Corporate Governance and Earnings Management: A Study of Indonesian Conventional and Islamic Banks

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Abstract - This study examines the influencing of corporate governance on earnings management of Indonesian conventional and Islamic banks. The 27 conventional banks and 10 Islamic banks were selected as a sample of this study which observed for 5 years (185 observations). This study found that audit committee and independent board positively influence earnings management of Indonesian banks. This study also provided evidence that concentration ownership negatively associate with earnings management. Moreover, in the context of Indonesian Islamic banks, this study found that the sharia supervisory board size negatively affect to earnings management.

Keywords - Earnings management; Audit committee; Independent board, Ownership concentration, Sharia supervisory board

I. INTRODUCTION

The purpose of the financial statements is to provide information about the financial position, financial performance, and cash flow of the company that is useful for investor, creditor, and others users in making economic decisions. The Earnings reporting is the very important information for investors, because they use that information to predict future earnings and cash flows as a basis for making their investment decisions. Investors will invest their money in the right companies when management provides the higher quality financial information. In contrast, when the managers manipulate that information, investor may take the wrong decision such as allocating funds in poor performance companies (Kilic et al, 2014). However, some studies highlighted the earnings management which affects to financial statements declining for various motive such as higher bonus plans, tax reduction, and stock price. Philips, et al (2003) argued that companies also conduct earnings management to anticipate future earnings decline and fluctuations.

Some previous studies found that earnings management practiced in various industries using accrued components. Fortunately, banks have fewer options to manage their earnings information because; they have a low number of accrual transactions. However, in fact banks also tend to manage earnings by loan loss provisions (Kilic et al, 2014). Some previous studies found banking sector practice earnings management activities (see for examples: Ismail and Be Lay, 2002; Anandarajan et al., 2007 and Taktak et al., 2010)

The agency theory views that earnings management is a logical consequence of asymmetric information and opportunism behavior faced by all companies that separate managers and owners, including conventional and Islamic banks. So earnings management could be practiced by those banks. Even though, those practices are contradictory to Islamic rule, previous studies found that Islamic banks practice earnings management by exploring loan loss provision components (Ismail & Be lay, 2002; Zoubi and al-Khazali, 2007; Misman and Ahmed, 2011; Hamdi and Zarai, 2012 and Othman, 2014). In the context of Indonesia Yusuf and Soraya (2004) Juniarti and Corolina (2005) found the Indonesian listed companies practiced earnings management. The earnings management also occurs in conventional banks (Masodah, 2007; Zen and Herman (2007) and Islamic bank (Zahara and Veronica, 2009).

Since the earnings management practice impact on the quality of financial statements and finally mislead decision makers, the practice must be reduced. Some scholars highlighted that the most effective ways to reduce earnings management practices is the corporate governance mechanisms (Jensen and Meckling, 1976; Dechow et al., 1996; Chitourou et al., 2001; Xie et al., 2003; and Ebrahim, 2007). Denis and McConnell (2003) state that corporate governance mechanisms consist of internal mechanism involves board of director and ownership structure and external mechanism refers to the takeover market and the legal system

Boubaker and Sami (2011) conclude that concentrated ownership will enhance firms’ earnings information by reducing earnings management practice. Alves (2012) found that ownership concentration reduce the levels of earnings management. Robert (2012) highlighted that the audit committee effect on earnings management practices reducing. Zhou and Chen (2004) also found that the existence of an effective audit committee can reduce earnings management practices. However, Eka (2009) states that the existence of audit committees has no affect in reducing earnings management practices. 

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Cornett et al (2009) conclude that the increasing of independent director proportion will be followed by earnings management reducing. Nasution and Setiawan (2007) showed that the composition of an independent board of directors had the effect of reducing earnings management practices. Dechow et al (1996) found a negative relationship between independent board and the earnings management. Agrawal and Chadha (2005) found that there was a negative relationship between the proportions of independent directors to earnings management. On the contrary, Hashim and Devi (2008), Osma and Noguer (2007) found a positive relationship between independent directors and the level of earnings management. Based on the inconsistencies of previous studies, this study re-examined the influence of corporate governance on Earnings Management for Indonesian selected conventional and Islamic banks.

II. LITERATURE REVIEW

A. Agency Theory

Anthony and Govindarajan (2007) stated that the agency theory is constructed on basis of the relationship or contact between principal and agent; where principal hire agents to perform tasks for the principal’s interests, including the delegation of authorization for decision making from the principal to the agent. This relationship is called the agency relationship, which is used as the basis for understanding the contact between the principal (shareholders) and agent (manager). Agency relations sometimes lead to a conflict between shareholders and managers, for an example is when the shareholders want to maximize their value, but managers want to maximize their compensation, including making decisions that affect the decline in shareholder wealth such as earnings management. Then this theory provides a solution through increasing the percentage of shares held by managers and the establishment of supervisory institutions such as the board of directors and audit committee.

