Further evidence on the ethics of managing earnings: an examination of the ethically related judgments of shareholders and non-shareholders

Steven E. Kaplan *

School of Accountancy and Information Management, Arizona State University, Tempe, AZ 85287, USA

Abstract

The current experimental study examines whether financial statement users’ assessments of the ethicalness of earnings management is a function of intended benefit. Evening MBA students, assigned to the role of either a shareholder or non-shareholder, read three hypothetical scenarios involving a manager engaging in earnings management. In response to each scenario, participants judged the ethicalness of the earnings management incident and the likelihood that shareholders will suffer financially from the earnings management incident. The results of the study indicate that the ethicalness of earnings management was assessed less unethically for one of the three scenarios by shareholders when the earnings management was intended for company benefit. The results also show that intent did not influence ethicalness assessments among non-shareholders. These results provide some evidence to support Dye’s (1988, pp. 201–207) analytic model and indicate that under certain conditions shareholders and non-shareholders are differentially influenced by the intent of earnings management. © 2001 Published by Elsevier Science Ltd.

1. Introduction

Companies as well as business-unit managers engage in earnings management (see Healy and Wahlen, 1999 for an excellent review), which can lead to a

*Tel.: +1-480-965-3631; fax: +1-480-965-8392.
E-mail address: steve.kaplan@asu.edu (S.E. Kaplan).
variety of consequences. For example, while earnings management may allow management to achieve an earnings-based bonus, it may also affect management’s reputation (Guidry et al., 1999, p. 120), and raise questions about management’s ethics (Bruns and Merchant, 1990, p. 24). Indeed, Merchant and Rockness (1994, p. 92) characterize earnings management as “probably the most important ethical issue facing the accounting profession”.

Merchant and Rockness (1994, pp. 87–90) provide initial evidence on the ethical assessments of earnings management among various organizational members (e.g., general managers, corporate staff, operating-unit controllers, and internal auditors). In this study I focus on assessments of those outside the organization – users of financial statements. Managers, companies, and policy makers should be interested in the extent to which external parties view earnings management activities as unethical. If earnings management is considered unethical by financial statement users, then managers’ and companies’ reputations may suffer and companies’ credibility in the financial markets may be damaged. Beneish (1997, pp. 288–292) found, for example, that firms actually violating GAAP earn negative returns for two years following the disclosure of the GAAP violation. Similarly, Dechow et al. (1996, pp. 22–25) found that the stock market responds negatively to allegations of earnings management by the financial press or the Securities and Exchange Commission. Alternatively, the cost of capital may be higher among firms perceived as employing a management of questionable ethical standards.¹

My paper provides evidence on the ethical judgments of earnings management by external parties. In particular, the paper develops hypotheses based on the idea that individuals reach egocentric or self-interested interpretations of ethics and fairness (Thompson and Loewenstein, 1992, pp. 178–179). In this regard, Thompson and Loewenstein (1992, p. 177) contend that individual’s ethically related judgments “will be biased in a manner that favors themselves.” Thus, users of financial statements are expected to assess earnings management as less unethical when they benefit from the earnings management.

I rely upon an analytic model developed by Dye (1988, pp. 201–207) to identify a situation in which certain users of financial statements benefit from earnings management. Dye’s (1988, pp. 201–207) overlapping generations model contains two classes of financial statement users – shareholders and non-shareholders. The model indicates that shareholders have a demand for earnings management that boosts the share price in the short run (Dye, 1988, pp. 204–205). While managers engage in earnings management to increase the stock price, they also engage in earnings management for personal gain (Healy and Wahlen, 1999, p. 380). I refer to the former as company intent and the

¹ I wish to thank an anonymous reviewer for suggesting this possibility.
latter as individual intent. When management engages in earnings management for company intent as opposed to individual intent, I expect shareholders to assess the earnings management less unethically. Since non-shareholders do not benefit from either kind of earnings management, I do not expect intent to influence their ethicalness assessments.

An experiment using evening MBA students was conducted to determine the relationship between user class and earnings management intent on how individuals view earnings management. In a between subjects design, participants were randomly assigned to one of two user class levels – shareholder or non-shareholder, and to one of two earnings management intent levels – company intent and individual intent. Participants were asked to evaluate three different earnings management scenarios. Each scenario described a manager engaging in an earnings management activity. The use of three scenarios provides a basis to assess the robustness of the results across different kinds of earnings management activities. Additionally, for each scenario participants judged the manager’s decision with respect to two dependent measures: the overall ethicalness of the decision and the likelihood that shareholders will suffer financially from the decision.

