

Corporate Governance Practices and Earnings Management in Islamic Banking Institutions

Faouzi Mohamed Hamdi^{1*} Mohamed Ali Zarai²

1.College of Business Administration, Al Majmaah University, Saudi Arabia

2.Faculty of Administrative and Financial Sciences, Al Baha University, Saudi Arabia

* E-mail of the corresponding author: faouzi_hamdi@yahoo.fr

Abstract

This paper examines corporate governance (CG) characteristics and relates them to earnings management (EM) behaviours in the context of a large emerging sector, Islamic banking industry. Empirical Investigation used multivariate probit analysis and relied on a sample of 90 Islamic Banks over the period of the years 2000-2009. Findings revealed that CG issues in Islamic banking differ significantly from those of the conventional system. Main differences are found with regard to philosophical aspects, including objectives of the bank, natures of contract involved, key players in the CG practice as well as the relationships between the players. We verified that these aspects provide strong justification for an additional layer in the CG of an Islamic bank being the Shari'ah Supervisory Board (SSB). The mechanism and tools for the effective implementation of CG are relatively the same as the conventional system. Results suggest also that audit committee plays a more significant role in moderating EM than the other aspects of CG. Moreover, the estimated coefficients of SSB embeddedness suggest that an in-house SSB is effective in mitigating EM. The results, however, do not provide evidence that SSB characteristics, such as SSB size, SSB members objectivity and SSB members competence are significant in mitigating EM. By the same, results revealed no difference between Islamic banks with and without governance committee in terms of EM intensity.

Keywords: Earnings Management, Corporate Governance, Islamic Banking Institutions.

1. Introduction

Islamic banks offer various investment accounts¹. The type of investment account elevates a set of problematic questions concerning the contractual relations between the Islamic bank and the holders of such investment accounts. This increases the possibility of conflict of interest facing the bank's executives. Such conflict may rise not just in their dealings with the investors; either shareholders or investment account holders, but also between the divergent interests of the two categories of investors (Grais and Pelligrini, 2006). These questions have been addressed, from the perspectives of agency theory, in the past two decades, by many Muslim and non-Muslim researchers (Mills and Presley, 1999; Warde, 2000; Lewis, 2005; Grais and Pelligrini, 2006a, 2006b, 2006c; El-Hawary et al., 2007; Benamraoui, 2008). In particular, previous studies have focused on a disparity between management and attributed control rights. They discussed the problem of corporate governance in Islamic banks and its influence on their global performance. The results revealed that the structure used to deal with investors funds involve a high degree of fiduciary responsibility on the part of an Islamic bank, "which should be, but it is not always, reflected in its corporate governance" (Ghayad, 2008).

What remains unknown is the phenomenon of earnings management. This phenomenon has great concern for the accounting literature in the last few decades (Elias, 2005; Cornett et al., 2006). However, studies to date mostly focus on industrial firms. Relatively little has been done with respect to earnings management at financial institutions, less has looked at how corporate governance mechanisms affect earnings management at banks (Karagolu, 2005; Cornett et al., 2006, Faouzi, 2013) and even no considerable study has investigated this topic in Islamic banking institutions (IBIs). This study tries to examine the issue of corporate governance and earnings quality in the context of Islamic banks. More specifically, it tests the influence on earnings management of a number of corporate governance attributes such as *Shariah* supervisory board, audit committee, governance committee and audit quality. It tests the relevance of Islamic banks' corporate-governance arrangements in mitigating potential earnings management.

This investigation is guided by the agency theory (AGT) since the *Mudharaba*² and *Musharaka*¹ contracts used

¹ The basic principle of Islamic banking is the profit and loss sharing (PLS) and the forbiddance of usury (*Riba'*). The most famous Islamic operations used in Islamic banking are profit sharing (*Mudharabah*), joint venture (*Musharakah*), cost plus (*Murabahah*) and leasing (*Ijarah*). (Tahir, 2007; Ghayad, 2008).

² *Mudharaba* is a contract between the capital provider and a skilled entrepreneur whereby the capital provider would contribute capital to an enterprise or activity, which is to be managed by the entrepreneur as the *Mudharib* (or labour provider). Profits generated by that enterprise or activity are shared in accordance with the terms of the *Mudharaba* agreement, whilst losses are to be borne solely by the capital provider unless they are due to the *Mudharib*'s misconduct, negligence or breach of contracted term.

by the Islamic banks represent complicated agency relation. This relation is in the one side, between the depositors and the Islamic bank and in the other side, between the Islamic bank and the business companies in the case of *Musharaka* contracts. This study goal is to see how the agency difficulties influence the earnings management behaviour of Islamic banks.

By this study we do not intend to reinvent the wheel by offering a completely new corporate governance framework. Instead, we want to build on the current accounting research stream that studies the impact of different attributes of corporate governance on financial reporting by particularly addressing the specificities of Islamic banking institutions.

To address the issues, the rest of this paper is organized as follow. Section Two presents basic concepts of corporate governance as well as general view of Islam in the issue. Section Three describes the research method and data collection process. Finally, a discussion of the empirical results and recommendation are offered in Section Four.

2. Background and Basic Concepts of Islamic Corporate Governance

The Encyclopedia of Corporate Governance (Encycogov)² defines CG as "a field in economics that investigates how to secure efficient management of corporations by the use of incentive mechanisms, such as contracts, organizational designs and legislation...". The OECD³ defines CG as "procedures and processes according to which an organization is directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among the different participants in the organization – such as the board, managers, shareholders and other stakeholders – and lays down the rules and procedures for decision-making"⁴. In *Cadbury Report of 1992*, CG is defined as "the system by which companies are directed and controlled. Board of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate structure is in place"⁵.

There are different models of CG across the world, each model has its own characteristics and features. The Anglo-American model also called the "managed corporation" model (Pound, 1995) of CG concentrates on the maximization of shareholder value and just look after the shareholder interests through increasing profitability and efficiency (Hasan, 2009). Accordingly, CG refers to the set of mechanisms designed to maintain an appropriate balance between the rights of shareholders and the need of the board of directors and management to direct and manage the company's affairs and ensure that the corporation optimizes the returns to shareholders over time.

Other prominent CG models are the Germany Model and the Japan Model. In these models, less emphasizes is given to shareholders' value than the perspective of the US and the UK corporations. This point of view represents the Stakeholder Model of CG (Hit et al, 2005). Specifically, the stakeholder model proposes that society is entitled to get positive contribution from corporations, especially large corporations that have great economic and social power, in return for 'granting' the corporations their legal status in the marketplace. However, some ambiguities exist in the model. It is not clear who or what is a legitimate stakeholder, to what each stakeholder is entitled, or how managers should balance competing demands among a range of stakeholders (Kasri, 2009; Steiner and Steiner, 2006, Faouzi, 2013).

