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Perspectives of Earnings Management In Islamic Banking Institutions

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ABSTRACT : *This paper examines whether executives in Islamic banking institutions (IBIs) are more likely to use efficient earnings management (EM) or opportunistic EM. A sample of 81 Islamic banks in a 10 year financial period from 2000 to 2009 has been analyzed and fixed effect regression method is applied. We found a positive and significant relationship between EM proxy and future profitability, which means that EM tends toward efficient. This indicates that Islamic banks executives do not use their discretion to opportunistically manipulate their earnings. But they use their discretion to communicate inside information about IBIs profitability.Furthermore, this paper provides indirect evidence that Islamic ethical standards affect the likelihood of unethical opportunistic EM. Islamic ethics, it is established, prohibit such managerial behaviour as it violates the Islamic ethical axioms.*

KEY WORDS*: Efficient Earnings Management, Opportunistic Earnings Management, Islamic Ethical System, Islamic Banking Institutions.*

I. INTRODUCTION

The previous literature highlighted the fact that Islamic banks are using earnings management (EM) to avoid disclosure of losses (Faouzi and Zarai, 2012; Farooq et al, 2012). According to public opinion, EM occurs when executives use judgment in financial-reporting and in arranging transactions in order to modify financial reports to either mislead some stakeholders about the underlying economic performance of the firm or to influence contractual outcomes that depend on reported accounting figures (Healy and Wahlen, 1999).
Executives can thus use EM to convey some useful and superior information which they know about company performance to stockholders and other stakeholders. If this is the case, then, EM may not be harmful to shareholders and the public. On the other hand, executives may manage earnings for self-serving rather than for the benefits of the stakeholders. Frequent public scandals highlighted behaviour by corporate administrators that could be characterized as self-serving, immoral or even criminal[1]. Fear of disclosure and legal action helps moderate, in part, this kind of behaviour. However, an additional possible mechanism for control could be the ethical or moral environment in which economic agents operate (Grullon et al., 2009). This paper considers the hypothesis that cultural controls affect the probability of such ethically problematic managerial behaviour.More explicitly, this paper examines whether executives in Islamic banking institutions (IBIs) are more likely to use efficient EM or opportunistic EM. It examines indirectly the impact of Islamic ethical values on the class of EM. It begins with a review of prior studies on EM perspectives, the monitoring mechanisms that constrain such practices and the Islamic perception of EM practices. This review of the literature is carried out to produce a foundation for relating Islamic ethics and EM. This paper then develops the research hypotheses predicting EM perspectives and indirectly the relationship between Islamic ethical system. The research methods employed in the study are also discussed in Section Three. Finally, Section Four reports the findings of the study.

II. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

Perspectives of Earnings Management : Beneish (2001) suggested that EM should be observed from two perspectives the information perspective and the opportunistic perspective. Scott (2000) stated that there are two perspectives of EM: efficient EM and, opportunistic EM.EM literature revealed these two opposite perspectives as the opportunistic behaviour and the signaling mechanism behaviour.

Efficient Earnings Management Perspective :EM is efficient if managers use their discretion to communicate inside information about company profitability, which is yet to be reproduced in the historical cost-based earnings.The proponents of the information perspective argued that executives manage earnings to convey their private information about companies' prospects and thus it serves as a signaling mechanism. Executives may be

[1]Examples include Adelphia, Enron, Xerox, AOL Time Warner, WorldCom, Reliant Energy, Tyco International, and others (seeLawrence et al., 2009 for more accounting scandals examples).

able to affect the stock price by means of EM, thus making a smooth and growing earnings series over time. As such, EM can be a signal mechanism by which inside information about the company can be spread from the administration to the investors.A number of recent and ancient studies modeled some forms of information asymmetry and represented EM as coherent equilibrium behaviour (Ronen and Sadan, 1980; Demski et al.1984; Lambert, 1984; Dye, 1988; Bartov et al., 2002; Lev, 2003). These studies recognized information evidence of EM to facilitate efficient communication between executives and information users to improve the value relevance of financial reporting and to enhance investors' ability in estimating firm's future performance.

Furthermore, the information perspective suggests that EM is sometimes demanded by investors. In fact, Beidleman (1973) and Dye (1988) argued that investors will demand for EM for two reasons. First, executives can reduce the capital cost through a smoother more predictable income stream. Second, Dye (1988) states that a more stable income stream influences prospective investors' perceptions of the company value. As current shareholders will sell their stocks to the subsequent generation of future shareholders, executives will act on behalf of the current shareholders and has an incentive to manage earnings so as to maximize the selling price received by the existing shareholders. Chaney and Lewis (1995) found evidences that support this argument.Some studies found indication that EM is more efficient, rather than opportunistic. In fact, Subramanyam (1996) concluded that the behaviour of discretionary accruals is consistent with efficient EM because discretionary accruals have a significant positive relationship with future profitability. A number of other studies argued that EM may be beneficial since it potentially enhances the information value of earnings. Executives may exercise discretion over earnings to communicate inside information to stockholders and the public (Al Fayoumi et al, 2010). Subramanyam (1996) concluded that discretionary accruals have a positive and significant relationship with future profitability. This positive relationship describes the ability that discretionary accruals have to propagate information about a company's future profitability to the public and this is consistent with efficient EM. The implication of his finding is that execuyives discretionary behaviour through accruals increase earnings persistence and thus improve the capacity of current earnings in signaling future company's prospect. Siregar and Utama (2008) showed that discretionary accruals have a significant and positive relationship with forthcoming profitability. This result shows that the type of EM tends toward efficient EM.

