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Determinants of Earning Management in Islamic Perspective

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This study examines the effect of return on assets (ROA), debt capability, and company size on earning management. The object of this study is the Islamic Boarding Schools (Pesantren) Business Units across East Java, Indonesia which is believed that the earning management practices in this object are less intense. The selected business unit shall reported profits in the last five years continuously. A total of fourteen business units met the selection criteria and were used as the sample. The hypotheses were tested using multiple linear regressions. The results show that out of three independent variables, only debt capability was not found to be significant predictor of earnings management, while return on assets (ROA) and company size were found as significant predictors of earning management in Pesantren business units.

Keywords: Earnings Management, Return on Assets, Debt Capabilty, Pesantren

INTRODUCTION

Business in Islamic concept is a series activities with various forms which are not limited in the number of owned product or services including profit, but are limited in the ways of obtaining and managing the asset due to Halal (allowed by Islamic rules) and Haram rules (prohibited by Islamic rules) (Purwitasari, 2011). Islam does not only encourage business and economic activities, but also recognizes it as a form of worship with the condition that any material growth leads to social justice and spiritual elevation. However, there are other types of activities, risks, or rewards that are prohibited or not recommended in Islam. For example, Islam does not oppose the concept of profit, but prohibits profit through unfair trade practices and socially hazardous activities (Rahman 2010). In addition, business decisions that relate to investment and production should primarily bring benefits to the community rather than profit maximization (Bash & Yusuf, 2013). Hence, it can be understood that Islam encourages the pursuit of ethical wealth. Business done is actually one of the implementation of human obligation in obtaining rizq (treasure). Halal aspects (obtaining treasure based on the Islamic rules) should be the basis of both the acquisition and utilization of property (Salim, 2009)[. In the context of Islam, seeking wealth is not solely to enrich themselves but all done for seeking God's blessing and being used in the way of God. In Islamic perspective, work is part of God's teaching, binding on all parties without exception, all bound by principles, morals, and work results (Fitria & Hartanti, 2010).

Business is basically a human effort to make a profit (Ali, 1989). Qur'an in Chapter at-Taubah (9) verse number 115 (Al-Qur'an and Its Indonesian Translation, 2005) offers a profit that does not know loss and fraud, by stating that:

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"And Allah will not lead a people astray, after Allah has guided them so that He may explain to them what they should turn away from. Allah is All-Knowing all things ".

The meaning contains in this verse is that the Qur'an offers an advantage that there is a promise of business profit that will never be lost. Even profit is a result of a good work of business, where life is to be run with hard work and faith. This means, the relationship between faith and work is like root, plant and fruit.

According to Islamic thought, business should be done without leaving the prayer. This is stated in Qur'an Chapter Al-Jumu'ah (62) verse number 9 (Al-Qur'an and Its Indonesian Translation, 2005):

"O ye who believe, when ye are called to give the Friday pray, so hasten ye in remembrance of Allah and abandon the trade, that is better for you if you know. "

The meaning of this verse is that if the priest has ascended the pulpit and the muezzin (a man who calls for worship Allah) has performed azan (call people to worship Allah) on Friday, then the Muslim must hasten to fulfill the call and leave all their business.

Doing business should also be done in a mutually beneficial manner so as not to cause any harm either at the time or after. The sale and purchase shall be the process of exchanging goods with other goods or by means of exchange instruments recognized through a contract of sale on the basis of likes between the sellers and the buyers without any coercion (Ali, 1989). This is explicitly described in the Qur'an chapter An-Nisa (4) verse number 29 which states (Al-Qur'an and Its Indonesian Translation, 2005):

"O ye who believe! Let not one another eat your neighbor's treasures except by the trade that arises from the intercession between you and do not kill yourself; Allah is most merciful to you"

According to Ali (1989), any fund managed in the business, is expected to bring profit. Islam has introduced to its people that business profits can be realized in three ways: (1) material gains, (2) non-material gains, which are blessings, rewards and favor of Allah, and (3) the existence of a third party as a blessing recipient. The existence of shares of property which are the rights of third parties or others in the Qur'an among others in Chapter Adz-Dzaariat (51) verse number 19 and Chapter AT-Taubah (9) verse number 103 (Al-Qur'an and Its Indonesian Translation, 2005).