Islamic perspective on CG, to some extent, looks a lot like to the stakeholder model. Indeed, it provides a more solid justification regarding who can qualify as a stakeholder and what are the rights and responsibilities that both corporations and their various stakeholders may assume. This framework is established in Islamic principles of property rights and contracts. According to Iqbal and Molyneux (2005), a stakeholder is defined as the one whose property rights are at stake or at risk as a result of voluntary or involuntary actions of the firm. This implies that a firm is expected to preserve property rights of not only the shareholders, but also those who have participated in the process of acquiring the firm's property and those who could be threatened as a result of its operation. They also posit that any group or individuals with whom a firm has any explicit and implicit contractual obligations qualifies as a stakeholder even though the firm may not have formal contracts with them

¹ *Musharaka* is a contract equivalent to the common joint venture business and partnership contracts. In a *musharaka* contract the profits made are shared on a predetermined ratio, whereas losses incurred are divided based on the equity participation ratio (Gayad (2008)).

² Encycogov is an interactive encyclopedia about corporate governance and financial issues intended for use by students, academics, investors and regulators.

³ The Organization for Economic Co-operation and Development is an international economic organization of 34 countries founded in 1961 to stimulate economic progress and world trade. It is a forum of countries committed to democracy and the free-market economy, providing a platform to compare policy experiences, seek answers to common problems, identify good practices and co-ordinate domestic and international policies of its members.

(http://en.wikipedia.org/wiki/Organisation_for_Economic_Co-operation_and_Development. Accessed April, 2013).

⁴ European Central Bank, 2004, Annual Report: 2004, ECB, Frankfurt, Glossary

⁵ The Cadbury Report, titled *Financial Aspects of Corporate Governance*, is a report of a committee chaired by Adrian Cadbury that sets out recommendations on the arrangement of company boards and accounting systems to mitigate corporate governance risks and failures. The report was published in 1992. The report's recommendations have been adopted in varying degree by the European Union, the United States, the World Bank, and others.

through mutual bargaining. Islam also believe that a individual's daily activities and transaction should be based on the values of truthfulness, firmness, fairness, respect for the law, kindness, forbearance, tolerance and uprightness, instead of deceit, haughtiness, class consciousness, ostentation, insubordination, envy, jealousy, backbiting and self-aggrandizement (Hassan, 2002). These should also naturally be manifested in persons' involvement in business activities and operations as well as their relationships with all their respective stakeholders. Overall, the Islamic view of CG is more comprehensive than the stakeholder view and strictly related to the ethical values in Islam. Islamic perspective sees the CG practice as individual's obligation to Allah, thus leads to the existence and obedient of the implicit contract with Allah and explicit contract with humans. In the end, these placed Allah and Islam itself as key players in the CG practice. This is in contrast to the conventional point of view that focuses on the material aspects.

In practical field, the differences are minor. The mechanism and tools for the effective implementation of CG are relatively the same. Both perspectives recognize that mechanism for CG constitutes of board of directors (BOD), executive management, and shareholder. Concerning the first two elements, the mechanisms are relatively the same in both cases. The boards have power to design the CG policy frameworks, direct the affairs of the organization punish and rewards executives, and protect shareholders' right and interests; the management's responsibility is running the operation of the corporation (Hitt et al, 2005; Chapra and Ahmed, 2002). However, the BOD of IBIs carries additional tasks. According to IFSB guidelines (2006a), the BOD of IIFS shall set up a Governance Committee, to coordinate and integrate the implementation of the governance policy framework. This Governance Committee may comprise of a member of the Audit Committee, a *shari'ah* scholar and a non-executive director.

The existence of the *shari'ah* scholar highlights effort to comply with Islamic rules. Differences also arise vis-à-vis shareholder position. According to the conventional model, depositor is not shareholder because their funds are insured and guaranteed. This denotes that no CG mechanism is required for them. However, in the Islamic perspective, the definition of shareholder should include the depositors' role. In particular, Investment Account Holders (IAHs) that participate in PLS arrangements should act like the shareholder in the conventional practice. However, currently they neither have voice in the shareholder's meeting nor have guarantee for their funds, to comply with *shari'ah* rules (Chapra and Ahmed, 2002, Kasri, 2009). Furthermore, the fact that the IAHs are represented by the IBIs management for the PLS contracts leads to situation where tripartite conflict of interests between the common stockholder, the executive, and the IAHs may happens. This remains unresolved by existing CG mechanism (Archer and Abdel Karim, 2007).

3. Methodological Issues and Analytical Model

3.1. Sample selection and data collection

The panel data set were extracted from balance sheets and income statements of Islamic banks. These data are made available by the Islamic Banks and Financial Institutions Information (IBIS) Database, which contains up to ten years of historical financial data from annual reports of IBIs around the world. To be included in the sample, a bank must have income statement and balance sheet information for at least two consecutive years .

CG related data were obtained from bank level annual report available on banks' websites. We have eliminated banks that do not have adequate data to evaluate either the earnings or the necessary control variables, and banks that do not have the CG data needed for us to compute our measure of general CG quality.

Variables were converted into United States dollars using end of year market value. We have accomplished this operation in order to take account of macroeconomic differences among countries during the time period of the study (Yudistira, 2003). Following previous literature, another explanation to make use of this method is to include environmental differences that can, of course, happen in the sample data. In addition, we have to notify that exchange rate had been drawn from the International Financial Statistics database.

3.2. Data Analysis

We conduct the parametric analysis using a Multivariate Probit Analysis to test whether CG mechanics affect Islamic banks EM. Our primary interest is in the Islamic bank's behaviour of manipulating earnings level from negative to positive value to avoid earnings losses. Because ordinary linear regression models are unable to capture the firm behaviour in earnings manipulation (Cosimo Beverelli,2011), we use a binary choice model as defined below.

$$\text{Prob}(Y=1) = F(\beta X)$$

$$X = (X_1, \dots, X_{11})$$

The dependent variable (Y) is assigned the value of 1 if scaled earnings level is positive and 0 otherwise. In using the binary choice model, we consider that a group of variables (X) that might explain the probability that Y has the value of 1 through a function F. There are several choices for the F function¹. In the probit model used in this chapter, F is the

¹ The Logit Model uses the logistic cumulative density function: $F(u) = 1/(1 + \exp(-u))$. The logistic cumulative density function is computationally much more tractable than the standard normal, but modern computers can calculate probits quite easily.

cumulative distribution function of normal distribution¹. Then the estimated coefficients will reflect the effect of X on the probability that an Islamic bank has positive earnings ($Y=1$). A positive coefficient means that an increase in the predictor leads to an increase in the predicted probability. A negative coefficient means that an increase in the predictor leads to a decrease in the predicted probability. The EVIEWS 7.0 software is used to empirically test the above models variables.

