The Comparison of Earnings Management Practices in Indonesia's Islamic Banks and Conventional Banks

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***Abstract* - Banking sector is playing an important role in the economic stability of a country which also cannot be avoided earnings management practices. Islamic banks have grown rapidly in Indonesia, and are seen as more conservative than conventional banks. This conservative attitude is reflected in the size of the loan loss provision, which is an indicator of earnings management in the banking sector. This study aims to compare earnings management practices and their components between Islamic banks and conventional banks. This empirical study is conducted using a sample of 11 Islamic banks and 40 conventional banks in Indonesia during a period that ranges from 2011 to 2017. The comparison model is estimated using independent sample T-test. This study found that the earning managements practices is estimated significantly different between Islamic banks and conventional banks. This significant difference is probably caused by differences in organizational goals, in which Islamic banks are not fully profit oriented. The high level of loan loss provisions in Islamic banks indicates a high level of prudence in this type of bank. This study gives insight for the stakeholders about the earnings management practices both in Islamic and conventional banks. This study also can be used as a reference for those banks to improve their loan performance in elevating their profitability.**

Keywords - Conventional banks; Earning managements; Indonesia; Islamic banks; Loan loss provisions.

I. INTRODUCTION

Banking sector has become an important role in keeping the economic stability and the wealth of a country. Some studies have discussed some earnings management of the banks. Based on the previous study, banks around the world have applied the earnings management (Mersni and Othman, 2016; Othman and Mersni, 2014; Quttainah *et al*., 2013). Since the banking is quite essential, earnings management application in banking sector is riskier than other sectors (Mersni and Othman, 2016).

Similarly, the main motivation done in earnings management in banking sector is to minimize the earnings volatility (Othman and Mersni, 2014). Also, banking sector has a problem in information asymmetry and conflict of interest like other sectors that leads to opportunist behavior. However, Islamic banks consider it is against ethical values and moral values based on Islamic rules (Mersni and Othman, 2016).

In doing earnings management, banks mostly use loan loss provisioning (Azzali *et al.*, 2014; Mersni and Othman, 2016; Othman and Mersni, 2014). Bank of Indonesia, issuing the regulation number 14/15/PBI/2012 that require all of the conventional banks to create loan loss provision. The establishment of loan loss provisions aims to reduce the risks faced by banks when customers are unable to fulfill their obligations. Similarly, Islamic banks create loan loss provision regulated by Bank of Indonesia Regulation Number 5/9/PBI/2003.

Based on the regulation, Bank of Indonesia provides the flexibility for the banks to decide the percentage of loan loss provision as long as it is not violating the regulations. Banks will be able to determine the percentage based on bank policies and some considerations such as economic condition of a country. This flexibility will be harnessed by some managers to manage their earnings.

Even though earnings management techniques have been researched widely in banking sector, there are still limited and inconsistency findings on Islamic banks. Some of the studies state Islamic banks do not use loan loss provision to manage their earnings (Abdelsalam *et al*., 2016; Quttainah *et al.*, 2013). While other studies argue that just like conventional banks, Islamic banks also do earnings management (Ali *et al*, 2015; Misman and Ahmad, 2011; Othman and Mersni, 2014; Taktak *et al.*, 2010; Taktak, 2011). Besides, some particular studies comparing the characteristics of earnings management between conventional banks dan Islamic banks are very limited.

This study use some samples of conventional banks dan Islamic banks in Indonesia. In this case, our contribution for the investors is they are able to know the conservative behavior of Islamic banks and consider it in making decision. The remains of the paper are organized as followed. Section 2 provides backgrounds for the study and develops hypotheses. Section 3 introduces the sample and describes our research design. Section 4 presents empirical results and our analysis. Section 5 concludes the paper.

