Extent of Idealism and Relativism in Earnings Management Behaviour

Noor Emilina Mohd Nasir¹, Nur Raihana Mohd Sallem¹, Rohana Othman²

¹Faculty of Accountancy
Universiti Teknologi MARA (Terengganu), 23000 Dungun, Terengganu, Malaysia

²Accounting Research Institute
Universiti Teknologi MARA (UiTM), 40450 Shah Alam, Selangor, Malaysia

Received: October 10, 2014
Accepted: November 21, 2014

ABSTRACT

The new millennium saw the uncharacteristic demise of several giant corporations, most notably Enron and WorldCom in the United States and Megan Media and Transmile in Malaysia. In the midst of the mayhem, the accounting profession bore the brunt of the blame since the main contributing factor to this debacle was dubious earnings management activities. Several studies have proven that ethical ideology is one of the important factors to determine if an individual possess a tendency to be involved in unethical behaviour viz. earnings management. This research examined the influence of ethical ideology on earnings management behaviour using a self administered questionnaire survey on accounting practitioners and students. Results revealed there is no significant difference in ethical ideology between the accounting practitioners and students. A binary logistic regression analysis indicates that there is a significant positive relationship between relativism and earnings management behaviour and a significant negative relationship between idealism and earnings management behaviour. This showed that idealism and relativism were significant predictors of earnings management behaviour. In conclusion, this study implied that ethical ideology able to influence the earnings management behaviour of the respondents.

KEYWORDS: Idealism, Relativism, Ethical Ideology, Earnings Management, Unethical Behaviour.

INTRODUCTION

The ethical behaviors and orientation of business leaders are of major concern to the public. Corporate scandals in the west (WorldCom, Enron, Arthur Andersen) as well as in Malaysia (Transmile and Megan Media Holdings Bhd) have ushered ethical issues to be given greater prominence and importance over the last ten years. Later investigation of the collapse of these big corporations revealed earnings management activities. For example, Enron created on-consolidated special-purpose entities (SPEs) to manipulate its reported figures by avoiding recording liabilities [6], World Com was involved in inappropriate revenue recognition by capitalising operating expenses to boost the firms earnings [16], Sunbeam Corporations recognized the sale of products as premature revenue prior to the actual shipment [24], Megan Media is involved with inflated sales and fictitious transactions [43, 44] which resulted the company to suffer a substantial net loss of RM1.14 billion [42]. These examples provide evidence that the corporations collapsed due to earnings management activities.

There is a need to understand the factors that influence people to engage in earnings management behaviour. Numerous researches on earning management have been conducted to identify the motives and techniques of earnings management [2, 15, 25], but there are limited researches conducted on the influence of ethical ideology on earnings management behaviour. Prior study proven that ethical ideology was significant predictors of moral judgment and hence affect business decisions [18]. Therefore, the primary objective of this research is to investigate whether ethical ideology influence earnings management behaviour and to examine whether there is a significant difference in the ethical ideology between the accounting practitioners and accounting students.

The remainder of the paper is organized as follows. The subsequent section describes the literature review followed by development of hypotheses. Next, a method section details the sample, measurement of variables, followed by a results section and a discussion section.

Earnings Management

There are various definitions of earnings management and these have been discussed in a variety of concepts in the accounting literature. Earnings management occurs when managers use their own judgements in reporting financial information with the intention of either to mislead the users of the financial statements about the economic performance of the entity or to influence contractual outcome that depends on the reported financial statements [25]. In his speech on “The Numbers Game”, the former Securities and Exchange Commission, earnings management as a game by market participants where the financial report reflects the
desired of the management rather than the performance of the company [29]. On the other hand, in [35] defines earning management as a purposeful involvement in the external financial reporting process with the meaning to achieve some private gain. Based on the definition, thus it can be said that managing earnings is something that causes harm to the stakeholders since an artificial financial statement has been presented to them.

On the contrary, some researches argue that earnings management is an appropriate managerial tool. For example, in [35] views earning management as inherent in the financial reporting system and the earnings are used to value the shares. In [2] views earnings management as a tool to communicate private information to the stakeholders and enhances the information value of the information, in [17] argues that earnings management ensure managers maximise shareholders’ value and hence, create stability of the financial performance for a firm.

