The current issue and full text archive of this journal is available on Emerald Insight at:
https://www.emerald.com/insight/1359-0790.htm

Earnings management as an ethical issue in view of Kohlberg's theory of moral reasoning

Abdulfatah Ali Belgasem-Hussain
Department of Finance, Gharian University, Gharian, Libya, and
Yousof Ibrahim Hussaien
Department of Accounting, University of Subrata, Subrata, Libya

Abstract

Purpose – The purpose of this paper is to shed light on and introduce the ethics of earnings management (EM) to researchers and students in the academic community in light of Kohlberg's theory.

Design/methodology/approach – The paper contextualises and analyses the relevant literature to provide insights around the key concepts of the issue of ethics of EM. Therefore, theoretical approach has been adopted by reviewing the literature using a descriptive method. The study suggests relevance of the theory of moral development and reasoning by Kohlberg (1969) as an approach in the process of exploring the background and the reasons behind ethics of managers regarding EM. This theory helps to explain how individuals demonstrate and justify a sense of right or wrong. Thus, the paper is a literature review concluded with a proposed conceptual framework.

Findings – The paper provides conceptual insights about the ethics of EM, and it proposes a link between manager's ethics regarding the phenomenon of EM and the framework of moral reasoning theory by Kohlberg (1969).

Originality/value – The importance and implications of Kohlberg's theory, in terms of EM, resides within the fact that the theory is concerned with questions about how one ought to act – being as it acknowledges the well-known ethical theories. The work of Kohlberg can be classified as a descriptive analysis to the extent that it attempts to describe individuals' moral development. This integration of normative and descriptive ethics, in turn, enables the theory to be used to explore managers' moral reasoning in a more helpful way.

Keywords Earnings management, Ethics, Kohlberg's theory of moral reasoning

Paper type General review

1. Introduction

The problem of earnings management (EM) is a worldwide phenomenon and has become one of the important ethical issues facing reliability of financial information. The grey areas in accounting standards and the great deal of subjective judgment open a space for opportunistic accounting, where managers improve positions, and the earnings reports do not necessarily reflect the underlying financial performance of the company. The manager as the decision-maker therefore directs every part of the organisation and his role in

Journal of Financial Crime
Vol. 30 No. 2, 2023
pp. 522-535
Emerald Publishing Limited
1359-0790
DOI 10.1108/JFC-11-2019-0138

establishing integrity in this process is fundamental. The purpose of this paper is to shed light on and introduce ethics of EM to researchers and students in the academic community in light of Kohlberg's theory. In this respect, the paper will be contextualising and analysing the relevant literature to provide insights around the key concepts of this issue. The paper started with defining EM with reference to its ethical acceptability – What is EM? Then the paper reflects on the role of the manager in this process – accountability of the manager, and alludes to the ethical obligations in earnings reporting. After that the paper turns to Kohlberg's theory of moral reasoning and its stages. Finally, the paper concludes by analysing the contribution of Kohlberg's theory in furthering an understanding of the ethics of EM, ending with a suggested framework – stages of moral development as applied to the manager with EM.

2. What is earnings management?

Almost there is no general agreement in defining EM, thereby a variety of definitions could be observed in the financial literature. Healy and Wahlen (1999, p. 368) see EM taking place:

> When managers use judgments in financial reporting and 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

This broad definition can be interpreted, as Nelson *et al.* (2003) did, as comprising:

- EM that is consistent with the generally accepted accounting principles (GAAP);
- EM which is not easy to characterise from GAAP; and
- EM that is obviously incompatible with GAAP.

Schipper (1989, p. 92) defines EM as a "purposeful intervention in the external reporting process, with the intent of obtaining some private gain". However, Dechow and Skinner (2000) assert that fraudulent disclosure that is noticeably planned to mislead others, should be separated from choices being made in determining earnings that include acceptable accounting judgments, but that are aggressive in some way.

The definition introduced by Schipper (1989) above, emphasises a decided management action with the aim of pursuing their own self-interest, as this might be the case when the share price is motivated by manipulated earnings earlier than the real exercise of share options. Healy and Wahlen (1999) highlight misinformation practiced on stakeholders, through advance intent of management, using accounting devices to deliberately affect reported earnings.

A different approach to EM is seen by Dechow and Skinner (2000) as they argue that only clear fraud is an unacceptable EM. Given the circumstances, the practice can be acceptable if linked to the accounting principles and estimates that could report higher earnings than other methods could report (Mintz and Morris, 2008).

McKee (2005, p. 1) describes EM as "reasonable and legal management decision making and reporting intended to achieve stable and predictable financial results". He believes that EM does not mean "cooking the books"; nevertheless, it reflects a conscious judgment by management to smooth earnings over time. That is, management seeks to keep earnings figures relatively stable by adding and removing income from reserve accounts, rather than having years of exceptionally good or bad performance.

