EL DINAR: Jurnal Keuangan dan Perbankan Syariah
Volume 12, No. 2, Tahun 2024
E ISSN: 2622-0083

EARNINGS MANAGEMENT AND PERFORMANCE: SHARIA VIS-A-VIS NON-SHARIA FIRMS

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Abstract

Earnings management and firm performance are crucial issues in corporate governance, particularly in contexts where ethical considerations intersect with financial practices. This study addresses a research gap by comparing earnings management practices and performance between Sharia and non-Sharia firms in Indonesia, a country with a majority Muslim population. The study analyzes data from firms listed on the Indonesia Stock Exchange during the 2015–2021 period, comprising 2,247 observations. Using independent t-tests, the findings reveal that Sharia firms engage in significantly lower earnings management compared to non-Sharia firms. Furthermore, Sharia firms demonstrate superior performance metrics. These results highlight the potential advantages of adopting Sharia-based governance principles, suggesting that such practices contribute to higher-quality financial reporting and improved firm performance. The study underscores the importance of integrating Sharia values into corporate governance frameworks to enhance ethical and financial outcomes.

Keywords*: Earnings Management; Firm Performance; Sharia Firms*

Abstrak

Manajemen laba dan kinerja perusahaan merupakan isu penting dalam tata kelola perusahaan, khususnya dalam konteks di mana pertimbangan etika berinteraksi dengan praktik keuangan. Penelitian ini meneliti praktik manajemen laba dan kinerja antara perusahaan berbasis Syariah dan non-Syariah di Indonesia, sebuah negara dengan mayoritas penduduk Muslim. Penelitian ini menganalisis data dari perusahaan yang terdaftar di Bursa Efek Indonesia selama periode 2015–2021, yang mencakup 2.247 observasi. Menggunakan uji t independen, temuan menunjukkan bahwa perusahaan berbasis Syariah melakukan manajemen laba yang secara signifikan lebih rendah dibandingkan dengan perusahaan non-Syariah. Selain itu, perusahaan berbasis Syariah menunjukkan metrik kinerja yang lebih unggul. Hasil-hasil ini menyoroti potensi keuntungan dari penerapan prinsip-prinsip tata kelola berbasis Syariah, yang menunjukkan bahwa praktik tersebut berkontribusi pada pelaporan keuangan yang lebih berkualitas dan kinerja perusahaan yang lebih baik. Penelitian ini menekankan pentingnya mengintegrasikan nilai-nilai Syariah dalam kerangka tata kelola perusahaan untuk meningkatkan hasil etika dan keuangan.

Kata kunci: Manajemen Laba; Kinerja Perusahaan; Perusahaan Syariah

INTRODUCTION

In recent decades, the study of corporate religiosity has garnered significant attention in financial research, particularly concerning irregularities in financial reporting (see Grullon et al., 2010; Dyreng et al., 2012; McGuire et al., 2012; Chen et al., 2013; Du et al., 2015; Cai et al., 2019; Alsaadi, 2019). This focus arises from recurring instances of earnings manipulation by management. For example, in Indonesia, high-profile cases such as PT Garuda in 2019 (Utami & Kartikasari, 2020) and PT Jiwaseraya in early 2020 (Monica et al., 2023) highlight the prevalence of such unethical practices.

Earnings management is widely regarded as immoral and unethical, as it distorts financial information, rendering it an inaccurate reflection of a firm's actual performance (Abdullah, 2013; Kusuma, 2023). It is also considered a form of fraudulent financial reporting (Kassem, 2012). Since morality is inherently tied to religion, which provides ethical frameworks to guide behavior, religious principles can play a pivotal role in discouraging unethical practices such as earnings manipulation (Conroy & Emerson, 2004; Longenecker et al., 2004; Hilary & Hui, 2009). Consequently, robust governance frameworks that emphasize moral and ethical considerations are essential in ensuring integrity within corporate activities.

Empirical evidence consistently demonstrates that religiosity can mitigate financial statement irregularities (Dyreng et al., 2012; McGuire et al., 2012; Chen et al., 2013; Du et al., 2015; Abdelsalam et al., 2016; Montenegro, 2017; Cai et al., 2019. Researchers have employed diverse methodologies to measure religiosity, such as analyzing regions with high religious adherence to evaluate the influence of the surrounding environment on firms (McGuire et al., 2012; Dyreng et al., 2012; Montenegro, 2017; Cai et al., 2018). Another approach involves assessing a company's proximity to religious sites or places of worship (Du et al., 2015). These studies collectively reveal that companies embedded in religious communities exhibit lower levels of earnings manipulation compared to those operating in secular environments.

