Impact of Culture, Market Forces, and Legal System on Financial Disclosures

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***Abstract:** This study examines the impact of legal systems (LSs) on financial disclosures by firms from different countries. The results indicate that firms from common law countries are associated with higher financial disclosures compared to firms from code law countries. The findings also reveal that cultural values have an insignificant impact on financial disclosures by firms from common law countries, and the results on firms from code law countries provide mixed signals. The results for multinationals are similar to the results for the total sample. The cultural values have no impact on financial disclosures of multinationals from common law countries, and there are mixed signals for multinationals from code law countries.*

Influence of cultural environment on accounting standards and practices has been examined by several studies (e.g., Jaggi, 1975; Gray, 1988; Perera, 1989; Doupnik and Salter, 1995; Zarzeski, 1996). In 1988, Gray (1988) developed hypotheses on the association between accounting sub-cultural values and cultural dimensions developed by Hofstede (1980). He hypothesized that financial disclosures in different countries would be influenced negatively by cultural dimensions of uncertainty avoidance (UA) and power distance (PD) and positively by individualism (IND) and masculinity (MAS). Zarzeski (1996), who recently empirically tested the impact of cultural values on financial disclosures by firms from seven industrialized countries, however, argued that in addition to cultural values, market forces would also have a significant impact on financial disclosures, and her findings supported her argument. Additionally, her findings reveal that the impact of cultural values on financial disclosures by international firms is insignificant, suggesting that cultural values may not be relevant for financial disclosures by firms operating across national boundaries.

In addition to cultural values, Gray's (1988) model also suggests that institutional factors, such as legal systems (LSs), will have an influence on the development of

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accounting systems (including standards, practices, and financial disclosures). Recently, findings of studies on the development of capital markets have provided evidence supporting the significant role of LS (common vs. code law) on the development of corporate ownership, corporate capital structure, and capital markets (e.g., La Porta and Lopez-de-Silanes, 1998; La Porta et al., 1996). These findings suggest that a country's LS can be expected to have a strong impact on financial disclosures. Prior studies have indicated that financial disclosures are strongly influenced by corporate ownership, corporate capital structure and capital markets (e.g., Adhikari and Tondkar, 1992; Zarzeski, 1996; Salter, 1998). Since LSs are influenced by cultural values, it can be argued that the impact of cultural values on financial disclosures will be reflected through the country's LS and their direct impact on financial disclosures would be minimal.

In this study, we empirically test whether there are differences in corporate financial disclosures in common and code law countries, and we also evaluate whether the impact of cultural values on financial disclosures differs in these countries. Additionally, we examine the impact of cultural values on financial disclosures of multinationals from common and code law countries.

The study is based on 401 firms from six countries, belonging to common and code law countries. Financial disclosures are measured in terms of a disclosure index developed by the Center for International Financial Analysis and Research (CIFAR) (1993). In addition to variables of LS, cultural values, and multi-nationality, the following variables are included in the analysis: firm size, debt ratio, and market capitalization as a percentage of Gross Domestic Product (GDP)¹ (for impact of these factors on accounting systems, refer to Adhikari and Tondkar, 1992; Zarzeski, 1996; Salter, 1998).

The results indicate that firms from common law countries are associated with higher financial disclosures compared to firms from code law countries. The results also show that the impact of cultural values on financial disclosures in common law countries is insignificant, and there are mixed signals for code law countries. The association between cultural values and financial disclosures by multinationals from common law countries is found to be insignificant. Overall, the findings show that financial disclosures by firms from common laws countries are significantly higher compared to firms from code law countries, and that the direct impact of cultural values on financial disclosures by firms from common law countries is insignificant.

The remainder of the article is organized as follows: Part 2 presents an international financial disclosure model to explain the linkage between financial disclosures and different variables. The impact of cultural values and LSs on financial disclosures and hypotheses for the study are also discussed in this part. Part 3 presents research methodology used in this study. Results are discussed in Part 4 and Part 5 contains discussion of results and concluding remarks.

CULTURAL VARIABLES, LEGAL SYSTEMS, AND ACCOUNTING

A Model for International Financial Disclosures

The main focus of this study is to examine the impact of LSs and cultural variables on financial disclosures of firms from different countries. This impact is examined by

considering interaction among important variables relevant to financial disclosures. A model on international financial disclosures (Fig. 1) demonstrates the linkage between financial disclosures and different variables.

The model shows that socio-political and economic environments of a country influence financial disclosures through intervening variables (see for example, Cooke and Wallace, 1990; Riahi-Belkaoui, 1995, 1997; Salter, 1998; Salter and Niswander, 1995). Several institutions in a society are the outgrowth of a socio-political environment, and these institutions include LSs, family groups, social groups, educational groups, etc. Because the social institution of a LS is considered to be the most relevant for business activities (e.g., La Porta et al., 1996), we focus only on this institution in our model. Though the direct impact of cultural values on accounting systems and procedures has been extensively evaluated in the literature, the impact of LSs on accounting systems and procedures, including financial disclosures, has not yet received the attention it deserves. First, we briefly discuss the association between cultural values and accounting systems and procedures (including financial disclosures), and then we examine how a LS influences financial disclosures.

Culture Values and Accounting

Several studies have explained the impact of cultural environments on accounting systems and financial disclosures (e.g., Jaggi, 1975; Gray, 1988; Perera, 1989). Jaggi (1975) argued that the cultural environments of a country would have a strong influence on financial disclosures by firms in that country. Gray (1988) developed a model to explain the association between Hofstede's (1980) cultural dimensions and accounting sub-culture values, and developed hypotheses on their association. Gray's (1988) model made an important contribution to explain the impact of Hofstede's (1980) cultural values on the measurement and disclosure dimensions of accounting systems in different countries. This model has been used by several research studies to examine international accounting issues (e.g., Perera, 1989; Douppnik and Salter, 1995; Salter and Niswander, 1995; Zarzeski, 1996).

