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paper text:

The Comparison of

Earnings Management Practices in Indonesia's **Islamic Banks and Conventional Banks** | 2 |

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Abstract - Banking sector

is playing an important role in the economic stability **of** | 28 |

a country which also cannot avoid

earnings management practices. Islamic banks have grown rapidly **in** | 12 |

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.** | 7 |

This study aims **to compare earnings management practices and** | 31 |

their components

between Islamic banks and conventional banks. This empirical **study** | 23 |

is conducted using

a sample of 11 **Islamic banks and** 40 **conventional banks in** | 8 |

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** | 16 |

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** [20]

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** [24]

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 the most important part 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** [27]

eanings 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 attitude. 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, require all of the convensial 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 Policy Number 5/9/PBI/2003.

Based on the regulation, **Bank** of **Indonesia** provides **the** flexibility **for** the banks **to** [26]

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.,** [18]

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; [2]

Taktak, 2011). Besides, some particular studies comparing the characteristics of profit management between conventional banks dan Islamic banks are very limited. This study use some samples of conventional banks dan sharia banks in Indonesia. In this case, our contribution for the investors is they are able to know the characteristics of conservative sharia banks and consider it in making decision. The remains

of the paper are organized as followed. **Section 2** [33]

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.** [1]

Section 5 concludes the paper. II. **LITERATURE REVIEW** A. Earning Management **In** [34]

banking sector, the previous research has proved some banking managers use their freedom

in accounting regulation to manage the reported earnings

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(Balboa et al., 2013; Fonseca and Gonzalez, 2008;

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Olson dan Zoubi, 2014; Othman and Mersni, 2014;

Pinho and Martins, 2009; Taktak et al., 2010b).

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The previous findings have shown the bank's performance is not good enough as the manager

will try to cover the information by manipulating

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the profit. 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

4

Zarai, 2012;

Misman and Ahmed, 2011; Taktak, 2011).

4

In

Islamic banking, it is true that the concept of earnings management

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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 dan conflik of interests leading to opportunist behavior against the Islamic teaching (Bukhari et al., 2013;

Safieddine, 2009; Shamsuddin and Ismail, 2013).

4

Supporting our assumptions, we have checked some profit managements in some banks following the model developed by Ben Othman and Mersni (2014). $LLP_{it} = \beta_0 + \beta_1 NPL_{it-1} + \beta_2 \Delta NPL_{it} + \beta_3 \Delta TL_{it} + \varepsilon_{it}$ (1)

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

1

1. Loan Loss Provision (LLP) Loan loss provision is the expense written into profit loss report signing manager's assessment to the future loss in the future. It means the growth of

loan loss provision decreases the net income.

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On the other hand, the decline of loan loss provision

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will rise the net income. Sun and Rath (2010) recorded the supported argument using particular accrual (ex.

loan loss provision) to detect profit management proposed by McNichols (2000)

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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 profit management with specific acrrue does not influence banks dan 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 profit 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 credit total and substandard quality, doubted, and jammed for the total credit. The best standar of NPL based on Indonesian Bank 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** `21`

total credit provided by Bank to Bank dan it is not Bank in Rupiah or foreign currency. B. Islamic Bank

Islamic banks have special features **compared to conventional banks.** They **have** `29`

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** `15`

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** `8`

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** `3`

and 40 conventional banks operating in Indonesia. B. Research Design

To examine the use **of loan loss provision** as **earnings** `11`

management's main tool

of Islamic banks and compare it to conventional banks in `12`

Indonesia, we use one-stage approach. This study measured non-discretionary accruals in

Islamic banks and compared them **to conventional banks.** `13`

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.** `36`

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. `1`

All variables deflated by beginning loans. This is similar to Mersni and Othman (2014)

and Othman and Mersni (2016). To **find** the results **of** `2`

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 `30`

the data used in this analysis is homogeneous and normal. Islamic Bank EM LLP NPL TL Stat 0.2 0.215 0.983 0.103 Skewness Std Error 0.491 0.274 0.379 0.309 3x Std Error 1.473 0.822 1.137 0.927 Stat 0.3 0.259 2.428 1.317 Kurtosis 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 Stat 0.366 0.259 0.624 0.092 Skewness Std Error 0.287 0.146 0.267 0.157 3x Std Error 0.861 0.438 0.801 0.471 Stat 0.31 1.163 1.521 2.043 Kurtosis 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** `3`

good variables for the sharia bank dan conventional bank will 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** `17`

this analysis, we classify the type of bank into two groups. Group 1

is the Islamic banks and group 2 **is the conventional banks.** `22`

The mean difference is the difference of

group 1 to **group 2** (the **value** of **group** 1 – the **value** of **group** `35`

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% 32

Just like the study conducted by

Othman and Mersni (2014) and **Taktak et al. (2010),** 2

Islamic banks also manage their earnings. Even based on our results,

earnings management by **Islamic banks is** greater **than conventional banks** 2

