INTERNATIONAL JOURNAL OF ACADEMIC RESEARCH IN BUSINESS & SOCIAL SCIENCES
www.hrmars.com
ISSN: 2222-6990

Earnings Quality and Bank Stability: Non-Empirical Study

Faros Faizdnor Roslan, Maslinawati Mohamad

To Link this Article: http://dx.doi.org/10.6007/IJARBSS/v12-i12/15893 DOI:10.6007/IJARBSS/v12-i12/15893

Received: *11* October *2022,* ***Revised:*** *14* November *2022,* ***Accepted:*** *27* November *2022*

Published Online: *16* December 2022

In-Text Citation: (Roslan & Mohamad, 2022)

To Cite this Article: Roslan, F. F., & Mohamad, M. (2022). Earnings Quality and Bank Stability: Non-Empirical Study. *International Journal of Academic Research in Business and Social Sciences*, *12*(12), 1153 – 1161.

Vol. 12, No. 12, 2022, Pg. 1153 – 1161

http://hrmars.com/index.php/pages/detail/IJARBSS	JOURNAL HOMEPAGE

INTERNATIONAL JOURNAL OF ACADEMIC RESEARCH IN BUSINESS & SOCIAL SCIENCES
HRMARS MANAGEMENT ACADEMIC RESEARCH SOCIETY
EXPLORING INTELLECTUAL CAPITAL
www.hrmars.com
ISSN: 2222-6990

Earnings Quality and Bank Stability: Non-Empirical Study

Faros Faizdnor Roslan[1], Maslinawati Mohamad[2]
[1]School of Accounting and Finance, Asia Pacific University of Technology and Innovation, Kuala Lumpur, Malaysia, [2]Accounting Research Institute (ARI) Universiti Teknologi MARA Selangor, Malaysia

Abstract
This study is a non-empirical paper that provides an overview of bank stability and its relationship to earnings quality. It investigates and assesses the numerous conceptualizations of bank stability and earnings quality. This study enumerated and briefly described the methods of earnings quality that usually being used to evaluate the impact on bank stability. This provides the reader with a thorough understanding of the methods that could be used in this area and how they impact the stability of banks. To be able to outline the specifics of this study's concepts, a variety of relevant literature has been gathered. This will be beneficial for future empirical research that related to this area.
Keywords: Bank Stability, Financial Stability, Earnings Quality, Earnings Management, Non-Empirical Study

Introduction

Financial institutions are vital to the economy and financial institutions' principal goal is to supply liquidity to the economy, allowing for greater economic activity than would otherwise be feasible. Turusbekova et al (2020) propose that banks and other forms of financial institutions can be compared to the economy's blood arteries. Riahi (2020) adds that the stability of the financial institutions also contributes to a country's overall monetary stability. Because of this, some researchers became interested in examining the problem of bank stability.

It is essential for the country's financial institutions to maintain a high level of consistency if we are to enjoy better economic performance. When there is instability in the banking system, the hiccups caused by financial crises that affect the macroeconomy are very visible. Therefore, in order to promote the expansion of the economy, it is essential to establish banking systems that are reliable (Albertazzi et al., 2020; Kyriazopoulos, 2020).

According to Alihodzic et al (2020), one of the criteria for determining whether or not a bank is successful is whether or not the bank is in a stable state. The direct participation of banks in interbank deposit markets and in syndicated loan markets is inextricably linked to the stability of banking systems. Indirect activity, such as lending to general sectors and registered transactions, are also tied to it. Because of recent shifts in both domestic and international financial institutions, financial stability is now often understood to refer to a multifaceted set of factors connected to the efficient operation of financial systems (Lassoued, 2018).

Recent events have cast fresh doubt on the viability of long-term economic performance as COVID-19 spreads across the entire globe. According to the conclusions of a few different bodies of research, COVID-19 exposure is detrimental to the stability and performance of banks. The repercussions of this circumstance have caused investors to respond more negatively to the banks (Ozsoy et al., 2020). During this epidemic, it is also anticipated that financial institutions will supply customers of such institutions with liquidity. On the other hand, there are concerns regarding their capability of satisfying the unforeseen demand (Strahan, 2020). The goal of their research was to investigate banks' ability to service their clients' liquidity needs throughout the COVID-19 period. The findings revealed that the liquidity and capital of many banks influenced bank liquidity supply. The circumstances were very similar in the weeks following the bankruptcy of Lehman Brothers in 2008.

