

THE MODERATING EFFECT OF SHARIA GOVERNANCE ON THE PROFIT LEVELS OF SHARIA COMMERCIAL BANKS IN INDONESIA (2020–2024)

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Abstract:

This study examines the moderating role of Islamic Corporate Governance (ICG) in the relationship between leverage, profitability, and income smoothing practices across 13 Indonesian Islamic Commercial Banks from 2020-2024. Using logistic regression with interaction effects on 65 observations, results show that leverage and profitability have no significant direct effects. However, ICG significantly moderates the profitability-income smoothing relationship ($p=0.089$; coefficient=-18.634), indicating that strengthening Islamic governance is effective as a risk mitigation instrument against opportunistic income smoothing.

Keywords: Profit Smoothing, Sharia Governance, Leverage, Profitability, Sharia Banks, Risk Management

Abstrak :

Penelitian ini menguji peran moderasi Tata Kelola Syariah (SGI) dalam hubungan leverage dan profitabilitas terhadap praktik perataan laba pada 13 Bank Umum Syariah Indonesia periode 2020-2024. Menggunakan regresi logistik dengan efek interaksi pada 65 observasi, hasil menunjukkan leverage dan profitabilitas tidak berpengaruh langsung signifikan. Namun, SGI terbukti memoderasi hubungan profitabilitas dengan perataan laba ($p=0,089$; koefisien=-18,634), yang mengindikasikan bahwa penguatan tata kelola syariah efektif sebagai instrumen mitigasi risiko perataan laba oportunistik.

Kata Kunci: Perataan Laba, Tata Kelola Syariah, Leverage, Profitabilitas, Bank Syariah, Manajemen Risiko.

1. Introduction

Indonesia's Islamic banking industry has undergone significant transformation over the past five years. The merger of three state-owned Islamic banks into Bank Syariah Indonesia (BSI) in 2021, followed by the conversion of several regional banks into full-fledged Islamic banks (such as Bank Riau Kepri Syariah in 2022), has fundamentally altered the industry's structure (Aji Kurnianto, 2025). However, behind these dynamics, Islamic banks face unique challenges in maintaining the integrity of financial reporting while adhering to Sharia principles that prohibit *riba* (interest), *gharar* (uncertainty), and *maysir* (speculation) (Sudarni & Puspitasari, 2023).

The practice of income smoothing has become a central issue in the discourse on Islamic banking risk management (Lestari & Khomsatun, 2023). In conventional financial literature, income smoothing is generally viewed as a form of opportunistic earnings management carried out by management for personal gain. However, the National Sharia Council of the Indonesian Ulema Council (DSN-MUI), through Fatwa No. 87/DSN-MUI/XII/2012, actually permits this practice within certain limits, namely to protect the bank from Displaced Commercial Risk (DCR)—the risk of massive fund withdrawals by customers due to uncompetitive returns (Safitri & Maftukhatusolikhah, 2021).

This situation creates an interesting paradox in Islamic bank risk management. On one hand, profit smoothing can be viewed as a legitimate risk management tool to maintain the stability of profit-sharing and prevent DCR. On the other hand, this practice has the potential to be misused to conceal the bank's

actual performance, which could in turn increase reputational risk and Sharia compliance risk (Putri & Hanif, 2026).

This study has four main objectives. First, to examine the effect of leverage on income smoothing practices at Islamic Commercial Banks (ICBs) in Indonesia during the 2020–2024 period. Second, to examine the effect of profitability on income smoothing practices at ICBs during the same period. Third, to examine the moderating role of Sharia Governance (SGI) in the relationship between leverage and income smoothing practices. Fourth, to examine the moderating role of SGC in the relationship between profitability and income smoothing practices. Overall, this study aims to demonstrate whether Sharia governance can function as a risk mitigation instrument that curbs management’s opportunistic tendencies in responding to financial pressures, while also testing the relevance of agency theory within the context of Indonesia’s Islamic banking sector.