Dechow and Skinner (2000) appear to link the acceptability of EM to conformity with accounting principles. McKee (2005) sees EM in the area of maintaining stability and achieving predictability for future earnings as reasonable and acceptable. So, the former authors seem to approve EM from a legal perspective (as long as the accounting principles are followed), the latter seems to determine the acceptability of this conduct in light of the results expected (stability and predictability) by distributing earnings over time. Nonetheless, from a general view of integrity, this might be not the case, that is to say, the acceptability of an action cannot be attained by only observing law or by only assessing the action's consequences.

3. Accountability of the manager

To a large extent, managers are responsible for the effectiveness and efficiency of the reports presented by an organisation (Bell, 2007). In accordance with the theoretical paradigm of corporate governance adopted by corporate rules of business, boards of directors should run the company for the benefit of its stakeholders with the shareholders on the top of the hierarchy. The traditional role of accounting is encompassed under the term stewardship, whereby a person or a group of persons is held responsible for safeguarding the assets of an entity and monitoring the proper operation of that entity. In the International Accounting Standards Board Framework, when discussing stewardship or accountability, paragraph 14 of the framework acknowledged that:

> Financial statements also show the results of the stewardship of management, or the accountability of management for the resources entrusted to it. Those users who wish to assess the stewardship or accountability of management do so in order that they make economic decisions; these decisions may include, for example, whether to hold or sell their investment in the enterprise or whether to reappoint or replace the management. (PAAinE, 2007, p. 9)

An area of anxiety on the part of users towards preparers of accounting information is whether the published annual report is a true report that signifies the end product of the actual transactions that have taken place for a given financial year period (Geriesh, 2003; Bell, 2007). It is argued (Lewis, 1985; Bruns and Merchant, 1990; Atkinson, 2002; Liandu, 2004; McKee, 2005; Bell, 2007; Berrone *et al.*, 2007; Stanga and Kelton, 2008; Mintz and Morris, 2008) that the published annual reports may have been manipulated by the management in a certain manner for specific reasons, such as evading the company tax cost or inflating managerial benefits. As such, providers of accounting information will possibly attempt to produce accounting results that favour their own interest. As Bainbridge and Johnson (2003) argued, companies are often governed by their managers for the benefit of those managers, rather than in the interests of their shareholders. In view of the opportunity the process of preparation and disclosure allows, then, managers can act in their own interests by manipulating the firm's operations or by manipulating only the reported results.

Anderson and Lauderback (1975, p. 343), in developing an earlier study, found that "managements have continued to select and 'follow GAAP' in a manner consistent with the income maximizing hypothesis" and managers do attempt to smooth earnings. Ronen and Sadan (1975) also in their work distinguished between two kinds of income smoothing. Classificatory smoothing refers to smoothing over the time of certain earnings numbers through the re-classification of chosen items, not of all revenues and expenses. Non-classificatory smoothing refers to the smoothing over time of all net revenues and expenses through the manipulation of the occurrence of events, their accounting recognition and/or their allocation over time. Ronen and Sadan tested whether extraordinary items were used in classificatory smoothing of ordinary income. Their results were consistent with the hypothesis that firms' managers behave as if they classify items, which potentially could be labelled as extraordinary, to dampen the fluctuations over time of ordinary income. The 1991 report of the American Committee of Sponsoring Organization declares that in 72 per cent of the fraud instances observed, the executive manager appeared to be linked to the fraud, and dominate the firms' board of directors (Geriesh, 2003).

It is necessary to consider the wider context of EM that extends beyond the mere pursuit of reasonable profit. Several pressures and influencing factors drive managers into detecting loopholes in reporting standards. These include managers' expectations across the market, personal perception of bonuses and the maintenance of a rank within a sector or a group. It can be argued that recourse to such practices can be mitigated by effective regulations and strong corporate governance mechanisms (Coung, 2007). Extensive research (Xie *et al.*, 2003; Rezaee, 2005; Duh *et al.*, 2009) has linked levels of discretionary accruals (as an approach to EM) with audit and board committee members and their financial and corporate backgrounds. These studies also highlight an association between the frequency of meetings of the committees and the reduced levels of discretionary accruals. They infer that good corporate governance and financially sophisticated members may be important factors in constraining the propensity of managers to engage in EM.