If a bank or other financial institution is in a condition of instability, they will confront a number of challenges they have not previously seen. Because of this, it's possible that they'll decide to adjust their loan loss provision in order to smooth out their income {Formatting Citation}. Due to this, we provide the literature and non-empirical study for the area of the relationship between earnings quality and bank stability.

The characteristics of consistency, information, sustainability, stability, predictability, and absence of variability in the provided revenue are some of the ways that the concept of earnings quality has been described. As a result of numerous multinational firms around the world revealing non-authentic and fleeting results in their quarterly reports, investors' worries about the quality of profits have increased over the course of the past decade. As a direct consequence of this development, investors are exercising increased caution when doing analyses of net earnings and drawing conclusions about the value of a company based on data that is publicly available. Because of disparities in their access to resources, level of financial education, and analytical ability, individual investors may arrive at different conclusions regarding the value implications of an earnings signal (Hamdan, 2020).

The paper is organised as follows; the following section of literature clearly describes the concept of bank stability, the current situation of bank stability in Malaysia, and the factors affecting bank stability. Next, earnings quality section is being briefly discuss which include the methodologies for evaluating earnings quality and the link between earnings quality and bank stability. The final section discusses the conclusions.

Bank Stability

Current Situation of Financial Stability: Malaysian Banks Evidence

Malaysia's banking industry is sizable and well-established. March 2021 saw RM 3,016 billion in total assets. The majority of the balance sheets of Malaysian banks are made up of government securities, loans, and advances, with variations depending on the type of bank. The primary supervisor and regulator of the Malaysian banking industry is Bank Negara Malaysia, the country's central bank, which has the task of promoting monetary and financial stability to sustain Malaysia's steady economic growth (World Bank and Bank Negara Malaysia, 2022)

Moreover, the COVID-19 crisis showed a bad impact in 2020 but slightly improved in 2021 and has shown some resilient. Capital buffers were adequate, with capital requirements to risk-weighted assets at 18.2 percent in September 2021. Non-performing loans to total gross loans ratio was 1.5 percent, one of the lowest among ASEAN countries. As of October 2021, the system-wide liquidity coverage ratio was 153 percent, far exceeding the Basel III regulation requirement of 100 percent. Financial stability was at risk due to Malaysia's GDP contracting by 4.5 percent in the third quarter of 2021. However, it is anticipated that the Malaysian economy will strengthen once business as usual resumes following the COVID-19 outbreak, easing pressure on the financial markets.

According to "Financial Stability Review 1st Half 2021," by Bank Negara Malaysia, a resilient financial sector continues to bolster Malaysia's domestic financial stability. The increase in provisions in 2020 has provided banks considerable leeway in modifying the amount of extra provisions set aside for credit losses and expanding loan repayment assistance to citizens and businesses. In addition, banks keep taking a forward-looking strategy to management of credit risk despite significant difficulties in updating creditworthiness assessments of borrowers. Banks have continued to boost credit loss provisions throughout the first half of 2021, anticipate a decline in asset quality as repayment assistance schemes are gradually untangled.

Even though a return of COVID-19 outbreaks and delayed vaccine workflows, particularly in many emerging economies, impacted on the world economy's rebound during first half of 2021, dangers to economic stability continued under control. The need to maintain remarkable supports for the market in the face of the pandemic's continued clouding of the outlook must be carefully balanced with the need to avoid the emergence of new vulnerabilities because of the increased in risk-taking, higher private sector leverage, and stretched asset valuations during an extended period of low interest rates. Monetary policy expectations normalisation in developed nations may pose risks to financial institutions where the recovery has not yet taken root and flaws are more visible.

The financial system's funding circumstances remained steady. Prior to the 30 September 2021 full compliance date, all banks satisfied the minimum NSFR standard of 100 percent. Deposits in the banking sector kept increasing as a result of enterprises' and households' precautionary saving, refer to Chart 1.0. During this time, non-bank financial institution (NBFI) deposits fell slightly, reflecting withdrawals by these institutions, in part to enable the government's relief measures take effect.

