

Structural Framework of Islamic Aqidah on the Practice of Earning Management

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Abstract: *There is growing concern among the users of financial statements about the level of frauds occurring in the business organization. The unexpected collapse of corporate giants such as Enron and WorldCom has driven those interested to pay more attention to the unethical practices in accounting systems. The phenomenon of Earnings Management (EM) is seen as one of the most problematic issues facing the accounting profession during the last few decades. It has been argued that EM misleads the users of financial statements. This is because when the managers alter earnings, the financial statements do not accurately reflect the economic wealth of the company, which ultimately leads to the gross violation of stakeholders' trust. The objective of this paper is firstly to address the ethical issue of EM and evaluate the progress of research in dealing with this issue where Islamic Structural Framework, based on Islamic creed (aqidah), can provide some insights into the behavioral pattern and actions that could be undertaken to reduce or*

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eliminate the practice of EM. Hence, the paper proposes a structural framework of Islamic Aqidah and the practice of EM that functions as a guidance to direct the intentions as well as behaviors of managers towards a proper manner (derived from the Quran and Sunna).

Key Words: *Earnings Management; Ethics; Islam; Islamic Finance*

I. Introduction

The increasing number and magnitude of recent accounting scandals have shown the spread of abusive practices and frauds among managers. These accounting scandals have made it evident that falsifying financial reports and managing earnings have become rampant and part of the culture of numerous organizations (Ferrell et al., 2008). Hence, this paper aims to identify the underlying principles and rules of practical guidance from Islamic tradition, namely the Structural Framework of Islamic Aqidah that may provide some insights into the behavioral patterns and actions that would be undertaken to control and reduce the practice of EM. (Islam is not a religion by itself but it is a way of life, therefore it is believed that by enhancing believing, instilling and practicing the right teaching of Islam particularly amongst the Muslim managers/accountants could solve the issues of EM). Building from the Islamic Principle, namely Aqidah and Fundamental Principle (Quran and Sunnah), it is believed that these Islamic values would intervene in all aspects of life including economic activities and business. Indeed, Islam views ethics as an offshoot of Iman (a Muslim belief system) that emerges from Islamic doctrine (aqidah) (Ahmed, 1997). Thus the achievement of fallah in this Worldly life and Hereafter cannot be sensed if there is no belief in this concept.

The insight behind this measure is available both in theoretical

and practical texts that observe the beneficial role of personal religiousness. It is a potential source of ethical norms (Clark & Dawson, (1996) and Hunt & Vitell, (1986). We develop this insight into a practical belief from an Islamic perspective, a strong aqidah. Given this understanding, it is assumed that managers that have adequate religious strength are more likely to behave ethically and to reject EM.

For the purpose of our study, we do not attempt to measure Religion with the Practice of EM, despite many prior studies attempting to categorize the practice of EM either as an ethical or non-ethical behavior and the effects of religion on the practice of EM. We develop and propose a fundamental framework that examines the origination of Structural framework for Islamic Aqidah on the Practice of EM. This Islamic Aqidah is an intellectual basis from which all thought, emotions, and state rules must be derived from. This is important because any action taken is normally influenced by the 'internal feeling environment' of an individual. Secondly, we illustrate further the usefulness of our theoretical framework into reality where the Islamic Structural Framework influences the behavior and character of an individual in practicing EM. Probing further, we find that aqidah and iman are incremental to each other in explaining earning management persistence, with Islamic Principles, the powerful determinant. Hence, this paper proposes a Structural Framework of Islamic Aqidah on the Practice of EM that functions as a guidance to direct the intentions as well as the behaviors of managers towards a proper manner derived from the Quran and Sunna. Finally, it is hoped that this paper forms the groundwork for future research opportunities that may stem from current work.

The remainder of the study is organized as follows. Section two presents the literature review. Section three discusses ethical issues of EM. Section four presents Islam and EM, which include general

Islamic Structural Framework. Section five, presents the development of the Structural Framework of Islamic Aqidah and the Practice of Earning Management. Our conclusion is provided in section six.

