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Is Managing Earnings Ethically Acceptable? Surveys Show Age and Seniority Affect Attitudes on Earnings Management

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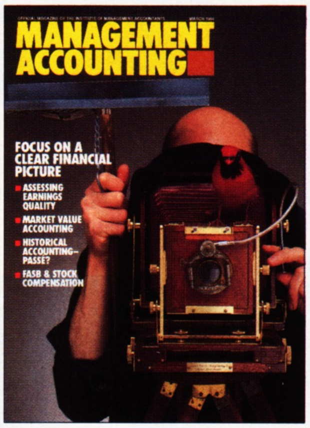

Cover: Getting a clear financial picture of any company means focusing on the details. See p. 27ff. Cover by Bob Grant, NYC.

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Is Managing Earnings Ethically Acceptable?

Survey shows age and seniority affect attitudes on earnings management.

BY KENNETH ROSENZWEIG, CMA, AND MARILYN FISCHER

Is managing earnings through accounting methods ethically acceptable? That's the question we recently asked a sample group of management accountants. The response to the survey was enlightening.

Our survey was designed as a follow-up and extension of the research done by Bruns and Merchant and published in MANAGEMENT ACCOUNTING® in August 1990.[1] They found that managers disagreed considerably on whether earnings management is ethically acceptable. They also found that in general the respondents thought manipulating earnings via operating decisions was more ethically acceptable than manipulation by accounting methods. Bruns and Merchant were disturbed by these findings. They were concerned that these practices could be misleading to users of the information and, over time, reduce the credibility of accounting numbers and thereby damage the reputation of the accounting profession.

Bruns and Merchant surveyed managers, but accountants as well can influence the level of reported earnings either directly by means of their impact on the choice of accounting methods or indirectly by monitoring the actions of managers who influence reported earnings. To learn more about accountants' attitudes toward earnings management, we surveyed 265 members of a regional organization of accountants (approximately 38% of the total membership). Our questionnaire was adapted from the one used by Bruns and Merchant and included 13 descriptions of managerial actions. The accountants were asked to rate these actions on a 5-point scale from "ethical" to "totally unethical." (See "Earnings Management Questions," p. 34.)

For the purpose of this study, we define earnings management in terms of the actions of a manager that are intended to increase (decrease) current

The University of Dayton prepares students to appreciate the moral and ethical dimensions of various disciplines. Here, faculty members Kenneth Rosenzweig and Marilyn Fischer bring the Rev. James L. Heft, S.M., provost, up to date on ethical issues addressed in the classroom.

TABLE 1 / MEAN SCORES OF ANSWERS TO EARNINGS MANAGEMENT QUESTIONS, GROUPED BY FACTORS

	Factor	Question #	Manager Actions	Mean	Mean of Factor Variable Means
Accounting Manipulation	Inventory Valuation	9	Write down inventory	1.68	1.49
		10	Write up inventory–product development	1.50	
		11	Write up inventory–profit target	1.29	
	Other	4	Record supplies next year	1.71	1.51
		8	Prepay next-year expenses	1.73	
		12	Delay consultant's invoice–small	1.76	
		13	Delay consultant's invoice–large	0.85	
Operating Decision Manipulation	Operating Expense	1	Paint ahead of schedule	3.82	3.44
		2	Defer expenditures–month	3.38	
		3	Defer expenditures–year	3.12	
	Operating Revenue	5	Pull sales–liberal terms	3.19	3.55
		6	Overtime to maximize shipments	3.70	
		7	Sell excess assets–profit	3.75	

4 = ethical; 3 = questionable; 2 = moderate; 1 = serious; 0 = totally unethical.

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. Our definition is consistent with the way Bruns and Merchant used the term, although there is no standard, widely accepted definition of earnings management.

The 13 questions on the survey can be grouped by categories (called "factors") of earnings management actions. Two of these factors involve accounting manipulation, and two involve operating decisions designed to influence reported earnings. The accounting factors include actions that influence earnings by changing accounting methods. Examples include recording an expense in the wrong year or changing an inventory valuation in order to influence earnings. Examples of operating decision manipulations are deferring necessary expenditures to a subsequent year or offering unusually attractive terms to customers at year-end to draw next year's sales into the current year.

ACCOUNTANTS' ATTITUDES: SURVEY RESULTS

Table 1 lists the mean score for the 13 questions, grouped by factors. To calculate factor scores, we averaged accountants' ethical ratings for the managers' actions that were included in that factor. The table shows that the accounting practitioners participating in the survey rated accounting manipulation much less acceptable ethically than operating decision manipulation. This finding parallels the attitude Bruns and Merchant found among managers. In our survey the accountants gave accounting manipulation an average rating between a moderate and a serious ethical infraction. They saw manipulation of inventory valuations as being just as questionable ethically as other forms of accounting manipulation.