All the above definitions of earnings management involves judgments made by the managers. Those judgements can be viewed in two aspects: legal and ethics. In the perspective of legal, earnings management is beneficial as long as the managers comply with the Generally Accepted Accounting Principle (GAAP). In most cases, the managers’ actions are completely legal when they use the discretionary accrual accounting choices or accounting method changes that best suits their interest in financial reporting [32]. Therefore, it is legal in the eyes of the law provided that it does not violate the accounting principles.

In the other side, the ethics of earnings management is very subjective. In [29] sees it as an unethical behaviour while in [33] feels that it is conducted within the accounting principles. Looking at the motives behind earnings management, these raise the speculation that managers do it for self-interest at the expense of others. Earnings management may not violate accounting standards. However, it may lead to inaccurate economic decisions since the true financial position of the company has been clouded by accounting manipulations.

**Idealism and Relativism in Ethical Ideology**

The terms used to explain the factor that affects the behavior of a person in making a decision will be different from one researcher to another. These include ethical ideology [4, 20, 26, 30, 39, 46], ethical orientation [10, 24, 38], ethical judgement [9], moral philosophies [15, 21, 22, 37, 40, 42] and ethical position [13].

For the purpose of this research, the term ethical ideology will be used. In [18] stated that people will differ in making decisions depending on their ethical ideology. In [40] concurred that ethical ideology is a significant determinant of ethical beliefs. Similarly, in [26] provided evidence that employees differed in their decisions to participate in workplace deviance depending on ethical ideology. Understanding the ethical ideology of the accounting preparer is crucial in attempting to identify the potential intentions of earnings management activities.

In [16] proposed two dimensions of ethical ideology, namely idealism and relativism. Idealism and relativism are regarded as individual differences that influence an individual in making judgments on moral issues. Individuals with idealism will concentrate on human welfare and try to avoid making decisions that will bring harm others. In [42], it defined idealism as an individual ethics that stresses on the inherent goodness of natural laws and will not harm others in all situations despite the urgency. The behaviour of an idealistic individual is driven by what he considers will be the consequences of that behaviour, and he believes that a positive result will be achieved by taking the ethically responsible behaviour [14].

On the contrary, relativism is about one’s tendency to ignore the universal moral principle when making ethical judgments [36]. Relativism is referred to as the degree to which individuals reject the universal set of moral rules when making ethical judgments [18]. The relativistic individual tends to agree with the statement of ‘whether a lie is judged to be moral or immoral depending upon the circumstances surrounding the action. This relativistic individual believes that a set of moral standard cannot be derived from universal principles, but it exists as a function of time, place and culture [41].

Idealism and relativism have been broadly used in business ethics literature. These dimensions are fundamental to the various aspects of an individual’s ethical decision [19] and have been shown in many studies that influence workplace deviance [26], accounting practices [30], earnings management behaviour [24, 27], determinants of earnings management ethics [15], and creativity [26].

Several empirical researches have shown that ethical ideology explains differences in ethical judgments [3]. This is supported by [28] who argued that an individual’s moral philosophy or ethical ideology can be a useful tool in understanding his or her decision making. Thus, applying the ethical ideology as proposed by [18] to the accounting practitioners allows the determination of the potential earnings management behaviour among them.

**Development of Hypotheses**

In [18] suggested that the behavior of a person is based on the idealism and relativism dimensions of ethical ideology. This is supported by many researchers [3, 5, 7, 13, 36, 45]. According to relativism principal, relativistic individual tend to reject the universal moral principal and tend to weigh circumstances in making ethical judgement. Several empirical studies showed that relativistic individuals are more likely to participate in
unethical behaviour. For example, the result of the study by [45] strongly supported that relativism had a significant and positive impact on how business managers in Mainland China favourably perceived business bribery and kickbacks. Congruent to this study, in [40] reported that consumer who scored higher on relativism is more likely to engage in questionable business activities. In addition, in [12] found that relativistic individuals were more likely to engage in budgetary slack reaction. Further, the result of the by [15] provide evidence that relativism was negatively related to ethical perceptions where a high relativist person judged earnings management behaviour as more ethical. In summary, this research suggests that relativists will be more likely to participate in earnings management activities. Hence, the above literature leads to the specifications of the following hypothesis.

