External Auditors' Judgment towards Short-Term Earnings Management Practices: Evidence from Bangladesh

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Abstract

The acceptability of practice of earnings management among the academicians and accounting practitioners was questionable before the study of Bruns and Merchant (1990). After conducting their first survey on the acceptability of practices in earnings management, Bruns and Merchant (1990) found that management was interested in short-term higher earnings performance and get involved more in earnings management practices. This study is based on the Bruns and Merhant (1990) survey and supplements their work by identifying the effects of gender factors towards earning management actions. As well as the acceptability of external auditors regarding earnings management actions based on some predetermined factors. Auditors and Articled students were surveyed. The results indicate that gender played a determining role in auditors' judgment towards earning management actions. Ethical judgments of the auditors were also found to be influenced by the types of earnings management practices (e.g., accounting vs. operating manipulation), consistency with GAAP, materiality, timing and purpose of the earning management actions. On the other hand, auditors' were less concerned about the direction of the earning management action. The study made a comparison between findings from the current study with those of prior studies. The respondents believe that accrual-based earnings management practice is less ethical than real earnings management practices likewise the previous studies.

Keywords: Earning Management; Auditor's Perception, Ethical Judgment.

1.0 Introduction

Corporations are considered as money-making machines and operate to achieve some predefined goals or expectations of different stakeholders. To meet those ever-growing expectations or out of pure moral hazard of certain people inside the organization, management often does not play by the rules. Sometimes, management engages in different scandals. A corporate scandal is an unethical behavior performed by people from inside or related to the organization to deceive different stakeholders by providing fallacious information (Hamid, Hashim, & Salleh, 2016). Though such scandals have been present in the corporate world for hundreds of years, the startling collapse of Enron Corporation in the United States (one of the major corporate accounting scandals in recent history) trembled public confidence in corporate governance and awakened the regulators. These types of scandals raise the questions as to how the auditors acted in the auditing process of those scandal-hit companies and how auditors got involved in those scandals. Consequently, the increased importance has been placed on the concepts of earnings quality and earnings management practices because of financial frauds and failures worldwide.

International financial reporting standards (IFRS) and International Accounting Standards (IAS) offer a wide variety of choices to treat the same event or transaction (Al-khabash & Al-Thuneibat, 2016). For example, the amount, timing, and purpose of transactions and events can be manipulated without such acts being categorized as fraud or misinterpretation (Foster, 1986). Besides, several principles of Generally Accepted Accounting Principles (GAAP) can be used in favor of management which may result in deteriorating quality of financial information (Makar & Alam, 1998). These loopholes allow managers to report falsified figures to satisfy different stakeholders. Thus, phrases such as earnings manipulation, creative accounting, Hollywood accounting, income skimming, earnings smoothing, and the big bath have become popular among current accounting practitioners. Though, the literature showed varied results regarding the legitimacy of earnings management practice.

It is believed that auditors can play an important role in curbing the number of corporate scandals as they are responsible for ensuring the reliability of the figures stated by the company management. Zhou (2012) stated that auditors are liable for measuring the risk of substantial misstatements, caused by fraud or mistake. Thus, in the majority cases of deception or misstatement of earnings, it is the auditors who are thought to be the first group of people being neglectful in their respective duties. Although the existence and core reasons behind occurrence of earnings management practices have been examined extensively in different countries across the world, until recently the issue has received little or no attention in Bangladesh. In recent time, a good number of companies from different industries are believed to have shown an acute tendency of getting into earnings manipulation to avoid taxes and to mislead different stakeholders (Hasan, 2014; Khan & Akter, 2017). The tendency of influencing stock prices through earning manipulation is quite common and this practice is supposed to be one of the main causes that triggered the recent of stock market debacles in Bangladesh. Studies on the presence of earnings management issues in Bangladesh are found in a limited number (Ahmed & Azim, 2015; Razzaque et al. 2006; Biswas, 2018; Bhuiyan, 2015; Muttakin et al. 2017; Karim et al. 2011; Kha, 2017; Hasan et al. 2014). All those studies are conducting to identify the existence of earnings management practice based on some established models in different industries. But, Studies on perception on earnings management as well as the view of auditors' on the practice on earnings management were hardly found. This study is conducted to analyze auditors' perception on the extent to which the earnings management activities are acceptable to them. The result of this study is intended to fill the gap and to enrich the knowledge of earnings management and develop awareness among regulators and auditors.

