Board of Director and Earnings Management in Islamic Bank

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Abstract: The purpose of this paper is to test and prove empirically the influence of the characteristics of the board of directors on earnings management. The characteristics of the board of directors used in this study are Islamic education background, size, number of independent directors and the financial background of members of the board of directors. The research sample is Islamic banks in Indonesia during 2013-2017. Data is taken from annual reports which can be accessed on the Islamic bank website. The proxy used to measure the amount of earnings management uses Discretionary Loans Loss Provision (DLLP). The results of this study indicate no significant results. The characteristics of the board of directors have no influence on the practice of earnings management in Islamic banks.

1 INTRODUCTION

The phenomenon of earnings management is a common thing in companies and banks, and even Islamic-based banks also take part in the practice (Quttainah et al. 2013). Viewed from an Islamic perspective, earnings management is not in accordance with Islamic teachings because there are efforts to deceive the company's financial condition to investors, which will harm investors (Obid and Demikha, 2011). One effective way to reduce earnings management practices is by governance mechanisms (Jensen and Meckling, 1976). One part of the governance mechanism is the existence of a board of directors that acts as a link between interests between shareholders and company management and ensures compliance with accounting principles (Dechow et al. 1996; McMullen and Raghunandan, 1996), preventing fraud in financial statements (Beasley, 1996) and limiting earnings management practices that are likely to occur in companies (Klein, 2002; Xie et al., 2003). One dimension in the board of directors is a board of directors who have an Islamic education background considering that earnings management practices are contrary to Islamic principles (Mersni and Ben Othman, 2015; Quttainah et al. 2013; Hamdi and Zarai, 2012; Ben Othman and Mersni, 2014). The size of the board of directors also plays a role in reducing earnings management practices (Xie et al. 2003; Quttainah et al. 2013; Mersni and Ben Othman, 2015). Likewise the existence of independent directors can reduce the practice of earnings management (Liu, 2012; Taktak and Mbarki, 2014). The board of directors with an accounting education background are expected to reduce earnings management practices with their capabilities (Dechow et al., 1996; Klein, 2002; DeFond and Jiambalvo, 1993; Naser and Pandlebury, 1997).

The purpose of this paper is to test and prove empirically the characteristics of the board of directors for earnings management. Since earnings management behavior is not in accordance with Islamic teachings, the board of directors are expected to play an important role in reducing earnings management practices.

2 LITERATURE REVIEW

There are many studies on the practice of earnings management in Islamic banks that are reviewed from the aspect of governance. Members of the board of directors who are members of AAOIFI play a role in reducing the practice of earnings management (Mersni and Ben Othman, 2015; Quttainah et al. 2013; Hamdi and Zarai, 2012). But other studies show the opposite results (Kolsi and Grassa, 2016). Thus, the first hypothesis is:
H1: There is a negative relationship between the board of directors who have an Islamic religious

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education background and earnings management practices.

Large board size can reduce the practice of earnings management (Quttainah et al. 2013). But there are also studies that argue the opposite (Beasley, 1996; Dechow et al. 1996; Loderer and Peyer, 2002). So, the second hypothesis is:

H2: There is a negative relationship between board size and earnings management practices in Islamic banks.

The existence of independent directors can reduce earnings management practices (Quttainah et al. 2013). However, some studies have argued otherwise (Liu, 2012; Taktak and Mbarki, 2014). So, the third hypothesis is:

H3: There is a negative relationship between the independent board of directors and earnings management practices.

Members of the board of directors with a financial background can reduce earnings management practices using their abilities (Naser and Pandlebury, 1997). However, other studies have argued otherwise (Kolsi and Grassa, 2016; Xie et al. 2002). Then the fourth hypothesis is:

H4: There is a negative relationship between the board of directors and the financial background and practice of earnings management.

3 RESEARCH METHOD

The research method used is a quantitative empirical study. In this study, researchers will conduct panel regression statistical testing of the influence of the characteristics of the board of directors on earnings management in Islamic banks in Indonesia. The object of this research is Islamic banks in Indonesia in 2013-2017. The research instrument used was documentation. Research uses quantitative data sourced from secondary data, namely annual reports that can be accessed on the website of Islamic banks. In addition, information is collected that supports research through books, online access media (internet), and published information such as journals, theses, and dissertations relevant to research. The initial sample used in the study amounted to 11 Islamic banks in Indonesia. However, there is one Islamic bank that does not have an annual report in 2014. Thus, the final sample is 10 Islamic banks in Indonesia for 5 years, namely 2013-2017.

The dependent variable in this study is earnings management. Measurement of earnings management To examine the relationship between the characteristics of the board of directors and earnings management in Islamic banks, following the approach taken by Ben Othman and Mersni (2014) and Mersni and Ben Othman (2015). This study uses a two-stage approach. In the first stage, using specific accruals to measure earnings management in Islamic banks. More specifically, using majority accruals in the banking sector, LLP. The proxy is divided into two components, namely discretionary and non-discretionary. Here's the form of the model equation:

$$LLP = Non\ diskresionari\ LLP + Diskresionari\ LLP$$

Non-discretionary components that are part of LLP are the portion of accruals arising from changes in the bank's business conditions. Because this cannot be directly observed, it is estimated to use variables that reflect the level of losses in the loan portfolio. Just like Ben Othman and Mersni (2014), the Non Discretionary LLP (NDLLP) component was measured using a series of variables including the initial balance of Non Performing Loans (NPL), changes in NPL and changes in total loans. So, the model equation is as follows:

$$LLP_{it} = \beta_0 + \beta_1 NPL_{it-1} + \beta_2 \Delta NPL_{it} + \beta_3 \Delta TL_{it} + \varepsilon_{it} \text{.......} 1$$

