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Earnings Management and Investment Accounts Holders Interests In Islamic Banking Institutions

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ABSTRACT: *This paper analysed three issues related to earnings management (EM) by Islamic Banking Institutions (IBIs). First, it tested the phenomenon of profit distribution management using a full sample of IBIs. Second it identified techniques usually used for any profit distribution management. Third it investigated its impact on investment accounts holders (IAHs) interests. The evidence gathered suggested that IBIs usually perform profit distribution management as a prudent practice on their own initiative to mitigate withdrawal risk. They may be however obliged to do so by the supervisory authorities as a measure of investor protection.For the techniques used, it was remarked that IBIs may save, accumulate, and drawdown two types of reserves namely Profit Equalization Reserves (PER), and Investment Risk Reserves (IRR). When reserves are insufficient, transfer of resources from IBIs' shareholders to IAHs could be accomplished by reducing the Mudharib's share below the contracted share, and/or by conveying larger losses or a lower profit to shareholders in the short term to benefit the IAH.With respect to the impact of profit distribution management on IAHs interest, it was ascertained that all profit distribution management techniques make it very difficult to IAHs to monitor the performance of their investment funds and have the effect of distorting fundamental dissimilarity between the Islamic and the conventional financial sectors. They may also generate moral hazard problems similar to those arising from deposit insurance schemes, or to "intergenerational shift problem" when an IAH who withdraws his funds loses his claim on the accumulated reserves.*

KEY WORDS*: Profit Distribution Management Techniques, Investment Accounts Holders Interests, Islamic Banking Institutions.*

I. INTRODUCTION

Prior studies highlighted the fact that Islamic banking institutions (IBIs) are using earnings management (EM) to avoid disclosure of losses (Majdi Anwar, 2011; Faouzi and Zarai, 2012; 2013).It is to be noted, however, that these exploratory surveys had focused largely on net distributable profit to shareholders and other shareholders related performance indicators. The findings provided evidence that EM, on average, is not detrimental to shareholders and is to be driven by efficient contracting purposes (Faouzi and Zarai, 2013). Apart from shareholders in IBIs there is also depositors or investment account holders (IAHs) who represent important stakeholders in IBIs (Islamic Financial Services Board (IFSB), 2013; Sundararajan, 2008). Investigations focusing on profit distributable to shareholders cannot provide indications about the impact of EM on the interest of these IBIs distinctive stakeholders. In fact, EM which has been verified to be beneficent to shareholders can however be detrimental of IAHs. It is thus worth to investigate the impact EM practices on IAHs' interests. This paper analyses, as follows, three issues related to earnings management (EM) by IBIs. First, it offers systematic evidence of the phenomenon of profit distribution management as anecdotally confirmed by previous literature(Sundarajan, 2005; Sayed and Mohamed, 2011; Farook et al., 2012) using a full sample of IBIs. Second, it tries to identify techniques usually used by IBIs for profit distribution managing and compensating for insufficiencies of investment earnings. Third ,it attempts to detect the impact, if any, of profit distribution management on IAHs interests. This paper is divided into five sections as follows. Section tow provides an empirical analysis of IBIs behaviour in managing profit distribution to IAHs. Section three describes the features of the various profit distribution management techniques while section four discusses the impact of profit distribution management on the interests of IAHs. Section five brings some concluding remarks.

II. MANAGINGTHE PROFIT PAYOUTTO IAHS

Recent studies indicate that EM practices are carried out for the main purpose of income smoothing (Buckmaster, 2001). The aim of this section is to furnish empirical evidence on smoothing profit payout to IAHs behaviour in the Islamic banking industry.

Literature Review and Hypothesis Development and Hypotheses Development

A greater portion of investment funds raised by IBIs is based on the *Mudharabah* contract. The contract includes profit-sharing for both partners and loss-bearing for the provider of capital. Under the *Mudharabah* contract, the IAHs agree to participate as *Rabb-UL-Mal in* the financial activities undertaken by the IBI as *Mudharib* and to share the profits engendered from financing and investment activities based on a prearranged profit-sharing ratio. As property owner, IAHs are liable to endure the losses arising from the assets funded under the *Mudharabah* contract, except for the case of fraud, misconduct, negligence, or rupture of contract terms and conditions by the IBI. In the *Mudharabah* contract, the IAHs thus endure the commercial risk associated with the assets funded by the funds provided by them. At the same time, the IBIs are responsible for managing the investment of assets and are under a fiduciary obligation to safeguard the interests of the IAHs via the establishment of rigorous and prudent policies in the administration of the assets financed by IAHs. However, IBIs are confronted to a number of restrictions while managing funds provided by the IAH. In most jurisdictions, the major restrictions have been the non-existence or limited convenience of *Sharia*-compliant instruments for managing liquidity, the deficiency of a *Sharia*-compliant interbank money market, and the unavailability of a *Sharia*-compliant moneylender of last resort facility provided by the central banks or any other monetary establishments. Identically important is the unavailability of a safety net in the form of a *Sharia*-compliant deposit insurance arrangement for PSIA.

The unavailability or a limited supply of the abovementioned instruments or market mechanisms in many jurisdictions influences on an IBIs' liquidity management and hence profitability. This may result, from time to time, in the returns earned on its IAH resources being uncompetitive compared to those being offered by its rivals, whether other IBIs or conventional banking institutions (CBIs), and hence to those projected by its IAHs. This leads to the rate of return risk, which is a specific problem with respect to funds of IAHs, who typically could withdraw their capitals at short notice subject to loss of profit sharing. In such a situation, the rate of return risk exposes the IBIs to withdrawal risk. If unmitigated, IAHs withdrawals can attain systemic magnitudes and become a cause for worry on the part of supervisory authorities (IFSB, 2010).In other words, a great proportion of the target market of IBIs is likely to be subtle to market based price measures like interest rates, particularly if these IBIs operate in competitive contractual environments with other banks (Islamic and conventional) and deposit taking organizations. Consequently, IBIs may be stressed in varying degrees to provide distributions comparable to other institutions or risk losing their depositors. In the Islamic banking literature, this risk has been labeled displaced commercial risk (DCR). It refers to the risk that IAHs will withdraw their funds in masses if the returns paid demonstrate a trend contrary to the IAHs' expectations of instruments or deposits of a comparable nature, and thereby subjecting the IBI to ruin (Farook et al., 2012). DCR denotes also the risk arising from assets managed on behalf of IAHs which is effectively transmitted to the IBI's own capital because the IBI follows the practice of forging parts or all of its *Mudharib* shares of income on such funds, or transferring to IAHs out of the shareholders' investment income as a gift, when it considers this necessary due to commercial or supervisory pressure. The rate of return paid to the IAH is thus "managed" to the detriment of the incomes attributable to the IBIS's shareholders (IFSB, 2010; Archer and Abdel-Karim2009; Alexakis and Tsikouras 2009).