II. Literature Review

It was reported that in a large firm, which practiced EM, 77% of senior managers were found to have been involved in unethical behaviors. The report claimed that Earnings Management is one of the main factors behind these scandals (ERC, 2005). Karcher (1996) propose that EM may be considered as a possible contributing factor in manipulating financial reports and thus leads to the dishonesty of managers. Since, the practice of EM is wide spread; several researchers argued that the flexibility of Generally Accepted Accounting Principles (GAAP) promotes the engagement of EM (Ferrell et al., 2008; Healy and Wahlen, 1999). This standard practice in setting accounting choices is commonly referred to as EM in both academic and professional literature (Belski et al., 2008). By definition, EM is the use of discretion and an accrual approach to alter financial statements to either portray a rosy image to stakeholders or to satisfy managers' interests (Healy and Wahlen, (1999); (Hao and Yao, 2007); and (Greenfield et al., 2008).

In other words, despite the secretive manner of practicing EM, empirical studies provide evidence that managers still use accounting earning management (AEM) Healy, 1985; Beaver, Eger, Ryan and Wolfson, 1989; Jone, 1991; Wahlen,1994; Sloan, 1996; Subramaniam,1996; Guay, Kothari & Watts, 1996; Healy & Wahlen, 1999; Dechow & skinner,2000) or real earning management (REM) (Dechow and Sloan 1991; Baber, Fairfield and Hagarad 1991; Bushee 1998; Rochowdhury 2006; Cohen, Dey andLys 2007; Zang 2006; Cohen

& Zarowin, 2010) in their work environment. It has not yet been agreed upon by accountants, academicians and standard setters whether the practice of EM is ethically justifiable (Gaa and Dunmore, 2007). In fact, the demarcation line between acceptable and unacceptable behavior is always unclear because different people have varying attributes in diverse places (Staubus, 2005).

Today, ethics in business begin to become more institutionalized and stakeholders demand to improve ethical standards in business. Ferrell et al., (2008) state that investors nowadays are increasingly concerned about ethics, social responsibility and the goodwill of companies in which they invest. This is because investors and creditors have been profoundly shaken by the managerial shortcomings which cause them to lose their confidence in world markets (Angelidis and Ibrahim, 2004).

This vast growing concern about business ethics has been accompanied by an increase in empirical research seeking to discover determinants of unethical conduct (Carpenter and Reimers, 2005). Several studies on the subject of ethics and EM have been conducted to test the ethicalness decision making of managers. For example, (Merchant and Rockness, 1994; Fischer and Rosenzweig 1995; and Kaplan, 2001) found that EM practices probably raise the most vital ethical issues facing the accounting profession today. Therefore, the acceptance of such practice overtime legitimizes its existence and thus it could not be viewed as an unethical act. Moreover, according to research, managers who are supposed to abide to rules set by the accounting regulatory body have been in favor of these practices (Fischer and Rosenzweig, 1995). In the Malaysian context, Abdul Rahman et al, (2005) examine the differences between the earnings management practices of the Muslim managed firms and the non-Muslim managed firms listed on the Kuala Lumpur Stock

Exchange (KLSE). The study found that the practice of EM is not influenced by the majority of Muslim managers in the company.

It is a known fact that managers' decision making plays a key role in shaping the development of the culture of an enterprise and its organizational ethical behavior (Malone, 2006; Forte, 2004). This is because individuals bring specific personalities and behavioral traits to their respective jobs. Merchant and Rockness (1994) indicate that religious background is one of the significant ingredients that influence individuals' behavior. Furthermore, Conroy and Emerson (2004) put forward that believers in God are less likely to engage in unethical acts for the fear of losing God's promised motivational rewards. Accordingly, religion determines right and wrong based on the value and norms that it holds.