2. Literature Review

Different authors have tried to discover the true meaning and scope of earning management through their studies over the years. Earning management is termed as an act of manipulating financial figures to earn extra profit for the personal interest of the managers or organizational benefit (Schipper, 1989). It is as a management action of applying self-assessment while reporting a company's financial information (Healy & Wahlen, 1999). Other scholars also shared the same belief that it is an occurrence that happens when managers' discretions alter financial figures to mislead stakeholders about the performance of the company or to impact performance-based contingent results (Prencipe & Bar-Yosef, 2011). Furthermore, earnings management actions had been defined as ways of tailoring income statement so that the statement does not show the real earnings for a particular period (Goel & Thakor, 2003). Earning management has also been defined as the deliberate construction of reporting or investment decisions, keeping the bottom-line impact in mind (Ayres & Frances, 1994).

Earnings management can also be observed from economic (or true) income perspective or an informational perspective. Managers manipulate income using their selections of accounting rules, decisions, or their timing or choice of operating decisions. Also, a number of their incentives influence managers' choices. Managers also show a propensity to manage earnings when earnings are extreme neither direction (Merchant & Rockness, 1994). Earnings management activities can be categorized as accounting-based activities or operating-based activities. Unduly altering the reserve amount to change reported income is an instance of accounting-based earning management. On the contrary, postponement of discretionary expenditures into the future to improve current income is an example of earning management through operating-based activity (Kaplan, 2001).

Discretionary accruals manipulation is an earnings management technique that involves modifying accruals to achieve desired earnings. As per other academicians, accrual management is the manipulation of financial data to hide the actual figure by remaining within the periphery of Generally Accepted Accounting Principles (GAAP) (Gunny, 2010). Beyond the range of GAAP, the manipulation will be considered a violation of accounting standards. Some authors described earnings management to be both artificial and real and they believed that artificial earnings management is realized utilizing the reporting flexibility awarded by the GAAP (Goel & Thakor, 2003). Costs related to artificial earnings management are not discernable like those related to loss of reliability or other such activities. In contrast, costs related to real earnings management are obvious, such as providing promotional discounts. It is pointed out by other authors that usually during seasoned equity off earrings accrual manipulation occurs. They also noticed that discretionary current accruals grow before the offering, peak in the offering year, and decline thereafter (Teoh, Welch, & Wong, 1998). They observed that compared to those non-issuers, discretionary current accruals are high around the IPO for equity issuers. Issuers can report abnormally inflated incomes by making changes using discretionary accruals.

Another study on Malaysian initial public offerings (IPOs), found that the companies reported inflated through earnings management in the IPO years (Ahmad-Zaluki, Campbell, & Goodacre, 2011). He, Yang, and Guan (2011) opined that accounting accruals used at the time of private placements stand as a sign of the post-issue long-term stock underperformance. In addition, managers' occasionally report smooth earnings as to show that the companies have ability to a certain amount of dividend as a means to increase the company's share price (Aljifri, 2007). Daniel, Denis, and Naveen (2008) reached a similar conclusion as they found that firms that pay dividends view the projected dividend level to be a key earnings threshold.

Till now, real operating activities as a means of earning manipulation have received less attention compared to accrual management although a major part of earnings management occurrences had happened as a result of manipulation of real operating activities. Real activities manipulation occurs when managers purposely try to influence the accounting outcome by modifying transactions related to business operations (Dechow & Skinner, 2000). Chen and Tsai (2010) defined real activities as the alteration of information regarding production and distribution to overstate financial reporting performance to achieve a target. As per Gunny (2010), real activities management decisions are usually made prior to the end of the fiscal year, while accrual management occurs after the fiscal year end. Matsuura (2008) suggests that real earnings management is done through the management of real production and investment choices. Osma (2008) found that managers usually increase short-term profit by cutting research and development expenses. Elias (2002), based on his survey on Certified Public Accountants (CPA), industry professionals, accounting faculties, and accounting students, found that the respondents assumed operating manipulation are more ethical than accrual manipulations.