Building on this literature, Alsaadi (2019) utilized the Sharia index to measure religiosity, concluding that Sharia-compliant firms are more likely to engage in accrual-based earnings manipulation than non-Sharia firms. His study, conducted across 12 predominantly non-Muslim European countries—

including Austria, Belgium, Denmark, and the United Kingdom—relied on data from the FTSE All-World Index and the FTSE Global Sharia Index between 2003 and 2017. However, the application of a Sharia index in such contexts raises questions about its relevance. This incongruity motivated us to extend this line of inquiry to Indonesia, a Muslim-majority country where the Sharia index is more contextually appropriate.

Indonesia provides a compelling case for this investigation due to the active role of the National Sharia Council (DSN) in overseeing Sharia-compliant businesses. In addition to regulation by the Financial Services Authority (OJK), Sharia firms in Indonesia adhere to guidelines issued by the DSN, which include fatwas outlining business practices aligned with Sharia principles. These guidelines encompass revenue recognition and financial reporting, ensuring transparency and accountability while discouraging earnings manipulation. Sharia principles, rooted in fairness and honesty, reinforce the ethical foundations of corporate governance within these firms.

This research is crucial for informing investors and business practitioners about the extent to which earnings manipulation differs between Sharia and non-Sharia firms. Higher levels of earnings manipulation indicate lower-quality reporting, which is a critical consideration for investors when evaluating financial statements and making investment decisions. Thus, the study seeks to empirically demonstrate that Sharia-compliant firms are less likely to engage in earnings management than their non-Sharia counterparts.

LITERATURE REVIEW

Religiosity embodies adherence to or commitment to specific religious principles, which manifest in both attitudes and behaviors (Johnson et al., 2001; Weaver & Agle, 2002). Within a corporate framework, Johnson et al. (2001) elucidate how organizational behavior is shaped by the religious beliefs held by the dominant coalition within the company. This dominant coalition—comprising shareholders with significant influence—adheres to particular religious ideologies and integrates these values into business practices. By virtue of their authority, they effectively internalize and propagate these religious principles more comprehensively than other stakeholders (Fang et al., 2013; Jiang et al., 2015; Pieper et al., 2020).

The internalization of religious values fosters a religious corporate environment, shaping the conduct and decision-making of individuals and management. This aligns with social norms theory, which posits that individual behavior and attitudes are influenced by the prevailing social norms within their environment (Elster, 1989; Sunstein, 1996; Cialdini & Goldstein, 2004; Boahen & Mamatzakis, 2015). Social norms encompass religious, moral, courteous, and legal dimensions (Lararenjana, 2020). Notably, religious beliefs significantly influence these norms, cultivating cohesion within community groups (Kimani, 2024). This cohesion, in turn, informs individual attitudes and behaviors across social and corporate spheres.

Firms that integrate religious values into their operations exhibit reduced tendencies toward earnings management. Earnings management refers to managerial practices of exploiting accounting discretion to achieve specific financial outcomes (Belkaoui & Riahi, 2006). According to agency theory, conflicts between management (agents) and owners (principals) arise from divergent interests, leading agents to prioritize personal gain over the principal's welfare (Jensen & Meckling, 1976). Earnings management exemplifies such conflicts, where managers compromise financial reporting transparency for self-serving objectives. However, firms with high moral and ethical standards embedded in religious values are less prone to such manipulations.

Drawing on social norm theory, the organizational environment plays a pivotal role in shaping individual behaviors. Firms with religiously driven social norms create environments conducive to ethical behavior, which mitigates earnings manipulation. Empirical studies affirm that companies situated in highly religious social environments are less likely to engage in financial reporting irregularities (Grullon et al., 2010; McGuire et al., 2012; Dyreng et al., 2012). Conversely, Alsaadi (2019) reveals that European firms listed on the FTSE Global Sharia Index demonstrate higher earnings management compared to their non-Sharia counterparts. His findings suggest that Sharia firms often prioritize image-building over substantive governance improvements, using their Sharia designation as a legitimacy tool to deflect scrutiny. Additionally, economic incentives, rather than genuine adherence to Sharia ethical principles, drive many companies to register under the Sharia index (Alsaadi et al., 2017).