However, in business reality, businessmen can also suffer losses. The impact of losses on the business will lead to business bankruptcy. One way that can be applied to get around the fluctuations in profits is to implement earnings management. The pressure to make this profit is often felt as a result of revenue generation for management. Consequently management performs earnings management to influence the number of earnings that cause the decline in the quality of the company financial statements (Scott, 2003).

According to Jensen and Meckling (1976)], earnings management is created by inequality of information between principal (owner) and agent (manager). Referring to the agency problem, earnings management is applied to firms that have a clear separation between the owner's and the manager's responsibilities. Therefore, earnings management is much more widely applied to large companies compare to the small one. This condition is based on the inequality of information from the agency theory, so that the agency theory is identical to the big size companies (Jensen and Meckling 1976). In this case, the emphasis is on how earnings management is used in companies that have a clear separation between owner's and manager's responsibilities (Byard, Hossain and Partners.2000).

According to Jaggi, Leung and Gui (2009), agency theory and earnings management are not widely used in small firms, because in this company size the owner also acts as the manager. However, a clear separation between owner's and manager's responsibilities also occurs in small businesses founded by Islamic boarding schools (Pesantren). This phenomenon motivates the researcher to conduct research in the Pesantren business units.

This study aims to: (1) analyze the effect of rate of assets return based on Islamic earning management practices, (2) analyze the effect of debt capability (based on capital amount) on the Islamic earning management practices, (3) analyze the effect of company size (based on the real sector) on the Islamic earning management practices.

LITERATURE REVIEW

Doing Business in Islamic Perspective

In general, business is defined as an organization that provides goods or services with the intent of earning profit (Gupta, 2003). Business is a complex reality, because many factors affect business activities, including managerial factors, technological and socio-culture (Eldine, 2010). As a social activity, business relates to the complexity of modern society. The factors that shape the complexity of modern business have been frequently researched and analyzed through scientific methods, particularly in economic and management theory (Eldine, 2010).

In Islamic concept, business is defined as a series of activities with various forms which are not limited in the number of ownership (products or services) including profit, but are limited in ways of obtaining and managing wealth due to Halal and Haram rules (Purwitasari, 2011). According to Shihab (2008), there are many expressions of economic and business in the Qur'an. For example, when invoking people for charity, it is often used terms that are known and closely related to the field of economy and business. Similarly, there are terms such as business, buying and selling, treasury, treasures, debts, capital, business and work, rizq, profit, wages, property, and others. Islam requires every Muslim, especially those with dependents, to work. Work is one of the principal causes that enable humans to have wealth. To enable humans to earn a living, Allah empties the earth and provides various facilities that can be utilized by humans to seek sustenance.

Figure 1 shows how firms operate business based on Islamic perspective. In term of input and process there is no different with the conventional concept. However, Islam puts God’s blessing in the most priority in the output compare to other business purposes such as growth, sustainability, and profit.

<u>**FIGURE 1 HERE**</u>

Construction of Islamic Financial Management

Sharia financial decisions are an application of Islamic financial management and surely will also be guided by general principles of Islamic economics based on Akhlakul Karimah (noble morals), inflation and profit sharing, multiple ownership, freedom of action, social justice, Tawheed (believe in only one God), justice, Nubuwwah (prophetic or obey the prophet), Khilafah (government), and Ma'ad (result). The desired form of expectation is the realization of an efficient and effective market that drives growth in the acquisition and cash flows of the company as well as fair profit sharing payments. Another noteworthy guide is an in-depth understanding of Islamic financial management applications in the form of mastery of Islamic and non-Islamic business characteristics, in the hope of being able to fully implement Islamic business and avoid non-Islamic business (Salim, 2009).