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** 9

the main tool for earnings management

in **Islamic banks is** also much **higher than conventional banks. This is** 10

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 the easiness productive business managed by customers. Based on profit sharing principles 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** 13

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 characteristic is allowed as long as it does not violate the present regulation. This analist is supported by NPL of Islamic bank which is noted 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, shariah bank 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** 19

banks

> **and conventional banks** using data **over the period** `16`

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** `10`

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** `9`

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** `14`

sharia 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. REFERENCES Abdelsalam, O., Dimitropoulos, P., Elnahass, M. and Leventis, S. (2016). "Earnings management behaviors under different monitoring mechanisms: The case of Islamic and conventional banks", Journal of Economic Behavior & Organization, 132, 155–173. Ali, Kabir and Abul. (2015). "Loan Loss Provisioning in OIC Countries: Evidence from Conventional vs. Islamic Banks", Journal of King Abdulaziz University: Islamic Economics, Vol. 28, No. 1. Azzali, S., Fornaciari, L. and Mazza, T. (2014). "Earnings management in bank industry", Economia Aziendale Online 2000 Web . 2014, Vol. 5 Issue 2, p99-110. 12p. Balboa, M., Espinosa, G.L. and Rubia, A. (2013), "Nonlinear dynamics in discretionary accruals: an analysis of bank loan-loss provisions", Journal of Banking & Finance, Vol. 37 No. 12, pp. 5186-5207. Barseghyan, L. (2010), "Non-performing loans, prospective bailouts, and Japan's slowdown", Journal of Monetary Economics, Vol. 57, pp. 873-890. Ben Othman, H. and Mersni, H. (2014), "The use of discretionary loan loss provisions by Islamic banks and conventional banks in the Middle East region: a comparative study", Studies in Economics and Finance, Vol. 2 No. 1, pp. 106-128. Ben Othman, H. and Mersni, H. (2016), "The impact of corporate governance mechanisms on earning management in Islamic banks in the Middle East region", Journal of Islamic Accounting and Business Research, Vol. 7 Issue: 4, pp.318-348. Bukhari, K.S., Awan, H.M. and Ahmedi, F. (2013), "An evaluation of corporate governance practices of Islamic banks versus Islamic bank windows of conventional banks: a case of Pakistan", Management Research Review, Vol. 36 No. 4, pp. 400-416. Fonseca, A.R. and Gonzalez, F. (2008), "Cross-country determinants of bank income smoothing by managing loan-loss provisions", Journal of Banking and Finance, Vol. 32 No. 2, pp. 217-228. Hamdi, M.F. and Zarai, M.A. (2012), "Earnings management to avoid earnings decreases and losses: empirical evidence from Islamic Banking Industry", Research Journal of Finance and Accounting, Vol. 3 No. 3, pp. 88-107. McNichols, M.F. (2000). "Research Design Issues in Earnings Management Studies", Journal of Accounting and Public Policy, 19, 313-345. Misman, F.A. and Ahmed, W. (2011), "Loan loss provisions: evidence from Malaysian Islamic and conventional banks", International Review of Business Research Papers, Vol. 7 No. 4, pp. 94-103. Olson, D. and Zoubi, T.A. (2014), "The determinants of loan loss and allowances for MENA banks: simultaneous equation and three-stage approaches", Journal of Islamic Accounting and Business Research, Vol. 5 No. 1, pp. 98 120. Peraturan Bank Indonesia Nomor 5/9/PBI/2003 tentang Penghapusan Aktiva Produktif bagi Bank Syariah. Peraturan Bank Indonesia Nomor 14/15/PBI/2012 tentang Penilaian Kualitas Aset Bank Umum. Peraturan Bank Indonesia Nomor 17/11/PBI/2015 tentang Giro Wajib Minimun Bank Umum dalam Rupiah dan Valuta Asing bagi Bank Umum Konvensional. Peraturan Bank Indonesia Nomor 19/6/PBI/2017 tentang Giro Wajib Minimun Bank Umum dalam Rupiah dan Valuta Asing bagi Bank Umum Konvensional. Pinho, P.S. and Martins, N.C. (2009), "Determinants of Portuguese bank's provisioning policies: discretionary behavior of generic and specific allowances", Journal of Money, Investment and Banking, No. 10, pp. 43-56. Quttainah, M. A., Song, L. and Wu, Q. (2013), "Do Islamic banks employ less earnings management?", Journal of International Financial Management & Accounting, Vol. 24, No. 3, pp. 203-233. Safieddine, A. (2009), "Islamic financial institutions and corporate governance: new insights for agency theory", Corporate Governance: An International Review, Vol. 17 No. 2, pp. 142-158. Shamsuddin, Z. and Ismail, A.G. (2013), "Agency theory in explaining Islamic financial contracts", Middle-East Journal of Scientific Research, Vol. 15 No. 4, pp. 530-545. Sun, L. and Rath, S. (2010), "Earnings management research: a review of contemporary research methods", Global Review of

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