Jiraporn et al. (2008) used the agency theory as a tool to differentiate between the opportunistic and beneficial uses of EM. The empirical evidence suggested that companies where EM occurs to a large (less) extent undergo less (more) agency costs. Moreover, a positive relation is documented between company value and the extent of EM. Taken together, the results revealed that EM is usually not detrimental.Scott (1997) pointed out that EM can be motivated by efficient contracting drives. Efficiency assumes that EM facilitate internal control and decision making, including monitoring executives, limit opportunism, diminish taxes, minimize costly debt covenant renegotiations, and reduce contracting costs. In the case of setting compensation contracts and lending contracts, owners or lenders will anticipate executives' incentives to manage earnings to transfer wealth among contracted parties, and they consider the effects in the amount of contracts they offer against any possible executive opportunism.Therefore, EM as such can be a tool used by executives to reinforce contracting efficiency. Nevertheless, a few researchers addressed this issue. In fact, Christie and Zimmerman (1994) investigated the frequency of acquired companies engage in income increasing EM to maximize reported earnings. They found that those income increasing discretions are not used to avoid potential takeover and therefore concluded that EM for contracting purpose is not as opportunistic as originally thought.Tucker and Zarowin (2006) found strong results that changes in the current stock price of higher-smoothing companies contains more information about their future earnings than does the changes in the stock price of lower-smoothing firms. Their results are generally consistent with Xue (2004) and suggested that EM is a viable instrument to disseminate the company's future prospects to the investors.

Opportunistic Earnings Management Perspective

EM is opportunistic if executives use their discretion to maximize their personal utility instead of communicating inside information about firm profitability (Subramanyam, 1996; Siregar and Utama, 2008). The perspective of opportunistic behaviour considers that executives use information asymmetry between insiders and outsiders to maximize their utility in dealing with compensation contracts, debt contracts and regulations. Investors are thereby deceived by the unreliable reported information. Watts and Zimmerman (1978) used opportunism attitude in explaining executives' discretionary behaviour over reported earnings to influence contractual outcomes and so affect capital transfers. Most researches which suggest parallel lines of arguments are Guay et al. (1996), and Bradshaw *et al.* (2001).

The opportunistic EM shows the executives' desire to affect wealth transfer among related contracting parties and themselves. Positive Accounting Theory (PAT) established that investors expect executives to exercise discretion toward their individual gain and take this into consideration when they offer executives with compensation plans. When the value of management compensation contains the expected managerial discretions, the compensation contracts increase managerial expectancy and accordingly increases the level of discretions itself. According to the agency theory, executives are more likely to maximize earnings when their ownership concentration is low, they could make income-increasing EM for the reason that their compensation is tied to earnings.There is a public awareness that EM is employed opportunistically by companies executives for their individual gain rather than for the benefit of the shareholders. This misalignment of executives' and shareholders' motives may perhaps induce executives to use the flexibility provided by the accounting standards to manage income opportunistically, in this manner creating misrepresentations in the reported earnings.

A lot of studies found evidence consistent with the opportunistic EM. For instance, Gaver et al. (1995) found evidence that accruals management focuses on the manipulation of bonus income. Balsam et al. (2002) examined a negative relationship between unexpected discretionary accruals and stock earnings around the earnings announcement date, and showed that the market considers discretionary accruals as opportunistic.Burgstahler and Dichev (1997) concluded that executives engage in EM to avoid reporting losses or earnings decline. Schipper (1989) and Healy and Wahlen (1999) found that companies may manage earnings to achieve more immediate earnings objectives, such as avoiding current earnings decreases or losses. This behaviour is not at all informative and may be thought as opportunistic.

Islamic Perception of Earnings Management Practices

Healy and Wahlen (1999) define EM as managers using judgment in financial reporting and structuring transactions to modify financial reports to either mislead some stakeholders about the underlying economic performance of the firm or to influence the contractual outcomes that depend on reported accounting figures. The expressions "*to mislead some stakeholders*" and "*to influence the contractual outcomes*" stress the opportunistic behaviour of managers. Such behaviours are immoral and prohibited in Islam. Islam encourages individuals to be involved in business but requires the individual Muslims to relate his conduct to his existence as recommended by Allah, i.e., to worship Allah[2].The Quran[3] shows the role of mankind in the universe; he is made to be the vicegerent of Allah in the earth and therefore all possessions held in this world are detained in trust from Allah (Gambling and Karim 1991 ; Hamid et al., 1993). It is thus analogous to the agency principle, here Allah is the principal and the disciples are the agents. However this agency relationship would not contain any elements of selfishness as the agent is seen here to be worshipping his principal, Allah, and therefore having faith and complete trust in the principal.TheQuran evidently permits

tradeandwealthaccumulation,moreover,itsetshighvaluesonwealthwhichitcallsas'thebountyofAllah'[4]and'gooddeeds'[5] .Itfurther conducts

[2]**Quran**, Surah 51, Al-Thariat, verse 56, "And I did not create the jinn and mankind except to worship Me".

[3]**Quran**, Surah 2, Al-Baqara, verse 30, "And [mention, O Muhammad], when your Lord said to the angels, "Indeed, I will make upon the earth a successive authority." They said, "Will You place upon it one who causes corruption therein and sheds blood, while we declare Your praise and sanctify You?" Allah said, "Indeed, I know that which you do not know"".

[4] **Quran**, Surah 62, Al-Jomoaa, verse 10, "And when the prayer has been concluded, disperse within the land and seek from the bounty of Allah, and remember Allah often that you may succeed".

Quran, Surah 27, An-Naml, verse 16, "And Solomon inherited David. He said, "O people, we have been taught the language of birds, and we have been given from all things. Indeed, this is evident bounty".

Quran, Surah 30, Ar-Roum, verse 23," And of His signs is your sleep by night and day and your seeking of His bounty. Indeed in that are signs for a people who listen".

