BOARD CHARACTERISTICS AND REAL EARNINGS MANAGEMENT: THE MODERATING ROLE OF SHARIAH COMPLIANCE

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Abstract: This paper assesses previous studies relating to real earnings management, board characteristics and Shariah compliance. The issue of real earnings management is being focused by academic researchers, policy makers, and accounting practitioners since it is classified as a "mystical behaviour" conducted by most companies in achieving their desired earnings’ goal. This paper explains various board characteristics such as board size, independence, expertise, meetings and gender that give effect on real earnings management. The board characteristics and Shariah compliance are evaluated consistent to Agency Theory, Maqasid As-Shariah Theory and Islamic Ethical Principles Theory. Agency Theory explains that agency problem occurs when conflict of interests happens between principal and agent involving different actions and risk preferences. Besides, Maqasid As-Shariah Theory explains about Islamic business transactions stated in Al-Quran. This theory assert that managers must; (i) make Halal (Legal) transactions, (ii) be fair and have mutual consent between principal and agent and (iii) write all transactions regarding debt contracts in order to remove doubts. Correspondingly, another theory which relates to Shariah compliance is the Islamic Ethical Principles Theory. This theory discusses Concept of Unity of God (Tawhid) and Justice that guide managers to; (i) believe that Allah (God) sees what they are doing and (ii) fear towards Allah. Interestingly, the findings suggest that good governance may reduce the probabilities of real earnings management to occur and Shariah compliance as a prescription in strengthening the relationship since Islamic ethics are based on divine commandment acquired from Al-Quran and Sunnah.

Keywords: Real earnings management, board characteristics, Shariah compliance

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1. Main Text

To date, the issue of earnings management is being focused by academic researchers, policy makers, and accounting practitioners. This is because the issue happens throughout the world. Previous studies reveal that board characteristics have impact on earnings management (Dechow, Sloan & Sweeney 1996). However, several scholars highlight that religion able to influence members in business organisations to promote best ethical practices (Conroy & Emerson, 2004).

For instance, Malaysia is an Islamic country which adheres to the concept of wasatiyyah (moderation). Malaysia is seen as a unique and progressive Islamic state that it is acknowledged by many other Muslim countries that follows Islamic law in daily life as well as in business transactions. Therefore, the Islamic law is mandated to enhance Muslim investors’ confidence and assist Malaysia to become an international centre for Islamic Capital Markets that identify Shariah-compliant investments (Securities Commission, 2006).

Furthermore, it is believed that Malaysia will improve the financial stability of Islamic financial institutions and give benefit to borrowers and institutional investors. In addition, the Islamic law or ‘fiqh’ prescribes the nature of allowable trade and services which generally requires fairness, honesty and justice in all business transactions. Any transactions which are unclear, unfair, unjust and fraudulent are explicitly forbidden in Islam (Falaika, 2002).

2. Earnings Management

Earnings management can be defined as techniques used by managers through discretion of accounting methods to achieve desired goals. Earnings management happens when managers make changes in financial statement as to deceive the companies’ stakeholders regarding the performance of the company and to control the result depending on accounting practices. The intervention can happen by operational decisions and not on the accounting methods and estimates (Healy and Wahlen, 1999).

DeFond and Francis (2005) mention that accounting standards allow the accounting choice to be done, judgment to be made and assumptions by managers in producing the financial statement. Therefore, the rationale and validity depends on the assumption of the researchers on the quality of reporting and the level of how the quality being measured. However, earnings management may lead to fraud if it is not being hindered appropriately. This is because there will always be a temptation to inappropriately manage earnings to meet projections that suits everyone (Millstein, 2005).