As a reaction to the major corporate scandals, there is heightened concern on the subject of corporate governance, not least the issues of internal controls over financial reporting. A new law has set new standards in the US financial legislations, and other countries have also responded with related legislation; it is the Sarbanes–Oxley Act (Coung, 2007). This act draws attention to managers' responsibility towards internal control and information quality, where Section 404 prescribes that an internal control report be presented with the periodic reports; such a report shall:

- state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
- contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

Furthermore the act requires each issuer to:

> [. . .] disclose whether or not, and if not, the reason therefore, such issuer has adopted a code of ethics for senior financial officers, applicable to its principal financial officer and comptroller or principal accounting officer, or persons performing similar functions. (Sarbanes-Oxley Act, 2002, p. 45)

To assess the performance of managers and to make investment decisions, the interested parties use financial statements to find the information that makes up the base for the expected decision and for the future plan as well. Therefore, they might assume that the financial information they use is reliable and fit for purpose. Rules of the accounting profession attempt to ensure dependability in accordance with a set of regulations that make it trustworthy. For these reasons, such information is considered a key measure of position and performance for shareholding companies and partnerships. In an interview with Ray Gonzalez, a Risk Consultant, Bell (2007) documents that there is remarkable awareness of controls for financial reporting, and managers are now responsible for design and implementation of such controls, in addition to the self-assessment of its effectiveness. Management runs an assessment of the organisation's internal controls related to the process of preparation and disclosure of financial reports periodically. As part of such assessment, managers are required to make assertions to such controls. On the other hand, the organisation's external auditor assesses management's evaluation process to conclude whether the management has an appropriate basis for its conclusions concerning controls over financial reporting. They also test the effectiveness of the internal controls of disclosure to determine whether what the management has done is fairly stated or not. Top to bottom procedures are used to examine completeness, accuracy and integrity of information. The chief executive managers or financial managers are required to make assertions related to governing financial statements and their disclosure. "The integrity of financial information reported to key stakeholders is crucial to the firm's survival. Culpability for accuracy is with top management" (Bell, 2007, p. 226).

4. Ethical obligations in earnings reporting

Because of well-known corporate failures such as those of Enron, Parmalat and Maxwell, quality of information and reporting with integrity have attracted the attention of business and media during the past few decades (ICAEW, 2007). As a result, the personal attributes of managers and the potential effects of misconduct on society are of increasing interest to both researchers and the business community (Mele, 2008). In addition, the growing importance of governmental legislation and the increasing pressure from stakeholders has brought personal ethics into discussion (Berrone *et al.*, 2007). Indeed, Atkinson (2002) asks whether any studies have been conducted to evaluate ethics in such circumstances; and he also raises concerns about how ethics is currently taught in relation to corporate financial reporting. Given the examples in the literature concerning EM practices, McKee (2005, p. 35) asks about "the line between ethical and unethical earnings management", and he assumes no clear distinction between them: "It is a question that we all must answer for ourselves using our own ethical values".

Managers, like others working in the business world, are faced with various ethical dilemmas. On the whole, most of these dilemmas are not easy to resolve. The focus of capital markets on regular profit growth, and the fact that lending institutions require a company to show credit stability to maintain its debt in good standing are two such dilemmas. These demands could oblige a company's management to modify or to break accounting rules to inflate or deflate declared net income. In these circumstances, professional competence is not enough for managers to come to the right decision concerning these pressures (Ethics in Accounting, 2009).

According to Mintz and Morris (2008) and Healy and Wahlen (1999), there is some understanding that EM involves distortion in applying GAAP; in this way, undermining the morality of the practice. There is some doubt about whether the distortion is simply a result of decisions made which are totally within the wide remit of GAAP, or if they are motivated knowingly by a decision to manipulate earnings for advantageous purposes, which is undoubtedly fraud (Mintz and Morris, 2008). Healy and Wahlen (1999), highlighting managers' use of judgment in terms of its importance and its sensitivity, suggest that if the purpose of financial reports is to communicate management information on their companies' underlying economy, professional standards should allow managers to use judgment in financial disclosure. Therefore, managers can exercise their knowledge about the business and its opportunities to choose reporting methods and estimates that represent the companies' affairs; possibly enhancing the role and the value of accounting as a form of communication. Nevertheless, as auditing and other governance mechanisms are insufficient, management's use of judgment creates opportunities to manage earnings, wherein managers select reporting disclosures, methods and estimates that do not truthfully reflect the companies' economic performance.

5. Kohlberg's theory of moral reasoning

Lawrence "Kohlberg" is an American researcher who was a Professor of Education and Social Psychology at Harvard University where he carried on and directed an extensive amount of research in moral development. Moral reasoning deals with how individuals think and what they consider about a moral situation. It is the process of determining right or wrong in a given situation.

Lawrence Kohlberg developed the early work of Piaget (1932/1965) with the aim of providing greater detail on moral reasoning beyond adolescence, as well as to analyse the link between progression through the stages of moral understanding and social role playing. According to Kohlberg, to have the opportunity to make decisions and consider ethical issues, serves to motivate the maturity of moral judgment (Smith, 1978). Also he maintains that moral action ought to be an indication of a maturity of moral thought (Kohlberg, 1981). Kohlberg offered what Hayes (1994) referred to the tradition of "progressivism", which fosters the encouragement of the individual's natural interaction with society or environment and a cognitive developmental psychology. Kohlberg attempts to avoid the dichotomy between the maturational tradition (where development is conceptualised as a qualitative property of the individual himself) and environmental tradition (where development/learning is believed to be controlled by environmental factors), and he argued instead that mature thought develops from active change in patterns of thinking produced by active problem solving arising from interactions between both the human being and the environment. Hayes (1994, p. 261) acknowledged that "these ideas were not entirely new with Kohlberg, but the credit must go to him for realizing the full implications of human development as a process of social interaction".