[5]**Quran**, Surah 2, Al-Baqara, verse 18, "Deaf, dumb and blind - so they will not return [to the right path]".

Quran, Surah 2, Al-Baqara, verse 215, "They ask you, [O Muhammad], what they should spend. Say,"Whatever you spend of good is [to be] for parents and relatives and orphans and the needy and the traveler. And whatever you do of good - indeed, Allah is Knowing of it."

Quran, Surah 2, Al-Baqara, verse 272, "Not upon you, [O Muhammad], is [responsibility for] their guidance, but Allah guides whom He wills. And whatever good you [believers] spend is for yourselves, and you do not spend except seeking the countenance of Allah. And whatever you spend of good - it will be fully repaid to you, and you will not be wronged".

Quran, Surah 38, Saad, verse 32,"And he said, "Indeed, I gave preference to the love of good [things] over the remembrance of my Lord until the sun disappeared into the curtain [of darkness]".

humankindtoconcludethatwealth,throughtradesandbusinesses,accountsforpeaceandprosperity[6].TheQuranalsowarns humankindofthe consequence ofthe misuse ofthewealth[7].Thefundamentalweaknessofmanasdepictedbythe Quranishispettinessandnarrownessofmind(Rahman, 1980).Thisunstablehumankind behaviour iswelldescribedintheQuran. Man,byhisnature,isveryimpatient[8]andhasbeen filled with voracity andselfishness[9].Itisthis voracity andselfishnessthatmakeshimimpatientanddriveshimintoprideand complete despair.TheQuran,therefore, condemns pride,self-righteousness, desperateness,and hopelessness[10].

TheQuran provides a remedying forsuch disease.It urges Muslimsto follow thelawsetoutin*Fiqh Al-Muamalat*(GamblingandKarim,1991). This*Fiqh*branchspecificallyprohibitsunclear,unfair,unjust,and deceitful transactions(Hamidetal.,1993;Beekun,1997).

In book.3,paper604of*Sahih*[11]*Muslim*[12], there is a Hadithanalogyofbusinesstransactionas "*Whenyouenterintoatransaction,say:Thereshouldbenoattempttodeceive*".Siddiqi(1977), elucidating thatallbusinesstransactionsshouldbebasedonthe major principleofmutual cooperation forthegoodcause. It stresses thatanydeviationfromthis rigorous principleare driven bythe thirst formoneyand wrong desireto accumulate prestige.Such detrimental behaviour is in Islam expected fromhypocrites.*Sahih Al-Bukhari*[13]and*Muslim*citesthe*Shari'ah's*definitionofahypocriteashavingthree features Prophet Mohammed (PBUH)[14] said:

[6]**Quran**, Surah 106, Quraysh, verse 1-4,"For the accustomed security of the Quraysh -(2) Their accustomed security [in] the caravan of winter and summer - (3) Let them worship the Lord of this House, (4) Who has fed them, [saving them] from hunger and made them safe, [saving them] from fear".

[7]**Quran**, Surah 4, An-Nisaa, verse 77,"Have you not seen those who were told, "Restrain your hands [from fighting] and establish prayer and give zakah"? But then when fighting was ordained for them, at once a party of them feared men as they fear Allah or with [even] greater *fear. They said, "Our Lord, why have You decreed upon us fighting? If only You had postponed [it for] us for a short time." Say, The enjoyment of this world is little, and the Hereafter is better for he who fears Allah. And injustice will not be done to you, [even] as much as a thread [inside a date seed]*".

Quran, Surah 40, Ghafir verse 39,*" O my people, this worldly life is only [temporary] enjoyment, and indeed, the Hereafter - that is the home of [permanent] settlement".*

Quran, Surah 42, Al-Shuraa, verse 36, *"So whatever thing you have been given - it is but [for] enjoyment of the worldly life. But what is with Allah is better and more lasting for those who have believed and upon their Lord rely".*

[8]***Quran***, Surah 70, Al- Ma'aarij, verse 19, *"Indeed, mankind was created anxious".*

[9]***Quran***, Surah 4, An-Nisaa, verse 128, *"And if a woman fears from her husband contempt or evasion, there is no sin upon them if they make terms of settlement between them - and settlement is best. And present in [human] souls is stinginess. But if you do good and fear Allah - then indeed Allah is ever, with what you do, Acquainted".*

[10]***Quran***, Surah 12, Yusof, verse 87, *"O my sons, go and find out about Joseph and his brother and despair not of relief from Allah. Indeed, no one despairs of relief from Allah except the disbelieving people".*

Quran, Surah 29, Al-Ankabut, verse 33, *"And when Our messengers came to Lot, he was distressed for them and felt for them great discomfort. They said, "Fear not, nor grieve. Indeed, we will save you and your family, except your wife; she is to be of those who remain behind".*

Quran, Surah 15, Al-Hijr, verse 50, *"And that it is My punishment which is the painful punishment".*

Quran, Surah 39, Az-Zomar, verse 53, *"Say, "O My servants who have transgressed against themselves [by sinning], do not despair of the mercy of Allah. Indeed, Allah forgives all sins. Indeed, it is He who is the Forgiving, the Merciful"".*

[11]*Sahih* (ARABIC: صحيح, *ṣaḥīḥ*) translates as *authentic* or *correct*.

[12]*Sahih Muslim* (ARABIC: صحيح مسلم, *ṣaḥīḥ Muslim*, full title *Al-Musnadu Al-Sahihu bi NaklilAdli*: المسند الصحيح بنقل العدل) is one of the six major hadith collections. It is the second most authentic hadith collection after *Sahih Al-Bukhari*, and is highly acclaimed by Sunni Muslims. It was collected by Abul-Hussein Muslim Ibn Al-HajjajIbn Muslim Al-Kushari An-Naisabouri, also known as Imam Muslim.

