Earnings Quality in Financial Institutions: A Comparative Study of Islamic Banks and Conventional Banks

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Abstract:
This paper outlines the background of a doctoral research which focuses on comparing the quality of financial reporting information between Islamic banks and conventional banks. Islamic banks should ideally operate in accordance with Shariah principles and portray a distinctly Islamic identity in their business activities as compared to conventional banks. Despite the phenomenal growing rate of Islamic banking industry recently, they are raising concerns among the critics of Islamic banking and finance regarding the products, services and overall operation activities. The embracing of conventional banking in Islamic banking operations gives rise to skepticism among customers on the purity of the products and will in some way erode the distinctly Islamic identity. This doctoral study will examine the extent to which Islamic banks internalising the Islamic business ethics in the context of financial reporting.

Keywords: earnings quality, Islamic banking, earnings management, financial reporting, discretionary accruals

1. Introduction
This paper outlines the background of a doctoral research which focuses on comparing the quality of financial reporting information between Islamic banks and conventional banks besides examining the impact of corporate governance mechanisms upon financial reporting quality within both banks. The paper starts with explaining the general overview of Islamic banking system and follows by discussing the importance of earnings. The discussion then summarises findings from past empirical research, the underlying theory and finally towards setting up the doctoral scene.

2. Islamic banking system
The Islamic banking system is defined as a banking system whose principles underlying its operations and activities are founded on Islamic or Shariah rules [1]. Contrasting conventional bank which is based solely on man-made laws, Islamic banking system is established on both civil laws and religious (Shariah) guidelines which the latter will be given priority. Shariah principles claim to regulate all aspects of life, ethical and social, and to encompass criminal as well as civil jurisdictions [2]. It incorporates a spiritual and moral framework that values human relations and not only concerned about material needs but also establishes a balance between material and spiritual fulfillment of human beings.

Further, unlike conventional banking which is interest-based system, Islamic banks should avoid any of such activities as clearly stated in al-Quran that any interest-dealing actions are strictly prohibited. Apart from that, Islamic banks must only deal with projects or practices that are halal (permissible) and not investing in unacceptable (haram) activities such as gambling, drugs, alcohol etc. Moreover, Islamic financial systems cannot be introduced merely by eliminating the practice of riba and haram activities rather it is done by adopting social justice into its rules and it is expected that Islamic banks will be more socially responsible than conventional banks. Further, another substantial difference between Islamic and conventional banks is the existence of SSB in IFIs corporate governance mechanism. In general, SSB’s responsibility is to ensure Shariah compliance of transactions and provide guidelines on competences, composition and decision making [3]. Based on the above characteristics, Islamic banks clearly have distinct ethical identity from conventional banks as overall activities of Islamic banks are established on religious moral and ethical values.

Issues in Islamic banking
However, there are raising concerns among the critics of Islamic banking and finance regarding the products, services and overall operation activities of IFIs. [for example, 4, 5-7]. They argue that Islamic banking and finance products in practical terms are merely replacing conventional banking terminology with terms from
classical Arabic language so that the products seem to be legitimate in Shariah context. El Gamal [4] describes some of Islamic financial products as ‘thinly veiled versions’ of conventional interest-based financial instruments and he further argues that Islamic finance is not built from authentic Shariah jurisprudence but a modification of conventional practice. Furthermore, in practice, most of Islamic banking operations are based on mark-up which is similar to interest-based financing rather than profit loss sharing (PLS) products [8, 9]. Dar and Presley [8] report on the International Organisation of Islamic Banks’ finding that less than 20% of Islamic banking operations adopt profit and loss sharing techniques or Shariah based transactions. This is supported by Khan [9] who finds that most largest Islamic banks in the world (i.e. Al Rajhi Bank, Kuwait Finance House, Dubai Islamic Bank) rely overwhelmingly on non-PLS financing which consist of on average 90.1% of total financing. The predominance of non-PLS products in Islamic banking operations as well as the uncritical emulation and embracing of conventional banking in Islamic banking operations will give rise to scepticism among customers on the purity of the products offered and thus will in some way erode the distinctly Islamic identity which should be ingrained in Islamic banking operations.

In financial reporting perspective, most Islamic banks prepare financial statements in accordance with International Financial Reporting Standards (IFRS) with exception of IFIs in Bahrain and Qatar which adopt the financial accounting rules established by The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) [10]. However, as pointed out by Archer and Karim [11], in developing the accounting standards for IFIs, AAOIFI tries to reconcile the unique Islamic products with IFRS which was claimed by Kamla [5] as another step of emulating Western capitalistic driven practices. She further argues that as Islamic banking and accounting fail to significantly depart from conventional banking and accounting, then “the effective actuality of Islamic banking and accounting institutions contradicts their own stated conceptual principles” [Spp. 927].

