

Effect of Long Term Orientation and Indulgence on Earnings Management: The Moderating Role of Legal Tradition

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Abstract : The objective of this study is to assess the impact on earnings management of latest two Hofstede cultural dimensions: long-term orientation and indulgence. Long-term orientation represents the alignment of a society towards the future and indulgence expresses the extent to which a society exhibits willingness, or restrain, to realise their impulses. Additionally, this paper tests if there are relevant differences by testing the moderating role of the legal tradition, Continental versus Anglo-Saxon. Our sample comprises 15 countries: Belgium, Canada, Germany, Spain, France, Great Britain, Hong Kong, India, Japan, Korea, Netherlands, Philippines, Portugal, Sweden, and Thailand, with a total of 12,936 observations from 2003 to 2013. Our results show that managers in countries with high levels of long-term orientation reduce their levels of discretionary accruals. The findings do not confirm the effect of indulgence on earnings management. In addition, our results confirm previous literature regarding the effect of individualism, noting that firms in countries with high levels of collectivism might be more inclined to use earnings discretion to protect the welfare of the collective group of firm stakeholders. Uncertainty avoidance results in downwards earnings management as well as high disclosure, suggesting that less manipulation takes place when transparency is higher. Indulgence is the cultural dimension that confronts wellbeing versus survival; dimension is formulated including happiness, the perception of live control and the importance of leisure. Indulgence shows a weak negative correlation with power distance indicating a slight tendency for more hierarchical societies to be less indulgent. Anglo-Saxon countries are a positive effect of individualism and a negative effect of masculinity, uncertainty avoidance, and disclosure. With respect to continental countries, we can see a significant and positive effect of individualism and a significant and negative effect of masculinity, long-term orientation, and indulgence. Therefore, we observe the negative effect on earnings management provoked by higher disclosure and uncertainty avoidance only happens in Anglo-Saxon countries. Meanwhile, the improvement in reporting quality motivated by higher long-term orientation and higher indulgence is dominant in Continental countries. Our results confirm that there is a moderating effect of the legal system in the association between culture and earnings management. This effect is especially relevant in the dimensions related to uncertainty avoidance, long term orientation, indulgence, and disclosure. The negative effect of long-term orientation on earnings management only happens in those countries set in continental legal systems because of the Anglo-Saxon legal systems is supported by the decisions of the courts and the traditions, so it already has long-term orientation. That does not occur in continental systems, depending mainly of contend of the law. Sensitivity analysis used with Jones modified CP model, Jones Standard model and Jones Standard CP model confirm the robustness of these results. This paper collaborates towards a better understanding on how earnings management, culture and legal systems relate to each other, and contribute to previous literature by examining the influence of the two latest Hofstede's dimensions not previously studied in papers.

Keywords : Hofstede, long-term-orientation, earnings management, indulgence

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