The degree to which IBIs actually manage distributions to their IAHs towards market based interest benchmarks is not only related to the pressures on the bank through its contractual environment, called demand side factors, but also by the bank's own characteristics which define its relations with this contractual environmental, called supply side factors. This is for the reason that the IBIs are likely to position themselves in the market based on its relative advantage and this positioning will be revealed in its product or service qualities (Farook et al., 2012).Hypothetically, there should be a positive correlation between an IBIs rate of return on assets or return on equity and the rate of return paid on UIA. To verify this, some empirical studies have compared the returns paid to IAH with a net return on assets and return on equity of IBIs in various jurisdictions (Farook et al., 2012; Sundararajan, 2005). The studies concluded that:

- The rate of return on investment accounts is not correlated with the net rate of return on assets nor with the rate of return on equity, in contrast to the significant positive relationship that should be anticipated if the returns on assets were shared between investment accounts and IBIs shareholders, without modifications in various reserves.
- The rate of return on investment accounts is significantly and positively correlated with the general market return on deposits, telling a significant reliance on the management of profit payout in order to align the returns on investment accounts with market rates.

This evidence is consistent with the general perception that, in a number of jurisdictions, IBIs resort to profit distribution management. Accordingly, our testable hypotheses (in alternative form) can be stated as follows:

H_1. Profit distribution management tends to be quite frequent among Islamic banking institutions.

Methodological Issues and Analytical Models

Sample Selection

The panel data set were extracted from balance sheets and income statements of Islamic banks. These data are made available by the Islamic Banks and Financial Institutions Information (IBIS) Database, which contains up to ten years of historical financial data from annual reports of IBIs around the world. To be included in the sample, a bank must have income statement and balance sheet information for at least three consecutive years.

Profit Distribution Management Detection

Detection Model

Before testing the above hypothesis, there is a need to operationalize profit distribution management behaviour, such that the likelihood of profit distribution management for each of our sample observations can be empirically estimated. In the literature, there are several methods to detect the income smoothing firms. Although the calculation differs among the methods, there is no significant difference of the results of the six out of the seven popular methods (Michelson, Wootton, et al., 2003; Egin Emre, undated). Eckel's model (1981) is among these six methods. According to this model values of the coefficient of variation of the annual change in the income out of the coefficient of variation of the annual change in sales which are between -1 and +1 are an indication of smoothing behaviour.

Taking this suggested approach of income smoothing and applying it to the profit distribution; we have formulated the following model:

$$\left|\frac{CV\,(Profit\ Payout\ Changes)}{CV\,(Net\ Income\ Changes)}\right| < 1$$

Where:

- **CV (Profit Payout Changes)** = σ(Profit Payout Changes) /X (Profit Payout Changes)
- **CV (Net Income Changes)** = σ (Net Income Changes) / X (Net Income Changes)
- **σ (Profit Payout Changes)** = Standard deviation of the annual change in net Profit Payout,
- **σ (Net Income Changes)** = Standard deviation of the annual change in Net Income,
- **X (Profit Payout Changes)** = Mean of the change in net Profit Payout,
- **X (Net Income Changes)** = Mean of the change in Net Income,
- **CV =** Coefficient of Variation.

We use this later indicator to classify our sample observations into profit payout smoothers and non-smoothers. In particular, we classify a bank as a smoother when the variability of its profit payout is lower than the variability of its income. To do so, for each sample bank, we calculate the ratio between the coefficient of variation in profit payout and the coefficient of variation in income. The ratio is calculated for each sample bank over a ten-year period (2000-2009), provided that at least three years of data are available. A ratio smaller than 1 implies that profit payout variability is lower than income variability, therefore the bank is classified as a *profit payoutsmoother*. A ratio equal to or greater than 1 implies that profit payout variability is higher than income variability, thus the bank is classified as a *profit payout non-smoother*.

III. RESULTS

The results are shown in Table.1. The profit distribution management indicator is 0.509 indicating that the variability of net income is the double of the variability of the profit distribution to IAHs. This finding is consistent with the hypothesis that IBIs managers resort frequently to the management profit disreputable to IAHs. The results in Table.2 support this interpretation.

[Insert Table.1]

It is also worth noting that the income smoothing indicator as displayed in Panel B is superior to 1 (2.652) indicating that IBIs do not resort to income smoothing as arrangement to manage earnings. Therefore the practice of EM is focused on the part of profit attributable to IAHs. This finding justifies our investigations of the impact of EM on IAHs interests, which is in fact the cause that has pushed to choose the subject for this paper. This issue will be detailed in Section four.

The number and percentage of smoother and non-smoother firms are shown in Table.2.

[Insert Table.2]

Table.2 indicates that 80% of the sample is classified as smoothers, confirming our hypothesis that profit distribution management tends to be quite frequent among IBIs. The high percentage of smoothing behaviour may have some reasons. Managers are more oriented to smooth income to convey their private information about future earnings in countries with strong investor protection (Cahan, Liu, et al., 2008). These findings are consistent with previous research either in CBIs or in IBIs. For example, in conventional banking industry, Genay (1998) finds that Japanese bank managers set aside reserves during the good times for use in bad times (Shrieves and Dahl, 2003), and institutional shareholders do not object to smoothing (Kwak, Lee, et al., 2009). Blasco and Pelegrin (2006) concluded that Spanish saving banks report increasing earnings rather than positive earnings, and managers artificially reduce earnings to report lower but stable growth rates. In IBIs context, the studies conducted by AAOIFI concluded that the smoothing is widely practiced. Likewise, the IFSB mentions that the practice of profit distribution management is a historical occurrence, through which the supervisory authority can deduce a constructive or implied obligation to smooth income in the future (Sayd and Mohammad, 2011). This practice is thus recognized as a normal feature of the Islamic banking (Sundararajan, 2008; Archer, Rifaat; 2006).

