Personal Moral Philosophies and Ethical Judgment of Earnings Management: Credit Analysts Perspective

Ahmad Subeki, Agil Novriansa, Tertiarto Wahyudi, Yusnaini, Aryanto
Department of Accounting, Faculty of Economics, Universitas Sriwijaya, Palembang, Indonesia

Keywords: Personal Moral Philosophies, Ethical Judgments, Earnings Management, Credit Analyst

Abstract: Previous study shows that personal moral philosophies can explain the difference in ethical judgments. This study aims to empirically examine the relationship between personal moral philosophies and ethical judgments of earnings management practice from non-shareholder perspective, i.e. credit analyst. Survey method is used in this study, in which, questionnaire delivered to bank employee of credit analyst section through hand-delivered survey and online survey. Based on the data analysis of 52 samples using independent sample t-test, the results show that credit analysts with idealism judge earnings management practices more firm (as unethical practices) compared to credit analysts with relativism. But, there is no statistically difference in ethical judgments of earnings management practices between credit analysts with idealism and relativism. These findings serve as an important external validity evidence on the phenomena associated with personal moral philosophies and earnings management, especially ethical judgment of earnings management by credit analyst perspective.

1 INTRODUCTION

Earnings management is an action that is still in the "gray area" in terms of perceived transparency and intended purpose of the action (Ronen and Yaari, 2008 as cited in Johnson et al., 2012). The ambiguity of earnings management purposes that are classified as "gray area" can cause potential ethical problems (Davis-Friday & Frecka, 2002; Johnson et al., 2012). Fischer & Rosenzweig (1995) state that earnings managements is a topic that has ethical ambiguity related to its practice. Some managers may view earnings management practices as legitimate and useful managerial tools to fulfill their responsibilities in maximizing shareholders profits (Fischer & Rosenzweig, 1995). However, other parties view earnings management as a practice of deviation that can mislead financial statement users (Fischer & Rosenzweig, 1995). The study results of (Puspawati, Ariani, & Abas (2018) show that individual moral have an impact on the earnings management ethical judgment that made by managers.

The differences in individual ethical judgments can be explained by *personal moral philosophies* (Barnett, Bass, & Brown, 1994). There are four dimensions of personal moral philosophies, namely situationists, subjectivists, absolutists, and exceptionists (Forsyth, 1980). Each individual in each of these dimensions has different characteristics in providing ethical judgments. Forsyth (1981, 1985) and Barnett et al. (1994) state that personal moral philosophies that are owned by individuals are related to the ethical judgments they give.

The study on the relationship between personal moral philosophies and ethical judgment has done quite a lot before. Forsyth (1981) examine the relationship between moral judgment and ethical ideology in a non-business context. Forsyth (1981) used the experimental method with a sample of psychology students. Students were asked to complete the Ethics Position Questionnaire (EPQ) in which the results will determine their personal moral philosophies position. Further, they were asked to give a moral judgment of the scenario which describing the extent to which a person was responsible for some events that result a positive or negative consequences. The results of Forsyth (1981) study show that absolutists judged the actors more firmly than exceptionists for the actions which

Subeki, A., Novriansa, A., Wahyudi, T., Yusnaini, . and Aryanto, .
Personal Moral Philosophies and Ethical Judgment of Earnings Management: Credit Analysts Perspective.
DOI: 10.5220/0008443406370644
In *Proceedings of the 4th Sriwijaya Economics, Accounting, and Business Conference (SEABC 2018)*, pages 637-644
ISBN: 978-989-758-387-2

lead to negative consequences, while relativists tend to be more moderate in providing ethical judgment.

Barnett et al. (1994) also examine the relationship between personal moral philosophies and ethical judgment relating to ethical issues in business. The sample in his study was 166 business class students. The result of his study shows that personal moral philosophies of individual are significantly related to differences in their judgment about business ethics. The results of his study are also consistent with previous study, which states that individual who have high idealism tend to provide firm ethical judgment. Barnett et al. (1994) states that the influence of personal moral philosophies on ethical judgment will be greater when an action is considered by the individual as a very unethical action compared to actions considered as ethical action. However, Barnett et al. (1994) suggests that further researchers need to pay more attention to this problem. This study responds the suggestions from Barnett et al. (1994).

