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Islamic Business Ethics Disclosure and Earnings Management – Evidence from Islamic Banks in Indonesia

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Abstract

This research is conducted to prove empirically the influence of Islamic business ethics disclosure, corporate governance, debt ratio, *syirkah* fund ratio and the profile of the Shariah Supervisory Board (SSB) towards earnings management. The samples are collected from Islamic commercial banks in Indonesia. Multiple regression analyses are employed in analyzing the data. From this research, it is found that (i) corporate governance, (ii) temporary *syirkah* funds, (iii) the size and educational level of the SSB, (iv) the *syirkah* fund ratio, and (v) the Islamic Ethics Disclosure Index or IEDI have negative impacts towards earnings management. The debt ratio, educational background of the members of SSB, and double membership of SSB do not have an impact on earnings management. Thus, the SSB should oversee the implementation of Islamic business ethics and avoid earnings management. Earnings management creates a false view of the performance of the Islamic bank, with respect to its profit and loss sharing system.

Keywords: Corporate Governance, Islamic Business Ethics, Temporary *Syirkah* Fund, Earnings Management.

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1. Introduction

The Law No. 21 of 2008 states that an Islamic bank is a bank that runs its business activities according to the principles of *Shari'ah*. The principles of *Shari'ah* are taken as the Islamic law that is used for banking activities. This is according to the *fatwa* (religious decree) issued by the agencies that have the authority to adjudicate *Shari'ah* matters. Based on the principles of *Shari'ah*, there are several principles that must be complied by an Islamic bank. One of such principles is transparency.

The principle of transparency is an indicator that is frequently discussed in researches. Such indicators are earnings management, earnings quality, and the implementation of accounting standards. Earnings management is in conflict with the principle of transparency which emphasizes on the openness of information for stakeholders. Previous studies relating to earnings management in Islamic banking produced different findings (Mersni and Othman, 2016). Taktak *et al.* (2011) found that Islamic banks are proven to have performed earnings management. Meanwhile, Quttainah *et al.* (2011) stated that earnings management practices are not performed by Islamic banks. Studies that were done relating to Islamic banking in Indonesia also produced different findings. Faradila and Cahyati (2013), and Padmantyo (2010) found that Islamic banks are proven to have performed earnings management. Utami (2010) generated a contrast finding, where it is found that Islamic banking in Indonesia does not perform earnings management.

Earnings management does not conform to Islamic law (Hamdi and Zarai, 2014). Earnings management is defined as the use of judgement in financial reports, and the arrangement of transactions to change the financial reports. Consequently, they may mislead the stakeholders about the economic performance of the company, or to affect contractual outcomes that depend on accounting (Healy and Wahlen, 1999). The emphasis of earnings management is opportunistic action, which is viewed as immoral and prohibited in Islam (Hamdi and Zarai, 2014). Normala *et al.* (2011) explained that earnings management is identified as the manipulation of financial reports by managers and it is unethical. This is due to the reason that the manipulation of financial reports provides false information to owners, bankers, and investors; and

provides unfair returns to the owners (Normala *et al.*, 2011).

Earnings management is the effect of agency's conflict. Agency's conflict could be reduced by good corporate governance or GCG (Farooq and Chetioui, 2012). Hamdi and Zarai (2014); Nasev *et al.* (2012); Shah *et al.* (2009); Farooq and Chetioui (2012), and Neffati *et al.* (2011) found that the implementation of corporate governance or CG has decreased the manager's opportunity to perform earning management. Another factor that affects managers in doing earnings management is the financial condition of companies that uses a lot of external funds rather than internal funds. Obtaining external funds is the trigger for management to improve its performance. Financial statements that are profitable will increase investors' confidence in the company's performance. Rastgoo *et al.* (2013); Nejad *et al.* (2012); and Ardison *et al.* (2012) have found that a leverage has an influence on the earnings management. In the context of *Shari'ah* entities, external funding sources can come from debt and temporary *syirkah* funds. Thus, there is a potential for debt and temporary circulation funds to affect the earnings management.