Mizik (2010) thinks of motivations that lead to earning management: propping stock price, and having private information that are not available to the market. He called real activities manipulation myopic management, as these are done to create positive market reactions. Roy Chowdhury (2006) blamed the presence for debt as the reason for real activity manipulation. According to him, firms strive to maintain a good relation with the debtors by hiding the real financial health. He believes there is evidence of a positive relationship between inventory stock, receivables, and growth prospects with real activity manipulations. He also affirms that the firms which are reporting positive profits in smaller amounts and smaller positive earnings forecast errors were managing earnings via real activities management. Cohen and Paul (2010) while probing public offerings, noticed that real earning management activities are more harmful than accrual management activities. Earnings management is a significant ethical issue because it is related to the manipulation of information relating to a company's earnings or performance. Many studies have been done with a common view to derive auditors' view on the acceptability of earning management issues.

Al-khabash and Al-Thuneibat (2016), for instance, studied how internal and external auditors view earning management through a specially designed questionnaire and tried to understand how the auditors perceive different earning management cases. In their study, they discovered that external auditors think the management takes part only in legitimate earning management which is undertaken either to inflate or deflate income. On the other end, internal auditors reflect that managers are involved in legitimate earning management practices that only lift income. They also concluded that internal governance arrangement have a significant effect on illegitimate earning management. However, they did not find any significant effect on internal governance structure on legitimate earning management. Merchant and Rockness (1994) opine that an assessment of the acceptability of earnings management must be undertaken to develop an understanding of the earnings management issue and to find ways to unravel those issues. Their study illustrates that acceptability of earnings management differs with type, size, timing, and purpose of the earnings management actions used. Additionally, it showed opinion also varies by respondent type (i.e. general managers, staff managers, operating unit controllers, and internal auditors). Hence, they called for additional research to draw responses from other group of respondents, i.e. external auditors, as their judgments concerning the acceptability of earnings management might be linked to the role they play in the reporting process. Chi, Lisic, and Pevner (2011) through their study opined that, when faced with limited opportunity for earning management, firms could resort to real earnings management. They also reported that better quality of audit can prevent firms from engaging accrual earnings management.

Bedard, Chtourou, and Corteau (2004) showed that auditors with more expertise are more effective in detecting earnings management. Chang et al. (2003) in another study examined what role the board of directors and audit committee play in preventing earning management with a focus on current discretionary accruals. The study found an inverse relationship between the number of independent managers and discretionary accruals. Furthermore, it also concluded that a strong inverse relationship exists between volume of sale, market capitalization/ size of equity, amount of book value of total assets, and accruals. On the basis of interviews with more than 400 executives working in US firms, Graham et al. (2005) concluded that earning management goals are attained by means of real economic actions such as postponing advertising expenditures, in contrast to manipulation by engaging accounting discretions, such as accrual management, which abide by GAAP rules. Auditors provide reliable assurance that financial statements door do not contain substantial misrepresentations.

Based on these studies following research questions have been developed –

Research Questions:

Q1: Whether there are any significant differences in opinion found between males and females on the ethicality of earnings management actions?

Q2: Whether judgment of external auditors' acceptability regarding earnings management actions depend on following six different earnings management attributes (Types 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).

Research Hypothesis:

H_1: There is a significant difference in opinion found between male and female on ethicality of the earnings management actions.

H_2: There is a difference found in the judgment of the external auditor's acceptability regarding earning management action.

3.0 Research Method

The method used in this study is analogous to the methodology used by Bruns and Merchant (1990). One of the key arguments for selecting this specific questionnaire is that the questionnaire is widely accepted and has been used in similar studies by different authors to study the ethical acceptance of business managers, undergrad students, academicians, and accounting practitioners. (Clikeman et al., 2001; Rosenzweig & Fisher, 1994; Fisher & Rosenzweig, 1996; Merchant & Rockness, 2011; Jooste, 2011). Our study adds to the existing literature not only by assessing the perceptions of external auditors of Bangladesh but also by testing any differences in their opinions based on gender. Additionally, by using a similar methodology, this study compared the results with the previous similar studies from all over the world.

Data has been collected using a survey questionnaire, originally developed by Merchant (1989) and subsequently modified and used by Bruns and Merchant (1990), which consisted of thirteen short scenarios, each describing a potentially questionable earnings management activity taken by a hypothetical profit center manager.

3.1. Data and Sample

The questionnaires were distributed among a sample of 150 auditors including Chartered Accountants, Associate chartered accountants, CA partly qualified, Articled students of some renowned audit firms on a random basis and based on convenient sampling methods. Out of the distributed questionnaires, only 97 were returned. The audit firms were chosen randomly by selecting the first firm and those at intervals of six thereafter. After checking all the returned questionnaires, thirteen (13) questionnaires were found to be incomplete, thus making the total number of useable questionnaires to be 84, yielding a response rate of 56 percent. The response rate appears to be more than half of the distribution, but it is considered as normal as mailed questionnaires are commonly not returned (Salleh & Stewart, 2013). The collected data were analyzed using the Statistical Package for the Social Sciences (SPSS) version 26.