This study examines the relationship between personal moral philosophies and ethical judgment by using more specific ethical issues. This study takes the topic of ethical judgment in the practice of earnings management. The collapse of large companies such as Enron, WorldCom, and Sunbeam caused by earnings management practice which carried out by company management over several financial reporting periods made the phenomenon of earnings management increasingly investigated by researchers in the field of accounting. The earnings management phenomenon had become a major concern for the accounting profession, investors, and other users of financial statements (Belski, Beams, & Brozovsky, 2008; Elias, 2002).

The study about the relationship between personal moral philosophies and ethical judgment of earnings management practices had been done previously by Elias (2002) and Greenfield et al. (2008). Elias (2002) examines the ethical perception of practitioner accountants; accounting academician and students related to earnings management practices. The results of Elias (2002) show that students are the most firm group in providing ethical judgments on manipulation of income operations while accountant practitioners in industry are the most tolerant group. For accounting manipulation, students are the most tolerant group in providing ethical judgments while academician are the most firmly group. In general, accountant practitioners in public accountants and industry are groups that provide the most tolerant ethical judgments of earnings management practice (Elias, 2002). Greenfield et al. (2008) examine the impact of ethical orientation (idealism and relativism) and professional commitment to earnings management practice by conducted a survey of 375 undergraduate business students. The results of his study show that participants who scored higher (lower) on idealism (relativism) showed a lower (higher) tendency to engage in earnings management behavior.

This study empirically examines the relationship between personal moral philosophies and ethical judgments of earnings management practice from different ethical judgments perspectives. Elias (2002) and Greenfield et al. (2008) use practitioner accountants, accounting academician, and accounting students perspectives, while this study used a non-shareholder perspective, i.e. credit analyst. Non-shareholders (credit analyst) are external parties of the company as well as users of financial statements so that their ethical judgment can affect the company. Kaplan (2001) states that non-shareholder ethical judgment on earnings management practice will be very important for managers, companies, and policy makers. If earnings management is considered as an unethical practice by credit analyst, the bank or lending institution will not trust to provide loans for company.

Kaplan (2001) examines the non-shareholder ethical judgment on the practice of earnings management by using the experimental method and samples of master students who act as non-shareholders. The difference of this study with Kaplan (2001) is this study used field survey method with a sample of non-shareholders, namely bank employee of the credit analyst section who use financial statements for lending analysis. The survey method in the study of ethical judgment of earnings management practice has also been carried out by previous study, namely Bruns & Merchant (1990); Elias (2002, 2004); Greenfield et al. (2008); Merchant & Rockness (1994); Rosenzweig & Fischer (1994); Shafer (2015).

This study serves an important external validity evidence on the phenomena associated with personal moral philosophies and earnings management, especially ethical judgment of earnings management by external users of financial statements i.e. non-shareholders. This study provides empirical results about the personal moral philosophies of non-shareholders (namely credit analyst) in making ethical judgment on earnings management practices.

2 LITERATURE REVIEW

2.1 Kohlberg's Theory of Cognitive Moral Development

Cognitive moral development (CMD) was introduced by Lawrence Kohlberg in 1969. Kohlberg proposed three levels of individual moral development consisting of pre-conventional levels, conventional levels, and post-conventional levels (Abdolmohammadi & Sultan, 2002). Kohlberg's theory of the CMD model predicts individual progress throughout life from a lower stage to a higher stage according to his moral tendencies and developments (Abdolmohammadi & Sultan, 2002). Kohlberg's CMD model has been widely used to estimate individual moral maturity based on their response to several ethical dilemmas. Mcphail & Walters (2009) states that CMD model from Kohlberg had been applied to accounting students, accounting practitioners at various career levels, students studying various disciplines, and practitioners from various professions.

2.2 Earnings Management

Earnings management is defined as the actions of a manager that increases (decreases) the reported profit currently from a division unit in which the manager is responsible for it without making an increase (decrease) in accordance with the long-term economic profitability of the division unit (Fischer & Rosenzweig, 1995). Earnings management occurs when managers use valuations in financial statements and in structuring transactions to change financial statements, with the intention to mislead some stakeholders about the economic performance of companies or to influence the outcome of the contract which depends on the amount of accounting reported (Healy & Wahlen, 1999). Managers can do earnings management through their choice of accounting policies, accounting judgment, timing, or operating decision choices (Merchant & Rockness, 1994).