Gray (1988, p. 11) hypothesizes that "the higher a country ranks in terms of uncertainty avoidance and power distance and the lower it ranks in terms of individualism and masculinity, then the more likely it is to rank highly in terms of secrecy." The cultural dimension of UA, which indicates the degree to which the members of a society feel uncomfortable with uncertainty and ambiguity, is associated with lower disclosure of financial information. The cultural dimension of PD, which relates to acceptance of institutional and organizational authority by individuals, suggests that high PD societies are secretive and do not encourage information sharing, which means there is a negative association between PD and financial disclosures.

The cultural dimension of IND encourages competitive environments, which suggests that these societies would be less secretive. Thus, there would an expectation of a positive association between IND and financial disclosures. The cultural dimension of MAS refers to societal preference for assertiveness, high achievement, and financial success, which means that business institutions would be much stronger in these societies, and individuals will value the achievement of goals. Thus, there will be a positive association between

Figure 1. International Financial Disclosure Model.

MAS and financial disclosures. Gray (1988), however, considers the link between MAS and financial disclosures to be less important.

Following Gray's hypotheses, Perera (1989) argued that accounting standards based on cultural environments of Anglo-American countries would encounter problems of relevance in countries with different cultural environments. Salter and Niswander (1995, p. 394) empirically tested the impact of cultural values on accounting practices across different countries. Their findings indicate that Gray's model has a significant explanatory power, and they contend that "Gray appears to have provided a workable theory to explain cross-national differences in accounting structure and practice, which is particularly strong in explaining differential financial reporting practices." Douppnik and Salter (1995) examined whether cultural values would explain the differences in accounting systems of different countries. Their findings show that cultural values, along with other factors, play an important role in identifying the clusters of countries with similar types of accounting systems.

Recently, Zarzeski (1996) examined the impact of cultural values on financial disclosures of seven industrialized countries. She argued that in addition to cultural factors, the market forces also would influence financial disclosures. She included the variables of firm size, debt ratio, and a firm's relative foreign sales in the market forces. Her findings indicate that market forces along with three cultural dimensions (excluding PD) have a significant impact on financial disclosures. Her findings on financial disclosures by international firms, classified on the basis of their total foreign sales, reveal that the impact of cultural values is weak. Thus, she concludes that cultural values do not play a significant part in disclosure of financial information by international firms.

Zarzeski's (1996) study is the only important empirical study on the association between financial disclosures and cultural values. Her findings show that three cultural values influence financial disclosures as hypothesized by Gray (1988), but the impact of market forces is equally important for financial disclosures. In this study, we argue that cultural values may not have any direct impact on financial disclosures. Instead, their impact is reflected through the LS of the country. The International Financial Disclosures Model (Fig. 1) depicts the linkage of cultural values through LSs to financial disclosures. We also argue that the impact of cultural values would differ with the country's LS. These arguments are further explained in the next section on the Impact of LS on Financial Disclosures.

Legal Systems and Financial Disclosures

Nature of Legal Systems

Even though laws of no two nations are alike, there are similarities in certain critical aspects between LSs of some countries. Legal experts have used these similarities to classify national LSs into two major families of law. On the basis of a number of criteria, LSs of different countries have been broadly classified into civil and common law systems (for a discussion of criteria used in the classification of law systems, refer to Glendon et al., 1992; La Porta et al., 1996). The civil law countries have also been referred to as code law countries (for example, see Ball, 1998; Ball et al., 1998). We use the code law terminology in this article.

The code law, which originated in Roman law, is also known as the Romano-Germanic law. This law is based on statutes and comprehensive codes and it relies heavily on the opinions of legal scholars (Merryman, 1969). The code law countries have further been classified into three common families of code law: French-origin, German-origin, and Scandinavian-origin (for differences in these three families of law, refer to La Porta et al., 1996). The French Commercial Code, which originated under Napoleon, first spread to some European countries, and later it influenced some Asian and Sub-Saharan African and other French colonies. The German Commercial Code, which was written under Bismarck after the unification of Germany, influenced the LSs of Austria, Switzerland, Japan, Korea, and other countries. Though the Scandinavian law is usually viewed as a part of the code law tradition, the Roman influence on the Scandinavian LS is not very strong. In fact, the Scandinavian law system is considered to be closer to common law in some respects (La Porta et al., 1996).

The common law tradition started with the law of England and it includes laws that have been modeled on the basis of English law. The common law, as opposed to code law, is formed by the judges' decisions on specific disputes. Precedents from these judicial decisions thus provide the basis for this law. The United Kingdom and old British colonies, including the United States, Canada, Australia, India, etc., belong to common law countries.

Differences in the nature of common and code laws have been highlighted by Zweigert and Kotz (1987) in the following words (quotation from La Porta et al., 1996, p. 10): "The tradition of the English Common Law has been one of gradual development from decision to decision: historically speaking, it is case law, not enacted law. On the Continent, the development since the reception of Roman law has been quite different, from the interpretation of the Justinian's Corpus Iuris to the codification, nation by nation, of abstract rules. So common law comes from the court, Continental Law from the study; the great jurists of England were judges, on the Continent Professors."

Impact of Legal Systems on Financial Disclosures

LSs can either directly or indirectly influence financial disclosures. A typical example of direct influence is the development of Companies Acts or accounting regulations, which prescribe general requirements for measurement and disclosure of accounting information. The measurement and disclosure policies can also be influenced through tax laws, especially in code law countries.

The LSs also influence financial disclosures indirectly through legal protection rights provided to investors and creditors, which have been examined by La Porta et al. (1996, p. 32). They argue that "when investors have relatively few legal rights, then managers can be induced to return the money to these investors if one, or a very small number of investors own the majority of shares." On the other hand, a strong legal protection provided to investors would encourage small investors to enter the stock market, and consequently, there will be a wider dispersion of ownership in these countries. Their analysis reveals that "relatively speaking, common law countries protect investors the most, and French civil law countries protect them the least. German civil law countries are in the middle, though probably closer to the civil law group (p. 27)". Their empirical findings support their argument that strong legal protection provided to investors by

common law countries has resulted in a greater dispersion of corporate ownership in these countries. Additionally, they conclude that the common law countries also offer better legal protection to creditors. They argue that with better protection for creditors, firms in common law countries have better borrowing capabilities, and thus have higher debt financing.

