

SHARIA BANKS AND THEIR BUSINESS EARNINGS: AN EMPIRICAL EXPLORATORY OF THE CASE OF INDONESIA

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Abstract

This research aims to identify the tendency of business earnings obtained by shariah banks and detect its patterns. The sample of this research was sharia commercial banks listed in Indonesia Bank and Financial Services Authority over the period of 2010-2017. The data of financial statements were utilized in this research. The result of this research pointed out that net income during eight periods of observation has shown fluctuative result. The further result found that the value of smoothness tends to go zero. It indicated that earnings pattern in sharia banks is highly smooth.

Keywords: Sharia Banks, Earnings, Smooth

1. Introduction

In principle, banks can be distinguished into conventional banks and sharia banks. The main principles of bank operations based on sharia principles are Islamic law sourced from the Quran and Hadith. In carrying out its operational activities, banks based on sharia principles do not use the interest system in determining the reward for the funds used or deposited by a party. The determination of the reward for the loan and the funds deposited in the bank is based on the principle of the outcome in accordance with Islamic law. In sharia banks, the magnitude of the result varies depending on business performance, *Falah* oriented, and there is a Shariah Supervisory Board. The sharia principle tends to yield-share systems. It explains that the risk for the result is made at the time of contract with the guidelines on the possibility of profit and loss, the magnitude of the ratio of the outcome based on the amount of profit gained, adjusted to the performance of the business. In the sense, the number of shares sharing increases adjusted to the increase in the amount of income, and the revenue share depends on the profit of the project being executed. If the project does not benefit then the losses will be borne by both parties. (Ahmed 2011)

The management of sharia financial institutions must be different from managing the financial institutions. Bank with profit sharing system is designed for the establishment of togetherness in carrying out business risk and share the business results between the fund owner (*Shahibul Mal*) who stores his money in institutions, institutions as fund managers (*Mudharib*), and the community who need funds that can be status of borrower funds or business managers. On the side of community funds, *Shahibul Mal* is entitled to the outcome of the financial institution's efforts in accordance with the agreed portion. The results of *Shahibul Mal* will go up and down fairly according to the success of the financial institution in managing the funds entrusted to him. There is no cost to be deposited because the result is not a cost concept. (Siddiqi 2006)

National Sharia Board of the Indonesian Ulama Council (DSN-MUI) issued a fatwa arrangement of earnings by assuming that there is a risk of transferring/withdrawing funds from Sharia financial institutions (LKS) due to an uncompetitive and reasonable (displaced commercial risk) reward

level, LKS created a policy known as income leveling method. Profit is one of the potential information contained in the financial statements and is very important for both internal and external parties of the company. The attention of investors centered on profit information encourages potential management to manipulate data by managing the profit. Earnings management is the way in which management is used to reduce the fluctuations in profits reported to match the desired target, either through the manipulation of accounting methods or transactions. (DSN MUI 2012)

(Choi, S., Farber, D., & Baik 2018) states that the level of income smoothing is affected by managerial discretion and fundamental characteristic and operating environment and business strategy . (Dewi 2018) and (Putra and Dwirandra 2019) have found that income smoothing can affect the level of profitability. The growth of Islamic banking has been the highlight for being studied. The latest research in the context of income smoothing is conducted by (RAHMADI 2019) in Bank Muamalat Indonesia. His result has stated that the bank commits income smoother. This research identifies the pattern of income in all sharia commercial banks under the existence of five percent in national banking. The income gained by firms is further detected its smoothing. The result of this research could be the insight in the context of Islamic finance.

2. Literature Review

2.1. Islamic Bank

Islamic banks have expanded rapidly over the last three decades. Islamic banks are now becoming more accepted and competitive with their commercial counterparts. Sharia financial institutions arise for two reasons are as follows.

- a. The nature of different transaction principles with conventional financial institutions
- b. Users of accounting information on sharia financial institutions differ from users of accounting information at conventional financial institutions.

The Islamic financial principles require that lenders and lenders face risks. The parties in the case of the capital and profit in which there is profit loss sharing during business conduct (Muhammad 2016) Sharia system is one of the instruments used to enforce Islamic economic rules. As part of the economic system, these institutions are part of the entire social system. Therefore, its existence should be viewed in the context of the overall

existence of people (human), as well as the prevailing values in the society concerned. Islam rejects the view stating that economics is a neutral-value science. In fact, economics is a science that is full of value orientation.

