Ethics of Manipulations in Accounting Decisions

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ABSTRACT

The goal of this study is to search for different ethical judgments of different groups of respondents and to see if these judgments vary according to the type of earnings manipulations. In this respect, data is collected via questionnaire study composed of several manipulations scenarios, the respondents are students in business schools, and business practionners as top executives and accountants in private firms. Findings show that significant variance exists concerning the type of manipulations groups of respondents

INTRODUCTION

Financial statements provide information about the economic performance of the companies. Stakeholders c ave an idea about the effectiveness of the managerial decisions by reviewing these reports. The performance of th ompany reflects also the performance of its top managers who make all the strategic decisions. These managers have also the power to manipulate earnings reported on the financial statements in order to build a fictive image of higher success. Extend and type of these manipulations is open to discussion about whether or how much they are ethical. Alternative ways of manipulations exist, however, they are totally labeled as earnings manipulations. All possible managerial decision whether on accounting policies or operations fall in these category (Black, Sellers and Manly, 1998; Schroeder and Clark, 1995). Earnings manipulations serve sometimes to the individual interests of the owners who concern about tax payments and prefer earnings to be reported as lower than the real amount and sometimes to those of the managers who concern about their image of success and prefer earnings to be reported h er. As a result of these manipulations reflected in the financial statements, users of information, including mment bodies, investors, other share and stakeholders, provided are misinformed about the real performance of the company. Ethical codes or norms about various types of earnings manipulations are not sufficiently existent or discussed and generally agreed upon. This leads to confusion in the minds of top managers when they decide about reporting earnings while trying to serve simultaneously to individual and organizational goals within the ethical limits. Although generally accepted accounting principles and financial records exist to guide accounting decisions, many ethical dilemma await to be solved by top mangers. Dealing with these ethical problems, managers utilize their personal experience, knowledge, intelligence perceptions and intentions, and make their final judgments. It is obvious that for different types of manipulations different people coming from different backgrounds or titles would have different judgments of morality. Individuals, as various studies on psychology (Massick and Sentis, 1979) and anizational behavior (Neale and Bazerman, 1983) show, tend to make evaluations based on their own experience d interest. Since a generally agreed upon a set of principles do not exist on earnings manipulations, such ethical judgments vary from people to people. As the complexity and ambiguity of the ethical dilemma increase this variance also increases (Thompsan and Loewenstein, 1992). Moreover people from different social and or organizational roles may have different ethical judgments on the same type of earnings manipulation (Kaynama, King and Smith, 1996). The goal of this study is to have an idea about the ethical climate in Turkish world of business and accounting, and compare the judgments of managers, accountants and business students. This paper proceeds in the following manner. First we provide a brief literature review on earnings managemen, then we explain our research method and report our findings, and finally comment on the results by making suggestions for searchers and practitioners.

2. LITERATURE REVIEW

Earnings management has been such a research area that attracted the interest of many scholars and practitioners in accounting, especially since the study of Healy (1985). Most of the studies about the ethics of earnings manipulations concentrate on weather certain accounting decisions are ethical or not, which manipulations are ethical and which are not and to what extent (Kaplan, 2001; Bruns and Merchant, 1990; Merchant and Rockness, 1994; Ficher and Rosenberg, 1995). In a study of Burns and Merchant (1990) on 649 managers it is found that manipulations on operational decisions and manipulations with smaller effects on earnings were generally evaluated as more ethical when we compare with the manipulations on book accounts. Merchant and Rockness (1994) compared the ethical judgments of different business people on certain types of manipulations and found that ethical concerns of the managers were more tolerant than auditors. Fischer and Rosenzweig (1995) commented as a result

of their study on 500 respondents including business students and accountants that if a manipulation obviously breaks a rule or a principle independent from the status of the respondent, it is evaluated as an unethical manipulation, otherwise respondents are more tolerant. Thus, ethics is seen as only written rules or generally accepted principles. The classification of earnings manipulations in the previous literature is done in the following manner. First of all, they are broadly divided into two groups, namely operating decision and accounting manipulations. Then each of these two groups is divided into two subgroups. Especially account manipulations are evaluated in the literature as being more unethical (Ficher and Rosenberg, 1995). Operating decision manipulations (Ficher and Rosenberg, 1995) consist of operation revenues and expenses manipulations. Expenses manipulations are those manipulations that are done with the intension to postpone some expenditure, that normally should be done in the terminating fiscal period, to the next period. Here the motivation of this type of manipulations is to attain the periodic income targets of the managers (Healy, 1985; Holthausen, Larcker and Sloan, 1995; Gaver, Gaver and Austin, 1995; Guidry, Leone and Rock, 1999). Revenue manipulations consist of those manipulations that are done with the intension to pull earnings that normally would be realized in the next fiscal period, into the current period. These manipulations may include such decisions as providing sales promotions, speeding up shipment of products and selling of some excess assets. Accounting manipulations are divided in the literature into two categories: Inventory Record and Expense Record Manipulations. Inventory Record Manipulations consist of those manipulations that are done to write up the value of the previously undervalued inventory. Expense Record Manipulations are done by postponing the record of an expenditure that is realized in the terminating fiscal period to the next one.