If guides are synergized, it will be able to produce Islamic financial management applications with various devices and able to improve risk completely categorized Halallan and Toyyiban (obey Islamic principles) and will raise Barokah (God’s blessing) as seen in Figure 2. The Islamic finance management in accordance with Sharia can be conceived as shown in Figure 1 and Figure 2 which show the importance of changing re-focusing resources application and financial functions according to Sharia in the year 2000s. In 2000s, the world business theme was characterized by the main drivers of business partnership (Shirkah) and cost reduction (sparing). Shirkah is shown by the increasing number of competitors to cooperate which more and more companies are exposed to strategic alliance activities, followed by a continuous movement to reduce cost in order to increase competitiveness to face the various choices of consumption and the elimination of monopoly that is not in accordance with Sharia.

<u>**FIGURE 2 HERE**</u>

Business Principles in Islamic Perspective

In Islamic perspective, business is guided by the general principles of Islamic economy. Salim (2009) states that the Islamic economy is based on the five universal values, namely: Tawheed (belief in only one God), 'Adl (Justice), Nubuwwah (prophethic), Khilafah (government) and Ma'ad (result). These five values serve as the basis for inspiration to develop Islamic economic propositions and theories.

In executing financial decisions in Islam, Halalism is one of the most important things in Sharia finance decisions, especially the effort to reach Barokah (God's blessing) deserves to be achieved through the application of Fathanah, Istiqomah, Amanah, and Tawaqal (FIAT) (Salim, 2009). Fathanah means intelligent which is characterized by the promotion and mastery of science and technology, smart, right-minded and sharp, and gifted through training. Istiqomah means principled/straight which is characterized in acting always prioritizes proactive and avoids reactive, forward-looking, forward straight through willingness to change properly and voluntarily, and broad minded. Amanah means mandate /honest which is characterized worthy of trustworthy and able to master work, open minded and fair honest, courageous because true, and full of inspiration. Tawaqal means resigned to Allah which is characterized in acting full of considerations, willing to bear the risk, ready to provide support, always patient, dynamic, and consistently worship Allah and pray.

Agency Theory

Agency theory was popularized by Jensen and Meckling (1976). The basis of this theory is the relationship between the principal (owner) and the agent (manager). According to Jensen and Meckling (1976), agency relationships arise when principle employs agent to do a job in accordance with the principal's interests by delegating some funding decision-making authority. In the context of financial management, this relationship arises between shareholders and managers.

Earning Management

According to Kanagaretnam (2010), earnings management is interfering management in the external financial reporting process by managing profits to reduce losses, managing earnings to meet or exceed previous year earnings and as an accrual-based proxy. Management also has a strong impetus in shifting financial earnings to maximize performance associated with bonuses and avoid losses. This can be achieved with one-off transactions, earnings management, and by manipulating transfer rates. Earnings management involves timing manipulation and transaction records. Likewise, accrual accounting will shift earnings from one fiscal year to another. The manipulation of transfer pricing done during the fiscal year will not affect the future earning reports (Nikoomaram et al., 2012). In this study discretionary accrual was used as proxy of earning management.

Discretionary accrual is the recognition of accrual earnings or free and unmanaged cost, as a part of management's policy which shows private information given by manager. Based on the accounting process, earnings are determined by using income or cost that already became the current period of equity or liability, although the account transaction occur in the next period, which is accrual based. Income is recognized on the basis of rights not on receipt, whereas cost is recognized based on liabilities rather than cash disbursements.

According to Scott (2003), earnings management can be efficient (increase the profitability in communicating private information) and can be opportunistic (maximizing personal interests). If earnings management is opportunistic, then the profit information can lead to incorrect investment decision made by investors.

Earnings management practices can lead to misunderstandings of some stakeholders (Healy and Wahlen, 1998). Therefore Islamic managers are not expected to practice earnings management and predict the inverse relationship between Kyai's (Informal-Islamic leader) role and earning management. The role of Kyai in the development of Pesantren business unit can be known by detecting how far the application of Islamic business characters in the management of Pesantren business unit.

Return on Asset

Return on asset (ROA) based on Islamic earning describes the ability of the company to make profit from invested asset for stakeholders. Asset return rate calculated by dividing net income with company's total asset. In Islamic business, earning can be viewed in three aspects: material profit (real profit obtained by business unit of religious boarding school or Pesantren, non-material profit (business manager has effort to give benefit in the form of humanity trough job opportunity, educational support, and social contribution), and benefit for the third party. Liability aspects to the third party are measured by acknowledging the amount of Sadekah (charity) paid by the Pesantren business unit.

