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Does National Ethical Judgment Matter for Earnings Management?

Abstract

This study analyses the effect of ethical judgment at country-level on earnings management. While previous literature document the role of ethical issues at personal- and organizational-level on earnings management practices, usually theoretically and through qualitative ways, we investigate that association in a large sample at international level taken a sample of 81,408 firm-year observations regarding 10,306 firms from 39 countries. Based on data from an international questionnaire developed by the World Values Survey, we construct a comprehensive index of ethical judgment of each country. Our empirical findings suggest that the level of ethical judgment of the countries are negative associated with accruals-based earnings management, suggesting that the manipulation of accounting amounts is lower in countries where ethically suspect behaviours are less acceptable. Additionally, we also provide empirical evidences that this phenomenon is verified both in developed and emerging countries, and that ethical judgment at country-level seem to moderate the association between IFRS adoption and earnings management practices.

Keywords: National Ethical Judgment, Earnings Management, Institutional Factors, IFRS.

1 Introduction

This study analyses the effect of ethical judgment at country-level on earnings management. In general terms, earnings management occurs when “managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers” (Healy, and Wahlen 1999, p. 368). Despite the existence of a huge literature on earnings management under which accounting information can be manipulated, their motivation and practices related specifically to ethical judgment at country-level seem to remain unexplored in empirical ways.

We define ethical judgment as the personal attitude towards the acceptability of certain ethical situations (Weeks et al., 1999 p. 302). Based on the theoretical framework proposed by Fritzsche (1991), we consider ethics as one key dimension in the business decision making process, with several implications to firms. Ethical judgment is, therefore, related to justice sense and perception about what could be accepted or not, what could be analyzed in a personal level (Aquino, and Reed, 2002), in a corporate environment (Schminke et al., 2015; Trevino et al., 2014) or even in a societal/country level (Schwartz, 2007). Thus, individuals, organizations and societies with high levels of ethical judgment present clearer perceptions and behaviors aligned with what is considered fair, good and acceptable, generally presenting a more individualism profile from the perspective that could cause harm to others, an outcome they tend to avoid (Forsyth, and Berger, 1982).

Despite not all accounting choices involve earnings management, and the term “earnings management” extends beyond accounting choice, the implications of accounting choice to achieve managers private goals are consistent with the idea of earnings management (Fields et al., 2001, p. 260). From this view, the issue-contingent nature of earnings

management highlights the importance of moral and ethical intensity of managers in understanding the underlying morality of earnings management activity (Johnson et al., 2012).

Therefore, considering this potential association between ethical issues and earnings management, previous literature document some implications of ethical issues at personal- (Elias, 2002; Hobson et al., 2011) and organizational-level (Elias, 2004) on earnings management practices. In a broad way, these studies suggest, usually theoretically and through qualitative ways, that individuals and organizations with higher levels of ethical judgment are associated with lower earnings management. We advanced in this discussion and investigate this phenomenon empirically in a large set of companies at country-level, which has not been separately documented.

Considering that the institutional context in which a firm operates may influence the moral behaviour of market players (Zhang et al., 2013), national ethical judgment can be a determinant, in general, of how manager could be engaged or not in earnings management. From this view, not only individual judgments seem to be relevant in the moment of make decisions, but also all macro-elements that frame and draw the “picture as a whole”. Johnson et al. (2012, p. 913) suggest that agents and individuals are influenced not only by unique issue-contingent factors of one specific situation, as well as how the behaviours “would be viewed in terms of social norms of morality”. In this line, therefore, intrinsic to the decision makers, constructs linked to macro-environment where individuals and organization are situated – such as the “social consensus”, the “magnitude of consequences”, the “temporal immediacy”, among others (see Jones, 1991) – play an important role about it.

Some studies, for instance, investigate how national culture can determine individual’s moral behaviour and its implications to earnings management. In a cross-country survey with 249 managers from six countries, Smith and Hume (2005) finds results lend support for the

presence of the individualism cultural element in the ethical responses of the accountants surveyed. Zhang et al. (2013) find that private benefits of control are larger, and earnings management is more severe in collectivist as opposed to individualist cultures, consistent with the argument that agency problems between corporate insiders and outside investors are severe in collectivist culture.

Based on that, considering the relevance of institutional environment where organizations are situated in determining moral behaviour of market agents, we expect that the level of ethical judgment where companies are situated also influence the managers behaviour about what be considered “wrong” and “right” and, therefore, having an impact on earnings management practices. To test this prediction, we investigate the association between ethical judgment and earnings management in a worldwide sample encompassing firms from 39 countries. Based on an international questionnaire prepared by the World Values Survey, we construct a comprehensive index of ethical judgment for each country. Our empirical finds demonstrate, in general, that the level of ethical judgment is negative associated with earnings management, suggesting that the manipulation of accounting amounts is lower in countries where ethically suspect behaviours are less acceptable. Our empirical findings are confirmed both in companies from developed and emerging countries.

This study offers several contributions to the literature. First, we contribute specifically to an earnings management literature still few explored discussing about the association between ethical issues and earnings manipulation in a large empirical way, providing an important discussion based on empirical worldwide data related to a subject extensively discussed in theoretical way (e.g., Elias, 2004; Johnson et al., 2012; Fassin, and Drover, 2017; Wany et al., 2018). Second, we contribute to earnings quality literature by constructing a comprehensive index about national ethical judgment that cover 39 countries

from different geographic contexts around the world which could be useful to future research in investigating different aspects of accounting quality, beyond earnings management.

Tirth, demonstrating an association between ethical judgment and earnings management, we also contribute to accounting literature demonstrating the role of issues linked to ethically suspect behaviours in determining the opportunist actions of managers within the scope of discretionary policy based on accounting choices. As earnings management can be related to fraudulent financial reporting, managers behaviour related to this practice has also been an area of concern and subject of study in the accounting profession. In fact, almost all fraudulent financial reporting could be characterized as earnings management, however not all earnings management is considered fraudulent (Grasso et al., 2009). Finally, in a more practical way, our results promote useful insights to regulatory agencies, or even investors and other stakeholders, promoting discussion about the role of national ethics issues in shaping managers' decision.

