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Moral Judgment and Causal Attributions: Consequences of Engaging in Earnings Management

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Abstract

Recent, well-publicized accounting scandals have shown that the penalties outsiders impose on those found culpable of earnings management can be severe. However, less is known about how colleagues within internal labor markets respond when they believe fellow managers have managed earnings. Designers of responsibility accounting systems need to understand the reputational costs managers impose on one another within internal labor markets. In an experimental study, 159 evening MBA students were asked to assume the role of a manager in a company and respond to a scenario in which another manager (the target manager) has the opportunity to engage in earnings management. Participants provided causal attributions, assessed the morality of the target manager, and indicated whether they would change their judgments about the target manager's reputation. The study manipulated three between-subjects factors: (1) whether the target manager chose to engage in earnings management, (2) whether the company's budgetary control system was rigid or flexible, and (3) whether the target manager's work history was average or above average. We found that causal attributions are affected more by the budgetary systems when the target did not manage earnings than when the manager did. We also found that morality judgments were significantly associated with the target manager's behavior, but not with the budgetary system. In addition, participants' judgments about the target manager's reputation were more strongly associated with morality judgments than with causal attributions. We discuss implications of the role of reputation in management control systems design.

Keywords

Accounting, budgetary control system, casual attributions, earnings management, moral judgement, work history

Disciplines

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Comments

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MORAL JUDGMENT AND CAUSAL ATTRIBUTIONS: CONSEQUENCES OF ENGAGING IN EARNINGS MANAGEMENT

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ABSTRACT

In an experimental study, one hundred fifty-nine evening MBA students were asked to assume the role of a manager in a company in which another manager has the opportunity to engage in earnings management. In response to the scenario, participants provided causal attributions, assessed the morality of the target, and indicated whether they would change their judgments about the target's reputation. The study manipulated three between-subjects factors: 1) whether the target manager chose to engage in earnings management, 2) whether the company's budgetary control system was rigid or flexible, and 3) whether the target manager's work history was average or above average. The results indicated an interactive effect such that causal attributions differ more across different budgetary systems when the hypothetical manager did not manage earnings than when the manager did. The results also indicated that morality judgments were significantly associated with the hypothetical manager's behavior, but not with budgetary system. In addition, the judgments subjects provided about the manager's reputation were found to be more strongly associated with morality judgments than with causal attributions. We discuss implications of the role of reputation in management control systems design.

Key words: Causal Attributions, Earnings Management, Moral Judgment

MORAL JUDGMENT AND CAUSAL ATTRIBUTIONS: CONSEQUENCES OF ENGAGING IN EARNINGS MANAGEMENT

Healy and Wahlen define earnings management as using judgment in reporting financial results "and in structuring transactions to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers" (1999, p. 368). More recently, Davidson, Jiraporn, Kim and Nemec (2004, p. 267) have conceptualized earnings management as a form of impression management whereby flexible accounting principles are used to influence reported earnings, thereby causing reported income to be larger or smaller than it might otherwise be. Opportunities for earnings management exist because managers typically have the ability to use judgment in shaping financial reports (Jensen 2001), both in setting earnings targets and in reporting actual results. Healy and Wahlen (1999) conclude that earnings management is motivated by both capital market factors and/or management compensation considerations.

As an example of the latter motivation, Guidry et al. (1999) use business-unit level data to demonstrate that earnings management occurs when managers attempt to maximize or increase their bonuses. In their field study, Guidry et al. (1999) found that business-unit managers in the bonus range appeared to manage earnings upward through the use of discretionary accruals, as compared to business-unit managers who were not in the bonus range. This evidence demonstrates that, on average, managers act as if the benefits from engaging in earnings management outweigh potential negative consequences whether internal or external to the firm. Simply put, a variety of inducements exist that may motivate managers to manipulate both earnings targets and reported results (Jensen, 2001).

While evidence indicates that some managers engage in earnings management in order to receive performance-based bonuses (Guidry et al. 1999; Healy, 1985), others refrain because they consider earnings management activities to be unethical (Merchant and Rockness, 1994; Elias, 2004). Accounting researchers have not explored the consequences of earnings management, i.e. whether managers who are discovered to have engaged in earnings management to enhance their compensation suffer any negative effects on their reputations *within* their firms.

Our work is motivated in part by Sprinkle (2001, p. 2), who suggests that management accounting researchers should investigate "the extent to which social norms, individuals' preferences for non-pecuniary factors such as honesty and fairness, and firms' information systems interact with more formal managerial accounting systems." The purpose of this study is to examine the reputational consequences when managers engage in earnings management. Specifically, the study proposes that observers' morality assessments and causal attributions about a target manager who has an earnings management opportunity will be shaped by both the target manager's behavior and the organization's budgetary control style. Further, it is suggested here that effects on the target's reputation will be significantly associated with morality assessments about the target manager. We believe that it is important for designers of responsibility accounting systems to understand these reputational costs as they design management control systems and formal information systems within firms.

In particular, in this study we ask subjects to judge the morality of earnings management decisions in differing budgetary and performance contexts to determine what causal attributions are given and how morality judgments and attributions affect others' impressions about the manager who engages in such behavior. Earnings management has been an area of longstanding concern in the field of accounting, but relatively little research has addressed morality judgments of the practice from a management perspective. Though research directly addressing the issue is lacking, it is generally felt that managers tend to be morally sensitive to differing work contexts (Brower and Shrader, 2000) and ethical climates (Forte, 2004) in making decisions. Research addressing specific moral judgments potentially help us understand the nature of corporate leadership in organizations (Kelly, 2004). To this end, we seek to empirically explore how various specific situations interact with moral judgments of earnings management.