Sundararajan (2005) found that IBIs manage profit distributions towards interest rates for a limited sample of 14 banks. His assertion that Islamic banks manage profit distributions relies on the strong significant correlation between market deposit interest rates and the distributions to depositors for the Islamic banks in his sample. Sundararajan's (2005) results essentially imply that IBIs may face competition costs which require an implicit contractual condition between the depositors and the bank to provide distributions similar to market based deposit interest rates. Furthermore, Zoubi and Al-Khazali (2007) supported the profit distribution management hypothesis. They find that banks in the Gulf Cooperation Council countries use Loan Loss Provisions (LLPs) to smooth their income. Ismail and Be Lay (2002) also provided evidence of EM using LLP in case of Malaysian banks over the period 1997–1999.

Later, Farook et al. (2012) gathered evidence suggesting that most IBIs manage profit distributions, with IBIs in Brunei, Malaysia and the United Arab Emirates demonstrating consistently lower average profit distribution management. In contrast, IBIs in Bahrain, Indonesia, Pakistan and Saudi Arabia have consistently higher average profit distribution management. All these studies corroborate our results that return smoothing is practiced in IBIs, but to what extent? The following paragraph tries to find an answer to this question using different measurement models that have previously proved in the income smoothing literature.

Profit Distribution Management Magnitude

Measurement Models

The extent of profit distribution management is a difficult attribute to quantity, mainly because there are no direct indicators of this activity (Sayed and Mohammed, 2011). Essentially, the extent of profit distribution management is the extent to which the banks return to IAHs varies from its fundamental return on its assets, less any *mudharib* payments. However, because of the infinite methods by which IBIs share profits with their IAH and the low current disclosure levels provided by IBIs, we can't review the financial reports of an IBI and assess the level of profit distribution management. For that reason, three different indirect measures are proposed. These measures are suggested by Farook et al. (2012).

The Assets Spread Profit Distribution Management Measure

This measure is the absolute spread between the return on assets and the return on investment account. It can be expressed by the following equation:

$$PDM = |ROA - ROIA|$$

Where:

- **PDM**: Investment Account Holder's Profit distribution management.
- **ROA**: Return on assets after considering all expenses but excluding depositors profits.
- **ROIA**: Return on investment accounts.

This indicator is theoretically the closest indicator of the profit distribution management measure, because it reflects all revenues and expenses and provides the spread between total asset return on the bank's assets and services portfolio and the distributions paid to IAHs (Farook et al., 2012).

The Deposit Spread Profit Distribution Management Measure

It is the absolute inverse of the spread between average market deposit rates for all banks for a particular year for a

particular country and the average rate of distributed profits of a particular Islamic bank in that particular year operating in that particular country. This permits the determination of the extent of profit distribution management towards the average deposit rate of the respective host country, with a higher inverse value signifying higher profit distribution management. It can be expressed by the following equation:

$$PDM = |MDP - ROIA|$$

Where:

- **PDM**: Investment Account Holder's Profit distribution management.
- **MDP**: Market Deposit Rate
- **ROIA**: Return on investment accounts.

The Equity Spread Profit Distribution Management Measure

The third indicator is the absolute spread between the average return on equity and the average rate of IAHs profits distributed, assuming that a larger absolute spread indicates higher profit distribution management. The rate of IAHs' profit distributed is estimated by dividing the profits distributed by the total IAHs' base (not including current accounts which are not eligible to profits).

$$PDM = |ROE - ROIA|$$

Where:

- **PDM**: Investment Account Holder's Profit distribution management.
- **ROE**: Return on equity after considering all expenses but excluding depositors profits.
- **ROIA**: Return on investment accounts.

IV. RESULTS

Table.3reports descriptive statistics for IAH profit distribution management and its variations.

[Insert Table.3]

As is reported, the maximum Asset Spread recorded is 180.6% with a mean and standard deviation of 9.696% and 16.38%, respectively. IBIs has high Asset Spread, indicating high profit distribution management and suggesting that they provide managed returns, instead of economic returns to IAHs. Regarding Deposit Spread, the mean is 1.409% and the standard deviation is 5.476%. Since the deposit rate is reported in inverse, the value of the spread between market deposit rate and return on investment accounts is less than one indicating that these two indicator are very close to each other. Thus, the deposit spread indicator supports the Asset spread measure and indicates that IBIs manages their profit distributions towards a market based interest rates or away from asset returns. The equity spread maximum is 514% and the mean is 13.27% and the standard deviation is 29.76%. These higher values corroborate the previous results and indicate widespread profit distribution management. The spreads reported seem to be reasonable since the Asset Spreads are quite small whereas the equity spreads are significant. This indicates that the IBIs provide higher returns to equity holders in compensation of the exposure to higher risk. The maximum asset and equity spreads reported may be determined by the hyper-inflation in countries such as Turkey, where inflation drove up interest rates to extreme highs. As a conclusion, we can say that the existence of the practice of profit distribution management by IBIs is well acknowledged. What remains unknown is the manner by which IBIs really do profit distribution management. The following section, tries to fill this gap by defining the technical meaning of the practice as well as verifying how it is put into operation by IBIs.

PROFIT DISTRIBUTIONMANAGEMENT TECHNIQUES

Features of Various Profit Distribution Techniques

Prior studies agree that profit distribution management can be achieved by two overall techniques: Variation of Reserves and Commingling of Funds (IFSB, 2010; Andrew, 2012; Ubaidillah Masli, 2012: Hassan and Mervyn, 2007). While the fundamental purpose of these techniques is profit distribution management, their mechanisms and implications are distinguishable. Features of these techniques are discussed in the following paragraphs.

Profit Distribution Management through Reserves Variation

profit distribution management, using a mixture of reserves retained from the profits attributable to both IAHs and shareholders, is a first mechanism (Sundararajan, 2008; Sundararajan, 2007; Archer and Rifaat, 2006). IBIs can incorporate a clause in the terms of contracts with IAHs giving the right to the bank to retain a certain fraction of their profits. Generally, the amount of reserves is positively related to the rate of return on assets (Sundararajan, 2007). Such reserve retention is a common practice of the majority of IBIs (Sundarajan, 2008, Archer and Rifaat, 2006).