The remainder of this paper is organized as follows. Section 2 discusses the previous literature and outline the hypotheses. Section 3 describes the research design. Sections 4 and 5 presents the empirical findings and additional analyses, respectively. Finally, Section 6 presents the summary and concluding remarks.

2 Background

Earnings management is defined as “the choice by a manager of accounting policies to achieve specific objectives” (Scott, 2003, p. 369). Unlike fraud – related to the use of artificial accounting transactions or those that occur outside of the regulatory framework – earnings management involves using the flexibility within accounting standards to deliver a predetermined profit (Jones, 2011).

Most financial accounting issues deal with matters of human behaviour, namely the judgments and decisions of managers (Koonce, and Mercer, 2008). In fact, the ethical issues involved in the financial reporting process has long been a concern of the accounting profession (Grasso et al., 2009). Despite of accounting choices flexibility by manager are inherent to the practice (Fields et al., 2001), many consider that higher levels of earnings management are tantamount to unethical practices (Grasso et al., 2009). Major corporate scandals like Waste Management, Enron, WorldCom or Tyco have all been linked directly or indirectly to deception, misleading, and untruthful accounting. In a similar way, the former global crisis of the financial system was associated with false accounting. Based on these evidences, “the accounting profession continues to struggle with the problem of veracity of its reports” (Vladu et al., 2017, p. 633).

More specifically about the association between ethical issues and earnings management, previous literature document the relevance of some implications of ethical judgment at personal- (Elias, 2002; Hobson et al., 2011) and organizational-level (Elias, 2004) on earnings management practices. At individual-level, for instance, Elias (2002) demonstrate, through a national sample of 763 accounting practitioners, a positive relationship between social responsibility, focus on long-term gains, idealism, and the ethical perception of earnings management, and negative relationship between focus on short-term gains, relativism and the ethical perception of this practice. From the same line, more recently tanking a sample 978 professionals from Australian and New Zealand, Clayton and Staden (2015) document that high levels of individual professional commitment seem to mitigate inappropriate social influence pressure, in that respondents who exhibit high levels of organisational and/or professional commitment are less likely to succumb to inappropriate social influence pressure.

Beyond the relevance of individual perspective about ethics, previous literature has also suggested the role of organizational environment in influence managerial responses to an employee's earnings management and morally questionable behaviours, given that ethics issues are integral part of the corporate culture of the firms that contribute to the improvement and enhancement of its strategic advantages (Filipovic, and Drobnjak, 2017). Elias (2004) surveyed 583 certified public accountants (CPAs) in public accounting, industry and academia, and presented results indicated that CPAs employed in organizations with high (low) ethical standards viewed earnings management activities as more unethical (ethical). Through an experimental design with 77 management accountants, Davis, DeZoort and Kopp (2006) reveal that despite pervasive perceptions of ethical conflict, almost half of the participants violated explicit policy and created budgetary slack when faced with obedience pressure from an immediate superior.

Lord and DeZoort (2001) also demonstrate, based on a sample of 171 auditors from one international firm, that obedience pressure in organizational environment significantly increased auditors' willingness to sign-off on an account balance that was materially misstated, although conformity pressure did not. The findings also supported the predictions for organizational commitment.

Considering this relevant literature focused on the associational between personal- and organizational-level moral issues and earnings management, we evaluate two important points to accounting literature. First, as noted, the scientific literature that analyses the various facets of ethics issues and their association for earnings management seems to be predominantly focused on qualitative designs, that in general consider personal- and organizational-level of analyses through small groups of interviewed and experiments really framed in specifics cases. Second, as a consequence of that, scars evidence was generated empirically about the role of institutional and macro-environments and their implications to earnings management

practices. About that, Chen et al. (2018) highlight the importance of empirical research on ethical and moral issues, based on a larger cross-country sample, in an effort to demonstrate external validity of the documented relation. Therefore, considering that moral behaviour are the results not only of personal trajectories but also of cultural experiences that vary across individuals due to differences in such experiences (Hobson et al., 2011), we overcome previous literature and focus our analyses considering the role of ethical judgment at a country-level in determining managers actions related to earnings management.

The approach of the political and economic sciences presupposes that the strategic actions devised by the policy makers result from a “strategic calculation” to foster exchange gains. Thus, based on this approach, rules associated with economic and institutional environment create (des)incentives for economic agents, as managers or even investor, given their cognitive preferences and abilities and how they shape the organization’s results (North, 1990).

More specifically in accounting literature, country characteristics and their implications to different constructs of accounting quality – included earnings management – are extensively documented in previous research. In this perspective, the characteristics at country-level empirically investigated in the literature are diverse. For instance, Nabar and Boonlert-U-Thai (2007) demonstrate empirically that earnings management is relatively high in countries with high uncertainty avoidance scores and relatively low in countries where the primary language is English. Lourenço et al. (2018) demonstrate empirical evidences that higher corruption perception is related to higher incentives for firms to manipulate earnings, but only in the case of emerging countries. McGuire et al. (2011) also demonstrate empirical finds suggesting that firms headquartered in areas with strong religious social norms generally experience lower incidences of accrual-based earnings management.

Especially about ethical judgment and the importance of a more macro-view and its the interference of environment in this phenomenon, Hobson et al. (2011) comments ethics issues reflect the long-term potential for an individual to form a sufficient moral judgment under a given moral setting or moral frame. Based on that, we predict that firms from countries where ethically suspect behaviours are less acceptable – and, therefore, that could be considered societies with higher levels of ethical judgment – present lower levels of earnings management, given that the moral characteristic of society will play a role in constraining potential opportunistic behaviour. This discussion leads us to follow the hypothesis that the level of ethical judgments of countries where firms are situated is negatively associated to the level of earnings management by managers.

3 Research Design

3.1 Sample and data

The empirical analyzes is based on a sample composed of 10,240 firms from 39 countries, which were selected based on the availability of financial-economic information in the Global Compustat database. Consistent with previous earnings management literature (e.g., Chen et al., 2015; Larson et al., 2018), to eliminate firms subject to more complex earnings management incentives and differences in disclosure practices associated with their regulatory environment, we exclude both financial and utility firms from our analysis.

We use data from the years 2000 to 2017, thus, the final sample is composed of 83,606 firm-year observations. Table 1 presents the sample distribution by country. China, Hong Kong, and the United Kingdom are the most representative countries, respectively, with 29%, 7% and 8% of the overall firm-year observations. Although China has a high weight in the composition of our sample, in additional analyzes without Chinese companies the results are maintained when compared to those runned with the total sample.