II. LITERATURE REVIEW

A. Earning Management

In banking sector, the previous research has proved some banking managers use their freedom in accounting regulation to manage the reported earnings (Balboa et al., 2013; Fonseca and Gonzalez, 2008; Olson dan Zoubi, 2014; Othman and Mersni, 2014; Pinho and Martins, 2009; Taktak *et al*., 2010b). The previous findings have shown the bank's performance is not good enough as the manager will try to cover the information by manipulating the earnings. Other research have figured out it is not only conventional banks, but also Islamic banks will manipulate earnings to produce more earnings (Ben Othman and Mersni, 2014; Hamdi and Zarai, 2012; Misman and Ahmed, 2011; Taktak, 2011). In Islamic banking, it is true that the concept of earnings management is against the ethical and moral value which become the foundation of these institutions. However, Islamic banks are similar to other companies dealt with asymmetry information and conflict of interests leading to opportunist behavior against the Islamic teaching (Bukhari *et al*., 2013; Safieddine, 2009; Shamsuddin and Ismail, 2013).

Supporting our assumptions, we have checked some earnings managements in some banks following the model developed by Ben Othman and Mersni (2014).

$$LLP_{it} = \beta_0 + \beta_1 NPL_{it-1} + \beta_2 \Delta NPL_{it} + \beta_3 \Delta TL_{it} + \varepsilon_{it} \qquad (1)$$

where:

LLP_{it}	total LLP for bank i at the year t, deflated by beginning loans.
NPL_{it-1}	the beginning balance of non-performing loan for bank i at the year t deflated beginning loans.
ΔNPL_{it}	change in the value of non-performing loan for bank i at the year t, deflated by beginning loans.
ΔTL	change in the value of total loan, for bank i at the year t, deflated by beginning loans.

1. Loan Loss Provision (LLP)

Loan loss provision is the expense written into income statement signing manager's assessment to the future loss in the future. It means the growth of loan loss provision decreases the net income. On the other hand, the decline of loan loss provision will rise the net income. Sun and Rath (2010) recorded the supported argument using particular accrual (ex. loan loss provision) to detect earnings management proposed by McNichols (2000) summarizing the profit into two.

First of all, this approach will enable some researchers to develop intuition for main factors influencing accrual characteristics. Next, this approach can be applied to industry with particular business producing specific material accrual. Besides, this problem connected to measure the earnings management with specific acrrual does not influence banks and insurance as some specific accrual (loan loss provision in bank case) is material due to the business characteristic.

Therefore, this is the big accrual for the banks and their provision will have a significant effect to the profit so that loan loss provision becomes the essential indicator to earnings management in banking sector.

2. Non Performing Loan (NPL)

According to Barseghyan (2010) and Zeng (2012), NPL is an unwanted side product, credit which is done and considered as "financial defamation" will create bad effect to economic growth.

Based on Bank of Indonesia Regulation Number 17/11/PBI/2015, non performing loan is ratio between the total credit with substandard quality, doubtful, and loss for the total credit. The best standar of NPL based on Bank of Indonesia is NPL under 5%. If a bank has surpassed the limit regulated by Bank of Indonesia, it will be considered as unfit bank.

3. Total Loan (TL)

Based on Bank of Indonesia Regulation Number 19/6/PBI/2017, total loan is the total credit provided by Bank to Bank dan non Bank in Rupiah or foreign currency.

B. Islamic Bank

Islamic banks have special features compared to conventional banks. They have three main products such as fund distribution, fund saving, and banking sharia service. According to Undang-undang Number 21 year 2008, Islamic bank is a bank runs its business based on sharia principles, which are the Islamic principle law in banking service based on fatwa issued by organization whose authority to legalize the fatwa in shariah. Besides, shariah principle are based on justice, benefit, balance dan universal values.

Sharia banking principles are part of Islamic teaching relating to economy which applies the principles not to do the business with the profits (illegal income), maisir (transaction depending on unsure condition and gamble), gharar (transaction with unclear objects), haram (transaction with forbidden objects by shariah), and zalim (transaction with unfairness to other people). In fact, profit sharing principles will create good and fair investment because everyone is able to share either profits or risks happening in the future so that it will lead to balance position between banks and customers.

C. Conventional Bank

According to Undang-undang Number 10 in 1998, conventional bank is a bank runs business conventionally in providing service in payment. In conventional bank, depositor is interested in compensation such as high interest deposit, while shareholders will get optimal spread like high interest deposit and credit. Moreover, the concern of debitor is retrieving low interests so that the cost will be lower. Therefore, there are three concerns that those three sides cannot fit into each other. In this case, a conventional bank only becomes a broker.

