



EARNING QUALITY IN ISLAMIC BANKS:
INTERNATIONAL EVIDENCE

BY

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ABSTRACT

The rapid growth of Islamic banks globally has shown a large awareness of Muslims. However, it may not be averted from potential risks that may reduce the popularity of Islamic banks, such as earnings management activities. The purpose of this study is to determine the extent of the quality of earning in Islamic banks. With distortions in earnings, Islamic banks are compromising the basic of the existence of profit sharing principle. By integrating the components of corporate governance, such as board independence, audit committee's expertise and SSB's expertise, this study aims to examine determinants of earning quality in Islamic banks. Banks characteristics are also examined to identify its significant influence on earning quality. 64 Islamic banks in 15 countries from MENA, ASIA and Europe are employed to be sample in this study. The main findings show that the earning quality of Islamic banks in ASIA is higher than in MENA. Moreover, the result documents that SSB's expertise, BIG 4 and leverage have a significant impact on earning quality in Islamic banks. None of corporate governance mechanisms has a significant influence on earnings quality, except SSB's expertise. This finding suggests on the improvement of sharia corporate governance mechanism to enhance the quality of earning. Studies on earning quality in Islamic banks are still limited. Major theoretical contributions includes that this study investigate earnings quality of Islamic banks worldwide. Understanding the role of corporate governance to curb earning management activities in Islamic banks makes this study unique.

ملخص البحث

النمو السريع للبنوك الإسلامية أدى إلى إقبال كبير على استخدامها من قبل المسلمين. ومع ذلك، فإنه لا يمكن تجنبها من المخاطر المحتملة التي قد تقلل من شعبية المصارف الإسلامية، مثل التلاعب بالأرباح. والغرض من هذه الدراسة هو تحديد مدى لجودة الأرباح في المصارف الإسلامية. مع إختلالات في الأرباح، البنوك الإسلامية تتعرض للإخطار الأساسية سبب وجود النظام الاساسى فى تقاسم الأرباح. من خلال دمج عوامل الحوكمة الشركات، كإدارة مستقلة، ولجنة تدقيق ورقابة شرعية (SSB)، وتهدف هذه الدراسة إلى دراسة محددات جودة الأرباح في البنوك الإسلامية. و فحص خصائص البنوك لتحديد التأثير على جودة الأرباح. وكان اربع وستون عددا من البنوك الإسلامية من خمس عشرة دولة فى منطقة الشرق الأوسط وآسيا وأوروبا كأنموذج عينية تحليلية فى هذه الدراسة. وأظهرت النتائج الرئيسية أن جودة الأرباح فى البنوك الإسلامية فى آسيا أعلى من البنوك الإسلامية فى منطقة الشرق الأوسط. كما أظهرت الدراسة أن خبرات هيئة الرقابة الشرعية (SSB)، ومدقق الحسابات الخارجية (BIG 4) والنفوذ أن تؤثر مباشرة على جودة الأرباح فى البنوك الإسلامية. كما أن آليات الحوكمة فى الشركات لم يكن لها تأثير كبير على جودة الأرباح، بخلاف هيئة الرقابة الشرعية (SSB). وأشارت هذه النتيجة إلى توحيد آلية حوكمة الشركات الشرعية لتعزيز جودة الأرباح. والدراسات حول جودة الأرباح فى البنوك الإسلامية مازالت محدودة. والمساهمات النظرية الرئيسية فى هذه الدراسة هى مناقشة جودة الأرباح فى البنوك الإسلامية فى جميع أنحاء العالم. وفهم دورعوامل حوكمة الشركات للحد من أنشطة التلاعب بالأرباح فى البنوك الإسلامية يجعل هذه الدراسة دراسة فريدة من نوعها.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science (Accounting).

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DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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To

My beloved family

Imam Sutrisno & Sri Hartini

Ria Nur Syaidatus Shafa

Muhammad Hisan Abqory Al Fatih

Thank you for your love and support

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CHAPTER ONE

INTRODUCTION

This is an introductory chapter that comprises of the background of the study, motivation of study, research objectives, research questions, and significance of the study which is followed by the organization of the study. This chapter is expected to provide a clear description of the purpose of the study.