The novelty of this research in comparison to previous researches is that this research uses (as a variable) the special characteristics of the governance of Islamic banks. This includes the variable of the *Shari'ah* Supervisory Board or SSBs' profiles that revealed the effectiveness of the various SSBs. Each SSB's profile is measured by the number of its members, their educational level and background, and the double position of the SSB in another company. The other new variables adopted in this research are (i) Islamic ethics disclosure, and (ii) the *syirkah* fund ratio. Based on previous researchers, such as Mersni and Othman, (2016), they used the size and competence of the SSB as a variable in measuring the SSB. Taktak *et al.*, (2011) did not use the SSB in predicting earnings management by Islamic banks. Meanwhile Quttainah *et al.*, (2011) used the size, interlock and SSB's membership of the Accounting, Auditing Organization for Islamic Financial Institutions or AAOIFI to determine the SSBs' variable, and relate it to the earnings management by Islamic banks. In addition, different from previous studies, this study uses the temporary *Shari'ah* fund ratio as a factor that causes earnings management.

This research is conducted to prove empirically the influence of Islamic business ethics disclosure, corporate governance, debt ratio, *syirkah* fund ratio and the profile of the *Shari'ah* Supervisory Board (SSB) towards earnings management. This research is necessary because researches that dealing with earnings management, and special characteristics of Islamic banking are limited, especially in the context of Islamic banking in Indonesia. Therefore, an analysis that relates with the special characteristics of Islamic banks is necessary because Islamic banks and conventional banks have differences in terms of their principles, implementation and corporate governance (Syafii *et al.*, 2012).

2. Stewardship Theory

The stewardship theory explains that managers forgo their own interests and act responsibly with their companies' assets on behalf of their stakeholders. The manager is the servant of the company's owners. The manager is there to manage corporate matters on behalf of and in alignment with the objectives of the owners (principal) (Hamid, 2011; Pepper and Gore, 2012; Slyke, 2006). Management's interests are satisfied when the owners are satisfied by the provision of incentives that match their performances.

The agency theory assumes that management prioritizes its own interests instead of the interests of the company's owners. The assumption is that the sense of ownership of the management is diffused (Donaldson and Davis, 1991). This diffused sense of ownership causes divided interests. In the agency theory, the manager is called the agent and the owner is called the principal. In harmonizing the interests of the manager and owner, agency costs are required (Donaldson and Davis, 1991). To satisfy the interests of the manager, it is possible for the manager to alter the financial reports so they reflect the interests of the manager. This false financial reporting is aimed at generating the incentives desired by the manager. This falsifying of financial reporting is called as earnings management.

3. Earnings Management

Hamdi and Zarai (2014) explained that earnings management can be seen from two perspectives, which are efficient earnings from the management perspective and the opportunistic earnings of management perspective. Meanwhile, Sugiri (1998) divided the definition of earnings management into two, i.e. the narrow definition and the wide definition. In the narrow definition, earnings management is defined as a management action that uses several standard methods. One of which is called discretionary accruals in determining the amount of profits. The wide definition of earnings management is an action by the manager to increase or decrease the currently reported profits of a business unit that the manager is responsible for, without causing an increase or decrease in the long-term economic profitability of the unit.

Managers perform earnings management for the following reasons: (i) to increase the confidence of the shareholders in the manager; (ii) to improve relations with creditors; (iii) to attract investors to invest, especially for companies that go public during their initial public offerings or IPO (Sutami, 2012). Several studies reported that 77% of senior managers have performed unethical actions in large companies and earnings management is a main factor in many scandals (Normala *et al.*, 2011). However, other opinions state that earning management is included in unethical actions depending on the situation and conditions. Dayanandan *et al.* (2012) argued that dominant ethical perception in decision making about earnings management rather than personal characteristics. According to Scott (2003) in Rachmawati (2010), earnings management patterns are performed by “taking a bath”, income minimalization, income maximization, and income or profit smoothing.

Meanwhile, the accrual models as referred by Belkaoui (2004) in Rachmawati (2010) are: (i) the total accruals model which includes the balance sheet approach and cash flow approach; and (ii) the discretionary accruals models or abnormal accruals, i.e. free and unregulated accruals acknowledgement and it is at the management’s discretion. Abnormal accruals involve subtracting the non-discretionary accruals from the total accruals. These measurements for detecting earnings management generated various research findings (Mersni and Othman, 2016). This is because researchers could use different measurements to detect earnings management.