The following two sections provide the background and hypotheses for the study. Subsequent sections present the method, the results, and a discussion of the research.

2. Background

Healy and Wahlen (1999, p. 368) suggest 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. Note that opportunities for earnings management exist because managers typically have the ability to use judgment in shaping financial reports (Healy and Wahlen, 1999, p. 366). Demski et al. (1984, p. 17) contend that it may be optimal for firms to allow managers some discretion over future accounting choices because a firm’s future circumstances are likely to change and managers have specialized knowledge of which accounting methods would maximize firm value.

Healy and Wahlen (1999, p. 380) conclude that earnings management occurs for a variety of reasons. Two of these relate specifically to my study. One motivation is to increase stock prices. Several studies contend that managers overstate earnings prior to equity offerings (Erickson and Wang, 1999, p. 153; Teoh et al., 1998a,b, pp. 68–79, pp. 1948–1956). Since investors view earnings as value relevant data, managers have an incentive to manage earnings upward,
especially prior to an equity offering. The results from these studies (Erickson and Wang, 1999, pp. 162–174; Teoh et al., 1998a,b, pp. 68–79, pp. 1948–1956) indicate that firms report income increasing unexpected accruals prior to an equity offering.

A second motivation for earnings management relates to management compensation contracts. To the extent that bonus plans are based on accounting numbers, managers may be motivated to engage in earnings management to maximize their bonus (Healy, 1985, pp. 88–90). While the results from studies using aggregated financial data are mixed (Healy, 1985, pp. 95–100; Gaver et al., 1995, pp. 17–25; Holthausen et al., 1995, pp. 46–55), the results from a more recent study by Guidry et al. (1999, pp. 127–133) using business unit-level data show strong support for the bonus-maximization hypothesis.

Merchant and Rockness (1994) applied an ethical perspective to examine earnings management. They (1994, pp. 81–82) contend that many types of earnings management are not obviously acceptable or unacceptable. Merchant and Rockness (1994, pp. 87–90) provide initial evidence on this issue by obtaining responses to a questionnaire containing 13 brief scenarios of earnings management from various organizational members. In response to each scenario, participants were asked to evaluate the acceptability of each practice (Merchant and Rockness, 1994, p. 85). Of current relevance, that study found (1994, p. 89) that the manager’s purpose mattered as a selfish motive (e.g., taken for individual gain) was judged to be less ethical than a non-selfish motive (e.g., taken to benefit the firm’s long-term interests).

3. Hypothesis development

Research in psychology (Messick and Sentis, 1979, pp. 424–430) and organizational behavior (Neale and Bazerman, 1983, pp. 384–386) has demonstrated that individuals make egocentric interpretations of fairness and ethics. In situations such as earnings management where no consensus on acceptable behavior exists, multiple interpretations of ethical actions are likely to arise. Thompson and Loewenstein (1992, p. 176) contend that interpretations will be self-serving. That is, individuals who benefit from an unethical or questionable act will not assess the act as negatively as other individuals who are not benefitting from the act.

Kaynama et al. (1996, pp. 585–586) demonstrate how differing roles can result in egocentric ethical perceptions. In the study (Kaynama et al., 1996, pp. 585–586) students indicated their extent of agreement with 12 common questionable practices that employees might engage in. Participants initially responded to the questionnaire assuming that they were an employee for a profitable manufacturing company (Kaynama et al., 1996, p. 584). Two
months later these same students responded to the same questionnaire assuming that they were a manager for a profitable manufacturing company (Kaynama et al., 1996, p. 584). Since employees performed the questionable acts, the egocentric bias would predict that students assigned to the role of an employee would view the practices more favorably than when assigned to the role of a manager. In fact, the results were consistent with an egocentric bias. Students perceived the questionable practices significantly less unethically in the role of employees compared to their responses as managers (Kaynama et al., 1996, pp. 585–586).