IBIs have in general two standard practices of retaining reserves to manage profit payout:

- the retention of the Profit Equalization Reserve (PER), and
- the Investment Risk Reserve (IRR).

Profit Equalization Reserve (PER)

The PER is generated from the total income before the profit distribution between shareholders and IAHs and calculating of *Mudharib* share. The retention of PER reduces earnings really distributable to both parties. It is needed to manage a low rate of return and diminish the volatility of IAHs returns (Archer and Rifaat, 2006; Grais Kulathunga, 2007; Sundararajan, 2008). In the contract in general, IAHs agree in advance on the percentage of their income that may be assigned to reserves, which is determined by the administration of the bank at their own discretion. A proportion of PER and the full amount of IRR belong to IAHs but retained by the Islamic bank. The remainder part of accumulated PER goes thus to shareholders. These reserves are usually invested by the Islamic bank to generate further returns to IAHs (Archer and Rifaat, 2006).In periods of excessive returns, the administration can choose to transfer parts of the income and profits from the investment of Islamic deposits to the reserve in that period. In the opposite case, that is, in periods of small returns, the administration can decide to reduce the reserve, thus improving the amount available for distribution in that period (Hassan and Mervyn, 2007).

Investment Risk Reserve (IRR)

An IRR is created by setting aside amounts out of the profit attributable to IAHs, after deducting the IBI's share *as a Mudharib*, in order to moderate the impacts of future investment losses on IAHs. This reserve is thus created in the equity of IAH. It enables the IBI to cover, fully or partially, surprising losses on investments of IAH funds (Sundarajan, 2008). Where the losses are entirely covered, use of the PER may enable a profit distribution to be made to the IAH anyhow the loss (IFSB, 2010). The use of these reserves (IRR) has some resemblances with the use of conventional revenue reserves to smooth dividend distributions to shareholders. However in case of conventional reserves which belong to shareholders and are reflected in their share value, IAH has no right to vote for or against the use of these reserves (Archer and Karim, 2006; Sundararajan, 2007, 2008). On the word of the contract, the IAHs agree in advance on the percentage of their income that may be taken to these reserves. In the same contract, IAHs also agree to give up any right they have to these reserves when they stop their relationship with the IBI. This exacerbates the inter-generational problem stated below. The calculation and use of IRR are decided by IBIs administration based on their own discretion and there are no specific supervisory disclosure requirements about this. Indeed, the publicly available information about these reserves is relatively limited (Sundararajan, 2005).

Islamic bank policies vis-à-vis PER and IRR play a critical role in the management of profit distribution and as a result the DCR (Sundararajan, 2008). If these reserves are sufficient to avoid the transfer of income from shareholders to IAHs, there is no exposure of the Islamic bank to DCR (Toumi and Vivian, undated). In the opposite case, if these reserves are insufficient and the transfer of some proportion of shareholders returns to IAHs is indispensable, then the DCR is positive (Sundararajan, 2008).Although IBIs are not obliged to carry out such profit distribution management in theory, they are practically obliged to do so under commercial pressure or supervisory authority pressure (Archer and Rifaat, 2007, Fiennes, 2007). In some countries (for example, Qatar and Malaysia), the supervision authority took the view that IBIs should not allow IAHs to undertake a loss of their capital or a significant decrease in their returns, so IBIs have a constructive obligation to continue this practice of profit distribution management. Thus, in lieu of being voluntary, the practice becomes obligatory and PSIA are being viewed as virtually certain capital (Archer and Rifaat, 2007; Fiennes, 2007; Toumi and Vivian, undated).

Profit distribution management through Funds Commingling

Theoretically, returns are shared in a pre-established ratio between IBIs and IAHs and all losses on assets financed by the investment funds are to be borne by IAHs, excluding the case of misconduct, negligence or breach of contracted terms by IBIs. In practice, under commercial or regulatory pressure, the majority of IBIs absorb a proportion of losses normally borne by IAHs in order to mitigate potential excessive withdrawal of funds (DCR). Three main measures are undertaken to realize this objective.

Return-Free Deposits Investment

A first method consists of investing a significant portion of unremunerated accounts in assets with certain return and lower risk (short-term maturity). This practice generates supplementary returns for shareholders and provides a cushion for IBIs to facilitate profit distribution management (Archer and Rifaat,

2006). Many IBIs dispose of a relatively large amount of return-free deposits on current accounts. After catering for a sufficient liquidity reserve, the bank can invest the residue and generate further income. This income is not due to IAHs; rather it enlarges the profits attributable to the shareholders. The current account deposits have to not be invested individually but can be commingled with IAHs funds or/and shareholders' resources. It is at the discretion of the administration to transfer parts of the income from the current account funds to the profits to be shared with the IAHs. This allows a return on IAHs deposits which is above the level which would be possible if only the income from the investment of the IAHs deposits were distributed. This helps stabilize the return on IAHs deposits without a reduction of the PER (Hassan and Mervyn, 2007).

Making Transfers from Shareholders' Current or Retained Profits

In this method, an IBI makes an allocation of profit to IAHs out of current or retained shareholders' profits on the basis of a *Hibah*. The shareholders' decision to agree to surrender part or all of their profits to enhance IAHs' returns signifies that the shareholders accept that the risk attaching to the returns of an assets portfolio financed partly or wholly by IAH funds is displaced, it is so that endured disproportionately by the shareholders (IFSB, 2010).