Given a strong impact of LSs on corporate ownership and debt financing, as evidenced by the La Porta et al.'s (1996) findings, we argue that the LS also has a significant influence on financial disclosures. Because investors' and debt holders' information needs to play an important role in financial disclosures, a widely dispersed ownership and a high level of debt financing in common law countries would place heavy demand on firms for detailed financial disclosures. Moreover, the management of firms with a wide dispersion of ownership would also be more inclined to make more financial disclosures to meet information needs of diverse groups of investors. Similarly, firms with high debt financing would disclose more information to enable debt holders to monitor the observance of debt covenants. Furthermore, Ball et al. (1998) argue that information asymmetry in common law countries is likely to be resolved by timely public disclosure compared to code law countries where asymmetry is likely to be resolved by private communication between managers and agents of suppliers of labor and capital. In code law countries, firms tend to be conducted by a small number of agents and there is close relationship between agents and principals, which does not encourage disclosure of public information.

The findings of prior accounting studies also provide evidence to support the impact of LSs on the development of accounting systems and accounting rules in different countries. Meek and Saudagaran (1990), who examined the legislative process for formulation of accounting rules, argued that different LSs have different types of impact on formulation of accounting rules. They argued that in code law countries, the laws stipulate minimum requirements, and accounting rules tend to be highly prescriptive and procedural. In common law countries, on the other hand, the law establishes limits and professional judgment is required within these limits. Salter and Doupnik (1992) examined the impact of LSs on the development of accounting systems in different countries, and they hypothesized that the differences in the LSs of different countries would explain the differences in the development of accounting systems. Their results at a two-cluster level analysis indicated that the LS family correctly classified the classes of accounting system (micro or macro) for 45 out of 50 countries, i.e., with a hit ratio of 90 percent. The results of their nine-cluster analysis also indicated that the LS was a significant predictor of accounting clusters. Based on the above discussion, we test the following hypothesis:

- H1:** The level of financial disclosures by firms in common law countries is higher than that in code law countries.

Impact of Legal Systems on the Association between Cultural Values and Financial Disclosures

The second important question addressed by this article relates to direct impact of cultural values on financial disclosures in common and code law countries. We would

examine whether the association between cultural values and financial disclosures would be the same for firms from common and code law countries. As shown in the model, cultural values influence the development of a country's LS, which in turn influences the firms' ownership structure, capital structure, and development of capital markets in the country (e.g., La Porta and Lopez-de-Silanes, 1998). Because of differences in the ownership and capital structures and development of capital markets, the information needs of financial statements users would also differ in common and code law countries.

It has been argued that contracting in common law countries is done in open public markets "at arm's length" (La Porta and Lopez-de-Silanes, 1998), and this creates a higher demand for publicly disclosed information so that the market participants have sufficient information for optimal investment decisions. A greater demand for financial information would encourage greater disclosures by firms in common law countries. Thus, financial disclosures in common law countries will be more influenced by information demand rather by cultural values.

On the other hand, because of ownership concentration in the hands of fewer individuals and/or institutions in code law countries, owners would have direct access to information, and demand for publicly disclosed financial information would not be very strong in these countries. The absence of strong demand is not likely to encourage management to disclose detailed financial information publicly. Thus, financial disclosures in code law countries are not influenced by information demand. Instead, they depend upon the management's attitude toward disclosures, which may be influenced by the country's, cultural values, as suggested by Gray's (1988) model.

Based on the above discussion, we expect cultural values to have an insignificant impact on financial disclosures in common law countries. On the other hand, cultural values may influence financial disclosures in code law countries to some extent. The following tests this expectation:

- H2:** Influences of cultural values on financial disclosures by firms will be significantly less in common law countries compared to code law countries.

Other Variables in the Model

In addition to cultural values and LSs, financial disclosures are influenced by several other factors, as reported in the findings of prior studies. The impact of these factors on financial disclosures is briefly explained below.

Firm Size

Prior studies have indicated that the firm size has a strong influence on financial disclosures (Chow and Wong-Boren, 1987; Cooke, 1989, 1992; Lang and Lundholm, 1993; Wallace and Naser, 1995; Zarzeski, 1996; Low, 1998). It has been argued that large firms compared to small firms will be more motivated to provide higher financial disclosures because of the following reasons. First, large firms are likely to have a broad-based ownership, which would require more comprehensive and

detailed disclosures to meet the information needs of diverse groups of investors. Second, large firms are generally well established and they can afford to provide detailed comprehensive information without the fear of their information being misinterpreted that could result in negative investor reaction. Thus, based on evidence provided by prior studies, we expect the association between firm size and financial disclosures to be positive.

Debt Ratio

Findings of most research studies indicate that there is a positive association between financial disclosures and debt–equity ratio (e.g., Chow and Wong-Boren, 1987; Low, 1998). Firms with higher debt are generally under greater scrutiny by creditors to ensure that firms are not violating debt covenants. Consequently, this scrutiny would result in disclosure of more comprehensive information on different items especially those relating to debt covenants. Zarzeski (1996), however, argues for an expectation of a negative association between financial disclosures and debt ratio on the ground that debtors would be closely associated with the firm and would have direct access to information. This argument would be valid if firms have private debt rather than public debt. If firms have a higher level of public debt, debt-holders are not likely to have close relationships with the firms. Consequently, there will be an agency problem and this would require detailed financial disclosures to ensure adherence to debt contracts. Thus, in the case of public debt, a positive association can be expected, as indicated by the findings of several prior research studies.

In the absence of reliable information on the nature of debt, we assume that firms from common law countries would issue more public debt, and firms from code law countries would issue more private debt (e.g., La Porta et al., 1996). Thus, we expect a positive association between debt and financial disclosures in common law countries and negative association in code law countries.

Capital Markets

It has been argued that a strong equity market with diverse groups of shareholders is generally associated with better production and disclosure of sophisticated information (Doupnik and Salter, 1995). Moreover, financial disclosures by firms listed on stock exchanges can be influenced by total market capitalization (e.g., Adhikari and Tondkar, 1992; Salter, 1998), and also by the disclosure requirements of stock exchanges. Based on this evidence, we expect that there will be a positive association between financial disclosures and market capitalization.