My study applies the notion of egocentric interpretations of ethics to the context of financial statement users’ evaluations of earnings management. Dye (1988, pp. 201–207) develops an analytic model of earnings management that contains two classes of financial statement users – shareholders and non-shareholders. In the model, shareholders can have a demand for earnings management whereas non-shareholders do not (Dye, 1988, pp. 201–207). While recognizing that the notion that shareholders have a demand for earnings management might seem perverse, this demand “derives from one shareholder generation’s attempt to impress the next generation with the firm’s past performance” (Dye, 1988, p. 197). Under Dye’s (1988, pp. 201–207) model, earnings management activities may make investors better off. If this is the case, then shareholders have a vested interest in managers engaging in earnings management activities that benefit the firm (e.g. maximize the value of the firm). For example, shareholders presumably would benefit when managers engage in earnings management activities that allow the firm to meet or exceed consensus earnings targets. Shareholders are unlikely to benefit from certain kinds of earnings management activities such as when managers engage in earnings management activities for personal gain (e.g., opportunism). For example, shareholders would not benefit if accounting or operating decisions were manipulated for the sole purpose of allowing a manager to qualify for a performance bonus.

On the other hand, non-shareholders do not have a demand for the firm to engage in earnings management activities (Dye, 1988, pp. 201–207). Non-shareholders who may have an interest in purchasing the stock in the future should prefer unmanaged earnings to managed earnings (Dye, 1988, p. 196). Earnings management obscures facts about the company and makes it more difficult to assess the company’s future prospects (Levitt, 1998, p. 16). From a self-interested perspective, non-shareholders are likely to believe that earnings management activities are unethical regardless of the reason or motivation. This discussion leads to the following hypothesis.

H1a: Shareholders are expected to judge the ethicalness of earnings management less unethically when undertaken for company as opposed to individual benefit.
H1b: Whether earnings management is intended for company or individual benefit will not influence non-shareholders’ ethicalness assessments.

Implicit in the notion of egocentric interpretations of ethicalness is that shareholders that may benefit from earnings management are aware that they may benefit. This suggests that when undertaken for company benefit shareholders will assess the likelihood that shareholders will suffer financially from earnings management to be lower than when undertaken for individual benefit. Again, the intent behind earnings management is not expected to influence likelihood assessments among non-shareholders. This discussion leads to the following hypothesis.

H2a: Shareholders are expected to judge a lower likelihood that shareholders will suffer financially when earnings management is undertaken for company as opposed to individual benefit.

H2b: Whether earnings management is intended for company or individual benefit will not influence non-shareholders’ judgments of the likelihood that shareholders will suffer financially.

4. Method

4.1. Overview and task

My study involved an experiment using evening MBA students as participants. Participants were presented with materials containing three scenarios, each describing earnings management by a general manager of a large division in a different publicly owned corporation. In response to each scenario, participants provided two ethically related judgments (described below). The same three scenarios were given to all participants. Participants were assigned to a single level of user class (shareholder/non-shareholder) and earnings management intent (individual benefit/company benefit). To complete the instrument, participants responded to manipulation checks and background questions. Participants responded anonymously.

4.2. Independent variables

The study contained three independent variables, as follows: user class, earnings management intent, and earnings management activity. Each independent variable is discussed in turn.

---

2 These three scenarios have been developed and adapted from three scenarios developed by Bruns and Merchant (1989, pp. 220–221). Harvard Business School Publishing gave their permission to the author for the use of these three scenarios.
4.3. User class

Participants were randomly assigned to one of two user class levels. Under
the shareholder level, participants were instructed to assume that they were a
shareholder of the company, and not employed by the company. Under the
non-shareholder level, participants were instructed to assume that they were
not a shareholder and not employed by the company.

4.4. Earnings management intent

Participants were randomly assigned to one of two earnings management
intent levels. This manipulation was embedded within the scenarios, which are
described and referenced below and previously footnoted. One level of this
variable indicated within each of the scenarios that the intent of earnings
management was to benefit the company as a whole. This level is referred to as
company intent. Under company intent each of the scenarios indicated that a
manager engaged in earnings management for the purpose of improving the
company’s chances of reaching financial goals. Alternatively, the second level
of this variable indicated within each of the scenarios that the intent of earnings
management was to personally benefit the general manager. This level is re-
ferred to as individual intent. Under individual intent each of the scenarios
indicated that a manager engaged in earnings management and that the pur-
pose for engaging in it was to reach a financial target, which in turn, would
trigger a financial bonus for the manager.

