

Discussion of “The Effects of Creative Culture on Real Earnings Management”*

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1. Introduction

This article is a discussion of, but mostly a further reflection on, the 2018 CAR conference paper by Ryan D. Guggenmos, “The Effects of Creative Culture on Real Earnings Management” (published in this issue, henceforth cited as Guggenmos 2020). If I could have (nit)picked a title for my discussion article, I would have called it “Alleged Unintended Consequences of Apparently Desirable Company Cultures,” for reasons that will become obvious as I develop my narrative. As there are two key terms in the title of Guggenmos (2020)—company culture and earnings management—my discussion inevitably resolves around these two core themes, and related, across the multiple sections that follow.

Earnings management comes in two forms: accounting-*related* earnings management also known as accruals-based earnings management, and accounting-*triggered* earnings management, which is the type Guggenmos (2020) focuses on—so-called “real earnings management” (REM). My definition of REM is any *operating action or decision* management or employees take to make *accounting earnings* look more desired than they otherwise would. Thus, *intent* is key—that is, those taking the actions or decisions know that they may not be taking particularly good actions or decisions, but they take them anyway because of the ‘desired’ effect on earnings.¹ Accruals-based earnings management, in contrast, involves changing the actual accounting numbers directly, either fraudulently or by way of stretching accounting conventions.

¹ It is tempting to say “positive” effect on earnings, but it should really be “desired” because sometimes the benefit to those taking the actions or decisions accrues from managing earnings up but sometimes also down. Moreover, the notion of “desired” meshes well with the idea of “intent” being the rationale behind the actions or decisions.

Next, I briefly summarize the key tenets and findings of Guggenmos (2020), after which I will return to the paper's two key concepts of company culture and earnings management as the basis for my further reflections.

2. Setup and tension

Upfront in Section 1, in the introduction, Guggenmos (2020) essentially argues and demonstrates that “creativity can increase opportunistic behavior even within the bounds of accurate reporting.” Two things about this quoted sentence. First, creativity is really the operationalization of what he more broadly alludes to as an “innovative company culture”. Second, “opportunistic behavior *even within the bounds of accurate reporting*” clearly establishes his study's focus on REM by taking accruals-based earnings management out; that is, *even when all the accounting is proper*, innovative company cultures may trigger “opportunistic behavior” or, in my terms, actions and decisions intended to make earnings look more desirable than they otherwise would.

Pertinently stated in Section 1, towards the end of the introduction when elaborating the study's contributions, the key tension in Guggenmos (2020) is that “Company leadership should be aware that cultivating an innovative company culture may have downsides.” Put bluntly, not everything that creativity produces is good. This is because “even though a company's culture [i.e., creativity] may not appear harmful, elements of the culture that increase risky behavior should be considered” [brackets added]. The key argument thus is that the potentially riskier behaviors creativity-based cultures encourage include a greater propensity to engage in REM.

However, here is the rub, which is my favorite part of the setup of Guggenmos (2020) in that same paragraph of his paper: “as it is inadvisable to suggest that companies forego

innovation, my results provide managers with interventions that can reduce REM behavior within more innovative company cultures.” Thus, the point is about *mitigating* potentially undesirable consequences within an otherwise desirable company culture. One should indeed not throw out the baby with the bathwater. To be so clear about this is the refreshing part of the Guggenmos (2020) paper. Less careful conceptualizing often inadvertently gets bogged down by wanting to *eliminate* the bad while overlooking that it also often implies throwing out the good. Guggenmos (2020) got it right with mitigation, not elimination.

During my CAR conference presentation, I illustrated this subtle but crucial point with the generic graph I drew in Figure 1, implying that indeed there is a “theoretical optimum” of creativity considering its benefits (upsides) and costs (downsides).

—— Insert Figure 1 here ——

3. Mitigating the downside

Because eliminating innovation is not an option, Guggenmos (2020) conceives of “an intervention that reduces REM within [or *given*] the firm’s culture” [brackets added]. For this, he draws on construal-level theory from (organizational) psychology. In my own words, the core and theory-consistent idea behind construal-level interventions for the purposes of Guggenmos (2020) is to *help curb the undesirable REM behaviors while maintaining the firm’s innovative culture*.

Without going into the details, construal-level interventions do this (or attempt to achieve this) by way of “abstraction”—that is, by *prompting someone to weigh the consequences of their actions or decisions before they make them*, either in operational terms (lower-level construal) or in a more strategic way (higher-level construal). Guggenmos (2020) gives examples of this. In

Section 6 of this discussion, I will make some comments about what I believe may be issues of (practical) feasibility and effectiveness of construal-type interventions.

