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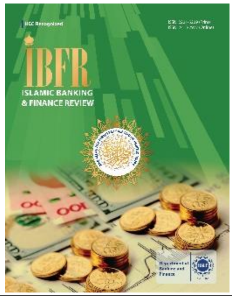

Title:	**A Critical Analysis of Earnings Management (EM): Role of Signal Theory in View of the Shariah's Primary Sources**
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A Critical Analysis of Earnings Management (EM): Role of Signal Theory in View of the *Shariah's* Primary Sources

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Abstract

Earnings Management (EM) is the manipulation of financial statements through different techniques. It is considered as an illegal act, although it is performed legally in a conventional financial system. The aim of this study is to critically evaluate EM in light of Quran and Hadith (the primary sources of the *Shariah*). Furthermore, this study critically examines the role of managers (who emit signals for their own benefit) as *wakeel* (agent), *amin* (custodian), and *shareek* (partner) from *Shariah* perspective. The findings revealed that EM, especially opportunistic signaling, is clearly prohibited by the primary sources of the *Shariah*. This behaviour distorts the true nature of the Islamic financial system, which is based on ethics. The managers who do so are involved in a lie, *khayanah*, theft and hypocrisy in partnership. These all are considered major sins in Islam.

Keywords: corporate governance, earnings management, Hadith, Quran, *Shariah,* signal theory

JEL Codes: G34, M41, Z12

Introduction

The main aim of a commercial enterprise is to make money. The owners of such an organization strive to make profit at the end of a financial year. Furthermore, they also want the financial statement of their organization to reflect its profitability. Financial statements are the only source of information for investors and creditors to make their investment decisions. Good financial statements attract investors because they intend to earn reasonable profit on their investments. Here, the concept of Earnings Management (EM) comes into play, which is currently debated in the financial world. It is difficult to identify a comprehensive definition of EM from the literature. According to Hill (2018), EM seems to be an illegal act which is performed legally.

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EM is the manipulation of financial information for different reasons. It has been defined variously by different authors. Scott (2015) argued that EM is the choice of managers, both in real activities and in making accounting policies, to achieve the predetermined objectives of the reported accounting earnings. EM is the intentional manipulation in financial statements by managers while remaining within the framework of the Accounting Standards, such as GAAP and IFRS, which is aimed to deceive the users of financial statements for private gain. To achieve these predetermined results and private gains, managers (insiders) apply different techniques and strategies. In the Corporate Governance (CG) literature, these strategies and techniques are explained and discussed as per the agency theory, the positive accounting theory, the entrenchment theory, the threshold management theory, and the signal theory (Mahjoub & Miloudi, 2015).

Information available about the performance of an organization is very important in view of financial markets. Within any organization there are a lot of imperfect information amongst all the stakeholders (Myers & Mjluf, 1984). Economic agents do not share all information with each other's. Due to this reason, managers are considered as the most authentic source of information about the future performance of an organization. They emit information which depicts the internal condition of the organization to the market and investors, occasionally. The act of emitting information by managers is called signal theory.

The signal theory is basically concerned with reducing information asymmetry between two parties. It was initially presented by Spence (1973) and developed afterwards by Ross (1977). He examined the relationship of investors and managers in the context of information asymmetry. Managers have the privilege of accessing internal information about the future prospects of an organization; therefore, they can use the earnings management technique to increase reported earnings. If the internal information is not available publicly, the market is dependent on the published results and the behavior of the managers for the formulation of its expectations (Aerts et al., 2013). So, the alignment of information by managers and market expectations can give a better choice to the investors (Sun et al., 2013). It is important to note that only those organizations that have future prospects and opportunities can emit signals to the investors and markets (Xue, 2004). Following the same strand of literature, Altamuro et al. (2005) reported that EM is used when the management intends to signal relevant information regarding the future performance of the organization.

Prior literature reported two types of signals: informational and opportunistic. Informational signals are circulated by those managers who want to show the real picture of the organization to enhance securities and to reduce information asymmetry between the capital market and investors. Organizations with future growth prospects use the technique of EM for depicting investment opportunities (Ahmed et al., 1999). On the other hand, opportunistic signals are given by managers who mislead the investors for personal gain at their cost. These signals emit false information about the performance of the organization to gain personal benefits, such as job security and maximization of wealth.

