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Sharia Compliance: An Exploration of Earnings Management and Performance in the IDX-IC

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ABSTRACT

This study aims to investigate the effect of Sharia compliance on performance and earnings management across all sectors. This research employs an empirical research method, using multiple linear regression and independent-samples t-tests on a dataset comprising 2,243 firm-year observations of companies listed on the Indonesia Stock Exchange over the 2015–2021 period. The findings show that Sharia firms generally perform better than non-Sharia firms. Sectoral analysis reveals that eight out of ten industrial sectors demonstrate superior performance in Sharia firms, while technology and consumer non-cyclicals show no significant difference. Regarding earnings management, no significant differences are observed between Sharia and non-Sharia firms, except in the Transportation and Logistics sector. The theoretical implication of this study extends the literature on the role of Sharia compliance in firm performance, confirming that religious adherence can enhance efficiency and value creation. However, it does not eliminate earnings management practices. The practical implication emphasizes the need for regulators, investors, and corporate managers to strengthen oversight and corporate governance to ensure transparent and accountable accounting practices across both Sharia and non-Sharia firms. The novelty of this research lies in its cross-industry scope and large-firm-year observations, providing a comprehensive view of performance and earnings management differences between Sharia and non-Sharia firms, which have been underexplored in previous studies.

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1. INTRODUCTION

Profit is one of the primary indicators of a company's performance, reflecting management's effectiveness in utilizing resources. However, managers with low ethical standards may manipulate earnings to make the company's performance appear better (Hanafi et al., 2024; Alodat et al., 2024). They used discretionary accruals to inflate earnings to meet a financial target or to smooth income (Alsaadi, 2025). Such practices create an artificial impression of stability and consistency in financial performance, potentially misleading investors and stakeholders (Fowler, 2023). Financial performance, particularly profitability, is often used as a benchmark for managerial effectiveness and long-term prospects, with return on assets (ROA) reflecting the efficiency of asset utilization in generating profits (Brigham and Daves, 2021; Kusuma, 2021). Nevertheless, questions arise as to whether reported profitability genuinely represents actual operational results or is influenced by earnings manipulation, which can mislead financial statement users and undermine the credibility of reported performance.

Although numerous studies on earnings management have been conducted, most research still analyzes entire industrial sectors in aggregate. This approach has the potential to obscure differences in managerial behaviour across sectors, even though the business dynamics of each sector can influence the quality of financial reporting. Earnings management practices tend to vary across industrial sectors, depending on competitive structure, regulations, earnings volatility, and market pressures (Nasrun and Adil, 2024). Cross-sector comparative studies in Indonesia are still relatively rare, resulting in a lack of empirical evidence on how earnings management practices and financial performance differ across industry classifications. Addressing this gap is essential for deeper insights into financial practices and sectoral differences.

Further sectoral differences, Sharia compliance is an important factor that may influence firm performance and earnings management. Sharia-compliant firms must avoid activities involving usury, excessive uncertainty, and unethical transactions, while maintaining governance that includes Sharia experts (Saba et al., 2020; Barafwala and Mehta, 2023). Such compliance promotes prudence, transparency, and long-term business orientation. Prior studies have shown that Sharia-compliant firms generally outperform non-compliant firms (Akguc and Al Rahahleh, 2018; Boulanouar et al., 2024; Pepis and De Jong, 2019; Taufik and Budiarsyah, 2025) and tend to be involved in less earnings manipulation (Khaw et al., 2023). Other studies also show that firms with lower levels of religiosity are more likely to engage in fraudulent practices (Agustia and Suryani, 2018). However, these findings remain inconsistent across contexts, indicating the need for further empirical testing in the Indonesian capital market.

In Legitimacy Theory (Dowling and Pfeffer, 1975), every organisation strives to align itself with the social values inherent or implicit in its activities, in order to align with the norms of behaviour considered appropriate by the broader community in which it operates. In the context of Sharia compliance, a company's adherence to Sharia principles aligns its business activities with societal values. It enables the company to maintain support from its social environment, thereby strengthening its market position. Furthermore, Sharia governance strengthens this legitimacy through ethical, accountable governance mechanisms that encourage prudent, efficient, and responsible decision-making.