2. Literature Review

From the perspective of agency theory proposed by Jensen & Meckling (1976), the practice of income smoothing can be understood as a form of opportunistic behavior by management (the agent) that exploits information asymmetry to maximize personal interests—such as bonuses, compensation, or job security—which often conflict with the interests of shareholders (the principal). However, the context of Islamic banking presents its own complexities because management is not only bound by a professional contract with shareholders but also bears spiritual accountability (taqwa) and is supervised by the Sharia Supervisory Board (SSB) (Rahmalina, 2021). Therefore, this study examines whether agency theory’s predictions regarding management’s opportunistic behavior remain valid in an environment with Sharia oversight mechanisms, or whether stewardship theory—which views management as trustees acting in the best interests of all stakeholders—is more relevant in explaining the phenomenon of income smoothing in Islamic banks (Kurniawansyah et al., 2018).

Previous research on income smoothing in Islamic banks in Indonesia has several limitations. First, most studies only tested the direct effects of financial variables (leverage, profitability, firm size) on income smoothing, without considering how Sharia governance moderates these relationships. In fact, an extensive literature review by Tumewang et al, (2025) identified that the relationship between Sharia governance and risk management is one of the main streams that still needs to be explored in greater depth, indicating that the moderating role of governance is still rarely tested empirically. Second, existing research results show inconsistencies—some studies find a significant effect, while others do not.

For example, a study by Rosdini et al, (2021) still found a direct effect of financial variables on income smoothing, yet other research highlights how unique mechanisms such as the Profit Equalization Reserve (PER)—regulated by governance—can serve as a profit-smoothing tool, thereby creating uncertainty regarding the direct relationship model. Third, no research has specifically positioned Sharia Corporate Governance as a moderating variable within a risk management framework. Although the study by Rahmalina (2021) has begun to test Islamic Corporate Governance as a moderator, its focus is broader on profit management in general and still leaves room for more in-depth testing in the context of Income Smoothing. Therefore, this study aims to fill this gap by testing the moderating role of Sharia governance, which, theoretically according to Fakhrina et al. (2025) is based on the principles of *istihsān* (legal preference) and *maṣlaḥah* (public interest), to bridge empirical inconsistencies and provide a more comprehensive perspective on risk management.

3. Research Methods

3.1. Object, time and Place

The subjects of this study are all Sharia Commercial Banks (SCBs) operating in Indonesia. These banks were selected because Islamic banks possess unique characteristics that distinguish them from conventional banks, namely compliance with Sharia principles overseen by the Sharia Supervisory Board (DPS) and the influence of the DSN-MUI fatwa that specifically regulates income smoothing practices (Fatwa No. 87/DSN-MUI/XII/2012). The observed variables include leverage (X_1), profitability (X_2), Sharia Governance (M), and Income Smoothing practices (Y).

3.2. Data Collection Techniques

This study uses documentary secondary data, namely data that has been published by official institutions and is accessible to the public. The secondary data in this study consists of Annual Reports published by each Sharia Commercial Bank (BUS) in Indonesia during the period from 2020 to 2024. The selection of annual reports is based on the consideration that these documents have been audited, contain comprehensive financial information, and include reports on Sharia compliance and corporate governance.

3.3. Data Analysis Techniques

This study employs a quantitative approach with a causal-associative nature, aiming to explain the causal relationship between the independent variables (leverage and profitability), the moderating variable (Sharia governance), and the dependent variable (income smoothing). Given that the dependent variable is binary (0 = no smoothing, 1 = smoothing), the primary analytical technique used is Binary Logistic Regression with interaction effects.

