Ethical Judgments of Directors' on Earnings Management Practices

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Abstract
The objective of this study is to determine directors' ethical judgments of earnings management practices. We use the questionnaire which was originally designed by Bruns and Merchant (1990) which consists of 13 earnings management scenarios. The questionnaire asked the directors to rate their acceptability of earnings management practices using a 5-point scale ranging from ethical to totally unethical. We find that the ethical judgments of directors are affected by the types of earnings management. The directors view accrual-based earnings management is more unethical than real-based earnings management. Our findings require attention of auditors and regulators to be aware of overlooked area in financial information as firms can switch from accrual to real-based earnings management method in preparing their financial statements.

Keywords: Earnings management, Types, Directors, Malaysia

Introduction

Issues related to earnings management has been a topic of great interest for the past two decades to accounting profession, academics, standard setters and press (DeFond, 2010; Dechow, Hutton, Kim and Sloan, 2012; Luippold, Kida, Piercey and Smith, 2015). The issue has become more controversial due to a series corporate failures and criticism regarding the quality of financial reporting during the Global Financial Crisis (Heinz, Patel and Hellmann, 2013). Furthermore, the move towards principle based accounting standards globally requires extensive use of professional judgment that allows greater discretion for managers in preparing their financial statements (Okamoto, 2011).

Despite the importance of this area of research, earnings management is difficult to observe (Elias, 2002; Heinz, Patel and Hellmann, 2013). Investigating earnings management remains a challenge for archival empirical research to convincingly document earnings management behavior (Graham, Harvey and Rajgopal, 2005). Due to the nature of earnings management that can be either legal or illegal earnings management, it is highly ambiguous and requires further investigation (Okamoto, 2011; Heinz, Patel and Hellmann, 2013).

Thus, we conducted a survey to understand the directors' ethical judgment with regards to earnings management practices focusing on types of earnings management commonly used by managers in managing earnings. We focus our sample on directors sitting on the board of Malaysian public listed companies. In the study, the directors are required to rate their acceptability of earnings management practices taken by manager. Managers may manage earnings either through accrual or real-based earnings management. Our study intends to understand the directors' judgment on different types of earnings management practices as their view is important to promote ethical accounting practices in their companies.

Our results indicate that the directors' judgment on earnings management practices are affected by types of earnings management. Our results demonstrate that the directors believe that real-based earnings management is less unethical than accrual-based earnings management. This is consistent with our expectation that directors may be more tolerance on real-based earnings management due to greater scrutiny by the capital market on the accrual-based manipulation. Our study contributes to business ethics research that investigates the ethical judgment of directors. While prior studies focused on earnings management from a capital market perspective mainly on detection, magnitude and consequence of earnings management, little research has examined the ethical perception of this practice (Elias, 2002).

Furthermore, our findings contribute to different environment settings, an emerging country that often associated with weak investor protection and low enforcement actions (Ipino and Parbonetti, 2011). We expect our results to be differ from those studies conducted in developed markets as the developed market firms is constrained by strong investor protection environments thus reduce the ability for the managers to manage earnings.

The remainder of this paper is organized as follows. The next section provides literature on earnings management studies related to our research, followed by the research methods in Section 3. The final two sections present the results and concluding remarks, respectively.

Literature Review

Earnings management is defined as manipulating reported earnings to achieve the desired financial results which may inaccurately present economic earnings (Goel and Thakor, 2003; Luippold et al., 2015). As argued by Healy and Wahlen (1999, p.368), earnings management may occur '…when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers'. While there are scholars who support the legality of earnings managements that conform to GAAP, others have questioned the ethics of earnings management practices that make the characteristics of earnings management as dubious (Okamoto, 2011).

There are several ways that managers can exercise their judgment in choosing the methods to estimate the accounting numbers in the financial reports. Judgment creates opportunities for managers to manage earnings by choosing the reporting methods and estimates that do not accurately reflect a firms' underlying economic performance of the company (Healy and Wahlen, 1999). The wider range of choices brings opportunities to management team of a firm to manipulate earnings for their own advantage. As suggested by Christensen, Hoyt and Paterson (1999), when managers have both the incentives (i.e. contractual incentives, market incentives and regulatory incentives) and the opportunities to manage earnings, they are more likely to engage in earnings management. Prior empirical evidences suggest that the incentives to manage earnings may possibly arise from the need to increase personal bonuses and remunerations (Goel and Thakor, 2003; Latridis and Kadorinis, 2009), to gain opportunities for promotion, to meet annual profit targets (Graham, Harvey and Rajgopal, 2005), to benefit the companies (Chen and Tsai, 2010) as well as to meet other parties' requirements (Chen and Tsai, 2010; Yang, Chi and Young, 2012). A survey by Graham, Harvey and Rajgopal (2005) reports that eighty percent of chief financial officers choose to decrease discretionary expenditures when faced with the possibility of earnings falling below the company desired earnings targets. The CFOs believe that hitting earnings benchmarks could build the market confidence and increase or at least maintain the stock price of their companies (Graham, Harvey and Rajgopal, 2005).

