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STATEMENT OF THE PROBLEM

OBJECTIVES

HYPOTHESES

RESEARCH METHODOLOGY

RESULTS & DISCUSSION

FINDINGS

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THE EFFECT OF INDIVIDUALITY AND POWER DISTANCE ON INCOME SMOOTHING

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ABSTRACT

In this study, the effect of cultural components on income smoothing possibility is investigated. The cultural components are selected according to the Hofstede model which includes individuality and power distance. Furthermore, the income smoothing is measured using IKAL model and income-to-sales coefficient of variations for net income and gross profit levels. The statistical population of this research consists of the companies registered in Tehran Stock Exchange (TSE) and another sample including 72 companies which were selected via systematic random sampling. The statistical methods used in this investigation are linear regression and F-test. Confidence level was considered as 90% and the research period is from 2006 - 2010. The study findings confirm the significant relationship of individuality and power distance components with income smoothing in net and gross income levels. This relationship is direct and positive and also the relationship intensity of cultural components with income-to-sales coefficient of variations for net income level is slightly higher than gross income level. Moreover, in larger companies, the income smoothing was higher, and also the employees' concerns in such companies were the possibility of participation in company's management and social responsibility.

KEYWORDS

Income Smoothing, Individuality, Power Distance.

INTRODUCTION

Increasing the awareness about environmental factors' role in forming accounting procedures and systems is an important achievement of the researches on accounting. These achievements have led to more serious attempts in identifying relative environmental factors and how they affect accounting. In these researches, culture is considered as one of the important environmental factors and effective on the nations' accounting systems. This attitude is based on this general reasoning that accounting is a social-technical activity (Thaghafi, 2010).

In this connection, several researches have been carried out in different countries into the effect of culture on the accountants' behavior. The Hofstede's definition of culture has been considered in all these researches. According to his definition, the culture could be investigated by five elements. These elements include the current power distance in the society, avoiding uncertainty about future, the level of individuality, the level of masculinity of the individuals' long-term and short-term views (Hofstede, translated by Farhangi et al., 2007).

REVIEW OF LITERATURE

Hofstede investigated in his research on the employees of IBM in 50 different countries including 116000 people on the difference of culture in various countries which included individuality, power distance, avoiding ambiguity and masculinity. Iran was ranked 29 in power distance, 43 in masculinity, 59 in avoiding ambiguity and 41 in individuality perspectives (Hofstede, 2002).

Hofstede, Van Deussen, Muller, and Charles claimed that people's sensitivity to risk is high in eastern cultures. Also, other observations show that group and collectivist cultures are more tolerant to risk than individual cultures (Hofstede, 2002). Hu, Kung and Yu found that income manipulation by companies' managers depends on value systems (culture) and structural aspects (legal environment) of the country under study (Hu, 2008). Baharmoghaddam and Hassani identified significant relationships among operational cash flow, inventory changes, and earnings management in companies registered in Tehran Stock Exchange (Bahar Moghddam, 2010).

Molanazari and Karimizad showed by their investigation that a strong and invert correlation exists between the size of corporation and income smoothing (Mola nazari, 2007). Thaghafi and Rezazadeh (2000) examined the cultural context of accountants' professional behaviors. In this study, the Hofstede's model and variables about culture from some aspects including effectiveness on the accountants' behavior in conservatism, secrecy and information disclosure were investigated (Thaghafi, 2003). Thaghafi and Baharmoghaddam studied the effective stimuli on the earnings management in stock exchange companies and came across some evidences concerning the relationships between ownership structure, block stocks, managers' compensations, audit firms quality, companies' growth, size of corporation as well as financial structure with the level of earnings management (Thaghafi, 2006). Roaya'e and Abdoli found no significant and important relationship between cultural components and earnings management. In fact, by including the type of company variable, whether public or private, the relationships between dependent and independent variables were slightly modified (Roaya'e and Abdoli, 2009).

