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Managerial Entrenchment through Earnings Management: A Critical Analysis in the Light of *Shariah* and Ethics

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Abstract

The managers of commercial organizations often seek to obtain the shares of their organizations in order to benefit both monetarily and non-monetarily, a phenomenon known as managerial entrenchment. This involves possessing both shareholding and employment positions simultaneously within the organization. It may be achieved through various means and techniques; one of these is known as earnings management (EM). This study aims to critically examine the practice of managerial entrenchment through EM in light of Islamic jurisprudence and ethics. The current evaluation is based on the primary sources of the *Shariah* and contemporary *fiqh*. It was found that this practice often violates *Shariah* law and ethical principles. Employment and shareholding within an organization are permissible according to some interpretations of Hanbali and contemporary Hanafi *fiqh* but only with certain prerequisites. Managerial entrenchment through EM often fails to meet these prerequisites. It may result in lying, misrepresentation, and unjust acquisition of wealth. Therefore, it is necessary to control the trend of EM and managerial entrenchment in order to prevent ethical violations and maintain ethical business practices.

Keywords**:** critical analysis, earnings management (EM), managerial entrenchment, *Shariah* principles, shareholders

Introduction

Managers act as agents of a company's shareholders. They are appointed to carry out specific tasks on their behalf. They are vested with decision-making powers to facilitate the company's smooth operation (Fama, 2008). To enhance their discretion and job security, managers may engage in entrenchment techniques, manipulating the corporate governance system to

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gain benefits that could potentially harm shareholders' interests (Berger et al., 1997). These benefits encompass both financial and non-financial rewards, such as cash remuneration, stock options, bonuses, fame, and job security. According to Weisbach (1988),

"Managerial entrenchment occurs when managers gain so much power that they are able to use the firm to further their own interests rather than the interests of shareholders."

Morck et al. (1988) proposed the managerial entrenchment theory, which posits that agents pursue personal gains at the expense of other stakeholders. As such, managers subvert internal and external control mechanisms of the company to expand their discretionary latitude. Increased power and discretion make them indispensable and hard to replace. Managers may also gain other non-financial rewards from entrenchment activities. Moreover, this discretionary power can also be utilized to obtain cash remuneration and equity bonuses. In the agency theory, Jensen and Meckling (1976) referred to this opportunistic behavior as 'moral hazard'.

Recent literature has expanded on the concept of managerial entrenchment and its impact on various stakeholders. For instance, Zhao and Wu (2018) suggested that entrenched managers may engage in short-termism, prioritizing their own interests over the long-term health of the company. Similarly, Kang and Kim (2020) found that managerial entrenchment negatively affects firm value and operating performance. Moreover, some studies explored the role of corporate governance mechanisms in mitigating the negative effects of managerial entrenchment. For instance, Achleitner et al. (2021) argued that independent boards and higher ownership concentration can help reduce the entrenchment behavior of managers.

The major technique used by managers for entrenchment is to obtain the equity of the organization. For this purpose, they utilize different techniques (Morck et al., 1988). The manipulation of financial statements is called earnings management (EM) in corporate governance and accounting literature. Through EM, managers manipulate the earnings of the organization in its published financial statements. They deliberately report reduced earnings which ultimately reduces the stock price value of the organization in the capital market. This is because decision-making by investors mainly depends upon the published financial statements and analysts' forecasts. The agents take advantage of this self-created situation and purchase shares at cheap prices. Empirical literature also proves that EM is used for managerial entrenchment (enhancing the share percentage of managers) in organizations (Klein, 2002; García-Sánchez et al., 2020).

Capitalism promotes free market strategies and has no concern with religion, rather it is concerned with profit and loss making. Therefore, the conventional literature regarding managerial entrenchment is also based on gains and losses, as well as value maximization and minimization of firms. It explicates two schools of thought. The first strand of literature postulates that agency conflict and moral hazards arise due to the separation of ownership and control. For example, Jensen and Meckling (1976) argued that managerial ownership in the firm aligns the interest of managers with shareholders. They believed that a certain percentage of managerial ownership makes managers more concerned about the consequences of their decisions and actions on their investments. Thus, a certain percentage of managerial ownership enhances the firm's value. They also posited that managerial ownership limits the managers from benefiting from their position in the firm. Hence, they may not expropriate the wealth of other stakeholders. It also prevents them from obtaining private gains. Rather, it ensures that their decisions and actions enhance the value of other shareholders as well. They called it *"the hypothesis of the convergence of interests"*.