1.1. BACKGROUND OF THE STUDY

The Islamic economic system has witnessed an exponential development all over the globe in the last decade, demonstrating an enormous demand towards Islamic finance products and services (Earns & Young, 2014). This growth was mainly triggered by the failure of the conventional economic system which operates on an interest-based system, in the realization of economic stability. Global interest in Islamic economics became more evident especially with the occurrence of several global financial crises such as in 1997 and 2008 (Mirakhor, 2009). These crises significantly influenced the stability of financial institutions across the world. As a result, banking institutions experienced the bigger impact of the crises due to their important role in global economic stability.

Against this drawback, the Islamic economic system is expected to be a solution for retaining a stable economy in various countries. Today, Islamic economic development is not only in Muslim majority countries, i.e. Middle East North Africa (MENA) and Asia regions. Western countries are attentive towards the implementation of the Islamic economic system. In recent years, Western countries

have started to give attention to the Islamic financial system as a potential infrastructure of their economy (Wilson, 1997). Furthermore, such curiosity is evidence with the existence of Islamic banking service in United Kingdom's banks such as British Islamic Bank and United Capital Bank.

There are many sectors under financial institution, such as banking, insurance and capital market. However, banking sector is vital in the economy as the engine of economic activities. Today, there are two systems under the banking sector, i.e. conventional banking and Islamic banking. Conventional banking system is a financial system that uses interest as a basis for profitability of transaction. On the other hand, Islamic banking system is a new financial system that complies on Islamic rules and principles as it promotes profit sharing method and prohibits interest-charge (*riba*), uncertainty (*gharar*) and gambling (*maysir*). All activities and transactions in an Islamic bank are concerned with achieving the *Maqasid al sharia* (Lewis, 2010). This institution was found to implement Islamic rules and Islamic principles that are based on the Qur'an and *Sunnah*.

In recent years, Islamic banking has been growing vastly in Muslim majority countries including Egypt, Qatar, Kingdom of Saudi Arabia, Bahrain, Malaysia and Indonesia. It is also growing in Muslim minority countries including United Kingdom, Australia and Hong Kong.

Although there has been enormous growth and interest in Islamic banking, a number of issues have emerged with regards to its practice in the modern context. Some literatures criticize the fact that the Islamic banking system is no different from conventional banks (Hanif, 2011). In fact, the operating costs of Islamic banks are found to be higher than those in conventional banks (Haron & Azmi, 2005). In addition, the return (profit sharing) of Islamic banks could not compete with the

interest rate of conventional banks. This phenomenon has demotivated Muslims from using Islamic banking facilities.

The issue of earning manipulation practice in Islamic banks has emerged in recent years (Hanif, 2010; Hamdi & Zarai, 2012; Olson & Zoubi, 2014). Moral hazard and information asymmetry in agency relationship between managers and shareholders has also started to emerge in Islamic banks. These have caused Islamic banks to significantly prevent shareholders from analyzing their real performance. Hence, this leads shareholders to make inappropriate decisions for their future investments.

The existence of earning management practices will affect the popularity of the Islamic bank as a religious institution that must provide benefit to all stakeholders. Earning management can result from misrepresentation of reported earnings through measuring either lesser or higher than the actual number. This finding is supported by Hamdi and Zarai (2012) and Olson and Zoubi (2014) who found that earning distribution in Islamic banks is being driven by earning management to show positive income.

Ismail, Kamarudin & Sarman (2012) confirm that high-earning management practice reduces quality of reported earnings. This is due to the opportunistic behaviour of the manager who manipulates actual earning to achieve earning target. Generally, the financial reporting of a company always shows a significant growth of its earning. Therefore, it is argued that opportunistic high-growth in a firm may result from earning management practice. Chen and Liu (2010) confirm that high-growth firms are associated with managers' opportunistic behaviour in manipulating earning. Therefore, the reported earning does not reflect the actual underlying economics in the financial reporting.

The quality of financial reporting in an Islamic bank is very crucial for stakeholders' decision making. Hence, it is necessary to measure and examine its earning quality. Earning quality measurement is very important in order to investigate the manager's opportunistic behaviour in earning management practice (Hanif, 2010). From the *Maqasid al sharia* perspective, Islamic banks should provide proper measurement of the accounting process for the investor's information in decision making. The proper measurement will protect the Muslim's wealth from unfairness and injustice.

Earning in Islamic bank is very important due to its profit sharing system. The distribution of profit is based on the amount of earning achieved in the current year. Therefore, a high quality of earning is also highly expected by shareholders and depositors to keep their confidence in decision making.