Based on the above discussion, this study aims to address two main questions: first, does Sharia compliance affect firm performance, and does this relationship vary across industry sectors? Second, does Sharia compliance influence earnings management, and are there sectoral differences? This research differs from prior studies by comprehensively analysing all industry classifications under the IDX-IC and examining Sharia compliance as both an influencing and differentiating factor in firm performance and earnings management. The findings are expected to

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enrich the empirical literature and provide practical insights for investors, analysts, and regulators to promote transparency and strengthen public trust through Sharia governance.

2. METHODS

This study uses a quantitative research method with a descriptive and causal-comparative approach, aiming to examine the relationships and differences among variables using empirical numerical data. This method was chosen because it enables objective measurement and statistical testing of hypotheses regarding Sharia compliance to earnings management and firm performance across different sectors.

This study uses a sample of firms listed on the Indonesian Stock Exchange (IDX) from 2015 to 2021. Data were collected from annual reports and the official IDX website. We include all industrial sectors except the financial sector. The financial sector is excluded because it exhibits distinct characteristics and regulatory frameworks compared to other industries (Korkmaz et al., 2017). In addition, firms with insufficient data over the observation period were excluded, resulting in a total of 2,289 firm-year observations. Furthermore, normality testing was conducted, and 46 extreme observations were removed. Accordingly, the final dataset for this study comprises 2,243 firm-year observations. **Table 1** presents the distribution of the sample across industrial sectors.

Table 1. Sample distribution

Industry	N (firms-years)
Healthcare	84
Basic materials	371
Transportation and Logistic	84
Technology	21
Consumer Non-cyclicals	399
Industrials	168
Energy	287
Consumer Cyclicals	434
Infrastructures	175
Properties and Real Estate	266
Semua data lengkap	2,289
Data extrem yang dikeluarkan	(46)
Final data yang digunakan	2,243

Source: Data IDX Processed (2025)

Earnings management is measured using the discretionary accrual (DA) proxy model of Jones, modified by Dechow et al. (1995). This model is widely acknowledged as having stronger predictive power than competing models (Gbadebo et al., 2023). To calculate discretionary accrual (DA) for firm *i* at year *t* in this study, several equations are used as follows:

$$TAC_{it} = NI_{it} - CFO_{it} \quad (1)$$

$$\frac{\mathrm{TAC_{it}}}{\mathrm{TA_{it-1}}} = \beta_1 \left(\frac{1}{\mathrm{TA_{it-1}}}\right) + \beta_2 \left(\frac{\Delta \mathrm{Rev_{it}}}{\mathrm{TA_{it-1}}}\right) + \beta_3 \left(\frac{\mathrm{PPE_{it}}}{\mathrm{TA_{it-1}}}\right) + \varepsilon \quad (2)$$

$$NDAC_{it} = \beta_1 \left(\frac{1}{TA_{it-1}}\right) + \beta_2 \left(\frac{\Delta Rev_{it} - \Delta Rec_{it}}{TA_{it-1}}\right) + \beta_3 \left(\frac{\mathrm{PPE_{it}}}{TA_{it-1}}\right) + \varepsilon \quad (3)$$

$$\mathrm{DAC_{it}} = \frac{\mathrm{TACC_{it}}}{\mathrm{TA_{it-1}}} - \mathrm{NDACC_{it}} \quad (4)$$

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where, TAC is total accruals; NI is net income; CFO is cash flow operating; TA is total assets; ΔRev is the change of revenue; PPE is property, plant, and equipment; NDAC is non-discretionary accruals; ΔRec is the change of receivable; DAC is discretionary accrual; *it* is firm and year; $\mathcal{E}$ is error.

Moreover, discretionary accruals (DAC) may take either positive (DAC+) or negative (DAC–) values. A positive DAC reflects managerial discretion aimed at inflating reported earnings, whereas a negative DAC represents discretion used to reduce reported earnings. In this study, the absolute value of DAC is employed, disregarding its sign, in order to capture the intensity of earnings management practices (Klein, 2002), consistent with prior studies that focus on the magnitude rather than the direction of accrual manipulation (Liu et al., 2018; Jiang et al., 2020).

Profitability is the level of success in achieving its financial and operational goals. Performance reflects how effectively and efficiently a company uses its resources to generate profit and value for stakeholders. Generally, performance is measured using return on assets (ROA), which is net income divided by total assets (Hanafi and Sutapa, 2024). ROA is considered one of the most reliable indicators for evaluating company performance (Taysi, 2020).