Later on, the above hypothesis of Jensen and Meckling (1976) was strongly criticized by Fama and Jensen (1983). They argued that managerial ownership has adverse effects on firm value and shareholders' interests because it increases agency costs. They also argued that instead of controlling the opportunistic behaviour of managers, this may even increase their opportunism. Managerial entrenchment and obtaining a higher percentage of the capital gives managers more powers and discretion to neutralize the internal and external control mechanisms and thus, they can easily expropriate other shareholders' interests. Following the same strand of literature, Morck et al. (1988) argued that managerial entrenchment allows managers to enhance their private gains, instead of enhancing shareholders' wealth. However, they also affirmed that managerial entrenchment is important for the job security of the managers. If the shareholders are dispersed in large numbers and the management holds some portion of shareholdings, then being insiders they enjoy the privilege of accessing internal information about the organization, which can be used for opportunistic acts. In this regard, Farhina (2003) argued that even a small portion of shareholdings in large firms leads managers to deploy opportunistic strategies for private gains.

Both strands of literature, that is, either against managerial entrenchment or in its favor, demonstrate strong empirical evidence. However, they remain inconclusive regarding whether managerial entrenchment is good or bad for shareholders. Similarly, discussion about the use of the EM technique to carry out managerial entrenchment also remains inconclusive. Hence, this study aims to critically evaluate the relationship between EM and managerial entrenchment in light of the *Shariah*. Specifically, the managerial entrenchment theory expounded by Jensen and Meckling (1976) has not been evaluated from the *Shariah* point of view, which is practiced by the managers for entrenchment. So, this theory is evaluated in this study based on the primary sources of the *Shariah* and contemporary *Fiqh*.

Earnings Management (EM) and Islamic Jurisprudence

Islamic ethical principles uphold the significance of conducting honorable and upright business activities. In instances where individuals are incapable of managing their own businesses due to varying reasons, they can appoint agents to represent them through the establishment of an agency contract warranted in Islamic jurisprudence. The legitimacy of an agency contract is subject to specific prerequisites and requirements. In essence, the relationship between managers and shareholders mirrors the nature of an agency contract, as managers function as agents on behalf of the shareholders (Khadim et al., 2021).

EM, being a specific act, comprises the manipulation of financial statements by managers for different reasons. The fabrication of financial statements hides the actual and real position of the firm. The management of the firms increases or decreases the earnings in their published financial statements, according to their specific requirements. EM by managers keeps the actual owners in the dark regarding their investments. They deceive the shareholders by presenting them with false information through manipulated financial statements which can harm them. This is because most shareholders plan the future of their investments on the basis of these financial statements. The act of EM raises questions about managers' integrity regarding their agency contract with the principals because agency contract binds them to work for their interest. EM is the breach of contract by managers. Islam strictly prohibits the breach of contract. The Holy Quran emphasizes the fulfilment of promises many times. According to the Quran,

"وَأَوْفُوا بِالْعَهْدِ ۖ إِنَّ الْعَهْدَ كَانَ مَسْئُولًا"

"and fulfill (Every) engagement, For (every) engagement Will be enquired."[1]

Similarly,

"بَلَىٰ مَنْ أَوْفَىٰ بِعَهْدِهِ وَاتَّقَىٰ فَإِنَّ اللَّـهَ يُحِبُّ الْمُتَّقِينَ"

***"**Nay. Those that keep their plighted faith and act aright verily God loves those who act aright**."*[2]

It is the obligatory duty of every Muslim to fulfil their promises. When they enter into a contract, it must not be breached. The Prophet Muhammad (P.B.U.H) also emphasized the fulfilment of promises. In this regard, a famous *Hadith* narrated by Ali Ibne Abi Taalib (RA) reports that Prophet Muhammad (P.B.U.H) said,

"Whoever breaks the covenant of a Muslim, upon him be the curse of Allah, the angels and all the people, and Allah will not accept any obligatory or naafil act of worship from him."[3]

Thus, involvement in EM is a breach of the covenant for which the managers get their remunerations as the agents of the shareholders.