3. Type of Earnings Management

There are two methods in managing companies’ earnings. The first method is through discretion on the ordinary or usual activities of the companies’ earnings that may affect the cash flow of the companies. The discretion on the ordinary activities of the companies is known as the real earnings management (REM) (Rowchowdhury, 2006). The second method is when the company modify the accrual activities as to earn the goal of companies’ earnings. Under this situation, managers usually judge the reporting of financial statements as to achieve companies’ goal and the activities is known as accrual earnings management (AEM) (Healy and Wahlen, 1998).
Accrual earnings management (AEM) can be defined as the action of the company in modifying their accrual activities as to achieve the companies’ goal in terms of their earnings. Under this situation, managers usually judge the reporting on the financial statements (Healy and Wahlen, 1998). In order to measure the accrual basis of earning management practice, most studies apply Jones’s (1991) discretionary accruals with book-to-market value, cash flow from operations and current-year ROA. These models control for firm performance. Prior studies Cohen, Dey and Lys (2008), Dechow, Sloan and Sweeney 1995, and Kothari, Leone and Wasley (2005) have documented that estimated discretionary accruals are correlated with stock price and firm performance measures. The higher the level of the discretionary accruals, the lower the earnings quality gathered.

In contrast, real earnings management (REM) can be known as the digression on the ordinary activities by the managers in deceiving the companies’ stakeholders in terms of companies’ earnings as to ensure that the stakeholders believe that the operations are normal and meet the desired goal of the companies. The best example that can be seen is in terms of the discount on prices and the cutting on expenses of the companies. Nevertheless, if managers always involve in the activities with the purpose of enhancing the desired goal of earnings, then it said that the managers are engaging with real earnings manipulation (Rowchowdhury 2006). Additionally, Chen, Chen, Lobo and Wang (2011) reveal that managers tend to use real earnings managements in manipulating the companies’ earnings rather than discretionary accrual basis. Rowchowdhury (2006) explains that he uses these methods in measuring real earnings management (REM) of the companies. The first method is through examining the discounted price of a company. The discounted prices are to boost the companies’ sales. The second method is through involving in overproduction as lessening the cost of goods sold (COGS) and the last method is through decreasing the discretionary expenditures in large amount as to enhance the companies’ profit.

3. Board Characteristics and Real Earnings Management

The board director is a person who is being appointed to monitor management in order to achieve its objectives. The board is responsible for the long term goal of the companies and deliver sustainable value to its stakeholders. The board plays an important role in placing effective and efficient control, leading decision making, championing good governance and presents ethical manners towards its company (MCCG, 2016). The average board size is nine members but most boards range from three to thirty one members. Some analysts think the ideal size is seven (Wall Street Journal, 2003).

Previous studies examine relationship between board size and earnings management. Alves (2011) reveals a “U” shape between size of board and earnings management. The U shape explains about the relationship which is related to each other. The result indicates that the smaller (seven) the board members, the negative the correlation with earnings management and the larger (more than seven) the board members, the positive the correlation with earnings management. Epps and Ismail (2009) report that small board size (six to eight and thirteen to fifteen) is not associated to income-decreasing discretionary accruals and large board size between 9 and 12 is seen to be positive. Specifically, the larger the board size, the higher the earnings management assessed. In contrast, several results reveal a positive relationship between board size and earnings management. As report by Banderlpe (2009), the study finds a positive association between board size and earnings management. Kang and Kim (2012)
mention that the larger board size is significantly and positively correlated with abnormal discretionary expenses.

Besides board size, board independence also gives effect on real earnings management. Independence is classified as a quality that can be possessed by individuals and is an essential component of professionalism and professional behaviour. It refers to the avoidance of being unduly influenced by a vested interest and to being free from any constraints that would prevent a correct course of action being taken. It is an ability to ‘stand apart’ from inappropriate influences and to be free of managerial capture, to be able to make the correct and uncontaminated decision on a given issue (ACCA Think Ahead, 2015). Beasly (1996), Klein (2002a), Davidson, Goodwin-Stewart and Kent (2005), and Duh, Lee and Lin (2009) reveal that board independence may mitigate earnings management practices. Xie, Davvidson, and DaDalt (2003) conclude basing on the data gathered on 110 companies in US. This study supports previous result by revealing a negative association between the board independence and the level of earnings management. In addition, the result of Niu (2006) also indicates that the Canadian companies have a negative relationship between the board independence and the extent of abnormal accruals.

