

Earnings Management In Terms Of Islam: A Literature Analysis

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Abstract

the main purpose of this study is to examine earning management practices in context of literature evidences in Islam. The data is collected from prime source of Islam & the past studies. Literature analysis depicted that earning management is a falsehood based, deceptive practice which is unethical and it is prohibited in Islam to practice such sort of tactics for personal benefits. This study will help the researchers, Islamic business bodies and other stakeholders to understand the earning management in terms of Islam Also it will help in creating trust between the financial reports stakeholders and the organization. The Literature analysis depicts that earning management can be beneficial to an organization in some cases but in majority cases it is a deceptive strategy to avoid tax, paying off of more dividend which is forbidden according to Islamic ideology of Financial and economic practices. Also under ethical approach this sort of practices is totally unacceptable and strict action should be taken to eliminate such practices.

Keywords: Earnings management, manipulation & deception, Falsehood, Islam, Qur'an & Hadith, ethics.

1. Introduction

Earning is the vital element in financial reporting and usually it is known as net income or the net earnings. The net earnings on an organization indicate the value added activities performed by that organization. However, the company's stock fair value is the present value of its future earnings. If the rise is observed in earnings it depicts that the value of a company, vice versa is the case of fall in earnings.

The Islamic ideology of Finance is based on truth, Sharia, and zulm free and ethic based practices. Earnings management is defined as the manipulation of financial figures of company earnings (Macintosh, 2009). Accounting scams like Waste Management in 1998, Enron in 2001, and WorldCom in 2002, Lehman Brothers Scandal in 2008, and Satyam in 2009 has create disequilibrium in the financial system Earnings management is an unethical practice according to Islamic literature (Hossain et.al., 2014). As it deceive the stakeholders by providing false information.

Earnings management is termed as lie in general terms and Islam prohibits lie and consider it as a sin. And Allah did like falsehood. Allah says in Quran;

"They only invent falsehood who do not believe in the verses of Allah, and it is those who are the liars". (An-Nahl, 16:105)

Prophet Muhammad (PBUH) who also worked as trader forced the followers of Islam to be fair in business dealing and gain the trust of the customers as trustworthy person is the companion of Prophets.

"A truthful and trustworthy merchant is associated with the prophets." (Al-Tirmidhi, No. 50)

The research study is based on the literature analysis which includes the prime source literature of Islam (i.e. Qur'an & Hadith) and the previous research studies. The particular study will help the readers, researchers, Islamic business bodies to understand the earnings management in terms of Islam and will help them in creating trust between the financial reports stakeholders and the organization.

1.1 What is Earnings Management?

Massive level of studies is done on this subject but there is a limited work on the summarization of existing research work. Few author like Mulford and Comiskey (2002) and Stolowy and Breton (2000) have done the remarkable work on earnings management. They have given the basic concept of earnings management and opened a new world of discussion.

Mulford and Comiskey (1996) defined earnings management as the manipulation of accounting results for creating altered impression of business performance which will give the positive signal in the market. Earnings management will help the organization to attain the trust of investors and to attain the investment in the organization.

In the literature records earnings management is also known as income smoothing, accounting hocus pocus, financial statement management, the number games, aggressive accounting, reengineering the income statement, juggling the books, creative accounting, financial statement manipulation, borrowing income from the future, banking income for the future, financial shenanigans, window dressing and accounting alchemy and lie based accounting.

The agency theory focuses that stakeholders are the principals and management act as agent. Stakeholders and debt-holders provide the financial resources for the operation of the organization against the future income share/return. Principals provides with funds for efficient usage by agents. Any conflict occur between these two party will damage the future return. To sort out this issue agents are provided with rewards, bonuses. The financial numbers are juggled in financial reporting by companies is to smooth out fluctuations in earnings or to meet stock analysts' earnings projections and to create the favorable financial scenario for the company. Large numbers of fluctuations are done in income and expenses which are may be a normal part of a company's daily operations, but the changes may alarm investors who prefer to see stability and growth, forcing managers to take advantage of accounting methods. Also, a company's stock price will often rise or fall after an earnings announcement, depending on whether it meets, exceeds or falls short of expectations. Sometimes manager apply the GAAP principles to get the rewards which ultimately deliver negative results in future.

