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Determinant of Earnings Management Pre and Post PSAK 109 in Indonesian Banks

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Abstract

This study aims to determine the differences in Earnings Management and the effect of Institutional Ownership, Managerial Ownership, Audit Committee Competencies, Capital Adequacy Ratio (CAR), and Nonperforming Loan (NPL) on Earnings Management proxied by Discretionary Loan Loss Provision (DLLP) pre and post-PSAK 109 implementation in Indonesian bank listed on the Indonesian Stock Exchange (IDX). This study uses Ordinary Least Square (OLS) regression and Wilcoxon signed-rank test to test the hypothesis. The study used the period pre and post implementation of PSAK 109. We traced each bank's financial report listed on the IDX from 2017 to 2020 to anticipate early implementation. Using purposive sampling, we obtained 40 pre-PSAK 109 and 40 post-PSAK 109 bank samples. This study found no difference in earnings management pre and post-PSAK 109. Institutional Ownership, Managerial Ownership, and Audit Committee Competencies do not affect Earnings Management pre and post-PSAK 109. NPL is positively related to Earnings Management pre and post-PSAK 109, and CAR is positively related to Earnings Management pre-PSAK 109 but has no effect on Earnings Management post-PSAK 109. This study provides additional information for standard setters and OJK regarding monitoring earnings management practices in banking pre and post-PSAK 109.

Keywords: Ownership Structure, Committee Competencies, Capital Adequacy Ratio, Nonperforming Loan, Earnings Management.

1. Introduction

The distribution of funds in the form of credit has a risk of default where the customer cannot return the loan according to the initial agreement when the credit is due. Banks must form a Loan Loss Provision (LLP) to manifest the bank's prudent principle for a higher level of business continuity. Recognition and measurement of LLP refer to the financial accounting standards applicable in Indonesia, namely PSAK 109, adopted from the International Financial Reporting Standard (IFRS) 9, which regulates the classification and measurement of financial instruments, impairment, and hedge accounting.

IFRS 9 was issued by the International Accounting Standards Board (IASB) on 17 July 2014 and effective on 1 January 2018. The Financial Accounting Standards Board - Indonesian Institute of Accountants (DSAK-IAI) ratified the PSAK 109, adopted from IFRS 9 on 26 July 2017. In the implementation, entities were given two years to prepare themselves until PSAK 109 became effective in Indonesia on 1 January 2020 as a replacement for PSAK 55 (IAS 39).

One of the changes that significantly impacts banking entities regulated in PSAK 109 is the change related to financial instrument impairment. Impairment of financial instrument in PSAK 55 based on incurred loss model where loan loss provisions are only formed based on incurred evidence or when there is a decrease in loan quality. That is why recognizing LLP under PSAK 55 is considered too little, too late. PSAK 109 introduces a new model, namely the Expected Credit Loss (ECL), using forward-looking macroeconomic conditions such as projections of economic growth, inflation, unemployment rates, and commodity price index at each reporting date. In this new model, LLP is recognized since the loan is originated and purchased, at least an estimate of losses for 12 months so that the risk of default can be anticipated early. If there is an increase in the loan's credit risk, lifetime ECLs are recognized. It will cause an increase in LLP and a decrease in the bank's profit.

The new provision model regulated in PSAK 109 aims to improve the timeliness of loss recognition by anticipating future losses so that a sudden decrease in income during the financial crisis in 2008 can be avoided [1]. Most European and European constituents see IFRS 9 as a big improvement. It will lead to a more timely recognition of inevitable losses and make it much more difficult for banks to hide problem loans on their balance sheets [2].

Loan Loss Provisions (LLP) can be influenced by at least three factors: the economic cycle, non-discretionary behavior, and discretionary behavior [3]. The economic cycle consists of a boom or prosperity period, depression, recession, and revival. The incurred loss model is accused of being one of the causes of the economic crisis in 2008. This is because banks tend to form lower LLPs when the economy is prosperous or booming, thus encouraging excessive credit distribution and causing the economy to grow too quickly. Conversely, banks form LLPs that tend to be

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high when the economy worsens (depression), resulting in small credit distribution and, as a result, slowing economic growth [4]. Non-discretionary accrual is an accrual that is considered fair and subject to generally accepted accounting principles, while discretionary accruals are accrual policies carried out by managers because they have the intention, not because of company conditions that require changes in accounting considerations and methods that shift costs and revenues. The discretionary component is associated with using LLP for managerial purposes, including capital management, earnings management, and signaling [5].

Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers [6]. Earnings management practices can reduce the quality of financial statements because reported profits do not reflect their actual value. In the literature on earnings management in banking, using LLP to meet corporate management objectives is often called Discretionary Loan Loss Provisions (DLLP). Bank managers can reduce the amount of LLP to increase low profits [7] and overstate credit loss provisions to reduce company income [8]. Although PSAK 109 minimizes the risk of late recognition of credit losses, the scope of managers' discretionary considerations and behaviors based on PSAK 109 will be substantially broader than PSAK 55 [9]. This is because PSAK 109 only provides a few guidelines for assessing credit risk, so PSAK 109 is considered too judgmental and less rule-based [10].

Wrong judgment can impact the quality of information presented in the financial statements and decision-making by stakeholders. This can be minimized by a Good Corporate Governance (GCG) mechanism. GCG is a system consisting of functions carried out by interested parties to maximize the creation of corporate value as an economic entity or social entity through the application of generally accepted basic principles [11]. Accounting standards with good quality only sometimes produce good quality financial information but are also related to GCG mechanisms [12]. GCG provides a framework to protect shareholders by ensuring compliance with the financial accounting system and the credibility of financial statements. The GCG mechanisms used in this study are ownership structure (institutional ownership and managerial ownership) and audit committee competencies.

Institutional investors are more aware and knowledgeable than other shareholders because their expertise, professionalism, and resources allow them to optimize their monitoring [13]. The efficient monitoring hypothesis states that the most significant shareholders can limit the opportunistic behavior of company management. The largest shareholders, such as institutional ownership, can minimize earnings management. This theory is supported by previous research, which found that institutional ownership is negatively related to earnings management [14]. The efficiency and effectiveness of the market in monitoring banks depend on the timeliness, consistency, and availability of reliable information related to the performance and risk exposure of banks, and IFRS 9 (PSAK 109 in Indonesia) is considered capable of providing such information [15], especially in the disclosure of financial asset quality. Companies adopting IFRS show improved reporting quality regarding earnings management, timely loss recognition, value relevance, and an increase in the quality of disclosure in financial statements after adopting IFRS [16]. The increasing disclosure quality in financial statements regulated in PSAK 109 will provide investors with more information in evaluating and understanding bank financial statements, thus increasing control in limiting earnings management. Based on this theory and previous research, we predict a negative relationship between institutional ownership and earnings management.

The Previous study found a systematic relationship between agency problems and the level of managerial ownership. The conflict of interest between agents and principals can be resolved by giving managers high-value shares. As managerial ownership increases, discretionary accruals decrease and corporate returns increase [17]. Providing a portion of shares to the company's management is expected to motivate managers to devote extraordinary monitoring efforts to maintain a satisfactory level of income that reflects the accurate income of the company. Managers who have incentives to adopt IFRS tend to apply strict accounting policies. So, it is expected that PSAK 109 can increase the effectiveness of monitoring by managers in the company. Based on this theory and previous research , we predict a negative relationship between managerial ownership and earnings management.

Audit committees exist to ensure adequate control from managers for shareholders' interest, such as controls to reduce earnings management and reassure users of financial information. In fulfilling its responsibilities, the audit committee must have the necessary expertise. The Blue Ribbon Committee (BRC) recommends that each audit committee member understand finance and that at least one member have accounting and financial management expertise. This theory is supported by previous research, which found that audit committee competencies are negatively related to earnings management [18]. This study distinguishes between accounting and financial educational backgrounds because mixed evidence is still found about which type of expertise affects financial reporting outcomes [19]. This condition indicates the need to separate audit committees with expertise in accounting and finance to obtain specific results. Because, in general, audit committees with accounting expertise can analyze and broadcast financial reports and understand applicable accounting standards. At the same time, audit committees with financial expertise are more related to specific financial expertise. The level of disclosure and transparency in financial reports under PSAK 109 is considered better than PSAK 55 so that the audit committee can obtain more in-depth information to analyze and understand financial reports. Based on this theory and previous research, we predict a negative relation between audit committee competencies and earnings management.