B. Earnings Management

According to Scott (2003), Earnings management is a managers’ action to choose an accounting policy from a certain standard intended to manipulate accounting data or information. The earnings management can reduce the credibility of financial statements that can mislead stakeholders in making economic decisions related to accounting numbers in financial statements.

C. Audit Committee and Earnings Management

In the establishment of an effective audit committee related to the control and supervision of company management. The audit committee must have enough members to carry out their duties properly. In the context of Indonesia, the National Committee on Governance Policy (KNKG, 2002) require that the audit committee must be consist of at least 3 members who chaired by an independent board and one of them should be have an accounting knowledge background. Therefore, the audit committee is expected to reduce agency conflicts and managers’ opportunity behaviour including earnings management. Some previous studies showed the existence of an audit committee can reduce the practice of earnings management (Othman, 2016; Nasution and Setiawan, 2007). Therefore:

H1: The Audit Committee influences earnings management.

D. Independent Board and Earnings Management

Independent boards must proactively ensure that the board of directors supervises and advises managers related to business strategies, information, control systems and audit systems, and Good Corporate Governance practices including high quality financial reporting. The ability of an independent board to influence the board's policy to ensure managers work in accordance with the interests of shareholders depends greatly on their proportion compared to the total members of the board of directors. Othman (2016), Nasution and Setiawan (2007), and Cornett et al (2006), concluded that the proportion of independent boards can reduce earnings management practices.

H2: The independent board influences earnings management.

E. Concentrated Ownership and Earnings Management

Concentrated ownership can be one of the internal mechanisms in the implementation of corporate governance, because the more concentrated shareholders in the company, the easier it will be for the parties to monitor, control and reduce information asymmetry that can lead to managerial opportunistic behavior and earnings management practices. Alves. (2012), Boubaker and Sami. (2011) and Nuryaman (2008) prove that concentrated ownership is an effective mechanism in controlling management and can reduce earnings management practices.

H3: The concentrated ownership influences earnings management.
F. Sharia Supervisory Board and Earnings Management

Besides the board of directors like those in conventional banks, Islamic banks must have a Sharia Supervisory Board (DPS) with a main role to ensure that the day-to-day operations of the bank are in accordance with the provisions of sharia. When earnings management practices are believed by DPS not in accordance with sharia provisions, they will supervise the practice. Othman (2016), Quttainah (2011) and Ghayad (2008), stated that effective DPS can reduce earnings management practices in Islamic banks.

H4: The sharia supervisory board influences earnings management

III. METHOD

A. Sample

The population in this study is Islamic banks in Indonesia and Conventional banks listed on the Indonesia Stock Exchange for the period 2012-2016. The sample is selected using purposive sampling. The reason for the research observation period is in accordance with International Accounting Standards (IFRS) which began to be applied in Indonesia in 2012. Table I shows that the sample fulfilled criteria was 37 banks with 185 observations for five years.

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Conventional</th>
<th>Sharia</th>
<th>Total</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conventional banks listed on the Indonesia Stock Exchange and Indonesian Islamic Banks</td>
<td>38</td>
<td>12</td>
<td>50</td>
<td>100</td>
</tr>
<tr>
<td>Incomplete data banks</td>
<td>11</td>
<td>2</td>
<td>13</td>
<td>26</td>
</tr>
<tr>
<td>Banks that meets research criteria (Samples)</td>
<td>27</td>
<td>10</td>
<td>37</td>
<td>74</td>
</tr>
<tr>
<td>Total Observations for 5 years</td>
<td>135</td>
<td>50</td>
<td>185</td>
<td></td>
</tr>
</tbody>
</table>

B. Data Analysis

The hypotheses of the study were tested using two multiple regression models. The model 1 is used to test the effect of audit committee, independent board, and concentrated ownership on earnings management for all samples (a combined sample of conventional banks and Islamic banks). While model 2 is used to test the effect of audit committees, board independent, concentrated ownership, and the size of the sharia supervisory board on earnings management for Islamic bank sub-samples only.

\[ DLLP = \beta_0 + \beta_1AC + \beta_2IB + B_3CO + \varepsilon \]  
\[ DLLP = \beta_0 + \beta_1AC + \beta_2IB + B_3CO + \beta_4DPS + \varepsilon \]

Where DLLP is the discretionary loan loss provision scaled with total assets. AC is the Audit Committee Size; IB is the proportion of independent board of directors; CO is the proportion of share ownership by dominant holders; and SSB is the sharia supervisory board size.

