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Prevention Of Earnings Management Behavior In The Banking Industry Through Government Regulations

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ABSTRACT

One of the motivations for managers to manage earnings is regulatory motivation. The banking industry is bound by various government and industry regulations, so that banks must be able to maintain their financial performance. one of the rules that causes the banking industry to practice earnings management is the obligation to fulfill bank capital. This ratio aims to maintain the bank's ability to deal with business risks, one of which is credit risk. Various studies have found that banks use LLP to manage earnings. In addition to capital regulations, financial reporting accounting standards and stock exchange regulations can motivate managers to manage earnings. The research results compiled were taken from various articles and literature from various countries in Asia, America and Europe.

Keywords : Earning Management Behaviour, Loan Loss Provision, Banking Industry, Government Regulation.

1. INTRODUCTION

The banking industry is a sector that plays an important role in driving economic growth, namely through its intermediary role in collecting and channelling funds to the public through the real sector and other financial sectors. It is this important role of the banking industry that makes the governments of each country enact various regulations to maintain banking security and soundness. In addition, this aims to protect people who keep their funds in banks by implementing accountable and transparent corporate governance.

Making bank financial reports is one of the media to account for bank performance in an accountable and transparent manner. However, in the process of preparing financial statements involving various parties, it can lead to various behaviours from preparing financial statements. One of the behaviours that are considered legally legal, but which can be considered unethical is earnings management behaviour. Earnings management is how manager manage profits for certain purposes expected by company management, these actions can be in the form of managing accrual accounts, to circumvent government regulations through the accounting policies used. According to Healy and Whalen (1999) earnings management changes the behaviour of managers through assessments in financial reporting and preparation of transactions so that it can cause information received by stakeholders regarding the company's economic performance to be misleading, it can also affect contractual results that depend on accounting numbers.

The application of earnings management in preparing financial reports also occurs in the banking industry, according to Abaoub and Gamra (2013) there are two specific dimensions of earnings management in the banking industry, namely incentives related to regulatory constraints and methods used to estimate earnings management. The development of earnings management research in the banking industry is no longer motivated only by the interests of individual management, for example to achieve performance bonuses, but to achieve shareholder welfare and also to fulfil the bank's goals in carrying out its duties as a financial institution. In Indonesia, the banking industry has the task of improving the standard of living of many people regulated through Law Number 10 of 1998.

According to Di Martino et al (2017) governments in Europe since 2014 have implemented a new banking regulatory framework called the Single Rulebook. The aim of the new regulation is to regulate all financial institutions in the single market so that they can apply the principles of prudence and transparency in managing their business. The government regulation also aims to suppress earnings management policies carried out by the banking industry. In the banking industry the rules regarding reserves for impairment losses or Loan Loss Provisions (LLP) is very important in strengthening the financial position of the bank. LLP assists bank managers in dealing with future declines in credit quality (Sari and Widaninggar, 2021). In several research results (Abaoub and Gamra, 2013; Di Martino et al, 2017; Sari and Widaninggar, 2020) it was found that LLP is used by bank managers in managing earnings in various countries, because the determination of LLP uses direct judgment by bank managers which is dominated by higher in subjectivity.

The purpose of this study is to examine research developments related to the role of government regulations in preventing earnings management in the banking industry. The various articles used are not only sourced from research in Indonesia, but also from various other countries. This is intended to develop thinking about the ability of government regulations to prevent earnings management from occurring.

2. LITERATURE REVIEW

2.1 Positive Accounting Theory (TAP)

Positive accounting theory is designed to explain and predict which methods companies will use in their accounting practices (Watts and Zimmerman, 1986). Scott (2009) adds that TAP is used to explain the reasons for an accounting practice used by a company. According to Gumanti (2002) managers and regulators will choose accounting methods with certain backgrounds and reasons, both based on economic and non-economic reasons. In addition, the choice of accounting method will reflect the relationship between the company's cash flow and the accounting numbers reported by the company.

2.2 Earnings Management in the Banking Industry

Profit is a form of measuring the success of management performance, including the banking industry. Each type of industry has a habit of using certain accounting methods, which can affect the motivation of managers in reporting the profits generated in their financial statements. The existence of agency theory and information asymmetry between managers and stakeholder raises opportunities for managers to manage reported earnings in order to provide a positive signal to stakeholders (Sari and Widaninggar, 2020). Efforts to manage profits made by bank managers are to meet expectations of stakeholders regarding the ability of banks to optimize the sources of public funds that they manage through their ability to generate profits. Apart from that, the achievement of the bank's goals as a financial institution that manages public funds also motivates managers to achieve optimal bank performance. However, government regulations require banks to be able to comply with applicable rules, one of which is related to transparency in bank governance.