Kohlberg's cognitive moral development theory is a well-known and extensively discussed theory of moral reasoning. It has been considered the most popular and tested theory of its realm and remains among the most-cited work in contemporary behavioural science (Weber, 1991; Trevino, 1992; Hayes, 1994; Fisher and Lovell, 2006; ICAEW, 2007; Weber and McGivern 2010). In his review of moral reasoning research relevant to business ethics, Trevino (1992) gives emphasis to Kohlberg's (1969) theory of cognitive moral development. He argued that Kohlberg's work is rather unique in the sense that his theory suggests a sort of an integration of normative and descriptive approaches to ethical behaviour (Trevino, 1992). These approaches are important in studying individual ethics in a sense that normative ethics is concerned with questions about how one ought to act while the descriptive approach provides empirical investigation of people's moral understanding. The work of Kohlberg can be classified as a descriptive research to the extent that it describes individuals' moral development. At the same time, it integrates normative ethics as its investigations and descriptions are carried out in view of the established prescriptive ethical theories.

The theory of moral reasoning by Kohlberg (1969) accounts for an individual's moral development and for the underlying factors of moral reasoning; he argues that moral reasoning both precedes and informs moral action, maintaining that "specific forms of moral action require specific forms of moral thought as prerequisites" (Kohlberg, 1981, p. 185).

In the moral exploration process, the theory applies production measures which concentrate on an individual's reasons and justifications for his view to elicit his own ethical understanding, rather than concentrating on his behaviour. Kohlberg stresses that studying behaviour does not tell much about moral maturity. A mature adult and a young child may both resist stealing an apple. In such a situation, their behaviour is the same. But if there is a difference in their moral maturity, their behaviour does not indicate it; the reasons for not stealing it do. What is more, Kohlberg does not concern himself with people's statements about whether an action is right or wrong. The reason is similar to the previous one. A mature adult as well as a young child may say that stealing an apple is wrong. Here again there seems to be no difference between the adult and the child. What do show differences in moral maturity are the reasons given why stealing an apple is wrong. These reasons are the indicators of the levels or stages of moral maturity. It is more informative to look at the reasons a person thinks an action is wrong than it is to look at the person's action (behaviour) or even to listen to what the person says is wrong (statement).

The theory can be helpful in approaching EM from an ethical perspective – in view of the sensitivity of the topic its way of investigation provides a valuable tool for exploring the moral reasoning of managers towards the ethics of EM.

6. Kohlberg's moral judgment stages

On the basis of reasoning about hypothetical dilemmas, Kohlberg presents and argues a typology of definitive and universal levels of development in moral thought. He maintains that people generally progress through specifiable approaches to moral situations. These approaches are characterised not in terms of particular values or moral positions, but rather in terms of the form of moral reasoning engaged in. He suggests universal stages of moral development, which people go through, irrespective of culture or society; and which are invariant that is they have a unique sequence, and people never violate the order of the stages by attaining a higher stage without first passing sequentially through lower ones. In his model, Kohlberg identifies six stages of moral reasoning – the first two stages cover behavioural norms relating to avoidance of punishment and serving one's needs. Stages three and four relate to individuals taking society's rules and incorporating them into their behaviour. The final two stages, five and six, reflect the belief in the validity of universal moral principles which bring justice and a sense of personal commitment.

Table 1 summarises these three distinctive levels according to the reasons of doing right.

7. Analysis – arguing the contribution of Kohlberg's theory in furthering an understanding of the ethics of earnings management

Kohlberg maintained that a moral obligation is an obligation to respect the rights of others – individuals and society (Lickona, 1976). This sort of responsibility, stressed by Kohlberg, typically applies towards users of financial information and earnings reports in particular. Thus, at least from this perspective, Kohlberg's theory begins to contribute to the field of EM ethics. And this has been enhanced by the in-depth exploration into individuals' mindset, and their views of different established moral perspectives. The engagement of Kohlberg's theory into EM practices and concepts can provide useful insights into the moral reasoning of managers about EM. In this respect, the importance and implications of Kohlberg's theory, in terms of EM, resides within the fact that the theory is concerned with questions about how one ought to act – being as it acknowledges the well-known ethical theories. On the other hand, the work of Kohlberg can be classified as a descriptive analysis to the extent that it attempts to describe individuals' moral development (Trevino, 1992). Primarily, this sort of integration of normative and descriptive ethics, in turn, enables the theory to be used to explore managers' moral reasoning in a more helpful way.