3. RESEARCH METHOD

As the data collection method we preferred to use questionnaire survey method as in the previous studies with the goal of determining variances of ethical judgments on certain earnings manipulations among managers, accountants and business students in Turkey. The questionnaire form utilized in this study is adopted from Ficher and Rosenweing's study where the original form is taken and developed from that of Burns and Merchant. In this form there are ten statements to which respondents are expected to declare their ethical judgments on a 1 to 5 Likert scale (1=totally unethical, 5= ethical). The respondents in our study consisted of 75 private sector top managers, 71 internal accountants, 23 undergraduate and 117 graduate business students. Using data from these 476 respondents we conducted - via SPSS 10.0 software program- factor, ANOVA and Duncan analyses.

4. FINDINGS

An exploratory factor analysis has been conducted in order to validate the measurement scale of our research. The 10 dependent variables were analyzed utilizing Principle – Components Analysis with Varimax Rotation. In line with our expectations, a four-factor solution (Operating Expense, Operating Revenues, Inventory Record, Expense Records) has been extracted, while eigenvalues being greater than one and total variance explained 61,94. All items loaded with high standardized coefficients onto their respective factors and with substantially lower coefficients onto other dimensions (see Table 1). We can, therefore, conclude that our measurement scale has adequate reliability. Table 2 shows mean scores of the variables and factors. The least tolerated type of manipulation is found to be Expenses Record Manipulations. This type of maniplations has not already seen as consistent with GAAP. The item which is evaluated as the most unethical within the factor of Expense Record Manipulations is the postponement of the record of large expenses for the services of the consulting firm. Respondents tend to view Inventory Record Manipulations as more ethically acceptable than Expense Record Manipulations. When we compare the two items of the factor of Inventory Record Manipulations, we see that respondents evaluate the transfer of increased inventory assets value as more ethical if its used for product development purposes rather than increasing this year's revenues. We then tried to analyze the diffrences of ethical judgements among our different groups of respondents, namely undergraduate students, graduate students, accountants and managers. Table 2 also shows Anova results on different manipulations. Different groups of respondents seem to share the same ethical judgement on the Inventory Record Manipulations. As for the other three types of manipulations a consensus of ethical judgement does not exist among diffrenet groups of respondents.

Table 3 shows the results of the Duncan Test in order to understand the differences of judgments on Operating Expense Manipulations among each group of respondents. Each subset of this table shows the mean scores (out of five) of those groups respondents having similar decrease of ethical approval for this type of manipulation, while statistically significant (alpha = .05) variance exists among different subsets. Since there are two subsets in this table we can say that there are two different sets of ethical judgments about Operating Expense

Manipulations. In the first set the mean scores out of five given by undergraduate students, graduate students and accounts are almost the same. However managers have a higher mean score which constitutes another subset. We can therefore conclude that managers' ethical judgment on Operating Expenses Manipulations -that defer operating expenses to the next fiscal term in order to increase this term's profits- is more tolerant than the other respondents. The reason behind this ethical tolerance in the managerial judgments may be related to the individualistic expectations of the managers acting selfishly with the goal of increasing their personal income without taking into consideration the possible organizational losses that may be caused by demolishing the normal and rational flow of operations.

Table 1: Means scores of earnings management variables, grouped by factors

Variables	A. Operating Decision Manipulations		B. Accounting Manipulations	
	1.Operating Expense	2. Operating Revenue	1. Inventory Record	2. Expenses Record
A1.1. Postponement of this month's expenditures to the next three month period in order to meet current period's earnings target (μ=3,46)	**0,857**	0,150	1,213E-02	4,114E-02
A.1.2. Postponement of this year's expenditures to the next year in order to meet current year's earnings target (μ=3,25)	**0,842**	-1,446E-02	4,791E-02	7,979E-02
A.2.1. Offering liberal payment terms to pull some sales that would normally occur next year in to the current year (μ=4,12)	0,219	**0,674**	1,756E-03	0,110
A.2.2 Ordering manufacturing to work overtime in order to accelerate shipment of products before the end of the year (μ=4,36)	-0,187	**0,757**	1,359E-02	0,119
A.2.3 Selling some excess assets in order to meet current year's earnings target (μ=4,10)	0,116	**0,602**	0,108	-0,199
B.1.1. Writing the previously written down inventory back up to full cost and transferring the corresponding increase in earnings to some important product development projects (μ=4,03)	-4,525E-02	0,110	**0,873**	3,626E-02
B.1.2. Writing the previously written down inventory back up to full cost and transferring the corresponding increase in earnings to meet current year's earnings target (μ=3,73)	0,109	-1,225E-03	**0,846**	0,170
B.2.1. Postponement of the record of expenses for purchased office supplies that occurred before the end of this year to the next year (μ=2,49)	-3,102E-02	-7,265E-02	-7,541E-02	**0,653**
B.2.2. Postponement of the record of small expenses for the services of the consulting firm that occurred before the end of this year to the next year (μ=3,00)	0,110	7,208E-02	0,193	**0,752**
B.2.3. Postponement of the record of large expenses for the services of the consulting firm that occurred before the end of this year to the next year (μ=2,40)	7,650E-02	5,690E-02	0,146	**0,729**
Total Variance Explained	**15,713**	**14,391**	**15,561**	**16,275**