Following Othman (2016), we measure earnings management using the discretionary loan loss provisions (DLLP) method. The method assumes that LLP consists of two components, namely discretionary and non-discretionary, so that:

\[ LLP = LLP \text{ discretionary} + LLP \text{ non-discretionary} \]

Furthermore, LLP discretionary and non-discretionary are estimated with the following steps:

1. Run the regression LLP with its non-performing loan change, and total loan as follow
\[ LLP_{it} = \beta_0 + \beta_1NPL_{it-1} + \beta_2\Delta NPL_{it} + \beta_3\Delta TL_{it} + \varepsilon_{it} \]

2. Calculate Non-Discretionary LLP
\[ NDLLP_{it} = \beta_0 + \beta_1 NPL_{it-1} + \beta_2 NPL_{it} + \beta_3 TL_{it} \]

3. Calculate Discretionary LLP
\[ DLLP_{it} = LLP_{it} - (\beta_0 + \beta_1 NPL_{it-1} + \beta_2 NPL_{it} + \beta_3 TL_{it}) \]

Where LLP_{it} is the Loan Loss Provision bank i in year t; NPL_{it-1} is the Non-performing loan balance for bank i in year t; \Delta NPL_{it} is the Non-performing loan balance change for bank i in year t, and ATL_{it} is the total loan change for bank i in year t.
A. Descriptive statistics

Descriptive statistics in this study are used to describe mean, minimum, maximum, and standard deviation values of earnings management, audit committee, independent directors, concentrated ownership, and sharia supervisory board. Descriptive statistics divided into 3 groups, namely all samples, conventional banks sub-samples, and Islamic banks sub-samples. Descriptive statistics in this study is presented in Table II.

Table II shows that on average, banks conduct earnings management practices (DLLP) with income minimization patterns. The average number of audit committee members (AC) is in accordance with the provisions of Indonesian SEC, namely 3 personal. The proportion of independent boards (IB) on average also meets the Indonesian SEC regulations of at least 30%. This study also shows the percentage of shares owned by dominant shareholders is relatively high or more than 50%. In addition, sharia banks also have the size of the Sharia Supervisory Board (SSB) in accordance with Bank Indonesia regulations, which are at least 2 people.

B. Multiple Regressions Analysis

Table III shows that the ability of the audit committee, independent board, and concentrated ownership to explain the variation in earnings management for model 1 (all samples) by 11.8%, model 2 (conventional bank), by 17.9%, and model 3 (Islamic banks) 28%. This explanation ability will increase to 34.9%, when the sharia supervisory board entered into model 4.

The results of multiple linear regression testing showed that the audit committee had a positive effect on earnings management practices for all conventional bank samples and subsample, whereas for sharia banks, the audit committee had no effect on earnings management. The results of this study indicate the ineffectiveness of a large audit committee in reducing earnings management practices. According to Effendi (2009), this is because there is a tendency that
the position of directors is usually very strong, even there are directors who are reluctant to share authority and do not provide adequate information to independent directors. In addition, there are obstacles that hamper the performance of independent councils, namely their weak ability and integrity to monitor management performance. This result is in line with Isnanta (2008) and Osma and Nouger (2008) who found a positive relationship between independent commissioners and profit management practices.

Multiple linear regression for all samples and conventional bank subsample shows that concentrated ownership negatively affects earnings management practices. But the results of testing the third and fourth models with a sample of Islamic banks alone show that concentrated ownership does not affect earnings management. This means that the more concentrated share ownership, the smaller the practice of earnings management. This result is in line with the agency theory that concentrated ownership can be one of the internal mechanisms in the implementation of corporate governance to reduce earnings management practices. This result is also in line with Boubaker and Sami (2011) and Nuryaman (2008) proving that ownership concentration negatively affects earnings management.

The results of the fourth linear regression show that the sharia supervisory board have a negative effect on earnings management practices. It means that there is a contribution of the sharia supervisory board in reducing earnings management practices. This finding is consistent with Othman (2016), Ghayad (2008), and Madji (2011), who find that an effective sharia supervisory board can reduce earnings management practices in Islamic banks.

V. CONCLUSION

This study aims to obtain empirical evidence regarding the influence of corporate governance on earnings management in Islamic banks and conventional banks. The results showed that the Audit Committee had a positive effect on earnings management for all samples and sub-samples of conventional banks. The results of this study also showed that the proportion of independent boards had a positive effect on earnings management for all Islamic banks and samples. In all samples and sub-samples of conventional banks, this study also found that the sharia supervisory board had a significant negative effect on earnings management in Islamic banks.

REFERENCES


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