There are two types of earnings management which have been identified in the literature: 1) accrual-based earnings management, and 2) real-based earnings management. Gunny (2010) suggests that accrual management involves the manipulation of information within the range of Generally Accepted Accounting Principles (GAAP) to hide the actual financial condition. On the other hand, Mizik (2010) suggest that real activities management may be done through the alteration of operational practices that reduce actual economic earnings in order to generate favourable market reactions. According to Gunny (2010), while accrual management can take place after a fiscal year end, which is the period during which the need for earnings management is very high, real earnings activities may occur prior to a fiscal year end. Although both practices relate to a deliberate attempt to either increase or decrease earnings, the relevant distinction between these two types of earnings management is that real earnings management imposes real costs on firms (Ipino and Parbonetti, 2011).

Findings from study by Bruns and Merchant (1990) report that managers view that management of accounting method (accrual-based earnings management) is less acceptable compared to manipulating operating method (real-based earnings management). They called the standard setters to get managers involved in discussion on short-term earnings management practices to establish clearer accounting and operating standards in a company. According to them, those who engage in earnings management practices may not necessarily be bad people but sometimes they do not have a clear understanding of the implication of their practices. Similarly, a subsequent study by Merchant and Rockness (1994) who surveyed general managers, staff managers, operation-unit controllers, and internal auditors also find that the accounting manipulations are judged more harshly as compared to operating manipulation.

Elias (2002) surveys practicing accountants, accounting faculty and students to identify the determinants of earnings management behavior. Based on 763 respondents who answered the questionnaire, he reveals significant differences among group of respondents on the ethics of earnings management. On the other hand, study by Giacomino and Akers (2006) document no significance difference between students and business managers' perception regarding earnings management practices. Using undergraduate students and MBA students who played the role of business manager, Jooste (2013) also reports no significant differences between students and business managers' perceptions regarding the morality of earnings management practices. She suggests that more exposure to and understanding of earnings management be given to business students with greater emphasis on accounting curricula on earnings management practices.

Research Methodology

To gather data regarding directors' ethical judgment of earnings management practices, a questionnaire survey designed by Bruns and Merchant (1990), which consists of thirteen (13) short scenarios, was used. Each scenario describes potentially questionable earnings management activity undertaken by the general manager. Out of 13 scenarios, 6 questions dealt with real-based earnings management and 7 questions dealt with accrual-based earnings management. Several studies have investigated earnings management ethics using this questionnaires such as Merchant and Rockness (1994), Elias (2002), Giacomino and Akers (2006) and Jooste (2013).

A set of questionnaires was sent to the directors of the sample firms through the mail in October 2012. The sample firms were randomly selected from the list of public listed companies on the Bursa Malaysia website. A total of 300 questionnaires were mailed. The directors were asked to evaluate each scenario by indicating their judgment as to the acceptability of earnings management practices using Likert 5-point scales ranging from ethical (1) to totally unethical (5) (note: The questions are available in Harvard Business Review, March-April 1989, pp. 220-221). The respondents were given 3 month to complete and return the questionnaire to the researcher. Out of the 300 questionnaires, 31 (10.33%) valid questionnaires were returned and used for discussions.

Findings

Table 1 presents the background of the respondents.

Table 1: Background of the Respondents

Descriptive items	Frequency	Per cent	Cumulative Per cent
Gender			
Male	25	80.6	80.6
Female	6	19.4	100
Age			
30 or under	3	9.7	9.7
31-40	8	25.8	35.5
41-50	7	22.6	58.1
51 or older	12	38.7	96.8
No answer	1	3.2	100
Race			
Malay	20	64.5	64.5
Chinese	9	29.0	93.5
No Answer	2	6.5	100
Highest education level			
First degree	15	48.4	48.4
Master degree	6	19.4	67.8
Others	9	29	96.8
No Answer	1	3.2	100
Professional qualification			
Yes	14	45.2	45.2
No	17	54.8	100
Current position in the company			
CEO	1	3.2	3.2
Executive directors	10	32.3	35.5
Independent directors	7	22.6	58.1
Others	13	41.9	100
Years in the current position			
10 or under	21	67.7	67.7
11-20	5	16.1	83.8
No answer	5	16.1	100
Involvement in decision making			
Yes	19	61.3	61.3
No	11	35.5	96.8
No answer	1	3.2	100