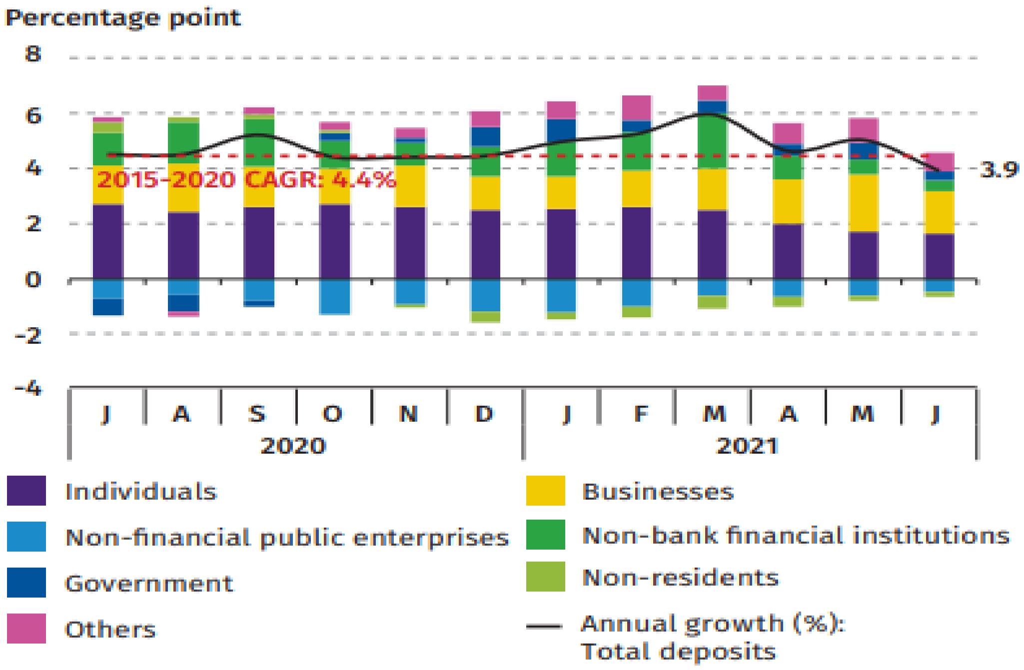

Chart 1.0: Banking system's contribution to economic growth
Source: Bank Negara Malaysia (2021)

Factors Affecting Financial Stability

The stability of the financial situation is influenced by several different aspects. This comprises the bank's corporate structure, level of competition, profitability, economic strategy, and fundamentals like liquidity and leverage, and many more. Competition is one of the elements that is frequently brought up in regard to financial or bank stability. According to studies on competition and stability, when there is less competition and greater market power, banks can charge higher interest rates on loans, increasing both the risk to the banks and the likelihood that borrowers would default (Hanggraeni, 2018). While Xia et al (2019) found no evidence that competition influences stability, Akins et al. (2016) and Kim (2018) proved that competition improves stability. In their investigation, Berger et al (2008) discovered evidence of both competition-fragility and competition-stability. Additionally, studies by Bahadur and Sharma (2018); Gonzalez et al (2017); Bahadur and Sharma (2016), demonstrated both the industry's competition-stability and -fragility. The findings of Iskenderoglu & Tomak (2013) study, however, do not support either the stability or fragility of competition. Managers and policymakers looking for empirical data to back their decisions may become perplexed by the findings' obvious contradictions because of variations in the methodology, competition measure, and risk proxy.

The relationship between corporate governance and bank stability is another factor that is constantly being researched. According to Al Farooque et al (2007), banks with good corporate governance can cut financing costs and investor investment risk. As a result of stability and tolerance for precise performance analysis, effective Corporate governance lowers perceived risk (James-Overheu, 2009). Corporate governance promotes a fair return on investment, prudent and efficient resource allocation within a firm, improved management, and higher productivity and performance (Tai, 2015). Additionally, it lowers the level of risk and raises the bar for performance (Maurya et al., 2015). Corporate governance increases openness and accountability in a company by encouraging senior management to handle organisational resources in an efficient and effective manner. On the other hand, the corporate governance's frail structure leads to significant levels of risk of default and financial insecurity.

Earning quality is another issue. The relationship between earnings quality and bank stability has only sometimes been researched, nevertheless. As a result, this study will explain some background information that might be useful for the literature in this field.

