

CORPORATE GOVERNANCE OF ISLAMIC BANKS, EARNING MANAGEMENT AND FIRMS VALUE: A CONCEPTUAL FRAMEWORK

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Abstract	<p><i>The majority of previous studies in Islamic banking mostly concentrate on assessing the banks' value. Islamic banking should also prioritize the implementation of effective corporate governance in order to boost its value. The Islamic bank value is a vital component in order to increase public confidence, and earnings management may have an impact if it happens. This article discusses the conceptual framework of corporate governance and firm value in the context of Islamic banking. This article proposes a framework for the highlighted issues and discusses the theory related to earnings management and corporate governance. The findings may plug in new contributions to the body of knowledge that bank value and governance are significant, especially in the setting where earnings management in Islamic banks is expected to be practiced.</i></p> <p><i>Keywords: Earnings, Management, Islamic, Banks, Firms Value.</i></p>
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INTRODUCTION

The detection of accounting manipulation, namely earnings management, is a subject that attracts significant attention from various interested parties. The stakeholders involved encompass investors, auditors, regulators, and specifically pertain to the banking sector, particularly Islamic banks. Earnings management is a deliberate strategy employed by company managers to manipulate financial outcomes, such as the income statement, statement of cash flows, and balance sheet. This manipulation is done with the intention of distorting the actual income and assets, deceiving certain stakeholders, or influencing contractual agreements (Healy & Wahlen, 1999; Degeorge et al., 1999; Leuz et al., 2003; Ronen et al., 2010; Ghosh, 2017). Because of that earnings management in one aspect is illegal activity as the results reported do not reflect economic reality.

On other means, earning management is known to be reasonable and legal for management decision-making and reporting, intent is to achieve stable and predictable financial results as long as it is appropriate with acceptable standards. The legitimate earnings management within the flexibility provided by the existing standards was also practiced and known to be accepted in the particular case (Degeorge et al., 1999; Jensen & Meckling, 1976; Dadbeh & Mogharebi, 2013; Goel, 2016; Muchoki, 2013). This intervention process by management in other terms, "cooking the books" seen to be the firms' strategic tool for optimizing firm value and reducing risk (Rahman et al., 2013; Akers et al., 2007; Al-thuneibat et al., 2016).

For Islamic Banks in particular, AAOIFI, (2022) mentioned the roles of internal shariah auditors to contribute among others to promote transparency and market control in accordance with the shariah regulations. The purpose for the reported performance is

on the actual fact truly reflecting the bank's condition The Quran has shown that any form of disguise, deception or attempt to distort fact means violates the principles of justice and equity on shariah (al-Quran. al-Nisa: 135; al-Mutaffifin: 1-3). Violation of compliance needs to be rectified. Thus, the shariah auditor could answer questions about any ethical issues. The quality of actual managerial performance is what as reflected in the financial result.

This study proposed a framework of corporate governance, and the firm value (we proposed the Islamic bank's value, addressing earning management behaviour that was expected. Thus, the next section will review literature related to and elaborate the theory and conceptual framework. Followed by a section that proposes the framework of this study highlighting the underlying theory of this study. Last but not least, the conclusion is included in the last section.

REVIEW OF LITERATURE

Earnings Management and Firms Value

Financial statements is important to provide a formal record of the financial transactions of an entity. The purpose of financial statements is to assist the user i.e. shareholders and potential investors, in making more informed decisions on how to allocate resources to stakeholders (IASB, 2018). The IASB, (2018) revised conceptual framework sets out the general objectives of financial reporting that conclude the presentation of the financial statements is a reflection of the firm characteristic and enable users to evaluate performance of management, capability to raise cash, and the risks that a business faces and how they may affect the entity (IASB, 2018).

Therefore managers will try to present financial reports by choosing the best accounting method or even manipulating financial report numbers for example earning management. Managing earnings or earning management is a mechanism by manager to change the financial for example, income statement and cash flow statement, or the reported balance sheet. Manager may alter actual income and assets in order to misinterpret the figures to stakeholders. Thus, within the constraints of accounting principles, an accountant can change earnings in a variety of ways. Unethical, but not always illegal, could be said.

