

*Full-length Research Paper*

# Survey effects of intent and materiality earnings management on ethical judgment of students in Iran

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**Earnings management is the practice of making discretionary accounting choices or timing operating decisions to move reported earnings toward a desired goal. Prior research reveals wide disagreement among both students and business executives regarding the ethical acceptability of earnings management. This study investigates whether intent and materiality influence students' perceptions of earnings Management. The main purpose of the study was to investigate the ethical perception of senior students concerning different earnings management scenarios. The study measures the differences in ethical perception concerning different groups. These groups consist out of males versus females and accounting versus non-accounting students. The results of the 250 questionnaires indicate that: Students will judge there are significant differences between individual intent of earnings management and company intent of earnings management. There is a significant difference between knowledge unethical high materiality earnings management and low materiality earnings management.**

**Key words:** Earnings management, professional judgment, ethical perception

## INTRODUCTION

Around the evaluation of individual ethical behavior; individuals to be an important issue in business practice and education. The study of ethical perceptions of future business executives is especially present students to the assessment of the overall ethical climate in Iran. Also With the continued expansion of companies into the "global marketplace," it is increasingly important to examine the ethical perceptions of individuals with different judgment in an attempt to evaluate the ethical climate that may exist in this burgeoning economy. Additionally, the effect of gender on ethical perceptions in business is not well understood, and the research to date on gender and ethical perceptions of business students (e.g., Paul M. Clikeman, Marshall A. Geiger and Brendan

T. O'Connell 2001) has produced conflicting results. The purpose of this study is to increase our understanding of future business persons' perceptions regarding the practice of earnings management (e.g., income smoothing), and whether those perceptions are influenced by intent or materiality earnings management. Specifically, we examine whether students' gender or field study significantly affects their perception of the practice of earnings management. Discerning differences between accounting and non-accounting individuals' perceptions about earnings management becomes more important as global trade increases and people rely more heavily on financial statements prepared by individuals from foreign countries. Further, understanding whether men and women have different views about earnings management has become increasingly important as more women enter the accounting profession and rise to higher levels of Responsibility. But this is very important to

survey that the broad ethical issue examined in this study is the acceptability of earnings management or not. Earnings management is the practice of choosing accounting estimates or timing operating decisions to move reported earnings toward a desired goal (Merchant and Rockness, 1994). Examples of earnings management include a company increasing its reported profits to avoid violating debt contracts, or a group of executives underreporting company earnings in order to negotiate a favorable price in a management buyout offer. Company executives might also manage reported earnings in order to increase their bonus compensation, obtain loans on more favorable terms, increase the company's stock price, or report smooth year-to-year revenues and earnings growth. Also Merchant and Rockness (1994) even identifies earnings management and manipulation as the greatest threats to ethics in accounting the literature mentioned numerous definitions of earnings management. Kaplan (2001), use this definitions that earnings management is using judgment in reporting financial results and in structuring transactions to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers. As well as, Elias (2002) uses a definition from a former SEC chairman which states that earnings management is accounting hocus-pocus where flexibility in financial reporting is exploited by managers who are trying to meet earnings expectations. Thirdly, Fischer and Rosenzweig (1995), use a more case specific definitions of earnings management as actions by division managers which serve to increase or decrease current reported earnings of a divisions without a corresponding increase or decrease in the long-term economic profitability of that division.

Finally, Prior et al (2008) defines earnings management as managers exercising their discretion over the accounting numbers. Prior (2008) gives three important motives for earnings managements. First managers' motive is to influence short term prices, particularly around the time of certain types of corporate events, such as stock issues. Second motive, is that certain contracts create an incentive for managers to engage in earnings management with the purpose of boosting bonus awards. Thirdly, there are also regulatory motivations for earnings management. Managers of regulated sectors suffer acute pressure from antitrust authorities regarding price controls and market share. Such pressure stimulates earnings management practices as a stratagem to appear less profitable. The remainder of the article is organized as follows: first, literature review which gives a comprehensive overview of the literature concerning earnings management, secondly, the hypotheses

development, thirdly the research method, fourthly research results and finally the conclusion.

## LITERATURE REVIEW

### Corporate ethical values and earnings management

Corporate ethical values are defined as a composite of the individual values of managers and both the formal and informal policies on ethics of the organization (Elias, 2004). Tone at the top is therefore very important in corporate environments and that it determines whether managers behave unethically or not. The study of Elias (2004) examines corporate ethical values as a potential determinant of earnings management ethics.

