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Theoretical Framework Measures Management Accounting Systems and Credit Risk Management Policies and Practices towards Organizational Performance in Palestinian Commercial Banks

Ahmed A.S. Thabet

Phd Candidate at Limkokwing University Kuala-Lumpur, Malaysia

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corresponding Author:
Ahmed Thabet
Phd Candidate at Limkokwing University Kuala - Lumpur, Malaysia

ABSTRACT

The aim of this paper is to report the results of a study on the linkages between credit risk management policies and practices and management accounting system (MAS) toward organizational performance through testing the match and joint effects of MAS and CRM on organizational performance. The research method involved two data collection methods. Firstly, this study implemented an empirical investigation for the relationship between credit risk management policies and profitability of commercial banks in Palestine over the period of 7 years (2008-2014), eleven commercial banks were selected. The financial theory was employed to create the research model; Return on Asset (ROA) and Return on Equity (ROE) are defined as proxies of profitability while capital adequacy (EQTA), credit monitoring (LLPI), income diversification (NIDR) and operational performance efficiency (DTL) are defined as proxies of credit risk management. Panel model analysis was used to estimate the determination of the profit function. Secondly, administering a questionnaire to 11 commercial banks listed on the Palestinian Monetary Authority website and the respondents were those in the risk management department on banks such as chief executive officers (CEOs), chief risk officers (CROs), chief financial controllers, general managers, risk managers, and bank employees at departments related to risk management in Palestinian commercial banks. Based on the IFAC's (1998) framework and the Bank of International Settlement report (2013).

KEYWORDS: ***Capital Adequacy Credit Monitoring, Income Diversification, Efficiency, Profitability***

INTRODUCTION

The banking sector plays an intrinsic role in the economy. It performs as intermediaries between two essential parties that are the surplus and deficit units. This intermediary action is considered decisive to ensure the efficient allocate of resources in the contemporary economy (Rampini and Viswanathan, 2017). As

noted in the latest US global financial crisis, the collapse of the financial institutions robustly affects the stability of the whole economy, and, consequently, it is crucial to preserve the veracity, soundness, and stability of the financial institutions.

Financial institution extend credit to the investors for investment purposes there are possibility that investment may not perform worthy or collapsed to generate positive Net Present Value (NPV). If this scenario happens investors are defiantly unable to refund the credit extended by financial institution and risk of default appears. Credit creation is the main income generating activity of banks (Kargi, 2011). With increase in bank exposure to credit it tendency to undergo a financial crisis also increase. These crisis leads to bad impact on the economy as a whole, particularly when central bank and supervisory authority unable to prevent and address the determinants of the problem. Fundamental portion of bank earning is created from the interest gained on loan extended to their clients.

Kithinji (2010) write credit risk mainly arises due to lack of institutional capacity, in appropriation of credit policies, poor quality of management, lapses of laws and regulation and inefficient lending practices and accurate interference of central bank. So, credit risk management indispensable for profitability and bank survival. Credit risk is internal determinant of bank profitability. The higher the exposure to credit risk, the higher the tendency for banks to experience financial crisis .Chen and Pan (2012) define credit risk as the extent of value fluctuation of loans and derivatives due to change in the credit quality of borrowers and counterparts as well.

Management Accounting System (MAS) indicates to the systematic implement of management accounting to achieve the main goals of the organizations. Great design of MAS helps managers to be more efficacious in decision making, thereby aiding organization improving their efficiency and become more competitive toward any challenging environment. This definitely improves the performance of organizations (Ismail and Isa, 2011). Authors like Collier et al., (2004), Soin (2005) and Williamson (2004) have claimed that management accounting system is backing risk management activities. Both of management accounting and risk management are expected to complement each other and support enterprise decision making. MAS affect risk management through risk aggregation, reporting, monitoring and communication. MAS contribute on reducing management decision making uncertainty by providing appropriate information (Winter, 2007).

We can observe that there is a growing body of literature that examines the effect of MAS and performance as well as RM and organizational performance, the knowledge of linkage method MAS and RM that can reinforce the banks performance remains a gap. Soin and Collier (2013) argued that very little is familiar about the relationship between risk management and management accounting system. This research intends to have solid risk management framework especially credit risk management, depending on accurate information for management decision making and appropriate measurement of credit risk. Credit risk management plays a significant role at the banks overall performance and profitability. This is considered the main motivation to procedure this research.