Throughout the analysis, the variables of our primary interest are banks CG practices. The Probit Analysis allows us to test whether any control variables would increase the probability of bank's EM. We then tried to identify as many explanatory variables as possible given the exploratory nature of this study. The next sub-section discusses how we operationalize and measure each variable and express our hypotheses concerning the dependent variable relationship to each independent variable.

3.3. Variables Measurement and Operational Hypotheses Development

3.3.1. *Dependent Variable*

The dependent variables that proxies EM will assign the value of 1 if scaled earnings or change in scaled earnings is positive and 0 otherwise. For the computation of the earnings, we use over net distributable profit divided by the total assets at the beginning of the period. We deflate earnings levels by beginning-of-the-year total assets for the sake of reducing the problem of heteroscedasticity (Mard, 2004). Hence, for every IBI and for every exercise of the period (2000–2009), we calculated the following ratio:

$$\text{Net earnings } t / \text{Total assets } (t-1)$$

To avoid the influence of extreme values, we eliminate the observations with absolute value of scaled earnings over 5.

3.3.2. *Corporate Governance Variables*

3.3.2.1. Audit Committee Effectiveness

The audit committee responsibilities include: proposing to hire or dismiss the external auditor, monitoring the firm's internal control system and its implementation, coordinating the communication between internal and external auditors, verifying the firm's financial information and its disclosure, and evaluating the firm's internal control system.

Some previous studies show that more effective audit committees are associated with lower intensity of EM (Klein 2002; Xie, et al. 2003). To control for the effect that the audit committee may have on EM behaviour in IBIs, we have incorporated *ACEFFECT* variable in the Probit Model.

Previous research, especially in the US context, measure this variable by generating a composite score consisting of ten dummy variables proposed by the Blue-Ribbon Committee for audit committee effectiveness (BRC 1999). The dummy variables are about assessing the committee's charter, fulfilling the charter, accountability for auditor relations, relation with external auditor, independence, financial literacy skills, discussion of accounting, disclosure of reviews, and reviewing of quarterly reports. Apart from U.S., the audit committee formation in some other country is voluntary. Thus, many Islamic banks yet have effective audit committee. Some banks have not established audit committees, other banks may have established it but do not activated for many reasons². For these reasons, we code our variable audit committee effectiveness (*ACEFFECT*) as 1 if a bank has an effectively functioning audit committee, and 0 otherwise³. We hand-collect information on whether a bank had an effective audit committee from the CG reports and construct a unique dataset on audit committee effectiveness for the sample of IBIs. As in previous research, we expect *ACEFFECT* to have negative coefficient in the Probit Model specified above⁴. Therefore, we can posit the following research hypothesis:

H₁: Ceteris paribus, more effective audit committees are associated with lower intensity of EM.

3.3.2.2. Auditor Quality

The audit quality is imperative to reporting integrity and earnings quality. Especially nowadays, the credibility of the external financial reporting process has been severely challenged by high-profile audit failures, material misstatements, and restatements of financial reports. The audit quality indicates as the capacity of external audits to detect material misstatements and improprieties (Kane and Velury, 2005).

Abundant research indicates that higher audit quality mitigates the EM (Becker et al., 1998; Francis et al., 1999; Zhou and Elder, 2004; Francis and Yu, 2009). The Big-4 auditors are expected to provide high-quality audit services. The levels of discretionary accruals for the firms audited by Big-4 are lower relative to those for the firms audited by non-Big-4 (Becker et al., 1998; Francis et al., 1999; Payne and Robb, 2000). Gore, et al. (2001) report that non-Big-5 auditors allow more EM than the Big-5 auditors⁵. We include a dummy variable to examine how the status of auditor affects the bank's EM practices. This variable assigned the value 1 if the bank *i* for the year *t* is audited by a Big-4

¹ For Probit model, $F(u) = \Phi(u)$, standard normal cumulative distribution function, $0 < F(u) < 1$ and F increasing.

² First, the board of directors may not fully recognize the importance of an audit committee. Second, an audit committee may have difficulties in coordinating with related parties. Third, an audit committee may be comprised of members who are not fully qualified and independent.

³ *ACEFFECT* equals 0 if a bank does not have an audit committee or a bank has an audit committee that does not activated.

⁴ This study adds to the auditing research on IBIs by examining how audit committees function in IBIs

⁵ The Big-5 became the Big-4 after the departure of Arthur Anderson in 2002, following its contribution in the Enron scandal

auditor an 0 otherwise. We expect negative sign for this dummy variable, indicating that Big-4 auditors¹ are less likely to allow the banks to manage earnings. Thus we hypothesise that:

H₂: Ceteris paribus, higher quality audited Islamic banks are less likely to engage in EM.

3.3.2.3. Board of Directors Size

Prior studies suggest that there is a relation between firm performance and size of the board of directors (BOD) (Pierce and Zahra 1992). Smaller boards are argued to be more effective because they have less difficulty coordinating efforts (Jensen 1993; Yermack 1996; Eisenberg et al. 1998). The AGT postulates the notion that in smaller BOD, size is appropriate to minimize agency monitoring costs and to ensure good communication and coordination amongst board members. This paper explores the role of BOD size in mitigating EM. Consistent with AGT, we hypothesize that there should be a positive relationship between the board size and EM practices in Islamic banks, as follows:

H₃: Ceteris paribus, BOD Size correlates positively with Islamic bank EM intensity.

3.3.2.4. Shari'ah Supervisory Board embeddedness

Shari'ah supervision in IBIs is comprised of two components, *Shari'ah* Apex Body appointed by national regulators and *Shari'ah* Body set up by a financial institution. *Shari'ah* Apex Body intends to assist the Islamic financial industry in the interpretation of the *Shari'ah* issues. Absence of one of these two governance bodies, either the Apex Body or the in-house SSB, can disturb the Islamic banking industry governance infrastructure (Shaffai, 2008). Therefore, IBIs which neglect embedding the SSB within their CG mechanisms, due to the distinct nature of the countries they operate in², are unable to benefit from the different roles and service the SSB provides like monitoring and controlling, advising and cancelling as well as providing access to resources (Anwar, 2011). Moreover, *Shari'ah* in Islamic banking has a central role not only in governing bank transactions and processes, but also in monitoring and controlling the roles of all players within the banking system. Hence, it is important to investigate the embeddedness of SSBs within the governance structure of the IBI. We include SSBEMBEDD as a dummy variable that equals 1 if SSB is within the governance structure of the IBI; and it equals 0 otherwise. We expect that, ceteris paribus, EM is lower for Islamic banks with the SSB board compared to Islamic banks without the board. Hence, the following hypothesis is formulated:

H₄: Ceteris paribus, Islamic banks with an in-house SSB are associated with lower intensity of EM.