4.5. Earnings management activity

Participants received three different earnings management scenarios de-
scribing the actions of a hypothetical general manager. The three scenarios
used in this study were developed and adapted from among those appearing in
scenario described a manager who managed earnings by ordering his em-
ployees to postpone until the next accounting period all expenditures that were
not essential. By postponing expenses, income for the current period is in-
creased. This case is referred to as the operating gain case. A second scenario
described a manager who managed earnings by calling the engagement partner
of a consulting firm performing services and requested that a billing for work
be postponed until next year. Postponing the billing would enable the division
to avoid recognizing the expense in the current period, which would increase
the current period’s income. This case is referred to as the accounting gain case.
The third scenario described a manager who wanted to lower current year’s
earnings. Consequently, the amount contained in an account for outdated
inventory was needlessly raised. Raising this allowance account increased
expenses for the current period, which lowers current year’s income. This case is referred to as the accounting loss case. While participants received the same three scenarios, the order in which they received the scenarios was randomized across participants.

4.6. Dependent variables

Two dependent variables, in the form of questions, were included with each scenario. The first question asked, “Overall, how unethical do you think the general manager’s decision is?” The end points on a nine-point scale were “very ethical” (1) and “very unethical” (9). While not identical, the question is based upon the question used in the Harvard Business Review questionnaire (Bruns and Merchant, 1989, pp. 220–221). The second question asked, “How likely is it that the stockholders will suffer financially as a result of the general manager’s decision?” The end points on a nine-point scale were “very unlikely” (1) and “very likely” (9). Question two, although modified for the current setting, is based on a series of studies by Singer (1996, p. 471), Singer and Singer (1997, p. 476) and Singer et al. (1998, p. 531).

4.7. Subjects

Evening MBA students at a major metropolitan state university were used as subjects for my study. Evening MBA students typically are older than day MBA students and have substantial work experience. Participating students were enrolled in a financial accounting course. One hundred forty six students completed the questionnaire. Background information about these subjects is presented in Table 1. As shown, the majority of subjects were male, had invested in common stock in the past, planned to invest in common stock in the future and had previously read an annual report. Thus, this group appears to be reasonably representative of a relatively knowledgeable group of financial statement users.

5. Results

5.1. Manipulation checks

After responding to the three scenarios, participants answered manipulation check questions about the user class and earnings management intent

---

3 The study also included a third question related to disclosure that is not related to hypothesis testing.
levels they were assigned. Regarding user class the question read, “You were asked to assume that you were:” Participants were asked to indicate either “stockholder” or “not a stockholder”. Of the 146 participants, 122 answered this question correctly. Regarding earnings management intent the question read, “As described, the decisions were made primarily for:” Participants were asked to indicate either “individual benefit” or “company benefit”. Of the 146 participants, 110 answered this question correctly. Of the 146 participants, 94 answered both manipulation check questions correctly.

The statistical analysis that follows is based upon the responses from these 94 participants. Participants not answering these questions correctly were dropped because of a lack of “inclusion importance” (Yates, 1990, p. 376). In this regard, Tan and Yates (1995, p. 315) contend that “if a decision maker never even acknowledges the existence of a particular dimension, then the decision maker cannot possibly respond to that dimension.”

The backgrounds of those passing the manipulation check questions were compared with the backgrounds of those not passing the manipulation check questions. Based on analysis of variance tests no significant differences between the two groups were found on any of the items presented in Table 1.

<p>| Table 1 |
| Background information on participants (n = 94) |</p>
<table>
<thead>
<tr>
<th>Variable</th>
<th>Mean</th>
<th>S.D.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Panel A: Continuous variables</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Age</td>
<td>30.6</td>
<td>6.0</td>
</tr>
<tr>
<td>Years of work experience</td>
<td>8.1</td>
<td>5.7</td>
</tr>
<tr>
<td>Number of accounting classes completed</td>
<td>2.0</td>
<td>2.5</td>
</tr>
<tr>
<td><strong>Panel B: Dichotomous variables</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gender</td>
<td>Percentage (%)</td>
<td>Number</td>
</tr>
<tr>
<td>Males</td>
<td>68.1</td>
<td>64</td>
</tr>
<tr>
<td>Females</td>
<td>31.9</td>
<td>30</td>
</tr>
<tr>
<td>Have you invested in common stock in the past?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yes</td>
<td>81.9</td>
<td>77</td>
</tr>
<tr>
<td>No</td>
<td>18.1</td>
<td>17</td>
</tr>
<tr>
<td>Do you plan to invest in common stock in the future?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yes</td>
<td>97.9</td>
<td>92</td>
</tr>
<tr>
<td>No</td>
<td>2.1</td>
<td>2</td>
</tr>
<tr>
<td>Have you previously read an annual report?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yes</td>
<td>85.1</td>
<td>80</td>
</tr>
<tr>
<td>No</td>
<td>14.9</td>
<td>14</td>
</tr>
</tbody>
</table>
5.2. Hypothesis testing