Multi-nationality of Firms

With globalization of business, the number of international firms is steadily increasing. In addition to selling their products abroad, more and more firms are setting up production facilities across national boundaries to avail of business and investment opportunities. An increasing number of listings on foreign stock exchanges (e.g., Saudagaran and Biddle, 1992) also shows that more and more firms are crossing

national boundaries. As a result of internationalization of business and of capital markets, firms are being challenged to meet the information needs of diverse groups of investors with different cultural backgrounds. In order to meet these information needs, firms will be required to disclose more detailed financial information. If investors at home, as well as in foreign countries, demand detailed information, financial disclosures will be more comprehensive and there will be a positive association between multi-nationality and financial disclosures. If foreign investors demand detailed information and investors' information needs of investors at home are limited, or vice versa, there will also be a positive association between multi-nationality and financial disclosures because multinationals will have to meet information needs of both groups of investors. Only in the case of limited information needs of investors at home as well as abroad, the association between multi-nationality of firms and financial disclosures would be negative. The probability of limited information needs of investors at home as well as abroad is likely to be very small. Therefore, we expect a positive association between multi-nationality of firms and financial disclosures.

RESEARCH DESIGN

The validity of relationships between LSs, cultural values, and financial disclosures, as depicted in our model, is tested on a sample of firms from common and code law countries. Multivariate analyses are conducted with financial disclosures as a dependent variable, LSs and cultural values as independent variables, and others as control variables.

Sample Selection and Financial Data Collection

The initial sample for this study was selected on the basis of availability of disclosure scores from the database developed by the Center for International Financial Accounting Research (1993), and also on the availability of country's cultural values from Hofstede's (1984) study. As a result of this selection process, the initial sample consisted of 964 firms from 37 countries. Because the 1993 CIFAR database covers the fiscal year ending 1991, the study is based on 1991 financial data, obtained from the PC Plus Global Vantage. The sample was further screened to examine whether financial data for the sample firms was available in the 1998 versions of the *Global Vantage* database. As a result of non-availability of financial data, 291 firms from seven countries were dropped from the sample. The remaining firms were again screened for availability of data for the multi-nationality criteria used in this study. This screening process resulted in a further reduction of the sample by 168 firms. The number of firms remaining in the sample was 505 from 28 countries.

In order to avoid lopsided representation of countries in the study, it was decided to screen the sample with regard to the number of observations for each country. If the number of observations was less than 20 firms from any country, the firms of that country were dropped from the analyses. As a result of this screening process, the sample was reduced to 403 firms. Two additional firms with a debt-equity ratio above

Table 1. Sample Distribution by Country

<i>Country</i>	<i>Legal system</i>	<i>Number of firms in CIFAR^a</i>	<i>Total sample firms</i>	<i>Multinational firms</i>	<i>Domestic firms</i>
Canada	Common law	40	22	20	2
France	Code law	64	36	28	8
Germany	Code law	52	25	20	5
Japan	Code law	96	77	61	16
UK	Common law	83	51	51	0
USA	Common law	274	190	134	56
Total		609	401	314	87

Notes: ^a The samples of this study is selected from the database in Center for International Financial Analysis and Research (1993).

one were dropped from the analyses because their ratios were influenced by their negative equity. The final sample consisted of 401 firms from six countries. Out of six countries, three are common law countries with 263 observations and three are code law countries with 138 observations. The number of sample firms from each country with their LS is provided in Table 1.

Measurement of Variables

Financial Disclosures

The dependent variable of financial disclosures (DISC) is obtained from “the International Financial Reporting Index (IFRI) for Industrial Companies” developed by Center for International Financial Analysis and Research (1993). The IFRI is based on the mean disclosure scores of 90 items on a sample of largest industrial firms in each country.² Information contained in the financial statements is divided into seven broad categories: general information, income statement, balance sheet, funds flow statement, accounting policies, stockholders’ information, and supplementary information. On the basis of actual information disclosed and disclosure expectation for each firm, percentage disclosures are calculated, which provide the basis for IFRI of a firm.

The IFRI scores, which are calculated from actual disclosures and not from disclosure requirements, have been considered reliable and used by other studies (for example, Salter, 1998). Cooke and Wallace (1989) audited the database and concluded that the scores were developed with great care and every attempt was made to prevent inadequacies and pitfalls. They concluded that there were no biases or errors in the scores.

Cultural Values

Cultural values for each country have been obtained from Hofstede (1984). A country’s cultural values for dimensions of UA, PD, IND, and MAS have been used as the firm’s cultural values. It means that cultural values of all firms from a single country will be the same. A similar procedure has been used by other studies (e.g., Gray and Vint, 1995).

Legal Systems

The LS variable is coded as one for common law countries, i.e., the USA, Canada, and the United Kingdom, and zero for code law countries, i.e., Germany, France, and Japan. Classification for LSs has been obtained from La Porta et al. (1996).

Other Variables

The variable of total assets is used as a proxy for firm size, and its log transformation is used in the regression analyses. The debt ratio is calculated by dividing the total debt by total assets to be consistent with Zarzeski (1996).

Market capitalization is represented by the mean of market capitalization in US\$ divided by GDP for 1988–1990 of a country. Information on market capitalization is obtained from the Emerging Stock Markets Factbook (International Financial Corporation, 1996), while data for GDP are obtained from the World Development Report (World Bank, 1990–1992).

A number of criteria can be used to identify multi-nationality of the firm and these include national or foreign ownership of the firm, trading of firm's shares on foreign or domestic stock exchanges, foreign or domestic business transactions, etc. Zarzeski (1996) used total foreign sales of a firm to classify the firm as an international firm. We characterize a firm as multinational on the basis of Center for International Financial Analysis and Research (1992) classification, which has been developed based on the following criteria: (1) geographic diversification, i.e., diversification across foreign countries based on aggregate foreign sales, (2) ratio of foreign sales to assets, (3) export, i.e., domestic production sold in foreign markets, and (4) number of subsidiaries. Other studies (e.g., Errunza and Senbet, 1984; Sullivan, 1994) have also employed a similar combination of factors to capture a firm's multi-nationality. If the firm is classified as a multinational, it is coded as one, otherwise zero.