3.3.2.5. Shari'ah Supervisory Board Effectiveness

The functioning of SSBs raises five main CG issues: independence, confidentiality, competence, consistency and disclosure (Graiss and Pelligrini, 2006). The first issue concerns the independence of the SSB from management. Generally, members of an SSB are appointed by the shareholders of the institution, represented by the BOD to which they report. As such, they are employed by the institution, and their remuneration is proposed by the management and approved by the board. The SSB members' dual relationship with the financial institution, as providers of remunerated services and as assessors of the nature of operations, could create a conflict of interest. Confidentiality issue arises from the practice of *Shari'ah* scholars often sitting on the SSBs of several IBIs, thereby gaining access to private information of possibly competing institutions. The third issue is competence in performing their function, *Shari'ah* scholars are expected to be familiar with Islamic law and to have financial expertise. The consistency of judgment across IBIs, over time or across jurisdictions, within the same institution. Such consistency would help promote the customer's confidence in the industry and the enforceability of contracts. Conflicting opinions on the permissibility of specific financial instruments or transactions would harm business confidence and market efficiency. Disclosure of all information relating to *Shari'ah* advisory functions would strengthen the credibility that the offered services are really distinct from conventional ones and, likewise, promote market discipline. (Graiss and Pelligrini, 2006)

To test the potential impact of the SSB on the managers' EM behaviour, we derive a composite measure of SSB effectiveness based on Pravitt et al. (2009); which used to measure the internal audit quality. Our composite measure is based on the five main CG issues discussed above from which we extract individual characteristics relating to the competence and objectivity of the work performed by the *Shari'ah* supervisor.

In fact, like internal auditors, members of SSB are expected to have the knowledge, skills, and other competencies required to execute their individual tasks (IIA 2005b). The more competent the SSB members, the more likely they are to understand the factors leading to and the indicators of management bias in accounting accruals and how it can be mitigated or at least moderated. In addition, executives may have less incentive to aggressively manage earnings if they have reason to believe that a competent SSB is also monitoring their accounting choices. Following and extending Beatty and Ritter (1986) to SSB members, a repeated invitation for the SSB members to serve on different SSB boards, develop a reputation. In addition, once the SSB members' reputation is in effect, they work harder in order to preserve their reputation, which leads to a superior-quality *Shari'ah* governance and religious rulings, which in turn enhances the IBIs performance. Therefore, the Islamic International Financial Organizations (IIFO) like the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) improves the SSB quality and soundness and thus improves the overall IBIs' performance. IBIs that subscribe to AAOIFI are or have been seeking to raise and improve the overall

¹ For the years before 2002, we consider the Big-5 auditors and after 2002 we consider the Big-4 auditors.

² The regulations in Iran, Pakistan and Sudan do not require the existence of an in-house SSB and rely only upon the *Shari'ah*-Apex to receive Fatwas on certain IBIs products and/or services, approaching the *Shari'ah*-Apex and wait for their religious ruling (Anwar, 2011).

products and services compliance and thus the performance of the IBs. Once the IBs are members, the AAOIFI may either elect an individual member of the IBs from the BOD and/or the SSB to represent the IB in the said organization. AAOIFI provides the necessary explicit and implicit knowledge and expertise in executing the accounting and auditing services in compliance with *Shari'ah* and that supports auditors in the process of conducting any auditing service. Combining both the explicit and the implicit knowledge and expertise enable smooth and transparent symmetric information sharing amongst the internal and external environment and thus far, we would expect SSB members that serve on one of the AAOIFI boards, are more competent. Therefore SSB member competence is proxied here by the IBs membership in the AAOIFI. *SSBCOMPET* is a dummy variable that equals 1 if the IBI is a member in the Auditing and Accounting Organization for Islamic Financial Institutions; it equals 0 otherwise.

Objectivity is important to SSB member's ability to play a significant role in affecting the quality of a bank's financial reporting. The more objective the SSB, the more probable it will be to report evidence of EM should it be discovered. Also, an objective SSB would be less likely to be steered away by executives from working in areas in which executives were managing earnings through manipulation of accrual. Again the same approach of Privatt et al (2009) will be used to proxy for the objectivity construct; we use a dummy variable which take the value 1 if the head of the SSB reports to the shareholders and the value 0 if it reports to management.

To create an overall composite measure of SSB effectiveness, we sum the scores of the individual effectiveness components to create *SSBEFFECT*, a composite measure of SSB effectiveness potentially ranging from zero to two. Larger *SSBEFFECT* scores indicate that SSBs are highly effective. This variable is expected to have a negative sign on the Probit Regression Model and we hypothesize that there should be a negative relationship between the effectiveness of the SSB and EM practices in Islamic banks, as follows:

H₅: Ceteris paribus, more effective SSBs are associated with lower intensity of EM.

3.3.2.6. Shari'ah Supervisory Board Size

Lipton and Lorch (1992) and Jensen (1993) suggest that larger boards could be less effective than smaller boards because of the coordination problems and the free riding of directors. Yermack (1996) reported that the ideal average board size to enable proper interaction and decision-making between top management and the board was around 6.5 to 8 members. In addition, as the size of the board increases, the board becomes diluted and less effective to the extent that it harts the performance of the firm. Thus, larger board size may not allow efficient utilization of resources due to the difficulties in coordination that cause fraction and increases the conflict between the members of the board and the top management. Smaller BOD size is able to mitigate any deficiency in communication and is more responsive to the needs of the firm. This is the reason why AGT scholars (Fama, 1980; Yermack, 1996; Jensen, 1993) recommend a relatively small BOD to reduce the monitoring duties costs. Extending the AGT theory of BOD size to the SSB size would lead us to expect that SSB Size correlates negatively with IBs EM. SSB Size is measured here by the total number of SSB member on the board.

H₆: Ceteris paribus, SSB size correlates positively with IBs EM intensity.

3.3.2.7. Governance Committee Existence

The IFSB (2006) suggests that each IBs set up a governance committee, comprising at least three members, to coordinate and integrate the implementation of the governance policy framework. This governance committee shall be authorized to oversee and monitor the implementation of the governance policy framework by working together with the administration, the audit committee and the SSB; and to provide the BOD with reports and recommendations based on its findings in the exercise of its functions. The roles of the governance committee shall complement those of the audit committee in some of the governance functions. However, if there are some perceived conflicts of interest between shareholders and IAHS, especially where the funds are commingled, the governance committee monitors primarily from the standpoint of the IAHS' interests if the audit committee monitors primarily from the standpoint of the shareholders' interests and in this regard the governance committee focus on the specificities of IBs (IFSB, 2006).