In a nutshell, the idea is that lower-level construal can alleviate REM behaviors by increasing the salience of downside risk, whereas higher-level construal is expected to do so by focusing decision makers on the “big picture” consequences of their decisions and, among other things, muted preferences for instant gratification and self-interested behavior.

Because there is presumably “more” to higher-level construal (i.e., making big-picture consequences more salient *plus* decreasing preferences for instant gratification *plus* some other features) than there is to lower-level construal (which is characterized by prompting the salience of downside risk *only*), higher-level construal interventions are expected to reduce REM to a greater extent or “more” than lower-level construal. Let me preambule now though that I rather find this a stretch, aside from the feasibility of using construal-level interventions in practice, which I will discuss further in Section 6.

Aside from this, what I find neat is the idea of trying to “mitigate the downside”—that is, alleviate REM behaviors that may come with innovative company cultures without however curtailing creativity itself. I illustrated that at the CAR conference by way of drawing an overlay of Figure 1 as shown in Figure 2.

——— Insert Figure 2 here ———

4. Guggenmos (2020) findings

Using an experimental research design, Guggenmos (2020) finds, first, that managers in a more innovative company culture engage in greater REM than managers in a less innovative company culture. Second, within the more innovative company culture, he finds that the intervention that highlights the downside risks of managers’ decisions (i.e., the lower-level

construal intervention) diminishes REM, but the intervention that helps managers see the big-picture impact of their decision (i.e., the higher-level construal intervention) reduces REM to a greater extent. However, contrary to his prediction, he also finds that the same big-picture (higher-level construal) intervention that reduces REM the most in a more innovative company culture, increases REM in a less innovative company culture.

Guggenmos (2020) then embarks on a post-hoc analysis for this unexpected result. My bare-bones, maximally-reduced (maybe borderline simplistic) interpretation of this rather complex post-hoc analysis is that higher-level construal interventions appear to work—i.e., they manage to prompt the decision-makers to consider the big picture; it’s just that, as I infer it, *the “big picture” is different* in more innovative than in less innovative company cultures. In more innovative company cultures, the “big picture” is about the decision’s impact on growth and moving the firm forward and engaging in behavior that is beneficial to the firm in the long run. But in less innovative company cultures, managers instead appear to view the “big picture” as preservation of the status quo. This may explain why, in a more innovative culture, REM is mitigated, because the earnings management is inherently myopic. But, in the less innovative culture, earnings management is not mitigated but instead exacerbated, because REM “saves the day” (my phrase) even though, or just *because*, REM is immediate in its short-term effect; that is, it *helps* to meet the target! Or, to quote from Guggenmos (2020, in Section 4, Results, under “Unexpected Effects”):

In more innovative cultures, considering the “big picture” consequences with respect to the company’s goals and values allows for the possibility that missing an earnings target in the current period may still mean that the company has advanced, grown, and performed in line with its ideals. This may be more

important than preserving the status quo of consistent performance. However, in less innovative cultures, where culture communicates that preserving the status quo is highly desirable, individuals considering the “big picture” may be more likely to fixate on preserving the status quo of consistent earnings performance.

Hence, I think I’m correct to suggest that if the “big picture” *is different* in more innovative compared to less innovative company cultures, then evoking it should also be expected to have different outcomes, the first more consistent with growth and the future and the latter more consistent with steady earnings and the present.

Finally, despite my (apparently unfounded) initial reservations, the results do, however, indicate “differential magnitudes” or “increased efficacy” commensurate with the “hierarchy” of construal-type interventions. In other words, the findings bear out that, where the interventions performed on the whole as predicted (i.e., in the more innovative culture conditions), the greatest REM occurred where there was no intervention; less REM occurred where there was a lower-level construal intervention, and the least REM occurred where the higher-level construal intervention took place. Thus, I rest my case (or maybe not yet, see later, in Section 6).

5. The bigger picture

With all the key features of Guggenmos (2020) now hopefully reasonably manageably summarized, let me stake a step back to make some bigger picture comments and offer some perspective on company cultures and the underlying model of culture’s effects.

5.1. Company culture

There has been a recent uptick in culture research in accounting, finance, and economics. An easy way to illustrate this are the Graham et al. (2017) papers that Guggenmos (2020) also cites. I welcome this. As I said at the 2018 CAR conference, it helps to “take culture out of the error term” in the (regression) equation that seeks to explain organizational performance.

