

PERCEPTIONS OF EARNINGS MANAGEMENT: COMPARING U.S. AND GERMAN ACCOUNTING STUDENTS

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ABSTRACT

Earnings management has attracted a large amount of attention in the U.S. literature. With the continued expansion of companies into the global marketplace and the internationalization of capital markets, it is increasingly important to examine the views of earnings management from an international perspective. The purpose of this study is to increase our understanding of accounting students' perceptions regarding the practice of earnings management, and whether those perceptions are influenced by nationality. Comparing U.S. accounting students to German accounting students we predict that there will be differences in perceptions of the ethical acceptability of earning management due to cultural differences and financial reporting environment differences in Germany. Ninety-five students (59 from the U.S. and 36 from Germany) were asked to evaluate the ethical acceptability of 13 earnings management activities. Our results show that for all scenarios, the U.S. students object more strongly to earnings management practices than do the German students.

INTRODUCTION

Earnings management can be defined in many different ways. The former SEC chair, Arthur Levitt (1998), defines it as "accounting hocus-pocus" (p. 16) where flexibility in financial reporting is exploited by managers who are trying to meet earnings expectations. Healy and Wahlen (1999) explain that "earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports either to mislead stakeholders or influence accounting numbers" (p. 368). Another definition is "purposeful intervention in the external financial reporting process with the intent of obtaining some private gain" (Schipper 1989, p. 92). In general, earnings management is a strategy used by the management of a company to deliberately manipulate the company's earnings so that the figures match a pre-determined target.

Some managers may view earnings management as a legitimate managerial tool that is useful for fulfilling their responsibilities to maximize shareholder returns. However, many others view earnings management as misleading at best and unethical at worst. Given the discretion and judgment accounting practitioners and managers can exercise, it is desirable to have knowledge about how different people perceive the acceptability of earnings management practices (Fischer & Rosenzweig, 1995).

Highly publicized corporate scandals such as Enron and WorldCom have aroused fresh interest in the issue of earnings management. Over the past decade, earnings management has attracted a large amount of attention especially in the U.S. literature. Now, with the continued expansion of companies into the global marketplace and the internationalization of capital markets, it is increasingly important to examine the views of earnings management from an international perspective. The purpose of this study is to increase our understanding of accounting students' perceptions regarding the practice of earnings management, and whether those perceptions are influenced by nationality. Specifically we examine whether accounting students from the U.S. and Germany differ significantly in their perceptions about the practice of earnings management.

BACKGROUND

American and German perceptions on earnings management are likely to differ for two reasons. First, U.S. and German firms operate in different financial reporting environments and thus have different motivations and incentives for earnings management. As described by Glaum, Lichtblau and Lindemann (2004) in their research, the U.S. is a country with a highly developed securities market, a case law system, clearly segregated financial and tax accounting systems, and a shareholder-oriented system of corporate governance. Investors are heavily dependent on information supplied in financial statements and investor expectations therefore play an important role as a determinant for earnings management. By contrast, Glaum et al. (2004) explain that stakeholders in most German companies are banks, other financial institutions, and the government. These equity and debt financing sources result in less need for public disclosure since public investing in a company is more limited. Germany is also a code law country, has closely connected financial and tax-accounting systems, and a stakeholder-oriented system of corporate governance.

Given the significant differences in reporting environments, previous studies have compared the presence and degree of earnings management in U.S. and German firms. Some studies provide evidence that German companies manage earnings more than U.S. companies (Daske, Gebhardt, & McLeay, 2003; Luez, Nanda, & Wysocki, 2003). However, Brown and Higgins (2001) find that U.S. companies resort to earnings management in order to avoid reporting earnings below analyst' forecasts more often than German companies and Glaum et al. (2004) find no significant earnings management practice differences between the U.S. and Germany.