In view of Kohlberg's assumption about a connection between the level of moral thought and moral behaviour, Kohlberg's analysis can aid in predicting behaviour according to moral maturity as a prerequisite (Kohlberg, 1981; Lovell, 1997; Boyce and Jensen, 1978). Research has revealed that personal moral reasoning and social responsibility are important determinants of EM ethics, and there is a link between these factors and EM actions (Elias, 2002). In view of this, and given Kohlberg's fundamental belief in a correspondence among moral reasoning, social interaction (e.g. loyalty to society at the conventional level) and moral behaviour, Kohlberg's theory can provide worthwhile implications on predictability and guidance of EM behaviour. As a result, this can aid in mitigating adverse practices of EM.

Level and stage	Reasons for doing right
Level I: Pre-conventional reasoning	
Stage 1. Heteronomous morality	Avoidance of punishment and the superior power of authorities
Stage 2. Individualism, instrumental purpose and exchange	To serve one's own needs or interests in a world where you have to recognise that other people have their interest too
Level II: Conventional reasoning	
Stage 3. Mutual interpersonal expectations, relationships and interpersonal conformity	The need to be a good person in your own eyes and those of others. You are caring for others. Belief in the Golden rule. Desire to maintain rules and authority which support stereotypical good behaviour
Stage 4. Authority and social order	To keep the institution going as a whole, to avoid the breakdown in the system "if everyone did it"
Level III: Post-conventional reasoning	
Stage 5. Social contract or utility and individual rights	A sense of obligation to law because of one's social contracts to make and abide laws for the welfare of all and for the protection of all people's rights. A feeling of contractual commitment freely entered upon, to family, friendship, trust and work obligations Concern that laws and duties be based on rational calculation of overall utility, "the greatest good for the greatest number"
Stage 6. Universal ethical principles	The belief as a rational person in the validity of universal moral principles, and a sense of personal commitment to them

Source: Kohlberg (1986)

Table 1. Kohlberg's stages of moral reasoning

The work of Kohlberg seeks to explore understanding through explanations and justifications rather than through simple words, indicating respondents' approvals and disapprovals about a certain issue. More specifically, the theory uses production measures rather than recognition measures. This way of investigation can be very helpful in view of the sensitivity of the topic of EM. That is, sensitivity related to a criminal dimension and sensitivity related to the ethical considerations of research rules. With the usage of interpretive qualitative research, Kohlberg's way of analysis can be advantageous in a topic which is closely related to perceptions about deception and fraud, such as EM.

In view of this, Kohlberg's moral hierarchy can be suggested as an appropriate framework for investigating managers' moral reasoning towards EM behaviour. Because of its in-depth analysis, Kohlberg's theory can be helpful for further qualitative research into more detailed work in this topic, for instance, in differentiating EM for individual intent from that of company intent. The theory might also help to explore the degree of ethicality of EM, according to gender differences. Kohlberg's view of justice ethics being the qualities of respect, reciprocity and equality, may also apply within the manager–stakeholder relationship. This view, if it is further investigated and linked to the financial reporting process, may help to guide appropriate professional judgment and to maintain objectivity and independence in the delivery of earnings reports.

In view of this analysis, financial-information processing regulations, as Crank and Caldero (2000) argued, (cited in Everett *et al.*, 2007) seem to have their "vices" that makes one wonder if the noble aim of accounting has not itself become questionable. Fischer and

Rosenzweig (1995, p. 440) believe that "following the law and explicit business policies is not and cannot be a sufficient guarantee that one's behaviour is ethical". In other words, an individual or a social behaviour may have official permission (legal), yet that behaviour might lack individual or social morality. Salcedo-Albarar *et al.* (2009) go further in this argument, maintaining that some rules, laws and professional regulations may protect actions that are considered as social perversions. In this sense, the authors believe breaking those rules may improve social welfare. That is to say, in a situation of perverse legality, illegality may be an advantage and may establish social benefits better than legality (Salcedo-Albarar *et al.*, 2009). The theory of Kohlberg had highlighted the issue of illegality and societal advantage in describing the post-conventional level.

> Aside from what is constitutionally and democratically agreed upon, the right is a matter of personal "values" and "opinion". The result is an emphasis upon the "legal point of view", but with an emphasis upon the possibility of changing law in terms of rational considerations of social utility (rather than freezing it in terms of Stage 4 "law and order"). (Kohlberg and Hersh, 1977, p. 55)

The Kohlbergian analysis of the post-conventional level of moral reasoning therefore, involves the possibility of changing the law or, at least, a kind of disrespect for rules in favour of social benevolence, which comes from moral responsibility. Kohlberg (1981) presented Martin Luther King as an example of someone who was at the post-conventional level on his (Kohlberg's) moral reasoning ladder. In line with advocating disrespect of some laws and obeying others, Kohlberg cited King's letter from a Birmingham Jail in 1965, stating:

> The answer lies in the fact that there are two types of laws, just and unjust. One has not only a legal but a moral responsibility to obey just laws. One has a moral responsibility to disobey unjust laws. An unjust law is a human law that is not rooted in eternal law and natural law. Any law that uplifts human personality is just, any law that degrades human personality is unjust. An unjust law is a code that a numerical or power majority group compels a minority group to obey but does not make binding on itself.
>
> I do not advocate evading or defying the law, as would the rabid segregationist. That would lead to anarchy. One who breaks an unjust law must do so openly, loving, and with a willingness to accept the penalty. An individual who breaks a law that conscience tells him is unjust, and willingly accepts the penalty of imprisonment in order to arouse the conscience of the community over its injustice, is in reality expressing the highest respect of law. (Kohlberg, 1981, p. 43)

Because of differences in human judgment in financial reporting treatments, "a challenge will be to differentiate between decisions made in good faith and those made with intention to misrepresent investors" by exploiting the letter of the law (Maines, 2007, p. 364).

