

The effects of profit volatility, income smoothing, good corporate governance and non-performing financing on profit quality of sharia commercial banks

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ABSTRACT

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The purpose of this study was to analyse the effects of profit volatility (X1), income smoothing (X2), corporate governance (X3), and non-performing financing (X4) on profit quality (Y) of sharia banks in Indonesia. The samples of this study were 10 sharia commercial banks in the period of 2012-2018 with 66 panel data that had been tested for outliers and normality. This study used a purposive sampling method, and it used the classical assumption tests, namely multicollinearity, autocorrelation, heteroscedasticity, and normality tests. This study used panel data regression analysis. The results of the study showed that profit volatility was detrimental to profit quality as evidenced by a beta coefficient of 0.0929 and the significance level of 0.1100, income smoothing was detrimental to profit quality as evidenced by a beta coefficient of -0.015 and the significance level of 0.1009, corporate governance had a negative influence on profit quality as evidenced by a beta coefficient of 0.0468 and the significance level of 0.293, non-performing financing was detrimental to profit quality as evidenced by a beta coefficient of -0.0096 and the significance level of 0.9139. The predictive ability of the four variables on profit quality was 16.34% while the remaining 83.66% was influenced by other factors not included in the research model.

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1. Introduction

Sharia bank is one that operates according to the principles contained in Islamic teachings, functions as a business entity that distributes funds to and from the public or as an intermediary financial institution. Sharia banking is a unit of the Islamic economic system that operates with doctrines and prohibitions against the practice of usury (Juhandi et al., 2019). Sharia banking has a strategic role to improve people's welfare through the intermediation process of collecting and distributing funds and providing other financial services based on the sharia principles (Yulianto & Solikhah, 2016). When the conventional banking system is unstable due to the monetary system and requires very large costs to maintain it, sharia banking can save some of the people's economy. The ability to survive sharia banking in the crisis era has attracted the attention of conventional bankers who then opened sharia bank branches (Elsa et al., 2018). Based on the 2017 Bank Indonesia statistical report, institutionally Indonesian sharia banking currently consists of 13 sharia commercial banks, 20 sharia business units, and 150 sharia people's financing banks with a total office network of 1681. Geographically, the distribution of sharia banking office network has now reached the public in more than 120 regencies/cities in 33 provinces in Indonesia. However, during its existence, the sharia banking market share has never exceeded 5% of the total national banking assets (Financial Services Authority's Sharia Banking Road Map, 2014-2019).

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Table 1

Financial Ratios of Sharia Commercial Banks and Sharia Business Units (Nominal in Billion Rp)

No	Indicator	2013	2014	2015	2016	2017	2018
1	TPF (Billion Rupiahs)	183.512	170.723	174.895	206.407	238.393	250.755
2	Financing (Billion Rupiahs)	184.122	148.425	154.527	178.043	190.445	200.292
3	CAR (%)	14.42	15.74	15.02	16.63	17.91	21.39

Source: Secondary Data Processed for the 2019 Sharia Commercial Bank Statistics Report

The third-party funds of sharia banks in 2013 amounted to 184,122 (billion rupiahs), decreased in 2014 by 170,723 (billion rupiahs) and fluctuated from 2015 to 2018 reaching 250,755 (billion rupiahs). The higher the third-party funds (TPF), the higher the profits generated by sharia banking. Financing in 2013 amounted to 184,122 (billion rupiahs) but in 2014 decreased by 148,425 (billion rupiahs), in 2015 financing increased by 154,527 (billion rupiahs) until 2018 with a nominal value of 200,292 (billion rupiahs). CAR in 2013 was 14.42%, in 2014 it was 15.74%, and slightly decreased in 2015 by 15.02%, from 2016 to 2017 it increased from 16.63% to 17.91%. In 2018, fluctuating CAR experienced a very rapid increase of 21.39%.