[13]*Sahih Al-Bukhari*(ARABI: صحيح البخاري*Ṣaḥīḥ Al-Bukhārī*) is one of the six major hadith collections. Sunni Muslims view this as one of the three most trusted collections of hadith along with *Sahih Muslim* and *Muwatta Al-Imam Malik*. In some circles, it is considered the most authentic book after the Holy Quran.

[14] Peace Be Upon Hima phrase that we Muslims regularly say after saying or listening the name of the Prophet Muhammed. It just as a sign of respect for our beloved Prophet. It is not that we are not sure that whether he is in heaven or not. This phrase means "May Allah's blessing and peace be upon him". Being an passionate lover of our prophet, every single Muslim is supposed to say *"SallallahuAlayhiWa Salaam"* (abrevated SAWS: In Arabicصلى الله عليه وسلم) the moment he hears to the word "Muhammad".

"*…Whenhetalkshelies,whenhemakesapromiseheactscontrary,andwhensomethingisentrustedtohimheembezzlesit*". Alternative *Hadith* quotes anothercharacteristic Prophet (PBUH) said: "*….whenhecontendsherevile*s".*Hadith*further citestheProphet (PBUH) categorizing lyingandgivingfalseevidenceasoneofthemajorsins.An individual whogoesonlyingis suchasayingof the Prophet is called aliarandwillbecondemned.

Executives behavingopportunistically managed earnings canbe regarded asputtingself-interestaboveeverything new.Theyhavethe trend toabusewealthand removal wealthto favored persons orgroupsofstakeholdersleadingtoeconomic abuse.By practicing opportunistic EM, executives modify financialreportstoeithermisleadusersoffinancialreportsorinfluencecontractingparties.ThisisMuslims,believethatgooddeedsarerewardedinheavenandbaddeedsarepunishedinhelltantamounttoprovidingfalseevidenceortakingafalse promise.Such behaviours usually arise fromadesireto amass wealthandprestige.

Islam requires us to support ethical business practices. The Islamic ethical system is based on the following key factors:

- Actionsanddecisionsare valued basedon person's intention-goodintentionthatisfollowedbygood deed or decisionisworshipandtheendsdonot defend themeans.
- Freewillbut persons areaccountableforall deedsanddecisions.
- Islampreachesethicalbusiness transactions andthus selfishness hasnoplaceinIslam(Beekun,1997).

Therefore Islamicethical system requireMuslimstoconsidertheirworkas reverence andbelievethatitisentrusteduponthemtobe ethical. TheIslamicethicalsystemisgroundedinfivekeyaxioms. Opportunistic EM isnotpermissibleinIslamasitcontradictsthefivekeyaxiomsofIslamicethics.By practicing EM,themanagercontravenes

- ***theunityaxiom****as his businesspractice(i.e.,self-serving)contradicts his religiouspractice(i.e.,communalserving),*
- ***theequilibrium axiom****ashecreatesasocialredistributionofwealth,*
- ***thefreewillaxiom****ashemayhavetomanageearningsagainst his ownwill(e.g.,ifinstructedtodosoby his superior),*
- ***theresponsibilityaxiom****asthemanagersnormallydonotdisclosetheactofEM,and*
- ***thebenevolenceaxiom*** *as hedoesnotconsiderallpartiesequally.*

Thus,Islamcondemns opportunistic EMandaMuslimshouldnotpractice opportunistic EM.IndividualsbasedonhisfreedommaypracticeEMbutheisanswerabletoAllahinthe Day of Judgment.

Islamic *Shari'ah* , in this sense, establishes the ethical codes for appropriate behaviour and accountability in Islamic societies. IBIs adopt these ethical codes for their strategic choices of products and services, how to deliver these products and services, how to finance their businesses, how to manage their day-today business practices and in what way they should be accountable to their stakeholders.IBIs are likely to adopt and keep higher standards of business ethics in the running of their business and their accountability to the stakeholders. As the choice for reaching *Shari'ah* status lies with senior executive, they are likely to have higher moral values and are less likely to have the need to hide inferior business practices. Therefore, with better business practices and higher standards of morality, IBIs will have a lesser need for manipulating their results through opportunistic EM. This behaviour is boosted by the moral requirement to keep higher standards of accountability in their reporting practices.

IBIs are expected to be free from unethical or immoral transactions management of earnings and insider trading which may have a divergent effect on investment activities. Islamic ethical values ensure that no one suffers from any kind of injustice or loss, and exposes directors to the importance of disclosing fair and reliable information in the IBIs' annual report. This is not a strong feature of the conventional banking system, which permits social inequity through unequal sharing of wealth, such as liberal profit based compensation packages to senior managers (Naughton and Naughton, 2000). In addition, based on the full disclosure model, IBIs must disclose all the necessary information about their activities, although the information being revealed is unfavorable (Maali et al, 2006). The reason for full disclosure is to help banks meet the anticipations of the stakeholders; the individuals and institutions that are expected to invest in IBIs (Baydoun and Willet, 1997; 2000). As annual reports are one of the main modes of information for classifying firms into *Shari'ah* -Approved firms, firms are likely to disclose more information regarding their primary activities in these reports. They will also disclose information that shows that their activities do not conflict with Islamic principles. In the case of the IBIs that are involved in certain banned activities for example interest-bearing loans, the IBI will disclose more information regarding the non-permissible elements to demonstrate whether or not they are within the benchmarks (Sulaiman, 2003).

