Income Smoothing and Islam: an Evidence from Malaysian Shariah Compliant Companies

Siti Masnah Saringat, Rosmawati Haron, and Henny Hazliza Mohd Tahir

Abstract—**As repeatedly emphasized by the Prophet S.A.W, weight and measures are two of the important elements in business transactions. Pedestal on that premises, we concur to discover the existence of income smoothing in Malaysian's Shariah compliant companies which are perceived as companies that go along with ethical Islamic precept in both business transactions and financial reporting. Even though in Islamic financial theory does not repudiate smoothing of profit, this study will examine types of smoothing behaviour that are undertaken by the executives. There are two types of income smoothing; real smoothing and artificial smoothing. Real smoothing comprises making production and speculation decisions that decrease income inconsistency. In dissimilarity, artificial smoothing is attained through accounting practices. We tested our objectives on 712 Shariah compliant companies in Malaysian capital market over the period of 2007 – 2011. By using test of artificial income as a measurement, we found that 53.6% of the companies are artificial smoothers.**

Index Terms—**Shariah compliant, income smoothing, Islamic teachings.**

I. Introduction

Managers and executives use the financial statements as the medium to display and to discharge their stewardship function towards the principal as the principal assigned resources to them. The financial statements are used as a mean of communicating the financial health, firm's performance and the cash flows of a firm. One of the cause why shareholders or the principal be heavily dependent on the statements is that they have restricted or no access at all to the firm's accounting records. Due to this, the managers and executives are likely to report a more favorable result in the financial statements as they know shareholders will make decision or conclusions based on these reports.

[1] Defined income smoothing as a "deliberate dampening of fluctuations about some level of earnings which is considered to be normal for the firm". To put it basically, income smoothing denotes to the deed of lessening variations in earnings over time.

Among the dissimilar approaches that may be classified as income smoothing is the approach of deferring the recognition of revenue that is received in one period until a following period that is predicted to produce a lesser amount of collected revenue. By means of this method can successfully help manage net income in a way that stops the business from spending the cash flow now, holding it for the future period after that cash flow will be less inexhaustible. A comparable approach would be to defer recognition of certain expenses during a slump in collected revenue and elect to account for them during a later period when income levels have improved.

Manuscript received December 14, 2012; revised February 14, 2013.

The authors are with the Universiti Teknologi MARA, Johor, Malaysia (e-mail: rosma741@johor.uitm.edu.my, sitima067@johor.uitm.edu.my, henny030@johor.uitm.edu.my).

II. What is Income Smoothing

Generally accepted accounting principles (GAAP) authorize a certain degree of administrative discretion in the application of accounting approaches. Using this discretion and flexibility to improve the discernment of the firm is usually mentioned to as "earnings management" in the academic and professional literature. Though not one commonly acceptable definition of earnings management currently subsists, [2] defined earnings management as managers' use decision in financial reporting and in organizing transactions to modify financial reports to either deceived some stakeholders about the fundamental economic performance of the corporation, or to stimulus contractual conclusions that be subjected to on reported accounting numbers. Note that the procedure includes taking cautious steps within the limitations of GAAP to bring about an anticipated level of reported earnings.

Numerous of the researches focused on income smoothing and it has developed interesting discussion and similarly become arguments. Nevertheless, these papers gave indications that income smoothing exists. Few frameworks have been developed to specify and to differentiate between smoother and non-smoother. This paper employed proposition by [3] which are; income is the linear function of sales, fixed cost could remain constant but it will not decrease, the ratio of variable costs in dollar remain constant and gross sales can only be deliberately smoothed by real smoothing and not by artificial smoothing. As a consequence, the coefficient of variation approach was developed on the ground of the above propositions which determine smoothing when the coefficient of variation of sales is greater than the coefficient of variation of income.

III. Why Smooth the Income

In [4], income smoothing expectations depend on three main assumptions, which the first is that the manager derives a non-monetary private advantage from running the firm. Another assumption is, deprived performance leads to interference by the firm which later resulting in a decrease of the manager's private advantage. Third, recent income annotations are weighted more than prior annotations in assessing the manager's recent performance.