Agus Sudiarto, Chairman of the Association of Indonesian Sharia Banks (Asbisindo), said that the capital adequacy ratio of Bank Syariah Indonesia was eroded due to financing expansion. As of March 2015, the growth of sharia commercial bank financing reached 6.16% to Rp147,146 trillion. However, according to him, the decline in CAR was driven more by the adjustment of CAR calculation to the new provisions. Even though it fell, Agus added that the CAR ratio was sufficient to support the expansion of sharia bank business development until the end of the year. Because the current CAR level was still above the minimum capital requirement at the end of 2015 and began to increase in 2018, the CAR of Bank Syariah Indonesia was recorded at 21.3963%, assets 477 trillion, third party funds grew by 70.67% to 371.83 trillion at the end of 2018 and made it a leading sector in the sharia banking business.

In Financial Services Authority's Regulation No. 21/POJK.03/2014 concerning Minimum Capital Adequacy Requirement for sharia commercial banks, the CAR ratio is set at a minimum of 8%-14% of risk-weighted assets (RWA) in accordance with applicable regulations, risk profile of each bank. The minimum capital will be lower if the risk profile is low, and vice versa. In addition, sharia banks are also required to provide additional capital in the form of a countercyclical buffer of 0%-2.5% from RWA. Especially for sharia banks with the capital above IDR 5 trillion, the capital component is also added with a capital conservation buffer of 2.5% of the RWA. Therefore, the banking industry in Indonesia is increasingly enlivened by the presence of rapidly growing sharia banks, which offer financial and investment products that are different from conventional banks. One of the factors that accelerate the growth of the banking industry today is the strategy of bank management to improve the performance of sharia banks by providing information about profits that not only managers but also investors and other interested parties want to know. Profit for a certain period together with other financial information is then evaluated for its development to be compared with previous data. Users of the information also want to know how the company will perform in the future. For investors, future income information can influence their investment decisions. Investors certainly expect the company's future profits to be better than before.

Profit quality is used by investors and creditors as the basis for making economic decisions, especially those concerning contracting decisions, investment decisions and is used as an indicator of the quality of profits generated by the maker as the standard setter. The decision to enter into contracts based on low income quality leads to unwanted welfare transfers. One example is overestimating income as an indicator of management performance, which will result in overcompensation for managers. A second example is that an overestimated profit can mask the true ability to pay off debts and provide creditors with misinformation.

Profits in the banking sector are expected to increase due to the revision of the Guidelines for Financial Accounting Standards 50/55 (revised 2011) which requires reporting of financial instruments to use fair value. Banking institutions experience a considerable impact on profit volatility because most of the assets and liabilities in banks are financial instruments (Adzis, 2012). To overcome the impact of profit volatility, bank managers are suspected of using discretion in the form of income smoothing to generate more stable profits. Previous research has stated that the loan loss provision (LLP) is the most frequently used method of income smoothing in the banking sector, including sharia banking (Othman & Mersni, 2014). Wijayanti and Diyanti (2017) suggest that sharia banks perform income smoothing to get customer returns that are more competitive than conventional banks.

This study also analysed the role of corporate governance (CG) to moderate the levels of profit predictability and profit management. Jiang et al. (2008) and Wijayanti and Diyanti (2017) state that a better CG mechanism can increase profit predictability. This is due to increased transparency in financial reporting which increases the accuracy of decision making by users of financial statements. Better CG mechanisms have also been shown to weaken profit management (Odean, 1998). The CG mechanism in this study was measured by using self-assessment scores on the CG implementation by commercial banks. The scores were expected to reflect the comprehensive implementation of CG in the banking sector. Previous research on NPF measured bank's ability to cover the risk of default on debtor returns. The high Non-Performing Financing (NPF) in sharia banks showed the unhealthy quality of sharia banks. This non-current financing was due to constraints on

any financing provided by sharia banks. The obstacle was because every financing provided by the banks was not all financing that could be returned in full by the customer so that NPF was detrimental to ROE (Fahrnisa & Sutoyo, 2016). From the grand theory and research gap that the author has described above, this study tried to examine it, by taking the title related to the effects of profit volatility (X_1), income smoothing (X_2), corporate governance (X_3), and non-performing financing (X_4) on profit quality (Y) of sharia commercial banks in Indonesia.