(Insert Table 1 here)

3.2 Main variables

3.2.1 Earnings Management

Following an extensive accounting literature (e.g., Chen et al. 2018; Cohen and Zarowin, 2010; Helaly, Georgiou, and Lowe, 2018; Lo, Ramos, and Rogo, 2017; Ng, 2011), we use the absolute amount of discretionary accruals as the proxy for earnings management. Considering the several empirical models proposed by accounting quality literature to capture the total amount of discretionary accruals, we consider three different models, measuring, therefore, three different variables for this construct. Using three variables for accruals measure, we expect a larger view and robustness of our empirical results.

Our first accrual quality metric ($/ACCI/$) is based on the modified Jones (1991) model, which was developed by Dechow et al. (1995). Thus, we first estimate the model of Equation (1) using an ordinary least square regression. We use the residuals from this model as our first measure of discretionary accruals.

$$\frac{TA_{it}}{Ats_{it-1}} = \beta_0 \frac{1}{Ats_{it-1}} + \beta_1 \frac{(\Delta Sales_{it} - \Delta AR_{it})}{Ats_{it-1}} + \beta_2 \frac{GPPE_{it}}{Ats_{it-1}} + \varepsilon_{it} \quad (\text{Equation 1})$$

where TA_{it} = total accruals, calculated as firm i 's net income minus cash flows from operations in year t . Ats_{it-1} = total assets for firm i in year $t-1$. $\Delta Sales_{it}$ = change in sales for firm i from year $t-1$ to year t . $GPPE_{it}$ = gross property, plant, and equipment for firm i in year t . ΔAR_{it} = change in accounts receivable for firm i from year $t-1$ to year t .

Our second accrual quality metric (*/ACC2/*) is based on Kothari, Leone and Wasley (2005). Also based on the Jones (1991) model, Kothari et al. (2005, p. 169) advance in the original model including a measure of firm performance, namely return on assets, arguing, among others, that “the effect of performance on estimated discretionary accruals is to adjust a firm’s estimated discretionary accrual by that of a performance-matched firm”. Similarly to Dechow et al. (1995), discretionary accruals by Kothari et al. (2005) model are estimate according to Equations (2), considering the residuals from this model as our second measure of discretionary accruals.

$$\frac{TA_{it}}{Ats_{it-1}} = \beta_0 \frac{1}{Ats_{it-1}} + \beta_1 \frac{\Delta Sales_{it}}{Ats_{it-1}} + \beta_2 \frac{GPPE_{it}}{Ats_{it-1}} + \frac{ROA_{it}}{Ats_{it}} + \varepsilon_{it} \quad (\text{Equation 2})$$

where ROA_{it} = net income for firm i in year t over total assets. All other variables as previous defined.

Finally, our third accrual quality metric (*/ACC3/*) is based on Dechow, Hutton, Kim and Sloan (2012)¹, which adjusts the Dechow et al. (1995) model by including lagged accruals in order to capture their natural reversal in subsequent periods, as in Equations (3), , where we also consider the residuals as our third measure of discretionary accruals.

$$\frac{TA_{it}}{Ats_{it-1}} = \beta_0 \frac{1}{Ats_{it-1}} + \beta_1 \frac{(\Delta Sales_{it} - \Delta AR_{it})}{Ats_{it-1}} + \beta_2 \frac{GPPE_{it}}{Ats_{it-1}} + \beta_3 \frac{TA_{it-1}}{Ats_{it-2}} + \varepsilon_{it} \quad (\text{Equation 3})$$

¹ Given that Dechow et al. (2012) accruals estimation model consider one more legged period compared to Dechow et al. (1995), Kothari et al. (2005), to avoid reducing the sample by almost 15%, the empirical estimations regarding specifically to */ACC3/* as dependent variable consider only 70,685 firm-year observations.

In accordance with previous earnings management literature (e.g., Cohen, and Zarowin, 2010; Doukakis, 2014; Lo et al., 2017), the models are estimate for each year and industry cluster with at least eight observations. Using this approach, we expect to partially control the industry-wide changes in economic conditions that could affect the dependent variables and allow the coefficients to vary across time.

3.2.2 Ethical Judgment Index

The World Values Survey (WVS) is a worldwide network of social scientists studying changing values and their impact on social and political life, led by a team of international scholars. Its surveys, largely used in high impact publications in many areas from social science research (Freese, 2004; Bruni, and Stanca, 2006; Aleman, and Woods, 2016; Ludeke, and Larsen, 2017; Banerjee, 2018), seeks to use the most rigorous, high-quality research designs for each country. “The WVS consists of nationally representative surveys conducted in almost 100 countries which contain almost 90 percent of the world’s population, using a common questionnaire”², already validated by others independent researches (e.g., see Johnson, and Mislin, 2012).

Among the several issues presented in the WSV questioner, we focus in the part where the respondents choose if certain actions related to ethically suspect behaviours “can always be justified, never be justified, or something in between”. Specifically, we use three items in WVS that capture how justifiable are the behaviours (1) someone accepting a bribe in the course of their duties, (2) cheating on taxes if you have a chance, and (3) claiming government benefits to which you are not entitled. We consider in our analyses survey data

² Beyond that, “the WVS is the largest non-commercial, cross-national, time series investigation of human beliefs and values ever executed, currently including interviews with almost 400,000 respondents. Moreover, the WVS is the only academic study covering the full range of global variations, from very poor to very rich countries, in all of the world’s major cultural zones”. For more details, see <http://www.worldvaluessurvey.org/WVSContents.jsp>.

between 1999-2014³. We thus compute the following variables: *BRIBE*, *TAXES*, and *BENEFITS*, which represent the weighted average of the number of respondents who answered “Never” for the questions (1), (2) and (3), respectively, divided by the total number of respondents. Thus, high level of *BRIBE*, *TAXES* and *BENEFITS* means that people are more intolerant to morally questionable behaviours related to “accepting a bribe”, “cheating on taxes”, and “claiming benefits to which you are not entitled”, respectively.