Hence, consistent with the discussion above, the central research objective is therefore to examine the extent of MAS dimensions moderate the relationship between credit risk management policies and practices and banks profitability. In order to assess this relationship several objectives are tested at this study which are:

1- To determine the relationship between credit risk measured by capital adequacy

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and profitability in commercial banks of Palestine.

2- To evaluate the relationship between credit risk measured by credit monitoring and profitability in commercial banks of Palestine.
3- To assess the relationship between credit risk measured by income diversification and profitability in commercial banks of Palestine.
4- To examine the relationship between credit risk measured by operational performance and profitability in commercial banks of Palestine.
5- To identify to what extent Palestinian commercial banks follow credit risk management practices techniques and what their effects are on bank's profitability?
6- To achieve the efficiency of the moderating role of management accounting system between credit risk management policies and Palestinian banks profitability.
7- To achieve the efficiency of the moderating role of management accounting system between credit risk management practices and Palestinian banks profitability.

THEORETICAL FRAMWEORK

Banking Theory

Over the last 10 years, the quality of the loan and its portfolios across many economies worldwide stayed comparatively stable until the emergence of 2007-08 financial crises. Since then the quality of the bank assets declined quickly because of the world economic downturn. The reality is that the loan performance is closely associated with the economy of any country and decline in the loan performance was not yet standardized across the world economies. Banking theory considers banking activity is very complicated and varied and thus it is hard to provide a definition for banks. From the operational banks are institutions whose current operations consist in granting loans and attracting deposits from the large public (Bhattacharya and Thakor, 1993). Several theories extracted from banking theory try to explain the existence of banks in economy were developed. These theories comprise certain concepts like: delegated monitoring, process of information, liquidity transformation, smoothing of consumption and commitment method. The essential functions of the banks are to collect funds, particularly in the form of deposits, from the surplus agents and to lend funds in the shape of credits to deficit agents.

Banking theory classified the function of the banking activities into four main categories (Andries, 2008). Offering of transfer and payment services: transformation of assets: risk management: processing of information and monitoring of client. Risk management, in general, constitutes the essential activity of the banks. Banks, in broad sense, must choose and control the risk ingrained to the management activity of deposits, credit portfolio and, recently with an increasing weight in the banking activity, extra balance-sheet operations. Considering that the bankruptcy of a banking institution can lead to a negative effect on the financial system as a entire, the regulation and supervision community of the banking system must accurately monitor the balance and extra balance-sheet operations of the banks. Banking theory points out six essential risks associated with the credit policy of bank. These risks are: credit risk, credit deficiency risk, operating risk, portfolio risk, interest risk, and trade union risk. However, credit risk is the most pivotal risk among them thus, it requires special concentration.

Figures from several studies indicates that non-performing loans ratio which is a sign for bad loans through the world commercial banking sector was considerably high between 2000 and 2011(Dash, 2010: Haneef and Riaz, 2012: and Peterson, 2004). This was defiantly because of several of reasons like poor loan processing,

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inadequate loan collaterals, inefficient credit risk management, and various negative impacts of banks profitability. Therefore, through ultimate importance of credit in the banking sector and it clear impacts on economic, it is totally significant to find the relation between credit and profitability of the banks. Hence, a sincere endeavour is established in this dissertation to make the modest contribution to the credit risk literature by analysing the impact on Palestinian banking sector with particular focus eleven commercial banks including Arab Bank, Bank of Palestine, Cairo Amman Bank, Bank of Jordan, Quds Bank, The National Bank, Palestine Investment Bank, Jordan Ahli Bank, Palestine Commercial Bank, Jordan Commercial Bank and Jordan Kuwait Bank.