BACKGROUND AND HYPOTHESES

Earnings Management

Merchant and Rockness contend that earnings management is "probably the most important ethical issue facing the accounting profession," (1994, p. 92). Given the recent "Enron" environment, this is even truer today. Merchant and Rockness (1994) provide initial evidence on how professionals assess the ethics of earnings management activities. The respondents, selected from two corporations and one chapter of the Institute of Internal Auditors, were general managers, corporate staff, or operating unit controllers. They were asked to answer several questions based on a series of brief scenarios, each of which described an earnings management activity undertaken by a hypothetical profit center manager. Participants were asked to evaluate the acceptability of each activity. General managers rated the activities as more unethical than the corporate staff or unit controllers did. This finding is consistent with earnings management having greater negative consequences for line managers than for staff. Presumably, non-managers such as corporate staff employees or internal auditors are not competing against other managers for compensation or promotion. The responses from the corporate employees differed significantly, causing Merchant and Rockness to speculate that respondents from

Corporation A may have rated the activities more unethically than did respondents from Corporation B because of “one or more difficult-to-observe control factors, such as *tone at the top*” (1994, p. 91). Additional research by Kaplan (2001a) showed that reactions to earnings management varied by the observer’s role. Those assigned the role of stakeholder saw any earnings management attempt as unethical, while those assigned the role of another manager in the company took a differentiated view of earnings management. In this case, subjects assigned the role of managers viewed accounting-related earnings management as more unethical than operations-related earnings management.

To a degree this study extends the work of Kaplan (2001a), by further examining the reactions of other managers within a firm to accounting-related attempts at earnings management. Rather than simply looking at the ethical judgments associated with accounting-related earnings management, this study seeks to ascertain the additional roles played by the target manager’s record of past performance as well the organization’s budgetary control system.

Attribution Theory

Attribution theory offers a framework for understanding the processes by which people explain, interpret, and respond to the behavior of others (Kelley and Michela, 1980; Weiner, 1985a). Attribution theorists are concerned with perceptions of causality, or the post-hoc reasons individuals use to explain events (Heider, 1958). In essence, attribution processes involve post hoc reasoning whereby the causes of a behavior or an event are inferred from the observation of the behavior or event (Mowday, 1983). Such post-hoc sense-making is important because individuals use it both to identify the causes of events and to assign personal qualities or attributes to others engaging in behavior (Lord and Smith, 1983). Specifically, causal attributions affect and reflect both how we feel about events and people and our expectations of those people (Weiner, 1985b). Thus, the particular causes that individuals attribute to a given behavior or event are closely related to more generalized evaluations (e.g., correspondent inferences) of those individuals engaging in behavior (Crant and Bateman, 1993).

The causal explanations people use to explain events vary on a number of dimensions (Weiner, 1985b), but for the purposes of this study the locus dimension is most relevant. That is, human behavior can be explained along a continuum in which the end-points are dispositional causes (e.g., internal to the individual engaging in behavior) and situational causes (e.g., external to the individual engaging in the behavior) (Kelley and Michela, 1980). The former is primarily concerned with an individual's assessment of the extent to which an event is caused by the character, disposition or intent of the person engaging in the event while the latter is due to situational factors.

The application of attribution theory to organizational settings was pioneered by the work of Green and Mitchell (1979), among others, and has more recently been applied to examine auditor judgments (e.g., Kaplan and Reckers, 1985, 1991, 1993) and jurors' evaluations (Lowe, Reckers, and Whitecotton, 2002). Attribution theory is most applicable when causality is uncertain. Understanding why a manager did or did not engage in earnings management involves uncertainty because frequently one cannot inquire too closely about or definitively ascertain that such behavior has in fact occurred.

In this study we explore the attributional processes occurring when an earnings management opportunity exists. Previous earnings management research is extended in three ways. First, the current study examines both the causal attributions and a morality-based correspondent inference (e.g., an overall assessment formed about the target manager's morality) individuals form in response to an earnings management opportunity by a target manager.

Whereas causal attributions have been examined extensively in auditor judgments and earnings forecasts (Kaplan and Reckers, 1985, 1991, 1993; Lowe et al., 2002; Baginski et al., 2004), the formation and implications of correspondent inferences has received less attention (Wong-on-Wing et al., 1989; Reckers and Wong-on-Wing, 1991). We test an alternative hypothesis based on Reeder and Spores (1983), who have specified a particular type of ethics-based correspondent inference to denote an individual's ethics or lack thereof. We provide further evidence on the antecedents and consequences of this inference.

Second, the current study examines whether an important component of the organizational environment, the budgetary control style (Van der Stede, 2000), is associated either directly or indirectly with the formation of causal attributions and/or ethically related correspondent inferences. As discussed below, the background and context in which behavior occurs are predicted to influence and shape causal attributions and correspondent inferences. We contend that any informal discipline in internal labor markets would be contingent upon the extent to which the occurrence of an unethical event (e.g., engaging in earnings management) is attributed internally, that is, to the disposition or character of the manager. That is, negative outcomes and responses directed towards a target manager are expected only when other managers make internal attributions and inferences about the target manager rather than external attributions that serve to excuse or exculpate the target manager. In this regard, we would not expect that a target manager's reputation would be damaged if engaging in earnings management is attributed primarily to strong environmental pressures, such as those present in certain budgetary control systems.