Sharia compliance is measured by Sharia-compliant firms that operate in accordance with Islamic law. These firms refrain from activities involving riba (interest), gharar (excessive uncertainty), and maysir (speculative or gambling-related activities), and they do not manufacture or provide products and services that are prohibited under Sharia principles. In this study, Sharia-compliant firms are identified based on their inclusion in the Indonesian Sharia Stock Index (ISSI). A value of 1 if listed on the ISSI and 0 otherwise (Alsaadi et al., 2017; Qoyum et al., 2022; Adiwijaya and Hanafi, 2025).

In addition to the main variables, this study includes control variables to account for firm-specific characteristics that may affect the dependent variable (Hanafi et al., 2024). The control variables used are those commonly employed by previous researchers, including debt level (proxied by leverage), company size (proxied by total assets), and audit quality (proxied by Big-4 audit firms, namely Deloitte, PwC, EY, and KPMG).

This study uses Model 1 to examine the effect of Sharia compliance on earnings management, and Model 2 to examine its effect on profitability. Furthermore, independent t-tests were conducted for each industry sector to examine differences in Sharia compliance and earnings management.

$$\text{Model 1, A\_DA} = \alpha + \beta_1 \text{SF} + \beta_2 \text{Control variables} + \varepsilon \quad (5)$$

$$\text{Model 2, PR} = \alpha + \beta_1 \text{SF} + \beta_2 \text{Control variables} + \varepsilon \quad (6)$$

3. RESULT AND DISCUSSION

3.1. Descriptive Statistics

Table 2 describes the variables used in this study using the full sample. The Absolute Discretionary Accrual (A_DA) indicates that the sampled firms exhibit a mean earnings management level of 0.083, with values ranging from 0 to 0.7. The average A_DA value of 0.083 indicates that the company's earnings management is in the moderate category. Meanwhile, the standard deviation of 0.086, which is nearly equal to the average, indicates significant variation in earnings management across companies.

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Table 2. Descriptive statistic full sample

Variables	Obs.	Min.	Max.	Mean	SD
A_DA	2,243	0.000	0.700	0.083	0.086
PR	2,243	-0.579	0.458	0.026	0.096
SF	2,243	0.000	1.000	0.730	0.445
LV	2,243	0.003	5.168	0.512	0.423
SZ	2,243	0.000	18.922	13.518	2.142
B4	2,243	0.000	1.000	0.386	0.487

Source: processed secondary data (2025)

Profitability (PR) has an average value of 0.026, indicating that companies generally generate profits of around 2.6% of total assets. PR values range from -0.579 to 0.458. The standard deviation of 0.096 reflects a fairly high level of data dispersion, indicating that profitability across companies is not uniform and exhibits quite significant variation. Sharia Firms (SF) have a mean of 0.73, indicating that approximately 73% of companies in the sample are included in the group of sharia companies, and the rest are non-sharia companies. The data distribution is quite even, with a standard deviation of 0.445 below the mean.

Furthermore, for the control variables, leverage (Lv) has a mean of 0.512 and a standard deviation of 0.423, indicating that, in general, the company's capital structure is balanced between debt and equity. The leverage range is 0.003 to 5.168, indicating companies with very low to very high debt levels and reflecting significant variations in funding policies. Firm size (SZ), proxied by the natural logarithm of total assets, has a mean value of 13.518 and a standard deviation of 2.142. The observed values range from 0.000 to 18.922, indicating substantial variation in firm size, from relatively small entities to huge firms. It indicates that the sample includes companies with highly varied asset characteristics. Meanwhile, the Big Four audit variable (B4) has an average of 0.386, indicating that around 38.6% of companies in the sample use the services of Big 4 auditors, with a relatively balanced distribution between companies audited by the Big 4 and those not audited by them.

In addition to describing each variable, this study also examines the industrial sectors associated with earnings management and profitability. It is shown in **Table 3** below.

