretation of the statistical results with respect to a continuous independent variable, even after centering the continuous predictors (Kachigan 1986), and to the very few countries (often only one) that would be relegated to each of the possible quadrants, regardless of how we might dichotomize our *Secrecy* score into high and low groups. Accordingly, we do not perform tests of the interaction of our two main independent variables.

cross-cultural study of response styles found respondents from Indonesia and Malaysia demonstrated a very high use of extreme responses. In order to assess whether country differences to “extremes” response bias to our instrument (i.e., either a general tendency to indicate a 1 or a 5 when responding; or general tendency to avoid indicating a 1 or a 5 when responding) may be affecting our results, we combine 1 and 2 responses and 4 and 5 responses and re-estimate our regression models using this modified three-point scale (1/3/5), which may be interpreted as ethical/uncertain/unethical. Results of these models using the modified three-point scale are substantively the same as those presented in Table 3 using the five-point scale. The *Stakeholder* factor is significant at the $p < 0.01$ level in the *AEM*, *TEM*, and *TYPE* regressions and at $p < 0.05$ level in the *OEM* regression. The *Secrecy* factor is significant at the $p < 0.01$ level in the *AEM* and *TEM* regressions and at the $p < 0.05$ level in the *TYPE* regression. Similar to the results of the five-point scale analysis the *Secrecy* factor is not significant in the *OEM* regression. These findings imply that culture-related response bias is not substantively affecting our regression results or our resultant conclusions.

Further, to provide additional testing of our composite *Secrecy* score, we separately analyze the three cultural components from Hofstede (2001) used to calculate the score—individualism (*IND*), power distance (*POW*), and uncertainty avoidance (*UA*). If we replace our *Secrecy* score in model 1 with the three component variables (*IND*, *POW*, and *UA*) and re-estimate the *AEM*, *OEM*, and *TEM* regressions we find that the *Stakeholder* factor and each of the three individual cultural variables is significant ($p < 0.01$) and in the expected direction in each of the regressions. These results are consistent and even stronger than the model 1 regression results using the composite *Secrecy* score, in that we found no significance ($p < 0.10$) for the *Secrecy* score in the *OEM* regression, yet we find that the individual components are significant at $p < 0.01$ in our expanded model. However, given that our objective in this study was to assess the level of secrecy in a country on perceptions of earnings management, we believe that the use of the composite *Secrecy* score provides a more parsimonious measure for our analyses, and our conclusions generally would not have changed with the inclusion of three separate cultural variables.

V. CONCLUSIONS

In this study we examine the association between perceptions of earnings management and institutional and cultural factors across 13 countries. We find that earnings management practices, including both accounting and operating earnings management practices, are perceived as less acceptable by individuals from stakeholder-oriented corporate governance countries in comparison to shareholder-oriented countries. These findings are consistent with the argument that the broader perspective of stakeholder-oriented countries would lead individuals to perceive any earnings management attempt as effecting multiple parties, and not just the shareholders, causing them to be less accepting of any earnings management attempts (Freeman et al. 2007; van der Laan Smith et al. 2005). In addition, we find that earnings management practices are perceived as more acceptable by individuals from countries with more secretive cultures, with accounting earnings management activities being perceived as significantly more acceptable in cultures with greater secrecy. Our study extends the literature by providing the first direct assessment of the relation between a country’s level of cultural secrecy and individual perceptions of the acceptability of earnings management practices.

However, our *perceptual* findings are somewhat in contrast to prior research that has argued that stakeholder-oriented countries exhibit greater amounts of *reported* accounting earnings management in their financial reports (e.g., Ball et al. 2000). The disparity in findings regarding perceptions of earnings management and those of prior stakeholder/shareholder researchers using surrogates for reported earnings management need to be further explored in the literature. Given that the examined surrogates for earnings management are actually representative of attempts to

manage reported earnings (e.g., the delayed reporting of financial losses in [Ball et al. 2000](#)), what other factors (i.e., institutional, financial, governmental, common financial practices, etc.) may account for the difference in perceptions versus reporting actions across the stakeholder/shareholder dichotomy found in these prior studies? Based on our findings, these additional factors or relationships may help identify countries or situations in which earnings management may be more or less likely to be found in a company's financial statements and disclosures ([Zeff 2007](#)).

Future research should also further examine the relation between perceptions of earnings management and actual financial reporting actions in disparate settings. In essence, do managers act similarly to their perceptions, and in what settings? Are there other personal, social, or institutional factors that help in identifying or explaining the difference between individuals' perceptions of earnings management and eventual reporting actions? Further, are there any differences with respect to internal reporting issues (i.e., budgets, operating, and internal reports) and external reporting situations (i.e., releasing the firm's financial information to the public) with respect to perceptions of earnings management? To date, research has only begun to address external reporting issues and has yet to address the subject of differences in internal reporting practices across countries, and whether these differences vary significantly due to institutional or cultural factors.