Third, we examine the relationship between causal attributions and ethically-based correspondent inferences, respectively, and subsequent reputationally-related judgments. While prior research (Kaplan, 2001a, 2001b) has examined ethics-based correspondent inferences as a dependent measure, we contend that such judgments drive subsequent reputationally-related judgments to a greater extent than causal attributions do.

Antecedents to Causal Attributions and Correspondent Inferences

Kelley (1972) introduced both the discounting and augmentation principles to the attribution literature. Under the discounting principle, engaging in behavior that is expected *in the situation* lessens the tendency to make internal attributions and correspondent inferences to the individual. Alternatively, under the augmentation principle, engaging in "contraindicated behavior" (Michela and Kelley, 1980, p. 470) will strengthen the tendency to make internal attributions and correspondent inferences to the individual. We consider the application of these principles to observing a target manager's decision regarding earnings management.

The situational variable that could either lead to either discounting or augmentation that we examine is the budgetary control system. While budgetary controls have been defined in various ways, the issue has generated strong and continuing interest among management accounting researchers (Hopwood, 1972; Merchant, 1998; Van der Stede, 2000). Budgetary control styles fall along a continuum ranging from rigid to flexible. A rigid budgetary control style provides a strong incentive for meeting accounting-based budgets (Merchant, 1998) and is one in which managers are evaluated primarily on whether or not they achieved their short-term accounting-based budget. A flexible budgetary control style places less reliance upon accounting-based budget information and considers such information in context with other information in a longer-term time frame.

Assuming that budgetary control style leads to discounting or augmentation, we propose the following relationships. Ceteris paribus, when engaging in earnings management allows managers to meet their financial targets and when managers work under a rigid budgetary control style, observers would expect managers to manage earnings. Hence, the observers' attributions would reflect discounting, i.e. less emphasis on internal or dispositional explanations. Similarly, when managers refrain from earnings management in a flexible budget regime, they are behaving as expected and again observers' attributions would reflect discounting. Alternatively, when budgetary control styles are rigid and the target manager faces pressure to manage earnings, his decision *not* to do so will lead to attributions that reflect augmentation, i.e. a greater emphasis on disposition. In the same vein, a target manager who chooses earnings management even though he faces a flexible budgetary control system is doing the unexpected and internal attributions made about him will be augmented.

> **Hypothesis 1 (a)**: Earnings management and budgetary control style will interact such that under a flexible control setting managers' causal attributions will be more internally oriented when the actor engages in earnings management. Alternatively, under a rigid control setting managers' causal attributions will be more internally oriented when the manager does not engage in earnings management.

We propose that observers will make morality judgments about the target manager that reflect their attributions. When the target behaves as the budgetary control style would lead him to, then the morality judgment of him is expected to be relatively neutral. But if he acts contrary to expectations then the judgments will be more extreme. In the case of managing earnings in a flexible budgetary setting he will be seen as unethical (e.g., less moral), in contrast to a rigid budgetary setting where a more neutral assessment is expected. In the case of refraining from managing earnings when the budgetary controls are rigid he will be seen as highly moral, in contrast to a flexible budgetary setting where a more neutral assessment is expected. As described, morality judgments about the manager will be more favorable under a rigid budgetary setting rather than a flexible budgetary setting. This argument leads to a related hypothesis regarding morality assessments.

> **Hypothesis 1 (b):** Morality judgments about the target manager will be more favorable when budgetary control style is rigid rather than flexible.

However, a somewhat different pattern of attribution is predicted by other theorists (Reeder and Spores, 1983; Erickson and Krull, 1999). They suggest that because negative information weighs heavily in one's overall impression of a person, a single immoral behavior, such as engaging in earnings management, may be enough to sour one's overall evaluation of a person (Reeder and Spores, 1983). This heightened role of negative information has been found by auditing researchers (Butt and Campbell, 1989; Kida, 1984; Trotman and Sng, 1989). Moreover, Reeder and Spores (1983), contend that when people observe unethical behavior they tend to focus on that behavior and to generalize from that observation. Under their model observers tend to believe that if someone behaves unethically in one situation, they are likely to do so in other situations and in other ways (cf. also Sanderson and Darley, 2002). Thus when the target engages in immoral behavior, an observer infers that the actor is immoral, regardless of the situational demands surrounding the behavior (Reeder and Spores, 1983) and holds that person accountable for his/her actions.

However, when ethical behavior is observed (e.g., not engaging in earnings management), the ethical behavior may reflect either the target person' prudence (i.e., he would prefer to engage in earnings management but there is no immediate payoff under flexible budgetary systems so he reports earnings accurately) or it may reflect good character. More recently, Erickson and Krull (1999) have also argued that morality judgments are more extreme than causal attributions, by suggesting that observers infer a dispositional or character trait from behavior and, depending on circumstances may look for causal explanations only after forming a morality judgment.

To test these alternative explanations, we posit the following set of competing hypotheses on the role of earnings management and budgetary control systems on causal attributions and morality judgments.