Therefore, if such accountability and full disclosure concepts are required in Islam, then the emphasis of Islamic corporate reporting practices would be more extensive and more reliable than conventional reporting practices (Abdul-Rahman, 2012).With reference to above analysis, we expect that IBIs are more likely to manage earnings efficiently than opportunistically. The following hypothesis can thus be formulated (alternative form).

H.1*.*Earnings Management tends toward efficient in IBIs

III. METHODOLOGICAL ISSUES AND ANALYTICAL MODELS

Sample and Data

The sample period is from the year 2000 to the year2009. The data are obtained from the Islamic Banks and Financial Institutions Information (IBIS) Database[15], which contains up to ten years of historical financial data from annual reports of IBIs around the world. To be included in the sample, a bank must have income statement and balance sheet information for at least two consecutive years[16].Some data, especially those of the operating cash flows variable, were not available in the IBIS database, as the cash flow statements are lacking. So we were obliged to collect these data from the Islamic banks financial reports when they were disclosed on the banks' websites.The final sample had 81 Islamic banks consisting of 503bank-year observations, across 22 countries and for the fiscal years 2000 to 2009. We investigate two earnings variables; one is earnings change and the other is earnings level. For the earnings change variable, there are 227 bank-year observations and for the earnings level variable, there are 276 bank-year observations. Table.1 reports numbers of banks according to the country.

[Insert Table.1]

Analytical Model

Subramanyam (1996) and Siregar and Utama (2008) and Rezaei and Roshani (2012) demonstrate that discretionary accruals have the ability to signal levels of future profitability. They test whether or not the EM has an effect on future profitability, by identifying efficient or opportunistic EM. If EM is efficient, then the EM proxy has a significant positive relationship with future profitability. If it is opportunistic, then EMproxy has a significant negative relationship or insignificant relationship with future profitability.Based on these previous research, we test whether EM is efficient or opportunistic by examining EM proxy's ability to signal future profitability. If EM is efficient, then its proxy will have a significant positive relationship with future profitability. If opportunistic, the EM proxy will have a significant negative relationship or insignificant relationship with future profitability. The following regression model is thus used for the test of hypothesis $H_{.1}$:

$$Y_{it+1} = \alpha + \beta EM_{it} + \varepsilon \qquad (1)$$

Where:

- Y_{it+1}: Bank i future profitability,
- EM_{it} : Bank i earningsmanagement proxy.

To test this model, the EM coefficient is considered and if the type of EM is efficient, the coefficient (β) will be positive. Otherwise, it will be either zero or negative.

Variables Measurement

Dependent variable: Future profitability

As highlighted above, the dependent variable in the models used for testing hypotheses is future profitability. Following previous studies (Subramanyam, 1996; Krishnan 2003; Siregar and Utama, 2008), we measure future profitability using the following variable: One-year-ahead cash flows from operation(CFO_{t+1}). This variable is deflated by beginning of the year total assets.

Independent variable: EM

The method that most often used to evaluate the level of earning management done by a company is a discretionary accrual method. In this section, a dummy variable is used to measure EM, which assigned the value of 1 if scaled earnings or change in scaled earnings is positive and 0 otherwise. For the computation of the earnings or the changes in earnings, we use net distributable profit divided by the beginning of the total assets. Specifically, the level of earnings is equal to Net earnings $_t$ / Total assets $_{(t-1)}$, while the change in earnings is(Net earnings $_t$- Net earnings$_{(t-1)}$/ Total assets $_{(t-2)}$).

[15] Consult www.**ibis**online.net

[16] since we scale earnings data by lagged assets

IV. RESULTS AND DISCUSSIONS

Results

Tables 2 and 3 below present descriptive statistics for the dependent and independent variable used in the regression model.

[Insert Table.2]

*Table.2*displays the descriptive statistics of scaled earnings levels in Islamic banks from the year 2000 to the year 2009. There are 276 bank-year observations in the sample. The mode of scaled earnings in the total sample is 1 indicating that most Islamic banks exhibit positive scaled earnings.Moreover, the positive median (0.037171) indicates that cash flow from operations is positive for most bank-year observations. This measure also exhibits substantial skewness (i.e., a large mean relative to the median), consistent with the sample containing a small number of very large cash flow from operation.It is worth noting that cash flows from operation variable shows a relatively high standard deviation (σ= 9.9152), indicating that there is sufficient variation in this variable. That is, it may be said that the sample does not exhibit abnormal properties. Other important statistics in this table is Jarque-Bera statistics. This statistics can be used to test a null hypothesis where each variable is considered to have a normal distribution. The results in *Table.2*show that scaled earnings levels variable and cash flows from operations variable do not have a normal distribution, since the null hypothesis that each variable has a normal distribution is rejected based on a p-value = 0.0000.Table.3 depicts the summary statistics the scaled earnings changes regression model, which are based on all 227 Banks-year observations.

[Insert Table.3]

The mode value of scaled earnings changes is 1. This indicates that most banks in the sample had succeeded in avoiding earnings decrease. The mean (median) value of bank one-year-ahead cash flows from operation is 0.174480 (0.036652).Since the mean is slightly larger than the median the cash flow distribution is slightly skewed in a positive direction. The Jarque-Bera statistics values show that scaled earnings changes variable and bank cash flows from operation variable do not have a normal distribution, since the null hypothesis that each variable has a normal distribution is rejected based on a p-value = 0.0000.

Table.4 presents the results of the estimate of regression equation (1).