8. Conclusion – the suggested framework

Kohlberg maintained that moral obligation is an obligation to respect the rights and claims of others – individuals and society (Lickona, 1976). This sort of responsibility, stressed by Kohlberg, typically applies towards users of financial information and earnings reports in particular. Thus, at least from this perspective, Kohlberg's theory begins to contribute to the field of EM ethics. An engagement of Kohlberg's theory into EM practices and concepts can provide useful insights into the moral reasoning of managers about EM. In this respect, the importance and implications of Kohlberg's theory, in terms of EM, resides within the fact that the theory is concerned with questions about how one ought to act – being it acknowledges the well-known ethical theories. On the other hand, the work of Kohlberg can

Table 2. Individual and organisational stages of moral development as applied to the manager and EM

Kohlberg stages of moral reasoning	Rationale and motivation applied to individuals	Rationale and motivation applied to organisations (As adapted by Logsdon and Yuthas, 1997)	Rationale and motivation applied to the manager and EM
Pre-conventional level			
Stage 1: Obedience and punishment	Act to avoid painful consequences to one self	Act to avoid painful consequences to the organisation	Act to avoid both individual and corporate financial loss
Stage 2: Instrumental purpose and exchange	Act to further one's interests	Act to further the interests of the organisation	Act to boost both corporate and individual income
Conventional level			
Stage 3: Interpersonal accord, conformity to group norms	Act to meet expectations of immediate peers	Act to meet expectations of peer companies, industry or local business community norms	Act to meet expectations of stakeholders and business norms
Stage 4: Social accord and system maintenance	Act to meet societal expectations stated in law	Act to comply with current laws and regulations	Act to fulfil GAAP and disclosure-related standards
Post-conventional level			
Stage 5: Social contract	Act to achieve social consensus and tolerance on conflicting issues	Act to achieve social consensus on issues not fully addressed by legal standards	Act to achieve social consensus on issues not fully addressed by business norms and disclosure standards
Stage 6: Universal ethical principles	Act consistent with self-selected moral principles	Act to identify, communicate and apply universal moral principles in organisational decision-making	Act to identify, communicate and apply universal moral principles in EM judgments

be classified as a descriptive analysis to the extent that it attempts to describe individuals' moral development (Trevino, 1992). Primarily, this sort of integration of normative and descriptive ethics, in turn, enables the theory to be used to explore managers' moral reasoning in a more helpful way.

In spite of the differences in organisational moral development because organisations are composed of many individuals with different beliefs, values and interests, at different hierarchical levels, Logsdon and Yuthas (1997) can see organisational matches to Kohlberg's individual moral stages (Table 2: Column 2). In view of this, individual moral development about a business-related issue is simpler for an organisation.

Therefore an adapted framework of Kohlberg's model, that links moral development stages to the managers' reasoning, is suggested accordingly. Kohlberg's model has been adapted to illustrate how the moral development model reflects on managers' reasoning about EM (Table 2: Column 3).

The suggested adaptation the paper presents is different from the work of Logsdon and Yuthas (1997) and Snell (1993), in that it attempts to translate Kohlberg's moral stages specifically into managers' understanding of the ethicality of EM. It suggests that managers, like other individuals, may reveal different levels of moral reasoning with reference to EM that simulate the levels exhibited by non-managers. For example, an executive manager who reduces costs or boosts revenues dishonestly because he wants to avoid reporting loss. Also, if similar behaviour is linked with a personal bonus which would be gained, then this suggests lower levels of moral reasoning, namely, an example of pre-conventional reasoning (pain/pleasure calculation). By contrast, a manager at the conventional level understands the morality of EM as acting in accordance with accounting principles and disclosure standards and meeting expectations of stakeholders and society (maintain rules and social norms). At a more mature stage, a manager who uses post-conventional reasoning when deciding on EM is expected to consider the rights and interests of the reports' users, beyond the legal requirements, thus addressing the obligation of the welfare of all people and for the protection of all rights. A manager at the post-conventional level, in view of this Kohlbergian analysis, acts to achieve social consensus on issues not fully addressed by business norms and disclosure standards. And he should believe in the validity of universal moral principles which bring justice rather than convention.

