



THE ETHICAL DECISION MAKING OF EARNINGS
MANAGEMENT: APPLYING THE THEORY OF
PLANNED BEHAVIOUR

BY

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ABSTRACT

Managers repeatedly tend to select accounting choices that affect earnings either positively or negatively. According to GAAP, the usage of accounting choices is not an explicit indication of managing earnings due to the inconclusive discussion about the morality of such action among users and regulatory authorities. To highlight this issue from an Islamic perspective, this study is motivated by the significant losses suffered by investors in companies electing to engage in questionable accounting practice. It is further motivated by the will to understand the attitude of managers from a religious perspective. The objective of the study is to ground the ethical issue of Earnings Management (EM) and to explore the impact of religious family background, religious practices and ethics education in orienting the decision making of managers toward the practice of EM. More specifically, this study aims to test whether the Islamic ethics plays an influential factor on the behaviour of Muslims' managers. This study also seeks a better understanding the construct of behavioural intention of managers. To do so, the study was implemented in three universities IIUM, UM and UPM. Using a sample of 104 MBA, Master accounting and finance students from three universities, the current study proposed a casual model to explain an individual's judgment with respect to an ethical question for managers. This study established its analysis on the framework of the theory of planned behavior. This study has come up with two primary results (1) religion has a minor impact on the managers' attitude in terms of the practice of EM. (2) Religion in general including Islamic religion does not lower the practice of EM in this particular study. These unexpected results can be pertained to the strong influence factor of western thinking in separating religion from life.

خلاصة البحث

إن لجوء مدراء الشركات بشكل متكرر لتحديد الخيارات التي تؤثر على الأرباح المحاسبية إما سلباً أو إيجاباً وفقاً لمبادئ المحاسبة المقبولة عموماً واستخدام الخيارات المحاسبية كمؤشر واضح لإدارة الأرباح جعل هذا الموضوع مثار إهتمام و نقاش حول دور الأخلاق في مثل هاته الحالة بين المستخدمين والسلطات التنظيمية . وعليه فإن الدافع لتسليط الضوء على هذه القضية من منظور إسلامي هي الخسائر الكبيرة التي تعرض لها المستثمرون في الشركات نتيجة الممارسات المحاسبية المشكوك فيها .أضف إلى ذلك الرغبة في فهم موقف المديرين من منظور ديني. إن الهدف من الدراسة هو فهم دقيق لموضوع إدارة الأرباح (EM) من خلال استكشاف تأثير هذه الممارسات على أفراد من أسر متدينة في عملية صنع القرار. وبشكل أكثر تحديداً، فإن هذه الدراسة تهدف إلى اختبار ما إذا كانت الأخلاق الإسلامية تلعب عاملاً مؤثراً على سلوك المديرين. إن هذه الدراسة تسعى أيضاً إلى فهم أفضل للأنشائية السلوكية للمديرين. و للقيام بذلك، تم تنفيذ هذه الدراسة في ثلاث جامعات UM IIUM و UPM باستخدام عينة من 104 طالب ماجستير في إدارة الأعمال و المحاسبة، والتمويل . أنشئت هذه الدراسة على تحليل الإطار لنظرية السلوك التخطيطي. خلصت هذه الدراسة إلى اثنين من النتائج (1) الدين لديه تأثير طفيف على موقف المديرين في مجال إتخاذ القرارات. (2) الدين بشكل عام بما في ذلك الدين الإسلامي لا تقلل من ممارسة العمليات المحاسبية المشكوك فيها. و قد جاءت النتائج مخالفة للتوقعات التي كانت مبنية على أن الإسلام له دور في تحديد الخيارات المتاحة لدى المديرين.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science (Accounting).

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DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Lotfi Demikha

Signature

Date

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In the name of Allah most gracious and most merciful. Praise be to Allah (S.W.T) and peace and prayer be upon the prophet Mohamed (S.A.W), his family, his companions, and his followers until the day of judgement.

