Attitudes of Students and Accounting Practitioners Concerning the Ethical Acceptability of Earnings Management

Marilyn Fischer
Kenneth Rosenzweig

ABSTRACT. There are many ways that accountants and managers can influence the reported accounting results of their organizational units. When such influence is directed at changing the amount of reported earnings, it is known as earnings management. The purpose of this paper is to present the results of surveys of undergraduate students, MBA students, and practicing accountants concerning their attitudes on the ethical acceptability of earnings management. Analysis of the survey results reveals how the attitudes of the three groups differ and what variables are associated with these differences. Based on the analysis, the authors suggest changes in accounting education curriculum and ethics awareness programs in business which might increase students' and practitioners' sensitivity to the ethical ramifications of earnings management.

Leading associations in accounting have called for increased emphasis on ethics education in accounting curricula. For example, the Report of the National Commission on Fraudulent Financial Reporting (commonly known as the Treadway Commission Report) made this recommendation: "The business and accounting curricula should emphasize ethical values by integrating their development with the acquisition of knowledge and skills to help prevent, detect, and deter fraudulent financial reporting" (page 82). The American Accounting Association has called for increased efforts in accounting education to foster students' sensitivity to ethical and social responsibilities (American Accounting Association Committee on the Future Structure, Content, and Scope of Accounting Education, 1986). Donnelly and Miller (1989) found empirical support among accounting professors for changing accounting curricula to include greater discussion of ethics as recommended by the Treadway Commission.1

In order to address these concerns, specific topics in ethics and accounting need to be identified for curricular development. Earnings management is one such topic because of ethical ambiguities associated with the practice. The purpose of this paper is to present information collected from undergraduate students, MBA students, and practicing accountants concerning their attitudes on the ethical acceptability of various earnings management actions. Analysis of this information will reveal which types of earnings management activities respondents consider to be ethically objectionable and which groups of respondents find the various earnings management activities to be most objectionable.

Knowing current attitudes toward earnings management will be helpful for educators interested in integrating ethical concerns into accounting programs. It will also be useful to businesses and professional associations as they develop their own policies, standards and educational programs regarding earnings management.

Marilyn Fischer, is Assistant Professor of Philosophy at the University of Dayton in Dayton, Ohio. She specializes in workplace ethics, particularly in the nonprofit sector, and has published articles in business ethics, and social and political philosophy.

Kenneth Rosenzweig, is Associate Professor of Accounting at the University of Dayton in Dayton, Ohio. He specializes in teaching management accounting, and has published articles in a wide variety of accounting areas.
Background on earnings management

While public respect for the accounting profession is quite high compared to many other professions, public confidence in the profession has been shaken by recent events involving accountants, such as the savings and loan scandal. Accountants perform the crucial function of preparing organizational statements which are fair representations of the organization's financial status; they are in effect gatekeepers of the public's trust in our institutions. Therefore, it is critically important that members of the accounting profession have a reputation of solid integrity, and that this reputation be deserved.

Earnings management is one practice which raises suspicion about accountants' and/or managers' integrity. Although earnings management has been examined in many empirical studies, there is no widely accepted definition of earnings management. For purposes of this paper, we define earnings management as referring to actions of a manager which serve to increase (decrease) current reported earnings of the unit for which the manager is responsible without generating a corresponding increase (decrease) in the long-term economic profitability of the unit. Such actions can be classified into two types: those which involve changing accounting methods and those which involve operating decisions. An example of changing accounting methods is adjusting the amounts of reserves, thereby changing reported net income. Offering special terms to customers at yearend to advance sales from next year to this year is an example of earnings management by means of an operating decision.

Some managers may view these practices as legitimate managerial tools, useful for fulfilling their responsibilities to maximize returns to shareholders. However, others view earnings management as involving distortion in ways which mislead users of financial statements.

There are ethical reasons to be wary of earnings management practices. Stakeholders rely on financial statements assuming that current reported earnings are indicative of long-term profitability. For example, stockholders and potential investors use these statements in making investment decisions. Suppliers may use them to decide which companies to do business with. Banks rely on them in making loan decisions. Communities use them in long-term community planning, such as decisions concerning which types of businesses to try to attract to the area, infrastructure development, and so on. Prospective employees may refer to them in making employment decisions. Managers utilize the statements of lower level units to evaluate their performance and make decisions concerning resources to be allocated to them.

When earnings are managed so that financial statements do not accurately reflect the economic health of the company, stakeholders' trust is violated. Stakeholders may make decisions contrary to their own best interest, which they would not have made, had they had undistorted figures. Understood in this context, earnings management is contrary to the “Standards of Ethical Conduct for Management Accountants” which states, “Management accountants have a responsibility to . . . disclose fully all relevant information that could reasonably be expected to influence an intended user's understanding of the reports, comments, and recommendations presented” (Institute, 1983).

Given the discretion and judgement accounting practitioners and managers must exercise, it is desirable for them to have knowledge of and ethical sensitivity regarding earnings management practices. There can be considerable pressure on managers or accountants to engage in earnings management. With an eye on the stock market, employers may pressure accountants and managers to distort quarterly reports to make them look more favorable. Also, accountants and managers may worry that their own performance evaluations will be linked less to the accuracy of their prepared statements than to how favorable those statements appear. These practitioners need the knowledge, good judgment and moral courage to resist such pressures. If the educational program of accountants and managers can inculcate ethical sensitivity to earnings management, then perhaps it can help reduce their tendency to engage in these practices.