Similarly, EM is also the misrepresentation of financial statements which is against telling the truth. False financial statements and their propagation constitutes unethical and unaccepted behaviour of the managers. The prohibition of lie has been documented in the primary sources of the *Shariah* many times and declared as a major sin. In this regard, the Holy Quran says

"وَلَا تَلْبِسُوا الْحَقَّ بِالْبَاطِلِ وَتَكْتُمُوا الْحَقَّ وَأَنْتُمْ تَعْلَمُونَ"

"*And do not mix the truth with falsehood or conceal the truth while you know [it].*"[4]

[1] Al-Quran 17:34
[2] Al-Quran 3:76
[3]Al-Bukhari, 1870; Muslim, 1370.
[4] Al-Quran- 2:42

EM is the concealment of truth; it is the replacement of truth by falsehood. Therefore, the managers involved in EM commit the major sin of lying. The Holy Quran declares,

"وَيْلٌ لِكُلِّ أَفَّاكٍ أَثِيمٍ"

"*Woe to every sinful liar.*"[5]

Cheating behaviour of the partners in business is also prohibited by the Prophet Muhammad (P.B.U.H). According to a famous Hadith,

"Allah Sunhan-o-Tallah has declared that He will become a partner in a business between two Mushariks until they indulge in cheating or breach of trust."[6]

EM is the breach of trust and constitutes a lie which is a prohibited act, prohibited by the primary sources of the *Shariah*. Hence, it is important to control this act. The purpose for which EM is performed by managers might be different.

Managerial Entrenchment through Earnings Management (EM) and Islamic Jurisprudence

As discussed in the previous section, EM is the manipulation of accounting results. Hence, it is considered a lie and a breach of contract. While, managerial entrenchment is obtaining the shares of the organization based on this lie. The Holy Quran strictly prohibits this kind of cheating behavior. Almighty Allah says in the Holy Quran,

" وَلَا تَأْكُلُوا أَمْوَالَكُمْ بَيْنَكُمْ بِالْبَاطِلِ وَتُدْلُوا بِهَا إِلَى الْحُكَّامِ لِتَأْكُلُوا فَرِيقًا مِنْ أَمْوَالِ النَّاسِ بِالْإِثْمِ وَأَنْتُمْ تَعْلَمُونَ"

> *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].*[7]

Obtaining shares through EM comprises the unjust consumption of shareholders' wealth. In fact, managerial ownership of shares harms the interests of the existing shareholders. Specifically, manipulating financial

[5] Al-Quran- 45:7
[6] Abu Dawood- 3374
[7] Al-Quran- 2:188

statements to reduce share prices amounts to deliberately lowering asset prices which is cheating.

Another major issue from the perspective of Islamic jurisprudence in this case is simultaneously keeping the employment and shareholdings of the same organization. Getting a salary while being a partner of the organization at the same time is prohibited in Islamic jurisprudence. Three major schools of thought namely *Hanafi, Shafi', and Maliki* opine that the salary of the partner is prohibited and unlawful. Although, there is no *Hadith* which prohibits explicitly the partner from getting a salary, these schools of thought argue for this prohibition based on four famous *Ahadith* in the *Sunnah* literature. These *Ahadith* emphasize some restrictions regarding financial transactions and contracts. Firstly, the combination of the contract of sale and loan is prohibited.[8] Secondly, the two contracts into one transaction are prohibited.[9] Thirdly, two transactions are also prohibited into one transaction.[10] Fourthly and finally, conditional sale is also prohibited as per Islamic jurisprudence. Based on these four prohibitions, most schools of thought in Islamic *fiqh* prohibit keeping shareholdings and employment contract at the same time because it becomes a combination of agency contract (employment) and partnership contract.

The *Hanbali* school of thought allows employment and partnership at the same time, subject to some restrictions. These restrictions include the condition that both the contracts (employment and partnership) remain separate and are not dependent on each other. The salary of the employee/partner remains in lieu of work and cannot be included as a fixed percentage of the profit. Similarly, the nature of employment must be different from the routine work of the partner. The salary of the employee would be *Ujrat Ul Misl* (market-based salary). The contemporary *Hanafi* scholar Mufti Rashid Ahmad Ludyanwi permits the employment of a partner in *Sharkit Ul Milk*.[11]

In the current scenario, the stocks of the listed companies are floated on the stock exchange and it is easy for anyone to purchase or sell these stocks. Hence, it is very common for the employees to purchase the shares of the

[8]Mauwatta Imam Malik- Vol 2. No.657
[9]Mauwatta Imam Malik- Vol 2. No.663
[10]Musnad Imam Ahmad- Vol 1, No. 198
[11]Ahsan Al Fatawa- 7:321

company. Conversely, the current shareholders may obtain employment in the company, therefore, it has become a common practice. Based on the rule for common practice, Mufti Rashid Ahmad Ludyuanwi permits the viewpoint of *Hanbali fiqh* in this regard.[12] *Shaikh Ul Islam* Mufti Taqi Usmani affirms that adopting the rulings of other *fiqh* is permissible occasionally on the basis of specific or general needs. Furthermore, there is no *Hadith* which prohibits employment and shareholding at the same time, specifically. The prohibition is based on the combination of two transactions as one transaction.[13] Therefore, it can be considered on the basis of these *fatawa* (rulings) that employment and shareholdings are conditionally accepted in the *Hanafi fiqh* by contemporary scholars due to contemporary needs and the structure of modern commercial organizations.

