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Corporate Nonmarket Strategy in Emerging Markets:
The Case of Mexico

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Dedication

“Thus far the Lord has helped us”.

1 Samuel 7:12b

Thank you Lord, for helping me along the way.

This work is dedicated to my mom, who has always been by my side in all my decisions, including this doctoral race.

To my grandparents Eva and Rodolfo, and my aunts and uncles Lourdes, Javier, Rubén, and Noemi, who taught me the value of education and helped me in many ways so that I could pursue my dreams.

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Corporate Nonmarket Strategy in Emerging Markets: The Case of Mexico

By

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ABSTRACT

Nonmarket strategy has always been an integral part of the firm's strategy. However, as scholars have studied nonmarket strategy, they have acknowledged its increasing relevance as part of the firm's strategy. Managers have become more interested in complementing the traditional market strategies focused on how to improve firm performance with either corporate social responsibility (CSR) initiatives or corporate political activity (CPA) actions. Even the government and the general public pay more attention to the firm's nonmarket actions.

For business, the use of CSR and CPA seeks to reduce uncertainty by creating social and political goodwill. However, most of what we have learned about nonmarket strategy in general is based on studies carried out in developed economies, which have strong institutions that provide a system of checks and balances and a set of guidelines. I contend that emerging markets such as Mexico have different "rules of the game" and thus nonmarket strategy will have different results when implemented in firms operating in such emerging contexts.

The present dissertation aims to explain how firms in emerging markets use corporate nonmarket strategy to obtain a strategic advantage. Specifically, three studies have been conducted to understand the use of nonmarket strategy in an emerging economy such as Mexico. The first paper aims to look at the influence of country level characteristics on the likelihood of engaging in earnings management. Results show that emerging economies

differ from developing economies in the effect of board characteristics CEO duality and board independence on the likelihood of earnings management, requiring that current theories adapt to the reality of these differences between both sets of countries. The second paper looks at the inner circle of firms listed in the Mexican Stock Exchange. This is a descriptive study that maps fifteen years of board members and their relationships, concluding that the disappearance of the inner circle that has been documented on other developed economies is not happening in Mexico. Finally, the third paper uses a foreground/background metaphor to explore how influence payments can be performed in the foreground (e.g. political donations) or in the background (e.g. questionable payments) and the effect of such in financial performance. We found a mediation mechanism between political donation and firm performance consisting of the firm's power in the network of board interlocks.

Together these three studies show both the complexity and importance of nonmarket strategy for securing a competitive advantage. However, results also show that strategies regarding board composition and its monitoring functions that are successful in developed economies might not translate with the same effect in emerging markets. Thus, the importance of conducting research in emerging contexts for testing our knowledge on nonmarket strategy. Results of the studies make contributions to the field of strategic management.

Keywords: nonmarket strategy, corporate political activity, political contributions, board of directors

Contents

	Page
Abstract	VI
Introduction	1
Paper #1: Earnings "Mis-management"? The Effect of Board Characteristics and Institutional Context	16
Paper #2: The Mexican Inner Circle in the 21st Century: An Exploratory Social Network Analysis	50
Paper #3: In the Foreground or in the Background? Influence Payments Among Firms in the Mexican Stock Exchange	73
Conclusion	111

INTRODUCTION

"When looking at the overlap of political and corporate spheres, we find that the two realms are growing closer and closer."
(Lock & Seele, 2017, p. 1)

1. Introduction

One of the central questions in the field of strategy is: why do some firms perform better than others? Numerous answers have been provided to this question, ranging from inner resources that provide a competitive advantage, to a better managing of external forces that exert pressure on the firm (Furrer et al., 2008). One common aspect these answers have in common is that most of the theories developed to explain firm success have been developed in advanced economies such as the United States or the European Union. Nevertheless, these insights have modelled how firms in emerging economies have structured their strategy and organizations even they face a different institutional context. Thus, firms operating in emerging economies face different “rules of the game” which increase uncertainty. For many firms, the implementation of nonmarket strategy is a way to overcome the weaker institutional context in emerging economies (Dorobantu et al., 2017).

The idea that nonmarket strategy is equally important as market strategy was generated in developed economies, such as the United States (Boddewyn, 2003), where firms compete in a well-functioning competitive market. According to the World Economic Outlook presented by the International Monetary Fund, from 194 countries in their report, only 39 are advanced economies (International Monetary Fund Research Department, 2018). In these developed economies, the nonmarket strategy of a firm is a complementary set of actions that support the market strategy set by the firm. This is enabled by the “rules of the game” (North, 1990) that are well established and where institutions provide mechanisms that allow firms to operate within certain set boundaries that constrain actors

from manipulating the rules to their favor (North, Wallis, & Weingast, 2009). But in emerging markets, which represent around 85.6 percent of the world's population (International Monetary Fund Research Department, 2018), a weaker institutional setting increases uncertainty for both the economic and political actors (North, Wallis, Webb, et al., 2009).

In this dissertation, nonmarket strategy is the starting point and emerging economies the context for analysis. Before presenting the design and content of the three papers that make up this dissertation, I would like to explore the title of this dissertation to highlight its relevance: "Corporate nonmarket strategy in emerging markets: The case of Mexico". Afterwards, a brief explanation of the three papers part of this dissertation will be summarized. Finally, I conclude this chapter with comments regarding the expected results of the three papers.

2. Dissertation focus

2.1 Corporate nonmarket strategy

Hirschman (1970) was the first to coin the term nonmarket to explain failures of markets, firms, and institutions. In 1995, Baron published two seminal papers that explored the nonmarket strategy system (Baron, 1995a, 1995b). Baron stated that issues, interests, institutions, and information form the nonmarket environment are more country specific than global (Baron, 1995b), and that firms must tailor their strategy to the specific market and nonmarket environments to obtain a competitive advantage (Baron, 1995a). Since then, it has been widely accepted that companies operate simultaneously in a market and a nonmarket environment and design strategies to attend each environment.

Scholars of nonmarket strategy have studied both the social and political aspects of strategies that help shape the "rules of the game" into their favor (Wrona & Sinzig, 2018).

Firms in both developed and emerging economies are incorporating, to different degrees, into their strategic planning the two main areas of nonmarket strategy: corporate social responsibility (CSR) and corporate political activity (CPA) (Mellahi et al., 2016). A nonmarket strategy used in conjunction with market strategy will allow the firm to reach its objectives, which can be broadly summarized in two: (1) increase firm performance and (2) obtain a unique competitive advantage.

In the nonmarket environment, firms are held accountable for their actions by governments, activists, media, among other actors (Doh et al., 2012). Firms often found themselves designing strategies to deal with a myriad of pressures from social and political nature that require their attention (Wrona & Sinzig, 2018). If firms want to address the challenges existing in the nonmarket environment, they must develop a tailored nonmarket strategy, which should be constantly updated to adapt to the changing reality of business (Boddewyn, 2003).

One of the main objectives of a firm's nonmarket strategy is to use public policy to influence the "rules of the game" (Holburn & Vanden Bergh, 2002). North defined institution as the "rules of the game in a society... the humanly devised constraints that shape human interaction" (North, 1990, p. 3) which including both formal rules (i.e. laws and property rights) and informal constrains (i.e. codes of conduct, norms of behavior or conventions). It is clear by this definition of institutions, that each country will have a different set of rules depending both on the formal and informal elements present in that society. Research shows that for nonmarket strategy to be sustainable over time, it must be unique or difficult to replicate by the firm's competitors, as well as tailored to the specific country and industry context (Baron, 1995b).

One important aspect to notice is that emerging countries have not reached the same level of maturity in their institutions and regulations as their counterparts in the industrialized world. Based on the assumption that institutions are unique to each country, and that differences might be greater between developed and emerging economies, there is a need to extend research of nonmarket strategy in the context of emerging countries (Doh et al., 2012).

2.2 Emerging markets: The Mexican case

According to the World Economic Outlook presented by the International Monetary Fund, only 39 countries are classified as advanced or developed economies (International Monetary Fund Research Department, 2018). This small group of developed economies produce 41.3 percent of the world's GDP and possess 14.4 percent of the population (International Monetary Fund Research Department, 2018). It can certainly be said that most of the world's population lives in an emerging country.

The institutional conditions found within a country, will determine how firms will select their nonmarket strategy (Doh et al., 2012). Some researchers have focused on how institutional differences across countries influence desired outcomes, especially when countries from a developed context are doing business in developing countries with less developed institutions (Hillman et al., 2004; Puck et al., 2013). For example, when Walmart, the largest retailer in the world, started its expansion in Mexico, the company used an aggressive policy that included bribe payments to bend the "rules" and obtain permits, which allowed it to become the largest retailer in the country in few years (Barstow & Von Bertrab, 2012; Sethi, 2014). This situation would have been unimaginable in a developed economy, where the presence of stronger institutions and the rule of law would have deterred managers from engaging in such practices.

The present research will discuss the role of nonmarket strategy of firms listed in the stock exchange. The sample of firms was limited to those that are public to be able to access the financial information and other details that public firms are mandated to disclose. Also, the context of emerging economies has been limited to Mexico. Since most of the research on nonmarket strategy has been presented from a United States perspective and context, the Mexican case can provide useful insights on how nonmarket strategies are implemented in emerging contexts.

Mexico's public companies are considered by some to be large family firms in which family ties or friendships shape many of the decisions within the firm (La Porta et al., 1999). This means that "... personal relationships and repeated interaction: a hierarchy of personal relationships among powerful individuals at the top of the social order" (North, Wallis, & Weingast, 2009, p. 32). The importance of personal connections is greater in emerging markets with weaker institutions. It is within this logic that Mexico has been selected as an appropriate context for this research.

3. Studies in the dissertation

Together, these three papers create an understanding of how firms in emerging economies use nonmarket strategy. This section provides an insight into what each paper will cover in the following chapters of this dissertation.

3.1 Paper 1: Earnings Management and Firm Performance in Emerging Economies

The first paper is concerned with the relationship between firm and country characteristics on the likelihood of earnings management. Earnings management is the manipulation of the firm's financial reports (Healy & Wahlen, 1999) and it relies heavily on managerial discretion (García-Meca & Sánchez-Ballesta, 2009). Thus, by doing a panel study of a group of firms in developed and emerging economies over a ten-year period. I

analyze how two board of directors' attributes, CEO duality and board independence, increase the likelihood of earnings management depending on the type of country. Additionally, I added two moderating effects about the institutional context: corruption perception and rule of law. Common wisdom suggests that these are characteristics that are more prevalent in one type of economy and the opposite in the other (high corruption and low rule of law in emerging economies; low corruption and high rule of law in developed economies).

It is important to clarify that earnings management is not an illegal practice, however it can distort or hide the true situation of the firm. The issue arises from the discretion managers have over certain accounting decisions (Chen et al., 2015). Some executives may decide to exert their power to obtain a personal advantage such as showing higher profits in order to access personal performance rewards. Other executives could hide behind this practice to divert monetary resources for questionable payments, including campaign contributions or even corrupt payments. For this paper, the model used for calculating earnings management is the modified Jones model as proposed by Dechow and colleagues (1995).

The objective of setting the research in both developed and emerging economies is to include institutional factors to better understand the conditions that allow firms to incur in earnings management practices. One aspect to measure is if the maturity of the institutions and how that could increase the likelihood of earnings management. The institutional factors studied in this paper include the corruption perception and rule of law.

Results show that CEO duality increases the likelihood in earnings management, regardless of the level of development of the economy. Unexpectedly, board independence had no relevance in developed economies in discouraging earnings management. Also, in

emerging economies independence was found to increase the likelihood of earnings management. These results show the difference that control mechanism might have in an emerging economy, challenging common wisdom.

3.2 Paper 2: The Mexican Inner Circle in the 21st Century: An Exploratory Social Network Analysis

The inner circle is a term used to define “a distinct politicized business segment, if a segment is defined as a subset of class members sharing a specific social location with partially distinct interests” (Useem, 1984, p. 61). In practical terms, the inner circle refers to the top-level executives of the large firms and has been studied through the relationships between board members that sit in different boards, thus creating a connection or interlock (Mizruchi, 1996). Research has shown that during the twentieth century there was a decline in the number of interlocks in several developed economies of North America and Europe (Heemskerk, 2007), thus creating the idea that the concept of inner circle is disappearing (Chu & Davis, 2016; Heemskerk et al., 2016; Mizruchi, 2004).

However, these studies are set in developed economies. This raises the research question: are emerging economies also facing a decline in the number of board interlocks and thus of the importance of their respective inner circles? The purpose of this paper is to present an exploratory study of the Mexican inner circle represented by the firms listed in the Mexican Stock Exchange (Bolsa Mexicana de Valores – BMV). In 2017, the value of just 30 firms listed in the Mexican Stock Exchange represented one-fifth of the country’s gross domestic product (GDP) (Calixto, 2018). Some of these firms are owned by a small group of business people, an economic elite or inner circle, usually connected through family relationships (La Porta et al., 1999), which enable concentration of shares and decisions in a few hands (Caiazza et al., 2018). In addition to familial ties, these firms also

collaborate through interlocking directorates (Husted & Serrano, 2002). This paper seeks to contribute to the understanding of the composition of the economic elite in Mexico in the twenty-first century.

The twenty-first century in Mexico started with political change. For most of its modern history, Mexico was under the rule of one party, sometimes called the “official party”. This situation created a political and economic stability in Mexico for most of the twentieth century (Gil-Mendieta & Schmidt, 1996). Since the year 2000, the presidential election has been won by three different political parties. It was not until recently that firms doing business in Mexico might have considered engaging more actively in the importance of board interlocks to gain a strategic advantage. Consolidating an inner circle in an emerging economy such as Mexico could be a way for firms to influence “the rules of the game” in a country with weak institutions.

For this research, I use social network analysis to map the interlocking directorates of the firms listed in the Mexican Stock Exchange from 2001 to 2015 to see whether the decline that has been reported in other economies is also present in Mexico. This exploratory research is the steppingstone in understanding other aspects of a firm’s strategy that rely on personal connections. By using network theory, I will map the relationships between different board of directors in Mexican public firms. A database with the names and board position of each Mexican firm was constructed using data from the annual reports. Therefore, the sample is limited to those firms that trade in the Mexican Stock Exchange (BMV).

Results show that the inner circle is not disappearing in Mexico as it has been reported in advanced economies. During the 15-year period, the network became denser,

this means that public firms in Mexico have been strengthening their business ties by sharing a larger number of directors.

3.3 Paper 3: In the Foreground or in the Background? Influence Payments Among Firms in the Mexican Stock Exchange

Firms implement nonmarket strategy as a way of influencing their context and advance their objectives. The purpose of this paper is to elucidate two actions, one in the foreground and another in the background, that firm managers use to gain influence, defined as the firm's potential to affect government decisions in order to improve financial outcomes for the firm (Esty & Caves, 1983). In this paper I contend that this influence can be obtained through influence payments, which can be done in two settings: foreground or background. The foreground/background distinction is an adaptation of the theatrical metaphor of frontstage/backstage proposed by Goffman (Ringel, 2018), which captures the idea that people operate in two stages. When acting in the frontstage, individuals comply with the established rules because they are seen by others. On the other hand, when in the backstage, individuals are in a private setting which allows them to perform freely and even engage in behavior that would be condemned if presented in the frontstage.

I contend that firms who want to use influence payments as a form of nonmarket strategy, can do so in one of these two spaces. In the foreground, the influence payments take form of political donations, a typical corporate political activity (CPA) form of nonmarket strategy. These donations are characterized by being regulated, recorded, and monitored. Thus, firms that participate in political donations are incurring in a legitimate practice to enhance their relationships with the political sphere. On the other hand, firms could also opt to implement a strategy in the background and make questionable payments,

such as bribes. In the background, payments are not subject to regulation, recording, and monitoring that political donations are subjected to.

In this paper, I test the effect of foreground (political donations) and background (questionable payments) forms of influence payments on the firm's financial performance. I analyze the firms listed in the Mexican Stock Exchange during the 2006 presidential election, which was characterized by high uncertainty (Domínguez, 2012). Additionally, I contend that there exists a mediation mechanism between these strategies and financial performance, which is facilitated by the firm's power in a network of board interlocks, which are the directors that sit on the boards of more than one company (Galaskiewicz & Wasserman, 1989). This analysis requires the construction of a political donations database as well as the use of a proxy for questionable payments, since accessing data on bribes would be almost impossible. I chose earnings management as a way to identify questionable practices that leave a mark on the firm's financial statements. As mentioned earlier, earnings management relies heavily on managerial discretion and discretionary choices made by executives (García-Meca & Sánchez-Ballesta, 2009; Healy & Wahlen, 1999).

4. Main contributions

I started this introductory chapter to my dissertation by quoting Lock and Seele (2017, p. 1): "When looking at the overlap of political and corporate spheres, we find that the two realms are growing closer and closer." We see in the news how both business and political realms rely on each other for advancing each side's objectives. From the firm side, having a nonmarket strategy in the form of corporate political strategy (CSR) or corporate political activity (CPA) has been a way of finding common ground with the political sphere. However, we know that for nonmarket strategy to be truly effective it has to take into consideration the particularities of the country in which the firm operates.

The three papers of this dissertation tell a story. First, I begin by presenting the differences between developed and emerging countries regarding an accounting practice that relies heavily on managerial discretion: earnings management. By presenting two board characteristics that have been found to be effective in improving transparency such as reducing CEO duality and increasing board independence, we test if those assumptions hold in emerging markets. Additionally, I incorporate two variables related to the level of institutional development of the country: corruption perception and rule of law. The objective is to determine if having in an emerging country the same type of board composition as it is encouraged by the literature, there is less likelihood of firms engaging in a practice that relies heavily on managerial discretion. Thus, this first study answers the call for conducting studies in emerging contexts to test the assumptions we have learned from studies conducted in developed economies.

One aspect that has been present during this dissertation is the difficulty of testing assumptions when data is not available. Access to reliable data might be a certainty in developed economies. However, both access and reliability of the data might not be widely available in emerging contexts. When moving away from the general emerging markets and choosing Mexico as our focus country, database construction was central. This led to early decisions such as focusing on public firms. Databases with information from firm characteristics, firm financial performance, boards of directors, and political donations were required to conduct both the second and third papers. Although the information is public, the information had to be found, requested, and recorded in order to conduct any analysis.

The second paper of this dissertation aims to shed some light on the network of board interlocks or the inner circle of Mexican public firms. This exploratory analysis allows to test another assumption, that is the disappearance of the inner circle, which has been

documented in developed economies. In the literature, the board of directors conducts an important monitoring function for protecting the firm from decisions that might be good for some individuals, but impact negatively the firm's position. Thus, this second paper allows us to have a better understanding of the Mexican board of directors' network. I consider important to get to know the subject of analysis, as it was important for earlier scholars who made such exploratory studies for their regions some decades ago.