Ahmed Seleim and Nick Bontis, (2009) investigate the relationship between the GLOBE (Global Leadership and Organizational Behavior Effectiveness) project national cultural dimensions of values and practices and the Corruption Perception Index (CPI). Their results provide empirical support for the influence of uncertainty avoidance values, human orientation practices, and individual collectivism practices on the level of corruption after controlling for economic and human development, which, in turn, adds to the efforts to build a general theory of the culture perspective of corruption.

Marshall and et al. (2006) investigates whether national culture influences perceptions of the acceptability of earnings management. Participants from eight countries evaluated 13 vignettes describing various earnings management practices. Results demonstrate considerable variation in perceptions across nations to the earnings management scenarios, providing strong evidence that the practice of earnings management was not perceived similarly in all countries. Using Hofstede's (1991) cultural indices, we find that the differences in aggregate perceptions across countries were not closely associated with any of the cultural dimensions examined. They, find that perceptions of earnings manipulations involving the timing of operating decisions were associated with both the Power Distance Index and the Masculinity Index.

Deresender and et al. (2007) finds a significant influence of both cultural measures. In line with Licht et al. (2004), who argue that individualistic societies may be less susceptible to corruption, we find that countries scoring high on individualism tend to have lower levels of earnings management. In addition, we find that

egalitarianism, defined as a society's cultural orientation with respect to intolerance for abuses of market and political power, is negatively related with earnings management. Our results are robust to different specifications and controls.

IMPORTANCE OF RESEARCH

The importance of executing this research is that it investigates the impact of cultural and behavioral components on financial performance of companies and despite other researches, its focus is not one-dimensional merely on financial figures. As the effect of cultural factors on financial performance in different studies confirms the meaningful relationship between them, therefore, we have investigated the issue in Iran in this study.

STATEMENT OF PROBLEM

The research questions are: Can cultural components express and explain income figures manipulation and smoothing? Does the existence of the morale of individuality (individualism) in companies result in possibility and probability of more income manipulation? Will the existence of high power distance in companies cause the probability of income figures smoothing to become more?

OBJECTIVES

Explanation of the relationship and the impact of the level of individualism in companies with the amount of income figures manipulation and smoothing at different levels in the accepted companies in Tehran stock exchange

Explanation of the relationship and the impact of the amount of power distance in companies with the amount of income figures manipulation and smoothing at different levels in the accepted companies in Tehran stock exchange

HYPOTHESES

1. There is a significant and direct relationship between income smoothing and power distance index.
2. There is a significant and direct relationship between income smoothing and individuality index.

RESEARCH METHODOLOGY

This study is an analytical-descriptive one and since it has utilized previous data, it is also an ex post facto study.

STATISTICAL POPULATION

The research's statistical population consists of the companies registered in Tehran Stock Exchange, which should include the following terms and conditions:

They should be included in the list of the companies registered in TSE during the research's period, i.e. 2006 – 2010.

They should not be of investment and broking companies.

Their fiscal year should end by the mid-March.

VARIABLES MEASUREMENT METHOD

INCOME SMOOTHING

In order to measure this variable for each company, a model which is based on the coefficient of variations – IKAL Model – was used. In this model, the variance of income variations to the variance of sales variations was calculated (Zhiang Yan, 2007).

The income smoothing index calculation method is as follows:

$$CY = CV_{income_{it}} / CV_{sales_{it}} \quad (1)$$

Where $CV_{income_{it}}$ is the coefficient of the dispersion of income variations in the company i during the t period, and

$CV_{sales_{it}}$ is the coefficient of the dispersion of sales variations in the company i during the t period.

The variance for income and sales variations is calculated according to the five-year figures of each company. These calculations for each company are performed in two levels of gross income and net income.

POWER DISTANCE

This index is obtained using the scores given to the each company's employees selected choices in the first three questions of the questionnaire, which are related to the management style in each company. In fact, prior to designing these questions, four management styles from autocratic to fully-cooperative, were described to each respondent. The following diagram presents the questions by which the power distance in each company could be measured:

TABLE 1: QUESTIONS RELATED TO THE MEASUREMENT OF THE POWER DISTANCE

Question 1 – What type of the above-described decision-makings are you interested in, for your top manager?
Question 2 – Which of these four types of decision-making is similar to your top manager's?
Question 3 – How many times have your colleagues hidden their disagreement with their manager's decision?