Table 3. Descriptive statistics abs_DAC and PR per industry

Industry	**A_DA**					**PR**				
	Obs.	**Min.**	**Max.**	**Mean**	**SD.**	**Obs.**	**Min.**	**Max.**	**Mean**	**SD.**
Healthcare	82	0.004	0.429	0.089	0.090	82	-0.238	0.310	0.080	0.082
Basic materials	362	0.000	0.530	0.099	0.091	362	-0.448	0.264	0.018	0.073
Transportation and Logistic	73	0.002	0.507	0.072	0.092	73	-0.576	0.168	-0.025	0.109
Technology	21	0.004	0.332	0.115	0.101	21	-0.134	0.158	0.060	0.068
Consumer Non-cyclicals	390	0.000	0.472	0.082	0.083	390	-0.460	0.432	0.039	0.107
Industrials	165	0.001	0.477	0.082	0.082	165	-0.401	0.316	0.031	0.082
Energy	284	0.001	0.513	0.086	0.084	284	-0.579	0.456	0.027	0.126
Consumer Cyclicals	429	0.000	0.700	0.085	0.086	429	-0.503	0.458	0.016	0.095
Infrastructures	171	0.002	0.651	0.069	0.078	171	-0.439	0.175	0.022	0.076
Properties and Real Estate	266	0.000	0.671	0.062	0.085	266	-0.375	0.359	0.029	0.076
Total	2,243					2,243				

Source: processed secondary data (2025)

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Based on the descriptive analysis by industry sector, the technology sector shows the highest average level of earnings management (A_DA = 0.115). This finding suggests that firms in the technology industry tend to engage more actively in discretionary accruals than those in other sectors. The dynamic, innovation-driven nature of this sector may lead managers to adopt greater flexibility in financial reporting to meet performance expectations or attract investors. Conversely, the property and real estate sector shows the lowest average A_DA (0.062), indicating a relatively lower tendency toward earnings management. This result implies that firms in this sector may adopt more conservative accounting policies or face tighter regulatory and reporting standards. The variable A_DA, which represents absolute discretionary accruals, measures the magnitude of earnings management regardless of whether firms increase or decrease reported income. Therefore, a higher A_DA value reflects greater discretionary accounting adjustments, signaling stronger earnings management within a sector.

In terms of profitability (PR), the Healthcare sector recorded the highest average profitability ratio (0.080), followed by the Technology sector (0.060) and the Consumer Non-Cyclicals sector (0.039). In contrast, the Transportation and Logistics sector posted the lowest average profitability of -0.025, indicating that several companies in this sector experienced significant losses. The PR variable (performance or profitability ratio) represents a firm's financial performance, commonly measured by indicators such as return on assets (ROA). A higher PR value reflects stronger profitability and better overall firm performance. These findings suggest that both earnings management practices and financial performance vary considerably across industries, highlighting the influence of sector-specific characteristics. This result can serve as a foundation for further analyses, such as difference tests.

3.2. The Correlation

Table 4 reports the correlation coefficients among the variables examined in this study. The correlation analysis aims to identify the strength and direction of linear relationships among variables and to test potential collinearity issues before conducting regression analysis. As shown in the Table, none of the coefficients exceeds 0.90, indicating the absence of multicollinearity problems among the variables (Hair, 2009). The highest correlation occurred between firm size (SZ) and Big Four audit (B4) with a coefficient of r = 0.342, which remains below the critical threshold of 0.90. It suggests that the data are suitable for further regression testing.

The correlation between the dependent variable, earnings management (A_DA), and the independent variables is relatively weak. A_DA has a small positive relationship with leverage (LV) (r = 0.130), indicating that firms with higher debt levels may engage slightly more in earnings management. Conversely, A_DA shows negative correlations with Shariah firms (SF) (r = –0.028), firm size (SZ) (r = –0.162), and Big Four audit (B4) (r = –0.019), suggesting that firms with higher Shariah compliance, larger size, and Big Four auditors tend to engage less in earnings management.

Furthermore, the dependent variable, firm performance (PR), correlates negatively with leverage (LV) (r = –0.224), implying that higher debt is associated with lower profitability. Conversely, firm performance (PR) shows positive relationships with Shariah firms (SF) (r = 0.195), firm size (SZ) (r = 0.117), and Big Four audit (B4) (r = 0.243), indicating that firms with higher Shariah compliance, larger size, and Big Four auditors generally show better performance.