The participants were asked to assess each of the 13 short-term earnings management activities (both accrual-based and real earnings management) and rate those practices based on a five-point Likert scale.

Interpretation of the results is based on the following explanation. High scores indicate that practice has a high degree of ethical unacceptability (Questionnaire is attached in the Appendix. The scenarios were designed to address the research questions as follows (Harvard Business Review, March-April 1989, pp. 220-221) –

1. *Type of earnings management action: Questions 1, 2a, 2b, 4a, 4b, and 4c described operating methods of managing earnings. The others described accounting methods.*
2. *Consistency with GAAP: Of the seven accounting manipulations, three were consistent with GAAP (questions 5b, 6a and6b).*
3. *Direction of effect: Three of the 13 scenarios referred to actions designed to decrease (as opposed to increase) earnings (questions 1, 5a, 5b).*
4. *Materiality was introduced as a concern between questions 7a and7b.*
5. *The period of effect was introduced as a concern between questions 2a and2b.*
6. *The purpose in mind was introduced as a concern between questions 6a and6b.*

4. Result and Discussion

4.1. Descriptive Statistics

Table 1 provides a breakdown of the respondents by group and gender. A total of 84 auditors (including 60 partly qualified chartered accountants and articled students) were included in the survey. It was found that 64% of respondents were male while 36% of respondents were female. The majority of the respondents were article students.

Table-1: Demographic data of the respondents

Respondents	Demographic data of the respondents	No. of Respondents	Percentage of Respondents
Group	Chartered Accountants	11	13%
	Associate chartered accountants	13	15%
	CA partly qualified	21	25%
	Articled students	39	46%
Gender	Male	54	64%
	Female	30	36%

4.2. Opinion difference in case of earnings management actions based on Gender

The first research question is designed to know whether there is any significant difference in opinion between females and males regarding the ethicality of the thirteen earnings management actions. Table 2 is about the mean differences in different aspects based on the questionnaire surveyed. It is found that female seemed stricter than their male counter parts (based on average ratings of 13 scenarios). Females rated 7 situations more strictly, while males have rated 4 situations more strictly than females. Both groups gave diverse opinion on 7 occasions, while gave similar ratings on 5 occasions and agreed on rating of one of the situations.

It has been found that significant differences in opinion exist between male and female based on mean ratings at 0.05 significant levels.

- Defer expenses to meet annual budget (Action 2b) – Male stricter
- Defer supplies expense by delaying recording invoice (Action 3) – Female stricter
- More liberal credit terms to reach budget target (Action 4a) - Female stricter
- Work overtime to reach budget target (Action 4b) - Female stricter
- Prepay expenses to reduce income by $60,000 (Action 5a) - Female stricter
- Increase reserve for obsolescence; reduce income $70,000 (Action 5b) - Female stricter
- Reduce reserve for obsolescence to meet budget target (Action 6b) - Male stricter

Table-2: Mean rating of respondents to various earning management actions

Action Description	Gender	
	Male	Female
1. Paint ahead of schedule (Action 1)	1.78	1.80
2. Defer expenses to meet quarterly budget (Action 2a)	2.22	2.20
3. Defer expenses to meet annual budget (Action 2b)	3.00	2.00
4. Defer supplies expense by delaying recording invoice (Action 3)	3.67	4.20
5. More liberal credit terms to reach budget target (Action 4a)	2.33	3.40
6. Work overtime to reach budget target (Action 4b)	1.44	2.60
7. Sell excess assets to reach budget target (Action 4c)	2.00	1.80
8. Prepay expenses to reduce income by $60,000 (Action 5a)	3.33	4.00
9. Increase reserve for obsolescence; reduce income $70,000 (Action 5b)	3.56	4.00
10. Reduce reserve for obsolescence to continue work (Action 6a)	3.00	3.00
11. Reduce reserve for obsolescence to meet budget target (Action 6b)	3.89	3.20
12. Request deferred billing from supplier, $30,000 (Action 7a)	3.67	3.80
13. Request deferred billing from supplier, $500,000 (Action 7b)	4.33	4.20
Overall Rating (Average)	2.94	3.09