The major objective of this paper is to critically evaluate the signal theory using the primary sources of the *Shariah,* that is, the *Quran* and Hadith. Additionally, this paper also explains the role of managers (agents) in light of the *Shariah* with special reference to EM and signal theory.

Methodology of Research

This is a qualitative research because it evaluates the signal theory in light of the primary sources of the *Shariah*. We used the translation of the Holy Quran by Abdullah Yusuf Ali.

Critical Analysis of Earnings Management and Signal Theory from *Shariah* Perspective

Islam is a complete code of life where the economic life of a person (natural as well as juridical) is expressed in ethical terms.

In *Surah Taha,* the Almighty Allah (S.W.T) says,

لَهُۥ مَا فِي ٱلسَّمَٰوَٰتِ وَمَا فِي ٱلۡأَرۡضِ وَمَا بَيۡنَهُمَا وَمَا تَحۡتَ ٱلثَّرَىٰ[طه: 6]

"To Him belongs what is in the heavens and on earth, And all between them, And all beneath the soil"[1]

These verses of the Holy Quran reveal that the primary right on wealth belongs to the Almighty *Allah*. On the other side, Islam fully understands that economic life is an integral part of human existence. Therefore, wealth

[1] Al-Quran: 20-6

is considered as a blessing of Allah Almighty and documented as *khair* in the *Quran,*

يَسۡـَٔلُونَكَ مَاذَا يُنفِقُونَۖ قُلۡ مَآ أَنفَقۡتُم مِّنۡ خَيۡرٖ فَلِلۡوَٰلِدَيۡنِ وَٱلۡأَقۡرَبِينَ وَٱلۡيَتَٰمَىٰ وَٱلۡمَسَٰكِينِ وَٱبۡنِٱلسَّبِيلِۗ وَمَا
تَفۡعَلُواْ مِنۡ خَيۡرٖ فَإِنَّ ٱللَّهَ بِهِۦ عَلِيمٞ [البقرة: 215]

"They ask thee what they should spend (in charity). Say: Whatever ye spend that is good is for parents and kindred and orphans and those in want and for wayfarers. And whatever ye do that is good God knoweth it well."[2]

كُتِبَ عَلَيۡكُمۡ إِذَا حَضَرَ أَحَدَكُمُ ٱلۡمَوۡتُ إِن تَرَكَ خَيۡرًا ٱلۡوَصِيَّةُ لِلۡوَٰلِدَيۡنِ وَٱلۡأَقۡرَبِينَ بِٱلۡمَعۡرُوفِۖ حَقًّا عَلَى
ٱلۡمُتَّقِينَ١٨٠ [البقرة: 180]

"It is prescribed when death approaches any of you if he leave any goods that he make a bequest to parents and next of kin according to reasonable usage; this is due from the God-fearing."[3]

The above mentioned verses of the Holy Quran clearly mention that wealth is considered as *khair* (blessing) in the *Shariah*. Thus, earning wealth is an important part of the life of a human being. However, there are some ethics to be followed and certain prohibitions to be observed while earning wealth.

The first and the foremost obligation ordained by the Quran and Hadith is to earn from permissible (*halal*) sources. According to the Quran*,*

يَٰٓأَيُّهَا ٱلنَّاسُ كُلُواْ مِمَّا فِي ٱلۡأَرۡضِ حَلَٰلٗا طَيِّبٗا وَلَا تَتَّبِعُواْ خُطُوَٰتِ ٱلشَّيۡطَٰنِۚ إِنَّهُۥ لَكُمۡ عَدُوّٞ مُّبِينٌ١٦٨
[البقرة: 168]

"O ye people! eat of what is on earth lawful and good; and do not follow the footsteps of the evil one for he is to you an avowed enemy.*"*[4]

يَٰٓأَيُّهَا ٱلرُّسُلُ كُلُواْ مِنَ ٱلطَّيِّبَٰتِ وَٱعۡمَلُواْ صَٰلِحًاۖ إِنِّي بِمَا تَعۡمَلُونَ عَلِيمٞ٥١ [المؤمنون: 51]

"O ye apostles! enjoy (All) things good and pure, And work righteousness : For I am well-acquainted With (all) that ye do"[5]

Almighty Allah (S.W.T) tells His messengers to eat from the *halal* blessings of Allah. Earning *halal* is considered *ibadah* (worshiping *Allah*).