2.3 Motivation in Earnings Management

There are three main motivations in earnings management proposed by Healy and Wahlen (1999), namely 1) Capital market motivation where companies carry out earnings management with the aim of profit from the capital market due to gap between company performance and investors' expectations, capital market investors still think that profit is relevant data that is more informative than cash flow. Profit is used as the best predictor of future cash flows than current cash flows. 2) Contractual motivation is seen as providing incentives for earnings management, contracts made by companies not only reflect the company's profit compensation with external stakeholders, but are also able to limit the actions of managers. Manager incentives can also be obtained through agreed contracts, managers manage earnings to increase bonuses, job security and potential breach of debt agreements. 3) Regulatory motivation, regulations that encourage managers to manage earnings can be in the form of industry regulations and mistrust rules. Regulatory considerations encourage companies to manage profits, to be able to comply with these regulations.

2.4 Loan Loss Provision (LLP)

One of the business risks faced by the banking industry is credit risk arising from lending to customers and the public. Credit risk will increase when the number of bad loans owned by a bank is high, usually measured by a ratio Non Performance Loan (NPLs). To be able to optimize the loans disbursed so as to be able to provide interest income for banks, banks also need to be careful in extending these loans. Allowance for loan losses has the objective of adjusting the bank's loan loss reserves so that it can recover the bank's loan portfolio in the future (Ahmed, Takeda and Thomas, 1999). According to Sari and Widaninggar (2021) one of the discretionary accrual accounts used by banks is reserves for allowance for loan losses, LLP can assist bank managers in generating information about estimated losses that banks must face. The use of LLP also provides benefits for bank managers in managing income and capital regulations and communicating to the stakeholder about the future prospects of the bank through future earnings information signals (Ahmed, Takeda and Thomas, 1999).

3. METHOD

This study uses a literature study approach, both obtained from textbooks, journal articles and online literature searches. Where the theme of the literature used must be in accordance with the theme of this study, which is related to government regulations, LLP and earnings management. From the results of this literature study, a conceptual framework related to government regulations, especially in the banking industry, will be obtained which can be used to prevent managers from using earnings management in managing their business.

4. RESULTS AND DISCUSSION

Various empirical evidence regarding government regulations, especially in the banking industry and regulations related to the use of LLP as a method for managing earnings, is demonstrated through various empirical evidence that will be presented in this article. Not only in Indonesia, the use of LLP is also carried out by the banking industry in various countries, starting in countries in Asia, America to Europe.

The use of LLP with the aim of providing for impairment of a bank's productive assets in the form of credit loans is not only carried out during normal economic conditions, but increases when an economic crisis occurs. LLP is used in earnings management behavior, namely to give the impression of an even profit, so that it increases in periods during which crises occur. Research by Agarwal et al (2007) tried to analyze earnings management behavior at 78 banks in Japan under three different economic conditions; namely during high economic growth in 1985-1990, when economic conditions experienced financial difficulties (1991-1996) and during economic crisis recession in 1997-1999. This study proves that in three different economic conditions the bank secures profits to manage income for three periods, and allowance for loan losses is used to manage bank profits. As a result of the recession of the economic crisis, there has been an increase in non-performing loans faced by the average bank in Japan. This causes banks to use reserves for loan losses to smoothen income and meet capital obligations. Kwak, Lee and Eldridge's research (2009) supports the results of Agarwal et al. (2007), particularly during the late recession period, banks in Japan were proven to use discretionary i.e. loan loss reserves to report positive profit gains. They reserve higher LLP (reduced earnings) when bank demand for external financing is high, concomitant with realized gains on sale of securities and when previous years' income taxes are high. However bank managers will lower LLP (increase earnings) when the previous ratio of capital to earnings is high.

Furthermore, the results of other studies on banks in Tunisia show that there is a tendency for banks to manage profits in order to meet needs shareholder and stakeholder. Overall banks in Tunisia showed increased reported profits despite the economic downturn. The results of research found by researchers in Tunisia from 1998 to 2007 (Hamza and Taktak, 2009) and from 1999 to 2010 (Abaoub et al, 2013) show that LLP has a relationship to earnings management. Even before 2005, LLP was used to manipulate the achievement of the profit targets expected by managers, while since 2005 banks have switched to using real earnings management, namely the sale of securities. The research results of Abaoub et al (2013) also prove that banks in Tunisia decrease reported profits by increasing LLP and conversely, these banks are more involved in earnings management practices when operational risk increases. Elluench and Taktak (2015) reexamined the practice of earnings management in Tunisian banks after the publication of the IMF report in 2002. The use of LLP is separated into discretionary and non-discretionary components. The impact of the IMF report led to a change in the provision policy behavior of Tunisian banks where they no longer managed yields by minimizing loan loss provisions. Even after the 2005 economic elections, these banks increased their loan loss provisions even further. Other results show that as many as 1,716 banks for the period 2006 to 2016, carried out other real management in the form of selling non-performing loans and selling investment securities to be able to increase their income. Bank managers seem to still be looking for other alternatives through earnings management practices, even though banks are under pressure from national and international regulations and supervision.