4. The Development of Hypotheses

Corporate Governance (CG) is a corporate management concept that is necessary to ensure that rights of all the stakeholders of a company are satisfied. The operation of complex companies separates the owners from the management. This separation can allow the management to prioritise its own interests (agency problem). An indication that the management prioritises its own interests is the occurrence of earnings management. Firms with better corporate governance mechanisms experience has fewer agency problems and have better corporate performance (Farooq and Chetioui, 2012). Corporate governance is the concept used by all the stakeholders to determine the direction and performance of their businesses (Choudhury and Alam, 2013).

Based on the agency theory’s perspective and asymmetry information, CG is required to guarantee the stakeholders’ interests. CG is a concept that can decrease agency costs by ensuring that the corporate mechanism can guarantee that the management work effectively and efficiently (Choudhury and Alam, 2013), and it can decrease any opportunistic management actions (Mersni and Othman, 2016). Developed mechanisms include both internal mechanisms (internal monitoring, such as an internal audit) and external mechanisms (external monitoring, such as external auditors, independent Board of Directors (BOD), etc). Therefore, corporate governance can increase the effectiveness of the business and avoid earnings management by reducing the agency conflict (Mersni and Othman, (2016); Jensen and Meckling, 1976). Therefore, it can be concluded that CG has a negative impact on earnings management.

Several studies have proven the relationship of CG to earnings management, such as works done by Hamdi and Zarai (2014); Nasev *et al.* (2012); Shah *et al.* (2009); and Farooq and Chetioui (2012). Neffati *et al.* (2011) found that the implementation of CG can decrease the risks, and decrease earnings management. Meanwhile, Nasev *et al.* (2012) found that CG implemented in Korean companies does not affect earnings

management.

One reason for a manager to undertake earnings management is a funding structure that is dominated by debt. Companies seek loans to increase their performance. Good performance increases the ability of a company to repay its debt. On contrary, bad performance would make it seem that the company would not be able to repay its debts, and would make it difficult to obtain further funding. Therefore, the funding structure of a bank may cause earnings management.

One main characteristic of Islamic banks is that they have two sources of funding, which are equity based (*Mudharabah* and *Musyarakah*) and debt based (*Murabahah, Salam,* and *Istishna'*). A consequence of the source of funding is that the bank must repay its debts and returns (such as margin of *Murabahah* and etc.) if the bank uses debt-based financing. If the bank uses equity-based financing, the bank has no obligation to repay the funding that the bank received (capital and return). In *Mudharabah* and *Musyarakah* transactions, the risk of any investment is only on the investor's side (customers). Profits derived from *Mudharabah* funds are shared by the two parties (bank and customer) according to a predetermined profit-sharing ratio. While in the event of losses, all the losses must be borne by the financier (customer) (Bacha, 1997).

Sutami (2012) stated that one benefit a bank gains from performing earnings management is it increases the confidence of its creditors. Banks with high leverage are much more interested in maintaining investor confidence than banks that have lower leverage. The assurance of its investors' confidence would prevent the accepted credit from being withdrawn. Zanjirdar and Vakilifard (2013) stated that the management would have to perform earnings management so that their company is viewed as a profitable company that able to pay its debts and interest in full. This will allow it to continue seeking credit at low interest rates. Several studies performed by Rastgoo *et al.* (2013); Nejad *et al.* (2012); and Ardison *et al.* (2012) have proven empirically that the amount of debt (leverage) positively affects earnings management. Furthermore, the amount of debt (leverage) positively influences the quality of the profits (Press *et al.*, 2011). Therefore, it can be concluded that the level of leverage would affect earnings management (Ardison *et al.*, 2012; Nejad *et al.*, 2012; Rastgoo *et al.*, 2013; Rahmani and Akbari, 2013).

