

AN EMPIRICAL INVESTIGATION REGARDING THE ETHICS OF EARNINGS MANAGEMENT

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Abstract

This paper assessed the knowledge structures underlying accounting representations, rarely investigated in accounting by examining the perceptions of master and last year accounting students from an ex-communist country relative to the ethics of short-term earnings management. In this respect a survey was conducted during one month period in one of the largest public universities in Romania. The results document a differentiated acceptance of the types of earnings management (e.g. accrual-based versus real earnings management). Overall Romanian students seem to accept as less ethical the accrual-based earnings management and to have a high moral development and understanding of the consequences of such manipulative practices. Limits of the paper are presented and also the scope for future research.

Keywords: ethical judgments, accrual based earnings management, real earnings management, ethical factors

JEL Classification: M40, M41

I. Introduction

Earnings management practices were and still are a great concern in the accounting profession. Since the accounting profession continues to adapt and evolve to the demand of the business world, ethical behavior is continuously assessed. Given the fact that in the past there has been an insufficiency of ethics in the profession, both in education and workplace, we all must strive in the future to ensure for accounting profession the honesty, integrity and commitment to the public's best interest. Today, previous empirical studies documented that the cost of integrity is cheap compared to the cost of not having it (Choi, 2012).

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In today's economic environment, the culture of money plays an important role, while most of the time money and values are associated. In this context an important question springs: How people's values and behavior changes when their sole purpose in life is devoted to acquiring money?

Tinker (2000), approaching the money culture asserted: "Money can't buy you love, but it can buy a piece of the editorial action of a prestigious journal like *Accounting Horizons*, especially when money materializes as academic labor power". Soros (1998), also approached the dangers of the money culture, where the profit-maximizing behavior follows the dictates of expediency and ignores the demands of morality, asserting: "What I can say with confidence is that the substitution of monetary values for all other values is pushing society toward a dangerous disequilibrium and suppressing human aspirations that deserve to be considered as seriously as the growth of GNP.[. . .] By contrast, collective decision making cannot function properly without drawing a distinction between right and wrong". (p. 208).

Given the relateness of accounting to and contingent upon organizational and social contexts, critical approaches have previously focused on a variety of uses and effects of accounting in space-time settings. Assessing especially the instrumental claims on and opportunistic adaptation of, accounting within power interplays at various levels and in different environments (Zambon and Zan, 2000). This paper is concerned with theoretical structures affecting accounting calculations, since some of such foundations (i.e. ethics theories) may shed some further light on the very roles of accounting. Since accounting can potentially serve many interests, its underpinnings can open room for its discursive use in terms of power (Hopwood, 1992). Dealing with ethical perceptions of accounting students towards opportunistic behavior acceptance, this study tries to contribute to a higher understanding of individual ethical judgments. In this respect, the purpose of this study is to examine in an empirical setting, the degree of acceptance of one of the most known short-term manipulative practices.

The earnings management choices of the respondents was measured using the Bruns and Merchant (1990). In this regard both accrual-based and real earnings management practices were tested. We find that ethical students, primarily accept earnings manipulation primarily through real actions rather than accounting choices.

Current economic environment has become increasingly diverse in its view regarding ethics. Approaching mainly the lack of ethics, a large body of literature assessed the lack of objective decision-making, which has been made clear through various accounting scandals and manipulative practices documented all over the world. In this respect in the aftermath of such scandals as Enron or Parmalat, the accounting profession had to regain the public's trust in order not to lose its reliability and trustworthiness. The main item approached in this paper is the key role of ethics in accounting while one the essential thing to realize in conjunction with such accounting scandals is that gross ethical failures were taken place previously to the legal failures.

While, ethics was found to be pivotal for accounting profession (one argument consists in the huge number of paper assessing its importance) and despite the fact that all scholars and users of accounting information regard it as a fundamental aspect of accounting, ethics is seemingly needed to be reinforced and reincorporated on daily basis. Since far, efforts have been made through accounting ethics education

courses, SOX law in USA in 2002, increasing awareness of ethics importance within the workplace. Despite all such efforts scholars continue to document manipulative practices all over the world (Choi, 2012), while the economy cannot continue to operate successfully if companies are consistently use mismanagement and act with a lack of ethics.