The single most essential thing in financial statements is earnings, also known as "bottom line" or "net profits." They reflect the scope of activities to which the firm adds value. This is where management select choices for reporting of earnings. The recent Satyam saga or Enron in the past are prime examples of abuse of flexibility in selecting the accounting methods and treatments by the management. The management of earnings takes place when its management uses its discretion to record transactions and prepare financial statement for securing private gains (Goel, 2016).

Beatty, Ke, & Petroni, (2002); Burgstahler & Dichev, (1997); DeGeorge et al., (1999); Hamdi & Zarai, (2012) argued that changing figures of the earnings of the firms is to avoid losses, earnings declines, and to achieve analysts' earnings presumptions (Fields et al., 2001; Onalo et al., 2013). There have been many arguments about the linkage between the financing compositions and the firm value. On a conceptual perspective there has already been discussion about correlation between the level of debt with the valuation of an individual company. Every concepts about the equity financing composition has its own assessment of the effect on corporate value of equity compositions.

Firms Value, Management of the Firms and Ownership

Considering the agency principle, managers in high value organizations are having more corporate governance disclosure of information in order to determine their added value capability (Katarachia et al., 2017). As stated by the theory of the agency, there is a closed relationship on those managing business with those who owned on a basis of contract in enhancing business value (Jensen & Meckling, 1976). Conflicts between owner of business and manager is manageable as long as their interests are appropriate. However, there are

situations where your business objectives are not suitable and this can cause to conflicts of interest (Suttipun, 2018).

Shareholders hire managers because they have specified competencies that adhere the firm value. Managers cannot utilize their competency except they have some discretion in the alternative of their actions. Nevertheless, managers will optimize shareholder wealth if they met with appropriate incentives. In order for managers to adhere to their firm value, the managerial remuneration agreement must be formulated to improve their estimated return. Consequently, controlled managerial remuneration contract requirements promote the achievement goal of corporate value (Smith & Stulz, 1985).

As a consequence of the rewards distinction, the moral hazard problem, and the adverse selection issue, so that the impact of conflict of interest could enlarges agency expenses and decreases firm value. Beside of that, Healy and Palepu, (2001) explained that higher agency costs have an impact on lesser corporate liquidity, poor management credibility and greater capital costs (Suttipun, 2018). Jensen and Meckling, (1976) simultaneously argue that firm value is positively correlated with the level of managerial ownership because of reduced agency costs and increased alignment of interests between managers and shareholders (Mishra et al., 2001). Thus, factor of ownership differences of the firms need to be taken into considerations

Study done by Yeh, (2005) investigated how shareholder control affected firm value. Substantial shareholder is one of the determinants that shows ownership increases the market value of the companies. Type of ownership; government influences, or the powerful politician; globally owned firm affect firms oversights and control (Abdelsalam et al., 2016; Xu et al., 2012) Basically the classic owner-manager conflict discussed by Berle and Means (1929), and, Jensen and Meckling (1976) reveals that concentrated ownership should increase firm value by alleviating owner- manager conflicts of interest.

Thomsen and Pedersen (2000) additionally emphasis family ownership concentration is positively correlated with the success of the companies after adjusting for the industry, capital structure, and nationality of the enterprises (Alipour, 2013). While Din et al., (2021) discovered that institutional ownership significantly improves performance in which government shareholdings that help to boost corporate financial performance (Din et al., 2021).

Management, Corporate Governance, and Shariah Governance

Each firm have their own resources. The firm must maximize all of its resources. For that we need a mechanism to ensure firm resources are efficiently and effectively managed. Thus, mechanism to achieve good corporate governance are an honest, accountable and openness of the management of firms. Additionally, Information is publicly communicated, upholds charity, justice and fairness. Besides there is a partnership among boards and owners, together with the stakeholders (Ahmad & Omar, 2016).

Corporate governance addresses the proper management, direction, and control of businesses. Besides the shareholders, board of directors and management make up the most common structure for businesses, there are also another important structures; rules and procedures for decision-making purposes; rights and responsibilities of the various participants in the organization (such as the board, managers, shareholders, and other stakeholders); and how rights and responsibilities were given to those participants to achieve firms' objectives. Along these, risks are to be monitor and analyse as well as maximising the firm value (Almutairi & Quttainah, 2017). According to Ahmad & Omar, (2016), corporate governance recently expensively built with multi-faceted areas combining finance, accounting, law ethics and economics all at once. They highlighted based on Worlds bank special definition of corporate governance as "*... the set of rules and incentives by which the management of a company is directed and controlled....the way rights and responsibilities are distributed among the board, company management, shareholders and other stakeholders. However, while policies and documentation are of undeniable importance, these are not enough to ensure good governance. The actions of*

companies toward promoting corporate transparency and accountability speak louder than words ..." (Ahmad & Omar, 2016). Thus, this special definition emphasis diverse applications of the corporate governance.

