A Critical Analysis of Earnings Management in the Islamic Banking in the Light of *Shariah*

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بِسْمِ ٱللَّهِ ٱلرَّحْمَٰنِ ٱلرَّحِيمِ

TITLE OF THESIS:

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A thesis submitted to *Shariah*& Law Department, International Islamic University Islamabad as a partial fulfilment of the requirement for the award of the degree of Ph.D in Islamic Banking and Finance.

DEDICATION

I would like to dedicate this thesis to the Prophet Muhammad (P.B.U.H) and his companions (R.A), along with all those scholars who dedicate their lives to the field of Islamic finance/economics to prevent the people from the sin of *Riba*.

DECLARATION

I hereby declare that the work present in the following thesis is my own effort, except where otherwise acknowledged and that the thesis is my own composition. No part of the thesis has been previously presented for any other degree.

Date 11 July 2023.

Qazi Yasir Arafat

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LIST OF ABBREVIATIONS

Acronym	Abbreviation
AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
ABEM	Accrual-Based Earnings Management
AEM	Accounting Earnings Management
ASEAN	Association of South East Asian Nations
BOD	Board of Directors
CG	Corporate Governance
CI	Cost to Income ratio
CPI	Consumer Price Index
DA	Deposits to Assets ratio
DLLP	Discretionary Loan Loss Provisions
ECR	Ethics Resource Center
EM	Earnings Management
GAAP	Generally Accepted Accounting Principles
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GFC	Global Financial Crisis
IAS	International Accounting Standards
IFRS	International Financial Reporting Standards
INF	Inflation
IPO	Initial Public Offering
LLP	Loan Loss Provisions
MgtInc	Management Incentives

NDLLP	Non-Discretionary Loan Loss Provisions
NPL	Non-Performing Loans
PBUH	Peace Be Upon Him
R&D	Research and Development
R.A	*RadiAllahu 'Anhu/Anha'*
ROA	Return on Asset
ROE	Return on Equity
SR	Stock Return
SSB	*Shariah* Supervisory Board
SWT	Subhanahu WaTa'ala
TA	Total Assets

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ABSTRACT

Islam encourages ethical standards such as fairness, trustworthiness, truthfulness and transparency in every field of life specifically the economic life of a person is well explained by the Quran and Sunnah under these standards. Earnings management (EM) being the manipulation of financial statements is considered a lie, misrepresentation and breach of trust in the prior literature. Therefore, it is considered as Haram (prohibited) act generally. Prior literature reported that EM is based on five theories. The first part of this thesis aims to critically evaluate these five EM theories in the light of the primary sources of Shariah. Specifically, signal, threshold management, political contractual, agency, and entrenchment theories are evaluated in the light of the Quran and Hadith. The second part of the thesis is comprised of empirical investigation. Consistent with prior literature EM is evaluated by the discretionary loan loss provisions, the internal performances are evaluated by the traditional return on equity and return on assets, and the external performance is evaluated by the stock returns. The stability is evaluated by the famous stability measure Z-score. The sample size of this study consists of the 75 largest Islamic banks worldwide in terms of total assets and the time frame is from 2009 to 2020. Further unbalanced panel data is used for the estimation of regression models. To reduce the biasness in the regression models the sample size is distributed in three regions. First overall worldwide, second the GCC region, and third-the ASEAN region was evaluated. By evaluating five EM theories severe violations of the Quran in Hadith are found in these theories. Specifically, the lie, misrepresentation, betrayal, theft, breach of contract, and deceiving the partners were found in the evaluation. These acts are considered to be the major sins in Islam. The result of the regression models shows the negative impact of EM on the internal performance variables which indicates that EM is not used for better performance; EM also negatively impacts the stability of these Islamic banks. While no significant impact of EM is shown on the management incentives which indicates that EM of these banks is not used by the board of *directors to gain cash monetary benefits. The EM also shows no impact on external performance variable which indicates that EM is not used to signal the market and further that signal theory is not in the practice of management in these banks. Although the managerial discretionary powers negatively impact the performance and stability of these banks but no evidence was found to show that these powers are used to gain monetary benefits. Since the EM reduces the performance and stability of these banks therefore, it is harmful for the investors and shareholders, because it reduces their returns and enhances the chance of destabilization. Therefore; authorities such as Shariah supervisory board, board of governors and Central banks needs to control these discretionary powers of the management which can be used for EM. It is also suggested to the Accounting and Auditing Organization for Islamic Financial Institutes (AAOIFI) to issue a separate and detail accounting standard to control EM practices. To our knowledge this is the first study which theoretically evaluates five EM theories in the light of Quran and Hadith. Similarly the impact of EM on internal/external performance, management incentives and stability is also new addition to the literature. For further research the association between EM and managerial job security, non-cash benefits, and tax rates would be beneficial.*

Keywords: Islamic Banks, Earnings Management, Financial Performance, Stability, Managerial Incentives, AAOIFI.

CHAPTER1. INTRODUCTION

1.1 Background of the Study

The blessings of Almighty *Allah* (S.W.T) on human beings are immeasurable and wealth is one of them. No one can deny the importance of wealth in this world, because it is necessary to sustain life in this world. Earning wealth is an essential element for survival. Before probing the real issue of earnings management (EM) it is beneficial to discuss what is earning in conventional and Islamic finance literature and what their differences are. In conventional literature, the earnings of an organization mean the difference between revenues and expenses. It is the income of an organization which pertains to a specific period of time. The earning is the net income of the corporate operation.[1]In Islamic law, earnings mean the same but with some restrictions. The difference between Islamic and conventional earnings is due to religious constrains. The earnings are distributed in two parts in Islamic law, legal (*Halal*) earnings and illegal (*Haram*) earnings. The difference between the legitimacy and illegitimacy of the earnings depends upon the permissibility and prohibition from where the earnings come from. "*Halal*" is an Arabic word which means permitted and no restrictions are affiliated with it (Al-Qardawi, 1985). In Islamic law, *Halal* is derived from the word *Halala* which means legally allowed, permissible, un-prohibited, and lawful (Jallad, 2008). The legitimacy and illegitimacy of earnings are the sole discretion of the Almighty *Allah* (S.W.T). In this regard Prophet Muhammad (P.B.U.H) said

[1]Robert G. Eccles, Robert H. Herz, E. Mary Keegan, David M. H. Phillips: The Value Reporting Revolution: Moving Beyond the Earnings Game; Price-Waterhouse-Coopers, 2001.

"What Allah has permitted in His Book is halal, and what is haram is haram."[2]

The income from illegitimate (*Haram*) sources such as interest (*Riba*), liquor, gambling, theft, burglary, and obtaining the wealth of others through illegal means is strictly prohibited. Therefore, these incomes cannot be considered legal earnings in Islam. The difference between conventional and Islamic earning is the religious constrains behind it. Earning is an important element for a commercial organization.

The main aim of formation either Islamic or conventional commercial organizations is to earn profit and make money. The owners of the organizations not only want to achieve the profit at the end of the financial year, but they also intend that the financial statements of their organizations look in good manners. Investors in the market consider financial statements as a tool of determination for the performance of the organizations. These financial statements include the statement of financial position, cash flow statement, statement of change in equity, and most important notes to accounts (Fairfield, Sweeney, Yohn, 1996). Financial statements are the only source of information for investors and creditors to make their investment decisions. The importance of all the financial statements is a proven fact but the major investors examine the income of the organization. Therefore, good profit & loss, and income statements attract investors as the main aim of the investor is to earn profit. This trend is well known by the management of the organizations that profit can influence the decisions making of the investors. Therefore, the management of the organization can possibly manage the earnings of the organization. Here the

[2]IbneMajah No. 3358

concept of Earnings Management (EM) comes into play which is a very debatable issue in the financial world.

It is difficult to identify the real and actual definitions of EM because it has different dimensions. Many researchers define EM according to their studies and findings. According to Hill (2018) EM seems to be an illegal act performs legally. Now the question arises that how an illegal act becomes legal. To answer this EM can be explained by the acronym WISE (Debnath, 2016). Elaborating the acronym WISE, W stands for window dressing, here the company dress up the financial statements for potential investors to show that the organization is profitable and their investment will be worthy. While I stand for internal targets where the company manipulates the financial statements to achieve internal targets such as budgeting requirements of different departments. S stands for smoothing where the organizations use different EM techniques to smooth their income in a consistent pattern because many investors like to invest in those companies where the growth pattern of profit is consistent. E stands for external expectations where the company manipulates the financial statements to achieve the predetermined targets of income. However, different authors defined EM in many respects. Mainly, it is defined from two perspectives; one strand of literature defines it from an opportunistic perspective, while the other defines it from an informational perspective.

According to Schipper (1989), EM is a "purposeful intervention in the external financial reporting process with the intent to obtain one private gain". Schipper argues that the managers of the firms intervene in the accounting results to reduce, enhance or flatten the profitability of the companies to maximise their private gain. Davidson, Stickney and Weil (1987) define EM through accounting principles as "the process of taking deliberate steps within the constraints of generally accepted accounting principles to bring about a desired level of reported earnings", while Giroux

(2003) defines EM as "using operations and discretionary accounting methods to adjust earnings to a desired outcome".

The above definitions are based on the manipulation of accounting information which means that managers intentionally manipulate the earnings of the organization in their published financial reporting for their own benefit. The managers perform this act in their own interest rather than the interest of the organization and other stakeholders. They take different measures to mislead the stakeholders, specifically by giving them wrong or falsified information about the organization. Literature reported various–reasons and different theories which compel the management to manipulate the accounting results of the organization. But basically, EM theories are surrounded by two dimensions. 1^{st} is the opportunistic approach while the 2^{nd} is the informational perspective. According to Watts and Zimmerman (1978 & 1986), managers manipulate earnings for two reasons. First, the managers who are the insiders of the company manipulate the accounting results for their own benefit at the cost of other stakeholders who are outsiders to the company. They take different measures to manipulate the accounting results for their own different benefits either financial or non-financial.

The financial benefits include the remunerations which the organization is giving them for their services, it also includes bonuses which are based on the performance of the management. These bonuses might be in the shape of cash rewards or stock incentives. The nonfinancial benefits include job security good reputation and getting more discretionary power in the organization. This type of manipulation negatively affects the interest of outsiders (Shareholders and other stakeholders). The second perspective is the manipulation of accounting results for the maximization of the company's value and informational perspective. That kind of EM may increase the stock price of the company in the stock market or maximize the company's wealth in terms of assets.

The second approach of EM is the informational perspective. According to this approach, EM is a tool for signalling the firm's internal information to the stock market. More liberally it is a tool to enhance the stock prices in the market by giving internal information. Based on this approach, Mahjoub and Miloudi (2005) define EM as "*any decision of reasonable, legal and appropriate management that provides value to stakeholders*". This technique is used by firms before some major business decisions like mergers or acquisitions are undertaken (Erickson & Wang, 1999).

Now a question arises that how the management of the organizations specifically financial institutions manipulate the financial statements. In the modern banking system, financial reports are being made under generally accepted accounting principles (GAAP) followed by the International Financial Reporting Standards (IFRS). Islamic banks also follow these standards worldwide while the GAAP is replaced by IFRS in many countries, in addition, they follow the ***Shariah*** auditing and accounting standards issued by Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). Financial institutions especially banks use loan loss provisions (LLPs) to cover their risks of default loans. The managers of the banks have significant power to manage this kind of accruals. A major strand of literature identified that the total accruals are used for the purpose of EM. The difference between operating activities of cash flow and earnings is called accruals. These accruals are adjusted by the management of the banks; they increase and decrease them according to their needs and specific goals. According to Richardson (2006),accruals are the main component of the manipulation of financial statements. Since the accrual is a very large component it can further be divided into two parts, non-discretionary accruals and discretionary accruals (Wijaya &Martani, 2011).

The non-discretionary accruals are also called normal accruals. The adjustments which reflect the basic performance are preordained to capture through the normal or non-discretionary accruals by the management. In other words, we can say that normal accruals are those accruals which happen normally with the activity changes in the company. These are important components and according to Guenther (1994) Jones (1991) model and modified Jones considered these as function of sales change before the concept of EM. The non-discretionary component of LLPs is reserved for expected credit losses (Whalen, 1994; Beaver & Engel, 1996; Hasan & Wall, 2004). Based on previous practices of banks worldwide the non-discretionary part of LLP is mostly used for non-performing loans (Laeven &Majnoni, 2003; Bikker &Metzemakers, 2005).

The second part of the LLPs is the discretionary accrual which is called abnormal accrual and cannot be observed directly in the financial statements of the banks. The value of discretionary accruals is estimated through a regression model. The discretionary accruals were first estimated by Jones (1991) and model of Jones (1991) was modified by Guenther (1994). The prior literature mostly used the discretionary part of the accruals as a proxy of EM.According to Wahlen (1994), this significant discretion of determining the LLPs can lead to opportunistic behaviour of the managers besides the risk management of default loans. Managers can use the LLPs for their personal benefits rather than institutional benefits. Wahlen (1994) further argues that in order to determine the LLPs the banks' management has significant discretion; this discretion can further be exploited by the management for their opportunistic EM besides the credit risk mitigation.

The accounting scandals such as Enron (2001), WorldCom (2001), and global financial crisis (GFC) of 2008 raised questions on quality of the financial statements. The financial statements of financial institutions were mostly fabricated through EM which was one of the major causes of failure of their corporate governance (CG) mechanism. The failure of the CG mechanism and false accounting reports cost them huge losses. The discretionary part of the LLPs is considered the main proxy of EM and it is mostly used for management objectives. The upcoming three management objectives were identified in prior research (Collins *et al.*, 1995; Ahmed *et al.*, 1999; Hasan & Wall, 2004; Kanagaretnam *et al.*, 2003; Kanagaretnam *et al.*, 2004;Anandarajan *et al.*, 2007).

The first objective of discretionary loan loss provisions (DLLPs) is income smoothing. The management of the banks smooth the income of the banks using the DLLPs, because they want it on a consistent pattern. When the earnings of the banks are expected to be high, they use their discretion through LLP to reduce the income. If the expected income is low then they deliberately keep their DLLPs low to achieve the predetermined income targets. There might be different reasons why the management of the banks want to achieve the predetermined income goals. It will be discussed further in EM theories.

The second objective related to discretionary actions is concerned with capital management. As far as capital management is concerned those banks which pertains low regulatory capital keep LLPs on the higher side because LLPs are mostly considered in Tier 2 capital and are tax-deductible in many countries. This means that increasing LLPs reduce earnings, which prevent Tier 1 capital increase on an after-tax basis, and LLPs are counted as Tier 2 capital therefore, the total capital increases on the after-tax basis. More precisely DLLPs are efficient tool which adjusts earnings to relax regulatory capital constraints.

The third banks management objective of the discretionary actions is signaling. Sometimes the management of the banks increases their DLLPs to signal the market and potential investors that the bank is stronger to absorb the credit losses by having more reserves (Bouvatier, 2012). The reasons for signaling by the management are further discussed in the signal theory separately.

The previous literature revealed that the managers resort to EM mainly due to two reasons; either to manipulate the accounting information for their own benefit at the cost of other stakeholders or to enhance the company's value. Prior literature also documented different causes and techniques which answered these main questions that why and how the management do EM. An important literature review in this regard is conducted by Mahjoub and Miloudi (2015). They found that EM is based on five (5) theories, signal theory, threshold management theory, agency theory, positive accounting theory, and managerial entrenchment theory. They provide detail answers that why and how the management do EM.

Islamic finance industry is expending day by day. The total worth of Islamic finance assets was 3.96 Trillion US dollars at the end of 2021.[3] While Islamic banking system is the major segment of this industry. Being the *Shariah* compliant institutions these banks are based upon the divine law of *Shariah* therefore, they are bound to follow the rules and regulations of *Shariah*. While prior literature reported the existence of EM in the Islamic banks therefore it is very important to review these five (5) EM theories as per the primary sources of *Shariah*.

The conventional financial system is based upon the capitalist ideology where religion has no concern with the financial matters of human beings. The ethics and behaviours in financial matters are watched and controlled by the government and law enforcement agencies. This control mechanism in capitalist ideology is different and varies from country to country, region to region basis. In contrast,Islam is a complete code of life where the entire life of a person (natural as well as

[3]https://www.statista.com/statistics/1090815/worldwide-value-of-islamic-finance-assets/

juridical) is expressed and controlled by the divine law which is called *Shariah*. It does not matter that a Muslim is from which race, color or country he is bound to obey the *Shariah* in every field of life. Specifically, the economic life of a person is expressed ethically. The economic life and ethical standards of *Shariah* can be understood from the *Quran* and *Sunnah*. According to *Quran*

"لَهُ مَا فِي السَّمَاوَاتِ وَمَا فِي الْأَرْضِ وَمَا بَيْنَهُمَا وَمَا تَحْتَ الثَّرَىٰ"

"To Him belongs what is in the heavens and what is on the earth and what is between them and what is under the soil"[4]

These verses of the *Quran* reveal that the primary right to wealth belongs to the Almighty *Allah*(S.W.T) because He is the actual owner of everyone and everything which is available in this universe. Therefore, being the actual owner of the wealth, humans are bound to obey the rules and regulations which is revealed in the holy *Quran*. Being a complete religion Islam fully understands that economic life is an integral part of the human being. Therefore, wealth is considered as the blessing of Almighty *Allah* and documented as *Khair* in the holy *Quran:*

"يَسْأَلُونَكَ مَاذَا يُنْفِقُونَ قُلْ مَا أَنْفَقْتُمْ مِنْ خَيْرٍ فَلِلْوَالِدَيْنِ وَالْأَقْرَبِينَ وَالْيَتَامَىٰ وَالْمَسَاكِينِ وَابْنِ السَّبِيلِ وَمَا تَفْعَلُوا مِنْ خَيْرٍ فَإِنَّ اللَّهَ بِهِ عَلِيمٌ"

"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."[5]

"كُتِبَ عَلَيْكُمْ إِذَا حَضَرَ أَحَدَكُمُ الْمَوْتُ إِنْ تَرَكَ خَيْرًا الْوَصِيَّةُ لِلْوَالِدَيْنِ وَالْأَقْرَبِينَ بِالْمَعْرُوفِ حَقًّا عَلَى الْمُتَّقِينَ"

[4] Sura TaHa- 20:6
[5] Sura Al-Baqarah- 2:215

"Prescribed for you when death approaches [any] one of you if he leaves wealth [is that he should make] a bequest for the parents and near relatives according to what is acceptable - a duty upon the righteous."[6]

The above-mentioned verses of the *Quran* mention that wealth is considered ***Khair*** in ***Shariah***. Thus, earning wealth is an important part of human life, but there are some ethics to be followed and certain prohibitions to be observed while earning wealth. The first and foremost obligation which is ordained by the holy *Quran* and *Hadith* is to earn *Halal*. According to *Quran*

"يَا أَيُّهَا النَّاسُ كُلُوا مِمَّا فِي الْأَرْضِ حَلَالًا طَيِّبًا وَلَا تَتَّبِعُوا خُطُوَاتِ الشَّيْطَانِ ۚ إِنَّهُ لَكُمْ عَدُوٌّ مُبِينٌ"

"*O mankind, eat from whatever is on earth [that is] lawful and good and do not follow the footsteps of Satan. Indeed, he is to you a clear enemy.*"[7]

"يَا أَيُّهَا الرُّسُلُ كُلُوا مِنَ الطَّيِّبَاتِ وَاعْمَلُوا صَالِحًا ۖ إِنِّي بِمَا تَعْمَلُونَ عَلِيمٌ"

"O ye apostles ! enjoy (All) things good and pure, And work righteousness: For I am well-acquainted With (all) that ye do"[8] *(23: 51)*

Almighty *Allah*(S.W.T) says to His messengers to eat from the *Halal* blessings of *Allah*. *Halal* earnings are considered to be worshipping *Allah* (*Ibadah of Allah)*. Islam promotes and encourages *Halal* earnings.A famous *hadith* of Prophet Muhammad (P.B.U.H) which is narrated by Abdullah (R.A)

"The seeking of a halal earning is the (next) Fardh (duty) after the Fardh".[9]

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[6] Sura Al Baqara- 2:180
[7] Sura Al-Baqara- 2:168
[8] Sura Muminun- 23:51
[9] Baihaqqi.

Another Hadith in this regard from the Prophet Muhammad (P.B.U.B) is

"A time will come upon the people when one will not care as to how he gets his money whether legally or illegally."[10]

Similarly in the context of *Halal* earnings, when the Prophet Muhammad (P.B.U.H) was asked about the best earnings He replied

"A man's work with his hands, and every legitimate sale"[11]

This *Hadith* shows the importance of *Halal* earning in human life, where it is a compulsion for every Muslim. Here the legitimate indicates the acceptability of the trade by Shariah. By doing this Almighty *Allah* (S.W.T) will reward, if the trade is free from cheat, betrayal, corruption and its aim is to provide the needs of people in a legitimate way (Alninawi, 1994). The Holy words of the *Quran* and the teachings of Prophet Muhammad (P.B.U.H) are significant to show the importance of *Halal* earnings. While earning *Haram* is considered a major sin in *Shariah*.

The questions, however, arise as to differentiate between *Halal* and *Haram* earnings. There has been extensive discourse in Islamic literature to identify and acquire *Halal* and desist from *Haram*. As reflected from the aforementioned injunctions of *Shariah*, the ideology of livelihood is based upon *Halal* earnings. Such earnings need to be *Shariah* approved, acquired through lawful means, and free from coercion and transgression. The means of *Halal* and *Haram* earnings are documented in the light of *Shariah* by Beekun (2006). He distributed the *Halal* earnings in two areas based on the aforementioned *Hadith*. The agriculture sector and the industry sector along with other professional areas. In the business area, some partial list of illegitimate earnings is also documented

[10] Bukhari: 1941
[11] Musnad Ahmad No: 1576

by Beekun (2006) such as trading in alcohol and dealing in drugs and intoxicants. Production and sale of *Haram* goods such as manufacturing idols, pornography, pork and all kind of similar activities which generates earnings are considered *Haram* earnings. Similarly, prostitution is also declared Haram earnings. The uncertain transaction is also declared *Haram* earnings. Similarly, sometimes the behaviour, intentions, and acts make the earnings *Haram*. EM might be the result of the intentions and acts which convert or divert the *Halal* earnings into *Haram*.

As EM is the manipulations of financial statements and it deceives the stakeholders by presenting wrong or false information to them, therefore it is considered as misrepresentation in general terms (Jalal, *et al.*, 2016). The lie or misrepresentation is considered as major sin in Islam. According to the holy *Quran,*

"إِنَّمَا يَفْتَرِي الْكَذِبَ الَّذِينَ لَا يُؤْمِنُونَ بِآيَاتِ اللَّهِ ۖ وَأُولَٰئِكَ هُمُ الْكَاذِبُونَ"

"Surely they who do not believe in the signs of Allah only fabricate lies, and those are they (who are) the liars."12

"يَا أَيُّهَا الَّذِينَ آمَنُوا اتَّقُوا اللَّهَ وَكُونُوا مَعَ الصَّادِقِينَ"

"O you who have believed, fear Allah and be with those who are true."[13]

أَلَا لِلَّهِ الدِّينُ الْخَالِصُ وَالَّذِينَ اتَّخَذُوا مِنْ دُونِهِ أَوْلِيَاءَ مَا نَعْبُدُهُمْ إِلَّا لِيُقَرِّبُونَا إِلَى اللَّهِ زُلْفَى إِنَّ اللَّهَ يَحْكُمُ بَيْنَهُمْ فِي مَا هُمْ فِيهِ يَخْتَلِفُونَ إِنَّ اللَّهَ لَا يَهْدِي مَنْ هُوَ كَاذِبٌ كَفَّار

"Indeed, sincere devotion is due only to Allah. As for those who take other lords besides Him, saying, "We worship them only so they may bring us closer to Allah," surely Allah will judge

[12] Sura Nahl- 16:105
[13] Sura Tauba- 9:119

between all1 regarding what they differed about. Allah certainly does not guide whoever persists in lying and disbelief."

"وَلَا تَلْبِسُوا الْحَقَّ بِالْبَاطِلِ وَتَكْتُمُوا الْحَقَّ وَأَنتُمْ تَعْلَمُونَ۝"

"And do not mix the truth with falsehood or conceal the truth while you know [it]."[14]

"وَيْلٌ لِّكُلِّ أَفَّاكٍ أَثِيمٍ"

"Woe to every sinful liar(45:7)"

All these verses of the holy *Quran* directly declared the 'lie' to be a major sin in Islam. As EM is the manipulation of accounting with the primary purpose of deceiving the stakeholders for the personal gains of the management therefore, it is considered sinful and unethical behaviour. Being owners of the organization the shareholders must be aware of the real position of the company, whether the company faces loss or earns a profit. The Prophet Muhammad (P.B.U.H)himself practiced trade and devised rules which provide guidance and prescribe *Halal* earnings through ethical and lawful means. According to a famous *Hadith*

"A truthful and trustworthy merchant is associated with the Prophets."[15]

In the continuation of being truthful, particularly, in financial matters, the Prophet Muhammad (P.B.U.H) said

"The seller and the buyer have the right to keep or return the goods as long as they have not parted or till they part; and if both the parties spoke the truth and described the defects and qualities [of

[14] Sura Al Baqara- 2:42
[15] Al-Tirmidhi, No. 50.

the goods], then they would be blessed in their transaction, and if they told lies or hid something, then the blessings of their transaction would be lost."[16]

Therefore, to receive the blessings of Almighty *Allah* (S.W.T), the traders must be truthful in the transactions and nothing should be hidden from the parties involved in the business transaction. If the management of the company manipulates earnings for their personal benefit, they misguide the stakeholders of the company which is not only a major sin, but they also deprive the business from the blessings of Almighty *Allah*.

Another major aspect of Islamic financial ideology is the concept of *Amanah*. *Shariah* complaint businesses are mostly based on *Musharakah* or *Mudarabah* models worldwide. A partner must take care of the interests of other partners. They are *Ameen* of each other's interests. According to *Hadis Qudsi*

"Allah (S.W.T) declared that He will become a partner in a business between two Mushariks until they indulge in cheating or breach of trust (Betrayal)".

The *Hadith* clearly indicates the role of trust and fair dealings in the business. According to *Quran*

"وَلَا تَأْكُلُوا أَمْوَالَكُمْ بَيْنَكُمْ بِالْبَاطِلِ وَتُدْلُوا بِهَا إِلَى الْحُكَّامِ لِتَأْكُلُوا فَرِيقًا مِنْ أَمْوَالِ النَّاسِ بِالْإِثْمِ وَأَنْتُمْ تَعْلَمُونَ"

"And do not consume one another's wealth unjustly or send it [in bribery] to the rulers in order that [they might aid] you [to] consume a portion of the wealth of the people in sin, while you know [it is unlawful]."[17]

[16] Al-Bukhari, No: 2079.

It is clearly prohibited to acquire the wealth of others through unjust means. Using EM techniques to fabricate the accounting results for personal benefits at the cost of shareholders can be considered betrayal which is a major sin in Islam. The word "Unjustly" mentioned in the *Ayah* covers different dimensions of unethical behaviours such as theft, falsehood, betrayal etc. The theme of this *Ayat* clearly contradicts the opportunistic dimensions of EM.

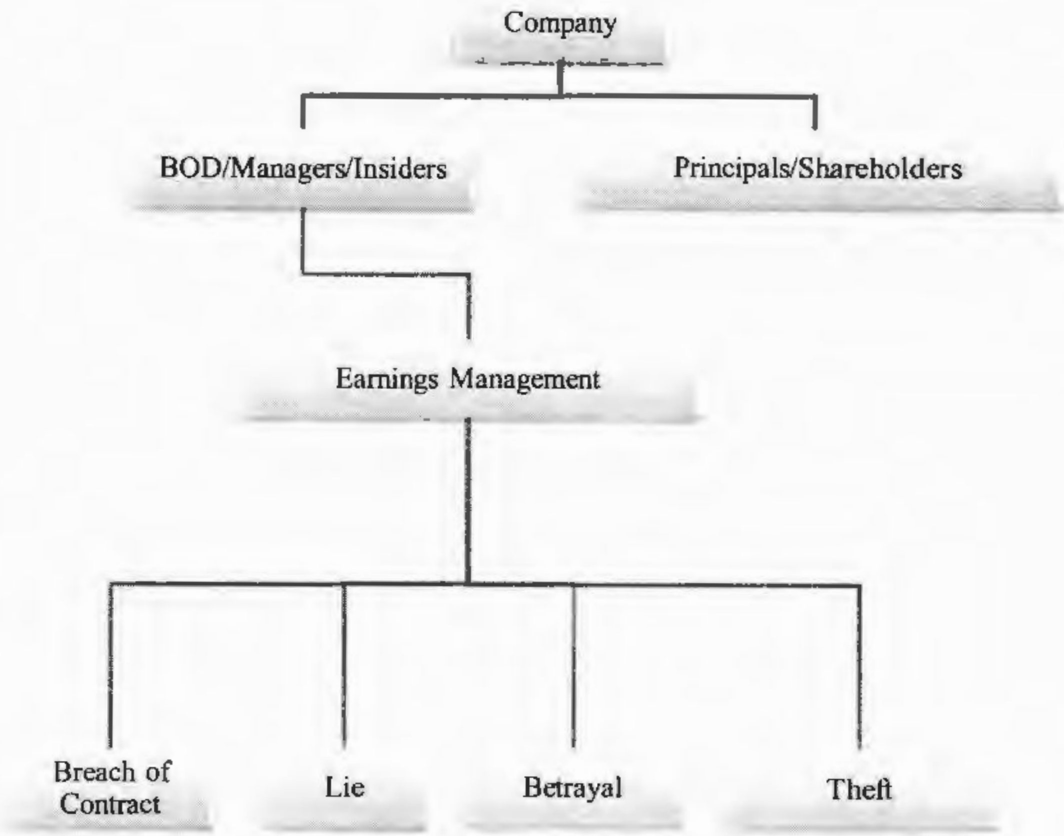
The listed Islamic banks are incorporated as limited liability companies and act as artificial/legal persons. This person collects the deposits from investors on the basis of *Musharakah* and *Mudarabah*, which both are participatory modes of financing. According to a famous *Hadith e Qudsi*

"AllahSunhan-o-TAllah has declared that He will become a partner in a business between two Mushariks until they indulge in cheating or breach of trust."[18]

Thus, to get the blessings of Almighty *Allah* it is necessary that all partners must not indulge each other in business activities and ethics must be followed. According to Hamdi and Zarai (2014) EM is not conformed to *Shariah*. Normala, Obid and Demikha (2011) argued that due to false accounting statements by the managers, EM is unethical behaviour which is not allowed. Islamic financial institutions were formed to eliminate *Riba*, and the main motive of this system is to provide a financial system, which is based on *Shariah* and free from *Riba* and betrayal (*Khayanah*). Therefore, it is expected from Islamic banks to be immune from opportunistic EM which is lies, betrayal and misrepresentation. EM from an Islamic perspective can be explained in Figure 1.1

[17] Sura Al Baqara- 2:188
[18] Abu Dawood- 3374

Figure 1.1 Earnings Management and Shariah



1.2 Gap Analysis

EM generally is studied in conventional finance, accounting and CG literature. This strand of literature mainly answers two major questions, why and how the management performs EM. Theoretically it was concluded from the aforementioned literature that EM is based on five theories signal theory, threshold management theory, agency theory, positive accounting theory, and managerial entrenchment theory (Mahjoub & Miloudi, 2015). Prior literature also reported that management of conventional and Islamic banks do EM. Being the manipulation of financial statements it is considered an unethical act. It is necessary to find out that what the stance of

Shariah on EM is? By reviewing the literature it is also found that signal theory, threshold management theory, agency theory, positive accounting theory and managerial entrenchment theory which are the base of EM, are not yet evaluated from *Shariah*'s point of view. This study theoretically tries to fill this gap in the literature in the light of primary sources of *Shariah*.

Similarly, the empirical literature of EM in Islamic banks mainly focuses on detecting the level of EM and its comparison with their conventional counterparts. Quttainah, Song and Wu (2013) compared the EM behaviour of Islamic banks (IBs) and conventional banks (CBs) in 15 countries and reported that IBs employ less EM than CBs. Vania, Nugraha and Nugroho (2018) compared 13 Indonesian and 15 Malaysian conventional and Islamic banks and reported that EM happened in both countries with significant differences. A recent study was conducted by Lassoued, Attia and Sassi (2018), theystudied the techniques of EM of IBs and CBs. They reported that in Mena region IBs employ fewer earnings management techniques as compared to CBs. They further reported that institutional ownership encourages EM practices while concentrated family ownership reduces these practices.