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Table 4. Correlation

Variables	A_DA	PR	SF	LV	SZ	B4
A_DA	1					
PR	-0.105	1				
SF	-0.028	0.195	1			
LV	0.130	-0.224	-0.293	1		
SZ	-0.162	0.117	-0.040	0.037	1	
B4	-0.019	0.243	0.047	-0.042	0.342	1

Source: processed secondary data (2025)

3.3. Multiple Linear Regression Analysis

Regression analysis was conducted using two models: Model 1 and Model 2. Model 1 examines the effect of Sharia firm status (SF) and control variables on earnings management (A_DA). Model 2 analyzes the effects of Sharia-firm and control variables on firm performance (PR). Based on **Table 5**, the regression results show that Sharia compliance does not significantly influence earnings management (A_DA) (β = 0.000; p = 0.907). Sharia firms (SF) do not differ significantly from non-Sharia firms in their discretionary accrual practices. It indicates that Sharia compliance is not yet a fully controlling factor for earnings management practices. However, on company performance (PR), Sharia compliance has a significant positive effect (β = 0.029; p = 0.000). These results indicate that applying Sharia principles can improve performance. It aligns with the findings of Panakaje et al. (2025), which indicate that leaders who implement Islamic values can create an environment conducive to moral behavior, transparency, and ethical decision-making, ultimately influencing organizational performance.

Leverage (LV) positively affected A_DA (β = 0.028; p = 0.000). It indicates that highly leveraged companies tend to engage in earnings management to maintain the appearance of financial statements. It is supported by the finding that leverage positively affects earnings management, as higher leverage increases pressure on managers to present profitable financial results to creditors (Nalarreason et al., 2019; Agustia and Suryani, 2018). Conversely, leverage negatively affected PR (β = -0.040; p = 0.000). The study supported that financial leverage significantly negatively impacts performance, indicating that high debt burdens can depress company profitability (Akhtar et al., 2022).

Size (SZ) significantly negatively affected A_DA (β = -0.007; p = 0.000). The research indicates that larger firms manage their earnings less than smaller firms, suggesting that firm size is a significant factor in earnings management. This finding is consistent with Gajdosikova et al. (2022), who report that small firms engage in aggressive earnings management, medium-sized firms adopt more conservative earnings management practices, and large firms tend not to engage in earnings management. It is consistent with the literature, which states that large companies are better able to leverage economies of scale, access funding, and diversify their businesses, thereby improving performance (Dang et al., 2018). Larger firms tend to exhibit lower levels of earnings management and better performance, which ultimately enhances firm value (Nurdin et al., 2023; Maulana et al., 2022).

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Table 5. Multiple liniar regression

Variables	Model 1 (A_DA)		Model 2 (PR)	
	β	p-value	β	p-value
SF	0.000	0.907	0.029	0.000
LV	0.028	0.000	-0.040	0.000
SZ	-0.007	0.000	0.003	0.006
B4	0.009	0.026	0.041	0.000
Const.	0.165		-0.025	
F-test	27.509		78.871	
	(0.000)		(0.000)	
Obs.	2,243		2,243	
R^2	0.047		0.124	

Source: processed secondary data (2025)

Big 4 (B4) significantly positively affects A_DA (β = 0.009; p = 0.026). This finding is somewhat counterintuitive, as Big Four auditors are typically considered capable of suppressing earnings management. This result can be explained by the local context, where the involvement of large auditors has not eliminated management's incentives to manage earnings. Conversely, B4 significantly positively affects PR (β = 0.041; p = 0.000). It is in line with Chi et al. (2021) 's finding that higher audit quality enhances financial performance.

Furthermore, to strengthen the regression model's results, this study also conducted a t-test for differences across all samples and within each industrial sector for earnings management (A_DA) and performance (PR), distinguishing between Sharia-compliant and non-Sharia-compliant companies.

Table 6. Test for differences in A_DA

Sector of Industry	SF		NSF		Diff.	ρ-value
	Obs.	Mean	Obs.	Mean	(SF-NPF)	
Healthcare	73	0.075	9	0.205	-0.131	0.019
Basic materials	262	0.096	100	0.110	-0.014	0.191
Transportation and Logistic	50	0.041	23	0.140	-0.099	0.002
Technology	18	0.123	3	0.066	0.058	0.373
Consumer Non-cyclicals	266	0.088	124	0.068	0.020	0.010
Industrials	127	0.085	96	0.071	0.014	0.350
Energy	188	0.084	96	0.089	-0.005	0.609
Consumer Cyclicals	313	0.083	116	0.091	-0.009	0.345
Infrastructures	117	0.073	54	0.061	0.012	0.360
Properties and Real Estate	218	0.061	48	0.066	-0.005	0.738
All sectors	1,632	0.081	611	0.087	-0.006	0.178