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[2] Al-Quran: 2-215
[3] Al-Quran: 2-180
[4] Al-Quran: 2-168
[5] Al-Quran: 23-51

A famous Hadith of the Prophet Muhammad ﷺprescribes “Abdullah (RA) narrates that Muhammad ﷺ said: "The seeking of a *halal* earning is the (next) *Fardh* (duty) after the *Fardh*.[6]" This Hadith shows the importance of *halal* earning in life where it is compulsory for every Muslim. However, earning from prohibited (*haram*) source is considered a major sin in the Islamic *Shariah*.

The question, however, arises as to the difference between *halal* and *haram* earnings. There has been extensive discourse in the Islamic literature to identify and acquire *halal* and desist from *haram*. As reflected from the aforementioned injunctions of the Quran and Sunnah, the Islamic 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.

Since EM is the manipulation of financial statements and it deceives the stakeholders by presenting the wrong information, therefore, it is considered as misrepresentation in general terms (Jalal et al., 2016). Lying or misrepresentation is considered a major sin in Islam. According to the Quran,

إِنَّمَا يَفْتَرِي ٱلْكَذِبَٱلَّذِينَ لَا يُؤْمِنُونَ بِـَٔايَٰتِ ٱللَّهِۖ وَأُوْلَٰٓئِكَ هُمُ ٱلْكَٰذِبُونَ[النحل: 105]

“It is those who believe not In the Signs of God, That forge falsehood: It is they who lie”[7]

يَٰٓأَيُّهَا ٱلَّذِينَ ءَامَنُواْ ٱتَّقُواْٱللَّهَ وَكُونُواْ مَعَ ٱلصَّٰدِقِينَ[التوبة: 119]

“O ye who believe! Fear God And be with those Who are true (in word and deed)”[8]

أَلَا لِلَّهِ ٱلدِّينُٱلْخَالِصُۚ وَٱلَّذِينَٱتَّخَذُواْ مِن دُونِهِۦٓ أَوْلِيَآءَ مَا نَعْبُدُهُمْ إِلَّا لِيُقَرِّبُونَآ إِلَى ٱللَّهِ زُلْفَىٰٓ إِنَّ ٱللَّهَ
يَحْكُمُ بَيْنَهُمْ فِي مَا هُمْ فِيهِ يَخْتَلِفُونَۗ إِنَّ ٱللَّهَ لَا يَهْدِي مَنْ هُوَ كَٰذِبٌ كَفَّارٌ [الزمر: 3]

Is it not to God That sincere devotion is due? But those who take for protectors other than God (say): “We only Serve them in order that They may bring us nearer To God.” Truly God will judge between

[6]Baihaqqi.
[7] Al-Quran: 16-105
[8] Al-Quran: 9-119

them In that wherein they differ. But God guides not Such as are false and ungrateful[9]

وَلَا تَلۡبِسُواْ ٱلۡحَقَّ بِٱلۡبَٰطِلِ وَتَكۡتُمُواْ ٱلۡحَقَّ وَأَنتُمۡ تَعۡلَمُونَ [البقرة: 42]

"And cover not Truth with falsehood nor conceal the Truth when ye know (what it is)"[10]

فَمَنۡ حَآجَّكَ فِيهِ مِنۢ بَعۡدِ مَا جَآءَكَ مِنَ ٱلۡعِلۡمِ فَقُلۡ تَعَالَوۡاْ نَدۡعُ أَبۡنَآءَنَا وَأَبۡنَآءَكُمۡ وَنِسَآءَنَا وَنِسَآءَكُمۡ
وَأَنفُسَنَا وَأَنفُسَكُمۡ ثُمَّ نَبۡتَهِلۡ فَنَجۡعَل لَّعۡنَتَ ٱللَّهِ عَلَى ٱلۡكَٰذِبِينَ[آل عمران: 61]