To control for the effects that the CG committee might have on EM behaviour in Islamic banks, we include the dummy variable *CGEXIST*; which indicates the presence or absence of a CG committee. This variable is proxied by the membership of the IBI in the IFBS; hence, the IBI which is member in the IFBS is supposed to have implemented a CG committee and assigned the value of 1 and the value of 0 otherwise. We use this variable because we expect that not all Islamic banks have established such committee. This is due the relatively recent recommendations to establish such committee in IBs and to the absence of consent about its effectiveness in mitigating opportunistic EM and in protecting IAHS interests (Grais and Pelligrini, 2006; IFSB, 2006). Since the roles of the governance committee is to complement those of the audit committee in some of the governance functions, thus we can plausibly expect that the presence of the CG committee can help mitigate EM behaviour. The following hypothesis is therefore stated:

H₇: Ceteris paribus, Islamic banks with CG committee are associated with lower intensity of EM.

3.3.3. Control variables

In addition to the above model variables, we have to control for several other factors suggested by previous literature as being associated with the EM behaviour as shown below:

3.3.3.1. Bank size

The asset size of the bank may play a role in the level of managers discretionary behaviour. Larger banks are the most

likely to be scrutinized by industry analysts. Similarly, while regulators are charged with maintaining the safety and soundness of the whole banking industry, they have at least some tendency to more closely inspect the largest banking institutions; which have the potential to brutally influence the industry and the overall economy. With analysts and regulators evaluating their performance, large banks would be less likely to artificially expand income using discretionary accruals¹ (Cornett et al, 2006). We will control for bank size by including the log of total assets (BANKSIZE), and we hypothesize the following:

H₈: Ceteris paribus, larger Islamic banks are less likely to manage earnings.

3.3.3.2. Bank Age

Due to the significant start-up costs associated with initializing operations, it is exceptional for new businesses to make profits in the first years of their operations. In the context of banks, this can be intensified because they may not be able to fully utilize the capital placed by investors. In this situation, banks may have low cumulative revenues relative to their capital base. Since in Islamic bank, IAHs share their profits with the shareholders and bear all losses, this would theoretically indicate that IAHs would have to share in the low returns in the first few years. This in fact can be conflicting with the interests of the IBI, as it can lead IAHs to withdraw their deposits and place them in banking institutions that provide better returns. To reduce this risk, IBIs will manage earnings to build confidence, even though it may result in instantaneous losses for the bank (Farook et al, 2012). Therefore, it is predicted that there is a negative relationship between the relative age of an IBI and the magnitude of profit distribution management. We will control for bank age by including the number of years of bank operation, and we hypothesize the following:

H₉: Ceteris paribus, older IBIs are associated with higher intensity of EM.

3.3.3.3. Bank Capital Position

The capital position of the bank also plays an important role in earnings and EM. That is, an unwell capitalized bank is subject to enlarged oversight by regulators, suggesting discretionary accruals would be minimized. In contrast, a better capitalized bank experiences less scrutiny by regulators and could more easily use discretionary loan loss provisions (LLPs) to manage earnings². Cornett et al. (2006) use the Tier 1 capital ratio to proxy for the capital position of the sample banks. Since We was unable to have the data concerning the tier capital of Islamic bank, we have proxy this variable by the Equity/Total Assets ratio as a capital adequacy ratio. We have included the variable BANKCP to control for both effects as demonstrated above. Hence, the appropriate hypothesis stated in alternative form is as follows:

H₁₀: Ceteris paribus, Islamic banks with higher capital position are associated with higher intensity of EM.

3.3.3.4. Bank growth

We include bank growth as a control variable because prior literature suggests that firm growth is positively associated EM behaviour (Menon and Williams 2004). Following Pravitt et al. (2008; 2009), we use the bank's cash flows from operations growth³ as a proxy for bank growth. It is calculated as the current period operating cash flows minus previous period operating cash flows divided by previous period operating cash. Operating cash flows growth may affect the propensities of banks to manage earnings. So it is necessary to control cash flows growth to isolate its effects on CG practices. The following hypothesis is therefore developed:

H₁₁: Ceteris paribus, bank growth is positively related to EM.

4. Results and Discussions

Table.1 exhibits the descriptive statistics of the variables used in the specified Probit Model.

Table.1 Descriptive Statistics

	Mean	Mode	Median	Std. Dev.	Jarque-Bera	Probability
<i>Scaled Earnings Levels*</i>	-	1	-	0.3067	998.132	0.0000
<i>Audit Committee Effectiveness*</i>	-	1	-	0.4999	68.3366	0.0000
<i>Auditor quality*</i>	-	1	-	0.4714	85.5447	0.0000
<i>Board of Directors Size</i>	8.2096	-	8	2.3917	10.1493	0.0062
<i>SSB Embeddedness*</i>	-	1	-	0.3311	629.280	0.0000
<i>SSB Effectiveness*</i>	-	2	-	0.5477	30.4434	0.0000
<i>SSB Size</i>	3.2851	-	3	1.6233	12.1921	0.0002
<i>CG Committee Existence*</i>	-	0	-	0.5002	82.5003	0.0000
<i>Bank size</i>	20.4905	-	20.4337	1.7778	2.5898	0.2739
<i>Bank Age</i>	14.2489	-	11	12.7080	1721.922	0.0000
<i>Bank Capital Position</i>	0.2344	-	0.1310	0.2450	386.606	0.0000
<i>Bank growth</i>	5.1261	-	-0.7126	79.9481	103191.6	0.0000

¹ Dechow and Dichev (2002) in contrast found that larger firms have larger accruals.

² Some prior research has found that highly leveraged firms are associated with both income-increasing accruals (Press and Weintrop 1990) to meet debt-covenant restrictions and income-decreasing accruals (DeAngelo et al, 1994; Frankel et al., 2002).

³ Menon and Williams (2004) used book-to-market ratio (BM), which is related to market expectations of growth prospects, as a measure of the firm growth. We were unable to collect reliable data about market value that's why we have adopted the cash flow ratio as a proxy for bank growth opportunities.

* These variables are categorical variables.¹

The mode of scaled earnings in the total sample is 1 indicating that most Islamic banks exhibit positive scaled earnings. For Audit Committee Effectiveness variable, the mode is 1 denoting that most Islamic banks have effectively functioning audit committees. The mode of SSB Effectiveness is 2, which is the highest indicating that Islamic banks have highly effective SSBs. For the audit quality variable, the mode is also 1 which indicates that most Islamic banks are audited by a Big-4 auditor. The same mode value is accorded the SSB Embeddedness variable indicating that most banks have an in-house Shari'ah supervisory board. For the CG Committee Existence variable, the mode is 0 indicating that not most Islamic banks had established an in-house CG Committee.

According to the median information, half of the Islamic banks have large sized board of directors (median =8) and small sized Shari'ah supervisory board (median = 3). The median is 0.131 for Bank Capital Position variable showing that half of banks are weakly capitalized. The mean of Bank Growth is 5.1261 and median is 0.7126 revealing that more than half of the Islamic banks are unable to improve their operating cash flows, in contrast it is declining over time.