In Islam, the integration of religious principles—referred to as Sharia values—into corporate practices underscores the prioritization of ethics and morals (Jazil & Hendrasto, 2021). Ethical leadership theory posits that firms adhering to moral and ethical tenets achieve superior long-term performance (Lencioni, 2012). Furthermore, ethical leadership fosters heightened employee engagement (Islam & Khatoon, 2024), cultivating commitment, motivation, and loyalty, which collectively enhance organizational performance (Samwel, 2018). Indonesia, home to the world's largest Muslim population, represents a unique case study for exploring religiosity's influence on corporate behavior. With approximately 231 million Muslims constituting 86.7% of its population (Nurhadi, 2021), Islamic principles profoundly influence the country's corporate landscape. This influence is institutionalized through the Majelis Ulama Indonesia (MUI) and its subsidiary, the Dewan Syariah Nasional (DSN), which regulate Sharia-compliant business practices.

The DSN significantly impacts Sharia firms by issuing fatwas that serve as legal guidelines for adhering to Sharia principles in business operations. These fatwas ensure that products and services comply with Islamic tenets, bolstering trust among investors, consumers, and other stakeholders. Enhanced trust subsequently translates into improved performance metrics such as sales, profitability, and long-term growth. Studies corroborate that Sharia firms enjoy higher investor confidence, which positively influences their performance (Hossain & Lipy, 2020). Sharia governance fosters transparency and accountability, further strengthening investor and consumer trust (Rafiq & Rashid, 2018; Alam & Ahsan, 2020; Mirza & Khalid, 2020).

The role of DSN extends beyond corporate governance and significantly impacts regulatory bodies as well. Otoritas Jasa Keuangan (OJK), as the primary financial regulator, has instituted regulations governing the application of Sharia principles within the capital market (Regulation No. 15/POJK.04/2015). These Sharia principles, which are grounded in Islamic law, are applied to various capital market activities, provided that they align with the fatwa issued by the DSN, unless such fatwa conflicts with existing OJK regulations. Specifically, Article 2, paragraph 1, enumerates activities and business practices deemed inconsistent with Sharia principles in the capital market, including: (a) gambling and activities classified as gambling; (b) financial services involving usury; (c) the buying and selling of risky assets that contain elements of uncertainty (gharar) and/or gambling (maisir); and (d) the production, distribution, trade, and provision of goods or services that are inherently unlawful (haram li-dzatihi), as well as those that are unlawful due to extraneous factors (haram li-ghairihi), as stipulated by the National Sharia Council of the Indonesian Ulema Council (MUI). Furthermore, Article 2, paragraph 2, identifies transactions that contravene Sharia principles, such as: (a) trades or transactions based on fraudulent offers and/or requests; (b) transactions lacking the requisite delivery of goods and/or services; (c) trade in goods not yet possessed; (d) the buying or selling of securities based on insider information from issuers or public companies; (e) margin transactions involving Sharia-compliant securities that contain interest (usury); (f) transactions with the intent to hoard goods (ihtikar); (g) trades that involve bribery (risywah); and (h) other activities that entail speculation (gharar), fraud (tadlis) including concealing defects (ghisysy), or attempts to deceive or manipulate others (taghrir).

In this study, a firm is classified as Sharia-compliant if it adheres to these regulatory criteria. By aligning business practices with Sharia principles, such firms commit to ethical governance, transparency, and accountability, positioning themselves as exemplary models within Indonesia's dynamic and predominantly Muslim business ecosystem.

Sharia Firms and Earnings Management

Earnings management emerges as a result of the inherent conflict of interest between management and ownership (Jensen & Meckling, 1976). This conflict can be mitigated if managers exhibit sound behavior, ethical attitudes, and integrity. According to social norms theory, behavior and attitudes are significantly influenced by the social environment in which individuals operate (Elster, 1989; Sunstein, 1996; Boahen & Mamatzakis, 2015; Boahen & Mamatzakis, 2015). Furthermore, the social environment is often strongly shaped by religious norms prevalent within a community. These social religiosity norms play a crucial role in shaping cultural values (Hamid et al., 1993) and guiding ethical conduct (Moid, 2016). The greater the intensity of social religiosity norms in a particular environment, the more pronounced their effect on individuals who live and work within it (Kennedy & Lawton, 1998).