Generally, the practitioners had few ethical qualms about operating decision manipulation. For these factors, the practitioners' scores indicated an average rating between (fully) ethical and questionable. The practitioners, however, generally felt that operating decisions that influenced expenses were somewhat more suspect than those that influenced revenues.

We also looked at whether there was a correlation between the accountants' answers and their experience and level of responsibility. Table 2 suggests that accountants with more years of accounting experience are more tolerant of operating decision manipulation that affected reported expenses than are their less experienced colleagues. Consistent with this finding, Table 3 shows that accountants with higher levels of organizational responsibility rate operating decision manipulations of both types as more ethical than do accountants with less responsibility.

ETHICALLY TROUBLING RESULTS

Like Bruns and Merchant, we are disturbed by these findings. That accountants are more sen-

TABLE 2 / DIFFERENCES IN MEANS OF ETHICAL RATINGS OF OPERATING DECISION MANIPULATION AFFECTING OPERATING EXPENSE AT DIFFERENT EXPERIENCE LEVELS

Experience Level	Number of Respondents	Mean, Operating Expense
Six years or less	56	3.1310
Greater than six years	209	3.5231

4 = ethical; 3 = questionable; 2 = moderate; 1 = serious; 0 = totally unethical.

sitive to accounting manipulation than operating manipulation is understandable in light of their training and experience. Several of the situations in the survey dealing with accounting manipulation not only involved ethically questionable practices, but they also involved violations of accepted accounting practice. For example, in survey question Number 4, the deferral of the recording of supplies received to a future accounting period is clearly a violation of generally accepted accounting principles. Analogous professional standards do not exist for the situations described in the operating manipulation questions.

The fact that the profession does not have explicit standards against operating manipulation does not mean that operating manipulation is any more ethical than accounting manipulation. Accountants' basic ethical concern here should be whether such practices involve distortions that mislead users of financial statements. Both accounting and operating manipulations can lead stakeholders to make inaccurate assessments of a company's economic health.

Given the kinds of decisions stakeholders make in light of reported earnings, both accounting and operating manipulations can be damaging to their interests. Stakeholders rely on financial statements, assuming that current reported earnings indicate long-term profitability. When earnings are managed so that financial statements do not reflect the economic health of the company accurately, stakeholders may make decisions they otherwise would not have made. Because of its distorting effects, 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."[2]

Our findings that accountants with more experience and higher positions in the organization are more tolerant of earnings management also is distressing. It could be that persistent pressure for short-term earnings growth tends to diminish accountants' ethical values, particularly with regard to manipulation of earnings. Perhaps accountants' ethical sensitivity weakens as they move up in a company, or, in some cases, accountants who already have loose standards regarding earnings management may be more likely to be promoted.

This finding suggests that it is crucial for accountants with a high level of responsibility in an organization to set a clear example concerning earnings management and truthful reporting. Newly hired accountants look to their more senior colleagues for guidance concerning ethical behavior. If senior-level accountants engage in considerable earnings management, those at lower levels on the promotion ladder will learn quickly that the route to success in the organization is not facilitated by truthful reporting.

THE PROFESSION'S RESPONSE

Our survey points out the need for individual accountants to become more sensitive to the ethical dimensions of earnings management. For example, accountants may feel pressured by their organization to engage in earnings management in order to make quarterly reports look more favorable. Also, accountants may be concerned that their own performance evaluations will be based more on how favorable their prepared statements appear than on accuracy. Individual accountants need a clear understanding of the distorting effects of earnings management and the judgment and courage to resist these pressures.

Because decisions by operating managers can distort reported earnings significantly, management accountants need to assume responsibility regarding operating decision manipulation of earnings. Management accountants are held responsible by their organizations for the integrity of the financial reporting process. Distorted earnings as a result of operating decision manipulation reflect negatively on the performance of management accountants. Thus, management accountants have a stake in the organization's implementing procedures to deter earnings management by means of operating decisions. As management accounting traditionally has been seen as a staff function, accountants may think it is not appropriate for them to "meddle" in the decisions of operating managers. But to the extent that the decisions of operating managers affect their ability to carry out their responsibilities with integrity, management

TABLE 3 / DIFFERENCES IN MEANS OF ETHICAL RATINGS OF OPERATING DECISION FACTORS AT DIFFERENT JOB LEVELS

Job Level	Number of Respondents	Mean, Operating Expense	Mean, Operating Revenue
Entry-level or junior accountant	14	2.7381	3.1905
Experienced employee or senior accountant	55	3.4061	3.4667
Supervisor or manager	124	3.5242	3.6129
Executive or partner	56	3.5119	3.6012

4 = ethical; 3 = questionable; 2 = moderate; 1 = serious; 0 = totally unethical.