Without doing so, culture has been both used and abused as it suits; that is, sometimes praised as a boon for success and other times as a bane for failure. Worse, cultures that have been praised can sometimes overnight turn into the alleged rot behind an unexpected failure. Cultures of laser-focused, performance-driven meritocracy in banks praised during propitious times apparently seamlessly became bastions of excessive greed when the financial crisis struck. Obviously, bank culture did not change overnight; only bank performance did, dramatically, for the worse. And hence, whether culture is “good” or “bad” appears to be inferred from performance—i.e., it is assumed that the culture *must* be good when a firm or a sector is doing well, with much being *read into* what such a presumably good culture is. Enter failure, and the narrative about otherwise the same culture changes. But culture is not an innocent bystander and infinitely acquiescent to performance. Instead, culture deserves to be treated as a proper explanatory variable of organizational performance instead of being retrospectively inferred from it.

One thing is sure: cultures are potent, for better or worse. To illustrate the “for worse” side, and pertinent to Guggenmos (2020), I gave an example at the 2018 CAR conference from the Toshiba 2015 accounting scandal (*The Financial Times*, 21 July 2015, online at <https://on.ft.com/2Ux4Jg9>):

[...] the panel found no evidence any of the three current and former chief executives had given specific instructions to division chiefs to inflate profit

figures. *It was a corporate culture*—one of exerting pressure on employees to meet aggressive, short-term profit targets spanning three generations of chief executives—in which employees were afraid to speak out against bosses when they pushed for unrealistic earnings targets. [Italics added.]

In other words, bosses do not always have to give explicit instructions to have their employees engage in earnings management, and the perpetrators do not always have to be looked for in the accounting and finance functions of the organization, as the earnings management can arise (or be aided and abetted, implicitly commissioned or normalized) throughout the organization through implicit cultural norms. As Guggenmos (2020, in Section 2, Literature, under “Creativity and Innovation”) states:

[w]hile the finance and accounting function is responsible for ensuring that the organization’s transactions are properly recorded and reported, it is often employees outside of financial reporting that make the decisions regarding when, and even whether, the real economic activities that underlie the accounting records occur.

To the extent that these choices are subject to managerial discretion, they may have an effect on reported firm performance. This is how Guggenmos (2020) came to focus on “real” earnings management (REM). However, if culture is as potent as suggested, then indeed, Guggenmos (2020) is justified in maintaining that, *even if finance and accounting subcultures discourage opportunistic behavior*, this may not carry over to the rest of the firm. We do not know whether in the Toshiba case the conditional part of this argument (about the finance and accounting subcultures)

applied. However, the investigation into the case certainly was quite clear in suggesting that “it was a company culture—one of exerting pressure on employees to meet aggressive, short-term profit targets” that had the effect on reported firm performance that Guggenmos (2020) is interested in (*The Financial Times*, 21 July 2015). Hence, the Guggenmos study is highly relevant and a welcome addition to the (accounting) literature for this reason.

5.2. Underlying model (or part-model) of culture’s effects

The potency of culture (in this and other contexts) also clearly warrants it to be taken out of the error term to try to explain a variety of outcomes (including (real) earnings management, as Guggenmos (2020) does). However, taking culture out of the error term requires that the researcher is clear about:

- 1) ***the construct***—which culture is it; e.g., company culture, the culture of a trade or functional area (e.g., salespeople, engineers, lawyers) or a subgroup/division in the organization (e.g., the accounting department);
- 2) ***the object***—the effect of culture on what; e.g., organizational performance, fraudulent behavior, capacity to innovate;
- 3) ***the sign***—i.e., is culture a “good” or “bad” thing; and,
- 4) ***the channel***—the type of effect through which culture is expected to have an effect; i.e., as a main, intervening, or moderating factor.

In the case of Guggenmos (2020) the answer to (1) is an “innovative company culture” experimentally manipulated to distinguish “more” vs. “less” of it, which is of course quite a challenge in an experiment, but Guggenmos’ attempt is well-conceived and well-executed.

The answer to (2) is REM. I already discussed the very valid and relevant focus on this in the paragraphs above. I deem REM to be a good choice, where the experimental analogue is quite a classic one (why not!) and, again, properly operationalized as a decision to spend *vs.* delay *presumably needed* maintenance with an effect on the current year earnings-per-share target (which would be missed if spent, but met if delayed). Thus, this gets at the usual intertemporal tradeoff often characterized under the rubric of “myopic” decision-making.