Additionally, future research should examine the relationship between the cultural dimension of secrecy and other financial reporting measures such as levels or the direction of discretionary accounting accruals, using special income statement items, or just meeting or beating analysts' earnings expectations in an effort to extend the extant literature (i.e., [Ball et al. 2000](#)). Examining these and other measures of financial reporting quality in the context of cultural factors, such as secrecy, would extend our knowledge of differences in financial reporting around the globe.

There are limitations related to the nature of our research and our results must be interpreted with these limitations in mind. First, our study used the dominant legal system in the country as a proxy for the country's stakeholder/shareholder orientation. While this proxy provided a robust measure for our analysis, we recognize that it does not include all of the variables that may influence perceptions of financial reporting and earnings management. Additionally, a concern with the use of perceptual data is that there are unmeasured, extraneous variables that may affect the responses. While we identified and measured variables based on prior research and theory, the risk remains that there are unidentified variables that may affect our results.

Notwithstanding these possible limitations, our perceptual findings provide evidence that differences in perceptions of earnings management across countries are significantly associated with the country's stakeholder/shareholder orientation and the level of cultural secrecy. Our findings also suggest the need for further research regarding the link between the perceptions of earnings management and the level and measurement of earnings management activities that may exist across countries as well as the institutional and market factors that may account for these disparities ([Ball et al. 2000](#); [Othman and Zeghal 2006](#); [Jeanjean and Stolowy 2008](#)). Overall, our findings contribute to the ongoing cross-country debate regarding the complex relationship between institutions, culture, and financial reporting ([Hope 2003](#); [Zeff 2007](#)).

APPENDIX

INSTRUCTIONS

The following questions reflect everyday ethical choices. Please evaluate the practices as they apply to a major division (annual revenues of, say, \$100 million) of a billion-dollar public company. Use the following scale to indicate how you judge their acceptability.

1. Ethical practice.
2. Questionable practice. I would not say anything to the manager, but it makes me uncomfortable.

3. Minor infraction. The manager should be warned not to do it again.
4. Serious infraction. The manager should be severely reprimanded.
5. Totally unethical. The manager should be fired.

QUESTIONS

1. The division's headquarters building was scheduled to be painted in 1999. But since profit performance was way ahead of budget in 1998, the division general manager (GM) decided to have the work done in 1998. Amount: \$150,000.
2. The GM ordered his employees to defer all discretionary expenditures (e.g., travel, advertising, hiring, maintenance) into the next accounting period, so his division could make its budgeted profit targets. Expected amount of deferrals: \$150,000.
 - a. The expenses were postponed from February and March until April in order to make the first quarter target.
 - b. The expenses were postponed from November and December until January in order to make the annual target.
3. On December 15, a clerk ordered \$3,000 of office supplies, and the supplies were delivered on December 29. This order was a mistake because the GM had ordered that no discretionary expenses be incurred for the remainder of the fiscal year, and the supplies were not urgently needed. The company's accounting policy manual states that office supplies are to be recorded as an expense when delivered. The GM learned what had happened, and to correct the mistake, he asked the accounting department not to record the invoice until February.
4. In September, the GM realized the division would need strong performance in the fourth quarter to reach its budget targets.
 - a. He decided to implement a sales program offering liberal payment terms to pull some sales that would normally occur next year into the current year; customers accepting delivery in the fourth quarter would not have to pay the invoice for 120 days.
 - b. He ordered manufacturing to work overtime in December so that everything possible could be shipped by the end of the year.
 - c. He sold some excess assets and realized profit of \$40,000.
5. At the beginning of December 1998, the GM realized the division would exceed its budgeted profit targets for the year.
 - a. He ordered his controller to prepay some expenses (e.g., hotel rooms, exhibit expense) for a major trade show to be held in March 1998 and to book them as 1997 expenses. Amount: \$60,000.
 - b. He ordered his controller to develop the rationale for increasing the reserve for inventory obsolescence. By taking a pessimistic view of future market prospects, the controller was able to identify \$700,000 worth of finished goods that conservative accounting would say should be fully reserved (i.e., written off), even though the GM was fairly confident the inventory would still be sold at a later date at close to full price.
6. The next year, the division sold 70 percent of the written-off inventory, and a customer had indicated some interest in buying the rest of that inventory the following year. The GM ordered his controller to prepare the rationale for reducing the reserve for obsolescence by \$210,000 (i.e., writing up the previously written-off goods to full cost). The GM's motivation for recapturing the profit was as follows:
 - a. To be able to continue working on some important product development projects that might have been delayed due to budget constraints.

- b. To make budgeted profit targets.
7. In November 1998, the division was straining to meet budget. The GM called the engagement partner of a consulting firm that was doing some work for the division and asked that the firm not send an invoice until next year. The partner agreed. Estimated work done but not invoiced:
 - a. \$30,000
 - b. \$500,000

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