Firms operating within a highly religious environment are likely to be influenced by the religiosity norms of their surroundings. These norms, in turn, significantly impact the attitudes and behaviors of the managers within these firms. Previous studies have demonstrated that companies situated in regions with strong social religiosity norms are less inclined to engage in financial statement irregularities compared to those located in areas with weaker religiosity norms (Dyreng et al., 2012; McGuire et al., 2012; Grullon et al., 2010).

According to Lassoued et al. (2018), ethical norms are internalized through control mechanisms that constrain the actions of opportunistic managers, with religion being a central source of ethical guidance. In agreement with Callen and Fang (2015), religiosity, as an institutionalized control mechanism, profoundly influences managerial decision-making in corporate financial reporting. Socio-religious norms, alongside other forms of external financial oversight, serve as mechanisms that reduce agency cost conflicts (Montenegro, 2017). Furthermore, studies by Chen et al. (2013), Du et al. (2015), and Montenegro (2017) have empirically shown that social religiosity exerts a negative influence on earnings management.

Sharia firms are organizations that operate in accordance with Sharia principles. These firms are prohibited from engaging in activities that contravene Sharia law, ensuring that their business practices align with religious precepts. Consequently, Sharia firms epitomize a form of genuine religiosity. Therefore, it is hypothesized that Sharia firms, in comparison to their non-Sharia counterparts, are less likely to engage in earnings management. This leads to the following hypothesis:

H1: Sharia firms exhibit lower levels of earnings management than non-Sharia firms.

Sharia Firms and Performance

The relationship between religion and economic growth is well-documented in the literature. Barro and McCleary (2003) assert that religious belief can foster higher economic growth, as it encourages individuals to enhance productivity through values such as honesty, strong work ethic, and openness to external influences. Religion teaches that pursuing excellence in all activities, while adhering to ethical principles, is a form of devotion and responsibility to Allah SWT (Amaliah et al., 2015). The application of religious values in daily life serves as a demonstration of this responsibility. These values, in turn, motivate employees to elevate their performance (Anwar et al., 2018). Numerous studies have confirmed that religiosity positively influences employee performance (Ramadhan & Eryandra, 2021; Hariyadi & Mahmudi, 2020) and job satisfaction (Amaliah et al., 2015). In the realm of accounting, companies with strong religiosity are associated with fewer financial statement irregularities (Dyreng et al., 2012; McGuire et al., 2012; Grullon et al., 2010). Entrepreneurs with deep religious convictions tend to exhibit superior accounting performance, which, in turn, facilitates easier access to bank credit (Lu & Wu, 2020). This enhanced financial reliability builds confidence among investors and creditors, thereby positively impacting the company's overall performance. As demonstrated by Lu and Wu (2020), religiosity has a significant influence on company performance. Based on these insights, the following hypothesis is proposed:

H2: The performance of Sharia firms is superior to that of non-Sharia firms.

Research Framework

Based on the reviews and hypotheses that have been present previously, the research framework in Figure 1.

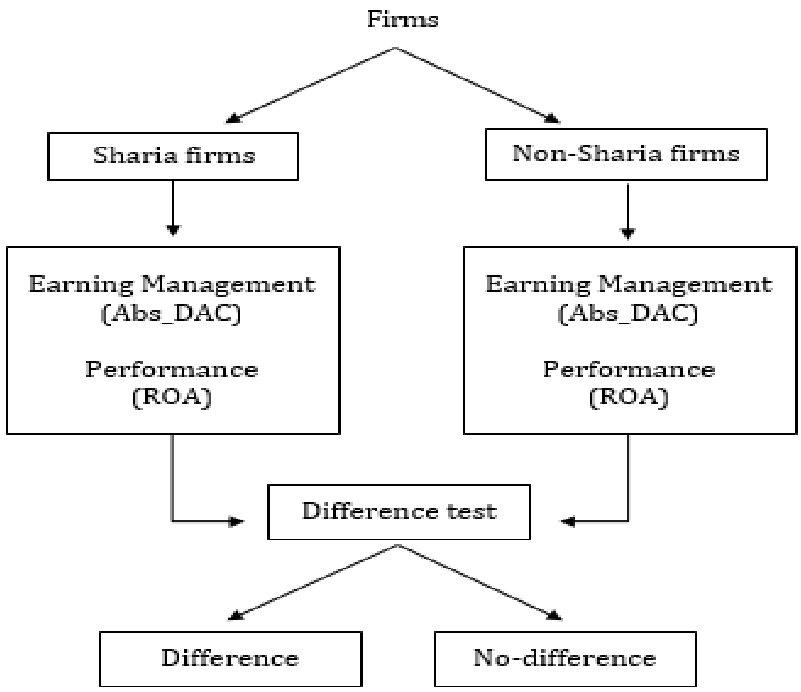

Figure 1. Research Framework
Source: processed by researchers (2023)