National Sharia Council's criteria and Capital Market Supervisory Agency (Bapepam) rules LK no. IX A.13 about Sharia securities publishing state that the main type activities of a business entities which considered to meet sharia is that the total debt allowed is 44% from the total asset. The rules also state that it is banned to do haram-based activity, such as gambling, usury, and liquor; and no trading without a clear handover of the goods or services and with a false demand.

Company Size

Company size is measured by natural asset logarithm. The total asset data is acquired from annual financial statement and transform it into total asset logarithm. Islamic company size describes the growth of asset owned by Pesantren business unit. Company size in this study is a natural logarithm from the assets. Therefore, this variable is measured by an absolute number.

RESEARCH METHODOLOGY

There are four variables used in this study: Islamic earning management (Y), return on investment based on Islamic profit (X1), debt capacity (X2), and company size (X3). This study used discretionary accruals as a proxy to measure Islamic earning management.

In the interview process, systematic way has been used by using the guidelines and the framework of questions for obtaining relevant information (Ghozali, 2007). The perspective objectivity of the analysis results is done by using informant's perspective. This study used a quantitative approach which works with numbers, data in numeral, and analyze with statistic to answer a specific questions or hypothesis. Statistic testing was used to accept or reject a hypothesis. The purpose of this study is to give a causal or relationship explanation among variables through hypothesis measure. Sample unit measured is business unit owned by Islamic boarding schools (Pesantren) in East Java. Sampling method used in this study is purposive sampling (Solimun, 2006). Sampling criteria for the Islamic boarding schools is that a business unit has a financial statement for 5 years period. Based on the survey, the Islamic boarding schools that have business units are as follows:

TABLE 1 HERE

Data used in this study was a primary data, collected through face to face interview by directly contact the managers or owners of the Pesantren business units. In addition, secondary data was collected by analyze financial statement of Pesantren business units during the research period. Analysis model used in this study is individual coefficient test (t-test), most dominant independent variable test, and qualitative information.

RESULTS AND DISCUSSIONS

Results of multiple linear regression analysis are shown in the following table:

TABLE 2 HERE

Results of multiple linear regression analysis obtained the following equation:

DA = 0.202 ROA + 0.102 KH + 0.233 UP + e

Whereas:

DA = Discretionary Accruals

ROA = Return on Asset

DC = Debt Capability

CS = Company Size

e = error model

Partial and simultaneous testing result can be seen in the figure below:

FIGURE 3 HERE

Furthermore, hypothesis test was done by t-test on each of the direct effect partially. The hypothesis test results are shown in the following table:

TABLE 3 HERE

There are three hypotheses that have been formulated in this study, which describe a direct effect of independent variables towards earning management. Those effects are: 1) the effect of return on asset (ROA) on discretionary accrual as proxy of earning management, 2) the effect of debt capability on discretionary accrual as proxy of earning management, 3) the effect of company size on discretionary accrual as proxy of earning management.

The Effect of Return on Asset (Based on Islamic Earning) on Discretionary Accrual

Return on Asset (ROA) based on Islamic earning is a fundamental work of the company. ROA capability (profitability) of the company were controlled because the capability of making profit among companies are different according to the business type, company maturity, or company size. Management in a highly profitable company shows the company's effectively in managing their resources. An efficient management work often does not need an opportunistic earning management. The effect of ROA on discretionary accruals as proxy of earning management can be found on its path coefficient t-statistic. The expected effect is a negative and the higher ROA the more conservative (income decreasing) discretionary accruals will be.

The effect of ROA on earning management shows a positive significant result, which means that the higher ROA the higher earning management practice will be. So the first hypothesis is accepted. This finding shows that ROA that is measured by ratio between earning after tax with asset is capable to explain the change variation of earning management practice Pesantren business units in East Java. This finding is also supported by McNichols and Wilson (1988), who predicted a positive relation between ROA and earning management.