Thus, we perform a Principal Component Analysis (PCA) in order to extract the first principal component of these three elements to develop a comprehensive ethical judgment index for each country. Both the Kaiser-Meyer-Olkin measure ($KMO = 0.651$) and the Bartlett’s test of sphericity ($\chi^2 = 34.225$, $p = 0.000$) suggest that our PCA procedure is adequate. Only one factor was generated based on eigenvalue higher than one, which explain around 70% of the total variance observed. Table 2 shows the extracted common factor (*ETHICAL JUDGMENT*) for each country.

(Insert Table 2 here)

We highlight Turkey as the country with highest ethical judgment index, characterized as a fast-growing emerging market (Coskun, and Akdere, 2017) as well as a country where the “modernity does not necessarily mean a shift away from spirituality and religion” (Gunay, 2014). This stronger characteristic of religion maybe justifies Turkey in the first position.

3.3 Empirical model

To test the research hypotheses, whether the level of ethical judgment is negatively associated to the level of earnings management, we estimate the following regression model:

³ For more details about WVS surveys, see Inglehart et al. (2014a) and Inglehart et al. (2014b).

$$\begin{aligned}
|ACCRUALS|_{it} &= \alpha_0 + \beta_1 ETHICAL\ JUDGMENT_j + \beta_2 ROE_{it} + \beta_3 SIZE_{it} \quad (Equation\ 4) \\
&+ \beta_4 CASH_{it} + \beta_5 LEVERAGE_{it} + \beta_6 GROWTH_{it} + \beta_7 LOSS_{it} \\
&+ \beta_8 IFRS_{it} + \beta_8 REGQUALITY_{jt} + \beta_8 FINMARKET_{jt} + \beta_8 CRISIS_t + \varepsilon
\end{aligned}$$

where $|ACCRUALS|_{it}$ is $|ACC1|$, $|ACC2|$, and $|ACC3|$, which represent the absolute amount of discretionary accruals according to Dechow et al. (1995), Kothari et al. (2005), and Dechow et al. (2012), respectively, for each firm i in the year t , and $ETHICAL\ JUDGMENT_t$ is the index of national ethical judgment of the country j .

Based on extensive previous accounting quality literature (e.g., Chen et al. 2018; Cohen, and Zarowin, 2010; Doukakis, 2014; Flores et al., 2016; Larcker and Richardson, 2004; Larson et al., 2018), beyond our main independent variable ($ETHICAL$), Equation (8) include several control variables related to firm- and country-level. ROA_{it} is the net income divided by total assets; $SIZE_{it}$ is the natural logarithm of total assets; $CASH_{it}$ is the operating cash flow divided by total assets; $LEVERAGE_{it}$ is the total liabilities divided by total assets; $GROWTH_{it}$ is the percentage change in sales from $t-1$ to t ; $LOSS_{it}$ is a dummy variable that assumes 1 for company-year observations with negative net income and zero otherwise; $IFRS_{it}$ is a dummy variable that assumes 1 for company-year observations in the post-IFRS mandatory period and zero otherwise; $REGQUALITY_{jt}$ is the index of regulatory quality for each country and year, according to World Bank; $FINMARKET_{jt}$ is the index of financial market development for each country and year, according to IMF; $CRISIS_t$ is a dummy variable that assumes 1 for 2007, 2008 and 2009 related to subprime worldwide financial crisis, and zero otherwise.

We expect that the coefficient β_1 would be significantly negative, suggesting that the level of ethical judgment at country-level is negatively associated with the level of earnings management. Equation (8) is estimated using Ordinary Least Squares (OLS) approach, controlling for country, industry, and year fixed effects. To adjust for possible cross-sectional and serial correlations, standard errors were corrected for firm-clustering effects. All continuous firm variables were winsorized at 1% and 99% tail in order to avoid outliers.

4 Empirical Findings

Table 3 presents the descriptive statistics of the continuous variables used in the empirical study. The mean of accruals variables (*/ACC1/*, */ACC2/*, and */ACC3/*) is around 0.08, similarly to previous studies about earnings management at cross-country level (e.g., Doukakis, 2014; Lourenço et al., 2018). We also highlight that considering the total firm-year observations, 22%, 50% and 21% are composed, approximately, by negative net income, consolidate financial statements following IFRS standards and inserted in the subprime worldwide financial crisis, respectively.

(Insert Table 3 here)

Table 4 presents the correlation matrix between the continuous variables used in the empirical analysis. Regarding ethical judgment index and earnings management measures, we identify a negative and significant correlation between */ACC3/* and *ETHICAL JUDGMENT* variables, in line with the hypothesis that higher levels of ethical judgment are associated with lower levels of earnings management. Correlation matrix analyses also suggests the discard of

multicollinearity problems considering correlations less than 0.62 among all the selected continuous control variables.

(Insert Table 4 here)

Table 5 introduces our results testing hypothesis, showing the summary statistics resulting from the estimation of Model (4) regarding the association between ethical judgment index and earnings management. After controlling for all of the firm- and country-level control variables, we consistently find negative and significant coefficients for *ETHICAL JUDGMENT* in all of the three models for each earnings management measures (*/ACC1/*, */ACC2/*, and */ACC3/*). Thus, we confirm our main prediction that firms from countries with higher levels of ethical judgments present lower levels of earnings management. In other words, these empirical findings suggest that the manipulation of accounting amounts is lower in countries where ethically suspect behaviours are less acceptable.

These findings confirm previous accounting literature that consider the role of ethics issues at personal- (Elias, 2002; Hobson, Mellon, and Stevens, 2011) and organizational-level (Elias, 2004) in contain opportunistic behaviours of managers in manipulate accounting information to achieve personal goals. Therefore, taking the ethics involved in the financial reporting, principally those related to accounting choices as an inherent practice by managers (Fields et al., 2001), we reinforce the idea that ethical judgment at country-level institutional environment seem to shape individual behaviours and interfere in opportunistic actions by managers.

Regarding the control variables, we also find that larger and more profitable are associated to lower levels of earnings management, which confirms the empirical results presented in the literature (e.g., Chen et al. 2018; Cohen, and Zarowin, 2010; Doukakis, 2014;

Flores et al., 2016). By contrast, companies with more leveraged and with higher growth levels are associated to a higher degree of earnings management, which also confirm the empirical findings of previous studies (Doukakis, 2014).