> **Hypothesis 2 (a):** Earnings management and budgetary control style will interact such that managers' causal attributions differ across budgetary control systems when the actor does not engage in earnings management (e.g., attributions will be more internally oriented under a rigid control setting than flexible control setting) but will not differ across budgetary control systems when the manager does engage in earnings management.

> **Hypothesis 2 (b):** Earnings management and budgetary control systems will interact such that morality judgments about the target will differ across budgetary control systems when the actor does not engage in earnings management (e.g., attributions will be more internally oriented under a rigid control setting than flexible control setting) but will not differ across budgetary control systems when the actor engages in earnings management.

Reputation Effects

Because our purpose is to examine possible reputational consequences of earnings management, it is appropriate to consider how attributions relate to a range of judgments and evaluations that managers may rely upon in forming opinions about their colleagues. If, as Erickson and Krull (1999) suggest, morality judgments differ from causal attributions, one of the differences may be that the process of generalization from moral judgments is stronger (broader in its range and more immediate) than generalizations from causal attributions. Consequently, we hypothesize that when observers assess the reputation of a target manager, their reputational judgments will be more strongly associated with morality assessments than with causal attributions.

> **Hypothesis 3**: Reputation effects will be more strongly associated with morality judgments than with causal attributions.

METHOD

Overview and Task

The subjects were presented with a scenario describing an earnings management opportunity for a target manager, Mr. Jones, a divisional manager for a public company. Participants were instructed to assume the role of another manager working for this same company. The earnings management opportunity involved the possibility that Mr. Jones could defer receipt and related expense accrual of a bill for $220,000, which is part of an ongoing consulting engagement. Participants received a single, randomly assigned case. In response to the scenario, participants provided a series of responses described below. To complete the questionnaire, participants responded to manipulation checks and several questions about their background.

Independent Variables

The study contained three between-subjects independent variables, as follows: behavior of the target manager, the nature of the organization's budgetary control system, and the target manager's work history.

Earnings Management Behavior

The target manager's behavior was operationalized as a binary variable with two levels. In the earnings management condition, the scenario indicated that the target manager engaged in the earnings management activity. Under this manipulation, the case read, in part:

> **For the most recent period, the division reached targeted net income…. You learn that divisional expenses did not include the costs from an ongoing consulting engagement. Mr. Jones 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 until next year. The partner agreed. Mr. Jones knew this action was questionable but that it would**

allow the division to reach targeted net income. … Divisional net income would have been below targeted net income had the expenses from the consulting engagement been included as part of this year's divisional expenses.

In the non-earnings management condition, the scenario indicated that the target manager did not engage in the earnings management activity. Subjects in this condition read a case that said, in part:

> **For the most recent period, the division did not reach targeted net income…. You learn, however, that divisional expenses included the costs from an ongoing consulting engagement. Mr. Jones considered calling the engagement partner of a consulting firm that was doing some work for the division and asking that the firm not send an invoice until next year. While Mr. Jones was sure that the partner would agree, he concluded that such an action would be wrong. … Divisional net income would have been above the targeted net income had the expenses from the consulting engagement been excluded from this year's divisional expenses.**

Budgetary Control Style

The nature of the organization's budgetary control style was manipulated to alter the situational demands confronting the hypothetical manager. Under the rigid style, the case described a budgetary control system with a heavy emphasis on meeting short-term targets. Specifically, the case read, in part:

> **As a manager you have found the company's reward structure to have a strong orientation towards short-term performance. As an example, a budgeted annual income target is set for each division and it is important for division managers to meet the target. Division managers achieving budgeted annual income targets receive favorable evaluations and a substantial bonus. However, division managers who do not meet budgeted incomes receive unfavorable evaluations and do not get the bonus. The extent to which the division is progressing towards long term strategic goals has almost no impact on the manager's performance evaluation.**

Under the flexible style, the case described a budgetary control system with less emphasis placed on meeting short-term targets. Specifically, the case read, in part:

> **As a manager you have found the company's reward structure to have a strong orientation towards long-term performance. To enhance coordination and communication, a budgeted annual income target for each division is established. However, within the company whether the budgeted annual income targets are achieved is not important. For example, the manager's bonus is not tied to achieving this budget and whether the budget is achieved has little influence on the division manager's overall performance evaluation. Instead, division managers are evaluated primarily with respect to measures more directly tied towards meeting long-term strategic objectives. Also, bonuses are tied to measures of long-term strategic goals.**

Target Manager's Work History

The target manager's work history was manipulated at two levels. Under the average work history level, the case read, in part, "**He has a reputation for being hard-working and knowledgeable, and his division and his evaluations have been average**." Under the above average work history level, the case read, in part, "**He has a reputation for being hard-working and knowledgeable, and his division and his evaluations have been very favorable**."

Dependent Variables

The study includes three groups of dependent variables: (1) causal attributions, (2) morality judgments, and (3) four other managerially related measures of reputation.

Attribution Measure

Participants were asked to indicate the degree to which (1) factors related to Mr. Jones's disposition or character (e.g., internal scale), and (2) factors related to the situation and the organization (e.g., external scale) contributed to Mr. Jones's action. Two separate nine-point scales were presented, anchored by "very unlikely cause" (1) and "very likely cause" (9). A net attribution score for each participant was computed by subtracting the rating on the external scale from the rating on the dispositional scale. The net attribution score has a range of -8 (situational causality) to 8 (dispositional causality). This net score indicates the relative importance of factors related to the manager's internal traits vs. situational factors. A positive score indicates that the participant attributed the manager's action more to dispositional (internal) causes than to situational (external) causes. A negative score indicates that the manager's action was attributed more to the situation than to the manager's character. A score of zero indicates that the two factors contributed equally to the manager's behavior. This method of netting attribution measures is common (Elig and Frieze, 1979) and has been used previously to measure auditors' net attribution scores (Kaplan and Reckers, 1985; Wong-on-Wing et al., 1988).

