

A Conceptual Paper: Islamic Corporate Governance and Earnings Management

Maya Indriastuti^{1*}, Winarsih², Ahmad Hijri Alfian³

^{1,2,3}Department of Accounting, Faculty of Economics, Universitas Islam Sultan Agung, Indonesia

*Corresponding author: maya@unissula.ac.id

Contributing authors: winarsih@unissula.ac.id; Hijrialfian@unissula.ac.id

Abstract

Earnings management is a theme that is still interesting to research today. This is because earnings management is able to provide an overview of managers' behavior in reporting their business activities in a certain period, namely the possibility of the emergence of certain motivations that encourage them to manage or to arrange the reported financial data. This study will examine the Islamic corporate governance of earnings management with a target sample consisting of 65 annual reports of Islamic banks in Indonesia from 2018 to 2022 and be analyze by using panel data regression analysis. This research contributes to the literature on earnings management practices by looking at the extent to which Islamic banks in Indonesia take their controlling market expectations and keeping stock prices high.

Keywords: *Islamic corporate governance; earnings management; Islamic banks in Indonesia*

Introduction

Earnings management (EM) is a common phenomenon that occurs in a number of companies, including the case of Enron, where the company tried to manipulate financial reports by inflating its income by more than US\$ 600 million which actually did not exist. The case of Xerox Corp which also inflated revenues and profits from 1997 to 2000 by recognizing revenue on contracts whose receipts were in the future (www.cnn.com). Apart from the earnings management case in America, similar cases have also occurred in Indonesia, such as PT. Jiwasraya Insurance and PT. Garuda Indonesia also involves financial reporting which started with manipulation and many other cases.

The banking industry, which is one of the industries that has an important role as a basis for national development and as a supporter of the community's economy, is not immune from the phenomenon of EM, where banking financial reports do not show the actual situation due to differences in interests between the owners and managers. The existence of management actions that increase or decrease profits through accounting policies on financial reports carried out by banking management will affect the profits displayed in the financial reports, so this profit information can lead to wrong investment decisions for investors. As the party who receives authority from the company owner, managers are responsible for maximizing the interests of the company owner. However, personally managers also have an interest in their own welfare. These differences in interests give rise to conflicts of interest which enable EM practices in companies (Adams & Scott, 1996).

EM practices that occur in several companies can be minimized with good corporate governance (GCG). GCG is a good governance system and can help build shareholder trust and ensure that all stakeholders are treated equally (IFSB, 2009). GCG from a

Islamic perspective is an organizational structure in which a company implements GCG guided by the principles of sharia compliance. Islamic CG is generally the same as conventional GCG, the only difference is the existence of a Sharia Supervisory Board (SSB). The SSB in Islamic banking is tasked with supervising and monitoring the activities of sharia financial institutions to ensure that these institutions comply with sharia principles so as to limit profit management practices in Islamic banking. With the existence of an audit committee (AC), independent commissioners (IC) and SSB in Islamic banking, it is possible to detect early EM practices carried out by Islamic banking managers.

Research on EM practices in banking has been proven by several previous researchers. Mosaid (2012) also shows that CG has no effect on performance. Suryanto (2017) shows that the AC has a positive effect on EM, whereas Neves et al., (2023) said that GCG (AC) has a negative effect on company performance. Mersni & Ben Othman (2016) found that the SSB has a negative effect on EM. In contrast to Suryanto's (2017) findings, it shows that the AC has a positive influence on EM but AC has a negative impact. Zhang et al., (2020) revealed that banks with stronger CG scores tend to have lower financial performance. Novitasari et al., (2019) said that AC and SSB had no influence on EM. Rahmadani & Haryanto (2018) indicated that AC not significantly reduce EM. Ermawati & Anggraini (2020) proved that IC is able to reduce EM, whereas SSB increases EM practices. Widyaningsih (2017) said that IC not significantly reduce EM. Rini (2019) resulted that Islamic banking financial institutions in Indonesia have not fully implemented Islamic CG.

This research contributes to the literature on EM practices in different ways. First, it shows the extent to which Islamic Banks in Indonesia take their GCG role seriously. Second, the study adds to the existing literature on the potential impact of Islamic CG on EM. Finally, this study is anticipated to provide feedback to the regulator (Financial Services Authority) regarding the adequacy of regulations related to GCG requirements for companies in Indonesia.

