

A New Approach of Measuring Earnings Quality in Islamic Banks

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The developments that have taken place in Islamic banking are need-based and not planned or structured, as is necessarily the case because there is no central body to oversee the growth of business. This has given rise to several inconsistencies and issues affecting the quality of Islamic banking. One of the main concerns is the strictness with which the rules of Shariah are applied. The way in which products are structured and marketed may possibly have an impact on the quality of earnings generated by Islamic banks. Despite its importance, this has been one of the most neglected areas in the literature on Islamic finance.

There are a number of studies on the efficiency and profitability of Islamic Banks [1-7]. However, an important dimension which has been neglected in the literature is the earnings quality of Islamic banking, especially insofar as quality relates to core Islamic financial contracts (products). Some researchers define earnings quality as “the absence of earnings management” [8]; others determine earnings quality from the perspective of those who use financial reports, judging quality by the reliability and relevance of financial reporting [9]. Different approaches have been used to measure earnings quality in earlier studies, including accruals quality, abnormal accruals, and earnings variability [10-12].

This paper presents a new approach that can be used to measure earnings quality of Islamic banks. The approach is based on a measure of the pureness and use of core Islamic financial contracts (products), which implies the strictness of adherence to Shariah principles in contracts. The approach considers the values and principles of Islamic banks and extends the meaning of earning quality to cover not only “absence of earnings management” and “reliability and relevance” but also cover the question of meeting certain specific standards (i.e., the level of strictness of compliance with Shariah law in contracts). Unlike conventional banks, Shariah rules in Islamic banks add an ethical dimension to relationships and introduce a concept of trusteeship and a greater role in meeting the needs of society and mankind. Aljifri and Khandelwal [13] explain that, “Contracts in conventional financial systems are purely drawn and based on material information, facts and conditions, whereas the contracts in the Islamic financial system are made of material and ethical components”.

The new approach suggests the construction of an index that outlines the relevant components of items presented in income statements. A content analysis is needed to reveal the structure of Islamic contracts (products) used by an Islamic bank for which earnings quality can be determined and evaluated. Islamic financial contracts can be classified into “Risk Shifting Contracts” (i.e., Murābaha, Salam and Ijārah) and “Risk Sharing Contracts” (i.e., Mushārah and Mudārah). Risk sharing contracts are considered to have a higher level of Shariah acceptance compared to risk shifting contracts. However, a number of studies show that risk shifting contracts are the ones that are commonly used by Islamic banks [14-17]. These contracts are attractive to banks because they are based on a cost-plus financial system which involves fewer risks compared to risk sharing contracts. When evaluating earnings quality, credit should be given to an Islamic bank that derives its main sources of earnings from risk sharing contracts. This is because these contracts are considered to be more fully Shariah-compliant, where profits and losses are distributed more equally. The goal of risk

sharing contracts is to achieve socio-economic justice which is one of the main values in Islamic principles.

This paper has made the first step by proposing a new approach to measuring earnings quality in Islamic banks. The paper contributes to the literature in the following ways:

(1) It introduces a new approach for measuring earnings quality in Islamic banks, and

(2) It explores the relationship between earnings quality and Islamic contracts (products).

This paper may serve to motivate policy makers, investors, customers, and others, to examine further the success of Islamic banks. The new approach raises the following question: Would including the dimension of Shariah compliance in measuring earnings quality increase confidence in Islamic banks, and would this in turn help this sector to have greater sustainability of earnings?

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