

Unveiling The Impact of Risk on Income Smoothing of Indonesia Islamic Commercial Banks

Novia Lestari¹, Siti Khomsatun²

¹Program Studi Akuntansi Syariah, Fakultas Ekonomi dan Bisnis, Institut Agama Islam Tazkia, Bogor

²Program Studi Akuntansi, Fakultas Ekonomi dan Bisnis, Universitas Nahdlatul Ulama Indonesia, Jakarta

Email: siti.khomsatun@gmail.com

Abstract: This study aims to test whether bank risk (financing/credit risk, liquidity risk and operating risk) had an impact on Income Smoothing (measured through Loan Loss Provisions) in Indonesia Islamic Commercial Banks or not. The research sample used 11 Indonesia Islamic Commercial Banks that established before 2015 and listed in Financial Services Authority (OJK) From 2015-2019. 11 Samples were taken using purposive sampling. The data used are secondary data from quarterly financial report, 220 in total. Hypothesis testing is done by using panel data regression method. Based on the analysis that have been made, the results shows that the financing/credit risk and liquidity risk had no impact on income smoothing. Operating risk had negative effect. While Total Loans as control variable affected dependent variable. For the size, as other control variable, do not affect the dependent variable. This study contributes to enrich the literature about income smoothing and bank risk, especially regarding operational risk which is less discussed than financing and liquidity risk.

Keywords: Financing Risk, Income Smoothing, Indonesia Islamic Banking, Liquidity Risk, Operating Risk

1. INTRODUCTION

The financial statement is the main resource for creditors and investors to make better decisions. In the term of agency theory, the financial statement is used by the principal (owner) to monitor the agent (management) (Jensen & Meckling, 1979). One of its important components is earning. It supports creditors and investors for estimating the ability of the company to make a profit in the long term, evaluating management performance, and assessing investment risk.

The majority investor avoids the company that generates fluctuated

earning because it indicates the uncertainty and high risk (Religiosa & Surjandari, 2021). It is one of the reasons why managers try to smooth their earning (Utari et al., 2018). In earning management, managers increase or decrease reported earnings to reduce fluctuations in company earning. According to Scott (2019), earnings management is the manager's decision to choose particular accounting policies to help the manager achieves the desired goals, either increase profits or reduce reported losses. One type of earnings management is income smoothing.

The common income smoothing practice in the banking industry is the dynamic provision by managing the loan loss provision (LLP). The magnitude level of the LLP is closely related to earnings management, as evidenced in previous research, which showed that the LLP was used as a tool to manage income in banking industries (Ozili & Outa, 2019). Several studies also find that Islamic banking uses LLP for managing and smoothing their profit (Farook et al., 2014; Lubis et al., 2021; Malik et al., 2020; Pramono et al., 2016; Taktak, 2011; Taktak et al., 2010).

In Indonesia, Islamic banks must comply with various financial statement provisions under Regulation of Financial Services Authority (Peraturan Otoritas Jasa Keuangan/ POJK) Number 8/POJK.03/2014 on assessment of the soundness of Islamic Commercial Banks and Islamic Business Units. Fulfilling the required criteria by the regulator is supposed to motivate the bank to manage the earnings (Malik et al., 2020; Religiosa & Surjandari, 2021)). Income smoothing of Islamic banking in Indonesia is also regulated by the DSN-MUI fatwa Number 87 of 2012. This regulation is driven by the possibility of conditions for withdrawals/ transfers of customer funds due to uncompetitive returns. This fatwa regulates Indonesian Islamic banking for smoothing earnings while still keeping compliance with Islamic sharia law.

Fulfilling the required criteria by the regulator is supposed to motivate the bank to manage the earnings. Limitations in investment

options and limited access to interest-free interbank transactions become challenges for Islamic bank managers in maintaining capital levels and liquidity risk levels. Islamic bank managers must maintain a favorable rate of return for customers and consider the possibility of losses from the financing disbursed (Elnahass et al., 2022).