Considerable research has been done into the relationship between ethics and religion. However, a review of the literature shows a general lack of research which studies Islamic business ethics and the issue of EM. This is despite the importance of such research in eliminating some of the serious dilemmas that managers experience in the current dynamic business environment.

Therefore, by inculcate the Islamic religious framework, namely the Structural Framework of Islamic Aqidah (SFIQ) to the ethical issues of EM, an interesting dimension would be proposed. It is assumed that SFIQ guidelines which are based on divinity and faith may provide a systematic framework to eradicate the occurrence of frauds among top management. It is worth noting that the Islamic perspective is also quite unique in the sense that 'Shariah' Islamic laws govern every aspect of human being's life such as, spiritual, economic, political, social etc.

III. Ethical Issues of EM

Ethical issues or the ethical dilemma is a term used to describe a situation where a decision must be taken to overcome an ethical behavior be it right or wrong. Recently, EM has become a concern to different sections of society such as public, standards setters, regulators, creditors and the accounting profession due to its undeniable impact on socio-cultural and the socio-economic welfare of stakeholders. Merchant and Rockness (1994) contend that investors' confidence has been profoundly shaken and economic stability has been grossly weakened.

In a speech delivered by the former head of the SEC regarding the issue of EM, says that it is unacceptable behavior despite its abundance (Elias, 2002). The ethical issue of EM typically arises due to the conflict among individual's personal moral value, the value and culture of organization and without doubt the negative impact of EM on (1) shareholders who need an informative report. (If the documents contain inaccurate information either intentionally or not, lawsuits may be imposed on managers (Ferral et al., 2008)); (2) Community uses financial statements for their long term planning (Fischer and Rosenzweig, 1995); (3) The Stock market uses financial statements in determining stock prices.

However, not all businesses and academic environments view EM as unethical conduct. Such perception is based on empirical studies, which prove that shareholders are in favor of managing earnings because of the positive results that EM can bring. For example, Dey (1988) argues that the demand of EM is mainly supported from shareholders in order to upgrade the share price, which in turn would attract new investors. In the same vein, Schipper (1989) stated that EM is inherent in financial reporting systems. This suggests that the

attempts to reduce the use of EM has been somewhat futile and what's more it is in fact a simplistic idea. Parfet (2000) goes further and notes that EM practice is not unethical behavior as many pinpointed and that it is a logical result of the flexibility of GAAP. The proponents of this argument also argue that the decentralization of organizations means the dispersal of information and thus it is useful for firms to manage earnings which may convey more information than unmanaged earnings. One thing that should be clear according to this argument is that instead of focusing on how to eradicate EM, it is better to concentrate on accounting properties (Arya et al., 2003).

IV. What Does Islam Says about EM

The uniqueness of Islam comes from the revealed teachings sent by Allah. Literally, Islam means peace through submission to the will of God. The believers in Islam have to declare that there is no god but Allah and that the Prophet Muhammed is the final of messengers. This declaration is known as 'Shahada'. Islam has defined the purpose of human beings in life and this would solve man's greatest problems (An-Nabahani, 2001). Allah says, 'I have created man and Jin only to worship me' [al-qur'an, 51:56]. The nature of worshiping Allah can be achieved by undertaking several actions and the worshiper is a servant of Allah. This entails that man has to follow all the orders that come from the Lord of this universe. In essence, Islam means that a Muslim must realize his relationship with Allah when undertaking any action, thus he directs his actions according to the commands and prohibitions of Allah (An-Nabahani, 2001).

Given this fundamental understanding, a Muslim must believe in two principles. First, the Qur'an is a holy book revealed from God. Second, the Sunnah, guides us to his conduct. These two principles

build the source of Islamic law (Shari'ah) (Abdul Rahman, 2003).

Unlike capitalist ideology, Islam does not recognize the dichotomy between religion and life. Walsh (2007), states that the separation between temporal and spiritual dimensions does not exist in Islam. This suggests that Islamic values and norms would intervene in all aspects of life including business and other economic activities.