The study clearly shows that accountants in organizations with high ethical values perceived earnings management actions as more unethical. CPA's in industry occupations were significantly less likely than those in public accounting to perceive high ethical values in their organizations. Finally, Elias concluded that different demographic factors influence the perception of corporate ethical values. CPA's in industry occupations With high level positions, high incomes and who changed jobs frequently were more likely to perceive high corporate ethical values in their organizations compared to those in entry level positions, lower incomes and who have been with fewer companies. Furthermore males and younger CPAs in public accounting were more likely to perceive high ethical values compared to their female and older colleagues. In conclusion, corporate ethical values were important determinants of earnings management perception. Young CPA's in industry occupations and those in larger companies did not view their organizations to have high ethical values. It is therefore possible that unethical activities are more common in larger firms.

### Avoiding accounting disclosure oversight

Managers can engage in earnings management if they are able to effectively avoid oversight by the audit committee. In an environment where shareholders and directors rely on management for critical information, management has substantial opportunities to deceive or provide them with information that insufficiently explains accounting practices. In the case study of Phillips (2000), they give a clear and extensive view, how managers deceive shareholders by manipulative company's receivables, inventories, loss contingencies, and capital asset depreciation. These accounts require technical knowledge as well as form of subjectivity. These factors make it hard for oversight to detect any form of

irregularities or deception. In the past, audit committees have often failed to protect shareholders by inadequately monitoring and controlling the accounting judgments made by management (Rose, 2008). In the article of Rose (2008), they investigate whether financial knowledge and trust influences audit committee members' judgment concerning client explanation for their accounting judgments. They find that audit committee members with less financial knowledge are more likely to accept insufficient client explanations for accounting judgment and are also more likely to reject sufficient client explanations for accounting judgments than more knowledgeable audit committee members. Another important finding concerning trust is that members with higher levels of trust in others are more likely to accept insufficient client explanations for accounting judgments than are less trusting committee members. Therefore it can be concluded that for audit committee members to increase the change of detecting earnings management, they have to be knowledgeable and be sceptic towards management explanation for their accounting judgment.

### **Management and voluntary disclosures**

The SEC requires publicly held US companies to disclose all information, whether it is positive or negative, that might be relevant to an investor's decision to buy, sell, or hold a company's securities (Miller, 2009). Furthermore, Jo (2008) argues that firms with extensive disclosures are less likely to face information problems, and more likely to lead to an active shareholder monitoring, and therefore, engage in fewer unethical activities, such as aggressive earnings manipulation, and have better long-term, post stock issue performance. Next to these required disclosures, managers also use voluntary disclosures. Two of the most common types of voluntary disclosures provided by companies are earnings forecasts and alternative non-GAAP earning measures. Why do managers use voluntary disclosures? One reason is that manager's issue forecasts to align the market's earnings expectations with management's beliefs. Secondly, managers use voluntary disclosures to reduce litigation risk associated with shareholder lawsuits. Finally, managers use voluntary disclosures to develop a favorable reputation for transparent and accurate reporting (Miller, 2009). In the article of Miller (2009), he finds evidence that managers engage in opportunistic disclosure behaviour that often benefits one group at the expense of other groups. Opportunistic disclosure is a voluntary disclosure in which managers seek advantages, through disclosure choices, that accrue specifically to either the firm, management, or a subset of investors. These opportunistic disclosures behaviour is

consistent with maximizing shareholder value however at the cost of other stakeholders such as investors and the public at large. This is also an important issue concerning earnings management where managers engage in earnings management which benefits some groups at the expense of other.

### **Macro- micro-manipulation**

Financial statements provide information that is used by interested parties to assess the performance of managers and to make economic decisions (Gowthorpe, 2005). As already mentioned above, preparers of financial statements are in a position to manipulate earnings and alter the view of economic reality and therefore mislead financial statement users. The article of Gowthorpe (2005) examines two categories of manipulative behavior. First of all, macro-manipulation which is defined as lobbying to regulators to persuade them to produce regulation that is more favorable to the interest of preparers. Secondly, micromanipulation, which describes the management of accounting, figures to produce a biased view at the entity level. Gowthorpe (2005) concludes that some preparers of financial statements are willing to engage in lobbying in an attempt to sway accounting regulators to produce rules that are advantageous to the interest of preparers (macro-manipulation). It also demonstrates how some preparers have strong influence and power over regulators. They also conclude that some preparers engage in manipulation at their entities in order to present a biased view of economic reality. In conclusion, these two forms of manipulative behaviour result in financial statements that suit the purposes of the preparer but are less likely to suit the purposes of the users. They clearly are not fair to users, and involve an unjust exercise of power, and they tend to weaken the authority of the regulators (Gowthorpe, 2005).