Variation of Mudharib Share

This mechanism consists of the variation of the percentage of profit taken by IBIs as the *Mudharib* Share. In practice, the concept of sharing the actual profits and losses with IAHs is not the common practice of IBIs in certain circumstances (Archer, Rifaat, 2006, Sundararajan, 2008). In fact, under commercial pressure, the main part of IBIs manage the rate of return attributable to IAHs at the expense of profits normally attributable to shareholders, in order to offer them a competitive return and encourage them to save their funds in the bank (Khan and Ahmed, 2001; Archer and Rifaat, 2006). An Islamic bank is strongly exposed to massive withdrawal risk because of lower rate of return on investments deposits, which can explain the reason of increasing the returns distributable to IAHs (Khan and Ahmed, 2001). The percentage of the *Mudharib* share in predetermined profit is the maximum part, while the share distributed actually is liable to vary from year to year according to the actual rate of return on asset financed by IAHs' funds (Archer and Rifaat, 2006). When reserves are insufficient, IBIs modify the *Mudharib* share, if obliged, and diminish it below to the contracted share (Sundararajan, 2008). Islamic banks may also transfer percentage of shareholders returns to IAHs (Sundarajan, 2008). Reducing the *Mudharib* share of profits to provide competitive returns to IAH remains an administrative decision. Under the *Mudharabah* contract, an IBI is eligible for a *Mudharib* share of profits in the form of a pre-agreed profit-sharing ratio. At the expiration of the financial period, IBI executives, in line with the formal agreement of the board of directors, can reduce the *Mudharib* share of profits *ex-post* to a fraction below the predetermined contractual level. The profit distribution management techniques discussed above are supposed to be the main techniques that can be used by IBIs to provide better rates of return to IAH. Each of them takes different form and therefore entails different legal and governance consequences for the IBIs. Some profit distribution management techniques may be more prevalent in some jurisdictions than in others. What remains unknown is the actual application of these techniques in the practice. In fact these techniques as discussed above are theoretical ones and we don't know the extent to which they are applied by IBIs in various jurisdictions. This is the focus of the next paragraph.

Identification of IBIs Profit Distribution Management Practices

Investigation Approach

To analyze the current industry practices across IBIs regarding management of profit payout, we have undertaken a study of the disclosures made by the IBIs in their annual reports. The focus is both on the extent of overall disclosure on profit distribution management and on the extent of disclosure related to five categories smoothing techniques, namely PER, IRR, Return-Free Deposits Investment, Making Transfers from Shareholders' Current or Retained Profits and Variation of *Mudharib* Share. The approach underlying this study is a widespread investigation of the extent of disclosure of return management techniques in annual reports. The disclosure study focuses on 283 annual reports published by IBIs during the period of 2000 to2009.We have also tried to analyze regulations and guidelines issued by the banking supervisors in each host country. However, there are limitations to such studies, since the supervisory authorities in most of the jurisdictions where IBIs operate have not laid down any disclosure requirements for profit distribution management practices by IBIs within their jurisdictions (IFSB, 2010). To address such limitations, we have used survey results conducted by IFSB regarding smoothing practices in a number of member countries in 2009, some of the findings are stressed and discussed in this paragraph.

V. RESULTS AND DISCUSSION

The industry practices identified in the previous section indicate that the bulk of IBIs are involved in profit distribution management. It may be pointed out that profit distribution management through forgoing part or the IBI's entire *Mudharib* share of profits, and transfers from shareholders' profits to IAH, remain undisclosed in annual reports. The only disclosure made in most of the annual reports, if any, is concerning PER and/or IRR. Publicly available information on IBI practices on PER and IRR is rather limited. In fact, the disclosure of the PER is detected in only about 23% of the 283 annual reports we have analyzed. By the same, the IRR is disclosed in only about 8% of the analyzed annual reports. The PER and IRR are most disclosed in IBIs operating in Malaysia then IBIs operating in Bahrain. Most central banks leave the methodology for the calculation of the rate of return on PSIA- comprising calculation and use of PER and IRR- to be decided by the IBI at their own discretion, and there are no precise supervisory disclosure requirements on PER or IRR, other than those arising from the valid accounting standards (Sundarajan,2008). In an original study, the IFSB surveyed 15 central banks and supervisory authorities on the disclosure rules for their IBIs, only 4 authorities imposed specific guidance on PER or IRR, 6 required IBIs to disclose policies for creating these reserves and only 5 authorities required disclosure of real practices of PER or IRR. It was noted that several IBIs across the jurisdictions maintain a PER and disclose its use in their annual report. However, except in a few jurisdictions, IBIs either do not maintain an IRR or do not disclose its use in their annual report. We also observed that some IBIs maintain just one reserve, either a PER or an IRR. This may be due either to regulatory requirements (IFSB, 2010) or to a choice by the IBIs based on their own conditions.

Whereas the generally accepted practice is to retain PER from profits before allocation between IBIs as *Mudharib* and IAHs as *rabbu-almal*, a number of divergences from this practice were perceived, including the following:

- Some IBIs (Dubai Islamic Bank for example) were not making retentions of the PER from profits before division between shareholders and IAH and before deducting the *Mudharib* share of profits; but, they were retaining the PER only from the IAH share of profits after deducting the *Mudharib* share. This is obviously beneficial to the shareholders, as their profits available for dividends are not reduced by such retentions.
- Some IBIs were found to be creating a profit equalization provision instead of a PER.
- Some IBIs are using the same method for making both an IRR and a PER; to be exact, retaining amounts to both of these reserves from the total profit before allocating the *Mudharib* share of profits.
- One IBI disclosed in its annual report that, on liquidation, the balance of its IRR would be transferred to the *Zakat* fund after deducting all expenditures and losses and would not be offered to its IAH.
- It was also stated in some reports that in the case of IBI liquidation, the balance of the PER (including the retentions from shareholders' profits) would return to UIAs according to the terms and conditions of the *Mudharabah* contracts.

At the institutional level, a recent IFSB survey indicates that forgoing part or the entire *mudharib* share of profit is the most widely practiced profit distribution management method among the IBIs. With this method, the IBI varies the fraction of profit taken as the *mudharib* share to increase the share attributed to the IAHs so as to maintain a competitive rate of return to them. Note 24 of Qatar Islamic Bank's 2009 financial statements shows that the shareholders made a contribution of QR141mn ($39mn) to the unrestricted IAHs, taking their return for the year to QR510mn. Thus the *Mudharib* share of profits stated in the contract is actually a maximum amount, while the precise fraction may vary from year to year (IFSB, 2010).Transfer of profits from shareholders to IAH in the form of a gift is the second most commonly used profit distribution management method. Maintenance of a PER as a cushion for profit distribution management and a mitigate of DCR is also a common practice, especially in jurisdictions where the supervisory authority makes it obligatory for IBIs to retain such a reserve. Notes 51 and 54 of Dubai Islamic Bank's 2009 financial statements show that the bank drew down Dh201mn ($55mn) from its PER (which looks to be what the ISFB would call an IRR) in 2008 and another Dh200mn in 2009 in order to increase returns to unrestricted IAHs. Some IBIs are also using an IRR as a profit distribution management method, however this is generally restricted to jurisdictions where IBIs are not permitted to establish any reserve apart from an IRR (IFSB, 2010).The most common methods for covering losses from assets financed by IAH funds were the same as those used for the profit distribution management – namely, adjusting the IBI's share of profits as *Mudharib* and relocating profits from shareholders to IAHs. The next most common practice is the construction of a PER. Although IRR is explicitly meant for covering such losses from assets financed from IAH funds, there is little indication that many IBIs were retaining such a reserve.