GCG applied to Islamic banking has special characteristics that are different from conventional banks and other non-financial companies. The characteristics of CG in Islamic banking include a supervisory board, namely the Sharia Supervisory Board (SSB), which was formed to be responsible for carrying out sharia governance practices which are essential in the Islamic financial CG model with the aim of building and maintaining the trust of all stakeholders that all transactions and Islamic banking activities in accordance with sharia principles.

The existence of GCG is able to increase both company performance and value (Mahrani & Sowarno, 2018; Harun et al., 2020; Tanjung, 2020; Neves et al., 2022), as well as the performance of Islamic banks (Khan & Zahid, 2018; 2020; Buallay, 2019). GCG also has a positive effect on financial stability in Islamic banking in Malaysia (Lassoued, 2018) and profit quality (Rezaee & Safarzadeh, 2023). Private public banks in Bangladesh show that along with increasing efficiency guided by GCG, EM practices carried out by private public banks can be reduced (Buallay, 2019; Chaity & Islam, 2022).

Elghuweel et al., (2017) found that on average, companies with GCG tend to be less involved in EM than companies with poor governance. Elghuweel et al., (2017) added that companies that demonstrate greater commitment to incorporating Islamic religious beliefs and values into their operations through the formation of committees tend to be less involved in EM than companies that do not have such committees. These results are in line with the findings of Fitri & Siswanto (2022) that the size of the AC is able to reduce EM actions. Kolsi

& Grassa (2017) reinforce that membership of Accounting and Audit Organizations in Islamic Financial Institutions has a positive impact on EM in Islamic Banks.

The SSB is able to encourage better company performance, because of its advisory and supervisory functions (Almutairi & Quttainah, 2017). Mersni & Ben Othman, (2016) added that small SSBs are more effective than larger SSBs, this may be due to higher costs and the negative impact of large groups on decision making. Elnahass et al., (2023) found that, on average in Islamic banks, a large and independent board of directors (and audit committee) is positively associated with all measures of information value.

Based on the background that has been explained, the research problem formulation is as follows:

1. Does the AC have an effect on EM?
2. Does the IC have an effect on EM?
3. Does the SSB have an effect on EM?

Literature Review

Agency Theory

Agency theory describes that EM practices are influenced by conflicts of interest between management (agent) and owner (principal) which arise when each party tries to achieve and maintain the desired level of prosperity (Jensen & Meckling, 1976). Conflicts of interest that occur between principals and agents encourage managers to make certain efforts to balance the expected conditions, one of which is through EM actions.

Earnings Management (EM)

Scott (2015), EM is the choice by a manager of accounting policies so as to achieve some specific objectives. Therefore, managers have the flexibility to choose several alternative ways of recording transactions while choosing options that exist in the same accounting treatment. This flexibility, which is intended to enable managers to adapt to various economic situations and reflect the true economic consequences of the resulting transactions, can also be used to influence the level of income at any given time with the aim of providing benefits to management and stakeholders. This is the essence of EM, namely the ability to "manipulate" the available options and make the right choice.

Islamic Corporate Governance (ICG)

ICG is an organizational structure in which sharia financial institutions can ensure the principle of independence regarding sharia compliance. This is done by compiling relevant sharia guidelines, distributing fatwa information, and internal reviews of sharia compliance (IFSB, 2009). ICG in this research includes the audit committee (AC), independent commissioner (IC) and sharia supervisory board (SSB).

The AC is a committee formed by and responsible to the Board of Commissioners to assist in carrying out the duties and functions of the Board of Commissioners (Financial Services Authority Regulation No. 55/POJK.04/2015 Article 1). The members of this AC consist of at least 3 (three) members from Independent Commissioners and parties from outside the issuer or public company (Financial Services Authority Regulation No. 55/POJK.04/2015 Article 4).

IC is a members of the Board of Commissioners who come from outside the issuer or public company and meet the requirements as regulated in Financial Services Authority Regulation No. 33/POJK.04/2014. In Indonesia, the existence of independent commissioners is regulated in Financial Services Authority Regulation No. 57/POJK.04/2017 Article 19 that (1) Securities Companies are required to have IC. (2) In the event that the Board of Commissioners consists of more than 2 (two) people, the percentage of IC must be at least 30% (thirty percent) of the total number of members of the Board of Commissioners.