If anyone disputes in this matter with thee now after (full) knowledge hath come to thee say: "Come! let us gather together our sons and your sons our women and your women ourselves and yourselves: then let us earnestly pray and invoke the curse of God on those who lie![11]

وَيۡلٞ لِّكُلِّ أَفَّاكٍ أَثِيمٖ [الجاثية: 7]

"Woe to every sinful liar"[12]

وَيَدۡرَؤُاْ عَنۡهَا ٱلۡعَذَابَ أَن تَشۡهَدَ أَرۡبَعَ شَهَٰدَٰتِۭ بِٱللَّهِ إِنَّهُۥ لَمِنَ ٱلۡكَٰذِبِينَ[النور: 8]

"But it will prevent punishment from her if she gives four testimonies [swearing] by Allah that indeed, he is of the liars"[13]

All these verses of the Holy Quran declare 'lie' to be a major sin in Islam. Since EM is the manipulation of accounting presentation with the primary purpose of deceiving the stakeholders for the personal gains of the management, it is considered as a sinful and unethical behavior in light of the above verses. Being the owners of an organization, the shareholders must be aware about the real position of the company, regardless the company faces loss or earns profit. Prophet Muhammad ﷺ himself practiced trade and devised rules which provide guidance and prescribe for *halal* earnings through ethical and lawful means. According to a famous Hadith, "A truthful and trustworthy merchant is associated with the Prophets."[14]

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[9] Al-Quran: 39-3
[10] Al-Quran: 2-42
[11] Al-Quran: 3-61
[12] Al-Quran: 45-7
[13] Al-Quran: 24-8
[14]Al-Tirmidhi, No. 50.

In the continuation of being truthful, particularly in financial matters, the Prophet Muhammad ﷺ 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 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.[15]

Therefore, to receive the blessings of Allah (S.W.T), traders must be truthful in their transactions and nothing should be hidden from the parties involved. If the management of the company manipulates earnings for their personal benefits, then they misrepresent them to their stakeholders which is a major sin that deprives the business from the blessings of Allah (S.W.T).

Another major aspect of Islamic financial ideology is the concept of *amanah*. *Shariah* compliant businesses are mostly based on *musharakah* or *mudarabah* worldwide. These models implicate that a partner must take care of the interests of other partners. They are the trustees (*amen*) of each other's interests. According to the Quran,

وَلَا تَأۡكُلُوٓاْ أَمۡوَٰلَكُم بَيۡنَكُم بِٱلۡبَٰطِلِ وَتُدۡلُواْ بِهَآ إِلَى ٱلۡحُكَّامِ لِتَأۡكُلُواْ فَرِيقٗا مِّنۡ أَمۡوَٰلِ ٱلنَّاسِ بِٱلۡإِثۡمِ وَأَنتُمۡ تَعۡلَمُونَ١٨٨ [البقرة: 188]

> 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.[16]

It is clearly prohibited to acquire the wealth of others through unjust means. Using EM to fabricate the accounting results and signal it in published reports for personal benefits at the cost of shareholders, is clearly breach of trust (*khayanah*), which is contrary to the concept of *amanah* and a major sin in Islam. The word "unjustly" mentioned in the verses covers different unethical behaviors, such as theft, falsehood, and *khayanah*. The theme of this verse clearly contradicts EM and false signal theory.

[15] Al-Bukhari, No: 2079.
[16] Al-Quran: 2-188

Managers as *Wakeel* (Agent)

The managers of an organization act as the *wakeel* (agents) of the investors (principles) in the organization. Performing the act of *wakeel* is allowed from the *Shariah* perspective. The Holy Quran clearly says,