The survey also underlined that profit distribution management is not limited to jurisdictions with a dual banking environment, because many IBIs in jurisdictions with a full-fledged Islamic banking system are also involved in profit distribution management[1].At the regulatory level, some supervisory authorities[2] have arranged certain requirements for the maintenance of reserves for profit distribution management purposes. Typically these supervisory authorities specify a superior limit for the balance of these accounts, commonly specified as a fraction of capital. One supervisory authority has fixed a maximum amount of the monthly retention to be credited to the PER. Another authority has identified a minimum amount as a fraction of net investment earnings that is to be credited to the "risk reserve account" till the maximum limit is reached. Some other regulatory authorities have set disclosure requirements for PER and IRR[3]. However, no supervisory authority has broadly addressed the subject of profit distribution management by IBIs in its jurisdiction, covering all conceivable techniques[4].It is evident from the above discussion that many IBIs resort to diverse profit payouts management practices within and across jurisdictions. Nevertheless, it would be better for such practices to be harmonized, at least within the same jurisdiction. The main reason is that the use of different practices harms transparency among both market players and, in particular, current and latent IAHs. If a supervisory authority decides to allow IBIs in its jurisdiction to practice profit distribution management, the question arises as to what profit distribution management techniques and/or associated reserves should it allow.

PROFIT DISTRIBUTION MANAGEMENT PPRACTICESAND INVESTMENT ACCOUNTS HOLDERS INTERESTS

Although there is evidence that profit distribution management takes place, its effect on IAHs interest remains unknown. Indeed, there is no doubt about the legality of the profit distribution management, but that is no guarantee that this practice supports the IAHs' interests. Both the use of reserves and the commingling of funds are recognized practices of Islamic banks which are considered *Shari'ah*-compliant[5], and at first glance they seem to be in the interests of IAHs. But a closer look reveals some conceptual and governance issues of these practices (Hassan and Mervyn, 2007).This section investigates the impact of aforementioned profit distribution management techniques on the interests of IAHs as specific stakeholders in Islamic banks.

Commingling of funds and IAHs Interests

The commingling of funds can work in favor of the IAHs only if the IBIs dispose of an above-average level of funds in current accounts. There are reasons to expect that in the long run – especially after IAHs have gained more experience with IBIs, more sound regulations of IBIs have been ratified, and competition within the Islamic banking sector has been established – the level of resources in current accounts will be reduced to a lower level comparable to that of current accounts in conventional banks. This will rigorously restrict or even eliminate the abilities for a stabilization of IAHs' returns through the allocation of profits produced from the investment of current accounts. But as long as this technique is applied, the criticism is valid that it is not well documented and cannot be supervised and evaluated by outsiders from the information published in IBIs reports. This clearly adds to the opaqueness of IBIs and to the information asymmetries (Hassan and Mervyn, 2007).The practice of profit distribution management has also the effect of distorting a fundamental dissimilarity between the Islamic and the conventional financial sectors. If IAHs are aware of profit distribution management practices in the past, which kept the payouts to IAHs roughly in line with the prevailing market rates of interest on conventional deposits, and if they expect the same practices to continue into the future, this implies that they will form prospects of future returns which are based on the same interest rates. However, in conventional financial sectors the shareholders bear all of the risk of losses (except in insolvency), while in IBIs the IAHs bear the risk of losses on assets financed by their assets. This has consequences on the risk appetite that is appropriate for IBIs in investing IAHs funds. As noted above, where IAHs funds are commingled with those of

[1]In Sudan's case as an example of jurisdictions with a full-fledged Islamic banking system, the general manager said that the central bank required Islamic banks to get approval from them before smoothing returns to IAHs (Ubaidillah Masli, 2012).

[2]Consult for example Bank Negara Malaysia (Central Bank Of Malaysia) (2012): "Capital Adequacy Framework for Islamic Banks (Risk-Weighted Assets". Paragraph 51 "Islamic banks are required to fill in the exposure amount and RWA by exposure class that are funded by Specific Investment Account (SIA), General Investment Account (GIA), Profit Equalization Reserve (PER) of SIA and GIA holders, as well as alpha (α) value that has been recognized by the Bank".

[3]Consult, for example, the Malaysian Islamic Banking Act of 1983 (IBA) or the Banking and Financial Institutions Act (BAFIA) of 1989.

[4] Central Bank of Malaysia (2001, 2004), for example, in its guidance to IBIs on the rate of return calculations proposes some limits on the size of PER that can be built up, and on the amount that can be deducted from gross income (prior to calculating the amount distributable to IAH). There is no guidance or limits on IRR in this Guidance documents (Sundarajan, 2008).

[5]*Shari'ah* Advisory Council of Bank Negara Malaysia (SAC), in its 14th meeting dated 8 June 2000, has resolved that the proposal to implement PER is permissible. There are however some different *Shari'ah* opinions on specific terms and details, especially with respect to the commingling of funds.

shareholders, the practice of profit distribution management appears to be intended to permit an IBI to adopt a greater risk appetite than is appropriate for the IAHs, in the pursue of higher returns for shareholders (IFSB, 2010).

1.1. Reserves Variation and IAHs Interests

1.1.1. Potential Abuse Problems

A PER provides an IBI with a mechanism to tap a pool of funds to release shareholders of the cargo of EM – that is, to diminish DCR as well as rate-of-return risk and the related problems of asset–liability management. However, a PER does not certainly operate to the benefit of the IAHs, since they are obliged to sacrifice profit distribution in good years so that the distribution in bad years may be better. As the riskiness of the fundamental profit stream is not reduced, this has the effect of reducing the current value of the stream of distribution to the IAHs. This reduction in current value denotes a cost endured by the IAHs. In contrast, shareholders enjoy the mitigation of DCR and rate-of-return risk, and executive benefit from the opaqueness, which may hide choices on their part that are not in the interests of the IAHs. Hence, from a corporate governance point of view, there is a strong risk of potential abuse.