2. Literature Review

2.1 Relationship between profit volatility and profit quality

Profit volatility shows the level of profit fluctuations obtained by the bank from its operational activities for several periods. Profit volatility also shows the level of risk reflected in the magnitude of deviation in the level of profits earned by the bank during a certain period. The greater the deviation, the higher the profit volatility, which means the greater the risk the bank has (Odean, 1998). Research by De Haan and Poghosyan (2012) which uses variations in Return on Assets (ROA) to calculate the volatility of bank income over a certain period, proves that banks with large asset size have lower income volatility than banks with small asset size. The greater the profit volatility, the lower the profit quality reported. This is because profits tend to fluctuate which will make it difficult for users of financial statements to predict the company's profits in the future.

2.2 Relationship between income smoothing and profit quality

Income smoothing used by bank managers to overcome profit volatility is to smooth out profits by using the allowance for losses on productive assets (Othman & Mersni, 2014). This is because the allowance for losses on productive assets (Loan Loss Provision / LLP) is a reflection of the anticipated loss and risk management of productive assets by bank managers (Anandarajan et al., 2007). According to Wahlen (1994), loan loss provisions are expenses that are recorded to increase the loan loss allowance and reduce profit before tax for the current period. An increase in the allowance for credit losses will reduce the amount of net income reported; on the other hand, a delay in the provision of allowance for losses will increase net income. On condition of low bank profits, bank managers are suspected of having incentives to delay the imposition of allowance for losses (Odean, 1998). The National Sharia Council of the Indonesian Ulema Council issued the fatwa No. 87/DSN-MUI/XII/2012 concerning the method of income smoothing in sharia banks. This fatwa was issued with the consideration that if sharia banks are on condition that there is a strong suspicion of facing the risk of transferring or withdrawing customer funds due to an uncompetitive and reasonable rate of return (displaced commercial risk), sharia banks can make a policy known as the smoothing method, namely smoothing profits in the form of profits without adjusting profit allowances, and distributing profits by forming profit-equalization reserve (PER).

2.3 Relationship between corporate governance and profit quality

What distinguishes the supervisory function of sharia and conventional banks is the existence of additional supervisory function of sharia banks. In sharia banks there is an additional supervisory mechanism, namely the Sharia Supervisory Board. Thus, sharia banks have two boards, namely the Sharia Supervisory Board and the Board of Directors (BoD) as in other commercial banks (Laela, 2012). According to Bank Indonesia Circular No. 8/19/DPbS 2006, the function of Sharia Supervisory Board is to provide supervision and advice to bank directors in carrying out operational activities based on the sharia principles (sharia compliance). According to Laela (2012), in sharia compliance, the Sharia Supervisory Board supervises and regulates the operational activities of sharia banks so that they are carried out with Islamic ethics and values. The things that are regulated include the prohibition of immorality and the prohibition of misappropriating information. In addition, the Sharia Supervisory Board must also ensure that the distribution of profits/losses to investors is carried out according to Islamic laws. With the double board, it is expected that the level of supervision of managers in sharia banks will increase so that the implementation of CG in sharia banks is predicted to be stronger in reducing managers' actions to facilitate income when compared to conventional banks.

2.4 Relationship between non-performing financing (NPF) and profit quality

High NPF will increase costs, thus potentially causing bank losses. The higher this ratio, the worse the quality of bank credit which causes greater number of non-performing loans, so that the bank must bear losses in its operational activities and it has an impact on the decrease in profit (ROA) obtained by the bank. Because the NPF value is an important indicator to measure the soundness of a bank, all banks will continue to try to reduce this NPF figure; if necessary, banks will not expand credit if they are not sure about the prospects of the borrower being financed. The NPF and CAR figures are two indicators of the bank's prudential principle that must be maintained in any credit expansion. NPF is also an indicator to show losses due to financing risk. The amount of NPF reflects the level of cost control and financing/credit policies implemented by the bank. High non-performing financing can reduce the ability of banks to channel funds to depositors because they have to create large write-off reserves for both new depositors and prospective depositors so that bad loans will appear which can

reduce the performance of bank fund distribution. As a result, assets become unproductive, asset turnover is hampered, causing the achievement of profit growth to tend to be low and can affect profit quality.