4.3. External Auditors' acceptability regarding earnings management actions

The second research question is defined to know whether judgment of external auditors' acceptability regarding earnings management actions depend on some specific attribute of earnings management practice. From the below mentioned Table 3, it has been found that:

4.3.1. Type:

Ethical judgments of the auditors were found to be affected by the Type of earnings management practice (t=20.71). Between the two earning management methods, auditors have rated operating method (mean rating: 2.19) more favorably than accounting method of earning manipulation (mean rating: 3.68). Auditors' ratings for both types ranged from 1-5, and they also showed considerable disagreement in their ratings for respective types (SD: 1.25 and 1.18).

4.3.2. Consistency:

Auditors' judgement was also found to be affected by whether or not the accounting manipulations were consistent with GAAP or not (t = 4.31). They rated both GAAP consistent and non- consistent earning manipulation actions comparatively harshly (mean ratings: 3.45 and 3.86). Auditors' ratings for both GAAP consistent and no consistent earning manipulations ranged from 1-5, and they also showed considerable disagreement in their ratings (SD: 1.23 and 1.12).

Table-3: Auditors' acceptability regarding earnings management actions based on following six different earnings management attributes

Particulars		Related Questions	Range	Mode	Mean	SD	T Test
Type	Operating Method	1, 2a, 2b, 4a, 4b, 4c	1 - 5	1.00	2.19	1.25	t = 20.71
	Accounting Method	3, 5a, 5b, 6a, 6b, 7a, 7b	1 - 5	5.00	3.68	1.18	
Consistency	Consistent	5b, 6a and 6b	1 - 5	3.00	3.45	1.23	t = 4.31
	Non-consistent	3, 5a, 7a, 7b	1 - 5	5.00	3.86	1.12	
Direction	Increase	2a, 2b, 3, 4a, 4b, 4c, 6a, 6b, 7a, 7b	1 - 5	3.00	2.99	1.40	t = 0.30
	Decrease	1, 5a, 5b	1 - 5	5.00	3.02	1.49	
Materiality		7a and 7b	2 - 5	5.00	4.00	0.94	t = 4.13
Period		2a and 2b	1 - 5	2.00	2.43	1.29	t = 2.15
Purpose		6a and 6b	1 - 5	3.00	3.32	1.25	t = 3.37

4.3.3. Direction:

Direction of earning management was not found to be very important. Auditors' judgement was not significantly affected by the direction of earning management actions (t=0.3). They rated earning manipulation actions through both increasing and decreasing earnings comparatively moderately (mean ratings: 2.99 and 3.02). Auditors' ratings for earning manipulations through both increasing and decreasing earnings ranged from 1-5, and they also showed considerable disagreement in their ratings (SD: 1.4 and 1.49).

4.3.4. Materiality:

Size of the earning management action found to have mattered (t = 4.13). Larger earning manipulations (7b) were more harshly rated than small earning manipulation action (7a).

4.3.5. Period:

Timing/period of the earning management action has also been found to have mattered (t=2.15). Deferring expenses to meet annual budget (2b) was more harshly rated than Defer expenses to meet annual budget (2a).

4.3.6. Purpose:

The purpose of managing earning was a real concern for the auditors (t = 3.37). Earning management for the corporation's best long-term interest (continuation of some important product development projects) was more favorably rated than a more selfish purpose (make budgeted profit targets).

4.4. Comparative Study

Lastly, a comparison is conducted between results found from this study with the prior studies from literature survey. From the summary shown below in Table 4, it can be seen that the mean value of 13 (thirteen) scenarios of current study is above the mean values of prior studies. It can be said that earning management actions seem less ethical to present day auditors' than the auditors did in the past. The respondents of current study rated 7 actions (action 1, 4a, 4c, 5a, 5b, 7a, 7b) comparatively more harshly than the respondents of previous studies.