[Insert Table.4]

Panel A depicts the main results of the Scaled Earnings Levels Regression Analysis. Our model is significant at the 5% level (F-value= 4.643519)[17], with R² of 1.67%[18] and adjusted-R² of 1.31%. The SEL coefficient is positive and significant at the level of 5%. This result indicates that managers apply efficient EM in Islamic banks. This result is consistent with our expectations and provides support to Hypothesis $\boldsymbol{H_{.1}}$.Panel B present inconsistent results with our expectation and therefore the hypothesis is rejected. In fact, the F-statistic is non-significant (F-value= 1.992006; p>0.10), we just conclude that the overall model is not significant and there is no relationship what's over. This result is not, however, surprising; it corroborates Faouzi and Zarai (2012) findingsthat Islamic banks are not committed to managing earnings to avoid earnings decreases. EM in IBIs is just for showing positive earnings.

Robustness Tests

A number of additional tests are carried out to examine the robustness of the regression results. First, to ensure that these results are not driven by the proxy used for future profitability, CFO_{t+1} is replaced with two following variables[19]:

- OI_{t+1}= One-year-ahead operation income
- NI_{t+1}= One-year-ahead net income

All variables are scaled by the beginning of the year total assets. Therefore, research model is re-estimated with two dependent variables separately and results of estimation are stated according to these two situations.

Table.5 show descriptive statistics of the variables used in the regression model. The first regression using OI_{t+1} as

[17]The F-statistic must be interpreted with its p-value. The F-statistics tells us whether our overall regression is statistically significant. If the p-value is less than .05, as in our case, it supports this. After that we can look at the individual regression coefficients of each independent variable to determine which variable is statistically significant. Although the F-statistic is significant, it doesn't mean that all variables would be significant - it just measures the joint effect of those variables.

[18]"R^2 can be low, while meaningful relationships may still exist. The R^2 statistic can be small, yet one or more of the regression coefficient p-values can be statistically significant. Such a relationship between predictors and the response may be very important, even though it may not explain a large amount of variation in the response"(James and Keith , 2002).

[19]Previous studies use indeed four proxies of future profitability. Apart from these three variables, they use also one-year-ahead nondiscretionary net income variable (net income minus discretionary accruals). Wedo not use this variable since we have not adopted the accruals approach in our research.

dependent variableis estimated on 397 bank-year observations. The second regression with NI_{t+1} as dependent is estimated on 398 bank-year observations. The mode value of the predictor (SEL) equal 1 in both regressions denoting that most Islamic banks exhibit positive scaled earnings. The Jarque-Bera statistics values show that all variables do not have a normal distribution, since the null hypothesis that each variable has a normal distribution is rejected based on a p-value = 0.0000.

[Insert Table.5]

The results of the regression analysis as shown in *Table.6* suggest that the results remain qualitatively the same and all the above conclusions are confirmed. The models are highly significant (F-value= 4.471913 and 34.43852 respectively). Also in these two additional cases, the results do not change qualitatively, hence, they confirm the robustness of the conclusions.

[Insert Table.6]

Taken together, *Table.4* and *Table.6*, display positive and highly significant coefficient of the SEL variable for each of the three dependent variables. Thus this study provides evidence that EM is efficient, rather than opportunistic; where EM proxy has a significant positive relationship with future profitability proxies. This positive relationship describes the ability that EM practices have to communicate information about an IBI's future profitability to the public and this is consistent with efficient EM. The implication of his finding is that executives discretionary behaviours increase earnings persistence, and thus improve the ability of current earnings in signaling future bank's prospect. Krishnan (2003), following Subramanyam (1996), also finds consistent evidence. Siregar and Utama (2008) show that the EM proxy has a significant and positive relationship with future profitability. Overall, these results indicate that the type of EM tends toward efficient EM. They are generally consistent with our expectations and suggest that EM as practiced in IBIs is a viable tool to communicate the bank's future prospects to the shareholders.

V. DISCUSSION

The above explained findings denote that IBIs executives have made a conscious choice that their banks should be *Shari'ah* compliant. This choice reflects the ethical principles of management. In fact, according to Jones (1995), and Lee and Mitchell 1994), through a process of self-selection, moral people are more likely to join or work in moral companies because such persons will find the standards of the company compatible with their own standards. Thus, executives with higher moral standards are likely to join a *Shari'ah* company or choose to make their company *Shari'ah* compliant. These ethical values are likely to be reflected in their managerial reporting practices. In other words, since executives of IBIs are expected to have higher moral standards, they are less expected to be involved in inferior business practices and manipulate the accounts of their companies in the event of poor performance. Likewise, with regards to accounting, it is empirically verified that IBIs have higher-quality accounting information.The concepts developed in the previous sections denote that Islamic ethics stress transparency in business transactions. Ali and Al-Owaihan (2008) asserted that transparency is prescribed as an ethical duty in Islam. Basically, transparency means that financial transactions must be conducted in such a way that all parties are clear about the important details of the transactions (Abdul Rahman, 2012). It is important to avoid all causes of disputes, clashes or damages to any party. In Islam, executives of IBIs are trustees of Allah on the earth (*Tawhid* Axiom).

As the trustees, executives must be responsible for each position that they are managing for Allah and at last be fully accountable to Allah for their actions (Responsibility Axiom). In discharging their accountability to Allah and society, the executives of IBIs need to provide corporate reports as stated by the full disclosure concept. The concept requires executives to disclose all the necessary information about their activities, even when the possibility of such information may be unfavorable for the corporations (Equilibrium Axiom) (Maali et al., 2006). Haniffa and Hudaib (2002) highlighted that the full disclosure of relevant and reliable information is essential in Islam because it helps users, especially those from outside the firm, make both economic and religious decisions. The disclosure also assists Muslim investors in recognizing *Shari'ah*-compliant investment and hence increasing their level of confidence when making investment decisions.Regardless of the approaches of opportunistic EM and their determinants, Shari'ah prohibits such practices. Opportunistic EM practices seem to violate the concept of justice in Islam. *Shari'ah*bans business transactions carried out by illicit ways.Indeed, we argue here that the Islamic religion has a role in determining and enforcing ethical behaviour such as truthfulness, honesty and fairness in business settings. Thus, Islamic religious ethical standards are accepted as one of the monitoring mechanisms for diminishing opportunistic behaviour among executives, and consequently diminishing managerial motives to opportunistically manage earnings either via discretionary accounting accruals or real economic decisions. This, in turn augment the reliability of financial information and the integrity of the financial reporting process (Watts and