Statistical Analyses

The regression model (Equation 1) used in this study in a general form is as follows:

$$\begin{aligned} \text{DISC}_i = & \alpha_i + \beta_{i1}\text{UA}_i + \beta_{i2}\text{PD}_i + \beta_{i3}\text{IND}_i + \beta_{i4}\text{MAS}_i + \beta_{i5}\text{LS}_i + \beta_{i6}\text{DEBT}_i + \beta_{i7}\text{SIZE}_i \\ & + \beta_{i8}\text{MKTC}_i + \beta_{i9}\text{MNC}_i + \varepsilon_i \end{aligned} \quad (1)$$

where: DISC_i = disclosure index of company i ; UA_i = uncertainty avoidance value of company i ; PD_i = power distance value of company i ; IND_i = individualism value of company i ; MAS_i = masculinity value of company i ; LS_i = 1 if the firm belongs to common law countries, and 0 if the firm belongs to code law countries; DEBT_i = debt-to-asset ratio for company i ; SIZE_i = firm size, proxied by log of total assets of company i ; MKTC_i = country's market capitalization divided by GDP for company i ; MNC_i = 1, if company i is multinational, otherwise zero; β_{i1-10} = coefficients of variables from 1 to 10; ε_i = residual term.

Table 2. Financial Disclosures by Firms in Common and Code Law Countries

	<i>Total sample</i>	<i>Common law countries</i>	<i>Code law countries</i>
<i>N</i>	401	263	138
Mean	73.09	74.21	70.96
Medium	73.00	74.00	72.50
Standard deviation	6.03	5.52	6.40
Min	47.00	47.00	52.00
Max	88.00	88.00	88.00
Difference in means:			
<i>t</i> -value		5.07	
Probability		.0001	

RESULTS

Descriptive Statistics

Descriptive statistics on disclosure scores of firms from different countries with different LSs are given in Table 2. The *t*-test results on comparative analysis of disclosure scores from common and code law countries are also provided in the table.

The results indicate that the mean disclosure score for firms from common law countries is higher than the mean disclosure score of firms from code law countries (74.15 vs. 70.96). The difference between the disclosure scores of the two groups of countries is statistically significant ($p < .001$).

Descriptive statistics on independent regression variables are contained in Table 3. The results on cultural variables indicate that the mean scores of UA, PD, and MAS are higher for code law countries compared to common law countries. But the mean score of IND is higher for common law countries compared to code law countries. A higher mean score of MAS for code law countries suggests that individuals in these countries are more assertive and business institutions are more competitive and goal-oriented. This seems to be contrary to the general expectation, according to which common law countries are supposed to be more competitive and the firms in these countries are supposed to be more goal-oriented. Even Gray (1988) pointed out in his model that the link of MAS dimension to financial disclosures might not be strong. The mean of debt–asset ratio is slightly higher for code law countries than common law countries (0.31 vs. 0.26). An analysis of this ratio for each country indicated that the Japanese firms exhibited significantly higher ratio compared to all other countries, which seems to be reasonable. Consequently, the mean ratio for code law countries is higher.

Correlation Results

Correlation results on different variables are contained in Table 4. The results indicate that the financial disclosures are significantly positively associated with the LS, suggesting that common law countries are associated with higher financial disclosures. The association of financial disclosures with cultural dimensions of UA, PD, and IND is

Table 3. Descriptive Statistics on Independent Regression Variables

<i>Variables</i>	<i>Mean</i>	<i>Standard deviation</i>	<i>Minimum</i>	<i>Maximum</i>
Panel A: Total sample ($N = 401$)				
MKTC	0.74	0.34	0.25	1.31
SIZE	10,395.68	18,393.97	297.42	184,325.50
DEBT	0.28	0.15	0.00	0.89
UA	58.32	20.91	35.00	92.00
PD	44.20	9.77	35.00	68.00
IND	78.21	17.46	46.00	91.00
MAS	66.84	15.07	43.00	95.00
Panel B: Common law countries sample ($n = 263$)				
MKTC	0.68	0.18	0.53	1.04
SIZE	8,751.11	19,300.68	297.42	184,325.50
DEBT	0.26	0.14	0.00	0.89
UA	44.03	4.47	35.00	48.00
PD	38.95	1.96	35.00	40.00
IND	89.69	3.04	80.00	91.00
MAS	61.94	3.39	52.00	66.00
Panel C: Code law countries sample ($n = 138$)				
MKTC	0.85	0.51	0.25	1.31
SIZE	13,529.89	16,135.61	569.14	84,825.50
DEBT	0.31	0.16	0.04	0.80
UA	85.54	10.02	65.00	92.00
PD	54.21	10.83	35.00	68.00
IND	56.33	11.72	46.00	71.00
MAS	76.18	22.52	43.00	95.00

Notes: Definition of variables: MKTC = Mean Market Capitalization in US\$ as a percentage of GDP in US\$ for 1988–1990; SIZE = Total Assets in US\$ (millions); DEBT = Total Debt divided by Total Assets; UA = Uncertainty Avoidance; PD = Power Distance; IND = Individualism–collectivism; MAS = Masculinity–femininity.

significant and is in the expected direction, but it is significantly negative with MAS, which is contrary to Gray's (1988) hypothesis. Financial disclosures are significantly positively associated with multi-nationality of firms and size, as expected. The correlation coefficient between disclosures and MKTC is positive and with debt is negative, but both are insignificant.

The results also indicate that the LS is positively correlated with the cultural value of IND (0.91) and negatively associated with the cultural values of UA (−0.94), PD (−0.74), and MAS (−0.45). All cultural values are strongly correlated among themselves. This means that their linear combination will not enable us to include all cultural variables and LS in the same regression test.