The fraction of the PER attributable to the IAH, and all of the IRR, are invested in assets that produce returns for the IAHs as a pool; however, the IBIs as *Mudharib* will also receive a percentage of these returns. As appropriations to the PER are made before the deduction of the *Mudharib* share of profits, the IBI may be considered to sacrifice part of the potential *Mudharib* share in one year in the hope of receiving greater *Mudharib* shares in future years. The fact that the *Mudharib* percentage share may in practice be variable rather than fixed, being larger in the more profitable years, can provide a further incentive for executive to build a PER, in addition to the practice of profit distribution management (IFSB, 2010).

One could argue that, in some situations, profit distribution management might be possibly consistent with the preferences of risk-averse IAHs, who may be ready to sacrifice part of the profit payout in some years in order to have a reduced instability of the expected level of payout (IFSB, 2007; Hassan and Mervyn, 2007). But, unless an IBI offers different investment accounts which differ in their risk/return outlines, the empirical relevance of this argument is hard to assess. And even if the preference argument is fundamentally correct, one has to consider that the decision on the real figures for the appropriations to or from reserves is at the pleasure of the administration. It is likely that the decision is guided by the interests of the IAHs, the shareholders or the executive. Outside observers will not be able to prove or disprove any precise assumption: neither calculation methods nor concrete figures are open to the outsiders. Based on balance sheets and income statements, the public can only see the appropriations to or from reserves, while the fundamental income from the employment of current account deposits and investment account deposits is usually not disclosed. Therefore it is almost not possible to assess the sustainability of a given return on Islamic deposits (Hassan and Mervyn, 2007).

Likewise, unlike shareholders, the IAHs have no opportunity to accept or reject the IBIs executive's decisions on the use of such reserves, and in some cases they are not even informed that the IBIs in which their assets are invested maintains such reserves. In contrast, the shareholders of an IBI have control over its dividend policy and the maintenance and use of reserves by administration, which must be accepted by them in the annual general meeting. For that reason, the argument that profit distribution management and the creation of reserves are in the best interests of the IAHs can almost not be sustained.

In fact, while the purpose of these reserves is to improve the profit distribution to IAHs in periods when the assets in an IBI's asset pool have underperformed, so that the returns to IAHs may be inferior for that IBI than for its Islamic and conventional peers, it is also the case that a PER can be used for smoothing or enhancing dividend payouts to shareholders if so desired by the executive It should be noted, however, that while shareholders benefit from the PER, it is less clear that IAHs do so, as they have no choice as to the amounts of their profits that are withdrawn, and may not even be aware that the profit performance of their investment is more risky than is apparent from the managed profit payouts.

Intergenerational Shift Problems

As noted above, IAHs lack the right to influence the use of reserves such as PER and IRR. IAHs may not opt out of their contribution in the accumulation of these reserves. Reserves such as the PER and IRR are a form of reserved profits, similar to retained profits for shareholders, which are intended to be reinvested in profit-earning activities. An IAH who withdraws his funds loses his claim on the accumulated reserves and is in effect contributing to the future profits of other IAH. This is what we label "intergenerational shift problem".

IFSB (2006) has discussed in detail the intergenerational problem with respect to reserves such as PER and IRR. If, in the long run, the effect of the profit distribution management is that the returns on Islamic deposits keep in line with benchmark interest rates, this may not be to the advantage of the IAHs who endure a higher risk than their conventional counterparts. If one considers the shorter periods, then the practice of profit distribution management through appropriations to or from reserves has the effect that IAHs do not fully participate in the income or profit generated by the investment of their funds. If they held investment account during a period of a net increase of reserves, they share a smaller fraction of the income or profit generated by the employment of the funds at the disposal of the IBI during the respective period than those who held their investment accounts during a period of a net reduction of reserves. This is a kind of 'intergenerational' shift of portions of income or profit to be shared which was not to be found in the traditional *Mudharabah* or *musharaka* contracts (which assumed a definite termination of a transaction whose profits were to be shared) (Hassan and Mervyn, 2007). This problem may also arise in cases where new IAHs, who have not contributed to PER and/or IRR, take the benefit from them due to the closure of the accounts by those IAHs who have contributed to the building up of the reserves (IFSB, 2010).

The building of reserves through profit retention, which is normally intended to finance the growth of assets and profits over time, rather than just to facilitate the payouts smoothing, is thus long-term in nature, and may be viewed differently by different types of investors. An investor with a long-term investment perspective might find it useful for management to retain profits in order to finance the growth of assets and profits. However, an IAH with a short-term investment perspective is likely to be negatively affected by the building of reserves which will likely be used for the benefit of someone else. Most IAHs, including restricted IAHs but especially unrestricted IAHs, are essentially short- to medium-term investors with no interest in forgoing current payouts in order to finance long-term growth (IFSB, 2010).

Moral Hazard Problems

The use of an IRR may also generate moral hazard problems similar to those arising from deposit insurance schemes, since the existence of an IRR in an IBI may encourage the executive to engage in too much risk-taking. This is because losses can be covered, at least in part, by this reserve, which is funded only from the resources of IAHs and not those of shareholders (Cihak and Hesse, 2010). Therefore, this is expected to increase the executive's risk appetite to a higher level than that of the IAH, especially as the IRR is taken from profits after the calculation of the *Mudharib* share, which means the IBI is unaffected, while in the case of a loss the *Mudharib* share is zero regardless the size of the loss. The use of reserves, such as PER and IRR, enables thus the executive of an IBI to satisfy the risk-return appetite of the shareholders while appearing to satisfy concurrently the more defensive risk-return appetite of the IAHs. Moreover, this is carried out in a way that exposes the IAHs to a risk of losses unrecompensed by a resultant level of return.