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LIST OF ABBREVIATIONS

EM	Earnings Management
SEC	Securities and Exchange Commission
IPO	Initial Public Offering
TPB	Theory of Planned Behaviour
MBA	Master of Business Administration
GAAP	Generally Accepted Accounting Principles
SOX	Sarbanes-Oxley act of 2002
TSE	Tehran Stock Exchange
PC	Professional Commitment
PB	Personal Benefit
ERO	Ethical Relativism Orientation
EIO	Ethical Idealism Orientation
TRA	Theory of Reasoned Action
PBC	Perceived behavioural control
IIUM	International Islamic University Malaysia
UPM	Universiti Putra Malaysia
UM	University of Malaya
CSR	Corporate social responsibility
INT	Intention
ATT	Attitudinal ethical issue of EM
RUFB	Religious family background
ED	Ethics education
SEM	Structural Equation Modeling
MANOVA	Multivariate Analysis Of Variance
RMSEA	Root Mean Square Error of Approximation
CFI	Comparative Fit Index
IV	Independent variable
DV	Dependent variable

CHAPTER ONE

INTRODUCTION

1.0 BACKGROUND

The increasing number and magnitude of recent accounting scandals have shown the spread of abusive behaviours and frauds among managers. These accounting scandals made it evident that falsifying financial reports and managing earnings had become rampant and part of the culture of numerous organizations (Ferrell et al., 2008). A survey conducted by The Ethic Resource Centre on national business ethics in the US found that observed misconduct is higher in largest firms and found 77% of senior managers involved in unethical behaviours (ERC, 2005). Staubus (2005) pointed out that most of the accounting scandals are ethical failures that represent breaches of fiduciary duties by individuals who accepted responsibilities, but did not fulfil them.

Fischer and Rosenzweig (1995) stated that the reputation of accounting profession must be protected due to the role of accountants in the business world. In this context, Earnings Management (EM) is seen by many as a suspicious practice, which raises risk in accountants' integrity (Fischer and Rosenzweig, 1995). Merchant and Rockness (1994) believe that EM practices possibly raise the most significant ethical issues encountering the accounting profession.

EM can be defined in many different ways. The former SEC Chairman *Arthur Levitt* defines it as "accounting hocus-pocus" where those who operate in the gray area between legitimacy, and absolute fraud are poisoning the reporting process (Grant et al., 2000). Healy and Wahlen (1999) explain that EM occurs when managers use judgments in financial reporting and in structuring transactions to alter financial

reports to either mislead some stakeholders or to influence contractual outcomes that depend on accounting numbers. However, Fischer and Rosenzweig (1995) provide a more precise definition of EM as an action attempted by division managers, which serve to increase (decrease) current reported earnings of a division without a corresponding increase (decrease) in the long-term economic profitability of this division.

Evidence from the academic literature has shown that the practice of EM is somehow prevalent among accountants (Kaplan, 2001). Kavousy et al. (2010) noted that managers may decide to manage earnings for a number of reasons such as, to increase bonus, raise capital through Initial Public Offering (IPO), delay or avoid covenant defaults or to influence specific regulatory outcomes. Further, empirical research has identified two major incentives that motivate managers to engage in EM: external and internal factors. According to Schneider (1987), internal factors such as employee ethics had more influence on organizational ethics compared to external factors.

It is not agreeable yet among accountants, academic and standard setters whether the practice of EM is enough ethically justifiable (Gaa and Dunmore, 2007). In fact, the dividing line between acceptable and unacceptable behaviour is always unclear because different people have different attributes in different places (Staubus, 2005). As argued by Grant et al. (2000) that there is a thin line that separates between EM and management fraud. In this regard, the former SEC Chairman mentioned that any EM behaviour is unacceptable, regardless of materiality. However, there are some authors that perceive EM as an acceptable behaviour. For example, Parfet (2000) argues that "good" EM should not be banned. Dye (1988) supports Parfet's view in the sense that current shareholders have a positive demand for EM because it

maximizes the value of the company's shares. Given the importance of ethical awareness among the future accountants and managers, a growing concern about business ethics has been accompanied by empirical research seeking to understand the driving force behind the practice of EM (Carpenter and Reimers, 2005).

Arguing that EM is an ethical issue would suggest looking for a theoretical framework that can deal with such a phenomenon. In this regard, Grasso et al. (2009) have highlighted the usefulness of the Theory of Planned Behaviour (TPB) in explaining and predicting unethical behaviours. Ajzen (1991) also claimed that, the major goal of the TPB is to predict and explain an individual's behaviour. According to TPB, the intention is the primary key, which motivates an individual to perform certain behaviour (Carpenter and Reimers, 2005). Ajzen (1991) assumes three main factors that influence intention, (1) attitudes toward the behaviour, (2) social norms, and (3) perceived control over the behaviour.