The concept of funding based on profit sharing means that the amount of return payments by a company to its creditors cannot be determined in a fixed manner. This is because it depends on the realised profits and losses of the company. If the company shows large profits, the return paid by the company is also large. On the contrary, if the realised company operations generated a poor performance, then the amount of profit sharing paid by the company also reduces. In Islamic banking, fund resources that use a profit-sharing system are *Mudharabah* savings and deposits products.

Mudharabah is a contract between the capital provider (*Shohibul Maal*) and a skilled entrepreneur whereby the capital provider would contribute a capital to an enterprise or activity, which is to be managed by the entrepreneur as the *Mudharib* (or labour provider) (Hamdi and Zarai, 2014). Profits generated by that enterprise or activity are shared in accordance with the terms of the *Mudharabah* agreement (profit-and-loss sharing). In the context of *Mudharabah* savings and deposits products, the bank acts as the *Mudharib* and its customers are the *Shohibul Maal.* This means that the bank's management might perform earnings management if they desire to show the profit sharing return due to be paid by the bank to its creditors is either large or small, depending on the motivation of the management.

The ratio of funding based on the profit-sharing system to the total funding is related to the level of the bank's funding (financing risk). Financing risk is defined as the higher probability of losses from the higher funding costs and the smaller level of funds owned by the bank. A rational manager would attempt to reduce this financing risk by reducing the profit share paid to the bank's creditors. However, if the amount of profit sharing paid by the bank to its creditors is less than they expect or desire, this could cause funds to be withdrawn from the bank by the creditors. This would increase the financing risk by reducing the funding received by the bank which in turn would reduce the bank's opportunities to expand.

There are not many researchers that done studies on the relationship between the financing risk and earnings management. However, there are studies into a similar subject as done by Mohamed *et al.* (2013). They found that Islamic banks performed earnings management when they determined the *nisbah* for profit

sharing. This is done to maintain the competitiveness of the profit share as given by the bank to its clients and in order to decrease the risk of funds which are being withdrawn by their clients. Based on Indonesian Islamic accounting standards, the funding resources that use a profit sharing system must report this on the balance sheet as part of a temporary *syirkah* fund (Institute of Indonesia Chartered Accountant, 2017).

Other than Good Corporate Governance (GCG), other factors that may affect earnings management relates to SSBs. Islamic banking is a version of a banking system that uses Islamic law as its operational basis. Banks must appoint a *Shari'ah* Supervisory Board to ensure that a bank's operations comply with Islamic law. AAOFI said that an SSB is defined as an independent body of specialised jurists in *Fiqh al-Mu'amalat* (Islamic commercial jurisprudence) (Kasim *et al.*, 2013). The SSB is required to ensure that the bank operates according to Islamic law and satisfies the ethical needs of the bank's customers (Abu-tapanjeh, 2009). The role of the SSB is similar to that of someone undertaking an internal audit (Mersni and Othman, 2016). This is because the SSB also has the obligation to assess the compliance of the bank's operations with Islamic law. Earnings management is an action that does not conform to Islamic law (Normala *et al.*, 2011). The presence of a *Shari'ah* Supervisory Board can prevent earnings management (Hamdi and Zarai, 2014; Mersni and Othman, 2016). Moreover, Quttainah *et al.* (2011) said that religious supervisory boards provide tighter monitoring and control and increase Islamic banks profitability as measured from their return on assets, return on equity and asset growth.

Unlike earlier studies, this study used the profile of the SSBs as the predictor of earnings management. The profile that the researchers developed here is related to the number of persons on a board, their educational background, education level, and the average of their double membership of the SSB. AAOIFI describes that the main responsibility of an SSB is to provide direction, guidance and supervision related to the activities of the Islamic financial institution, and to ensure that the Islamic bank is in compliance with *Shari'ah*'s rules and principles (Kasim *et al.*, 2013). This research was developed according to the idea that the size of SSB, the education level and educational background (of the SSB's members) are SSB internal factors that could affect the effectiveness of the SSB's performance. Furthermore, the greater numbers of SSBs with double membership in several institutions would also affect the SSBs' performances.