The ethical system in Islam is not utilitarian and relative; rather, its principles are eternal and absolute (Hassan, 1995). Indeed, Islam views ethics as an offshoot of Iman (a Muslim belief system) that emerges from aqidah or the Islamic doctrine (Ahmed, 1997). Within the context of Islamic framework, business ethics is defined as organizational and management ethics whereby the Qur'an and Sunna are considered as two major sources (Abuznaid, 2009).

This begs the question of whether Islamic Doctrine (Aqidah) can positively contribute to the endeavors to eliminate the occurrences of frauds in financial statements. In other words, how effective are Aqidah in decreasing the practice of EM?

Initially, the practice of EM occurs when managers have the intention to maximize their compensations. It is believed that managers who adopt western philosophy or capitalist ideology would evaluate their actions on the basis of benefit. Thus, the materialistic system is the measure in this life. However, in Islam the basis of actions is the Halal and the Haram. Accordingly, the Halal is performed and the Haram is prohibited. In fact, the measure neither evolves nor changes; and it is not influenced by benefit (Maslahah) (An-Nabahani, 2001).

Therefore, Islam does not leave any room for ambiguity and individuals are supposed to adhere to the ethical system that Islam presents. It has been narrated in one of the Hadith of Prophet Muhammad (SAW), 'An honest business man will be amongst the

prophets, the truthful and the martyrs on the Day of Judgment' [Tirmizi: Abu Sayeed (RA)]. This Hadith is an indication that a manager is encouraged in Islam to possess good characteristics and behaviors. Abuznaid (2009) states that code of ethics may enhance ethical behavior of employees as well as managers in private and public sectors. The code has assumed that a Muslim manager willing to comply with the code for the reason of religious belief. In other words, the compliance with the materials of the code is derived from the fact that managers perceive that they are obeying Allah's order and refraining from things forbidden by Him (Abdul Rahman, 2003).

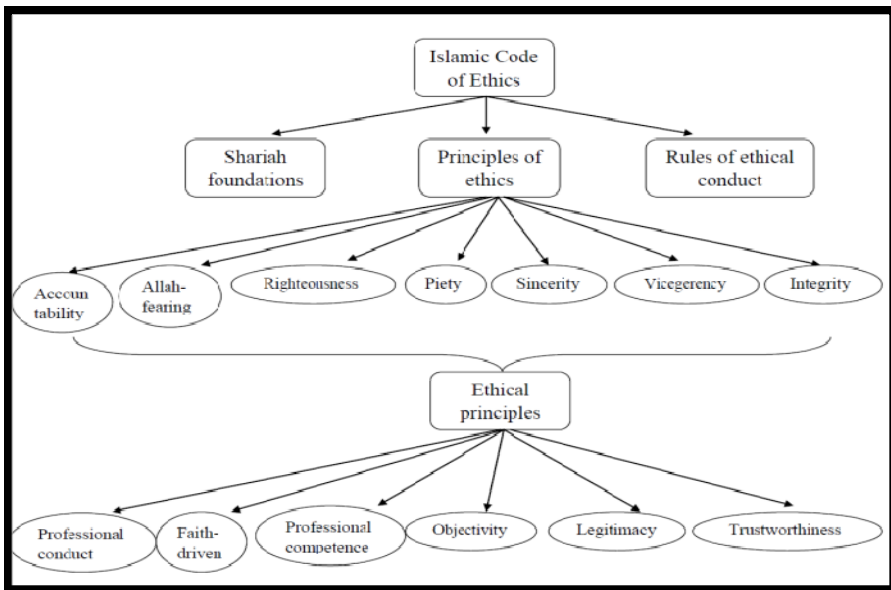
Hence, it is important in this context to highlight the underlying basis of the Aqidah framework. The above discussions motivate us to think about the possible tools that can be used in order to instill Islamic ethical discipline into managers. In this regard, a moral code or code of ethics that guides managers through the choices they encounter in the organization would be proposed.