Last characteristic of board is board gender. The issue regarding gender difference grabs public’s attention. This is because the gender difference may represent the ability to operate in a true and fair manner and possibly to maintain good quality of financial reporting. Past studies find negative association between female directors and earnings management. Konrad et al. (2008) conclude that the existence of at least three women on boards is most probably to exhibit a very real change of the board. Female directors always influence the corporate governance and the ethical manner to be better. Although women are more risk averse and are more conservative than men, it is good in term of reducing the earnings management practice since it is illegal conduct to be done. Differences in gender indicate that women tend to have more cautious, risk adverse and ethical compared to men (Powell and Ansic, 1997; Gold et al., 2009). Result of the study conducted by Wood et al. (1985) conclude that women signify greater communication skill, very thorough in dealing with work and able to solve problem with the best outcome as compared to men. Gender difference is being supported by the agency theory (Jensen and Meckling, 1976). Gender difference will likely decrease the level of conflicts of interest between managers and shareholders. The diversity will enhance companies’ independence, may influence companies to come out with new ideas, technologies and perspectives as to have innovative and creative decision.

4. The Moderating Role of Shariah Compliance on Real Earnings Management

Shariah compliance is the action of obeying to Islamic laws and principles. Shariah law is introduced to act as a good platform to verify true and fair corporate governance among companies by prohibiting illegal (haram) transactions (The Securities Commission, 2009e). Indeed, religion has a major role in enforcing and shaping a good behaviour such as benevolence, piety, justice, truthfulness, and honesty. Consequently, it enables companies to have good practice, reliability of financial information and the integrity of the financial reporting process (Watts and Zimmerman, 1990 and, Lewis, 2001).

With regards to real earnings management practices, Hua (2009) explains that Shariah law is highly accepted among most companies in Malaysia since Islamic view is considered as a better way in managing and operating the activities when compared to conventional ways.
Consequently, Shariah-compliant equities show low variability and are less risky compared to conventional perspectives. Besides, Shariah compliant is a mirror image of truthfulness and transparency manner of piety Muslim which has good corporate governance practices in managing the operation of the companies and to disclose reliable information to the public (Dadgar and Naderi, 2009).

Additionally, Shariah-compliant companies tend to be more transparent as compared to non-Shariah-compliant companies. The Islamic law is anticipated to restrict illegal conduct among Shariah-compliant companies. To this point, companies that comply with Shariah are influenced to provide high quality financial reports as compared to noncompliance companies. By complying with Islamic law (Shariah law), companies are ensure to mitigate management problems (earnings management) such as manipulating financial reports that violates the concept of justice (Wan Ismail, Kamarudin and Sarman, 2015).

Shariah compliance is being supported by *Maqasid As-Shariah* Theory. This theory explains about Al-Quran verses regarding Islamic business transactions. Managers must; (i) make *Halal* (Legal) transactions, (ii) be fair and have mutual consent between principal and agent, (iii) write all transactions regarding debt contracts in order to remove doubts. Consequently, another theory that relates to Shariah compliance is the Islamic Ethical Principles Theory. It allows readers to understand Islamic law related to the Concept of Unity of God (Tawhid) and Justice that guide managers to; (i) believe that Allah (God) sees what they are doing and (ii) fear towards Allah.

5. Conclusion and Recommendation for Future Studies

Board of directors who believe in Allah (God) Almighty and obey to the Holy Quran and As-Sunnah may restrict themselves to engage in unethical manner such as earnings management. This is due to believing that Allah (God) sees what they are doing and fear towards Allah. Accordingly, board must (i) make *Halal* (Legal) transactions, (ii) be fair and have mutual consent between principal and agent and (iii) write all transactions regarding debt contracts in order to remove doubts.

Interestingly, Shariah compliance is believed to strengthen the board in mitigating real earnings management and to enhance high reporting quality in portraying good image of the companies. The study on Shariah compliance and earnings management among Malaysian companies is still lacking and considered as a variable that might mitigate earnings management (see for example, Saeed et al. (2001); Dadgar and Naderi (2009); Abdul-Rahman et al. (2012); Wan Ismail et al. (2015). As such, it is recommended that standard setters, regulators and authorities should be steadfast to consider Shariah compliance as one of the approaches that may eliminate real earnings management.
References


its implications for standard setting., 2-23.