Kustono & Lasado (2015) stated that management perform income smoothing in order to avoid existing risks. For the risky financial institution, the Islamic bank tries to manage the risk well to fulfill the regulation and stakeholder attention. The risk management principles applied to Islamic banking in Indonesia align with the Islamic Financial Services Board (IFSB). According to financial services authority regulation No. 65/POJK.03/2016, there are ten risks that Islamic banks have to manage, i.e., credit risk, market risk, liquidity risk, operational risk, litigation risk, reputation risk, strategic risk, compliance risk, rate of return risk, and equity investment risk. The management perform income smoothing in order to avoid existing risks.

Several studies investigated and found that company/ bank risk influences income smoothing (Moghaddam & Abbaspour, 2017; Religiosa & Surjandari, 2021). But, Fricilia & Lukman (2015) and also Kustono & Lasado (2015) found that risk has no effect on income smoothing. Kustono & Lasado (2015) took the research sample of Islamic banks with period 2010-2011, when several Islamic banks began. They suggested that future research

extend the period sample of Islamic banks.

In the past decade, there have been several issues of the Indonesian banking industry related to bank risk. Bank Muamalat Indonesia (BMI) had an increase in credit or financing risk with rising levels of bad loans. In the national daily newspaper Kontan, it was written that as of June 2019, Bank Muamalat's gross NPF swelled to 5.41% from 1.65% in June 2018. Net NPF also rose sharply from 0.88% to 4.53% or has approached the normal threshold according to the provisions of 5%¹.

Several years earlier, Islamic banking also experienced excess liquidity. Operational efficiency is also a problem for Islamic banking. A sharia compliance division and sharia board will increase costs that conventional bank does not have them. In addition to these three types of risk, Islamic banks also need to manage other risks, especially in compliance with financial services authority regulation no. 65/POJK.03/2016.

Based on the descriptions and arguments above, this research aims to investigate how the bank risk affects the income smoothing of Islamic banks in Indonesia. the bank risk tested is limited to 3 out of 10 risks determined by the OJK. It is because the three risks can be measured using financial ratios. Based on the research objectives above, this research is expected to

provide insight to academics, especially regarding bank risk and income smoothing in Indonesia Islamic commercial Banking.

The research is structured as follows. Section 1 begins with the introduction. Section 2 describes the theoretical basis related to the theme and hypothesis development. Section 3 is related to the methodology and the section 4 and 5 are the results and recommendations.

2. LITERATURE REVIEW

Agency Theory and Positive Accounting Theory

Agency theory explains the relationship between the management (agent) and the shareholders (principal) of the company. Agency theory discusses problems arisen from the conflicts of interest between agent and principal (Jensen & Meckling, 1979). Shareholders and managers have different goals and each party wants to maximize their goals. The different interests and objectives from both parties create agency conflict.

A seminal paper of Watts dan Zimmerman (1986) promotes Positive Accounting Theory (PAT) (Scott, 2019). They empirically prove that accounting numbers often determine the relationship between principal and agent. They also explain that stock return or investor reacts when financial reporting abnormal return, whether created by nature or accounting intervention. Managers,

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<https://keuangan.kontan.co.id/news/kredit-macet-bank-muamalat-naik-tinggi-ke-level-541-di-semester-i-2019>

as an agent, use accounting number and policy to maximize their interests. One of the agent's activities is earnings management. Watts dan Zimmerman (1986) stated the manager's motives to interferes the accounting numbers, i.e., bonus plan, debt covenant, and political cost (Scott, 2019). One of the accounting number interventions is earning management (Nalarreason et al., 2019).

Income smoothing

According to (Scott, 2019) income smoothing is a reduction in profit fluctuations from year to year by moving income from high-income period to less profitable period. This form of action is most often carried out to anticipate conditions that the company is smoothing reported earnings to reduce fluctuations in earnings because investors prefer relatively stable earnings. In earning management, managers increase or decrease reported earnings to reduce fluctuations in company profits (Wild, 2018).