Repeated measures analysis of variance (ANOVA) was used to test each hypothesis. The analysis was conducted under the general linear models program of SAS (SAS Institute Inc., 1990, pp. 891–996) that accommodates unequal cell sizes. The Pearson product-moment correlation between the two dependent variables is 0.32 ($C < 0.01$, two tails). While this correlation was significant, its magnitude suggests that the two variables were not viewed as measuring a single underlying construct. \(^4\)

5.3. Overall ethics judgment

After each scenario, participants answered, using a nine-point scale, the following question: “Overall, how unethical do you think the general manager’s decision is?” The response to this question was used as the dependent measure to test Hypotheses 1a and 1b. Hypothesis 1a predicts that shareholders are expected to judge the ethicalness of earnings management less unethically when undertaken for company as opposed to individual benefit. This hypothesis is tested using the subset of subjects assigned to the shareholder treatment of user class. Earnings management intent had two levels and earnings management activity had three levels.

Panel A in Table 2 presents the statistical results and Panel C presents descriptive statistics. As shown, earnings management intent is significant ($F = 8.21, C < 0.01$). Further, as shown in Panel C the overall mean for shareholders with company intent was lower than the overall mean for shareholders with individual intent, supporting H1a. However, the interaction between earnings management intent and earnings management activity was significant ($F = 5.53, C < 0.01$). To provide additional insight, analysis of

\[^4\] A third dependent variable not related to hypothesis testing was based on responses to the following question: “In your opinion, do you believe the general manager’s decision should be separately disclosed in the annual report?” The end points on a nine-point scale were “definitely yes” (1) and “definitely not” (9). The repeated measures analysis among shareholders indicates that earnings management intent was not significant ($F = 0.64, C > 0.42$), earnings management activity was significant ($F = 3.24, C < 0.05$), and that the interaction between the two was significant ($F = 2.65, C < 0.08$). In separate analyses of each scenario, earnings management intent was significant ($F = 3.33, C < 0.08$), in the operating gain case, with shareholders indicating stronger agreement for disclosure under individual intent. Earnings management intent was not significant in either of the other two scenarios. The repeated measures analysis among non-shareholders indicates that earnings management intent was significant ($F = 9.71, C < 0.01$), earnings management activity was significant ($F = 4.84, C < 0.02$), and that the interaction between the two was not significant ($F = 0.20, C > 0.82$). In separate analyses, earnings management intent was significant ($C < 0.05$) in each of the three scenarios, with non-shareholders indicating stronger agreement for disclosure under company intent.
Table 2
Overall judgment of ethicalness of the general manager’s decision

<table>
<thead>
<tr>
<th>Source</th>
<th>SS</th>
<th>df</th>
<th>MS</th>
<th>F</th>
<th>Prob.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Panel A: Analysis of variance summary table related to Hypothesis 1a: Shareholder participants (n = 48)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Earnings management intent (EMI)</td>
<td>28.6</td>
<td>1</td>
<td>28.6</td>
<td>8.21</td>
<td>0.01</td>
</tr>
<tr>
<td>Earnings management activity (EMA)</td>
<td>15.5</td>
<td>2</td>
<td>7.8</td>
<td>3.33</td>
<td>0.05</td>
</tr>
<tr>
<td>EMA × EMI</td>
<td>25.7</td>
<td>2</td>
<td>12.9</td>
<td>5.53</td>
<td>0.01</td>
</tr>
</tbody>
</table>

Panel B: Analysis of variance summary table related to Hypothesis 1b: Non-shareholder participants (n = 46)

| Earnings management intent (EMI) | 0.5  | 1   | 0.5  | 0.10 | 0.75  |
| Earnings management activity (EMA) | 39.5 | 2   | 19.7 | 6.94 | 0.01  |
| EMA × EMI | 7.5  | 2   | 3.8  | 1.33 | 0.27  |