H1: There will be a significant positive relationship between relativism and earnings management behaviour.

Conversely, this research hypothesize that idealism will have a negative relationship with earnings management behaviour since idealism addresses “The tendency to avoid harming others while making moral judgement” [42]. This research proposes idealism is related to greater ethical behavior. Several studies provide the evidence which support the hypothesis. For example, in [39] found that, in the context of consumer ethics, idealism has a significant relationship with basic human values and ethical belief of the consumer in which the more idealistic the individuals, the less likely they will engage in ethically questionable behaviour. In addition, in [34] provides evidence that there is a negative relationship between idealism and the willingness to sacrifice ethical standards for individual and firm financial rewards on Chinese employees. Similarly, in [5] found that marketing practitioners who scored high on idealism scale considered questionable act as unethical.

A summary of the literatures from 1996 to 2003 by [31], established that idealistic individuals tend to be more ethical than relativistic individuals. They concluded that idealism research done in more than two decades revealed consistent findings in which idealism is positively related to ethical decisions making than relativism is negatively related to ethical decision making. According to the idealism principle, individuals who tend to be more idealistic should decide not to manage earnings. It would harm others, an outcome they tend to avoid since they are concerned with the welfare of the others.

By the same rationale, idealism is expected to be negatively associated with earnings management behaviour. This is because idealistic individuals tend to reject earnings management activities since they are concerned of human welfare and try to avoid bring harm to the others. Hence, hypothesis 2 is developed as follows.

H2: There will be a significant negative relationship between idealism and earnings management behaviour.

In [17] compared the attitudes of students’ and accounting practitioners’ ethical acceptability of earnings management and ascertained that accounting practitioners judged the scenario relating accounting manipulation and operating manipulation more harshly than accounting students. Similarly, in [15] findings indicated that accounting students were more tolerant of the unethical practice than practitioners. In [8] confirmed that there is a significant higher ethical decision-making score among the educators than students. Contrary to those studies, in [23] found that there is no significant difference between undergraduates’ and business managers’ ethical decision of the earnings management activities. Based on this rationale, accounting students are expected to be less idealistic and more relativistic since they are less concerned on their moral duty. This research would then hypothesize that:

H3a: There will be a significant difference in the idealism scores between accounting students and accounting practitioners.
H3b: There will be a significant difference in the relativism scores between accounting students and accounting practitioners.

RESEARCH DESIGN AND METHOD

Data Collection

Primary data was collected using self-administered survey questionnaire of accounting students and the accounting practitioners in public practice and industry. The accounting practitioners are attached to firms registered with the Malaysia Institute of Accountant (MIA) in the State of Selangor and Klang Valley, since most of the accounting firms are concentrated in these regions.

Measurement and Instrument

Ethical ideology was determined by using a summation of the respondent's response to the items [18] EPQ to determine each respondent’s high or low level of idealism and relativism. The EPQ has 10 items on idealism and 10 items on relativism. The idealism score will be the summation of items 1 to 10 while the relativism score
will be the summation of items 11 to 20. Possible scores on the idealism and relativism sub scales ranged from 10 to 50. Generally, a higher score on the idealism scale implies that respondents are more idealistic and similarly on the relativism scale, in which a higher score implies that respondents are more relativism. Subsequent to its development, the EPQ has been used extensively in examining idealism and relativism as related to moral judgements behaviour [20], business [3, 19], marketing [46], and consumer ethics [11]. Thus, the EPQ scale has been demonstrated as a useful instrument to measure the ethical ideology in the business, marketing and consumer ethics.

In order to examine the effect of ethical ideology on earnings management behaviour, it is important to identify the earnings management scenario. This study used an ethics scenario adopted by [24]. The scenario indicated that the respondent would be personally gained by engaging the earnings management activities. The current year income and the respondent’s compensation will be increased if the company postponed all maintenance scheduled during the last two weeks of December until March the following year. The respondents were then asked to give their opinions whether to support or oppose to the proposal to delay the expenses for maintenance until the following year.

