The Role of Ethical Leadership in Constraining Earnings Management Practices: A Survey of Literature

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Abstract

This paper aims at reviewing the literature on ethical leadership and earnings manipulation, with an emphasis on the role of ethical leader in reducing earnings management practices. The review reveals that the accounting system and accounting standards (e.g. IFRS, US GAAP, national GAAP) have plenty of leeway in changing the reported earnings. On the other hand, prior research highlights the significance of an ethical perspective in the financial reporting process. As a result, the current study adds to the body of knowledge by introducing ethical leadership as a solution to constrain earnings manipulation practices to the greatest possible extent. The findings of this paper will be useful to, investors, management, shareholders, auditors, and regulators seeking to understand and control earnings manipulation practices. This is a conceptual paper, future studies are required to empirically verify the proposed proposition.

Keywords: Earnings management, earnings manipulation, integrity, moral management, ethical leadership

1. Introduction

Investors and shareholders evaluate the success of businesses based on earnings information (Goel, 2016). In scholarship, when investigating the quality of financial information, the quality of the entity's earnings is always utilized (Cudia & Cruz, 2018). An accounting system gives managers authority over the selection process and allows them to use the discretion provided by the system to determine earnings in the direction of attaining their goals (Dechow, 1994; Roychowdhury, 2006). Therefore, there is substantial evidence that managers can participate in earnings management by manipulating accruals using creative accounting methods (Rahman & Chowdhury, 2020). Unfortunately, earnings management may not accurately reflect an entity's actual performance, leaving shareholders unable to assess their economic decisions properly (Barkhordar & Tehrani, 2016; Toumeh, 2022).

The earnings management literature attempts to grasp why managers manipulate earnings (García-Sánchez et al., 2020; Islam et al., 2011; McNichols, 2000). The incentives beyond earnings management have been extensively investigated in several contexts (e.g., Cohen & Malkogianni, 2021; Jiang, 2020; Monteiro et al., 2022; Toumeh et al., 2020). Mayer et al. (2012) and Mihelic et al. (2010) highlighted that ethical dilemmas are prevalent in the scandals of high profile companies. Thus, the conclusion might be reached that the most important factors influencing earnings manipulation revolve around management ethics.

The ethics of financial reporting practices have gained a major interest after several corporation scandals in the last decade (Fleischman et al., 2017; Grasso et al., 2009). Chen (2010) stressed that the scarcity of character traits like the integrity of the leadership roles in an organization had caused these scandals, and unethical leaders may engage in fraud to maximize their own welfare. In this regard, several scholars have linked corporate failures to unethical management practices (Jooste, 2011; Madanchian et al., 2018). As a result of these huge corporate failures, companies are now more concerned with recruiting and retaining ethical leaders (Trevino et al., 2000).

Researchers claimed that personal traits of the leaders like honesty and trustworthiness would be significant in shaping the perceptions of leadership effectiveness (Brown & Trevino, 2006). Moreover, ethical leadership has been shown to be successful in improving an organization's overall performance. Accordingly, the current article seeks to observe and highlight the role of ethical leadership in the financial reporting process, particularly its impact on earnings management practices.

2. Earnings Management

Earnings management has evolved into a worldwide challenge confronting the accounting profession; it has been rapidly developing over the last two decades and continues to pique the interest of academics (Chen & Sheng, 2013; Hosseini et al., 2016; Toumeh & Yahya, 2019). Corporate collapses such as Enron, WorldCom, HIH Insurance, Satyam Computer Services, and Arthur Anderson have clearly demonstrated that many of today's businesses engage in earnings manipulation (Juhmani, 2017). Hence, there is compelling evidence that management may engage in these behaviors (Cudia & Cruz, 2018; Dechow et al., 1996; Toumeh et al., 2021).
Earnings management dates back to the inception of commercial exchange (Ramírez-Orellana et al., 2017). The majority of scholars concur that its roots can be traced back to the mid-twentieth century. Franceschetti (2018) pointed out that a clear definition of the earnings management was difficult to obtain in scholarship. He added that the term was first defined in practical literature by Davidson et al. (1987), who observed earnings management as "the process of taking deliberate steps within the constraints of generally accepted accounting principles to bring about a desired level of reported earnings" (p. 17). However, it should be noted that this definition implies that earnings management is legal if it falls within the limits of GAAP.

In accordance with Ramrez-Orellana et al. (2017), Healy and Wahlen (1999) offered the most often used definition of earnings management. They defined it as "earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers" (p. 368). In addition, Schipper (1989) offered a narrower definition. She said that "earnings management is the purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain" (p. 92).