POWER DISTANCE INDEX FORMULA

The average score of the third question + the total percentage of the second question's choices 1 and 2 – the percentage of the first question's choice 3

The answers to these questions are collected through sending written questionnaire to the statistical population and also through face-to-face visits. This questionnaire was previously used by Thaghafi, Rezazadeh, Abdoli, and Roya'e in their accounting Ph.D. thesis. Therefore, it enjoys high validity and reliability.

The power distance index was calculated for each company in the same manner.

INDIVIDUALITY

In order to measure this variable, 14 questions (presented in the written questionnaire) related to the career goals of an ideal job were used. For eliminating the effects of optimism in answering the questions (answering positively to the questions disregarding their content), the answers were firstly standardized. During the standardization process, all answers would be stated as a distance from their common average and based on common standard deviations. Then, the factors derived from the employees standardized answers were analyzed using the factor analysis statistical technique. Firstly, the primary results of factor analysis were obtained, which indicated two effective factors and another not so much important one. Due to the fact that the primary results of each factor analysis do not generally enjoy high interpretation capability, the factors are rotated to obtain two related factors in terms of the correlation level with each career goals. Then, both factors extracted by the factor analysis as well as the correlation coefficient of each career goal with factors are examined by the help of theoretical principles and the main research literature and the basis for determining each individuality and masculinity indices.

The following table shows the factors effective on measuring the individuality variable:

TABLE 2: FACTORS RELATED TO THE MEASUREMENT OF INDIVIDUALITY VARIABLE

Career Goals Presented in the Questionnaire	Symbol
Personal satisfaction in performing the job	A1
To provide a desirable dwelling for family	A2
Possibility of achieving higher income	A3
Good work relationship among the colleagues	A4
To create educational opportunity in order to improve skills or to learn new skills	A5
To enjoy employment benefits	A6
To expect to be appreciated whenever doing a job properly	A7
The existence of proper physical conditions at work environment (Air-conditioning, light, etc.)	A8
Considerable latitude in applying one's desired viewpoints	A9
Job security to cooperate with the company as long as you desire	A10
Grounds for job advances	A11
The possibility to establish proper working relationship with the direct supervisor	A12
The possibility to take advantage of one's own skills and capabilities	A13
To specify an advisable and desirable time to spend with the family	A14

These coefficients are obtained considering the importance attached by the respondents to each of the career goals. In other words, these coefficients are the resultant of the viewpoints of the employees in the companies under study on individualism or collectivism components. In order to measure the individuality variable according to the theoretical principles and career goals presented in the above table, symbols A1, A2, A3, A4, A5, A6, A7, A8 and A10 were taken into account, considered by the statistical population as the indicators of the individuality concept. Therefore, the standard deviation of employees' responses in each company to every question (mentioned career goals) were calculated using the Microsoft Excel's spreadsheet, and then the standard deviation of these questions were considered as the individuality index. The average of these figures is the same expected index.

RESULTS & DISCUSSION

The descriptive statistics results indicate that companies with larger size believe that the latitude is more important than any other factors in applying one's views. Moreover, they think that the grounds for job advances are also important. However, in smaller companies, work environmental conditions and the possibility to achieve higher income are considered as important. Additionally, in large companies, the difference between net incomes with gross incomes is about 25%, while it is around 10% in smaller companies; that is, the share of general, administrative and welfare expenses in small companies is small and the management of such companies do not pay much attention to the financial aids of personnel, administrative, and work environment. The average power distance index in small companies is bigger than large companies, i.e. the management of large companies is cooperative while in smaller companies, it is more autocratic.