The focus of this study is to measure the earning quality of Islamic banking industry across the globe. Furthermore, this study provides a comparative analysis between Islamic banking in the Middle East and North Africa and in Asia. This study does not examine the conventional bank due to its difference in nature from the Islamic bank. Islamic bank is expected to have better financial credibility through its ability to achieve good earning quality. The quality of earning shall be measured through accrual quality.

1.2. MOTIVATION OF STUDY

Islamic banks in several countries have witnessed gradual growth in recent years (Khan & Bhatti, 2008). However, Islamic banking asset is still lagging behind its conventional counterpart. Currently, worldwide Islamic banking's total assets are much lower than conventional banking's total asset. This is evident since the demand

for Islamic banking services is still less attractive than conventional banks. A survey conducted by Kuwait Finance House found that global Islamic banking's asset in 2013 was US\$1.6 trillion which is still small compared to global banking industry. In addition, the existence of earning manipulation issues through income smoothing in Islamic banking is another setback which leads to inappropriate decision making of shareholders and depositors.

Even if the earning manipulation does not violate the accounting rules (accounting standard), it leads to potential risk for stakeholders, especially for both investors and depositors. Earning manipulation practice contradicts with the rules, values and principles of Islam. Furthermore, Islamic bank as an institution which operates on Islamic values, should meet the *Maqasid al sharia* as the main objective of all human activities from the Islamic perspective. Therefore, to protect investors' wealth, the accounting process in Islamic banks should be more appropriate.

Many studies have been conducted to measure and evaluate earning quality in public listed companies (Radzi, Islam & Ibrahim, 2011; Bistrova & Lace, 2012; Ismail et al., 2012), investigate earning quality in financial service companies (Kanagaretnam, Lim & Lobo, 2011) and examine earning quality in *sharia* compliant and *non-sharia* compliant companies (Ismail et al., 2012). Nonetheless, they have excluded financial institutions from the sample due to its specific accounting requirements which complicates comparisons with industrial and commercial companies. Moreover, Ugbede, Lizam, Kaseri and Lame (2013) compare Malaysian accounting standard and Nigerian accounting standard toward producing higher earning quality. The present study therefore provides an analysis of earning quality in financial institutions particularly Islamic banks.

This study is expected to enhance the development and the regulation of Islamic banks. As religious and ethical-based financial institutions, Islamic banks should provide proper accounting measurement to support shareholders' decision making. This is in line with the objectives of Islamic rules (*Maqasid al sharia*) in order to protect Muslims' wealth as an essential responsibility. Managers can give a secure protection for investors' wealth by providing high quality of earnings. Then, investors would be more confident to invest their funds in Islamic banks. Furthermore, earning reporting with profit sharing underpinning the structure of Islamic banking and providing good quality in accounting measurement are crucial. This is because Islamic banking relies on earnings for profit and dividend distribution. This measurement persistently can enhance market sharing within the banking industry. Also, this measurement supports Islamic banks, showing their ability to compete with others in the banking industry.

For further analysis, this study compares between Islamic banking in MENA and ASIA. Viverita, Brown and Skully (2007) found that Islamic banks in MENA have less efficiency compared to Islamic banks in ASIA. Moreover, Olson and Zoubi (2014) found that banks in the MENA region have been engaging in income smoothing practice from year to year. Then, this study expects that Islamic banks in ASIA have higher earning quality than Islamic banks in MENA. Other studies on Islamic banks in the MENA region are IMF (2004), Yudistira (2004), Ali (2011) and IMF (2014).

This study incorporates corporate governance variables that are relevant to earning quality, e.g. board independence, Sharia supervisory board size, Sharia supervisory board expertise, audit committee expertise and banks' characteristics such as institutional ownership, external auditor quality, accounting standard, size and

leverage as control variables. These variables may become a concern of managers in enhancing earning quality in Islamic banks.

1.3. RESEARCH OBJECTIVES

Earning quality is important to support profit sharing principle. Compromising with earning quality means that Islamic banks are attracting their foundation of their existence since earning quality measurement in an Islamic bank is essential for management to evaluate its performance as well as to maximize the value of shareholders and depositors. This study is also an effort to fill potential gaps in the literature on earning quality. Previous studies did not incorporate corporate governance variables. The present study aims to fill that gap through measuring earning quality in Islamic banks from selected countries that are developing the Islamic banking system. Briefly, this study sets to achieve the following objectives:

- a. To examine earning quality of Islamic banks across countries.
- b. To identify the determinants of earning quality across Islamic banks, globally and regionally.