RESULTS AND ANALYSIS

Hypotheses 1 and 2 were developed to examine whether there was any relationship between the ethical ideology and earnings management behaviour. Hypothesis 1 stated that relativism will have a significant positive relationship with earnings management behaviour, while hypothesis 2 stated that idealism will have a negative relationship with earnings management behaviour. To test those two variables (i.e. idealism and relativism), a binary logistic regression analysis was carried out using earnings management behaviour as the dependent variable; idealism and relativism as the independent variable.

Table 1 shows the contribution of each of the variables to the logistic regression model by reporting the Regression coefficients, Wald statistics, odds ratios and the significant level. The regression coefficient was determined by β. If the sign of β is positive, then the probability will increase as the variables increase. On the contrary, if the sign of β is negative, then the probability will decrease as the variables decrease. Based on the Wald statistics as an indication of the unique significance of the predictor variables, only idealism and relativism scores were statistically significant (p < .05) as predictors of earnings management behaviour. The Wald statistics was used to examine whether each predictor variable made a statistically significant unique contribution to the model. The odds ratio is the exponential of regression coefficients. If the odds is greater than 1, the odds will increase as the variable increases. And if the odds is less than 1, this means the odds will decrease as the variable increases.

Table 1: Binary logistic regression

<table>
<thead>
<tr>
<th></th>
<th>ß</th>
<th>Wald</th>
<th>Sig. Level</th>
<th>Odds ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Relativism</td>
<td>1.43**</td>
<td>16.155</td>
<td>0.00</td>
<td>1.154</td>
</tr>
<tr>
<td>Idealism</td>
<td>-2.19**</td>
<td>32.079</td>
<td>0.00</td>
<td>0.804</td>
</tr>
<tr>
<td>Constant</td>
<td>2.638</td>
<td>1.948</td>
<td>0.163</td>
<td>13.987</td>
</tr>
</tbody>
</table>

** Significant at p < .05

EMB = 2.638 + .143RV - .219ID + e

Hypothesis 3a and 3b were developed to test whether there was a significant difference in the ethical ideology of accounting practitioners and students. An independent t-test on this hypothesis gave a result as presented in Table 2. The mean idealism score was 38.64 (SD = 5.029) for the practitioners and 37.96 (SD = 4.301) for the students. Levene's test used to assess the homogeneity of variance gave the p-value as not significant since p = 0.175. The idealism scores of the practitioners and students were compared using the independent t-test. The mean of idealism scores indicate that accounting practitioners were more idealistic than accounting students (M_practitioners = 38.64, M_students = 37.96). However, based on the independent t-test, there was no significant difference between the idealism scores of the accounting practitioners and students i.e. t(243) = 1.14, p = 0.25 (two-tailed). Based on the result of the analysis, hypothesis 3a is rejected.

As for relativism, the mean score was 34.20 (SD = 5.460) for the practitioners and 34.21 (SD = 5.135) for the students. The test of homogeneity of variances was not significant since p = 0.916. The mean of relativism scores for relativism scores indicate that accounting practitioners were less relativistic than accounting students (M_practitioners = 34.20, M_students = 34.21). However, based on the independent t-test, there was no significant difference between the relativism scores of accounting practitioners and students t(243) = -0.017, p = 0.986 (two-tailed). Thus, hypothesis 3b is rejected.
As predicted, the results of the regression confirmed that there was a significant positive relationship between relativism and earnings management behaviour. The logistic regression coefficient was .143 with the p value of .000. The positive sign implied that as the relativism score increased, earnings management behaviour will also increased. Hence, based on the results, hypothesis 1 which stated that there would be a significant positive relationship between relativism and earnings management behaviour was supported. The results of this research indicated that relativistic individuals would be more likely to participate in earnings management activities. This is because as discussed before, these individuals were more likely to reject the universal moral principle and thus increase the likelihood to engage in earnings management behaviour.

Similarly, the results of the regression showed that idealism had a significant negative relationship with earnings management behaviour. The logistic regression coefficient was -.219 with the p value of .000. The negative sign implied that as the idealism score increased, earnings management behaviour will be decreased. Therefore, the results supported hypothesis 2 which stated that there would be a significant negative relationship between idealism and earnings management behaviour. The results of this research indicated that idealistic individuals would be less likely to participate in earnings management activities. This is because as discussed earlier, these individuals were concerned about the human welfare and tried to avoid bringing harm to others. Thus, idealistic individuals tended to reject earnings management activities.