The ethical values developed by the company is another factor that is considered in this study in order to project possible earnings management. Several previous studies have shown that ethical values have a significant impact on performance (Zaki *et al.*, 2014; Jo and Kim, 2008). Paredes and Wheatley (2017) believed that the culture developed by the company should be accessed before the performance of the company can be analysed. Therefore, the company's culture would affect (i) honest, (ii) fair, and (iii) familial performance of the company. Some scholars also agreed that earnings management is an unethical action (Mohamed *et al.*, 2013; Mersni and Othman, 2016; Normala *et al.*, 2011). The practice of earnings management has raised a concern on the importance of ethics in the accounting profession (Merchant and Rockness, 1994).

Several researchers have connected ethical values to earnings management (Merchant and Rockness, 1994; Rahman *et al.*, 2005; Hamdi and Zarai, 2014; Kaplan, 2001) and earning quality (Ghodrati *et al.*, 2013; Romano and Onesti, 2016). The company's performance and earnings management are the result of its employees' behaviour. Thus, they cannot be separated from ethics (Romano and Onesti, 2016). The company's performance is measured and interpreted from its overall firm's performance (such as from earnings quality, return on assets (ROA) and return on equity (ROE)).

From Islamic perspective, Rahman *et al.* (2005) have tested the difference in earnings management performed by Muslim managers and non-Muslim managers in companies that are registered at the Kuala Lumpur Stock Exchange. The use of difference in religious backgrounds is highly reasonable because one of major factors in culture is religion. This reason was also used by Hamdi and Zarai (2014) who found that the implementation of Islamic ethics can prevent earnings management.

The measurement of a company's culture used in this study is the disclosure ethics index adopted from previous studies done by Zaki *et al.* (2014); Rahman *et al.* (2014), and Normala *et al.* (2011). Based on the above discussion, the researchers come out with these relevant hypotheses:

H_1: Corporate governance has a negative influence on earnings management.
H_2: Debt ratio has a positive influence on earnings management.
H_3: The temporary *syirkah* fund ratio has an impact on earnings management.
H_4: The SSB's size has a negative influence on earnings management.
H_5: The level of education of the SSB's members has a negative influence on earnings management.
H_6: The educational background of the SSB's members has a negative influence on earnings management.
H_7: Double membership of an SSB has a negative influence on earnings management.
H_8: The Islamic ethics disclosure index has a negative effect on earnings management

5. Research Methods

The population in this study is taken from Islamic banks in Indonesia. The sample was determined by using the purposive sampling where the samples were selected if they matched specific criteria. These are taken from Islamic banks that issued financial reports, annual reports, and a GCG implementation report based on an observation period from years of 2009 to 2016. The variables used are measured with the following formulas:

(a) GCG implementation is measured according to the GCG Disclosure Index. It is based on the disclosure scores of all disclosures as stipulated in the Regulation of Bank Indonesia No. 11/33/PBI/2009 (OJK, 2019). The score was determined by giving zero points if there is no information or explanation in the report. One point is given if the report has some explanation or information but incomplete. Two points are given if the report has a complete explanation (that includes pictures, tables, and diagrams) which provides a qualitative and quantitative explanation.

$$GCGDI = \frac{The\ score}{Maximum\ scores} x\ 100\%$$

(b) The *Shari'ah* Supervisory Board's profile must have (i) the number of SSB members, (ii) the number of *Shari'ah* entities that each board member belongs to (double position), (iii) the educational level of the SSB's members, and (iv) their educational background.

(c) The size of the SSB is determined by referring to PBI No. 11/33/PBI/2009 (OJK, 2019). They must be at least two people or 50% out of the number of directors, and with maximum number of three people. The following is the measurement for each variable used in measuring the *Shari'ah* Supervisory Board's profile:

$$Size\ of\ SSB = \frac{Number\ of\ SSB\ Members}{Maximal\ number\ of\ SSB\ members} x\ 100\%$$

(d) The SSB members' educational level is given three points if the member has a doctorate. Two points are given if she or he has a master's degree, and one point is given if she or he has a bachelor's degree or lower. We developed this indicator from studies of Farook *et al.* (2011), and Rahman *et al.* (2013).