Zimmerman, 1990).Former research seems to support these findings (Dyreng et al., 2010; Grullon et al., 2010; McGuire et al., 2010). In fact, Grullon et al. (2010) found that religious ethical codes diminish unethical corporate behaviour. In particular, they documented that religion-influenced companies are less likely to backdate options, practice aggressive EM, grant large compensation packages to their executives, among others. Their results suggest that religious ethical codes play an important role in deterring immoral corporate behaviour.Many other studies noted that unethical business activities such as financial fraud, financial restatement, and opportunistic EM can be attributed to the ethical failures in company financial reporting (Brief, et al., 1996; Rockness and Rockness, 2005; Staubus, 2005). Ethics play an central role in reducing agency costs (Noreen, 1988). They act as a monitoring mechanism in constraining opportunistic behaviour among executives, and accordingly diminish the executives' incentives to manage accounting figures. This, in turn improves the reliability of financial information as well as the integrity of the financial reporting process.It has been admitted that religion is a the source of ethical norms. A number of scholars highlight the role of religion in endorsing ethical behaviour in business organizations (Conroy and Emerson, 2004; Longenecker, McKinney, and Moore, 2004; Weaver and Agle, 2002). For instance, Noreen (1988) examined the boundaries of human behaviour in agency settings and argued that agency contracts by itself cannot limit opportunistic behaviour. He suggested that religion works as one of the enforcement devices for good ethical behaviour in business organizations.

Empirical evidence looks to support this perspective. For instance, McGuire et al. (2010) found that religion-influenced companies have a lower probability of accounting restatement and accounting irregularities that result in shareholder complaints. In a similar way, Dyreng et al. (2010) report that religion-influenced companies have higher accruals quality and a lower risk of fraudulent accounting. The results suggested that religion is a key social tool for controlling executives’ behaviour, which in turn diminishes unethical corporate practices.
In the same line, scholars in sociology and business ethics indicated that religion has a intense impact on executives’ standards, behaviours and business ethics, whichever directly or indirectly. In trying to elucidate why religion may affect moral attitudes, Weaver and Agle (2002) argued that religion offers role expectations which contribute to an individual’s self-identity as an believer in a specific religion. When religion is a crucial part of an individual’s self-identity, withdrawals from religious role-expectations could engender higher levels of intellectual and emotional discomfort, which encourages believers to keep their behaviour consistent with religious role-expectations. Thus, they asserted that the more prominent an individual’s religious identity, the more likely an individual is to act in line with the role expectations of his religion.Furthermore, Hirschi and Stark (1969) affirmed that religion constrains unethical behaviour through its sanctioning system that legitimizes and reinforces social standards. Conroy and Emerson (2004) also argued that believers in Allah are less likely to act unethically because of the fear of being “caught” by Allah and being punished.

Dyreng et al. (2010) examined whether religious social standards are associated with aggressive financial reporting. They contended that religious social standards might influence executive reporting behaviour in two ways. First, religious persons are in general characterized as risk averse (Hillary and Hui, 2009). Therefore, if a corporation is located in regions where religious social standards are more prevalent, executives of such corporation become more risk averse and more subtle to litigation risk when making a financial reporting decision. Second, religious social standards may perhaps invoke reminders of personal standards. Schelling (1968) and Durant (1950) argued that religion is the basis of civilized behaviour in contemporary societies since religion provides the rudimentary premises for ethics and accountability. Indeed, we argue in this paper that religion had a role in determining and enforcing ethical behaviour such as truthfulness, honesty and fairness. Islamic *Shari'ah*, in this sense, introduces the moral codes for right behaviour and accountability in Islamic societies. In the case of IBIs, since entry into the category is via attaining certain criterions of good conduct, this paper establishes that they are likely to accept and keep higher standards of business ethics in the management of their business and their accountability to the stakeholders. The IBIs are directed by these moral codes in their strategic choices of which products and services to handle, how to provide these products and services, how to finance their transactions, how to manage their daily business practices and in what way they would be accountable to their various stakeholders.

VI. CONCLUSION

This paper examines whether managers in IBIs are more likely to use efficient EM or not. By the same, it tries to acquire an understanding of whether the Islamic ethical framework is an effective monitoring tool in mitigating executive opportunistic behaviour in managing results, thereby enhancing the quality of reported earnings.We first formulate a conceptual framework for understanding EM fundamental determinants based on market deficiency of information asymmetry and agency conflicts.

We then highlight the arguments of opportunistic behaviour and signaling mechanism in order to address that EM is not necessarily bad; it can be a tool that enhances communication with external parties and improves internal efficiency. Then, we review diverse incentives that drive EM and we discuss the linkage between efficient contracting, opportunistic behaviour and Islamic ethical system. Finally, we have put the hypothesis that EM in these institutions tends toward being efficient.A sample of 81 Islamic banks in a 10 year financial period from 2000 to 2009 has been analyzed and fixed effect regression method is applied. We found a positive and significant relationship between EM proxy and future profitability, which means that EM tends toward efficient. This indicates that Islamic banks executives do not use their discretion to opportunistically manipulate their earnings. But they use their discretion to communicate inside information about IBI profitability. This enables the executives to propagate the future prospectuses to the shareholder and to convey their private information about IBIs' prospects. Thus EM serves as a signaling mechanism. As such, it is a signal mechanism through which privileged information about the IBIs is communicated from the executive to the shareholders.