METHOD

Sample and Data Collection

The initial sample for this study consisted of 777 public companies listed on the Indonesia Stock Exchange (IDX) as of 2021. Data was collected over a period of seven years, from 2015 to 2021. The year 2015 was selected as the starting point for data observation, as the Financial Services Authority (OJK) began categorizing and grouping companies that adhere to Sharia principles at that time. Additionally, a sample of 124 companies from the financial sector—comprising banks, financing institutions, insurance companies, securities firms, and other financial entities—was excluded due to the distinct characteristics and regulations governing this sector (Zhong et al., 2007; Korkmaz et al., 2017). The financial sector is regulated under the supervision of the OJK, in accordance with Law No. 21 of 2011, and the regulations established by the OJK are specifically applicable to financial companies.

Moreover, 324 companies were excluded from the sample due to suspension or incomplete data. As a result, the final sample included 329 companies, with a total of 2,303 company-year observations over the seven-year period. Following the removal of 56 extreme data outliers, the dataset was reduced to 2,247 valid observations. A boxplot analysis revealed these 56 data points as outliers, confirming the normality of the data post-adjustment.

Measurement of Earnings Management

Several measurement alternatives have been employed in the extant literature to estimate earnings management. In this study, we utilize discretionary accruals as a proxy to capture earnings management activities. Discretionary accruals are measured using the modified Jones (1991), as adapted by Dechow et al. (1995), which is widely recognized and employed by researchers in the field of earnings management (Kothari et al., 2005; Jaggi & Tsui, 2007; Kasznik, 1999; Perols & Lougee, 2011; Alves, 2012). Moreover, many scholars argue that discretionary accruals provide a more robust estimation model compared to alternative approaches (Ashbaugh et al., 2003; Guay et al., 1996; Jaggi & Tsui, 2007). The following presents the modified Jones model:

$$\frac{TAC_{i,t}}{A_{i,t-1}} = \beta_1\left(\frac{1}{A_{i,t-1}}\right) + \beta_2\left(\frac{\Delta Rev_{i,t}}{A_{i,t-1}}\right) + \beta_3\left(\frac{PPE}{A_{i,t-1}}\right) + \varepsilon_{i,t} \quad (1)$$

$$\frac{NDAC_{i,t}}{A_{i,t-1}} = \beta_1\left(\frac{1}{A_{i,t-1}}\right) + \beta_2\left(\frac{\Delta Rev_{i,t} - \Delta Rec_{i,t}}{A_{i,t-1}}\right) + \beta_3\left(\frac{PPE}{A_{i,t-1}}\right) + \varepsilon_{i,t} \quad (2)$$

$$DAC_{i,t} = TAC_{i,t} - NDAC_{i,t} \quad (3)$$

Where DACi,t is discretionary accruals for a company i in year t; TACi,t is total accruals for a company i in year t; NDACi,t is non-discretionary accruals for a company i in year t; Ai,t is total assets for a company i in year t; ΔRevi,t is change in revenue for a company i in year t; ΔReci,t is change in receivables for a company i in year t; PPEi,t is gross property, plant, and equipment for a company i in year t; $\varepsilon_{i,t}$ is residual for a company i in year t.

DAC values can be either positive or negative. A positive value indicates the exercise of discretion to increase profits, while a negative value reflects the use of discretion to reduce profits. The absolute value of DAC is employed to measure the extent of high (or low) DAC in earnings management (Liu et al., 2018). Consequently, this study utilizes the absolute value of DAC to capture the degree of corporate earnings management, as suggested by previous studies Chen et al., 2007; Bergstresser & Phillipon, 2006; Liu et al., 2018; Jiang et al., 2020).

Measurement of Firm Performance

Firm performance is typically measured using profitability metrics. One common measure of profitability is return on assets (ROA), which assesses a company's ability to generate profit from its assets. ROA is calculated by dividing net income by total assets. It is widely regarded as one of the most reliable indicators for evaluating a company's performance, as it provides accurate and objective results (Taysi, 2020).