Similarly Watts and Zimmerman (1986) theory of positive accounting considered that strong financial outputs generate positive signals in external environment buildup the confidence of the investor and debtor and the fund inflow in the company by them become easier. Managers to get huge financial benefits practice these principles. The firm investment inflow increases and the use this investment in operations.

A usual criticism on practicing earnings management is that it alters the real picture by window dressing and this is violation of the actual purpose of financial reporting as no true picture and true economic assessment can be done through such sort of forged financial statements. Whereas the academicians believe that it has some positive impact also. It is perceived that it reduce the transparency. It provides that information which is demanded by the stakeholders, ultimately it raise their trust level (Glover, Arya & Saunder , 2003).

2. Literature Review

Earnings management was not under attention in academics and in financial practices, but when accounting scams like Waste Management in 1998, Enron in 2001, and WorldCom in 2002, Lehman Brothers Scandal in 2008, and Satyam in 2009 were highlighted in the worldwide media researches paid attention to earnings management and transparency in the accounting information(Stubben, 2008). The direct studies provided the evidence about the earnings management and tools and techniques used by corporation in overwriting and underwriting the company's earnings (Lee, 2007; Charoenwong & Jiraporn, 2009; Caramanis & Lennox, 2008). The value able empirical studies were done on Anglo-Saxon Countries to study earnings management (Othman & Zeghal, 2006). Anis bin Amir and Ezzeddine Abaoub (2010) investigated the earnings threshold phenomena in Tunisia which is a non-Anglo Saxon country. Managers manipulates the net earnings of company to create favorable results i.e. overlying the predictions and market forecast ultimately it has pushed the Tunisian managers to alter the financial figures to deliver the positive signals to the markets to get tax benefits(Lee, 2007). The literature knowledge describes that the financial statements represents the real economic changes in the wealth of the enterprise but in reality accountants, analysts manipulates the earnings to acquire more investment inflow and trust of the stakeholders and to raise the worth of stock (Macintosh, 2009). Frankfurth (2005) claimed that earnings management is short lie to get benefit for long-term. Companies do it to get finance for short-term and reap the long-term benefits.

Earnings of the company is altered by subjective decision making and Generally Accepted Accounting Principles, and designing the transactions by taking the help of external auditors. The financial Mangers apply their knowledge to manipulate the financial records to coverup losses with the subjective matter (Burgstahler and Dichev ,1997). Also continuous changes in GAAP and conceptual framework and recognition rulings have given the window for practicing the earnings management. Designing the transactions is also use to manage earnings and to get the benefit which unethical. Researches claimed that the higher level of transparency in the financial reporting mechanism will help in tackling the higher level earnings management. As greater level of transparency in reporting of income will reduces the chance of mangers to practice earnings management (Hunton et.al., 2006). With reference of Anglo-American and Euro-Continental models, Othman and Zeghal (2006) investigatory study about the factors affects the earnings management policy. Accountants manage the accrual principles & GAAP in order to manipulate the bonuses (Graver and Austin, 1995; Obid

and Demikha, 2012). Managers usually practice this technique to cover up the short-term earnings objectives (Schipper, 1989; Healy and Wahlen, 1999; Burgstahler and Dichev, 1997). It is considered that the religion is one of the prime source of ethics and it is depicted in the different aspects. In many ways religion make impacts on the behavior and activities of beings. That is why researchers associated the earnings management as an ethical issue which can be addressed by use of religion. The Islamic finance researchers gave importance to the Islamic values and ethics and its relationship with earnings management (Obid and Demikha, 2012; hamdi and Zarai, 2013; Yunanda and Majid, 2011; Saringat et.al., 2013). Earnings management is an unfair practice and it is based on lie so it is forbidden in Islam (Yunanda and Majid, 2011).

3. Methodology

The study is based upon the literature analysis of earnings management in terms of Islamic ideology. The data is collected and analyzed from Prime source of Islam (i.e. Qur'an & Hadith) & the past research studies conducted of conventional business research scholars and Islamic business practices scholars.

