Corporate Governance, Earnings Management, And Credit Risk Of Banking Firms : Evidence From Asian Bank

by Puji Harto

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Corporate Governance, Earnings Management, And Credit Risk Of Banking Firms : Evidence From Asian Bank

Diana Atika Ghozali, Puji Harto, Faisal, Karlina Aprilia Kusumadewi, Imam Ghozali

Abstract : Banks in ASIA have a highly concentrated organizational structure. Executives have do more control over accounting policies than principals. Full executive control of accounting policies provides an opportunity for executives to do earnings management. Earnings management by executives can reduce the credibility of financial statements. This study examines the factors that influence earnings management conducted in ASIAN bank. This study uses the agency theory framework in explaining the relationship of executive compensation to earnings management through credit risk. This study uses a quantitative approach. A total sample of 41 companies listed on the stock market in countries in ASIA with a total of 164 observations in 2013-2016. The results showed that executive compensation negatively affects earnings management, executive compensation negatively affects credit risk taking, and credit risk positively affects earnings management. These findings also indicate credit risk as an intervening variable of relationships between executive compensation and earnings managementnd Business

Keywords: Compensation, earnings management, credit risk

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1. INTRODUCTION

Asian bank have low level of transparency and disclosure quality (Fan, J. P. H., dan Wong, 2002). Compliance with international disclosure regulations and the application of international accounting standards is important to increase trabsparecy bank in Asia. Coporate governance is an important, concern in overseeing companies to incrase transparacy. Coporae governance is recommended by executive to ensure the effectiveness of the company to protecting principals and providing guidance for benefit of the company and principals. The executive throught members makes an annual financial report containing company information. Financial statement made by executive cannot be separated from earnings management practice. Earnings ,anagement is cariied out by executives to increase earning when profit are low and lower earning when profit are high (Fudenberg, D., dan Tirole, 1995). Earnings management practices are carried out with the aim of increasing or decreasing company profits. Earnings management by executif can conceal the performance company. Earnings management is carried out in three forms, namely maximizing profits, minimizing profit, and income smoothing. This study specifically examines the equitable distribution of profit conducted by Asian bank. Previous study of corporate governance and earnings management in banking industry has contribuited to bank all over the world. Executive compensation will be reduce earnings management (Almadi & Lazic, 2016; Fich, E. M., dan Shivdasani, 2005; Hassen, 2014; Ye, 2014). The following empirical studies related to credit risk and earnings management, the Bank will hide excess risk taking when disclosing company information, so that excess risk taking is negatively related to disclosure of bank information (Cordella, T., dan Yeyati, 1998). According to (Bushman, R. M., dan Williams, 2012) banks will hide excess risk taking by manipulating information that will affect company profits. Often underestimated the number of problem loans and determined that loan loss provisions did not match what was needed (Yasuda, Y., Okuda, S. y., and Konishi, 2004). Empirical studies related to compensation and credit risk diambil (Acrey, J. C., McCumber, W. R., Nguyen, 2011; Bolton, P., Mehran & Shapiro, 2015; Chen, C. R., Steiner, T. L., dan Whyte, 2006). This study specifically examines earnings management through loan loss provision. The greater the loan loss provision that is reserved, the company's profit will increase. Based on corporate governance mechanisms aimed at controlling banking companies, this study aims to indentify what influences earnings management at Asian Bank.

- *Diana Atika Ghozali is Ph.D student at the Faculty of Economics and Business Diponegoro University*
- ***Puji Harto, Faisal, Karlina Aprilia Kusumadewi, and Imam Ghozali** are lecturer at the Faculty of Economics and Business Diponegoro University*

2. LITERATURE REVIEW

the effect of executive compensation on earnings management agency theory explaoms the difference in interests between principals and agent. The principals ad the owner gives authority to the agebt as the executive to make dicisions that reflect the interests that prioritize his own welfare. The role of the owner in corporate governance to align the company's goals by implementing responds to both high and low compensation contracts. Earnings management is an executive action to use its decisions in the process of making financial statements by influencing earnings. Executives who use their authority to present undue financial statements that habe an impact on bank losses. Earnings management in the banking industry can be seen from the determination of the value of loan loss provision. Loan loss provision becomes an object that can affect the amount of company profit. Loan loss provision is needed in the banking industry to show bank performance more preciesely. When loan loss provision decreases, the burden of impairment losses on financial assets tends to low. Credit losses that must be written off result in improved earnings management. Previous study argue that high compensation influences executive to increase their independence (Adams, R. B., dan Ferreira, 2008).

