Advances in Accounting, incorporating Advances in International Accounting 29 (2013) 299–311

Contents lists available at ScienceDirect

Advances in Accounting, incorporating Advances in International Accounting

journal homepage: www.elsevier.com/locate/adiac

Some theoretical and methodological suggestions for studies examining accountants' professional judgments and earnings management

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ARTICLE INFO

Keywords:
Theoretical and methodological suggestions
Accountants' professional judgments
Earnings management
Ethics
Personality variables
Multidimensional Ethics Measure (MEM)
"Holier-than-thou" perception bias

ABSTRACT

The objective of this paper is to provide theoretical and methodological suggestions to guide future research on the controversial topics of accountants' professional judgments and earnings management. Based on an evaluation of prior research, this paper provides four suggestions. First, it is suggested that a focus on the influence of personality variables is likely to provide sharper insights into judgments of individuals. Two relevant personality variables have been selected for this paper, namely, Construal of Self and Regulatory Focus Theory. Both Construal of Self and Regulatory Focus Theory have been, primarily in psychology literature, proven as valid and relevant for judgments, decisions and behavior. Second, prior literature conducted studies on earnings management and ethical issues to a large extent in the United States, often assuming that findings are generalizable and transferable to other countries. Given the importance of contextual factors and of gaining insights from global perspectives, the examination of nations with different contextual environments and particularly of countries in which ethical issues have not been rigorously examined, is suggested. Third, prior research has largely relied on simplistic unidimensional ethics measures that are unlikely to capture the complexity of accountants' professional judgments. It is suggested that a combination of a unidimensional measure and 'Multidimensional Ethics Measure' (MEM) provides richer insights into judgments. Fourth, this paper also suggests measuring "holier-than-thou" perception bias. "Holier-than-thou" perception bias means that individuals consider themselves as more ethical than their peers. This bias is important because it may foster an unethical organizational culture. Some of the suggestions included in this paper may provide useful guidance for future studies examining accountants' professional judgments and earnings management.

1. Introduction

Accountants' professional judgments and earnings management are important and controversial topics in accounting, as shown by significant recent corporate collapses, audit failures, and criticisms regarding the quality of financial reporting during the current Global Financial Crisis (Dechow, Myers, & Shakespeare, 2010; Jiraporn, Kim, & Mathur, 2008; Kothari & Lester, 2012; Laux & Leuz, 2009; Van Tendeloo & Vanstraelen, 2008). However, earnings management is not only a current but also a longstanding issue, dating back to the beginning of accounting and has been of serious concern to the accounting profession and the business world in the last decades (Ball, 2009; Elias, 2004; Kaplan, McElroy, Ravenscroft, & Shrader, 2007; Naser & Pendlebury, 1992). Earnings management has been defined in a number of ways and for the purpose of this paper is defined as the use of "judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers" (Healy & Wahlen, 1999, p. 368). This definition has been used extensively in previous research and is relevant and useful particularly for this paper, as it relates to professional judgments, earnings management, and ethics (Braun & Rodriguez, 2008; Elias, 2002; Kaplan, 2001a; Niskanen, Karjalainen, Niskanen, & Karjalainen, 2011).

Global standard-setters have moved toward the concept of 'substance over form' or principles-based accounting standards, which require extensive use of professional judgments (Heidhues & Patel, 2012, p. 17). This global shift from rules-based to principles-based accounting standards in combination with imprecise reporting standards has increased the scope for exercising professional judgments which may lead to greater earnings management (Nelson, 2003; Okamoto, 2011). As such, accountants may exercise their professional judgments to engage in earnings management within the guidelines provided by Generally Accepted Accounting Principles (GAAP). Indeed, previous research provides evidence that earnings management is often related to discretionary accruals and as such is not necessarily inconsistent with GAAP (Ball, Kothari, & Robin, 2000; Chung, Firth, & Kim, 2002; Ibrahim, 2009; Merchant & Rockness, 1994; Peasnell, Pope, & Young, 2005). However, earnings management can also be difficult to distinguish

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0882-6110/$ – see front matter © 2013 Published by Elsevier Ltd.
http://dx.doi.org/10.1016/j.adiac.2013.09.002

from appropriate applications of GAAP and may also be inconsistent with the objectives of GAAP (Ball, 2009; Nelson, Elliott, & Tarpley, 2002, 2003). For example, it has been noted that financial fraud is one extreme form of earnings management, and further that a thin line separates earnings management from fraud (Dechow & Skinner, 2000; Elias, 2002). As such, earnings management can result from both legal and illegal means and is therefore a highly ambiguous and controversial issue that requires further examination.

Importantly, despite the argument that earnings management may be within the boundaries of law, ethical issues arise because numerous stakeholders relying on financial statements may be misled (Barua, Lin, & Sbaraglia, 2010; Geiger et al., 2006). Therefore, earnings management provides an excellent construct through which to examine ethical issues and judgments of accountants. Prior literature provides evidence that inappropriate application of professional judgments and ethical issues are clearly related (Jackling, Cooper, Leung, & Dellaportas, 2007). Moreover, recent accounting scandals and the current Global Financial Crisis have focused public attention toward issues related to ethics and accounting (Abdolmohammadi, Fedorowicz, & Davis, 2009; Birnberg, 2011; Smith & Hume, 2005; Sweeney & Costello, 2009). As such, it is concluded that professional judgments, earnings management and ethical issues remain controversial and important topics.