Panel C: Descriptive statistics by cell

<table>
<thead>
<tr>
<th>User Class</th>
<th>EMI</th>
<th>Hypothesis</th>
<th>Operating gain</th>
<th>Accounting gain</th>
<th>Accounting loss</th>
<th>Overall mean</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shareholder</td>
<td>Individual</td>
<td>1a</td>
<td>6.7</td>
<td>6.4</td>
<td>6.5</td>
<td>6.5</td>
</tr>
<tr>
<td>Shareholder</td>
<td>Company</td>
<td>1a</td>
<td>4.5</td>
<td>6.1</td>
<td>6.3</td>
<td>5.6</td>
</tr>
<tr>
<td>Non-shareholder</td>
<td>Individual</td>
<td>1b</td>
<td>5.3</td>
<td>5.6</td>
<td>6.9</td>
<td>5.9</td>
</tr>
<tr>
<td>Non-shareholder</td>
<td>Company</td>
<td>1b</td>
<td>5.4</td>
<td>6.4</td>
<td>6.5</td>
<td>6.1</td>
</tr>
<tr>
<td>Overall mean</td>
<td></td>
<td></td>
<td>5.6</td>
<td>6.1</td>
<td>6.6</td>
<td></td>
</tr>
</tbody>
</table>

a Participants responded to a question described in the text that used a nine-point scale anchored by “very ethical” (1) and “very unethical” (9).
variance was performed on each scenario. The results from these tests indicate that earnings management intent was significant \((F = 15.7, C < 0.01)\) for the operating gain scenario but not for the accounting gain scenario \((F = 0.46, C > 0.50)\) or the accounting loss scenario \((F = 0.41, C > 0.50)\). Thus, Hypothesis 1a is only supported under the operating gain scenario.

Hypothesis 1b predicts that non-shareholders’ judgments of the ethicalness of earnings management will not be influenced by the earnings management intent. This hypothesis is tested using the subset of subjects assigned to the non-shareholder treatment of user class. Again, earnings management intent had two levels and earnings management activity had three levels. Panel B in Table 2 presents the statistical results and Panel C presents descriptive statistics. As shown, earnings management intent is not significant \((F = 0.10, C > 0.75)\) and the interaction between earnings management intent and earnings management activity is not significant \((F = 1.33, C > 0.27)\). Analysis of variance also was performed on each scenario. The results from these tests indicate that earnings management intent was not significant for any of the three scenarios. 5 This pattern of results is consistent with Hypothesis 1b.

5.4. Likelihood that stockholders will suffer

Using a nine-point scale, participants answered the following question: “How likely is it that stockholders will suffer financially as a result of the general manager’s decision?” The response to this question was used as the dependent measure to test Hypotheses 2a and 2b. Hypothesis 2a predicts that shareholders are expected to judge a lower likelihood that shareholders will suffer financially when earnings management is undertaken for company as opposed to individual benefit. This hypothesis is tested using the subset of subjects assigned to the shareholder treatment of user class. Panel A in Table 3 presents the statistical results and Panel C presents descriptive statistics. As shown, earnings management intent is not significant \((F = 2.47, C < 0.13)\). Thus, Hypothesis 2a is not supported even though the overall mean for company intent was lower than the overall mean for individual intent. Analysis of variance was also performed on each scenario. The results from these tests indicate that earnings management intent was significant \((F = 5.9, C < 0.02)\) for the operating gain scenario but not for the accounting gain scenario \((F = 0.03, C > 0.86)\) or the accounting loss scenario \((F = 0.33, C > 0.56)\). This evidence provides support for Hypothesis 2a only under the operating gain scenario.

---

5 For the operating gain \((F = 0.0, C > 0.95)\), the accounting gain \((F = 1.61, C > 0.21)\), and the accounting loss \((F = 0.7, C > 0.40)\) scenarios the results were not significant at traditional levels.
Table 3
Likelihood that the stockholders will suffer financially from the general manager’s decision

