Re-Examining the Role of Corporate Governance in Controlling opportunistic Earnings Management

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Abstract: This paper examines whether corporate governance mechanisms affect managers' earning management tactics at the largest publicly traded bank holding companies in Indonesia, by taking into account one of major economic theories explaining managers' behaviours: stewardship theory. However, in these cases, stewardship theory provides little help in shedding theoretical light on, and even has no ability to explain agent's opportunistic behaviours.

Keywords: corporate governance, earning management, stewardship theory

Introduction and Brief Theoretical Framework

Many commentators complain that earnings-based bonus strategies are a well-liked means of rewarding corporate executives. The use of high-powered incentives –personally beneficial projects – are an archetype of value-destroying executive behaviour (Bergstresser and Philippon, 2006), which are associated with earnings management (Fuller and Jensen, 2002), and the likelihood of beating analyst forecasts (Cheng and Warfield, 2005).Their findings point out that the existence of accounting-based compensation schemes is positively associated with companies' methods of recording. Furthermore, investigation evidence in Graham et al., (2005) points out that CFOs are also concerned with beating earnings benchmarks and seek to report a smooth series of earnings. Consistent with these voiced concerns, Leuz et al., (2003) find that CFO turnover increases following the failure to meet certain earnings benchmarks.

As evidence of corporate governance measures have important role in financial reporting, even though the "accrual accounting system" as mandated by *Generally Accepted Accounting Principles*(GAAP) permits companies to make adjustments when reporting earnings. David et al., (2017) theorise that a corollary of the corporate deception syndicates and governance relation is that companies that have a high risk of corporate fraud react differently to enhancements in governance than firms that are at low risk of fraud. That is, there is heterogeneity in the corporate governance and performance relation across companies. Studies in that body of research, Watts (1977) and Watts and Zimmerman (1978) postulate that bonus schemes may generate an inducement for managers to select accounting procedures and accruals to increase the present value of their

awards. And various triggers that encourage the occurrence of income smoothing are positively related to a higher percentage of the shares, among the composition of executive pay packages, ownership structure, board composition, and firm performance (David et al., (2017).

If superior corporate governance is more closely effective to aligning the interests of a firm's agents and principals, then governance mechanisms are required–and will add value–in firms that are experiencing a material divergence in principal–agent interests. Ahn and Choi (2008), empirically examining the effectiveness of bank monitoring by using the direct measure of a borrower's moral hazard problem (i.e., earnings management), find that bank monitoring plays an imperative role in constraining a company manager's opportunistic financial reporting activities. They elucidate that project financing structure may be related to agency problems between a lender and a borrower. Additionally, a corporate-purpose loan is more likely to be related to asymmetrical information due to its multi-purpose schemes, hence, providing a bank with a stronger incentive to supervise a borrower than a loan with other purpose. That is, corporate governance measures may reduce the extent of fraud and improve the welfare of shareholders only in firms where agents of the firm are prone to fraudulent behaviour. In well-managed firms, abiding by strict governance standards may in fact be a costly endeavour that reduces its efficiency by forcing a deviation from their optimal governance structure (David et al., 2017).

The debate about the influence of extrinsic and intrinsic rewards on motivation appears to be cast in dichotomous terms. According to Merchant, et al, (2003) the primary goal of an incentive scheme is to motivate employees. They state

that there are, broadly speaking two strands of literature dealing with incentive schemes: the economic, based on agency theory, and the behavioural, based on psychology and sociology. Nevertheless, Van Slyka (2006) is in conformity with Kunz and Pfaff (2002) and postulates that there is the potential for goal conflict between the wealth-maximising behaviour of the principal and the utility maximising behaviour of the agent. And CG issues are intrinsically linked to the "principal-agent problem", which exists because managers (i.e. the agents), in the absence of perfect information and effective sanctions, can thwart shareholders (i.e. principal) and pursue their own goals (Berle and Means, 1932). Stewardship theory, as cited by Davis et al., (1997a,b), considers this side, portraying individuals as stewards, intrinsically motivated to put the interests of the organization and stakeholders ahead of self-serving interests.

The other strand of the literature related to this paper is on the determinants of risk taking behaviour at commercial banks. In the exercise of their duties, bank managers may misrepresent or modify the reported earnings to investors in order to make their financial circumstances look better by domineering the discretionary portion of accruals. In general, accounting income is a barometer for evaluating financial reporting. Conversely, naive investors would misinterpret high reported earnings as being favourable news about bank health, and undervalue bank risk. If so, the discretionary portion of accruals should be negatively associated with the level of bank risk ("naive investor hypothesis").Imperfect information there fore lies at the heart of the concept the acquisition of reliable information. Even though, the ability of a firm to earn above-normal rates of return on its investment and operations does not imply market imperfections. 'It may only mean that the firm has monopoly power in the product markets and is able to earn (quasi) rents for a finite period' (Kothari, 2001).