Table-4: Comparison of Findings from this study with Prior Research Findings

Action Description	Current Study	Clikeman, Geiger and O'Connell (2001)	Fischer and Rosenzweig (1995)	Rosenzweig and Fischer (1994)	Merchant and Rockness (1994)
1. Paint ahead of schedule (Action 1)	1.79	1.09	1.20	1.18	1.26
2. Defer expenses to meet quarterly budget (Action 2a)	2.21	2.81	1.98	1.62	1.81
3. Defer expenses to meet annual budget (Action 2b)	2.64	3.56	2.29	1.88	2.09
4. Defer supplies expense by delaying recording invoice (Action 3)	3.86	2.96	3.27	3.29	3.42
5. More liberal credit terms to reach budget target (Action 4a)	2.71	2.24	1.70	1.81	1.96
6. Work overtime to reach budget target (Action 4b)	1.86	2.08	1.42	1.30	1.31
7. Sell excess assets to reach budget target (Action 4c)	1.93	1.73	1.41	1.25	1.25
8. Prepay expenses to reduce income by $60,000 (Action 5)	3.57	2.76	2.96	3.27	3.27
9. Increase reserve for obsolescence; reduce income $70,000 (Action 5b)	3.71	3.06	3.21	3.32	3.51
10. Reduce reserve for obsolescence to continue work (Action 6a)	3.00	2.55	3.11	3.50	3.59
11. Reduce reserve for obsolescence to meet budget target (Action 6b)	3.64	3.16	3.43	3.71	3.69
12. Request deferred billing from supplier, $30,000 (Action 8a)	3.71	2.79	2.89	3.24	3.76
13. Request deferred billing from supplier, $500,000 (Action 8b)	4.29	3.76	3.75	4.15	4.05
Average Rating	2.99	2.66	2.51	2.58	2.69

*The mean values of prior studies were based on the results presented in the respective studies

At present, the respondents believe that accrual-based earnings management practice is less ethical than real earnings management practices. These findings are similar to the findings from Bruns and Merchant (1990), Merchant and Rockness (1994), Clikeman et al., (2001) studies. In addition, auditors especially female auditors think that earning management issues are unethical and they are more concerned whether the earnings management practices are consistent with GAAP. But, differences were found in case of Clikeman et al. (2001) studies. They asserted that male and female both acknowledged the ethical practices in the similar ways. Their empirical study found no indication that gender has a substantial impact on the judgment of ethical acceptability which is contradictory with the findings of the current study.

5. Discussion and Conclusion

The perception of individuals from different countries in an attempt to evaluate the climate for earnings management and potential for financial wrongdoings is important. Even after the adoption of a common set of laws worldwide, a constant pressure in accounting and business across the globe pressure on the firm's financial reporting executives to manage the company's reported financial results (Hogan et. Al. 2008). Because of the pressure of Stakeholders to report constant financial position of a company, the information of financial misconduct is in a constant stream around the world. This study is conducted to know the perception of auditors in earnings management practice in case of Bangladesh. First, the study aimed at identifying whether gender plays any determining role in case of judgment towards earning management actions. The result shows that gender indeed played a determining role. Female auditors have rated questionable earning management actions more harshly than the action did by the male auditors. Secondly, the study wanted to determine whether judgment of external auditors' acceptability regarding earnings management actions depends on some predetermined factors or not. It is found that acceptability of the auditors are influenced by the method of earnings management practice, consistency with GAAP, materiality, timing, and purpose of the earning management actions. On the other hand, they were less concerned about the direction of the earning management action.

The result from this study confirms that auditors rated the operating method more favorably than the accounting method for earning manipulation. It is also found that larger earning manipulations were more harshly rated than small earning manipulation actions. Auditors view earning management practice for the long-term interest of the company more favorably than a more selfish purpose. The direction of earning management was not found to be very important. Timing of the earning management action has also been found to have any impact on auditors' judgment. As decades have passed since the occurrences of major accounting scandals and the enactment of corporate governance worldwide, it is believed that there could be a shift in attitude among auditors toward the acceptability of short-term earnings management practices. This revelation opens up scope for future studies as to whether auditors' perception has changed with time or not. It also raised the question of what caused such a shift in auditors' judgment towards questionable earning management actions. It is also imperative to examine whether the past scandals and corporate governance of the organization have influenced auditors' judgment regarding earnings management actions.

Nonetheless, there are some limitations of this study. At first, individual judgment may vary from time to time due to varying exogenous factors such as organizational pressure, incentives, and the tendency to meet business targets or other motives. Secondly, this study only takes 13 predefined scenarios into account where managers use multifarious techniques to boost the bottom line of a company. Again, the study only considers the responses of a selective set of students and professional auditors who might not be representative of all students and business managers nationally. Moreover, while all answers were anonymous, some psychological or social biases could have been active during the response process. The timing of the responses may also have influenced the judgment of respondents. Even though there is a growing number of researches are being undertaken to study earnings management practices, there is little concern about focusing on auditors' view or acceptability of such cases. Ensuing studies can supplement present study by using diverse sets of respondents such as managers, students, regulators, teachers, etc. or may examine the effect of ethnicity, race or seniority level of respondents on the acceptability of earnings management.