Correlation matrix of independent variables used in the scaled earnings probit regression is displayed in Table.2.

Table.2 Correlations Matrix of Independent Variables

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
(1)ACEFFECT	1.0000										
(2)AUDITQUALITY	0.1172	1.0000									
(3)CGEXIST	-0.0417	0.1928* **	1.0000								
(4)BODSIZE	0.1280*	- 0.1353*	0.1282*	1.0000							
(5)SSBEMBED	0.0845	0.3331* **	0.2761* **	0.1596* *	1.0000						
(6)SSBEFFECT	-0.0528	-0.0026	0.2704* **	-0.0490	0.1596* *	1.0000					
(7)SSBSIZE	0.0738	0.1009	0.1653* *	0.2826* **	0.4320* **	0.2438* **	1.0000				
(8)BANKSIZE	-0.7750	0.0284	0.3773* **	0.1162	- 0.300** *	0.1105	0.1235*	1.0000			
(9)BANKAGE	- 0.255* **	- 0.245** *	0.1080	0.0061	- 0.334** *	0.0764	- 0.1501**	0.4401* **	1.0000		
(10)BANKCP	-0.0213	0.2136* **	- 0.1315*	0.0077	0.1657* *	-0.0333	-0.0284	- 0.521** *	- 0.309* **	1.0000	
(11)BANKGROWTH	-0.0009	0.0327	-0.0587	0.0122	- 0.250** *	-0.0773	-0.1181	0.0117	0.0190	-0.032	1.0000

***: Indicates significance level at less than 1% - **: Indicates significance level at less than 5% - *: Indicates significance level at less than 10%

The highest correlation is between BANKCP and BANKSIZE ; -0.521 (p <0.010), suggesting that larger Islamic banks have lower Equity/Total Assets ratios. The correlation between BODSIZE and ACEFFECT is also significant at the 10% level; the correlation coefficient is 0.128 implying that larger BOD sizes are associated with better audit committee effectiveness. The correlation between BANKCP and AUDITQUALITY is also positive and significant at the 1% level. This correlation shows that the more capitalised Islamic banks resort more to Big-4 external audit services. This result seems reasonable since Big-4 audit services are costly, only the well capitalized banks can support their charges. Idem, SSBEMBED and CGEXIST are positively and significantly associated with AUDITQUALITY indicating that Islamic banks with in-house SSBs and those who had established governance committees are more likely to resort to Big-4 external audit services.

BANKAGE an AUDITQUALITY correlation is significantly negative indicating that older Islamic banks resort less to Big-4 services. Likewise, BODSIZE is significantly and negatively associated to AUDITQUALITY implying that larger BOD resort less to Big-4 services.

Correlations between each of BODSIZE, SSBEMBED, SSBEFFECT, SSBSIZE and BANKSIZE on

¹ For categorical variables, the numbers are arbitrary, they simply provide a convenient label for a particular value. More precisely, the values in a categorical variable are expressed on a nominal scale: they each represent a logically separate concept. Hence they cannot be meaningfully ordered or manipulated as numbers would. Consequently, the central tendency of a set of categorical variables is given by its mode. Neither the mean nor the median can be defined.

one side and CGEXIST on the otherside are significantly positive implying that IBIs are more likely to establish governance committees when they have larger SSBs or BODs or when they have effective in-house SSBs. However, the correlation between CGEXIST and BANKCP is surprisingly negative and significant. We don't have an explanation for this finding; it calls for an independent deep research to take along its explanations.

Another substantial correlation is the one between SSBSIZE and BODSIZE. It is positive and highly significant indicating that IBIs with larger BODs are more likely to have larger SSBs. This finding is expected, indeed, the BODs delegate responsibilities and duties and then monitors the management behaviour as a measure to guarantee management's compliance in implementing and deploying the BOD's strategies. SSBs monitoring and controlling overlap with the BOD but from the religious and ethical perspective and they delegate the BOD and the management the responsibility of executing the ex-ante approved products and services as well as ensuring compliance to their religious guidelines. These duties overlaps make SSBs and BOD size to be somewhat analogous (Anwar et al., 2011).

Positive and significant correlation between BODSIZE and SSBEMBED can take the same explanation. Moreover, positive and significant correlation between SSBSIZE and SSBEMBED is also normal; we cannot talk about SSB size if the IBI does not have an in-house SSB. The SSBEMBED and SSBEFFECT positive correlation indicates that *Shari'ah* supervision is more effective when it is made by an in-house SSB. Positive and significant correlation between BANKCP and SSBEMBED denotes that the better is the capital position of an IBI the more it is likely to establish an in-house SSB. Nevertheless, the negative and highly significant correlations between BANKSIZE, BANKAGE or BANKGOWTH on one side and SSBEMBED on the other side are surprising, because larger, older and higher growing IBIs are the more expected to have in-house SSBs. We do not have a justification for these findings, they can be the objective of an independent future research.

SSBSIZE and SSBEFFECT correlation is positive and highly significant indicating that larger SSBs are more effective in performing *Shari'ah* supervision. This finding is in line with AGT precepts, but it is consistent with the Steward Theory (STD) and the Resource Based View Theory (RBV). Both of the STD and RBV suggest that larger boards are better. On the other hand, the BANKSIZE and SSBSIZE correlation is positive and significant implying that larger IBIs are more likely to employ larger SSBs. This is due to the fact that enormous numbers of transactions in larger IBIs require more Shari' a scholars to monitor and certify them.

Positive and highly significant BANKAGE and BANKSIZE correlation indicates that older IBIs are larger in the sense that they have more assets that they have collected over time. Finally, correlations between BANKAGE on one side and BANKCP or SSBSIZE on the other side are negative suggesting that older IBIs are less capitalized and resort the service of smaller SSBs.

We include these variables in the Probit regression model since correlations are not too strong (lower than 0.700: See Norman Mohd et al., 2005 and Welkowitz et al., 1991).

Table.3 reports estimates from Probit regression.