This particular study comprises the four branches of ethics: descriptive, normative and metaethics and applied ethics. The segment referring to descriptive and applied ethics comprises the empirical study were a factual investigation of moral standards took place in the business ethics field. Moreover, some moral praxis are described (i.e. moral opinions, attitudes or actions). In the segment of the state of the art both normative ethics and metaethics can be found. As such, in the normative ethics assessed, my goal was to investigate some of the existing norms and values as approached in the literature, having the purpose to clarify how they are to be understood, interpreted and applied to moral issues. The metaethics segment was part from both state of the art and empirical investigation where some ethical judgments and analysis of methods of reasoning in ethics took place. While in the segment of the state of the art, the metaethics addressed the meaning of ethical terms such as morality and responsibility, in the empirical investigation I examined whether morality is subjective or objective.

The subject is timely and relevant at least for two reasons. First, in the light of previous accounting scandals, opportunistic behavior and the lack of ethics became topics of higher importance in the accounting research. Second, given the decreasing public confidence due to events that affected the credibility of audit and accounting profession, acting ethically and responsible was the proposed solution (Arel et al., 2012). Thus, examining the ethics of opportunistic behavior deserves continuous attention. This particular paper extends the spring of research by assessing the opinions of accounting students from an ex-communist country, an emerging one, compared to previous empirical studies conducted in western cultures as USA or UK.

The remainder of this paper proceeds as follows. The next section discusses the theories behind ethics and earnings management practices. Following that, I describe the research method and data analysis. the next section provides the results. The paper concludes with limitations and discussion of future research.

II. State of the art

2.1. Discussions and findings on ethics in accounting

As the literature stated (Ferrell and Gresham, 1985; Ferrell et al., 1989), the aim of ethical theories is, among other, to present and defend answers regarding the moral standards that should be taken into account when assessing various actions and decisions and, moreover, how such standards should be justified. Since ethics, is all about weighing different reasons and considerations for and against each other, this field oh research has never been easy to explore. Comprising various theories, ethics

field of research can be viewed moreover like a battlefield of strong ideas than an area of consensus. In this regard, teleological theories (i.e. consequentialism, utilitarianism and virtue ethics) and deontological theories (i.e. Kantian and Rossian), do not seem to be able to converge to a consensus (Ferrell and Gresham, 1985; Hunt and Vitell, 1986).

While the teleological theories assert that an act is morally right if it promotes the good or what has value, the deontological theories conclude that whether an act is morally or wrong depends on whether it is in conformity or conflict with moral duties and rights.

A theory that can be approached in connection with earnings management area can be consequentialism (and utilitarianism), when ethics is examined in connection with manipulative practices, given the fact that some value based theories comprised in consequentialism can explain such behavior. So, for the people engaging in such practices whether an act is morally right depends solely on the consequences or the goodness of consequences. Since earnings management can be either opportunistic or informative, some practices are not regarded as being not ethical.

Moreover, some practices comprising informative purposes or real earnings management practices are regarded as being more ethical than other manipulative practices. Some earnings management practices can fall under the influence of virtue ethics, where an act is morally right or good when it depends on whether it is in conformity or conflict with certain virtue or character traits. In this regard, individuals engaging in manipulative practices consider them as being not harmful and being value maximizing for the company.

Both types of consequentialism can be applied to earnings management area when trying to explain the actions undertaken by various individuals engaging in manipulative practices. Egoistic and particularistic consequentialism, on one side, can explain the actions undertaken when one only takes into consideration how such consequences of an act will affect oneself or a given group. Ethical egoism asserts that individuals should promote their own greatest good (Hunt and Vitell, 1986). On the other hand, universal consequentialism can explain the actions undertaken by individuals when one takes into account how the consequences of an act will affect all the parties involved. In this setting, moral rightness depends on the consequences for all affected people or sentient beings.

From the utilitarian perspective, various manipulative practices can be accepted on moral terms. Since for the utilitarian, an act has value as right or wrong, then it can only be derivatively, because of the good or bad states of affairs that it produces. The morally right action is the one that produces the best overall consequences with regard to the utility or welfare of all the affected parties. When all affected parties gain, even if some accounting practices are considered manipulative, they can be morally acceptable.

In contrast with consequential teleological theories, non-consequential theories hold that

the good or rightness of an action should not be determined by its consequences, and that actions are correct in and of themselves because they are conducted according to fundamental obligations (Laczniak and Murphy, 1993). Kant, as representative of non-

consequentialist theories, acknowledged that people may perform good works and derive pleasure in the process, but he denied that such consequences should be their motivation. In this respect, there are situations when people can do good things for bad reasons, and when they do so, these actions, have no moral worth. From the point of view of Kant deontology, earnings management practices are not morally acceptable. Since earnings management is a deliberate misrepresentation of the firm's "true" financial position in order to increase managers' wealth or human capital, any form of such activities can be regarded as unethical, even when managers use it for informational purposes.