Hypotheses

H₁: *Profit volatility affects profit quality.*

H₂: *Income smoothing has an effect on profit quality.*

H₃: *Corporate governance has an effect on profit quality.*

H₄: *Non-Performing Financing has an effect on profit quality.*

Based on the formulation of the hypotheses above, the framework of this study was:

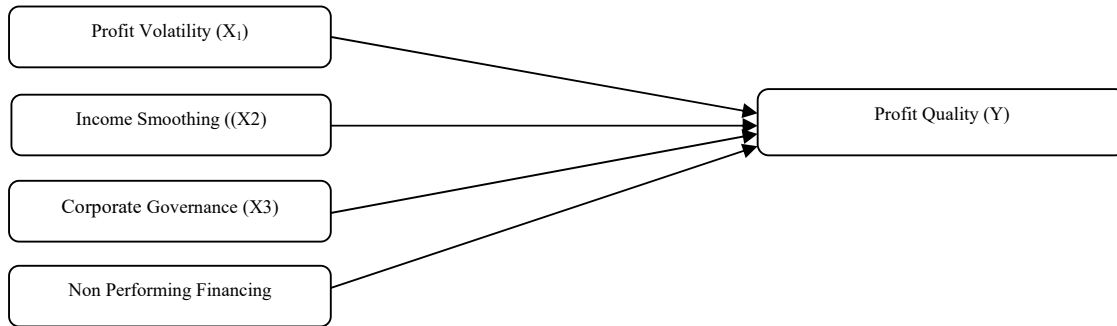


Fig. 1. The Influence of Profit Volatility, Income Smoothing, Corporate Governance, and Non-Performing Financing on Profit Quality of Sharia Commercial Banks

3. Method

This study used panel data analysis using statistical software, namely Eviews-10. To analyse the data, this study used descriptive analysis, classical assumption tests, panel data regression analysis, and tests. The type of data used in this study was quantitative data. The source of the data used in this study was historical secondary data, namely quarterly financial reports issued by the banks concerned for seven consecutive years from the first quarter to the fourth quarter during the 2012-2018 period. This study used purposive sampling method to get 10 sharia commercial banks meeting the requirements. Panel (pooled) data is a combination of time series data and cross-sectional data; therefore, the panel data have the characteristics of combined data, namely the data consisting of several objects and times. The regression model estimation method using panel data can be done through three approaches. Generally, parameter estimation in regression analysis with cross-sectional data is done by using the method of estimating small squares or called Ordinary Least Square (OLS). Fixed effects model is a technique for estimating panel data using dummy variables to capture differences in intercepts. Intercept between companies, intercept differences can occur due to differences in work culture, management, and incentives. In addition, this model also assumes that the regression coefficient remains between company and time. This approach with dummy variables is known as the least square dummy variable (LSDV) method. Panel data regression analysis was used to determine the accuracy of the relationship of profit quality (dependent variable) and profit volatility in management discretion, income smoothing, corporate governance implementation, and financial problems in sharia banks.

4. Results

4.1 Results

The following explains the results of panel data regression using three approaches, namely Ordinary Least Square (OLS), Fixed Effects Model, and Random Effects Model. Likelihood Ratio Test was conducted to determine whether the model to be analyzed used the pooled least square or fixed-effects method. This test was carried out by using the F-stat test procedure with the following hypotheses:

H_0 : Pooled Least Square Model (restricted)

H_1 : Fixed Effects Model (unrestricted) The results of the Likelihood Ratio Test were as follows. This test was needed in order to choose the most appropriate model between the common effects and fixed-effects models. The results of the Chow test can be seen in Table 2.

Table 2
Likelihood Ratio Test

Effect test	Statistics	d.f.	Prob.
Cross-section F	5.844786	(9,52)	0.0000
Cross-section Chi-Square	46.129326	9	0.0000

Source: Output display, 2019

The cross-section probability value was 0.0000 or <0.05 , so H_0 was rejected. Therefore, the selected model had fixed effects. Next, we would do regression with a random effects model to determine which model was appropriate.”