The business activities developed by the Muslims must be put into the rules and sharia laws. In fact, it is not only related to the prohibition of business related to alcohol, gambling, and other activities that are based on Islamic views such as immoral and anti-social. However, the business under sharia aims to make a positive contribution to the achievement of the socio-economic goals into better society. It are executed to create a good business climate and escape the practice of cheating. Accordingly, reporting on business activities should be conducted based on the principles of sharia. To achieve the main target, it is necessary to set up an accounting system for business practices based Islam. (Siddiqi 2006)

Sharia commercial banks as mudharib should be able to manage the funds entrusted to him with care and earn maximum income. In managing these funds, they essentially have four types of income consisting of revenue share, profit margin, service reward, rental of property storage (specifically on eligible banks), and administrative costs. On profit loss sharing, large income is dependent on the right choice of the type of business financed. By giving mudharib a share of greater results, it is the effort to motivate him to be more active in trying, and vice versa. Therefore, the portion of fifty-fifty is considered fair enough. Islamic bank revenues can be optimized to take a small profit policy per transaction to maximize the amount of transactions financed. (Iqbal and Mirakhor 2011)

In the distribution of funds to the public, most of sharia bank financing is channeled in the form of goods or services traded by Islamic banks for their customers. Thus, financing is only given when the goods and services are present in advance. With the method of having goods in advance, it is then paid and the community is encouraged to produce goods and services. Further goods are held to guarantee (collateral) debt. Broadly, the economic relationship based on Islamic principle is determined by the relationship of the agreement consisting of five basic concepts of contract, namely the saving system, profit share, margins, rent, and fee (Zaher and Kabir Hassan 2001)

2.2. Income Smoothing

The action of income smoothing is an action that may mislead use of financial statements by presenting inaccurate information, and is

sometimes even the cause of illegal actions, such as the presentation of a distorted or incompliant financial statement.

Income smoothing is one part of earnings management. It can be measured by discretionary accrual. (Scott 2015) states that managing the earnings is a way to deliver the information in the terms of expected earnings. The initial definition of income smoothing is a rational behavior based on the assumptions in positive accounting theory, where the management of a company performs certain policies to maximize its importance. Smoothing the income is a reduction in profit fluctuations from year to year by transferring revenues from a year high in revenue to less favorable periods (Belkaoui 2002)

Smoothing practice usually has the belief that investors have limited information in making decisions (information asymmetric). If the investor gets smarter and has access to the information, finally the actual situation will be revealed also and the decision made will be different, so the investor is spared the unwanted loss. Regarding the occurrence of profit leveling action can be analogous that the reporting of financial statements take the action so that financial statements look smooth (soft), not fluctuating so that will make investors interested in investing in the company. The phenomenon of earnings management in which contained income smoothing like two sides of different currencies. On one side of the light, earnings management is a legal action, because it is an action in building image (image) will capability in the enterprise development effort. On the other hand, it is considered unethical, as there are deceptive elements in it. Some of the people consider it as a misleading judgement of stakeholders. (Nofsinger 2017)

Income smoothing is a way to anticipate of the level of future income. (DeFond and Park 1997) states when current income suffers poor, managers take earnings from future for use in the current period with the purpose of future income to be good. (Peterson and Arun 2018) understands that income smoothing is a stability mechanism for banks. The pattern of earnings management (income decreasing-increasing) induces the manager to increase the firm value (Abbas 2018)

3. Research Methods

This research uses a type of quantitative research with the sample of Islamic commercial

banks in Indonesia obtained from Indonesia Bank dan Financial Services Authority. The total of the sample in this research is 13 banks presented in Table 1.

Table 1. Islamic Commercial Banks

| No. | Name |
|-----|--|
| 1 | Bank Aceh Syariah |
| 2 | Bank Muamalat Indonesia |
| 3 | Bank Victoria Syariah |
| 4 | BRI Syariah |
| 5 | Bank Jabar Banten Syariah |
| 6 | BNI Syariah |
| 7 | Bank Syariah Mandiri |
| 8 | Bank Mega Syariah |
| 9 | Bank Panin Dubai Syariah |
| 10 | Bank Syariah Bukopin |
| 11 | BCA Syariah |
| 12 | Maybank Syariah Indonesia |
| 13 | Bank Tabungan Pensiunan Nasional Syariah |
| 14 | BPD Nusa Tenggara Barat Syariah |

Purposive sampling is used in this research to determine the final sample with the criteria that the sample should be listed in Indonesia Bank and Financial Services from 2010 to 2017 and provides the data related to financial statements. Final sample of this research is 7 banks with 56 observation periods. The banks are presented as follows.