Therefore, levels of moral development of the modified model attempt to create links with concepts of financial reporting and the ethics of EM. It can be used as a basis for observation and categorisation of managers. Thus, it adds to the conceptual base needed to further explore the concept of moral reasoning about EM.

References

Anderson, J.C. and Lauderback, J.G. (1975), "Income manipulation and purchase-pooling: some additional results", *Journal of Accounting Research*, Vol. 13 No. 2, pp. 338-343, Autumn.

Atkinson, A.S. (2002), "Ethics in financial reporting and the corporate communication professional", *Corporate Communications: An International Journal*, Vol. 7 No. 4, pp. 212-218.

Bainbridge, S.M. and Johnson, C.J. (2003), "Managerialism, legal ethics, and Sarbanes-Oxley section 307", *Law Review of the Michigan State University-Detroit College of Law, Forthcoming*, from SSRN, available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=434721 (accessed 12 June 2009).

Bell, R.L. (2007), "The manager's role in financial reporting: a risk consultant's perspective", *Business Communication Quarterly*, Vol. 70 No. 2, pp. 222-226.

Berrone, P., Surroca, J. and Tribo, J. (2007), "Corporate ethical identity as determinant of firm performance: a test of the mediating role of stakeholder satisfaction", *Journal of Business Ethics*, Vol. 76 No. 1, pp. 35-53.

Boyce, W.D. and Jensen, L.C. (1978), *Moral Reasoning: A Psychological-Philosophical Integration*, University of NE Press, Lincoln, NE.

Bruns, W.J. Jr. and Merchant, K.A. (1990), "The dangerous morality of managing earnings", *Management Accounting*, Vol. 72 No. 2, pp. 22-25.

Coung, N.H. (2007), "The need for legislation like Sarbanes-Oxley for IT governance: an Australian perspective", *Information Systems Audit and Control Association*, available at: www.isaca.org/AMTemplate.cfm?Section=20075&Template=/ContentManagement/ContentDisplay.cfm&ContentID=42528 (accessed 2 May 2009).

Crank, J.P. and Caldero, M.A. (2000), *Police Ethics: The Corruption of the Noble Cause*, Anderson Publishing, Cincinatti.

Dechow, P.M. and Skinner, D.J. (2000), "Earnings management: reconciling the views of accounting academics, practitioners, and regulators", *Accounting Horizons*, Vol. 14 No. 2, pp. 235-250.

Duh, R.R., Lee, W.C. and Lin, C.C. (2009), "Reversing an impairment loss and earnings management: the role of corporate governance", *The International Journal of Accounting*, Vol. 44 No. 2, pp. 113-137.

Elias, R.Z. (2002), "Determinants of earnings management ethics among accountants", *Journal of Business Ethics*, Vol. 40 No. 1, pp. 33-45.

Ethics In Accounting (2009), Available at: http://highered.mcgraw-hill.com/sites/0072994029/student_view0/ebook/chapter1/chbody1/ethics_in_accounting.html (accessed 14 June 2009).

Everett, J., Neu, D. and Rahaman, A.S. (2007), "Accounting and the global fight against corruption", *Accounting, Organizations and Society*, Vol. 32 No. 6, pp. 513-542.

Fisher, C. and Lovell, A. (2006), "Business ethics and values: individual", *Corporate and International Perspective*, 2nd ed., FT Prentice Hall, London.

Fischer, M. and Rosenzweig, K. (1995), "Attitudes of students and accounting practitioners concerning the ethical acceptability of earnings management", *Journal of Business Ethics*, Vol. 14 No. 6, pp. 433-444.

Geriesh, L. (2003), "Organisational culture and fraudulent financial reporting", *The CPA Journal*, available at: www.nysscpa.org/cpajournal/2003/0303/features/f032803 (accessed 29 November 2007).

Hayes, R.L. (1994), "The legacy of lawrence Kohlberg: implications for counseling and human development", *Journal of Counseling and Development*, Vol. 72, pp. 261-267.

Healy, P.M. and Wahlen, J.M. (1999), "A review of earnings management in literature and its implications for standard setting", *Accounting Horizons*, Vol. 13 No. 4, pp. 365-383.

ICAEW (2007), "Reporting with integrity: an initiative from the institute of chartered accountants in England and Wales", *Information for Better Markets*, available at: www.icaew.com/index.cfm/route/127759/icaew_ga/en/Technical_amp_Business_Topics/Topics/Information_for_better_markets/Reporting_with_Integrity

Kohlberg, L. and Hersh, R.H. (1977), "Moral development: a review of the theory", *Theory into Practice*, Vol. 16 No. 2, pp. 53-59.

Kohlberg, L. (1986), "A current statement on some theoretical issues", in Modgil, S. and Modgil, C. *Lawrence Kohlberg: Consensus and Controversy*, GB: Taylor & Francis.

Kohlberg, L. (1969), *Stages in the Development of Moral Thought and Action*, Holt Rinehart and Winston, New York, NY.