Morality Measure

The second measure is participants' assessment (or judgment) of the morality of the hypothetical manager. Participants were asked, "Based on the available information, how would you judge the morality of Mr. Jones?" The end-points on a nine-point scale were "very immoral" (1) and "very moral" (9).

Other Managerial Reputation Effects

The study also examines other managerially relevant judgments. These include how knowledgeable Mr. Jones is, how hard-working Mr. Jones is, Mr. Jones' decision making ability, and how willing the subject would be to work with Mr. Jones.

As part of the background information describing Mr. Jones, he was characterized as having "a reputation for being hard-working and knowledgeable." On two separate scales participants were asked to indicate the extent to which Mr. Jones' actions changed their impressions of Mr. Jones in terms of his reputation for being (1) hard working, and (2) knowledgeable. Each nine-point scale was anchored by "Action greatly diminishes reputation" (1) and "Action greatly strengthens reputation" (9). Participants were also asked, "Based on the available information, how would you assess Mr. Jones's decision-making ability during the current year?" The end-points on a nine-point scale were "substantially below expectations" (1) and "substantially above expectations" (9). The mid-point (5) was labeled "at expectations." Finally, participants were asked, "Based on the available information, how willing would you be to work with Mr. Jones on an important company project?" The end-points on a nine-point scale were "extremely unwilling" (1) and "extremely willing" (9).

Subjects

Evening MBA students at a major metropolitan state university were used as participants for the study. The students were enrolled in a managerial accounting course, which is taken in the second year. Evening MBA students typically are older than full-time students and have substantial work experience. One hundred sixty two questionnaires were distributed and 159 questionnaires were completed. The remaining three had missing data and were excluded from the analysis. The majority of participants was male (65 percent) and had been involved in preparing a budget or providing information for others preparing a budget (63 percent). In addition, the mean age and professional work experience among participants were approximately 32 years and 10 years, respectively.

RESULTS

Manipulation Checks

After reading the case, participants answered manipulation checks to determine whether they were aware of the budgetary control system and work history of the hypothetical manager. Regarding the budgetary control style faced by the manager, participants were asked two questions. The first question asked, "How would you assess the culture of the company?" on a nine-point scale anchored by "long-term performance oriented" (1) to "short-term performance oriented" (9). The second question asked, "How important is it for division managers to achieve budgeted annual income targets?" on a nine-point scale anchored by "not important at all" (1) to "very important" (9). Mean responses to these two questions among participants in the rigid condition were 8.3 and 8.0, respectively. Mean responses to these two questions among participants in the flexible condition were 3.4 and 4.2, respectively. On each of the two questions, the differences between the two groups were significant ($p<.01$). Regarding the work history of the hypothetical manager, participants were asked, "Prior to the current year, how would you assess the manager's work history:" The nine-point scale was anchored by "very below average" (1) to "very above average" (9). Mean responses from the average and above average work history treatment levels were 4.8 and 6.7, respectively. The two groups were statistically different from one another ($p<.01$). These responses indicate that participants attended to the manipulations of budgetary control system and target manager's work history.

Hypothesis Testing

Table 1 presents the descriptive statistics and a correlation matrix for the dependent variables used in this study. Hypotheses 1(a and b) and 2(a and b) were tested using a 2x2x2 between-subjects factorial design. The three independent variables of target behavior (earning management versus no earnings management), the organization's budgetary control style (rigid versus flexible) and the target's work history (average versus above average) were analyzed using the general linear analysis of variance model, which accommodates unequal cell sizes. Hypothesis 3 was tested using regression analysis.

Insert Table 1 about here

Table 2 reports the ANOVA results for the effects of earnings management, budgetary control style and work history on net attributions and morality judgments. Significant main effects were found for both earnings management ($F=20.54$, $p \leq .001$) and work history ($F=4.65$; $p \leq .05$) on net attributions. Subjects turned to more internal/dispositional attributions when the target manager did not engage in earnings management (Mean=1.54) than when the manager did in engage in earnings management (Mean=-.58; $p<.001$). As shown in Table 2, earnings management explained 12 percent of the variance in net attributions. Moreover, the behavior of the target manager was attributed more to internal factors when the manager was described as an average performer (Mean=.97) than when he was described as an above average performer (Mean=.01; $p<.05$). In this case, work history explained 3 percent of the variance in net attributions. However, it is the finding of a significant interaction effect (explaining 4 percent of the variance) between the earnings management and the budgetary control style that is most relevant to this study. Recall, that both Hypothesis 1(a) and Hypothesis 2(a) predict a significant interaction between earnings management and budgetary control style. However, each predicts a different interaction pattern. Figure 1 shows the nature of the observed interaction. The observed pattern conforms to the pattern predicted by hypothesis 2(a). That is, net attributions were not affected by budgetary control style when earnings management occurred but were affected by budgetary control style when earnings management did not occur. The strongest internal attributions were assigned to the actor who did not engage in earnings management in the rigid budgetary control system (Mean = 2.60).