Table 2. The Final Sample of Research

| No. | Name |
|-----|-------------------------|
| 1 | Bank Muamalat Indonesia |
| 2 | Bank BNI Syariah |
| 3 | Bank BRI Syariah |
| 4 | Bank Syariah Mandiri |
| 5 | Bank Syariah Bukopin |
| 6 | Bank BCA Syariah |
| 7 | Bank Panin Syariah |

This research identifies the sharia banks by analyzing the earnings obtained over seven periods. The purpose is to get the trend of earnings of islamic banks as a part of the performance. Having obtaining it, this study then analyzes each income generated by Islamic banks and detects the patterns, whether income looks smooth or not. To detect the patterns, this research uses a concept established by prior literature (Francis et al. 2004) as it is also utilized by the following literature (Lassaad and Khamoussi 2013; Sunarto, Murwaningsari, and Mayangsari 2016). The measurement is the ratio of earnings variability to cash flow variability.

$$\text{Smoothness} = \frac{\sigma \text{ Earnings Variability}}{\sigma \text{ Cash Flow Variability}}$$

Earnings variability becomes an element for smoothness proxied using the standard deviation of net income (NI_t) divided beginning total assets (TA_{t-1}). Cash flow variability proxied using the standard deviation of cash flows from operation (CFO_t) divided beginning total assets (TA_{t-1}). Larger value of smoothness shows less earnings smoothness. Sharia bank is considered to smooth the earnings if trend of the value generated goes to zero.

4. Result and Discussion

4.1. The Growth of Islamic Banking Income

Sharia commercial banking in Indonesia provides fluctuative performance in the income.

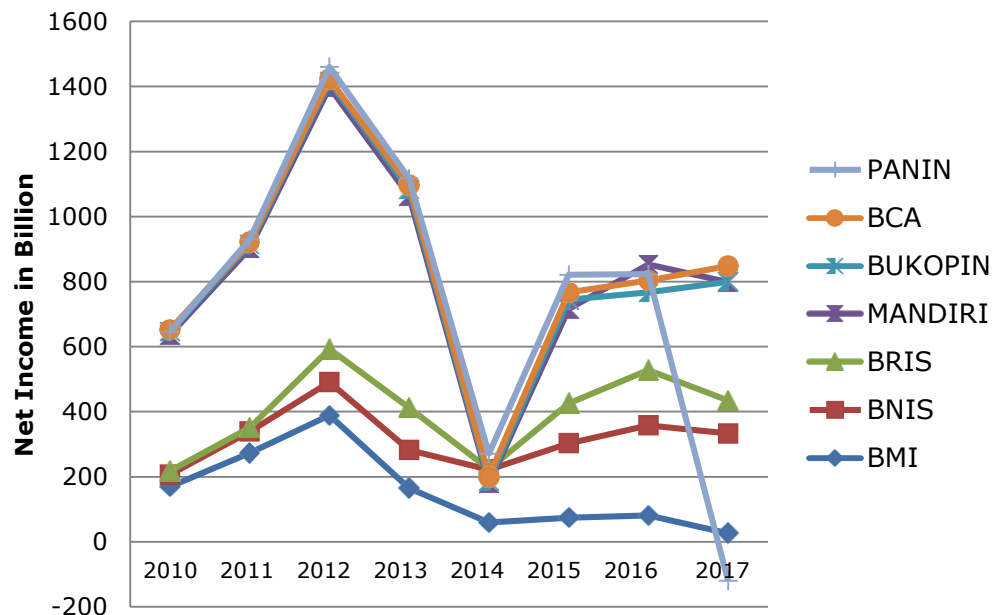
This research investigates net income during eight periods.