Manager in the ordinary firms initially expected to have their own interest referring to the basic principal agent relationship. Shareholders known to be interested in reducing the discretionary funds for a better alignment between the interests of managers and those of the shareholders, to minimize the agency cost (Jensen & Meckling, 1976; E. F. Fama & French, 1998; Holthausen et al., 1995). While owners were financially attracted when given more influence over the firm's management. Those are known to be another corporate Governance mechanism in creating harmony between managers and shareholders. The interests of the shareholder are sustained at the same time reducing agency conflict (Alhazaimeh et al., 2014). Hence, the mechanism since earlier were discovered and the intentions were expected as the contractual arrangement. The aims are for aligning interests and reducing conflict (E. Fama & Jensen, 1983; Jensen & Meckling, 1976; Salehi et al., 2017).

An effective and efficient management control system can only be achieved if good corporate governance complies with the principles of shariah. General definition of corporate governance: *"the system by which companies are used to guide and manage businesses and controlled. The governance of their companies is the responsibility of the Board of Directors (BOD). The appointment of directors and auditors, as well as ensuring that the right framework is in place, are the shareholders' roles in governance."* This was put out by Sir Adrian Cadbury (1992), the UK's head of the Committee on the Financial Aspects of corporate governance. Furthermore, an effort toward this was seen through the issuance of the 2013 Islamic Financial Services Act and the establishment 1999 Auditing, Accounting Organisation of Islamic Financial Institution (AAOIFI).

In this regard, more regulatory enforcement of Banks to comply with Shariah and what is known as reformation of regulation of Islamic Financial Institutions (IFI) and capital markets was begun and it spread to not only in GCC countries but also to Philippines, Hong Kong, UK, and Singapore. There is an exigent need to conduct good shariah governance to secure the interests of entities and Islamic finance stakeholders, such as those involved directly in IFI business transactions. Those are IFI board, Shariah Advisors, depositors, shareholders, investors, and regulators. As Sori and Rashid, (2015) emphasized, poor management would influence market distortion and the capital market would become dry up, and the entire financial system would eventually bankrupt

The functions of Shariah Supervisory Board (SSB) is important towards managing the banking institutions. Asutay, (2007) stated that Islamic banking is not only wants to benefit internal stakeholders but also need to do so according to *Fiqh Muamalat*. Thus, SSB is an additional layer of governance and being an important mechanism to ensure all transactions conform shariah. The SSB need to be independent and perform as the second board to assure compliance with shariah in Islamic banks' transactions, more than general bank board of directors. CEOs and top managers should therefore provide SSB all necessity details to assist them in implementing shariah guidelines for financial and goods transactions. Additionally, SSBs give suggestions and recommendations, releases fatwas, interpretate rule and thus removes all doubt regarding all stakeholder's concerns (Almutairi & Quttainah, 2017).

Thus, the SSB as part of the corporate governance mechanism responsible for making sure the reliability of financial statements by observing, regulating, and assessing managers' strategy and firm practices that have an implications on all stakeholders, including society (E. F. Fama, 1980; Abdel-Fatah, 2008; E. Fama & Jensen, 1983; Habbash, 2016; Minnis & Sutherland, 2017). According to Abdelsalam et al., (2016) increased moral responsibility pressures on the managers of Islamic banks similarly as firms which are likely to result in reducing agency costs. Grassa & Matoussi, (2014) added clarity and honesty in any activity that focuses on equality with all stakeholders. They emphasis on

this aspect as main character that distinguishes shariah governance from conventional governance.