In the Islamic sphere, the noticeable effort to structure a code of ethics through Islamic Structural Framework has been carried out by Accounting and Auditing Organizations of Islamic Financial Institutions (AAOIFI) in 1998. AAOIFI deals with promulgating, and reviewing accounting standards and ethical issues encountered by accountants. This has been derived from Islamic sources such as the Qur'an, Sunna and Ijma - the pronouncement, representing the consensus of the companions of prophet Muhammad (PBUH) on matters not addressed explicitly by the Qur'an and Sunna (An-Nabahani, 2003).

A review of the code shows it has been split into three sections. First, Shariah foundations of accounting ethics deal with the principles of the ethical system in Islam such as, integrity, vicegerency, sincerity, piety, righteousness, Allah-fearing and accountability. Second, this

section highlights the principles of ethics for accountants. Finally, the code presents rules of ethical conduct for managers. Using the principles of the first section, AAOIFI developed six basic ethical principles; namely, trustworthiness, legitimacy, objectivity, professional competence and diligence, faith-driven conduct, and professional conduct and technical standards.

Figure 1: Structural framework of AAOIFI Islamic Code of Ethics



Nevertheless, some researchers do not favorably dispose to the code of ethics as earlier mentioned for various reasons. For example, Abdul Rahman (2003) argues that having a code of ethics is not sufficient to make the accountants more ethical. He added that empirical studies should be undertaken to assess the level of acceptance of the code among accountants. Another issue remarked by Abdul Rahman (2003) is the lack of practical guidelines or the

procedures that should be followed to adhere to the code. To overcome these shortcomings, he proposed the principle of Maslahah (benefit) to be as an ethical filter mechanism and as an ethical framework to resolve conflicting issues.

V. Structural Framework of a Moral Behavior in Islam

There is no doubt that the use of Maslahah concept as an arbitrator in determining ethical action is in fact an Islamization of the utilitarian theory which is based on the mind and action of individuals without paying any attention to the religious values. However, morals are part of Islamic Shari'ah and a branch of the commands and prohibitions which a Muslim should refer to when there is a need to perform actions. However, the way in which the whole society attains these morals is by establishing the Islamic emotions and thoughts. This is because society is built upon the systems of life and is affected by thoughts and emotions (An-Nabahani, 2003). Thus, once the community has attained the desired thought and emotions, the individuals will inevitably acquire them.

Most definitely, calling upon morals themselves, without establishing the thoughts and emotions is meaningless and it will exhaust the effort of individuals and render them unable to change people. In coming to terms with this fundamental understanding, this study suggests a different framework starting with the intellectual basis of Islam which is aqidah (where a Muslim must believe certainly in Allah's existence which entails that a man has to worship only Allah) The characteristics would then be built on it, because morals alone will not produce the perfect man and the Islamic personality (see figure 2).

This figure explains that a Muslim manager is not characterized

by truthfulness for the sake of truthfulness in itself but because Allah commanded the Muslim to acquire this virtue. It is essential to understand that the individual who possesses good morals but aqidah is not Islamic, cannot be seen as an ethical person or does not have Islamic values because initially he/she was a disbeliever. Likewise, the person who has good morals but does not worship Allah accordingly, a reformation of such personality, aqidah needs to be carried out.