The two dimensions of ethical ideology (i.e. idealism and relativism) were significant predictors of earnings management behaviour. The findings of this study were supported by [18] who argued that the idealism and relativism were significant predictors of moral judgment and could impact business ethical decisions [19].

In order to examine whether there was a significant difference in the ethical ideology between the accounting practitioners and accounting students, an independent t-test was conducted. The results demonstrated that this research failed to support hypothesis 3 where there was no significant difference in ethical ideology between the two groups. This result was consistent with the findings in [23], who found there was no significant difference in the ethical ideology between the undergraduate students and the business manager. However, this research was not in line with [8], who indicated that there was a significant difference in the ethical ideology of the educators and students. The results of this research failed to support the notion that accounting practitioners and students differed in their idealism and relativism scores. This implies that while the respondents differ in earnings management activities.

The collapse of the giant corporations such as Enron and World Com has increased our attention on the ethical behaviour of accounting practitioners. Several researchers have provided evidence that most of the bankruptcies events are because of the earnings management activities. Earnings management activities occur in the business world because of the conflict of interest between the shareholders and management. Therefore, this research was conducted to investigate whether ethical ideology influence earnings management behaviour.

This research found that idealism and relativism scores were significantly related to earnings management behaviour negatively and positively respectively. This shows ethical ideology affect earnings management behaviour of the respondents. This is consistent with the results of several previous studies [3, 20, 24, 26, 45], where they found that relativism was positively correlated with unethical behaviour and idealism was negatively related with unethical behaviour.

The results demonstrated that a relativistic individual would tend to be involved in earnings management activities. This is because relativism will cause them to weigh the circumstances more than the ethical principle when making a decision. For example, if they aim to maximize the wealth of the shareholders, they will engage in earnings management activities so that they are able to show an artificial profit and increase the market value of the shares. They do not follow the ethical principle and feel that their action is not wrong since they are doing it for the shareholders with a goal to maximize the wealth of shareholders.

In conclusion, it is suggested that ethical ideology may be an important mechanism through which an organisation is able to determine which employees will be more likely to engage in earnings management activities. In addition to that, it could be useful in the empirical test of theoretical models of business ethics. A key point to note is the absence of a significant difference in the ethical ideology between the undergraduate

### Table 2: Means and standard deviation of ethical ideology scores for accounting practitioners and students

<table>
<thead>
<tr>
<th>Variable</th>
<th>Practitioners (n = 126)</th>
<th>Students (n = 119)</th>
<th>Levene's Test</th>
<th>t-test</th>
<th>Sig. Level</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>M  SD</td>
<td>M  SD</td>
<td>Levene Statistic</td>
<td>Sign. Level</td>
<td></td>
</tr>
<tr>
<td>Idealism</td>
<td>38.64 5.029</td>
<td>37.96 4.301</td>
<td>1.852</td>
<td>.175</td>
<td>1.143 .254</td>
</tr>
<tr>
<td>Relativism</td>
<td>34.20 5.135</td>
<td>34.21 5.029</td>
<td>.011</td>
<td>916</td>
<td>.017 .986</td>
</tr>
</tbody>
</table>

### DISCUSSION

In conclusion, it is suggested that ethical ideology may be an important mechanism through which an organisation is able to determine which employees will be more likely to engage in earnings management activities. In addition to that, it could be useful in the empirical test of theoretical models of business ethics. A key point to note is the absence of a significant difference in the ethical ideology between the undergraduate
students and the business manager. Considering that undergraduate students will eventually become future business manager, their ethical ideology in the formative stages should be given close attention. This situation deserves a closer look by institutions of higher learning offering accountancy major. It should be noted that the pedagogy in teaching accounting must use approaches that incorporate noble and ethical values and ideals. In essence this serves to start the undergraduates on the right path towards practicing ethical accounting.

Theoretically, this research contributed to the field of business ethics by successfully adding to the understanding of the factor that affected earnings management behaviour. In addition to that, the findings of this study added the empirical evidence on the ethics literature by broadening views on the interactions of ethical ideology and earnings management behaviour.

ACKNOWLEDGEMENT

The authors would like to thank Mr Zairi Ismael Rizman for his guidance and assistance in getting this paper published.

REFERENCES