Secondly, cultural differences could play a role in why U.S. and German accounting students' perceptions on earnings management practices may differ. Culture is, as the social researcher G.P. Ferraro (2006) said, "everything that people have, think, and do as members of society" (p. 18). Several studies have demonstrated how cultural settings are an important individual conditioning factor (Hofstede, 1980, 1984, 1991; Poortinga, 1989; Triandis, 1985, 1989; Wines & Napier, 1992). According to Hofstede (1980, 1991), perceptions and actions of individuals

will be influenced by cultural factors individuals have been exposed to throughout their lives. Hofstede's (1980) study and later extensions extracted five primary dimensions to differentiate cultures: power distance, individual/collectivism, masculine/feminine, uncertainty avoidance, and Confucian dynamism. This taxonomy is the most widely used framework for differentiating among cultures in the accounting literature. These five cultural dimensions are thought to have a profound and lasting impact on the ethical perceptions and decisions of individuals from different countries (Cohen, Pant, & Sharp, 1996).

One of the key cultural differences between Germany and the United States is the level of tolerance for uncertainty and ambiguity within a society, which Hofstede (2001) labels "uncertainty avoidance" (p. 87). Germany is classified as a strong uncertainty avoidance country while the United States is classified as a weak uncertainty avoidance country. Strong uncertainty avoidance countries, like Germany, have a low tolerance for uncertainty and ambiguity. As Schmidt (2007) explains, there are more rigid rules of behavior, laws are stricter, and penalties heavier. Laws and regulations are instituted to reduce the amount of uncertainty. In a weak uncertainty avoidance country, there tends to be less discomfort with uncertainty and ambiguity and more tolerance for flexibility. This is reflected by a society that is less rule-oriented and more readily accepts change. Organizations are more flexible and people more easy-going and creative in weak uncertainty avoidance countries. Interestingly, Schmidt (2007) notes in his research that although Germany tends to implement rules and regulations for greater control, this tendency towards regulation does not apply to business ethics. While American firms regularly institute ethical codes of conduct, German firms instead tend to rely on the "informal mechanisms of social control within the company" (p. 79).

Another key cultural difference between Germany and the U.S. is the level of individualism. The U.S. is a very individualistic society where people are more concerned for themselves than others. In contrast, Germans place more value on doing things for the good of the group. Schmidt (2007) notes that Americans take great pride in their individualism and see themselves first as an individual and second as a member of a group or an organization. Consequently the views of the individual may differ from the views of the group. American values encourage individuals to report unethical activities. In contrast, Schmidt (2007) says that Germans are more likely to make decisions according to the group, not personal beliefs and are less likely to be a whistle-blower on another member of their group because "whistle-blowers are seen as outsiders rather than heroes" (p.79). German workers feel a great sense of loyalty towards the organization.

While interest in business ethics and regulatory rules and standards has increased considerably in Europe over the last decade, it is not near the persistent public concern with the integrity of business behavior as in the U.S. An example of the U.S.'s focus on business ethics is the adoption of Sarbanes-Oxley in 2003 following the Enron and Worldcom scandals. In the U.S., unethical practices are now punished with prison terms and heavy financial penalties.

Several prior studies (i.e. Becker & Fritsche, 1987; Karnes, Sterner, & Wu, 1989) suggest that individual ethical judgments are influenced by national origin. Becker and Fritsche (1987) compared the ethical beliefs of marketing managers from the U.S., France, and Germany and found significant differences related to nationality. Karnes et al. (1989) studied the ethical perceptions of accountants from the U.S. and Taiwan. The American accountants were found to

be more concerned about the legal consequences of their actions, while the Taiwanese accountants were more concerned about how their group would be affected. While the precise impact of national culture on individual perception and decision-making is not entirely resolved in the literature, culture is likely to influence students' perceptions in some way.

Based on the preceding discussion, we believe that U.S. and German students' perceptions of the ethical acceptability of earnings management may differ. Thus, the hypothesis we test in this paper is:

H₁: There are differences in perceptions of the ethical acceptability of earnings management between accounting students in the U.S. and accounting students in Germany.

METHODOLOGY

Subjects

There were 95 participants in this study; 59 undergraduate accounting students (either at the junior or senior level) from a large public university in Minnesota and 36 undergraduate accounting students from a university in Germany. Participation was voluntary and the responses to the questionnaire were anonymous.

The students ranged in age from 20 to 51 years with a median age of 23. All students were accounting majors and have completed an average of 7 accounting classes at the time of the survey. Fifteen percent of the U.S. students, compared to none of the German students, had studied abroad during college and over 40% of the students participating in this study had completed an internship.