Finally, the third paper seeks to integrate the previous two by presenting the foreground and background dichotomy of influence payments. Common wisdom says that in emerging countries such as Mexico executives rely on connections to become more influential. This is a way for firms to operate in a setting in which institutions are not mature as it helps reduce uncertainty. Influence payments done in the foreground or in the background can be strategies to improve performance. By analyzing one of the most contested elections in modern Mexican history, we can learn if firms choosing either path had a positive impact in their financial performance.

There is no doubt that nonmarket strategy is important for firm success, thus understanding the differences between developed and emerging countries will help companies conducting business in the emerging world to choose wisely. When taking the three papers together we can see that the board of directors and some of the assumptions on its composition and connectedness with other boards needs to be reassessed. The level of institutional development found in emerging countries, calls for testing how effectively our assumptions about how boards and directors will behave in countries similar to Mexico. In the next chapters, I will present the three papers detailed in this chapter. At the end, some general conclusions of the three studies will be summarized.

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Paper #1: Earnings "Mis-management"? The Effect of Board Characteristics and Institutional Context

Abstract

Earnings management is the manipulation of the firm's financial reports to appear different than reality, which makes it difficult to assess the real situation of the firm. Managerial discretion has been found to lead to this practice. Although the reasons for any firm to incur in earnings management can be varied and the practice falls within what is legally allowed, it can open a grey area in which the motives for financial statement manipulation can be damaging to the firm or even illegal if used to cover practices such as bribery. We contend that some firms are more inclined to engage in earnings management. Is the board of directors' oversight not effective in preventing this practice? Or could the country-level institutional factors contribute to this practice? This research paper seeks to understand the relationship of firm and country characteristics on the likelihood of earnings management. By better understanding the effectiveness of current corporate governance models, which stress the importance of CEO and board independence to minimize managerial discretion, we advance agency theory when applied to emerging markets who present a weaker institutional setting. For this purpose, we analyzed 1,890 firms from 18 developed and emerging economies during a 10-year period. The findings in this paper will be helpful for firms interested in operating emerging markets where the institutional setting presents an additional challenge to corporate governance. Results also provide insights for governments defining rules and guidelines for firms operating in countries with weaker institutions.

Keywords: corporate governance, earnings management, board of directors

Earnings "Mis-management"?

The Effect of Board Characteristics and Institutional Context

*"Don't do good things that appear to look bad,
and bad things that appear to look good."*

Old Mexican saying

1. Introduction

The complex relationship between principal and agent (Fama & Jensen, 1983) creates an agency problem most firms suffer despite the corporate governance model chosen or the country in which the firm operates. Having a strong corporate governance model can be challenging specially for firms operating in emerging economies (Allen, 2005). Shleifer and Vishny (1997) concluded that corporate governance mechanisms vary greatly around the world. However, some Western practices have been identified in the literature to be effective in alleviating the principal-agent problem (Epps & Ismail, 2009). As a result, firms in both developed and emerging markets have adopted the Western model of governance (Filatotchev et al., 2013) with little adaptation to the local "rules of the game" (North, 1990). It is expected that the board of directors, serving as a monitoring mechanism, will perform correctly regardless of the maturity of the institutions of the country in which the firm operates. As promising as it might be to have a "board formula" that can be implemented in all types of firms, the prevalence of practices such as earnings management by firms in both developing and emerging economies makes us question the real effectiveness of the Western ideal of board composition when applied to firms operating in emerging economies.

There are few multinational studies that focus on emerging markets which, due to their institutional characteristics, may not follow the same patterns between principals and agents as those that apply in developed economies (Bao & Lewellyn, 2017). It is unclear if

the Western model of corporate governance is as effective in emerging economies as it is in developed economies with stronger national institutions. Agency theory is commonly used as the framework for understanding the relationship between the board and the firm's management in both developed and emerging economies (Aguilera et al., 2008; Aguilera & Jackson, 2003). With the recent interest in understanding emerging economies, it is important both for academia, managers, and governments to find other perspectives that account for the specific conditions found in emerging economies (Bao & Lewellyn, 2017).

Earnings management is the manipulation of the firm's financial reports (Healy & Wahlen, 1999) and relies heavily on managerial discretion (García-Meca & Sánchez-Ballesta, 2009). The ambiguity present in earnings management presents an opportunity to further understand if the Western model of board of directors helps prevent earnings management practices in emerging economies as it does in developed countries. The firm's management makes discretionary choices, such as to be more or less conservative with their estimations or adjust their reporting, in order to influence performance and appear better in the eyes of its stakeholders (Chen et al., 2015). Ideally, the board serves as the agent and monitoring mechanism that acts on behalf of the principal (Fama, 1980) and will prevent practices that could harm the firm. There is an opportunity to understand whether the institutional setting helps firms situated in countries with lower economic development to prevent earnings management that could lead to managerial opportunism and consequently to earnings management.

If managers can manipulate earnings despite being monitored by the board, it is important to determine which external factors could enhance or prevent discretionary decisions that might benefit the agent but harm the principal. In this paper, we contend that the Western corporate governance model does not have the same expected results in

preventing earnings management when implemented in emerging economies. By relying on the concepts presented by agency theory (Fama & Jensen, 1983), this paper seeks to contribute to a better understanding of the difference between the effectiveness of current corporate governance models in developed and emerging economies. Two research questions will be presented: (1) How do firm-level characteristics such as board composition influence the likelihood of earnings management? (2) How do country-level institutional characteristics influence the relationship between the board characteristics and earnings management? To answer these questions panel data analysis from 2008 to 2017 of firms in developed and emerging economies was conducted. Results show that beyond traditional agency theory, there is a need for alternate frameworks that explain why firms in emerging economies behave differently than expected. The findings in this paper contribute to the understanding of emerging economies and give insights to firms interested in operating in context where the institutional setting presents an additional challenge to effective corporate governance. Results can also assist governments when defining rules and guidelines for firms operating in their territories.

The rest of this study is organized as follows. The second section will review the relevant literature and present the hypotheses guiding this study. Then, the third section presents the proposed methodology for this research paper, while the fourth section shows the results from the different panel regression models. The fifth section presents the discussion and implications.

2. Literature review and hypothesis development

“Corporate governance and board of director characteristics have implications for the quality of financial reporting” (Iyengar et al., 2010, p. 50). Looking at the prevalence earnings management, a practice that relies on managerial discretion (Lewellyn & Bao,

2017), we can evaluate the effectiveness of monitoring mechanisms that are widely accepted both in developed and emerging countries. We will begin by describing earnings management. Afterwards we present the firm and country characteristics that influence this practice.

2.1 Earnings management

In their seminal paper on earnings management detection, Dechow, Sloan, and Sweeney (1995) observed that firms that were targeted by the authorities (the SEC in the United States), showed evidence of earnings manipulation for private gain. Thus, earnings management is defined as a practice in which managers exert discretion on the manipulation of financial reports (Healy & Wahlen, 1999). This opportunistic behavior intends to mislead external stakeholders on the true situation of the firm, either for a personal gain or an organizational purpose (García-Meca & Sánchez-Ballesta, 2009). The causes for incurring in this practice are varied, but among others include: improved managerial compensation, access to debt, encourage investors to invest in the firm, increase the value of the stock (Dechow et al., 1996).

Earnings management is possible partly due to how accounting guidelines are established and enforced. Chen et al. (2015, pp. 19–20) state that: “Unlike cash-based accounting whereby income or expense is recorded at the time of the cash transaction, accrual-based accounting recognizes income when it is earned and expense when it is incurred, regardless of when the actual cash transaction occurs.” Since accruals are not attached to a cash exchange between the firm and a third party, managers employ their judgement following a set of guidelines which allow certain flexibility in the accounting choices they make (Dechow & Skinner, 2000).

Discretionary accruals are the most common proxy of earnings management used in the literature (García-Meca & Sánchez-Ballesta, 2009; Xu et al., 2007) and it measures the proportion of the accruals that is subject to managerial discretion. The direction of the discretionary accrual, that is if it is positive or negative, is not what is more relevant when studying earnings management, but how far it is away from zero. The number obtained for nondiscretionary accruals is reported as absolute value, the smaller or closer to zero meaning that there are no discretionary accruals in that firm (Sáenz González & García-Meca, 2014). On the other hand, a high absolute value of the discretionary accruals would imply the presence of earnings management. Tang and Chang (2015) found that discretionary accruals have a negative effect on the return on assets which in turns reduces the firm's financial performance.

2.2 Firm characteristics

Agency theory is concerned with the interactions between agents and principals and the problems resulting when their desires and goals differ (Jensen & Meckling, 1976). In principle, both owners and managers share the goal of firm survival. However, there can be situations in which the interests of the agents may be different. The board of directors helps to align the interests of the principal and the agents (Wowak et al., 2011). Monitoring is a fundamental function performed by the board of directors that helps the firm avoid practices that can have a negative effect on performance (Fama & Jensen, 1983). It is therefore in the interest of different stakeholders, from shareholders and potential investors to the government, to understand the mechanisms that help ensure correct monitoring by the board of directors.

One important characteristic of the board is that it is expected to act on behalf of the firm's shareholders (Chen et al., 2015). When a firm engages in a practice such as earnings

management, the information asymmetry between the firm and its owners increases. This situation creates an agency problem, because the actions of the board of directors might not be aligned with the best interest of the people they represent.

2.2.1 CEO duality

CEO duality indicates that the CEO is also the chair of the board (Sáenz González & García-Meca, 2014). When the CEO's evaluation is based on the financial performance of the firm, the incentive for presenting good results is greater. In this situation, managers are tempted to "beat benchmarks" and present a favorable picture of the firm (Dechow & Skinner, 2000). If the CEO is also the chair of the board, he or she will be able to apply their discretion in a more relaxed manner. When CEO duality exists, the CEO's main interest might not be the same as the stockholder's especially under pressure. By manipulating the firm's financial statements, the CEO could protect his or her personal interests while not representing those of the firm's owners.

CEO duality concentrates power in one person, reducing the effectiveness of the board monitoring function. Research shows that firms with CEO duality have lower levels of firm performance (Bradbury et al., 2006; Park & Shin, 2004; Rechner & Dalton, 1991). Therefore, we contend that when a firm presents CEO duality, the board's monitoring function is not as effective as if the roles were separated into two different actors.

H1 *There is a positive relationship between CEO duality and earnings management.*

2.2.2 Board independence

In a board of directors, there are people who are employed by the firm, but also external members who do not have an employer-employee relationship with the firm (Iyengar et al., 2010). So, independent members are part of the board, but do not work for the company or are related to the firm in any way. Previous research on corporate

governance shows that board independence is considered as a proxy for transparency (Sáenz González & García-Meca, 2014). Outside directors have fewer conflicts of interest than directors inside the firm (Chen et al., 2015). As mentioned by García-Meca and Sánchez-Ballesta (2009), separating the board from the management allows effective monitoring, thus reducing the principle-agent conflict.

Research shows that a greater proportion of independent members improves board monitoring of the managers, reducing the possibilities for financial statement manipulation in the firm (Chen et al., 2015). Supporting the idea of stronger monitoring when independent directors are present on the board, Xie, Davidson, and DaDalt (2003) found that earnings management was less likely to occur in firms whose boards had a large proportion of independent directors. Therefore, we contend that the greater the proportion of independent board members, the lower the likelihood of earnings management.

H2 *There is a negative relationship between the proportion of independent board members and earnings management.*

2.3 Institutional characteristics

North (1991) stated that institutions are humanly devised mechanisms that are created to reduce uncertainty, that is they provide the “rules of the game” that actors follow. Corporate governance has developed its own set of rules that help firms establish mechanisms that will help monitor the agent acting on behalf of the principal. Two of such mechanisms are the ones described in the previous section: preventing CEO duality and encouraging board independence. However, these “rules of the game” are influenced by the context in which the firm is located.

The institutional environment is composed both of formal and informal institutions, which provide a framework for firm’s behavior (Keig et al., 2015). It is expected that

depending on the context, that is on the country of operation, a firm will adopt a strategy tailored to that specific institutional environment (Hoskisson et al., 2000). A wide range of factors, both formal and informal, create a unique mixture on the composition of the institutional environment of a country.

Emerging economies have not reached the same level of maturity in their institutions and regulations as their counterparts in the industrialized world. Despite the differences in context of developed and emerging economies, the prevention of CEO duality and the promotion of independent directors is promoted in both sets of countries. However, implementing the Western model of corporate governance is not a guarantee that the monitoring function of the board will be effective across different institutional settings.

In emerging economies, questionable business practices, such as bribery, extortion, nepotism, accounting fraud, or conflicts of interest, are more frequent than in developed economies (Rose-Ackerman & Palifka, 2016). In this paper, we will study two institutional factors that can affect the monitoring function of the board and thus enable earnings management practices: corruption perception and rule of law.

2.3.1 Corruption

Transparency International defines corruption as “the abuse of an entrusted power for private gain” (Rose-Ackerman & Palifka, 2016, p. 9). A corrupt act must be hidden from the public, therefore a more flexible system regarding accounting practices, will be better at “camouflaging” the corrupt act (Riahi-Belkaoui, 2004). This statement is supported by a recent study, that found that countries with higher levels of corruption provide a setting with fewer accounting controls (Lourenço et al., 2018).

One of the problems faced when studying corrupt acts is that there are a variety of ways in which corruption can be manifested (Rose-Ackerman & Palifka, 2016). Søreide

(2014) found that the variation in the levels of corruption found across countries is explained mostly by the differences of the quality of the institutions in the country. In a study of 100 multinationals with operations in emerging countries, Transparency International found that these multinationals had low transparency standards and weak mechanisms for information disclosure (Kowalczyk-Hoyer, 2016). It is important to know that these firms were headquartered not only in emerging markets but came also from developed economies. So, it is not only the country of origin, but the country of operation that influences firm's behavior. As it can be seen in the yearly publication of the Corruption Perception Index, corruption is more prevalent among emerging economies. Therefore, we contend that countries in which corruption perception is higher, the board monitoring function will be less effective. We present the following hypotheses:

H3a *A high level of perceived corruption increases earnings management.*

H3b *A high level of perceived corruption enhances the effect of CEO duality thus increasing earnings management.*

H3c *A high level of perceived corruption decreases the effect of the proportion of board independence thus increasing earnings management.*

2.3.2 Rule of law

One key concept for understanding rule of law is that it requires not only that laws are respected and applied today, but that they provide certainty for the future (Weingast, 2008). Proper law enforcement by the government includes having clear laws and holding accountable public officials, private entities, as well as any other actor. Having strong rule of law in a country will promote effectiveness in different areas, including a reduction in firm's opportunistic behaviors (Sáenz González & García-Meca, 2014). However, when governments fail to regulate issues such as property rights, there is a rise in the firm's

opportunity cost of operating in that country, and managers might be tempted to resort to their managerial discretion to reduce uncertainty (Hoskisson et al., 2000). As posited earlier, CEO duality increases the likelihood of a negative practice, such as financial statement manipulation. However, an institutional setting in which laws are enforced, could help in reducing the effect that the concentration of power in a single individual could have. This is if the manager knows that by incurring in earnings management, he or she is breaking the law and will face a personal consequence, the opportunistic behavior will be halted. So, when the country's rule of law is strong, the effect of CEO duality on earnings management is diminished. Independent board members increase transparency of the board's decisions since they have fewer conflicts of interest. A country with a strong rule of law provides a setting in which independent members can be truly independent and perform their monitoring functions correctly. Therefore, we posit that when there is a stronger rule of law, independent directors will be more effective in their monitoring function, thus reducing a negative behavior such as earnings management. We present the following hypotheses:

H4a *A high level of rule of law decreases earnings management.*

H4b *A high level of rule of law decreases the effect of CEO duality thus reducing earnings management.*

H4c *A high level of rule of law increases the effect of the proportion of board independence thus reducing earnings management.*

The next section will describe the methodology employed in this paper. The first step was to determine if the hypotheses should be tested jointly or separately by group: developed and emerging economies.

3. Methodology

We have presented a series of hypotheses to provide an answer to the research questions regarding board attributes and institutional factors and their effect on the likelihood of engaging in earnings management practices. This section on methodology will detail how the sample was established, the studied variables, and the statistical methods employed in this research.

3.1 Sample and data collection

Earnings management is a construct that requires collection of data from different periods so results can be properly analyzed (Dechow et al., 1995). The full period covered in this study is from 2008 to 2017. Since it is a multi-country study, 18 countries, both developed and emerging economies were selected. Emerging economies were selected from the list provided by Marquis and Raynard (2015). These authors define emerging economies as countries in which informality, government infrastructure, corporate governance, among other characteristics are not mature as those of developed economies (Marquis & Raynard, 2015). A complementary group of developed economies was selected in order to have both sets of institutional development in the sample. A total of 8 developed economies and 10 emerging economies were selected.

Table 1 shows the list of countries, number of firms, and observations. As it will be explained later, the calculation of discretionary accruals requires an additional year for lagging some indicators. Therefore, the column observations also includes the year 2007, which was required for discretionary accrual calculation (the proxy for earnings management), but dropped for further analysis.

Table 1 List of Firms by Country

Country	Firms	Observations 2007-2018	Country	Firms	Observations 2007-2018
Canada	213	2,255	Argentina	7	77
France	100	1,097	Brazil	94	1,019
Germany	27	294	Chile	15	165
Netherlands	19	189	Colombia	10	89
Spain	49	525	Mexico	53	553
Sweden	70	755	Russia	39	427
United Kingdom	175	1,911	South Africa	79	862
United States	761	8,312	South Korea	97	1,005
<i>Subtotal developed</i>	<i>1414</i>	<i>15,338</i>	Thailand	42	457
			Turkey	40	432
			<i>Subtotal emerging</i>	<i>476</i>	<i>5,086</i>

The firm level information was collected using the Bloomberg terminal equity screen (EQS), which provides the information of the firms that were actively trading during the selected period. This database provides financial information which is widely available due to the obligation of public firms to disclose such data. Also, Bloomberg provides ESG (environmental, social, and governance) data containing information on the board of directors. For calculating the dependent variable at least two consecutive years are needed to estimate some parameters. Therefore, for discretionary accruals estimation purposes we downloaded financial information for 2007. The governance information has been recorded from the late 2000s on. However, information availability is limited and varies greatly from developed to emerging countries. The 2007 to 2015 period was chosen in part due to the availability of governance information from 2007 onwards. One of the problems presented when building the database was the missing values in the sample, thus we are presenting an unbalanced panel. Missing values are a common situation when analyzing firms listed in a stock exchange, since each year new firms enter and leave their country's stock exchanges. In order to create a more balanced panel without only including firms that were active for

the 10-year period, only firms who were active 5 or more years during the 10-year period and that had disclosed their ESG data to Bloomberg, were considered for this research.

3.2 Measures

3.2.1 Dependent variable

Dechow et al., (1995) tested several methods for determining earnings management. In their seminal paper, they identified the Modified Jones Model as the best method for detecting earnings management. The Modified Jones Model is a variation of the model proposed by Jones (1991) which estimates nondiscretionary accruals. As mentioned earlier in section 2, accruals are how firms record their activities in their financial statements. Total accruals can be decomposed into nondiscretionary and discretionary accruals, being the latter a proxy for earnings management (Teoh et al., 1998). This means that earnings management occurs when managers manipulate the discretionary part of the total accruals.