### **Earnings management and reputation effects**

A lot of the articles concerning earnings management investigate why and how managers engage in earnings management. Kaplan (2004) designed a model to investigate the ethical reputation effect of a target manager who must decide whether to engage in earnings management.

Managers face costs as well as benefits when they choose to engage in earnings management. In the article of Kaplan (2004), managers decide to engage in earnings management or not. Furthermore the organizational incentive structure is either short-term which could tend to encourage earnings management or long-term with less reward for engaging in earnings management. He

also measures three variables: managers' ethical assessment, judgments of abilities and work related opportunity judgments. Managers' ethical assessment is measured by asking 9 respondents how ethical they judge the manager on a nine-point scale. The respondents also judged the manager's ability on three dimensions: competence, knowledge of the industry and business practices, and willingness to work hard. Finally, respondents were asked to provide judgments of the relative strength of their support for three professional opportunities the target manager might face which relate to the work related job opportunity. The main results of the article indicate that managers engaging in earnings management are perceived to be less ethical. Ethical assessments and managerial ability assessments are positively associated. Finally, ethical assessments will be positively related to work related opportunity judgment. Consequently, it can be concluded that engaging in earnings management will provide the manager with short-term benefits such as a bonus. However, the long-term cost can be severe and limit managers' work related opportunities as well as their ability assessment by colleagues and others.

### **Moral intensity and propensity to manage earnings**

Moral intensity refers to situations whereby the actual characteristics of the moral issue itself will have an impact on the moral decision-making process and the moral behavior (Ng, 2009). Therefore, it can be said that moral intensity has a focus on the moral issue, not on the characteristics of the individual making the decisions or the organizational context. The moral intensity model consists out of six characteristics. First, magnitudes of consequences which are defined as the sum of the harms or benefits performed on victims or 16 beneficiaries in relation to the moral act. Second, social consensus which is defined as the extent of social agreement that a proposed act is good or evil in nature. Third, proximity which refers to the feeling of nearness that the manager feels for the victims or beneficiaries of the evil or beneficial act in question. Fourth, probability of effect which refers to the likelihood that the action taken will actually result in harm. Fifth, temporal immediacy defined as the length of time for the consequences of the moral act in question to become apparent. Finally, the concentration of effect which is where the perceived ethicality of a situation is determined by whether the action taken impacts on an individual or a group.

The article of Ng (2009) shows a clear interaction between the social consensus and the proximity dimension. Secondly, it shows an interaction between temporal immediacy and magnitude of consequences. Finally, it shows an interaction between the probability of

effect and the proximity dimension. Therefore it can be concluded that the article tries to measure the effect of moral intensity on managers' propensity to manage earnings. It is important to understand how the moral issue impacts the decision and the behavior of a manager and understand why a manager chooses to engage in earnings management.

### **Earnings management and corporate social responsibility**

The article of Prior (2008) identifies 3 major incentives to engage in earnings management. First, managers try to influence short-term prices, particularly around the time of certain types of corporate events such as stock issues. Second, compensation contracts create an incentive for earnings management with a view to boosting bonus awards. Finally there are also regulatory motivations for earnings management. Managers of firms in regulated sectors suffer acute pressure from antitrust authorities regarding price controls and market shares. Therefore, this pressure stimulates earnings management practices as a stratagem to appear less profitable. Furthermore, the article states that corporate social responsibility (CSR) is related to ethical and moral issues concerning corporate decision-making and behavior and, as such, addresses complex issues like environmental protection, human resources management, health and Safety at work, local community relations, and relationships with suppliers and customers. The main findings are that the extent of earnings management is positively associated with the extent of corporate social responsibility. Reason for this finding is that executives with incentives to manage earnings will be very proactive in boosting their public exposure through CSR activities. Finally, earnings management negatively moderates the relationship between CSR and corporate financial performance (ROA). This means the greater the level of earnings management, the lesser the positive effect of CSR on corporate financial performance. This article clearly shows that managers use CSR as a tool to reduce the likelihood of Earnings management practices being scrutinized by the firm's stakeholders.