DOI: 10.7763/IJSSH.2013.V3.218

In contrast, other studies assess income smoothing as an instrument for executives to disclose their private information about forthcoming earnings [5] and [6]. Such statement could be either active or passive. For instance, [7] showed that reported earnings have dual roles. The level of reported earnings allows investors to conclude the level of stable future cash flows. The variations of reported earnings decrease the investors' confidence in the concluded stable component. The dual roles cause executives to smooth earnings. Using [8] signalling framework, [5] claimed that only firms with decent future prospects smooth earnings since borrowing from the future could be catastrophic to a poorly performing firm once the problem explodes in the near term.

Private information about forthcoming earnings can similarly be communicated passively. [6] Exhibited that executives smooth income to smooth consumption besides that in so doing they disclose private information about future earnings. [9] Revealed that, even in the nonattendance of an incentive, forthcoming earnings are partly communicated in effective contracting as long as managers use future earnings information to decide whether they smooth current earnings. Whether information is communicated actively or passively, income smoothing might make firms' current and past earnings further informative about forthcoming earnings and cash flows.

According to [10], there are two types of smoothing: real and artificial. Real smoothing comprises making production and speculation decisions that decrease income inconsistency. In dissimilarity, artificial smoothing is attained through accounting practices. [11] Performed a long-run empirical analysis between smoothing and stock profitability, using U.S. companies' stock information as their sample. They categorized the companies as smoothers and non-smoothers on the ground of the sales variation coefficient vs. the earnings variation coefficient. By means of geometric series of returns as a foundation for calculation, they revealed that the non-smoother sample had greater average income than the smoother sample. Nevertheless, the monthly average income used in their study was not adjusted for risk. There is also a variance in size and risk among the two samples: the smoothing group was larger and had a smaller beta than the non-smoothing group, even though there was no statistical evidence to support this result.

[12] Studied the Finnish market to comprehend if abnormal return, as derived from earnings disclosures, was different among companies that do and do not demonstrate smoothing behavior, based on the variation coefficient method. The results exhibited that smoothers inclined to be bigger than non-smoothers, and the former also had smaller betas than their equivalents. When speaking of abnormal returns, the non-smoothers displayed better market performance against variability of income when linked to smoothers.

More in recent times, [13] re-examined their study of [11] to perceive if the accounting performance measures are associated to income smoothing, but this time using abnormal returns. The results of this approach are based on the accumulation of abnormal returns by means of arithmetic series. The results exhibited that smoothers have a suggestively higher abnormal return than non-smoothers. The smoothers, according to the market value of liquid assets, were bigger than non-smoothers.

IV. Income Smoothing from Islamic Perspectives

Muslims originate their ethical system from the teachings of the Qur'an (which Muslims believe is a book revealed by God to Muhammad in seventh century Arabia), and from the Sunnah (the recorded sayings and behaviour of Muhammad). The objectives of Islam are not predominantly materialist. They are constructed based on Islamic notions of human well-being and good life which stress brotherhood/sisterhood and socioeconomic impartiality and necessitate a well-adjusted gratification of both the material and spiritual needs of all humans [14].

This motion is well supported by [15] who accentuated that companies that claim to be Shariah compliant should abide by high standards of good conduct and thus requirement for earning management is zero. They also added that Shariah compliant companies firms are expected to be free from unethical or immoral transactions manipulation of earnings and insider trading which may have an adverse effect on investment activities.

Conversely, in Islamic financial theory, smoothing of the profit to investment account holders (IAH) is a well-acknowledged exercise. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) financial accounting standard (FAS) 11 necessitates the recognition of the profit equalization reserves (PER) and the investment risk reserves (IRR). These reserves alleviate the returns for Islamic banking institutions and moderate withdrawal risk. Nevertheless, empirical studies associated to return smoothing practices are inadequate and report mixed results.