The results of hypotheses analysis for net income level are presented in the following table:

TABLE 3: THE STATISTICAL RESULTS OF THE RELATIONSHIP BETWEEN NET INCOME (FROM TAXES) AND CULTURAL COMPONENTS

Results	F	Sign	Durbin -Watson	St.eror	R ² adj	R ²	Variables
confirm	2.201	0.077	1.85	0.200	0.293	0.418	Power distance
confirm	2.382	0.046	1.87	0.200	0.312	0.515	Individuality

As shown in the above table, the relationship between income smoothing and individuality is confirmed at 90% confidence level. The F statistics also confirms such relationship. The individuality relationship intensity indicates that around 30% of the variations could be explained by cultural components. Consequently, in the companies where the power distance and individuality is high, the income smoothing may be also high.

TABLE 4: THE STATISTICAL RESULTS OF THE RELATIONSHIP BETWEEN GROSS INCOME (FROM TAXES) AND CULTURAL COMPONENTS

Results	F	Sign	Durbin -Watson	St.eror	R ² adj	R ²	Variables
confirm	2.011	0.073	2.159	0.176	0.194	0.321	Power distance
confirm	2.483	0.088	2.118	0.176	0.196	0.298	Individuality

As shown in the above table, the relationship between the income smoothing and individuality is confirmed at 90% confidence level. However, the intensity of individuality relationship and power distance at the gross income level is lower than the net income level. The F statistics also confirms such relationship. Thus, in the companies where the income smoothing has performed, the power distance and individuality governing such companies are effective on its occurrence and could explain about 25% of the variations.

CONCLUSIONS

Based on the theoretical principles and research literature, it is expected that there would be positive and significant relationship between the management behavior and cultural components in regard to financial reporting. It is while in the environments with high power distance, where the responsibility is in low levels, the cases of non-observance of legal and accounting standards and income manipulation could be high. Inversely, lower power distance and more sense of responsibility in the individuals may lead to lower possibility of income manipulation by them. The statistical test results of the first hypothesis confirm such achievement in the statistical population. Furthermore, based on the statistical results, the relationship between both net and gross incomes levels with the power distance is approved, and the relationship intensity of the net income is more than the gross income. This result could be due to closeness of gross income to sales figures and its effect on the dependant variable ratio and the possibility of manipulating the mentioned figures. Therefore, in companies where income manipulation is higher, the power distance would be higher and this could be some more in larger companies. In the smaller companies, the possibility of income manipulation is decreased due to more vicinity of the owners and the managers and also consistent presence of ownership in the company. Meanwhile, in order to improve the personnel efficiency, their standpoints would be used and the moral hazards related to the agency theory would not be also proposed.

Based on the second research hypothesis and according to the theoretical principles, there should be a direct and significant relationship between income smoothing and individuality. That is, the more the individuality, disregarding others' opinions and lack of cooperation with others, the more the possibility of income manipulation, because the others are not included in determining, measuring, and classification of the accounting and financial figures. The result of the statistical test for the research's first hypothesis confirms a significant relationship between them; in the companies with higher income manipulation, the individuality level would be also higher, and there would be seen less cooperation by the employees. In fact, this is higher in larger companies which could be due to further distance between ownership and management and the agency theory as well as the role of managers' performance moral hazards. In smaller companies, due to more supervision by the owners on the managers' performance, the possibility of income manipulation and reporting them with bias would be decreased.

SCOPE FOR FURTHER RESEARCH

1. In future studies, the impact of some components such as avoid uncertainty, long/ short view horizon of individuals and also masculinity on the amount of income figures manipulation be investigated at different levels.
2. Income figures manipulation issue be measured with contribution of other models apart from IKAL model
3. The impact of the type of ownership (state and private) on income figures manipulation be investigated

RECOMMENDATIONS

Considering that there is an approved presence of income manipulation in gross income level, the designers of Iranian accounting standards should pay attention to this issue and reconsider the standards in calculating the cost price of the goods.

With regard to more intense effect of cultural components resulted by income manipulation in larger companies, the owners of larger companies should show greater sensitivity to this issue and ask it from the managers.

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