The SSB is tasked with conveying messages and suggestions to the board of directors. They also control Islamic banking activities in accordance with sharia guidelines (Financial Services Authority Regulation No. 30/POJK.05/2014). Bank Indonesia indicated that members of the SSB must receive recommendations from the National Sharia Council formed by the Indonesian Ulema Council. The number of members of the SSB is at least two people or a maximum of 50% of the total number of directors. Moreover, SSB board meetings must be held at least once a month. SSB meeting decisions must be held at least once a month and carried out by deliberation and consensus (Bank Indonesia Regulation No. 11/3/PBI/2009).

Hypothesis Development

Audit Committee and Earnings Management

The AC is the party responsible to the board of commissioners in order to help carry out the duties and functions of the board of commissioners in terms of company accounting policies, internal supervision and financial reporting systems (Financial Services Authority Regulation No. 55/POJK.04/2015 Article 1). In line with agency theory, management is more likely to prioritize its own interests, resulting in conflicts of interest. Independence is needed to overcome conflicts of interest. The AC acts as an independent party in mediating agent and principal relationships. The AC will act independently to produce objective results. An independent AC is able to improve profit quality. This is because the large number of non-independent AC in a company has a positive relationship with EM. The lower the percentage of independent members of the AC, the greater the opportunity for EM.

Agency Theory views that if the principal and agent have the same goals, the agent will support and carry out everything ordered by the principal. Based on the duties and responsibilities of the AC, the conclusion is that the function of the AC itself is to assist the board of commissioners in monitoring financial reports and creating work discipline and control that can reduce the opportunity for irregularities in company management and increase the effectiveness of the internal audit and external audit functions. Neves et al., (2023); Fitri & Siswantoro (2022); Elghuweel et al., (2017); Suryanto's (2017) states that there is a negative relationship between EM and the AC.

H1: The audit committee has a negative effect on earnings management.

Independent Commissioner and Earnings Management.

In agency theory, independent commissioners are considered the highest internal control mechanism, responsible for monitoring top management actions. Supervision is carried out so that managers' tendency to carry out earnings management is reduced so that investors continue to have confidence in investing in the company. The principal as the owner wants profitability to always increase for the capital they invest, while the management as the agent wants to maximize personal economic needs for the performance they carry out (Jensen & Meckling, 1976). Agency theory views independent commissioners as the highest internal

control mechanism who have better and more information. Thus, the agent's opportunity to maximize his own interests by carrying out inappropriate actions. In addition, because verification of information is difficult, agent actions will be difficult to monitor. Ermawati & Anggraini (2020) prove that there is a negative relationship between EM and IC.

H2: Independent commissioners have a negative effect on earnings management.

Sharia Supervisory Board and Earnings Management.

The existence of a SSB in Islamic banking acts as an advisor and provides advice to managers as management parties in every decision making so that the decisions taken do not cause conflict. The SSB is an independent board placed by the National Sharia Council (NSC) in Islamic banking and financial institutions. In carrying out its duties and responsibilities, the SSB is obliged to follow the facts issued by the SSB. SSB has an important role related to EM practices and with the existence of a sharia supervisory board, SSB can limit and detect EM practices in Islamic banking. The existence of a SSB that provides effective supervision will reduce the occurrence of EM because EM is an action to manage profits so that financial performance looks good so that it is not in accordance with sharia. revealed that the number of SSB is an important factor in the effectiveness of the SSB.

Agency theory assumes that all individuals act in their own interests. As an independent body tasked with directing, consulting, evaluating and supervising Islamic bank activities in order to ensure that Islamic bank business activities comply with sharia principles as determined by Islamic fatwas and sharia have the potential to carry out inappropriate actions. Mersni & Ben Othman (2016); Elghuweel et al., (2017) stated that the activities of the SSB have a negative effect on EM actions in Islamic banking. This means that the existence of the SSB is able to reduce EM actions in Islamic banks. Khalil & Boulila (2020) found a negative influence between the SSB on company performance. In addition, Lu et al., (2015) stated that board characteristics have a negative effect on company reputation.

H3: The sharia supervisory board has a negative effect on earnings management.