Monitoring Problems

IRR and PER reduce the ability, if not the incentives, of IAHs and shareholders to monitor the IBI's performance, and thus may negatively affect market discipline. This is similar to an effect of deposit insurance schemes in conventional banking, which is to reduce the incentives of depositors to monitor banks. Such a situation contributes to both weak market discipline and a lack of transparency. Another implication of the use of a PER and IRR together with a lack of transparency is that it would distort competition among IBIs, in that IAHs would not see the need to withdraw their funds, which is the only means available to them to signal dissatisfaction with the performance of the IBI as a *Mudharib*, thus disciplining the IBI. As long as IAHs receive a smoothed rate of payout on their investment that is commensurate with the going market rate, and they cannot observe the underlying profit stream which may be showing a downward trend, they will not be aware of any reason to withdraw their funds until the IBI finally runs out of the means to "smooth".

Erosion of Islamic distinctiveness problems

A core concept of Islamic finance is that of an equitable sharing of profits and losses or of risks and chances between the providers and the users of funds. The practice of smoothing returns moves the system in the opposite direction. It is not only that smoothing emulates fixed returns on deposits; it also links the Islamic deposit business economically to the interest-based system. This is not justified if the Islamic and conventional segments differ markedly in projects, transactions, competition and so on (Hassan and Mervyn, 2007). The use of reserves such as the PER and IRR to emulate the rate of payout on conventional deposits could enable an IBI to emulate a conventional institution by investing in riskier assets than is consistent with the risk appetite of the IAHs and skimming off the excess returns for the benefit of the shareholders. Such practices are highly undesirable because, unlike conventional depositors, IAHs bear the risk of losses, having no claim as creditors for the return of their invested capital (IFSB, 2010).Further, the emulation blurs the distinction between the

Islamic and the conventional sector. It can also create significant problems for IBIs if competition compresses their profitability and if current account deposits shrink to a lower ('normal') average level comparable to that of CBIs.

VI .CONCLUSIONS

The objective of this paper is to ascertain whether Islamic banks do in fact manage profit distributions to IAHs. If so, determining the technical meaning of the profit distribution management practice; in other words verifying how it is put into operation by IBIs; then identifying the effects -especially from the perspective of IAHs- of the practice. The evidence gathered suggests that most Islamic banks manage profit distributions to their IAHs. They usually perform this as a prudent practice on their own initiative, to mitigate withdrawal risk and DCR. They may be however obliged to do so by the supervisory authorities as a measure of investor protection. By the same, we have highlighted that there is evidence of IBIs resorting to profit distribution management practices even in jurisdictions applying a fully Islamic model like Sudan, Iran and Pakistan.For the techniques used, we have remarked that in order to manage the returns actually paid out to IAHs, IBIs may save, accumulate, and drawdown two types of reserves namely profit equalization reserves (PER), and investment risk reserves (IRR). The accumulation and draw down of these reserves can help smooth the returns paid to IAHs and preserve the value of IAHs funds against variations in the IBI's income from assets invested with IAHs funds. Thereby help pay market related compensation to IAHs. IBIs may maintain the pay-out to IAHs at market related levels even though actual asset returns exceed market benchmark rates and cover any losses that might arise from time to time.

In addition, we have underlined that when asset returns are low, and PER is insufficient, IBIs owners may transfer some portion of their income or reserves to IAHs, thereby offering them returns that are not deviating or varying greatly from market levels despite insufficient asset returns. Such transfer of resources from IBIs shareholders to IAHs could be accomplished by reducing the *Mudharib's* share below the contracted share, and/or by conveying larger losses or a lower profit to shareholders in the short term in order to benefit the IAHs, thereby mitigating the impact of lower asset returns on IAHs.With respect to the impact of profit distribution management on IAHs interest, we have found that all profit distribution management techniques create an impression of stable returns and we have demonstrated that they are in general detrimental to IAHs. They lead to lack of transparency issues or to stable return investment concentration problems. This makes it very difficult to IAHs to monitor the performance of their investment funds. These techniques therefore introduce a façade of opaqueness between IAHs and the IBIs. Without appropriate disclosure to IAHs and other stakeholders, this opaqueness can only lead to a false impression that an IBI is performing better than it actually has performed .It is thereby advised that supervisory authorities develop and make public an explicit policy regarding return distribution management in general and the use of reserves such as PER and IRR in particular. In fact, if they choose to permit the use of such reserves, they should also ensure that the relevant IFSB standards on corporate governance, transparency and market discipline are properly implemented in their respective jurisdictions. Supervisory authorities are also recommended to place some constraints on the permissible practices, such as the following:

- A maximum deduction in terms of the percentage of earnings to be transferred to PER and IRR;
- Maximum balances of these reserves. It is implicit that if the balance on one of the reserves has reached the maximum laid down by the supervisory authority, the IBIs in question should abstain from making further deductions to that reserve;
- The treatment of unemployed balances of the reserves in case of the liquidation of IBIs or withdrawal of funds by IAHs.

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Table.1. Results for Profit distribution management Indicator

Panel A: Profit distribution management Analysis (N = 352)			
Profit Payout Changes Mean	Profit Payout Changes St. Dev	Net Income Changes Mean	Net Income Changes St. Dev
0.022676863	0.072328814	0.009602827	0.060220521
Profit Payout Changes Coefficient of Variation		Net Income Changes Coefficient of Variation	
3.189542361		6.27112401	
Profit distribution management Indicator = 0.508607764			
Panel B: Income Smoothing Analysis (N = 398)			
Net Income Changes Mean	Net Income Changes St. Dev	Sales Changes Mean	Sales Changes St. Dev
0.010669963	0.098617195	0.040312811	0.14047566
Net Income Changes Coefficient of Variation		Sales Changes Coefficient of Variation	
9.242506036		3.484640638	
Income Smoothing Indicator = 2.652355578			

Table.2. Number and Percentage of Profit Pay Out Smoother and Non-Smoother

Smoothers	**Percentage**	**Non-Smoothers**	**Percentage**	**Total**	**Percentage**
28	**80%**	**7**	**20%**	**35**	**100%**

Table.3. Descriptive Statistics for IAH Profit Distribution Management

Variables	**N**	**Mean**	**St. Dev**	**Min**	**Max**	**Skewness**	**Kurtosis**
Asset Spread measure	432	9.696	16.38	0	180.6	6.217	52.18
Deposit Spread Measure	314	1.409	5.476	0.0099	85.003	12.192	176.84
Equity Spread Measure	430	13.27	29.76	0.062	514	12.13	190.9