Ronen and Yaari (2008) classified earnings management definitions into three categories based on 14 definitions from the previous research, which were denoted by the colors white, grey, and black as follows:

1. "Earnings management is taking advantage of the flexibility in the choice of accounting treatment to signal the manager's private information on future cash flows" (labelled as beneficial using white).

2. “Earnings management is the choosing an accounting treatment that is either opportunistic (maximising the utility of management only) or economically efficient” (labelled as neutral with grey).

3. “Earnings management is the practice of using tricks to misrepresent or reduce the transparency of the financial reports” (labelled as pernicious with black) (p. 25).

Ronen and Yaari (2008) added that the fraudulent practices fall under the third category (black earnings management), while the other two groups may be deemed creative accounting activities that are permitted under IFRS/GAAP and thus not considered fraudulent.

Al-khabash and Al-Thuneibat (2008) divided earnings management into several types based on a variety of factors such as legitimacy, direction, cash flow impact, and management intent. Earnings management might be legal or illegal. To report the desired income, legitimate earnings management exploits the discretion provided by either GAAP or regulations. While illegitimate earnings management manipulates profits by deviating from GAAP or regulations in order to meet specified objectives. Earnings management can be defined as either income-decreasing or income-increasing, depending on the direction of manipulation.

Further, accrual-based earnings management uses existing accounting options and estimates to determine income, and these accruals typically have no impact on direct cash flows. On the other hand, real earnings management influences cash flow by implementing real decisions, such as selling particular assets to generate income. Discretionary costs like advertising and R&D are used extensively in real earnings management. Finally, based on management intent, earnings management can be characterized as either informative or opportunistic. Informative earnings management is to reveal to shareholders management’s private expectations for an institution’s future cash flows. Conversely, opportunistic earnings management seeks to assure private benefits for mangers at the expense of other parties by deceiving shareholders (Al-khabash & Al-Thuneibat, 2008).

3. Ethical Leadership

The aforementioned moral scandals drew attention to the concept of ethical leadership, which focuses on managers as ethical value guardians and executors.

Although ethical values should apply to all parties in an organization, many tend to focus on management ethics when making decisions (Babalola et al., 2019; Benlahcenea & Meddourb, 2020; Conrad, 2013; Stouten et al., 2013). However, in the early 2000s, the phrase ethical leadership emerged as a new approach to leadership (Kul, 2017).

According to Giessner and Quaquebeke (2010), Brown et al. (2005) offered the most influential definition of ethical leadership. They defined ethical leadership as “the demonstration of normatively appropriate conduct through personal actions and interpersonal relationships, and the promotion of such conduct to followers through two-way communication, reinforcement, and decision-making” (p. 120). Moreover, Kul (2017) determined ethical leadership as “a style of leadership that possesses universal values such as reliability, impartiality and justice, reinforces these values through two-way communication with viewers and encourages the formation of moral thought” (p. 564).

Even though ethical leadership is a predominant feature in the other types of leadership theories (transformational leadership, genuine leadership, and spiritual leadership), it is a distinct theory (Craig & Gustafson, 1998; Naiyananont & Smuthranond, 2017).

Nevertheless, there is a scholarly conundrum in which the definition of ethical leadership is linked to other sorts of leadership behaviours that are not always relevant (Yukl et al., 2013). To address this issue, Brown and Trevino (2006) conducted a study that described the similarities and differences of the other types of leadership theories that interfere with ethical leadership scope, which are outlined in Table 1.

Table 1: Similarities and Differences between Ethical, Spiritual, Authentic and Transformational Theories of Leadership

	Key similarities with ethical leadership	**Key differences with ethical leadership**
Authentic leadership	- Concern for others (Altruism) - Ethical decision-making - Integrity - Role modelling	- Ethical leaders emphasize moral management (more transactional) and “other” awareness - Authentic leaders emphasize authenticity and self-awareness

Spiritual leadership	- Concern for others (Altruism) - Integrity - Role modelling	- Ethical leaders emphasize moral management - Spiritual leaders emphasize visioning, hope/faith; work as a vocation
Transformational leadership	- Concern for others (Altruism) - Ethical decision-making - Integrity - Role modelling	- Ethical leaders emphasize ethical standards, and moral management (more transactional) - Transformational leaders emphasize vision, values, and intellectual stimulation

Source: Brown and Trevino (2006)