EARNINGS MANAGEMENT QUESTIONS

For each question, mark in pencil the letter on the General Purpose Data Sheet that best reflects your assessment of the ethical nature of the action as supervisor of the General Manager (GM) of the division. A = Ethical; B = Questionable; C = Moderate; D = Serious; E = Totally Unethical.

1. The division's headquarters building was scheduled to be painted in 1992. But since profit performance was way ahead of budget in 1991, the GM decided to have the work done in 1991. Amount: $150,000.

This information applies to the following two questions. The GM ordered division employees to defer all discretionary expenditures (e.g., postpone employee travel, advertising, hiring, maintenance) into the next accounting period so the division could make its budgeted profit targets. Expected amount of deferrals: $150,000.

2. The expenditures were postponed from February and March until April in order to make the first-quarter target.
3. The expenditures were postponed from November and December until January in order to make the annual target.
4. On December 15, a clerk ordered $3,000 of office supplies, and the supplies were delivered on December 29. This order was a mistake because the GM had ordered that no discretionary expenses be incurred for the remainder of the fiscal year, and the supplies were not urgently needed. The company's accounting policy manual states that office supplies are to be recorded as an expense when delivered. The GM learned what had happened and, to correct the mistake, asked the accounting department not to record the invoice until February.

This information applies to the following three questions. In September, the GM realized the division would need strong performance in the fourth quarter to reach its budget targets.

5. The GM decided to implement a sales program offering liberal payment terms to pull some sales that normally would occur next year into the current year; customers accepting delivery in the fourth quarter would not have to pay the invoice for 120 days.
6. The GM ordered manufacturing to work overtime in December so that everything possible could be shipped by the end of the year.
7. The GM sold some excess assets and realized a profit of $40,000. This information applies to the following two questions. At the beginning of December 1991, the GM realized the division would exceed its budgeted profit targets for the year:
8. The GM ordered the division controller to prepay some expenses (e.g., hotel rooms, exhibit expense) for a major trade show to be held in March 1992 and to book them as 1991 expenses. Amount: $60,000.
9. The GM ordered the division controller to write down the inventory due to obsolescence (i.e., reduce its asset value and record a corresponding loss in the income statement). By taking a pessimistic view of future market prospects, the controller was able to identify $700,000 worth of finished goods that conservative accounting would say should be written off even though the GM was fairly confident the inventory would still be sold at a later date at close to full price.

This information applies to the following two questions. The next year, the division sold 70% of the written-off inventory, and a customer had indicated some interest in buying the rest of that inventory the following year. The GM ordered the division controller to write the inventory back up to full cost. This would involve a $210,000 increase in the inventory asset value (which had been previously written down due to obsolescence) and a corresponding increase in net income. The GM's motivation for recapturing the profit was:

10. To be able to continue working on some important product development projects that might have been delayed due to budget constraints.
11. To make budgeted profit targets.

This information applies to the following two questions. In November 1991, the division was straining to meet budget. The GM called the consulting firm that was doing some work for the division and asked that the firm not send an invoice until next year. The firm agreed. Estimated work done but not invoiced:

12. $30,000
13. $500,000

accountants should be involved.

A number of things can be done to help accountants and managers become more aware of the ethically damaging effects of earnings management. For example, organizations could institute ethics awareness seminars and workshops. Ethical analyses of specific earnings management situations could be included as case studies in professional publications.

Also, a number of specific measures could be adopted to deter earnings management. Company recruitment policies could be revised to attract employees who already have ethical sensitivity to issues such as earnings management. Ethical codes that include explicit policies on both accounting and operating manipulation could be adopted. Management accountants and their organizations could adopt specific monitoring procedures regarding operating manipulation.

Because of its potential to distort reported earnings and mislead users of financial information, earnings management is a significant ethical concern. Individual practitioners, their organizations, and professional associations should take steps to identify and deter this practice. ■

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[1]W. J. Bruns and K. A. Merchant, "The Dangerous Morality of Managing Earnings," MANAGEMENT ACCOUNTING®, August 1990, pp. 22-25.
[2]"Standards of Ethical Conduct for Management Accountants," SMA 1C, Institute of Management Accountants, Montvale, N.J., 1983.

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