Managers take income smoothing because they expect a benefit for themselves. There are several motivations for taking income smoothing. The first motive is to increase the investor's confidence related to the company's future and improve their ability to predict future cash flows. The second is to increase management compensation, especially if the compensation is related to steady income growth. The third motive is perceptions of company capabilities especially related to the company risk and further reduce the cost of the

company's capital. The fourth motive is to reduce corporate tax expense (Obaidat, 2017).

For banking, as the riskiest financial institution, the third motive could encourage the manager taking the income smoothing. Normally, In the banking, the practice of income smoothing is using dynamic provisioning by reducing the value of the loan loss provision (LLP). The magnitude of the LLP level is closely related to earnings management, it was proven in previous research conducted by previous researchers (Lubis et al., 2021; Obaidat, 2017; Ozili & Outa, 2019; Pramono et al., 2019).

In Principle, to mitigate credit risk, banks will set aside a specific amount as a cushion to absorb expected loss on banks' loan portfolios. This amount is referred as loan loss provisions (Ozili et al., 2023). Loan loss provision is an expense recorded to increase the Loan Loss Allowance and reduce profit before tax for the current period (Scott, 2019; Wahlen, 1994).

An increase in the allowance for credit losses will reduce the amount of reported net income, on the contrary, delaying the imposition of allowance for losses will increase net income (Lubis et al., 2021). When a bank has a good performance and has a fairly high profit in the current period and predicts low performance in the future, bank managers tend to save or reduce the profit for the current period to be used in the future by reducing profits through increased LLP (Embuningtiyas, 2018). In conditions of low bank profits, bank managers are suspected of having incentives to delay the imposition of

allowance for losses. Bank managers have their information related to the risk of default on each loan or financing given to customers, so the manager's judgment and discretion is needed to estimate the amount of LLP (Wahlen, 1994).

The Regulator has required every bank to manage the risk of earning assets by maintaining portfolio quality and establish an adequate allowance for asset losses in order to minimize potential losses. Reserves forming LLP are set at least 1% of earning assets classified as current, 5% of those classified as special mention, 15% of those classified as substandard, 50% of those classified as doubtful, 100% of those classified as loss. Therefore, companies can reserve more funds on LLP if they feel that their credit failure is large for reasons of prudence. It is one of the choices of accounting policies owned by management, which can be used as a "gap" to carry out earnings management.

Islamic Bank Risk

Islamic Banking is an institution that is close to risk. According to No. 65 /POJK.03/2016 risk is defined as the potential loss due to the occurrence of certain events. Islamic banks have a greater risk than conventional banks. Interest-free affect the investment choices and types of Islamic banks fewer than conventional banks ((Elnahass et al., 2022).

According to financial services authority regulation No. 65 /POJK.03/2016, there are ten categories of risk faced by sharia bank, i.e., credit, market, liquidity,

operational, litigation, reputation, strategic, compliance, rate of return, and equity investment risk. The last two mentioned risks are the unique risk of sharia bank. Some of the risks are assessed by the financial ratio, such as credit risk, operating risk, and liquidity risk.

Credit risk describes the bad debt/ credit. In an Islamic bank, financing risk is determined with the non-performing financing (NPF) ratio. NPF is calculated by non-performing financing divided by total financing. Operating risk describes the inherent risk that appeared because of inadequate or failure of internal process, human error, system failure, or the external affected to banking operational.

Liquidity risk is defined as the risk of the bank's inability to meet maturing obligations originating from cash flow funding sources and/or from high-quality liquid assets that can be used as collateral without disrupting the bank's activities (OJK regulation of No. 65 /POJK.03/2016). Funding or debt from the third parties is risk potential if the company does not meet its claim. Claims happened that are borne by the investor as cost or loss are categorized as risk. In other words, the debt of funding is also a risk. The high funding and debt pose a high risk.