Ghofur (An owner of Pesantren business units) said: "I only gained luck, the money gained were used for maintaining the boarding school. Here, when someone has money they pay for themselves, if they don't, I pay for them. They can drink for free, for I have managed a free 7000 liters of drinking water every day. This is my gift for the students so that they can easily learn and recite Qur'an."

Based on the above informant's opinion and supported by multiple comprehensive theory, practically earning management in a level that still justified by General Accounting Principles (GAP), is an ethical method. By ethical method it means that the intervention to reported earnings done by the manager is unintentionally done for private gain.

The Effect of Debt Capability (Equity Based) on Discretionary Accrual

Watts and Zimmerman (1986) stated that in a generally accepted condition of accounting procedure, the higher the debt capability or equity, the higher the probability of the manager to choose an accounting procedure that will increase the earnings. A higher debt capability also provides a more flexible way to manage earning through the discretion of short-term liabilities acknowledgement (Duh & Lee, 2009). The effect of debt capability on discretionary accruals as an earning management measurement can be found on its path coefficient and t-statistic. Expected effect of debt capability on discretionary accruals is negative, and the higher the debt capability, then the company tends to perform increasing discretionary accruals.

The effect of debt capability on discretionary accruals analysis result shows a positive effect but not significant, which means that the hypothesis states the high number of debt capability will affect the discretionary accruals, is unacceptable due to lack of evidence. This result shows that financial leverage can't explain a variation change of discretionary accruals in the business unit. This finding also means that the increasing of debt capability cannot increase the discretionary accruals, and vice versa. This finding also differs from most of the previous researches and theoretical studies.

Explainable argument from the difference is the debt capability encourage creditor to watch the company more strictly. The strict supervision by the creditors connected to the borrowed funds security with its interest, with hope that the company as the debt holder will be spared from the possibility of debt contract breaching between the company and business unit as a creditor. Other possibilities that can explain the unacceptable hypothesis are, firstly, the Islamic boarding school is an established, stable, and capable of earning profits, which means that the company already reach the maturity cycle. This condition encourages the company to be dependent of debt in the capital structure so there is a tendency to decrease debt-source funding. It could also be seen on the field that the long term debt is very low compared to the short term debt, and during the observation of this study, debt capability decreased 4% per year. This fact seems to be greatly appreciated by the investor, as the investor considers debt capability as one of the financial risk source in investing and has a small potency towards the possibility of bankruptcy in the *sharia* business field. Thus, the high earning management practices were not necessary determined by the declining use of funding resources in the company's capital structure that has a fixed cost, instead much more determined by the Islamic managers increasing behavior.

*National Sharia of Indonesian Council of Ulama (*DSN-MUI) policy on debt ratio interest-based indicator towards equity should be maximum 82% (interest-based debt 45%, equity 55%) is still too high because it gives a really high risk to the investor to invest in *sharia* business. Ideally that criteria is under 50% (33%:67%), because *Sharia* emiten already has a bigger current liabilities average than the non-current liabilities, although in reality, the finding of this study indicates that the investors feel safe with the DSN-MUI policy. This shows uniqueness that investors who invest their asset in *Sharia* business prioritizing their desicion on *Aqidah* aspect, which consider *Halal* aspect first, then rational judgement.

The Effect of Company Size (Real Sector Based) on Discretionary Accrual

The effect of company size on discretionary accrual as proxy of the earning management can be found in its path coefficient and t-statistic. The expected effect is negative, and towards the earning management direction is bigger. The effect of company size on discretionary accruals as proxy of earning management shows a positive and significant result. This means that the hypothesis states that the bigger the company size the bigger the discretionary accruals will be, is accepted. This result also shows that the company size is capable in explaining the change variation of earning management in Pesantren business unit.

This finding confirmed the positive accounting theory by Watts and Zimmerman (1986). Positive accounting theory focused on the ability to explain and predict accounting practices. According to Scott (2003), this theory is beneficial to understand and predict company's accounting change.