Then, using the estimated coefficient from equation $(\hat{\beta}_0, \hat{\beta}_1, \hat{\beta}_2, \hat{\beta}_3)$ we can calculate the non-discretionary component of LLP, namely NDLLP:

$$NDLLP_{it} = \hat{\beta}_0 + \hat{\beta}_1 NPL_{it-1} + \hat{\beta}_2 \Delta NPL_{it} + \hat{\beta}_3 \Delta TL_{it} + \varepsilon_{it} \text{.......} 2$$

Finally, the discretionary component of LLP can be calculated through the difference between toral LLP and NDLLP estimates. So the estimation of the equation is as follows:

$$DLLP_{it} = LLP_{it} - [\beta_0^{\wedge} + \beta_1^{\wedge} NPL_{it-1} + \beta_2^{\wedge} \Delta NPL_{it} + \beta_3^{\wedge} \Delta TL_{it}] \text{.......} 3$$

then the equation uses the dependent variable and independent based on the hypothesis as follows:

$$DLLP_{it} = \beta_0 + \beta_1 BOD\_ISLAM_{it} + \beta_2 BOD\_Size_{it} + \beta_3 BOD\_INDEP_{it} + \beta_4 BOD\_FIN_{it} + \beta_5 SIZE_{it} + \beta_6 ROA_{it} + \beta_7 CAR_{it} + \varepsilon_{it} \text{.......} 4$$

Where:

a. $DLLP_{it}$: Discretionary loan loss provision for loans, investment, murabaha, musyarakah and mudharabah to bank I in year t

b. $BOD - ISLAM$: Percentage of board members who have Islamic education background in bank i in year
c. $BOD - Size_{it}$: The size of the board of directors in bank I in year t, expressed as the number of board members in the bank i in year
d. $BOD - INDEP$: Percentage of number of external directors on the board of directors in bank i in year t
e. $BOD - FIN_{it}$: Percentage of number of board members who have an financial background at bank i in year t
f. $SIZE_{it}$: The size of the company is proxied by the logarithm of natural total assets in bank i in year
g. ROA_{it} : ROA is obtained from net income divided by total assets in bank i in year
h. CAR_{it} : CAR is determined by the formula for capital divided by risk weighted assets bank i in year t.

4 ANALYSIS

Descriptive Statistic

Table 1: Statistic Descriptive.

Variables	Mean	SD	Min	Max
DLLP	441190.1	970730.1	11046.05	6667881
BOD_Islam	0.11	0.22	0	1
BOD_Size	3.7	1.01	2	6
BOD_Indep	0.69	0.17	0.5	1
BOD_FIN	0.95	0.1	0.6	1
SIZE	15.9	1.65	9.06	18.29
ROA	0.003114	0.042257	-0.2013	0.12
CAR	0.21827	0.133338	0.111	0.7583

Table 1 provides the descriptive statistics for the variables used in those estimation during the period 2013 to 2017. The mean of DLLP, measured as the residual value from equation (1), was 441190.1 with a minimum 11046.05 and maximum 6667881. The average board of directors who have an Islamic education background is 0.11 with a maximum of 1 and a minimum of 0. The average board of directors size is 3.7 with a maximum of 6 and a minimum of 2. While the average percentage of independent directors is 69% with a minimum of 50 % and 100% maximum. Board of directors who have a financial background have an average of 95% with a minimum of 60% and a maximum of 100%.

Panel regression analysis

Table 2: Panel Regression.

Variables	Coefficient estimate	(p-value)
constant	-260116.8	0.671
BOD_Islam	93341.43	0.681
BOD_Size	99381.97	0.373
BOD_Indep	38666.72	0.668
BOD_FIN	-27030.57	0.78
SIZE	-109896.5	0.287
ROA	-1733738	0.461
CAR	58815.76	0.965
VIF	4.34	
Wald chi-squared	0.23	

Based on regression results, there are no significant variables on earnings management. Islamic education background has a positive but not significant effect. this result is not in accordance with previous research. So, this result is not in accordance with hypothesis 1. So is the variable size of the board of director. The regression results show a positive but not significant relationship. This result is in accordance with the Taktak and Mbarki (2014). Thus, hypothesis 2 is rejected. The number of independent directors has no significant effect on earnings management. The regression results show a positive but not significant relationship. This result is in accordance with Mersni and Ben Othman's (2015) study. Thus, hypothesis 3 is rejected. The number of members of the board of directors with a financial background also has no significant influence on earnings management. Regression results show a negative but not significant relationship. Thus, hypothesis 4 is rejected.

This insignificant result can be caused by a small number of samples. It is necessary to do a similar study with more sample sizes. In addition, state conditions also play a role in these insignificant results. As is known, the growth of Islamic banks in Indonesia is something new, unlike other Islamic countries. So, the case of earnings management in Islamic banks is still considered normal. Possible perspectives that influence the actions of the board of directors in dealing with earnings management behavior. It is expected that the results of this study can make the board of directors more aware of earnings management behavior.

5 CONCLUSIONS

Based on the results of the study, the characteristics of the board of directors did not play a significant role in reducing the practice of earnings management in Islamic banks. However, these results cannot be generalized because the number of samples is small and carried out in only one country. Hopefully, further research can include more samples with various countries.

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