Contingency Theory

Recently, Management Accounting System (MAS) becomes an integral part of the management process and activities. According to Chenhall (2003) and Ismail and Isa (2011), appropriate and well-designed MAS helps organizations improving their efficiency and remain competitive will automatically improve the organization's performance. In theoretical terms, a variable can be considered as a moderating variable if it affects the strength and/or direction of the relationship among a predictor and an outcome. Generally, a moderator variable is a qualitative or quantitative variable that affects the direction and/or strength of the relation between an independent or predictor variable and a dependent (Baron and Kenny, 1986). According to Mikes (2006) and Woods (2008), both of ERM and MAS are considered as control systems that complement each other which consistent with the contingency theory. Contingency theory depends on a main concept which is "Fit" (Drazin and Van de Ven, 1985). "Fit" clarification made by three different forms which is used in several previous contingency-based management accounting research, are selection, interaction and system approaches. Contingency theory is an approach to the study of organizational behavior in which illustration are given as to how contingent factors like; technology, culture and the external environment influence the design and function of organizations. The assumption underlying contingency theory is that no one type of organizational structure is evenly applicable to all organizations. To some extent, organizational effectiveness is relay on a fit or match between the type of technology, environmental volatility, the size of the organization, the features of the organizational structure and its information system. Contingency theories were developed from the sociological functionalist theories of organization structure such as the structural approaches to organizational studies by Reid and Smith (2000), Chenhall, (2003) and Woods (2009). These studies assumed that organizational structure was contingent on contextual factors such as technology, dimensions of task environment and organizational size. In some other literature, contingency theory was still regarded as a dominant paradigm in management accounting research (Fisher, 1995; Cadez and Guilding, 2008).

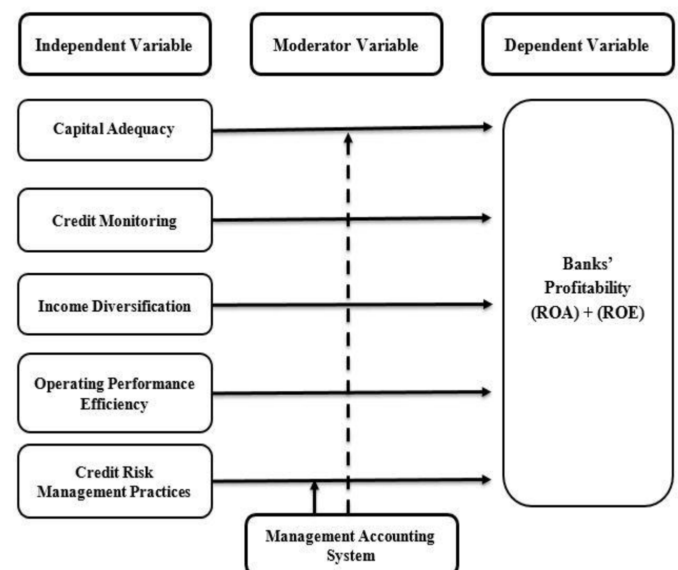

Figure 1: Theoretical Framework of the Research.

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LITERATURE REVIEW

Bank Capital and Profitability

According to Newman (2010) the main reason which generates the decrease in the dollar and foreign reserves is the variation in foreign exchange earnings which also affected banks' capital. Goddard, Molyneux, and Wilson (2004) mention that a bank that is operating over-cautiously and ignoring potentially profitable trading chances should be signified by a high capital adequacy ratio. And a negative relationship between equity to asset ratio and bank performance is implied. Banks which has higher equity to asset ratio usually requires lower needs of external funding and as a result there will be higher profitability (Pasiouras and Kosmidou, 2007). Iannotta,Nocera and Sironi (2007) found an important positive relationship between regulatory capital ratios and two indicators of banks performance using 15 European countries as a sample. Likewise, Lee and Hsieh (2013) found that capital ratios are positively correlated with banks when they examined some banks in Asia. Demirguc-Kunt et al (2013) stated that in the time of the financial crisis 2007-2008, higher capital ratios have a positive effect on bank stock returns. Further, Ozili (2017) studied some African banks and remarked that regulatory capital has a significant positive impact on profits of listed banks, while higher regulatory capital thresholds have a reciprocal influence on the profits of non-listed banks.

H1: There is no significant relationship between capital adequacy and the Palestinian commercial banks' profitability.

Credit Monitoring and Profitability

Measures in credit monitoring are used to ensure that the current financial condition of the borrower and counterparty is understood by the bank, to make sure that the existing covenant is in subjugation with all credits, to follow the use customer make of approved credit lines, to confirm that debt servicing requirements are in compliance with cash flow on major credits, and to ensure that where applicable, collateral provides adequate coverage relative (Seppala, 2000).