Research of listed companies in China found that the compensation relationship had significant negative effect on executive earnings management (Ye, 2014). The executive uses his authority to reflect the principal's decision when compensated as a bonus or motivation, so that compensation become a solution that aligns the principal's interests to improve company performance and the executibe gets recognition and bonuses for his performance.

H1: Executive compensation has a negative effect on earnings management

The effect of executive compensation on cerdit risk

There is a view that high risk taking improves bank performance. When executives take high risks without analyzing their success in improving performance will be bad for the bank, while when the risks are taken low will be a cost for the principal and will have bad consequences in the future (Stulz, 2014). Principals need tools to oversee improper risk taking by executives. Agency theory suggests compensation as a solution to align principal and executive interests. Compensation given to the executive will affect the risk taking by the executive (Chen, C. R., Steiner, T. L., Whyte, 2006). The executive decides to provide high credit must be balanced with good credit quality debtors. Executives take credit risk because the risk taken is the basis of bank investment and the level of business the executive does influences bank returns (Bolton, P., Mehran & Shapiro, 2015). When risk taking does not match the level of business and the level of bank returns, the executive tends to avoid credit risk. Previous aalysis explains when high executive compensation tends to take low risk because the executive portofolio become less diverse. The results of (Houston, J. F. & James, 1995) research support the hypothesis that compensation will influence executive decisions to avoid risk taking. The results of previous studies show a negative relationship between compensation and bank risk (Ayadi, N., Boujèlbène, 2012; Vallascas, F., Hagendorff, 2013)

H2: executive compensation has a negative effect on credit risk

The effect of credit risk on earnings management

Information asymmetry and conflict between principals and executives are caused by the separation of ownership and control functions. The executive decides to take high credit risk trying to cover up the mistakes of his decision. High credit risk taking provides benefits for banks by increasing assets. Earnings management is done by using considerations in financial statements and in the structure of transactions that can change financial statements. Obstacles to the achievement of earnings due to credit risk and the need to meet financial analysis estimates motivates executives to conduct earnings management. In the case of long-term credit, banks sometimes report earnings for the next period in the current period. Inappropriate analysis by executives related to problem loans caused the loan loss provision to be too low or too high. Prudential regulations imposed by the Central Bank and International Bank agreements in the Basel Accord provide obstacles for executives to achieve the expected profit (Abaoub, E., Homrani, K., Gamra, 2013). In accordance with the research of (Abaoub, E., Homrani, K., Gamra, 2013; Arif, A., Nauman Anees, 2012) credit risk is positively related to earnings management supported by high loan loss provisions when credit risk is high.

H3: Credit risk has a positive effect on earnings management.

The effect of executive compensation on earnings managment through credit risk

Executive compensation provided by the principal encourages earnings management practices. Agency theory explains that compensation contracts are used to align the interests of principals and agents. There is an assumption that the executive is not interested in compensation and the company is not committed to a long-term incentive contract, so the agency problem solution with compensation to reduce earnings management has no maximum effect (Fudenberg, D., dan Tirole, 1995). Credit risk can be a variable that mediates the relationship of executive compensation to earnings management because credit is the main business of the bank. there are arguments related to compensation regulations to reduce risk assuming executive compensation can drive overall company risk (Acrey, J. C., McCumber, W. R., dan Nguyen, 2011). Unlike capital and assets which indirectly influence managerial decisions, compensation structures can directly influence managerial decisions, especially risk-taking decisions. Increased compensation will form a strategy that will increase bank risk. Increased credit risk will affect the company's earnings management practices. When executives take a high risk sign of conducting analysis, executives will try to cover it up by carrying out earnings management practices. Based on the description of the theory and the results of previous studies, the hypothesis is as follows:

H4: Credit risk mediates the relationship of executive compensation to earnings management.

3. SAMPLE SELECTION

This study collect annual information from 181 bank from stock market exchange database for the fiscal years 2014-2016, but only 181 bank were included in this study. There are three variable used to study the reletionship between executive compensation and earnings management and indicate credit risk as intervening variable of relationship between executive compensation and earnings management among the listed Asian bank. Table 1 summarized definition each variable.