وَكَذَٰلِكَ بَعَثۡنَٰهُمۡ لِيَتَسَآءَلُواْ بَيۡنَهُمۡۚ قَالَ قَآئِلٞ مِّنۡهُمۡ كَمۡ لَبِثۡتُمۡۖ قَالُواْ لَبِثۡنَا يَوۡمًا أَوۡ بَعۡضَ يَوۡمٖۚ قَالُواْ رَبُّكُمۡ أَعۡلَمُ
بِمَا لَبِثۡتُمۡ فَٱبۡعَثُوٓاْ أَحَدَكُم بِوَرِقِكُمۡ هَٰذِهِۦٓ إِلَى ٱلۡمَدِينَةِ فَلۡيَنظُرۡ أَيُّهَآ أَزۡكَىٰ طَعَامٗا فَلۡيَأۡتِكُم بِرِزۡقٖ مِّنۡهُ
وَلۡيَتَلَطَّفۡ وَلَا يُشۡعِرَنَّ بِكُمۡ أَحَدًا [الكهف: 19]

> "Such (being their state), We raised them up (from sleep), That they might question Each other. Said one of them, "How long have ye stayed (here)?" They said, "We have stayed (Perhaps) a day, or part of a day." (At length) They (all) said, "God (alone) Knows best how long Ye have stayed here… Now send ye then one of you With this money of yours To the town: let him Find out which is the best Food (to be had) and bring some To you, that (ye may) Satisfy your hunger therewith: And let him behave With care and courtesy, And let him not inform Any one about you"17

Similarly, *wakalah* is allowed in the Hadith of Prophet Muhammad (S.A.W) and practiced by His companions. However, there are some obligations on a person who becomes *wakeel*.

A *wakeel* must take care of the general interest of the principal and deliver his services honestly. If the business faces loss due to the negligence and misappropriation of the *wakeel,* he is responsible to compensate for the losses of the principal because the principal is the actual owner of the business. EM emit false signals to the principals and other stakeholders of the businesses. These signals are emitted by the managers for their own benefits and it badly affects the true nature of *wakalah*.

Managers as *Amin* (Custodian)

Amanah literally means trust, honesty, loyalty, and faithfulness and the one who is trusted is called *amin*. The Prophet Muhammad (S.W.A) was called *amin* even during the times of *jahilayyah* (before Islam) because he was the most trustworthy and honest person amongst all. In *Shariah* compliant businesses, the managers act as *amin* because the principals trust

[17] Al-Quran: 18-19

them with their *maal* (wealth). The *Shariah* emphasizes the concept of *amanah*. The Holy Quran says,

يَٰٓأَيُّهَا ٱلَّذِينَ ءَامَنُواْ لَا تَخُونُواْ ٱللَّهَ وَٱلرَّسُولَ وَتَخُونُوٓاْ أَمَٰنَٰتِكُمۡ وَأَنتُمۡ تَعۡلَمُونَ [الأنفال: 27]

"O ye that believe! betray not the trust of God and the apostle nor misappropriate knowingly things entrusted to you."18

إِنَّ ٱللَّهَ يَأۡمُرُكُمۡ أَن تُؤَدُّواْ ٱلۡأَمَٰنَٰتِ إِلَىٰٓ أَهۡلِهَا وَإِذَا حَكَمۡتُم بَيۡنَ ٱلنَّاسِ أَن تَحۡكُمُواْ بِٱلۡعَدۡلِۚ إِنَّ ٱللَّهَ نِعِمَّا يَعِظُكُم بِهِۦٓۗ إِنَّ ٱللَّهَ كَانَ سَمِيعَۢا بَصِيرٗا [النساء: 58]

Allah doth command you to render back your trusts to those to whom they are due; and when ye judge between man and man that ye judge with justice: verily how excellent is the teaching which He giveth you! for God is He who heareth and seeth all things.19

قَالَتۡ إِحۡدَىٰهُمَا يَٰٓأَبَتِ ٱسۡتَـٔۡجِرۡهُۖ إِنَّ خَيۡرَ مَنِ ٱسۡتَـٔۡجَرۡتَ ٱلۡقَوِيُّ ٱلۡأَمِينُ[القصص: 26]

"One of the women said, "O my father, hire him. Indeed, the best one you can hire is the strong and the trustworthy."[20]

وَٱلَّذِينَ هُمۡ لِأَمَٰنَٰتِهِمۡ وَعَهۡدِهِمۡ رَٰعُونَ [المؤمنون: 8]

"And they who are to their trusts and their promises attentive"[21]

These verses clearly indicate that *amanah* is a very important concept in the *Shariah*. EM and circulating wrong information by emitting signals to the market is the opposite of the concept of *amanah* and it becomes *khayyanah*, which is a major sin. This act breeches the trust of the investors and principals and shake their confidence on the managers who are supposed to be the *amin* of their *maal*.