In comparison with conventional banks Zainuldin and Lui (2018) reported important findings. They observed 53 Islamic and 111 conventional banks from 2006 to 2011, which also covered the GFC period and reported that Islamic banks are engaged in more EM practices than their conventional counterparts. This means that as for as financial reporting is concerned Islamic banks are engaged in more manipulation than conventional banks which is against the Islamic notion of fairness, transparency and ethical standards in conducting business activities. Hamdi and Zarai (2013) conducted a very important study regarding EM and the future profitability of Islamic banks. They used 81 Islamic banks for the period of 10 years in their sample and reported that there is a positive impact of EM proxy on future profitability. But they used only EM proxy to evaluate future profitability ignoring control variables and there might be a chance of biasness in the study. It is empirically proven fact that management of the Islamic banks also involves in EM. But what is the impact of their EM on the internal and external performance variables and stability of Islamic banks? It is yet to be found out. Similarly, it is also important to find out that the EM of the management is associated with their monetary benefits or not.

1.3 Problem Statement

Islam encourages ethical standards to be followed in every field of life, especially in business the transparency, truthfulness and fairness are the obligations of every partner. EM is the manipulation and misrepresentation of financial statements which is considered to be a Lie and Betrayaland is prohibited in Islam. Islamic banks were formed to perform ethical business and to prevent people from the major sin of *Riba* and all its types. These banks work on the *Mudarabah* model where their responsibility is to perform the act of *Wakeel* (Agent), *Ameen* (Trustee), and *Shareek*(Partner). Therefore, involving in EM will disturb their ethical standards of transparency and truthfulness, which is the core of Islamic finance.

Islamic banks must be immune from EM especially opportunistic EM which is considered the manipulation of financial statements for their own benefit at the cost of other stakeholders. This is a major sin and is considered to be *Haram* in Islam.

1.4 Objectives of the Research

Prior literature reported EM as a manipulation of accounting results therefore, in general it is considered to be *Betrayal* and *haram* from *Shariah's* point of view. This study further evaluates the (5) five theories of EM from the primary sources of *Shariah i.e Quran* and *Sunnah*. Hence, the first part of the study is qualitative analysis of these theories.

Empirically some literature reported that Islamic banks are involved more in EM practices as compared to their conventional counterparts. Therefore, there is a need to evaluate whether the EM of Islamic banks is opportunistic or not. The objectives of this study as such relate, in general, to the evaluation of various theories related to EM and their implications for Islamic banks. To achieve these objectives empirically the impact of EM on the internal and external performances of the banks, management incentives, stock returns, and stability is evaluated. However, the particular objectives are presented as under:

1. To evaluate theories of EM from Islamic perceptive. Specifically,

   1.1 To evaluate signaling theory from Islamic perceptive.

   1.2 To evaluate threshold management theory from Islamic perceptive.

   1.3 To evaluate agency theory from Islamic perceptive.

   1.4 To evaluate enrichment theory from Islamic perceptive.

   1.5 To evaluate political-contractual accounting theory from Islamic perceptive.

2. To evaluate the impact of EM on the internal and external performances of Islamic banks specifically,

   2.1 To evaluate the impact of discretionary loan loss provisions on return on equity (ROE) of Islamic banks.

2.2 To evaluate the impact of discretionary loan loss provisions on return on assets (ROA) of Islamic banks.

2.3 To evaluate the impact of discretionary loan loss provisions on the stock returns of Islamic banks.

These three objectives help us to investigate that the EM of the Islamic banks is performed for better performance or not. The impact of DLLP on stock returns also demonstrates the presence and non-presence of Signal theory practice.

3. To evaluate the impact of discretionary loan loss provisions on management incentives. This objective is important to evaluate the moral hazards of agency theory which is in fact opportunistic EM.
4. To evaluate the impact of discretionary loan loss provisions on the stability of Islamic banks

1.5 Research Questions

Keeping in view the objectives, the following research questions have been framed:

1. What is the viewpoint of *Shariah* on EM theories? Specifically, what is the viewpoint of the *Quran* and *Hadith* on Signaling, Agency, Threshold, Entrenchment, and Political Contractual theories? And how these theories contradict Islamic work/business ethics?
2. What is the impact of discretionary loan loss provisions on the performance specifically,
    2.1 What is the impact of discretionary loan loss provisions on the return on equity (ROE) of Islamic banks?

2.2 What is the impact of discretionary loan loss provisions on the return on assets (ROA) of Islamic banks?

2.3 What is the impact of discretionary loan loss provisions on the stock returns of Islamic banks?

3. What is the impact of earnings management on management incentives of Islamic banks?

4. What is the impact of earnings management on the stability of Islamic banks?

1.6 Significance of the Study

This study enhances the literature on EM in Islamic banks. Specifically, the study of five EM theories in the light of *Shariah* is a valuable addition to the literature. Moreover, the impact of EM variable DLLP on internal and external performance variables ROE/ROA/Sr, management incentives, and stability of these banks is beneficial for all the stakeholders of these banks.

The result of the empirical analysis is very important for the shareholders of these banks. They may be aware of the financial performance and stability of their banks. Besides the financial performance and stability, they would also be aware of the following ethical and religious standards hy the management of these banks. From the empirical results, in terms of cash benefits, they shall be aware of the behaviour of the management of these banks whether the EM of the management is opportunistic or not.

The investors of Islamic banks mainly invest in these banks due to religious reasons. If opportunistic behaviour of the management is detected in the operation of EM this might be a very serious concern for the investors of these banks because of the prohibition of unethical and opportunistic behaviour. Furthermore, the objective of their investment is to earn a profit, they must be aware of the reduction in their earnings due to EM. The findings of this study may guide the investors that whether, these banks follow ethical Islamic standards or not.

In the case of the detection of opportunistic EM, the findings of this study may be very important for the *Sharia* boards of the banks as well as authorities to take measures to control it. The qualitative and quantities parts of the study would be beneficial for the policy makers of the Islamic banks in different ways e.g., detecting unethical EM practices is a violation of basic Islamic principles so they would make policies to control it, furthermore, the evaluation of five EM theories from Shariah perspective would be beneficial for *Shariah* boards in terms of enhancing the knowledge about these theories.

1.7 Scope of the Research

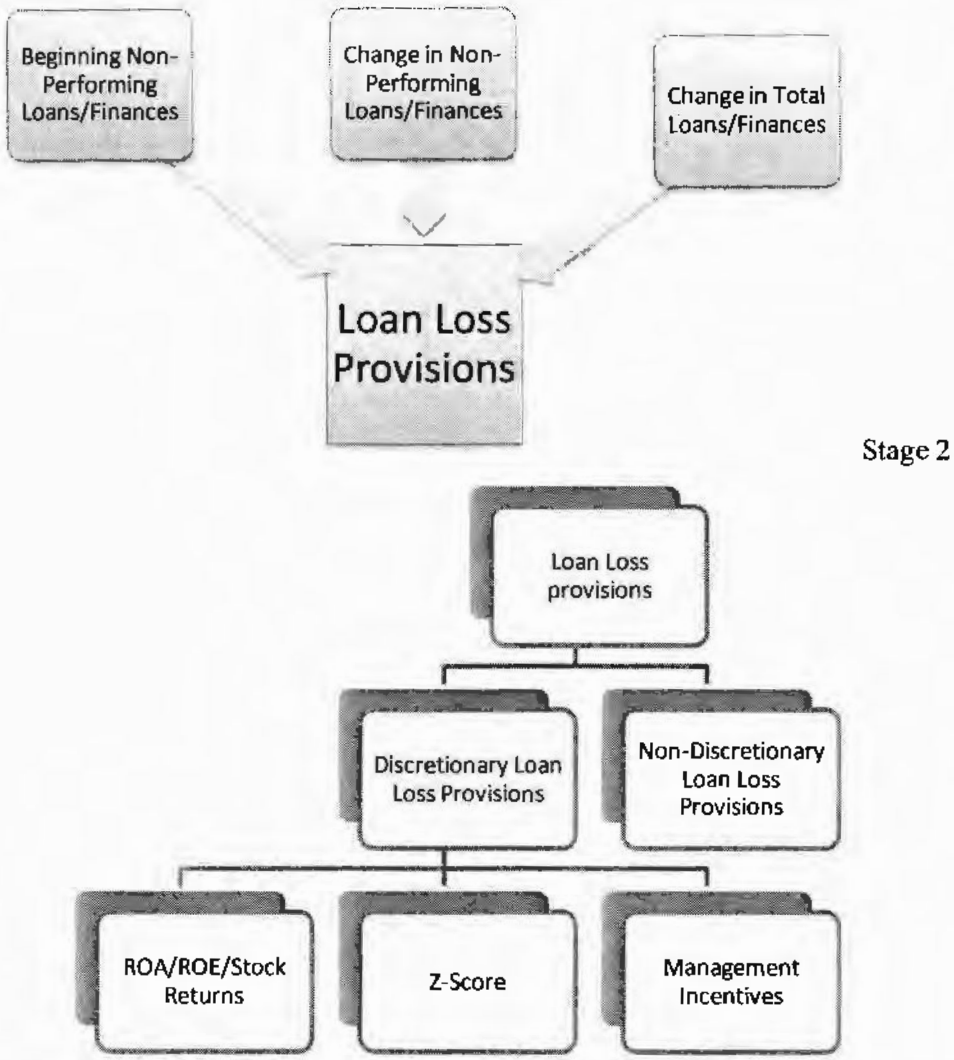
The aim of this study is to generally evaluate EM from the primary sources of *Shariah*. Specifically, the first part of the thesis critically evaluates the five EM theories in light of primary sources of *Shariah*. Furthermore, in the second part of the thesis, the impact of EM variable DLLP on the internal (ROE/ROA) and External (Stock Returns) performance of Islamic banks is investigated. The impact of DLLP is also investigated on the cash remunerations taken by the board of directors. Moreover, the impact of DLLP on the stability variable (Z-Score) of Islamic banks is also investigated. The sample size includes all the listed75 full fledge largest Islamic banks worldwide which also includes all 23 full fledge Islamic banks from the GCC region, and 23 full fledge Islamic banks from the ASEAN region. The time frame of the research is from 2009 to 2019. 2009 is a post-GFC year while the available data of Islamic banks on their websites were up to 2019 at the time of data collection. The Islamic windows and divisions of conventional banks are excluded because of mixed financial statements and combined share prices.

1.8 Design of the study

This section of the thesis discusses the design and framework of the study in detail. First, it shows the design of the study which consists of two stages, and then the design is discussed with a theoretical framework in detail.

Figure 1.2: Design of the Study

Figure 1.2 Design of the Study



The first stage shows the total loan loss provision which is dependent on non-performing loans at the beginning of the year, change in non-performing loans and change in total loans. The total loan loss provision is the combination of discretionary and nondiscretionary loan loss provisions. We need to estimate the discretionary loan loss provisions from the total loan loss provisions because these are not available directly in the financial statements. To separate the discretionary loan loss provisions from total loan loss provisions we follow Kanagaretnam (2004) and Taktak, Zouari and Boudriga (2010). After the estimation of discretionary loan loss provisions, stage 1 of the study is completed.

In stage 2 we use this estimation as a proxy for earnings management and further use it in our next models. Now, this discretionary part is the earnings management of the bank. The impact of this earnings management (DLLP) is shown further on internal (ROE/ROA) and external (Stock returns) performance variables, stability (Z-score) and management incentives of the Islamic banks.Theoretically from *Shariah*, the earnings management of Islamic banks will impact positively on the performance variables, and positively on the stability of the banks and no significant impact of earnings management with management incentives is expected.

The positive impact of earnings management on internal performance variables (ROE/ROA) indicates that earnings management is good for the profitability of the banks. The positive impact of earnings management on stock price indicates that the Signal theory is in practice and the informational signals of the management attract the investors from the stock market this also indicates that earnings management of the Islamic banks enhances the stock value of the banks. Further, the positive impact of Z-score indicates that earnings management is done for the stability of the banks. The positive impact of earnings management on stability also indicates that earnings management is done to reduce the risk of insolvency. While the positive impact of earnings management on management incentives indicates that their discretion of earnings management is used for personal benefits and the agency theory persists and needs to be controlled.

CHAPTER2.LITERATURE REVIEW

This chapter of the thesis covers the prior studies on earnings management (EM), specifically, the studies regarding EM and its history in general, which is covered in part 3.1 followed by EM in banks in part 3.2 and finally literature on EM in Islamic banks in part 3.3.

2.1 Earnings Management

The financial statements show the current position of the entity based on past events and transactions. These financial statements are further used by the users for prediction and investment decisions in the entity. The trend of decision-making on the basis of financial statements gained the attention of scholars regarding income smoothing and creative accounting. The concept of income smoothing was presented and developed in the middle of the 20th century by Hepworth (1953). He argued that the management of the firms smoothes their income to reduce or save their taxes. The management uses the techniques to shift the earnings between periods, differs the expenses and costs or select several types of accounting techniques. The concept of creative accounting was presented by Park (1958) later on. He considered creative accounting as an innovative tool of accounting which is performed under the given limits of GAAP.

From the middle to almost the end of the 20th century the researchers believed that income smoothing is a tool of accounting that reduce the large fluctuations of income in the financial statements (Beattie et. al., 1994; Moses, 1987; Beidleman, 1973; Copeland, 1968). The management of the organizations smooth the income for their compensation and job stability along with the satisfaction of shareholders (Gordon, 1964). Similarly, the techniques through income smoothing done by the management are also studied in the 20th century. For example, Ronen and Sadan (1975) found that income smoothing is done through extraordinary items in the financial statements. While Beattie et al. (1994) endorsed their statement. Moses (1987) found that income smoothing is done by the management through accounting changes. The findings of Greenawalt and Joseph (1988) are very important in this regard. They empirically found that the management of the companies smoothed their earnings through loan loss provisions. Similarly, Ma (1988) also reported the same findings. To manage the earnings the management of the companies use accruals (Healy, 1985).His empirical work examined the relationship between accounting decisions and bonus plans of the management. The concept which he introduced is used widely in the studies of earnings and the manipulation of accruals. For example, the Studies of (Sweeney, 1994; DeFond & Jiambalvo, 1994).

These researchers showed the world a different dimension of income smoothing. Many researchers after that argued that income smoothing is just one part of a broader mechanism which they called and define as earnings management (Leuz et al., 2003; Beattie et al., 1994; Schipper, 1989; Dechow and Skinner, 2002; Lang, Raedy and Wilson, 2006).Recently some studies are conducted on income smoothing such as Hope and Thomas (2013), and Sun (2011).

EM is well defined by Schipper (1989) and his definition was extended by Healy and Wahlen (1999). Their definitions of EM are around the incentives of management, the judgment of the financial statements and the intention of management to influence the financial reports. These definitions are used widely in the literature on EM. However, these definitions ignored the association between GAAP and EM. Therefore it is difficult to understand from their definitions that the misstatement has occurred from fraud or error.

The difference between fraud and EM is discussed by Dechow and Skinner (2000). They argued EM is the accounting choices within the rules and regulations of GAAP while accounting frauds does not comply with the rules and regulations of GAAP. They believed that the conservative or aggressive accounting to manage earnings is called EM. Conservative accounting is explained by Bushman and Piotroski (2006) as recognition of the gain and loss of the organization.

The EM is classified into two parts, the decisions in real operations which are called "real EM" and the decisions in financial statements which are called "accruals management" (Ewert and Wagenhofer, 2005; Peasnell, Pope and Young, 2000 & Schipper, 1989). The difference between these two decisions making systems is elaborated by Schipper (1989). He argued that managing the timing of the production and investment is called real EM while the selection of the accounting techniques under the rules and regulations of GAAP is called accruals EM. A major form of EM is Ewert and Wagenhofer (2005) explained that one form of EM is shifting the income between different periods within the accounting standards. These two classifications can be explained further separately.

2.1.1 Real Earnings Management

The real EM consists of those activities by which the management of the companies tries to influence the reported earnings which affect the cash flow of the companies (Gunny, 2005). According to Roychowdhury (2006)

"*Real activity manipulation is defined as departures from normal operational practices, motivated by managers' desire to mislead at least some stakeholders into believing certain financial reporting goals have been met in the normal course of operations*"

He argued that this action impacts the cash flow negatively while sometimes also accruals. The act of real EM may not contribute to achieving the company goals; sometimes it negatively impacts the organizational objectives. According to Zang (2005)

"Measures aimed at changing the declared profits in a specific direction. This change is achieved through structuring transactions and manipulating timing or financial transactions to reach the optimum level. Real earnings management is based on the availability of two basic elements, which are real decisions and means operations and investment activities such as decisions to accelerate sales Reducing research and development expenditures from activities, and these transactions usually affect cash flows, and The second element is that managers take measures to deviate and move away from ideal procedures, and this component is the basis for the problem of agency theory".

It means a purposeful intervention to manipulate the reported earnings in a specific direction is called real EM. The specific goals can be achieved by the management through the change in the structure and time of an operation, financial transaction or investment. This indicates that the managers intentionally manipulate the real activities of the companies because they have incentives to do so. These incentives include the predetermined targets set by the companies and management. According to Xu, Taylor and Dugan (2007)

""Managerial technique to alter the published profits of an organization through adjustment its scales and timing is called real earnings management."

They divided the real EM into two parts. First; controlling operations which include sales, inventory, growth and capital spending. Second manipulating the investing activities which include stock options, stock repurchase, investments, and financial instruments. Real EM is also defined by Ewert and Wagenhofer (2005)

> *"Manipulating of real business activities of an organization by altering its time to increase or decrease earnings at specific reporting time."*

They emphasized the realization of the transaction and record it in the books of accounts. The gape between both of these events is utilized by the management for the purpose of EM. More recently Choen, Pandit, Wasley and Zach (2015) defines real EM as

> *"It represents the measures taken by managers to change the real activities of the company to achieve the desired goals of financial reports".*

The desired goals of financial reports might be different and diverse. These goals are the predetermined targets of the management. The predetermined targets include overcoming on previous period's profit, avoiding losses to report zero results and beating analysts' expectations. The management of companies gives very high priority to achieving these targets (Graham, Harvey and Rajgopal, 2005). They are sometimes willing to fabricate real activities to achieve these predetermined targets. This behaviour can cost the company and reduce the cash flow in the following period which may ultimately reduce the value of the company. For example, the discount scheme on the products of the company may increase the short-term cash flow and the predetermined targets but in long run, this will impact the profitability and value of the firm (Roychowdhury, 2006).

Literature reports different techniques to perform real EM such as manipulations of sale, manipulations of productions costs, manipulations of discretionary cost and timing the sale of a fixed asset for reporting the gain. We discuss these techniques further in detail.

The company's biggest source of income is a sales account. Therefore, management of the companies manipulates the sales account to increase the company profile. Sales manipulation is a major tool of real EM in companies. It is defined as the managerial attempt to increase the sales of the company temporarily before the end of a financial year (Chine, 2008). The managers take measures which affect the volume and process of sales (Gunny, 2005; Roychowdhury, 2006).The major technique of real EM through sales is price discount. When the company introduces a price discount it enables the management to increase their sales to the peak even before the financial year ends (Chapman, 2008). The cut in the price will increase the demand for the products naturally while in the next year, the company will not be in a position to offer discounts. The natural price of the products will reduce their sales. Therefore the increase in the sales of the current year is not real while the gains from this kind of sales are purely temporary and will harm the company in the future. Another technique of real EM is providing a credit discount to the customers. With these discounts, the managers can enhance their sales and can achieve the predetermined targets. Similarly, leniency in credit terms can increase demand and enhance sales (Elmadhoun & Gaddam, 2021).

Another major technique of real EM is to reduce discretionary expenditures. The management of the companies manipulates these expenses to show their managed profitability. In this regard, the expense of research and development (R&D) is manipulated widely. The expenditures spent on R&D are considered to be a major tool of profitability, especially in technologically advanced companies. The impact of this expenditure comes in the future therefore if the management intends to increase their profitability of the current year they reduce spending on this expense which is real EM (Elmadhoun & Gaddam, 2021). Similarly, advertising expense plays an important role in increasing sales. If the management intends to show high profitability in the fiscal year they reduce spending on advertising and general expenses. This kind of real EM may affect future performance negatively.

Another means of real EM is overproduction. The over or excessive production increases the produced units automatically decrease per unit cost which ultimately reduces the cost of units sold. To minimize the cost of finished goods the management uses the idea of overproduction and increasing the produced units which is one of the means of real EM. This method is used to reduce the cost and mean of real EM (Roychowdhury, 2003). The management enhances the units through production to meet the expected demand; while the fixed expenditures are divided by the number of units produced which ultimately reduces the production cost (Roychowdhurv, 2006). The managerial costs increase over time but this exceeds does not exceed the per unit fixed cost, ultimately the total cost of the production decreases. By using this technique the profitability may increase in the fiscal year. But this excessive production may increase the storage cost (Chapman, 2008).

The management of the companies has significant control over the assets therefore they can influence reported earnings from the timing of the sales of the assets. If the asset which holds unrealized profit is sold this timing of the sale of the asset will improve the recorded earnings, while the sale of that asset which holds unrealized loss will decrease the earnings. Hence the sale of assets and their time to sale can be used for real EM purposes (Bartov, 1993). Recently Gunny (2010) also reported the use of asset sale timing for achieving earnings targets by the companies.

When we look at the consequences of real EM, it usually hurts the companies' interest. When the managers achieve the profitability targets set by the owners for incentives, they are bound to pay their contractual obligation. Secondly, the management of the companies utilizes their time and resources for manipulation they would rather utilize these recourses and time in fruitful activities. Therefore, real EM activities such as manipulation minimize efficiency and place heavier financial requirements on companies (Demski, 2004). When the management involves in real EM and manipulates the actual business activities tbey deviate from the standard market protocol and waste the money of the company. For instance, to compete in the market, innovative techniques, effective products and boosting the cash flow and sales R&D is argued to be the best tool (Seifert & Gonenc, 2011). Managing and reducing R&D through real EM might increase profitability temporarily but it may have some serious consequences in the future. In this regard, Kumar, Vij and Gowswami (2021) presented interesting results. They investigated the real EM practices of 108 firms in 21 industries from 2006 to 2018 in the Indian capital market. They found that these firms were involved in real EM while their real EM practices negatively impacted the internal accounting performance (ROE/ROA) and external performance (Price to earnings) in the market.

The real EM affects the firm value; this statement is also supported by the empirical evidence of Susanto (2017). His study investigated the real EM practices of 162 companies from 2015 to 2015 in the Indonesian stock market with the conclusion that real EM negatively impacts the firm value. Similarly, Bhojraj *et al.* (2009) found that real EM affects the firm long-term value. Cohen and Zarowin (2010) reported that firms that are engaged in real EM activities face lower performance in the future. Wilson (2015) argued that real EM impacts the informational content of earnings negatively.

However, there are some studies which reported the positive impact of real EM on firm value and performance. For example, Gunny (2010) found that the companies which engaged in real EM to overcome zero earnings and earnings growth experienced a higher return on assets in the following 3 years. The association between real EM and future performance is investigated by Taylor and Xu (2010). They concluded that when management intends to beat analysts' forecasts and do real EM, this kind of EM does not reduce the future performance of the companies.

Although there are some studies which concluded that real EM is not that effective in contrast the majority of the literature warned that real EM activities such as reduction in the expenditures of R&D, manipulating sales and overproduction can influence the future performance of the companies negatively.

2.1.2 Earnings Management through Accruals

It is very important to understand the function of accruals before understanding EM through accruals. The major function of accruals is to reduce the information asymmetry between the stakeholders and management of the company; it is also a good tool to observe the performance of the company in continuous intervals (Dechow, 1994). The accruals are often estimated on the basis of managerial judgment which may lead to managerial opportunism and the transfer of wealth from stakeholders to managers. Therefore, the management of companies manipulates the accrual which has no cash flow consequences directly. The delaying assets write-off and provisions for bad debts are the best examples of earnings through accruals management (Roychowdhury, 2006).

Different kinds of accruals are available in different kinds of companies. These accruals can be used by the management to acquire the predetermined profit goals (Dharan, 2003). According to the situation, they may increase and decrease the level of these accruals. For example prepaid expenses, accrued liabilities, payable accounts, differed revenue, accounts receivables and inventory are easy for managers to manipulate. While studying the accruals management from the literature it is revealed that there are two types of accruals, discretionary accruals and non-discretionary accruals.

Non-discretionary accruals are classified as those accruals which depend on external factors and are out of the control of the management (Jones, 1991). For example, the organic sales growth of a company will enhance the account receivable account along with the bad debts of the company even if the proportion of bad debts remains the same. In contrast, the discretionary accruals are in the control of the management therefore they can be manipulated (Jones, 1991). Hence the main focus of the researchers is on discretionary accruals because the management uses them for accrual-based earnings management (ABEM). According to Wróblewski (2016), the ABEM is performed in two ways, first, the EM is performed under the rules and regulations by using the flexibility in the laws, and second, the EM is performed violating the accounting standards such as IFRS, GAAP, IAS or other locally made laws in which the company is registered and perform business.

The prior literature documented the techniques of ABEM. According to Amat, Blake and Dowds (2003), Dechow and Skinner (2000), Bauwhede and Willkekns (2003) and McKee (2005) reported the ABEM techniques. First, we discuss those reported techniques mentioned in these studies which violate the accounting norms and rules. Then we will discuss their reported techniques which are applied under the rules and regulations.

In the first category, the management of the companies utilizes and manipulates the sales account. They record the sales before the realization while sometimes they record factious sales to increase fabricated profitability. Sometimes the management overstates the inventory by factious entries.

In the second category, they documented that the management uses the "*overly aggressive recognition of provision and reserves*" technique which is the recognition of the costs that will be incurred in the future. By recording this in the current financial year they increase the costs. They also apply "overvaluation of acquired in-process R&D" to enhance the cost of the whole process of R&D and increase the whole costs of the company. The understatement or overstatement of provisions for bad debts is also used as a technique for ABEM. The "cookie jar reserve" technique is also used for ABEM.

The cookie jar reserve technique is used by the management of the companies due to the relaxation and flexibility in accounting standards and framework. The different amounts are stored and utilized under this technique according to the need of the management. They increase or decrease their earnings by using this cookie jar. This cookie jar is filled by the managers by estimating and recording the costs even if they become due in the following years it is done under national laws and international accounting standards. These estimates give the management a good chance of EM. If the management of companies chooses to reserve the highest possibly justified amount they report higher costs to create a cookie jar. This cookie jar is further used by the management to meet the predetermined thresholds. While it is legally justified according to the IFRS, GAAP and other accounting standards. Strakova (2021) gives three examples of the cookie jar technique i.e return of goods, amortization of inventories and warranty expenses. If the company expects the return of goods in the following fiscal year and needs to refund the payment, they record this in their cost and correspondence allowance which gives the chance of EM to the management. Similarly, the management makes possible the EM by estimating the value of inventories, this needs a complex estimation process. The complaint cost needs to be estimated by the management of the companies, by increasing and decreasing the complaint cost they have a possible chance to manipulate the earnings.

Another technique in the ABEM is the "big bath" technique. This technique is applied to the principle of manipulating the accrual costs. During the fiscal year, the management reports all the costs which are related to the revenues. The reason behind this is to make a profitable future for the following year/s. By this technique, the new management of the company can blame the huge losses on their predecessors and show their efficiency in the next years. If the company expects a weak positive gain the management turns it into a loss the reason behind this is to avoid future losses. Operational restructuring, discounted operation and impairment of the assets are the main areas of concern in this kind of manipulation (Rahman, Moniruzzaman, Sharif, 2012).

ABEM can also arise from changes in accounting standards. When a company seeks to adopt the new accounting standards it may give a chance to management to manage earnings. For example, a company which records its expenses in cash and changes its rule to shift to accrual-based accounting makes room for the management of EM (Ayu, Gamayuni, Urbanski, 2020).

Another major means of ABEM is the accounting choice of a transaction to be recorded in operational or non-operational earnings. The generation of operating profit is a normal accounting practice because it is expected and can be determined. While, the non-operating earning is occasional and on and off. The analysts often evaluate the operating profit of the organization and the share price of the company also depends mostly on the operating profit, therefore there is a chance of EM for the management to show the non-operational income into operational income to enhance their operational profit.

There are some empirical studies in the literature which studied the EM through accruals. For example, Razzaque, Rahman and Salat (2006) evaluated the EM practices in 14 Bangladeshi textile firms. They reported significant discretionary accruals in more than 35% of companies. Lee and Xue (2004) investigated the 329 Chinese companies regarding ABEM and reported that before the loss years, these companies increased their discretionary accruals to avoid or differ the occurrence of loss. Lin (2006) found that 112 Chinese companies increased their discretionary accruals before the tax rate was increased by the government. They took the advantage of the lower tax rate by increasing their discretionary accruals.

Shen, Coakley and Instefjord (2008) empirically found that the discretionary accruals of the firms are positively correlated with the under-pricing in IPO years but negatively correlated to the performance of stocks in the long term.

2.1.3 Increasing/Decreasing Earnings Management

Generally, EM comes in two forms. EM in increasing income form and EM in decreasing form. The increasing and decreasing EM depends upon management purposes. The income-increasing EM is generally considered an aggressive accounting technique because it intends to increase earnings, while the income-decreasing EM is generally considered a conservative accounting technique.

The association between managerial incentives and the pattern of EM is studied by many empirical studies. Most of these studies find that management of the organizations employs increasing or decreasing income EM through accruals management to gain high benefits (Guidry, Leone and Rock, 1999 & Healy, 1985). Many studies report that management of the companies used increasing or decreasing EM techniques to gain benefits from specific circumstances (Erickson and Wang, 1999; Guenther, 1994; Jones, 1991; Perry and Williams, 1994; Pourciau, 1993). In this regard, Burgstahler and Dichev (1997) found that management used accruals management to exceed or overcome the analysts' forecasts. The association between analysts' forecasts and EM is also reported by (Burgstahler and Eames, 2006; Dhaliwal, Gleason and Mills, 2004; Matsutomo, 2002; Abarbanell and Lehavy, 2002). Similarly, many studies found the use of accrual management to achieve debt covenant agreements (Jaggi and Lee, 2002). The question however arises that why the management of the organizations involves in increasing or decreasing EM. We can answer this from the literature.

The analysts' forecast is one of the main factors which is involved in the increasing earnings technique of EM. The analysts in the market set some forecasts regarding the performance of the companies, and the management of the companies intends to exceed these forecasts. Therefore they increase the income of the company through EM. Specifically, the management of those companies where the percentage of institutional ownership is high is always keen and under pressure about the performance of the company. Because the earning shocks strongly influence the institutional investors (Matsutomo, 2002). Similarly; the company with large number of stakeholders also concerned about the analyst's forecast. The empirical shreds of evidence are given by Abarbanell and Lehavy (2002). They found that those companies are involved in income increasing which stocks are recommended to buy by the analysts' forecasts. They increased their income through EM to beat the analysts' forecast. Dhaliwal, Gleason and Mills (2004) found that the account of tax expense can be used for manipulation purposes to beat analysts' forecast. Burgstahler and Eames

(2006) reported that cash flow and accruals are used for the purpose of income increasing to slightly exceed or achieve the earnings forecasts of analysts.

The second reason for increasing income EM is that companies avoid reporting a sudden drop in income, they also avoid reporting losses. This is because their stocks in the market will suddenly face a reduction in prices which will ultimately decrease the company's value. To save its face from this situation the management of the companies deliberately propagates the fabricated income. The empirical evidence in this regard is provided by Burgstahler and Dichev (1997). They found that 8% to 12% of the size of their sample used income-increasing EM who faced a small drop in income, while 30% to 44% of their samples used income-increasing EM who faced negative earnings. Similar findings are reported by Park and Shin (2004). They argued that some of their samples avoided reporting the loss and increased their income through EM. Peasnell, Pope and Young (2005) argued that the income is increased by their sample through EM and the abnormal accruals are used for this purpose.

Another major reason for increasing income EM is the price of the stock of the company. According to Louis (2004) when a company needs a stock-to-stock merger the increasing income EM is preferable by the management of the company. They manipulate their financial statements and push their income upwards. This will increase their stock prices in the market. Erickson and Wang (1999) argued that before the merger the companies reduced their stocks in the markets and used EM to increase their stock prices.