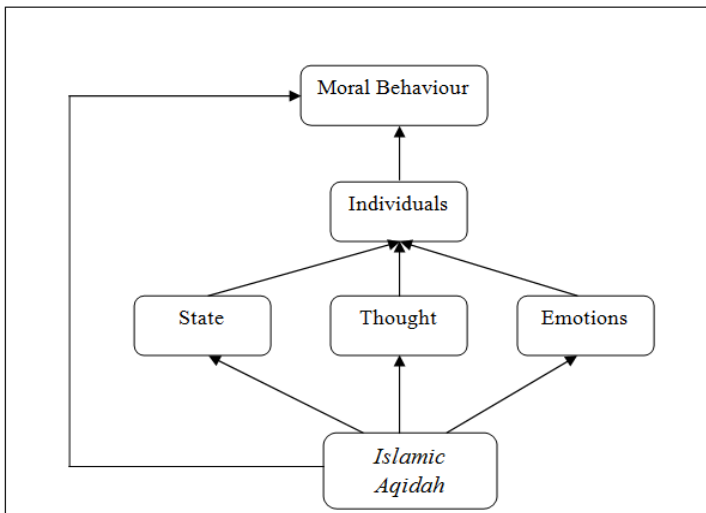


Figure 2: Structural Framework of a Moral Behavior in Islam

From the perspective of EM, Muslim managers first should reinforce their Iman (belief) by changing their current thought. This is because thought is the main factor in influencing the behavior of man. Allah says: "Allah does not change the circumstances of any people until they have changed what is within themselves" [Qur'an, 13:11]. To do so, the manager is motivated to rethink the principles that Islam is based on namely, the existence of Allah, the prophecy of Muhammad and the Qur'an. Again, the manager must comprehend that whatever derives from this aqidah must be adopted and fulfilled.

Otherwise, his practice of EM will be considered Haram, thus his conduct becomes questionable. Realizing the loss of motivational reward in the hereafter will make managers shun the bad practices of EM within firms.

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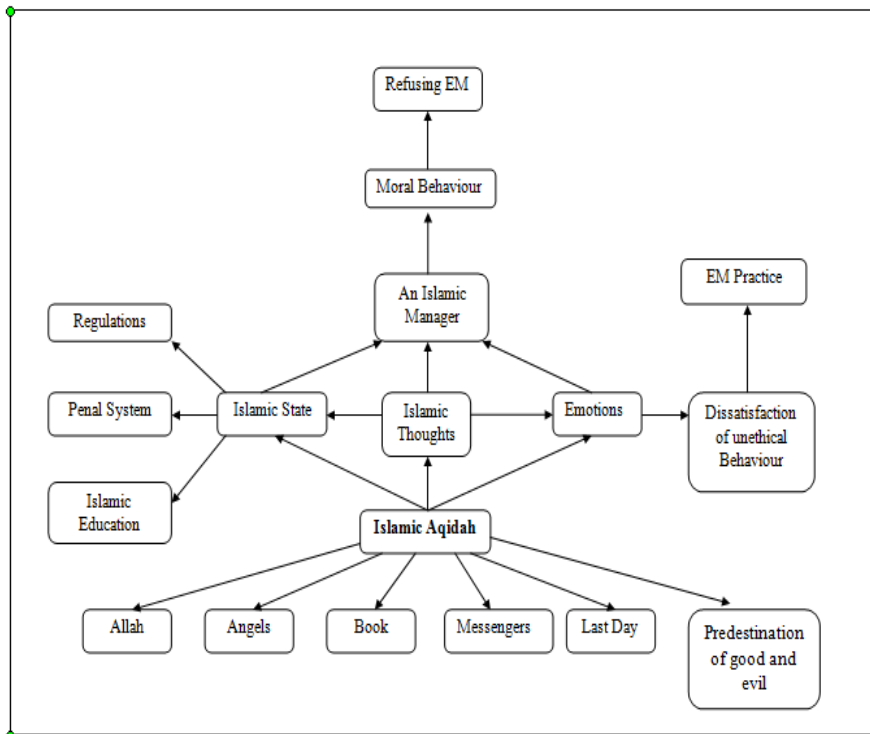