Earnings Quality

Investors were aware of the growing earnings for the past ten years as part of their quarterly report because many companies reported phoney and transient profitability. Investors now exercise greater caution when estimating net earnings and assessing the value of a company using information that is readily available to the public. Due to variations in each investor's resources, financial expertise, and analytical capabilities, the value implications of an earnings signal may be seen by each investor in a different way. According to Hamdan (2020), the consistency of wages has been the subject of several reports (Hamdan, 2020). The study of the financial accounts places a high premium on the identification of income's quality. Good earnings quality will be attained at the very least in the absence of indicators of poor earnings quality, such as red restatement flags of previously reported results and comments on Security and Exchange (Du et al., 2020).

Methods of Measuring Earnings Quality

A loan loss provision is the approach that is most frequently employed. In the banking sector, research on earnings quality has focused on figuring out how well accounting earnings can estimate future bank performance and earnings management utilising particular elements such as loan loss reserves. Following the recent, well-publicized banking crisis, bank earnings' capacity to correctly reflect bank performance has been put into doubt. The motives for earnings management, as well as the efficacy of internal and external control mechanisms in minimising earnings management, are also of interest. The literature that is currently available on using an LLP to manage earnings has mostly focused on identifying earnings management (Kanagaretnam et al., 2013). Banks are proven to employ LLP to fund their profits, according to (Wahlen, 1994). However, it is unknown what drives managers' underlying decisions or what elements account for bank earnings management.

Managing earnings to match or exceed recent years' earnings is another strategy that may be taken into consideration. The effect of prediction dispersion on managers' desire to "meet or beat" analyst estimations is examined in research by (Payne & Robb, 2000). They also said that during that time, SEC Chairman Arthur Levitt had expressed concern over the practise of results management to meet Wall Street profit forecasts set by analyst forecasts. Similar outcomes are obtained when managers align earnings to market expectations determined by analyst estimates. Furthermore, in circumstances where analyst forecast dispersion is low, their findings are consistent with managers responding as if they had stronger incentives to increase income. They find that earnings are in line with market. When there is little variation in analysts' earnings expectations and they have a constant desire to increase reported earnings, managers likewise work harder to "meet or beat" analysts' earnings estimates.

Earnings Quality and Bank Stability

In contrast to the findings of Riahi's (2020) research, Dal Maso et al (2018) did an investigation on the relationship between earnings quality and bank stability. They come to the conclusion that it is simpler to create larger loan loss reserves as a result of the post-crisis improvements in financial reporting techniques. In actuality, loan write-offs are absorbed by more broad loan loss provisions in good times by both accounting and bank authorities. It is reasonable to assume that as a result, the conflicts between accounting and bank authorities indicated above will be much reduced. Both authorities will encourage increased loan loss provisioning since it will increase loss reserves and support bank stability. To test this theory, they examined information from the post-crisis period. In conclusion, according to his study, earnings quality will strengthen the bank stability.

Conclusions

Financial institutions play a crucial role in an economy's overall health. The financial crisis will have a detrimental influence on the stability of banking industry, which will cause an economic disruption. As a result, many banks might seek to demonstrate that their businesses are operating at a stable level. They might manage earnings quality as a result of this. As was previously described in this paper, banks typically use loan loss provisions as their primary technique. If the level of the provision is too great, the stakeholders may become concerned. There has been relatively little research done in this area thus far, and the results have been inconsistent. It is crucial that researchers explore this topic further because doing so could add to the body of literature.

Acknowledgement

Financial support from the Research Management Centre of Universiti Teknologi MARA (UiTM), Malaysia is greatly acknowledged – GIP Grant – 600-RMC/GIP 5/3 (051/2021).

Corresponding authors

Dr. Maslinawati Mohamad
Accounting Research Institute (ARI), Universiti Teknologi MARA (UiTM), Malaysia
Email: masli856@uitm.edu.my

Reference

Al Farooque, O., Van Zijl, T., Dunstan, K., & Karim, A. W. (2007). Corporate governance in Bangladesh: Link between ownership and financial performance. *Corporate Governance: An International Review*, *15*(6), 1453–1468. https://doi.org/10.1111/j.1467-8683.2007.00657.x

Albertazzi, U., Barbiero, F., Marques-ibanez, D., Popov, A., & Acri, C. R. D. (2020). *Working Paper Series the analytical toolbox reviewed*. *2377*.