2.3 Personal Moral Philosophies

Personal moral philosophies are the extent to which a person is relativism or idealism (Elias, 2002). Relativism is described as the extent to which individuals reject universal moral rules (Forsyth, 1980). Individuals who have high relativism generally feel that moral action depends on the nature of the situation and the individuals involved, while individuals who have low relativism argue that morality requires acting in a way that is consistent with moral principles, norms, or law (Forsyth, 1992). Idealism is described as an individual's attention to the extent to which the consequences of an action can affect the welfare of others (Forsyth, 1980). Individuals with high idealism feel that actions that can harm others must always be avoided, while individuals with low idealism are more likely to think that losses will sometimes be needed to produce something good (Forsyth, 1992).

2.4 Hypothesis Development

Earnings management is a practice that still has ethical ambiguity. Ethical interpretation of earnings management actions will tend to be egocentric interpretation, i.e. individuals who are involved in or feel benefited from earnings management actions will tend to judge the action more ethically than individuals who are not involved or not benefited from such actions (Kaplan, 2001). Personal moral philosophies that are owned by individuals are related to ethical judgments that they will give (Barnett et al., 1994; Forsyth, 1981, 1985). Individuals with high idealism will provide a more firmly ethical judgment of the actions that resulted ethical or ambiguous consequences ethically, meanwhile individual with high relativism will provide will provide ethical judgments that are more tolerant in assessing individuals who violate moral norms or actions that are ambiguous ethically (Elias, 2002; Forsyth, 1992).

Non-shareholders are parties who do not have a direct relationship with the company. In the credit analyst perspective as non-shareholders, credit analysts have an interest in the financial statements when making decisions to give credit for company. Credit analysts usually use financial statement to analyze the prospective of debtors. When assessing financial statements of company, credit analysts will tend to have caution because if the credit decision was made wrong then they have the risk of not getting a loan return. These risks can affect ethical judgment of credit analyst. The ethical judgment of earnings management from credit analyst perspective will be based on the universal moral principles that they believe and their views of consequences that will occur from those actions. Credit analyst with idealism will judge earnings management practices more firmly than credit analyst with relativism. Credit analysts with idealism will view earnings management practices as unethical actions because these actions produce negative consequences while credit analysts with relativism will view earnings management practices as ethical actions because the responsibility of manager is basically to maximize shareholder profits regardless of whatever method is used by the manager. The hypothesis of this study stated that:

H_1 : credit analyst with idealism will judge earnings management practices more firmly than credit analyst with relativism.

3 METHODS

This study uses survey method with questionnaire. The sample in this study is bank employee of the credit analyst section. Credit analysts are chosen as a sample of non-shareholders because credit analysts are external parties of companies that use financial statements for analysis in determining loan decisions. This study uses snowball sampling method in selecting its study sample. Data collection of this study is conducted by hand-delivered survey and online survey. Hand-delivered survey is conducted by distributing questionnaire to several bank credit analysts in Palembang, while online survey is conducted by giving online questionnaire links to several credit analysts through social media application.

Personal moral philosophies are measured using the Ethics Position Questionnaire (EPQ) developed by (Forsyth, 1980). EPQ assesses personal moral philosophies by asking individuals to show their level of acceptance of items that vary in terms of relativism and idealism (Forsyth, 1992). The EPQ contains 20 statements consisting of 10 statements about idealism and 10 statements about relativism (Forsyth, 1980). Respondents are asked to indicate their level of agreement or disagreement on a nine-point Likert scale (1 = strongly disagree to 9 = strongly agree) on each statement, and the average score of their response to the idealism item and the average score of their response to relativism items are made as their two EPQ scores (Forsyth, 1980).

Earnings management are measured using thirteen earnings management scenarios used in Elias (2002). The scenario consists of six scenarios regarding operation manipulation and seven scenarios regarding accounting manipulation, respondents are asked to play the role of supervisors of managers involved in earnings management actions (Elias, 2002). Each respondent in each group is asked to give their ethical judgment of earnings management scenarios using a five-point Likert scale (1 = ethical practice to 5 = very unethical) (Elias, 2002).

4 FINDINGS

Based on the hand-delivered and online survey, the numbers of samples obtained are 54 samples of credit analysts, but 2 samples are excluded because they had never read financial statements. The amount of final sample analyzed in this study is 52 samples. Most of the non-shareholder samples in this study are bank credit analysts who have read the financial statements (100%) and used financial statements in making a decision to give credit (98%). This indicated that the sample of non-shareholders in this study used financial statements in carrying out their work. Most of the non-shareholder samples in this study are male (54%), age 20-30 years old (75%), and had working experience as credit analyst for less than 5 years (67%) and 5-10 years (25%).