1.4. RESEARCH QUESTIONS

From the above objectives, three questions have been developed for this study:

- a. To what extent is the quality of earnings of Islamic banks across countries?
- b. What are the relevant determinants influencing the earning quality level across Islamic banks, globally and regionally?

1.5. SIGNIFICANCE OF STUDY

This study aims to analyze the quality of earning in Islamic banks globally. Islamic banks are expected to have high earning quality with lower earning management practice. Earning quality helps shareholders to ensure that their funds are in profitable and secure investments. This measurement will enhance investors' confidence to make a decision for their future investment. Overall, the contributions of this study are as follows:

- a. Major theoretical contributions includes that this study investigates the earning quality of Islamic banks across the globe. Studies on earning management of Islamic banks are still limited. Study by Hamdi and Zarai (2012) focuses only on the earning management of Islamic banks by measuring frequency of high earnings and losses. This study extends the literature by incorporating corporate governance variables. Earning quality is fundamental to the existence of Islamic banks due to its profit sharing principle. Understanding the role of corporate governance variables to curb earning management activities in Islamic banks makes this study unique.
- b. To the stakeholders, practitioners and regulators, this study shall give more insights on earning quality and earning management practices in Islamic banks. The results of this study shall also be useful to the respective governments in analyzing the potential risks affected by a tendency of opportunistic behaviour in Islamic banks. Then, the governments can strengthen the regulation to prevent potential risks in Islamic banks, such as earning manipulation practice.

- c. To future researchers, this study shall provide a deeper understanding on earning quality and shall enrich the existing literature on earning quality that could be considered as a progress to elicit positive comments and as reference for future research.

1.6. ORGANIZATION OF STUDY

Chapter One provides the introduction of this study that comprises of the background of the study, motivation of study, research objectives, research questions, significance of study, followed by organization of study and finally a conclusion.

Chapter Two gives an overview of Islamic banking. The discussion also focuses on the characteristics and current issues in Islamic banks and provides an overview of global Islamic banking performance. Then, it is followed by a discussion on the correlation between *Maqasid al sharia* and agency theory, as well as the importance of earning in Islamic banks. In the last section, it briefly concludes on the need for earning quality measurement in Islamic banks.

Chapter Three is a literature review on earning quality. This chapter defines earning quality, provides the correlation between earning quality and earning management, as well as earning quality from the Islamic perspective. This chapter also explains earning quality measurement and earning quality determinants. In the last section, this chapter provides the gap in the area and the conclusion.

Chapter Four explains the theoretical framework that comprises of the agency theory and the concept of *Maslahah*. This is followed by the hypothesis development.

Chapter Five deals with the research methodology which begins by providing the characteristics of research, type of data and sample selection. Then it is followed

by technique of data analysis and research design that comprises of earning quality measurement and research model.

Chapter Six contains the analysis of findings and discussion. This chapter provides the rank of Islamic banks with the highest earning quality and statistical result; first, the descriptive statistics provide the details of the variables then, the examination of classical assumption on the data followed by analysis of data through panel regression. Finally, the chapter explains the findings of the hypothesis testing.

Chapter Seven provides a conclusion that summarizes the whole study. It delivers a brief summary of the findings. Implications and limitations of the study are also clearly described. The chapter also provides some recommendations for future research on earning quality.

1.7. CONCLUSION

This chapter provides a brief introductory of the study that consists of the background of the study, motivation of study, research objectives, research questions, significance of the study followed by organization of study.

Islamic banking is a new financial business system that prioritizes justice and fairness. This system is operated based on Sharia compliance that encourages religious and ethical values in every single activity. Earning management issues in Islamic banks lead to the decrease of their popularity. Furthermore, projection of high growth of Islamic banks is expected to be free from earning management practice as a result of managers' opportunistic behaviour. To create mutual confidence in investors and shareholders, Islamic banks have to show that their business provides good quality. Islamic banks' earning credibility can be identified by measuring their earning quality. This measurement is required for shareholders to make the right decisions. Hence, this