Alihodzic, A., Eksi, I., & Dogan, B. (2020). The determinants of bank stability: Evidence from selected Balkan countries and Turkey. *International Review*, *1–2*, 94–105. https://doi.org/10.5937/intrev2001094a

Bank Negara Malaysia. (2021). Financial Stability Review - First Half 2021. https://bnm.gov.my

Dal Maso, L., Kanagaretnam, K., Lobo, G. J., & Terzani, S. (2018). The influence of accounting enforcement on earnings quality of banks: Implications of bank regulation and the global financial crisis. *Journal of Accounting and Public Policy*, *37*(5), 402–419. https://doi.org/10.1016/j.jaccpubpol.2018.09.003

Du, K., Huddart, S., Xue, L., & Zhang, Y. (2020). Using a hidden Markov model to measure earnings quality. *Journal of Accounting and Economics*, *69*(2–3), 101281. https://doi.org/10.1016/j.jacceco.2019.101281

Gonzalez, L. O., Razia, A., Bua, M. V., & Sestayo, R. L. (2017). Competition, concentration and risk taking in Banking sector of MENA countries. *Research in International Business and Finance*, *42*, 591–604. https://doi.org/10.1016/j.ribaf.2017.07.004

Hamdan, A. (2020). The role of the audit committee in improving earnings quality: The case of industrial companies in GCC. *Journal of International Studies*, *13*(2), 127–138. https://doi.org/10.14254/2071-8330.2020/13-2/9

Hanggraeni, D. (2018). Competition, bank fragility, and financial crisis. In *Banks and Bank Systems* (pp. 22–36).

Iskenderoglu, O., & Tomak, S. (2013). Competition and Stability: An Analysis of the Turkish Banking System. *International Journal of Economics and Financial Issues*, *3*(3), 752–762.

James-overheu, C. (1946). Corporate Governance , Sustainability and the Assessment of Default Risk. *Finance*, *1*(1).

Kanagaretnam, K. (Giri), Lim, C. Y., & Lobo, G. J. (2013). Effects of International Institutional Factors on Earnings Quality of Banks. *SSRN Electronic Journal*, *3*(1). https://doi.org/10.2139/ssrn.2350306

Kyriazopoulos, G. (2020). *Mergers and Acquisitions and how they affect the Labor productivity . Evidence from the Greek Banking system . January*.

Lassoued, M. (2018). Corporate governance and financial stability in Islamic banking. *Managerial Finance*, *44*(5), 524–539. https://doi.org/10.1108/MF-12-2016-0370

Maurya, V. N., Sharma, R. S., Talib, S., Aljebori, H., Maurya, A. K., & Arora, D. K. (2015). *Correlation analysis between the corporate governance and financial performance of banking sectors using parameter estimation 4 . Determinants of Implementation of Corporate Governance in Banks*. *4*(8), 27–32. https://doi.org/10.11648/j.ajtas.s.2015040201.14

Ozsoy, S. M., Rasteh, M., Yonder, E., & Yucel, M. (2020). COVID-19 Impacts on Bank Stability in a Liquidity-Backed Environment. *SSRN Electronic Journal*. https://doi.org/10.2139/ssrn.3713526

Payne, J. L., & Robb, S. W. G. (2000). Earnings Management: The Effect of Ex Ante Earnings Expectations. *Journal of Accounting, Auditing & Finance*, *15*(4), 371–392. https://doi.org/10.1177/0148558X0001500401

Riahi, Y. (2020). Examining the relationship between bank stability and earnings quality in Islamic and conventional banks. *International Journal of Islamic and Middle Eastern Finance and Management*. https://doi.org/10.1108/IMEFM-10-2018-0328

Rivard, R. J., Bland, E., Morris, H. G. B. (2003). Income smoothing behavior of U.S. banks under revised international capital requirements. *International Advances in Economic Research*, *9(4)*(2003), 288–294.

Strahan, P. E. (2020). *Banks as Lenders of First Resort : Evidence from the COVID-19 Crisis*. *0*(July), 1–29. https://doi.org/10.1093/rcfs/cfaa009

Wahlen, J. M. (1994). The Nature of Information in Commercial Bank Loan Loss Disclosures. *Source: The Accounting Review The Accounting Review*, *69*(3), 455–478.

http://www.jstor.org/stable/248234%5Cnhttp://about.jstor.org/terms

World Bank and Bank Negara Malaysia (BNM). (2022). An Exploration of Nature-Related Financial Risks in Malaysia. Kuala Lumpur. World Bank. https://www.worldbank.org/en/news/press-release/2022/03/15/bank-negara-malaysia-and-world-bank-assess-nature-related-financial-risks-for-malaysian-banks