Based on Table 1, 25 (80.6%) of the respondents are male and 6 (19.4%) are female. In terms of age, majority of respondents are 51 years old or older (38.7%). More than half of the respondents are Malay (64.5%). With regards to the highest education, 15 (48.4%) out of the 31 respondents have a first degree and the remaining respondents have either a masters degree (19.4%) or other professional qualifications (29%). 1 (3.2%) of the respondent is CEO, 10 (32.3%) out of the 31 respondents are executive directors, 7 (22.6%) are independent non-executive directors while the remaining respondents are in other categories, i.e. finance manager, account manager; 13 (41.9%). The respondents have been serving in their current position for a period ranged between 1 to 20 years. Finally, 19 (61.3%) of the respondents have been involved in decisions that touch upon earnings management during their tenure. Table 2 reports the means scores and standard deviations for each of the 13 scenarios of the respondents in this study.

Table 2: Mean Scores and Standard Deviations (*n*=31)

Question	Mean	Std. Deviation	Range
1	2.19	1.06	1-4
2a	2.39	1.16	1-5
2b	2.58	1.34	1-5
3	3.48	1.07	1-5
4a	2.39	1.13	1-5
4b	1.74	1.08	1-5
4c	2.23	1.41	1-5
5a	3.35	1.31	1-5
5b	3.55	1.34	1-5
6a	3.19	1.33	1-5
6b	3.00	1.46	1-5
7a	3.35	1.31	1-5
7b	3.94	1.22	1-5

Consistent with prior findings by Merchant and Rockness (1994), large ranges of responses and high standard deviations that are observed from Table 2 suggests disagreement among respondents for most of the scenarios. Similar to Merchant and Rockness (1994, p. 91), our data shows *'far less than unanimous agreement about where the line between right or wrong should be drawn'*, thus, require further attention.

Table 3: Acceptability of Earnings Management Practices (*n*=31)

Attribute	Questions	Mean Rating	Std. deviation	*t*-statistics
Accrual-based earnings management	3, 5a, 5b, 6a, 6b, 7a, 7b	3.4101	0.87345	-5.991**
Real-based earnings management	1, 2a, 2b, 4a, 4b, 4c	2.2527	0.66370	

** $p < 0.01$

Consistent with prior studies (Bruns and Merchant, 1990; Merchant and Rockness, 1994), our results indicate that the acceptability of earnings management practices by directors is affected by the type of earnings management. As shown in the Table 3 above, the directors view that accrual-based earnings management is more unethical than real-based earnings management. Hence, real-based earnings management is more ethically acceptable form of earning management practices as opposed to accrual-based earnings management. As suggested by Gunny (2010), firms prefer real earnings manipulation due to several reasons: 1) aggressive accrual manipulation may result in subsequent regulatory scrutiny and litigation, 2) limited flexibility in managing reported earnings through discretionary accruals, and 3) while accounting choices are subject to auditor examination, real earnings manipulation is controlled by managers. Therefore, she suggests that real earnings manipulation is more likely to pass unnoticed by regulatory bodies and auditors as compared to accrual manipulation.

Furthermore, the mandatory adoption of IFRS further may constrain accrual-based earnings management due to a heightened scrutiny of accounting practices by regulatory bodies. Ipino and Parbonetti (2011) report a decrease in accrual-based earnings management after the mandatory adoption of IFRS. In countries with weak legal enforcement framework, managers change their preference in managing earnings by using real-based earnings management rather than accrual-based earnings management that lead to a much stronger decline in performance subsequent to IFRS adoption. Kuo et al. (2014) suggest that the costs of manipulating accruals increase as a result of greater scrutiny by the capital market following the regulatory changes. As a result, firms switch from accrual-based earnings management to real-based earnings management activities.

Conclusion

Our study documents evidence on directors' ethical judgment on earnings management practices. Our study contributes to earnings management research on the behavioural perspective which is not observable through archival empirical research. Using survey instruments, our results indicate that ethical judgments by directors are affected by the type of earnings management where the directors view that accrual-based earnings management is more unethical than real-based earnings management.

Directors' judgments towards earnings management practices have important practical implication for auditors who need to be more vigilant in their search for errors in the financial statements. As pointed out by Luippold et al. (2015), the more skeptical auditors are more likely to discover earnings management. Auditors' responses to earnings management may reduce attempt by managers to manage earnings thus help to improve the quality of the reported earnings. Furthermore, on policy implication, we recommend regulators to be aware of the overlooked area while improving the quality of accounting information. Despite regulatory changes that resulted in greater availability of information, Kuo, Ning and Song (2014) suggest that there is always an opportunity for firms to continue manipulating earnings as they can switch from accrual to real-based earnings method.

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