Similar to the increasing income EM sometimes the management of the companies has incentives to report decreasing income through EM. The management of the companies follows conservative accounting techniques and reduces the income of the company deliberately. McNichols and Wilson (1988) argued that management of companies reports reduced income to maximize their compensation in the future. They empirically investigated the behaviour of the management and reported that the management reduces the income through EM by enhancing the provisions for bad debt accounts. This is done when the income of the company is high therefore, they shift the income to the next year to gain more compensation. Pourciau (1993) argued that the management of the companies report decreased income and shift their income to the next year after a change in the executive. They increase the discretionary accruals for EM purposes. This is because the changes in the management give them the chance to report decreased earnings in the current year and increased earnings in the coming year to show performance. In contrast, the previous management also wants to report the decreased earnings in their last year of service because of the compensations earned by them on accounting-based income increased adjustments. They intend to readjust these by decreasing earnings EM before they leave the company.

Similar to the previous studies Perry and Williams (1994) also reported the decreasing income EM by choosing accounting practices and adjustment of accruals by the management. They do it when they intend to purchase the shares from the shareholders. Propagating the poor performance of the company reduces the stock price of the company which helps them in buying the stocks of the company.

Another major reason for conservative accounting and decreased earnings EM is to gain government protection and assistance (Jones, 1991). His empirical investigation found that 23 U.S. firms of five industries were involved in decreased income EM to gain import relief during 1980-85. Similarly, Guenther (1994) found some firms in involving the shifting of current-year profits to the following years to save taxes. Nelson, Elliot and Tarpley (2002) reported without the manipulation of standards and transactions the companies manipulate the accounting choices to decrease earnings of the current year to boost the next year's earnings. They reported the revenues and reserve accounts were the most manipulated areas in the financial statements.

The debt agreements in conventional companies play a very important role in the determination of EM. The management uses decreasing or increasing earning EM when the company get close to a violation of debt agreements. The financial crunches and difficulties of the firms set the trend of decreasing or increasing EM (Jaggi and Lee, 2002). They argued that increasing earning EM is applied when the management intends to show the creditors that the impact of financial difficulty is temporary. This might help them to overcome the violations of the debt covenant. In contrast, the decreasing income EM is applied when the crunch or difficulty is not temporary, and the creditors reject a waiver, this might help the management to renegotiate the debt contracts.

2.1.4 Earnings Management and Ethics

Whether it is increasing or decreasing income EM it is the fabrication of the financial statements which is not the neutral picture of the company. Because the management does not reports the fair and neutral earnings. A major strand of literature reported that EM is unethical behaviour of the managers. The ethical values of the managers positively impact the performance of the companies, in this regard, several studies are available such as (Zaki, Sholihin & Barokah, 2014; Paredes & Wheatley, 2017). Paredes and Wheatley (2017) further reported that the honest and fair behaviour of the management positively and significantly impacts the performance of a company. Due to the dishonest and unfair behaviour of the management EM is considered an unethical action (Mohamed *et al.*, 2013; Mersni and Othman, 2016; Normala *et al.*, 2011). The practice of earnings management has raised a concern about the importance of ethics in the accounting profession (Merchant & Rockness, 1994).

The transparency and authentication of financial statements presented by the financial institutions was remained questioned marked after the accounting scandals of 21th century and later on the global financial crisis (GFC, 2008). The quality of accounting statements becomes worse and substandard before the financial crisis (Magee and Bertomeu, 2012). According to the ethics resource centre (ERC, 2005),EM practices were 77% in large firms where senior management was found involved in unethical behaviour thus, EM can be considered the major element which caused these scandals.[19] Similarly, Karcher (1996) declared EM as a major cause of manipulation the financial statements. Many researchers reported that rooms (Healy & Wahlen, 1999) and flexibility (Ferrell et al. 2008) in the GAAP encourages the management to engage in EM. According to Belski *et al.* (2008), the practice of setting accounting options is called EM. Some contemporary researchers defined EM as the utilization of a discretionary accrual approach for amendment of financial reports to satisfy the manager's interest or to expose a fine reflection (Greenfield *et al.* 2008; Healy & Wahlen 1999; Hao & Yao 2007). It is proven by empirical studies that managers still use EM practices through accruals (Dechow & Skinner 2000; Healy 1985; Beaver *et al.* 1989; Wahen1994;Jone 1991; Sloan 1996;Subramaniam, 1996;Guay*et al.* 1996; Healy & Wahlen 1999)and as well as real earnings management (REM) (Cohen & Zarowin, 2010; Dechow & Sloan 1991; Baber *et al.* 1991; Bushee, 1998; Rochowdhury, 2006; Cohen *et al.* 2007; Zang 2006) in their institutions.

[19]Ethics Resource Center (ERC). *National Business Ethics Survey: How Employees Perceive Ethics At Work.30*, 2005.

Fair transparent and ethical behaviour of the insiders (managers) is highly desirable nowadays. Gaa and Dunmore (2007) argue that it is a matter of disagreement between managers, policymakers and academicians whether EM practices are ethically justifiable or not. The difference between unacceptable and acceptable behaviour is uncertain because of the different attributes of the public and diverse places (Staubus, 2005). Ethics and ethical practices in the business are very demanding now a day from the stakeholders and it becomes more institutionalized. Today's investors are very keen on the goodwill, social responsibility and ethics of the institutions they intend to invest in (Ferrell *et al.* 2008). The reason behind this is their lack of confidence which is profoundly shaken by the managerial shortcomings in the world's markets (Angelidis & Ibrahim, 2004). Many researchers consider that EM is immoral and lying to the stakeholders therefore it is an unethical act (Ellingsen & Johannesson 2004; Gneezy2005; Cai & Wang 2006; Charness & Dufwenberg 2006, 2010; Vanberg 2008; Hurkens & Kartik 2009; Lundquist et al. 2009; Sutter 2009; Erat & Gneezy 2012; Jiang 2013).

The concern regarding ethical business practices accompanied by empirical studies seeks to explore the determinants of unprincipled behaviours (Carpenter & Reimers, 2005). Much empirical research has been conducted on EM and ethics to evaluate the ethicalness of the managers such as (Kaplan, 2001; Merchant and Rockness ,1994; Fischer & Rosenzweig,1995). They report that EM practice raised important moral issues practicing the accounting profession. They argue that the acceptance of EM practices ultimately legitimizes its existence; therefore these practices cannot be called unethical acts. Fischer and Rosenzweig (1995) argued that those managers who abide by the accounting regularity bodies are in favor of EM practices.

Prior research suggests that EM arise due to the conflict between personal's interest and moral values. Ferral *et al.* (2008) argue that EM arises when the stakeholders need the informative reports of the institution. Fischer and Rosenzweig (1995) argue that EM arises when the stakeholders use the accounting results for long-term planning, they also report that the stock market also uses financial statements for the stock pricing. Some researchers are partially in favour of EM and they do not consider EM as an unethical practice. For example, Dey (1988) argues that the major shareholders supported the EM practices because it increases the stock price of the company and attracts fresh investors. Following the same strand of literature Schipper (1989) argue that EM practices are inherent in accounting and to reduce these practices is somehow meaningless. Parfet (2000) documented that EM practices are not unethical; it is the rational result of the flexibility in GAAP. Arya *et al.* (2003) argue that instead of eradicating EM practices it is healthier to focuson the accounting properties of the organization.

The question, however, arises that how the organization do EM, and which techniques they use to perform this unethical act within the rules and regulations which they follow. A major strand of literature answers this question such as (Healy, 1985; DeFond & Jiambalvo, 1994; Sweeney, 1994). These studies concluded that in the majority of cases of EM, the company prefers the accruals to manage their earnings. Based on the accruals the management can use the time for EM. They can manipulate the time of the transaction, and the difference between the occurrence of a transaction and the recording of a transaction can be used for EM purposes. Reporting or recording this kind of transaction at the end of the financial year leads to the difference between the valuation of the same at the recognition time and the valuation of the same at reporting time. While the accounting standards are much more flexible for global companies (Hepworth,1953). In this regard, the management of the companies can create much room to make accounting decisions which cannot be justified ethically. Furthermore, it is also easy for the management to use accruals for EM because it does not affect the cash flows of the companies.

By evaluating the findings and arguments of both standards of literature it can be concluded that either EM is performed under the rules and regulations of GAAP, IAS or IFRS but it cannot be justified ethically and morally. The decision-making of the managers plays an important role in the development of giving shape to the organization and ethical behaviours (Malone, 2006).It is because a manager brings specific personality and moral traits to his/her respective job. Religion and the religious background of a person are essential ingredients which influence the behaviour of a person (Merchant & Rockness, 1994). Believing in God prevents individuals from unethical acts because they fear losing the motivational rewards promised by God (Conroy & Emerson, 2004). Similarly, religion sets the norms of ethical and unethical behaviours of a person. Plenty of research on ethical behaviour and religion has been done however reviewing the literature it is revealed that literature is scarce on ethical behaviour, EM and Islam.

2.2 Earnings Management in Banks

The banks are considered the backbone of an economy. In EM literature the banks are mostly neglected intuitions because of their structural difference from other firms (Peasnell, Pope & Young, 2000). There is a difference between the financial reporting of financial and non-financial companies. Although transparent financial reports are highly desirable in all firms either financial or non-financial. However, after the recent financial crisis, it is an ongoing hot topic that the banks need to be more transparent. Investors need to monitor the status of their investments therefore, transparency in the bank financial statements is highly desirable (Freixas& Rochet, 2008). Similarly, the opacity in the financial statements of the banks would induce agency conflicts which ultimately make the bank less efficient. According to Zgarni and Fedhila (2019), there is a complexity of information asymmetry and agency conflicts due to multiple stakeholders in the banking industry, which makes the environment of EM for managers in this sector more than any other sector of the economy. The management of the bank is more aware of the internal information about the bank than any other stakeholders; this gives them chance to manipulate the financial statements of the banks to achieve their desired results.

One major reason for the management of the banks to be involved in EM is to boost the confidence of the creditors (Sutami, 2012). The banks with higher leverage ratios are more concerned about the confidence of the creditors. This confidence is needed for them because they are afraid of the withdrawal of the credits at any time. In this regard, Rastgoo, Zanjirdar and Vakilifard (2013) argued that the management of the banks performs EM due to the reason that their bank looks profitable and capable to pay its liabilities, which allows the management to seek more cheap credits. The positive impact of the leverage ratio on EM is reported by Rastgoo, Zanjirdar and Vakilifard (2013). Similarly, Nejad, Abdollahi and Kabiri (2012) also found a positive association betweena high leverage ratio and EM. The same results are presented by Ardison, Martinez and Galdi (2012) from Brazil. The quality of profits is influenced by the leverage ratio (Press, Valipour & Moradbeygi, 2011). It is easy to conclude that the leverage ratio affectsthe EM practices of the banks (Rahmani and Akbari, 2013; Ardison *et al.*,2012; Nejad*et al.*, 2012; Rastgoo *et al.*, 2013).

There is a scarcity of literature on the EM of banks as compared to non-financial firms, however, there are some empirical studies regarding EM and banks. For example, Beatty, Chamberlain and Magliolo (1995), Beatty and Petroni (2002) found in their studies that the banks' "realization of the securities" are used for the purpose of EM in banks. Cornett, McNutt and Tehranian (2009) also support their findings. However a major strand of literature found that loan loss provisions are used for the purpose of EM in the banking sector (Zhou & Chen, 2004; Ahmed et al., 1999; Kanagaretnam, 2004; Taktak&Mbarki, 2014; Ben Othmen&Mersni, 2016; Zgarni et al., 2018). These studies consider the loan loss provisions (LLPs) as a major tool of EM in banks. The LLPs are those provisions which a bank reserves to cover their loan losses but there is a privilege for banks' management to use these provisions for EM (Ahmed *et.al.*, 1999). Empirically the EM is studied by Greenawalt and Sinkey (1988). They analyzed the behaviour of banks' LLPs as a profitability function on the loan portfolio quality. They used the LLPs as dependent variables and reports that LLPs are used by banks' management for income smoothing purposes. Similarly, Ma (1988) also found the use of LLPs for income smoothing purposes. Ma (1988) concluded that the LLPs are not associated with the loan portfolio quality but it is a tool of EM because the banks increase these provisions to reduce the profitability when it is on the higher side and vice versa. LLPs as dependent variables are used in both these studies.

The use of LLPs is a proven fact by the banks for EM. In this regard, an important study is conducted in the U.S. financial market by Collins, Shackelford and Wahlen (1995). They investigate the role of LLPs in income smoothing by using bank by bank approach and conclude that two third of the U.S. banks are using the LLPs as a tool of income smoothing and EM. Similarly in the U.S. banking sector, Bhat (1996) reports a significant association amongst the LLPs and earnings. He concludes that the banks with low assets, low growth rates, high debt-to-asset ratio, low ROA and a high percentage of nonperforming loans smooth their income by using the LLPs. Another strong empirical example of the use of LLPs for income smoothing is given by El-Sood (2012). This study used the sample size of 878 U.S. bank holdings companies from 2001 to 2009. The study concludes that these bank holding companies used their LLPs for income smoothing from 2001 to 2009. Hasan and Hunter (1999) investigate the efficiency of LLPs with relevant factors in Spanish banks and find the inefficient decision-making of LLPs. Similarly, Anandarajan, Hasan and Vivas (2003) empirically found the use of LLPs for EM in Spanish depository institutions.

Most of the prior literature in the banking industry studied income smoothing in the context of EM. Prior literature reports different motives for banks' involvement in EM. Beatty (2002) found that the banks' managers used their discretions in the loan loss provision to smooth the earnings of the banks to avoid a small decrease in earnings. This might be to show good risk management measures or managerial self-interests. Fonseca (2008) argues that EM through LLPs might be due to concerns of bankruptcy of banks. Wahlen (1994) found that banks' managers use their discretionary part of LLPs to improve the future cash flows of the banks. The management of the banks overstate the LLPs and understate write-off loans to meet their minimum capital requirement (Healy, 1999). Kilic (2013) found that the ineffective hedging of the banks is responded by LLPs of the banks.

There are some studies which contradict the perception that banks use their LLPs for EM. For example, Wetmore and Brick (1994) found that for the determination of LLPs the management of the banks depends upon the economic circumstances, foreign risk, past loan risk and quality of loans. In their views, the management does not consider changes in loan compositions and off-balance sheet exposure. There is only a small correlation between EM and LLPs while no evidence is found that banks used their LLPs for EM (Beatty et al. 1995). The LLPs reflect the quality of loans rather than a technique of EM (Ahmed et al. 1999). However, these studies are criticized by Wall and Koch (2000). They argued that the difference between declaring or non-declaring the LLPs as a tool of EM is due to different sample sizes and time frames. In their conclusion, they stated that LLPs are a major tool of EM and the management has incentives to use LLPs for EM.

2.3 Earnings Management in Islamic Banks

An important empirical study conducted by Abdul Rahman *et al.* (2005), examined the EM practices of listed firms on the Kuala Lumpur Stock Exchange (KLSE). They report that EM practices were not influenced by Muslim managers but rather by non-Muslims.

The Islamic perspective is very unique because *Shariah* governs every field of life such as spiritual, social, political and economic. This uniqueness of *Shariah* comes from the revealed sources of '*Allah*'. The purpose of human life is defined by Islam which can solve great problems (An-Nabahani, 2001). *Allah* says in *Quran* "*I have created man and Jin only to worship me*" (51:56). Being the servant of *Allah* the primary duty of humans is worshipping *Allah*, which can be achieved by undertaking several actions. Before taking any action the relationship between the Almighty *Allah* and humans must be realized, what *Allah* orders to follow must be followed and the prohibited actions must not be taken, it is the essence of Islam (AnNabahani, 2001). Based on this basic understanding, two principles are essential to belief for a Muslim, 1st the Holy Qur'an revealed from *Allah*, while the 2nd is the *Sunnah* of Prophet Muhammad (PBUH). These are the primary sources of Islamic Law (Abdul Rahman, 2003).

The capitalist ideology separates religion from life, while Islam does not recognize the difference between life and religion. There is no division between spiritual and temporal dimensions in Islam (Walsh, 2007). It means that the values of Islam would interfere in every field of life which includes the economic life as well. The ethical system of Islam is absolute and eternal (Hassan, 1995). In Islam, ethics are considered the essential element of *Iman*. In *Shariah,* business ethics can be defined as managerial and organizational ethics which do not contradict the primary sources of Islam *Quran* and Sunnah (Abuznaid, 2009).

Now a question arises that whether Islamic Doctrine or *Aqidah* (belief) can eliminate misrepresentations, fraudulent activities or EM in financial reports. The answer is yes it can. Because the practices of EM occur when the insiders (managers) intend to increase or maximize their own compensations. In a capitalist economy or western philosophy, the actions of the managers are evaluated on the basis of benefits. Therefore they follow a materialistic approach in their management system. While Islam evaluates earnings on the basis of *Halal* and *Haram*, where *Halal* earnings are encouraged and *Haram* earnings are illegal. In fact, the measures neither evolves nor changes; and benefit does not influence it (An-Nabahani, 2001). So there is no room for ambiguous interpretations and the Muslims must fully follow the ethical system of Islam. In this regard the Holy Prophet Muhammad (PBUH) said, "*An honest businessman will be amongst the prophets, the truthful and the martyrs on the Day of Judgment*" (Tirmizi: Abu Sayeed R.A). The *Hadith* is encouragement for those managers who follow good behaviours and characteristics. An important and noticeable effort is taken by the "*Accounting and Auditing Organization of Islamic Financial Institutions*" (AAOIFI) in 1998. This organization is responsible for issuance the Shariah, accounting and governance standards for Islamic financial institutes. These standards are derived from the primary sources of *Shariah i.e Quran* and *Sunnah*. Furthermore, the contemporary issues of finance which are not addressed in primary sources of the *Shariah* this organization follows *Ijma*to address these issues. (An-Nabahani 2003). Based on *Shariah* moral and ethical considerations cannot be removed from Islamic banks (Azam Ahamed , 2008).

The Islamic banks are formed on the principles of *Shariah* (Octavia and Florentina, 2018). These principles include the prohibition of *Haram* (income from illegal transactions), *Maisir* (gambling), *Gharar* (Uncertainty in transactions) and *Zulm* (unfairness to other stakeholders). Islamic banks are bound to obey these primary principles in their business. The participatory modes of financing of these banks share the risk of loss between the bank and its customers, similarly, the profit is shared at a predetermined rate. Involvement in EM by the management of Islamic banks makes these institutions similar to their conventional counterparts which are against the *Shariah* principles of *Halal* earnings and it is similar to *Zulm* on other stakeholders.

Empirically there are some studies on EM in Islamic banks with different findings (Mersni & Othman, 2016). For example, Hatane, Octavia and Florentina (2018) compared the EM practices of the Islamic and conventional banks in Indonesia. They studied 11 Islamic and 40 conventional Indonesian banks from 2011 to 2017. They report the significant difference between the EM of Islamic and conventional banks through a T-test. They further reported a higher level of LLPs in Islamic banks as compared to their conventional counterparts. According to Zahara and Veronica (2009) there were strong shreds of evidence that Islamic banks were involved in EM practices from 2004 to 2006 in Indonesia. Similarly, Chanifah, Hamdani, and Wiedyaningtias (2020) studied the EM practices of 11 Islamic banks listed on the Indonesian stock exchange from 2012 to 2016. They reported that EM happened in these 11 Islamic banks through discretionary accruals. Padmantyo (2010) reported that Islamic banks manipulated their financial statement for the purpose of EM. Similar to conventional banks Islamic banks also do EM for different reasons (Misman and Ahmad, 2011; Othman and Mersni, 2014; Ali *et al*, 2015; Taktak, 2011; Taktak *et al.*, 2010). By using the earnings distribution approach Hamdi and Zarai (2012) investigated the EM practices in the Islamic banking industry with the conclusion that Islamic banks used EM techniques to avoid reporting losses. They further reported that these banks also used EM to avoid a decrease in earnings. In this regard, a recent study is conducted by Zainuldin and Lui (202). They investigate the EM practices of 35 Islamic and 111 conventional banks in emerging markets of the world from 2006 to 2011 with a total of 838 banking years. They found that the EM practices of Islamic banks were more than their conventional counterparts which was unexpected for them.

The ABEM and real EM in Islamic banks are studied by Wafaretta and Restuningdiah (2020). They found that Islamic banks applied real EM techniques to increase operational revenue and reduced distributable revenue. This manipulation increased their earnings in the financial year. Similarly, the real EM practices have been studied by Surifah (2015) with the conclusion that real EM practices in Islamic banks owned by family and private ownership are similar, while the real EM practices are very high in government-owned banks with low profitability. Similarly in this context, a more recent study was conducted by Syarif, Qorib, Siregar and Muda (2021). They studied the association between EM and managerial ownership, institutional ownership, family ownership, foreign ownership, board of governors and state ownership in twelve *Shariah*-based banks in the Indonesian market from 2013 to 2019 and concluded that board of governors, individual ownership, managerial ownership has a positive association with EM in these banks.

Generally, Shariah supervisory board (SSB) is considered to promote religious and ethical values in the Islamic banking. But Alam, Ramachandran and Nahomy (2022) reported that SSB has no significant impact on preventing opportunistic EM. They further report no difference in the level of EM between conventional and Islamic banks. In contrast Elnahass, Salama and Yusuf (2022) suggested that SSB can significantly reduce the EM practices. They found that large and independent BOD negatively impacted EM. Nurianah (2019) found that Islamic banks employ fewer EM practices as compared to conventional banks. By using the sample size of 11 Islamic and 36 conventional banks from Indonesia she concluded that the level of discretionary accruals was high in conventional banks.

2.4 Earnings Management and Performance

Prior literature consistently examined the impact of EM on performance. For example, Kasznik (1999) and Dechowet *et al.* (1995) empirically found that EM positively impacts firm performance. Similarly McNichols (2000) reported the positive impact of discretionary accruals on long term profitability. By using the sample size of 119 firms Tabassum *et al.* (2015) found the negative impact of EM on future performance. Specifically in banking sector Bornemann *et al.* (2012) found that German banks used EM techniques to increase the net income and to avoid decrease in income from last year. In this regard an important study is conducted by Alhadab and Al-Own (2017). They used the data of all European banks and found that discretionary loan loss provisions of these banks negatively impacted the current and future ROA and ROE, which were proxied for financial performance.

Although the banking system is well regulated; but EM is still in the practice of the management because it is performed under the rules and regulations of GAAP and IFRS. This belongs to the ethics and ethical standards of the management. Islamic banks not only follow the accounting and financial standards but they are formed to work under the rules of *Shariah* which is divine law and there is no room for unethical behaviour. EM is also reported in Islamic banks, but it is yet to be decided that their EM is opportunistic or not.

2.5 Hypothesis Development

Islam prohibits Lies, *Khayyanah* and misrepresentations and these are considered major sins. Being the manipulation of financial statements EM is considered an illegal act in Islamic Jurisprudence. According to *Jalal et al.* (2016) EM is unethical, falsehood based and deceptive practice. They argued EM practice for the personal benefits is unethical and prohibited in Islam because it is the understating or overstating the financial statements for the benefits of the few which affects the majority. Therefore, keeping in view the Islamic ethics of business the following theoretical and empirical hypothesis are developed.

According to Mahjoub and Miloudi (2015)EM is based on 5 theories (Signal theory, threshold management theory, agency theory, positive accounting theory and managerial entrenchment theory). On the basis of the primary sources of Shariah the following theoretical hypothesis regarding these 5 theories is developed.

H_1 There are severe violations of *Shariah* in five (5) EM theories.

Alhadab and Al-Own (2017) empirically found the negative impact of EM on the current and future performance of European banks. But the structure of Islamic banks is different from their conventional counterparts. According to Hamdi and Zarai (2014) EM is not confirmed to *Shariah* therefore, being the *Shariah* compliant institutions Islamic banks must be immune from opportunistic EM. Their EM may not impact their performance negatively. Similarly the EM may not be used for the personal benefits of the management. Keeping in view that Islamic banks fully follow the ethical standards of *Shariah* the following empirical hypotheses are developed.

H_2 EM positively impacts the internal performance variables ROE/ROA.

H_3 There is no impact of EM on management incentives.

H_4 EM positively impacts the stock returns of Islamic banks.

H_5 EM positively impacts the stability of Islamic banks.

CHAPTER3.EARNINGS MANAGEMENT AND ITS THEORETICAL BACKGROUND

Before probing the real issue of the impacts of earnings management it is necessary to define and understand earnings management (EM). There is no sole definition of EM (Healy and Wahlen, 1999). EM gained attention in the mid of the twentieth century. The research-related topic is considered to be started by Hepworth (1953). Watts and Zimmerman (1978)argued that EM occurs when the management has a discretionary behaviour to change accounting figures with or without limits to maximise the value of the firm.

Similarly, EM is defined by Davidson, Stickney and Weil (1988) that EM is the process to take deliberate steps to obtain desired results within generally accepted accounting principles (GAAP). Schipper (1989) believe that EM is the intentional behaviour of management for altering financial statement to acquire private gain. However, the most comprehensive definition is presented by Healy and Wahlen (1999). They define EM as "*the manipulation of the company's financial statement by managers based on their own judgment, with the purpose of confusing users about the company's real economic situation, either, to influence contracts that can rely on financial statements.*" Similar to all these definitions Phillips, Pincus and Rego (2003) define EM as a strategy for generating earnings through discretionary powers related to cash flows and accounting choices. Later on Garcia, Osma and Mora (2005) defines EM as a management practice which carried out intentionally to alter accounting results for either private gain or informational purposes. From all these definitions we can get the results that EM is the manipulation of accounting results due to various reasons.

EM can further be explained by discussing EM theories. According to Mahjoub and Miloudi (2015) prior literature on EM is based on five theories. Signal theory, agency theory, political contractual/positive accounting theory, threshold theory and entrenchment theory. We give hereunder the explanation of these theories and furthermore, these theories are discussed and evaluated from *Shariah's* point of view one by one.

3.1 Theories of Earning Management

3.1.1 Signal Theory

Information about the organization's performance is very important in the financial market. Within the organization, there is a lot of imperfect information among all the stakeholders (Myers & Mjluf, 1984). The economic agents do not share the same information. Due to this reason, the managers are considered to be the source of authentic information about the future performance of the organization. The managers emit information about the internal conditions of the organization to the market and investors from time to time. This act of emitting information by managers is called the Signal theory.

The signal theory basically concerns with reducing information asymmetry between two parties. It was initially presented by Spence (1973) and developed later on by Ross (1977). He examined the relationship between investors and managers in the context of information asymmetry. Regarding information asymmetry, Kirmani and Rao (2000) explain the signalling model by providing a general example. They argue that the firms exactly know about their own position while the other stakeholders e.g. customers and investors have no idea about the internal situation of the firms, thus the information asymmetry is present. The managers have the privilege of internal information about the future prospects of the organization therefore, they can use earning management techniques by increasing reported earnings. If the internal information is not available the market is dependent on the published results and the behaviour of the leaders for the formulation of its expectations (Aerts, Cheng & Tarca, 2013).So the alignment of information by managers and market expectations can give a better choice to the investors (Sun, *et al.* 2013).Here this is important that only those organizations which have future opportunities can emit signals to investors and the market (Xue, 2004). Following the same strand of literature (Altamuro, Beatty & Weber, 2005) reported that the use of EM becomes active when the management intends to signal the relevant information regarding the future performance of the organization. Thus the signal theory is to reduce information asymmetry between the two parties.

After reviewing the literature on signal theory three major components are identified. First the signaler, second the receiver and third the signal itself.

Signaler. Prior literature of different fields defined different signalers. The management literature considers that a firm, product or persons can be signalers. Organizational behaviour studies consider that some individuals *i.e.* recruiters, managers or employees can be signalers (Ramaswami *et al*, 2010; Ma & Allen, 2009; Hochwater *et. al.*, 2007; Rynes, et.al. 1991). Another strand of entrepreneurship studies explores that the leaders of new organizations are mainly the signalers, they specify that the leaders of initial public offer (IPO) organizations play the role of the signalers (Bruton.et.al., 2009; Zimmerman, 2008). The owners of the sole proprietorship and the franchisors also sometimes act the role of signalers (Michael, 2009; Elitzur & Gavious, 2003).

Strategic management has a balanced view regarding signalers. Many experts on strategic management argue that firms are signalers (Basdeo.et.al 2006; Zhang & Wiersema, 2009), but some consider that some specific kinds of people such as directors, managers or sometimes employees are the signalers (Miller &Triana, 2009; Carter, 2006; Kang, 2008;Goranova et al., 2007). A limited amount of strategy studies consider the product signals (Lampel & Shamsie, 2000; Chung & Kalnins, 2001). The marketing literature extensively examines product signals (Rao et al., 1999; Gammoh, Voss & Chakraborty, 2006).

There might be a conflict of interest between the signaler and the receiver. Therefore, the inferior signalers might have the intention to "cheat" the receivers by producing wrong or false signals (Johnstone & Grafen 1993). According Ndofor and Levitas (2004) the management studies mainly focus on high and inferior-quality signalers. Similarly, Westphal and Zajac (2001) report that many firms signal to the market that they will repurchase the stock; but actually they do not, they named this discrepancy as decoupling. Because there is difference amongst the formal published plans or signals and the performed actions by the signalers. The decoupling plans of the executives and firms developed a dishonest reputation over time. Therefore, management studies emphasize signal honesty (Durcikova& Gray, 2009).

Management experts argue that the receivers are mainly a group of individuals or individuals. The entrepreneurship experts declare that receivers are somehow potential investors with some bifurcations between public and private investors (Busenitz *et al.*, 2005; Daily, Certo, & Dalton, 2005; Cohen & Dean, 2005; Jain, Jayaraman, & Kini, 2008; Michael, 2009). They further argue that receivers can be existing shareholders, new investors or both of them (Kang, 2008; Park & Mezias, 2005), they further expand the range of receivers by adding all stakeholders i.e. employees, customers and competitors (Basdeo et al., 2006; Carter, 2006).

Receiver. The effectiveness of the signaling is determined by the receiver's characteristics. The signals will not be effective if the receiver is not looking for them or they might be unaware of the signals. The receiver's attention is a vital part of the signaling process. Observing the market is very important for weak signals because weak signals are very hard to observe unless the receivers are searching for them (Ilmola & Kuusi, 2006). If the signals are clicked by the receivers successfully and they understand the information they might click similar signals again in the future (Cohen & Dean, 2005). In the market, signals are observed by the receiver's differently according to their information and ability (Perkins & Hendry, 2005; Srivastava, 2001). The receiver's intention and information are necessary for signaling.

Signal. The negative and positive information of an organization are obtained by the insiders and they decide to emit this information either positive or negative to the outsiders. As for as signals itself are concerned; prior literature report two types of signal *i.e.* informational and opportunistic signals. The informational signals are circulated by the managers, directors and employees who want to show the real picture of the organization to enhance the securities of the organization and to reduce information asymmetry between the capital market and the investors. Organizations with future growth prospects use this technique of EM for investment opportunities (Ahmed, Takeda & Thomas, 1999). The opportunistic signal and false information propagated by directors, managers and employees mislead the investors or other stakeholders. They emit these false signals to gain personal benefits at the cost of outsiders, which show the dishonest and cheating behaviour of the insiders who have the privilege of internal information and discretion to manage the earnings of the organization.

3.1.2Signal Theory and Islamic Jurisprudence

If we review the signal theory in brief it is the reduction of information asymmetry between two parties the insiders and outsiders of the organization. The insiders emit signals to the outsiders to reduce information asymmetry and give a fair chance of investments to the outsiders. The insiders can be a group of people, managers, directors or employees of the organization. The literature reports two types of signals, informational and opportunistic. If the insiders emanate informational signals to reduce the information gap between different parties this is informational signals.

Signaling to the market and stakeholders through financial statements is modern and new concept therefore it is important to review its *Shariah* permissibility. There is no prohibition in *Shariah* to fairly signal the market and receivers for the sack of information. Signaling fair and accurate information to the market and receivers shows the good intentions of the signalers. These types of good intentions are desirable in every field of life. According to a famous *Hadith*, "*every action is judged upon intention*". Therefore every action is judged by the first-place intention. If the intention is good *Allah* (S.W.T) will reward by the Day of Judgment and vice versa.