Capital Adequacy Ratio (CAR) and Nonperforming Loan (NPL) ratios are key indices in measuring management performance. Management seeks to increase CAR and keep NPL values below standard to achieve their goals, such as bonus plans, job preservation, and goals to meet regulators' capital adequacy ratio and NPL requirements. When they cannot achieve their targets, they can use accruals, loan loss provisions, loan charge-offs, and realizing gains or losses on securities or other gains and losses to adjust the capital and nonperforming loan ratios [20]. After implementing PSAK 109, banks will experience a decrease in capital and a significant decrease in CET 1 (Common Equity Tier 1). This change can cause a decrease in the bank's capital base, which can cause the bank to fail to meet the capital requirements set by the regulator [21]. So, it is predicted that banks will be more aggressive in using LLP to meet the minimum CAR ratio set by the OJK. PSAK 109 can accelerate the recognition of NPLs because ECL is forward-looking (although recognition of NPLs that are too fast can also limit bank lending during times of economic downturn) [22]. Based on theory and previous research, we predict a negative relationship between CAR and earnings management and a positive relationship between NPL and earnings management.

The difference between this study and previous studies is in the object, variables, and year of the study. Most previous studies have focused more on non-financial companies. The banking industry is often excluded from studies examining the relationship between corporate governance and earnings management because the regulations in the banking industry are stricter than in other industries. This study aims to add to the literature by testing the effect of ownership structure and audit committee competence, CAR, and NPL on earnings management using a sample of banking companies in Indonesia pre and post the implementation of PSAK 109. The difference between the results of previous studies, both theoretically and empirically, and the implementation of PSAK 109, which is relatively new in Indonesia, makes researchers interested in conducting this research.

2. Research Method

This study uses a quantitative approach. Quantitative research is an approach to test objective theories by testing the relationship between variables. These variables can, in turn, be measured using instruments so that the number of data can be analyzed using statistical procedures. The dependent variable in this study is earnings management proxied by Discretionary Loan Loss Provision (DLLP), and the independent variable for this study is institutional ownership, managerial ownership, audit committee competencies, CAR, and NPL. We also use control variables for this study, such as company size, leverage ratio, and type of company (dummy variable). The data for this research was collected from the Indonesian Stock Exchange (IDX), including financial and annual reports. We use the purposive sampling method to collect a sample with the criteria below on Table 1.

Table 1. Sample Criteria Selection

Criteria	Total
Indonesian bank listed on IDX	47
Sharia Bank (PSAK 109 not applicable)	(4)
Banks that have not been listed on the IDX during the research period	(3)
Subtotal	40
Years of observation (1 year pre, one year post PSAK 109)	2
Total	80

To anticipate the early implementation of PSAK 109 in Indonesia, we traced each bank's financial report listed on the IDX from 2017 to 2020. We found that PT Bank Pembangunan Daerah Jawa Timur already implemented PSAK 109 in 2017. So the period for pre-PSAK 109 for PT Bank Pembangunan Daerah Jawa Timur is 2017, and the post period is 2018, while the other bank uses 2019 for pre and 2020 as the post-PSAK 109 period. In this study, we use the following model to estimate DLLP, where the DLLP component is given by the residual term. $LLP_{it} = \beta_0 + \beta_1 NPL_{it-1} + \beta_2 CHNPL_{it} + \beta_{3t} CHLOANS_{it} + \mu_{it}$. Where: LLPit: provision for loan losses deflated by beginning; loans; NPL_{it-1}: the beginning of nonperforming loans deflated; by beginning loans; CHNPLit: change in the value of nonperforming loans; deflated by beginning loans; CHLOANS : change in the value of loans deflated by beginning loans.

After we estimate the DLLP for each sample then, we determine the effect of institutional ownership, managerial ownership, audit committee competencies, CAR, and NPL on earnings management using the following model $DLLP_{it} = \beta_0 + \beta_1 INST\_OWN_{it} + \beta_2 MAN\_OWN_{it} + \beta_3 AC\_EXPERT_{it} + \beta_4 CAR_{it} + \beta_5 NPL_{it} + \beta_6 SIZE_{it} + \beta_7 Lev_{it} + \beta_8 COMP_{it} + \mu_{it}$. Where: $DLLP_{it}$: discretionary loan loss provisions; $INST\_OWN_{it}$: percentage of Institutional ownership of bank i year t; MAN_OWN_{it}: percentage of managerial ownership of bank i year t; AC_EXPERT_{it}: percentage of accounting experts in the audit committee of bank i year t; CAR_{it}: tier 1 capital deflated by risk-weighted assets of bank i year t; NPL_{it}: nonperforming loan deflated by total loan of bank i year t; $SIZE_{it}$:natural logarithm of total assets of the bank i year t; Lev_{it}:totalLiabilities deflated by total assets of bank i year t; $COMP_{it}$: type of company (dummy variable. 1 for BUMN company, 0 otherwise).