Dugan (2009) suggests that the level of loan loss provisioning have to be able to demonstrate the beliefs of bank management on the quality on the loan portfolio that they own stating that provisions must be able to include the whole spectrum of potential credit losses if they think of provisions as a measure of true credit risk. Gremi (2013) analysed the essential and more important eternal factors that affect Albanian commercial banks profitability over the time from 2005 to 2012 through using regression analysis fixed effect. These factors are bank size, credit risk, loans, deposits and interest income. Findings come with various results and show that higher total asset leads to higher profit. Higher loans contribute toward profitability but it comes with less significant impact on overall profitability. There is a negative relationship between credit risk and banks profitability. Total deposits to total assets and total equity to total asset provide a positive and significant relationship with bank's profitability. Ramlall (2009) talked about the negative relationship between credit risk and profitability. He shows that whenever there is a negative relationship between them, they reveal greater risk linked with loans, the higher the level of loan loss supplies which thereby and create a trouble at the profit-maximizing strength of a bank.

H2: There is no significant relationship between credit monitoring and the Palestinian commercial banks' profitability.

Income Diversification and Profitability

Huang and Chen (2006) believed that non-interest income is one of the important sources of variegation for banks. Chiorazzo, Milani, and

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Salvini (2008) remarked that non-interest income reduces volatility since it is uncorrelated or somehow least correlated. In addition, changing their concentrations form traditional income sources into non-interest sources, banks will be able to increase shareholders' value (Gurbuz, Yanik, and Ayturk, 2013). Despite of being an important source of diversification, DeYounga and Rolandb (2001) considered that non-interest income increases the volatility of profits for the banks. The low switching cost, the high operating and the financial leverage requirements for fee based activities make non-interest income sources more volatile than traditional interest based activities. Delpachitraand Lester (2013) mentioned that over-diversification of revenues increases the risk of default rather than improving profits. In addition, the strategy of income diversification needs great are as extensive diversification of income sources may reduce the financial performance of banks (Sahoo and Mishra, 2012). Being involved in non-interest based activities; income diversification may show new risks for which specialized managerial expertise are required. Being not well-planned, these risks could affect the performance, (Sahoo and Mishra, 2012). The effect of non-interest income and revenue diversification on performance of Australian banks was the study of Delpachitra and Lester (2013). It has found that non-interest income and diversification of revenue negatively affects the profitability. Besides, despite of the much reliance on non-interest income, the profitability and risk of default were not improved. Turkmen and Yigit (2012) showed the negative effects of sartorial and geographic diversification on performance measures of banks working in Turkey. Gurbuz et al. (2013) observed that income diversification improves the risk-adjusted performance of banks.

H3: There is no significant relationship between income diversification and the Palestinian commercial banks' profitability.

Operational Performance Efficiency and Profitability

In 2006-2008 banks were characterized by overly loose lending standards and significant weaknesses in credit risk management by banks, especially in the case of consumer loans. Banks paid little attention toward borrower's ability of repaying their loans on the basis of their financial standing while sometimes banks depending too much on the verification of a positive credit history. Consequently, the overly optimistic credit risk assessment and too loose lending policy leads in an accumulation of credit risk on banks' balance sheets. A Debt to Income ratio (DTI) helps lenders to evaluate borrower's credit status and how much debt they can handle and how much of a credit risk they pose. A low debt to income ratio explains a suitable balance between debt and income. The ratio of debt to income expected to have a negative significant effect on the banks profitability, in which a lower ratio is the better for the bank's profitability. From a theoretical point of view, limits on DTI can kill two birds with one stone. They might enclosure the feedback between mortgage credit availability and house price appreciation and, by restraining household leverage they can help reduce the incidence and loss given default of residential mortgage loan delinquencies. Some cross-country evidences at the gross level are presented by Wong et al. (2011). These evidences show that low DTI would decrease delinquencies in response to economic downturns and property price busts.

H4: There is no significant relationship between operational performance efficiency and the Palestinian banks' profitability.

Management accounting system and banks credit risk management policies and practices

Distinctly that the linkage between both of management accounting and risk management is rapidly growing. Authors like Williamson (2004);

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Collier et al (2004); Mikes (2006) McWhorter et al (2006) Collier and Berry (2002); Soin (2005) have reached and discussed this linkage. Williamson (2004) conducted a research clarifying that management has know-how in determining, analyzing, and decision making and so on, be able to assist developing enterprise risk management tools and techniques. Moreover, well understanding of organizational economic implication also its behavior, management accounting should be ready for better explicate and communicate risk management information more effectively. Management accounting is supporting risk management and control whether by assessing, estimating the consequences of expected results from risk events, quantifying objectives, and analyzing risk management cost and benefits processes, or comparing the real performance of risks faced.