Results on Legal System and Financial Disclosures

The association between financial disclosures and LS is first examined by conducting regression tests on the total sample. Because of the linear combination of cultural values, all of them could not be included in a single regression test. Therefore, we included

Table 4. Pearson Correlation Results on Regression Variables

	DISC	MKTC	MNC	SIZE-log	DEBT	LS	UA	PD	IND
MKTC	0.07	—							
MNC	0.40***	0.09	—						
SIZE-log	0.11*	0.15**	0.17***	—					
DEBT	−0.00	0.25***	−0.07	0.21***	—				
LS	0.26***	−0.24***	−0.01	−0.25***	−0.15**	—			
UA	−0.26***	0.33***	−0.02	0.23***	0.24***	−0.94***	—		
PD	−0.11*	0.12*	−0.03	0.10*	0.19***	−0.74***	0.85***	—	
IND	0.24***	−0.55***	−0.03	−0.27***	−0.24***	0.91***	−0.93***	−0.64***	—
MAS	−0.15**	0.87***	0.02	0.25***	0.26***	−0.45***	0.51***	0.12*	−0.72***

Notes: Definition of variables: DISC = Disclosure scores from Center for International Financial Analysis and Research (1993); MNC = 1 if the firm is a multinational, 0 otherwise; LS = 1 if the firm belongs to common law countries, and 0 if the firm belongs to code law countries. Table 3 provides definition of other variables.
* Significant at 0.05 (two-tailed test).
** Significant at 0.01 (two-tailed test).
*** Significant at 0.001 (two-tailed test).

individual cultural variables in separate regressions. Regression results on the total sample are presented in Table 5.

Table 5 contains results of six regression tests. In regression Model 1, the variable of LS and control variables are included in the analysis. In regression Model 2, LS is allowed to change with control variables of MKTC, MNC, and DEBT. This is done by including three interaction terms between LS and control variables.³ Models 3 through 6 include LS and a single cultural variable. The results show that the variable of LS is significantly positively associated with financial disclosures ($p < .001$) for Models 1, 2, 4, and 6. The coefficient of LS for Model 3 is positive, but not significant. It is, however, significantly negative for Model 5, with IND. This is because of positive correlation between LS and IND (see Table 4). The coefficient for the interaction term LS_MKTC is significantly positive ($p < .0001$), which means that the positive association between financial disclosures and LS is even higher in countries with high capitalization of capital markets. The coefficients of other interaction terms are insignificant.

The regression results of a positive association between financial disclosures and LS are consistent with the correlation as well as *t*-test results. The adjusted R^2 value of Models 1 and 2 is 23.86 and 30.43 percent, respectively. These results thus show that firms from common law countries are associated with higher financial disclosures and the models have a good explanatory power. These results thus support Hypothesis 1.

Results on Cultural Values, Legal System, and Financial Disclosures

The results of Models 3 through 6 (Table 5) show that the coefficients UA and IND are in the expected direction, but PD and MAS coefficients are not in the expected direction. Furthermore, only PD, IND, and MAS coefficients are statistically significant. Thus, only the IND coefficient is in the expected direction and is also significant.

To overcome the multicollinearity problem between LS and cultural variables, we ran regression tests on the total sample again on individual cultural variables but without the LS variable. The results (not reported) indicated that the coefficients for UA, IND, and MAS were similar to those reported in Table 5 for Models 3, 5, and 6. The coefficient for PD was negative. Thus, on an overall basis, there was no qualitative difference in the results with or without the LS variable. To have a better insight into the association between financial disclosures and cultural values under different LSs, we decided to run separate regressions for common and code countries. The results are contained in Table 6.

The regression results on common law countries (Panel A) indicate that none of the coefficients for cultural values are significant. The coefficients for IND and MAS are also not in the expected direction. These results suggest that there is no significant association between financial disclosures and cultural variables in common law countries, and the association is also not in the expected direction.

The results for code law countries (Panel B) indicate that the coefficients for all cultural values are statistically significant. But only the IND coefficient is in the expected positive direction. This result supports Gray's (1988) hypothesis on IND that the higher the individualism, the higher the financial disclosures. The coefficients of UA and PD are positive instead of being negative, and the coefficient of MAS is negative instead of being

Table 5. Regression Results on Financial Disclosures for Total Sample (N = 401)Refer to Tables 3 and 4 for definition of other variables

Variables	Expected sign	Model 1		Model 2		Model 3		Model 4		Model 5		Model 6	
		Coefficient	t-value	Coefficient	t-value	Coefficient	t-value	Coefficient	t-value	Coefficient	t-value	Coefficient	t-value
Intercept		60.27	27.90	55.55	25.24	65.32	16.08	50.16	15.30	32.31	6.29	72.50	28.67
MKTC	+	1.64	2.00	7.73	6.24	2.04	2.37	2.00	2.48	8.54	6.09	12.97	8.03
MNC	+	5.52	8.44	4.91	7.71	5.41	8.22	5.57	8.66	5.39	8.58	4.71	7.64
SIZE-log	+	0.51	2.15	0.55	2.40	0.49	2.06	0.65	2.77	0.54	2.37	0.83	3.71
DEBT	+	1.15	0.60	3.26	1.76	1.78	0.92	-0.11	-0.06	2.47	1.35	1.04	0.59
LS	+	3.96	6.77	4.40	7.79	1.48	0.82	6.56	7.61	-7.53	-3.74	1.56	2.51
LS_MKTC	?	-	-	12.60	6.14	-	-	-	-	-	-	-	-
LS_MNC	?	-	-	-1.13	-0.86	-	-	-	-	-	-	-	-
LS_DEBT	?	-	-	3.33	0.88	-	-	-	-	-	-	-	-
UA	-	-	-	-	-	-0.06	-1.47	-	-	-	-	-	-
PD	-	-	-	-	-	-	-	0.16	4.04	-	-	-	-
IND	+	-	-	-	-	-	-	-	-	0.38	5.94	-	-
MAS	+	-	-	-	-	-	-	-	-	-	-	-0.32	-7.95
Adj. R ² (%)		23.86		30.43		24.09		26.71		29.95		34.23	
F-value		26.07		22.87		22.15		25.30		29.50		35.70	

Notes: Definition of variables: LS_MKTC = interaction between mean-adjusted LS and mean-adjusted MKTC; LS_MNC = interaction between mean-adjusted LS and mean-adjusted MNC; LS_DEBT = interaction between mean-adjusted LS and mean-adjusted DEBT.