<table>
<thead>
<tr>
<th>Source</th>
<th>SS</th>
<th>df</th>
<th>MS</th>
<th>F</th>
<th>Prob.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Panel A: Analysis of variance summary table related to Hypothesis 2a: Shareholder participants (n = 48)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Earnings management intent (EMI)</td>
<td>13.0</td>
<td>1</td>
<td>13.0</td>
<td>2.47</td>
<td>0.13</td>
</tr>
<tr>
<td>Earnings management activity (EMA)</td>
<td>4.4</td>
<td>2</td>
<td>2.2</td>
<td>0.81</td>
<td>0.45</td>
</tr>
<tr>
<td>EMA × EMI</td>
<td>11.8</td>
<td>2</td>
<td>5.9</td>
<td>2.19</td>
<td>0.12</td>
</tr>
</tbody>
</table>

| **Panel B: Analysis of variance summary table related to Hypothesis 2b: Non-shareholder participants (n = 46)** |     |    |     |     |       |
| Earnings management intent (EMI) | 8.6  | 1  | 8.6  | 1.13 | 0.29 |
| Earnings management activity (EMA) | 15.9 | 2  | 7.9  | 3.12 | 0.05 |
| EMA × EMI | 0.1  | 2  | 0.0  | 0.01 | 0.98 |

| **Panel C: Descriptive statistics by cell** | | | | | |
| User Class | EMI | Hypothesis | Operating gain | Accounting gain | Accounting loss | Overall mean |
| Shareholder | Individual | 2a | 4.6 | 4.0 | 4.5 | 4.4 |
| Shareholder | Company | 2a | 3.1 | 3.9 | 4.1 | 3.7 |
| Non-shareholder | Individual | 2b | 4.1 | 3.7 | 4.6 | 4.1 |
| Non-shareholder | Company | 2b | 4.6 | 4.3 | 5.1 | 4.6 |
| Overall mean | | | 4.2 | 4.0 | 4.6 | |

aParticipants responded to a question described in the text that used a nine-point scale anchored by “very unlikely” (1) and “very likely” (9).
Hypothesis 2b predicts that non-shareholders' judgments of the likelihood that shareholders will suffer financially will not be influenced by the earnings management intent and is tested using the subset of subjects assigned to the non-shareholder treatment of user class. Panel B in Table 3 presents the statistical results and Panel C presents descriptive statistics. As shown, earnings management intent is not significant \((F = 1.13, C > 0.29)\) and the interaction between earnings management intent and earnings management activity is not significant \((F = 0.01, C > 0.98)\). Again, analysis of variance was performed on each scenario. The results from these tests indicate that earnings management intent was not significant for any of the three scenarios. \(^6\) This pattern of results is consistent with Hypothesis 2b.

6. Discussion

The purpose of my study was to provide initial evidence on the judgments of users of financial statements regarding earnings management practices. The current study extends work initiated by Bruns and Merchant (1990) and Merchant and Rockness (1994) in several key respects. My study focuses on external users of financial statements, tests the implications of an analytic model developed by Dye (1988, pp. 201–207), and examines two dependent measures.

Before discussing the results of my study, four limitations related to the use of an experimental approach should be noted. As part of an experimental approach participants responded to hypothetical scenarios about earnings management activities. This approach has previously been used in studies to measure ethically related judgments (Becker and Fritzche, 1987; Flory et al., 1992; Singer, 1996; Singer and Singer, 1997; Singer et al., 1998). The strength of this approach is that it allows for greater control and manipulation of variables than provided by non-experimental approaches. A concern, however, with this approach is that it is not possible for the stimulus materials to contain all relevant information in order for the task to be completed in a timely manner.

Second, the case unambiguously manipulated earnings management intent. In general, intent is unobservable and must be inferred from behavior and the surrounding context (Kelley, 1973, p. 107). An unambiguous manipulation of intent was needed, however, in order to appropriately test the hypotheses involving intent. Examining ethical judgments when intent is inferred with greater uncertainty represents a topic for further research.

---

\(^6\) For the operating gain \((F = 0.65, C > 0.42)\), the accounting gain \((F = 0.92, C > 0.34)\), and the accounting loss \((F = 0.52, C > 0.47)\) scenarios the results were not significant at traditional levels.
A third concern regards assigning participants to the roles of either shareholders or non-shareholders. Potentially, assigning participants to the role of stockholder represents a weak proxy for the incentives faced by stockholders. To the extent that evening MBA students responding to hypothetical cases do not face the same incentives as their assigned group (e.g., shareholders and non-shareholders), the ability to obtain results consistent with expectations should have been diminished.

Fourth, approximately one-third of the participants missed one of the manipulation check questions. While it is undesirable for such a high proportion to miss a manipulation check question, it may reflect using evening MBA students as subjects. These students have typically worked a full day prior to class and some may have had trouble concentrating on the instrument, especially given the lack of incentives to attend fully to the instrument.