Measurement of Sharia Firms

Sharia firms are companies whose business activities align with Sharia principles. The Financial Service Authority of Indonesia, as the regulator, has facilitated and identified companies that comply with Sharia principles to be included in the Indonesian Sharia Stock Index (ISSI). This selection is based on OJK Regulation No. 15/POJK.04/2015, which mandates that a company's business activities must adhere to Sharia principles. Specifically, these activities must not involve gambling or games classified as gambling; must avoid usurious financial services; must not engage in transactions that involve uncertainty (gharar) or gambling (maisir); and must not produce, distribute, trade, or provide goods or services that are unlawful in substance (haram li-dzatihi) or due to other factors (haram li-ghairihi), as stipulated by the National Sharia Council - Indonesian Ulema Council. Therefore, Sharia firms are measured using a dummy variable, where the value is 1 if the company is indexed in the ISSI as a Sharia firm, and 0 if it is classified as a non-Sharia firm.

Data Analysis Technique

This study employs independent sample t-test analysis, a technique used to determine whether two unrelated samples have different mean values. The analysis compares the mean values and standard errors of two distinct group samples. The formula for the t-test is as follows:

$$t = \frac{M_1 - M_2}{S_{pooled}} \quad (4)$$

Where M1 is the mean of group 1, M2 is the mean of group 2, and Spooled is the pooled standard error. Furthermore, a data normality test and a data homogeneity test are required to conduct a t-test.

RESULTS AND DISCUSSION

Descriptive Statistics

Table 1 presents the descriptive statistics for the full sample and sub-sample firms, including Sharia and non-Sharia firms. The full sample consists of 2,247 data points, of which 76.3% (1,715 data points) are Sharia firms, and 23.7% (532 data points) are non-Sharia firms. The descriptive statistics indicate that the mean Abs_DAC is 0.082, with a range from 0.000 to 0.503, and the mean profitability is 0.027, with a range from -0.548 to 0.527. Table 1 also shows that Sharia firms have a mean Abs_DAC value of 0.079, while non-Sharia firms have a mean of 0.088. The mean absolute value of discretionary accruals is lower for Sharia firms than for non-Sharia firms. This result suggests that non-Sharia firms are more likely to engage in earnings management than Sharia firms. Additionally, Sharia firms have a mean performance value of

0.035, compared to 0.001 for non-Sharia firms. This finding indicates that Sharia firms outperform non-Sharia firms.

Table 1. Descriptive statistics

Var.	Min	Max	Skew.	Kurt.	Full samples		Sharia		Non-Sharia	
					Mean	SD	Mean	SD	Mean	SD
Abs_DA	0.000	0.503	1.998	4.908	0.082	0.082	0.079	0.080	0.088	0.086
Prof.	-0.548	0.527	-0.272	5.978	0.027	0.095	0.035	0.090	0.001	0.106
N					2.247		1.715		0.532	

Source: Data processed by researchers (2023)

Independent Sample Test

This study uses an independent sample t-test to test hypotheses 1 and 2. This test aims to determine whether there is a difference in mean earnings management and performance between Sharia and non-Sharia companies. Before testing the mean differences between the two variables, the first step is to test the data for normality and homogeneity of variance.

In this study, the normality test utilized skewness and kurtosis, rather than the Shapiro-Wilk and Kolmogorov-Smirnov tests. According to Kim (2013), the Shapiro-Wilk and Kolmogorov-Smirnov tests are suitable for small to medium-sized samples (e.g., n < 300) but are unreliable for large samples. This issue can be addressed by using skewness and kurtosis tests, which are generally reliable for both small and large samples (Kim, 2013). Based on Table 1, the Abs_DAC data has a skewness value of 1.998 and a kurtosis value of 4.908, while Profitability has a skewness value of -0.272 and a kurtosis value of 5.978. Data is considered normally distributed if the skewness value is < ± 2 or the kurtosis value is < ± 7 (West et al., 1995; Kim, 2013; Ghozali, 2021). Based on these results, both Abs_DAC and Profitability data are normally distributed because both have skewness values < ± 2 (Abs_DAC: 1.998, Profitability: -0.272) and kurtosis values < ± 7 (Abs_DAC: 4.908, Profitability: 5.978).