TABLE 1. GENDER DEMOGRAPHICS

	<i>Male</i>	<i>Female</i>	<i>Total</i>
U.S. Students	27	32	59
German Students	24	12	36
Total	51	44	95

TABLE 2. OTHER DEMOGRAPHICS

	<i>U.S. Students</i>	<i>German Students</i>	<i>All Students</i>
Accounting Classes Completed	9.78	2.09	6.88
Previously Studied Abroad	15%	0%	9.5%
Completed an Internship	29%	67%	43%

EARNINGS MANAGEMENT QUESTIONNAIRE

The students responded to 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), Fisher and Rosenzweig (1995), and Clikeman, Geiger, and O'Connell (2001) to study accountants' perceptions of the ethics of earnings management. The scenarios address practices such as delaying (accelerating) discretionary expenses to increase (decrease) earnings and manipulating inventory reserves. Students responded to each scenario using a 5-point Likert scale ranging from 1 for "ethical practice" to 5 for "totally unethical". Higher scores correspond with higher degrees of ethical unacceptability. The German students responded to a questionnaire written in German that was translated by a professional translation firm.

RESULTS AND ANALYSIS

The 13 scenarios describe a variety of earnings management techniques. Table 3 presents the mean responses to each of the earnings management scenarios. The mean responses varied widely among the scenarios. The students objected most strongly to the practice of writing down inventory as obsolete when the managing group believed the majority of inventory could be sold in the future at close to full price (scenario 5b; mean = 4.05). Students had the least objection to painting a building early when the division was ahead of its profit target (scenario 1; mean = 1.23).

COMPARISON OF U.S. STUDENTS AND GERMAN STUDENTS

The second and third columns of Table 3 report the mean responses of the 59 U.S. students and the 36 German students. A univariate t-test and Wilcoxon signed-rank test were used for each scenario to compare the responses of the two groups of students. The results indicate that the U.S. and German students differ significantly (at the $p < .05$ level) for all but two scenarios (5b and 6a).

For all the scenarios, the U.S. students *object* more strongly than do the German students¹. In order to test for any aggregate culture effects, the responses were also analyzed using multivariate analysis of variance (MANOVA). This analysis assesses student responses across all 13 vignettes. The results of this multivariate analysis indicate a significant overall difference between responses of U.S. students and German Students ($F = 10.81$). These findings support our univariate test results.

TABLE 3. MEAN RESPONSES TO EARNINGS MANAGEMENT SCENARIOS

<i>Scen-ario</i>	<i>All Students (n=95)</i>	<i>U.S. Students (n=59)</i>	<i>German Students (n=36)</i>	<i>Signif.</i>
1 Paint building early	1.23	1.32	1.08	.023
2a Defer expenditures from March to April	2.61	3.13	1.78	.000
2b Defer expenditures from Dec. to Jan.	3.27	3.86	2.33	.000
3 Record supplies next year	3.38	3.84	2.64	.000
4a End of year sales program	2.47	3.02	1.61	.000
4b Overtime in December	1.57	1.78	1.22	.000
4c Sell unused assets	1.42	1.64	1.06	.000
5a Prepay \$60K travel expenses	3.18	3.78	2.19	.000
5b Writedown \$700K inventory	4.05	4.19	3.83	.064
6a Writeup inventory – product development	2.93	3.1	2.64	.063
6b Writeup inventory – meet budget	3.66	3.88	3.33	.008
7a Delay recording \$30K invoice	2.77	3.43	1.69	.000
7b Delay recording \$500K invoice	3.45	4.13	2.39	.000

¹ We also compared mean responses of male and female students using a t-test to assess differences in responses due to gender. We found significant differences for scenarios 3, 4a, 5a, and 6a. In all 4 four scenarios, the female students found the scenario a more serious ethical infraction than the male students.

SITUATIONAL FACTORS THAT INFLUENCED JUDGMENTS

Merchant and Rockness (1994) report that (1) type, (2) direction, (3) materiality of the manipulation, and (4) the intentions of the manager committing the manipulation will influence accountants' perceptions on the ethical acceptability of earnings management. Following is a brief examination of these four categorical issues regarding earnings management. Table 4 reports the influence of these four factors on the students' ethical judgments.