V. The Methodology and Hypothesis Development

To satisfy our research objective, we have adopted tests of artificial income smoothing introduced by Eckel (1981):

If $CV_{\Delta Si} > CV_{\Delta Ii}$

and $df > 1$, then the company is an artificial smoother where

$CV_{\Delta Si}$	=	The coefficient variation for change in sales time series for company i
$CV_{\Delta Ii}$	=	The coefficient variation for change in income time series for company i
d_f	=	$\lvert CV_{\Delta Ii}\ /\ CV_{\Delta Si} \rvert$

We have hypothezed that company is artificially smoothing if the variability measure of sales is greater than the same variability measure of income. We tested our hypothesis with a sample of 712 Shariah compliant companies in Malaysian capital market over the period of 2007 – 2011. We trimmed down the samples to 588 companies, due to the unavailability of data.

Since the entry into the Shariah compliant counters is by means of following strict guidelines of business ethics, Shariah compliant companies are expected to maintain higher standards of good business conduct in running of their business (Rahman, et al., 2008). As such, the need of concealing mediocre business transaction is lesser for the executives of Shariah compliant companies. Based on these reasons, we hypothesized that our sample should not reveal artificial smoothing in income recognition.

VI. The Findings and Discussions

Based on pooled sample in Table I, we found that 315 Shariah compliant companies practices artificial income smoothing while non-smoother companies account for 46.4%. It indicates that this is inconsistent with [16] where he found out only 3 percent sample practices income smoothing during the twenty year period.

TABLE I: DESCRIPTIVE STATISTICS ON INCOME SMOOTHING

Year	Firm	*Smoother*	*Percentage*	*Non-smoother*	*Percentage*
Pooled sample	588	315	53.6%	273	46.4%

Note: The table indicates significance at 1% (***), 5% (**) and 10% (*) levels of confidence

VII. Conclusions

Income smoothing is not wrong. Consistent with our aim to find income smoothing in Shariah compliant companies in Malaysian capital market, we however, are unable to associate to what extend income smoothing, particularly artificially, is allowed by The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). Taken together our results indicate that 53.6% of Shariah compliant companies are artificial smoothers, economic circumstances may be the key factor of the executives to inflate sales against costs. Hence, based on the same samples, we recommend future researchers to investigate further.

Acknowledgement

A thank you to the management of Accounting, Business and Economy Research Center (ABERC) of Universiti Teknologi Mara, Johor and Accounting Research Institute (ARI) Dan Research Management Institute (RMI) for their believe and continuous support.

References

[1] D. W. Albrecht and F. M. Richardson, "Income smoothing by economy sector," *Journal of Business Finance & Accounting*, vol. 17, pp. 713-30, 1990.

[2] P. Healy and J. Wahlen, "A review of the earnings management literature and its implications for standard setting," *Accounting Horizons*, vol. 13, pp. 365- 383, 1999.

[3] N. Eckel, "The income smoothing hypothesis revisited," *Abacus*, vol. 17, no. 1, pp. 28-40, 1981.

[4] D. Fudenberg and J. Tirole, "A theory of income and dividend smoothing based on incumbency rents," *Journal of Political Economy*, pp. 75-93, 1995.

[5] J. Ronen and S. Sadan, *Smoothing Income Numbers: Objectives, Means, and Implications*, Boston, MA: Addison-Wesley Publishing Company, 1981.

[6] M. Sankar and K. R. Subramanyam, "Reporting discretion and private information communication through earnings," *Journal of Accounting Research*, vol. 39, no. 2, pp. 365-386, 2001.

[7] M. Kirschenheiter and N. Melumad, "Can Big Bath and earnings smoothing co-exist as equilibrium financial reporting strategies?" *Journal of Accounting Research*, vol. 40, no. 3, pp. 761-796, 2002.

[8] M. Spence, "Job market signaling," *The Quarterly Journal of Economics*, vol. 87, no. 3, pp. 355-374, 1973.