Figure 3: Structural Framework of Islamic Aqidah on the Practice of EM

To be more specific figure 3 provides a comprehensive explanation about the relationship between Islamic creed (aqidah) and the practice of EM. The figure shows the organic relationship between the components of Islamic Aqidah as an intellectual basis whereby all thoughts, emotions and state rules must be derived from. By definition, aqidah is the solid creed that one's heart is fixed upon without any

hesitant or doubt. Despite the seriousness of such term in the life of Muslims, we find that Qur'an and Sunna do not use the word aqidah, instead Qur'an and Sunna refer to this as an Iman. Allah says in the Qur'an, "And thus We inspired in You (Muhammad) a Spirit of Our command. You did not know what the Scripture was, nor what the Faith was. But we have made it a light whereby We guide whom We will of our servants..." [Qur'an, 42:52]. In the Hadith of Gabriel, the Prophet explained the pillars of this faith in which every human must believe, when he was asked, "What is Iman?", he said, "To believe in Allah and His angels and His books and His messengers and the Last Day and predestination of good and evil."

It is necessary for every Muslim to know these pillars and to believe in them with a correct understanding. It is important to know that one will not be called a complete believer just by knowing and understanding these pillars but he must adhere and submit to all the required duties including behaving in a moral manner.

Based on figure 3, it is obvious that aqidah generates three subdivisions, namely emotions, thought and state. Starting by the emotions, the Islamic Aqidah would determine the emotional feeling toward any action or object by producing either satisfactory or dissatisfactory emotions. In the case of EM, the expected feeling of the Islamic manager would be a negative response to the practice of EM due to the breaching of contract between owners and agents (managers). The manager has developed this emotion based on the holding concepts of Ajarah/Ijarah.

The second component is the Islamic State whereby regulations should be enacted in order to limit the practice of frauds within companies along with a penal system that functions as a siege of the economy and the wealth of the nation. This cannot be achieved without having an Islamic educational system that produces a

generation that respects and adheres to the Islamic doctrine. After putting all of these components into place it is suggested that an Islamic individual would be produced and the practice of EM is seen as something which is illicit or Haram. In fact, the manager who obtains such understanding will not engage in EM. In contrast, he will work to prevent the practice of EM in his company, whether in his/her department or other departments.

Although the aqidah influences the behavior of individuals, the opportunistic attitude is often presented in the actions. In this context, the manager must usually think about the Day of Judgment. In other words, the accountability concepts must shape the behavior of managers in running the business and making decisions.

VI. Conclusion

EM has been defined as the indented manipulation of financial statements by managers in order to obtain bonus or compensation. This action is seen as unethical behavior due to the following reasons. First, it misleads users of financial reports such as shareholders, bankers, and potential investors. Second, it may likely distort the returns on shareholders' investment. Third, the economy may be weakening if the manipulation is not discovered on time. However, detecting the practice of EM is somehow difficult, but despite that, GAAP permits managers to use various accounting choices. Nonetheless, managers still carry out their unholy behavior secretly among themselves.

Several attempts have been made to decrease the practice of EM particularly after the collapse of Enron and WorldCom where Walsh (2007) contends that SOX introduced ethical principles in order to restore the public confidence after Enron's scandal. From an Islamic

perspective, business and management decisions are guided by faith or Iman which in practice means complying with shariah injunctions, and engaging in Halal activities and avoiding Haram activities. Islam has defined a Muslim manager as a person who considers the accountability of God in all decision making. Therefore, being honest and fair the manger would tend to reveal accurate information in financial statements. Propagating and maintaining this behavior require an organic relationship between the components of Islamic Aqidah as an intellectual basis from which all thoughts, emotions and state rules must be derived from. By definition, aqidah is the solid creed that one's heart is fixed upon without any hesitant or doubt. Therefore it is necessary for every Muslim to know these pillars and to believe in them with a correct understanding. However, it is important to know that one will not be called a complete believer just by knowing and understanding these pillars but must adhere and submit to all the required duties including behaving in a moral manner. In this regard, Structural Framework of Islamic Aqidah is projected to enhance the moral reasoning of managers by increasing the level of Iman that relates the behavior with standard Islamic Aqidah (basic rules of the guidelines).

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