

Do Shariah-compliant Companies Engage Lesser Earnings Management Behaviour?

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ABSTRACT

Manuscript type: Research paper.

Research aims: This study aims to understand how reputation, financial distress and financial performance influence Shariah-compliant companies into engaging earnings management behaviour. The financial data of 69 FTSE Bursa Malaysia 100 Index companies, dating 2010 to 2014 (five years), were analysed.

Design/ Methodology/ Approach: This study uses the Modified Jones model (Jones, 1991; Dechow, Sloan, & Sweeney, 1996), Roychowdhury's model (2006) to examine earnings management behaviour of Shariah-compliant companies.

Research findings: The results of this study suggest that company's reputation, financial distress and financial performance are factors that can influence company's earnings management behaviour and that Shariah values are ineffective in deterring the management from earnings management behaviour.

Theoretical contribution/ Originality: The findings of this study contribute to the literature by showing that Shariah values may not

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be beneficial in shaping good business management and reporting practices.

Practitioner/ Policy implications: The alarming results drawn from this study is a reason for policy setters and relevant accounting bodies to give more emphasis on developing better accounting and reporting policies.

Research limitation: This study is limited to non-financial sectors due to measurement limitations.

Keywords: Earnings Management, Financial Distress, Financial Performance, Fraud Diamond Theory, Reputation, Shariah-compliant

JEL Classification: M41

1. Introduction

The global Islamic finance market value is experiencing rapid growth. In the year 2012, its value was USD1.2 trillion and expected to reach USD2.6 trillion in 2017 (PwC, 2013). Malaysia aspires to become the leader in the global Islamic finance market. It established the Shariah Index in 1999, and the Islamic Financial Services Act was enacted in 2013. Further, the Securities Commission Malaysia (SC) reported that the Islamic capital market in Malaysia has grown at an average of 12 per cent per annum (SC, 2015). In 2014, the Malaysia Islamic Capital Market contributed RM1.59 trillion, an amount that is equivalent to 58 per cent of the RM2.76 trillion of the total Malaysia's capital market.

The goal of Islamic business practices is primarily, not about materialism. Instead, it is based on the concept of consumers' well-being and good life. It also stresses on social justice and the balancing of materials and spirituality (Rice, 1999). Scholars (e.g., Noreen, 1988; Kennedy & Lawton, 1998; Longenecker, McKinney, & Moore, 2004) believe that in general, religion is one of the mechanisms that helps an individual to refrain from unethical conduct especially in business operations.

Issues regarding earnings management and creative accounting have been extensively researched (Hossain, Karim, & Eddine, 2014) since Enron's accounting scandal caused by earnings management behaviour (e.g., Gordon, 2002; Healy & Palepu, 2003; Li, Pincus, & Rego, 2008; Desai & Dharmapala, 2009; Ibrahim, Darus, Yusoff, & Muhamad, 2015). Ibrahim et al. (2015), for example, found that companies offering Islamic products and services tend to practise sustainability reporting, which are also less involved in earnings management behaviour.