Table 6. Regression Results on Financial Disclosures in Common and Code Law Countries

Variables	Expected sign	Model 1		Model 2		Model 3		Model 4	
		Coefficient	t-value	Coefficient	t-value	Coefficient	t-value	Coefficient	t-value
Panel A: Common law countries (n = 263)									
Intercept		121.49	0.20	59.63	2.37	57.89	6.75	57.65	8.99
MKTC	+	-14.59	-0.06	11.47	1.91	12.07	7.36	12.23	5.34
MNC	+	4.52	6.32	4.52	6.32	4.52	6.32	4.52	6.32
SIZE-log	+	0.51	2.04	0.51	2.04	0.51	2.04	0.51	2.04
DEBT	+	4.47	2.12	4.47	2.12	4.47	2.12	4.47	2.12
UA	-	-1.05	-0.10	-	-	-	-	-	-
PD	-	-	-	-0.06	-0.10	-	-	-	-
IND	+	-	-	-	-	-0.01	-0.10	-	-
MAS	+	-	-	-	-	-	-	-0.01	-0.10
Adj. R ² (%)		33.17		33.17		33.17		33.17	
F-value		27.01		27.01		27.01		27.01	
Panel B: Code law countries (n = 138)									
Intercept		26.76	3.72	42.78	8.68	-64.32	-2.80	69.55	17.52
MKTC	+	-6.21	-4.32	-0.38	-0.38	35.72	5.37	13.01	4.90
MNC	+	5.17	4.39	5.17	4.39	5.17	4.39	5.17	4.39
SIZE-log	+	1.33	2.95	1.33	2.95	1.33	2.95	1.33	2.95
DEBT	-	-2.62	-0.80	-2.62	-0.80	-2.62	-0.80	-2.62	-0.80
UA	-	0.40	5.52	-	-	-	-	-	-
PD	-	-	-	0.25	5.52	-	-	-	-
IND	+	-	-	-	-	1.59	5.52	-	-
MAS	+	-	-	-	-	-	-	-0.33	-5.52
Adj. R ² (%)		29.55		9.55		29.55		29.55	
F-value		12.49		12.49		12.49		12.49	

Note: Refer to Tables 3 and 4 for definition of variables.

positive. These results thus show that the association between cultural value of IND and financial disclosures is significant for code law countries.

Ignoring the dimension of MAS, which is the least important dimension for disclosures (Gray, 1988), these results show that UA and PD cultural values have no significance for financial disclosures either in common law or code law countries. Recall that both cultural variables are not in the expected direction for code law countries, though they are significant. These findings thus provide evidence that the impact of cultural values on financial disclosures in common law countries is insignificant, but the results for code law countries provide mixed signals. These results support Hypothesis 2 for common law countries only.

Additional Tests on a Broader Sample

We also conducted tests on a broader sample of 503 firms from 28 countries, representing economically developed and developing countries (results not reported).⁴ The regression tests also included the economic growth variable to capture the impact of the economic development in each country. The results on this broader sample are qualitatively similar to the results presented in this article. The results indicate that financial disclosures are significantly higher in common law countries compared to code law countries, and the impact of cultural values on financial disclosures in common law countries is insignificant. With regard to code law countries, the results also provide mixed signals.

Impact of Debt on Financial Disclosures

The results on the total sample in Table 5 show that the coefficients for DEBT except for Model 4 are positive, but are statistically insignificant for all models. The results of regression tests conducted separately on common law and code law countries (Table 6) indicate that the DEBT coefficients are positive and significant for common law countries, and negative but insignificant for code law countries. The signs for DEBT coefficients for common and code law countries suggest that financial disclosures in common law countries are positively associated with debt–equity ratio in common law countries, and negatively associated in code law countries, as expected.

Financial Disclosures by Multinationals

The results contained in Tables 5 and 6 indicate that the coefficient of multi-nationality (MNC) for the total sample as well as for common and code law countries is positive and statistically significant. These results suggest that multinationals are associated with high financial disclosures irrespective of the LS or cultural values of the country.

In order to gain better insight into the impact of cultural values on disclosures by multinationals of common and code law countries, we conducted regression tests on the total sample of multinationals from both LS countries, and also on common and code law countries separately. The results are contained in Table 7.

Table 7. Regression Results on Financial Disclosures for Multinational Firms

Variables	Expected sign	Model 1		Model 2		Model 3		Model 4		Model 5	
		Coefficient	t-value	Coefficient	t-value	Coefficient	t-value	Coefficient	t-value	Coefficient	t-value
Panel A: Total sample (N = 314)											
Intercept		65.70	27.33	74.14	17.37	55.67	15.23	36.48	6.99	78.31	29.90
MKTC	+	1.39	1.60	1.93	2.17	1.80	2.10	8.27	6.01	13.59	8.35
SIZE-log	+	0.61	2.39	0.56	2.19	0.78	3.07	0.64	2.67	1.03	4.41
DEBT	+	-0.59	-0.26	0.88	0.38	-2.41	-1.07	1.26	0.59	-1.32	-0.66
LS	+	3.85	5.98	-0.38	-0.20	6.41	6.73	-8.23	-4.04	0.92	1.37
UA	-	-	-	-0.10	-2.39	-	-	-	-	-	-
PD	-	-	-	-	-	0.16	3.59	-	-	-	-
IND	+	-	-	-	-	-	-	0.40	6.22	-	-
MAS	+	-	-	-	-	-	-	-	-	-0.35	-8.55
Adj. R ² (%)			9.73		11.08		13.08		19.54		26.81
F-value			9.44		8.80		10.42		16.21		23.93
Panel B: Common law countries (n = 205)											
Intercept		250.84	0.40	68.73	2.75	63.60	7.52	62.90	9.96		
MKTC	+	-66.61	-0.26	10.11	1.69	11.90	7.66	12.35	5.60		
SIZE-log	+	0.68	2.55	0.68	2.55	0.68	2.55	0.68	2.55		