In some situations, Rossian deontology is susceptible to accept some practices or earnings management, since rights and duties here are not considered absolute standards, but rather strong moral demands or considerations or principles. The informative purpose of earnings management practices can be partially morally acceptable. One could argue that since people hold a more subtle view, some sort of earnings management practices can be ethical if not all of them, since its methods used fall within generally accepted business practices, and the objectives are not opportunistic to managers but rather equitable to the firm's other stakeholders.

Since both ethics and earnings management area of research is a complex one, a normative analysis can be difficult to assess. Instead, an examination of previous empirical analysis based on a social scientific method can be more suitable, because people often judge whether an action is ethical based on emotions rather than on the type of reasoning expounded in utilitarian, consequentialist, and deontological theories of ethics (Prinz 2007).

Given the fact that social norms and specific cultural practices seem to drive evaluations about both morality and ethicality of people's actions, ethics comprises a cultural relativism. Moreover, several empirical studies of moral reasoning have established firm links between ethical judgments, intentions and actions (Vitell and Hunt, 1986). In this respect the empirical studies conducted by Bruns and Merchant (1990), Merchant and Rockness (1994) or Graham et al., (2005) documented that managers regard accrual-based earnings management as less ethical than "real" earnings management.

While discussions about ethics in accounting are important to be assessed, more important is to determine how a person makes decisions of what is wrong and right. Since ethics governs the people's life, their work is performed based on their view of what ethics is, must be implemented and how they are making every day decisions. Given the above simplicity in explaining what ethics is, one could assume that its application would be equally simple. Given the various accounting scandals and extensive documentation of manipulative practices in today's economic environment is becoming obvious that this is not the case. For instance, Richard Scrushy, the former CEO of HealthSouth, asked his subordinates to manipulate the books in order to meet analyst's forecasts, based on the fact that he considered that all companies are acting in the same manner (Beam, 2009).

Regarded as one of the most suitable path to limit manipulative behaviors, ethics is regarded most often as the ultimate solution in this increasingly diverse world. Most of the scholars and users of accounting information reacts positively when such solution

is proposed and use it as main argument, as the right or wrong should be universal, and should not vary to different cultures and backgrounds. Moreover, what one person may accept as ethically wrong, another may view it as perfectly acceptable (Copeland, 2005).

In the end why is ethics important? Maybe one of the most convincing argument should rely on the consequences of unethical behaviors, as a consequence of the lack of ethics. As Copeland (2005) observed, today's environment seems to be placed solely on meetings expectations instead of upholding reputation.

One cannot stop wondering when observing documented lack of ethics, what is the root of such problem. My view is that such root relies in the awareness of personal responsibility of each individual in the society, responsibility that is finally assessed through the choices and decisions that people make. Therefore, the decisions of people and ethical viewpoints should be examined as the ultimate determinants of ethical behavior and should have the upmost important in every discussion related to ethics or the lack of it.

Moreover, in accounting, there must be a string commitment to honesty and reliability. Since ethical decision-making relies in priorities, one person must rank integrity higher than any other item comprised in the making of decisions. When such commitment do not exist, often problems arise, coming from the people creating them. Often the explanations regarding the lack of ethics relies in the fact that accounting is not used appropriately. Copeland (2005) for instance documented that real problems in accounting and auditing comes from insufficient character and ethics, when accountants and auditors do not do the right things in spite of the consequences.

Many scholars acted like proponents of ethics in education and asserted that its implementation would make a great difference in this area. One of the first was Theodore Roosevelt, who one stated that when educate a person in mind and not in morals is to educate a menace to society.

Since ethics is undeniably a pivotal component of accounting, the argument for including it in accounting education is a very strong one. Proponents as Bean and Bernandi (2005) summarized the importance of ethics in one questions: "What courses are more important in a curriculum educating accountants than an accounting ethics course?"

Burke and D`Aquila (2004) underlined the effects on long term of the lack of ethics and concluded that in the light of recent accounting scandals and the consequential deterioration of the public's trust in the accounting profession, education should better reflect the needs to the public by expanding the coverage of ethics. Moreover, the main argument was that accounting professionals must learn how to deal with ethical situation, adding more ethical questions and simulations to the exams would be beneficial in equipping accounting professionals with the necessary ethical judgments that they will need at their workplace.

II.2. Discussions and findings on earnings management area of research

Earnings management behavior has been a concern in the accounting profession for many years. Manage earnings practices spring because GAAP allow for flexibility and

judgment on the part of managers' to select reporting methods, estimates, and disclosures that match firm's underlying economics. The use of judgment provides the perfect opportunity for management to achieve their desired objectives, while they argue that they operate the corporation to produce continuous improvement in operating performance, steadily and reliably increasing financial returns, and long-term growth in shareholder's value.