The detection of abnormal discretionary accruals is an indicator of earnings management that will be used in this research. The Modified Jones Model has been used in different studies to estimate nondiscretionary accruals (Choi et al., 2013; Sáenz González & García-Meca, 2014; Teoh et al., 1998; Xie et al., 2003). This result is then subtracted from the total accruals to estimate the discretionary accruals. The variable is then transformed using absolute value and entered to the model (Choi et al., 2013).

The information needed to calculate the Modified Jones Model was obtained from data found in the balance sheet of the firms. Since the sample consists of public firms, the balance sheets and income statements were downloaded for each firm-year from the Bloomberg terminal. For calculating earnings management, first the nondiscretionary accruals are estimated following the procedure proposed by Dechow et al. (1995). Please refer to Appendix A for calculating the firm-specific parameters ($\alpha_1, \alpha_2, \alpha_3$) of the Modified Jones

Model (Dechow et al., 1995). Appendix B shows the list name by which Bloomberg identifies these variables.

The Modified Jones Model formula is:

$$NDA_{\tau} = \alpha_1 \left(\frac{1}{A_{\tau-1}} \right) + \alpha_2 (\Delta REV_{\tau} - \Delta REC_{\tau}) + \alpha_3 (PPE_{\tau})$$

where

NDA = nondiscretionary accruals in year τ

A = total assets in year $\tau-1$

ΔREV_{τ} = change in revenue between year τ and year $\tau-1$

ΔREC_{τ} = change in net receivables between year τ and year $\tau-1$

PPE = gross property, plant, and equipment in year τ

$\alpha_1, \alpha_2, \alpha_3$ = firm-specific parameters

Afterwards the discretionary accruals are estimated using:

$$DAC_{\tau} = \frac{TAC_{\tau}}{A_{\tau-1}} - NDA_{\tau}$$

where

DAC = discretionary accruals in year τ

TAC = total accruals in year τ

A = assets in year $\tau-1$

NDA = nondiscretionary accruals in year τ

3.2.2 Independent variables

CEO duality. This variable indicates whether the CEO holds both the general manager and chair of the board positions (Finkelstein & D'Aveni, 1994). The information comes from

the Bloomberg ESG database. The variable is coded 1 if there exists CEO duality and 0 otherwise for each firm-year.

Board independence. This variable indicates the percentage of independent board members (Weisbach, 1988). The information comes from the Bloomberg ESG database. The variable is a percentage between 0 and 100 based on the size of the board for each firm-year.

3.2.3 Moderating variables

Corruption. Transparency International publishes the Corruption Perception Index (CPI), which is a widely known and used measure of corruption (Svensson, 2005). One problem cited by Bardhan (2006) in using perceptions of corruption as an indicator of corruption is that perceptions are not reality, but are bounded by an individual's context. Morris (2008) found that perceptions of corruption are highly linked to the individual's perception of the state of the economy. In the case of the CPI, foreign businessmen are surveyed regarding their experience when doing business in a certain country. Their experience can be very different to that of any other foreign businessman or local in a similar setting. However, perceptions of a corrupt environment can actually impact the level of corruption in that particular place (Søreide, 2014). If both foreigners and locals in a country perceive that the "rules of the game" are not strict, their behavior might be different as if their perception were the opposite due to the level of corruption perceived. The information was obtained from the Corruption Perception Index website for each of the years in the sample. It is important to mention that the CPI score is from 0 to 100, countries with higher scores are perceived as being less corrupt. Therefore, the information was transformed so that the higher scores reflect a higher perception of corruption in a scale from 0 low levels of perceived corruption to 100 high level of perceived corruption.

Rule of law. This index reflects what the general public and experts perceive on the effectiveness of the rule of law in the country. The elements included for the estimation are crime incidence perception, judiciary effectiveness, and contract enforceability. The variable was obtained from the Quality of Governance Standard Dataset 2016 published online by the Quality of Government Institute in Sweden. The data goes from -2.5 to 2.5, with a higher score indicating better rule of law in the country. The data was transformed adding 2.5 to each score in order to have a 0 to 5 scale.

3.2.4 Control variables

One potential problem of not including control variables is that we might not be able to “fully assess the unique contribution of the IV (independent variable) in the presence of other variables or rule out alternative explanations” (Schjoedt & Sangboon, 2015, p. 245). Therefore, three control variables used previously in empirical papers on earnings management are used in this study (Choi et al., 2013; Park & Shin, 2004). The selected control variables are related to the financial performance of the firm. Thus, by using this set of control variables we control for firm size, since larger firms might have additional incentives to incur in earnings management practices (Chi & Gupta, 2009). Additionally, by obtaining the financial information of the firms from the Bloomberg ESG database, we ensure that data collected from the different firms across the different years and countries, received the same processing and thus we can compare firms from different locations and times. However, we acknowledge that in the 10-year period covered in this research, firms in different geographies could have changed from a local accounting standard to an international accounting standard, and thus difficult the measurement process. Regardless of this possibility, we believe that by using the following controls we can reduce some of the variability that is outside our control.

Debt to assets. This leverage ratio is defined as the total amount of debt relative to assets. It enables comparisons of leverage to be made across different companies. It is measured as a percentage.

ROA. The return on assets is an indicator of how profitable a company is relative to its total assets, in percentage. It is obtained by dividing net income by total assets. It gives an idea as to how efficient management is at using its assets to generate earnings.

Total liabilities. This is the sum of both current and non-current liabilities.

3.3 Data analysis

Previous research calls for integrating institutional variables to the study of corporate governance and earnings management (García-Meca & Sánchez-Ballesta, 2009).

Consequently, we have presented the question of whether developed and emerging economies should be analyzed together or separately. Also, due to the nature of earnings management studies, which is a phenomenon best analyzed over time, a longitudinal approach is also recommended. Therefore, the first step proposed in this research is to perform a t-test to determine whether the groups of countries should be analyzed as separate groups. The result of the t-test with unequal variances is $p\text{-value} = 0.2725$ (two-tailed probability). We conclude that the differences between developing and emerging economies is not statistically different from zero, therefore we analyze them together.

Since the sample is composed by a group of firms during a series of years, a panel data analysis was conducted. Stata version 13 was used to run the panel. After performing the Hausman test to determine if fixed effects or panel effects panel was required, the test suggested a fixed effects approach. A modified Wald test for groupwise heteroscedasticity was done and the result showed the data had to be corrected for this condition. Also, a Wooldridge test for serial autocorrelation in panel data was done and results show data does

not present first order autocorrelation. The Pesaran test for cross-section dependence could not be performed since we have an unbalanced panel.

The series of hypotheses proposed in the previous section were tested on both groups of countries, developed and emerging, simultaneously. In the next section we will present the results, beginning with the descriptive statistics and following with our panel regression models.

4. Results

Before running the panel regressions, we conducted descriptive statistics (Table 2) and a correlation analysis (Table 3) of the variables used in this study. When conducting this analysis, we found that the control variables debt to assets, return on assets (ROA) and total liabilities had a larger scale than the rest of the variables of the study. We decided to use the natural logarithm of for total liabilities only, since both debt to assets and ROA are ratios. In Table 3 we observe that most correlations are below ± 0.5 which is expected and desired. However, the correlation between corruption perception index (CPI) and rule of law index (ROLI) is 0.968. This shows that the moderating variables have a multicollinearity problem. Therefore, the moderating effects will be tested separately.

Table 2 Descriptive Statistics

Variables	Count	Mean	Median	Standard Deviation	Minimum	Maximum
Discretionary accruals ⁺	17,957	2.701	0.000	329.673	0.000	44,127.098
Total debt to assets	20,367	28.455	21.628	308.197	0.000	39,311.724
Return on assets (ROA)	20,214	-2.834	4.592	177.187	-13,787.406	2,507.597
Total liabilities ⁺⁺	20,402	6.674	6.864	2.251	-4.154	13.436
CEO duality	17,357	0.291	0.000	0.454	0.000	1.000
Board independence (%)	16,977	64.478	66.670	21.278	0.000	100.000
Corruption Perception Index (CPI)	20,424	67.592	73.000	16.486	21.000	93.000
Rule of Law Index (ROLI)	20,424	1.259	1.610	0.755	-0.970	2.038

⁺ Discretionary accruals are reported as absolute values.

⁺⁺ Total liabilities transformed using natural logarithm.

Table 3 Correlation Matrix

Variables	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
(1) Discretionary accruals	1							
(2) Total debt to assets	0.000	1						
(3) ROA	-0.278***	-0.369***	1					
(4) Total liabilities	-0.022**	-0.000	0.090***	1				
(5) CEO duality	0.032***	0.002	-0.016*	0.047***	1			
(6) Board independence	0.004	-0.038***	0.012	-0.021**	0.096***	1		
(7) CPI	0.003	0.002	-0.018*	-0.112***	0.031***	0.473***	1	
(8) ROLI	0.004	0.002	-0.025***	-0.124***	0.113***	0.493***	0.968***	1

* $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Table 4 presents the results of the panel analyses, for both developed and emerging countries running simultaneously, using Newey-West regression to correct for heteroscedasticity and cross-section dependence. Model 1 is for the control variables, while model 2 includes the direct effects. As mentioned earlier, due to a multicollinearity problem the moderating effects of corruption perception were tested separately needing separate models, 3 for CPI and 4 for ROLI.

When running the models with both developed and emerging countries simultaneously, some interesting results emerge. **H1** stated that CEO duality increases the likelihood of earnings management. It can be seen in model 2 that CEO duality is significant with a p-value of 0.038. However, when running the moderating effect of corruption in **H3b**, the effect was significant but not the predicted sign. Regarding board independence, the direct effect proposed in **H2** was not significant, neither as a direct effect nor as a moderation when corruption or rule of law are present. Rule of law was not found to be statistically significant and when running the direct effect (**H4a**) nor the moderating effects with board independence (H4b). However, the moderation effect between CEO duality and rule of law was significant with a p-value of 0.022, but with the opposite sign. Therefore, CEO duality seems to be a variable to study further.

Table 4 Panel models – All countries

Variables	Predicted sign and Hypothesis	(1)	(2)	(3)	(4)
Total debt to assets		-0.115 (-0.99) [0.322]	0.002 (0.74) [0.458]	0.002 (0.74) [0.458]	0.002 (0.74) [0.458]
Return on assets (ROA)		-0.567 (-0.96) [0.338]	-0.005 (-1.03) [0.303]	-0.005 (-1.03) [0.303]	-0.005 (-1.03) [0.303]
Total liabilities (Ln)		0.924 (0.48) [0.632]	-0.110 (-1.71) [0.087]	-0.110 (-1.70) [0.090]	-0.110 (-1.70) [0.090]
CEO duality	H1+		0.312 (2.08) [0.038]	0.686 (2.12) [0.034]	-0.657 (-2.41) [0.016]
Board independence (%)	H2-		0.001 (0.49) [0.623]	0.001 (0.38) [0.704]	-0.000 (-0.07) [0.942]
Corruption Perception Index (CPI)	H3a+			0.003 (0.68) [0.498]	
CEO duality x CPI	H3b+			-0.012 (-2.15) [0.031]	
Board independence x CPI	H3c+			-0.000 (-0.48) [0.629]	
Rule of Law (ROLI)	H4a-				-0.057 (-0.54) [0.586]
CEO duality x ROLI	H4b-				0.249 (2.29) [0.022]
Board independence x ROLI	H4c-				0.000 (0.20) [0.844]
Constant		-1.963 (-0.18) [0.858]	0.688 (2.07) [0.039]	0.599 (2.10) [0.035]	0.904 (1.48) [0.140]

t statistics in parentheses*p*-values in brackets

Even though the t-test suggested that developed and emerging countries were not statistically significant, we separated the sample into the two groups and generated a new set of models for each type of economy. This will allow us to assess more closely how CEO duality behaves in developed versus emerging economies. Also, to evaluate if the other variables might show a different behavior once the sample is split by the level of country development. Table 5 shows the models for developed economies. The direct effect of CEO duality presented in **H1** was once more supported, as it was found statistically significant (p-value=0.039) and with the predicted sign. The presence of CEO duality in firms operating in developed countries was of 31% and the average score of the CPI from Transparency International was 76 for this group of countries. The moderating effect of CEO duality and corruption perception (**H3b**) was not statistically significant. Board independence is highly present in developed economies with an average of 70% independent members vs non-independent members in analyzed boards of directors. **H3c** that suggested high levels of board independence would lower earnings management, was supported. However, it was interesting to find that for earnings management in developed economies, rule of law was not a significant moderator in any of our hypotheses. This is interesting because all developed countries had ROLI scores above zero between 0.9 and 2.03. This would suggest that firms having CEO duality will be more likely in engaging in earnings management, and that it is the board characteristics more than the institutional environment the one affecting this likelihood.

Table 5 Panel models – Developed economies

Variables	Predicted sign and Hypothesis	(5)	(6)	(7)	(8)
Total debt to assets		-0.115 (-0.99) [0.322]	0.002 (0.74) [0.459]	0.002 (0.74) [0.459]	0.002 (0.74) [0.458]
Return on assets (ROA)		-0.568 (-0.96) [0.339]	-0.005 (-1.02) [0.307]	-0.005 (-1.02) [0.307]	-0.005 (-1.02) [0.307]
Total liabilities (Ln)		1.036 (0.47) [0.640]	-0.126 (-1.69) [0.090]	-0.127 (-1.70) [0.090]	-0.127 (-1.70) [0.093]
CEO duality	H1+		0.398 (2.07) [0.039]	0.341 (1.62) [0.104]	1.322 (1.19) [0.234]
Board independence (%)	H2-		0.000 (0.19) [0.848]	0.006 (1.41) [0.158]	-0.004 (-0.39) [0.698]
Corruption Perception Index (CPI)	H3a+			0.011 (1.59) [0.111]	
CEO duality x CPI	H3b+			0.003 (0.49) [0.626]	
Board independence x CPI	H3c+			-0.000 (-1.83) [0.067]	
Rule of Law (ROLI)	H4a-				-0.039 (-0.28) [0.781]
CEO duality x ROLI	H4b-				-0.226 (-0.97) [0.331]
Board independence x ROLI	H4c-				0.001 (0.40) [0.687]
Constant		-3.225 (-0.24) [0.809]	0.789 (2.09) [0.036]	0.507 (2.13) [0.333]	0.942 (1.17) [0.241]

t statistics in parentheses*p*-values in brackets

Table 6 Panel models – Emerging economies

Variables	Predicted sign and Hypothesis	(9)	(10)	(11)	(12)
Total debt to assets		0.000 (4.67) [0.000]	0.000 (4.55) [0.000]	0.000 (4.54) [0.000]	0.000 (4.65) [0.000]
Return on assets (ROA)		-0.000 (-0.78) [0.436]	0.000 (0.07) [0.947]	0.000 (0.07) [0.942]	0.000 (0.12) [0.906]
Total liabilities (Ln)		-0.001 (-12.58) [0.000]	-0.001 (-11.39) [0.000]	-0.001 (-11.45) [0.000]	-0.001 (-11.57) [0.000]
CEO duality	H1+		0.000 (2.15) [0.032]	0.001 (1.75) [0.080]	-0.000 (-0.79) [0.427]
Board independence (%)	H2-		0.000 (2.10) [0.036]	-0.000 (-0.94) [0.394]	0.000 (2.03) [0.042]
Corruption Perception Index (CPI)	H3a+			-0.000 (-0.85) [0.394]	
CEO duality x CPI	H3b+			-0.000 (-1.52) [0.130]	
Board independence x CPI	H3c+			0.000 (1.32) [0.187]	
Rule of Law (ROLI)	H4a-				0.000 (1.72) [0.086]
CEO duality x ROLI	H4b-				0.000 (1.09) [0.278]
Board independence x ROLI	H4c-				-0.000 (-1.57) [0.115]
Constant		0.004 (12.90) [0.809]	0.004 (10.88) [0.000]	0.004 (6.62) [0.000]	0.003 (6.02) [0.000]

t statistics in parentheses*p*-values in brackets

We also ran the models for emerging economies. Contrasting with the results found on Table 4 and Table 5, the models presented in Table 6 for emerging economies found statistically significant both **H1** (CEO duality) and **H2** (board independence). However, there are two important notes to mention. Challenging general wisdom, we found CEO duality to be less present in emerging economies, with 23% of the firms presenting this condition contrary to almost one third in developed economies. Regarding board independence, the predicted sign was opposite to what expected. In emerging economies, less than half of the board of directors is considered independent (45%). The moderating effects of corruption and rule of law were not significant, even though corruption was more prevalent (42 score CPI average) and rule of law was weaker (0.080).

5. Discussion, Limitations, and Future Research

The information asymmetry between managers and stakeholders may cause earnings management. This asymmetry is a constant that can be reduced, although not eliminated, with a proper board composition. This study researched how does the firm's board attributes increase or reduce the likelihood of earnings management and how does the context of being in developed or emerging country can affect these board characteristics. Understanding the mechanisms by which the information asymmetry between the firm and its stakeholders work, both firms and stakeholders can be better prepared in the detection of financial statement manipulation. However, as seen in this paper, it is not as straightforward as one might think.

Across all models presented, CEO duality seems to have a positive relation with earnings management practices. This confirms our argument that a CEO who is also chair of the board can exert managerial discretion more freely. It is like the saying referring to a "judge, jury, and executioner". A firm with CEO duality will see the monitoring power

captured and therefore more inclined to employ managerial discretion. What was interesting is that this condition was relevant both in developed and emerging economies. Although the lower corruption and higher rule of law of developed economies could theoretically discourage managerial discretion, the results showed the reduction effect was not present. We could say that CEO duality is a condition that affects firms regardless of their country of operation. Further research on the effect of CEO duality on managerial decisions needs to be carried to further understand the effect.

Board independence had not the expected results. In developed economies it was not significant although boards are on average highly independent. However, in emerging economies, although the results were significant, the direction was contrary to what expected. In line with previous research, we proposed that board independence will be effective in lowering earnings management. This would be a result of the independent members not having a personal stake at the company and wanting to maintain their reputation. However, as a study of firms operating in Mexico regarding board independence the effect of independent directors on preventing earnings management is highly dependent on the state of the firm (San Martín Reyna, 2012). Also in a study across firms operating in Latin America, the authors indicate that one of the main limitations for understanding the independence of independent directors is the lack of clarity regarding possible conflicts of interest (Sáenz González & García-Meca, 2014). As found by La Porta, Lopez-De-Silanes, and Shleifer (1999), many firms especially in emerging markets are considered family firms, so many of the independent directors, although not direct employees of the firm, have family or personal ties that might interfere with their monitoring capacity.

This research contributes to the literature by presenting a large analysis of 18 countries in a 10-year analyses of both developed and emerging economies. To the best of

our knowledge, such comparison between developed and emerging countries in the same study has not been done previously. Although common knowledge tells us that there should be differences between countries with different levels of institutional development, earnings management studies are usually single-country studies. Another contribution was to test the effects of corruption perception and rule of law. One may think that these two measures (corruption perception and rule of law) are both sides of the same coin. However, results show that the effects found are not mirror of one another.