Insert Figure 1 about here

Table 2 reveals a strong, significant effect for earnings management on morality assessments (F=251.95; $p \leq .001$), explaining 63 percent of the variance. The absence of a significant main effect for budgetary control style fails to support Hypothesis 1(b). Further the absence of a significant interaction effect for target behavior and the budgetary control style fails to support Hypothesis 2(b). The finding of a significant interaction between earnings management and work history, while not directly related to Hypothesis 1(b) or 2(b) is interesting, nonetheless. Above average performers were judged more moral when they engaged in earnings management than were average performers ($M_{above\ avg.}$=4.21, M_{avg}=3.49), but slightly less moral when they did not engage in earnings management ($M_{above\ avg.}$=7.23, $M_{avg.}$=7.39). This interaction effect explained 3 percent of the variance in morality assessments.

Insert Table 2 about here

Hypothesis 3 addresses the extent to which other managerially-relevant judgments are associated with either causal attributions and/or morality assessments. These include assessments of how much the reputation of the target has changed in terms of how hard-working and knowledgeable the target is, his decision-making ability, as well as changes in the observer's willingness to work with the target. Regression analysis was used to determine the association between causal attribution and morality assessments on each of the four dependent variables.

Table 3 shows the results of regressing the subjects' net attributions and morality assessments on the four reputation perceptions of the target manager: diligence (i.e. willingness to work hard), knowledge, decision making capability, and their willingness to work with the target manager. As shown in Table 3, morality assessments have a much greater and more pervasive affect on reputational judgments about the target manager than do net attributions, findings that support Hypothesis 3.

Insert Table 3 about here

DISCUSSION

While prior research (Healy, 1985; Guidry et al., 1999) has provided important insights indicating that some managers opportunistically manage earnings, little attention has been given to the potential internal negative consequences associated with engaging in such behavior. The current paper provides evidence on these potential negative consequences in terms of causal attributions observers make to explain such behavior, the morality judgments observers make, and reputational consequences, including perceptions of their work ethic, knowledge, decision making abilities and the future willingness of colleagues to work with them.

Limitations

Before discussing the results of the study, several limitations related to the use of an experimental approach should be noted. As part of an experimental approach, participants responded to a scenario about a target manager's opportunity to engage in earnings management. This approach has previously been used in studies to measure ethically-related judgments (Becker and Fritzche, 1987; Flory et al., 1992; Singer and Singer, 1997), attributions, and performance-related judgments (Kaplan and Reckers, 1985). The strengths of this approach include experimental control and the ability to manipulate key variables. A concern, however, with this approach is that it is not possible for the stimulus material to contain all relevant information that would be available in a real-world setting. For example, although amounts were given for the potential earnings management activity as well as the size of the company, other financial statement information as well other non-financial information was not provided. Potentially, the availability of such additional information might have influenced the judgments examined in this study.

Second, the participants in the study were evening MBA students asked to assume the role of a company manager. While the majority of these students had substantial professional work experience and had been involved with the budgeting process, caution is warranted in extrapolating these findings to the work environment. Third, the dependent measures used in the study were almost exclusively one-item scales. The use of such measures leaves open questions of the validity and reliability of these measures.

Results

The results of the study support Reeder and Spores' (1983) notion (Hypothesis 2a) that causal attributions would differ more across budgetary systems when a target manager had not engaged in earnings management than when he had. This is based on the notion that immoral behavior reflects immoral dispositions, while moral behavior may sometimes indicate moral character but could also indicate prudent or strategic behavior by an immoral person. The data provided support for the hypothesized relationship.

When the target manager behaved ethically (i.e., did not engage in earnings management) the mean net attribution measure was positive, indicating that internal factors were perceived as having greater influence on the target manager's actions than the circumstances. This finding is consistent with the actor-observer attributional effect reported by Jones and Nisbett (1972), which showed that observers of a target person (actor) naturally turn to the actor per se as the cause of an event. However, when the target manager engaged in earnings management the mean net attribution measure was slightly negative, indicating that organizational factors were perceived as having a slightly greater influence on the target's actions than did the character of the target manager. In other words, the short term nature of the budget focus faced by the target manager may have served as a potential (situational) explanation for the engagement in earnings management. Given that most of the subjects in this study had experience with a budgetary process, they may have empathized with the target manager who engages in earnings management. Empathy for the situation faced by an actor has been shown to offset the actor-observer effect (Regan and Totten, 1975), a finding similar to an effect found by Tan and Lipe (1997), that MBA subjects were not likely to judge a target's actions harshly, even when the outcomes of the target's decisions were negative.

The results supported a strong main effect of behavior on morality judgments, but neither the predicted main effect for budgetary control style (Hypothesis 1b) nor the predicted interaction between budgetary control style and behavior (Hypothesis 2b) was significant at traditional levels. Thus, no support is found for either Hypotheses 1b or 2b. Respondents judged target managers who did not engage in earnings management as being more moral, regardless of the situational (budgetary control) constraints. The lack of a significant interaction effect may reflect differences in the ethicality of events considered by the two studies. In their second experiment Reeder and Spores used an incident where the subject sees someone drop a twenty-dollar bill and chooses either to keep it or to call out to the person who dropped the money. Their second incident involved stealing from a charity box set up by the cash register in a pizzeria. These incidents may be less morally ambiguous than earnings management is, particularly in this age of Enron. In this regard, Bruns and Merchant (1990) contend that there is a lack of agreement among managers regarding the acceptability of earnings management activities.