[1] 5= ethical; 4= questionable; 3 = moderate; 2= serious; 1= totally unethical

Table 2: ANOVA Table for Differences of Ethical Judgments among Different Groups of Respondents

Earnings Manipulations	*Mean*	*F values*
A.1. Operating Expense Manipulations	**3,34**	**2,758*** **
A.2. Operating Revenue Manipulations	**4,19**	**4,900** **
B.1. Inventory Record Manipulations	**3,87**	**1,966**
B.2. Expenses Record Manipulations	**2,61**	**7,231***

p< *0,001, **0,01 and ***0,05

Table 4 shows the results of the Duncan Test in order to understand the differences of judgments on Operating Revenue Manipulations among each group of respondents. Since there are three subsets in this table we can say that there are three different sets of ethical judgments about Operating Revenue Manipulations. The first set shows the mean scores given by managers, the second set by graduate students and the last one by accountants, while graduate students have a mean score that fits both first and second sets. It is clear that all groups of

respondents have high mean scores for this type of manipulation. However some respondents state much higher ethical tolerance than others. In this case those most tolerant respondents are the accountants and the least tolerant ones are the managers, while the students position in between. We can therefore conclude that since this type of manipulation has nothing to do with the principles or records of accounting they may prefer not do judge or criticize operational decisions of managers.

Table 3: Duncan Test for Operating Expense Manipulations

Groups of Respondents	Subset for alpha = .05	
	1	2
Undergraduate Students	3,2823	
Graduate Students	3,2974	
Accountants	3,3071	
Managers		3,6467

Table 4: Duncan Test for Operating Revenue Manipulations

Groups of Respondents	Subset for alpha = .05		
	1	2	3
Managers	4,0135		
Undergraduate Students	4,1511	4,1511	
Graduate Students		4,2389	
Accountants			4,4493

Table 5 shows the results of the Duncan Test in order to understand the differences of judgments on Expense Records Manipulations among each group of respondents. Since there are two subsets in this table we can say that there are two different sets of ethical judgment about Expense Record Manipulations. The first set shows the mean scores given by managers and accountants, the second set undergraduate and graduate students. Accountants and managers -the combined group of business practitioners- that consistitute the first set have less tolerance for Expense Record Manipulations that are directly in contradiction with accounting principles, while students are a bit more tolerant. We can therefore conclude that those respondents that are responsible from their manipulations - accountants or managers feel more uncomfortable when making this type of manipulations than the students who just theoretically evaluate the morality of a given case, or they may be not so well educated on the principles of accounting.

Table 5: Duncan Test for Expense Record Manipulations

Groups of Respondents	Subset for alpha = .05	
	1	2
Accountants	2,3330	
Managers	2,3426	
Undergraduate Students		2,7119
Graduate Students		2,7827

5. RESULTS AND IMPLICATIONS

The type of manipulation that is evaluated as the most ethical one by our respondents is found to be the operating revenue manipulation which is something parallel to the previous literature. Our study however does not confirm the literature in that all the groups of respondents do not have a greater tolerance for operating expense manipulation, since according to our findings the second highest mean score for ethical tolerance given by our respondents go to the inventory record manipulations instead of operating expense manipulations. And the ethical manipulation according to our respondents is found to be expense record manipulations which are clearly against to GAAP. The possible reason of these ethical judgments may be the common ethical understanding of obeying existing rules. If a decision does not break a rule it may easily accepted as ethical. However the results of this decision may have very harmful effects on our shareholders, while in some cases the same decision may be in our individual benefit. We may therefore interpret the highest tolerance coming from the managers for Operating Expense Manipulation as their selfishness. As for the accountants that are the most tolerant group of respondents for

operating revenue manipulations, we can also assume that when they judge the morality of a decision they only scrutinize its conformity with the existing rules. As for the students' combined group that is more tolerant for expense record manipulations we can assume that they are not aware of what breaks GAAP, which underlines a serious problem in business schools. As for the limitations of our research, our sample size is not sufficiently large to represent and compare the Turkish business practitioners' and students. In the design of future studies some points to be taken into consideration should include the followings: Firstly, the sample size should be as large as possible. Secondly, the number of items (cases of ethical dilemma) may be increased so that more reliable scales can be produced. Thirdly, antecedents of ethical judgments and reasons for the differences of judgments may be investigated by developing and testing appropriate models composed by related variables. These variables may include cultural, personal and organizational characteristics.

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