(Insert Table 5 here)

Considering the high weight of Chinese firms in our sample composition (see Table 1), with approximately 25% of the total of firm-year observations, we also estimate the Model (8) without the Chinese firms. From the same perspective, we also examine Model (8) balancing the panel data. In other words, we selected only firms presented in all the eighteen years from the analysed temporal window (2000-2017). In both scenarios, the coefficient of *ETHICAL JUDGMENT* variable consistently remains negative and significant considering the three accruals variables related to earnings management practices (untabulated), confirming the main findings regarding the negative association between ethical judgments and earnings management.

Following previous literature about earnings quality and the effects of cross-country differences (e.g., Chen et al., 2018; Epps, and Guthrie 2010; Han et al., 2010), we also estimate our main empirical model splitting our final sample in positive and negative accruals, according to Table 6.

(Insert Table 6 here)

The results also confirm the negative effect of national ethical judgment on earnings management, except for */ACC1/* and */ACC2/* variable in negative accruals estimations, ratifying the research hypothesis and suggesting that the practice of earnings management

seems, on average, to be less present in companies from countries with higher levels of ethical judgment.

Taking together, our empirical findings, therefore, are aligned with the proposed theoretical framework that earnings management is, in fact, associated with national cultural aspects (Gray, 1988), more specifically the issues surrounding societal moral judgments and how society accepts or rejects morally questionable behaviours.

5 Additional Analyses

To provide a broader understanding related to the effect of ethical judgment on earnings management, we proceed in some additional analyses. First, considering the role of the level of countries' development to accounting practices (Nobes, 2011, 2013), we also estimate Model (8) splitting the sample in developed and emerging countries⁴. The results, presented in Table 7, show that in all estimations, *ETHICAL JUDGMENT* coefficient is negative and significant, confirming a negative association between the ethical judgment level and earnings management practice. Beyond that, we highlight that the coefficient of *ETHICAL JUDGMENT* variable is also more negative for the estimations considering firms from emerging countries when compared to those from developed ones. These findings suggest a greater effect of ethical judgment at country-level on earnings management practices in firms from emerging countries when compared to developed economies.

(Insert Table 7 here)

⁴ We considered IMF classification in the classification process of countries between “developed” and “emerging” economies. Thus, countries classified as “Advanced Economies” by IMF were considered “developed” and the other ones as “emerging”.

Second, we further exploit whether national ethical judgment moderate the effect of IFRS mandatory adoption on earnings management. It's possible to identify a large previous literature about the effect of IFRS adoption on earnings management with a cross-country design (e.g., Barth et al., 2008; Capkun et al., 2016; Mongrut, and Winkelried, 2018). However, the empirical finds presented by these studies are mixed. Therefore, discussing about how ethical judgment could moderate the impact of IFRS on earnings management, we raise a relevant discussion for financial accounting cross-country studies, increasing the view on the actual effects of these standards on the quality of financial reporting.

Thus, in order to analyze the additional question addressed, whether national ethical judgment moderate the effect of IFRS mandatory adoption on earnings manipulation, we proceed in the estimation of Model (8) considering additionally the interaction variable between *ETHICAL JUDGMENT* \times *IFRS*. For that analyze, we only consider countries that adopted mandatorily IFRS standards in the temporal analyzed window investigated (2000-2017). Following IFRS empirical literature (Chen et al., 2014, p. 1404), “we use a relatively short event window and focus on the two years preceding and the two years following the mandatory IFRS adoption”. The results are presented in Table 8.

(Insert Table 8 here)

We identify that the coefficient of *ETHICAL JUDGMENT* is negative and significant considering */ACC3/*, and *IFRS* coefficient is not significant in any of the three dependent variable estimation. We also observe a negative and significant coefficient to *ETHICAL JUDGMENT* \times *IFRS* interaction variable, witch suggest that, on average, the positive effect of IFRS adoption in decreasing the level of earnings management seem to be perceived only in firms from countries with a high level of national ethical judgment.

6 Conclusions

This study analyses the effect of ethical judgment at country-level on earnings management in a large sample database encompassing 81,408 firm-year observation from 39 countries. Our results suggest a negative association between national ethical judgment and accruals-based earnings management practices, suggesting that the manipulation of accounting amounts is lower in countries where ethically suspect behaviours are less acceptable. Our empirical findings also suggest that this phenomenon is verified both in developed and emerging countries, and that ethical judgment at country-level seem to moderate the association between IFRS adoption and earnings management practices. Our results are robust considering different accrual model estimations and sensitivity tests regarding eventual sample process bias.

Our study has several theoretical and practical implications. First, we contribute to accounting literature empirically demonstrating the role of ethical issues to earnings management practices, specifically manipulation of accounting amounts through accruals. Although not all accounting records involving accruals are considered “purposely manipulated information”, our results confirm a negative association between the level of accruals and the level of national ethical judgment of the countries where firms are situated. This suggests a greater intolerance or even more criticism of accounting information with high levels of accruals in societies regarded as more “honest” judgments – corroborating the underlying idea that managers use the accrual accounting to manipulate more intensely the information in countries where people culturally are more compliant with anti-ethical attitudes.

Second, demonstrating the role of ethics on earnings management, we raise a relevant discussion for governing bodies and regulators about the importance of strategic planning that

also considers aspects related to culture, moral and ethical issues, besides economic and political issues. Finally, in the same line, given the demonstrated negative association between earnings management and national ethical judgment, we also highlight a higher level of criticality that should possibly be adopted by investors and analysts in the analysis of accounting information of companies located in countries with low levels of ethical judgment.