In Islamic S*haria* perspective, an investment will get a balanced reward, so in Islamic perspective, Muslim is encouraged to gain success and try to increase the investment result, and abandon bad and unprofitable investment. Investors may hope a high return of their investment by analyzing and choosing a *Sharia* business that capable to make a high profit from its asset.

In Islamic S*haria* perspective, *Sharia*-based investment will be rewarded positively yet a non-*Sharia*-based investment will gained a negative return. Investors can expect a high return for their investment as long as they hold *Sharia* strongly. An informant, Iwan also clarified this with his statement, " Earnings in Islam are not limited in numbers or nominal but in morality, as *Hadist* (prophet Muhammad's teaching) states that "once there is a person who took a 100% of profit and Muhammad (peace be upon him) praise and make him a prayer. It means with a God's blessing prayer, it's totally fine to seek a high profit." This statement implies that investor can expect a high return as long as it was gained based on *Sharia* rules.

CONCLUSION AND RECOMMENDATIONS

From the hypothesis tests results show that ROA has a positive significant effect on earning management, which means that the higher ROA the higher earning management practice will be. This finding shows that ROA which is measured by the ratio between earning after tax with asset is capable to explain the change variation of earning management practice in Islamic boarding school, in East Java. Furthermore, the effect of debt capability on discretionary accruals shows a positive effect but not significant, which means that the higher debt capability will not affect the discretionary accruals. This result shows that financial leverage can't explain a variation change of discretionary accruals in the Pesantren business unit. This finding supports sharia investment theory which combining the real world and the hereafter. The uniqueness of this finding is that investors who invested in sharia business do not only consider the rationality aspect of their investment decision but also highly considering Halal aspect of it.

The effect of company size on discretionary accruals as an earning management measure can be found within the numbers or the directions of it. The expected effect is negative, and towards the discretionary accrual direction is bigger. Based on the analysis of the effect of the company size towards earning management shows a positive and significant result. This means that the bigger the company size the lower the earning management are. This result shows that the company size is capable in explaining the change variation of earning management in Pesantren business unit.

Based on this findings can be concluded that in conventional accounting, financial statement arranged according to financial accounting standard and no indication of fraud in it, then that financial statement are valid. While Islamic ethic in accounting need a rightfully written fincancial statement. Reported data must be in accordance with the true transaction. Earning management practice has become a common behavior believed as a result of flexibility of accounting. Financial accounting standard in Indonesia are adopted from America. Indonesia with a majority of Muslim citizen certainly has a different value and ethics with America which most of the citizen is non-Muslim. So, even though earning management is an ethical practice by accounting standard, it may not consider as such by Islamic ethic. But Islam does not necessarily consider earning management as haram and is banned.

Practically, these findings will help investor especially Muslim investor whose commit with their beliefs to get to know sharia business and understand a certain characteristic in it, as well as to practice Sharia value in business transactions. The findings will also help investors' judgment in their investment policies by observing companies that has a good fundament in prospect and risk that determines earning return rate, especially in Pesantren business unit, because a high earning return rate will give a high return as well. The Kyai's (leader in Pesantren) role is practically strong too as the owner of the Pesantren business unit. This can be seen by the way he leads and directs the Pesantren business unit, like holding a meeting once a week on Friday. This study result indicates the religious background effect the earning management practices.