Furthermore, this paper provides indirect evidence that Islamic ethical standards affect the likelihood of unethical opportunistic EM. Islamic ethics, it is established, prohibit such managerial behaviour as it violates the Islamic ethical axioms. According to these axioms, executives are not permitted to abuseother contracting parties nor manage trusts given to them through deception, dishonesty, or falsification. Therefore, EM as such is a tool used by IBIs executives to support contracting efficiency. In general, the findings are in accordance with those of prior studies that identify religion as an enforcement tool for ethical behaviour in business organizations by diminishing agency problems (Longenecker et al., 2004; Noreen, 1988; Weaver and Agle, 2002), and as a contributing element to a higher quality of financial reporting (Dyreng et al., 2010; McGuire et al., 2010). Overall, given the solid ethical codes in a well-defined institutional setting, religious ethical standards are able to provide a more effective monitoring tool in controlling unethical corporate behaviour such as opportunistic EM than in a conventional market setting.
It is noted, however, that exploratory survey in this paper has focused largely on net distributable profit to shareholders and other shareholdersrelated performance indicators. The Findings provide evidence that EM, on average, not detrimental to shareholders; is to be driven by efficient contracting purposes. Apart from shareholders in Islamic banks there is also depositors or investment account holders who represent important stakeholders in IBIs. Our investigation focusing on profit distributable to shareholders cannot provide indications about the impact of EM on the interest of these IBIs distinctive stakeholders. In fact, EM which has been verified to be beneficent to shareholders can however be detrimental of IAHs. It is thus worth to investigate the impact EM practices on IAHs' interests. This issue is the main objective for future researches.

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Table.1: Sample Country Distribution

Country	Frequency	Percent
ALBANIA	1	1.24%
AZERBIJAN	1	1.24%
BAHRAIN	16	19.75%
BANGLADESH	1	1.24%
INDONESIA	1	1.24%
IRAN	6	7.41%
IRAQ	1	1.24%
JORDAN	2	2.47%
KINGDOM OF SAUDI ARABIA	2	2.47%
KUWAIT	3	4.94%
MALAYSIA	11	13.58%
PAKISTAN	5	6.17%
PALESTINE	1	1.24%
QATAR	5	4.94%
SOUTH AFRICA	1	1.24%
SUDAN	8	9.88%
SYRIA	2	2.47%
TUNISIA	1	1.24%
TURKEY	3	3.70%
UAE	4	4.94%
UNITED KINGDOM	4	4.94%
YEMEN	2	2.47%
Total	81	100%

Table.2 Descriptive Statistics for Scaled Earnings Levels Regression Models

	N	Mean	Mode	Median	Std. Dev.	Jarque-Bera	Prob
Scaled Earnings Levels (SEL)	276	-	1	-	0.276887	996.4132	0.00000
One-year-ahead cash flows from operation (CFO_{t+1})	276	4.516941	-	0.037171	69.91517	351619.3	0.00000

Table.3 Descriptive Statistics for Scaled Earnings Changes Regression Models

	N	Mean	Mode	Median	Std. Dev.	Jarque-Bera	Prob
Scaled Earnings Changes (SEC)	227	-	1	-	0.477394	39.40165	0.00000
One-year-ahead cash flows from operation (CFO_{t+1})	227	0.174480	-	0.036652	0.769750	42221.00	0.00000

Table.4 Results of Regression Analysis from Equation (1)

Panel A: Results of Scaled Earnings Levels Regression Analysis			
Independent Variables	***One-year-ahead cash flows from operation (CFO_{t+1})***		
	Coef.	**t-Stat**	**p-Value**
N	276	276	276
Intercept	-25.3629	-1.75126	0.0810
Scaled Earnings Level (SEL)	32.59622	2.154883	0.0320
R-squared **Adjusted R-squared**	0.016665 **0.013076**	**F-statistic** **Prob. (F-statistic)**	4.643519 **0.032042**

Panel B: Results of Scaled Earnings Changes Regression Analysis			
Independent Variables	***One-year-ahead cash flows from operation (CFO_{t+1})***		
	Coef.	**t-Stat**	**p-Value**
N	227	227	227
Intercept	0.641845	19.79659	0.0000
Scaled Earnings Change (SEC)	0.058099	1.411384	0.1595
R-squared Adjusted R-squared	0.008776 0.004370	F-statistic Prob. (F-statistic)	1.992006 0.159513

Table.5 Descriptive Statistics

	N	**Mean**	**Mode**	**Median**	**Std. Dev.**	**Jarque-Bera**	**Prob**
Scaled Earnings Levels	397	-	1	-	0.264331	1842.160	0.00000
One-year-ahead operation income	397	0.050858	-	0.036651	0.053889	22533.10	0.00000
Scaled Earnings Levels	398	-	1	-	0.260241	2001.591	0.00000
One-year-ahead net income	398	0.028721	-	0.017498	0.072447	40136.08	0.00000

Table.6 Regression Analysis Results from Robustness Tests

Independent Variables	**Dependent variable variations**					
	OI_{t+1}			***NI_{t+1}***		
	Coef.	**t-Stat**	**p-Value**	**Coef.**	**t-Stat**	**p-Value**
N	397	397	397	398	398	398
Intercept	0.030573	3.068513	0.0023	-0.04428	-3.42761	0.0007
Scaled Earnings Level (SEL)	0.021884	2.114690	0.0351	0.078743	5.868434	0.0000
R-squared Adjusted R-squared F-statistic Prob. (F-statistic)	0.011195 0.008691 4.471913 0.035082			0.080008 0.077685 34.43852 0.000000		