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Appendix

Questionnaire

This questionnaire consists of 13 short scenarios, each describing a potentially questionable earnings management activity taken by a hypothetical profit center manager. Assume that the divisions referred to are part of a 1 billion corporation, which has a January-December financial year. Each division has annual sales of 100 million, with annual before-tax operating profit of 12 million. Some of these actions are clearly ethical. Others are judged by some or most people to be unethical, and the judgments as to the degree of severity of the infraction can vary widely.

Please indicate your judgment as to the acceptability of each of the practices using the following scale:

1. Ethical practice
2. Questionable practice: I would not say anything to the person involved, but it makes me uncomfortable.
3. Minor infraction: The person should be warned not to engage in the practice again.
4. Serious infraction: The person should be severely reprimanded.
5. Totally unethical: The person should be fired.

Answer each question separately (Assume the incidents are independent)

	Questionnaire on ethics	**Ethical Practice**				**Totally Unethical**
	Action	**1**	**2**	**3**	**4**	**5**
1.	The division's buildings were scheduled to be painted in 2002. Since the division's profit performance was way ahead of budget in 2001, however, the division general manager (GM) decided to have the work done in 2001.					
	Amount: 1,5000	1	2	3	4	5
2.	The GM instructed his employees to defer all discretionary expenditures (e.g. travel, advertising, hiring, and maintenance) into the next accounting period so that his division could make its budgeted profit targets. Expected amount of deferral: 1,50,000	1	2	3	4	5
	The expenses were postponed from February and March to April in order to make the first quarter target. The November and December expenses postponed to January in order to make annual target.	1	2	3	4	5
3.	On December 15, a clerk in the division placed an order for 3,000 worth of office supplies and the supplies were delivered on December 29. This order was a mistake because the division GM had ordered that no discretionary expenses be incurred for the remainder of the fiscal year, and the accounting policy manual states that office supplies are to be recorded as an expense when delivered. The division GM learned what had happened, however, and to correct the mistake, he ordered the accounting department not to record the invoice until February.	1	2	3	4	5
4.	In September, a GM realized that the division would need strong performance in the last quarter of the year in order to reach its budget targets.					

	He decided to implement a sales program offering liberal payment terms to pull some sales that would normally occur next year into the current year; customers accepting delivery in the 4th quarter would not have to pay the invoice for 120 days.	1	2	3	4	5
	He instructed manufacturing to work overtime in December so that everything possible could be shipped by the end of the year.	1	2	3	4	5
	He sold some excess assets and realized profit of 40,000	1	2	3	4	5
5.	At the beginning of December 2001, a GM realized that the division would exceed its budgeted profit targets for the year.					
	He ordered his controller to prepay some expenses (e.g., hotel rooms, exhibit expense) for major trades show to be held in March 2002 and to book them as 2001 expense. Amount: 60000……….	1	2	3	4	5
	He ordered his controller to develop the rationale for increasing the reserve for inventory obsolescence. By taking a pessimistic view of future market prospects, the controller was able to identify 7,00,000 worth of finished goods that conservative accounting would say should be fully reserved (i.e., written off), even though the GM was fairly confident the inventory would still be sold at a later data at close to full price.	1	2	3	4	5
6.	The next year, the division described in question 5b sold 70% of the written off inventory, and a customer had indicated some interest in buying the rest of that inventory the following year.					
	The GM ordered his controller to prepare the rationale for reducing the reserve for obsolescence by 2,10,000 (i.e., writing up the previously written-off goods to full cost). The GM's motivation for recapturing the profit was:					
	To be able to continue working on some important product development projects that might have had to be delayed due to budget constraints…….	1	2	3	4	5
	To make budgeted profit targets……………	1	2	3	4	5
7.	In November 2001, a division was straining to meet budget. The GM called the engagement partner of a consulting firm that was doing some work for the division and asked that the firm not send an invoice for work done until the next financial year. The partner agreed. Estimated work done but not invoiced:					
	30,000………………..	1	2	3	4	5
	5, 00,000……………..	1	2	3	4	5
Full Name: **Gender:** **Qualification:**						