The subject of ethics and EM has been a well-pursued research topic. However, gaps still exist in the understanding of the influential factors that associate with such matter due to the limited research in the emerging market. Accordingly, further research may probe these gaps, and a particular stress should be placed in order to investigate the ethical judgments of EM in the developing world.

Therefore, the present study is part of an ongoing effort, which aims to identify the factors that may influence the behaviour of future managers' (MBA and Post graduate Accounting and Finance students as a proxy) opinions whether EM, is ethically acceptable or unacceptable. The study will examine the perceptions of the participants in three Malaysian universities, International Islamic University Malaysia (IIUM), University Putra Malaysia (UPM) and University Malaya (UM). All the

universities are located in the Klang Valley which is an area comprising Kuala Lumpur and its suburbs, and adjoining cities and towns in the state of Selangor.

1.1 PROBLEM STATEMENTS

The ethical issue of EM was examined in prior studies (Merchant and Rockness, 1994; Kaplan, 2001a, 2001b; Fischer and Rosenzweig, 1995; Elias, 2002). Kaplan (2001a) investigates MBA students' attitude toward EM. The study found that EM activities undertaken to benefit the company (and ultimately the shareholders) were viewed less unethical. Greenfield et al. (2008) studied 375 undergraduate business majors in one university and two colleges in USA. The findings indicate a significant relationship between an individual's ethical orientation and decision-making.

Unlike previous studies, the current study focuses on the ethical issue of EM from the postgraduate students' perspective. It is presumed that different factors may have an influential power on the decision of students. To prove such assumption it is necessary to conduct an empirical study that would provide an analytical explanation about the perception of students regarding the ethical issue of EM. In doing so, the following research questions are being proposed for the study:

1. To what extent the religious family background would influence the attitude towards EM?
2. To what extent the religious practices would influence the attitude towards EM?
3. To what extent the ethics education would influence the attitude towards EM?
4. Is attitude toward the practice of EM related to intention to engage in EM?

1.2 OBJECTIVES OF THE STUDY

The objective of this research is to scrutinize the ethical issue of EM by exploring the impact of religious family background, religious practices and ethics education in orienting the decision making of managers toward the practice of EM. More specifically, this study aims to test whether the Islamic ethics play an influential factor on the behavioural intention of Muslims' managers.

This study also seeks a better understanding on the construct of behavioural intention of managers. To achieve these objectives the study utilizes the Theory of Planned Behaviour (TPB), which has been used regularly in numerous studies to understand and predict human being's behaviours.

In fact, much of the existing literature on the ethical issue of EM has not utilized the TPB as a theoretical framework in predicting managers' behavioural intention. Thus, this study examines the validity of this particular theory in the field of EM.

1.3 MOTIVATIONS OF THE STUDY

Owing to the losses related to EM, several studies had attempted to classify the practice of EM either as an ethical or non-ethical behaviour. However, very few studies that aim to link religious family background, religious practices and ethics education with the attitudes of managers. Even though the religiousness dimension has received wide attention in the business and accounting literature, there is a dearth of knowledge about an Islamic ethical input, in particular, within the context of EM.

Seeking to explain the practice of EM from an Islamic perspective is the primary push factor in conducting this research. Additionally, the falsification of the western pattern in enhancing the moral values among managers inspires the researcher

to empirically prove the validity of Islamic ethics in eliminating frauds in financial reporting and safeguard the wealth of the nation by putting it into cleaned hands.

1.4 CONTRIBUTION OF THE STUDY

This study is significant for several reasons. Firstly, the study extends the EM literatures by examining the Theory of Planned Behaviour TPB within the context of EM, which is according to the best of the researchers' knowledge that this topic does not receive sufficient attention. More importantly, conducting the study in the Malaysian setting would contribute to the body of knowledge in the emerging market.

Secondly, this study will also provide an overview on the perceptions of the future managers about the most suspicious practice in the accounting profession. Thirdly, an understanding of the factors that could influence the attitude of managers may assist in the future recruitment and training of accountants. Importantly, a study of the ethical attitudes of future managers may turn the attention of academics to the strengths and weaknesses of the education system.