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Table 1 – Overall Sample Composition

Countries	Firms		Observations	
	N° Firms	% N° Firms	N° Obs.	% N° Obs.
Argentina	27	0.26	233	0.29
Australia	239	2.32	1,353	1.66
Brazil	196	1.90	1,573	1.93
Chile	109	1.06	992	1.22
China	2,567	24.91	23,631	29.03
Colombia	27	0.26	196	0.24
Cyprus	48	0.47	392	0.48
Estonia	13	0.13	126	0.15
Finland	129	1.25	1,264	1.55
France	585	5.68	4,573	5.62
Germany	566	5.49	4,247	5.22
Ghana	7	0.07	35	0.04
Hong Kong	611	5.93	5,713	7.02
Hungary	21	0.20	95	0.12
India	109	1.06	734	0.90
Italy	207	2.01	1,432	1.76
Japan	390	3.78	3,201	3.93
Kazakhstan	10	0.10	65	0.08
Malaysia	594	5.76	4,998	6.14
Mexico	85	0.82	799	0.98
Netherlands	134	1.30	1,194	1.47
New Zealand	18	0.17	124	0.15
Nigeria	64	0.62	378	0.46
Norway	236	2.29	1,581	1.94
Pakistan	44	0.43	360	0.44
Peru	75	0.73	665	0.82
Philippines	115	1.12	1,061	1.30
Poland	534	5.18	3,184	3.91
Romania	100	0.97	307	0.38
Slovenia	22	0.21	173	0.21
South Africa	54	0.52	389	0.48
Spain	105	1.02	806	0.99
Sweden	517	5.02	3,709	4.56
Switzerland	163	1.58	1,475	1.81
Thailand	367	3.56	2,442	3.00
Tunisia	33	0.32	168	0.21
Turkey	273	2.65	1,696	2.08
Ukraine	897	8.70	5,990	7.36
United Kingdom	15	0.15	54	0.07
TOTAL	10,306	100.00	81,408	100.00

Table 2 – Ethical Judgment Index

Countries	Development Level	N° Respondents	Index	Index (stand.)
Argentina	Emerging	3,312	0.6023	0.7172
Australia	Developed	2,898	1.7056	0.8253
Brazil	Emerging	2,986	-1.2814	0.5326
Chile	Emerging	3,200	-0.5586	0.6034
China	Emerging	5,291	0.2177	0.6795
Colombia	Emerging	4,537	1.6845	0.8232
Cyprus	Developed	2,050	0.8942	0.7457
Estonia	Developed	1,533	-0.1430	0.6441
Finland	Developed	1,014	1.0153	0.7576
France	Developed	1,001	-2.3382	0.4290
Germany	Developed	4,110	0.7223	0.7289
Ghana	Emerging	3,086	1.5796	0.8129
Hong Kong	Developed	2,252	-1.5834	0.5030
Hungary	Emerging	1,007	0.3078	0.6883
India	Emerging	8,081	-0.7997	0.5798
Italy	Developed	1,012	1.8681	0.8412
Japan	Developed	4,901	2.4544	0.8986
Kazakhstan	Emerging	1,500	-1.5817	0.5031
Malaysia	Emerging	2,501	-4.1746	0.2491
Mexico	Emerging	5,095	-2.5917	0.4042
Netherlands	Developed	2,952	1.9133	0.8456
New Zealand	Developed	1,795	1.6024	0.8151
Nigeria	Emerging	3,781	0.4052	0.6978
Norway	Developed	1,025	0.8652	0.7429
Pakistan	Emerging	3,200	2.7108	0.9238
Peru	Emerging	2,711	-0.7499	0.5847
Philippines	Emerging	2,400	-6.7165	0.0000
Poland	Emerging	1,966	0.5325	0.7103
Romania	Emerging	3,279	1.3331	0.7888
Slovenia	Developed	2,106	1.0348	0.7595
South Africa	Emerging	9,519	-4.4001	0.2270
Spain	Developed	3,598	1.0001	0.7561
Sweden	Developed	3,223	0.1921	0.6770
Switzerland	Developed	1,241	1.9626	0.8504
Thailand	Emerging	2,734	-1.7152	0.4901
Tunisia	Emerging	1,205	0.3894	0.6963
Turkey	Emerging	2,951	3.4889	1.0000
Ukraine	Emerging	2,500	-2.3949	0.4235
United Kingdom	Developed	1,041	0.5469	0.7117
TOTAL	-	114,594	-	-

ETHICAL JUDGMENT is the aggregation of the *BENEFITS*, *BRIBE* and *TAXES* scores in a comprehensive measure defined by the principal component of them based on the WVS questioner. *ETHICAL JUDGMENT stand.* represent the *ETHICAL JUDGMENT* measure standardized in a scale of 0 to 1. *BENEFITS* is the weighted average of respondents that answered “Never” [considering one scale that range from “Never” to 10] to the phrase: “Claiming government benefits to which you are not entitled”. *BRIBE* is the weighted average of respondents that answered “Never” [considering one scale that range from “Never” to 10] to the phrase: “Someone accepting a bribe in the course of their duties”. Finally, *TAXES* is the weighted average of respondents that answered “Never” [considering one scale that range from “Never” to 10] to the phrase: “Cheating on taxes if you have a chance”. Countries development classification of countries is based on IMF methodology.

Table 3 – Descriptive Statistics of Variables at Firm-Level

Variables	N	Mean	Median	Q2	Q3	St. Deviation	Minimum	Maximum
<i> ACC1 </i>	81,408	0.0882	0.0519	0.0230	0.1066	0.1090	0.0000	0.6137
<i> ACC2 </i>	81,408	0.0801	0.0509	0.0227	0.0998	0.0921	0.0000	0.5423
<i> ACC3 </i>	70,685	0.0804	0.0484	0.0215	0.0989	0.0960	0.0000	0.5099
<i>ROA</i>	81,408	0.0127	0.0322	0.0033	0.0686	0.1395	-0.9243	0.2757
<i>SIZE</i>	81,408	6.7865	6.9090	5.2363	8.1959	2.2738	1.4171	12.8351
<i>CASH</i>	81,408	0.0477	0.0551	0.0057	0.1066	0.1171	-0.5362	0.3373
<i>LEVERAGE</i>	81,408	0.4686	0.4748	0.3057	0.6250	0.2123	0.0467	0.9999
<i>GROWTH</i>	81,408	0.1721	0.0780	-0.0411	0.2352	0.5615	-0.7764	3.9188
<i>LOSS</i>	81,408	0.2222	-	-	-	-	-	-
<i>IFRS</i>	81,408	0.5006	-	-	-	-	-	-
<i>CRISIS</i>	81,408	0.2048	-	-	-	-	-	-

Continuous variables. *|ACC1|*, *|ACC2|*, and *|ACC3|* are the absolute amount of discretionary accruals according to Dechow et al. (1995), Kothari et al. (2005), and Dechow et al. (2012), respectively. *ROA* is the net income divided by total assets. *SIZE* is the natural logarithm of total assets. *CASH* is the operating cash flow divided by total assets. *LEVERAGE* is the total liabilities divided by the total assets. *GROWTH* is percentage change in sales. **Dummy variables.** *LOSS* assumes 1 for firm-year observations with negative net income and zero otherwise. *IFRS* assumes 1 for company-year observations in the post-IFRS mandatory period and zero otherwise. *CRISIS* assumes 1 for firm-year observation in 2007, 2008 and 2009 related to subprime worldwide financial crisis, and zero otherwise. The mean of dummy variables represents only the percentual of firm-year observations that assumed value 1.