DEBT	+	1.34	0.54	1.34	0.54	1.34	0.54
UA	-	-3.09	-0.31	-	-	-	-
PD	-	-	-	-0.17	-	-	-
IND	+	-	-	-	-0.31	-	-
MAS	+	-	-	-	-	-0.04	-0.31
Adj. R^2 (%)			22.96		22.96		22.96
F-value			16.20		16.20		16.20
IND	+	-	-	-	-0.31	-	-
Panel C: Code law countries ($n = 109$)							
Intercept		28.85	3.67	45.80	8.47	-2.72	74.16
MKTC	+	-7.95	-5.27	-1.77	-1.70	5.11	12.41
SIZE-log	+	1.57	3.44	1.57	3.44	3.44	1.57
DEBT	-	-1.48	-0.40	-1.48	-0.40	-0.40	-1.48
UA	-	0.43	5.45	-	-	-	-
PD	-	-	-	0.26	5.45	-	-
IND	+	-	-	-	-	5.45	-
MAS	+	-	-	-	-	-	-
Adj. R^2 (%)			22.64		22.64		-5.45
F-value			8.90		8.90		22.64
							8.90

Note: Refer to Tables 3 and 4 for definition of variables.

The results on the total sample for multinationals (Panel A) indicate that all cultural variables are statistically significant but only UA and IND coefficients are in the expected direction. These results differ somewhat from Zarzeski's (1996) results. In order to have a better insight into the association between financial disclosures and multinationals from common and code law countries, separate regressions for multinationals from common and code law countries were conducted. The results are contained in Panels B and C of Table 7.

The results for multinationals from common law countries indicate that coefficients for all cultural variables are statistically insignificant and coefficients for IND and MAS are not even in the expected direction. The results for code law countries indicate that all coefficients of cultural variables are statistically significant, but with the exception of IND, none of them are in the expected direction.

The above results thus show that cultural values have no significant impact on financial disclosures of multinationals from common law countries. As far as multinationals from code law countries are concerned, the cultural variable of IND seems to be the only variable that has a significant impact on financial disclosures.

DISCUSSION OF RESULTS AND CONCLUSION

Discussion of Results

The findings show that the LS of a country plays an important role in financial disclosures. A comparatively higher level of legal protection rights provided to investors and debt-holders in common law countries, as documented by La Porta et al. (1996), results in a broad-based corporate ownership and high level of debt financing. These corporate characteristics are expected to trigger higher information demand from the financial statements users, which is likely to be matched with detailed financial disclosures in common law countries. The regression results also show that there is no significant association between cultural values and financial disclosures in common law countries. We interpret these results to suggest that financial disclosures in common law countries are more influenced by information demand rather than by cultural values. Thus, cultural values have a minimum direct impact on financial disclosures in common law countries.

As far as code law countries are concerned, the regression results show that only the cultural value of IND seems to have a significant impact on financial disclosures. Though the coefficients of other three cultural variables are statistically significant, they are not in the expected direction. These results thus provide mixed signals with regard to the impact of cultural values on financial disclosures in code law countries.

The results on multinationals are similar to the total sample. Financial disclosures by multinationals from common law countries are not influenced by any cultural variable. The cultural variable of IND seems to have an impact on financial disclosures by multinationals from code law countries.

On an overall basis, these results thus indicate that common law countries are associated with higher financial disclosures, and that none of the cultural values seem to have any direct significant influence on financial disclosures by firms in these countries. Disclosures by firms in these countries are more influenced by information needs, which

are determined by the ownership structure, capital structure, and capital market. The results on code law countries show that the cultural variable of IND has an influence on financial disclosures. The high F and R^2 values indicate that the models are well specified and the results are robust.

The following explanations can be offered for these findings: First, cultural values, which were developed 25 years ago, may have become outdated because of globalization trends in business and industrial changes in different countries. Second, it is possible that the methods used by Hofstede (1980) for determining the cultural values may not have properly captured managerial attitudes from different countries. Since the analyses were primarily based on the attitudes of individuals employed by a single firm, i.e., IBM in different countries, the cultural values may not have reflected the diversity of managers' attitudes in a country. Third, it is possible that the hypotheses developed by Gray may not be valid for financial disclosures, because disclosures are more influenced by business environment rather than cultural environment.

Conclusion

The findings of this study show that firms respond to information demand from financial statement users. With globalization of business, investors and debtors' information needs are steadily increasing, and it is even possible that the market equilibrium for information generation can be achieved without intervention from regulatory at some later date. But the achievement of such an equilibrium may take a long time, which will create asymmetry of information in different countries.

In order to reduce asymmetry of information, it is important that reliable and comprehensive financial information is disclosed, and it should be comparable across national boundaries. This can be achieved by developing international accounting standards, which can be followed by firms from different countries on a voluntary basis. If firms are interested to provide financial information, which are comparable at the international level, they may decide to follow these standards. The findings of this study show that cultural values are not likely to impact the compliance with international accounting standards, if firms choose to follow them. The results on disclosures by multinationals indicate that national cultural values do not appear to have a significant influence on financial disclosures. Instead, global cultural values may be more relevant for disclosures at the international level.

We would, however, like to mention that the findings of this study should be interpreted with caution. The validity of these findings is constrained by the validity and reliability of the disclosure index used in the study. Future studies could develop a disclosure index, which is directly based on financial disclosures contained in the firms' financial statements. Additionally, future studies could also refine the methodology used in this study to provide a better insight into the association between cultural values and financial disclosures.

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NOTES

1. Some studies also consider the variable of "economic growth" as an important variable for the development accounting systems and practices (e.g., Mueller, 1968; Radebaugh, 1975; Enthoven, 1981; Cooke and Wallace, 1990; Adhikari and Tondkar, 1992; Riahi-Belkaoui, 1997). This variable is not being considered in this study because the sample is based on firms from economically developed countries.
2. The list of 90 items can be found in Salter (1998, p. 231).
3. In order to reduce multicollinearity of interaction variables, mean-adjusted variables were used to form the interaction variables.
4. A list of countries and number of firms from each country is available from the authors.

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