### **Ethics of managing earnings**

Merchant and Rockness (1994) investigates how people judge the acceptability of earnings management actions. These judgments depend on the type of action (accounting vs. operating manipulation), consistency with GAAP, the direction of the effect on earnings, materiality, the period of effect and the purpose in mind. Furthermore, they investigate whether moral judgments are consistent across different populations such as

managers in different firms and personnel in different roles. The results indicate that people's ethical judgments were affected by the type of earnings management. The accounting manipulations were judged much more harshly than the operating manipulation. Secondly, it did not matter whether accounting manipulations were consistent with GAAP concerning people's acceptability judgments. Thirdly the direction of effect on earnings was not important. This means that actions which boosted earnings were not rated significantly different from those which boosted earnings were not rated significantly different from those which decreased earnings. Fourthly, acceptability judgments concerning materiality mattered. Larger earnings management actions were rated significantly less acceptable than the smaller immaterial actions. Fifthly, the period of effect also mattered. The year-end earnings manipulations were judged significantly less acceptable than quartered earnings manipulation. Finally, the manager's purpose for engaging in earnings management was a concern. People judge the selfish action (bonus reward) more harshly as the earnings manipulation for the corporation's best long term interest. The results also indicate that managers in different firms judge earnings management significantly more harshly than others. The firm which had a recent major fraud incident judged earnings management more harshly than the company which did not have a major fraud incident. Furthermore general managers were judging earnings management more harshly were internal auditors were significantly more liberal in their judgments.

### **Management's preannouncement strategies**

Management has a duty to provide timely and accurate financial statement information to investors and potential investors about the company's business activities. The article of Cianci (2008) examines investors' judgments of management's trustworthiness in response to management's earnings preannouncements. The article focuses on preannouncement decisions because such decisions are ethically charged in that they impact a large amount of stakeholders. The results of the study show that managers' preannouncement decisions are significantly associated with investors' evaluations of management's trustworthiness. Furthermore, the judgments of management's trustworthiness are damaged more following a negative as opposed to a positive earnings surprise. The study also shows the benefits from the issuance of accurate earnings and/or conservative earnings preannouncement. Consequently, managers who are able to issue accurate preannouncements are judged as more trustworthy than other managers.

### **Ethical management and corporate governance**

Ethical earnings management practices would include, for example, using derivative securities to hedge business risks whereas unethical earnings management practices include accrual management to cosmetically smooth earnings (Huang, 2008). In this article they test whether a company's ethical management which does not engage in earnings management, does influence the nomination of strong independent boards in order to signal their earnings quality. The board of directors is an important internal control mechanism designed to monitor the actions of top management, presumably including the use of accruals to manage earnings. They found strong evidence that a commitment to improving board independence serves as a signal of ethical governance, which in turn increases firm value. Therefore it can be concluded that a high ethicalness of management and strong independent board of directors is a strong signal towards shareholder and non-shareholder about the quality of the firm's financial information as well as a strong internal control mechanism to Prevent or detect abusive earnings management.

### **Hypotheses development**

In the introduction I mentioned several definitions of earnings management. The definition used in this study is by Kaplan (2001) and states that earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports either to mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers.

A manager in a company has usually two main purposes or intentions to engage in earnings management. The first intention can be seen as being in the long term best interest of the company. This intention is called company intent and may involve a manager engaging in earnings management to be able to continue an important product development project. The second intention to engage in earnings management is a selfish purpose and involves a manager who engages in earnings management to reach a financial target which in turn triggers a bonus award for the manager in question. This intention to engage in earnings management is called individual intent. Merchant and Rockness (1994) found in his study that the manager's purpose for engaging in earnings management was a concern. People judge the selfish action (individual intent) more harshly as the earnings manipulation for the company's long term interest (company intent). In other words, I hypothesize that students in my study will also judge the