From the *Shariah* point of view, fair and accurate signals are desirable while opportunistic signals are fabricated and harmful to gain the attention of the receivers which are prohibited. This trend shows the bad intention of the signalers to cheat the receivers therefore, it is strictly prohibited. Fake signaling to the market and receivers is just like propagating disinformation.

يَٰٓأَيُّهَا ٱلَّذِينَ ءَامَنُوٓا۟ إِن جَآءَكُمْ فَاسِقٌۢ بِنَبَإٍ فَتَبَيَّنُوٓا۟ أَن تُصِيبُوا۟ قَوْمًۢا بِجَهَٰلَةٍ فَتُصْبِحُوا۟ عَلَىٰ مَا فَعَلْتُمْ نَٰدِمِينَ ٦

"O you who have believed, if there comes to you a disobedient one with information, investigate, lest you harm a people out of ignorance and become, over what you have done, regretful. (Al-Hujrat: 6)"

The Holy *Quran* strictly emphasize that do not believe in fake news or disinformation. The person who spread this kind of disinformation is called *Fasiq* in the *Holy Quran*. By reviewing the theory it is also revealed that the false signals are propagated by the signalers to cheat the receivers. Thus faking the receivers by doing this act makes them liars and cheaters. *Shariah* has strictly stressed upon honesty in general, especially in financial dealings. The Holy *Quran* confirm this says

"يَٰٓأَيُّهَا ٱلَّذِينَ ءَامَنُوا۟ لَا تَأْكُلُوٓا۟ أَمْوَٰلَكُم بَيْنَكُم بِٱلْبَٰطِلِ إِلَّآ أَن تَكُونَ تِجَٰرَةً عَن تَرَاضٍ مِّنكُمْ ۚ وَلَا تَقْتُلُوٓا۟ أَنفُسَكُمْ ۚ إِنَّ ٱللَّهَ كَانَ بِكُمْ رَحِيمًا"

"O you who have believed, do not consume one another's wealth unjustly but only [in lawful] business by mutual consent. And do not kill yourselves [or one another]. Indeed, Allah is to you ever Merciful."[20]

This verse of the Holy *Quran* emphasizes not eating each other's wealth by unjust means. False signaling to the receivers and getting benefits from them are unjust means and clearly prohibited by the Holy *Quran*. Circulating false signals in the market is a fraudulent activity as well because it intends to cheat the receivers by fraud. In this regard the Holy *Quran* says

"وَيْلٌ لِّلْمُطَفِّفِينَ"

"*Woe to those who give less [than due].*"[21]

Do not give less in trade, it is fraud and the Holy *Quran* prohibited fraudulent activities. Being a fraud false signaling is prohibited according to this verse of the Holy *Quran*. Another good example which shows the prohibition of false signaling is from the market of *Madinah* where the Prophet

[20] Sura Nesa- 29
[21] Sura Mutwafifen- 1

Muhammad (P.B.U.H) found that dried corn is up on the top of the heap while the wet corn is on the lower side. He said to the merchant.

"Why did you not then keep (the wet portion of) it above the dry corn, so that men may see it? He who deceives, is not one of us"[22]

This example is closely related to false signaling; the signalers deceive the receivers by passing them false signals. Sometimes they fabricate the accounting results of the organization and show the manipulated results in their published documents, the viewers of the manipulated accounting results can face harm or loss in investing in these organizations. Therefore this behaviour is strictly prohibited.

Playing false in business dealings is also a sign of hypocrisy because it is the clear *Hadith* of the Prophet Muhammad (P.B.U.H) that

"The signs of a hypocrite are three: when he speaks, he is false, when he promises, he fails; and when he is trusted, he plays false".[23]

Here all these three signs of hypocrite fit on the false signalers. First, when he signals false on the opportunistic intention he propagates a lie. Secondly in his employment contract he promise to work for the interest of the shareholders while propagating the false information for their own interest makes conflict of the interest between insiders and outsiders so he fails to keep promise. And thirdly when he is trusted in the organization as an employee, manager or director he plays false.

[22] Sahih Muslim Book 1, Hadith 190
[23] Riyad as-Salihin Hadith 199

By reviewing the Signal theory from the Islamic perspective we can conclude that severe violations can be found in propagating false signals. The managers work as agents of the principals on the basis of employment contracts by doing EM for giving false signals to the market they violate their employment contract. They involve themselves in the sin of the lie by manipulating financial statements. Propagating false signals to achieve private gain also involves them in cheating and fraudulent activity.

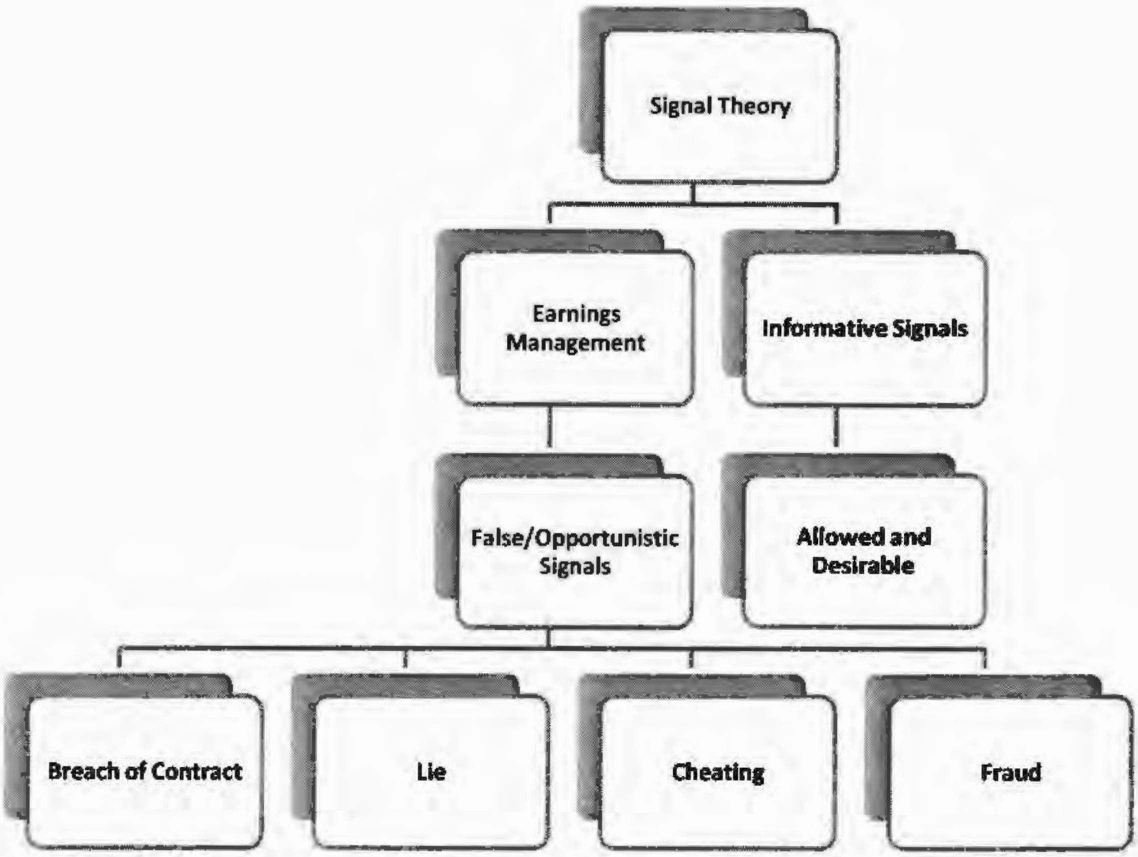
According to the contemporary scholars of Hanafi *fiqh* propagating false signals are prohibited because it is promoting lie. A recent ruling in this regard is issued by well known Hanafi Madrassa. According to this ruling

"It is not feasible to falsify information in order to gain extra benefits from the government. Not only is this an act of deceit, but it is also means endangering oneself in case one is prosecuted by the relevant authorities for committing fraud through misrepresentation for the purpose of gaining extra benefits".[24]

Signaling false to the market to deceive stakeholders is the same case and it is fraud and deceit therefore contemporary jurists consider it prohibited. Signal theory from the Islamic point of view can be explained in Figure 3.1

[24]FatāwāMahmūdiyyah, v. 18 p. 483, DārulIftaaJāmi`ahFārūqiyyah; FatāwāHaqqāniyyah, v. 6 p. 247, Jāmi`ahDārul `Uloom Haqqāniyyah

Figure 3. 1 Signal Theory &*Shariah*



3.2.1 Threshold Management Theory

Threshold management theory was presented by Burgstahler and Dichev(1997). According to this theory, the management uses EM to gain expected results which are called the threshold. They examined the manipulation and irregularities in accounting practices and find the existence of two types of thresholds. The first 1st threshold of zero results to avoid financial losses. The managers of the organizations avoid reporting financial losses therefore they report zero results or a weak positive gain. Using EM techniques to manipulate the accounting results is the best option for them. Similarly, the 2nd threshold they report is a decrease in income. The management of the organizations compare the current year's earnings with last year's earnings and if they find the earning is lesser than last year they manipulate the accounting results through EM and show the earnings more than the previous year. Both these scenarios are empirically evaluated by the theory presenters. The empirical is also supported by Mard (2003) from the French capital market; he reports that between 35% and 48% of 294 French listed companies create positive gains who face the risk of loss.

Now a question arises that why managers of organizations avoid reporting the loss or low profit of the current year from the last year. There can be several reasons behind this act. In the current scenario, people rely on the published financial reports of the companies. Reporting loss or low profit spoils the reputation of the organization as well as raise question on the performance of the management. Therefore, managers try to avoid loss or low profit in the published financial statements. Another reason might be the job security and personal reputation of the managers. The consistent losses of a commercial organization compel the owners to take hard decisions on management. Their job becomes risky in the organization and their market reputation also becomes shaky when they report a loss or low profit. Another major reason is the compensation of the management. The organization compensates those managers who enhance the profitability of the organization. Management compensation also plays an important role but other than compensation some others factors such as their good reputation their job demand etc. also the objectives which influence the accounting results (Aerts, Cheng & Tarca, 2013).

Another important threshold which is added by Degeorge, Patel and Zeckhauser (1999) is called the threshold of analyst's expectations. The performances of the companies are often evaluated by financial analysts through these thresholds. The managers of the organizations gain information about the analyst's expectations. Then these organizations use EM techniques to reach or overcome these thresholds (Vidal, 2010). The management of the companies avoids reporting losses, they manage their reports as null results or to show a weak positive gain because the negative results impact negatively on investors. Overall these three thresholds are ranked by Degeorge*et.al* (1999). They ranked the thresholds in the sequence that first preference is given to weak positive results, the second is given to results in growth and finally they ranked respect for predictions. The cognitive theory also supports this ranking system where Schelling believes that people make a huge difference between negative and positive numbers. These things compel managers to publish positive results instead of negative results or losses.

3.2.2 Threshold Management Theory and Islamic Jnrisprudence

The relationship between manager and shareholders is agent and principal. The manager as an agent works on the principal's behalf. It is the responsibility of the manager to carry out the business activities in transparent and ethical manners and obligatory in *Shariah*. Maintaining transactional records and making accurate and transparent financial statements is part of their responsibilities and obligatory. Being the owners of the organization it is the right of shareholders to examine the financial statements of the organization. And mostly the decision-making of the future of the business or organization depends upon these financial statements. The act of manipulating these financial statements to overcome any kind of threshold shows the opportunistic behaviour of the managers which is against the Islamic notion of a fair and transparent financial accounting system.

The three basic thresholds of avoiding losses, decrease in income and analysts' expectations are defined by prior literature, and the management of the institutions manipulates their financial statements to overcome these thresholds. The reasons for overcoming these thresholds might be different. Here the intention of the management is very important to review. They mainly manipulate these financial statements to get monetary compensation, to secure their jobs, or for their personal reputation. And if the intention of the management is to gain these results this is opportunistic behaviour of them. We can evaluate these thresholds one by one.

The first threshold is to avoid losses. If the organization faces losses the management of the organization falsely shows a weak positive gain in their financial statements through EM. Similarly, the second threshold is a decrease in income which is overcome by false financial statements using EM techniques. This behaviour of the management can be a disaster in the future and the shareholders of the organization may face huge losses because their future decisions are mostly dependent on the current financial results of the organization. The management shows the unreal picture of the organization to the owners to gain monetary benefits, job security and a good reputation while this behaviour can spoil the investments of shareholders. Hence this behaviour is strictly forbidden in Islam due to various reasons.

Presenting the fabricated financial statements of the organization to shareholders and other stakeholders is the propagation of a lie which is a major sin in Islam. The primary sources of *Shariah* forbid lying and misrepresentation especially in financial matters, many times.

"يَا أَيُّهَا الَّذِينَ آمَنُوا اتَّقُوا اللَّـهَ وَكُونُوا مَعَ الصَّادِقِينَ

"*O ye who believe ! Fear God And be with those Who are true (in word and deed)*"25

طَاعَةٌ وَقَوْلٌ مَّعْرُوفٌ ۚ فَإِذَا عَزَمَ الْأَمْرُ فَلَوْ صَدَقُوا اللَّـهَ لَكَانَ خَيْرًا لَّهُمْ

"*Were it to obey And say what is just, And when a matter Is resolved on, it were Best for them if they Were true to God.*"26

Similarly, the *Hadith* of Prophet Muhammad (P.B.U.H) also emphasize truthfulness. In fact the life of Prophet Muhammad (P.B.U.H) was exemplified by the word *Saadiq* (Truthful). According to a *Hadith* narrated by Abdullah (R.A)

"The Prophet (P.B.U.H) said, "Truthfulness leads to righteousness, and righteousness leads to Paradise. And a man keeps on telling the truth until he becomes a truthful person. Falsehood leads to Al-Fajur (i.e. wickedness, evil-doing), and Al-Fajur (wickedness) leads to the (Hell) Fire, and a man may keep on telling lies till he is written before Allah, a liar."[27]

Being clear involvement in lie the fabricated or false financial statements from the management to shareholders and other stakeholders is clearly prohibited in the primary sources of *Shariah*. Now for what purpose the management of the organizations involves themselves in the

[25] Sura Tauba- 9:119
[26] Sura Muhammad- 47:21
[27] Sahih Bukhari- 6094

major sin of lying? The answer is simple, sometimes for monetary benefits, job security and a good reputation.

Presenting false performance of the management to overcome these thresholds through manipulated financial statements for monetary or non-monetary incentives is getting benefits from the shareholders through unfair means. In fact, this act is to cheat and deceive the principals' of the organization for their own which is prohibited from *Shariah's* point of view. The strict prohibition of cheating and deceiving is documented in the primary sources of *Shariah*. According to Abu Hamra (R.A)

"I saw the Messenger of Allah (S.W.T) pass by a man having food in a vessel. He put his hand in it and said: 'Perhaps you are cheating. Whoever cheats us is not one of us'."[28]

A similar kind of *Hadith* is also narrated by Abu Hurairah (R.A)

"The Messenger of Allah (saw) passed by a man who was selling food. He put his hand in it and saw that there was something wrong with it. The Messenger of Allah (saw) said. 'He is not one of us who cheats'."[29]

The Hadith regarding cheating in financial matters is also narrated by Ibn e Abbas (R.A)

"When the Prophet (P.B.U.H) came to Al-Madinah, they were the worst people in weights and measures. Then Allah, Glorious is He revealed: Woe to the Mutaffifun (those who give less in measure and weight), and they were fair in weights and measures after that."[30]

[28] Sunan Ibn e Maja- 2225
[29] Sunan Ibn e Maja- 2224
[30] Sunan Ibn e Maja- 2223

The last threshold analyst's expectations seem to be a little different from the above two thresholds. To overcome the threshold of analyst expectations the management of the organizations manipulates the profitability or stability indicators through EM. They show false accounting results according to the expectations of analysts in the market. The management of the organization may get the benefits of job security, monetary incentives and a good reputation from this threshold because the principals who are outsiders and not fully informed about the organization may consult the analyst's expectations and opinion regarding the accounting result of their organization.

Here it might also be possible that the agents and principals both are involved in this type of EM. The reason behind this is to propagate the good reputation of the organization. These fabricated results may increase the share price of the organization temporarily which can be beneficial for both the management and their agents. This strategy can be used to enhance the price of the organization at the time of merger and acquisition because the analyst's expectation can also influence the buyers of the organization.

From the *Shariah* point of view, this kind of threshold is also forbidden because of the propagation of false financial statements which is involved in the lie. Secondly, the intention behind this is to cheat the principal or sometimes buyers. Therefore, on the basis of *Quranic* verses and the *Ahadith* of Prophet Muhammad (P.B.U.H) this type of behaviour is discouraged and strictly prohibited.

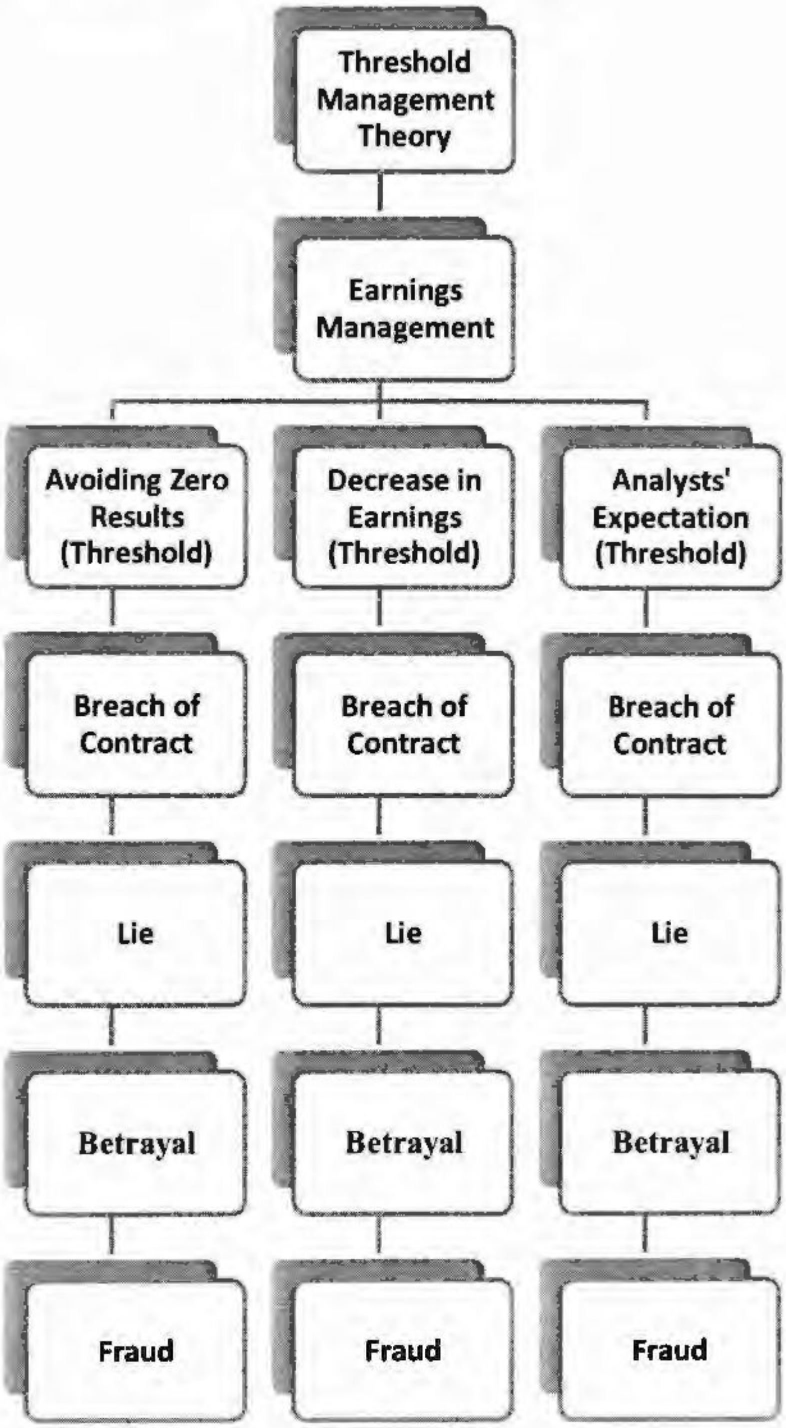
Based on the primary sources of *Shariah* we can conclude that involvement in EM to overcome these three types of thresholds *i.e.* zero results, decrease in income and analyst's expectations is prohibited because of the propagating lie, cheating and misrepresentation. We did not find any positive intention in these thresholds therefore; involvement in EM to overcome each threshold is a violation of *Shariah*.

This prohibition is also confirmed by the contemporary Hanafi jurists. According to Shaykh Mohammed Tosir Miah "*moving around money in the accounts to claim benefits is deception and cheating which is strictly forbidden in Islam*".[31] It is the same situation which we discussed in threshold theory. The management of the organization moves the different heads of accounts upward or downwards to overcome these three thresholds to gain or claim monetary and non-monetary benefits. Therefore this is considered forbidden and trickery in the Hanafi *fiqh*.

Figure 3.2 shows the Islamic perspective on threshold management theory for the sake of understanding.

[31] https://islamqa.org/hanafi/daruliftaa-birmingham/19563/deception-in-claiming-benefits/

Figure 3. 2 Threshold Management Theory & Shariah



3.3.1 Political-Contractual/Positive Accounting Theory

The Political contractual theory is also called positive accounting theory, and it is the most discussed and cited theory in the prior literature. This theory was presented by Watts & Zimmerman (1978). They argue that the management uses different accounting techniques to affect the accounting results of the organization due to two reasons. First for their personal interests at the cost of the other stakeholders, and secondly, they affect the accounting results for the implementation of accounting standards to maximize the value of the company. Later on, Watts and Zimmermen (1990) presented three important hypotheses of positive accounting theory.

- **The bonus Plan**: According to this hypothesis the management of the organization manipulates the financial statements to gain bonuses. Sometimes the principals make slabs for management to gain bonuses. Hence to obtain these bonuses the management of the organization report the future income in the current year through manipulation of financial statements.
- **The debt agreement**: According to the theory developers when the debt ratio of the organization is relatively high the management of the organization drags the expected future profit to current year financial statements through EM techniques. Management of the organization performs this action to avoid debt covenant violation. Furthermore, this is done when the management knows some creditors intend to invest in the organization (Bhutto et al. 2020).
- **Political cost**: The political cost hypothesis suggests that the management of the companies with higher profitability ratios will move their current year's profit to the next year's financials using EM techniques. They do this to avoid political costs.

We elaborate on these three hypotheses separately for the sake of understanding. According to the bonuses plan hypothesis, if there is any straightforward relation between the compensation ratio and achieved results this increases the possibility that the financial statements are manipulated through EM. This kind of EM which increases the compensation of managers directly affects the interests of other stakeholders (Jeanjean, 2002). Compensation-based contracts are not always valid, Jeanjean (1999) reports that incentive-based contracts are mostly used in the U.S.A but in Europe, it is rarely used. The relation between management compensation and EM is reported by the study of Akinobu (2007) from Japan. This study empirically reports that the executives of the firms use discretionary accruals to enhance their compensations. This behaviour supports the hypothesis of the bonus plan of the positive accounting theory. Specifically in the banking sector Uygur (2013) reports the positive association between stock bonuses and EM, she further reports that the loan loss provisions are used for the purpose of EM.

The debt covenant hypothesis is also a very important part of the positive accounting theory. The incentives of the management which are based on the income of the companies align the interest of shareholders with the managers. This trend harms the interests of the creditors of the companies because it transfers the wealth to shareholders at the cost of the creditors of the company. The creditors can protect themselves against this kind of opportunistic behaviour through management by implementing some limitations in the debt contracts. Avele (2013) reports that two explanations justify the contractual clauses, first to prevent the creditors from shareholders by limiting their dividend ratio, second to prevent the old creditors from new creditors by increasing the level of debt. In the context of debts Duke, Franz and Hunt (1995) report that the United States use three contract terms, which required a minimum level of Non-Distributable earnings, compelling a minimum level of working capital and commanding a maximum debt level. No new debt can be taken below these clauses. If the company exceeds these clauses the additional costs of renegotiations occur, or the control of the company can go into the hands of creditors. Therefore, to avoid these situations the management of the companies manages their earnings to prevent the violation of debt covenants.

As for as the political cost hypothesis of this concerned; it is closely related to the size of the organization. The bigger firms manipulate the financial statements through EM to reduce their earnings for several reasons. The presenters of the positive accounting theory Watts and Zimmermen (1978) and Healy and Wahlen (1999) report that those companies which generate important results are more likely to be monitored by the government and other monitoring agencies therefore, to evade sanctions of the country and avoiding antitrust law these companies can reduce their results through EM techniques. These firms report their earnings low and push the earnings to the next years to reduce or avoid political costs such as taxes etc. But this criterion may vary from region to region or country to country, such as Turki and Abdelmoula (2007) report that the bigger companies in the Tunisian market are not trying to reduce their results to diminish their political visibility.

3.3.2 Political-Contractual Accounting Theory and Islamic Jurisprudence

The main difference between conventional and Islamic financial institutes is their structure of formation. Conventional financial institutes are built upon the investments of shareholders and creditors. The shareholders receive the dividends along with capital gains while the creditors earn the interest on their investments. Islamic financial institutes are built upon the investment of shareholders and those account holders who agree to invest in the participatory mode of financing products. These participatory modes of financing are based upon the profit and loss sharing system.

There is no concept of creditors in Islamic financial institutes. The only creditors of Islamic financial institutes are the current account holders on the *Qard E Hasan* base, they can withdraw their amount without giving any prior notice to the financial institutions and there is no concept of interest on these accounts. Therefore the second hypothesis of the positive accounting theory which is based on debt agreements becomes irrelevant to Islamic financial institutes and banks. The management of Islamic banks has no chance to manipulate the financial statements through EM for debt agreements.

Another important hypothesis of the positive accounting theory is the bonus plan hypothesis. This hypothesis shows the greedy and opportunistic behaviour of the management because the management drags the future profit of the organization to the current year's financials through EM to receive monetary benefits. This behaviour is also strictly prohibited from the *Shariah* point of view due to several reasons.

The first and most prominent reason is a lie because the management presents false reports to the owners of the organization. The second reason is the cheating behaviour of the managers, they involve themselves in EM to gain those monetary benefits which are not their legal right. Furthermore, this behaviour is also a violation of their employment contract. Being the custodian of the investments of the principals the managers also involve themselves in the major sin of Betrayal.

Due to the major sins of the lie, cheating, breach of trust and betrayal the bonus plan hypothesis of the positive accounting theory is the violation of the primary sources of *Shariah* and can be considered as *Haram*.

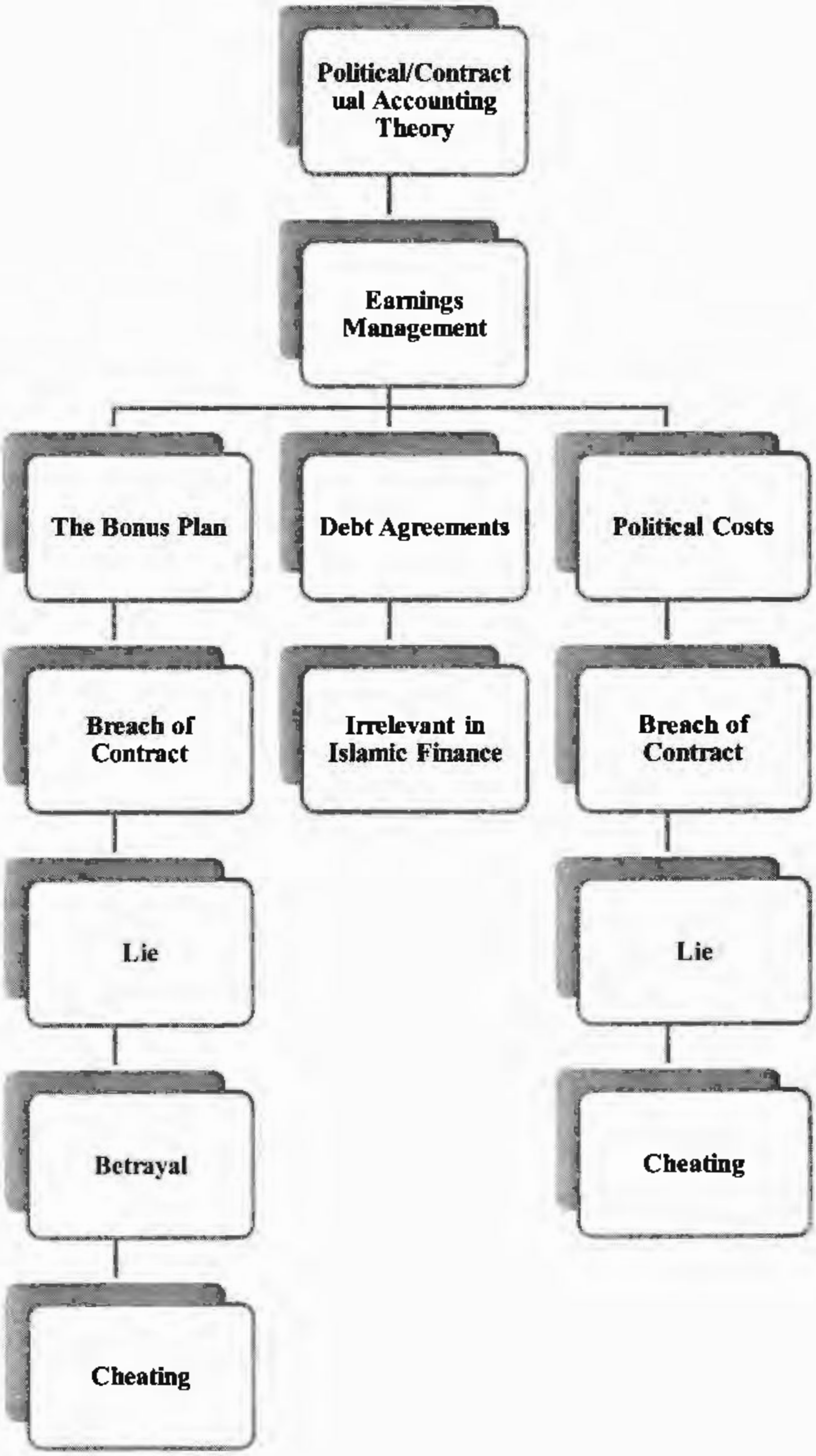
The last hypothesis of positive accounting is the political cost hypothesis where the management of a big organization reduces their profit and shifts the current year's profit to the next year using EM techniques. The reason behind this is to reduce or eliminate political costs such as taxes. This behaviour aligns with the interest of agents and their principals. Here we can see that the beneficiary of this act might be the management and shareholders of the organization together. Therefore this act can be seen as an action performed by the organization as a legal person.

Being a legal person the company is bound to work under the rules and regulations of the country and the legal authorities. Manipulating the accounting results for reducing profit is a violation of law in most countries. This act is to defraud the government and monitoring authorities for the purpose of reducing or avoiding tax expenses. While cheating and defrauding are the major violations of *Shariah*. Furthermore, this institutional act is also a violation of the contract with the government and monitoring agencies because the institution reports false financial statements to them. Here at this stage, they breach the contract which is considered the major sin of Islam.

According to the contemporary Hanafi Jurists deceiving the government for the purpose of monetary gain is fraud and it is forbidden. According to Tabraze Azam "*it is not permitted to lie and deceive in order to gain wealth- from the government or otherwise. Such is Haram for you to take.*"[32] This ruling contradicts the two hypotheses of this theory. The bonus plan is deceiving the shareholders to gain bonuses while avoiding political costs is deceiving to avoid political costs and enhance wealth. Figure 3.3 shows the diagram of positive accounting theory for understanding.

[32]https://islamqa.org/hanafi/seekersguidance-hanafi/85533/cheating-the-government-out-of-welfare-money/

Figure 3. 3 Positive Accounting Theory &*Shariah*



3.4.1 Agency Theory

Agency theory was presented by Ross (1973) and later on developed by Jensen and Meckling (1976) who describe it as the principal-agent relationship. The process starts when the principal/s who is basically, the owner hires some agent/s to perform a specific task on his behalf. The principal is the actual owner who delegates funds to the agent with some decision-making authority and the agent utilizes these funds on his behalf as a manager or employee. The agency relationship is a common practice and persists everywhere in our lives. According to Jensen and Meckling (1976) this relationship is involved in each stage of organizational hierarchy. The relationship between BOD and CEO, the relationship between shareholders and BOD, CEO and managers are common examples of the agency relationship.