TYPE OF MANIPULATION (TYPE)

Earnings can be managed either by altering the recording of existing transactions (accounting manipulation) or by timing year-end transactions to move revenues and expenses into the desired reporting period (operating manipulation). An example of an accounting manipulation would be to adjust the amount of reserve to increase or decrease reported net income.

TABLE 4. MEAN VALUES OF FACTORS THAT INFLUENCE EARNINGS MANAGEMENT JUDGMENTS

Variable	Description	All Students (n=95)	U.S. Students (n=59)	German Students (n=36)	Signif.
ACC	$(3 + 5a + 5b + 6a + 6b + 7a + 7b)/7$	3.35	3.76	2.67	.000
OPER	$(1 + 2a + 2b + 4a + 4b + 4c)/6$	2.10	2.46	1.51	.000
TYPE	ACC – OPER	1.25	1.31	1.16	.276
DIR	$2b - 1$	2.04	2.53	1.25	.000
MAT	$7b - 7a$.69	.69	.69	.997
INTENT	$6b - 6a$.73	.78	.69	.620

Offering special terms to customers at year-end to advance sales from next year to this year is an example of an operating manipulation (Fisher & Rosenzweig, 1995). Merchant and Rockness (1994) report that accountants judge accounting manipulations to be more serious ethical violations than operating manipulations. Scenarios 3, 5a, 5b, 6a, 6b, 7a, and 7b describe accounting manipulations. Most of these scenarios involve practices that violate U.S. GAAP. The students' mean response to the seven accounting manipulation scenarios (ACC) is 3.35. Scenarios 1, 2a, 2b, 4a, 4b, and 4c describe operating manipulations. These scenarios do not violate accounting rules, but involve operating decisions to move revenues and expenses from one period to another. The students mean response to the six operating manipulation scenarios (OPER) is 2.10. The difference between the responses to ACC and OPER has a mean value of 1.25 and is significantly different from zero at $p < .000$ ($t = 19.408$). Consistent with prior research (Merchant & Rockness, 1994; Clikeman et al., 2001), accounting students find violations of accounting rules more ethically troubling than operating manipulations of income.

DIRECTION OF MANIPULATION (DIR)

Scenarios 1 and 2b are similar except that scenario 1 involves accelerating a discretionary expenditure to reduce current period income and scenario 2 involves delaying a discretionary expenditure to increase current period income. The difference between the responses to scenarios 1 and 2b (DIR) has a mean value of 2.04 and is significantly different from zero at $p < .000$ ($t = 14.624$). Accounting students consider it an ethical infraction to delay expense in order to increase reported income, but object less strongly to operating manipulations that reduce reported income.

MATERIALITY (MAT)

Scenarios 7a and 7b are identical except for the amount of the unrecorded liability. The difference between the response to 7a and 7b (MAT) has a mean value of .69 and is significantly different from zero at $p < .000$ ($t = 9.881$). Students judge the omission of a large liability to be a more serious infraction than the omission of a small liability.

INTENTIONS (INTENT)

Scenarios 6a and 6b are identical except for the manager's motives to manage earnings. In 6a the manager wants to report higher earnings to obtain funding for important product development projects, while in 6b the manager simply wants to meet the division's budgeted profit targets. The difference between the responses to scenarios 6a and 6b (INTENT) has a mean value of .73 and is significantly different from zero at $p < .000$ ($t = -8.214$). Students find earnings management more ethically acceptable if it is committed with "good" intentions.

COMPARISON OF U.S. STUDENTS AND GERMAN STUDENTS

The second and third columns of Table 4 report the mean values of TYPE, DIR, MAT, and INTENT for the U.S. and German students. The only significant difference between U.S. and German students is for DIR, $p = .000$. The U.S. students objected more strongly to income-increasing manipulations over income-reducing manipulations than the German students. There are no differences between the U.S. students and German students for TYPE, MAT or INTENT. This provides little evidence that U.S. and German students differ on these situational factors.