An increase in more aggressive earnings management practices during the financial crisis was also found in the research of Cohen et al (2014), using 4,112 samples of banks in the United States they found that stock market risk was much higher after the financial crisis occurred indicating a fall in stock prices that had an impact to a reduction in future operating performance. This is an early warning sign for bank policy makers, negative information that is revealed can change market perceptions of bank operating performance and have an impact on bank share prices. Finally, bank managers will increase earnings management behavior aggressively to maintain investor confidence in the capital market. In research conducted by Ceccobelly and Giosi (2019) on 156 banks from 19 European countries during the 2006-2016 period, it aims to prove the practice of income smoothing by banks using LLP and explore the relationship between earnings management, capital adequacy ratios and signaling to outsiders. . A series of special regulations and supervision carried out in the banking industry are able to control the behavior of bank managers in the practice of income smoothing and signaling. These instruments are considered effective and able to reduce accounting discretion and make financial reports more reliable. This study also states that the loan loss allowance component plays an important role, especially when a financial crisis occurs. This result is in contrast to the results of research conducted by Elluench and Taktak (2015).

Application of government regulations to suppress earnings management practices is also applied to the banking industry in Europe. The mandatory disclosures required in the Single Rule Book (Basel III) which were enforced in 2014 required banks to be more careful in managing their banking activities. This has an impact on minimum capital requirements, higher liquidity and information transparency. Di Martino et al (2017) used 116 European banks that implemented the Single Book Rule policy, namely before the 2011-2013 period and after the 2014-2016 period. The results obtained show that government regulations through LLP rules are able to inhibit earnings manipulation and improve earnings quality. The application of rules relating to banking supervision by the government was also carried out in Nikulin and Downing's research (2020) by analyzing a comparison of the use of LLP for earnings management and capital adequacy ratios in banks in Russia before and after changes in regulations and banking supervision in Russia (Basel III). In contrast to findings in Europe, banks in Russia still use LLP as a form of income smoothing, namely as a method of earnings management, both before and after regulatory changes. Another reason for the different results between the impact of LLP on capital adequacy ratios and earnings management is because changes in regulations and supervision are only related to banking regulations and not to accounting standards. So LLP can still be used by managers to manage earnings.

The earnings management method used by banks is not only aimed at fulfilling capital ratios. Based on research by Barth and Kasznik (2017) which found that the use of earnings management was also carried out in the management of commercial bank securities in the United States, both registered and unregistered, from 1996 to 2011. These banks used the profits and losses of securities available for sale with the aim of leveling income and increasing the capital adequacy ratio. The earnings management method used in banks with positive profits is income smoothing, while banks with negative profits use take big baths. Both are used in conditions of positive or negative profit to fulfill the purpose of fulfilling regulations related to capital and income. Sales of securities in the capital market use information related to company profits, as a reflection of company performance. In addition, this information can be a signal for investors regarding the company's future earnings. As stated by Healy and Wahlen (1999), one of the motivations for managers to manage earnings is capital market motivation.

Kao and Yang (2009) examined Chinese government regulations regarding IPOs from state-owned banks against opportunistic behavior by 479 issuers during 1996-1999. A company going for an IPO can increase its earnings during the pricing period to affect negative post-IPO performance. Companies with overly optimistic profit forecasts experience declines return which was lower after the IPO. The results of this study prove that IPO companies that report higher accounting performance in the pricing period engage in earnings management to increase their earnings.

The research results of Agarwal et al (2007) and Kwak, Lee and Eldridge (2009) show that the impact of government regulations as reflected in the capital adequacy ratio and the determination of the LLP value is a form of precautionary measure that must be taken by banks in maintaining bank health. The use of LLP in helping bank managers manage their earnings through earnings management was not previously found in banks in Canada during 1977-1987, namely through research by Chen and Daley (1996). They cannot prove that managerial policies, in the form of regulations on capital ratios, taxes and earnings management, are factors driving changeLoan Loss Accruals (WITH). LLA includes a custom backup orLoan Loss Experience (LLE) and general backup orLoan Loss Provision (LLP). LLE is effectively used by bank managers in determining the level of allowance for doubtful accounts, while LLP is used in determining allowance for loan losses and is also treated as a deduction in determining taxable income while LLP is not. These reserves can create tax deductions and increase capital ratios, but do not affect income. The absence of the use of LLP in earnings management at 113 banks during 1986-1995 in the United States is proven in the research results of Ahmed, Takeda and Thomas (1999). However, LLP is used in fulfilling the bank's capital adequacy ratio. According to them, LLP reflects a significant change in the quality of a bank's loan portfolio, the capital adequacy ratio is an important determinant of provision for loan losses, earnings management is not a determinant in providing allowance for loan losses and providing information signals to outsiders is not an important determinant in determining allowance for loan losses.