In this study, we examine the association between earnings management at publicly traded commercial bank holding companies in Indonesia and particularly how corporate governance mechanisms affect earnings management. This study contributes to the growing body of literature and on-going discussion related to CG in the various ways. First, it extends the very limited research on the relation between CG and EM especially in Indonesia and provides a more comprehensive picture of this association. A large volume of reference in financial economics explores how banks carry out their unique roles and how firm-bank relationships have an effect on a firm's business (e.g., Rajan (1992), Fama (1985), Vesala (2007), and Diamond (1984)). More recently, Cornett et al. (2008) observe the impact of incentive-based compensation and corporate governance on firm performance in light of potential earnings management. They find that incentive-based compensation has a noteworthy impact on financial performance as considered by reported earnings. However, a number of theoretical elucidations on bank monitoring, however, little empirical confirmation is provided about their role (Ahn and Choi, 2008; Shleifer and Vishny, 1997). Second, this study is expected to examine anecdotal evidence suggesting that strong incentives are reluctant to avoid reporting earnings decreases. Third, our primary contribution to the literature is a comprehensive and econometrically defensible analysis of the relation between corporate governance and earning management behaviours by considering stewardship theory.

Data and methodology
Data
The dataset used in our study is limited to Indonesia-listed commercial banks for a five-year period (2011-2015). The corporate governance data were extracted from the Risk Metrics Group – the world's leading provider of proxy voting and corporate governance data services – which promulgates a Corporate Governance Quotient (CGQ) index employing openly accessible documents. This is an aggregate measure of corporate governance efficiency adopted by a number of previous scholars (Leventis and Dimitropoulos, 2012; Bauer et al., 2010; Brown and Caylor, 2009; Anderson and Gupta, 2009; Aggarwalet al., 2009; Epps and Cereola, 2008; Cornelius, 2005). Based on these references, a scoring act is conducted.

Testing for earnings management
In addition to loan loss provisions, previous studies have suggested that banks manage earnings through the realization of security gains and losses (Beatty et al., 2002; Moyer, 1990). Realized security gains and losses according to Cornett et.al. (2009) are a relatively unregulated and unaudited discretionary management action. If the person who is responsible for managing an organization choose to sell an investment security to increase or decrease earnings it is unlikely that auditors, regulators, or shareholders will subsequently take issue with the decision. Thus, realized security gains and losses represent a second way that management can smooth or manage earnings. Similarly, Jiang, et al., (2010) conclude that income from discretionary transactions (similar to our miscellaneous gains and losses variable) is realized to manage earnings. Finally, they find evidence that loan charge-offs, securities issuances, and dividends are all used to manage primary capital, and that the loan loss provision is used to manage earnings. Therefore, the challenge is to count a measure of discretionary loan loss provisions (DLLP) and discretionary realized securities gains and losses (DRSGL), or more specifically, a measure of earnings management (EM), We follow Cornettet al.(2009) model by running fixed-effects OLS regressions in order to calculate discretionary loan loss provisions.

$$\text{LOSS}_{it} = \alpha_t + \beta_1 \text{LASSET}_{it} + \beta_2 \text{NPLit} + \beta_3 \text{LLR}_{it} + \beta_4 \text{LOANR}_{it} + \beta_5 \text{LOANC}_{it} + \beta_6 \text{LOANI}_{it} + \varepsilon_{it}$$

Where LOSS is loan loss provisions as a percentage of total loans, LASSET is the natural log of total assets, NPL is the ratio of non-performing loans to total loans, LLR is loan loss allowance as a percentage of total loans, LOANR is real estate loans as a percentage of total loans, LOANC is the ratio of commercial and industrial loans to total loans, LOANI is consumer loans as a percentage of total loans, ε is error term. The discretionary component of loan loss provisions is the error term from the above regression. We standardize the error term by total assets and formulate our measure of discretionary loan loss provisions ($DLLP_{it}$) as:

$$DLLP_{it} = (\varepsilon_{it} \times LOANR_{it})/ ASSET_{it}$$

Where:

LOANS = total loans and,

ASSETS = total assets.