Future research could include integrating additional institutional variables such as judicial efficiency and minority shareholder protection. These two variables could help further explain the mechanisms that help control behaviors such as earnings management. Regarding methodology, since we are presenting variables at different levels of analysis (firm- and country-level) a hierarchical panel could help as a complementary set of analysis.

Although the idea behind this research is simple and logical: there is a difference between developed and emerging countries regarding earnings management likelihood. This paper provides additional elements that help understand better the differences and similarities of both sets of economies. With these insights governments and firms operating in developing economies could evaluate if the current governance models should be further adjusted to reflect the different reality prevailing in the emerging world. As Bebchuk and Weisbach (2010) asked almost a decade ago, how can we make boards better? This study is a step in that direction calling for a further and deeper understanding of the differences so that we can now act on improving the monitoring mechanism and have better boards which will not only provide benefits to the firms, but to us all.

Appendix A Discretionary Accruals Calculation

The procedure for calculating the discretionary accruals, which is the variable for earnings management, consists of four stages:

1. Calculation of the total accruals (TA) using this model proposed by Dechow et al. (1995):

$$TA_t = (\Delta CA_t - \Delta CL_t - \Delta Cash_t + \Delta STD_t - Dep_t) / (A_{t-1})$$

where

ΔCA_t = change in current assets in year t minus current assets in year t-1

ΔCL_t = change in current liabilities in year t minus current liabilities in year t-1

$\Delta Cash_t$ = change in cash and cash equivalents in year t minus cash and cash equivalents in year t-1

ΔSTD_t = change in debt included in current liabilities in year t minus debt included in current liabilities in year t-1

Dep_t = depreciation and amortization expenses in year t

A = total assets in year t-1

2. Estimation of the firm specific parameters

$$TA_t = a_1 \left(\frac{1}{A_{t-1}} \right) + a_2 (\Delta REV_t) + a_3 (PPE_t) + v_t$$

where

TA_t = total accruals in year t, scaled by total assets in year t-1

ΔREV_t = change in revenue in year t minus revenues in year t-1, scaled by total assets in year t-1

PPE = gross property, plant, and equipment in year t, scaled by total assets in year t-1

$a_1, a_2, a_3 = \alpha_1, \alpha_2, \alpha_3$ = firm-specific parameters

3. The firm-specific parameters obtained in the second step are then introduced into the Modified Jones Model (Dechow et al., 1995):

$$NDA_{\tau} = \alpha_1 \left(\frac{1}{A_{\tau-1}} \right) + \alpha_2 (\Delta REV_{\tau} - \Delta REC_{\tau}) + \alpha_3 (PPE_{\tau})$$

where

NDA = nondiscretionary accruals in year τ

A = total assets in year $\tau-1$

ΔREV_{τ} = change in revenue in year τ minus revenues in year $\tau-1$, scaled by total assets in year $\tau-1$

ΔREC_{τ} = change in net receivables in year τ minus revenues in year $\tau-1$, scaled by total assets in year $\tau-1$

PPE = gross property, plant, and equipment in year τ , scaled by total assets in year $\tau-1$, scaled by total assets in year $\tau-1$

$\alpha_1, \alpha_2, \alpha_3$ = firm-specific parameters

4. Finally, the discretionary accruals are calculated by subtracting the nondiscretionary accruals calculated in step 3 from the total accruals obtained in step 1 (Sáenz González & García-Meca, 2014):

$$DAC_{\tau} = \frac{TAC_{\tau}}{A_{\tau-1}} - NDA_{\tau}$$

where

DAC = discretionary accruals in year τ

TAC = total accruals in year τ

A = assets in year $\tau-$

NDA = nondiscretionary accruals in year τ

Appendix B List of Bloomberg fields

Variable	Description	Bloomberg field
CA	Current assets	BS_CUR_ASSET_REPORT
CL	Current liabilities	BS_CUR_LIAB
Cash	Cash and cash equivalents	BS_CASH_NEAR_CASH_ITEM
STD	Debt included in current liabilities	NON_CUR_LIAB
Dep	Depreciation and amortization expense	CF_DEPR_AMORT
A	Total assets	BS_TOT_ASSET
REV	Revenue	SALES_REV_TURN
REC	Net receivables	BS_ACCT_NOTE_RCV
PPE	Gross property plant and equipment	BS_GROSS_FIX_AASET

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Paper #2: The Mexican Inner Circle in the 21st Century: An Exploratory Social Network Analysis

Abstract

In recent years it has been reported that the inner circle is disappearing. The inner circle refers to the economic elite of a country, usually composed of the members of the board of directors of the major companies. Research shows that this network of directors is now less connected as it was during the twentieth century. Reports from declining connections show this trend in developed nations from North America and Europe. However, research has focused mostly on developed economies which have a different institutional setting than emerging nations such as Mexico. Are emerging economies, which have weaker institutions, also facing a decline in the number of board interlocks and thus of the importance of their respective inner circles? The purpose of this exploratory research is to present the inner circle of Mexico in the twenty-first century. We use social network analysis to map the interlocking directorates network of the firms listed in the Mexican Stock Exchange from 2001 to 2015 to see whether the decline that has been reported in other economies is also present in an emerging country such as Mexico. This exploratory research is the steppingstone in understanding other aspects of a firm's strategy that rely on personal connections.

Keywords: interlocking directorate, social network analysis, strategy

The Mexican Inner Circle in the 21st Century:

An Exploratory Social Network Analysis

“The organization of the network leaders is the dominant coalition of the society.”
North, Wallis, and Weingast (2009, p. 35)

1. Introduction

There is an ongoing idea that the inner circle is disappearing (Chu & Davis, 2016; Heemskerk, 2007b; Heemskerk et al., 2016; Mizruchi, 2004). The inner circle is defined as “a distinct politicized business segment, if a segment is defined as a subset of class members sharing a specific social location with partially distinct interests” (Useem, 1984, p. 61). A way of studying and understanding the inner circle has been through the study of a firm’s board of directors and its interlocks, which occur when a director sits on multiple boards (Mizruchi, 1996). Research has shown that during the twentieth century there was a decline in the number of interlocks in several developed economies of North America and Europe (Heemskerk, 2007a). This decline has been attributed to different factors ranging from changes in the characteristics of the directors to regulations introduced by the government to prevent firms from becoming too powerful (Chu & Davis, 2016).

However, a basic question arises: are emerging economies also facing a decline in the number of board interlocks and thus of the importance of their respective inner circles? This question is not easy to answer since most of the research on interlocking directorates is done on firms operating in developed economies (Carroll & Sapinski, 2014; Mizruchi, 2010; Sapinski & Carroll, 2018; Zona et al., 2018). Although certain findings from advanced countries can be applied to other economies, only a handful of nations share their same institutional conditions. Based on the assumption that institutions and their “rules of the game” (North, 1990) are unique to each country, and that differences might be greater

between developed and emerging countries, there is a need to extend research of board interlocks to the context of emerging economies.

The purpose of this paper is to present an exploratory research of the Mexican inner circle represented by the firms listed in the Mexican Stock Exchange (Bolsa Mexicana de Valores – BMV). In 2017, the value of just 30 firms listed in the Mexican Stock Exchange represented one-fifth of the country's gross domestic product (GDP) (Calixto, 2018). Some of these firms are owned by a small group of business people, an economic elite or inner circle, usually connected through family relationships (La Porta et al., 1999), which enable concentration of shares in a few hands (Caiazza et al., 2018). Also, it might not come as a surprise to learn that in addition to familial ties, these firms also collaborate through interlocking directorates (Husted & Serrano, 2002). By understanding the Mexican case we can shed some light not only to this specific market, but also gain insights that can be applied to other developing nations with similar institutional conditions. In this paper, we use social network analysis to map the interlocking directorates of the firms listed in the Mexican Stock Exchange from 2001 to 2015 to see whether the decline that has been reported in other economies is also present in an emerging country such as Mexico.

This paper seeks to contribute to the understanding of the composition of the economic elite in Mexico in the twenty-first century. This exploratory research is the stepping stone in understanding other aspects of a firm's strategy that rely on personal connections. We contend that boards of directors, especially in developing economies such as Mexico, are the way in which strategy spreads from one firm to another, thus helping the economic elite maintain their position as one of the dominant coalitions of society (Díaz-Cayeros, 2012). Therefore, having a clearer picture of the reality of the Mexican economic elite will help advance further research.

The rest of this study is organized as follows: Section 2 presents a brief overview of the Mexican case. Then section 3 reviews the extant literature relevant to interlocking directorates and social network analysis. Section 4 presents the proposed methodology for this research paper. Afterwards, section 5 shows the results from the exploratory social network analysis of the network of firms listed in the Mexican Stock Exchange. Finally, section 6 presents the discussion, limitations and future research.

2. The emerging economies: The Mexican case

According to the World Economic Outlook presented by the International Monetary Fund, from 194 countries in their report, only 39 are advanced economies (International Monetary Fund Research Department, 2018). This small group of developed economies produce 41.3 percent of the world's GDP and possess only 14.4 percent of the world's population (International Monetary Fund Research Department, 2018). It can certainly be said that most of the world lives in an emerging or developing economy. North and his colleagues identify two dominant social orders: (1) limited access and (2) open access orders (North et al., 2009). In one hand, in a limited access order countries are more vulnerable to economic shocks, there are a limited number of organizations, government tends to be centralized, and social relationships shape the structure of society, meaning that not everyone is the same (North et al., 2009). On the other hand, in an open access order there is political and economic growth with minimal negative impact, civil society is involved in creation of organizations, government is decentralized, and social relationships are impersonal, meaning everyone is the same (North et al., 2009). Only a handful of countries that are usually labeled as developed, such as the United States, fall under the open access order category. Most nations in the world, including Mexico, are at some level of development of the limited access orders.

We present Mexico as a suitable context for this research, since its institutional context provides an opportunity for expanding our knowledge of interlocking directorates in emerging economies with weaker institutions as those typically found in developed countries. Mexican firms listed in the stock exchange can still be considered as large family firms, in which family ties or friendships shape many of the decisions within the firm (La Porta et al., 1999). This finding fits with the description of a limited access order country that "... builds on personal relationships and repeated interaction: a hierarchy of personal relationships among powerful individuals at the top of the social order" (North et al., 2009, p. 32). Since most of the research on interlocking directorates has been presented from a United States perspective, and context is crucial to understand firms' strategy adoption, the Mexican case can provide with useful insights on how strategies are shaped in most of the emerging world.

For most of its modern history, Mexico was under the rule of one party, the Institutional Revolutionary Party (*Partido Revolucionario Institucional* – PRI), sometimes called the "official party". This situation of a dominant "state-like" party created political and economic stability in Mexico for most of the twentieth century (Gil-Mendieta & Schmidt, 1996). It was not until the year 2000 that an opposition party won a presidential election for the first time since the Mexican Revolution of the early 20th century. Since the year 2000, the presidential election has been won by three different political parties, creating political alternation and thus impacting many aspects of the Mexican society (Soto Zazueta & Cortez, 2015). It was not until recently that firms doing business in Mexico might have considered engaging more actively in the importance of board interlocks to gain a strategic advantage. Since it has become more difficult to know who will win an election in Mexico, firms doing business in the country need to have a strategy to ensure the next

president will be sensitive to their firm's needs. This resonates with the description of North and his colleagues on how the elites have historically been the dominant coalition in limited access states (North et al., 2009). It also shows how consolidating the inner circle as a strategy might aid firms to influence the "rules of the game" to their favor. It is within this logic that Mexico has been selected as an appropriate context for this research.





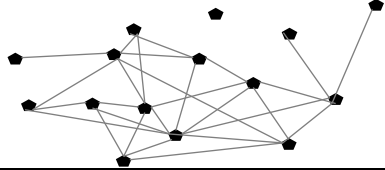
3. Literature review: Interlocking directorates and social network analysis

To reduce the problems created by the tension between principal and agent (Fama & Jensen, 1983), the figure of board of directors serves as a monitoring mechanism. This group of individuals are expected to balance expectations between the firm's owners and managers. Directors are individuals who may or may not be a formal part of the firm, this is, they can be employees or external individuals. For the individual, being part of a firm's board is a sign of personal development and connections (Westphal, 1999). From the firm's perspective, having certain individuals as members of the board, provides a sign of quality (Sun et al., 2012).

Interlocking directorates are a common business practice around the world that allow firms to cooperate and coordinate to reduce uncertainty (Caiazza et al., 2018). Mizruchi (1996) defined an interlocking directorate when a director affiliated to one firm sits also on the board of another firm, providing a link between the two firms. This connection allows the connected firms to exchange information, ideas, and resources (Burriss, 2005). It can be thought that if a firm wants to transform the context into a favorable setting for itself, managers might choose to use an individual approach and be the only ones receiving an advantage. However, context could be important to understand if firms acting in a weaker institutional environment would rather prefer to adopt a collaborative strategy and work together with other firms to pursue similar objectives. Strengthening connections among

firms through board interlocks could be a way for firms to gain a strategic advantage in emerging markets (Wright et al., 2005).

Table 1 Levels of analysis

Visual description	Management	SNA*
	Director	Node
	Interlock (two directors are connected)	Dyad
	Board of directors (same firm)	Ego
	Interlocking directorate (two firms connected at least by one director)	Ego network
	Network	Network

*SNA = social network analysis

Strategy scholars have called researchers into using other perspectives such as social network analysis to get a broader understanding of relationships both within the firm and with external actors, such as other firms or the government (Doh et al., 2012). The use of a network approach consists in shifting from analyzing firms as isolated units to examining a network of related elements (Zaheer et al., 2010). To understand how board interlocks serve as a mechanism to create an inner circle and a joint strategy by groups of firms, we must separate the workings of these mechanisms into five levels of analysis: (1) node–director, (2) dyad–board interlock, (3) ego–board of directors, (4) ego network–interlocking directorate, and (5) network. Table 1 illustrates the different levels of analysis and the common name given both in management and in social network analysis research.

As it can be seen in Table 1, board interlocks are an aggregate of smaller units of individuals and relationships. A director, the smallest unit into which one could conduct an

analysis, is an individual that possesses certain characteristics which are divided into two categories: attributes and roles. Attributes are specific to the individual such as age, gender or tenure. Within a firm the director can have different roles both in the board and in the firm. Inside the board the most important position is the board chair, while in the firm it would be the CEO or head of the company. When the same person presents both of these dual roles, chair of the board and head of the firm, it is called CEO duality (Baliga et al., 1996). Individuals who possess CEO duality, will be in a “stronger” position since they have privileged information from both ends: the firm and the board. When a node (director) who possesses CEO duality sits in another firm’s board, those in the said board will form a dyad with the individual. Thus, when said director possessing CEO duality shares some information to this second board, his or her opinion could have more “weight” than that of other member due to the director’s role in its focal firm. The literature on corporate governance has studied the creation of interlocks and the advantages they give to corporations. This set of advantages has created terms such as the inner circle, a close-knit group of individuals, which is the object of study in this research paper.

4. Methodology

4.1 Sample and database construction

There are calls to study board interlocks over time, since “this is the only way we can truly determine causality between interlocks, director behaviors, and organizational outcomes” (Caiazza et al., 2018, p. 11). To analyze the board interlocks, we need access to information including the name of the firm, the name of the director, and the position occupied by said director within the firm. To build the database, we included only firms who are listed in the Mexican Stock Exchange and therefore required to publish their annual reports to investors and the general public. To the best of our knowledge, there are

no public databases with the information of board members of firms listed on the Mexican Stock Exchange. Although there are databases such as Bloomberg and Capital IQ which present information of board membership, the information presented is only for the current period. Therefore, the first step for constructing the database was to define which firms that were to be part of the network (Knoke, 1990), which was defined as those listed in at least one year from years 2001 to 2015 in the Mexican Stock Exchange. A list of 255 firms listed in the Mexican Stock Exchange at least one year during the proposed period was created.

The next step was to find the information of board members for each firm/year. The firms' annual reports are available both in their corporate websites and in the Mexican Stock Exchange website. In these reports, along with the financial information, the composition of the board of directors is included. However, although board information must be included, the detail of the information is not standardized across firms. Categories for labeling the position and role of the board member were included in the coding phase to capture this diversity. Table 2 presents the labels for both position and relationship of board members used.

The first source for looking for the annual reports was the Mexican Stock Exchange website. If the report was older than 10 years or for some technical reason, usually a broken link, the report did not appear, then the website of the firm was consulted. If the annual report was still not found it was finally searched using Google. After doing this procedure, some firms and years were not available. A total of 21 firms from the 255 were removed from the sample since no annual report was found using the before mentioned procedure. Therefore, the final sample of firms is 234.

Table 2 Labels for role and relationship of board members

Code #	Role*	Code #	Relationship**
1	Board chair	1	Owner
2	Vice-president	2	Independent
3	Secretary	3	Relational
4	Secretary (substitute)		
5	Treasurer		
6	Commissioner		
7	Commissioner (substitute)		
8	Member		
9	Member (substitute)		
10	Member (honorary)		
11	Board chair (substitute)		

** When relationship was not explicitly indicated, relationship was coded as "1 Owner"

*When role was not explicitly indicated, role was coded as "8 Member"

It is important to mention that the information collected represents an unbalanced panel. That is that number of observations, both firms and directors, vary each year. This variation is due to the nature of firms' behavior in a stock exchange. Each year new firms are incorporated while others leave for any of the following reasons: they were acquired by other firm, they decided to get delisted (removed) due to bankruptcy, financial problems, or they were transformed from public to private entities. In the hypothetical scenario that all the 234 firms were listed during the 15-year period, a total of 3,510 firm/years would make a balanced panel. However, since only 51 of the firms in the sample were listed during the whole period, the total number of firm/years is 2,323. From this total, 110 annual reports were either not available or the file was damaged, and it was not possible to consult it. This 110 firm/year represent 4.7% of the 2,323 firm/years. Thus, the final number of firm/years is of 2,213. Table 3 provides a summary of the composition of the database by year. As shown in Table 3, the number of actual firms listed on each year varied from 86 in 2001 to 173 in 2015. Table 3 also presents the number of directors each year and the number of interlocks, this is when a director sits at more than one board during the same year, thus creating a connection with other directors and firms. Due to the length of both directors'

and firms' names, in the database a number was assigned to each director of firm. The next section will describe how the 15-year period of 234 firms with 2,213 firm/year observations was transformed into matrices to be able to use social network analysis.