Table 4 – Correlation Matrix

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
1. <i> ACC1 </i>	1.0000										
2. <i> ACC2 </i>	0.8108***	1.0000									
3. <i> ACC3 </i>	0.8341***	0.7810***	1.0000								
4. <i>ETHICAL JUDGMENT</i>	-0.0006	0.0009	-0.0084***	1.0000							
5. <i>ROA</i>	-0.2145***	-0.1630***	-0.2422***	-0.0258***	1.0000						
6. <i>SIZE</i>	-0.1863***	-0.1932***	-0.1944***	0.0411***	0.2574***	1.0000					
7. <i>CASH</i>	-0.1874***	-0.1663***	-0.1877***	-0.0106***	0.6202**	0.1982***	1.0000				
8. <i>LEVERAGE</i>	0.0285***	0.0108***	0.0345***	0.0783***	-0.1082***	0.1306***	-0.0108***	1.0000			
9. <i>GROWTH</i>	0.1752***	0.2049***	0.1755***	-0.0003***	0.0405	-0.0205***	-0.0507***	-0.0202***	1.0000		
10. <i>REGQUALITY</i>	0.0732***	0.0892***	0.0814***	0.0787***	-0.1652***	-0.3243***	-0.0585***	0.0515***	-0.0092**	1.0000	
11. <i>FINMARKET</i>	0.0397***	0.0389***	0.0278***	0.2271***	-0.1158***	-0.1319***	-0.0799***	0.0327***	0.0212***	0.5493***	1.0000

This table presents Pearson correlation between all analyzed continuous variables regarding to the main empirical model estimations. *|ACC1|*, *|ACC2|*, and *|ACC3|* are the absolute amount of discretionary accruals according to Dechow et al. (1995), Kothari et al. (2005), and Dechow et al. (2012), respectively. *ETHICAL JUDGMENT* is the index of ethical judgment for each country and year. *ROA* is the net income divided by total assets. *SIZE* is the natural logarithm of total assets. *CASH* is the operating cash flow divided by total assets. *LEVERAGE* is the total liabilities divided by the total assets. *GROWTH* is percentage change in sales. *LOSS* is a dummy variable that assumes 1 for firm-year observations with negative net income and zero otherwise. *IFRS* is a dummy variable that assumes 1 for company-year observations in the post-IFRS mandatory period and zero otherwise. *REGQUALITY* is the index of regulatory quality for each country and year, according to World Bank. *FINMARKET* is the index of financial market development for each country and year, according to IMF. *, **, and *** indicate significant correlations at the 10%, 5%, and 1% levels, respectively.

Table 5 – The effect of ethical judgment on earnings management

	ACC1	ACC2	ACC3
<i>cons</i>	0.340*** (6.73)	0.275*** (6.08)	0.321*** (6.19)
ETHICAL JUDGMENT	-0.369*** (-4.84)	-0.263*** (-3.90)	-0.356*** (-4.61)
<i>ROA</i>	-0.097*** (-10.81)	-0.047*** (-6.41)	-0.113*** (-12.67)
<i>SIZE</i>	-0.010*** (-28.46)	-0.009*** (-29.39)	-0.009*** (-27.03)
<i>CASH</i>	-0.063*** (-6.70)	-0.062*** (-7.43)	-0.034*** (-3.80)
<i>LEVERAGE</i>	0.034*** (12.43)	0.023*** (9.74)	0.031*** (11.59)
<i>GROWTH</i>	0.000*** (25.19)	0.000*** (27.60)	0.000*** (24.69)
<i>LOSS</i>	0.000 (0.12)	-0.004*** (-3.00)	0.005*** (3.74)
<i>IFRS</i>	-0.006*** (-3.15)	-0.007*** (-4.51)	-0.002 (-1.12)
<i>REGQUALITY</i>	0.008** (2.19)	0.006* (1.78)	0.006* (1.68)
<i>FINMARKET</i>	0.031*** (4.42)	0.024*** (3.92)	0.036*** (5.13)
<i>CRISIS</i>	0.033*** (11.19)	0.013*** (5.40)	0.014*** (5.37)
<i>Firm Cluster effects</i>	YES	YES	YES
<i>Industry fixed-effects</i>	YES	YES	YES
<i>Year fixed-effects</i>	YES	YES	YES
<i>Country fixed-effects</i>	YES	YES	YES
R ²	0.1348***	0.1270***	0.1541***
No. Obs.	81,408	81,408	81,408

This table presents the estimation results of a selection model that analyzes the effect of ethical judgment on earnings management. The dependent variables are |ACC1|, |ACC2|, and |ACC3|, that represent the absolute amount of discretionary accruals according to Dechow et al. (1995), Kothari et al. (2005), and Dechow et al. (2012), respectively. *ETHICAL JUDGMENT* is the index of national ethical judgment for each country. *ROA* is the net income divided by total assets. *SIZE* is the natural logarithm of total assets. *CASH* is the operating cash flow divided by total assets. *LEVERAGE* is the total liabilities divided by the total assets. *GROWTH* is percentage change in sales. *LOSS* is a dummy variable that assumes 1 for firm-year observations with negative net income and zero otherwise. *IFRS* is a dummy variable that assumes 1 for company-year observations in the post-IFRS mandatory period and zero otherwise. *REGQUALITY* is the index of regulatory quality for each country and year, according to World Bank. *FINMARKET* is the index of financial market development for each country and year, according to IMF. *CRISIS* is a dummy variable that assumes 1 for 2007, 2008 and 2009 related to subprime worldwide financial crisis, and zero otherwise. Parameter estimates are reported first, followed by robust *t*-statistics corrected for firm-level clustering in parentheses. *, **, and *** indicate significant coefficients at the 10%, 5%, and 1% levels, respectively (two-tailed).