4.2 Hausman Test

The Hausman test was used in order to choose the best approach between Fixed Effects Model and Random Effects Model. This test follows the chi-square distribution with the hypotheses:

H_0 : Random Effects Model

H_1 : Fixed Effects Model (unrestricted)

Hausman test results were as follows:

Table 3
Hausman Test Results

Test Summary	Chi-Sq. Statistics	Chi-Sq. d.f.	Prob.
Cross-section random	1.062747	4	0.9001

Source: Data processed, 2019, view output

Based on the results of Hausman test above, the probability value of cross section random was 0.09001; this value was greater than 0.05, meaning that H_0 was accepted and H_1 was rejected, so the model chosen was the Random Effects Model (REM).

4.3 Classical Assumption Tests

The model used in this study was panel data regression. In order for the regression results to be valid, the classical assumptions must be fulfilled, namely normality, autocorrelation, multicollinearity, heteroscedasticity.

4.3.1 Normality Test

The results of the normality test on the residual value of the regression equation showed a probability value of 0.200. This showed that the value was $0.200 > 0.05$, meaning that the data were normally distributed. “

4.3.2 Multicollinearity Test

Multicollinearity is indicated if there is a linear relationship between the independent variables used in the model. The multicollinearity test shows that the pairwise correlation coefficient (r) is high among the explanatory variables; if the correlation coefficient is high enough, say, above 0.8, there is a possibility of serious multicollinearity in the model. The results of the analysis showed that the values of the correlation coefficients of the independent variables were below the value of 0.8. So it could be concluded that there was no multicollinearity in the regression model. The results obtained can be seen in the following table:

Table 4
Multicollinearity Test Results

	VOL	LLP	CG	NPF
VOL	1.000000	0.684692	0.299362	0.191510
LLP	0.684692	1.000000	0.462434	0.560240
CG	0.299362	0.462434	1.000000	0.293894
NPF	0.191510	0.560240	0.293894	1.000000

Source: Data processed, 2019, view output

4.3.3 Heteroscedasticity

Heteroscedasticity aims to test whether in the regression model there is inequality of variances from the residual of one observation to another observation which is constant called homoscedasticity and if it is different, it is called heteroscedasticity. A good regression model is that there is no homoscedasticity or heteroscedasticity. To test the presence or absence of heteroscedasticity, this study used the Park test, namely by regressing the squared residuals on the independent variables. The presence or absence of heteroscedasticity is known by looking at its significance level of 5%. If the Sig value

> 0.05, then there is no symptom of heteroscedasticity. The results of heteroscedasticity test showed that the probability values of the independent variables were not less than the significance level of 0.05. This means that the Glesjer test that had been carried out rejected H_0 and accepted H_1 so that there was no heteroscedasticity problem in the regression. The heteroscedasticity can be seen in the table below.

Table 5
Heteroscedasticity Test Results

Variable	Coefficient	Std. Error	t-Statistics	Prob.
C	0.080981	0.040365	2.006205	0.0493
VOL	0.026402	0.034772	0.759289	0.4506
NPF	0.000202	0.004510	0.044796	0.9644
LLP	-0.006019	0.005918	-1.017024	0.3132
CG	0.036497	0.022725	1.606023	0.1134

Source: Data processed, 2019, view output

4.3.4. Autocorrelation Test

Detecting autocorrelation, the probability of F-count alpha level is 0.05.

Table 6
Autocorrelation Test Results

Test Summary	Chi-Sq. Statistics	Chi-Sq. d.f.	Prob.
Cross-section random	1.062747	4	0.9001

Source: 2019 data processed, view output

The Chi-Squared probability value of 1.062747 was also known as the calculated F probability value greater than 0.05, so it could be concluded that there was no autocorrelation, meaning that the model used in this study did not experience autocorrelation. Based on the classical assumption tests (normality, autocorrelation, multicollinearity, heteroscedasticity), the model used did not deviate from the classical assumptions, meaning that the regression model in the study could be used as a basis for analysis.