Table 3 Board of directors' database by year

Year	# Firms	# Directors	# Interlocks
2001	86	1,191	173
2002	122	1,638	266
2003	129	1,737	304
2004	132	1,755	310
2005	149	1,955	360
2006	144	1,863	347
2007	155	1,935	388
2008	154	1,892	388
2009	151	1,861	396
2010	158	1,861	428
2011	159	1,816	454
2012	165	1,952	469
2013	160	1,829	451
2014	165	1,848	441
2015	173	1,930	444

4.2 Matrices for social network analysis

Social network analysis requires data to be presented in matrix form. There are two main types of matrices: 1-mode and 2-mode network matrices. In the 1-mode network, the matrix has a $n \times n$ size and the information represented is either the relationship of directors with other directors or firms with other firms. For this research, a 1-mode network for both directors and firms was created for each of the 15 years in the studied period. The 2-mode network has a $n \times m$ size and represents the relationship between two types of actors. In this case the matrices for *director x firms* were generated for each year from 2001 to 2015. All matrices were first created in Excel and then by using the software UCINET (Borgatti et al., 2002) transformed into an UCINET file for the analyses. Aside from the matrices that

represent relationships between directors and firms, an attribute matrix with characteristics of both directors and firms was created for further analysis.

5. Exploratory social network analysis

One of the most used measures in social network analysis is centrality (Everett & Borgatti, 2005; Freeman, 1978). Centrality has been studied by social network scholars because it provides information on who is the individual or firm with most power, and therefore, occupies a critical position in the network (Valente et al., 2008). The centrality degree measures the number of actors that an actor is directly linked to. The more central an actor, the more powerful.

Centrality is a measure that can be obtained both at the actor and at the network level. For this exploratory analysis, centrality was obtained at network level. Five different indicators for network centrality were obtained, which are summarized in Table 4.

Table 4 Indicators

Indicator	Description
<i>Mean</i>	presents the mean number of relations between the actors from all possible relations.
<i>Standard deviation</i>	shows mean variation, if the number is close to the mean it is an indicator a dispersed network.
<i>Sum</i>	is the total number of all possible relations in the network.
<i>Maximum</i>	shows the maximum number of relations that an actor presented in the network.
<i>Network centralization</i>	indicates the centrality of the whole network, this is how each of the actors plays a central role in connecting the network. A 100% score will indicate a “star network” in which all connections pass by a central actor.

5.1 One-mode network: Directors x directors

Using UCINET, centrality measures were obtained for the 1-mode directors' networks for each of the years covering the period from 2001 to 2015. Table 5 presents the results for each measure per year. As it can be seen on average each director is connected to

10 other directors. With the passing of time, both the mean and the maximum number of connections tend to increase. The maximum number of connections averaged 225. It is important to note that the network centralization indicator remained almost unchanged. The average network centralization was 0.663%.

Table 5 Descriptive statistics: Directors' network centrality

Year	Mean	Standard Deviation	Sum	Maximum	Network Centralization
2001	5.992	13.526	28,916	179	0.598%
2002	8.576	16.810	41,390	221	0.734%
2003	9.843	18.677	47,504	215	0.608%
2004	9.900	19.368	47,778	216	0.610%
2005	11.024	20.067	53,202	219	0.616%
2006	9.958	18.525	48,056	206	0.677%
2007	10.352	18.711	49,960	215	0.707%
2008	10.229	19.040	49,364	250	0.710%
2009	10.243	19.422	49,434	247	0.701%
2010	10.065	19.227	48,572	218	0.616%
2011	10.151	19.804	48,988	256	0.728%
2012	11.065	20.340	53,398	244	0.690%
2013	10.190	19.730	49,178	222	0.627%
2014	9.986	18.876	48,192	222	0.628%
2015	10.139	18.647	48,932	246	0.698%

We wanted to see which of the actors had the greatest betweenness each year.

Betweenness measures how an actor acts as an intermediary between other actors. In network studies, it is usually used as a proxy of social capital. Therefore, using UCINET, we calculated the Freeman betweenness centrality. Table 6 presents only the measure for the most central actor or that with “greater betweenness” for each year of the 2001-2015 period. From the 15 years in the study, ten years have been dominated by one director, Fernando Benjamín Ruiz Sahagún. According to Bloomberg, Mr. Ruiz Sahagún has served in the boards of different companies such as ACCELSA, BOLSA, GMEXICO, GMODELO, KIMBER, MEXCHEM, and SANLUIS.

Table 6 Freeman Betweenness Centrality: Directors' network

Year	Name	nBetweenness	Network Centralization Index
2001	Lorenzo H. Zambrano Treviño	0.765	0.76%
2002	Lorenzo H. Zambrano Treviño	1.217	1.21%
2003	Manuel Francisco Arce Rincón	0.663	0.66%
2004	Vicente Grau Alonso	0.909	0.90%
2005	Ricardo Guajardo Touché	0.942	0.94%
2006	Fernando Benjamín Ruíz Sahagún	0.842	0.84%
2007	Fernando Benjamín Ruíz Sahagún	1.141	1.14%
2008	Fernando Benjamín Ruíz Sahagún	1.131	1.12%
2009	Fernando Benjamín Ruíz Sahagún	1.298	1.29%
2010	Fernando Benjamín Ruíz Sahagún	1.189	1.18%
2011	Fernando Benjamín Ruíz Sahagún	1.209	1.20%
2012	Fernando Benjamín Ruíz Sahagún	1.271	1.26%
2013	Fernando Benjamín Ruíz Sahagún	1.021	1.02%
2014	Fernando Benjamín Ruíz Sahagún	1.041	1.04%
2015	Fernando Benjamín Ruíz Sahagún	1.306	1.30%

5.2 One-mode network: Firms x firms

For the matrices containing the firms' networks, a similar analysis as in the previous section was performed as shown in Table 7, which presents the centrality measures for the firms' network by year.

Table 7 Descriptive statistics: Firms' network centrality

Year	Mean	Standard Deviation	Sum	Maximum	Network Centralization
2001	4.436	11.703	1038	81	1.375%
2002	7.385	15.918	1728	93	1.273%
2003	8.547	16.783	2000	97	1.271%
2004	9.410	18.136	2202	89	1.144%
2005	10.786	19.339	2524	111	1.440%
2006	9.214	16.216	2156	83	0.994%
2007	10.094	16.417	2362	80	1.004%
2008	10.650	17.262	2492	93	1.109%
2009	10.598	17.781	2480	93	1.076%
2010	11.068	17.417	2590	93	1.039%
2011	12.453	18.523	2914	90	0.983%
2012	12.906	18.899	3020	97	1.342%
2013	13.009	19.180	3044	104	1.401%
2014	12.761	18.106	2986	97	1.729%
2015	12.897	17.718	3018	86	1.432%

As it can be seen in Table 7, the mean number of connections between firms almost tripled during the studied period. In the first year, it was 4.436 while by 2015 it was 12.897. In a parallel form, the total number of connections in the network (sum) almost tripled itself. However, it is important to note that the maximum number of connections remained almost unchanged with an average of 92 maximum connections. Network centralization varied throughout the years. The minimum centralization was 0.983% while the maximum was 1.729.

As with the directors' matrices, we wanted to know which firm had greatest betweenness for each of the 15 years of the studied period. Table 8 presents only the firm with greatest betweenness in each year. It shows at the beginning of the studied period a "dominance" of firms based in Monterrey, Mexico such as ALFA, VITRO, and KOF (Femsa). However, as with the directors' matrices, eight of the 15 year-period is dominated by BOLSA. Interestingly, the director with the most betweenness has been member of the board for BOLSA.

Table 8 Freeman Betweenness Centrality: Firms' network

Year	Ticker	nBetweenness	Network Centralization Index
2001	ALFA	2.067	0.0200
2002	VITRO	2.558	0.0241
2003	SANLUIS	3.285	0.0313
2004	SANLUIS	2.355	0.0215
2005	BACOMER	2.532	0.0233
2006	KOF	2.391	0.0219
2007	BOLSA	4.735	0.0455
2008	BOLSA	4.627	0.0441
2009	SANLUIS	3.098	0.0289
2010	BOLSA	6.263	0.0603
2011	BOLSA	4.978	0.0476
2012	BOLSA	4.053	0.0381
2013	BOLSA	3.805	0.0359
2014	BOLSA	3.792	0.0357
2015	BOLSA	4.319	0.0404

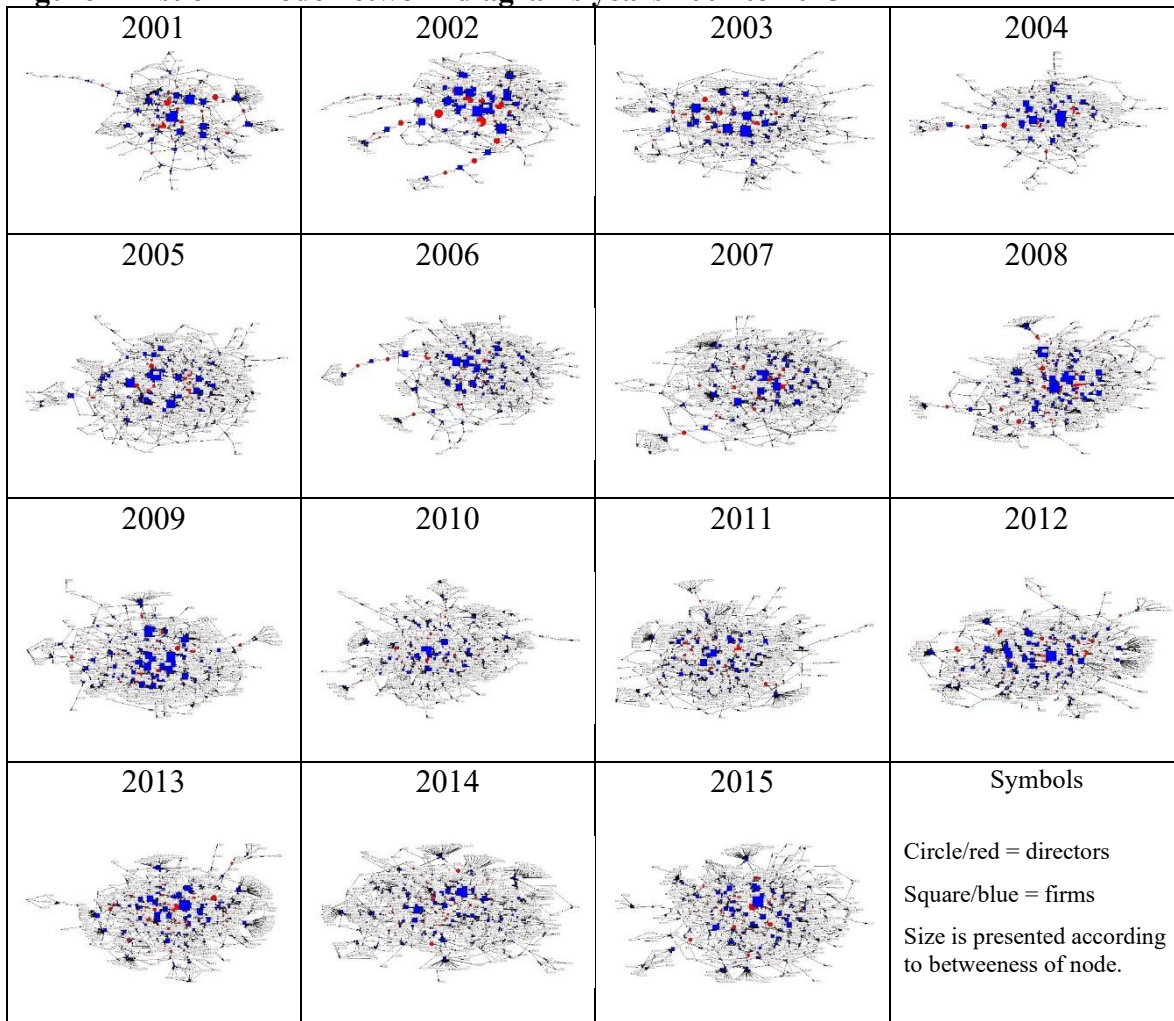
5.3 Two-mode network: Directors x firms

Some of the most interesting analyses come from studying two mode networks due to the interactions between two sets of actors, in this case directors and firms. However, due to the complexity of calculating certain indicators because matrices are not square, the approach was different.

For this exploratory research, only a graphical representation of each network and year was generated. Using NETDRAW (Borgatti, 2002), a graphical representation of each year's network was generated. Figure 1 presents a composition of the fifteen two-mode matrices. The nodes representing directors are red circles and the representing firms are blue squares. We also scaled the size of the nodes to represent betweenness. A bigger node represents consequently a director or firm with the highest betweenness level. Another important consideration is that firm or directors that were isolates were removed from the graph. An isolate is a node, a director or a firm, that has no connections to any other nodes. Therefore, in a graphical representation they would appear "floating" without any line (arrow) that connects that node to the rest of the network.

From this visual representation it can be seen that as the number of both directors and firms grew over the studied period, the network appears to be denser. This visual representation corresponds to what the one-mode network analyses of the directors and firms' matrices show: the interlocks of directors and firms listed in the Mexican Stock Exchange have grown during the period from 2001 to 2015, thus contradicting the idea of a declining inner circle in the United States.

Figure 1 List of 2-mode network diagrams years 2001 to 2015



5.4 Results

After conducting the descriptive statistics, 1-mode, and 2-mode network analyses, some patterns can be seen which support the idea that the Mexican inner circle is not disappearing. We follow the seminal work of Davis and Mizruchi (1999) in which they analyzed the decreasing role of banks in the United States. The authors use centrality as a measure that helps understand the declining role of banks in American boards. In table 5, we see that in the 15-year period the mean number of board interlocks grew from 5.992 in 2001 to 10.139 in 2015 for the directors' network. This result shows that directors

increased their ties with other directors in 69%. When looking at table 7 which shows the firms' network centrality, we can see that the mean number grew from 4.436 in 2001 to 12.897 in 2015. This represents an increase in ties between firms of 290%.

In their study, Davis and Mizruchi (1999) present a comparison of the most central firms in the first and last years of their study. To select the top firms they estimated the Bonacich centrality, which “weights interlock ties according to the interlock partner's number of ties such that sharing a director with a firm whose other directors serve on many boards is weighted more heavily than sharing a director with a firm with few ties.” (Davis & Mizruchi, 1999, p. 227). We present the results using this measure for the firms in the Mexican Stock Exchange in Table 9. Even though the top ten firms changed between the first and last years of the studied period, the centrality measure has become larger, thus indicating that the Mexican inner circle has been strengthening over the years.

Table 9 Ten Most Central Firms in the Mexican Network, 2001 and 2015

Ticker	2001		Ticker	2015	
	Centrality	Normalized		Centrality	Normalized
TELMEX	119,669.45	4.813	GPH	158,231.80	6.012
GCARSO	111,679.74	4.492	GNP	156,011.97	5.928
AMTEL	80,376.84	3.233	PE&OLES	154,387.25	5.866
TELECOM	78,224.23	3.146	GPROFUT	115,020.56	4.370
GSANBOR	75,235.02	3.026	FEMSA	103,039.32	3.915
GFINBUR	74,145.91	2.982	KOF	95,009.00	3.610
AMX	30,262.70	1.217	FRES	53,303.49	2.025
SANLUIS	22,452.12	0.903	BACOMER	43,508.77	1.653
KIMBER	19,033.11	0.766	TLEVISA	42,635.72	1.620
GMEXICO	17,900.55	0.720	DINE	30,221.90	1.148

6. Discussion, Limitations, and Future Research

We opened this paper with a simple question: are emerging economies also facing a decline in the number of board interlocks and thus of the importance of their respective inner circles? Based on this exploratory analysis of the Mexican case we would answer no. Contrary to the trend that has been seen in advanced countries such as the United States, we

can see that the firms listed in the Mexican Stock Exchange intensified their relationship in recent years. It is important not only to analyze the trend of growing interlocks, but also to link what is seen through social network analysis with the context, what was happening in the country as these relationships were strengthened.

Social network analysis is a powerful research technique that can help us understand complex relationships. In strategy, some of the relationships that are studied involve not only different levels of analysis within the organization, but also the relationships between different sets of firms. By using both matrices and diagrams, we can map a complex network of relationships and identify powerful individuals.

This study is not without limitations. Some important firms operating in Mexico might not be listed in the Mexican Stock Exchange, which will make it impossible for us to collect the information needed for analysis. Although the firms listed are not all the important firms in the country, they provide a good idea given that they represent an important part of the country's GDP.

We hope that this analysis and future findings can be helpful not only for further understanding of the Mexican case, but also to shed light to firms and managers operating in emerging countries, in which what has been found in other advanced economies might not always provide a satisfactory answer that explains what is happening.

This is an ongoing research for which this paper represents a first step. Now that the picture of the interlocking directorates for Mexico has been presented, we can perform further analysis that can help answer some questions, especially those in which relationships between individuals are important. As Useem noted "when the inner circle enters politics, its capacity to act, and its central concerns are decisively shaped by the economic and social foundation on which it rests" (Useem, 1984, p. 57). One of the further

research avenues we pursue is the understanding of the corporate political strategy that has been adopted by firms operating in Mexico since the year 2000 election. We believe that directors and their interlocks are an important path by which this political strategy is communicated among individuals of the inner circle. The economic elite has many ways of maintaining its predominant position in society. We as scholars of strategy, can help in understanding these mechanisms which are critical for transforming emerging, limited access economies into developed, open access countries.

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**Paper #3: In the Foreground or in the Background? Influence Payments Among
Firms in the Mexican Stock Exchange**

Abstract

Firms in emerging markets rely not only on their market strategies but on their relationships with government officials in order to advance their objectives by shaping the context in these markets characterized by weak institutions. In this study the premise is that firms that support candidates running for office will receive some benefit, which will be reflected in their financial performance. However, we hypothesize that influence payments have two ways of being conducted with different results: in the foreground are those donations given to political parties which are recorded and monitored by the authorities. In the background are questionable payments such as bribes, which are hidden from the public eye but will leave a mark on the firm's financial statement. For testing the differences between both strategies, we analyzed the firms listed in the Mexican Stock Exchange during the 2006 presidential election, which was characterized by high uncertainty. Results show that 1) in the foreground there is a mediation mechanism between political donation and firm performance consisting of the firm's power in the network of board interlocks and 2) there is a negative direct effect on financial performance for firms who donated in the background. These results help advance our understanding of political strategies in emerging markets.

Keywords: nonmarket strategy, political strategy, board interlocks

In the Foreground or in the Background?

Influence Payments Among Firms in the Mexican Stock Exchange

“The question, then, is whether the only force that keeps us from carrying out misdeeds is the fear of being seen by others”.

Ariely (2013)

1. Introduction

Recent cases portrayed in the media show firms obtaining benefits from their government relationships. Firms must rely heavily on their capacity to influence other firms and political leaders, especially in emerging markets characterized by weak institutional settings (Levitsky & Murillo, 2009). However, firms might choose one of two broad approaches when engaging with the government: strategies in the foreground such as “campaign donations (which) are highly visible and easily accessed” (Kowal, 2018, p. 6) or strategies that remain in the background such as questionable payments (e.g., bribes) “to obtain the minimum benefits necessary to ensure the survival of the firm” (Faccio, 2006, p. 380).