Apart from being a form of bank compliance with various government regulations, the use of LLP in earnings management is considered as a tool to signal the bank's future income strategy. Anandarajan, Hasan and Lozano-Vivas (2003) retested this on banks in Spain. The results obtained show that LLP in Spain is not used as a tool to manage the capital adequacy ratio with the enactment of new regulations. This has resulted in banks adopting more aggressive earnings management strategies and LLPs have not proven to be a signaling tool about future bank earnings. In this case it is known that the enactment of government regulations in Spain is not able to suppress earnings management practices. Not only in Spain, research conducted by Anandarajan, Hasan and Lozano-Vivas (2007) was developed in banks in Australia. They research related to how the use of LLP in capital adequacy ratios, earnings management practices and as a signal to outsiders. LLP in banks in Australia is used in revenue management, earnings management practices are found to be more aggressive in commercial banks listed on the stock exchange than those that are not. And earnings management behavior is more prominent after the implementation of the new regulations related to Basel than before the regulations came into force, this also indicates that reported profits may not reflect the actual economic reality achieved by banks. So LLP is not used with the aim of signaling future high earnings to investors.

Providing positive signals related to bank performance to outsiders (investors) through increased income and bank profits is one of the reasons managers use earnings management to achieve this. Equity incentives provided by bank owners to bank management can encourage earnings management behavior. As the results of research presented by Cheng, Warfield and Ye (2014) used 712 banks during the period 1994 to 2007. They found that the higher the equity incentives received by bank managers, the more likely managers were to manage earnings, especially when the capital ratio was high. implied by government regulations is close to the minimum. Researchers link future sales behavior with earnings management, the relationship between the two is positive with a low capital ratio. In contrast, bank owners with high equity incentives and lax regulatory oversight do not exhibit equity selling behavior and the result is no increased earnings management.

In addition to government regulations related to capital ratios, there are other regulations that must be complied with by companies in various sectors including the banking industry, namely standards governing financial reporting.International Financial Reporting Standard (IFRS) is a financial reporting standard that is generally accepted in all countries. Since it became effective in 2005 in the European Union and began to be fully adopted in Indonesia in 2012, many studies have linked the impact of changes to these standards on earnings management practices. The application of this standard is claimed to be able to increase transparency in financial reporting practices so that it is expected to suppress earnings management behavior in companies. Leventis et al (2011) examined the impact of IFRS adoption on the use of LLPs to manage earnings and capital ratios. The study was conducted on 91 commercial banks registered in the European Union during the period 1999 to 2008. Not only looking at the impact of IFRS on banks, this study also observed the impact of changes in implementation according to Basel II. The results prove that risky banks show higher earnings management behavior than those that are less risky but decrease significantly during the post IFRS implementation period. IFRS is considered capable of suppressing earnings management behavior and improving the quality of bank reported earnings. The research results of Sari et al (2017) found a decrease in earnings management practices when the implementation of IFRS was enforced in 2012. The banks that were the research sample suppressed their earnings management behavior from 2012 to 2015, while in 2008 to 2012 prior to the implementation of IFRS earnings management behavior was still found in banks in Indonesia.

Sari and Widaninggar (2020) used a sample of banks with the largest total assets in Indonesia and Malaysia in the 2015-2018 period. The results obtained by LLP affect earnings management at banks in Indonesia, but not at banks in Malaysia. The application of accounting standards that have been implemented by banks in Malaysia, namely IFRS 7, is able to suppress earnings management practices through the use of LLP. IFRS 7 requires provision for impairment losses on assets as early as possible, so that it does not directly affect the eroded profit reported in the period concerned. Meanwhile, banks in Indonesia still use PSAK 55 which allows allowance for impairment losses on assets to be assessed using fair value after objective evidence of impairment of assets is found.

5. CONCLUSION

Based on the empirical evidence presented by the authors, we conclude the following: 1) Regulatory motivation as one that encourages managers to manage earnings, especially for the banking industry, is related to meeting capital ratios. The majority of the research results that have been reviewed show that the capital ratio is an important indicator that the banking industry pays close attention to. 2) Increases in earnings management practices were also found during economic crises and post-crisis, particularly to increase bank capital ratios and protect banks from the risk of losses faced during and after the crisis. 3) The method of earnings management commonly used is *Loan Loss Provision* (LLP). This is also related to the capital ratio which can decrease due to the credit risk that may be faced on bad loans. 4) In addition to the motivation to comply with government regulations, banks are also motivated to carry out earnings management in order to comply with applicable financial reporting standards, such as IFRS, Capital Market Rules. This is done in order to provide a signal to outsiders about the bank's performance and projected future income that will be used for decision making.

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