(e) The SSB members' educational backgrounds are also considered. The SSB member will be given three points if she or he is a graduate in Islamic economics. Two points are given if she or he is a graduate with economics or *fiqih*, and one point is given if she or he has a different educational background. The educational level and background indicators would be measured as a percentage, by totalling all the scores and dividing this with the maximum score.

$$Averages\ of\ double\ membership\ of\ SSB = \frac{Total\ number\ of\ double\ membership\ of\ SSB}{(Maximum\ membership\ of\ SSB)} x\ 100\%$$

(f) The Islamic Ethics Disclosure Index (IEDI) is based on disclosure scores of all the disclosures. It is modified from previous studies done by Zaki *et al.* (2014), and Haniffa and Hudaib (2007). The score is set to be zero points if there is no information or explanation in the report. One point is given if the report has some explanation or information but incomplete. Two points are given if the report has a complete explanation (that includes pictures, tables, and diagrams) that provides a qualitative and quantitative explanation. These indicators are vision and mission statement; BODs and top management; product and services; *Zakah*, charity, and benevolent loans; commitments toward employees, debtors, and society; and SSB (Haniffa and Hudaib, 2007).

$$IEDI = \frac{The\ score}{Maximum\ number\ of\ scores} x100\%$$

(g) Leverage is measured from the debt ratio (total debt against assets) and *syirkah* funds ratio (total *syirkah* funds against assets).

(h) Earnings management refers to the Modified Jones Model adopted in the studies of Rastgoo *et al.* (2013), i.e. by calculating the difference between the Total Accrual (TA) and the Non-Discretionary Accrual (NDA). TA is calculated with the following formula:

$$TA_{it} = (\Delta CA_{it} - \Delta CL_{it} - \Delta CASH_{it} + \Delta STD_{it} - \Delta DEP_{it}$$

NDA is calculated with the following formula:

$$NDA_{it} = \alpha_i \left(\frac{1}{A_{it-1}}\right) + \alpha_2 \left(\Delta REV_{it} - \frac{\Delta REC_{it}}{A_{it-1}}\right) + \alpha_3 \left(\frac{PPE}{A_{it-1}}\right)$$

Description:

ΔCA = change in current assets
ΔCL = change in current debt
ΔCASH = change in cash
ΔSTD = change in long-term debt
ΔDEP = change in assets amortisation assets
A = asset
ΔREV = change in net profit
ΔREC = change in accounts receivable
ΔPPE = change in fixed assets

In accordance with the measurement data of the above variables, the researchers can see that all variables have ratio data. Hence, the appropriate analytical tool that can be used is a multiple regression analysis. Testing of the hypotheses was performed when the model is fine where it passes the classical assumption test. Hypotheses testing were performed by conducting a double regression analysis. This means that each hypothesis testing was performed by looking at the significance of the relations between the independent variable and the dependent variable, both partially and simultaneously. H_a is accepted if the significance level value is less than 0.05 or 0.10.

6. Results

The descriptive statistics for the variables used in the researchers' estimation between 2009 to 2016 is provided in Table 1.0 as follows.

Table 1.0: Descriptive Analysis

	N	Minimum	Maximum	Mean	Std. Deviation
Earning Management	138	-5.8E+13	9.67E+12	5.62E+11	7.38831E+12

Corporate Governance Index	138	0.00	1.00	0.7285	0.24862
Debt Ratio	138	0.03	0.33	0.1675	0.07001
Syirkah Fund Ratio	138	0.32	0.81	0.6808	0.09298
Size of SSB	138	2.00	3.00	2.4058	0.49283
Education Level of SSB	138	1.33	4.50	2.4662	0.55630
Background Field Education of SSB	138	1.00	4.50	2.4710	0.68524
Double Membership of SSB	138	1.00	5.50	2.9227	0.95630
Islamic Ethics Disclosure	138	0.00	0.75	0.4774	0.19921
Valid N (listwise)	138				

The results of the hypotheses testing were obtained by looking at the significance of the test results, both partially and simultaneously. Partial testing was performed to describe the relations between each independent variable and dependent variable. Simultaneous testing of each hypothesis was performed to describe the overall relations between independent variables used in this study and the dependent variable.