Of course, one can never be entirely sure whether managers who delay the maintenance expenditures act truly “opportunistically” or actually “truly” believe that they are making a “good” decision not driven by self-interest or some bonus-maximizing, short-term rationale. Yet, the assumed tenor or starting point of Guggenmos (2020), and typically every other study of this type, is that the decisions are opportunistic. Whether the decisions are opportunistic, however, depends on whether the maintenance (in this case) is “needed” which is not an exact determination, especially in the real world. Such decisions (e.g., *whether, how much, and when* to “invest” or “spend” on maintenance, training, R&D, customer loyalty, etc.) are inevitably grey, not black and white.

When managers cut R&D, it is easy to take that as opportunistic. But what if the R&D project is a dud? Would not cutting it then be akin to throwing just more good money after bad? Decisions of this type should, therefore, be analyzed from a “real options” perspective (e.g., Gong et al. 2011), which I don’t mean to be taken in a technical finance meaning of the term, but rather in an organizational or even behavioral way. For example, some managers may believe that spending just enough on “upkeep” now is fine, whereas others may believe that it would be better to not spend anything at all now thinking that a more significant “redevelopment of the estate” later is a better course of action. Both “mere upkeep” and “redevelopment of the estate”

are reasonable considerations when pondering seemingly “simple” maintenance decisions. This is not to say that these considerations are not colored by earnings management rationales, which may be particularly suspect when the amounts spent happen to also help meet a budget or earnings target. Managers have admitted to that being an important consideration indeed (see Graham et al., 2005). But how does one really know? This harks back to the critical notion of “intent” in Section 1 of this discussion above. Intent is just impossible to establish with certainty. However, experiments, when well-designed, can come closer than any other method. Altogether, Guggenmos (2020) manages to credibly capture the “opportunistic” or “earnings management” rationale of the maintenance decision in the totality of his experimental setup, although I personally spent a lot of time reflecting and seeking reasonable reassurance on this.

In this regard, I found the “should” vs. “want” analysis in Guggenmos (2020, in Section 4, Results, under “Additional Analyses”) reassuring, as indeed the underlying idea was to try to “understand managers’ *motivations* to engage in REM” [italics added]. To the extent that “motivation” gets at intent, this type of additional analysis in Guggenmos (2020) perhaps will trigger ideas for him and others to exploit this further to measure *alleged* earnings management even more prominently in future work.

The answer to (3) about the sign of the effect is clear in Guggenmos (2020): it is about how creativity (an innovative company culture) may have a “dark side” or “unintended consequences” through increased REM, which addresses (4) about the “channel” through which culture is expected to have an effect. Of course, if the ultimate variable were to be organizational performance, then it is not entirely clear that *even earnings management* (if it can be established to be earnings management indeed, see above) has a “universally negative” effect on performance (as acknowledged in fn. 2 in Guggenmos 2020).

In my depiction of the effects of culture in Figure 1, organizational performance is the ultimate dependent variable, where there are benefits and cost of culture (depicted separately as well as showing their combined net effect). Guggenmos (2020) specifically studies the negative effect of a culture that emphasizes creativity, but only (one of) its cost(s) as manifested by increased REM. He then also examines how to mitigate this cost (which I depict in Figure 2); specifically, how REM can be curtailed through two construal-type interventions. Thus, Guggenmos (2020) focuses on a more limited model of culture's effects. However, I deem his choice of this particular focus to be wise because he picked a relevant angle, both managerially (as I suggested in Section 5.1 immediately above) as well as for accounting researchers to study.

Actually, if one were to seek to summarize the answers to (3) and (4) in one sentence, then I would pick this one, straight from the key point leading into, and immediately preceding, Guggenmos' statement of Hypothesis 1: "Because more innovative corporate cultures have been associated with greater risk acceptance [...], I predict that managers will be more likely to accept the risk that comes with engaging in REM in these cultures." This exemplifies, in one short sentence, the cost of creative cultures that Guggenmos (2020) focuses on, and how he expects it to come about. Clear!