1.5 ORGANIZATION OF CHAPTERS

Chapter One: Introduction: This chapter presents a brief discussion of the background of the study, statement of the problem, research questions, general purpose and specific objectives of the study, motivation for the research and significance of the study.

Chapter Two: Literature Review: Chapter two provides an extensive prior literature review in the area of ethics and EM. This chapter has been split into two parts. While the first part discusses the conducted studies in the developed market, the second discusses studies in the developing markets.

Chapter Three: Theoretical Framework: This chapter develops the theoretical foundation of the study. The TPB would be the underlying theory that is used in the current study.

Chapter Four: Research Method: Chapter four discusses the survey procedures which include, sample selection procedures as well as sample size and questionnaire development. Data's sources will also be explained.

Chapters Five: Research analysis and discussion: Results of the study will be presented in this chapter.

Chapter Six: Conclusion: In this chapter, the limitations of the study and the suggestions for future research are provided.

1.6 CONCLUSION

Owing to the increasing concern about the authenticity of financial reporting in portraying the real situation of the company, several attempts have been made to reduce frauds and the manipulation of accounting figures. In the accounting science, such manipulation is named as Earnings Management (EM). This particular study investigates the perception of postgraduate students toward the practice of EM within the context of Malaysian universities. The main objective is to scrutinize the ethical issue of EM by exploring the impact of religious family background, religious practices and ethics education in orienting the decision-making of managers toward the practice of EM. The study contains six chapters in which every chapter deals with a specific matter.

CHAPTER TWO

LITERATURE REVIEW

2.0 INTRODUCTION

In light of the recent accounting scandals and the consequential deterioration of the public trust in the accounting profession, a large body of literature on Earnings Management (EM) has grown (Myers et al., 2010). One of the earliest literatures on EM was Healy (1985) who studied how managers' bonus plan incentives affect their accrual's choices.

Anecdotal evidences show that managers are increasingly relying on EM activities to delude stakeholders into thinking the company is performing well or to gain a personal advantage (Kaplan, 2001). Indeed, categorizing the practice of EM, whether an acceptable behaviour or not is, not always clear. This can be pertained to the different perceptions and attitudes that individuals held about a certain behaviour.

Given the complexity of ethical dilemmas within financial reporting using EM, there is a growing tendency among the stakeholders to think about ways that can protect their wealth. This belief has transferred into the practical arena by linking ethics to business. Carpenter and Reimers (2005) argue that business ethics have been accompanied by an increase in empirical research seeking to discover determinants of unethical conduct. Using a variety of methods, several researches, including Bruns and Merchant (1990), Merchant and Rockness (1994) and Clikeman and Henning (2000) show mixing results in categorizing EM behaviours as either good or bad.

While, it is noticeable that most of the empirical studies on ethics of EM conducted in developed countries such as, USA and UK, very few studies paid

attention to the Asian region. The lack of such studies in this region could be related to the nature of the economic development, in which most of the Asian countries are being classified as emerging markets. In this regard, the survey of Simon (2001) on Malaysia, Hong Kong and Singapore contribute to the ethics of EM literature in terms of providing an overall view about the practice of EM within Asian managers.

In chapter two an emphasis insight will be given to the main prior researches in the domain of ethics and EM. In particular, those studies which mainly associate with the research as well as objectives of this study. Thus, this chapter would be split into two parts, while the first will emphasize on prior researches conducted in developed countries, the second will be in developing countries.

2.1 PRIOR STUDIES OF ETHICS AND EARNINGS MANAGEMENT IN THE DEVELOPED COUNTRIES

Initially, the studies in the area of ethics and EM began during the nineties of the last century in USA. Starting with Bruns and Merchant (1990), who surveyed 649 managers from different companies and sectors in USA. The respondents were asked to rate each practice on a five-point scale as follows: (1) Ethical Practice. (2) Questionable Practice. (3) Minor Infraction. (4) Serious Infraction. (5) Totally Unethical. The purpose of Bruns and Merchant study is to examine the acceptance's level of practicing EM among managers. It also aims to test the ethical dimension of EM from the perspective of managers.