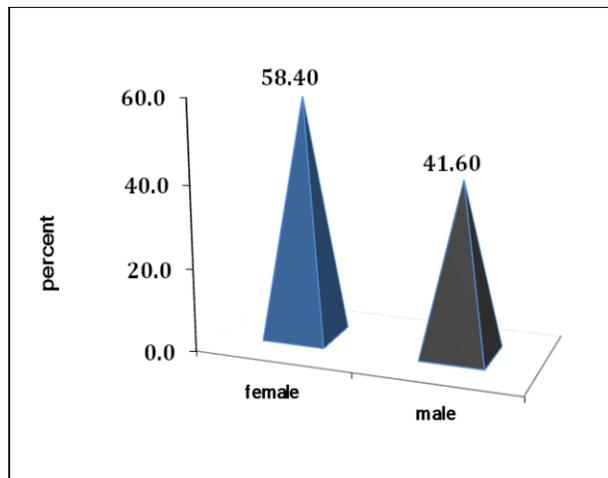


Figure 1. Gender

Table 1. Gender

Valid percent	frequency	gender
58.40	146	Female
41.60	104	Male
		Missed
100.00	250	total

individual intent of earnings management more severe than the company intent of earnings management.

H1: Students will judge there are a significant difference between individual intent of earnings management and company intent of earnings management.

Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful (Soltani, 2007). The results of Merchant and Rockness (1994) show that materiality matters. The larger earnings management action was rated significantly less acceptable than the smaller (immaterial) earnings management action. Consequently, I will hypothesize that students will judge high materiality earnings management less ethical than low materiality earnings management.

H2: There is a significant difference between knowledge unethical high materiality earnings management and low materiality earnings management.

## RESEARCH METHOD

In order to collecting data a questionnaire designed and developed based on Five Likert scale which adopted from Merchant and Rockness (1994) and Fischer and Rosenzweig (1995) studies. The questionnaire contains two parts the first part covers bio data of participants and the second one is related to hypotheses of the study. The questionnaire consists out of 15 questions which show several earnings management scenarios. The students were asked to evaluate each earnings management scenario. They will indicate their ethical perception concerning the earnings management practices on a scale of 1 to 5. The meaning of the scale is as follow; 1= ethical, 2= totally ethical, 3= minor infraction, 4= unethical, 5= totally unethical.

## RESEARCH RESULTS

The questionnaire consists out of 15 earnings management scenarios and 2 personal/demographic questions. The total numbers of questionnaires used in this study equals 250. As already mentioned before, to test hypothesis 4, I needed to know the gender of the respondents (figure 1). Total number of respondents was 250 including 104 males (41.6%) and 146 females (58.4%).

It should be noted that frequency non-accounting students and accounting students is equally in the questionnaire To test the hypothesis the following procedure is do: Descriptive statistics used to place on the distribution of data in frequency tables, charts and the the central and scattering parameters. However, because given that a five-choice questions and Likert methods have been developed, so to determine the normal distribution of variables used of test ANOVA and T Test. also, The following, we Be provided The main formula for the tests of these hypothesis.

$$\text{Variable OverallEM} = \frac{Q1 + Q2 + Q3 \dots Q15}{15}$$

$$\text{Variable CompanyIntent} = \frac{Q1 + Q13}{2}$$

$$\text{Variable IndividualIntent} = \frac{Q2 + Q12}{2}$$

We present following the statistical tables:

Initially, Runs test and Kolmogoroff-Smirnoff test for

**Table 2.** Runs Test

	Mean
Test Value <sup>a</sup>	2.93
Cases < Test Value	123
Cases >= Test Value	127
Total Cases	250
Number of Runs	102
Z	-3.039
Asymp. Sig. (2-tailed)	.002

**Table 3.** One-Sample Kolmogoroff-Smirnoff Test

	Mean	
N	250	
Normal Parameters <sup>a</sup>	Mean	2.8477
	Std. Deviation	.82581
Most Extreme Differences	Absolute	.076
	Positive	.076
	Negative	-.069
Kolmogoroff-Smirnoff Z	1.197	
Asymp. Sig. (2-tailed)	.114	

accident data and normal is done:

Then following statistical tests have been done:

Therefore, we accept the first hypothesis:

Students will judge there are a significant difference between individual intent of earnings management and company intent of earnings management. Results tests of other hypothesis in the thesis provided following: The results indicate type, intent, time, material earnings management among the groups studied in this paper is judged differently from other studies. So that judge sample students has been that managers engaging in earnings management for individual intent as more unethical as compared to company intent. So, we accept the second hypothesis. There is a significant difference between knowledge unethical high materiality earnings management and low materiality earnings management.