There are different examples of how firms in emerging markets influence governments to advance their strategies. In 2004, the Mary Nour, a ship loaded with cement, was denied access to Mexico after Cemex, one of the largest cement manufactures in the world, used its position as dominant player in the industry to prevent the ship to dock in Mexican ports, forcing it to eventually turn away (Lyons, 2004). After years of legal battles and media coverage, the authorities fined Cemex after it was proved that the company used its influence, to block the entrance of a cheaper cement option (Stevenson, 2012). This influence went from cement suppliers in Indonesia and Taiwan to cement brokers in Switzerland, that backed up to sell cement to the company behind the Mary Nour

after being pushed by Cemex (Lyons, 2004). In Mexico, the government denied the importing company a registry as an authorized cement importer in response to pressure from the Mexican National Cement Chamber, in which Cemex was the largest of its five members at the time (Stevenson, 2004). However, there are cases of influence that are hidden from the public eye, such as the corruption of the Brazilian construction multinational Odebrecht (Gallas, 2019). This company bribed government officials to win contracts in many countries especially in emerging markets. Eventually, Odebrecht was the subject of investigations in many Latin American countries involving politicians and businesspeople (Shiel & Chavkin, 2019). Ongoing research suggests that Odebrecht had an intricate network of bribe recipients which allowed the company to win bidding processes, ignore environmental regulations, and even alter legislation (Durand, 2019). As seen from these cases, firms use their influence to move their interests forward, especially in countries where the institutional setting and the rule of law are weak.

The purpose of this paper is to elucidate two actions, one in the foreground and another in the background, that firm managers use to gain influence, defined as the firm's potential to affect government decisions in order to improve financial outcomes for the firm (Esty & Caves, 1983). Previous research has found that a "direct link between market power and political power is clear: economic rents translate into political influence through campaign contributions, bribes, or other forms of CPA (corporate political activity)" (Weymouth, 2012, p. 6). However, we contend that there exists a mediation mechanism between these strategies and financial performance, which is facilitated by the firm's power in a network of board interlocks, which are the directors that sit on the boards of more than one company (Galaskiewicz & Wasserman, 1989). We hypothesize that by donating to the

incumbent party, firms acquire more power in their network, which they can leverage for a positive impact on their financial performance. On the other hand, since analyzing questionable payments such as bribes would not be possible due to the nature of that action, we use earnings management as a proxy. Earnings management is an accounting practice that can be used to measure managerial discretion. We hypothesize that by showing improved financial numbers, managers acquire more recognition in the network of board interlocks which allows them to become more connected and affect the firm's performance.

For testing our hypotheses, we study the network of firms listed in the Mexican Stock Exchange during the 2006 Mexican presidential election, which was marked by heightened political uncertainty (Domínguez, 2012). The findings contribute to the nonmarket strategy literature in emerging economies, which has been under-researched due to the difficulty of obtaining data. The findings can be helpful to create and shape public policy regarding influence payments by individuals who are board members of public companies and the possible conflicts of interest they might cause. Also, the findings have implications for policy to define oversight measures on questionable accounting practices that could lead to bribery.

The rest of this paper is organized as follows: section 2 presents the theoretical framework and development of hypotheses. Then section 3 presents the proposed methodology for this research paper. Section 4 shows the results from the analysis of the Mexican network of firms. Finally, section 5 presents the discussion, limitations, and directions for future research.

2. Theoretical Framework and Development of Hypotheses

The literature has acknowledged that for firms to be successful in the long-term they need to integrate both market and nonmarket strategies (Baron, 1995). Nonmarket strategy “refers to a firm’s concerted pattern of actions to improve its performance by managing the institutional or societal context of economic competition” (Mellahi et al., 2016, p. 144). The nonmarket strategy of firms can take the form of corporate social responsibility (hereafter CSR) or corporate political activity (hereafter CPA), and both are used to reduce uncertainty by creating social and political goodwill (Mellahi et al., 2016).

There are several incentives for firms across different countries and industries to become politically connected. These incentives include preferential treatment, lighter taxation, relaxed regulatory oversight, among others (Faccio, 2006). However, nonmarket strategies can be difficult to achieve since the interested firm might not have the financial or relational resources to establish a relationship with the incumbent government leaders. Rajwani and Liedong (2015) identify three broad categories of strategies executives use to influence the government: 1) financial strategies (contributions to PACs and soft money), 2) relational strategies (political connections), and 3) informational strategies (lobbying, petitions, and comments). However, this categorization presumes different actions that are set in the foreground and are somehow regulated or overseen by the authorities.

In this study, we contend that executives who want to develop an influence strategy by supporting politicians through influence payments, can opt to do so either in the foreground, with campaign donations, or in the background, through questionable payments such as bribes. We chose political donations as a strategy that is in the foreground and which is characterized by being legal, regulated by the authorities, and registered. This last

characteristic allows the public, media, and researchers to access information. In contrast, since we cannot access data on questionable payments, we decided to study earnings management as a proxy, not for bribes per se, but for questionable practices that are kept in the background.

Figure 1 Theoretical model

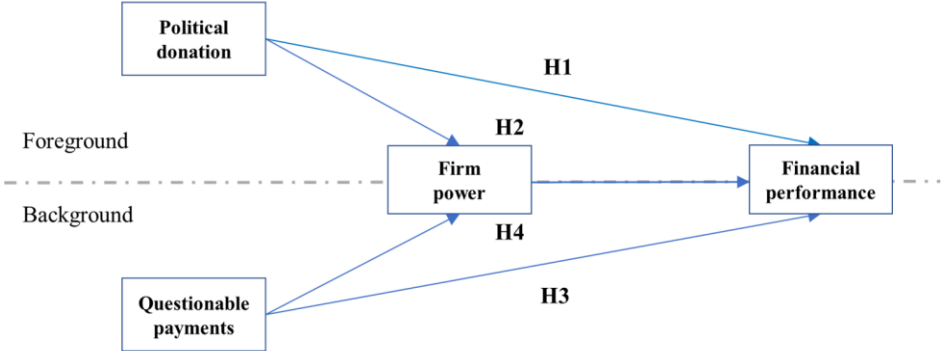


Figure 1 shows the theoretical model followed in this research. The model is divided into two sections to represent the foreground and background, which is an adaptation of Goffman’s theatrical metaphor of two spaces: 1) frontstage, where “individuals display their compliance with and endorsement of generally accepted societal norms and values” (Ringel, 2018, p. 60) and 2) backstage, where “the organizational ‘maladies’... are directly related to the invisibility of backstage behavior (corruption, leniency in rule enforcement, inefficiencies, micropolitics, crooked deals, etc.)” (Ringel, 2018, p. 69). In this research, foreground and background represent two metaphorical spaces in which the foreground is closer to the viewer’s eyes so whatever happens is easier to see (Feng & O’Halloran, 2013) and where actors comply with socially accepted rules. In contrast, the background is set behind the foreground, and further away from the viewer’s eyes, giving the opportunity to individuals to incur in questionable practices. We use this metaphor in our theoretical model: political donations are in the foreground, where they are regulated, recorded, and

monitored. Questionable payments are hidden from sight; therefore, we will use earnings management as a proxy to “see” if some questionable managerial practices might be occurring in the background, out of our sight.

In the next subsections we will present first our dependent variable, financial performance. Then, we will explain the foreground and present a mediation between political donations, the firm’s power, and financial performance. Finally, we will present the background, where we will explain the proxy earnings management and present a mediation model for this questionable practice, firm’s power, and the effect on financial performance.

2.1 Financial performance

Financial performance is a broad term usually used to describe the financial health of a firm (Kenton, 2020). Financial performance can be measured in three ways: 1) market-based (such as the share price in public companies), 2) accounting-based (through indicators such as return on assets-ROA), and 3) perception-based (based on surveys where respondents estimate how the firm is performing compared to others) (Orlitzky et al., 2003). In this research we use the accounting-based distinction because “accounting returns are subject to managers’ discretionary allocations of funds to different projects and policy choices” (Orlitzky et al., 2003, p. 408). Financial performance accounting measures are seen as critical to the success and survival of the firm. In their classic article, Cochran and Wood (1984) mention that accounting returns are one of the primary methods of measuring financial performance. “The basic idea behind using accounting returns as a measure of financial performance is to focus on how firm earnings respond to different managerial policies” (Cochran & Wood, 1984, p. 46). As mentioned earlier, when the firm’s management decides to become politically connected an improvement on financial

performance is among the results that are expected. Thus, in this research we expect to see a positive effect on the financial performance when firms engage either in political donations or in questionable payments. As a note, we are not endorsing questionable payments such as bribery as a legitimate way for increasing financial performance, however, from a managerial point of view, bribery would only make sense if it helped advance the firm's objectives (see Walmart Mexico case in Sethi, 2014).

2.2 Foreground hypotheses

In this research, the foreground consists of the strategic actions that firms make that have three characteristics: 1) regulated by the authorities, 2) recorded by the firm, and 3) monitored by an entity external to the firm. As with Goffman's frontstage concept, being in the "public light" encourages firms to behave according to the social norms. Therefore, for examining a political strategy that fits the foreground description, we choose corporate political donations to parties and their election campaigns.

Corporate political donations serve as a mechanism for firms to gain access to the government and shape the "rules of the game" (Lu et al., 2016). The practice of giving donations to politicians is performed in many countries. However, depending on the country of operation and the level of political resources, there are variations set by the laws and regulations in each place (Zhang et al., 2016). Political donations can be made by individuals (Ovtchinnikov & Pantaleoni, 2012), corporate directors (Lu et al., 2016), political action committees (PACs) (Tripathi, 2000), or firms (Harrigan, 2017). Also, donations can be directed towards a specific political party (Acker et al., 2018; Fink, 2017) or candidate (Bronars & Lott, Jr., 1997). The maximum amount that can be donated is usually limited by the local laws and regulations (Alzola, 2013).

From a firm's viewpoint, corporate political donations are an instrument to shape the regulatory environment (Funk & Hirschman, 2017) in ways that improve the financial performance of the firm. Teichman (2002) explores the relationships of the private sector and the government in Argentina, in which big companies supported the presidential campaign of Carlos Menem with political donations. In her research, she documents that in Argentina "members of the private sector were involved in the development of tenders assuring them not only of winning the bids but of advantageous terms" (Teichman, 2002, p. 496). This example shows through the exchange of resources such as political donations that firms can obtain favorable decisions from government officials (Hadani et al., 2017).

"Performance benefits accrue to firms that create linkages with the political environment" (Hillman et al., 2009, p. 1413). Creating a relationship with politicians is a way for firms to secure future benefits. In a quid pro quo relationship, when the supported politicians get elected, the firms that supported the campaign would be benefited. The influence granted by the political donation, could allow firms to have a closer relationship with the government officials and mold the "rules of the game" to their benefit. The benefits of those adjustments in the regulatory environment will reflect in an improved financial performance. This leads to our first hypothesis:

H1 *Political donations have a positive effect on the firm's financial performance.*

However, when reviewing the causes and effects of political donations the literature has been more concentrated in developed economies (Sun, 2018). Most of what we know about the effect of political donations is based on the United States political system which 1) has a strong set of institutions that regulate political donations and 2) records are available for public scrutiny. From studies set in this context, it is estimated that firms that engage in lobbying and campaign contributions, can achieve up to a 20% increase in their

value (Mellahi et al., 2016). Also, split giving, that is donating to more than one candidate, is rarely done in the United States because of the regulations on PACs (Mizruchi, 1989). In contrast, according to the database Party Facts, based on research by Coppedge (1997), in Latin American countries the average number of political parties per country in the region during the 20th century was 23 political parties.

Thus, we argue that political donations in emerging economies present a different reality to that of developed economies (Boas et al., 2014). We propose that in weaker institutional contexts, the connections that the firm has established with other firms in the network through board interlocks, will be important for having a positive effect on financial performance resulting from political donations. We contend that firms use board interlocks as a means of gaining political power. In the case of Mexico, publicly-listed firms rely heavily on board interlocks (Musacchio & Read, 2007) even creating powerful groups such as the Monterrey business group (Teichman, 2002) or the *CMHN-Consejo Mexicano de Hombres de Negocios* (in English the Mexican Council of Business Men) (Ortiz Rivera, 2002). In these cases, managers invited to sit on different boards have more connections and thus increase their firm's power within the network of interlocked firms. We define power as a relational phenomenon, in which the beliefs and behaviors of one actor are affected by those of another actor (Lawrence, 2012; Smith et al., 2014).

Power and power relations in organizations are difficult constructs to observe, define, and operationalize (Clegg, 1989). Thus, we will use the concept of power-as-access defined as the "actor's potential to access other actors' resources through the actor's position in the network" (Smith et al., 2014, p. 163). This means that actors can be powerful if they have more connections to other actors. "Actors who are the most important or the most prominent are usually located in strategic locations within the network" (Wasserman &

Faust, 1994, p. 169). These strategic locations provide the actors with certain characteristics that denote how powerful they are for the functioning of the whole network. Since power is derived from the relationships between actors, the location of the firm in the network will define who has power (Scott, 1991).

Ibarra (1993) mentions that network centrality is a source of firm power, which implies holding a high position in the status hierarchy in the network. When directors become recognized by other firms in the network and accept invitations to join other boards, a new board interlock is created between two firms. These interlocks increase the connectedness of the firm, thus increasing its centrality in the network. When a firm is more central, it has access to more resources that might previously been unavailable to the firm. Thus, having a central position in the network has been found to have a positive effect on firm performance (Larcker et al., 2013; Takes & Heemskerk, 2016).

Political donations by board directors help the firm increase its influence over the political parties and candidates. As mentioned earlier, when a member of the board supports a political candidate, the expectation is to receive some benefit when the politician gets elected. Bond (2007, p. 64) mentions that “corporations will make donations when the expected political benefit of a corporate donation exceeds the cost of the donation.” However, the political donation by itself might not be enough for the benefit to materialize. When board members of a firm engage in political donations, those board members become more attractive to other firms, fostering interlocks and thus power within its network (Lu et al., 2016). That resulting power within the network increases the influence of political donations, resulting in benefits from the elected officials that eventually translate into an improved firm performance. Therefore, we contend that firm power as a higher number of

board interlocks will mediate the relationship between the political donation done by its board members and the resulting firm performance.

It has been found that there exists a positive relationship between a board that has a high number of connections to other boards and the firm's performance (Horton et al., 2012). The positive effect on the firm's profitability is achieved due to the connections the interlocking directors make with other directors in different firms, which gives them more opportunities among other things to access resources and information that can be used to give an advantage to the firms in which they sit (Horton et al., 2012). In a separate study, it was found that "firms with well-connected boards experience a larger increase in future profitability" (Larcker et al., 2013, p. 240). Therefore, we expect that firms whose boards exhibit high centrality will positively affect the firm's financial performance. This leads to our second hypothesis:

H2 *Firm power will mediate the relationship between political donation and financial performance.*

2.3 Background hypotheses

In this research, the background consists of the strategic actions that firms make hidden from the public eye. According to Ringel (2019), for organizations there are three types of secrets kept in the backstage: 1) strategic secrets (includes hidden practices in order to achieve instrumental goals), 2) inside secrets (which grant an individual membership in a certain group), and 3) dark secrets (include practices like corruption or bribery that are legally wrong or ethically questionable). Therefore, for analyzing a strategy in the background, we need to use a proxy, as it would be almost impossible without insider information to obtain data on questionable payments. Thus, we selected earnings

management as an accounting practice that can signal managerial discretion, which can include questionable managerial practices (Fields & Keys, 2003).

Generally questionable payments or questionable practices cannot be observed directly. However, they can leave a trace through the firm's accounting system in the form of earnings management, which is the manipulation of the firm's financial reports (Healy & Wahlen, 1999) and represents managerial discretion (García-Meca & Sánchez-Ballesta, 2009). The firm's management makes discretionary choices, such as to be more or less conservative with their estimations or adjust their reporting, in order to influence performance and appear better in the eyes of its stakeholders (Chen et al., 2015). In their seminal paper on earnings management detection, (Dechow et al., 1995) observed that firms that were targeted by the authorities (the SEC in the United States), showed evidence of earnings manipulation for private gain. This opportunistic behavior misleads external stakeholders regarding the true situation of the firm, for either personal gain or an organizational purpose (García-Meca & Sánchez-Ballesta, 2009).

The causes for engaging in this practice are varied, but include, among others: improved managerial compensation, access to debt, encouraging investors to invest in the firm, increasing the value of the stock (Dechow et al., 1996). Earnings management is possible partly due to how accounting guidelines are established and enforced. Chen et al. (2015, p. 1397) state that: "Unlike cash-based accounting whereby income or expense is recorded at the time of the cash transaction, accrual-based accounting recognizes income when it is earned and expenses when they are incurred, regardless of when the actual cash transaction occurs." Since accruals are not attached to a cash exchange between the firm and a third party, managers employ their judgement following a set of guidelines which allow certain flexibility in the accounting choices they make (Dechow & Skinner, 2000).

We contend that when a manager chooses to exercise her/his discretion and engage in earnings management, at the core of that decision is the search for showing good financial results, as that is the measure by which her/his job will be assessed by the board. As Fields and Keys (2003, p. 14) mention: “The incentive for earnings management is clear. Firms that are unable to meet or beat analyst expectations pay a penalty in the marketplace.”

Thus, when managers use their discretion and engage in earnings management, the firm’s financial results will show an improved firm performance in the short term (Braam et al., 2015; Jiraporn et al., 2008; Tabassum et al., 2015). This leads to the third hypothesis:

H3 *Questionable payments have a positive effect on the firm’s financial performance.*

If some managers can manipulate earnings despite being monitored, it is important to determine how this discretionary use of firm’s resources will be affected depending on the firm’s position within the network of board interlocks. The board of directors is expected to act on behalf of the firm’s shareholders (Chen et al., 2015). When a firm engages in a practice such as earnings management, the information asymmetry between the firm and its owners increases, with managers making decisions that might not be aligned with the best interest of the people they represent. Thus the use of earnings management is “a means of influencing the accounting message to external stakeholders” (Hong & Andersen, 2011, p. 461).

The favorable “accounting message” is not only seen by shareholders, but by others such as managers and board members in other firms of the network, which in the case of this study is the Mexican stock exchange. The positive “accounting message” helps managers that incur in earnings management to appear successful (Chen et al., 2015), and thus are more likely to be recognized by other members of the firm’s network. This recognition leads to invitations for the manager to participate on the boards of other firms

(Fields & Keys, 2003), thus increasing the firm's centrality in the network, and thus its influence within the network.

We argue that firm power will mediate the relationship between earnings management done by the firm's managers and the resulting firm performance.

H4 *Firm power will mediate the relationship between questionable payments and financial performance.*

In the next section we will present the methodology to test the presented hypotheses by using the 2006 Mexican presidential election case.

3. Methodology

In this section we will describe the sample, the construction of the two databases required for the analysis, the measures used, and the analytic method used to analyze the data.

3.1 Sample

In order to have access to information on the firm such as the members of the board of directors, the network of board interlocks was composed of public firms listed in the Mexican Stock Exchange. Public firms are required to publish annual reports where they disclose, among other information, the composition of their boards of directors and the firm's financial performance. In 2006, there were 143 firms listed in the Mexican Stock Exchange.