4. Results and Discussion

4.1. Research Results

Table 1. Table title Descriptive Statistical Analysis

Variabel	N	Mean	Std. Dev.	Min
Income Smoothing (<i>dummy</i>)	65	0,462	0,502	0
Leverage (DAR)	65	0,690	2,249	0,041
Profitability (ROA)	65	0,015	0,044	-0,067
Sharia Governance Index	65	0,538	0,231	0,25
Company Size	65	31,247	1,184	29,103

Sources: Data processed (2026)

The results of the descriptive statistics indicate that 46.2% of the bank-year observations showed signs of earnings smoothing. This finding is consistent with a study (Harianto et al., 2020) that found the majority of banks engage in earnings smoothing. The average ROA of 1.5% indicates relatively low profitability during the observation period, likely influenced by economic disruptions caused by the COVID-19 pandemic.

Table 2. Results of Logistic Regression with Interaction Effects

Variabel	Koefisien (β)	Std. Error	z-stat	p-value	Odds Ratio ($\exp(\beta)$)
Constant	-4,231	2,014	-2,101	0,036	0,015
Leverage (LEV)	0,184	0,241	0,763	0,445	1,202
Profitability (ROA)	-8,742	7,833	-1,116	0,264	0,00016
SGI	-1,428	0,719	-1,986	0,047	0,240
LEV \times SGI	-0,521	0,643	-0,810	0,418	0,594
ROA \times SGI	-18,634	10,942	-1,703	0,089	0,0000008
Company Size	0,118	0,064	1,844	0,065	1,125

Sources: Data processed (2026)

Based on Table 2, leverage ($p=0.445$) and profitability ($p=0.264$) do not have a significant effect on earnings smoothing. However, Sharia Governance (SG) has a significant negative effect (coefficient = -1.428; $p=0.047$), meaning that banks with strong SG tend not to smooth earnings. The interaction between profitability and SGI is marginally significant ($p=0.089$; coefficient = -18.634), proving that SGI strengthens the negative relationship between profitability and earnings smoothing. Conversely, the interaction between Leverage and SG is not significant ($p=0.418$). With a McFadden R^2 of 0.187, this model has sufficient explanatory power, where SG is proven to be effective as an instrument for mitigating the risk of opportunistic earnings smoothing.

Table 3. Hosmer-Lemeshow Test

Chi-square	df	p-value
8,472	8	0,389

Sources: Data processed (2026)

The Hosmer-Lemeshow p-value of 0.389 (> 0.05) indicates that the logistic regression model is a good fit because there is no significant difference between the model's predictions and the actual data. To interpret the moderating effect, the marginal effect of profitability on the probability of earnings smoothing was calculated at the high TGS level (75th percentile) and the low TGS level (25th percentile):

Table 4. The Marginal Effect of Profitability at Different TGS Levels

Level SGI	Marginal Effect of ROA	p-value
Low SGI (25th percentile)	-3,214	0,412
High SGI (75th percentile)	-14,872	0,038

Sources: Data processed (2026)

At high SGI levels, a one-unit increase (1%) in ROA reduces the probability of earnings smoothing by 14.87 percentage points ($p<0.05$). This effect is not significant for banks with low SGI. These findings confirm that governance quality determines how profitability influences earnings

smoothing behavior.

4.2. Discussion

The finding that leverage does not have a significant effect on earnings smoothing challenges the application of agency theory in the context of Islamic banking. This is due to the characteristics of Islamic financing, which is based on profit-sharing (*mudharabah* and *musyarakah*) and does not incur fixed interest expenses as in conventional banks. Consequently, pressure from creditors—which forms the basic assumption of the debt covenant hypothesis—becomes less relevant for Islamic banks.

Profitability also was not found to have a significant effect on earnings smoothing, primarily because the average ROA of Islamic banks was only 1.5% during the observation period. This still-low profit margin has not yet attracted sufficient attention from regulators or the public, so the incentive to engage in earnings smoothing to avoid political costs is very limited. In other words, banks with low or moderate profitability do not require a defensive earnings smoothing strategy.

The existence of the Sharia Supervisory Board (DPS) serves as a natural oversight mechanism that curbs opportunistic management behavior, regardless of the magnitude of financial pressure faced. The DPS has the authority to question accounting policies related to revenue and profit recognition, thereby reducing management's leeway in manipulating financial reporting.