LIMITATIONS

In interpreting the results of this study, the following study limitations should be considered. First, the sample size was relatively small. Small samples make significance more difficult to achieve and the significant differences found may indicate the presence of large real differences. Second, the sample sizes for the two countries were unequal, and this may have affected the results. However, the statistical analysis techniques used were conservative and adjusted for sample size. Third, the study has not controlled for extraneous variables, such as age or work experience of subjects, which could impact the findings. Finally, using accounting students from Germany and the U.S. might potentially impact the external validity of our results and may not adequately represent the views of German or US managers.

DISCUSSION AND IMPLICATIONS

Earnings management is one of the most important practical ethical issues faced by accountants. Accountants are responsible for publishing fair and reliable financial statements, but many incentives exist for companies to try to move their reported earnings toward a desired goal. Prior research reveals wide disagreement among accountants regarding the ethical acceptability of earnings management (Bruns & Merhcant, 1990; Clikeman et al. 2001; Merchant & Rockness, 1994).

Our study hypothesizes that there will be differences in perceptions of acceptability of earnings management between U.S. and German accounting students due to differences in financial reporting environments as well as cultural factors. Based on mean responses to a 13 scenario questionnaire, we find that U.S. and German accounting students' perceptions of the acceptability of earnings management differs significantly. U.S. students object more strongly to the earnings management scenarios than do the German students. This was true for eleven out of thirteen scenarios. Prior research has found differences in earnings management practices between U.S. and German firms and also differences in perceptions of earnings management between groups of different nationalities. This study furthers those findings.

In this study we also looked at situational factors that may influence perceptions on the ethical acceptability of earnings management. We found that both U.S. and German students object more strongly to accounting manipulations than to operating manipulations. They judged violations of GAAP less ethically acceptable than operating manipulations that accomplish similar results without breaking any explicit accounting rules. We also found that both groups of students objected more to decreasing earnings than increasing earnings, immaterial infractions than material infractions, and objected less to manipulations if they were for "good" intentions. There was only one significant difference, direction of manipulation, between U.S. and German students for the individual cases. Compared to German students, U.S. students more strongly object to income increasing manipulations than decreasing manipulations.

One of the primary environmental differences between the U.S. and Germany that may explain our results pertains to the relationship between tax reporting and financial reporting. One of the key objectives of financial reporting in the U.S. is to provide useful information for those making investment and credit decisions. While U.S. companies do try to minimize income taxes, they are able to do so while simultaneously maintaining more transparent numbers for financial reporting purposes. In Germany, most companies essentially are required to use the same numbers for tax and financial reporting. Thus, financial accounting in Germany is significantly influenced by a company's desire to minimize taxes. In years of strong profits, firms will attempt to report a more moderate level of income to reduce taxes by adopting the most conservative options available within the rules. As a result, earnings management for the purpose of minimizing taxes may be acceptable in Germany and actually represent good corporate management so long as it does not violate specific laws.

Another environmental difference that may have significant impact on the view of earnings management and may help explain our results pertains to the stakeholder differences between

U.S. and German companies. In Germany, banks are significant stakeholders both as investors and lenders. Historically, German companies had little concern with adequate disclosure in their financial statements. Since the banks were deeply involved with the company in a variety of ways, banks did not need to rely on publicly available information and disclosure of annual results was not considered important. With the integration of European Union reporting rules into German code law, disclosure now is more transparent. However, changing the reporting culture probably is not easy given the prior tendencies. While fuller disclosure may now be required, the concept of secrecy and managed earnings may still exist.

The U.S. and Germany also differ on the degree of conservatism embedded in each country's accounting rules. As discussed earlier, Germany is considered a strong uncertainty avoidance country. Countries that rank high on uncertainty avoidance are more likely to rank highly in terms of conservatism as well. Douppnik and Perera (2007) describe in their book that German accounting follows a strongly conservative approach that stems from a fundamental concern with creditor protection and the perceived need to cope with the uncertainty of future events. German accounting philosophy has been that conservative balance sheet valuations are important for creditor protection. Douppnik and Perera (2007) go on to explain that consistent with this philosophy, German companies have a preference for more conservative measures of profit and have even embedded conservatism into the law. Some of the earnings management practices in this study may have been viewed by the German students as reasonable within a conservative framework rather than an unethical or unacceptable practice.