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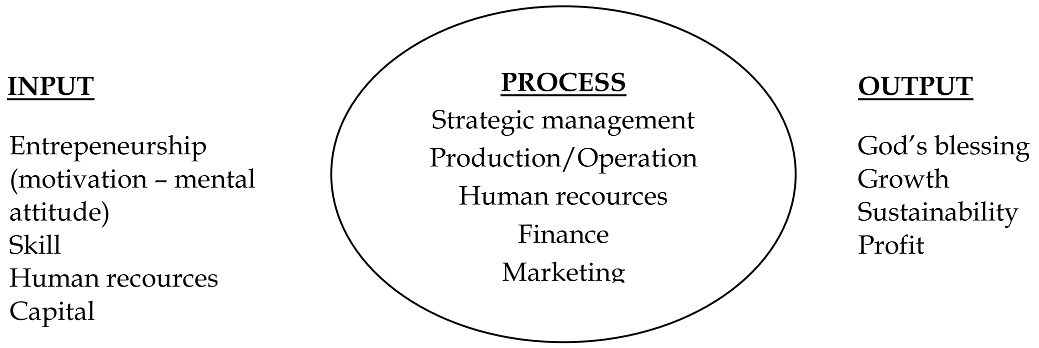
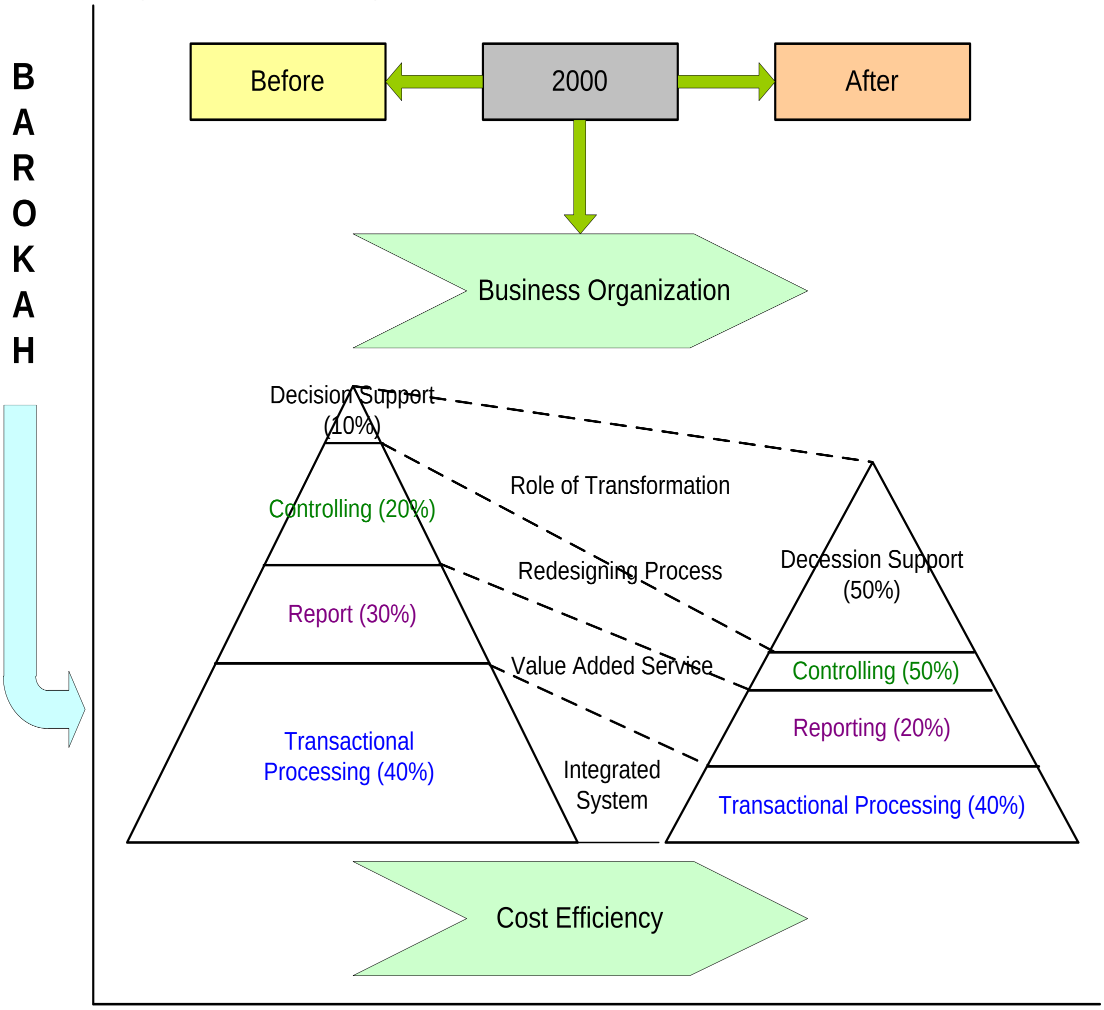
APPENDIX

Figure 1. Islamic Enterprise Operation Process



Source: Salim (2009)

Figure 2. Refocusing Resources of *Sharia* Compliant Financial Functions



Source: Salim (2009).