Table 1. *Variable explanation*

Koede Variabel	Definisi Variabel	Pengukuran
EM	LLP is a reserve that was formed to debit losses on credit and funding whose economic value is reduced	Nilai Loan Loss Provision $llp = PD \times LGD \times LIP$
EC	Contract between principal and	Total annual salary

	agent	$compensation = salary + bonus$
CR	NPL is an indicator of bank health by comparing the total non-performing loans with the total loans given to debtors	$NPL = \frac{problem\ loans}{total\ loan} \times 100\%$

Using partial least square (PLS) , predict credit risk as intervening variable of relationship between executive compensation and earnings management is analyzed based on the following equation :

$$EM = \alpha + \beta_1 EC + e$$
$$CR = \propto + \beta_1 EC + e$$
$$EM = \propto + \beta_2 CR + e$$

Where :
EM = Earnings management
EC = Executive compensation
CR = Credit risk
e = random error
β = Parameters to be estimated

4. RESULTS AND DISCUSSIONS

***Table 2**. Discription Statistic*

Variable	N	Minimum	Maximum	Mean	Std.Deviasi
Dependen					
LLP	164	-173.51	593467.03	26163.4	63437.83
Independen					
Executive Compensation	164	421	1321000000	68525045.15	233400366.9
Risk Credit	164	0.19	24.1	3.02	4.07

***Table 3**. Regression result using WarpPLS*

Model fit indices and P-value	APC=0.170, P<0.001 ARS=0.066, P=0.031 AVIF=1.009, GoF=0.257, medium>=0.25 SPR=1.000, ideal=1 RSCR=1.000, ideal=1 SSR=1.000, NLBBCDR=0.833,	
Path Coefficient and P-value	EC-EM	-0.08***
	EC-CR	-0.10***
	CR-EM	0.33***

***Table 4**. Indirect effect, total effect, and effect size*

	PATH	COEFFICIENTS AND P-VALUE
Indirect Effect	KOMP-ML	-0.032***
Total Effect	KOMP-ML KOMP-RISKKRDT RISKKRDT-ML	-0.112*** -0.095*** 0.334***
Effect Size	KOMP-ML KOMP-RISKKRDT RISKKRDT-ML	0.012 0.090 0.114

The research model is explained in table 3. The overall research model is concluded to be fit with an AVIF value of less than 5 which explains the absence of multicollinearity. The fit model is stated as moderate with a GoF value of 0.257. The tidal model has a causal relationship with an NLBBCDR value of 0.8333. Estimates of this study indicate that executive compensation as part of good corporate governance has a significant negative effect on earnings management through loan loss provision. Consistent with H1 (p <0.001) significant negative executive compensation on management raenings, explained in table 3. The next hypothesis estimate executive compensation has a positive effect on credit risk. Inconsistent with H2, table 3 shows a significant negative executive compensation (p <0.001) for credit risk as indicated by Non Performing Loans (NPL). Subsequent estimates of credit risk have a positive effect on earnings management. Described in table 3 is consistent with H3 credit risk as indicated by a significantly positive NPL on earnings management (p <0.001). last, consistent with H4, credit risk mediates the relationship of executive compensation to earnings management indicating credit risk is a mediating variable with a coefficient of -0.032 (p <0.001).

5. CONCLUSION

Executive compensation has a negative effect on earnings management. The greater the principal compensation given to the executive, then earnings management through loan loss provision by the executive decreases. This research is consistent with agency theory, namely compensation as a solution that aligns the interests of principals and executives, so that executives are more independent in their performance and earnings management practices are reduced. Executive compensation has a negative effect on credit risk. The greater executive compensation eats the credit risk taken by the executive decreases. When compensation increases, the executive portfolio is less diverse and executives prefer to avoid risk (Chen, C. R., Steiner, T. L., Whyte, 2006). The results of this study support the agency theory that makes compensation as a solution to align the interests of owners and executives and motivate. Credit risk has a psychological effect on earnings management. The greater executive compensation provided by the executive, the higher the possibility of executives to do earnings management. When executives take high credit risk, the executive has a tendency to cover up his decision mistakes if credit risk taking does not meet expectations. Credit risk can cause obstacles in achieving profits, thus motivating executives to conduct earnings management. Limitation of this study is the small number of samples which causes a small degree of freedom. There are several studies that can be scheduled in the future which can test any variable that determines the amount of compensation.

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