Jenson and Mackling (1976) argue that the agents may not perform their duties according to the interests of the principals. This is because of the conflicts of interest among the managers (agents) and the shareholders (principals). This conflict of interest causes agency problems. The prior literature reports two types of agency conflicts (Eisenhardt, 1989). First is the conflicts of goals and objectives, the main concern of the principals is maximizing their profits while the agents are mainly concerned about their remunerations. This conflict may lead the agents to perform for their own interest which can harm the objectives and goals of the organization. According to this conflict, the agents of the stakeholders (managers) maximize their personal utilities such as wealth, job security and surety, and indispensability at the cost of shareholders and other stakeholders. Mostly the managers' remunerations including incentives are based on the achieved results of the company. This act encourages managers to manage the earnings of the company to gain more personal benefits. To secure their own interests the managers manipulate the results upward and show a different picture of the organization.

The second conflict arises when the principals have no access to information about their business or organization. It happens normally in large organizations where the shareholders of the organization are huge in numbers and they do not have control over the management of the organization. Hence the information asymmetry arises. At the time of decision making, being the fully informed party the managers or insiders of the organization takes different actions and the principals are not aware that these actions are in their best interest or not. Sometimes in the decision-making process, the owners are not aware of the actions taken by the management (Demski & Feltham, 1978). This self-interest, opportunistic, shirking and fraudulent behaviour of the agents is called Moral Hazard in agency theory. According to Mc.Colgan (2001) the main cause of the agency conflict or agency problem is moral hazard. Sholihah and Fatwa (2021) argue that a moral hazard is an act of the economic agents which cause harm to others sometimes themselves. A moral hazard is an act of misappropriation of the agents for their chance without noticing by others (Mishkin, 2001).

Prior literature of agency theory and EM reports that the existence of type I and type II agency problems can be considered as major cause of opportunistic EM (Ratnawati, Hamid, Popoola, 2016).Type I agency problems are called principal-agent conflicts. According to Purkayastha, Veliyath and George (2022) when the shareholders are large in numbers and disperse and they cannot monitor the managerial activities the type I agency problems arises. Here the managers can obtain undue monetary and non-monetary benefits by using EM techniques because their actions are difficult to observe and judge. Agency type II problems are concerned with shareholders. The majority shareholders can manipulate the rights of the other shareholders due to EM. In majority cases the board of directors is appointed by the majority shareholders due to their voting rights.

Therefore the board of directors may align their interests with the majority shareholders (Nurim & Raharti, 2017).

3.4.2 Agency Theory and Islamic Jurisprudence

As compared to the conventional economic system the agency relationship in Islam is documented in its primary sources and very old concept. The first step of the agency theory is the formation of a contract between the principal and agent. The theory of the contract is well expressed in Islam because the formation of the contract is an essential element for legal significance. It ensures the guidelines of the contracting parties, further, the formation of a contract is very important for the terms and conditions, transactions and all other key points involved in the business. The Islamic contract is emphasized in the *Quran*ic Verse

"يَا أَيُّهَا الَّذِينَ آمَنُوا أَوْفُوا بِالْعُقُودِ"

"O you believe, fulfill all obligations."[33]

The *Aqd* or contract in Islamic law is a consent or promise to be fulfilled by the contracting parties mentioned in the above verse of the *Quran*. For the formation of the contract two essential elements are important to discuss. First the free consent of the contracting parties and second the element of the contract. In this regard *Quran* says

"يَا أَيُّهَا الَّذِينَ آمَنُوا لَا تَأْكُلُوا أَمْوَالَكُم بَيْنَكُم بِالْبَاطِلِ إِلَّا أَن تَكُونَ تِجَارَةً عَن تَرَاضٍ مِّنكُمْ"

"O ye who believe, squander not your wealth among yourselves in vanity, except it be a trade by mutual consent."[34]

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[33] Sura Maida-5:1
[34] Surah Al-Nisa 4:29

In this *Ayah* Almighty *Allah* clearly defines the way of earning wealth, involving vanity (such as theft, snatching, and gambling) is prohibited while trade with mutual consent is preferred. In this *Ayah,* mutual consent is specified because without free consent the fulfillment of the responsibility will not be possible. Similarly in the context of mutual consent Prophet Muhammad (P.B.U.H) was reported to have said

"A sale is a sale only if it is made through mutual consent"[35]

The three major schools of thought such as Shafi, Hambali and Maliki consider that there are three main elements of an Islamic contract which is quite similar to common law. The first is the offer (*Ijab*) and acceptance (*Qabool*). The *Ijab* is basically an offer made by the principal and the *Qabool* is the acceptance of an agent in this case. The offer may consist of price (Salary) or other remunerations such as commission or other benefits. The agent accepts the *Ijab* of the principal against the work or duty which shall be performed by him. There is no Islamic contract without *Ijab* and *Qabool.*

Secondly, the subject matter of the contract must be defined. If the contract is in commodity it shall not be prohibited by *Shariah*, for example, pork and liquor cannot be the subject matter of the contract. If the contract is for services, the services must not be prohibited by *Shariah*, such as theft, Riba, Snatching or other such act which is prohibited by the *Shariah*.

Thirdly, the capacity of contracting parties, it is important that both the contracting parties must be capable of entering in a contract. According to *Shariah,* the insane person is not capable of making contracts. Similarly a minor is also not capable to make a contract unless it is endorsed by his or her guardian. A person falling into insolvency is also not capable of making a contract. A

[35] Sunan Ibne Maja No. 2176

person who is suffering from that illness which leads him to death is also not capable of making binding contracts.

As for as the agency contract is concerned it itself is permitted by the *Shariah*. The Prophet Muhammad (P.B.U.H) made his agents for different jobs on different occasions. According to Uqbah Ibne Amir (R.A)

"Prophet (S.A.W) gave me some sheep to distribute amongst my companions in order to sacrifice them, a male kid was left after distribution. I informed Prophet (S.A.W) about it and the Prophet (S.A.W) said sacrifice it on my behalf".[36]

Similarly, in financial transactions, Urwah Al-Bariqi narrated

"Prophet (S.A.W) gave me a dinar to buy a sheep for sacrifice, I bought two sheep by it and sold one of them for one dinar on the way, when I brought a dinar and a sheep to the Prophet he said to me, may Allah bless the bargain of your right hand".[37]

Both these *Ahadith* prove that a person can assign his agent to perform a specific task. An agency contract is allowed in Islam with some restrictions and the proper guidelines to be followed. There are some obligations on the principal and agents which must be followed. In fact the regulations of the Islamic contract discussed earlier and the agency contract are tbe same. For example, the principal is obligated to delight his full authority to the agent. A minor and an insane person cannot be a part of the agency contract. Although there is some room for a minor person, he or she can appoint an agent to enter into an agency contract on his/her behalf. On the other side, the agent can perform his duties with some restrictions and the guidelines of the principal. Some general rules are

[36]Sahih Bukhari, Book 47, No. 17

[37]Kitab Al-Buyu, Sunan Abu Dawud, retrieved from: www.ahadith.co.uk

derived from the classical Hambali, Shafi and Hanafi jurists such as, the agents are not allowed to dispose of the subject matter of the principal, while a minor is not allowed to work as an agent of others (Mansuri, 2020).

Similar to the conventional financial system there are conflicts of goals in Islamic financial institutes. Specifically, in Islamic banks, the bankers who are working as the agents of the accountholders and shareholders can behave irresponsibly by using the principals' money. The management of the banks and their staff does not perfume their fiduciary responsibility according to the *Shariah* and the guidelines of the contract (Shamsuddin and Ismail, 2013). They further argue that the monitoring cost is very high and there is a problem to monitor bank officials, and this problem remains unsolved up till now. Another agency problem that can occur for Islamic banks' is the conflict of goal between the bank and tbe borrowers. Basically, the products of Islamic banks are mainly participatory modes of finance based on a profit and loss sharing system. The borrowers may not provide the full information regarding the project for which they need finance while the bank may not have direct access to the actual information about the project.

When the problem of moral hazard arises because of a conflict of interest it becomes a serious issue from a *Shariah* point of view. To judge whether the act that it is a moral hazard or not we need to learn about the *Shariah* principles of transactions and business (Hariyanto, 2001). The concept of agency theory is different in the Islamic financial system as compared to the conventional system. There are some moral ethics which has to be followed by the agents and their principals in Islamic agency contract, by not following these some serious legal issues arises from the Islamic point of view. The Muslims believe that their existence in this world is temporary and they must return to Almighty *Allah*. According to *Quran*

"الَّذِينَ إِذَا أَصَابَتْهُم مُّصِيبَةٌ قَالُوا إِنَّا لِلَّهِ وَإِنَّا إِلَيْهِ رَاجِعُونَ"

"Who say when afflicted with calamity, To Allah we belong and to Him is our return."[38]

It is not only returning to *Allah* but the next life (*Akhirah*) will be dependent on the performance of this existing life. In this regard *Quran* says

"وَاتَّقُوا يَوْمًا تُرْجَعُونَ فِيهِ إِلَى اللَّهِ ۖ ثُمَّ تُوَفَّىٰ كُلُّ نَفْسٍ مَّا كَسَبَتْ وَهُمْ لَا يُظْلَمُونَ"

"And fear the Day when you shall be brought back to Allah. Then shall every soul be paid what it earned, and non shall be dealt with unjustly."[39]

Being practicing Islam it is the primary duty of a person to ensure that he must not involve in opportunistic behaviour at the cost of others. Being an agent of the principal he is answerable to the Almighty *Allah*. His acts and behaviours are judged and he will get a reward for it. Involving in moral hazards by opportunistic EM is a clear violation of basic Islamic rules and ethics and is answerable to the Almighty *Allah*.

This system is based on a unity whicb means cooperation and participation. This is a unique feature of *Shariah* which teaches fair treatment to all humans irrespective of their color, skin, age, gender and religion. These moral values are also merged into our business lives; therefore the parties of the agency contract must obey these values. When the problem of moral hazard arises the unity of the contracting parties not remains the same. Being the decision-making authority the opportunistic behaviour of the agents badly shakes the concept of unity in the organization because they are in the driving seat of the organization. By using the techniques of opportunistic EM in the organization for their own benefit the agents involved themselves in moral hazards. To retain unity

[38] Sura Al-Baqara- 2:156
[39] Sura Al-Baqara- 2:281

in the organization it is the feudatory duty of the agents to perform their assigned tasks under the Islamic rules, principals and laws without involving in moral hazards.

When the agent and principal enter into a contract they promise each other that the agent will work on the principal's behalf with honesty while the principal promise that he will pay the predetermined reward. The importance of keeping the promise is one of the basic teachings of *Shariah*. *Quran* says

"وَأَوْفُوا بِالْعَهْدِ ۖ إِنَّ الْعَهْدَ كَانَ مَسْئُولًا"

"*and fulfill (Every) engagement, For (every) engagement Will be enquired.*"[40]

"وَأَوْفُوا بِعَهْدِ اللَّـهِ إِذَا عَاهَدتُّمْ"

"Fulfill the Covenant of Allah When ye have entered into it"[41]

Similarly in this context *Quran* says

"كَبُرَ مَقْتًا عِندَ اللَّـهِ أَن تَقُولُوا مَا لَا تَفْعَلُونَ ○ يَا أَيُّهَا الَّذِينَ آمَنُوا لِمَ تَقُولُونَ مَا لَا تَفْعَلُونَ"

"O ye who believe ! Why say ye that Which ye do not ? Grievously odious is it In the sight of God That ye say that Which ye do not."[42]

"لَّـٰكِنِ الَّذِينَ اتَّقَوْا رَبَّهُمْ لَهُمْ غُرَفٌ مِّن فَوْقِهَا غُرَفٌ مَّبْنِيَّةٌ تَجْرِي مِن تَحْتِهَا الْأَنْهَارُ ۖ وَعْدَ اللَّـهِ ۖ لَا يُخْلِفُ اللَّـهُ الْمِيعَادَ"

"But it is for those Who fear their Lord, That lofty mansions, One above another, Have been built : Beneath them flow Rivers (of delight) : (such is) The Promise of Allah : Never doth Allah fail in (His) promise."[43]

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[40] Sura Al-Isra-17:34
[41] Sura Nahl- 16:91
[42] Sura Saff- 61:2,3

When *Quran* tells the story of Prophet Musa (A.S) Almighty *Allah* says

"فَرَدَدْنَاهُ إِلَىٰ أُمِّهِ كَيْ تَقَرَّ عَيْنُهَا وَلَا تَحْزَنَ وَلِتَعْلَمَ أَنَّ وَعْدَ اللَّهِ حَقٌّ وَلَٰكِنَّ أَكْثَرَهُمْ لَا يَعْلَمُونَ"

"So, did We restore him to his mother, that she might be delighted, and that she might not grieve, and that she might know that the Promise of Allah is true."[44]

"بَلَىٰ مَنْ أَوْفَىٰ بِعَهْدِهِ وَاتَّقَىٰ فَإِنَّ اللَّهَ يُحِبُّ الْمُتَّقِينَ"

"Nay. Those that keep their plighted faith and act aright verily Allah loves those who act aright."[45]

All these verses of the Holy *Quran* clearly emphasize the fulfillment of promises. Being the primary source of the *Shariah Quran* shows how important is promise. Similarly, in the *Hadith* of Prophet Muhammad (P.B.U.H) the fulfillment of the promises is obligatory for all Muslims. A famous Hadith in this regard narrated by Abdullah Bin Omar (R.A)

"There are four characteristics, whoever has them all is a pure hypocrite: when he speaks he lies, when he makes a promise he breaks it, when he makes a covenant he betrays it, and when he disputes he resorts to obscene speech. Whoever has one of them has one of the characteristics of hypocrisy, until he gives it up."[46]

Similarly, Ali Ibne Abi Taalib (R.A) narrated that Prophet Muhammad (P.B.U.H) said

"Whoever breaks the covenant of a Muslim, upon him be the curse of Allah, the angels and all the people, and Allah will not accept any obligatory or naafil act of worship from him."[47]

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[43] Sura Zumar- 39:20
[44] Sura Qasas- 28:13
[45] Sura Al-i-Imran- 3:76
[46] Bukhaari, 3178; Muslim, 58.
[47] Bukhaari, 1870; Muslim, 1370.

In a similar context, Abdullah Bin Omar (R.A) narrated that Prophet Muhammad (P.B.U.H) said

"Allah will set up a banner for the betrayer on the Day of Resurrection, and it will be said: This is the betrayer of So and so."[48]

The fulfillment of promises is an obligatory and important principle in the primary sources of *Shariah*. It is because breaking promises creates social problems. Violation of the contractual obligation by the agents or principals through moral hazard is a violation of the *Quran* and *Hadith*. It is considered not only one of the major sins but it raises questions on the legal position of the contract.

Another major issue which is occurred in the agency contract through moral hazard and opportunistic EM is the concept of honesty and *Amanah*. These are the primary and obligatory principles of *Shariah*. The term *Amanah* is originated from the Arabic word *Aminah* and defined as safety, peace and security. Literally, *Amanah* means trust, faithfulness and reliability. *Amanah* enhances the characteristics of honesty and moral values. Honesty and *Amanah* both are important principles of a Muslim character. The individual faith establishes peace in the society and the concept of honesty and *Amanah* bind the society and individuals. The term betrayal is the opposite of *Amanah* which means failing in the expected desire results from a person. In the context of business, we can say betrayal is a moral hazard which is occurred through the opportunistic behaviour of the contracting parties. The primary sources of *Shariah* emphasize keeping trust, honesty and *Amanah*. According to *Quran*

"وَالَّذِينَ هُمْ لِأَمَانَاتِهِمْ وَعَهْدِهِمْ رَاعُونَ"

[48]Bukhaari, 6178; Muslim, 1735.

"And those who respect Their trusts and covenant"[49]

"يَا أَيُّهَا الَّذِينَ آمَنُوا لَا تَخُونُوا اللَّـهَ وَالرَّسُولَ وَتَخُونُوا أَمَانَاتِكُمْ وَأَنتُمْ تَعْلَمُونَ"

"O ye that believe! betray not the trust of Allah and the apostle nor misappropriate knowingly things entrusted to you"[50]

"ثُمَّ لَتُسْأَلُنَّ يَوْمَئِذٍ عَنِ النَّعِيمِ"

"Then, shall ye be Questioned that Day About the joy (Ye indulged in !)."[51]

"فَإِنْ أَمِنَ بَعْضُكُم بَعْضًا فَلْيُؤَدِّ الَّذِي اؤْتُمِنَ أَمَانَتَهُ وَلْيَتَّقِ اللَّـهَ رَبَّهُ ۗ وَلَا تَكْتُمُوا الشَّهَادَةَ ۚ وَمَن يَكْتُمْهَا فَإِنَّهُ آثِمٌ قَلْبُهُ ۗ وَاللَّـهُ بِمَا تَعْمَلُونَ عَلِيمٌ"

"And if one of you deposits a thing on trust with another let the trustee (faithfully) discharge his trust and let him fear his Lord. Conceal not evidence; for whoever conceals it his heart is tainted with sin. And Allah knoweth all that ye do."[52]

"وَمَا كَانَ لِنَبِيٍّ أَن يَغُلَّ ۚ وَمَن يَغْلُلْ يَأْتِ بِمَا غَلَّ يَوْمَ الْقِيَامَةِ ۚ ثُمَّ تُوَفَّىٰ كُلُّ نَفْسٍ مَّا كَسَبَتْ وَهُمْ لَا يُظْلَمُونَ"

"No prophet could (ever) be false to his trust. If any person is so false He shall on the Day of Judgment restore what he misappropriated; then shall every soul receive its due whatever it earned and none shall be dealt with unjustly."[53]

"قَالَ اجْعَلْنِي عَلَىٰ خَزَائِنِ الْأَرْضِ ۖ إِنِّي حَفِيظٌ عَلِيمٌ"

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[49] Sura Mu-minum-23:8 and Sura Ma'arij- 70:32
[50] Sura Anfal- 8:27
[51] Sura Takathur- 102:8
[52] Sura Al Baqara- 2:283
[53] Sura Al-i-Imran- 3:161

"(Joseph) said : " Set me Over the store-houses Of the land : I will Indeed guard them, As one that knows (Their importance)."[54]

These verses of Holy *Quran* clearly emphasize that keeping *Amanah* is important and obligatory for a practicing Muslim. Similarly in the *Hadith* of Prophet Muhammad (P.B.U.H) the importance of *Amanah* and trust is documented. A famous *Hadith* is narrated by IbneMasod (R.A) in this regard

"The two feet of the son of Adam will not move from near his Lord on the Day of Judgment until he is asked about five (matters) about his life - how he spent it; about his youth - how he took care of it; about his wealth - how he earned it: and where he spent it and about that which he acted upon from the knowledge he acquired."[55]

If we evaluate the agency theory and specifically the agency contract in the light of this Hadith, involvement in moral hazard through opportunistic EM is the involvement of life, wealth, earning source and sometimes youth in strictly prohibited activities. This kind of involvement will be questioned by the Almighty *Allah*. Another Hadith in this regard which is narrated by Abu Hurairah (R.A), said that Prophet Muhammad (P.B.U.H) said that Almighty *Allah* says

"There are three people whom I shall be their opponent on the Day of Judgment: A man who was given something in My Name and then betrays: A man who sells-off a free man (as a slave) and

[54] Sura Yusuf- 12:55

[55] Jami at-Tirmidhi, 2416

consumes the price; and A man who hires a labourer, makes use of his service then does not give him his wages."[56]

Here in this *Hadith* Almighty *Allah* emphasize the honesty of both contracting parties. Conventional finance is available everywhere, but most people prefer Islamic finance or Islamic contract (where available) because of religious concerns. They try to avoid the sin of *Riba* and invest money in Islamic products or Islamic financial institutes. The first part of this *Hadith* explains the behaviour of the agents who betray the principals through moral hazards and opportunistic EM. The last part of the Hadith binds the principals that they must not involve in moral hazards and pay the wages or remunerations of the agents timely and complete. Similarly, Abu Sa'id (R.A) narrated that Prophet Muhammad (P.B.U.H) said

"The honest and trustworthy merchant will be with the prophets, the truthful, and the martyrs."[57]

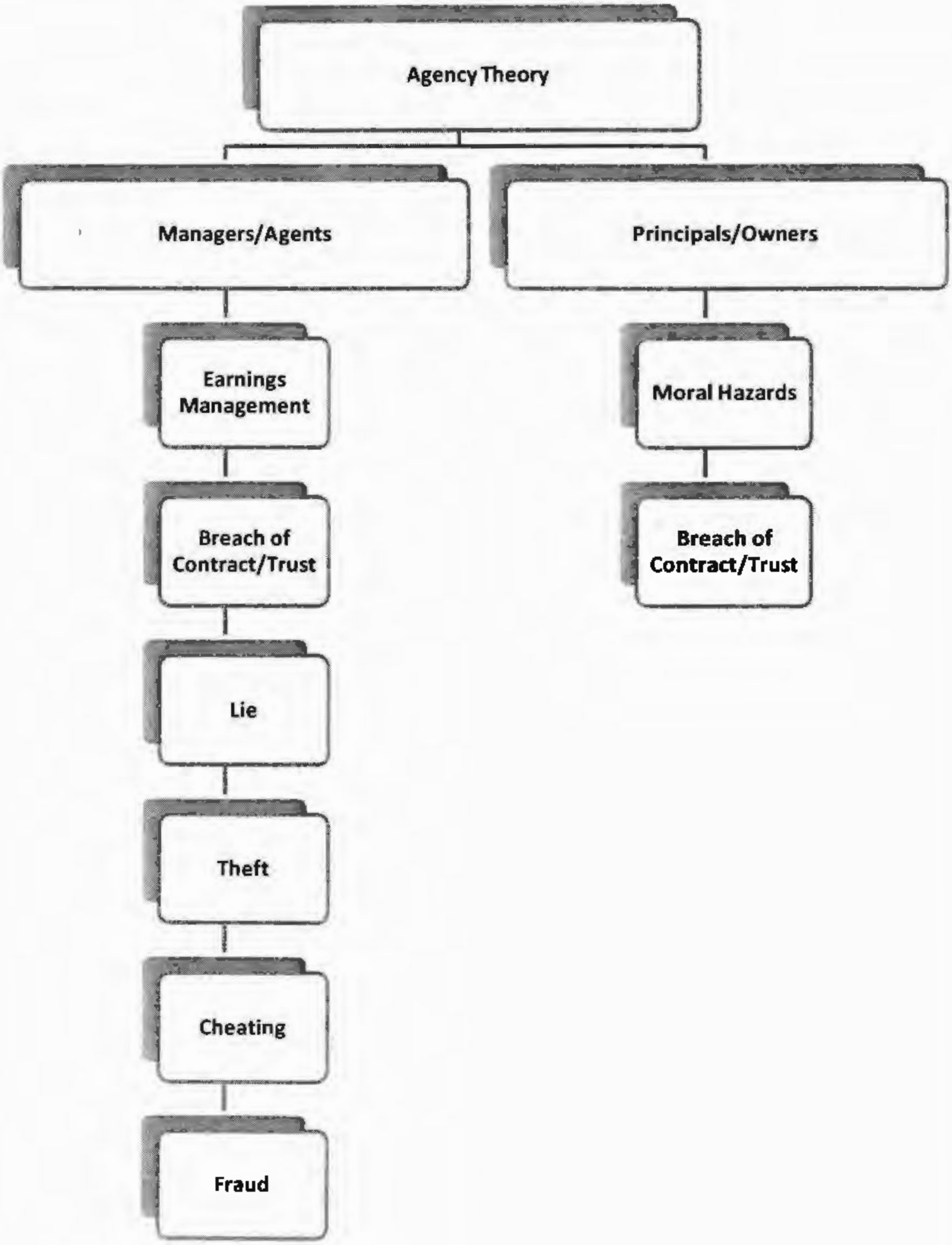
Honesty, truthfulness and taking care of *Amanah* are the essential *Shariah* principals for life specifically the economic life of Muslims. It can be concluded that involvement in moral hazards especially opportunistic EM is a strictly prohibited activity by *Shariah*. Among the four signs of hypocrisy, three signs are deemed fit on a person who is involved in the moral hazard and opportunistic EM specifically in an agency contract. The first sign is telling lie to the stakeholders. When a person involves in opportunistic EM and issues manipulated financial statements to shareholders and other stakeholders, that person is involved in the propagating lie, which itself is a major sin in Islam and the first sign of hypocrisy. Similarly, if a principal is not giving the predetermined remuneration to the agent he is also committing the same sin. The second sign is not

[56]Sahih Al-Bukhari, 2227
[57]Sunan al-Tirmidhī, 1209

fulfilling the promise. In an agency contract, the agent promises the principal to perform a specific task with honesty while the principal promise the agent that he will pay the reward. If a conflict of interest arises and either party involves in a moral hazard it is a breaking of the promise which is the second sign of hypocrisy. Similarly,an agency contract is basically a covenant between the agent and principal to perform a specific business and the moral hazard is the betrayal of this covenant which is the third sign of hypocrisy. In the light of the same *Hadith*, involvement in the conflict of interests through opportunistic EM and moral hazard is hypocrisy.

The agency theory from the Islamic point of view is further explained in Figure 3.4

Figure 3. 4 Agency Theory and *Shariah*



3.5.1 The Entrenchment Theory

The corporate governance (CG) literature widely discussed conflicts of interest amongst the manager (agent) and the shareholders (owners). Some researchers argue that the separation of ownership and control is a major reason for it (Berle and Means, 1932). This means the separation of decision-making authority and the owners of the organization. This relationship between the agents and principals is studied extensively in prior literature (Jenson & Meckling, 1976; Williamson, 1988; Morck, Shleifer &Vishny, 1988). After studying the relationship between the agents and the principals Morck, Shleifer and Vishny (1988) comes up with a theory which is called the entrenchment theory. This theory is also called the managerial entrenchment theory. According to this theory the managers of the organizations use entrenchment techniques to generate revenues or make their position strong and essential. The entrenchment theory also supposes that these agents (managers) are able to defuse many control mechanisms of the organization to enhance their discretionary powers. Thus, to show their indispensability of the job they imply different entrenchment strategies. Obtaining some shares in the organization is a part of this strategy. According to a famous American economist Michael Weisbach

"Managerial entrenchment occurs when managers gain so much power that they are able to use the firm to further their own interests rather than the interests of shareholders."

Therefore entrenchment theory says that managers who are also shareholders can act for their personal interests by enhancing their shares through EM (Mard and Marsat, 2009).

Empirically Klein (2002) reportsthe positive association between EM and the acquisition of shares by managers. In his study, he evidently proved that the management uses EM techniques to increase their percentage of shares in the organization. The same kind of observation is also reported by Stolowy and Breton (2003) and Aboody and Kaznik(2000) in their empirical analysis. They found that the managers opt to decrease the earnings before major transactions such as issuing new shares to reduce the share price of the company deliberately temporarily and to purchase the shares of the company at low prices. This tends to make them the major owners of the company at a low cost.

If we evaluate the entrenchment theory it can be concluded that the managers (agents) of the organization use entrenchment techniques such as obtaining shares of the organization to obtain revenues along with job security, powers and discretion to control the organization.

3.5.2 Entrenchment Theory and Islamic Jurisprudence

By looking at the entrenchment theory from *Shariah's* point of view we found that the characteristics of the entrenchment strategy are similar to the "Moral Hazard" of managers (agents). The prohibition of moral hazard is discussed from the *Shariah point* of view earlier in agency theory. One thing which is additionally explained by entrenchment theory is the obtaining of shares by the managers (agents) in the organization for different reasons e.g. earning revenues, making themselves indispensable and enhancing their discretionary powers to control the organization.

If the managers (agents) acquire shares of the organization they become partners in the organization. Being a manager the agent is entitled to get a salary while being a partner he has the right to get profit. There is no *Quran*ic verse or *Hadith* which specifically prohibits a partner to be an employee. However, drawing salary being a partner is prohibited because the employment and partnership contract cannot be combined. This is the viewpoint of major schools of thoughts such as Hanfi, Shaafi and Malakis. This principle is based on the *Hadith* of Prophet Muhammad (P.B.U.H) where he forbids two transactions in one. Similarly, drawing a salary and getting profit from the organization are two contracts and cannot be combined in one contract. The prohibition of the drawing salary being a partner is mainly due to two reasons. The main reason behind this is if the organization suffers losses the loss of the salary drawing partner will not be proportionate according to his investment due to the fixed salary. And the main principle of Islamic finance is that loss will be according to the ratio of investment. Secondly, the conflict of interest is always there, the salary-drawing partner may not work with full efforts to maximize the profit of the organization because his interests are already secured to draw a salary while the other partners are only dependent on profit.

The Hanbali school of thought permits salary drawing as an employee and profit earning as a partner by one person with some conditions.[58] The partnership contract will not be bound by the employment contract. Both contracts will be separate. Similarly, the salary will be dependent on work performed and cannot be fixed in the profit of the partner. The nature of the employment will be different from the normal work performed by the partners. Therefore the salary will be in lieu of employment and work performed by the partner and cannot be fixed in the profit of the partner. Thus permissibility of employment along with partnership is dependent on the following three points in Hanbali *Fiq*.

- The contract of partnership and the contract of employment will be different and not dependent on each other.
- The salary and allowances must be in lieu of work and cannot be included in profit as a fixed amount.

[58] Imadad Al-Fatawa 3-518, FatawaQasimeyah 20-57

- The salary and allowances must be *Ujrat-ul-Mithl* (Market rate). This means stopping the employee from getting undue benefits being a partner.

In the current scenario, large organizations are established. Most commercial organizations are public limited their stocks are floated on the stock exchange and their partnership is open to everyone. A shareholder can be an employee of the company similarly an employee can purchase the shares of the company, both these scenarios are very common practices in the current financial world. Being a common practice the contemporary Hanafi scholars also allowed this situation. According to Mufti Rashid Ahmad Ludyanwi, there is no *Quran*ic verse or *Hadith* which prohibits the combination of partnership and employment in this specific context it can be allowed as for as it does not contradict with *Quran* and *Hadith*.[59] According to him, only both transactions are not allowed in one transaction which is prohibited by Prophet Muhammad (P.B.U.H).[60]

As for as entrenchment strategies of management are concerned they seem different from the above justifications. The managers (agents) apply entrenchment and purchase the shares of the organization to get revenue, power and control of the organization. First of all the intentions of the managers are to be evaluated from the Islamic point of view. According to a famous *Shariah* maxim "acts are judged by the intentions behind them". The maxim is derived from a famous *Hadith* of Prophet Muhammad (P.B.U.H)

"The reward of deeds depends upon the intentions and every person will get the reward according to what he has intended for. So whoever emigrates for worldly benefits or for a women to marry, his emigration will be for what he emigrated for."[61]

[59] Ahsan Al-Fatawa- 7-328
[60] Sunan Al-Tirmidhi- 1231
[61] Sahih Al-Bukhari- 1

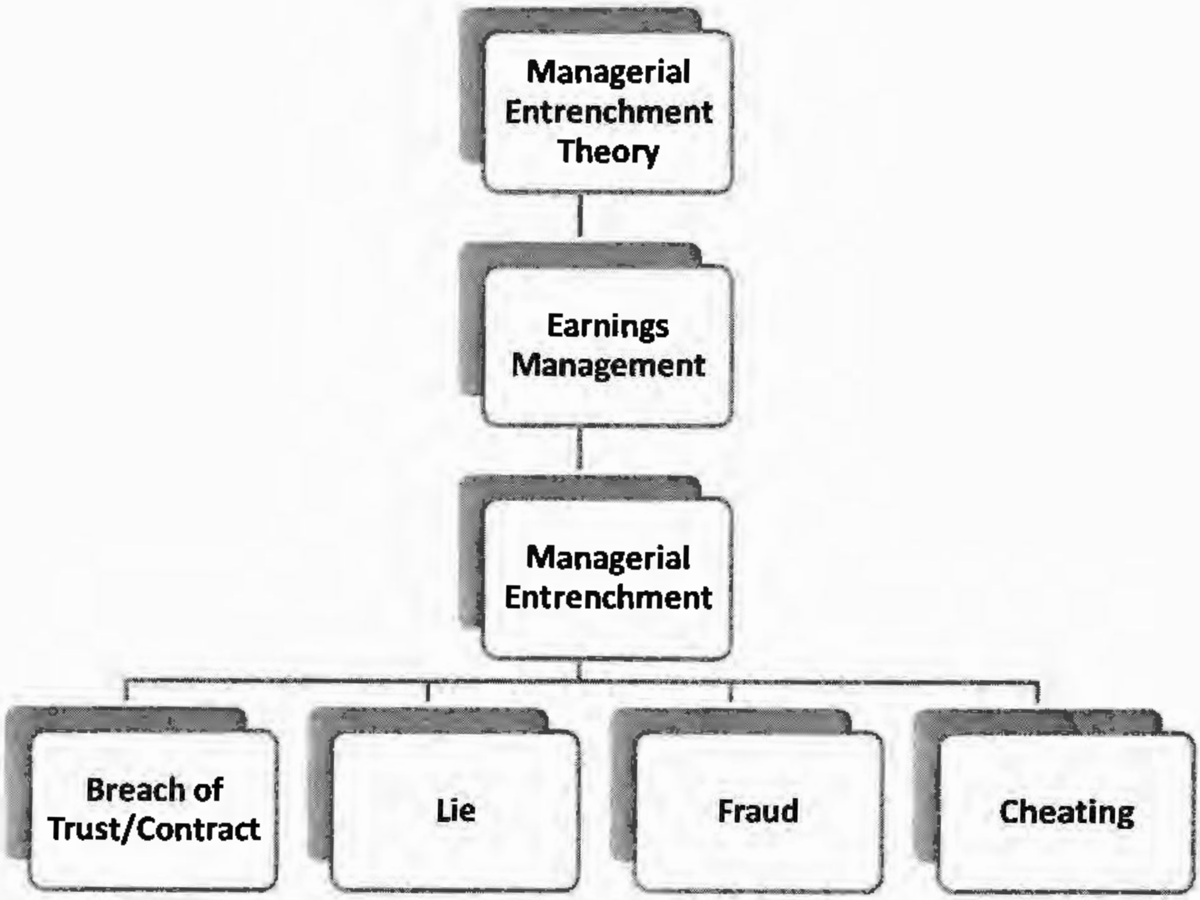
Here the intention of the manager seems to be involved in moral hazards through entrenchment. Obtaining shares for the control of the organization is a clear involvement in moral hazards.