The personal moral philosophies and earnings management instrument in this study has been tested and validated. The results of reliability test using Cronbach's Alpha statistical test shows that personal moral philosophies instrument has Cronbach's Alpha value of 0.834, while earnings management instrument has Cronbach's Alpha value of 0.886. These results show that personal moral philosophies and earnings management variables in this study have a good reliability.

Respondents in this study are classified into two dimensions of personal moral philosophies based on their EPQ answer, i.e. idealism and relativism. The average score of their response to 10 items of idealism statements and 10 items of relativism statements were compared. If the respondent has a higher average score of idealism compared to the average score of relativism, then the respondent will be classified into idealism, and vice versa. Based on the personal moral philosophies criteria, the credit analyst samples in this study are divided into 38 respondents in idealism dimension and 14 respondents in relativism dimension. Respondents in each group give their ethical judgment of earnings management using the scale that consists of: (1) ethical practices; (2) questionable practice. I will not say anything to the manager, but it makes me feel uncomfortable; (3) minor violation. Managers must be warned not to engage in practices like this again;

(4) gross violation. Managers must be given a strong reprimand; (5) very unethical practices. The manager must be fired.

The hypothesis of this study stated that credit analyst with idealism will judge earnings management practices more firmly than credit analyst with relativism. Independent sample t-test will be used to test this hypothesis. Table 2 presents the group statistic sample of credit analysts in this study.

Table 1: Group Statistics

Personal Moral Philosophies		N	Mean	Std. Deviation
Earnings Management	Idealism	38	3.0102	0.707
	Relativism	14	2.7472	0.957

Based on Table 1, it can be seen that the mean value of earnings management ethical judgments of credit analysts with idealism is 3.0102, while credit analysts with relativism is 2.7472. It is clear that the average score of earnings management ethical judgments of credit analysts of both groups are very distinct. Based on the average score in Table 1, it can be seen that credit analysts with idealism judge earnings management practices more firm (as unethical practices) compared to credit analysts with relativism. However, the difference of average score should be statistically proven through independent sample t-test. Table 2 presents the results of independent sample t-test of this study.

Table 2: The Results of Independent Sample t-test

			Earnings Management	
			Equal Variances Assumed	Equal Variances Not Assumed
Levene's Test for Equality of Variances	F		0.779	
	Sig.		0.382	
t-test for Equality of Means	t		1.079	0.938
	df		50	18.483
	Sig. (2-tailed)		0.286	0.360
	Mean Difference		0.263	0.263
	Std. Error Difference		0.244	0.280
	95% Confidence Interval of the Differences	*Lower*	-0.227	-0.325
		Upper	0.753	0.851

Table 2 shows that the value of $F_{statistic}$ from Levene's test is 0.779 with significance level of 0.382 (significance value > 0.05), it can be concluded that H_0 cannot be rejected which means that the population variance of ethical judgments of earnings management between credit analysts group with idealism and credit analysts group with relativism was the same. These results indicated that the analysis of independent sample t-test of this study must use the assumption of equal variances assumed. Based on Table 2, it can be seen that the value of $t_{statistic}$ at equal variances assumed is 1.079 with a significance value of 0.286 (significance value > 0.05).These results indicated that the hypothesis of this study is not supported, which means that there is no statistically difference in the ethical judgments of earnings management between credit analysts with idealism and credit analysts with relativism.

The logical explanation for unsupported results of this study is that credit analysts do not rely too much on financial statements in making lending decisions to companies. Financial statements of companies are not the main basic determinant of lending decisions made by credit analysts. There is a risk that the money lent does not return, so the credit analysis is very careful in assessing companies that will become prospective debtors. There are many aspects and information needed by credit analysts in assessing prospective debtors. Credit analysts usually carry out a feasibility study of prospective debtor to assess the feasibility of company from financial, macroeconomic, and social aspects. Credit analysts also check the information of prospective debtor companies to the central bank, suppliers, and customers. In addition, the credit analyst also checks the legal aspects of the prospective debtor company and its compliance with various regulations.