Table 3. Net Income over the Period of 2010-2017 (in Billion Rupiah)

| Name | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|----------------------|------|------|------|------|------|------|------|------|
| Bank Muamalat | 170 | 273 | 389 | 165 | 59 | 74 | 81 | 26 |
| BNI Syariah | 37 | 66 | 102 | 117 | 163 | 229 | 277 | 307 |
| BRI Syariah | 11 | 12 | 102 | 130 | 2 | 123 | 170 | 101 |
| Bank Mandiri Syariah | 419 | 551 | 805 | 651 | -45 | 290 | 325 | 365 |
| Bukopin Syariah | 10 | 12 | 17 | 20 | 8 | 28 | 86 | 1 |
| BCA Syariah | 6 | 7 | 8 | 13 | 13 | 23 | 37 | 48 |
| Panin Bank Syariah | -7 | 9 | 37 | 21 | 71 | 54 | 19 | -986 |

Net income over the period of 2010-2017 shows fluctuative result. Bank Muamalat, BNI Syariah, BRI Syariah, Bukopin Syariah, and BCA Syariah have been recorded as banks gaining positive earnings in the fluctuative level. On the other hand, Bank Mandiri Syariah dan Panin Bank Syariah are banks ever suffering the loss during the observation periods. Unfortunately, Panin Bank Syariah in 2017 suffered extreme loss of 986 billion rupiah.

Chart 1
 Trend of Net Income



In period of 2014, all Islamic banks suffered sharpest drop. It is described in chart 1. The income declined because of the national economic growth from 5.8 percent in 2013 to be 5.1 percent in 2014. Central bank also enhanced the interest rate. As a result, the finance suffered the decline and the asset financing quality became worse. The increase of non performing financing made the allowance cost affecting the level of income

4.2. Sharia Banks: Do They Smooth The Earnings

Earnings and cash flow variability points out the content of information in term of variation of earnings and cash flow obtained Islamic banks that the lower the variability, the smoother the earnings quality of Islamic banks.

In Table 2, variability of earnings and cash flow each bank shows the value not reaching one. The lowest variability in earnings is imposed into BRI Syariah and BCA Syariah, and in cash flow is BNI Syariah. This research further detects the pattern each bank, whether it looks smooth or not. This is measured by utilizing the standard deviation into the variability of earnings and cash flow. The lower the value, the smoother the earnings of banks.

Table 2. Variability of Earnings and Cash Flow

| Name | Variability | |
|----------------------|-------------|-----------|
| | Earnings | Cash Flow |
| Bank Muamalat | 0.005 | 0.095 |
| BNI Syariah | 0.005 | 0.015 |
| BRI Syariah | 0.003 | 0.038 |
| Bank Mandiri Syariah | 0.006 | 0.038 |
| Bukopin Syariah | 0.007 | 0.075 |

| | | |
|--------------------|-------|-------|
| BCA Syariah | 0.003 | 0.054 |
| Panin Bank Syariah | 0.004 | 0.362 |

The pattern of smoother earnings provides low value going to zero. Based on Table 3, Bank Muamalat showed the smoothest earnings at the value of 0.056 and Bank BNI Syariah showed 0.318 indicating less earnings smoothness. The smoothest earnings is obtained by Bank Muamalat due to generate low variability of earnings followed by high variability of cash flow. On the other hand, the larger value is obtained by BNI Syariah because its earnings and cash flow has generated the lowest variability. In the average of smoothness value, sharia banks show 0.135 indicating lower value.

Table 3. Earnings Smoothness

| Name | Result |
|----------------------|--------------|
| Bank Muamalat | 0.056 |
| BNI Syariah | 0.318 |
| BRI Syariah | 0.100 |
| Bank Mandiri Syariah | 0.178 |
| Bukopin Syariah | 0.097 |
| BCA Syariah | 0.068 |
| Panin Bank Syariah | 0.132 |
| Mean | 0.135 |

5. Conclusion

Income is one of initial goals for stakeholders in evaluating the financial performance. The information concerning the income leads the management to pay attention the level of its obtained income. The average sharia bank has shown positive financial performance in net income. The increase of revenues and the reduction of cost each period have been a way attempted by sharia banks in keeping their performance. Net income gained by sharia banks over the period of 2010-2017 has shown fluctuative result in this research.

The external factors including uncertainty of global economy or related to economic macro such as inflation, the government policy (interest rate, GDP, loan) become the challenges for sharia banks in smoothing their performance. Smoothing the earnings is a practice for anticipating fluctuative performance. This research successes to add the literature in the context of sharia banking. It detects earnings pattern obtained by sharia banks. The result of this research finds lower value of smoothness. It demonstrates that the average smoothness has trend of the value reaching zero. Therefore, it is considered that the average sharia bank is found smooth in the earnings

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