Source: processed secondary data (2025)

Table 6 shows that, across all sectors, the mean absolute discretionary accruals (A_DA) of Sharia firms (SF) are lower than those of non-Sharia firms (NSF) (0.081 < 0.087), although the difference is not statistically significant (diff = -0.006; p-value = 0.178). Similar tests were conducted for each industry sector. The results indicate that across the Healthcare, Basic Materials, Transportation and Logistics, Energy, Consumer Cyclicals, and Property and Real Estate sectors, non-Sharia firms exhibit higher earnings management than Sharia firms. However, the differences are statistically significant only in the Healthcare sector (p-value = 0.019) and the Transportation and Logistics sector (p-value = 0.002). In contrast, sectors such as Technology, Consumer Non-Cyclicals, Industrials, and Infrastructure exhibit higher mean earnings management among Sharia firms than among non-

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Sharia firms. However, these differences are not statistically significant. Overall, the sectoral analysis suggests that, on average, Sharia firms tend to exhibit lower earnings management than non-Sharia firms. However, significant differences are only observed in two sectors: Healthcare and Transportation and Logistics.

Table 7. Test for differences in PR

Sector of Industry	SF		NSF		Diff.	p-value
	Obs.	Mean	Obs.	Mean	(SF-NPF)	
Healthcare	73	0.088	9	0.021	0.067	0.021
Basic materials	262	0.026	100	-0.002	0.028	0.001
Transportation and Logistic	50	-0.006	23	-0.067	0.061	0.026
Technology	18	0.060	3	0.056	0.004	0.934
Consumer Non-cyclicals	266	0.038	124	0.042	-0.004	0.735
Industrials	127	0.044	38	-0.013	0.057	0.000
Energy	188	0.054	96	-0.026	0.080	0.000
Consumer Cyclicals	313	0.030	116	-0.022	0.053	0.000
Infrastructures	117	0.035	54	-0.005	0.040	0.008
Properties and Real Estate	218	0.037	48	-0.008	0.046	0.006
All sectors	1,632	0.563	611	0.357	0.206	0,000

Source: processed secondary data (2025)

Table 7 shows significant differences in profitability (PR) between Sharia firms (SF) and non-Sharia firms (NSF) across several industry sectors, except for the Technology and Consumer Non-Cyclical sectors. On Sharia firms, the mean profitability (PR) is 0.563 across all sectors, while non-Sharia firms achieved only 0.357. This difference is statistically significant (Diff = 0.206, p-value = 0.000), indicating that Sharia-governed firms tend to perform better than non-Sharia firms.

Furthermore, at the sectoral level, 8 out of 10 industries show higher profitability for Sharia firms than for non-Sharia firms. These sectors include Healthcare, Basic Materials, Transportation and Logistics, Industrials, Energy, Consumer Cyclicals, Infrastructure, and Properties and Real Estate, all of which show significant differences in profitability. In contrast, the Technology and Consumer Non-Cyclical sectors display no significant differences between Sharia and non-Sharia firms.

This result suggests that Sharia-compliant firms generally exhibit greater efficiency in asset management, thereby generating higher profits. Meanwhile, the lack of significant differences in the Technology and Consumer Non-Cyclical sectors may be attributed to the homogeneous nature of these industries, their reliance on innovation or stable consumer demand, and the relatively limited influence of Sharia financial principles on asset efficiency within these sectors.

The results of the above study also reinforce previous studies indicating that companies implementing Sharia principles tend to perform better than those that do not. It is due, in part, to higher operational efficiency, lower risk profiles, and minimal reliance on debt-based financing. Compliance with Sharia principles, which prohibit speculative practices and transactions involving uncertainty, contributes to stability and better risk management (Khaw et al., 2019). The study's results also reinforce prior research indicating that Sharia firms perform better on financial indicators than conventional firms (Akguc and Al Rahahleh, 2018; Mustofa and Janatin, 2022; Sahalani et al., 2024; Boulanouar et al., 2024). Furthermore, the rigorous screening process of the Sharia compliance assessment encourages companies to be more selective in making investment decisions, thereby avoiding excessive risk. Other research also indicates a significant positive relationship between Sharia compliance and financial performance, and that consistent long-term

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application of Sharia principles can provide a competitive advantage (Pepis and De Jong, 2019; Taufik and Budiarsyah, 2025).