According to the literature, earnings management practices include accounting-based activities or real earnings management. Fisher and Rosenzweig (1995) approaching the accrual-based earnings management, gave as example the adjusting the amounts of the reserves, thereby changing reported income. For real earnings management, the same authors offered as example the timing of transactions.

While earnings management should be accepted as ethical or not, raised one the of the most important and controversial ethical issues in the accounting profession (Johnson et al., 2012). Given the fact that ethicalness of earnings management was examined in previous studies with mix results (Bruns and Merchant, 1990; Merchant and Rockness, 1994; Fisher and Rosenzweig, 1995; Clikeman et al., 2001; Jooste, 2011; Johnson et al., 2012), a strong empirical field of research was assessed so far in the literature.

The main conclusion of previous empirical literature it seems that ethics is overridden by the opportunistic behavior (Wesley and Ndofor, 2013). Also, it is documented empirically that individual differences in making ethical decisions do exist and those came either from national origin either gender (Clikeman et al., 2001).

In order to summarize the above results documented in the literature, ethical perspective raised various questions over time. In this regard, this particular study is trying to extend previous cited sources by examining Romanian students' perceptions of the ethical acceptance of earnings management. No surveys using the Bruns and Merchant (1990) questionnaire are available in Romania. Therefore, the results obtained can be compared with other available studies in the literature.

Taking into account the preceding discussion, students' perceptions regarding earnings management ethicality can vary. Given the cultural differences, the hypothesis (null) tested in this paper is:

H: There is no difference in perceptions of the ethical acceptability of earnings management for students from Romanian economic environment.

3. Methodology

The methodology used is similar to the methodology comprised in Bruns and Merchant (1990). The main argument for choosing this particular questionnaire consisted in the fact that it was extensively used in previous similar studies (Clikeman et al., 2001; Rosenzweig and Fisher, 1994; Fisher and Rosenzweig, 1996; Merchant and Rockness, 2011; Jooste, 2011). In order to be able to compare the results obtained in Romania to similar studies documented all over the world, a similar path and instrument of research was chosen. All the respondents comprised in the survey were tested in the same time and location, having the same age and the same unit

specialization. The language used was Romanian. A translation was necessary since respondents' line of study was Romanian and the questionnaire was developed in English language.

4. Research design

This particular study comprises a survey testing where last year and master students from accounting field were used as respondents. Accounting students were chosen since they tend to give us a generalized understanding on how the general business public accepts such manipulations and given the technical nature of the scenarios comprised.

Data was collected by means of one restricted form questionnaire, administrated to the respondents with the goal of examining the ethical acceptance of earnings management practices. The questionnaire comprised 13 practices, including both accrual-based earnings management and real earnings management. The practices included are considered short-term earnings management activities.

IV.1. Sample

One group was surveyed comprising last year and master accounting students from one of the largest public university in Romania. Participation was voluntary, since the students were informed that the responses to the questionnaires were assessed as anonymous. The students ranged in age from 22 to 28 years with a median age of 24 years. 5 students did not answer all the questions comprised in the survey, resulting in 43 usable responses. From the students participating, 34 were female. All students were residing in their home country. There were no significant differences between our participants in terms on accounting course hours or ethics course hours and the participants from previous studies conducted in the literature, using students as respondents.

IV.2. The questionnaire

In order to evaluate the ethical acceptability of short-term earnings management practices, both accrual-based and real earnings management ones, the instrument developed by Bruns and Merchant (1990) was used. Among the reasons to use this particular questionnaire was the fact that this instrument was used previously in various empirical studies in many countries, giving the possibility to compare the results obtained with the ones already documented in the literature.

In this respect the respondents were informed that this instrument refers to \$1 billion Company consisting of different divisions which has a January-December fiscal year. Like in Bruns and Merchant (1990) , this particular study comprised a segment of explanations regarding the fact that each division has a turnover of \$100 million and net profits before taxation of \$12 million. Also, similarly like in the empirical study conducted by Bruns and Merchant (1990) in the first page of the questionnaire it was comprised the information regarding a short description of a variety of actions that individuals have taken. Some of the practices described are considered ethical,

having a higher acceptance in the view of the most people, while others are assessed as being unethical by the large majority of people. The participants were asked to assess each of the 13 short-term earnings management practices (both accrual – based and real earnings management) and rate them based on a five-point Likert scale. The interpretation of the results are based on the following explanations:

1 = Ethical practices (mean below 1,5);

2 = Questionable practice. I would not say anything to the person involved but it makes me uncomfortable (mean between 1,5 and 2,5);

3 = Minor practice. The person should be warned not to engage in the practice again (mean between 2,5 and 3,5);

4 = Serious infraction. The person should be severely reprimanded (mean between 3,5 and 4,5);

5 = Totally unethical. The person should be fired (mean between 4,5 and 5).