Empirical Research Model

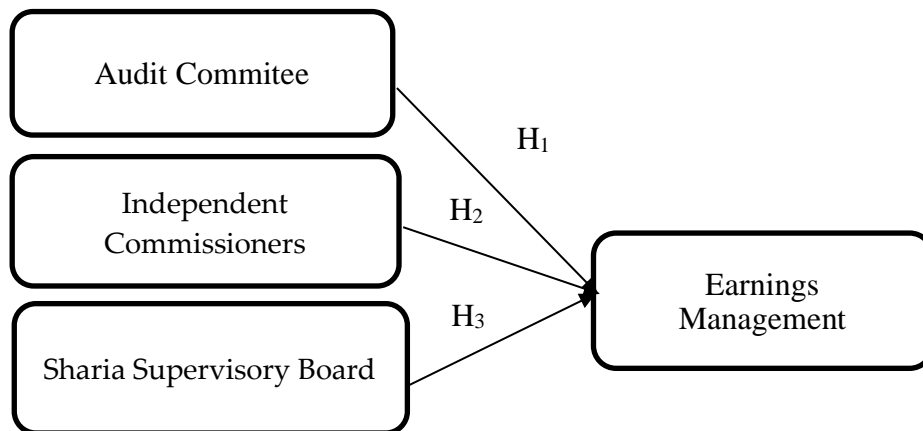


Figure 1. Research Model

Research Method

The population in this research is Islamic Banks registered with Bank Indonesia in 2018-2022. The sample collection method used in this research is the purposive sampling method, with criteria are as follows:

1. Islamic banks registered with Bank Indonesia in 2018 – 2022.
2. Islamic banks that publish annual reports during the observation year.
3. Islamic banks that have complete data during the observation period.

This research is included in causality research because it tests hypotheses relating to the relationship between the effects of one thing or another, more variables with one or more other variables. This research model was developed to identify and integrate the determinant variables of earnings management by involving Islamic corporate governance as well as conducting empirical testing of the model.

Measurement Method

The variables in this research consist of the independent variable, namely Islamic corporate governance, which includes the audit committee, independent commissioners and sharia supervisory board and the dependent variable, namely earnings management..

Earnings Management (EM)

EM is the process of taking deliberate steps within the limits of general accounting principles both within and outside the limits of the General Accepted Accounting Principle (Stubben, 2010). EM measurements using the Stubben method:

$$\Delta AR_{it} = \alpha + \beta \Delta R_{it} + \varepsilon_{it}$$

ΔAR_{it} = amount of receivables in year t

α = constant

Islamic Corporate Governance (ICG)

Audit Committee (AC)

AC is a committee formed by and responsible to the Board of Commissioners to assist in carrying out the duties and functions of the Board of Commissioners (Financial Services Authority Regulation No. 55/POJK.04/2015 Article 1). AC is proxied by the number of audit committee members in the company.

Independent Commissioners (IC)

The IC is responsible for ensuring the company operates in a legal and ethical manner, evaluating the strength of the board of directors, monitoring conflicts of interest, and complying with CG guidelines (Financial Services Authority Regulation No. 33/POJK.04/2014.). IC is proxied by the ratio between the number of independent commissioners and the number of board of commissioners.

Sharia Supervisory Board (SSB)

SSB is a board tasked with conveying messages and suggestions to the board of directors. They also control Islamic banking activities in accordance with sharia guidelines (Financial Services Authority Regulation No. 30/POJK.05/2014). This SSB measurement uses the number of meetings.

Data Collecting Plan

The type of data used in this study is secondary data sourced from www.bi.go.id. The secondary data is in annual reports from Islamic banks listed on the Bank Indonesia from 2018 to 2022.

Data Analysis Plan

All hypotheses are processed using panel data regression analysis with equation is as follows:

$$EM = \alpha + \beta_1AC + \beta_2IC + \beta_3SSB + e..... \text{model 1}$$

In which:

- EM : Earnings Management
- α : Constant
- β_1 - β_3 : Regression Coefficient
- AC : Audit Committee
- IC : Independent Commissioners
- SSB : Sharia Supervisory Board
- e : Error

Conclusion

EM practices are a form of moral hazard, namely deviant behavior from an agent. The agent does not carry out things mutually agreed upon in the employment contract, or deviates from the agreement that has been stipulated. Therefore, to reduce EM practices in the world of Islamic banking, good and strong CG is needed which is based on sharia principles. Islamic CG ensures principals and agents that all their actions and behavior are supervised by Allah SWT.