The permission to employment and be a partner of a person is given by the Hanbali school of thought and contemporary Hanafi jurists under some principles. Here in entrenchment theory, the manager uses their entrenchment strategy to acquire shares of the organization to make his job indispensable. This is a violation of the principle that employment and partnership contract will be independent. Here the manager uses the power of the partnership contract to support his employment. He makes himself strong by obtaining shares to get more discretionary powers to control the organization. Thus the contract of partnership automatically gives support to make his employment strong, powerful and sometimes indispensable which is against the permissibility principle.

Managerial entrenchment is also performed to obtain revenue. This is also the permissibility principle of the partnership and employment that being an employee the partner will get *Ujrat-Ul-Mithal*, which means he will get a market-based salary for his work performed. If the manager gets more discretionary powers through entrenchment he will get more revenue and if it is more than *Ujrat-Ul-Mithal* then the permissibility principle is violated because this act will harm the interest of other shareholders or partners.

Another major *Shariah* problem is that when manager intentionally shows the reduced profit or income of the organization in their financial reports through EM techniques and they decrease the share price to purchase these shares at a low price is a fraudulent activity and a clear violation of *Shariah*. Reducing share prices through EM is the reduction of the value of assets of the shareholders intentionally which is against their contract of employment. Here the conflict of interest arises and the managers give benefits to themselves at the cost of shareholders because the values of their assets are intentionally brought down by the managers. Thus this act of the managers comes under fraud, *Khayyanah*, breach of trust, breaking the promise and lying, which are major sins in *Shariah*.Figure 3.5 shows the Islamic perspective on entrenchment theory.

Figure 3. 5 Managerial Entrenchment Theory &*Shariah*



3.6 Theories of Earnings Management and Islamic Work/Business Ethics

The moral principles which distinguish right and wrong can be defined as ethics. Islamic business ethics are based on *Taqwa* (piety), *Birr* (righteousness), *Haq* (right and truth), *Khair* (goodness), *Adl* (justice) and so on (Abbasi, Rehman & Abbasi, 2012). The major justification of these ethics to be followed in the business is the benevolence of The Almighty *Allah* (S.W.T) which is the primary duty of a practicing Muslim. According to a famous Hadith of the Prophet Muhammad (P.B.U.H) *"You are not better than people with red or black skins unless you excel them in piety."* In the context of honesty once the Prophet Muhammad (P.B.U.H) was asked "when would the Hour (Doomsday) take place?" He replied, "*When honesty is lost, then wait for the Hour (Doomsday).*" He was again asked, "*How will that be lost?*" He answered, "*When the power or authority comes in the hands of unfit persons, then wait for the Hour (Doomsday)*" (Beekun, 1997). Hence the Islamic ethics of business does not allow dishonesty. Abbasi *et al.*(2012) further documented the components of Islamic business ethics such as sincerity, proficiency, justice, truthfulness, patience, and promise-keeping. These components clearly prove that in Islamic business ethics, there is no room for deceiving, stealing, dishonesty, manipulation and fraud. Five EM theories which are discussed earlier from the Shariah perspective are further discussed in the light of these components separately.

3.6.1 Sincerity

Ikhlas (Sincerity) is a major component of Islam. It is an absolute value, either one is insincere or sincere (Abbasi et. al, 2012). *Quran* said in this regard

قُلِ اللَّـهَ أَعْبُدُ مُخْلِصًا لَّهُ دِينِي

" It is God I serve, With my sincere (And exclusive) devotion"[62]

Sincerity from the agents (managers) is a desirable quality. The management of the organization should be sincere to their organization and the principals (owners). If they are insincere this shows there is an opportunistic intention which is prohibited.

Signal theory: If we look into the signal theory we find two types of signals, informational and opportunistic. For the informational signals, there is no need for EM. The management emits the actual position of the organization through financial statements. This act can be called a sincere act by the management. If the managers do EM and emit opportunistic signals due to different reasons this is their insincerity of them and a prohibited act.

Threshold management theory: The management of the banks' does EM in their financial statements to overcome three thresholds, avoiding zero results, decrease in income and analysts' expectations. This act shows the insincerity of the management because this operation is usually performed with opportunistic intentions.

Positive accounting theory: Here the management of the banks' does EM for the bonus plan and reducing political costs. EM for bonus plan shows the insincerity of the management because they do the EM with the intention to get bonuses. Similarly by doing EM to reduce political costs shows the insincerity of management (sometimes owners) to the whole society.

Agency Theory: Agency theory is the study of the relationship between agents and principals. The agency problem and conflict show the insincerity of the agents for being involved in the EM. Similarly, involvement in moral hazards shows the insincerity of the principals.

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[62] Sura Zumr- 39:14

Managerial Entrenchment and Sincerity: Using different EM techniques to entrench for obtaining ownership of the organization shows the insincerity of the management.

Thus in all five EM theories, the element of insincerity persists. Therefore, all these theories are unethical in light of the sincerity component of Islamic business ethics.

3.6.2Proficiency

The second major component which the literature documented in Islamic business ethics is *Ihsan* (proficiency). In the business context, *Ihsan* can be defined as doing or giving more than the minimal requirements. Proficiency the management means efficiency which increases productivity (Al Habshi& Ghazali, 1994). *Quran* says in this regard

وَابْتَغِ فِيمَا آتَاكَ اللَّـهُ الدَّارَ الْآخِرَةَ وَلَا تَنسَ نَصِيبَكَ مِنَ الدُّنْيَا وَأَحْسِن كَمَا أَحْسَنَ اللَّـهُ إِلَيْكَ وَلَا تَبْغِ الْفَسَادَ فِي الْأَرْضِ إِنَّ اللَّـهَ لَا يُحِبُّ
الْمُفْسِدِينَ

" But seek, with the (wealth) Which God has bestowed on thee, The Home of the Hereafter, Nor forget thy portion in this World : but do thou good, As God has been good To thee, and seek not (Occasions for) mischief in the land : For God loves not those Who do mischief."[63]

Here in this verse of the Holy *Quran* the good means *Ihsan*. The life of Prophet Muhammad (P.B.U.H) is full of proficiency and doing good to others. For example, Abu Rafi (R.A) narrated that

"The Prophet (P.B.U.H) asked a man to give as a loan a young camel and said: "When the camels of the Sadaqah come, we will pay you back." When the camels came, he said: O Abu Rafi', pay this man back for his Young camel. But all I could find was a seven-year-old camel or that which is

[63] Sura Qasas 28:77

better. I told the Prophet and he said: Give it to him, for the best of People are those who are best in repaying."[64]

The importance of *Ihsan* is an undeniable fact due to its encouragement in the primary sources of *Shariah*. The managers being the agents of the principals may work with proficiency for the benevolence of the Almighty *Allah* (S.W.T). Similarly, the principals being the owners of the organization may also treat their agents with proficiency.

Signal Theory: It is the primary duty of the management to give accurate and fair information about the organization to all the stakeholders. By giving opportunistic and fabricated signals they do not perform their primary duty. Besides giving the extra performance on the basis of *Ihsan* they do not perform their primary responsibility for which they are being paid. Hence they violate the component of *Ihsan* in Islamic business ethics.

Threshold Management Theory: EM to achieve any kind of threshold avoiding zero results, decrease in earnings and analysts' expectation is against the proficiency notion of Islamic business ethics. In fact it is against the word *Ihsan* because the major aim of achieving the threshold is deceiving the shareholders or sometimes the general public and government.

Positive Accounting Theory: EM to achieve bonuses, incentives and avoiding or reducing political costs shows the opportunistic intention of the management and sometimes shareholders. Therefore it is also against the notion of proficiency and against Islamic business ethics.

Agency Theory: The agency conflict between the agents and principals badly affects Islamic business ethics. The management opts to enhance their wealth at the cost of principals which is

[64] Sunan IbneMajah No.2285

against the proficiency notion of Islamic business ethics. Similarly, proficiency encourages the principals to pay more to the management if they perform their duties efficiently. If the remuneration system is not on time and not market-based it is against the notion of proficiency.

Managerial Entrenchment Theory and Proficiency: The managerial entrenchment to obtain shares in the organization shows the proficiency of the management but to themselves. This act costs the shareholders financial losses. Hence this act and theory are also against proficiency.

3.6.3Justice

Similar to sincerity justice is an absolute value. Either a person is just or unjust. Justice is emphasized in all the religions of the world (Abbasi et.al, 2012). Because it is an undeniable value which keeps the collective and individual affairs straight in society (Murphy, 1999). The universality of justice is acceptable to everyone (Alhabshi & Ghalzai, 1994). Holy *Quran* says in this regard

إِنَّ اللَّهَ يَأْمُرُ بِالْعَدْلِ وَالْإِحْسَانِ وَإِيتَاءِ ذِي الْقُرْبَىٰ وَيَنْهَىٰ عَنِ الْفَحْشَاءِ وَالْمُنكَرِ وَالْبَغْيِ ۚ يَعِظُكُمْ لَعَلَّكُمْ تَذَكَّرُونَ

"Allah commands justice, the doing Of good, and liberality to kith And kin, and He forbids All shameful deeds, and injustice And rebellion : He instructs you, That ye may receive admonition."[65]

For doing justice the life of Prophet Muhammad (P.B.U.B) was exemplary. In financial matters justice is an important value because by doing injustice the social life circle and economic system will not be trustworthy. The justice in financial matters of the Prophet (Muhammad (P.B.U.H) is clear from a famous Hadith narrated by Aisha (R.A)

[65] Sura Nahl 16:90

"Usama (R.A) approached the Prophet (P.B.U.H) on behalf of a woman (who had committed theft). The Prophet (P.B.U.H) said, "The people before you were destroyed because they used to inflict the legal punishments on the poor and forgive the rich. By Him in Whose Hand my soul is! If Fatima (the daughter of the Prophet (P.B.U.H) did that (i.e. stole), I would cut off her hand."[66]

Financial justice is an essential element in Islamic work or business ethics. Therefore the agents and principals must be just otherwise they will be answerable to the Almighty *Allah* (S.W.T) on the day of justice. By viewing EM in general it can be observed that the behaviour of the agents is unjust in this regard. Specifically,

Signal theory: EM propagating it through opportunistic signals.

Threshold management theory: Setting up any kind of threshold and achieving or overcoming it through EM.

Positive accounting theory: EM to achieve personal gains or to avoid and reduce taxes.

Agency theory: Agency conflicts between the principals and agents and getting involved in moral hazards.

Entrenchment theory: Getting the shares through the entrenchment of management, EM to reduce the prices of the shares.

These all are unjust and unfair behaviours by the management of the companies and sometimes the owners.

[66] Bukhari No. 3610

3.6.4 Truthfulness

Truthfulness (*Sidq*) is the backbone of Islamic Shariah. *Quran* and Hadith specifically commanded us to be truthful many times. In this regard, Alhabshi and Ghazali (1994) argued that a person can be declared "truthful" if he is truthful in his speech, intentions, resolutions and fulfillment of resolutions. Beekun and Badawi (1999) argued that the consistency between words and deeds is truthfulness. EM generally is considered as a lie in the financial statements which is totally opposite the of truthfulness specifically the lies in EM theories are

Signal theory: Propagating false signals

Threshold management theory: Fabrication of financial statements to overcome thresholds

Agency Theory: EM and manipulation of financial statements due to opportunistic behaviour of the management

Positive accounting theory: EM and manipulation of financial statements to gain private gains and reduce or avoid taxes

Entrenchment theory: Reporting the reduced earnings to reduce stock prices

3.6.5 Patience (*Sabr*)

For the followers of Islam, patience (*Sabr*) is one of the main characteristics defined by the *Quran* (Beekun& Badawi, 1999). Patience means to control the "self" (*Nafs*) from the prohibited activities by *Shariah*. In financial matters, patience means controlling the self from the prohibited earnings. To take the benefits from the available opportunities for earning prohibited wealth is against patience. According to the Hadith of the Prophet Muhammad (P.B.U.H)

"Truly every nation there is a trail, and the trail of my nation is wealth"[67]

Here this trail of wealth means the trail of patience regarding wealth matters of a person. The patience in earning wealth from legitimate sources and the patience to prevent "self" from illegitimate earnings is the major theme of this *Hadith*. The lust for wealth to be earned from illegitimate sources is strictly prohibited. EM being the manipulation for private gain is the lust for wealth through illegitimate ways which is against patience. The opportunistic behaviour of the management shows that they do not have the patience to earn legitimate remunerations, or they are not satisfied with their contractual legitimate remunerations. Similarly, if we evaluate EM theories from this business ethic we found that management loose patience such as

Signal theory: Manipulation of earnings and propagation it to gain financial benefits

Threshold management theory: Setting up thresholds and EM to overcome these thresholds

Agency theory: The agency problem itself

Positive accounting theory: EM for private gain and avoid or reduce taxes

Entrenchment theory: Entrenchment itself through unfair means.

3.6.6 Promise Keeping (*Ifa-Ul-Hd*)

Promise-keeping is a very important ethic of Islamic business/work ethics. The importance of keeping promises is emphasized by *Shariah* in its primary sources. Breaking a promise is declared a major sin and it is declared one of the signs of hypocrisy. The relationship between management and owners is the relationship between agents and principals. Therefore they are naturally bound in a contract that the agents will work on the behalf of the principals with honesty

[67] Al-Tirmidhi No. 2336

and up to the best of their abilities. And the principals will pay their predetermined remunerations timely. EM is the manipulation of the financial statements by the agents for different reasons to hide the actual position of the business from its owners, which raises questions about their integrity. The malicious behaviour of EM is a breach of their natural agency contract. Therefore EM is generally against Islamic business/work ethics. Specifically in five EM theories breach of contract can be found in each one for example

Signal theory: EM for fabricated signals

Threshold management theory: EM to overcome several thresholds

Agency theory: Agency conflict itself

Positive accounting theory: EM for private gain and reduction of taxes

Entrenchment theory: Entrenchment itself.

After evaluating the five EM theories from the *Shariah*primary sources and Islamic business/work ethics, it can be concluded that EM is prohibited and unethical behaviour of the management. Severe violations of *Shariah* can be found in each theory while these theories violate the six major Islamic business/work ethics.

CHAPTER4. METHODOLOGY AND DATA

This chapter describes the methodology of the empirical part of the thesis. The nature of this study is descriptive and empirical research, because it extends the knowledge regarding EM. Further it empirically examines EM impacts on Islamic banks. First, data and sampling techniques are described, then the variables used in the study are defined, and lastly the regression models used in the study are discussed in detail.

4.1 Data and Sample

This section comprised of discussion on sample size, data collection methods, econometric techniques, and the time period of the study.

The sample size includes 75 largest Islamic banks worldwide. The list of the top 100 banks in terms of total assets was obtained from theasianbanker.com.[68] Out of 100 Islamic banks, the data of 75 Islamic banks were available at the end of 2020. Specifically, the following Islamic banks were included in our empirical analysis.

Table 4. 1

Sample Size

S.No	Name	Country	Total Assets $ Million	S.No	Name	Country	Total Assets $ Million
1	Albarka Banking Group	Bahrain	26104	38	Bank Islam Malaysia	Malaysia	16011
2	Alsalam Bank Bahrain	Bahrain	5819	39	AmBank Islamic	Malaysia	10793
3	Kuwait Finance House (Bahrain)	Bahrain	4440	40	Hong Leong Islamic Bank	Malaysia	9149

[68]https://www.theasianbanker.com/ab500/2018-2019/largest-islamic-banks-2020

4	Bahrain Islamic Bank	Bahrain	3415	41	Bank Muamalat Malaysia	Malaysia	5702
5	ABC Islamic	Bahrain	2309	42	HSBC Amanah Malaysia	Malaysia	4618
6	Islami Bank Bangladesh	Bangladesh	13658	43	OCBC Amin	Malaysia	3936
7	First Security Islami Bank	Bangladesh	5424	44	Alliance Islamic Bank	Malaysia	3422
8	Export Import Bank of Bangladesh	Bangladesh	5261	45	Kuwait Finance House Malaysia	Malaysia	2029
9	Al-Arafah Islami bank	Bangladesh	4651	46	Standard Chartard Sadiq	Malaysia	1661
10	Social Islami Bank	Bangladesh	4068	47	Jaiz Bank	Nigeria	482
11	Shah Jalal Islamic Bank	Bangladesh	3,236	48	Bank Nizwa	Oman	2755
12	Bank Islam Brunei Darussalam	Brunei	7941	49	Meezan Bank	Pakistan	7521
13	Al Baraka Bank Egypt	Egypt	4559	50	Dubai Islamic Bank Pakistan	Pakistan	1746
14	Abu Dhabi Islamic Bank Egypt	Egypt	4042	51	Bank Islami Pakistan	Pakistan	1706
15	Bank BTPN Syariah	Indonesia	1057	52	Albarka Bank Pakistan	Pakistan	120
16	Bank Panin Dubai Syariah	Indonesia	734	53	MCB Islamic Bank	Pakistan	716
17	Bank NTB Syariah	Indonesia	708	54	Arab Islamic Bank	Palestine	1469
18	Bank Mega Syariah	Indonesia	597	55	Palestine Islamic Bank	Palestine	1291
19	Bank BCA Syariah	Indonesia	590	56	Qatar Islamic Bank	Qatar	45540
20	Bank Jabar Benten Syariah	Indonesia	509	57	Masraf Al Rayan	Qatar	30032
21	Bank Syariah Bnkopan	Indonesia	380	58	Dukhan Bank	Qatar	20717
22	Bank Victoria Syariah	Indonesia	146	59	Qatar International Islamic Bank	Qatar	16289
23	Bank Aceh Syariah	Indonesia	1672	60	Qatar First Bank	Qatar	699
24	Jordan Islamic Bank	Jordan	6414	61	Al Rajhi Bank	Saudi Arabia	111338
25	Safwa Islamic Bank	Jordan	2377	62	Alinma Bank	Saudi Arabia	37904
26	Islamic International Arab Bank	Jordan	3295	63	Bank Aljazira	Saudi Arabia	24489
27	Gulf African Bank	Kenya	319	64	Bank Al Bilad	Saudi Arabia	23677
28	First Community Bank	Kenya	175	65	AlBarka Bank	South Africa	460
29	Boubyan Bank	Kuwait	19894	66	Amana Bank	Sri Lanka	506
30	Ahli United Bank Kuwait	Kuwait	14363	67	Kuveyt Turk KatilimBankasi	Turkey	20119
31	Warba Bank	Kuwait	11019	68	TurkiyeFinansKatil imBankasi	Turkey	9928
32	Kuwait International	Kuwait	8910	69	Albaraka Turk	Turkey	8689

	Bank				KatilimBankasi		
33	MayBank Islamic	Malaysia	57951	70	ZiraatKatilimBankasi	Turkey	6727
34	CIMB Islamic Bank	Malaysia	26068	71	Dubai Islamic Bank	UAE	80261
35	Bank Rakyat	Malaysia	25561	72	Abu Dhabi Islamic Bank	UAE	33874
36	RHB Islamic Bank	Malaysia	18238	73	Emirates Islamic Bank	UAE	17478
37	Public Islamic Bank	Malaysia	16089	74	Sharjah Islamic Bank	UAE	14340
				75	Ajman Bank	UAE	6413

Total Assets in Million $ at the end of 2020 896600

The available data of these 75 Islamic banks are from different regions of the world and 18 different countries. The total assets of Islamic banks globally were 1.84 Trillion US Dollars at the end of 2020.[69] Our sample size of 75 Islamic banks with total assets of 0.8966 Trillion US Dollars which covers almost 49% of 1.84 Trillion Dollars. Hence this sample size covers almost half of Islamic banks globally in terms of total assets. We describe this sample size as Worldwide further in discussions.

To reduce the biasness, we also evaluate the sample size of the GCC region and ASEAN region separately. The total number of Islamic banks in the GCC region is twenty (Braima, 2021). While the asianbankers.com shows 23 Islamic banks. Therefore, we include 23 Islamic banks which is the whole Islamic banking sector of the GCC region. Braima (2021) argue that the data of all Islamic banks in the GCC is homogenous. Therefore, we include the GCC as one region and use panel data for the GCC region. We also include the 23 Islamic banks of the ASEAN region as another panel to cross-check another region. Thus, the regression models are run on the Worldwide sample, GCC region and ASEAN region separately.

[69]https://www.statista.com/statistics/1264618/islamic-banking-assets-region/

The time frame of every quantitative study is very important because the relationship of variables is not always the same. Data from these banks is collected from 2009 to 2020. The time frame of this study is also very important because the global financial crisis (GFC) occurred in 2008 and the issue of EM regained attention after the huge losses of financial institutions. Thus, this study pertains to post-GFC (2008). Data from these banks were available up to 2020 on their respective websites, because we collected data in 2021.

Secondary data included in the balance sheets are obtained from the annual reports of these Islamic banks. The annual reports are downloaded from the official websites of these banks. The data on internal control variables are also obtained from the annual reports. Macroeconomic data is downloaded from the reliable source of the world bank.

4.2 Empirical Models

This section includes the empirical models used in the study followed by a discussion on the dependent, independent and control variables in detail.

Detection of EM is a difficult task and needs a series of estimations and calculations. According to prior studies, to detect EM, Jones (1991) and modified Jones model Dechow, Sloan and Sweeney (1995) are used widely. But the structure of financial and non-financial institutes is different. Therefore, the EM is proxied by Loan Loss Provisions (LLP) in financial institutes in the prior studies. In fact, the LLPs are used as a tool of EM (Ahmed, Takeda & Thomas, 1999; Beatty, Chamberlain &Magliolo, 1995; Greenawalt &Sinkey, 1988; Taktak&Mbarki, 2014; Zgarni, et al., 2018, Ben Othmen&Mersni, 2016).

The LLP can be calculated by adding Provisions for Credit Losses, Releases of Provisions and recoveries, Direct Write-off loans and other advances (Abu Jledan, 2016). While the total LLP is the combination of non-discretionary loan loss provisions (NDLLP) and discretionary loan loss provisions (DLLP). NDLLP are those provisions which are the essential part of LLP based on the non-performing finances and total financing of the banks. DLLP is discretionary part of the LLP which can be controlled by the management according to the situation and conditions. According to Montgomery (1998) this discretionary part of LLP is exploited by the banks for EM. Othman and Mercni (2014) also reported that DLLP is used by Islamic banks for earnings management in the Middle East. Based on the pieces of evidence from prior literature we use the DLLP as a proxy of EM and include it as a main independent variable.

Since the discretionary loan loss provisions (DLLPs) are not available directly in the financial statements of the banks therefore, Kanagaretnam (2004) and Taktak, Zouari and Boudriga (2010) estimate the NDLLP from the LLP. They subtract the estimated NDLLP from the LLP to obtain the DLLP. Othman and Mersni (2014), Shawtari and Ariff (2015) also used the same methodology to separate the DLLP from the LLP. Following the same strand of literature, we use two stages approach to separate the discretionary part of provisions from total loan loss provisions. At the first stage, we need to estimate the non-discretionary loan loss provisions. We use Model 4.1 consistent with prior literature.

$$LLP_{it} = \alpha + \beta_1 NPL_{t-1} + \beta_2 \Delta NPL_{it} + \beta_3 \Delta Loan_{it} + \epsilon_{it} \tag{4.1}$$

where

LLP is total loan loss provisions at the end of the year deflated by total financing and loans. (The financing structures of conventional banks and Islamic banks are different. Since Islamic banks do not issue loans, therefore, the total financing and loans mean Islamic financings such as *Mudarabaha, Musharakah, Ijarah* and *Qarz e Hasan*). $NPL_{t-1}$is non-performing loans (Islamic finances) at the beginning of the year deflated by total loans at the beginning of the year. $\Delta NPL_{it}$is the change in non-performing loans (Islamic finances) at the end of the year deflated by the beginning loans of the year. $\Delta Loan_{it}$is the change in the total loans (Islamic finances) deflated by the beginning loans.

From the above equation, we get the estimated value of the non-discretionary loan loss provisions of each bank. This is the non-discretionary estimated part of the total loan loss provisions which cannot be controlled by the management. The residual of equation 4.1 is used as the estimation of the NDLLP. The estimated equitation becomes 4.2.

$$N\widehat{DLLP}_{it} = \alpha + \widehat{\beta_1} NPL_{t-1} + \widehat{\beta_2} \Delta NPL_{it} + \widehat{\beta_3} \Delta Loan_{it} \quad (4.2)$$

Where

$N\widehat{DLLP}_{it}$= Estimated non-discretionary loan loss provisions at the end of the year, $N\widehat{PL_{t-1}}$is estimated non-performing loans at the beginning of the year. $\Delta \widehat{NPL}_{it}$is the estimated change in non-performing loans at the end of the year. $\Delta \widehat{Loan}_{it}$is the estimated change in the total loans at the end of the year deflated by the beginning loans of the year.

The last step of the first stage is to isolate the estimated value of discretionary loan loss provisions (DLLP) from the total loan loss provisions by using equation 4.3 which is the main independent variable of this study.

$$\widehat{DLLP}_{it} = LLP_{it} - N\widehat{DLLP}_{it} \quad (4.3)$$

Where

$\widehat{DLLP}_{it}$ is estimated for discretionary loan loss provisions at the end of the year. LLP_{it} is a loan loss provision at the end of the year and $N\widehat{DLLP}_{it}$ estimated non-discretionary loan loss provisions at the end of the year.

From the above equation, we get the estimated value of DLLP which is the discretionary part of the loan loss provisions and is controlled by the management. This estimation is used further as a proxy of EM consistent with prior studies.

To evaluate the impact of EM on internal performance the following two models are used.

$$ROE_{it} = \alpha + \widehat{\beta_1}DLLP_{it} + \beta_2 CI_{it} + \beta_3 DA_{it} + \beta_4 TA_{it} + \beta_5 BOD_{it} + \beta_6 SSB_{it} + \beta_7 GDP_t + \beta_8 Inf_t + \epsilon_{it} \quad (4.4)$$

$$ROA_{it} = \alpha + \widehat{\beta_1}DLLP + \beta_2 CI_{it} + \beta_3 DA_{it} + \beta_4 TA_{it} + \beta_5 BOD_{it} + \beta_6 SSB_{it} + \beta_7 GDP_t + \beta_8 Inf_t + \epsilon_{it} \quad (4.5)$$

where

ROE_{it} is the return on owners' average equity of bank i at year t. ROA_{it} is the return on average assets of bank i at year t. $\widehat{DLLP}_{it}$ is estimated discretionary loan loss provisions of bank i at year t. CI_{it} is the cost-to-income ratio of bank i at year t. DA_{it} is the deposits to total ratio of bank i at year t. TA_{it} is the log of total assets of bank i at year t. BOD_{it} is the size of the board of directors of bank iat year t. SSB_{it} is the size of the *Shariah* board of bank i at year t. GDP_t is the GDP growth rate of a country at year t. Inf_t is the inflation rate (CPI) of the country at year t.

After evaluating the impact of DLLP on internal performance variables the impact of DLLP on external performance is evaluated. External performance is proxied by the stock returns of these banks.

$$SR_{it} = \alpha + \widehat{\beta_1} DLLP_{it} + \beta_2 CI_{it} + \beta_3 DA_{it} + \beta_4 TA_{it} + \beta_5 BOD_{it} + \beta_6 SSB_{it} + \beta_7 GDP_t + \beta_8 Inf_t + \epsilon_{it} \quad (4.6)$$

where

SR_{it} is the stock returns of the bank i at year t. $\widehat{DLLP}_{it}$ is estimated discretionary loan loss provisions of bank i at year t. CI_{it} is the cost-to-income ratio of bank i at year t. DA_{it} is the deposits to total ratio of bank i at year t. TA_{it} is the log of total assets of bank i at year t. BOD_{it} is the size of the board of directors of bank i at year t. SSB_{it} is the size of the *Shariah* board of bank i at year t. GDP_t is the GDP growth rate of the country at year t. Inf_t is the inflation rate (CPI) of the country at year t.

After evaluating the impact of DLLP on internal and external performance we evaluate the impact of DLLP on management incentives by using Model 4.7

$$MgtInc_{it} = \alpha + \widehat{\beta_1} DLLP_{it} + \beta_2 CI_{it} + \beta_3 DA_{it} + \beta_4 TA_{it} + \beta_5 SSB_{it} + \beta_6 BOD_{it} + \beta_7 GDP_t + \beta_8 Inf_t + \epsilon_{it} \quad (4.7)$$

where

$MgtInc_{it}$ is the log of total incentives taken by the board of directors in US $ of bank i at year t. $\widehat{DLLP}_{it}$ is estimated discretionary loan loss provisions of bank i at year t. CI_{it} is cost to income ratio of bank i at year t. DA_{it} is deposits to total ratio of bank i at year t. TA_{it} is log of total assets of bank i at year t. BOD_{it} is the size of the board of directors of bank i at year t. SSB_{it} is the size of the *Shariah* board of bank i at year t. GDP_t is the GDP growth rate of the country at year t. Inf_t is the inflation rate (CPI) of a specific country at year t.

Finally, to evaluate the impact of EM on the stability of Islamic banks Model 4.8 is used

$$Zscore_{it} = \alpha + \widehat{\beta_1} DLLP_{it} + \beta_2 CI_{it} + \beta_3 DA_{it} + \beta_4 TA_{it} + \beta_5 SSB_{it} + \beta_6 BOD_{it} + \beta_7 GDP_t + \beta_8 Inf_t + \epsilon_{it} \tag{4.8}$$

Z-$score_{it}$ is the log of the Z-score of bank i at year t. $\widehat{DLLP}_{it}$ is estimated discretionary loan loss provisions of bank i at year t. CI_{it} is the cost-to-income ratio of bank i at year t. DA_{it} is the deposits to total ratio of bank i at year t. TA_{it} is the log of total assets of bank i at year t. BOD_{it} is the size of the board of directors of bank i at year t. SSB_{it} is the size of the *Shariah* board of bank i at year t. GDP_t is the GDP growth rate of the country at year t. Inf_t is the inflation rate (CPI) of the country at year t.

4.3 Variables

This section of the thesis discusses the independent and dependent variables used in the study. How these are calculated and what are their justifications to be included in the study. According to Ongore (2013) banks' performance is affected by external and internal variables. These variables can be classified into macroeconomic (external) and banks' specific (internal)variables. We include the dependent variables followed by banks' specific variables and at the end, we explain the external variables in detail.