Furthermore, Sharia-compliant firms' financial structures, which tend to avoid interest-based debt, make them more sustainable in the long term. However, some findings suggest that not all Sharia firms experience consistent improvements in market performance. The implication is that compliance with Sharia principles can improve certain aspects of company performance but does not necessarily guarantee overall financial success (Pepis and De Jong, 2019).

The empirical findings indicate that the level of earnings management in Sharia-compliant firms does not differ significantly from that of non-Sharia firms. This result suggests that Sharia compliance does not necessarily constrain managerial discretion in financial reporting. Several explanations may account for this outcome. First, although Sharia firms are expected to operate under ethical principles emphasizing fairness (*adl*), transparency, and trustworthiness (*amanah*), they still function within the same institutional and market environment as conventional firms. Moreover, while their inclusion in the Sharia index may signal sound governance, it does not effectively mitigate managerial opportunism in earnings manipulation; instead, it may serve primarily as a mechanism of legitimacy (Alsaadi, 2019).

Second, the regulatory emphasis on Sharia compliance primarily concerns the nature of financial transactions and business operations—prohibiting interest (*riba*), uncertainty (*gharar*), and speculative activities (*maysir*)—rather than specific accounting practices. As a result, managers in Sharia-compliant firms retain considerable discretion in accrual estimation and earnings smoothing, provided that such practices remain consistent with Islamic ethical principles and do not contravene Sharia prohibitions (Kazemian et al., 2018).

Third, from an institutional perspective, both Sharia and non-Sharia firms in Indonesia operate under the same accounting standards (IFRS-based) and regulatory framework. Previous studies indicate that IFRS convergence does not necessarily lead to homogeneity in reporting behavior; instead, it may even encourage earnings management practices, contradicting the assumption that IFRS convergence reduces such behavior. In Indonesia, the model of financial reporting convergence integrates IFRS with local standards, potentially weakening the distinct characteristics of Sharia-compliant practices and leading to persistent earnings management issues (Sujana and Mukhlisin, 2025).

Overall, the insignificant difference in earnings management levels implies that Sharia compliance may not yet be fully internalized in managerial behavior or embedded within the corporate reporting culture. This finding suggests that the mere formal classification of firms as Sharia-compliant does not automatically translate into superior ethical conduct or enhanced financial transparency. In many cases, compliance with Sharia principles may be approached more as a structural or regulatory requirement than as a deeply rooted ethical commitment guiding managerial decisions.

Such partial internalization can be attributed to several factors. First, while Sharia screening enforces compliance with specific financial ratios and business activities, it does not directly regulate the qualitative aspects of financial reporting, such as judgment in accrual estimation or revenue recognition. Second, the absence of dedicated Sharia supervisory boards in non-financial listed firms means that ethical oversight is largely external, relying on periodic reviews by regulatory bodies rather than continuous internal monitoring. Consequently, managerial discretion remains relatively unconstrained within the boundaries of formal compliance.

4. CONCLUSION

The findings of this study reveal that Sharia-compliant firms generally outperform non-Sharia-compliant firms. This result highlights that implementing Sharia principles, which emphasize

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transparency, ethical conduct, and social responsibility, can enhance operational efficiency and long-term sustainability, ultimately leading to stronger financial outcomes. Nevertheless, the analysis shows no significant difference in earnings management practices between the two groups. It suggests that, despite operating within a framework of religious values, Sharia-compliant firms remain subject to external pressures and managerial incentives that may influence reporting behavior in ways similar to those of conventional firms. Accordingly, reinforcing oversight and governance mechanisms in both Sharia and non-Sharia contexts is essential to safeguard the integrity of financial reporting.

However, this study is not without limitations. The analysis focuses solely on the Indonesian context, which may limit the generalizability of the findings to other markets with different institutional and regulatory characteristics. Additionally, this study relies on secondary quantitative data, which may not fully capture managerial motivations or ethical considerations underlying financial reporting behavior. Future research could extend this study by incorporating longitudinal or cross-country comparisons to better understand how institutional settings shape the relationships among Sharia compliance, earnings management, and firm performance. Additionally, future studies may benefit from integrating qualitative approaches or additional variables, such as corporate culture, managerial ethics, or stakeholder pressure, to provide a more comprehensive understanding of how Islamic principles shape corporate behaviour and financial outcomes.

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