Earnings management has been examined using a number of theoretical and methodological perspectives including normative approaches, capital market research, and experiments. Additionally, some prior studies on earnings management have applied behavioral approaches, which is the approach taken in this paper. Behavioral researchers have frequently examined the influence of national culture on earnings management, with an extensive reliance on the theoretical dimensions developed by Hofstede (1980) and operationalized in accounting contexts by Gray (1988). It is acknowledged that studies relying on Hofstede and Gray provide valuable insights into differences and similarities at national levels. However, as argued by Heidhues and Patel (2011), such extensive reliance on Hofstede and Gray's cultural dimensions can also be viewed as an obsession with categorization, quantification, and narrowly focused cultural dimensions in accounting research, which often do not adequately capture the complex and dynamic construct of culture. To obtain sharper insights, it is important to broaden theoretical and methodological perspectives by examining various factors that may influence professional judgments and earnings management. Therefore, the objective of this paper is to provide some holistic theoretical and methodological suggestions to enhance research on earnings management.

In particular, this paper recommends that this strand of research be extended by examining the influence of relevant personality variables on accountants' judgments on earnings management. Personality is defined as "the dynamic and organized set of characteristics possessed by a person that uniquely influences his or her cognitions, motivations, and behaviors in various situations" (Ryckman, 2007, p. 4). While culture has an impact on individuals and addresses how, in general, an individual should behave in a particular role or status in a given society, personality "speaks to differences in behaviours or responses by individuals in the same roles or statuses in a given society" (Harrison, 1993, p. 325). For example, Hofstede, Hofstede, and Minkov (2010, pp. 4–7), by comparing individuals' thinking, feeling, and potential acting to the way that computers are programmed, distinguishes between human nature, culture, and personality. Fig. 1 (adopted from Hofstede et al., 2010, p. 6) shows the pyramid of 'Three Levels of Uniqueness in Mental Programming' and illustrates that personality is on top of the pyramid. Fig. 1 also shows that personality is both inherited and learned, which means that personality is shaped by both genetic and environmental influences (Triandis & Suh, 2002). Importantly, Fig. 1 highlights that personality is specific to individuals.

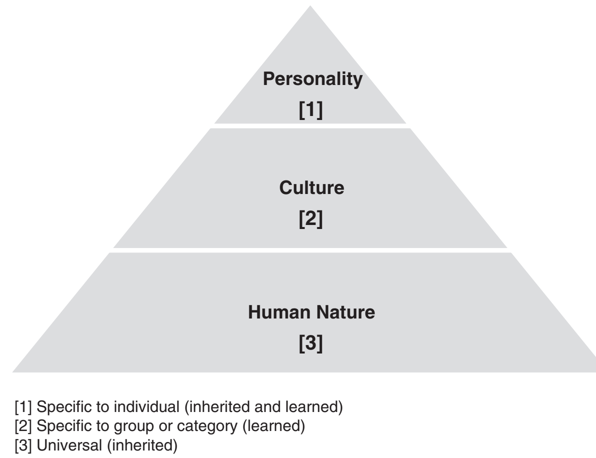

Fig. 1. Hofstede's 'three levels of uniqueness in mental programming'.

As such, national culture differences try to explain differences in judgments across cultures, whereas personality variables provide clearer insights into differences among individuals (Cable & Patel, 2000). Despite the influence of culture on personality, personality is not merely "culture in microcosm," and studies focusing on personality may provide different and sharper results than studies that focus on culture (Rohner, 1984, p. 123; Triandis & Suh, 2002). Therefore, this paper suggests that a focus on the influence of relevant personality variables is also likely to provide sharper insights into the judgments of individuals in the context of earnings management.

The study of personality variables is relevant in the field of accounting, as it is likely to provide valuable insights into factors that may influence judgments and behaviors of accountants (Taggar & Parkinson, 2007). However, prior research has largely failed to recognize the importance of personality variables in accounting research. For example, Taggar and Parkinson (2007, p. 135) conclude that "there is a limited amount of research published where personality is used to address accounting issues." Additional calls have been made in accounting to acknowledge the importance of personality and to examine the influence of personality variables on accountants' judgments (Andon, Chong, & Roebuck, 2010; Heidhues & Patel, 2012, p. 162; So & Smith, 2003; Wheeler, 2001).

This paper responds to these calls by providing suggestions to examine the influence of personality variables on accountants' judgments related to earnings management. For this paper, two relevant personality variables have been selected, namely, Construal of Self and Regulatory Focus Theory. Both Construal of Self and Regulatory Focus Theory have been, primarily in psychology literature, proven as valid and relevant for cognition, judgments, goal pursuit, decisions, and behavior (Brockner & Higgins, 2001; Cesario, Higgins, & Scholer, 2008; Crowe & Higgins, 1997; Gardner, Gabriel, & Lee, 1999; Higgins, 1998; Higgins & Silberman, 1998; Leonardelli, Lakin, & Arkin, 2007; Markus & Kitayama, 1991, 2010; Singelis, 1994). Construal of Self is a relevant personality variable because it focuses on individuals' notions of themselves in relation to others and distinguishes between independent and interdependent Construal of Self (Markus & Kitayama, 1991). The second relevant personality variable selected in this paper, Regulatory Focus Theory, distinguishes between two self-regulatory systems to pursue specific goals or desired end-states, known as promotion-focus and prevention-focus (Higgins, 1997, 1998). It is suggested that both Construal of Self and Regulatory Focus Theory are likely to provide additional insights into factors that may influence judgments on earnings management.

A further theoretical suggestion of this paper relates to the selection of countries in which to examine accountants' judgments, earnings management, and ethical issues. Prior literature has, to a large extent, focused on the United States context. However, while these studies have provided valuable insights, the findings may not be generalizable and transferrable to other countries, as has often been presumed