This study used the Wilcoxon signed test and multiple linear regression (extension of OLS) to test the hypothesis. Main assumptions underlying multiple linear regression models must be satisfied, such as normality, multicollinearity, heteroscedasticity, and autocorrelation.

3. Result and Discussion

The Wilcoxon Signed Ranks test is used to evaluate a particular treatment on two observations, before and after a particular treatment. If the data used as a sample in this study is not normally distributed, then the Wilcoxon Signed Ranks test is used as an alternative to the Paired Sample T-Test. The results of normality tests of earnings management pre and post-PSAK 109 in this study can be seen in Table 2.

Table 2. Normality test of DLLP pre and post-PSAK 109

	Kolmogorov-Smirnov[a]	Shapiro-Wilk
	Sig.	Sig.
DLLP pre PSAK 109	0,145	0,010
DLLP pre PSAK 109	0,200	0,280

Based on the results of the Shapiro-Wilk normality test, it is known that the DLLP value after the implementation of PSAK 109 has a significance value of 0,010 < 0.05, so the data is not normally distributed. Because the data is not normally distributed, the difference test will use the Wilcoxon signed ranks test. The results of the wilcoxon signed ranks test of earnings management pre and post-PSAK 109 in this study can be seen in Table 3.

Table 3. Wilcoxon signed-rank test

	DLLP pre and post PSAK 109
Z	-0,430[b]
Asymp. Sig. (2-tailed)	0,667

Based on the results of the Wilcoxon test, it is known that the probability value pre and post-PSAK 109 is 0.667 > 0.05. It shows no significant difference in earnings management pre and post-PSAK 109 implementation. The change in the LLP formation method from incurred loss in PSAK 55 to expected credit loss in PSAK 109 does not provide more room for management to perform discretionary behavior. This is due to the COVID-19 pandemic in 2020, which impacted Indonesia's economic conditions. The loan repayment rate by debtors decreased, so bank management had to mitigate long-term risks rather than carry out discretionary behavior for short-term interests. The relaxation provisions also cause it due to COVID-19, where Financial Services Authority Regulation (POJK) Number 11 of 2020 states that banks do not need to form new provisions if credit restructuring occurs. The regulation was then updated with POJK Number 48 of 2020, which states that the loan loss provision is formed for debtors who can no longer survive after credit restructuring. Therefore, the difference that did not occur in earnings management is reasonable based on this regulation. The results of the normality test pre and post-PSAK 109 can be seen in Table 4.

Table 4. Normality test pre and post-PSAK 109

		Unstandardized Residual
Pre PSAK 109	N	40
	Asymp. Sig. (2-tailed)	0,200
Post PSAK 109	N	40
	Asymp. Sig. (2-tailed)	0,200

Based on the table above, it is known that the probability value pre and post-PSAK 109 implementation is 0,200, which is bigger than 0.05. it means that the data is normally distributed. The results of the multiple regression test pre and post-PSAK 109 in this study can be seen in Table 5.

Table 5. Multiple regression test pre and post PSAK 109

Model	Pre PSAK 109		Post PSAK 109	
	T	Sig	T	Sig
INST_OWN	0,612	0,545	0,700	0,489
MAN_OWN	1,328	0,194	1,119	0,272
AC_EXPERT	0,081	0,936	-1,798	0,082
NPL	2,711	0,011	2,398	0,023
CAR	4,102	0,001	1,849	0,074
SIZE	1,091	0,284	3,168	0,003
LEV	1,000	0,325	0,951	0,349
COMP	0,773	0,446	0,924	0,363

The result shows that INST_OWN has a significant level at 0,545 pre and 0,489 post-PSAK 109, which is more than 0,05. Institutional ownership does not impact earnings management pre- and post-PSAK 109. This is because institutional investors may not need to perform their role well and more effectively as sophisticated investors with more ability and resources to control management in carrying out earnings management actions. In addition, this study does not distinguish the size of each institution, so all institutions are considered to have the same influence in controlling earnings management practices. The results of this study support previous research, which also found that institutional ownership has no impact on earnings management.

MAN_OWN has a significant level at 0,194 pre and 0,272 post-PSAK 109, which is more than 0,05. This means that managerial ownership does not impact earnings management pre- and post-PSAK 109. This is due to the low portion of managers' ownership in Indonesian banking, which is only 0.2%. This value is relatively low when compared to the total shares owned by other investors. With a small portion of shares, management does not feel like they "own" the company and play a less critical role in decision-making. It will cause managers to fail to fulfill optimal efforts to increase company value. However, they prioritize their goals as managers rather than shareholders and tend to follow the decisions of the majority shareholders by increasing profits to attract investors to invest their money. That way, management's goal of increasing profits for bonus purposes and job preservation can be maximized. The results of this study support previous research, which also found that managerial ownership has no impact on earnings management.