III. METHODOLOGY

A. Sample Selection

To test earnings management, this study use samples of Islamic banks and conventional banks in Indonesia over the period 2011 to 2017. This study initially selected 13 Islamic banks from *Otoritas Jasa Keuangan*'s Islamic Banking Statistics and 42 conventional banks with data available on Bloomberg database. Then, we selected banks for which annual report is available for seven successive years. This reduced the sample to 11 Islamic banks and 40 conventional banks operating in Indonesia.

B. Research Design

To examine the use of loan loss provision as earnings management's main tool of Islamic banks and compare it to conventional banks in Indonesia, we use one-stage approach. This study measured non-discretionary accruals in Islamic banks and compared them to conventional banks. As is known, non-discretionary components reflect part of uncontrollable factors such as changes in business conditions. Non-discretionary components cannot be observed directly. Therefore, in this study non-discretionary components will be estimated through variables that reflect the level of loan loss provisions.

Following Mersni and Othman (2014) and Taktak *et al.* (2010), this study consider that Islamic banks operate using sharia principles as guideline. This has caused a different Islamic bank loan scheme from conventional banks. The main financing scheme in Islamic banks consists of Murabahah, Mudharabah and Musyarakah. Therefore, this study use all three schemes to estimate the value of loan loss provisions.

This study estimate the non-discretionary accruals using equation (1). Non-discretionary accruals component is estimated using variables including the beginning balance of non-performing loans, change in non-performing loans and change in total loans. All variables deflated by beginning loans. This is similar to Mersni and Othman (2014) and Othman and Mersni (2016). To find the results of the comparison, we use independent sample T-test for loan loss provisions and each variables.

IV. EMPIRICAL RESULTS AND DISCUSSION

A. Normality Test

Table I presents the normality of the data used in our estimation. For the normality standard, 3x std error of skewness or kurtosis must be higher than the stat value. And for the Levene's sig value must be higher than 0.05 in order to meet the homogeneity. Based on the table it is known that the data used in this analysis is homogeneous and normal.

Islamic Bank		**EM**	**LLP**	**NPL**	**TL**
Skewness	Stat	0.2	0.215	0.983	0.103
	Std Error	0.491	0.274	0.379	0.309
	3x Std Error	1.473	0.822	1.137	0.927
Kurtosis	Stat	0.3	0.259	2.428	1.317
	Std Error	0.953	0.146	0.552	0.608
	3x Std Error	2.859	0.438	1.656	1.824
Levene's Test Sig Value		0.519	0.576	0.462	0.232

Source: Author's compilation

Conventional Bank		**EM**	**LLP**	**NPL**	**TL**
Skewness	Stat	0.366	0.259	0.624	0.092
	Std Error	0.287	0.146	0.267	0.157
	3x Std Error	0.861	0.438	0.801	0.471
Kurtosis	Stat	0.31	1.163	1.521	2.043
	Std Error	0.566	0.291	0.294	0.312
	3x Std Error	1.698	0.873	0.882	0.936
Levene's Test Sig Value		0.519	0.576	0.462	0.232

Source: Author's compilation

B. *Descriptive Statistics*

Table II provides the descriptive analysis for all variables used in our analysis. All of the variables both for the Islamic bank and conventional bank have deviation standard above 1 or close to 1. It shows that the samples of data is spreading from the mean.

Variables	Mean	Min	Max	SD
EM				
IB	-3.6425	-7.15	-0.12	1.77505
CB	-4.4243	-7.55	0.21	1.52480
LLP				
IB	-3.7883	-7.75	-0.06	1.44850
CB	-4.7763	-9.38	-0.18	1.32606
NPL				
IB	-3.6186	-6.91	-0.82	1.12411
CB	-3.9920	-7.36	-0.67	0.94099
TL				
IB	-1.3681	-4.63	1.91	1.14576
CB	-1.7823	-5.09	2.28	1.01636

Source: Author's compilation

C. *Independent Sample T-Test*

Table III shows the results of comparison of Islamic banks and conventional banks using independent sample t-test. For the purposes of this analysis, we classify the type of bank into two groups. Group 1 is the Islamic banks and group 2 is the conventional banks. The mean difference is the difference of group 1 to group 2 (the value of group 1 – the value of group 2). It is significantly different if the t-value is higher than 1.96 or sig (2-tailed) is maximum lower than standard error (α) 10%.