6. Final points and implications

Let me just mention two further points relating to the two key aspects of the study: culture and REM. I will then also make a final point about the implications of the study. First, culture. Whereas Guggenmos (2020) focuses on "innovative company cultures", I found it sometimes difficult to not read this as "creativity" (and for the author to always stick with the chosen term in a disciplined manner). If we were to substitute every instance of "innovative company culture"

with “creativity” would the substantive reading, meaning, findings, and interpretations of the study be different? Yet, is an innovative company culture reducible to just creativity? Can innovative company cultures entail more than just creativity? Alternatively, is it conceivable that, in some cases, innovative company cultures could be quite different from creativity entirely? Maybe innovation could be about experimenting with new operational aspects of the business, but does that require creativity? Maybe it means spotting tried-and-tested approaches already in existence and implement these quickly (ahead of competitors). Hence, innovation then stems from speed rather than creativity per se. I just mention this. It does not reduce the value and validity of the study, but it may have implications for its application areas and generalizability, such as to contexts where creativity is less central to innovation, and hence, where the critical creativity-induced risk-taking channel on which this study pivotally relies may be less pronounced or absent.

Second, REM. Again, the assumption is for the (real) earnings management to be opportunistic. I have discussed above in Section 5.2 how difficult, if not impossible, it is to distinguish “real” REM from otherwise benign and good faith decisions that involve inevitably difficult tradeoffs, especially but not exclusively, with respect to their timing (and hence, their likely determination as being “myopic” or not). The irony is that this determination is *likely to be especially difficult in innovative settings*. Innovation requires difficult tradeoffs about whether, how much, and when to invest *by its very nature*, even setting aside any possible earnings management or other incongruent or dysfunctional rationales. This causes a difficult “real” endogeneity for studies of this kind. Indeed, the settings in which the unintended behaviors are most likely to be relevant and exploitable—i.e., more innovative settings—are also the settings in which they are most difficult to distinguish from their benign versions. Moreover, the types who

self-select into creative environments perhaps are inherently less myopically inclined, and if so, this may introduce further error in our observation (measurement) of what are deemed to be myopic decisions (yielding false positives)?²

REM indeed may be easier to study and/or less prone to measurement error in a sales or production environment in a stable industry, say, than in a creative setting. There is less ambiguity about the intent behind “shipping bricks and other tricks” at month-end than there is about the amount that should be spent on training or R&D in fast changing, uncertain environments. But studying the former also stands to offer a less substantive incremental contribution compared to the latter.

Finally, implications. Drawing on construal-level theory, Guggenmos (2020) tests two “consequence-focused” interventions that are designed to reduce REM within the company’s existing culture. I have two points about this. First, I still believe that Guggenmos (2020) makes too much out of the “hierarchy” of these two interventions to predict that the “higher-level” one will be “more” effective than the “lower-level” one (even though that is what he finds, so maybe there is validity to this, but I am still curious about any possible alternative reasons behind the two types of interventions that may drive this result beyond one just being “more inclusive”—and thus, “higher-level”—than the other). Be that as it may. But, second, I struggle to see how a firm would implement such “consequence-focused” interventions in practice? It requires bringing the decision-maker into a mindset where she is prompted to weigh the consequences of her decision before she makes it, either in operational terms (lower-level construal) or in a more strategic way (higher-level construal). But how to do that concretely? And *who* does the

² Sorting effects that may occur in practice do not inflict Guggenmos (2020) due to the random assignment of experimental subjects.

prompting? Given that REM often takes place at quite high managerial levels, might there be *not anyone* to do this, or might the one who should be doing it also be complicit in the REM (or stand to benefit from it, and hence, not wanting to curb it)? Or, should decision processes have some built-in features that trigger the prompting or pausing? What are these features and how do they work? Some more guidance about these questions could have brought the study perhaps even more to “real” life beyond it being very interesting as it is.

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FIGURE 1
Net effect of Ψ ('creative culture') on π ('performance')