3.2 Databases

For this research, we created two databases: one with information on the firm's board interlocks and another with political donations to each political party. This section details the construction of each database.

3.2.1 Board interlocks database

To the best of our knowledge, there are no public databases with the information of board members of firms listed on the Mexican Stock Exchange. The director's network database was constructed following previous research where board composition is manually collected from the firm's annual reports (Connelly et al., 2011; Heemskerk et al., 2016). For building the relationships among the 143 firms in the network, 1653 different directors' names were manually collected from the public annual financial reports. All names were manually screened to homogenize names and last names to have a final list and avoid duplication of a person. Once the list of directors' names was cleaned for duplicates and standardized, we aggregated the boards at the firm level. As we mentioned earlier, individual director behavior resembles firm-level behavior (Krause et al., 2019). Therefore, we assume that the firm's actions can be inferred from the actions of its board members.

3.2.2 Political donations database

The first step for building the political donations database was to map which political parties were active. Mexico has a multi-party system and for the 2006 presidential election there were eight active political parties: PAN (Partido Acción Nacional), PRI (Partido Revolucionario Institucional), PRD (Partido de la Revolución Democrática), PT (Partido del Trabajo), PVEM (Partido Verde Ecologista de México), CONVER (Convergencia), PANAL (Partido Nueva Alianza), and PASC (Partido Alternativa Socialdemócrata y Campesina).

The documents detailing the donations for political parties in the 2006 presidential election were found on the website of the electoral institute, known at that time as the Instituto Federal Electoral – IFE. The information on political donations was divided into two categories depending on the relationship of the donor to the political party: (1)

donations by members of the party (*militantes*) and (2) donations by supporters who do not belong to the party (*simpatizantes*). We collected documents, both of members and supporters, with detailed information on donations, such as the name of the donor, political party supported, amount donated, and date of donation for all eight political parties. Donations were received either in cash or in kind, and were made to the political party, not to specific candidates. Manual transcription of the donations took place to build the database of anyone, board member or not, donating to the political parties. The total of donations by political party and type of donor is detailed in Table 1.

According to Table 1, PAN, PRI, and PRD concentrated most of the donations (94% of the total). Therefore, only the records for the three largest political parties were analyzed to look for potential matches between donors and members of boards of directors of firms listed in the Mexican Stock Exchange in 2006. This means, we analyzed 112,738 records of donations for anyone that donated to PAN, PRI, and PRD in the 2006 election cycle to verify whether any of the 1,653 directors had contributed with a donation in cash or kind to one of these political parties.

Table 1 Donations by type to political parties in Mexico (2006)

Political party	Members	Supporters	Total donations ^{*+}
PAN	301'259'301,28	183'692'349,75	484'951'651,03
PRI	117'475'608,08	8'496'175,03	125'971'783,11
PRD	52'575'102,43	84'161'493,19	136'736'595,62
PT	2'208'090,56	1'536'437,40	3'744'527,96
PVEM	1'046'153,00	1'196'123,62	2'242'276,62
CONVER	-	34'069'720,00	34'069'720,00
PANAL	-	5'226'415,86	5'226'415,86
PASC	2000,00	763'400,16	765'400,16
Total	474'566'255,35	319'142'115,01	793'708'370,36

^{*}Amounts in Mexican Pesos

⁺Donations include both cash and kind. Parties estimate the value of donations in kind.

3.3 Measures

3.3.1 Dependent variable

Financial performance. Return on assets (ROA) is an indicator of how profitable a company is relative to its total assets. This means it provides an idea as to how efficient the firm's management is at using its assets to generate earnings. Data is measured as a percentage. The information was obtained from three main sources: EMIS Pro database part of the ISI Emerging Markets Group Company, Capital IQ from S&P, and hand-collected and estimated from the firm's financial statements if the information was not available in the databases.

3.3.2 Independent variables

Political donation. This variable represents how much money was donated to the incumbent party in 2006 which was PAN. After analyzing the data for the three political parties (PAN, PRI, and PRD). The donated quantity is registered in Mexican Pesos (MXN). When the contribution was in kind, the political parties estimated the monetary value of the donation. We decided to use a dummy variable to indicate whether the firm had donated to the incumbent party, in which 0 represents that no donation was given to PAN, and 1 that the company donated to PAN. The information for measuring political donations was obtained from the public donation registries that enabled the creation of the political donations database presented previously.

Questionable payments. As mentioned earlier, we will use earnings management as a way to detect questionable payments. Discretionary accruals are the most common proxy of earnings management used in the literature (García-Meca & Sánchez-Ballesta, 2009; Xu et al., 2007) and it measures the proportion of the accruals that is subject to managerial discretion. The modified Jones Model has been used in different studies (Choi et al., 2013;

Sáenz González & García-Meca, 2014; Teoh et al., 1998; Xie et al., 2003) to estimate nondiscretionary accruals. The sign of the discretionary accrual, that is if it is positive or negative, is not relevant when studying earnings management, but rather the magnitude of the absolute value. Warfield and colleagues (1995, p. 78) mention that “absolute abnormal accrual serves to measure the extent to which managers knowingly pursue certain techniques to adjust reported numbers”. The number obtained for nondiscretionary accruals is reported as an absolute value, the smaller the value means that there are lower discretionary accruals in that firm (Sáenz González & García-Meca, 2014). On the other hand, a high absolute value of the discretionary accruals would imply the presence of earnings management. Thus, after estimating the nondiscretionary accruals using the modified Jones Model, the result is subtracted from the total accruals to estimate the discretionary accruals. Then, the result is transformed using the absolute value. The information needed for the calculations of the modified Jones Model for the year 2006 was obtained from the Bloomberg terminal equity screen (EQS). This includes information found in the financial statements for years 2005 and 2006 as some information that is entered into the model is lagged by one year.

3.3.3 Mediating variable

Firm power. As mentioned in the previous section, there are different measures used for power. We explained previously, we have chosen power-as-access as defined by Smith and colleagues (2014) as our definition of power, which focuses on how one member of the network can reach other members. In this paper, for measuring power of the firm in the network, we use a network centrality measure that shows how connected a firm is to other firms, called *Freeman Degree Centrality*. It is the measure most commonly used to measure power-as-access (Smith et al., 2014). This centrality measure is computed by

counting the number of directors that are shared between firms. This reasoning is in line with Mariolis and Jones (1982, p. 582), that mention that “the highest level of analysis is the organizational level ... The resulting measure is the centrality of each corporation, here given by the number of interlocks.” Thus, firms that share more directors with one another will have a “stronger” bond. This measure is estimated for each firm from the relationships collected in the board interlocks database and using the network analysis software UCINET (Borgatti et al., 2002).

3.3.4 Control variables

CEO duality. When the CEO is both the CEO and the president of the board, there is CEO duality in the firm (Finkelstein & D’Aveni, 1994), which has been found to signal the absence of the separation between decisions taken by management and the monitoring function of the board (Rechner & Dalton, 1991). The variable is coded 1 if there exists CEO duality and 0 otherwise. The information was obtained from the board interlocks database created for this research.

Board size. Represents the number of members that make up the board of directors (Pearce II & Zahra, 1992). According to John and Senbet (1998), larger boards might be better for monitoring purposes, however the downside includes problems around coordinating large groups of people for meetings and decision making. The variable is a number which indicates the size of the board. The information was obtained from the board interlocks database created for this research.

Board independence. Represents the percentage of independent board members (Weisbach, 1988). Studies have mixed results regarding how a high number of independent directors improves firm performance. However, a recent study that took into consideration the context in which the firm operates, found that there is a positive effect, especially in

contexts with greater legal and judicial protection (Uribe-Bohorquez et al., 2018). The variable is a percentage between 0 and 100 based on the number of independent directors in the board. The information was obtained from the board interlocks database created for this research.

HQ in Mexico City. According to Cárdenas (2016) half of the largest corporations in Mexico are headquartered in the country's capital, which would lead to a more cohesive network. It could also lead to greater connections to government officials and hence greater political power (Ovtchinnikov & Pantaleoni, 2012). Therefore, we used a dummy variable to control for this effect. The information was obtained from the board interlocks database created for this research.

Total asset turnover. A financial efficiency ratio that measures the amount of sales generated for its assets. This variable is included because it reflects the firms' strategy in reaching future profitability (Fairfield & Yohn, 2001). The information was obtained from EMIS database, Capital IQ database, or estimated from information on the firm's financial reports.

Debt to assets. This leverage ratio is used to determine financial risk by measuring how much of the firm's assets have been financed by debt. This variable is included because it takes into consideration the role of external creditors as monitors of the firm (Cosset et al., 2016). The information was obtained from EMIS database, Capital IQ database, or estimated from information on the firm's financial reports.

3.4 Data analysis

We used OLS regressions to test the proposed direct and mediating hypotheses using Stata version 16. As mentioned earlier, to calculate the centrality measure we used UCINET version 6.668.

4. Results

First, we conducted descriptive statistics (Table 2). As mentioned earlier, information was obtained from different sources. This creates a difference in the number of observations available for each variable. The sample was defined to include all companies who were listed in the Mexican Stock Exchange in 2006. The annual reports to investors were obtained from each of the 143 firm's site. In those reports, variables regarding the board composition were collected. Thus, we have 143 observations for CEO duality, board size, board independence, and the location of the headquarters. Also, since the list of all board members was collected from these reports, we could search for their names in the political donations database to establish if someone had donated to the incumbent party. Thus the 143 observations for donated to PAN. Four firms were listed in 2006, but not in 2007, thus the difference for ROA, total asset turnover, and debt to assets. Finally, for estimating discretionary accruals we have 71 observations. The modified Jones model requires nine financial variables for estimating discretionary accruals. Most of the missing observations¹ are of firms in the financial sector (banks, mortgage or insurance companies) which have a different way of reporting their financial situation.

In Table 3 we present the correlation matrix and observe that most correlations are below ± 0.5 which is expected and desired. The variance inflation factor (VIF) was estimated, and all values are less than 2.0, suggesting that multicollinearity is not a problem (O'brien, 2007; Salmerón et al., 2018).

¹ 35 firms without information are from the "financial and insurance" industry. 4 firms correspond to "real estate and rental and leasing" industry.

Table 2 Descriptive statistics

	Count	Mean	Median	Standard deviation	Minimum	Maximum
ROA	139	0.044	0.039	0.081	-0.519	0.293
CEO duality	143	0.287	0.000	0.454	0.000	1.000
Board size	143	17.259	16.000	7.763	5.000	39.000 ²
Board independence	143	0.394	0.410	0.198	0.000	0.920
HQ in CDMX	143	0.636	1.000	0.483	0.000	1.000
Total asset turnover	139	0.691	0.660	0.498	0.000	2.513
Debt to assets	139	0.332	0.265	0.266	0.000	0.990
Donated to PAN*	143	0.497	0.000	0.502	0.000	1.000
Discretionary accruals**	71	0.003	0.000	0.014	0.000	0.120
Degree centrality***	143	15.371	8.000	18.880	0.000	84.000

* Political donations are measured by donation to the incumbent (PAN).

** Earnings management is measured by the absolute value of discretionary accruals.

*** Firm power is measured using Freeman degree centrality.

Table 3 Correlation Matrix

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
(1) ROA	1									
(2) CEO duality	0.073	1								
(3) Board size	0.218**	0.053	1							
(4) Board independence	0.068	0.050	0.197*	1						
(5) HQ in CDMX	-0.039	-0.099	0.078	0.127	1					
(6) Total asset turnover	0.184*	0.007	0.098	0.114	-0.142	1				
(7) Debt to assets	-0.273**	-0.066	-0.294***	-0.254**	0.142	-0.180*	1			
(8) Donated to PAN	0.097	-0.011	0.209*	0.248**	-0.005	0.009	-0.091	1		
(9) Discretionary accruals	-0.241*	0.184	-0.151	0.117	-0.147	0.036	-0.140	0.078	1	
(10) Degree centrality	0.202*	0.041	0.565***	0.208*	0.150	0.025	-0.040	0.415***	-0.117	1

$p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

² A board of 39 members might seem like an outlier, however it is not the case. From the sample, a total of 14 firms have boards larger than 30 members: 31 members – GCC, MEDICA; 32 members – INGEAL, INVEX, PE&OLES, TLEVISA; 33 members – GFNORTE; 34 members – TELMEX; 35 members – BIMBO, KOF, PROCORP; 38 members – FEMSA, GMODELO; and 39 members – GRUMA

In mediation analysis there are two paths to be followed for each mediation (Hayes, 2009): (1) a direct path named *path c'* which relates the independent variable with the dependent variable and (2) an indirect path where a third variable serves as the mediator. This second path can be subdivided into two parts: *path a* (from independent to mediator variable) and *path b* (from mediator to dependent variable). To quantify the indirect effect, we then obtain the product of the coefficients from *path a* and *path b*. In our model we presented two sets of hypotheses, one for illustrating *path c'* and another for *path a x b* for each of our influence options (political donations and earnings management). We ran each set of hypotheses separately and present the results for political donations in Table 4 and earnings management in Table 5. For each path there are two columns: the first one with the control variables and the second one with the variables of interest.

We presented two hypotheses related to political donations, performed in the foreground, that help the firm improve its financial performance. In **H1** we stated that “*Political donations have a positive effect on the firm’s financial performance.*” Results shown in Table 4 Model 2 under *path c'* indicate that the coefficient for political donations is 0.0096 ($p=.504$), suggesting that there is no direct effect between political donations and an improved financial performance. The mediation hypothesis **H2** stated that “*Firm power will mediate the relationship between political donation and financial performance*”. Both *path a* (model 4, $b=11.51$, $p=0.000$) and *path b* (model 6, $b=0.007$, $p=0.093$) were significant and with the expected positive sign. The effect size measured as eta squared which is a measure of the ratio of variance explained of the dependent variable by the independent variable (Adams & Conway, 2020). Path a ($\eta^2 = 0.13$) presents a 13% increase in firm centrality for firms that donated to the incumbent party compared to firms that did not. Path b ($\eta^2 = 0.02$) presents a 2% increase in financial performance. The total

indirect effect of political donations on firm performance mediated by firm power is estimated by multiplying the coefficients of path a x path b, which is 0.081. These results suggest a full mediation as there is evidence of mediation (indirect effect) and the direct effect is statistically non-significant.

Table 4 Foreground: Political donations

Variables	Path c'		Path a		Path b	
	(1) ROA	(2) ROA	(3) Degree centrality	(4) Degree centrality	(5) ROA	(6) ROA
CEO duality	0.0095 (0.65) [0.518]	0.0097 (0.66) [0.510]	1.246 (0.42) [0.672]	1.508 (0.55) [0.584]	0.0095 (0.65) [0.518]	0.0086 (0.59) [0.557]
Board size	0.0015 (1.67) [0.097]	0.0014 (1.52) [0.131]	1.431 (7.93) [0.000]	1.289 (7.51) [0.000]	0.0015 (1.67) [0.097]	0.0005 (0.43) [0.671]
Board independence	-0.0135 (-0.38) [0.706]	-0.0185 (-0.51) [0.613]	11.40 (1.60) [0.112]	5.138 (0.75) [0.453]	-0.0135 (-0.38) [0.706]	-0.0218 (-0.61) [0.543]
HQ in CDMX	0.0010 (0.07) [0.942]	0.0017 (0.12) [0.908]	2.641 (0.92) [0.358]	3.399 (1.27) [0.208]	0.0010 (0.07) [0.942]	-0.0009 (-0.06) [0.951]
Total asset turnover	0.0220 (1.61) [0.110]	0.0224 (1.63) [0.105]	-0.321 (-0.12) [0.907]	0.129 (0.05) [0.960]	0.0220 (1.61) [0.110]	0.0222 (1.64) [0.104]
Debt to assets	-0.0642 (-2.35) [0.020]	-0.0646 (-2.36) [0.020]	11.01 (2.01) [0.046]	10.57 (2.06) [0.041]	-0.0642 (-2.35) [0.020]	-0.0723 (-2.62) [0.010]
Donated to PAN		0.0093 (0.67) [0.504]		11.51 (4.46) [0.000]		
Degree centrality						0.0007 (1.69) [0.093]
Constant	0.0260 (0.96) [0.340]	0.0248 (0.91) [0.365]	-19.34 (-3.56) [0.001]	-20.82 (-4.08) [0.000]	0.0260 (0.96) [0.340]	0.0401 (1.42) [0.158]
R ²	0.1162	0.1192	0.3645	0.4483	0.1162	0.1351
Adjusted R ²	0.0760	0.0721	0.3356	0.4188	0.0760	0.0889
Number of observations	139	139	139	139	139	139

t statistics in parentheses *p*-values in brackets

Table 5 Background: Questionable payments

Variables	Path c'		Path a		Path b	
	(7) ROA	(8) ROA	(9) Degree centrality	(10) Degree centrality	(11) ROA	(12) ROA
CEO duality	0.0095 (0.65) [0.518]	-0.0020 (-0.13) [0.898]	1.246 (0.42) [0.672]	2.793 (0.61) [0.542]	0.0095 (0.65) [0.518]	0.0086 (0.59) [0.557]
Board size	0.0015 (1.67) [0.097]	0.0004 (0.36) [0.720]	1.431 (7.93) [0.000]	1.548 (5.36) [0.000]	0.0015 (1.67) [0.097]	0.0005 (0.43) [0.671]
Board independence	-0.0135 (-0.38) [0.706]	0.0244 (0.51) [0.609]	11.40 (1.60) [0.112]	5.362 (0.38) [0.703]	-0.0135 (-0.38) [0.706]	-0.0218 (-0.61) [0.543]
HQ in CDMX	0.0010 (0.07) [0.942]	0.0135 (0.91) [0.364]	2.641 (0.92) [0.358]	6.117 (1.41) [0.164]	0.0010 (0.07) [0.942]	-0.0009 (-0.06) [0.951]
Total asset turnover	0.0220 (1.61) [0.110]	-0.0028 (-0.16) [0.876]	-0.321 (-0.12) [0.907]	0.162 (0.03) [0.975]	0.0220 (1.61) [0.110]	0.0222 (1.64) [0.104]
Debt to assets	-0.0642 (-2.35) [0.020]	-0.149 (-3.26) [0.002]	11.01 (2.01) [0.046]	11.74 (0.87) [0.388]	-0.0642 (-2.35) [0.020]	-0.0723 (-2.62) [0.010]
Discretionary accruals		-1.235 (-2.35) [0.022]		-18.49 (-0.12) [0.905]		
Degree centrality						0.0007 (1.69) [0.093]
Constant	0.0260 (0.96) [0.340]	0.0713 (2.00) [0.050]	-19.34 (-3.56) [0.001]	-19.64 (-1.87) [0.067]	0.0260 (0.96) [0.340]	0.0401 (1.42) [0.158]
R ²	0.1162	0.2168	0.3645	0.3457	0.1162	0.1351
Adjusted R ²	0.0760	0.1298	0.3356	0.2730	0.0760	0.0889
Number of observations	139	71	139	71	139	139

t statistics in parentheses *p*-values in brackets

For understanding behavior in the background, we chose a proxy for questionable payments called earnings management and developed two hypotheses **H3** for the direct effect (*path c'*) and **H4** for a mediated effect (*paths a+b*). **H3** stated that “*Questionable payments have a positive effect on the firms’ financial performance*”. We found the relationship to be significant as seen in model 8. However, the negative sign of the coefficient ($b=-1.235, p=0.022$), consistent with the correlation shown in table 3, signals a negative effect of discretionary accruals on ROA. The mediation hypothesis **H4** stated that

“Firm power will mediate the relationship between questionable payments and financial performance.” We found *path a* (model 10), which measured the relationship between earnings management and firm power, to be non-significant ($p=0.905$). This result suggests that there is no mediation, neither direct nor indirect, between questionable payments and financial performance. What we found is the previously reported negative direct effect that discretionary accruals have on ROA.