The prohibition of *khayanah* is clearly emphasized in the famous Hadith of the Prophet Muhammad (S.W.A) from Abd Allah ibn 'Amr ibn al-'As

Four characteristics constitute anyone who possesses them a sheer hypocrite (*Munafiq*), and anyone who possesses one of them possesses a characteristics of hypocrisy till he abandons it, when he talks he lies,

[18] Al-Quran: 8-27
[19] Al-Quran: 4-58
[20] Al-Quran: 28-26
[21] Al-Quran: 23-8

when he makes a promise he violates it, when he makes a covenant he acts treacherously, and when he quarrels, he deviates from the Truth.[22]

This *Hadith* is closely related to EM and *khayanah.* The first part is regarding lie and EM is considered as a lie, while the third part of the *Hadith* is about *khayanah*. Both of these acts are performed by managers for their own benefits, which brings them very close to hypocrisy.

Manager as *Shareek* (Partner)

Sometimes, the managers of an organization become *shareek* (partners) with the consent of *Rab ul Maal* (principals). This is an ideal situation in Islamic finance because Allah Almighty encourages *shirkah* (partnership). According to a famous Hadith-e-Qudsi "that He (Allah) will become a partner in a business between two *Musharik* (partners) so long as they do not indulge in cheating or breach of trust (*Khiyanah*)." This Hadith clearly indicates that Allah (S.W.T) becomes a partner in the business if the partners carry out the business according to the *Shariah* norms and ethics.

If the managers are involved in opportunistic EM using signal theory or any other techniques of EM, then this is cheating. This act not only eliminates *barkah* (partnership of Allah) from the partnership but also involves the managers in fraud and lies, which are great sins.

Legal Effects of Earnings Management (EM) on Islamic Contracts

The main elements of Islamic contracts, in general, are the capability of the partners, free consent of the partners, and freedom from fraud and misrepresentations. The act of opportunistic EM is considered as misrepresentation, especially EM through circulating false signals raises questions about the legality of the contracts. The managers who act as *wakeel, ameen,* and *shareek* must perform their assigned duties honestly up to the best of their abilities. Any act of dishonesty or circulating false information badly affects the trust and interest of actual owners (*rab ul maal*), which is against the true nature of Islamic contracts.

Conclusion

Earnings Management (EM) is the manipulation of financial statements for different internal and external reasons. Managers, who are considered the

[22]Sahih al-Bukhari 34 In-book reference : Book 2, Hadith 27 USC-MSA web (English) reference : Vol. 1, Book 2, Hadith 34

insiders of the organization, emit signals to the outsiders, that is, the investors and other stakeholders. These signals are mainly emitted for two reasons. Firstly, it is to show the true picture of the organization. Secondly, they emit false signals for their own benefits. This behavior of the managers is clearly prohibited in Islam.

Manipulation of accounting results through emitting false signals or other EM techniques to the market is considered as a lie, which is a major sin from the *Shariah* perspective. Managers act as the *wakeel* (agents) of shareholders and other stakeholders of the organization, while they also act as the *amin* of their investments. Sometimes, they also act as *shareek* (partners) in the organization. Thus, the status of being a *wakeel, ameen,* or *shareek* bind the managers to different *Shariah* obligations. Gaining personal benefits at the cost of their investors, principals, and partners by circulating false information clearly involves them in fraud, *khayanah,* and lie, which are great sins and makes them hypocrites and answerable to the Almighty *Allah*.

Future Research Directions

Empirical studies are needed to evaluate the intentions of the signals emitted from the managers to the market to know that either these signals are opportunistic or informational in character. Furthermore, evaluating more theories of E M would also be beneficial from the *Shariah* perspective.

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