Managerial entrenchment is obtaining the shares of the organization mainly for two reasons. The first is to enhance their monetary benefits. While, the second is to gain more discretionary powers in the organization. It has been discussed that obtaining shares through EM is obtaining the wealth of others through unjust means which is *haram* in the *Shariah*. Obtaining monetary benefits via employment based on shareholdings is a violation of the *Shariah*. In this regard, permissibility is only granted if the contracts of employment and shareholdings remain separate. The partnership contract gives undue benefits to the managers or employees which is against the rule of permissibility, since it can harm the interest of other shareholders. Similarly, obtaining monetary benefits, which is more than *Ujrat Ul Misl,* is also against the permissibility of employment and shareholdings at the same time, since it ties remunerations with shareholdings. Similarly, enhancing discretionary powers and job security based on managerial entrenchment is purely the use of one contract to strengthen the other. This practice ties both the contracts and hence remains illegal in Islamic jurisprudence. This act shows the opportunistic behaviour of the managers which is considered an illegal and punishable act in light of the *Shariah*.

Similarly, managerial entrenchment specifically achieved through EM is also against Islamic business/work ethics. The work/business ethics were documented by Beekun (1997) and later on by Abbasi et al. (2012). These include sincerity, proficiency, justice, truthfulness, patience, and promise

[12] Ahsan Al Fatawa- 7:328
[13] Sunal Al Termidhi- 1231

keeping. These work/business ethics have been derived from the primary sources of the *Shariah.* It is a proven fact that there is no room for dishonesty, as well as deceiving and opportunistic behaviour in Islam. Managerial opportunism through EM contradicts each one of these ethics documented in the prior literature.

There is a conditional permissibility of employment and shareholdings in *Hanbali* and the contemporary *Hanafi fiqh.* However, these conditions are not followed in managerial entrenchment through EM. Specifically,

- "The contract of employment and shareholdings will be independent and separate". Through managerial entrenchment, managers entrench themselves or their employment based on shareholdings; therefore, these contracts do not remain independent and separate.
- "The employment and its remuneration must be in lieu of work and not merely a means to earn fixed profit". A major aim of managerial entrenchment is to obtain more discretion and job security on the basis of shareholdings, rather than in lieu of work.
- "The salary and remunerations of a shareholder-employee must be based on Ujrat Ul Misl." While, in managerial entrenchment, managers enhance their discretion and the power to increase their monetary benefits.

Therefore, managerial entrenchment, specifically obtained through EM, is a violation of the three conditions of permissibility. Hence, contemporary *Hanafi fiqh* considers it to be an illegal act and against Islamic work/business ethics.

Conclusion

A distinct contrast exists between the conventional and Islamic financial systems. The conventional financial system is grounded in the free market system. Hence, it operates without the influence of any religious considerations. While, Islamic financial system is entirely grounded in the *Shariah* principles. This system leaves no room for falsification, deceit, dishonesty, and misrepresentation to stockholders. These acts in business activities are considered as major sins. Consequently, this system is built upon the ethical standards of proficiency, truth, keeping promises, justice, sincerity, and patience.

Earnings management (EM), which is the manipulation of financial statements, is generally considered a lie. It is also considered against the ethical standards of the *Shariah*. It might be legal in the conventional financial system if it is within the accounting standards. However, Islam does not allow this kind of behavior. Hence, obtaining shares of the organization by applying EM techniques is obtaining the wealth of others through lies and misrepresentation and it remains *haram*. The *Hanbali* and the contemporary *Hanafi fiqh* allow shareholdings and employment at the same time with certain conditions. However, managerial entrenchment through EM violates each of these conditions because the major aim of managerial entrenchment is to gain greater discretionary powers and monetary benefits for the managers. Therefore, EM generally and managerial entrenchment through EM specifically can be considered illegal and need to be controlled by the authorities. For further study, empirical investigation is needed to determine the association between managerial remunerations and managerial entrenchment. Furthermore, an association between managerial entrenchment and job security, fame, and discretionary power is also suggested in this study.

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