Hypothesis

One of the reasons banks perform income smoothing is the high risk (Kustono & Lasado, 2015; Moghaddam & Abbaspour, 2017). Customer is risk adverse which tend to prefer the stable income. Kustono

& Lasado (2015) stated the greater the company's debt, the greater the risk faced by investors so that investors will ask for a higher level of profit. As a result of these conditions, companies tend to practice income smoothing. Debt that is considered a threat to investors because of creditor claims so that there is a desire for managers to avoid violations and the cost of debt can be interpreted as risk. So the higher the risk, the greater the tendency of managers to smooth income.

The risk of Islamic banks can be seen from bad financing due to customers do not fulfill their obligations as stipulated. The higher the ratio of bad loans, it will reduce profits and increase costs for back up financing. This will reduce the bank's capital, the portion or claims of investors on the company/bank. When the bank acts as a shareholder, it tends to maintain stable profits and capital through income smoothing. Credit risk marked by an increase in the NPL ratio will trigger income smoothing (Moghaddam & Abbaspour, 2017; Religiosa & Surjandari, 2021). The same assumption can occur in Islamic banks as a financial industry that maintains stable profits. So it can be hypothesized:

H1: Financing Risk effects positively income smoothing in Islamic Bank

Liquidity risk is a bank's ability to meet its short-term obligations. A high liquidity ratio describes bank liquidity in a risky state, but a low ratio indicates the bank's inability to absorb third party funds for financing so it omits the opportunity to earn more profit (Malik

et al., 2020; Moghaddam & Abbaspour, 2017; Religiosa & Surjandari, 2021). Excess third party funds may be the manager's action to delay profit. High risk triggers managers to do earnings management (Bhat, 1996). Based on the argumentations, the next hypothesis is as follows:

H2: Liquidity risk effects income smoothing in Islamic bank

Operating risk is inherent risk cause of inadequate or failure of internal process, human error, system failure, or the external affected to banking operational. If bank fail to manage the internal operation, it would need more cost that decrease income. The operation risk shows the ability internal bank managing the fund from the third or other external parties. Manager would ensure the third party or investor trust by the stable income. So, the hypothesis is as follows:

H3: Operating risk effects positively income smoothing in Islamic bank

3. RESEARCH METHOD

The type of study is quantitative, which aims to analyze the relationship between bank risk and income smoothing of sharia commercial bank in indonesia.

The research sample used is Islamic Banks that established before 2015 and listed in Financial Services Authority (OJK) From 2015-2019. This research take sample through a purposive sampling method, with selection of criteria to determine the final number of samples. The data used is quarterly financial reports. After selecting all Islamic Commercial Banks in Indonesia from

2015 until 2019, there are 11 Islamic banks that met all criteria.

Table 1. Sample Selection

Criteria	Bank
Islamic Commercial Banks in Indonesia established before 2015	12
Islamic Commercial Banks in Indonesia that publish financial reports quarterly from March 2015 to September 2019 expressed in rupiah (Rp)	12
The Financial statement contains the data needed for research.	11
The number of samples that meet the criteria: 11	
The Amount of data used: 220	

In this study there are three variables. Income smoothing as dependent variable, Bank risks as independent variable, and bank size as control variable. We use the control variable that are Size and LOA. The measurement is as follows:

Tabel 2. Research Variables

No	Variable	Formula	Ref.
1.	Liquidity Risk	Financing to deposit ratio (FDR) = $\frac{\text{Total Loans}}{\text{Total Deposit}} \times 100\%$	(Pathi, 2017)
2.	Operational Risk	Operational Risk = $\frac{\text{Operating Cost}}{\text{Operating Income}} \times 100\%$	(Efendi & Suharto, 2018; Pathi, 2017)
3.	Financing/Credit Risk	NPF = $\frac{\text{Bad Debt}}{\text{Total Financing}}$	(Efendi & Suharto, 2018)
4.	LOA	LOA = $\frac{\text{Total Loans}}{\text{Total Asset}}$	(Taktak, 2011)
5.	Size	Size = $\log(\text{total asset})$	(Taktak, 2011)