Furthermore, the homogeneity of variance was tested using Levene's statistical test. The results of the homogeneity of variance test for Abs_DAC and Profitability are presented in Table 2. The Levene value for Abs_DAC, based on the mean, is 1.851 with a p-value of 0.174 (greater than 0.05), indicating that there is homogeneity of variance between the Abs_DAC groups. Since homogeneity is assumed, the results of Levene's test with equal variances are used.

Table 2. Test of Homogenity of Variance

Variables	Levene Statstic		df1	df2	Sig.
Abs_DAC	Based on Mean	1.851	1	2245	0.174
Profitability	Based on Mean	5.559	1	2245	0.018

Source: Data processed by researchers (2023)

Table 3. Independent Samples Test

Variables	Samples	t	df	Sig.	Mean Diff
Abs_DAC	Equal Var. Ass.	-2.209	2245	0.027	-0,009
	Equal Var. not Ass.	-2.130	837.491	0.034	-0,009
Profitability	Equal Var. Ass.	7.377	2245	0.000	0,034
	Equal Var. not Ass.	6.783	784.738	0.000	0,034

Source: Data processed by researchers (2023)

Based on the descriptive statistics (Table 1), Sharia firms have an average earnings management measure (Abs_DAC) of 0.079, while non-Sharia firms exhibit higher earnings management, with an average of 0.088. According to the independent samples test (Table 3), there is a significant difference in earnings management, with a mean difference of -0.009 (0.079 - 0.088), which is significant at α = 5% (p-value = 0.027). Therefore, this study suggests that Sharia firms engage in significantly lower earnings management than non-Sharia firms. Hence, H1 is accepted.

Furthermore, the firms' performance is measured by Profitability. The value of Profitability, based on the mean, is 5.559 with a p-value of 0.018, which is < 0.05, indicating a lack of homogeneity of variance between the groups for Profitability. Since homogeneity is insignificant, Levene's test assumes unequal variances. Based on the descriptive statistics (Table 1), Sharia firms have an average Profitability of 0.035, while non-Sharia firms have a lower average Profitability of 0.001. According to Table 3, the performance difference of 0.034 (0.035 - 0.001) is significant at α = 1% (p-value = 0.000). Therefore, this study suggests that the performance of Sharia firms is superior to that of non-Sharia firms. Hence, H2 is accepted.

Robustness Test

This study conducted further tests to robustly validate the results of the previous independent sample test, which showed that, first, Sharia firms have lower earnings management than non-Sharia firms, and second, Sharia firms have better performance than non-Sharia firms. This indicates that firms managed according to Sharia principles have a negative influence on earnings management and a positive influence on performance. To confirm these findings, this study performed additional regression analysis to examine the impact of Sharia firms on earnings management and performance. The results of the linear regression are presented in Table 4:

Table 4. Linear Regression

Variable	Model 1 (Abs_DA)	Model 2 (Prof)
	β (ρ-value)	β (ρ-value)
SF	-0.009 (0.027)	0.034 (0.000)
F-test	4.879 (0.027)	54.413 (0.000)
Adj. R^2	0.002	0.023
Obs.	2.247	2,247

Source: Data processed by researchers (2023)

Based on the regression results in Table 4, Model 1 shows that Sharia firms (SF) have a significant negative effect on earnings management (Abs_DA) at $\alpha = 5\%$ ($\beta = -0.009$; p-value = 0.027). Model 2 indicates that Sharia firms (SF) have a significant positive effect on company performance (Prof) at $\alpha = 1\%$ ($\beta = 0.034$; p-value = 0.000).

Discussion

This study demonstrates that Sharia firms exhibit better performance and earnings management behavior than non-Sharia firms. Sharia firms adhere to governance practices grounded in Sharia values, such as avoiding activities prohibited by religion, including gambling, usury, risk or uncertainty, producing illicit goods, fraud, and concealing defects. The application of these Sharia values creates a religious social environment within the company. This environment influences the behavior and attitudes of the company's internal members, employees, and managers. Consistent with social norms theory, behavior and attitudes are shaped by the social environment in which individuals live or work (Elster, 1989; Sunstein, 1996; Cialdini & Goldstein, 2004; Boahen & Mamatzakis, 2015). Empirically, this study confirms that firms aligned with religious values engage in less earnings management behavior than non-religious firms.

The religiosity values within the company foster a positive environment. This atmosphere encourages employees and management to work honestly and ethically, performing activities to the best of their ability (Amaliah et al., 2015). These values and the resulting work enthusiasm contribute to better company performance. Therefore, this study also supports the finding that Sharia firms outperform non-Sharia firms. This result aligns with Audi et al. (2021) and Gati et al. (2020), who found that the performance of Sharia firms surpasses that of traditional firms.