## CONCLUSION

The literature gives many earnings management definitions. The definition used in this study is by Kaplan (2001). The definition states that earnings management

occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports either to mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting number. The main purpose of the study was to investigate the ethical ethical judgment of students concerning different earnings management scenarios. The study measures the differences in ethical perception concerning different groups. These groups consist out of males versus females and accounting versus non accounting students. Furthermore, the questionnaire tries to capture five factors that affect student's ethical perception of earnings management scenarios. These factors include; type if action (accounting versus operating manipulation), the direction of the effect on earnings (increase versus decrease earnings manipulation), materiality (low versus high materiality), the period of effect (quarter end versus year end manipulation) and the purpose in mind (company versus individual intent).

The results of the 250 questionnaires indicate that:

- (1) Students will judge there are a significant difference between individual intent of earnings management and company intent of earnings management.
- (2) There is a significant difference between knowledge unethical high materiality earnings management and low materiality earnings management.

A plausible answer for this result may be that students have learned that there is generally a high tolerance for conservatism in financial reporting. Furthermore, students may believe that this conservatism does generally not affect investors' financial decisions as much as boosting earnings and therefore students judge earnings management that high materiality as less unethical. As also mentioned in Merchant and Rockness (1994), there is a significant disagreement among the respondents for most of the scenarios. This implies that students do not clearly have an understanding about where the line between right and wrong should be drawn. However, it has to be noted that students in this study judge most of the earnings management scenarios as more unethical as compared to Merchant and Rockness (1994) and Fischer and Rosenzweig (1995). An explanation may be that after the Enron and WorldCom scandals and the credit crisis, respondents' judge earnings management as less ethical than during the period in which Merchant and Fischer and Rosenzweig conducted their research.

Finally, it can be concluded that an important purpose of professional accounting education is to introduce students to the ethics and values of their chosen profession. It should be clearly stated what is wrong and

**Table 4.** Paired Samples Statistics

	Mean	N	Std. Deviation	Std. Error Mean
Pair 1 Company intent	2.3300	250	1.29336	.08180
Individual intent	3.3940	250	1.34200	.08488

**Table 5.** Paired Samples Correlations

	N	Correlation	Sig.
Pair 1 intent	250	.001	.993

**Table 6.** Paired Samples Test

	Paired Differences					t	df	Sig. (2-tailed)
	Mean	Std. Deviation	Std. Error Mean	95% Confidence Interval of the Difference				
				Lower	Upper			
Pair 1 intent	-1.06400	1.86327	.11784	-1.29610	-.83190	-9.029	249	.000

**Table 7.** Paired Samples Statistics

	Mean	N	Std. Deviation	Std. Error Mean
Pair 1 Low materiality	3.36	250	1.382	.087
High materiality	2.33	250	1.349	.085

**Table 8.** Paired Samples Test

	Paired Differences					t	df	Sig. (2-tailed)
	Mean	Std. Deviation	Std. Error Mean	95% Confidence Interval of the Difference				
				Lower	Upper			
Pair 1 materiality	1.032	2.014	.127	.781	1.283	8.103	249	.000

right when preparing budgets and financial statements and reporting earnings. It is advisable for Universities that they provide ethics courses to students during their accounting education. Furthermore, it is important for companies to have strong corporate governance and clearly indicate what is seen as acceptable and what is seen as unacceptable in their accounting practices. Also the current bonus culture in companies should be revised

because this is one of the major causes of earnings management.

**Some suggestions for future research**

Future research can investigate whether students from different universities in all the world have different ethical perceptions concerning earnings management. A second

suggestion could be to investigate the difference between cultures. For example, investigate whether there is a significant difference in ethical perception concerning earnings management between Asia and Europe or America. A third suggestion could be to further investigate the difference in study. This study only makes a distinction between accounting and non accounting students. It could be interesting to see the differences in ethical perception concerning earnings management between accounting, marketing, finance and logistic students. Finally, it would be important to know whether an ethics course has some impact on the students' ethical perception of earnings management. Therefore, at the end of the questionnaire, an extra question could be added, asking students whether they have followed an ethics course in the past.

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