Figure 3. Regression Analysis Results

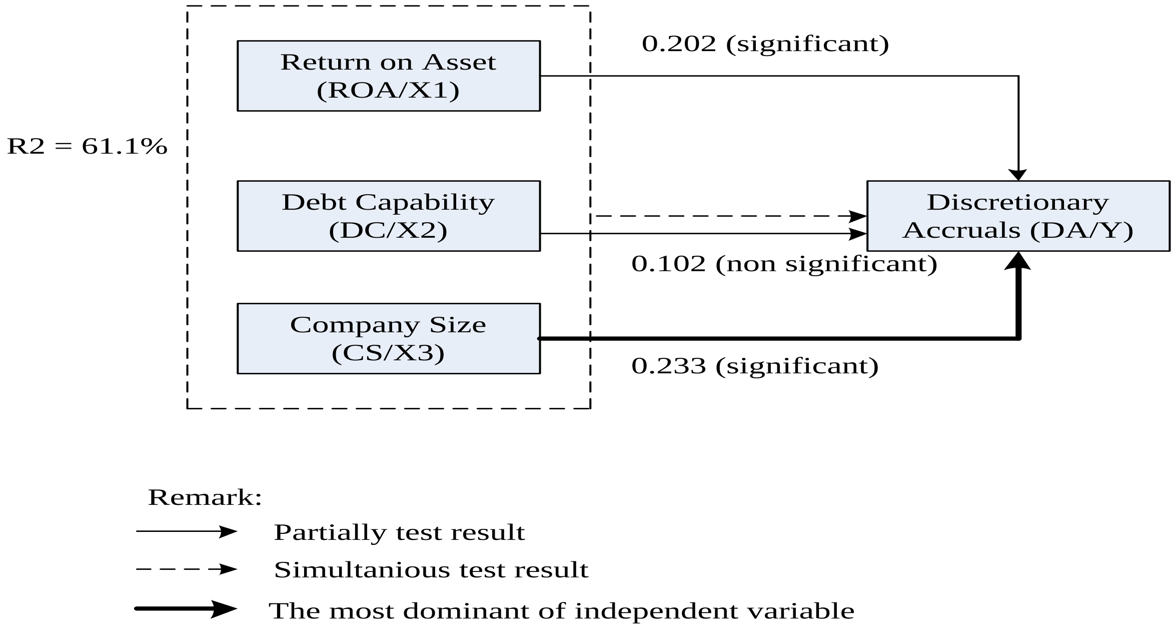


Table 1. Sample of Study

No.	Name of Islamic Boarding School	Number of Business Unit
1.	Pesantren Gontor Pusat	2
2.	Pesantren Annur 2	2
3.	Pesantren Arrifai	2
4.	Pesantren Al-Hikam	2
5.	Pesantren Dahrul Ulum	2
6.	Pesantren Sunan Drajat	2
7.	Pesantren Bahrul Ulum	2
Total Business Unit		**14**

Table 2. Results of Multiple Linear Regression Analysis

Independent Variable	Path Coefficient	$t_{statististic}$	Sig t	Remark
Return on Asset (ROA)	0.202	3.161	0.003	Significant
Debt Capability (DC)	0.102	1.380	0.177	Not significant
Company Size (CS)	0.233	3.000	0.005	Significant
R-square = 0.611 $t_{statisic}$ = 2.039 $F_{statistic}$ = 16.214 F_{table} = 2.911 Sig F = 0.000 *Dependent Variable* = Discretionary Accruals (DA) as proxy of earning management				

Table 3. Hypothesis Testing Results

Independent Variable	Dependent Variable	Path Coefficient	t-statistic (t_{table}=1,96)	Remark
Return on Asset	Discretionary Accrual	0,202	3,161	Significant
Debt Capability	Discretionary Accrual	0,102	1,381	Not Significant
Company Size	Discretionary Accrual	0,233	3,002	Significant