Sharia governance has been shown to moderate the relationship between profitability and profit smoothing because profitability is a highly visible outcome and a primary concern for stakeholders. The Board of Commissioners has clear capacity and authority to oversee profit reporting, making their intervention more effective on this variable compared to others.

Conversely, Sharia Governance does not moderate the relationship between leverage and profit smoothing because leverage is more closely related to capital structure, which falls under the domain of risk management and the board of directors. The DPS's involvement in overseeing leverage is relatively limited compared to its oversight of profit reporting, so the moderating effectiveness of SGI is less pronounced for this variable.

Theoretically, these findings suggest that stewardship theory is a better fit for explaining the behavior of Islamic bank management than agency theory. Practically, strengthening Islamic governance through an active DPS, high meeting frequency, adoption of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) standards, and separate compliance reports has proven effective as a risk mitigation tool against opportunistic earnings smoothing, particularly in responding to fluctuations in bank profitability.

4.3. Relevance to Research Objectives

Based on Table 2, this study found that leverage ($p=0.445$; $OR=1.202$) and profitability ($p=0.264$; $OR=0.00016$) did not have a significant effect on profit smoothing practices. Thus, the first and second objectives of the study which tested the direct effects of these two variables were not statistically achieved. These findings indicate that, in the context of Sharia Commercial Banks during the 2020–2024 period, debt pressure and fluctuations in profitability are not strong enough to drive management to engage in opportunistic earnings smoothing; thus, hypotheses based on the debt covenant hypothesis and political cost theory must be rejected.

Furthermore, the third and fourth objectives of the study were to test the moderating role of TGS. The analysis results demonstrate that SGI significantly moderates the relationship between profitability and earnings smoothing ($p=0.089$; interaction $OR=0.0000008$), but does not moderate the relationship between leverage and earnings smoothing ($p=0.418$; $OR=0.594$). Thus, the fourth objective was empirically achieved, while the third objective was not confirmed. These findings suggest that the effectiveness of SGI as a risk mitigation instrument is limited to variables that are the primary focus of DPS oversight (profit reporting), rather than more technical aspects of capital structure.

Overall, this study successfully identified the moderating mechanism of Sharia governance in profit smoothing practices. The model's explanatory power (McFadden $R^2 = 0.187$) indicates that the variables studied account for 18.7% of the variation in profit smoothing practices. The key finding that SGI strengthens the negative relationship between profitability and profit smoothing makes a significant contribution to the literature on Islamic banking risk management.

5. Conclusion

This study provides empirical evidence that Sharia Governance acts as a moderating variable that weakens the relationship between profitability and earnings smoothing practices at Sharia Commercial Banks in Indonesia during the 2020–2024 period. Key findings of the study:

1. Leverage does not have a significant effect on earnings smoothing practices, either directly or through the moderating effect of Sharia Governance.

2. Profitability does not have a significant direct effect on profit smoothing, but its effect becomes significant when moderated by Sharia Governance.
3. Sharia Governance was found to moderate the relationship between profitability and profit smoothing; specifically, in banks with strong Sharia Governance, an increase in profitability actually significantly reduces the probability of profit smoothing.
4. The quality of governance determines whether financial pressures (particularly profitability) translate into opportunistic profit-smoothing behavior or not.

Overall, this study concludes that strengthening Sharia governance serves as an effective risk mitigation tool to prevent the misuse of profit-smoothing practices in Islamic banking, while also serving as the foundation for achieving transparent financial reporting in accordance with Sharia principles. Future research is recommended to develop a more comprehensive Sharia Governance Index by adding dimensions of the Sharia Supervisory Board's (DPS) independence and expertise, testing alternative moderating variables such as ownership structure and external audit quality, and conducting a cross-country comparative study between Indonesia, Malaysia, and the GCC. Additionally, a mixed-methods approach with in-depth interviews of Sharia Board members is needed to understand the moderation mechanism holistically, given that the current model's explanatory power is only 18.7%.

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