4. Islam and Earnings Management

In Islam all the dealing should be based on truth which creates the sense of trust among the parties. Islam prohibits telling lies in every aspect of life and especially in dealings as the earnings management is based upon fabrication of truth. According to Macintosh (2009) and Frankfurt (2005), earnings management is the manipulation of figures or it can be called as financial reporting based on short lies. All the financial information related to earnings are altered in order to gain the trust and investment. Also the conventional finance scholar's ideas, facts, and findings on earnings management based upon the basic concept of agency theory and solving mechanism of agency issue (Hossain et.al., 2014). This concept directly influenced managers that if they depict that organization is doing well they will get appreciation and extrinsic reward even in the case of losses. However this practice is unethical according to every society and Islam strictly denounce these sorts of concepts. as telling organization has got profit during the losses which is lie and Islam prohibit lie.

4.1 Qur'an and Telling lying

According to Islam lying is a sin of tongue and it is the source of all sins. Lying is considered as a major sin in Islam. Evidence can be found in Qur'an and Hadith related to consequences of lying. In Qur'an one who tell lie is called as "Kazib" and lying is related to unethical acts like deception, fraud, and hypocrisy and flourishing with the false testimony and Allah dislikes one who practice the falsehood.

Allah say in Qur'an:

- *"They only invent falsehood who do not believe in the verses of Allah, and it is those who are the liars". (Al-Qur'an, Surah An-Nahl, 16:105)*
- *"O you who have believed, fear Allah and be with those who are true." (Al-Qur'an, Surah At-Tawbah, 9:119)*
- *Surely Allah does not guide him aright who is a liar, ungrateful." (Al-Qur'an, Surah az-Zumar, 39:3)*
- *"And do not mix the truth with falsehood or conceal the truth while you know [it]."(Al-Qur'an, Surah Al-Baqarah, 2:42)*
- *"... and pray for the curse of Allah on the liars." (Al-Quran, Surah Ali-Imran 3:61)*
- *"Woe to every sinful liar." (Al-Qur'an, Surah Al-Jathiyah, 45:7)*
- *"... the curse of Allah be on him if he is one of the liars." (Al-Quran, Surah an-Nur 24:8)*

4.1.1 Interpretation of Qur'an Verses

By analyzing these verses of Holy Quran it can be concluded that Allah dislikes those who tell lie or those who become the part of lie. Islam force one to be fair in dealings and called lying is the source of all illness. Even valuing the falsehood when truth is known it is also prohibited. The Earnings management fabricates the true information, deceive the stakeholders regarding money for personal gain which is forbidden and is unethical As a Muslim one should discourage practicing earnings management and those who are in a position to give information to stakeholders should not manipulate earnings.

Whether the company is earnings high profits or bearing losses they should clearly convey it to others. Muslims should search for the bounty of Allah Almighty by adopting the principles of Islamic business.

4.2 Hadith related Falsehood

The Prophet Muhammad (Peace-Be-Upon Him) advised Muslims to be honest and truthful. And when the life of Prophet is observed it is concluded that believers or non-believers trusted Him for his honesty, truthfulness and fair dealing.

“On the authority of Abdullah Ibn Amr Ibn Al-As (May Allah Be Pleased With Him) who narrated that The Prophet (PBUH) said: “Whosoever possesses these four characteristics is a sheer hypocrite and anyone who possesses one of them possesses a characteristic of hypocrisy till he gives it up: When he makes a covenant, he acts treacherously; When he talks, he lies; when he makes a promise, he breaks it; and when he quarrels he deviates from the Truth he begins to abuse.” (Bukhari, Sahih, Al-Bukhari, No: 33)

Islam focuses on transparency in business dealings and in transactions. Islam discourages any sort of false and deceptive practices in business dealings.

“The Prophet Muhammad (PBUH) was asked what type of earning was best, and he replied: A man’s work with his hands and every business transaction (lawful).” (Tirmidhi, Sahih, Al-Tirmidhi, No. 846; Bukhari, Sahih, Al-Bukhari, No. 1937)

The trustful business personnel is more valuable and worthy than the one who adopt falsehood practices in business dealings.

“The Prophet also said: A truthful and trustworthy merchant is associated with the prophets.” (Tirmidhi, Sahih, Al-Tirmidhi, No. 50)

“The Prophet Muhammad (Peace-Be-Upon Him)) has also exhorted the believers to strictly adhere to truthfulness in business transactions. He says: 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 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.” (Bukhari, Sahih, Al-Bukhari, No: 2079; Muslim, Sahih, Al-Muslim, No:1032)

The tradition implies that Allah blesses business dealings if both parties (i.e. buyer & Seller) are true to each other. Telling lies and hiding facts will result in the loss of divine blessing.