When high scores were obtained that practice was interpreted as having a high degree of ethical unacceptability.

5. Findings and discussion

Table no. 1 comprises the mean values for acceptance scores of earnings management practices in our one group sample. Also, in table 1, presented below the mean values of previous studies are comprised for comparison purposes.

Table 1

Table title Mean values of short-term earnings management practices

No.	Description of the short-term earnings management practices	Mean values	Prior studies*
1	Paint ahead of schedule	2,05	1,32
2	Defer discretionary expenses to meet quarterly budget	2,56	2,24
3	Defer discretionary expenses to meet annual budget	2,42	2,60
4	Defer suppliers expenses to delaying recording invoice	2,42	3,30
5	Credit that has more liberal terms to reach budget target	2,56	2,04
6	Work overtime to reach budget target	2,05	1,66
7	Sell excess assets to reach budget target	2,56	1,61
8	Prepay expenses to reduce income by \$60 000	3,32	3,03
9	Increase reserves for inventory obsolescence, reduce income \$700 000	2,42	3,26
10	Decrease reserves for inventory obsolescence to continue work	3,32	3,15
11	Reduce reserve for inventory obsolescence to meet budget target	3,25	3,34
12	Request deferred billing to suppliers \$30 000	3,05	3,17
13	Request deferred billing from suppliers \$500 000	3,40	3,89

Average rating for study overall	2,56	2,66
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**The mean values of prior studies were calculated by the author. Those mean values were calculated by the author based on the results presented in the studies approached.*

Source: Author's projection

Summarizing the results presented in table 1, we can assert that the mean values disclosed are above the average in prior studies for seven of 13 scenarios described (1, 2, 5, 6, 7, 8 and 10). This empirical evidence indicates a stricter view of our students compared to previous results documented in the literature. The overall responses showed a significant lack of agreement and the dispersion of ratings was great. In this respect the results obtained are documenting a striking lack of agreement, since none of the participants viewed any of the 13 practices unanimously as an ethical or unethical practice.

The average responses documented that none of the 13 practices are considered ethical by our participants (mean below 1,5). Students had the least objection to the practice of painting ahead of schedule (scenario 1 and 5; mean 2.05) similarly to previous results documented in the literature (Clikeman et al., 2001).

On average, similarly to Bruns and Merchant (1990) the participants in this particular study regarded accrual-based earnings management less acceptable than real earnings management practices. Based on those results it can be accepted that the method of earnings management do matters in terms of ethical acceptability. From the 13 practices examined, six are rated as moderate as ethical acceptance, among them six being real earnings management scenarios (1, 2, 3, 5, 6 and 7). Similarly to the empirical study conducted by Clikeman et al., (2001) or Merchant and Rockness (1994), our students objected more strongly to accrual based earnings management compared to real earnings management. This particular study found no evidence that gender significantly affects judgments about the ethical acceptability of earnings management practices. Similarly to Clikeman et al. (2001), female and male students perceived the ethical practices in the same way. This can be explained based on the fact that the scenarios used do not have an explicit interpersonal component.

VI. Conclusion, limits and scope for future research

This empirical study documents that students have a higher tolerance for real earnings management practices when compared to accrual-based one. Second, it seems that Romanian accounting students have a deeper understanding of the morality and ethicality of such practices since their answers are above the mean values documented in the literature in terms of acceptance of such activities. The author believes that part of the answers can be explained by the fact that students often are making their judgment using a legalistic view of ethics, and since they are not really working in the field (compared with managers) their incentives to manipulate earnings are merely lacking. Similarly, with previous results documented in the literature, students' perception regarding the ethical acceptability of earnings manipulation depends on the type of manipulation.

Given the small sample and the fact that students were used as respondents, the results should be treated with caution. Also, given the complexity of some manipulative techniques comprised the questionnaire used, some of the students may not fully understand the practices explained. Gender was not considered as being a factor that could influence the results based on the results documented.

Future research can identify and summarize the main factors impacting ethical decisions in the process of decision making in the economic environment more thoroughly. Also, given the contradictory results in terms of personal values, future research can examine the impact of such variables.

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