Substance over form leads to more transparent financial reports and probably makes it somewhat more difficult to manage earnings. In the US substance over form prevails throughout our accounting rules. In many transactions, for example in capitalized lease situations, German accounting rules allow form over substance. German companies have more freedom to write down assets as impaired. This conservative approach, which is part of the cultural business environment, might make it easier for German companies to justify the management of earnings. Another example of a common accounting practice in Germany is to establish liabilities, known as hidden or secret reserves for "uncertain future liabilities" (Douppnik & Perera, 2007, p. 184) with an offsetting expense in profitable years. Reserves are seen as a conservative approach to protect against unforeseen risks and possible insolvency. In less profitable years, adjustments can be made to these reserves with a corresponding revenue adjustment.

In 1998, Germany added a new law requiring companies that issue equity or debt on organized capital markets to use International Financial Reporting Standards (IFRSs) or some other internationally accepted accounting principles (such as US GAAP) in their consolidated financial statements. In 2005, Germany changed the requirement to IFRS specifically. Nonpublic German companies and publically traded companies, when preparing the nonconsolidated statements for tax purposes, continue to use German GAAP (Douppnik & Perera 2007). The adoption of IFRS by countries around the world is growing. The acceptance of IFRS (rather than requiring US GAAP) by the NYSE for foreign firms listed on the exchange, lessens the motivation by foreign companies, including German firms, to eliminate earnings management. The IFRS are much more broad and flexible than US GAAP. The IFRS allow for more liberal interpretations and sometimes more creative accounting. IFRS also favor a "true and fair" view over conservatism. The international reporting culture and climate, with a global shift towards IFRS, do little to

discourage earnings management in one sense. The Securities and Exchange Commission (SEC) has proposed that US issuers adopt IFRS by 2011, which could change the perceptions and practice of earnings management by US companies as well.

The final reason German students may view earnings management as less objectionable than U.S. students may be due to the current emphasis in the U.S. on business ethics. Accounts of unethical behavior can be found almost daily in the U.S. business press. Business colleges across the country are incorporating business ethics into the curriculum. U.S. accounting students are taking courses in auditing, detecting fraud, and corporate governance where earnings management, Sarbanes-Oxley, and other ethics and fraud topics are thoroughly discussed. Students role play ethical situations in classroom settings and practice applying the essential steps towards ethical problem solving. This may not be the case in Germany. Discussion of ethics in Germany may be limited in scope and more theoretical than practical. U.S. students may be more sensitive to business ethics and the ramifications of unethical behavior than their German counterparts, and therefore, may object more strongly to debatable earnings management practices like the ones addressed in this study.

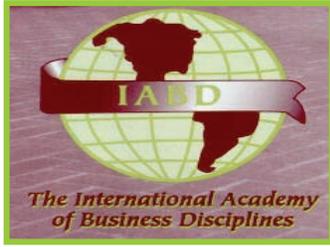
The results of this study have important implications for accounting education, accounting practice, and accounting regulators. Earnings management issues arise because of judgments made about the realization of revenues and expenses. This research shows that cultural factors have an impact on these accounting judgments. Accounting educators must realize that cultural factors play a role in accounting judgments and decision making. Even though international students studying accounting in the U.S., study the same material as American students, their cultural differences may lead to different applications of GAAP where judgment is used in the decision making process. American accounting practitioners practicing internationally should be aware that cultural factors will affect accounting judgments and they should be aware of those cultural factors. Finally, accounting regulators, who are responsible for promulgating accounting standards, must be cognizant of these cultural differences and the potential for these differences to cause different interpretations or application of accounting principles due to applying accounting judgment. This will become increasingly more important as the world turns to international standards of accounting.

In conclusion, while this study has some interesting and useful findings, and implications for accounting teachers, practitioners, and regulators, future research should continue to focus on earnings management and the international perceptions and implications of earnings management as the business world becomes increasingly global.

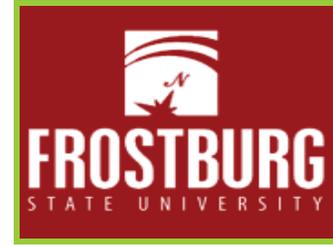
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