Supporting the above, monitoring, control, and evaluation are critical components of an efficiency and effectiveness banking operation, in particular the Islamic banking institutions. Monitoring is considered functional through intensive monitoring, information collection, and analysis; directing, coordinating, and supervising the bank's operations; handling their assets, goods, services, and transactions efficiently while conforming to shariah law that could be performed by the SSB as well as the bank's board of director. Those are in order to ascertain shariah conformance in terms of equity ownership, interest-free investment products, benefit-sharing contracts, and zakat transactions at the same time to improve managerial decision-making and performance (Shordt, 2000). Banks need to ensure that they adequately disclose their compliance with shariah in their annual report based on the current and historical events recorded that were compiled by the management (Bank Negara Malaysia, 2014; Bank Indonesia, 2013; Mohammed & Muhammed, 2017; Almutairi & Quttainah, 2017; Aliyu et al., 2017).

Hence, shariah governance in Islamic banking takes a part in forming the ethical behaviour of managers and it is the function of the SSB and Board of directors to fulfill it. The AAOFI as the regulatory mechanism via standards they gazetted emphasizes the need to audit and verify the financial transactions including ex-ante and ex-post activities (Moradi et al., 2017; Almutairi & Quttainah, 2017). Thus, enhanced integrity ensure openness, liability, honesty, fairness, and responsibility of the manager. Despite auditing proves to be an effective controlling mechanism in earnings management (Davidson, Stewart, & Kent, 2005; Lin et al., 2006; Abbott et al., 2007; Krishnan et al., 2011; Al-thuneibat et al., 2016; Othman, 2016; Khalid et al., 2017), cases that happened in conventional banking and difficulties in limiting the act of earnings management were subject to arguments among scholars.

An adequate mechanism of disclosing information that would encourage good corporate behaviour was to call for. The interest in building faithfulness and dedication among the various stakeholders involved in the organization was needed to avoid the earnings modifications to strengthen the credibility of their financial information (Leuz et al., 2003; Rogers, 2008; Jimoh & Iyoha, 2012; Al-thuneibat et al., 2016; Bidabad & Sherafati, 2017; La Porta et al., 2002). Thus, the Islamic law (shariah) is part of the religious rules to be complied with by shariah banks for shariah governance purposes in establishing standards in presenting financial statements ethically and restricting over the managerial decision-making in the earnings management practices (Almutairi & Quttainah, 2017).

UNDERPINNING THEORY AND PROPOSED FRAMEWORK

The Agency Theory

The agency theory appears from the shareholder-agent relationship. This is the basis of agency relationship proposed in the framework in which corporate governance issues generally raised. The agency idea that is first emerged is consistent with and understanding of shareholder hires the management (agent) due to shareholder's poor of experience and skills that are needed to manage the business (Ross, 1973; Michael C. Jensen & Meckling, 1976; Farhan et al., 2017).

Agency Theory argues that when managers are not owners of the entity that they lead or they have a low equity stake in it, their behaviour is influenced by self-interest that is far from goals of maximizing corporate value and, therefore, from the interest of shareholders. Thus, it will increase probability of earning management (Michael C. Jensen & Meckling, 1976; E. F. Fama, 1980; E. Fama & Jensen, 1983; Healy, 1985; Eisenhardt, 1989; Holthausen et al., 1995). The theory suggests that when managers are not adequately controlled, they will take advantage of the excess cash due to misalignment of the managers and the shareholders incentives (Dittmar & Mahrt-Smith, 2007; Brown et al.,

2005; Harford et al., 2008; Kalcheva & Lins, 2007; Pinkowitz et al., 2006). This attached behaviour of the managers who are indicated to waste the firms' resources such as cash reserves, reduce the value of the firm (Durnev & Kim, 2005; Frésard Laurent & Salva, 2010; La Porta et al., 2002). Such behaviour can be controlled by adopting the corporate governance provisions (Akhtar et al., 2018).

Firms in most of situations managed earnings through manipulating the accounting method in order to influence the user vision of the financial statement. Accounting principles contain different alternative treatments for the same situations that may manipulate financial information in order to look alike attract by provide spurious financial information which did not reflect reality (Goel, 2012; Muchoki, 2013; Iraya et al., 2015).

The Signalling Theory

The signalling theory is about financial informations, where the firm level might be manipulating the public expectation through earning announcements, dividend announcements, repurchase and merger and several other actions. Firms try to distinguish themselves from bad quality firms, using these actions (Zhao et al., 2004; Cheng, 2006). If the managers know they could influence investors through expectation to "control" the market, they might do something more to attain a benefit for themselves.