References

Adams, S., & Scott, M. (1996). Scott Adams. *Business Ethics: The Magazine of Corporate Responsibility*. <https://doi.org/10.5840/bemag199610473>

Almutairi, A.R. & Quttainah, M.A. (2017). Corporate governance: evidence from sharia banks. *Social Responsibility Journal*, 13(3), 601-624. <https://doi.org/10.1108/SRJ-05-2016-0061>

Bank Indonesia Regulation No. 11/3/PBI/2009 concerning *Sharia Commercial Bank*.

Buallay, A. (2019). Corporate governance, sharia’ah governance and performance: a cross-country comparison in MENA region. *International Journal of Sharia and Middle Eastern Finance and Management*, 12(2), 216-235. <https://doi.org/10.1108/IMEFM-07-2017-0172>.

Chaity, N.S. & Islam, K.M.Z. (2022). Bank efficiency and practice of earnings management: a study on listed commercial banks of Bangladesh. *Asian Journal of Accounting Research*, 7(2), 114-128. <https://doi.org/10.1108/AJAR-09-2020-0080>

Elghuweel, M.I., Ntim, C.G., Opong, K.K. and Avison, L. (2017). Corporate governance, Islamic governance and earnings management in Oman: A new empirical insights from a behavioural theoretical framework. *Journal of Accounting in Emerging Economies*, 7(2), 190-224. <https://doi.org/10.1108/JAEE-09-2015-0064>

- Elnahass, M., Tahir, M., Abdul Rahman Ahmed, N. and Salama, A. (2023). Internal governance mechanisms and information value of banks' earnings. *Journal of Accounting in Emerging Economies*. <https://doi.org/10.1108/JAEE-09-2020-0247>
- Fitri, V. & Siswantoro, D. (2022). Can corporate governance mechanisms reduce earnings-management practices in Islamic banks?. *Journal of Islamic Accounting and Business Research*, 13(1), 16-31. <https://doi.org/10.1108/JIABR-04-2019-0081>
- Ermawati, L., & Anggraini, N. (2020). Pengaruh Komisaris Independen dan Dewan Pengawas Syariah Terhadap Manajemen Laba (Studi Pada Bank Umum Syariah Di Indonesia). *Jurnal Akuntansi dan Keuangan Islam*, 01(01), 61–70.
- Financial Services Authority Regulation No. 33/POJK.04/2014 concerning on the Board of Directors and the Board of Commissioners of Listed Companies or Public Companies.
- Financial Services Authority Regulation No. 30/POJK.05/2014 concerning Good Corporate Governance for Financing Companies.
- Financial Services Authority Regulation No. 55/POJK.04/2015 concerning on the Establishment and Work Implementation Guidelines for the Audit Committee.
- Financial Services Authority Regulation No. 57/POJK.04/2017 concerning on the Implementation of Good Corporate Governance for Securities Companies Conducting Business as Underwriters and Broker-Dealers.
- Harun, M.S., Hussainey, K., Mohd Kharuddin, K.A. and Farooque, O.A. (2020). CSR disclosure, corporate governance and firm value: a study on GCC sharia banks. *International Journal of Accounting & Information Management*, 28(4), 607-638. <https://doi.org/10.1108/IJAIM-08-2019-0103>
- IFSB (2009), *Guiding principles on sharia governance systems for institutions offering sharia financial services*, sharia financial services board. www.isfb.org
- Jensen, M., & Meckling, W. (1976). Theory of the firm: Managerial behavior, agency costs, and ownership structure. In *The Economic Nature of the Firm: A Reader, Third Edition*. <https://doi.org/10.1017/CBO9780511817410.023>
- Khalil, A. & Boulila Taktak, N. (2020). The impact of the shariah board's characteristics on the financial soundness of sharia banks. *Journal of Sharia Accounting and Business Research*, 11(9), 1807-1825. <https://doi.org/10.1108/JIABR-08-2018-0127>
- Khan, I., Zahid, S.N. and Akhtar, T. (2018). Shari'ah governance and sharia banks performance: evidence from South Asia. *South Asian Journal of Management Sciences*, 12(2), 173-187. <http://dx.doi.org/10.21621/sajms.2018122.04>
- Khan, Imran & Zahid, Syeda Nitasha. (2020). The impact of shari' ah and corporate governance on sharia banks performance: evidence from Asia. *International Journal of Sharia and Middle Eastern Finance and Management*, 13(3), 483-501. doi: 10.1108/IMEFM-01-2019-0003
- Kolsi, M.C. & Grassa, R. (2017). Did corporate governance mechanisms affect earnings management? Further evidence from GCC Islamic banks". *International Journal of Islamic and Middle Eastern Finance and Management*, 10(1), 2-23. <https://doi.org/10.1108/IMEFM-07-2015-0076>
- Lassoued, M. (2018), Corporate governance and financial stability in sharia banking. *Managerial Finance*, 44(5), 524-539. <https://doi.org/10.1108/MF-12-2016-0370>
- Lu, Y., Abeysekera, I. and Cortese, C. (2015). Corporate social responsibility reporting quality, board characteristics and corporate social reputation: evidence from China. *Pacific Accounting Review*, 27(1), 95-118. <https://doi.org/10.1108/PAR-10-2012-0053>