Table 2.0: Decision to Accept / Reject Hypothesis

Hypothesis	**Beta**	**Sig**	**Decision**
H_1: Corporate governance has negative influences on earnings management	-0.695	0.000	H_a accepted
H_2: Debt ratio has a positive influence on earnings management	0.159	0.151	H_a rejected
H_3: *Syirkah* fund ratio has a positive influence on earnings management	0.224	0.003	H_a accepted
H_4: SSB's size has a negative influence on earnings management	-0.730	0.000	H_a accepted
H_5: Education of the members of a SSB has a negative influence on earnings management	-0.245	0.002	H_a accepted
H_6: Education background of the members of a SSB has a negative influence on earnings management	0.039	0.729	H_a rejected
H_7: Double membership of a SSB has a negative influence on earnings management	-0.064	0.397	H_a rejected
H_8: Islamic Ethics Disclosure Index has a negative influence on earnings management	-0.828	0.000	H_a accepted

By referring to Table 2.0, there are five hypotheses accepted with a significance level of 5%, and three rejected hypotheses. The accepted hypotheses have significance values of less than 5%, while the rejected hypotheses have significance values of more than 5%.

Based on the findings, the above study results show that GCG's implementation, which is measured using the GCG Disclosure Index, has a negative impact and significance on earnings management. This means that the better the GCG's implementation is; the smaller the chance of the management performing earnings management is. GCG can decrease agency conflict (Jensen and Meckling, 1976), which may control management's opportunistic actions (Mersni and Othman, 2016).

In the concept of GCG, banks are required to have a management model that provides a guarantee to the stakeholders' interests in the bank. The board's commissioner (as the owner's representative) is supposed to conduct management oversight as well. There is an independent commissioner among the bank's commissioners. The independent commissioner cannot be a member of the owner's family. It is necessary to ensure the interests of stakeholders including investors, communities, and the government. Banks are also required to have audit committees and other sections. The Board of Commissioners and the Audit Committee

have a duty to advise and supervise the director. Furthermore, GCG can increase the effectiveness of monitoring which will minimise risks (Neffati *et al.* 2011). This study supports previous studies as done by Shah *et al.* (2009); Mersni and Othman (2016); Hamdi and Zarai (2014); and Neffati *et al.* (2011).

It is proven that the debt ratio does not affect the director in performing earnings management. This study was not in line with previous researches that were done by Ardison *et al.,* (2008); Rastgoo *et al.* (2013); and Nejad *et al.* (2012). Many researchers believe that companies that have high leverage will make an effort to beautify the appearance of their financial statements with earnings management. This effort aims to increase the creditor's trust with the bank. A company that has high leverage will increase its creditors' monitoring (Ardison *et al.*, 2012). The creditors will be evaluating the capital and credit returns of loans as already disbursed.

However, the results of this study indicate that such leverage does not affect earnings management. This is because Islamic banks have three types of funding structures which are: (i) debts, (ii) *syirkah* funds, and (iii) equity. In this study, the researchers referred to Islamic banks that have largest funding sources, such as temporary *syirkah* funds. The amount of average debt payments received by Islamic banks is only 16.75%. This is contrary to a research done by Rastgoo *et al.* (2013) which they had only a leverage level of 62.5%.

The largest funding source of Islamic banks is the funding received from *syirkah* funds, i.e. at 68.08%. This means that the banks' management prioritizes the confidence of the owners of the *syirkah* funds over the confidence of the owners of the debt funds. This is proven in various studies' results, which show significant and negative relations between the ratio of temporary *syirkah* funds to assets and earnings management. This means that when the ratio of temporary *syirkah* funds is small, a bank's management could have performed earnings management, and on the other hand, the management would not have performed earnings management if the temporary *syirkah* funds are plentiful.

Other findings from this study are related to the relations of the profile of the SSB against earnings management. This study found that the number of members of an SSB has a significant effect and negative relation to earnings management. The earnings management behaviour is regarded as an act that cannot be justified. The SSB has the function to provide consultation and supervision of their company's operations to ensure that they comply with *Shari'ah* (Farook *et al.*, 2011). Whereas earnings management is an action that is not in accordance with Islamic law (Obid and Demikha, 2012; Hamdi and Zarai, 2014). Thus, SSB has a duty to supervise the management when they perform earnings management. In conducting this supervision, an increase in the number of members of an SSB will increase their effectiveness in carrying out their duties. These findings are supported by the findings of Quttainah *et al.* (2011), and Hamdi and Zarai (2014) who found that the number of members of an SSB is a significant factor in decreasing the risk of earnings management.