“The Prophet said: ‘Traders are wicked people’. The Companions asked: ‘O Messenger has Allah not permitted business?’ The Messenger replied: ‘Of course He has declared trading lawful. But they (i.e. the traders) will swear by Allah and do evil, they will not speak but tell lies’”. (Ahmad, Musnad Ahmad Ibn Hanbal, No: 14982)

4.2.1 Interpretation of Hadith

The hadith shed light on the fact that earnings management is lying, based on hypocrisy. As by practicing it the break of vows is observed and Prophet Muhammad the Messenger of Allah dislikes these sort of acts in dealings. Islam forced on the fair and lawful practices in earnings and called the deceptive, falsely hood based practices as illegal. Now-a-days earning management involves the deceptive techniques by misusing the GAAP and accruals to attain the attention of the stakeholders in business for the personal benefits, which is totally unethical according to Islamic ethical ideology and according to the ethical ideology of any society.

4.3 Earnings Management Impact and Islamic Ethics

In the recent years accounting frauds and failure increased in numbers and the accounting standard boards and regional associations working and upgrading the accounting standards on ontological and epistemological grounds to reduce the chances of accounting frauds. The Security and Exchange Commissions and regulatory institutions are demanding for more fair and accurate recordings. As tax frauds, fraudulent reporting and unethical practices are performed by accountants by using GAAP which is affecting the overall economy and in developing countries this issue is more serious because it stagnant the growth of economy. Lehman Brothers Scandal in 2008, and Satyam fraud in 2009 has ignited the process of reviewing the accounting standard and correcting the flaws the conceptual framework is continuously upgrading with passage of time. The historical evidence of literature has also thrown the light of the opportunistic behavior of the personnel’s who are in management level. The manipulation in the accruals and GAAP are done to avail

personal benefits by disturbing the majority. It has delivered the financial distress in the environment as well as financial loss to the real owners and other stakeholders.

Islam also forced to practices ethics in dealings and also in different aspect of life. Akhlaq is termed as the characteristics of human that he practices. Akhlaq is related to Islamic ethics and composed of four elements: (1) Understanding of what is right & wrong, good & bad based on human logic and perception level. (2) Relationship with humans and between man & Allah. (3) Looking for bounty of Allah. (4) Practicing its spiritual thoughts and knowledge he learnt (Kamri, 2009; Ismail et.al., 2011). Imam Ghazali believed that human body has the physical and spiritual part and ethical values are derived from the spiritual part and apply them in his deeds (Rahim, 2013). Hence it can be said that ethically earnings management is a crime. This also depict that fraudulent practices like earnings management are considered as unethical as it violates the basic beliefs.

5. Controlling the Earnings Management Practices

The Literature analysis depicts that earning management can be beneficial to an organization in some cases but in majority cases it is a deceptive strategy to avoid tax, paying off of more dividend which is forbidden according to Islamic ideology of Financial and economic practices. Also under ethical approach this sort of practices is totally unacceptable and strict action should be taken to eliminate such practices. The policymakers and think tanks of the accounting standards boards should effectively response on this prime issue. They should follow some steps; (1) analyzes the current accounting practices critically and detects the laps by using which earnings management is practiced. (2) The regulatory bodies like SEC (Securities and Exchange Commission should workout to strengthen the rules and modify them according to the need of the time. (3) No, influence should make impact on the rules and proceedings. (4) Awareness should be given to general public as well as the corporate public which will help in overcoming this issue. Also Ethics can be used in order to minimize the earnings management practice. By conducting seminars, awareness campaign regarding the ethics and accounting practices will also help in overcoming the issue.

6. Conclusion

The Islam focuses on fair play in terms of business transaction and in other dealing. The use of unethical tactics like deception, falsehood, manipulation to earn money is prohibited and earnings management is involves lie, deception, manipulation by overstating and understating the financial statements on an organization for the benefit of few and affect the majority. Earnings management has increased the financial distress in the financial setup of the world and can be controlled if the Islamic ethics and Islamic business principles are applied. Also the policymakers and the accounting standard setting accountants should observe the flaws in the present accounting standard and address these flaws in order to control this issue. Also according to ethical point of view deceiving others unacceptable in society and such sort of fraudulent practices create economic, social and societal disruption which led toward the instability of a state, economic and financial system.

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