The data analysis used in this research is panel data regression. The following show the research model:

$$LLP_{it} = \alpha_0 + \alpha_1 FR_{it} + \alpha_2 LR_{it} + \alpha_3 OR_{it} + \alpha_4 LOA_{it} + \alpha_5 SIZE_{it} + \varepsilon_{it}$$

Description:

LLP = Loan Loss Provision, for detecting Income Smoothing

LR = Liquidity Risk

OR = Operational Risk

FR = Financial Risk

LOA = Loan per Total Asset

SIZE = size of Islamic bank, measured by ln total asset

4. RESULT AND DISCUSSION

Descriptive Statistics

The summary of descriptive statistics that consists of Loan Loss Provision (Y) as measurement of income smoothing, Financing Risk (X1), Liquidity Risk (X2), Operating Risk (X3), LOA (X4) and SIZE (X5) can be seen as follows:

Table 3. Descriptive Statistic

Var	Obs	Mean	Std. Dev.	Min	Max
LLP	220	0.156	1.913	0.001	28.391
FR	220	0.897	0.130	0.239	1.442
LR	220	0.945	0.152	0.065	2.174
OR	220	0.120	0.951	0.0004	13.54
LOA	220	4.985	63.940	0.028	949.026
SIZE	220	30.369	1.423	24.464	32.790

Result

Before we test the hypothesis, we have to test the Multicollinearity, Heteroscedasticity, and autocorrelation. Tabel 4 shows the Multicollinearity test that conclude the model does not multicollinearity

between the independent variables because the VIF value is no more than 10.

Table 4. Multicollinearity Test

Variable	VIF	1/VIF
Financing Risk (X1)	1.02	0.979504
Liquidity Risk (X2)	1.11	0.900157
Operating Risk (X3)	1.00	0.996305
LOA (X4)	1.09	0.913481
SIZE (X5)	1.20	0.832634
Mean VIF	1.09	

Table 5 shows the autocorrelation test that the value of Asymp.Sig (2-tailed) 0.00 lower than 0.05 which indicates that there is autocorrelation between the residual values.

Table 5 Autocorrelation Test

N(runs)	Z	Prob> z
51	-8.11	0.00

In the table 6, the results of the heteroscedasticity test obtained a p-value of 0.5809 which is less than (0.05). This means that it fails to reject Ho, which means that there is no heteroscedasticity

Table 6 Heteroscedasticity Test

chi2(1)	Prob > chi2
0.30	0.5809

We use panel data regression to test the hypothesis. Based on the Chow, Hausman and Lagrange Multiplier Test, the best estimation method is Common Effect Model. Table 7 present the hypothesis testing.

Table 7 Statistical Result

Variable	Coef.	P-value
Independent Variable		

Financing Risk (X1)	.0467936	0.138
Liquidity Risk (X2)	.0641374	0.101
Operating Risk (X3)	-.0028642	0.002
Control Variable		
LOA (X4)	.0299173	0.000
SIZE (X5)	.0019607	0.195
Const	-.1939025	0.073
N	220	
F-stat	0.0000	
R ²	0.9987	
Note: 5% statistically significant		

Based on the result that shown in the table 7, p-value is 0.0000 that means that the value is lower than 0.05. It means that model is meet the goodness fit of model. The table 7 also present that coefficient of determination (R²) of 0.9987. It indicates that the risks significantly and simultaneously have a 99,87 % effect on income smoothing in Islamic Commercial Banks. The residual 0,13% is influence by other variables that are not used in this research.

Table 7 also present the hypothesis testing from the P-value of t-test. The hypothesis is discussed below.

Discussion

The first hypothesis is to know whether financing risk has an effect on income smoothing or not, can be seen from the table above that the significant value (p value) 0.138 > 0,05 and with coefficient value .0467936 which means that the financing risk has no effect on income smoothing.