- Mersni, H. & Ben Othman, H. (2016). The impact of corporate governance mechanisms on earnings management in Islamic banks in the Middle East region. *Journal of Islamic Accounting and Business Research*, 7(4), 318-348. <https://doi.org/10.1108/JIABR-11-2014-0039>
- Mahrani, M., & Soewarno, N. (2018). The effect of good corporate governance mechanism and corporate social responsibility on financial performance with earnings management as mediating variable. *Asian Journal of Accounting Research*. <https://doi.org/10.1108/ajar-06-2018-0008>
- Neves, M.E., Proença, C. and Cancela, B. (2023). Governance and social responsibility: what factors impact corporate performance in a small banking-oriented country?. *International Journal of Accounting & Information Management*, 31(1), 66-92. <https://doi.org/10.1108/IJAIM-08-2022-0166>
- Neves, M.E., Santos, A., Proença, C. and Pinho, C. (2022). The influence of corporate governance and corporate social responsibility on corporate performance: an Iberian panel data evidence, *EuroMed Journal of Business*. <https://doi.org/10.1108/EMJB-01-2022-0002>
- Novitasari, T., Hisamuddin, N., & Maharani, B. (2019). Pengaruh Tata Kelola Perusahaan dan Kualitas Auditor terhadap Manajemen Laba pada Bank Umum Syariah di Indonesia. *Jurnal Ekonomi Akuntansi dan Manajemen*, 18(2), 85. <https://doi.org/10.19184/jeam.v18i2.12410>
- Rahmadani, S., & Haryanto, H. (2018). Manajemen Laba: Peran Keaktifan Komite Audit dan Auditor Eksternal Big Four (Studi Empiris Pada Perusahaan Manufaktur Yang Terdaftar Di BEI 2013-2015). *Jurnal Akuntansi Aktual*, 5(1), 46-62. <https://doi.org/10.17977/um004v5i12018p046>
- Rini, N. (2019). The Implementation of Islamic Corporate Governance (ICG) on Sharia Banking in Indonesia. *TIJAB (The International Journal of Applied Business)*, 2(1), 29. <https://doi.org/10.20473/tijab.v2.i1.2018.29-38>
- Rezaee, Z. & Safarzadeh, M.H. (2023). Corporate governance and earnings quality: the behavioral theory of corporate governance (evidence from Iran). *Corporate Governance*, 23(1), 189-218. <https://doi.org/10.1108/CG-08-2021-0289>
- Scott, William R. (2015), *Financial Accounting Theory*, 7th Edition, Canada : Pearson Education Limited.
- Suryanto, T. (2017). Manajemen Laba Pada Bank Syariah Di Indonesia: Peran Komite Audit dan Dewan Pengawas Syariah. *Kinerja*, 18(1), 90. <https://doi.org/10.24002/kinerja.v18i1.520>
- Tanjung, M. (2020). A cross-firm analysis of corporate governance compliance and performance in Indonesia. *Managerial Auditing Journal*, 35(5), 621-643. <https://doi.org/10.1108/MAJ-06-2019-2328>
- Widyaningsih, H. (2017). Pengaruh Corporate Governance Terhadap Manajemen Laba. *Nominal, Barometer Riset Akuntansi dan Manajemen*, 6(2). <https://doi.org/10.21831/nominal.v6i2.16652>
- www.cnn.com
- Zhang, Y., Chong, G. and Jia, R. (2020). Fair value, corporate governance, social responsibility disclosure and banks' performance. *Review of Accounting and Finance*, 19(1), 30-47. <https://doi.org/10.1108/RAF-01-2018-0016>