Variables	Mean Difference	T-value	Result
EM	0.78180**	2.016	IB higher than CB
LLP	0.98807***	5.669	IB higher than CB
NPL	0.37334***	2.899	IB higher than CB
TL	0.41419***	2.752	IB higher than CB

Source: Author's compilation

Notes: Statistical significance at *10%, **5% and ***1%

Just like the study by Othman and Mersni (2014) and Taktak *et al*. (2010), Islamic banks also manage their earnings. Even based on our results, earnings management by Islamic banks is greater than conventional banks as shown in table III. But keep in mind that NPL and TL variables for Islamic banks are also higher than conventional banks. Regarding the LLP variable which is the main tool for earnings management in Islamic banks is also much higher than conventional banks. This is likely to occur due to the type of financing provided by Islamic banks that use a profit sharing principles as stated in Bank of Indonesia regulation Number 5/9/PBI/2003. The type of financing is known as Mudharabah dan Musyarakah.

Both Mudharabah and Musyarakah provide financing for productive businesses managed by customers. Based on profit sharing principles for Mudharabah scheme, if business gets loss it will be borne completely by Islamic banks as the investors except intentional fault, negligence, or violated agreement. Similar to Musyarakah, if a business has loss, it will be borne by Islamic bank based on the composition and agreement. Besides bearing the business loss, Islamic banks will bear the loss if a customer cannot afford to return the capital after the due date.

Based on the scheme, it shows the risk faced by Islamic banks is higher than conventional banks. The risk of financing productive business is higher as the business conditions is unpredictable dan uncontrollable. The situation is different from conventional banks bearing the loss if only a customer does not pay his installments. However, the bank will not bear the loss of the productive business run by the customer.

Because Islamic banks face greater risks than conventional banks, Islamic banks are more conservative. This conservative behavior is reflected in the policies of Islamic banks that form large loan loss provisions to avoid future losses. Conservative behavior is allowed as long as it does not violate the present regulation.

This analist is supported by NPL of Islamic bank which is higher than conventional banks drawn in the table III. The higher NPL score in Islamic bank is caused by the soft solution in debt payment. Islamic banks hold the principles to help needy people. Based on the principles, Islamic banks will analyze the reasons why the customers are not able to pay their debts. Bank will see if the customers do not have any money to pay their debts or they can pay the debt but they do not have any willingness to settle it. If the customers are not able to pay, it will be solved by Islamic sharia principle.

For example, if a customer cannot complete his debts, Islamic banks will be allowed to do settlement for the debts by taking Murabahah objects based on some policies. Murabahah objects will be sold based on the market price so that the customer can settle his debts from the selling. If the selling income is more than the remaining debt, it will be owned by the customers. However, if the selling income is smaller than the debts, the remaining will be still the customer's responsibility to pay. In this stage, Islamic bank will ensure if the customer is able to pay or not. If a customer still cannot pay, the bank will release him from the debts.

Islamic banks will emphasize to avoid the conflict by discussing the problems firstly. Islamic banks will try to avoid the settlement by litigation such as *Badan Arbitrase Syariah*. This tendency will lead to the weakness of debt payment by sharia banks.

V. CONCLUSION

The purpose of this study is to compare the practice of earnings management and its components between Islamic banks and conventional banks using data over the period 2011-2017. This study specifically uses loan loss provisions as the main tool used by managers to conduct earnings management.

This study found that earnings management carried out by Islamic banks was higher than conventional banks. However, this result is different from our initial expectations. This study indicate that this is due to the prudent behavior of Islamic banks. Islamic banks deliberately increase the percentage of loan loss provisions to reduce the risks faced by Islamic banks due to the non-performing loans.

Based on our findings, this study made several recommendations. Banks must pay attention their loan portfolio and be careful in lending a loan to avoid the rate of non-performing loan. On the other hand, the investors may consider the awareness and loan portfolio of Islamic banks before investment.

The limitation of this study is having less number of samples from sharia banks due to unavailable data. For the next research, it would be better to emphasize the smoothing income done by Islamic banks dan conventional banks.

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