Theoretically, the higher the financing risk followed by bad financing of the bank, the higher probability that bank will perform

income smoothing. But in this study, the result shows that the financing risk has no effect on income smoothing. Financial risk does not influence the income smoothing because the bank with high risk is under tight attention of third parties in measuring the company's performance (Religiosa & Surjandari, 2021). Hence, the tendency of bank with high financial risk is not indicated to do income smoothing. The result of this research is not in line with the research conducted by Religiosa & Surjandari (2021).

The second hypothesis in this study is that Liquidity risk effects income smoothing in Islamic bank. Based on the results of statistical testing, the coefficient value of liquidity risk is .0641374 with 0.101 *p*-value. The results of this study state that there is no effect between liquidity risk and income smoothing in Islamic commercial bank.

This shows that investors give bigger attention to profit report. As long as the profit generated by the company is stable, liquidity will not affect investors' assessment of the company's management in paying its short-term obligations. Thus, managers do not need to do income smoothing practices as long as the profit generated by the company is stable.

The third hypothesis in this study is operating risk effects positively income smoothing in Islamic bank, based on the results of statistical testing, the coefficient value of Operating risk is -.0028642 with *p*-value 0.002. The results of this study state that there is a negative effect between Operating risk and income smoothing in Islamic commercial

bank. This means that the higher the operational risk, the smaller the income smoothing carried out by Islamic banks through LLP.

Operational risk in this study obtained from Operational Cost to Operating Income (BOPO). BOPO is used to measure the level of efficiency and ability of a bank in carrying out its operations. The operational risk shows the ability internal bank managing the fund from the third or other external parties.

Manager would ensure the third party or investor trust by the stable income. The smaller the BOPO, the more efficient the operational costs incurred. However, the greater the BOPO indicates that the bank do not operate efficiently and the large amount of operating costs will reduce the amount of profit that will be obtained by investors because operating costs or expenses act as a deduction factor in the income statement and will destabilize the financial statements (Kustono & Lasado, 2015; Moghaddam & Abbaspour, 2017; Religiosa & Surjandari, 2021).

This research uses an additional control variable which is represented with Loan per Total Asset as control variable. Based on the statistic test result the coefficient score of LOA is .0299173 with *p*-value of 0.000. The result shows that there is a significant relationship between LOA and income smoothing in Islamic commercial bank.

The positive effect of total financing on income smoothing implies that companies that have a high amount of financing will have a tendency to practice high income smoothing. This can be caused by the

higher the Islamic bank disbursing financing, the higher the possibility of the Islamic bank to get benefit from it. Due to the benefits, the tendency of Islamic banks to practice income smoothing is getting higher (Melinda & Setiawan, 2020; Taktak, 2011).

This research also used an additional control variable which is company size that measured by ln total asset. Based on the statistic test result the coefficient score of size is .0019607 with p -value of 0.195. The result shows that there is a no relationship between company size and income smoothing in Islamic commercial bank.

The company size does not influence the income smoothing because the conditions on the scale of total assets of large companies are under tight security from analysts and investors. Hence the tendency of large company is not indicated to do income smoothing. This is because large companies are not always identified with capital intensive, but they can be labour intensive. The category of the company's asset size will guarantee performance, so that company with large assets do not have a tendency to smooth their profit (Taktak, 2011).

5. CONCLUSION

This study aims to analyze whether there is an effect of risks (Financing, risk, liquidity and operational risk) on income smoothing in Islamic commercial banks. Using 220 observations, this research concludes that: There is negative effect between Operating risk and income smoothing in Islamic commercial bank. While, Financing

risk and Liquidity risk has no effect on income smoothing.

This research has two limitations and suggestions for future research. First, his study only focuses on income smoothing as measured by LLP without examining discretionary or non-discretionary, as well as whether the types are income maximization or income minimization. The study gives suggestions to include discretionary or non-discretionary and the types for the future research. Second, this research uses the risks that exist both in conventional and islamic banks, for further research, the author provides suggestion to use special risks that only exist in Islamic banks.

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