

**The Cultural Contexts of Subsidiary Location and Internal Control Weaknesses in  
Multinational Enterprises**

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### **Synopsis**

#### ***The research problem***

This study examines the relationship between the cultural contexts of subsidiary locations belonging to United States-headquartered multinational enterprises (USMNEs) and the internal control weaknesses (ICW) disclosed under Section 404 of the Sarbanes-Oxley Act.

#### ***Motivation or theoretical reasoning***

Despite growing attention on the determinants of the ICW of publicly trading entities since the enactment of the Sarbanes Oxley Act of 2002, little is known about the ICW of multinational enterprises. In particular, the influence of country-level institutional determinants of subsidiaries remains silent. Thus, drawing on agency theory, social norms theory, and institutional theory, this study argues that the cultural context of subsidiary locations can influence the ICW of multinational enterprises.

#### ***The test hypothesis***

***H<sub>1</sub>***: The culture of USMNEs subsidiary location has an effect on the effectiveness of internal controls.

#### ***Target population***

United States -headquartered multinational enterprises and their subsidiaries

#### ***Adopted methodology***

Logistic regression, Pooled OLS regression, Fixed-effects model, Entropy balancing approach

#### ***Analyses***

Our main analysis tests the impact of subsidiary location culture on the ICW of USMNEs. We used three proxies, namely Hofstede's six dimensions of culture, cultural diversity, and cultural distance to subsidiaries to measure the cultural context of subsidiaries (independent test variable) and two proxies to measure the internal control weakness: whether the internal control is effective or not and the

number of material internal control weaknesses reported. An additional analysis evaluates the interaction effects of investor protection and auditor quality on the link between ICW and culture. We use 748,916 subsidiary-year observations spanning over the period of 2004-2020 for the analyses. This dataset covers 162,136 unique subsidiaries operating in 70 countries that belongs to 1833 distinct USMNEs.

### ***Findings***

The findings indicate more ICW in USMNEs when their subsidiaries are located in high power distance, uncertainty avoidance, or long-term orientation environments. Conversely, fewer ICW are observed when subsidiaries are in countries characterized by higher levels of individualism, masculinity, or indulgence. Moreover, our results show more ICW in USMNEs when there is greater cultural diversity in the group as well as when there is a greater distance between the subsidiary and the HQ. Furthermore, we find that the strength of investor protection and the presence of Big4 auditors can moderate the relationship between culture and ICW.

*Keywords:* Culture; distance; internal control weakness; multinational; Sarbanes-Oxley Act (SOX); subsidiary.

JEL Classification: G38, M16, M41, M42, M48.