Kohlberg, L. (1981), *Essays on Moral Development: The Philosophy of Moral Development*, Harper and Row.

Lewis, P.V. (1985), "Defining 'business ethics': like nailing jello to a wall", *Journal of Business Ethics*, Vol. 4 No. 5, pp. 377-383.

Liandu, N. (2004), "Earnings management- why worry about it?", *ACCA*, available at: www.accaglobal.com/students/publications/student_accountant/archieve (accessed 13 December 2007).

Lickona, T. (1976), *Moral Development and Behavior: Theory, Research, and Social Issues*, Holt, Rinehart and Winston, New York, NY.

Logsdon, J.M. and Yuthas, K. (1997), "Corporate social performance, stakeholder orientation, and organizational moral development", *Journal of Business Ethics*, Vol. 16 Nos 12/13, pp. 1213-1226.

Lovell, A. (1997), "Some thoughts on Kohlberg's hierarchy of moral reasoning and its relevance for accounting theories of control", *Accounting Education*, Vol. 6 No. 2, pp. 147-162.

McKee, T.E. (2005), *Earnings Management: An Executive Perspective*, Thomson.

Maines, L.A. (2007), "Spotlight on principles-based financial reporting", *Business Horizons*, Vol. 50 No. 5, pp. 359-364.

Mele, D. (2008), "Integrating ethics into management", *Journal of Business Ethics*, Vol. 78, pp. 291-297.

Mintz, S.M. and Morris, R.E. (2008), *Ethical Obligations and Decision Making in Accounting*, McGRAW-HILL, New York, NY.

Nelson, M.W., Elliott, J.A. and Tarpley, R.L. (2003), "How are earnings managed? Examples from auditors", *Accounting Horizons*, Vol. 17 No. s-1, pp. 17-35.

PAAinE (2007), "Pro-Active accounting activities in Europe. Stewardship/accountability as an objective of financial reporting: a comment on the IASB/FASB conceptual framework project", available at: www.frc.org.uk/documents/pagemanager/asb/PAAinE%20Stewardship%20paper.pdf (accessed 18 November 2010).

Piaget, J. (1932/1965), *The Moral Judgment of the Child*, The Free Press, New York, NY, available at: www.archive.org/texts/flipbook/flippy.php?id=moraljudgmentoft005613mbp (accessed 3 April 2009).

Rezaee, Z. (2005), "Causes, consequences, and deterrence of financial statement fraud", *Critical Perspectives on Accounting*, Vol. 16 No. 3, pp. 277-298.

Ronen, J. and Sadan, S. (1975), "Classificatory smoothing: alternative income models", *Journal of Accounting Research*, Spring, Vol. 13 No. 1, pp. 133-149.

Salcedo-Albarar, K., Kuszewski, A., Leon-Beltran, I. and Garay, L.J. (2009), "Rule-breaking from creativity to illigality: a trans-disciplinary inquiry", METODO Working Papers No. 63, available at: http://papers.ssrn.com/so13/papers.cfm?abstract_=1528842 (accessed 25 July 2010).

Sarbanes-Oxley Act (2002), "An act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes. s. 404", available at: http://fl1.findlaw.com/news.findlaw.com/hdocs/docs/gwbush/sarbanesoxley072302.pdf (accessed 2 May 2009).

Schipper, K. (1989), "Commentary on earnings management", *Accounting Horizons*, Vol. 3 No. 4, pp. 91-102.

Smith, A.F. (1978), "Lawrence Kohlberg's cognitive stage theory of the development of moral judgment", *New Directions for Student Services*, Vol. 4, pp. 53-67.

Snell, R.S. (1993), *Developing Skills for Ethical Management*, Chapman and Hall, London.

Stanga, K.G. and Kelton, A.S. (2008), "An attributional analysis of ethicality of judgments of earnings management", in Jeffrey. C. (Ed.). *Research on Professional Responsibility and Ethics in Accounting (Research on Professional Responsibility and Ethics in Accounting, Volume 13)*, Emerald Group Publishing, pp. 87-112.

Trevino, L.K. (1992), "Moral reasoning and business ethics: implications for research, education, and management", *Journal of Business Ethics*, Vol. 11 Nos 5/6, pp. 445-459.

Weber, J. (1991), "Adapting Kohlberg to enhance the assessment of manager's moral reasoning", *Business Ethics Quarterly*, Vol. 1 No. 3, pp. 293-318.

Weber, J. and McGivern, E. (2010), "A new methodological approach for studying moral reasoning among managers in business settings", *Journal of Business Ethics*, Vol. 92, pp. 149-166.

Xie, B., Davidson, W.N. III. and DaDalt, P.J. (2003), "Earnings management and corporate governance: the role of the board and the audit committee", *Journal of Corporate Finance*, Vol. 9 No. 3, pp. 295-316.

Corresponding author
Abdulfatah Ali Belgasem-Hussain can be contacted at: abelgasemhusain@gmail.com