Table 6 – The effect of ethical judgment on earnings management: positive and negative accruals

	Positive Accruals			Negative Accruals		
	<i> ACC1 </i>	<i> ACC2 </i>	<i> ACC3 </i>	<i> ACC1 </i>	<i> ACC2 </i>	<i> ACC3 </i>
<i>cons</i>	0.259*** (5.97)	0.247*** (6.51)	0.188*** (4.08)	0.085 (1.46)	0.092* (1.81)	0.132** (2.04)
<i>ETHICAL JUDGMENT</i>	-0.284*** (-3.86)	-0.272*** (-4.30)	-0.157** (-2.17)	-0.113 (-1.34)	-0.086 (-1.16)	-0.196** (-2.08)
Control variables	<i>Inserted</i>	<i>Inserted</i>	<i>Inserted</i>	<i>Inserted</i>	<i>Inserted</i>	<i>Inserted</i>
<i>Firm Cluster effects</i>	YES	YES	YES	YES	YES	YES
<i>Industry fixed-effects</i>	YES	YES	YES	YES	YES	YES
<i>Year fixed-effects</i>	YES	YES	YES	YES	YES	YES
<i>Country fixed-effects</i>	YES	YES	YES	YES	YES	YES
R ²	0,3334***	0,3623***	0,4148***	0,5270***	0,3880***	0,4882***
No. Obs.	39,231	36,035	33,714	42,177	45,373	36,971

This table presents the estimation results of a selection model that analyzes the effect of ethical judgment at country-level on earnings management, splitting the results by positive and negative accruals. The dependent variables are *|ACC1|*, *|ACC2|*, and *|ACC3|*, that represent the absolute amount of discretionary accruals according to Dechow et al. (1995), Kothari et al. (2005), and Dechow et al. (2012), respectively. *ETHICAL JUDGMENT* is the index of national ethical judgment for each country. Control variables inserted as described in previous estimations. Parameter estimates are reported first, followed by robust *t*-statistics corrected for firm-level clustering in parentheses. *, **, and *** indicate significant coefficients at the 10%, 5%, and 1% levels, respectively (two-tailed).

Table 7 – The effect of ethical judgment on earnings management: the role of countries development

	ACCI		ACC2		ACC3	
	<i>Developed Countries</i>	<i>Emerging Countries</i>	<i>Developed Countries</i>	<i>Emerging Countries</i>	<i>Developed Countries</i>	<i>Emerging Countries</i>
<i>cons</i>	0.282*** (14.74)	0.499*** (3.47)	0.221*** (13.11)	0.269* (1.90)	0.235*** (12.52)	0.359*** (2.95)
<i>ETHICAL JUDGMENT</i>	-0.220*** (-13.37)	-0.722** (-2.43)	-0.169*** (-12.18)	-0.307 (-1.05)	-0.216*** (-14.02)	-0.471* (-1.82)
Control variables	<i>Inserted</i>	<i>Inserted</i>	<i>Inserted</i>	<i>Inserted</i>	<i>Inserted</i>	<i>Inserted</i>
<i>Firm Cluster effects</i>	YES	YES	YES	YES	YES	YES
<i>Industry fixed-effects</i>	YES	YES	YES	YES	YES	YES
<i>Year fixed-effects</i>	YES	YES	YES	YES	YES	YES
<i>Country fixed-effects</i>	YES	YES	YES	YES	YES	YES
R ²	0,1666***	0,1237***	0,1532***	0,1134***	0,1927***	0,1236***
No. Obs.	37,353	44,055	37,353	44,055	32,532	38,153

This table presents the estimation results of a selection model that analyzes the effect of ethical judgment at country-level on earnings management, splitting firm-year observations by developed and emerging countries. The dependent variables are |ACCI|, |ACC2|, and |ACC3|, that represent the absolute amount of discretionary accruals according to Dechow et al. (1995), Kothari et al. (2005), and Dechow et al. (2012), respectively. *ETHICAL JUDGMENT* is the index of national ethical judgment for each country. Control variables inserted as described in previous estimations. Parameter estimates are reported first, followed by robust *t*-statistics corrected for firm-level clustering in parentheses. *, **, and *** indicate significant coefficients at the 10%, 5%, and 1% levels, respectively (two-tailed).

Table 8 – The moderate effect of ethical judgment on the association between IFRS mandatory adoption and earnings management

	<i>/ACC1/</i>	<i>/ACC2/</i>	<i>/ACC3/</i>
<i>cons</i>	0.266*** (3.43)	0.253*** (3.68)	0.271*** (3.81)
<i>ETHICAL JUDGMENT</i>	-0.183 (-1.46)	-0.157 (-1.44)	-0.242** (-2.07)
<i>IFRS</i>	0.004 (0.50)	0.009 (1.37)	0.005 (0.61)
<i>ETHICAL JUDGMENT x IFRS</i>	-0.034*** (-3.35)	-0.031*** (-3.62)	-0.018* (-1.70)
Control Variables	<i>Inserted</i>	<i>Inserted</i>	<i>Inserted</i>
<i>Firm cluster effects</i>	YES	YES	YES
<i>Industry fixed-effects</i>	YES	YES	YES
<i>Year fixed-effects</i>	YES	YES	YES
<i>Country fixed-effects</i>	YES	YES	YES
R ²	0,1214***	0,1360***	0,1462***
No. Obs.	23,358	23,358	19,480

This table presents the estimation results of a selection model that analyzes the moderate effect of ethical judgment at country-level on the association between IFRS mandatory adoption and earnings management. The dependent variables are */ACC1/*, */ACC2/*, and */ACC3/*, that represent the absolute amount of discretionary accruals according to Dechow et al. (1995), Kothari et al. (2005), and Dechow et al. (2012), respectively. *ETHICAL JUDGMENT* is the index of national ethical judgment for each country. Control variables inserted as described in previous estimations. Parameter estimates are reported first, followed by robust *t*-statistics corrected for firm-level clustering in parentheses. *, **, and *** indicate significant coefficients at the 10%, 5%, and 1% levels, respectively (two-tailed).