In spite of a large number of research critically examines the structure, operation and management of Islamic banks [for example 1, 2, 12, 13-17] as well as the accounting practices in Islamic banks [2, 5, 18-20], little attention has been paid to empirically investigate the actual accounting practices by Islamic banks as relative to the conventional banks. A growing number of studies on Islamic banks accounting practices are descriptive or analytical in nature and mainly focussed on the theoretical framework from which accounting standards for Islamic entities could potentially be derived [21]. Kamla [5] suggests that Islamic accounting research should embark on interrogating any issues or limitations of contemporary practices of Islamic banking rather than just explaining what should be taking place. Therefore, this research is intended to address that gap by assessing the quality of financial reporting particularly on earnings quality of both Islamic banks and conventional banks.

The aims of this doctoral research are (1) to compare the quality of earnings between Islamic banks and their conventional counterparts and (2) to examine the impact of corporate governance mechanisms especially board of director characteristics, audit committee characteristics and one unique component in Islamic banks’ corporate governance mechanisms i.e. Shariah Supervisory Board (SSB) characteristics upon earnings quality within both Islamic banks and conventional banks.

3. Importance of earnings

Earnings are important for both internal and external financial statements users because of the informative role and the stewardship role of accounting [22]. The informativeness role on the one hand, comes from the demand of shareholders for information to forecast future cash flows and assess their risk. A considerable amount of literature explains the informativeness empirically by examining an impact of earnings to share price [23]. On the other hand, the stewardship role of earnings arises from the separate entity concept, which puts the manager as a steward to shareholders. There is a possibility that managers will act on their own interest as opposed to shareholders’ interest. Therefore, to align the interest of both parties, shareholders will demand information in the form of financial reports.

Nonetheless, the informativeness of earnings is questioned as the association between earnings and share price has been decreasing overtime [24]. A number of research studies discover that the weight of earnings in prices movements has been on the decline [for example 25, 26]. With respect to stewardship role, the relative weight of earnings in managers’ rewards has reduced with increased in equity-based compensation in managers’ incentives package. If the weight of earnings is small, then compensation benefit might be too small to justify the large costs associated with providing earnings. The evidence of declining in the informativeness and stewardship roles of earnings proves that the financial results have been managed and the quality of earnings is diminishing.

Earnings quality refers to the relationship between reported earnings and the true earnings of a company [27, 28]. From the perspectives of financial reporting users, the quality of earnings has two important aspects: reliability that is to accurately reflect underlying economic effects and relevance which is to help users forecast future cash flows. The quality of earnings may diminish as a result of earnings management practices [23, 29, 30]. A company that managed its earnings the most has a bad earnings quality.
Earnings management has been defined by Schipper [31] as a purposeful intervention in the external financial reporting process with the intent of obtaining private gain. According to Healy and Wahlen [32], earnings management is when managers use judgment in financial reporting and in structuring transactions to alter financial reports in order to either mislead stakeholders about the underlying economic performance of the company, or to influence contractual outcomes that depend on reported accounting numbers. Some reasons why managers manipulate earnings are (1) to convey private information to stakeholders about the underlying economic performance (2) to influence contractual outcomes and (3) to achieve regulatory capital requirements etc. [33-35].

As banking sector is a highly regulated industry, bank managers tend to manage earnings in order to comply with the regulatory requirements. Moreover, managers of banks manipulating earnings so as to: minimise political costs, minimise the cost of capital and maximise managers’ wealth. To safeguard financial stability of the economy and prevent any crisis that will affect the whole nation, a number set of ratios for example liquidity risk management ratios, interest rate risk management ratios, capital account management ratios, credit risk management ratios and cost management ratios need to be complied by banks. This seems to be a motivational factor for bank managers to manipulate earnings figures in order to avoid violating regulations [36]. Furthermore, if missing key ratios, it will adversely affect stock prices and consequently damage reputation and lead to a loss of business. Apart from that banks also often experience pressure to distribute dividends. Therefore, bank managers will tend to reduce possible uncertainty and minimising their earnings fluctuations over time.

4. Empirical research

Empirically, earnings management practices by banks have been confirmed in several studies [37-42]. However, the work of Scheiner [43], Wetmore and Brick [44] and Ahmed, Takeda and Thomas [45] find otherwise. Other studies in different countries such as Anandarajan, Hasan and McCarthy [46] in Australia and Shrieves and Dahl [35] and Agarwal et al. [47] in Japan also find the evidence of earnings management practices. Furthermore, the tools that have been used to manage earnings are through (1) loan loss provisions which are the biggest discretionary accruals in banks’ expense account, [34, 35, 37, 39-41, 46-50], (2) realised security gains and losses [35, 37, 39, 41, 42, 47, 49] and (3) loan write-offs [37, 39, 41].