4.3.1 Dependent Variables

This section discusses the details of dependent variables used in the study, specifically ROE, ROA, stock returns, management incentives, and Z-score are discussed.

4.3.1.1 ROE and ROA

The basic aim of a commercial financial institution is to earn profit. To evaluate the profitability of the organizations, especially in the banking sector, ROE and ROA are considered to be the best ratios for internal performance. The ROE is the return on equity. It is calculated as net profit divided by total average equity multiplied by hundred. This indicates the percentage of income earned on the equity or the capital of the shareholders. In the context of EM ROE is very important variable. The EM practices and ROE are closely related (Liu, Lin, Sun & Yuan, 2021). Similarly, Alhadab and Al-Own (2017) argued that ROE shows the capability of the management to utilize the wealth of the investors. Since ROE is the pure return of shareholders on their investments and EM is the manipulation of the overall earnings figures therefore the impact of EM on ROE is very necessary to evaluate.

The ROA is the return on assets. To calculate the return on assets the net profit is divided by the total average assets multiplied by one hundred. It is determined by the net income (after tax) against every $ owned by the bank. A bank that uses its assets efficiently will have a higher ROA. Haniff *et al.* (2013) argued that greater ratio of ROA indicates that the resources of the organization are used efficiently. Similarly, it is a very important profitability indicator which affects the bank's value as well. The impact of ROA on firm value is documented in previous literature for example the recent literature (Athifah, 2021; Haryanto *et al.*, 2019; Nilai *et al.*, 2013; Fajaria, 2018; Santoso *et al.*, 2018; Ekasari*et al.*, 2020; Ganar&Sekuritas, 2018; Sholahuddin *et al.*, 2020) shows the positive impact of ROA on firm value. Similarly, EM is closely related to returns therefore, ROA is also a very important indicator which needs to be included.

Recently, Fatzel *et al.* (2022) studied the association between ROE and ROA with EM in the Covid-19 pandemic. Being the traditional and important performance and profitability measures ROA and ROE, both are included in the study as dependent variables.

4.3.1.2 Stock Return

The stock performance of a bank is considered to be a very important performance variable. In prior literature on banking and finance the stock return of the bank is considered as the external performance indicator. The external performance of the banks in the stock market is judged and compared on the basis of stock returns. Literature reported different factors which impact the stock returns of the banks positively and negatively. For example, Alper and Anbar (2011) studied the relationship between banks' internal variables and macroeconomic variables with stock returns in Turkey, they reported that total assets and non-interest income significantly and positively impact the stock returns of banks. While total loans and non-performing loans negatively impact the stock returns. Similarly, Sakarya and Aytekin (2013) found no impact of financial performance on the stock returns of banks in Turkey. In a worldwide sample size of 75 Islamic banks, the stock prices of 55 banks are available. It is because some banks are not listed while the data of some banks regarding the stock price is not available on their respective stock exchanges. Therefore, we include the stock returns of 55 Islamic banks for the worldwide sample. Out of 23 GCC region Islamic banks stock prices of 21 banks are available therefore the stock returns of these 21 banks are included. In the ASEAN region the stock prices of 18 banks are available therefore, we include the stock returns of 18 banks.

4.3.1.3 Management Incentives

The agency problems type I suggests there is conflict between shareholders and managers; the basic aim of manager is to get private gain. Similarly, the threshold theory also suggests that managers engage in EM practices to overcome different thresholds to gain private gain. Gopalan and Jayaraman (2011) investigated the association between EM practices and managerial private gain in 22 countries. They reported the strong association among the compensation of the management and EM. This strong association between EM and managerial incentives shows the moral hazards of the insiders. Following Goplan and Jayaraman (2011) managerial incentives as dependent variable is used in this study. Management incentives are the total monetary remunerations taken by the board of directors, such as board fees, meetings fees, and bonuses in cash along with all cash emoluments. These incentives were obtained from the annual reports of Islamic banks. To make the data similar the amounts were converted into US dollars. Further to reduce the standard deviation and skewness of management incentives its natural log is used as proxy.

The positive impact of discretionary loan loss provisions on management incentives indicates that the management used their discretionary powers to enhance their own incentives. The nature of the EM of Islamic banks can be detected through the relationship between DLLP and managerial incentives. Association between these two variables helps us to conclude the argument that the EM of the Islamic banks is opportunistic (in terms of monetary benefits) or not. We expect no association between these variables because Islamic banks are based on the divine law of

Shariah and there is no room for private gain. The impact of discretionary loan loss provisions on management incentives is an addition to the existing literature on earnings management in Islamic banks.

4.3.1.4 Z-Score

The GFC (2008) compel the regulators and authorities to be concerned about the stability the banks because during this crisis huge financial institutions and banks were destabilized and then defaulted. The risk of the destabilization of banks cannot be observed directly. To evaluate the risk of destabilization of banks different variables are estimated. CAPM model, stock returns of the banks are widely used to evaluate the risks of the banks. If the stock returns are not available or the banks have not listed the risk of destabilization can be measured from the publicly published accounting data as well. The most common stability measures discussed in the accounting and CG literature is Z-score. A huge strand of literature declared the Z-score as a common stability and risk measure (Boyd & Runkle (1993); Beck, Demirgüç-Kunt & Levine (2007); Demirgüç-Kunt, Detragiache & Tressel (2008); Laeven & Levine (2009).

The Z-score was introduced by Boyd and Graham (1986). In their pioneer study, they suggested that Z-score is the best indicator to evaluate the solvency of the banks because it measures the probability of banks' bankruptcy. Later on, Hannan and Hanwek (1998) developed a risk index which measures the risk of insolvency and destabilization. De Nicoló (2000) and Stiroh (2004) also used Z-score. Following this strand of literature, Z-score is used frequently as a proxy for risk and insolvency. According to Chiaramonte et al. (2016) Z-score can predict 76% of bank failure. If the value of the Z-score is high it indicates that the bank has a lower chance of failure, the lower Z-score enhance the risk of failure (Čihák& Hesse, 2010).

The most basic model of Z-score can be calculated as

$$Z - \text{score}_{it} = \frac{\text{ROA}_{it} + \left(\frac{Eq_{it}}{TA_{it}}\right)}{\sigma(\text{ROA})}$$

where

ROA is the return on average assets, Eq is the total owners' equity, TA is total assets, and the ROA at the end of the year is added with equity to the total asset percentage at the end of the year and divided by the standard deviation of the ROA. Sometimes the Z-score value of different banks is highly skewed therefore, Laeven and Levine (2009) suggest taking the natural log of the Z-score to normalize its skewness. Z-score is frequently used for Islamic banks as a stability measure in the prior literature (Imam &Kpodar 2010; Aris, 2010; Abedifar. et al. 2013; Alqahtani & Mayes, 2018). According to Malik *et.al.* (2022) Z-Score less than 1.1 shows the distress position which shakes the stability of the banks and lead to default, Z-Score less than 2.6 is the grey area of the banks with less chances of default while Z-Score more than 2.6 is safe area which indicates that the bank is stable and has no chance of default.

Following the same strand of literature, we also use the basic model of Z-score for Islamic banks' stability and insolvency measure as a dependent variable. To reduce the chance of skewness and normalize the standard deviation we took the log of Z-score consistent with prior studies.

4.3.2 Independent Variables

In this section, the independent variables used in the study are discussed, specifically the bank-specific variables.

4.3.2.1 Estimated Discretionary Loan Loss Provisions

The estimated discretionary loan loss provisions $\widehat{DLLP}$ are the discretionary parts of the total loan loss provisions. It can be exploited as per the situation and required needs. Following Kanagaretnam (2004)this study uses DLLP as proxy of the EM. Taktak, Zouari and Boudriga (2010) used DLLP as a tool of EM. While Chang, Shen and Fang (2008) empically proved that DLLP is used in the banking sector as a tool of EM. Similarly, Cornett et al. (2006) empirically found that management of the banks use DLLP to manipulate earnings for enhancing their own personal benefits. Recently Zgarni and Fedhila (2019) found that banks were opted for EM practices through DLLP. This discretionary EM is associated with the performance of the banks. Shantaram, and Kozlowski (2021) recently proved this statement empirically. They found that the discretionary part of the loan loss provisions is positively associated with abnormal stock returns of the banks in good economic state.An important study in this regard is conducted by Malik et.al. (2022). They used the discretionary loan loss provisions as proxy of EM and report that this accounting discretion of management is positively associated with financial distress. As for as the Islamic banks are concerned Zulfikar and Sri (2019) argued that discretionary loan loss provision can happen in *Shariah* financing. Charifah, Hamdani, and Wiedyaningtias (2020) empirically found that EM is happened in Islamic banks through DLLP. Muhamad and Sulong (2019) also used the DLLP of Islamic banks as a proxy of EM.

4.3.2.2 Cost-to-Income Ratio

The cost-to-income ratio (CI) is the total operating cost of the bank to total operating income and can be calculated as $\frac{OperatingExpenses}{OperatingIncome}$ X 100. Operating expenses include all those expenses which are normally occurs in the yearly operation of the bank. It includes compensation, property, information technology expenses with all other expenses which are calculated under the head of "operating expenses" mentioned in the profit and loss account of the bank. It is a very important internal determinant of bank profitability because this indicates the ratio of cost and income of the bank. According to Mokni and Rachdi (2014) the CI ratio is the measurement of the banks' efficiency to control and manage operating expenses. The higher CI ratio indicates lower efficiency in controlling and managing operating costs. If the management of the banks fails to control or manage the CI ratio this will negatively impact the ROE and ROA of the banks because the management will pass on these costs to the shareholders or customers. Therefore, the CI ratio is one of the main and important determinants of banks' profitability (Athanasoglou *et al.*, 2008).

Empirical pieces of evidence proved that the CI ratio negatively impacted the profitability ratios of the banks. Mathuva (2009) reported the significant and negative impact of the CI ratio on banks' profitability. Onuonga (2014) found that the increase in expenses reduces the profitability ratios of the banks. Similar to prior studies we expect a negative relationship between the cost-to-income ratio with profitability ratios and the stability of the banks.

4.3.2.3 Deposits to Total Assets Ratio

Another key financial indicator which impacts the profitability of the banks is the deposit portfolio of the banks. It is very essential for a bank to receive deposits for onward financing to the customers. Therefore, it is understood that if a bank can enhance its deposit portfolio it has a chance to finance more, and financing is the main source of income for banks therefore, this makes the bank more profitable. Haddawee and Hakeem (2020) report the positive and significant impact of different kinds of deposits on bank profitability.

For simplicity, we calculate the deposit to total assets ratio i.e$\frac{TotalDeposits}{TotalAssets}$X100

Total deposits include the balance of current and investment accounts which received from Islamic bank from customers. It is obtained from the liability side of the balance sheet of Islamic banks. Generally, the positive and significant impact of the deposit to total assets ratio is reported. We expect the same.

4.3.2.4 Total Assets (Bank Size)

The previous literature on the banking sector acknowledges the impact of bank size on their profitability. Worldwide studies are conducted regarding the size of the bank and profitability with different conclusions. Redmond *et al.* (2007) report the negative relationship between the size of the banks and profitability. Kasimodou *et al.* (2006) report that smaller banks are more profitable than larger banks. In contrast, Murthy (2008) reports that the profitability of larger banks is higher as compared to smaller banks in the GCC region. Similarly, Spathes (2002) reports that larger Greek banks are more efficient in terms of ROE.

We converted the total asset side of the balance sheet in US dollars for homogeneity. Then to reduce the chances of biasness due to skewness we took the log of the total assets. The importance of bank size which is proxied by total assets compels us to include it in our study as a control variable.

4.3.2.5 Board of Directors (BOD) Size

The Board of directors plays a very important role in the decision-making and implementation to achieve the goals of the organization. According to resource dependence theory, the large size of the board of directors enhances the chances of better performance and good governance. This is because the large board has more external links for support ultimately resulting in better performance. Some academicians and researchers consider the board of directors to be the main driver of banks' performance (Van Den Berghe&Levrau, 2004). The size of the board is a widely debatable issue in prior literature (John &Senbet, 1998). Diwedi and Jain (2005) report the positive impact of board size on performance. Adams and Mehran (2005) also report positive associationamong board size and banking performance. They argue that banking firms desirable to make larger boards to enhance performance.

However, some studies contradict this theory and reported the negative association amongst board size and banks' performance. According to Chaganti, Mahajan and Sharma (1985) the size of a larger board affects corporate performance negatively. Jensen (1993) reports that the larger size of the board is less effective compared to the smaller size of the board, this is because an increase in board size enhances the changes of agency problems. Lipton & Lorsch (1992) argue that a larger board size enhances the chances of the agency problem. Against the resource dependence theory, Lorsch (1992) presented the theory regarding board size, he argues that involving more people on board by enhancing the board size makes the decision power of the board very slow which negatively impacts the performance of the banks. Jensen (1993) also supports this theory. The negative impact of board size on performance is also reported by Bennedsen *et al.* (2004).

There is also the role of BOD in EM. According to some studies, a larger BOD can reduce EM practices (Quttainah *et al.* 2013). In contrast, some studies found a positive association between large BOD and EM practices (Beasley, 1996; Dechow *et al.* 1996; Loderer and Peyer, 2002).

It is a proven fact that board size positively or negatively affects the banks' performance, therefore following the prior literature the numbers of the members listed in the of the board of directors in the annual reports of Islamic banks is included as a control variable.

4.3.2.6 *Shariah* Board Size

Islamic banks are preferred by the Muslim community because of religious concerns. *Riba* is prohibited in Islam, therefore, Muslims try to avoid the conventional banking system and turn to Islamic banks because of the *Riba*-free banking system. The operations of Islamic banks are under Islamic law. *Shariah* non-compliance will be a reputational risk for Islamic banks which may lead to instability or failure (Ahmad, 2014). To attract the attention of investors Islamic banks must give surety that all their products and investment schemes are *Shariah* compliant (Grais& Pellegrini, 2006). If Islamic banks' fails to give surety about their major function *Shariah*-compliant business, the investors and depositors will withdraw their money because of customers' trust (Grassa, 2015). Therefore, to take care of the religious concerns of the customers the Islamic banks maintain a *Shariah* supervisory board (SSB).

It is the obligation of Islamic banks to appoint SSB "the independent body of specialized jurists in *Fiq-ul-Mua'amalat* (Islamic commercial jurisprudence)."To fulfil the ethical needs and requirements of the customers *i.e* that bank operates under the rules of *Shariah*, SSB is essential (Abu-tapanjeh, 2009). They perform just like internal auditors of the operations under the standards of *Shariah* (Mersni and Othman, 2016). EM is an unethical act which does not conform to *Shariah*(Normala et al., 2011). And SSB acts as a guard of *Shariah* principles therefore the presence of SSB can eliminate EM from Islamic banks (Hamdi and Zarai, 2014; Mersni and Othman, 2016).

The SSB can not only prevent the EM but it may have a positive impact on banks'profitability such as ROE/ROA and assets growth (Quttainah, Song & Wu, 2011)

Although the decision-making authority is BOD in Islamic banks SSB plays also a very important role. The main function of the SSB is to overlook the transactional structure of the banks, give *Shariah* opinions about the Islamic banks' products, and conduct *Shariah* audits. The size of *Shariah* board is also very important for Islamic Bank's performance. According to AAOIFI the minimum size of SSB is three *Shariah* scholars. Being a powerful authority the BOD might have a chance to control small SSB rather than large ones (Nomran & Haron, 2020). Hamza (2016) argues that large SSB is better as compared to smaller, it is because they have more experience and understanding of *Fiq* and financial products.

Although empirical literature is scarce on the size of the SSB, however, some studies are available. According to Hendra (2016) the size of the *Shariah* supervisory board positively impacts the improvement of earnings quality in Islamic banks. Musibah and Alfattani (2014) report the significant impact of the effectiveness of SSB on the ROE/ROA of Islamic banks in the GCC region. Similarly, Adnan and Arafat (2020) report the positive impact of *Shariah* Board size on the internal performance variables ROE and ROA. Al-Nasser Mohammed and Muhammad (2017) also report the positive impact of SSB size on the financial performance of Islamic banks. Mollah and Zaman (2015) along with Matoussi and Grassa also support the argument through their empirical findings that the size of SSB impacts the banks' profitability.

Due to the important role of SSB size in Islamic banks, we also follow the prior literature and include the total numbers of *Shariah* supervisory board mentioned in the annual reports as bank specific control variable.

4.3.3 Control Variables

This section of the study discusses control variables, the macroeconomic variables are included in the study to control the country-specific economic conditions.

4.3.3.1 Gross Domestic Product

Theoretically gross domestic product (GDP) growth rate positively affects banking performance in different ways. The growth of the economy reduces unemployment in the country and it gives a better chance to the loan borrowers to pay their debts timely and the banks face lesser loan losses. Similarly, the growth of GDP also increases the net interest incomes of banks because the savings of the people increases and they invest it in banks (Calza *et al.*, 2006; Jiménez *et al.*, 2009; Bolt *et al.*, 2012).

The positive impact of GDP on bank performance is reported by several studies. For example, Guru and Balashanmugam (2002) found a positive impact of GDP on the performance variables of banks in the Malaysian market. The positive and significant impact of GDP on bank performance is also reported by Naceur (2003) in Tunis. Similarly, the significant relationship between GDP and domestic banks' performance in the UK is reported by Tanna and Pasiours (2005). South Eastern Europium region has been studied by Delis and Staikouras (2006) who also report the same. The positive relationship between GDP and banks' performance in China has been reported by Sufian and Habibullah (2009). Likewise, McDonald and Schumacher (2009) report the same findings for African commercial banks. In contrast, Sanusi and Ismail (2005) report no significant impact of GDP on the performance of Islamic banks in Malaysia. They used fifteen Islamic banks and windows for this analysis.

In this study following the prior literature we took the GDP growth rate of the countries of specific banks from the reliable source of World Bank website.

4.3.3.2 Inflation

Inflation plays an important role in the performance of an organization. The positivists believe that inflation positively impacts the banks' performance. The positivist theory was presented by Griffiths (1977). He argued that the inflation rate in a rapidly growing economy converts wages into profits, and this trend encourages investors to invest more. Better investment opportunities make the banks more profitable. In contrast, the negativists' theory considers inflation as the enemy which adversely impacts performance. They believed that the devaluation of the currency increases the risk which ultimately reduces investments. Lack of funds for further investments reduces the performance of the banks (R.Cameron, 1972). While naturalists believe that inflation has no impact on the bank's performance (J. P. Jarrett & J. G. Selody, 1972).

The empirical performance of banks and inflation was introduced by Revell (1979). He argued in his theory that inflation indirectly affects a bank's performance and profitability. The increase in inflation rate affects the operating cost, overheads and administrative costs such as salaries and allowances, which ultimately negatively affects the bank's performance and profitability. Similarly, Sufyan and Chong (2008) report the negative impact of inflation on Philippine banks. Kumar, Kiran and Munikumar (2017) report that Indian banks absorbed the inflation to a certain limit. If the inflation rate increases it impacts the Indian banks negatively. On the other side, Trujilo-Ponce (2013) argue that if the management of the bank fully anticipates the inflation rate and increases the revenues fast than the costs the impact of inflation will be positive on the profitability. The positive impact of inflation is reported by Kosmidou, Tanna, and Pasiouras

(2005). They studied determinants of earnings of domestic banks in the UK from 1995 to 2002. The positive impact of inflation on the profitability of Chinese banks is reported by Tan and Floros (2012). As for as Islamic banks are concerned if a larger portion of their profits accrues from shareholding, trade activities and direct investment inflation may positively impact their performance (Bashir, 2003). Similar to the GDP we took the inflation rate of countries included in the study from the reliable source of the World Bank website.

Both the external macroeconomic variables GDP and Inflation play a very important role in the profitability and performance of the banking sector. Therefore, we include both these variables as control variables in this research.

CHAPTER5. EMPIRICAL RESULTS

This chapter shows and discusses the results of the models used in the study. The results of Model 4.1, followed by the descriptive statistics and correlation of the variables are given in detail. Finally, the results of Models 4.4, 4.5, 4.6, 4.7 and 4.8 with our conclusion are given in detail.

To evaluate regression Model 4.1 the unbalanced yearly panel data of a worldwide sample size of 75 Islamic banks from 2009 to 2020 is used. After estimating the regression Model 4.1 for worldwide sample size the same model is used for yearly unbalanced panel data of 23 Islamic banks fromthe GCC region followed by unbalanced panel data of 23 Islamic banks from the ASEAN region separately. To use the appropriate regression model some econometric tests are essential. To check the appropriation of the OLS regression we conduct the Breusch-Pagan test. Based on this test if the probability value of this test is insignificant and more than 0.05 then the OLS estimation method is appropriate and we can use OLS regression model otherwise we will use random/fixed effect model. Table 5.1 presents the results of the Breusch-Pagan test.

Table 5. 1

Breusch-Pagan Test OLS Model 4.1 (Worldwide)

	Test Hypothesis		
	Cross-Section	Time	Both
Breusch-Pagan	1297.648	1.404855	1299.053
	(0.0000)	*(0.2359)*	*(0.0000)*
Honda	36.02288	-1.185266	24.63391
	(0.0000)	*(0.8820)*	*(0.0000)*
King-Wu	36.02288	-1.185266	11.79099
	(0.0000)	*(0.8820)*	*(0.0000)*
Standardized	36.61567	-1.020960	19.77692

Honda			
	(0.0000)	*(0.8464)*	*(0.0000)*
Standardized King-Wu	36.61567	-1.020960	8.069971
	(0.0000)	*(0.8464)*	*(0.0000)*
Gourieroux, et al.			1297.648
			(0.0000)

The result of the Breusch-Pagan test is highly significant and lower than 0.05 which indicates that the OLS regression model is not appropriate for Model 4.1. The next step is to apply Hausman Test to check the appropriation of the random effect model. Table 5.2 shows the results of the Hausman Test. The acceptable range of probability for selecting random effect model is more than 0.05. If the p value is lesser than 0.05, we will use fixed effect model.

Table 5. 2

Hausman Test Random Effect Model 4.1 (Worldwide)

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f		Prob.
Cross-section random	5.481780	3		*0.1397*
Cross-section random effects test comparisons:				
Variable	Fixed	Random	Var(Diff.)	Prob.
NPL_{t-1}	0.546818	0.557217	0.000046	*0.1252*
ΔNPL	0.483359	0.486974	0.000024	*0.4606*
ΔLoan	0.013521	0.012901	0.000000	*0.1126*

The result of the Hausman Test shows that the significance level of the test is more than 0.05 which indicates that the random effect model is appropriate for overall 75 banks. And we can use the random effect model for Model 4.1. Thus, we run model 4.1 for the overall sample size with a random effect model. And the results are presented in Table 5.3

Table 5. 3

Regression Result: Random Effects Model 4.1 (Worldwide)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.024927	0.005842	4.267103	*0.0000*
NPL_{t-1}	0.557217	0.027752	20.07879	*0.0000*
ΔNPL	0.486974	0.035230	13.82290	*0.0000*
ΔLOAN	0.012901	0.003789	3.405290	*0.0007*

Adjusted R^2 41% F-Statistics 161.3^{***}

Consistent with prior studies the results of model 4.1 shows a positive and significant impact of beginning non-performing loans, change in non-performing loans and change in total loans. This indicates that the loan loss provisions are increased by these banks with the increase of their beginning non-performing loans, change in non-performing loans and total loans. The overall significance of Model 4.1 is high with a probability level of 0.000. The adjusted R-squared Model 4.1 is 41% with a highly significant F-Statistic value of 161.3.

The same process is used to estimate Model 4.1 for the GCC region separately. Table 5.4 shows the results of the Breusch-Pagan test.

Table 5. 4

Breusch-Pagan Test OLS Regression Model 4.1 (GCC Region)

	Test Hypothesis		
	Cross-Section	Time	Both
Breusch-Pagan	211.7065	44.57712	256.2836
	(0.0000)	*(0.0000)*	*(0.0000)*

Honda	14.55014	6.67661	1500958
	(0.0000)	*(0.0000)*	*(0.0000)*
King-Wu	14.55014	6.67661	13.82582
	(0.0000)	*(0.0000)*	*(0.0000)*
Standardized Honda	14.97715	6.951814	11.41971
	(0.0000)	*(0.0000)*	*(0.0000)*
Standardized King-Wu	14.97715	6.951814	10.37831
	(0.0000)	*(0.0000)*	*(0.0000)*
Gourieroux, et al.			256.2836
			(0.0000)

The result of the Breusch-Pagan test suggests that OLS regression is not appropriate because the value of the Breusch-Pagan test is highly significant and under 0.05 for the GCC region. Further, we run the Hausman test to select a random or fixed effect model. Table 5.5 shows the results of the Hausman test.

Table 5. 5

Hausman Test Results: Random Effects Model 4.1 (GCC Region)

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f	Prob.
Cross-section random	21.510834	3	*0.0001*

Cross-section random effects test comparisons:

Variable	Fixed	Random	Var(Diff.)	Prob.
NPL_{t-1}	0.481687	0.524765	0.000422	*0.0361*
ΔNPL	0.301858	0.350687	0.000237	*0.0015*
ΔLoan	0.007095	0.002973	0.000001	*0.0002*

The results of the Hausman test suggest that the random effect model is not appropriate for Model 4.1 in the GCC region because the significance level is under 0.05. Thus, fixed effect model is used to estimate Model 4.1 for the GCC region. The results of the fixed effect regression of Model 4.1 are given in Table 5.6

Table 5. 6

Regression Result: Fixed Effect Model 4.1 (GCC Region)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.023359	0.002415	9.672938	*0.0000*
NPLt-1	0.481687	0.043402	11.09832	*0.0000*
ΔNPL	0.301858	0.054999	5.488405	*0.0000*
ΔLoan	0.007095	0.004836	1.467015	*0.1439*
Adjusted R^2 70%	F-Statistic Value 22.46^{***}			

The regression result shows the positive and significant impact of non-performing loans at the beginning of the year and the change in non-performing loans. However, the impact of change in the loan is positive but not significant. The adjusted R Squared is 70% with an F-Statistic value of 22.46 is highly significant.

The estimation process is repeated for the ASEAN region. Model 4.1 is tested on the Breusch-Pagan test for the appropriation of OLS regression. Table 5.7 shows the result of the Breusch-Pagan test of Model 4.01 for the ASEAN region.

Table 5. 7

Breusch-Pagan Test Result: OLS Regression Model 4.1 (ASEAN Region)

	Test Hypothesis		
	Cross-Section	Time	Both
Breusch-Pagan	219.2842	1.705603	220.9898
	(0.0000)	*(0.1916)*	*(0.0000)*
Honda	14.80825	-1.305987	9.547539
	(0.0000)	*(0.9042)*	*(0.0000)*
King-Wu	14.80825	-1.305987	7.493057
	(0.0000)	*(0.9042)*	*(0.0000)*
Standardized Honda	15.74791	-1.131961	6.296151
	(0.0000)	*(0.8712)*	*(0.0000)*
Standardized King-Wu	15.74791	-1.131961	4.253685
	(0.0000)	*(0.8712)*	*(0.0000)*
Gourieroux, et al.			219.2842
			(0.0000)

The result of the Breusch-Pagan test suggests that OLS regression is not appropriate because the significance level is under 0.05. The Hausman test is performed to select a random or fixed effect model. The result of the Hausman test is presented in Table 5.8.

Table 5. 8

Hausman Test Result Model 4.1 (ASEAN Region)

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f	Prob.
Cross-section random	13.258204	3	*0.0041*

Cross-section random effects test comparisons:

Variable	Fixed	Random	Var(Diff.)	Prob.
NPL_{t-1}	0.682325	0.689654	0.000010	*0.0217*
ΔNPL	0.798896	0.799407	0.000004	*0.8034*

ΔLoan	0.001698	0.001601	0.000000	*0.5401*

Above mentioned Hausman test suggests that random effect model is not suitable for Model 4.1 ASEAN region because the significance level is under 0.05. Thus, we use the fixed effect model for estimation Model 4.1. The regression result of fixed effect model 4.1 for the ASEAN region is presented in table 5.9.

Table 5. 9

Regression Result: Fixed Effect Model 4.1 (ASEAN Region)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.018452	0.001395	13.22660	*0.0000*
NPL_{t-1}	0.682325	0.039770	17.15673	*0.0000*
ΔNPL	0.798896	0.044638	17.89723	*0.0000*
ΔLoan	0.001698	0.004401	0.385849	*0.7001*
Adjusted R^2 97%	F-Statistic	304.6^{***}		

Similar to the results of Alhadab and Al-Own (2017) the regression result shows the positive and significant impact of beginning non-performing loans and change in loans on total loan loss provisions. The impact of change in the loan is positive but not significant. The adjusted R squared is 97% which is very high with a highly significant F-Statistic value of 304.6.

On the basis of the above-mentioned results of Model 4.1, we can use the estimated results for further models. The residual of model 4.1 is taken to estimate the non-discretionary loan loss provisions as shown in equation 4.2. Finally, these estimations are subtracted from the total loan loss provisions to obtain the total value of the estimated DLLP as discussed in equation 4.3. This estimated value of DLLP is used further as an EM proxy for the overall sample size, GCC region and ASEAN region separately.

Table 5.10 presents the descriptive statistics of the total variables used in the study.

Table 5. 10

Descriptive Statistics

Variable	N	N*	Mean	SE Mean	StDev	Minimum	Median	Q3	Maximum	Skewness
ROA	689	4	1.0012	0.0482	1.2649	-12.4148	0.9555	1.4698	10.2080	-0.98
ROE	688	5	9.332	0.327	8.575	-44.149	9.646	14.384	36.223	-1.18
SR	423	270	0.01279	0.00607	0.12477	-0.92894	0.00588	0.06898	0.53288	-0.54
MgtInc	564	129	5.8726	0.0235	0.5581	4.0573	5.8837	6.1863	7.2214	-0.49
Z-Score	660	33	1.3805	0.0140	0.3606	0.2659	1.4131	1.6195	2.3562	-0.38
DLLP	693	0	0.05475	0.00144	0.03780	-0.14095	0.04405	0.06063	0.32602	3.00
CI	659	34	0.5808	0.0121	0.3104	0.0510	0.5294	0.7120	4.0917	5.03
DA	663	30	0.74963	0.00727	0.18728	0.02693	0.81550	0.85341	0.94732	-2.31
TA	663	30	9.6591	0.0272	0.7014	6.7960	9.6973	10.1013	11.1725	-0.49
BOD	692	1	9.315	0.127	3.354	5.000	9.000	11.000	21.000	1.75
SSB	692	1	4.4697	0.0792	2.0831	2.0000	4.0000	5.0000	12.0000	1.99
GDP	692	1	3.543	0.131	3.448	-11.457	4.450	5.473	19.592	-0.64
Inf	693	0	3.686	0.139	3.656	-4.863	3.031	5.380	29.507	1.80

The descriptive statistics show a standard deviation of ROA 1.26 with a minimum value of -12.14 and a maximum value of 10.20, while its skewness is -0.98. The standard deviation of ROE is 8.57 which is relatively high compared to ROA. It is because the owners' equity is lower than the total assets of the banks. The minimum value of ROE is -44.14 and the maximum value is 36.23, however, its skewness is around -1. The standard deviation of stock returns is under 1 while its skewness is under 0. The log of management incentives is taken as variable therefore its standard deviation is under 1 and negatively skewed around -1. The log of the Z-score of the banks is taken for the sack of normality therefore, its standard deviation is under 1 and the skewness is around -1. DLLP which is the main independent variable also behaved normally its standard deviation is under 1 while its skewness is 3. The skewness of CI is a bit high as compared to other variables of the study but its standard deviation is around 1. DA is negatively skewed around -2 while its standard deviation is around 1. The log of total assets in $ is taken as variable and its standard deviation is under 1 while its skewness is around -1. The maximum BOD size is 21 from Bangladesh while the minimum is 5 from Malaysia. The standard deviation of BOD is 3.3 which is a bit high. This is because of the large sizes of BOD in Bangladesh however its skewness is under 2. The standard deviation of SSB is 2.08 positively skewed up to 1.99. GDP growth rate and inflation also behaved normally with a standard deviation of around 3 and skewness around -1 and 2 respectively.

From the results of descriptive statistics, we conclude that almost all the dependent and independent variables behaved normally. The next step is to calculate the correlation between dependent and independent variables. Table 5.11 presents the Pearson correlation results amongst variables.