Table.3 Multivariate Probit Analysis Results

Panel A: CG Variables			
	Coefficient	Z - Statistic	Prob.
Intercept	-1.915146	-0.688665	0.4910
Audit Committee Effectiveness	-1.024735	-2.718129	0.0066
Auditor quality	-0.746773	-1.479799	0.1389
BOD Size	0.001382	0.021593	0.9828
SSB Embeddedness	-0.953679	-2.356993	0.0184
SSB Effectiveness	0.423385	1.631738	0.1027
SSB Size	-0.147314	-1.515452	0.1297
CG Committee Existence	-0.145555	-0.474479	0.6352
Panel B: Control Variables			
	Coefficient	Z - Statistic	Prob.
Bank size	0.240038	1.605664	0.1083
Bank Age	-0.011453	-0.706264	0.4800
Bank Capital Position	-1.318029	-1.907301	0.0565
Bank growth	0.015364	1.832855	0.0668

Our expectation about the association between earning management and audit quality is not strongly supported. The results are at the same direction of our expectation (coefficient = -0.747) but statistically insignificant ($z = -1.480$; $p = 0.138 > 0.10$). The loss avoidance EM is really negatively associated with the audit quality variable but this association is not statistically significant. Thus, we can't conclude

that the crossing zero thresholds EM is likely to increase for low audit quality firm. The literature attribute the insignificance of an association between the audit quality and loss avoidance EM practices to different reasons. For example, Francis and Krishnan (1999) showed that external auditors are more conservative with respect to income increasing than income decreasing accruals. Higher quality external auditors (Big-4 firms) are more effective in monitoring opportunistic behaviour than non-Big-4 external auditors in firms with income-increasing accruals, but that Big-4 external auditors are less effective than non-Big-4 external auditors at deterring opportunistic behaviour when firms have incentives toward income-decreasing accruals. Idem, Francis et al. (1999) argued that high-accrual firms have greater opportunity for opportunistic management and have an incentive to hire a Big-5 auditor (now big-4) to provide assurance that earnings are credible. They found that high accrual firms are more likely to hire a Big-5 auditor, but report lower discretionary accruals, consistent with Big-5 auditors constraining opportunistic reporting of accruals.

Thus the use of big-4, non-Big-4 as proxy of audit quality can be the cause of the unexpected result. An alternative proxy of audit quality can be used in future research in the Islamic banking. For example, we can use industry specialist auditor as a proxy. Indeed, Krishnan (2003) finds that Big-5 industry specialist auditors are associated with lower discretionary accruals for existing publicly-traded companies. Balsam et al. (2003) indicate that the use of an industry specialist auditor is negatively associated with the absolute value of discretionary accruals. Zhou and Elder (2002) find that industry specialist auditors are associated with lower discretionary accruals for IPO companies. We examine whether IBIs specialist auditors are associated with reduced earnings management.

With regards to the effectiveness of audit committee to mitigate EM, the results show a significant negative association between ACEFFECT and EM (Coefficient = -1.025; $z = -2.718$; $p = 0.0066$). This suggests that an effective audit committee can reduce the probability of EM to avoid reporting losses. Hypothesis $H_{4.1}$ is thus supported which suggests that IBIs which intend to manipulate earnings may choose not to form effective audit committee, whereas IBIs with ineffective audit committees leave doors open for EM.

Line 8 of Table 3 exhibits a negative association between *CGCEXIST* and EM. The result suggests that the existence of CG committee decreases the probability of EM (Coefficient = -0.145). However, the association is not statistically significant ($z = -0.474$; $p = 0.635 > 0.10$). This suggests that governance committee is not effective to mitigate EM as expected and as stipulated by the IFSB guiding principles on CG (IFSB, 2006). However, due to the distinct nature of governance committee and its role, which complements the BOD, the SSB and audit committee roles and due to the importance of having the right capable members that are able to fulfill their role in a situation where the IBIs are large, we can assert that investigation into this issue is subject to further in-depth research utilizing other methods and measurements tools.

Line 4 displays the Probit regression results on the effect of BODs size on EM. The estimated coefficient of *BOD size* is positive (Coefficient = 0.001), indicating that a larger members serving on the *BOD* are likely to lead to more EM. This result is consistent with the AGT precepts which postulate that smaller BOD size is appropriate to minimize agency monitoring costs and to ensure good communication and coordination amongst board members. However, we cannot validate the hypothesis $H_{4.3}$ since this coefficient is not statistically significant ($z = 0.022$; $p > 0.10$). This result is really alarming that Board Size has no impact on EM. May be this is due to the reason that board size in Islamic banks is not actually of great importance.

The estimated coefficient of *SSB embeddedness* is -0.95 and statistically significant ($z = -2.357$; $p < 0.05$). This coefficient is in the expected direction. It indicates that there is difference between IBIs with in-house SSB or without in-house SSB within their governance structure. The IBIs with an in-house SSB are less likely to conduct EM. Thus, there is evidence supporting the effects of SSB embeddedness on EM. SSB in Islamic banking has therefore a crucial role in governing bank transactions and operations, and in monitoring and supervising the roles of all players within the banking system (Anwar, M., 2011).

The estimated coefficient of *SSB size* is -0.147 not in the expected direction, indicating that a larger SSB members serving on the SSB leads to less EM. However, it is not statistically significant ($z = -1.515$; $p = 0.13 > 0.10$). This does not support the belief that SSB size is important element, like BOD size, that provides additional support to the BOD members in conducting and executing ex-ante and ex-post audit to confirm that IBIs are compliant with Islamic *Shari'ah* precepts. Thus, it does provide support for hypothesis $H_{4.6}$. Furthermore, this result is not consistent with prior literature findings and AGT precepts suggesting that larger boards could be less effective than smaller boards because of coordination problems and the free riding of directors (Fama, 1980; Lipton and Lorch, 1992; Jensen, 1993; Yermack, 1996).

The estimated coefficient of *SSBEFFECT* is 0.423 signifying that more effective *SSB* leads to more income-increasing EM. However, the coefficient is not statistically significant ($z = 1.632$; $p = 0.103 > 0.10$). It indicates that competent and independent members serving on the *SSB* do not impact bank managers' financial reporting decision-making. This result does not provide any support for significant effect of *SSB* characteristics on EM. It appears, therefore, that in spite of having a unique position in the governance structure of Islamic banks, *SSB* seems to not be efficient in mitigating EM behaviours. There are a few possible reasons that could explain the results of no effect of *SSB* characteristics on the management accounting choices decisions among Islamic banks. First, it is possible that some *SSB*'s members are less devoted to their religion and adhere less to the teachings of Islam. Probably, the *SSB*'s members are originally¹ western trained as the mainstream education system in the majority of country where Islamic bank are implemented where religious teachings are incorporated as a minor subject (Abdul Muthalib, 2002). Second, it is possible that the Probit model used is not robust enough to capture the effect of *SSB* characteristics. The proxy used to measure *SSB*'s variables, i.e., *SSBEFFECT*, may not be an accurate measure of the Shari'ah audit effectiveness. Finally, it is possible that there are omitted variables that need to be included in the model.

When we rerun the results for Table.3 using the individual components of Shari'ah supervisory board effectiveness in place of our composite *SSBEFFECT* measure, we find that these individual components *SSBCOMPET* and *SSBOBJECT* are not significant. In fact, the *SSBOBJECT* estimated coefficient is insignificant ($z = -0.050$; $p = 0.960 > 0.10$) which does not support any effect of *SSBOBJECT* on EM. It unfirms the prediction that the more objective the *SSB*, the more likely it will be to report evidence of EM should it be discovered. On the other hand, the *SSBCOMPET* estimated coefficient is positive but statistically insignificant ($z = 1.472$; $p = 0.141 > 0.10$). This result indicates that higher reputation of *SSB* members does not constrain Islamic banks managers from manipulating earnings. Consequently, findings for individual components (*SSBCOMPET* and *SSBOBJECT*) do not support hypothesis H.4.5.