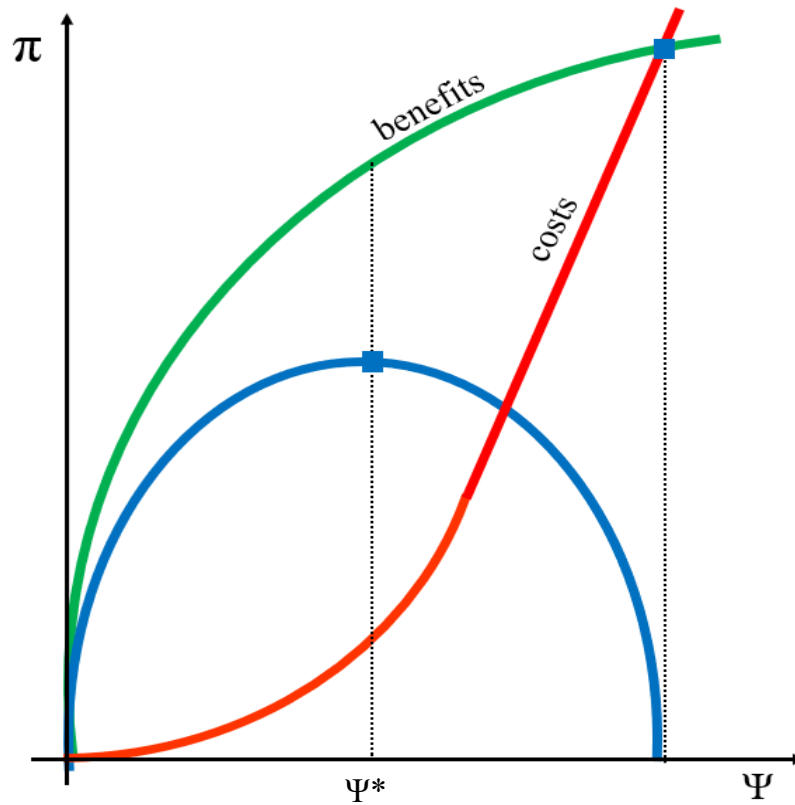


Figure 1 depicts the optimal amount of creativity (Ψ^*) considering its benefits (upsides) and costs (downsides). In this figure, Ψ is optimal where performance (π , equal to the benefits minus the costs of creativity) is greatest or where the distance between the benefits and costs is the widest (dotted line).

FIGURE 2
Post-intervention net effect of Ψ ('creative culture') on π ('performance')

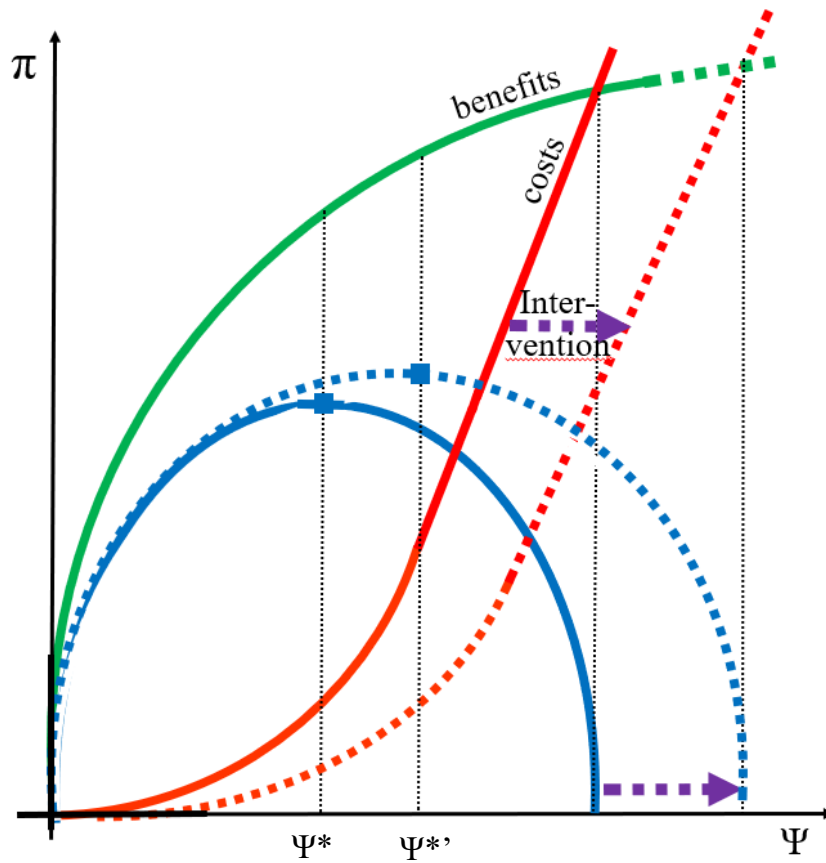


Figure 2 is an overlay of Figure 1. It depicts the mitigation of one of the costs of creativity (real earnings management, REM) by way of an “intervention” (shown by the arrow). Such a construal-level intervention that helps curb undesirable REM thus pushes the cost curve to the right, and in so doing improves the level of creativity (from Ψ^* to $\Psi^{*'}$) at which performance is maximized.