4.3.5 Coefficient of Determination

Coefficient of determination is very important to measure how far the model's ability to explain the variation of dependent variable. R-squared value close to one means the ability of independent variables to provide almost all the information needed to predict the dependent variable. The coefficient of determination can be seen in the following table:

Table 7
Coefficient of Determination

		Weighted Statistics	
R-Squared	0.163497	Mean dependent var	0.127273
Adjusted R-Squared	0.108645	S.D. dependent var	0.138479
S.E. of regression	0.130966	Sum Squared Residual	1.046279
F-Statistics	2.980665	Durbin-Watson Statistics	1.279464
Prob (F-Statistics)	0.025849		

Source: Output display, 2019

This shows that the contribution of independent variables to the dependent variable was 16.34% (based on R-squared value). Or it could be interpreted that the independent variables used in the model could explain 16.34% of the dependent variable. The remaining 83.66% was influenced by other factors outside the regression model.

5. Discussion

5.1 Hypothesis One: Profit volatility has a negative effect on profit quality

The profit volatility variable had a significant negative effect on profit quality; this was indicated by the significance value of 0.1100 < 0.05. The negative effect indicated that the greater the profit volatility, the higher the profit quality. According to Khah and Shah (2007), profit volatility is a business risk inherent in the company's operations, describing it as a business risk due to inefficient management practices. Profit volatility is the variation in the amount of profit a company generates. Uncertainty about the profit of a bank is a risk faced by the bank.

5.2 Hypothesis Two: Income smoothing has a negative effect on profit quality

The income smoothing variable had no effect on profit quality; this was indicated by the significance value of 0.1939 > 0.05. The negative effect indicated that the greater the income smoothing, the lower the profit quality. One of the methods

used by bank managers to overcome profit volatility is to smooth out profits by using the allowance for losses on productive assets (Othman & Mersni, 2014). This is because the allowance for losses on productive assets (Loan Loss Provision / LLP) is a reflection of the anticipated loss and risk management of productive assets by bank managers (Anandarajan et al., 2006).

5.3 Hypothesis Three: Corporate governance has a negative effect on profit quality

The results of the analysis showed that corporate governance had no effect on profit quality; this was indicated by the significance value of $0.2093 > 0.05$. The negative effect indicated that the greater the corporate governance, the lower the profits quality. The greater the institutional ownership, the greater the role of institutional ownership in the corporate governance mechanism so that the aspect of monitoring the company's performance would increase. High profit quality would pressure management to improve its performance, reduce profit management actions and produce quality profit reports.

5.4 Hypothesis Four: Non-performance financing has a negative effect on profit quality

The results of the analysis showed that non-performance financing had no effect on profit quality; this was indicated by the significance value of $0.1939 > 0.05$. The negative effect indicated that the greater the corporate governance, the lower the profit quality. Non-Performing Financing (NPF) is one of the main indicators to assess bank performance. The level of bank business continuity is closely related to productive assets; therefore, bank management is required to continuously monitor and analyze the quality of its productive assets. Productive asset quality indicates asset quality against credit risk faced by banks as a result of lending and investing bank funds.

6. Conclusions

It has been stated in the previous section that the following conclusions could be drawn:

1. Profit volatility variable had no significant effect on profit quality. Profit volatility in the banking sector is expected to increase due to the revision of the Financial Accounting Standards Guidelines 50/55 (revised 2011) which requires reporting of financial instruments to use fair value. To overcome the impact of profit volatility, bank managers are suspected of using discretion in the form of income smoothing to generate more stable profits.
2. Income smoothing variable had no effect on profit quality. This means that the greater the income smoothing, the lower the profit quality. An increase in the allowance for credit losses will reduce the amount of net income reported; on the other hand, a delay in the provision of allowance for losses will increase net income. On conditions of low bank profits, bank managers are suspected of having incentives to delay the imposition of allowance for losses.
3. Corporate governance variable had no effect on profit quality. High corporate governance will pressure management to improve performance, reduce profit management actions and produce quality profit reports.
4. Non-performance financing variable had no effect on profit quality. The negative effect indicates that the greater the non performing financing, the lower the profit quality. The results of this study were not in line with previous research. Non-Performing Financing (NPF) is one of the main indicators to assess bank performance. The condition of large NPF in a period does not directly result in a decrease in profit in the same period. On the other hand, high NPF could disrupt the bank's working capital turnover, so that when the bank has a high amount of non-performing financing.

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