Turning to a discussion of the results, Hypotheses 1a and 1b related to ethicalness judgments. As predicted by Hypothesis 1b, earnings management intent did not influence non-shareholders’ ethicalness judgments. However, among shareholders a significant earnings management intent by earnings management activity interaction was unexpectedly found. Further analysis indicated that earnings management intent only influenced the operating gain scenario. In considering these results two points are worth noting. First, the results suggest that the expected relationship between user class and earnings management intent does not hold across all situations. This finding demonstrates the importance of including multiple earnings management scenarios. Had only one scenario been used, it would not have been possible to assess the generalizability of the findings.

Second, while the three cases were labeled as operating gain, accounting gain, and accounting loss, this is a simplistic characterization of the cases. Each scenario involves a specific example of an earnings management activity within the class (e.g., operating gain) and a specific method of operationalizing the specific earnings management activity. One of the cases involves someone outside the organization while the other two cases relate only to the organization itself. In addition, both of the accounting scenarios involved recognition issues (e.g., the financial statements recognized (or did not recognize) an economic event that had not (or had) occurred) whereas the operating scenario did not involve a recognition issue. Since the scenarios differ along several dimensions it is not clear whether the differences in results are due to whether the activity was an operating or an accounting event.

In speculating about these results, I believe two factors merit attention. First, it may be that recognition/non-recognition represents a boundary condition and that the results only hold for non-recognition issues. For recognition issues the financial statements are apparently misstated, which is not the case for non-recognition issues. Perhaps, even though shareholders may benefit immediately from the manager’s act, they may view the act as ethically
troubling as non-shareholders because it may be symptomatic of future actions that could harm shareholders.

Secondly, it may be that the perceived commonness of the earnings management activity may be an important explanatory factor. That is, shareholders may perceive deferring discretionary expenses as a relatively common and/or expected form of earnings management. To the extent that the activity is viewed as common and/or expected, shareholders may be more tolerant of its occurrence, especially when it occurs for their benefit. Perhaps, shareholders are less tolerant of noncommon and/or unexpected forms of earnings management because it may be a signal or be indicative of managerial behavior that is considered outside of an accepted norm, and thus perceived as dysfunctional.

This second view is grounded in attribution theory (Kelley, 1973, pp. 108–113), which identifies consensus information as key to attributional analysis. Information is high in consensus when the manager’s current action is not significantly different from the actions of other managers (Kelley, 1973, p. 112). This literature has found that individuals tend to make weaker attributions to and about an actor when consensus information is high (Kelley and Michela, 1980, 463–465). Regardless of what is driving these differences, the results from the current study indicate that there are some boundary conditions that limit the relationship between user class and earnings management intent. Further research is needed to identify the specific nature of these boundary conditions.

The pattern of results for Hypotheses 2a and 2b were relatively similar to Hypotheses 1a and 1b. As expected under Hypothesis 2b, intent did not influence non-shareholders’ judgments of the likelihood that shareholders will suffer financially. Among shareholders, evidence from tests conducted at the scenario level indicated that intent significantly affected this judgment for the operating gain scenario. This evidence suggests that, under certain circumstances, shareholders appear to realize that they are less likely to suffer financially when the intent of the earnings management activity is to benefit the firm.

Recognizing the existence of boundary conditions should not diminish from the equally important finding that for one earnings management activity support was found for an implication from Dye’s (1988, pp. 201–207) analytic model. That is, for the operating gain scenario the ethical judgments and likelihood of financial suffering judgments of shareholders were found to be egocentric. As additional tests are conducted across a range of earnings management activities it may be possible to incorporate boundary conditions into the analytic model.

In closing, my study provides initial evidence on the ethicalness judgments of financial statement users regarding earnings management practices. Given the paucity of research on the topic, additional research should be encouraged. In this regard, the results of the current study suggest that, in spite of its limitations, an experimental approach is a viable and appropriate method to
examine ethical issues surrounding earnings management. Further use of experimental methods could overcome some concerns, however, by attempting to replicate better the incentives of the groups they ask their participants to represent. Further work also is needed to understand better how differences in approaches, implementations, and expectations to earnings management influence financial statement users’ ethical perceptions. Finally, further work could examine whether and why the occurrence of earnings management is associated with actions to buy, sell, or hold equity in the firm. By examining economic outcomes it might be possible to integrate economic and ethical perspectives of earnings management.

Acknowledgements

I wish to thank three reviewers, Steve Loeb, and the workshop participants at Boston College and Louisiana State University for their helpful comments.

References