While Merchant and Rockness (1994) showed a lack of consensus among professionals about the morality of earnings management, the societal context surrounding earnings management today appears to have resolved any such ambiguity.

The third hypothesis is based on the distinction Hamilton (1980) notes between ascribing causation and assigning moral responsibility. We hypothesized that when the participants formed a variety of reputation-related judgments about the target manager, these would be more closely associated with their morality judgments than with their causal explanations (internal attributions). Consistent with hypothesis 3, the results from each of the four reputation-related judgments indicated a stronger association with morality judgments than with net attribution judgments. These results support the contention by Erickson and Krull (1999) that morality judgments are more extreme than causal attributions. Our results are also consistent with the findings of Reeder and Spores (1983), who found that subjects are likely to generalize from their morality judgments. That is, if a person behaves immorally in one context, observers infer that the person will behave immorally in other ways.

Implications

Reputational consequences of ethical actions have not been widely studied in accounting. These findings are important, however, because they indicate that managers engaging in earnings management may face negative reputational costs from other managers, which in turn, may serve as a disincentive towards engaging in earnings management. Several implications stem from this research. First, to the degree that managers who engage in earnings management go unpunished, or are perhaps even rewarded, the tendency to continue to engage in such practices is reinforced. As the support for Hypothesis 2a suggests, observers tend not to blame an individual for earnings management when the budgetary control system supports such behavior. Blaming the target for behaving as rewarded results in what Kerr (1995) calls the folly of rewarding A while hoping for B. That is, we would hope that managers would not engage in such behavior, but the system rewards them for doing so.

Second, research has shown that failing to discipline has consequences not only for the person who engages in suspect behavior, but also for observers of such behavior (Trevino, 1992). Trevino's research shows that others within organizations expect rule violators to be punished in order to maintain the social order and the punishment or failure to punish can be expected to influence observers' subsequent behaviors. In short, punishment or the failure to punish sends very real messages throughout the organization.

The ethical reputation a manager has among colleagues can play an informal, but significant, role in internal disciplining of managers by other managers. Research by Hollinger and Clark (1983) on employee deviance demonstrated that the effect of informal sanctions was 2 ½ times greater than that of formal sanctions. The results of this study offer some evidence on what shapes the way workers view the morality of their colleagues. For example, we find evidence that among participants there is a tendency to generalize from a morality judgment to other dimensions that relate to competence, such as being hard working, knowledgeable, and able to make decisions. Informal assessments managers make regarding their colleagues, based at least in part on ethical concerns, can play a real but not well-measured or understood aspect of management control systems. We have provided evidence that social costs are imposed on managers when they do not behave in goal congruent ways. Cohen and Prusak (2001) reinforce the importance of establishing social capital, i.e. goodwill and trust among employees within firms. These authors maintain that high social capital results in better financial results. The loss of trust that can be engendered by earnings management would be a loss of such social capital, and is an issue that accounting researchers could examine more fully. Noreen (1988, p. 367) noted that a cost of unethical behavior is a decline in ethical norms, which leads to an increase in unethical behavior.

Given the paucity of research on the topic of informal, ethically-related aspects of control systems, additional research should be encouraged. For example, further research could explore whether the negative consequences vary across different kinds or magnitudes of earnings management activities. In this regard, the results of the current study suggest that in spite of its limitations, an experimental approach is a viable and appropriate method. Perhaps, within an experimental setting the influence of ambiguity could be examined. For example, a future study could manipulate the degree to which organizations include various types of earnings management activities in following Section 406 of the Sarbanes-Oxley Act specifying the inclusion of understandable disclosure in reports and documents filed with the SEC (Lander, 2004). Another possible avenue of further research is to look at how informal discipline within internal labor markets can lead to changes or reductions in more formal monitoring procedures.

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Table 1

Dependent Variable Descriptive Statistics and Correlation Matrix
(N=159)

	Mean	S.D.	(1)	(2)	(3)	(4)	(5)	(6)
Internal Attributions (1)	.48	3.33	-					
Morality (2)	5.56	2.24	.34**	-				
Hardworking (3)	5.28	1.56	.06	.43**	-			
Knowledgeable (4)	5.52	1.57	-.04	.35**	.61**	-		
Decision Making Ability (5)	5.62	1.91	.08	.59**	.41**	.50**	-	
Willingness to Work With (6)	5.69	2.16	.23**	.75**	.31**	.38**	.64**	-

**p≤.01

Table 2

The Effect of Earnings Management, Budgetary Control Style and Work History on Causal Attributions and Morality Assessments

Source	Net Attributions	Morality Assessments
	F-Score	F-Score
Earnings Management (EM)	20.54 *** (.12)[a]	251.95*** (.63)
Budgetary Control Style (BCS)	3.46	3.12
Work History (WH)	4.65* (.03)	1.74
EM X BCS	**5.44* (.04)**	**3.05**
EM X WH	1.65	3.85* (.03)
BCS X WH	1.35	.96
EM X BCS X WH	.08	2.30

*$p \leq .05$
**$p \leq .01$
***$p \leq .001$

[a] eta ^{2} values presented in parentheses

Table 3

Descriptive Statistics – Net Attributions and Morality Assessments

Panel A: Earnings management Behavior and Budgetary Control Style Means for Net Attributions (standard deviation)