The results of Bruns and Merchant (1990) suggest that there was little agreement among the managers. Some of the managers considered certain scenarios to contain ethical issues while others did not. Overall, the study found no consensus

among managers that any of the scenarios was either completely ethical or completely unethical.

Numerous subsequent studies have applied Bruns and Merchant (1990) survey. For example, Merchant and Rockness (1994) extended this stream of research when they examined for agreement involving the same 13 EM situations for a sample of internal financial statement users: 37 general managers, 90 internal auditors, 61 operating unit controllers and 96 corporate staff members. The researchers tested six factors for their influence on judgments of acceptability of EM practices: type, size, timing and purpose of the EM, consistency with GAAP and direction of the effect. The study found that respondents' judgments varied across the groups. The general managers judged the activities least ethically while internal auditors were the most lenient in their judgments. This result is consistent with the study of Bruns and Merchant (1990) who found that managers tend to classify the morality of EM differently. Merchant and Rockness (1994) conclude that utilizing a questionnaire in a study that aims to test the individual's perception would be an effective tool which would give an accurate analysis of the exact attitude.

Similarly, Fischer and Rosenzweig (1995) surveyed undergraduate students, MBA students, and practicing accountants concerning their attitudes on the ethical acceptability of EM using a five-point scale from totally unethical to completely ethical using an adapted version of the questionnaire developed by Bruns and Merchant (1990). Across all the groups, the findings suggest that accounting manipulations, which is the adjustment of the reserve's amount, were judged more harshly than operating manipulations. Whilst, the practitioners judged accounting manipulations significantly more harshly than the students did, the MBA students were significantly less harsher than undergraduate accounting students on accounting

manipulations not involving inventory, and the reverse was true for accounting manipulations involving inventory. The accounting students judged operating expense manipulations most harshly, followed by the MBA students and accounting practitioners. This study proves the lack of consensus among different categories in the society about the practice of EM. So far, almost all the research in this domain suffers from the disagreement which in turn may not facilitate the progress of resolutions.

Although there has been much research on the ethical issue of EM, there has been a little consensus among the users of financial reporting about the transparency provided by managers when they disclose internal information. An ongoing research in the accounting literature aims to identify the attitude of students and other interested parties about the legality of practicing EM. Clikeman and Henning (2000) address this concern by investigating accounting and other business students' opinion within two periods. First, when they were sophomores and second, when they were seniors. Students were given a short case, which involved a financially distressed firm planning to delay normal maintenance expenditures to the next year in order to increase current-year earnings. On a seven-point scale (where 1 is "strongly oppose the postponement", 4 is "neutral," and 7 is "strongly support postponement"), the results revealed that whilst, accounting students became less accepting of EM techniques from the sophomore to senior year, the other business students became more accepting of EM technique. The Clikeman and Henning (2000) results provide evidence that EM behaviour is still a debating topic which needs a thorough research.

Recent ethics and EM research has begun to explore the dynamic capability of MBA students to detect EM techniques and its legal aspect. Using an adapted version of the three scenarios from Bruns and Merchantand (1990), Kaplan (2001a) studied

the ethical acceptability of EM behaviour of MBA students. The Students were randomly assigned to act as either a shareholder, another manager from the company unfamiliar with the manager in the case, or another manager from the company familiar with the manager in the case. Students were asked to judge four cases, the ethicality of the manager's decision, the probability that the company would suffer financially due to the decision, the seriousness of the consequences of the decision, and the fairness of the decision. Kaplan (2001) found that for the accounting gain/loss scenarios, the responses of students in the role of a manager were generally more unfavourable than those of the students in the role of a shareholder (except for the overall ethicality judgment). Evidence also suggested that the students in the role of the manager who knew the manager in the case judged the scenario more favourably than the students in the role of the manager, who did not know the manager in the case.

Expanding the coverage of the issue of ethics in EM, Clikeman et al. (2001) surveyed members of a regional organization of accountants (approximately 38% of the total membership). The questionnaire of this study was adopted from the one used by Bruns and Merchant (1990). The researchers report similar results and suggest that accountants gave accounting manipulation an average rating between a moderate and a serious ethical infraction. The practitioners' scores indicated an average rating between (fully) ethical and questionable. The results suggest 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. Consequently, the study concludes that minor differences in views based on national origin and gender; however, none of the differences were significant.