Results of the previous literature on earnings management behaviour and the tools used to manage earnings are mixed. The question now arises to investigate whether this practice is also applied in Islamic banks. In fact financial reporting quality through earnings management practices in Islamic financial institutions has received only limited research interest so far. Yet more recently, several scholars have found mixed results on earnings management practices through loan loss provisions in Islamic banks [for example 51, 52, 53]. Based on a sample of 47 banks operating in the GCC region from 2000 to 2003, Zoubi and Al-Khazali [53] confirm the income smoothing hypothesis through managing loan loss provisions. Similarly, Taktak, Zouari and Boudriga [52] observe the income smoothing practices on a sample of 66 Islamic banks over the period of 2001-2006 using Beidleman and Eckel coefficients. However, they find the smoothing is not practiced through loan loss provisions. This finding is consistent with Ismail, Shaharudin & Samudhram [54] which discover that managers of 10 commercial banks in Malaysia that offer Islamic banking services used realised security gains rather than loan loss provisions to manage earnings.

On the one hand, with comparing the practices of income smoothing between Islamic and non-Islamic banks, Shahimi, Ismail & Ahmad [14] highlight that the Islamic banks in Malaysia do exercise income smoothing through loan loss provisioning as well as their conventional counterparts on a panel of 15 commercial banks offering Islamic banking window over the period 1996-2003. On other hand, Quttainah, Song & Wu [51] discover that Islamic banks are less likely to conduct earnings management. They use a sample of 82 Islamic banks and 82 conventional banks in the ERF region and cover the period from 1994-2008 and also find that Shariah Supervisory Board (SSB) size and outside board members are the determinants of earnings management for Islamic banks.

5. Social identity approach to corporate identification

In order to explain how could the earnings quality of both Islamic banks and conventional banks may differ, the research will draw on an established theory of Social Identity. Social Identity Theory by Tajfel and Turner [55] explains how perceived membership in a social group can shape an individual’s cognition and behaviour. According to this theory, person’s self-interest may not always be defined at the individual level and one may redefine their self-interest in favour of the group rather than themselves. The group with which an individual identifies may include the company he works for. This notion is supported by Hogg, Terry and White [56] who emphasise that when a specific social identity becomes the basis for behaviour in a particular context, one’s self perception and conduct become aligned with the group and individual behaviour is influenced accordingly.

Davis [57] examines the possible reasons why individual may not act in accordance with traditional economic theory (self-interest and wealth maximisation). He
categorises into three approaches to linking social identity to personal identity: (1) the neoclassical approach (people take action in order to reduce anxiety), (2) the commitment approach (people want to identify with groups) and the complexity approach (people choose to belong to a group that fits their self-image). Further, Haslam et al. [58] shows that social identity salience may impact a group’s willingness to maintain commitment to a project that is closely aligned with its organisational identity.

6. Setting up the research

The research mainly used archival data in the form of both Islamic and conventional banks annual reports which will be extracted from the Bankscope database for the period 2006-2010. The sample of Islamic banks will be selected from the GCC countries (Bahrain, Kuwait, UAE, Saudi Arabia and Qatar) which share 52% of total assets, Malaysia 7% and Turkey 2% of total assets of the whole Islamic capital markets [59]. Since Indonesia has the largest Muslim communities in the world, the study will also include Islamic banks in Indonesia. The total number of sample of Islamic banks will be 85 which represents 61% of the total number of Islamic banks in the whole world [59]. The study will then match for each of Islamic banks, a conventional bank of relatively same size from the same country.

In order to achieve the aims i.e (1) to compare the quality of earnings between Islamic banks and their conventional counterparts and (2) to examine the impact of corporate governance mechanisms upon earnings quality, the study explores six different proxies of earnings quality which could be categorised into two i.e (a) accounting based measures that consists of (1) abnormal loan loss provisions, (2) earnings persistence, (3) earnings predictability, (4) earnings opacity and (b) market-based measures (5) value relevance and (6) earnings response coefficient. To achieve the first aim, univariate analysis will be conducted via an independent two sample t-test to determine significant differences of earnings quality between Islamic banks and conventional banks. Moreover, to attain the second aim, multivariate analysis will be used to test the association between corporate governance mechanisms (board of director characteristics, audit committee characteristics and SSB characteristics) upon earnings quality after controlling for other factors that may affect the earnings quality.

7. Conclusion

As Islamic banking is established on Shariah i.e. Islamic religious based guidelines, the teachings of Islam would mould Islamic banks into organisations that place more importance on moral elements as compared to conventional banks. This doctoral study will examine the extent to which Islamic banks internalising the Islamic business ethics in the context of financial reporting. The study can contribute to new knowledge to the existing discussion on earnings management behaviour and the current discourse on the theories of social identity approach to corporate identification.

References