[9] J. S. Demski, "Performance measure manipulation," *Contemporary Accounting Research*, vol. 15, no. 3, pp. 261-285, 1998.

[10] J. Ronen and V. Yaari, "Legal insider trading, CEO's incentive, and quality of earnings," *Corporate Governance and Control*, vol. 4, no. 2, pp. 210-219, 2007.

[11] S. E. Michelson, J. J. Wagner, and C. W. Wootton, "A market based analysis of income smoothing," *Journal of Business Finance and Accounting*, vol. 22, no. 8, pp. 1179-1193, 1995.

[12] G. G. Booth, J. P. Kallunki, and T. Martikainen, "Post-announcement drift and income smoothing: finnish evidence," *Journal of Business Finance and Accounting*, vol. 23, no. 8, pp. 1197-1211, 1996.

[13] S. E. Michelson, J. J. Wagner, and C. W. Wooton, "Accounting income smoothing and stockholder wealth," *Journal of Applied Business Research*, vol. 10, no. 3, pp. 96-110, 2001.

[14] M. Chapra, *What is Islamic Economics?* Jeddah: Islamic Research and Training Institute, 2001.

[15] R. A. Rahman, A. Rahman, and S. Courtenay, Religion and Earning Management - Some Evidence From Malaysia Massey University, 2008.

[16] A. Barnea, J. Ronen, and S. Sadan, "Classificatory smoothing of income with extraordinary items," *The Accounting Review*, vol. 56, no. 1, pp. 110-22, 1976.

[17] A. G. Ismail and A. T. Be Lay, "Bank loans portfolio composition and the disclosure of loan oss provisions: an empirical evidence of Malaysian banks," *Asian Review of Accounting*, vol. 10 no. 1, pp. 147-62, 2002.

Siti Masnah Saringat is an accounting lecturer specialising in Financial Accounting and Taxation in the Universiti Teknologi MARA, Johor, Malaysia. Her career as a lecturer began in 2007 after involved in the manufacturing and service industries for 10 years. She has developed an exceptional background in cost reduction through the development and implementation of integrated system within the company. Siti Masnah has a Bachelor in Accounting from Universiti Utara Malaysia and Master in Accounting from Universiti Teknologi MARA, Johor, Malaysia. At present, Siti Masnah has developed a keen interest in corporate social responsibility. She is a fellow of the Accounting, Business and Economy Research Center (ABERC) in Universiti Teknologi MARA, Johor.

Rosmawati Haron is an accounting lecturer specialising in Financial Reporting at the Universiti Teknologi MARA, Johor, Malaysia. Her career as a lecturer began in 2008 after being exposed in local automotive industries for 12 years. Rosmawati has developed an exceptional background in cost management accounting and cost reduction activities based on excellent team work and an ability to make the best possible use of her personal network. Rosmawati has a Bachelor in Commerce from the University of New England, Australia and Master in Accounting from the university where she is currently working. Based on her immense working experience, At present, Rosmawati has developed a keen sense in Financial Criminology and Forensic Accounting in Public Sector. She is a fellow of the Accounting, Business and Economy Research Center (ABERC) in Universiti Teknologi MARA, Johor and is an active member for Accounting Research Insitute (ARI).

Henny Hazliza Mohd Tahir is an accounting lecturer specialising in Auditing and Social Reporting at the Universiti Teknologi MARA, Johor, Malaysia. Her career as a lecturer began in 2008 after being exposed as auditor for 2 years. Henny Hazliza has developed an exceptional background auditing and assurance services and due diligence audit based on excellent team work and an ability to make the best possible use of her personal network. Henny Hazliza has a Bachelor in Accountancy and Master in Accountancy from the Universiti Teknologi Mara. Based on her immense working experience, she was appointed as the Course Coordinator for accounting undergraduate students since 2011. She is a fellow of the Accounting, Business and Economy Research Center (ABERC) in Universiti Teknologi MARA, Johor and is an active member for Accounting Research Insitute (ARI).