The coefficients on *BANKGROWTH* is significant in the expected direction (Coefficient = 0.015; $z = 1.833$; $p = 0.067 < 0.10$) indicating that Islamic banks with higher growth ratio tend to have higher probability of reporting small positive earnings. This result roughly confirm our prediction as well as past empirical findings.

The *BANKCP* coefficient is significant but in the opposite direction of that predicted (Coefficient = -1.318; $z = -1.318$; $p = 0.057 < 0.10$). It suggests that low and medium capitalised IBIs exhibit higher propensity to report small positive earnings than the high capitalised IBIs. A possible explanation may be found from the fact that it may be more difficult to manage earnings for the IBIs with high capital intensity ratio than the IBIs with low capital intensity ratio. So, the degree of EM is more extensive if low capitalised IBIs tend to report positive earnings by manipulating earnings.

For *BANKAGE* variable, the coefficient is negative but insignificant, unfirming our expectation that mature and stagnant IBIs are more likely to report positive earnings. In contrast, we find that a growth Islamic banks are more likely to enjoy stable and positive net income. This result is conflicting to White et al. (2003), Stickney and Weil, 1996) and Savich and Thomposon (1978), in that they provide little evidence of a pattern that firms with shorter life-cycle are more likely to manage earnings. The results are somewhat surprising and we may have to question how valid age is in assessing the IBI behaviour in EM. Finally, the coefficient of the variable representing the bank size is estimated at 0.240 ($Z=1.606$). These estimates suggest that large IBIs tend to report more positive earnings than small ones even though these effects are not statistically significant; we cannot thus support the hypothesis that large IBIs have stronger desires and are more likely to manipulate earnings to keep consistent positive earnings.

5. Conclusion

This paper examines corporate governance (CG) characteristics in Islamic banking institutions (IBIs). In particular, it studies CG variables identified as relevant by academics and practitioners and examined their respective impact on the EM behaviour of Islamic banks. Investigation has used multivariate probit analysis and relied on a sample of 90 Islamic Banks over the period of the years 2000-2009.

Findings reveal that the governance issues in Islamic banking differ significantly from those of the conventional system. Main differences are found with regard to philosophical aspects, including objectives of the bank, natures of contract involved, key players in the CG practice as well as the relationships between the players. These differences provide "strong justification for an additional layer in the CG of an Islamic bank" (Nienhaus, 2007), being the Shari'ah Supervisory Board (*SSB*) which acts as a religious supervisory board and aims to ensure that the bank's practices and activities do not contradict Shari'ah

¹ The primary and the secondary schools.

principles (Colditz, 2009). The mechanism and tools for the effective implementation of CG in IBIs are relatively the same as the conventional system.

The results also indicate that most CG mechanisms do not have significant impacts on IBIs earnings management behaviour. Taken as a whole, they suggest that audit committee plays a more significant role in moderating EM than the other aspects of CG. Moreover, the estimated coefficients of SSB embeddedness suggest that an in-house Shari'ah supervisory board is effective in mitigating EM. The results, however, do not provide evidence that SSB with stronger governance characteristics are associated with higher earnings quality. Effects of SSB variables are modest in the sense that they are not statistically significant. In the same way, no difference has been detected between IBIs with and without governance committee in terms of EM practices. This denote that governance committee is not an effective body in IBIs. It has no significant effect on EM intensity. Given that governance committee is supposed to ensure the interests of IAHs (IFSB, 2006a), we can say that the interest of IAHs are not well considered when practicing EM.

These later results are unexpected and can be interpreted in different ways. First, it is argued that despite the significant conceptual and philosophical differences between Islamic and conventional CG, mechanism and tools for the implementation of CG in IBIs are relatively the same as the conventional system. This fusion of Islamic CG with pre-existing conventional CG, without prior critical assessment of conventional CG, denotes a substantial imitation of conventional CG methodology and content. This failure to systematically apply an independent Islamic CG mechanisms that is coherent in Islamic epistemology, method and content, may be seen as an aberrant tendency in the islamization of financial systems. Unfortunately, research that is capable of catalyzing Islamic banking industry developments, are constrained by industry and market realities; the international dominance of the conventional banking system and the application of the OECD¹ principles of CG and the BCBS² guidelines, by the IFSB upon IBIs (Marilyn, 2010). These conventional mechanisms may be irrelevant for Islamic banks that's why they were found insignificant for deterring EM in IBIs while they were proven as relevant EM moderators in conventional banks.

Second, it is argued that SSB has extensive provisions for good business behaviour and accountability, but the causality of SSB leading to less EM requires further theoretical and empirical examination. While the principles of Shari'ah call for honest and trustworthy behaviour, whether or not the SSB member take appropriate action in accounting on the basis of Shari'ah needs further inspection at the bank and the individual levels. Another explanation for the unexpected dissociation between SSB characteristics and EM can be related to the issue of the missing variables. For example, professional values of SSB members, membership in International Islamic Financial Organizations accountants or board composition can affect the preparation of accounting financial reports. Further research is needed to deal with these limitations before we can draw reliable conclusions about the role of SSB in accounting decision making.

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¹Organization for Economic Cooperation and Development.

² Basel Committee on Banking Supervision.

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Faouzi Mohamed Hamdi was born in *Thala*, Tunisia, in 1976. He received the bachelor's degree in Accounting from the University of Tunis, Tunisia, in 1999, and the M.Sc. and Ph.D. degrees from the University of Manouba and the University of Tunis, in 2002 and 2014, respectively. He holds also a bachelor's degree in Islamic *Shari'ah* sciences, from the Higher Institute of Theology of *Zaytuna* University in 2009. He is a postgraduate in information technology Specialization: "Networking and Telecommunication Services" from the Higher School of Telecommunication of Tunis. Dr. Faouzi is a Certified Islamic Professional Accountant (CIPA) and a Certified *Shari'ah* Adviser and Auditor (CSAA). He is a Certified Islamic Banker and he is a Member of the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI). His current research interests include corporate governance, Islamic financial accounting practices, Islamic financial transactions auditing, and Accounting Information Systems in Islamic financial institutions

Mohamed Ali ZARAI is Associate Professor of Financial accounting at Al Baha University (KSA). He obtained a Phd from the University of Nice, France in 2002. Previously worked as an expert of financial

accounting for many French and German companies. He also served head of the accounting and financial department for a company specializing in industrial engineering in Tunisia. He has more than twenty research published in international journals. He also participated in several seminars related to development, quality and academic accreditation. His research interests: corporate governance, Islamic economics, international accounting standards, audit.

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