Table 5. 11

Correlations of Variables

Variable	ROA	ROE	SR	MgtInc	Z-score	DLLP	CI	DA	TA	BOD	SSB	GDP
ROE	0.800											
	*(0.000)******											
SR	0.112	0.201										
	*(0.022)***	*(0.000)******										
MgtInc	0.191	0.085	0.040									
	*(0.000)****	*(0.044)***	*(0.450)*									
Z-score	0.162	0.074	0.014	0.117								
	*(0.000)****	*(0.056)**	*(0.777)*	*(0.006)***								
DLLP	-0.249	-0.241	-0.018	-0.263	-0.244							
	*(0.000)****	*(0.000)****	*(0.713)*	*(0.000)****	*(0.000)****							
CI	-0.549	-0.491	-0.074	-0.087	-0.168	0.182						
	*(0.000)****	*(0.000)****	*(0.133)*	*(0.039)***	*(0.000)****	*(0.000)****						
DA	0.025	0.100	0.048	0.070	-0.139	0.047	-0.132					
	(0.526)	*(0.010)***	*(0.331)*	*(0.075)**	*(0.040)***	*(0.223)*	*(0.000)****					
TA	0.172	0.206	-0.016	0.388	0.080	-0.282	-0.381	0.089				
	*(0.000)****	*(0.000)****	*(0.743)*	*(0.000)****	*(0.710)*	*(0.000)****	*(0.001)****	*(0.022)***				
BOD	0.017	0.072	0.027	-0.221	-0.014	0.051	-0.105	-0.098	-0.008			
	(0.663)	*(0.058)**	*(0.538)*	*(0.000)****	*(0.047)***	*(0.182)*	*(0.000)****	*(0.012)***	*(0.841)*			
SSB	-0.060	0.121	0.002	-0.460	-0.077	0.176	-0.128	0.129	-0.010	0.588		
	(0.117)	*(0.002)***	*(0.971)*	*(0.000)****	*(0.0.47)***	*(0.000)****	*(0.007)***	*(0.001)***	*(0.805)*	*(0.000)****		
GDP	0.144	0.180	0.042	-0.098	-0.009	0.029	-0.056	0.103	-0.043	0.131	0.244	
	*(0.000)****	*(0.000)****	*(0.385)*	*(0.020)****	*(0.808)*	*(0.443)****	*(0.148)*	*(0.008)***	*(0.247)*	*(0.000)****	*(0.000)****	
Inf	-0.032	0.149	0.054	-0.171	-0.259	0.166	0.078	0.067	-0.284	0.243	0.228	0.203
	(0.399)	*(0.000)****	*(0.270)*	*(0.000)****	*(0.000)****	*(0.000)****	*(0.045)***	*(0.085)**	*(0.000)****	*(0.000)****	*(0.000)****	*(0.000)****

*** p≤0.01, **≤0.05, *≤0.10

The ROE is significantly and positively correlated with stock returns management incentives and stability of the Islamic banks. While the negative significant correlation of ROE with discretionary loan loss provision and cost to income is observed. Deposit to asset and total assets are also positively correlated with ROE. Board size and *Shariah* board size are also correlated with ROE significantly. While the GDP and Inflation are also positively correlated with ROE.

The ROA is positively and significantly correlated with ROE, management incentives, stock returns and Z-score. While it is negatively correlated with discretionary loan loss provision and cost to income. While the positive correlation of ROA with total assets and GDP is observed.

The management incentives are positively correlated with Z-score, deposits to assets and total assets. While it is negatively correlated with discretionary loan loss provisions, the board size, *Shariah* board size, and cost to income. The GDP and inflation are also negatively correlated with management incentives.

The Z-Score which is the measurement of stability is negatively correlated with discretionary loan loss provisions, cost to income, deposit to total assets and inflation. While Z-score is positively correlated with management incentives.

Discretionary loan loss provisions are positively correlated with cost to income, *Shariah* board size, GDP and inflation. It is negatively correlated with total assets.

Deposit to assets is positively correlated with total assets, *Shariah* board size, GDP and inflation. It is negatively correlated with board size. Total assets are negatively correlated with inflation. There is a negative correlation between GDP and inflation. The correlation of these variables suggests that there is a significant relationship between dependent and independent variables. Thus, we can further run our stage 2 regression models.

To select the appropriate regression for Model 4.4 the Breusch-Pagan test is performed on Model 4.4 for the overall sample size, GCC region and ASEAN region separately. The result of the Breusch-Pagan test is demonstrated in table 5.12

Table 5. 12

Breusch-Pagan Test Result: OLS Model 4.4

	Test Hypotbesis		
Breusch-Pagan	Cross-section	Time	Both
Worldwide	327.208039	0.1186913	327.3267
	(0.0000)	*(0.7305)*	*(0.0000)*
GCC Region	22.78518	0.562458	23.34764
	(0.0000)	*(0.4533)*	*(0.0000)*
ASEAN Region	109.4583	0.169733	109.628
	(0.0000)	*(0.3402)*	*(0.0000)*

The result of the Breusch-Pagan test suggests that the OLS model is not appropriate for the overall sample size, GCC region and ASEAN region. The probability of all three regions is highly significant and less than 0.05 therefore, we have to choose the random effect of the fixed effect model. To select the appropriate model between random or fixed effect Hausman test is performed. Table 5.13 demonstrates the result of the Hausman test.

Table 5. 13

Hausman Test Result: Random Effect Model 4.4

Test Summery	Chi-Squ Statistic	Chi-Squd.f	Prob.

Cross-Section Random			
Worldwide	33.494217	7	*(0.0000)*
GCC Region	16.917707	7	*(0.0179)*
ASEAN Region	34.215493	7	*(0.0000)*

Hausman test suggests random effect model 4.4 is not suitable for the overall sample size, GCC region and ASEAN region because the probability of all the three models is less than 0.05. Therefore, we use the appropriate Fixed effect model 4.4 for the overall sample size, GCC region and ASEAN region. The result of the regression is demonstrated in model 5.14

Table 5. 14

Regression Result: Fixed Effect Model 4.4 (ROE)

	Worldwide			GCC Region			ASEAN Region		
Variable	Coeff.	t-Stats	Prob.	Coeff.	t-Stats	Prob.	Coeff.	t-Stats	Prob.
C	24.33368	0.780748	*0.4353*	-170.122	-3.28432	*0.0012*	71.42414	1.898606	*0.0593*
DLLP	-48.0724	-5.32913	*0.000****	-103.301	-3.85067	*0.000****	28.32858	1.033438	*0.3029*
CI	-12.9254	-8.56236	*0.000****	-9.95994	-3.0282	*0.0028***	-9.52969	-4.62237	*0.000****
DA	7.537337	2.491483	*0.013***	5.491494	1.297093	*0.1962*	14.5774	2.498073	*0.013***
TA	5.432263	3.748793	*0.000****	16.8356	4.534877	*0.000****	3.34122	1.316859	*0.1897*
BOD	0.214934	0.079958	*0.9363*	1.264943	0.391637	*0.6958*	-13.9198	-3.40179	*0.000****
SSB	-14.7623	-2.44865	*0.0146***						
GDP	0.334579	4.881113	*0.000****	0.719023	4.824009	*0.000****	0.427573	3.4688	*0.000****
INF	0.122514	1.230717	*0.2189*	0.267364	0.981201	*0.3278*	-0.36389	-1.24245	*0.2158*

*** p≤0.01, **≤0.05, *≤0.10

	Worldwide	GCC Region	ASEAN Region
Adjusted R^2	64%	65%	71%
F-statistic	15.4***	14.8***	17.9***

The regression of Model 4.4 shows interesting results. The adjusted R-squared for worldwide 75 Islamic banks is 64% with an F-statistic value of 15.4 highly significant which show explanatory powers of independent variables on the dependent variable.

The DLLP negatively impacts the ROE of these banks. This indicates that the discretionary part of the total loan loss provisions negatively affects the ROE of Islamic banks worldwide. The findings are against our hypothesis and support the results of Alhadab and Al-Own (2017) regarding ROE. This indicates that EM negatively impacts the ROE of Islamic banks similar to conventional banks.Cost to income negatively impacts the ROE, which indicates that the increased cost reduces the profitability of these banks. The deposit to asset positively impacts the ROE, which supports the arguments that deposits work as blood for banks' performance. Log of total assets also impacts positively the ROE of these banks. No impact of the size of BOD is observed on the ROE while the size of the SSB negatively impacts the performance variable ROE. As for as the external performance variables are concerned the GDP positively impacts the ROE, this indicates that ROE is increased as countries' GDP increases. While no impact of inflation is observed on the ROE of these banks.

The result of Model 4.4 for the GCC region shows almost the same results. The adjusted R-Squared is 65% with an F-Stats value of 14.8 highly significant.

The negative impact of DLLP and cost to income is observed. Deposits to assets have no significant impact on the ROE of these banks while total assets positively impact the ROE. No impact of BOD is shown on the ROE. The GDP positively impacts while no impact of inflation is observed in the GCC region.

Similarly, Model 4.4 for the ASEAN region shows the adjusted R-Squared 71% with an F-Stats value of 17.9 highly significant. Here the DLLP shows a positive tendency but shows no significant impact on ROE. Cost to income negatively impacts ROE while deposit to assets has a positive impact on ROE. Total asset shows no impact while the negative and significant impact of the size of BOD was observed on ROE. The GDP has a positive impact but inflation has no impact on the ROE of Islamic banks in the ASEAN region. With this, we conclude the results of model 4.4.

To evaluate the appropriation of Model 4.5 first we run the Breusch-Pagan test. The results are given in Table 5.15.

Table 5. 15

Breusch-Pagan Test Result: OLS Regression Model 4.5

	Test Hypothesis		
Breusch-Pagan	Cross-section	Time	Both
Overall Sample	474.4435	0.442846	474.8863
	(0.0000)	*(0.5058)*	*(0.0000)*
GCC Region	31.80483	0.457240	32.26207
	(0.0000)	*(0.4989)*	*(0.0000)*
ASEAN Region	148.3993	3.241718	151.6410
	(0.0000)	*(0.01718)*	*(0.0000)*

The result of the Breusch-Pagan test for Model 4.5 suggests that the OLS model is not appropriate for the worldwide, GCC Region and ASEAN Region. Therefore, we run Hausman Test to select a random effect or fixed effect model. Result of the Hausman test is presented in the table 5.16.

Table 5. 16

Hausman Test Result: Random Effect Model 4.5

Test Summery	Chi-Squ Statistic	Chi-Squd.f	Prob.
Cross-Section Random			
Overall	18.597410	7	*(0.0172)*
GCC Region	2.135778	7	*(0.9519)*
ASEAN Region	52.076859	7	*(0.0000)*

The result of the Breusch-Pagan test suggests that the random effect model is only appropriate for the GCC region because the significance level of Model 4.5 is more than 0.05. Thus we use the random effect model for the GCC region. For worldwide and ASEAN regions the random effect model is not appropriate because the significance level for both is less than 0.05. Depending on Hausman Test we use Fixed Effect Model 4.5 for worldwide and ASEAN regions. The regression results are demonstrated in Table 5.17

Table 5. 17

Regression Result: Model 4.5 (ROA)

	Worldwide (Fixed Effect)			GCC Region (Random Effect)			ASEAN Region (Fixed Effect)		
Variable	Coeff.	t-Stats	Prob.	Coeff.	t-Stats	Prob.	Coeff.	t-Stats	Prob.
C	3.169155	0.856933	*0.3918*	-9.53388	-3.48904	*0.000*	94.04889	3.001297	*0.0031*
DLLP	-5.718942	-4.95649	*0.000****	-13.7638	-4.82745	*0.000****	-8.7198	-0.38188	*0.703*
CI	-1.683595	-8.71641	*0.000****	-1.41483	-7.65815	*0.000****	-5.11027	-2.97574	*0.0034***
DA	0.623014	1.610954	*0.1077*	0.512831	1.241114	*0.216*	2.985565	0.61421	*0.5399*
TA	0.141947	0.76766	*0.443*	1.063892	4.524956	*0.000****	0.892414	0.422246	*0.6734*
BOD	0.013639	0.042039	*0.9665*	0.025616	0.35531	*0.7227*	-13.4296	-3.94007	*0.000****
SSB	-0.655385	-1.27224	*0.2038*	0.111082	0.946885	*0.3448*			
GDP	0.048643	5.536524	*0.000****	0.107614	6.473215	*0.000****	0.200795	1.955631	*0.0522**
INF	-0.012593	-0.98888	*0.3231*	-0.02861	-0.82577	*0.4099*	-0.35095	-1.43855	*0.1521*

*** $p \leq 0.01$, ** ≤ 0.05, * ≤ 0.10

Adjusted R^2	73%	68%	82%
F-statistic	23.28364***	58.07679***	32.91147***

The regression results for Model 4.5 worldwide show an adjusted R-Squared 73% with an F-Statistic value of 23.9 highly significant.

The discretionary loan loss provisions show a negative and significant impact on ROA worldwide. The findings are against our hypothesis and support Alhadab and Al-Own (2017) regarding ROA. Similar to their findings in conventional banks DLLP negatively impacts the ROE of Islamic banks also. Similarly, the cost to income negatively affects the ROA of these banks worldwide. GDP growth rate positively impacts the ROA while no significant impact of deposit to assets, total assets, size of BOD, Size of SSB and inflation is observed.

The adjusted R-Squared of Model 4.5 for GCC region is In GCC region is 68% with an F-Statistic value of 58.07 highly significant.

The negative impact of discretionary loan loss provisions and cost to income on ROA is observed in this region. Total assets and GDP growth rate positively impact the ROA of these banks. While deposit to assets, the size of BOD, Size of SSB and inflation shows no significant impact on the ROA of these Islamic banks of the GCC region.

For the ASEAN region, the adjusted R-Squared of Model 4.5 is 82% with an F-Stats value of 32.91 highly significant.

Similar to the result of Model 4.4 no significant impact of discretionary loan loss provisions is observed on the ROA of Islamic banks in the ASEAN region. Cost to income and size of BOD negatively impacts the ROA of these banks. While deposit to asset, total assets and inflation have no significant impact on the ROA of these banks.

To evaluate the impact of discretionary loan loss provision on stock returns Model 4.6 is used. For the appropriation of Model 4.6 Breusch-Pagan test is used. The result of the Breusch-Pagan test is demonstrated in Table 5.18

Table 5. 18

Breusch-Pagan Test Results:OLS Model 4.6

	Test Hypothesis		
Breusch-Pagan	Cross-section	Time	Both
Worldwide	7.457707	15.71377	23.17148
	(0.0063)	*(0.0001)*	*(0.0000)*
GCC Region	0.612573	2.767510	3.380083
	(0.4338)	*(0.0962)*	*(0.0660)*
ASEAN Region	4.511224	1.405006	5.916229
	(0.0337)	*(0.2359)*	*(0.0150)*

Breusch-Pagan suggests that the OLS model is appropriate for the GCC region, however for the Worldwide and ASEAN region random or fixed effect models will be used. To use an appropriate model the Hausman Test is applied to Model 4.6. The result of the Hausman Test is demonstrated in Table 5.19.

Table 5. 19

Hausman Test Result: Random Effect Model 4.6

Test Summery	Chi-Squ Statistic	Chi-Squd.f	Prob.
Cross-Section Random			
Worldwide	11.656811	7	*(0.1124)*
ASEAN Region	9.661068	6	*(0.1379)*

The result of the Hausman Test suggests that random effect model 4.6 is appropriate for the Worldwide and ASEAN Region because its probability level is more than 0.05. On the basis of Hausman Test we use random effect model 4.6. The regression result of Model 4.6 is demonstrated in Table 5.20.

Table 5. 20

Regression Result: Model 4.6 (Stock Returns)

	Worldwide (Random Effect)			GCC Region (OLS Regression)			ASEAN Region (Random Effect)		
Variable	Coefficient	t-Statistic	Prob.	Coefficient	t-Statistic	Prob.	Coefficient	t-Statistic	Prob.
C	0.012441	0.069411	0.9447				0.124255	0.220125	0.8261
DLLP	-0.09394	-0.27773	0.7814	0.203672	0.466965	0.6411	-0.64281	-1.44087	0.152
CI	-0.03944	-1.04245	0.2978	-0.00705	-0.28208	0.7782	-0.04218	-0.35812	0.7208
DA	0.008386	0.168912	0.8659	0.033928	0.624742	0.533	-0.12676	-0.38709	0.6993
TA	0.001061	0.064382	0.9487	-0.00084	-0.0807	0.9358	0.009833	0.241358	0.8097
BOD	0.001044	0.279753	0.7798	-0.0004	-0.04787	0.9619	-0.00813	-0.6736	0.5018
SSB	-0.00067	-0.12294	0.9022	-0.00665	-0.54629	0.5856	0.000448	0.017759	0.9859
GDP	-0.00318	-1.10594	0.2694	0.00172	0.580345	0.5625	-0.02665	-2.54727	0.012
INF	0.003006	0.924337	0.3558	0.005478	0.816054	0.4156	0.036598	1.716119	0.0885

*** p≤0.01, **≤0.05, *≤0.10

Adjusted R	1%	2%	1%
F-Statistic	0.44	2.403	1.304
Prob(F-Stats)	0.896	0.765	0.246

The result of Model 4.6 shows a very low adjusted R-squared of 1% with no significant value of F-Statistic 0.44 for the worldwide sample size. This is because there is no significant impact of discretionary loan loss provisions along with internal bank-specific variables. Cost to income, deposit to total assets, and total assets have no impact stock returns of these banks. Corporate governance variables, size of BOD and size of *Shariah* board also show no impact on the stock returns of these banks. Further, the external economic variables GDP and inflation have shown no impact on stock returns.

Similar results are shown in the GCC region. No impact of discretionary loan loss provisions is observed. The internal bank-specific variables, cost to income, deposit to assets and total assets also show no impact on the stock returns of Islamic banks in the GCC region. The external economic variables GDP and inflation also show no effect.

In ASEAN region discretionary loan loss provisions show no impact. Cost to income, deposit to total assets, and total assets have no association with stock returns. While the negative impact of GDP and slight positive impact of inflation is observed on stock returns. But the adjusted R-squared and F-Statistic value is too low and insignificant, Therefore, these impacts are negligible.

From the above-mentioned results, we report that there is no impact of DLLP, internal and external variables on stock returns of Islamic banks worldwide as well as region-wise.

To evaluate the appropriation of Model 4.7 Breusch-Pagan test is applied worldwide, the GCC region and ASEAN region. The result of the Breusch-Pagan test is demonstrated in table 5.21

Table 5. 21

Breusch-Pagan Test Result: OLS Model 4.7

	Test Hypothesis		
Breusch-Pagan	Cross-section	Time	Both
Worldwide	1348.035	2.756239	262.3284
	(0.0000)	*(0.0969)*	*(0.0000)*
GCC Region	259.5721	2.756329	262.3284
	(0.0000)	*(0.0969)*	*(0.0000)*
ASEAN Region	278.0101	1.352564	279.3926
	(0.0000)	*(0.2397)*	*(0.0000)*

The result of the Breusch-Pagan test suggests that OLS Model 4.7 is not appropriate for worldwide, GCC region and ASEAN region. To select a random effect or fixed effect the Hausman test is performed. The result of the Hausmantest is demonstrated in table 5.22.

Table 5. 22

Hausman Test Result: Random Effect Model 4.7

Test Summery	Chi-Squ Statistic	Chi-Squd.f	Prob.
Cross-Section Random			
Worldwide	14.476286	7	*(0.0702)*
GCC Region	22.808879	7	*(0.0009)*
ASEAN Region	4.059417	7	*(0.7729)*

Hausman test suggests that the random effect model is appropriate for worldwide and ASEAN regions because it probability is higher than 0.05. However, it is not appropriate for the GCC region because its probability is less than 0.05. Therefore, we use a random effect model for the worldwide and ASEAN region and a fixed effect model for the GCC region. The regression result for model 4.7 is presented in Table 5.23.

Table 5. 23

Regression Result: Model 4.7 (Management Incentives)

	Worldwide (Random Effect)			GCC Region (Fixed Effect)			ASEAN Region (Random Effect)		
Variable	Coeff.	t-Stats	Prob.	Coefficient	t-Stats	Prob.	Coeff.	t-Stats	Prob.
C	2.089141	4.333455	0.000***	-0.74207	-0.60888	0.5435	2.89938	2.740039	0.0068*
DLLP	-0.96068	-2.61547	0.009***	-3.39586	-4.08084	0.000***	-0.67375	-0.73838	0.4613
CI	0.083826	1.592877	0.111	0.027341	0.286016	0.7752	0.074079	0.637095	0.525
DA	0.088587	0.815984	0.414	0.061335	0.513659	0.6082	-0.17524	-0.46009	0.6461
TA	0.433096	9.51295	0.000***	0.697096	5.908389	0.000***	0.333647	3.240626	0.0014**
BOD	0.007159	0.375291	0.707				0.090739	2.18805	0.0301
SSB	-0.11441	-3.76254	0.000***				-0.17628	-2.52469	0.0125**
GDP	0.001118	0.416059	0.6775	0.008552	1.842913	0.0672*	0.003066	0.407878	0.6839
INF	0.000232	0.056933	0.9546	-0.01213	-1.52348	0.1296	-0.00147	-0.08103	0.9355

*** p≤0.01, **≤0.05, *≤0.10

Adjusted R^2	14%	82%	5%
F-stats	15.6***	31.3***	2.03***

The result of Model 4.7 for the worldwide sample showsa low adjusted R-squared 14% with an F-Statistic value of 15 highly significant.

The main independent variable discretionary loan loss provisions negatively impact the management incentives. However, total assets positively impact management incentives worldwide. The size of the *Shariah* board negatively impacts the management incentives of these banks. The rest of the variables such as cost to income, deposit to assets, size of the BOD, GDP and inflation have shown no significant association with management incentives.

The result of Model 4.7 for the GCC region showsastrong adjusted R-squared 82% with an F-Statistic value of 31.3 highly significant.

The discretionary loan loss provisions show a negative impact on management incentives. Total assets positively impact the management incentives, while other variables i.e cost to income, deposit to total asset, GDP and inflation show no effect on management incentives.

The result of Model 4.7 for the ASEAN region shows different results. The adjusted R-squared is 5% which is too low with an F-Statistic value of 2.03 and significant.

The discretionary loan loss provision shows no significant impact on management incentives. Total assets and size of BOD positively impact the management incentives, while the size of the *Shariah* board negatively impacts the management incentives. Cost to income, deposit to assets and inflation has no significant impact on management incentives.

To evaluate the impact of external and internal variables along with discretionary loan loss provisions on the stability of Islamic banks Model 4.8 is used. The appropriation of this model is evaluated by the Breusch-Pagan test. The result of the Breusch-Pagan test is presented in 5.24.

Table 5. 24

Breusch-Pagan Test Result: OLS Model 4.8

	Test Hypothesis		
Breusch-Pagan	Cross-section	Time	Both
Worldwide	2038.578	2.505177	2041.083
	(0.0000)	*(0.1135)*	*(0.0000)*
GCC Region	499.0382	3.268588	14.51778
	(0.0000)	*(0.0706)*	*(0.0000)*
ASEAN Region	279.1978	0.192358	279.3901
	(0.0000)	*(0.6610)*	*(0.0000)*

The result of the Breusch-Pagan test suggests that OLS model 4.8 is not appropriate for the worldwide, GCC region, and ASEAN region because its probability level is less than 0.05. To select a random or fixed effect model the Hausman Test is conducted. The result of the Hausman Test is presented in table 5.24.

Table 5. 25

Hausman Test Result Random Effect Model 4.8

Test Summery	Chi-Squ Statistic	Chi-Squd.f	Prob.
Cross-Section Random			
Worldwide	34.466792	7	*(0.0000)*

GCC Region	28.930852	7	*(0.0001)*
ASEAN Region	0.000	7	*(1.0000)*

The Hausman Test suggests that random effect model 4.8 is only appropriate for the ASEAN region because its probability level is higher than 0.05, thus we use the random effect model for the ASEAN region while fixed effect model for the worldwide and GCC region. The results of regression Model 4.8 is demonstrated in Table 5.26

Table 5. 26

Regression Result: Model 4.8 (Z-Score)

	Worldwide (Fixed Effect)			GCC Region (Fixed Effect)			ASEAN Region (Random Effect)		
Variable	Coeff.	t-Stats	Prob.	Coeff.	t-Stats	Prob.	Coeff.	t-Stats	Prob.
C	3.304285	6.614541	*0.000****	2.049445	2.974087	*0.003***	1.536087	3.4953	*0.000****
DLLP	-0.57961	-3.71954	*0.000****	-1.43117	-4.01013	*0.000****	-0.75469	-1.86424	*0.063**
CI	-0.0622	-2.38452	*0.017***	-0.06615	-1.51179	*0.132*	-0.07854	-2.14028	*0.033***
DA	-0.13163	-2.5234	*0.011***	-0.03327	-0.59066	*0.555*	-0.17751	-1.71555	*0.087**
TA	-0.20367	-8.12895	*0.000****	-0.09727	-1.96943	*0.050***	-0.03531	-0.86576	*0.387*
BOD	0.033797	0.772811	*0.44*	0.046929	1.092158	*0.276*	0.054566	2.087726	*0.038***
SSB	-0.02175	-0.31326	*0.754*				0.024389	0.64709	*0.518*
GDP	0.000579	0.487519	*0.626*	0.008534	4.303719	*0.000****	0.002603	1.177896	*0.240*
INF	-0.00175	-1.01061	*0.312*	-0.00693	-1.91232	*0.057**	-0.02089	-3.98196	*0.000****

*** $p \leq 0.01$, ** ≤ 0.05, * ≤ 0.10

	Worldwide	GCC Region	ASEAN Region
Adjusted R^2	93%	95%	12%
F-stats	125.09***	146.07***	4.454***

The results of the fixed effect model 4.8 for worldwide sample size show the adjusted R-squared 93% with a highly significant F-Statistic value of 125.09.

The discretionary loan loss provision negatively impacts the stability of these banks overall, this indicates that EM is not used by the management to stabilize these banks. Cost to income, deposit to total asset and total asset also impact the stability of these banks negatively. However, no impacts of the BOD size, size of SSB, GDP and inflation are observed on the overall sample size.

The result of fixed effect Model 4.8 for the GCC region shows the adjusted R-Squared 95% with a highly significant F-Statistic value of 146.07.

The discretionary loan loss provision of Islamic banks of the GCC region negatively impacts its stability. Total assets also impact negatively the stability proxy of these banks. GDP growth positively impacts the stability. The negative and significant impact of inflation on stability is observed in the GCC region. Cost to income and deposits to assets have no significant impact on stability in the sample period.

The result of random effect Model 4.8 shows the adjusted R-squared 12% with a highly significant F-Statistic value of 4.45 for the ASEAN region.

The discretionary loan loss provisions negatively impact the stability of Islamic banks in the ASEAN region. Cost to income and deposit to assets also negatively impact the stability. The size of BOD positively impacts the stability while the impact of inflation is negative. However, no significant impact on total assets and GDP is observed in the ASEAN region.

CONCLUSION

Islamic banks are different from conventional banks due to their formational structure. These banks are based upon the principles of *Shariah*, where the interest (*Riba*) has been declared prohibited along with many more activities such as business in pork, liquor, gambling, and uncertain transaction. Besides these operational restrictions, the financial reporting of these banks is also different from the conventional banks. The conventional banking system has to follow the GAAP, IAS or IFRS along with country regulations while the Islamic banks must follow these rules along with the universal rules of *Shariah*. EM is the manipulation of financial statements sometimes within the rules of GAAP, IAS or IFRS may be considered legal in the conventional financial system but *Shariah* does not allow the fabrication and manipulation of accounting reports due to different reasons and restrictions. Therefore, Islamic banks must be immune from the practices of EM. This study evaluated the five EM theories *i.e* Signal theory, Threshold management theory, Agency theory, Positive accounting theory, and Managerial entrenchment theory in the light of *Shariah* and Islamic business/work ethics.

From the evaluation of these theories in the light of *Shariah* this study found severe violations of the *Quran* and *Sunnah* such as lying, misappropriation, betrayal, cheating, breach of contract and deceiving the shareholders by fraud. Similarly, tbe opportunistic earnings management techniques mentioned in these theories also violates Islamic business/work ethics such as sincerity, proficiency, justice, truthfulness, patience, and promise-keeping. Therefore, any practice of opportunistic earnings management mentioned in these theories in Islamic banks will be the severe violation of *Shariah*.

Furthermore, this study investigated the impact of earnings management on internal and external performance, management incentives and stability of Islamic banks. The result of regression models on internal performance variables shows the significant negative impact of discretionary loan loss provisions on the ROE and ROA of Islamic banks worldwide and GCC region separately. However, no significant relation between DLLP was observed on the ROE and ROA of Islamic banks in the ASEAN region. The empirical results indicated that earnings management is not used for the better internal performance of Islamic banks. Besides the better performance, it impacts negatively the internal profitability measures which are against Islamic norms. The negative impact of DLLP indicates that the discretion of the management reduced the profitability of the shareholders.

The DLLP shows no impact on the stock returns on the worldwide sample size. Similarly, no association between the DLLP and stock returns was observed in the GCC region and ASEAN region separately. The result of this regression model suggests that the earnings management of Islamic banks is not informational for the stock market. It is because their signals in the shape of financial reporting to the stock market have no impact on the performance of their stock returns. The empirical results indicate that the signaling theory is not followed in Islamic banks worldwide, further signaling theory is not in the practice in GCC and ASEAN regions separately.

Another important finding of the study is the negative impact of DLLP on management incentives in worldwide and the GCC region. In the ASEAN region, the DLLP shows no significant impact on management incentives. This indicates that their dictionary powers are not used for their cash emoluments. The empirical evidence suggests that the earnings management in these banks is at least not opportunistic in terms of getting cash emoluments.

Besides earnings management impacts the internal yearly performance negatively; it is observed from empirical models that it also impacts the stability of these banks negatively. The Z-score is a long-term reliable assessment variable for stability negatively impacted by the DLLP. The use of managerial discretion reduced the value of the Z-score in Islamic banks. This increases the chance of default because the lower Z-score indicates a higher chance of default and insolvency. This also indicates that their discretionary provision which is in fact earnings management has the risk of destabilizing the stability of Islamic banks in the long run. This trend is alarming not only for the long-run stability of these banks but also prohibited by *Shariah* because the earnings management practices of the management reduced the stability and enhance the risk of default of the investment of shareholders.

In light of the primary sources of *Shariah*, this study find that following and adopting opportunistic EM techniques described in five EM theories of financial and accounting literature is the severe violation of *Shariah* and Islamic business/work ethics. Therefore, the management of these banks must look into this matter to stop the violation of *Shariah* and keep the true spirit of Islamic business by avoiding or at least minimizing the EM practices. Furthermore, the empirical shreds of evidence of this study also indicate that the EM practices of these banks are not used for the betterment of internal or external performance. Besides the better performance, the practices of EM reduce the internal performance and stability of these banks. The findings of this study need the serious attention of the board of directors and specifically the *Shariah* supervisory boards to look after the quality of the financial reporting system of Islamic banks to control EM. The results also recommend AAOIFI to issue a separate standard regarding EM.

- **Contribution of the Study**

This study contributes to the literature of accounting and finance, corporate governance and Islamic banks in two ways. Theoretically it evaluated the five EM theories in the light of *Quran* and *Hadith* which is the addition to the literature. Empirically as per our knowledge the impact of EM on the internal/external performance, managerial incentives and stability in worldwide, GCC region and ASEAN region is also the new addition to the literature.

- **Limitation of the study**

This study is limited to pure Islamic banks only. Banks with Islamic windows are excluded due to the mixed financial statements of these banks in different regions. Similarly, other Islamic financial institutions such as Takaful companies, non-banking financial institutes were also excluded due to the nature of their business. Only largest Islamic banks in terms of total assets were included in worldwide sample size, small banks were also excluded because this study aimed to cover the maximum share of Islamic banks in terms of total assets.

- **Directions for further research**

For further research, the impact of EM on job security of the management and non-cash managerial emoluments is suggested. Similarly, type I and type II agency problems between management and shareholders need to be empirically investigated in Islamic banks. Furthermore, the comparison between the remunerations taken by the managers who are shareholders and those managers who are not shareholders will also be beneficial in the context of EM. The association between EM of Islamic banks and tax rates in different countries is also a good research topic.

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