This result aligns with several previous studies that suggest religion negatively affects financial statement irregularities (McGuire et al., 2012;

Dyreng et al., 2012; Du et al., 2015; Montenegro, 2017). Other researchers have used Sharia governance as a proxy for religiosity and found that firms managed with Sharia governance have a negative correlation with financial statement irregularities (Elghuweel et al., 2017; Abdelsalam et al., 2016). Our findings contradict those of Alsaadi (2019), who states that Sharia firms are more likely to engage in accruals manipulation than non-Sharia firms. He argued that Sharia firms only use a 'label' to attract investors. This may be due to his research, which covered firms in 12 European countries, most of which are non-Muslim. This differs from our study, which was conducted in a Muslim-majority country. Our research has proven that firms managed according to Sharia values have lower earnings management than non-Sharia firms, thereby refuting the notion that Sharia firms merely use a 'label.'

Furthermore, Table 5 shows that firms based on religious values or Sharia principles positively impact performance. Sharia firms perform better because they adhere to strict principles, including honesty and social responsibility. Sharia firms also face lower risks due to the prohibition of excessive speculation and haram investments (Beck et al., 2013). This creates a positive reputation and builds trust among consumers and investors, thereby enhancing company performance. This result aligns with the findings of Lu and Wu (2020), which show that religiosity impacts company performance, and Siddiqui and Ghori (2024), who found that Sharia compliance positively affects firm performance.

Sharia firms are not only compliant with existing laws and regulations but also with financial ratios, governance, and business activities (Can, 2020). This Sharia compliance fosters higher ethical behavior among management. A corporate environment rooted in such values also motivates other stakeholders to act honestly, responsibly, and with high work motivation. These positive behaviors are reflected in the religious values taught in these firms. As a result, these values have a positive impact on the company. For management, high ethical standards reduce fraudulent, corrupt, and selfish behaviors. This study has shown that earnings manipulation behavior, as proxied by discretionary accruals, is lower in Sharia-based companies.

The religiously grounded environment in these companies encourages management to work honestly, responsibly, and with a strong work ethic for the benefit of the owners, in accordance with the work contract between the agent and the principal. In the context of Sharia, there is no conflict of interest between agents and principals, as suggested in agency theory Jensen and Meckling (1976). Religious values, as a source of morals (Conroy & Emerson, 2004; Longenecker et al., 2004; Hilary & Hui, 2009) and ethical guidelines (Weaver & Agle, 2002), must be followed in Sharia firms. This environment fosters trust in the principal, which, in turn, encourages other investors to contribute more capital. The synergy between managers who manage the company honestly and responsibly, and the trust investors place in the company through their capital, enhances company performance. Thus, companies that comply with Sharia-based religious values perform better. This study has proven that Sharia-compliant companies outperform non-Sharia companies.

This study's findings provide new insight that Sharia firms can reduce the conflict of interest between agents and principals, as evidenced by the reduced interest in earnings management. This has significant implications for investor confidence, which, in turn, encourages improved company performance.

CONCLUSION

This study examines the differences in earnings management and performance between Sharia firms and non-Sharia firms. The empirical results show that Sharia firms exhibit lower earnings management and better performance than non-Sharia firms. The governance of these firms, grounded in religious values or Sharia principles, fosters a religious social environment that encourages employees and management to act honestly and ethically. This environment contributes to the effective execution of business activities and leads to improved company performance. This study contributes to agency theory by arguing that corporate governance, when strengthened with religious values or Sharia principles, helps reduce conflicts between agents and principals. Practically, the findings suggest that Sharia-based companies are more attractive to investors, as they are associated with lower earnings manipulation and better overall performance.

However, this study has some limitations. The measurement of performance and earnings management relies on a single type of metric, namely return on assets and discretionary accruals. Future research should expand the scope by incorporating additional market performance metrics and alternative measures of earnings management. Additionally, the sample in this study could be expanded to include firms from other countries with a majority Muslim population to further strengthen the generalizability of the findings. The results have important implications for investors and regulators. Investors should be encouraged to invest in Sharia-based firms, given their superior reporting quality. For regulators, the study recommends strengthening the implementation of Sharia principles in the oversight of public companies, which would enhance trust among investors and other stakeholders.

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