THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

Department of Accounting

Earnings Management Decisions: The Role of Economics and Ethics

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Abstract

This study through a survey of 225 CFOs and CEOs of listed companies attempts to better understand earnings management (EM) decisions. We extend Graham et al. (2005) by providing participants with a case study scenario which asked them to decide on whether to manage earnings when earnings were not expected to meet market expectations. The survey then evaluates how they incorporate economic factors such as costs and benefits to various stakeholders in their decision making, as well as evaluating whether their perception of whether EM is ethical makes a difference. We find the most significant economic factor affecting the EM decision is to avoid the costs to current shareholders from *not* managing earnings to meet the market expectations. However, the perception of whether EM is ethical and the related issue of whether EM is perceived as lying are also significant factors that affect the decision to manage earnings. Finally, we provide evidence that the choice by managers on the method of accrual compared to real operational EM is primarily driven by ethical perceptions of these alternative actions.