AC_EXPERT has a significant level at 0,936 pre and 0,082 post-PSAK 109, which is more than 0,05. It means that the audit committee with an accounting background has no impact on earnings management pre- and post-PSAK 109. This is thought to be due to the existence of at least one audit committee with an accounting and financial background only to fulfill the Financial Services Authority Regulation Number 55/POJK.04/2015 concerning the Establishment and Guidelines for the Implementation of the Audit Committee's Work so that in its implementation the audit committee is less effective and optimal in developing and implementing the supervisory process to minimize profit management practices. A previous study also argues that the purpose of the company forming an audit committee is only to fulfill the mandatory regulation from the capital market regulator (Bapepam) so that the company can avoid penalties that will be given by the regulator.

During the researcher's data collection related to the educational background of the audit committee, although many audit committees do not have an accounting educational background, several members of audit committees at banks in Indonesia already had work experience in the field of internal audit. They had participated in various training programs to improve their competencies. In addition, many audit committees have obtained master's and PhD degrees in finance and economics, so the audit committee's competence, work experience, and training can be considered for a more comprehensive measurement of audit committee competence.

NPL has a significant level at 0,011 pre and 0,023 post-PSAK 109, which is less than 0,05. This means that the Nonperforming Loan (NPL) is positively related to pre- and post-PSAK 109 earnings management. The greater the NPL value, the lower the interest income the bank receives, and the more significant the LLP formed will be. (although for short-term purposes, banks can form smaller LLPs when the NPL value is high in order to achieve bonus goals and to maintain their jobs) When the LLP is formed, it will get bigger, and banking profits will decrease. The decrease in profit levels will impact investor decisions and public trust. So that managers become motivated to perform earnings management practices. The results of this study support previous research, which also found that NPL is positively related to earnings management.

CAR has a significant level at a 0,001 pre-PSAK 109 less than 0,05 and 0,074 post-PSAK 109 more than 0,05. The capital Adequacy Ratio (CAR) positively related to earnings management pre-PSAK 109. Banks with a low capital will form a low LLP, and vice versa. Managers of banks with low capital prefer to reduce rather than increase loan loss provisions. Related to CAR, bank managers are more concerned about financial reporting pressures and tax costs. Because increasing capital (other than dividends) will affect reported profits and taxes, bank managers consider these factors when increasing capital. For the post-PSAK 109 period, CAR has no impact on earnings management. Banks in Indonesia themselves have a healthy capital ratio of above 8%. The average CAR value of banks post PSAK 109 is 26% pre-PSAK 109. This value is relatively high, considering the minimum CAR regulated by the OJK is 8%. Therefore, more aggressive capital management after IFRS 9 does not incentivize managers to perform earnings or capital management after PSAK 109 implementation. This result contradicts our hypothesis but supports other research.

Lev and Comp have significant levels at 0,325, 0,446 pre-PSAK 109 and 0,349, 0,363 post-PSAK 109, which is more than 0,05. This means that leverage ratio and company type do not impact earnings management pre and post-PSAK 109. While Size has a significant level at 0,284 pre and 0,003 post-PSAK 109. It means that company size does not impact earnings management pre-PSAK 109 but positively relates to earnings management post-PSAK 109.

4. Conclusion

Although PSAK 109 is considered not rule-based and widens the scope of managers' judgment in determining loan loss provisions, this study's results indicate no significant difference in managers' discretionary behavior before and after PSAK 109. We also found that institutional ownership, managerial ownership, and audit competencies do not impact earnings management. Banks can increase LLP to improve asset quality and reduce the NPL ratio in the future. Management is willing to accept a decrease in profit this year for better financial performance in the following year if managers cannot achieve this year's goals. Bank managers may also reduce LLP even though the NPL level is high to achieve compensation goals and motivation to maintain their jobs. In mitigating credit risk, banks will set aside higher LLP if the NPL value is high. CAR positively related to earnings management pre-PSAK but did not affect earnings management post-109. Other variables, such as state ownership, family ownership, audit committee independence, and audit committee activity, can be considered for further research. Competence alone is insufficient if the audit committee is not independent and active in controlling earnings management. Further researchers are expected to consider other criteria in assessing audit committee competence, such as work experience or audit committees that have Certified Public Accountants (CPA) and use different models as earnings management proxies.

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