Ross (1977) shows how debt could be used as a costly signal to separate the good from the bad firms. Under the asymmetric information between management and investors, signals from firms are important to get financial resources. Ross assumes that managers (the insiders) know the true distribution of firm returns, but reverse with investors. Signalling of higher debt by managers indicates an optimistic future. In another way, this good firm can distinct itself by charming information while the bad firm would not do the same action (higher debt) because the bad firm doesn't want to be found (Zhao et al., 2004).

The Prospect Theory

The main assumption of prospect theory is loss aversion that result are evaluated as gains and losses depend on a reference point. the reference point is denoted by 0. Gains are money amounts larger than 0 and losses are money amounts smaller than 0. A gain prospect involves no losses and a loss prospect involves no gains. A mixed prospect involves both a gain and a loss (Abdellaoui et al., 2013). People are more sensitive to losses than to absolutely commensurate gains. There is considerable qualitative support for loss aversion (e.g., Camerer & Hogarth, 1999; Tom et al., 2007) and it is the key factor in explaining people's attitudes toward risk (Rabin, 2000).

In general, prospect theory posits four novel concepts in the framework of institutional risk preferences: institutions evaluate financial alternatives according to gains and losses and not according to final wealth (mental accounting); institutions are more averse to losses than they are attracted to gains (loss aversion); institutions are risk-seeking in the domain of losses, and risk-averse in the gains domain (asymmetric risk preference); and individuals evaluate extreme events in a sense of overestimating low probabilities and underestimating high probabilities (probability weighting function) (Kahneman & Tversky, 1979; Alam & Boon Tang, 2012). Most individuals make a combination of risk-seeking and risk-averting behavior when they get different return levels.

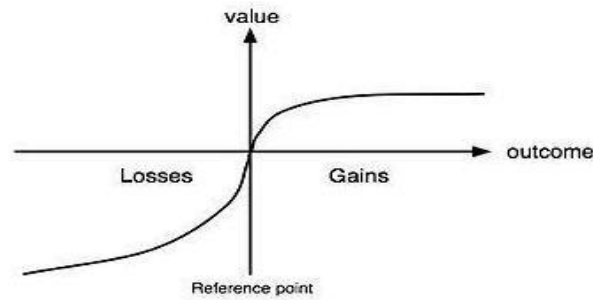


Figure 1: The Prospect Theory by Kahneman and Tversky, 1979)

Additionally, based on the figure 1 indicate that the risk-return trade off could adequately be described by prospective theory, i.e. Islamic banks with earnings higher than the earnings cut off point are risk averters, while those with earnings less than the earnings cut off point are risk seekers. The different level risk and return show that there are an asymmetric risk-return which are measured by the standard deviation of bank-standardized earnings (or changes in bank-standardized earnings). That is, we compute the mean of earnings numbers (it is called "return") and the standard deviation (it is called "risk") of standardized earnings numbers (as the difference between earning mean and earnings upper threshold).

Banks encounter multiple risk from agency conflict between depositors and banks, banks and borrowers, and banks and government policies such as investor protection, according to Diamond and Rajan (2005). Due to the existence of informational asymmetries, Islamic banks must specify a method of financing that maximizes their return whilst also reducing risk. One of the Islamic principles is justice for human society, which should be reflected in economic transaction processing by financial institutions distributing profit and loss without charging the borrower for the overall cost of losses. For that reason, owners must conduct a more thorough risk analysis and exercise greater control over the management's utilization financial resources. Consequently, management, acting as the owner's agent, should avoid activities that lead in asymmetric information because it has detailed information over how resources would be used (Mili & Abid, 2017).

Corporate Ownership Structure Theory

The structure of ownership of a company is an important tool in the corporate governance system (Perrini et al., 2008). This tool often resolve the conflict of interest that exists between the shareholders of a company and the managers of that company and give better firm value (Jensen & Meckling, 1976; Shleifer & Vishny, 1986; Filatotchev & Nakajima, 2010).

A. A. Berle and Means, (1932) for first time discovered an inverse association between the widespread distribution of shareholders and the successful operation of institutions. Demsetz and Lehn, (1985), who contended that there is not necessarily a systematic link between changes in ownership and company performance, questioned the findings of their study and suggested that such a relationship does not exist. Furthermore, they maintained that the concentration of ownership as an endogenous variable maximizes the wealth of shareholders. Meanwhile, individual objectives of the managers are taken into consideration in the decision-making process, and this may be in line with the problem of enhancing the earnings that are distributed to shareholders. Thus, from this theory perspective, ownership important to serve the foundations of good corporate governance and increase shareholder control effectively.