Several measures of ethical leadership exist in literature. For example, Yukl et al. (2013) reviewed the literature on ethical leadership measurements before developing and validating the Ethical Leadership Questionnaire (ELQ). They used several items from previous studies (e.g., Brown et al., 2005) and claimed that the ELQ had several advantages over previous measures because it contains crucial categories and focuses only on ethical behaviors while neglecting other leader behaviors. The ELQ consists of 15 items, each with a 6-point Likert-style response format. (1=strongly disagree, 2=moderately disagree, 3=slightly disagree, 4=slightly agree, 5=moderately agree, 6=strongly agree). Communication of ethical values, consistency of behaviour with proclaimed values, honesty, integrity, fairness, providing ethical guidance, and altruism are the ELQ characteristics that characterize several dimensions of ethical leadership. Sample items are “my boss shows a strong concern for ethical and moral values, my boss is honest and can be trusted to tell the truth, my boss is fair and unbiased when assigning tasks to members, my boss Acknowledges mistakes and takes responsibility for them, and my boss puts the needs of others above his/her own self-interest.”

4. Ethical Leadership and Earnings Management

Chen (2010) said that judging executives based on their ability to meet potential investors’ and analysts’ projections is problematic. In this regard, Trevino et al. (2000) noted that executives’ efforts should not be focused solely on the business aspect, which is concerned with outperforming competitors and achieving profit targets, but also on instilling moral values in their organizations. According to Brown and Trevino (2006) and Kul (2017), one key duty of leaders who strive to implement these principles in their decision-making and leadership roles is establishing ethical values in the workplace.

Ethical leaders demonstrate their followers that performing right thing is appreciated and compensated (Ruiz & Ruiz, 2011). This moral role model fosters an ethical environment for employees, including the knowledge and skills needed to deal with ethical concerns. Furthermore, the significance of preserving ethical norms in the face of outside pressure and attempting to accomplish business objectives neutrally is also communicated to employees by their ethical leaders (Brown & Trevino, 2006; Mayer et al., 2010). These leaders highlight the importance of ethical behaviour by implementing ethical guidelines and procedures, as well as facilitating the message that morality is a major emphasis of the organization by establishing moral values, following these values, and rewarding ethical staff members while disciplining those who breach moral values (Babalola et al., 2019; Brown et al., 2005).

Immoral leaders could manipulate reported accruals to modify earnings in the direction of maximizing their own interests (Cheng et al., 2022; Tian & Peterson, 2016). In fact, the major corporate scandals were strongly linked to unethical behaviour such as earnings management practices (Benlahcenea & Meddourb, 2020; Jiang, 2020; Mayer et al., 2012; García-Sánchez et al., 2020). These activities may not accurately reflect an entity's actual performance, causing harm to shareholders (Goel, 2016; Rahman & Chowdhury, 2020). On the other hand, ethical leaders strive to incorporate moral values into their decision-making and managerial roles, and they operate altruistically in order to maximize the interests of others (Conrad, 2013; Kul, 2017; Mihelic et al., 2010). However, while many researchers focused on detecting earnings manipulation, few studies examined the phenomenon from an ethical standpoint (Elias, 2002).

Based on the preceding considerations and previous studies (e.g., Brown & Trevino, 2006; Donegan et al., 2017; Fleischman et al., 2017; Grasso et al., 2009; Jooste, 2011; Madanchian et al., 2018; Stouten et al., 2013; Taylor & Pattie, 2014; Trevino et al., 2000), the current article contributes to the existing earnings management literature by demonstrating that ethical leadership can play a critical role in constraining earnings manipulation practices. Therefore, this paper develops the following proposition:

Proposition: Ethical leadership is negatively related to earnings management practices.

5. Conclusion

Earnings manipulation reduces the trustworthiness of the published earnings by distorting reported accruals quality, concealing the business's real performance, and consequently undermining confidence in financial reports. Thus, shareholders have lost faith in the reliability of the published accounting information, prompting scholars to concentrate more on earnings quality. On the other hand, leadership is a method of inspiring and influencing employees to work toward the priorities of the leader, and ethics are important aspects of any institution, especially in leadership and management. Accordingly, ethical leaders are assumed to be concerned about morals, and they should take an active role in steering employees to adhere to these norms.

This study is a conceptual paper that concentrated on proposing the association between ethical leadership and earnings management. A theoretical arguments had been developed rather than examining the proposed relationship empirically. However, as with all conceptual papers, this study has limitations, and some contributions may have been overlooked. The criteria used for scanning, obtaining, and investigating related papers could have also affected the findings. As a result, the research methodology utilized to evaluate and categorize each article in this paper is critical, as it will enable future studies to replicate the current research. Finally, future studies might be directed towards testing earnings management from the accountability perspective like Islamic leadership.

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