5. Discussion, Limitations, and Future Research

5.1 Discussion

When dealing with the government, firms and their managers implement different strategies to acquire influence. However, in the process of becoming more influential there are different approaches which can be taken. We started this research with a quote: “The question, then, is whether the only force that keeps us from carrying out misdeeds is the fear of being seen by others” (Ariely, 2013) and presented two spaces of behavior: foreground and background. In the foreground, activities can be seen by others, thus there is a pressure to behave according to socially accepted rules and norms. In contrast, the background provides ample opportunity for engaging in questionable managerial practices. Our interest in this research was to understand the effect a practice done in the foreground (political donations) and another in the background (questionable payments) on the firm’s performance.

One key aspect present in this research is managerial discretion. In countries such as Mexico, where the country’s institutions are weak, it is important to understand how managerial decisions can maybe help the individual, but not advance the firm’s objectives. We stated that managers who either donate to political parties or engage questionable

payments, expect a positive effect on the firm. We argued that by engaging in either of these practices, they would send a positive message to the network of board interlocks, thus becoming more powerful. Power can be measured by the increased level of centrality that the firm acquires in the network of board interlocks. The managers themselves, become recognized from either their connections to politicians (through political donations) or by a positive “accounting message” (through earnings management).

However, when board members decide to become politically active through influence payments, it becomes difficult to assess how their firms will benefit from these actions. Common wisdom might tell us that it is just through donations that directors will be able to help advance their firms objectives. However, results show that in an emerging-market country like Mexico, donations alone have no impact on financial performance. The model presented here shows that it is when members of a firm’s board of directors donate and acquire power as members of different boards across the network, that there is a positive effect on the financial performance. This positive effect is achieved once the supported party wins and the party candidate favors its contributors. These results show that we need further understanding of how individual actions play a role in the firm’s political strategy, especially in emerging economies in where personal relationships might replace the role of institutions.

We also examined earnings management as a proxy to understand behavior in the background. This accounting practice in which some managers exercise discretion to present a positive “accounting message” is not the same as bribery. However, we think that when someone decides to disguise the true situation of the firm, one of the motives could be to hide behavior that does not fit the foreground (regulated, recorded, and monitored). Although earnings management can be undertaken under the limits established by generally

accepted accounting principles (GAAP) (Dechow et al., 1996), when managers present information to their personal benefit, it can have the opposite effect as to what they intended for their firm. Results show that when managers engage in earnings management, there is a negative direct effect on financial performance. This is the opposite of what we expected, which raises further questions on why managers would in the first place decide to engage in such practice, unless it were for their own personal benefit.

In this research, we presented the role of firm power as a mediating mechanism. This poses interesting questions on how important it can be for a firm to increase its power in the network of board interlocks, as this was the mediating mechanism by which political donations had a positive effect in improving firm performance. We can infer that in emerging-market countries such as Mexico, firms need to rely on their connections to achieve their strategic goals. There is research that states that the relationship between firms and political actors is defined by the context that sets incentives or restrictions on both managers and firms' behaviors (Scherer, 2018). By engaging in practices such as political donations managers seek to advance the firm's goals. We need further understanding on how relationships within the network of board interlocks, help to link individual behavior with the firm's interests.

5.2 Limitations and Future research

There have been calls for research to better understand the relationship between individual behavior and corporate political activity (Frynas & Stephens, 2015; Scherer, 2018). We agree that this research is important, especially in emerging countries, where weak institutions might not provide sufficient "checks and balances" to prevent managers from making decisions that can harm the firm.

There are limitations to our results. First, there is the issue of generalizability outside

Mexico. We do not presume these results will be similar for other emerging markets. We concentrated our efforts on one country and a single election cycle. As explained in the methodology section, although information is publicly available, it is neither easy to obtain nor analyze. This is a limitation commonly found when researching political donations but magnified in emerging markets. However, we think that the Mexican case presents a view of the relationships between business and politicians' work. As mentioned earlier, most of our knowledge on CPA stems from the US political system, which is bipartisan and in a country with strong institutions. Most emerging markets, like the examples documented for Latin America, have a multiparty system and weaker institutions. This combination could provide incentives for firms to engage in background activities such to mold the "rules of the game". Not having access to detailed records, makes it difficult to test this assumption. However, cases such as Odebrecht might provide some light on further understanding influence payments in emerging economies.

A second limitation includes the generalizability of results to firms that are not listed in the stock exchange. In order to construct the database, we limited our sample to firms that are members of the Mexican Stock Exchange, which enabled us to have access to the list of board members. However, with greater calls to transparency for both listed and unlisted firms, it might be possible in the near future to corroborate that non-listed firms might present the same behavior regarding their foreground/background influence strategies.

A third limitation is related with possible measurement problems: one related with the firm-level of analysis and another with the proxy for questionable payments. As we mentioned in the methodology section, in Mexico firms cannot directly donate to political parties. Thus, we aggregated the donations made by the directors to estimate the donation at

a firm-level. We found this to be a solution in a country with the type of political system found in Mexico. As it has been mentioned, most of what we know about the political behavior of firms comes from research set in the United States. In this country, the laws allow for firms to participate and create PACs to raise and perform donations. Therefore, we found the proposed solution suitable for the Mexican case and other countries that might face similar limitations. However, we acknowledge that there could be some measurement concerns, thus we need to continue with further studies in order to determine the best way to measure firm-level political behavior out of individual-level data. The second limitation related to measurement is the proxy for questionable payments. As it was detailed previously, how firms act in the background is not accessible to third parties for scrutiny. Earnings management captures discretionary behavior, and it can only show that there might be “something” happening in the background. However, it cannot tell us more accurately which was the purpose behind executives acting discretionally. We acknowledge that it is important to find other proxies that help capture behavior in the background which will allow us to better understand what the effects on firm performance from decisions are that are not regulated, registered, and monitored by third parties.

In this research we advocate for bringing managerial practices to the foreground. With increasing pressures on disclosure from the public, we believe that there are many future research opportunities that will help us move forward in our understanding of corporate political strategy in emerging countries. Future research should include analyzing the pattern of donations across several elections to see if donation patterns change overtime and their effect on the firm. Also, where firms donate to the losing candidate, are these firms “punished” by the government of the winning candidate? Case studies on specific firms who made donations and were later assigned contracts, can help establish the long-

term “benefits” received by firms that are more politically connected.

Finally, it is important that governments work with industry on setting the foreground: regulation, recording, and monitoring. Regulation on how board members of publicly listed companies engage in political donations could help prevent unethical behavior. This measure supported by detailed recording of donations and access to this information for monitoring purposes can also be a way to prevent wrongdoing. We recognize the importance of firm-government relations; however, we encourage firms to set these relations in the foreground, the space where actions are done according to the “rules of the game”.

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CONCLUSION

“I went back to graduate school with the clear intention that what I wanted to do with my life was to improve societies, and the way to do that was to find out what made economies work the way they did or fail to work.”
North (1994)

1. Introduction

Firms today operate in a complex environment. From the firm’s perspective, there are many voices asking for more than “just” good financial performance. As Bach and Allen (2010, p. 42) mention, “nonmarket strategy recognizes that businesses are social and political beings, not just economic agents.” This conception has raised increased interest in looking at nonmarket strategy in more detail, which means a better understanding of the relationships between the firm and other actors that are key for its success, such as governments, activists, or the general public (Freeman et al., 2010).

However, as I have mentioned throughout this dissertation, nonmarket strategy is closely related to the context in which it is implemented. For example, in their study of the “new” multinationals originating in emerging economies, Guillén and García-Canal (2009) found that these firms are a result of imitating multinationals from developed economies. However, they also found that the institutional characteristics of the emerging countries had an influence in shaping the multinationals internal characteristics. This response was a kind of survival mechanism to adapt the firm to countries where weaker institutions set different behavioral expectations. Therefore, as this example shows, nonmarket strategy effectively implemented in a developed country does not necessarily will show the same results in an emerging country such as Mexico.

In a recent issue of the *Journal of Management*, the authors mention the importance of conducting research in Latin America (Aguinis et al., 2020). One of their proposed solutions is to “emphasize the value of Latin American data, researchers can show that the phenomenon they examine is (a) relevant, (b) prevalent beyond the focal country where the data are collected, and (c) informative for theory development” (Aguinis et al., 2017, p. 18). With the three studies that make up this dissertation, my intention has been not only to document the Mexican case, but to see possible connections with what happens in other countries that have a similar level of institutional development.

In this last chapter of the dissertation, I will present the main overall contributions. Also, some ideas on how these results can inform theory and help us expand the boundaries of our assumptions to include the reality present in emerging countries. Finally, I will share some ideas of future research opportunities, as I believe the dissertation is just one step in helping advance the field forward from an emerging market perspective.

2. Dissertation contribution

The three studies center their attention on a monitoring body present in all firms organized as a corporation: the board of directors. In agency theory we have the concepts of principal and agent. As Eisenhardt (1989, p. 64) mentions in her classic article, “agency theory reminds us that much of organizational life, whether we like it or not, is based on self-interest.” Thus, there is always a tension for managers of doing what is best for the company versus what is good for them. A solution to the principal-agent problem was the creation of the board of directors. This body is composed ideally by a mix of inside and outside firm members, that are experts in their field, and that will help with the decision making process of the firm (Fama & Jensen, 1983). However, this “ideal” board that serves

as a counterweight to diminish risk, is not the prevalent model in firms operating in emerging countries such as Mexico.

Initial findings in paper 1 show that two of the elements which are sought after in board composition (absence of CEO duality and independent members) do not seem to show the same effect in emerging contexts when dealing with earnings management likelihood. CEO duality is a board characteristic that is usually discouraged, since it can give “too much” power to a director who can eventually overpower the rest of the board members and have greater influence in the decision making process (Krause et al., 2019). However, as mentioned in the study on multinationals in emerging countries (Guillén & García-Canal, 2009), even though firms created in emerging markets might have the same organizational structure as those in developed countries, these controls do not work as expected and thus are just a “formality”. For example, it has been found that in Mexico independent directors do not seem to ensure better corporate governance practices (Avina-Vazquez & Uddin, 2016).

Another concept that appears throughout this dissertation is managerial discretion. Varying degrees of discretion are to be expected when managing a firm. Not having this possibility could lead to the firm not being able to act as quickly as needed and seize opportunities, thus affecting its competitive advantage. However, managerial discretion can also become problematic if not managed adequately. For example accounting guidelines such as Generally Accepted Accounting Principles (GAAP) or the International Financial Reporting Standards (IFRS) allow a degree of discretion in the way firms can report certain expenses such as advertising (Corelli, 2016). This allows the firm to decide, depending on its industry and financial situation, how best to report such expenses. However, discretion

can also lead managers to use this flexibility and incur in questionable practices such as earnings management. As mentioned earlier, earnings management per se is a legitimate practice. According to paper 1 and paper 3, research shows that the motives for engaging in this practice can be personal, to trying to increase the perceived value of the firm (Zahra et al., 2005). In the end, when firms incur in this practice, they are distorting the true situation of the firm, misleading external stakeholders.

In a developed economy a strong rule of law and the institutions that monitor firms, especially those listed in the stock exchange, might serve as a deterrent for managers that would be tempted to gain some personal benefit over the interests of the firm. But what happens when the firm operates in a context with weak institutions? Or when public firms' shares are owned by people related by familial ties? The second study of this dissertation added a detailed account of how the inner circle in Mexico has been growing closer together. Unlike what happens in developed countries in where there is a limit to the number of boards a person can sit on, in Mexico there is no regulation that sets such limit (Sánchez, 2021). Having big boards, some of them with more than 30 members as reported in paper 3, could diminish the monitoring capacity of the board over the discretionary decisions made by some managers. Thus, another contribution of this dissertation is having a clearer picture of how firms are connected in Mexico, by showing the relationships between the interlocking directorates in a 15-year study. From extensive research by academics such as Useem and Mizruchi, we have learned how boards have behaved in the United States over several decades. Such knowledge has been important for theory development. Expanding knowledge of board interlocks to countries in emerging contexts, will allow us to design better monitoring mechanisms that adapt to those contexts.

Connecting the findings of the usefulness of certain board of directors' good practices with the concept of managerial discretion, is the foreground/background metaphor presented in paper 3. This framework presents two distinct spaces in where both executives and firms can have opposite behaviors. Once again, in a developed economy the degree of differentiation between foreground and background might be not so stark, as the institutional context provides the incentive for managers to behave according to the accepted rules, even when acting in the background, away from the scrutinizing eyes of others. However, in an emerging country, the foreground/background setting does present an opportunity for two different sets of behaviors: one that is accepted and according to the rules and regulations, and another where managerial discretion would allow managers to incur in illegal practices.

When implementing a nonmarket strategy in the form of either corporate social responsibility (CSR) or corporate political activity (CPA) firms could engage in two different sets of behaviors. For example, Grupo México, one of the largest Mexican multinationals has been shown to be responsible for the 2014 toxic spills from the Buenavista del Cobre mine into the Sonora and Bacanuci rivers (Rojas, 2019). This same company has on the other hand, a strong and popular CSR program called Dr. Vagón, in which a train functions as a moving health center that reaches faraway communities in remote areas of Mexico (Ramírez, 2019). Regarding the firm's political strategy, they were the largest donors to the incumbent party in the 2006 election documented in paper 3. The foreground/background distinction of firm behavior can be a way to understand managerial discretion in emerging economies, and how nonmarket strategy (CSR and CPA) could be used to present different behaviors if acting on the foreground or on the background.

Table 1 summarizes the above-mentioned contributions, by highlighting what we have learned from research in developed economies, and how some of these concepts might work differently in emerging economies such as Mexico. Even though these practices refer to what was observed in the Mexican case, they could reflect more accurately the situation of other emerging economies.

Table 1 Contrast between practices in developed economies and Mexico

Developed economies	Mexico
Boards will be more effective in their monitoring function with the presence of independent directors.	Independent directors might not be as “independent” as in developed economies. Even though these directors do not work for the firm, the relationships (family or friends) could explain why this mechanism does not have the same effect in firms from emerging economies.
The practice of inviting executives to be members of different boards has been declining, partly due to restrictions regarding board size and composition.	The practice of inviting executives to be members of different boards is common, partly due to low restrictions regarding board size and composition.
Managerial discretion in the background is bounded by the perceived consequences if discretionary actions affect the firm or violate laws/regulations.	In countries with weak institutions, executives could use managerial discretion knowing that they will not face consequences if those actions affect the firm or violate laws/regulations.
Recording of political donations by independent institutions allows for follow-up and scrutiny from government and society on how firms participate in the elections.	Lack of public records and difficulty for accessing and processing data does not allow for third parties to follow-up and scrutinize how firms participate in the elections.

Finally, one of the contributions of this dissertation is also the documentation and creation of databases. As mentioned in the introductory chapter, access to quality information is not the standard found in emerging markets. On one hand, there could be no governmental bodies that requests public firms or government entities to disclose information. This makes it difficult to access information such as political donations. On the other hand as with financial information, even though IRFS standards are required for domestic companies trading in the public market, financial institutions and insurance

companies follow Mexican Financial Reporting Standards (MFRS), which made it difficult to include such companies in the analyses (IFRS Foundation, 2016). Creation of different databases and the continue update of information will allow us to conduct long-term research of the Mexican case.

3. Final reflection and further research opportunities

I am convinced that nonmarket strategy is especially important when conducting business in emerging markets. The instability present in such a context forces firms to rely on their connections to navigate the “rules of the game”. Therefore, I consider that we need more research set in these countries to determine whether what scholars have tested should be copied or adapted to the reality that dominates these countries. I believe the studies that make up this dissertation are just the tip of the iceberg regarding corporate nonmarket strategy in emerging economies.

For instance, additional information, especially across time, will allow to see how firms operating in emerging countries have adapted to the external calls on being more transparent about their nonmarket strategy and the status of the institutions in these countries. In his study about institutional change in Latin America, Weyland (2009, p. 50) mentions that “to enhance political stability, cliques of elites elaborated informal mechanisms of power sharing and political succession that were sustained through the systematic manipulation of elections”. Additional research is required to understand such power mechanisms that have been set in place in such countries and contrast them with those established in developed economies.

Also, we need to study the implementation of nonmarket strategy and its results in the long-term. In emerging countries such as Mexico, politics affects business. We have seen how the change of ruling party comes also with changes in the “rules of the game”. With the last change of ruling party in Mexico, we have seen changes that affect business that range from the elimination of outsourcing as a way to hire talent (Straulino-Rodriguez et al., 2020) to the changes in investment rules and contracts for renewable energy (Tan et al., 2020). Conducting research in markets characterized by constant change and political instability can provide insights not only for firms doing business in these regions, but for firms operating in other types of economies that are facing changes. Additionally, we are all facing unprecedented grand challenges defined by the United Nations such as poverty, inequality, global warming, health issues, among others. I mentioned before that in the study on emerging multinationals, these firms were created as a “copy” of multinationals in developed economies. However, learning from firms in emerging contexts could also show insights that travel the other way around and inform firms in developed economies how to do business when facing a world with increasing uncertainty.

And it is with this idea that I would like to conclude my dissertation: firms in emerging markets can also help to advance theory. The challenges that lay ahead of all of us, regardless of country of origin or operation, need new perspectives. For many years scholars in emerging economies have learned the theories based on the experience of developed economies. We have adopted such insights and model them to the best of our knowledge to shape our institutions and firms based on those assumptions. The expectation has been that by adopting such models, our economies will soon resemble those who we are imitating. However, more needs to be done. We scholars in emerging economies need to

challenge and test those assumptions that we have adopted. This exercise will allow us to know ourselves and provide us with the resources needed to share the wisdom that we have also created in our countries to help alleviate the grand challenges of this century.

The quote at the beginning of this chapter is from Douglas North's biography after he won the Nobel Prize in Economic Sciences on why he abandoned photography and decided to become an economist. My journey has been different, but I also decided at some point that by leaving industry and returning to grad school I could make a difference. I hope this dissertation is the starting point to improve how we conduct business in emerging economies, which will bring prosperity to the 85.6 percent of the population of the world that lives in such countries.

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