This study found that there is a significant and negative relationship between the educational level of the SSB's members and earnings management. It means that the average level education of an SSB could reduce earnings management. The education level of an SSB can affect its effectiveness in performing its duties. These results are in accordance with the study of Farook *et al.* (2011). It was found that the ratio of the members of an SSB who have a doctorate has an impact on its social performance. An SSB should function in a similar manner to an external auditor Farook *et al.* (2011), but the audit object of an SSB is its bank's compliance with Islamic law, including earnings management. These findings are compliant with the findings of Quttainah *et al.* (2011) and Hamdi and Zarai (2014), who found that the competence of an SSB's members is a significant factor in decreasing the earnings management risks.

The educational background of an SSB does not affect earnings management. Having a background in Islamic economics does not mean the practice of earnings management will be reduced or stopped. Earnings management is an action related to the measurement, and recognition, of both the earnings and income of the bank. The field of education that understands earnings management is accounting. Managers manage earnings through their choice of accounting policies, their accounting judgment, and their selection of operating decisions (Merchant and Rockness, 1994). An education in Islamic economics provides a limited knowledge and understanding of the practice of earnings management. Nevertheless, the members of an SSB

that have a background in Islamic economics can improve the social performance of the bank, as revealed by researches of Indrawaty and Wardayanti (2016), and Farook *et al.* (2011).

There is no significant relation between double membership of SSBs with earnings management. In Indonesia, the National *Shari'ah* Board of Indonesia allows the members of SSB to also become members of a maximum of five other supervisory bodies. The National *Shari'ah* Board of Indonesia believes that an SSB's member, who also joins five other supervisory bodies, will not reduce the effectiveness of the SSB in performing its duties.

The Islamic Ethics Disclosure Index (IEDI) is statistically proven to have a significant and positive effect on earnings management. This finding supports the developed theory, i.e. the action of earnings management is an unethical action (Mersni and Othman, 2016; Normala *et al*., 2011). This is because earnings management activities can mislead the users of financial statements and sometimes act as a trigger for more serious, illegal (fraudulent reporting) activities (Merchant and Rockness, 1994). Consequently, a company that has a good ethical culture would not perform earnings management.

It is essential that ethics are required to minimize the potential of earnings management practices. Merchant and Rockness (1994) mentioned that earnings management practices raises the need for ethics in the accounting profession. A form of ethics that could reduce earnings management is Islamic ethics. Islam emphasizes honesty and fair disclosure in financial statements so as not to mislead the stakeholders. The results of this study are supported by Mohamed *et al.* (2013) who found that Islamic ethical standards influence the possibility of unethical opportunistic earnings management.

7. Conclusion

This study has given empirical support that proper monitoring (internal and external) is negatively correlated with the performance of earnings management by managers. Monitoring can be performed by the implementation of GCG and supervision by the SSB. The effectiveness of an SSB in overseeing earnings management is influenced by its number of members and their level of education. Furthermore, the implementation of a corporate culture would generate ethical values that support accountability, honesty, and familiarity, so that earnings management actions can also be minimized. Earnings management is unethical, so it can be eliminated by the implementation of a good ethical system, especially Islamic ethics.

An external factor that can affect earnings management is the percentage of temporary *syirkah* funds. It is because funds originating from *syirkah* funds are the main funding source for Islamic banks and high levels of *syirkah* funds will lead to greater observation from investors, in relation to the bank's performance. This study uses variables that measure according to the rules developed by the researcher. Therefore, these research findings are limited in terms of the measurement variable, and the population studies used. Measurement variables, found using other methods, are highly recommended for subsequent researchers, so that the research material concerning earnings management in Islamic banks becomes more varied. Besides, the ethical disclosure uses Islamic ethics disclosure, which can be obtained directly from bank statements. It is recommended that further studies be conducted with different approaches and perspectives, to gain a deeper analysis.

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