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IMPACT OF PERCEIVED ROLE OF ETHICS AND SOCIAL RESPONSIBILITY ON ETHICAL EVALUATION OF EARNINGS MANAGEMENT

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Abstract. *The application of earnings management in accounting has raised concerns among researchers. Although there is no consensus in the literature as to whether the application of earnings management in companies is ethical. This paper suggests that the ethical assessment of earnings management may depend on personal perceptions of ethics and social responsibility. The paper presents the results of a study carried out in Lithuania on the impact of personal perceptions of business ethics and social responsibility on the ethical evaluation of earnings management by accountants in accounting service firms. The results of the study show that the ethical evaluation of earnings management is directly influenced by the evaluator's personal perception of ethics and social responsibility. The study suggests that in order to reduce the use of earnings management and improve the quality of accounting, it is important to promote ethics and social responsibility among accountants.*

Keywords: *earnings management, ethics, social responsibility*

Introduction

Due to variety and diversity of companies, accounting standards and rules are flexible. This flexibility should help companies to present their results in true and fair view, but it also creates an opportunity for earnings management [1]. Earnings management is a process when financial statements are distorted by choosing accounting methods that result in inaccurate financial data [5]. There are two types of earnings management: accrual-based and real earnings management. Accrual-based earnings management is the manipulation of the size of accounting accruals by increasing or decreasing the value of costs, revenues, assets, or liabilities. Real earnings management is the active actions that change the core business of an enterprise, which are very similar to corporate governance decisions, such as increasing or decreasing sales, divesting assets [1].

Some authors consider earnings management unethical [3; 6], while others place it in the grey area between morally right and wrong actions [4; 7]. This may be because attitudes towards ethics themselves vary greatly. As far as the ethics of earnings management are concerned, it should be noted that the company's accountant keeps the books and prepares the financial statements. Therefore, the question of whether the application of earnings management is ethical should also be addressed in terms of the accountant's perception of ethics. A lack of understanding of business ethics can be one of the preconditions for the application of earnings management.

The aim of this paper is to assess the impact of the perception of personal ethics and social responsibility of accountants working in the Lithuanian accounting services sector on the ethical evaluation of earnings management.

Methodology of investigation

Research shows that accrual-based earnings management is considered as less ethical than real earnings management [2; 4; 7]. Accrual-based and real earnings management are defined by different actions: the first one relies on accruals, the latter – on active actions that change company's core business. Accrual-based earnings management can be easily detected by reevaluating circumstances that cause accruals. Detecting real earnings management requires more investigation, as it is hard to distinguish real earnings management from governance decisions. Consequently, some people may mistake real earnings management for governance decisions and evaluate it as more ethical than they would if they understood the true nature of transactions. Accrual-based earnings management is more visible, therefore, more people recognize it as earnings management. Based on this assumption, research hypothesis was formed:

H1: accountants believe that accrual-based earnings management is less ethical than real earnings management.

There are a lot of factors that influence ethical evaluation of earnings management. Some studies show that perceived role of ethics and social responsibility is one of them [2; 4]. People who believe that ethics and social responsibility is very important have higher moral criterion for every action. Therefore, they may consider earnings management as less ethical than individuals who do not care about ethics and social responsibility. Based on this assumption, research hypothesis was formed:

H2: accountants' perceived role of ethics and social responsibility has an impact on ethical evaluation of earnings management.

To achieve the aim of the paper and to test the hypotheses, a questionnaire survey of accountants working in Lithuanian companies providing accounting services was carried out using a 5-point Likert scale. In the first stage, the personal perception of ethics and social responsibility of accountants providing accounting services is assessed. The perception is assessed using the Singhapakdi scale adapted to the Lithuanian accounting system [8]. The second stage examines how accountants perceive the ethical implications of earnings management on an accrual-based and real earnings management. The adapted Merchant scale is used [7]. Hypothesis *H1* is tested using *t-test*, ANOVA analysis and comparison of means. In the third stage, correlation analysis is used to assess the relationship between personal perceptions of ethics and social responsibility and the evaluation of earnings management. The second hypothesis *H2* is tested by means of a *t-test* and the calculation of the correlation coefficient between the variables.

Main results

Before analyzing the answers, distribution was tested using Jarque-Bera test. Validity and reliability were verified by calculating Cronbach's alpha. Cronbach's alpha for perceived role of ethics and social responsibility was 0,822, for ethical evaluation of earnings management – 0,812. These results show that questionnaires are valid and reliable.

Once it was clear that data is valid, reliable, and normally distributed, research hypotheses were tested. Hypothesis *H1* was tested by *t-test* and ANOVA (Fig. 1). Results show a significant difference between the means of the groups. Based on these results, a reasonable conclusion can be drawn that ethical evaluation of accrual-based and real earnings management is not equal. In addition, the mean of ethical evaluation of accrual-based earnings management is $\overline{x_A}$=2,461 and the mean of ethical evaluation of real earnings management is $\overline{x_R}$=3,153. It means that accrual-based earnings management is evaluated as less ethical than real earnings management. Results of *t-test*, Analysis of Variance and comparison of the means show that hypothesis *H1* can be accepted.

Hypothesis *H2* was tested by correlation analysis and *t-test* for significance. Correlation coefficient r=0,132 shows a weak link between perceived role of ethics and social responsibility and ethical evaluation of earnings management. However, a *t-test* shows (Fig. 1.) that there is a statistically significant difference between the means. Based on significance of relationship between perceived role of ethics and social responsibility and ethical evaluation of earnings management, hypothesis *H2* is accepted. Although the correlation coefficient shows a weak relationship between ethical perception and earnings management, the relationship is statistically significant. It can therefore be concluded that personal perceptions of ethics and social responsibility have an impact on the ethical evaluation of earnings management.

	H1	***H2***
t-test		
t	5,713*	4,620*
t_{crit}	2,358	2,358
ANOVA		
f	32,640*	
f_{crit}	6,851	

*p<0,05

Fig. 1. Hypothesis testing statistics

Conclusion

Ethical evaluation of earnings management depends on its type. Accrual-based earnings management is considered less ethical than real earnings management. The reason behind this finding may be the fact that it is difficult to distinguish real earnings management from operational activities.

Perceived role of ethics and social responsibility is one of the factors that influence ethical evaluation of earnings management. The results show that the higher the personal perception of ethics and social responsibility, the more rigorous the ethical assessment of earnings management. Consequently, ethics and social responsibility should be promoted in companies that provide accounting services, because strengthening moral views may result in decrease of earnings management.

Weak relationship between perceived role of ethics and social responsibility and ethical evaluation of earnings management suggest that other factors have a great influence on ethical assessment of earnings management. Therefore, it is recommended that future research focuses on factors that impact ethical evaluation of earnings management.

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