Abdul Rasid et al, (2014) studied the linkages between management accounting systems (MAS), enterprise risk management (ERM) and organizational performance. Finding of this study indicated that implementation of ERM requires the use of sophisticated management accounting system information. Both of ERM and MAS complement each other and they are integral to decision making, planning and control in an organization. In another study, Abdul Rasid et al, (2011) examined the link between management accounting and risk management through measures the extent to which management accounting practices assist in managing risk. His study implemented a survey directed to financial institutions listed in the Malaysian Central Banks web site. Finding indicated that budgetary control, budgeting, and strategic planning contribute significantly in managing risk. Furthermore, the management accounting function was extremely involved in the organizations risk management. Mikes (2006) conducted a research to discover the changing context and internal dynamic of a multiple control system in a financial services organization as a contribution to link between risk management and management accounting. The study showed how the firm-wide risk management system and accounting control complemented each other also competing between each other due to their relevance, importance, and attention from the top management. Consequently, accounting system was widely used in organization management decision making.

H5: Palestinian banks profitability is positively related to the interaction between management accounting system and credit risk management policies.

Since exposure to credit risk consider the main source of problems in banks world-wide, banks and their supervisors should deal with this risk accurately. Bank of International Settlement (2013) set a sound practices to manage credit risk practices which are addressed through the following areas: (1) Establishing an appropriate credit risk environment. (2) Operating under a sound credit granting process. (3) Maintaining an appropriate credit administration, measurement and monitoring process. (4) Ensuring adequate controls over credit risk. (5) The role of supervisors. However specific credit risk management practices may vary among banks depending upon the nature and complexity of their credit activities, a comprehensive credit risk management program will address these five areas.

H6: There is no significant relationship between credit risk management practices and the Palestinian banks' profitability.

H7: Palestinian banks profitability is positively related to the interaction between management accounting system and credit risk management practices.

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METHODOLOGY

Research Design and Data Analysis Techniques

This step is to determine the research design that would encourage and enable the researcher to provide answers for the research questions. There are two main objectives of this study as discussed before. The first part of objective is to study and realize the impact of credit risks policies on the profitability of Palestinian's commercial banks, while the second part of the study is to measure the management accounting system techniques and tools role on link between credit risk management policies and practices and banks performance.

According to this particular study the adopted design on this research are as follows:

Secondary data study using regression analysis was implemented for this study to understand the impact on credit risks policies on profitability. SPSS statistical software was used in the analysis process for the following purposes: Multiple Liner Regression: was used since there were several independent variables. The T-Distribution test which used for the proposed hypothesis was used to examine the relationship between the dependent and independent variables. The F-Test. was used to examine the appropriateness of the model as a whole. The Variance Inflation Factor was used to examine the overlap (relationship) between the independent variables. Durbin –Watson Test: Statistics is the ratio of sum of squares of successive differences of residuals to the sum of squares of errors.

A survey method was adopted for the risk management in banks, management accounting system practices, and credit risk management practices. After the stage of collecting survey questions from responses, and establishing coding procedure, the responses data was coded and transferred to the computer for analysis level through using SPSS Windows which is considered statistical software. The researcher will follow some steps in the process of analysing the data. 1- Successive interval which allows classifying, sort rank, measure and compare the size difference between the value (Tabachrick and Fidell, 2014). Beside the calculation of the median, mode, and the percentage, the calculation of average and range can already be used on a interval technique. 2- Methods of data analysis included descriptive statistics (e.g. mean and S.D.), factor analysis, reliability analysis, and relevant tables. 3- Correlation analysis to study the relationship between variables. 4- Multiple hierarchical regressions to test and then analyse whether trust and satisfaction mediate the relationship among the independent variables and the dependent variable. 5- Multiple moderated regression (MMR) strategies to test and then analyse whether organizational support the relationship among the independent variables, mediators, and the dependent variable. 6- A moderating model, interaction effect approach and application were also used in this study (Baron and Kenny, 1986; Stone-Romero & Anderson, 1994; Yousef, 2000; Parker, 2003).

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