The many aspects and information used by credit analysts in making lending decisions caused there is no difference in ethical judgments about earnings management between credit analysts with idealism and relativism. Credit analysts as non-shareholders and external users of financial statements tend to provide the same ethical judgment of earnings management practices. Credit analysts in both dimensions of personal moral philosophies tend to judge the practice of earnings management as a questionable practice or minor violation. This study results support the results of Kaplan (2001). The results of Kaplan (2001) study show that ethical judgment of non-shareholder on the acceptance of ethical earnings management was not influenced by the intent or purpose of earnings management.

Based on the credit analyst perspectives, earnings management practice did not have an impact or did not provide direct benefits to credit analysts so that they tend to give moderate ethical judgment of earnings management. These results supported Kaplan (2001) statement which explains that ethical judgment of earnings management practices will tend to be egocentric interpretation, i.e. individuals who are involved in or feel benefited from the practice of earnings management will tend to judge the practice as more ethical than individuals who are not involved or not benefited from the practice.

4.1 Additional Analysis

This study carries out additional analysis to test the ethical judgment of earnings management from credit analysts by gender. The study sample consisted of 28 male and 24 female. Based on the independent sample t-test, the mean value of earnings management ethical judgments of male credit analysts is 2.876, while female credit analysts is 3.013. The value of $t_{statistic}$ at equal variances assumed is -0.624 with a significance value of 0.535 (significance value > 0.05). These results indicated that there is no statistically difference in the ethical judgments of earnings management between male credit analysts and female credit analysts.

5 CONCLUSION

Ethical judgment of earnings management practices still does not have a clear consensus. Some individuals may judge earnings management practice as an ethical practice, while some others will judge it as unethical practice. This study empirically examines ethical judgment of earnings management practices from non-shareholder perspective, namely credit analysts. This study examined earnings management ethical judgment from credit analysts based on their personal moral philosophies. The results of analysis in this study indicated that there is no statistically difference in the ethical judgments of earnings management between credit analysts with idealism and relativism. Credit analysts in both dimensions of personal moral philosophies tend to give moderate ethical judgment of earnings management. This study result supports the notion of egocentric interpretations or self-interested interpretations in ethical judgment related earnings management practices.

There is a limitation of this study so that the interpretation of the results needs to consider it. This study used survey method but the number of samples in this study was quite small. The future research needs to consider the number of samples when do the same topic research with this study.

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APPENDIX

Earnings Management Questionnaire (Adopted from Elias (2002))

Indicate your judgment as the acceptance of the following scenario as a supervisor from division's general manager. Please read each statement carefully. Then state your judgment by giving a number, where:

1 = ethical practice
2 = the questionable practice. I will not say anything to the manager, but it makes me feel uncomfortable.
3 = minor violation. Managers must be warned not to engage in practices like this again.
4 = gross violation. Managers must be given a strong reprimand.
5 = very unethical. The manager must be fired.

Operating Manipulations

1. Expenditures that were originally planned for next year were raised this year because current year profits have exceeded the budget.
2. Delay unnecessary expenses so that divisions can meet the current budgeted profit targets. Delays from February and March to April to meet quarterly targets.
3. Delay unnecessary expenses so that divisions can meet the current budgeted profit targets. Delays from November and December to January to meet annual targets.
4. Offering looser sales requirements at the end of the year to attract sales next year in order to meet this year's sales target.
5. Order the manufacturing division to work overtime to deliver all possible items at the end of the year.
6. Selling some excess assets and realizing profits.

Accounting Manipulations

1. Do not record inventory received in December to February.
2. Because the division's profit target has exceeded for the current year, the manager orders to record

prepaid expenses next year as expenses for the current year.

3. Because the division's profit target has exceeded for the current year, the manager ordered to remove inventory that he knew could be sold in the future at full price.
4. (continued statement no. 3) The following year, customers buy inventory that has been written off. The manager reverses previous write-offs, with the aim of being able to continue to work on development projects that may have been delayed due to budget constraints.
5. (continued statement no. 3) The following year, customers buy inventory that has been written off. The manager reverses the previous write-off, in order to achieve the profit target.
6. To achieve the profit target, the manager asks a consulting firm, which is currently working on its division, not to send the bill until next year. The amount of the bill is not material.
7. To achieve the profit target, the manager asks a consulting company that is currently working on its division, not to send the bills until next year. The amount of the bill is material.