	Earning Management Behavior		
	Did not Manage	**Did Manage**	
BCS1 –rigid	-0.7 (2.9)	2.6 (3.6)	1.0 (3.6)
BCS2 - flexible	-0.5 (2.7)	0.5 (3.1)	0.1 (2.9)
	-0.6 (2.8)	1.5 (3.5)	

Panel B: Work history Means for Net Attributions (standard deviation)

	Work history
Average	1.0 (3.1)
Above average	0.0 (3.5)

Panel C: Earnings management Behavior and work history means for morality assessments (standard deviation)

	Earning Management Behavior		
	Did not Manage	**Did Manage**	
Work history –average	3.5 (1.1)	7.4 (1.7)	5.3 (2.4)
Work history – above	4.2 (1.0)	7.2 (1.7)	5.8 (2.1)
	3.8 (1.1)	7.3 (2.1)	

Table 3

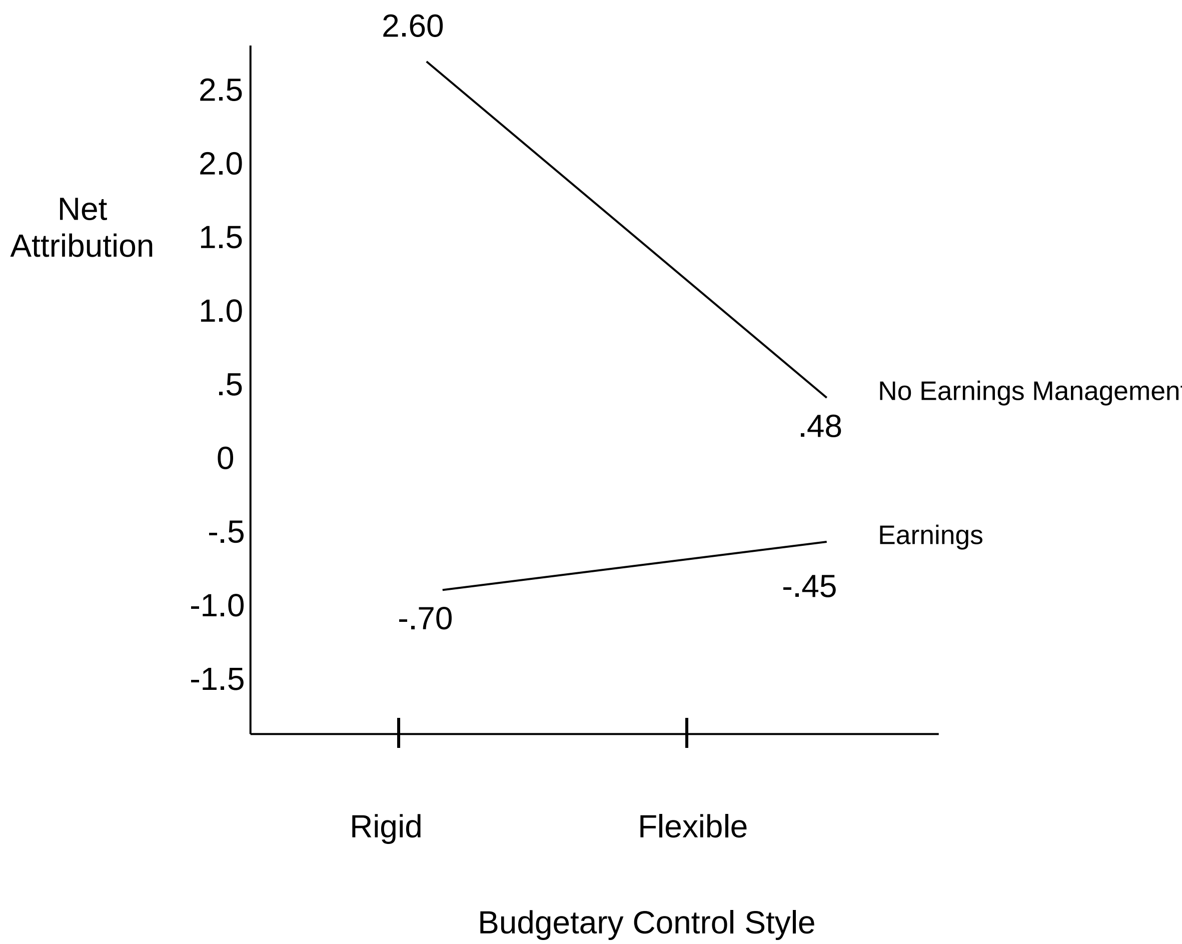
Regression Analysis on Target Manager's Reputational Judgments

	Hardworking		Knowledgeable		Decision Making Capability		Willingness to work with	
	Beta	t-value	Beta	t-value	Beta	t-value	Beta	t-value
Net Attributions	-.04	-1.23	-.08	-2.23*	-.07	-1.92	-.02	-.51
Morality Assessments	.32	6.01***	.29	5.20***	.54	9.27***	.74	13.62***
Model R^2	.19		.15		.36		.57	

*$p \leq .05$
**$p \leq .01$
***$p \leq .001$

Figure 1

Interaction of Earnings Management and Budgetary Control Style on Net Attributions[1]



[1] Positive scores on the net attribution measure are indicative of internal attributions, while negative scores indicate situational attributions.