Based on the proposed model applying the theory above, the SSB expected to be another form of an independent board or second board to assure compliance with shariah in Islamic banks' transactions. SSB responsible for making sure of the reliability of

financial statements and expected to contribute to a strong corporate governance structure restrict over the managerial decision-making in earnings management practices as well having credibility of financial information and considered high value firms. Besides, characteristics of the banks also plays its role Thus the framework taking into consideration several characteristics namely asset growth (AG), capital adequacy (CAR), non performing financing (NPF) as well as ownership type of the banks especially considering Indonesian Islamic banks case.

PROPOSED FRAMEWORK

The framework as shown in figure 2 is developed to address the following whether earning management moderates the relationship between corporate governance and firm value, the Islamic bank characteristics, directly influence the value of the bank, and ownership directly influences the bank value. It is in line with the signaling theory that managers give information to shareholders on targeted performance aims by shareholders.

As mentioned in the agency theory, the conflict between the manager and shareholder will appear if the manager cannot meet the shareholder's expectation to increase their firm value. Furthermore, based on prospect theory, managers will take a safe position by modifying the financial statement figures when the company's performance shows a potential decline so that their performance appears to be good. The existence of a shariah supervisory board will supervise managers' policies in increasing the bank's value. The role of the shariah supervisory board will be weakened if managers still have the desire to modify financial statement figures.

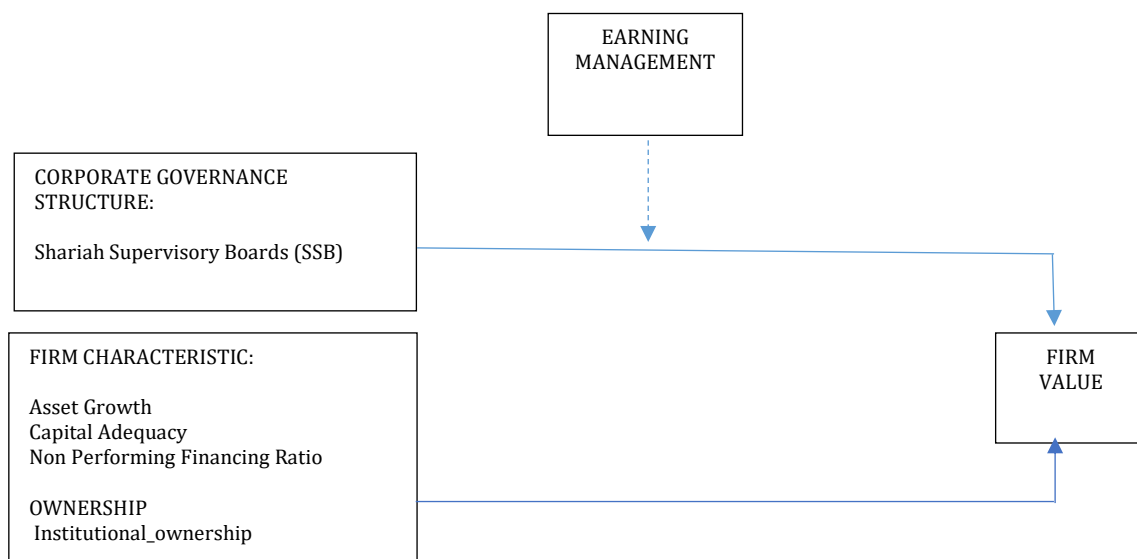


Figure 2: Research Framework

CONCLUSION

Examining the value, a relationship is expected to be moderated by an earnings management on banks governance. The framework proposed can be used as foundation in study on the corporate governance of Islamic banks, earning management and firms value. Concerning the cases highlighted in Indonesia (The controversial case happened such as in case PT Bank Lippo Tbk and case Bank Bukopin Tbk), management issuing double financial statements where the bank were penalise, and public accountant company Ernst and Young, Sarwoko and Sanjaya were also being penalise the in the form of fines as they are responsible for auditing Lippo Bank's Financial Statements for the period (Kurniawan, 2019; Rachman, 2018). It is anticipated that corporate governance mechanisms unique for Islamic banks, the SSB, is a significant factor which provides contribution to existing study.

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