Furthermore, to estimate the discretionary realized security gains and losses ($RSGL_{it}$), we again follow regression model as used by Cornett et.al. (2009) by running fixed-effects OLS regressions:

$$RSGL_{it} = \alpha t + \beta_1 LASSET_{it} + \beta_2 URSGL_{it} + \varepsilon_{it}$$

Where RSGL is the realized security gains and losses deflated by total assets, LASSET the natural logarithm of total assets, URSGL the unrealized security gains and losses deflated by total assets. In the final stage in determining of earnings management is to estimate discretionary accruals. We run Yasuda et al.(2004) regression model to obtain the discretionary portion of total accruals. The regression model is:

$$ACCR_t = \alpha_1(1/TA_{t-1}) + \alpha_2(OI_t/TA_{t-1}) + \alpha_3(BRE_t/TA_{t-1}) + \varepsilon_t$$

Where ACCR is the total accruals estimated as the difference between net income and operating cash flows, TA is the total assets, OI is the change in operating income, and BRE is bank premises and equipment.

Empirical Results

Descriptive statistics of sample variables

Table I presents brief descriptive statistics comparing mean and median values of sample variables. According to the table I, it can be noticed that measurements of all variables to replicate the reality of conditions (practice worlds) place ranges from a smallest of 0.000 to a maximum of 7.283, with a tendency scale (mean) of 0.238 to 5.121. Such a wide range of value signifies that they closely tie to, and would be lopsided towards the proportion of observed characteristics imitated by the models. Furthermore, the skewness of 0.017 to 1.235, with a value range of standard deviation from 0.001 to 1.502, indicates that the distributions of the data-set are slightly right-skewed and peaked (leptokurtic) but it is close to be symmetrical and normal distribution. It means that the measurements implanted in this model can be proceeded with the next statistical analyses and specifically used to deal with the proposed research concerns, since they do augment a tendency to avoid over-simplify the uncertainty disturbing outcomes achieved.

Table I: Descriptive statistics of sample variables

Variables	Minimum	Maximum	Mean	Median	Skewness	SD
EM	0.005	3.452	1.538	1.810	0.017	0.861
EBT	0.000	1.011	0.402	0.606	0.142	0.005
CGS	1.060	3.662	1.332	1.841	0.702	0.501
SPOS	0.072	5.610	0.843	2.837	0.720	0.486
AUDQ	0.001	5.522	5.121	2.680	1.235	1.138
GR	0.091	1.263	0.838	0.675	0.230	0.001
SIZE	4.307	7.182	4.182	3.630	1.087	1.502
LEV	1.910	4.861	1.633	2.550	0.853	0.095
CAP	0.426	4.452	0.843	2.302	0.765	0.269
LLP	3.307	6.107	4.601	3.353	0.908	1.416
RSGL	0.623	5.821	1.838	2.761	0.682	0.185
ACCR	1.307	1.639	1.041	0.830	0.531	1.102
DACC	0.103	7.283	0.238	3.714	1.150	1.085

Note: This table presents the test of descriptive statistics of sample variables. EM is the metric of earnings management, predicted as the dissimilarity between discretionary loan loss provisions and discretionary realized security gains and losses, CGS is the general corporate governance score for each bank, SPOS is a dummy obtaining 1 if a bank's income deflated by total assets and 0 otherwise, EBT is earnings before extraordinary items and taxes, AUDQ is a dummy obtaining 1 when the bank is audited by Big-4 audit companies and 0 otherwise, GR is calculated for the ratio of market-to-book value of equity signifying enlargement opportunities, SIZE is the bank size, LEV is the leverage calculated for the ratio of whole money owing to common equity, CAP is the capital adequacy ratio, LLP is the ratio of loan loss provisions to total loans and RSGL is the ratio of realized security gains and losses deflated by total assets, ACCR is total accruals counted as net income minus operating cash flows deflated by lagged total assets, DACC is the discretionary accruals estimated from model as formulated by Yasuda Yasuda et al.(2004).

Pearson correlation coefficients of sample variables
The correlations of the main variables are reported in Table II. The Pearson correlation coefficients provide some evidence of the direction of the results. Consistent with predictions, SPOS is positively and significantly correlated with EM. EM is positively and significantly associated with earnings, EBT, at the 5 percent level, and negatively correlated with AUDQ and GR, although the correlations are insignificant. In addition, other variables are significantly correlated to EM and those sample variables moderately still consider economic sense. It should be pointed out that the reported models in this table are constructed in consideration of maximizing the number of observations rather than for a balanced sample, due to the limited available data and the purpose of maintain as large sample size as possible. Overall speaking, the correlations among the variables are not high indicating that there might be no serious multicollinearity problems existing.

Table II: Pearson correlation coefficients among the sample variables

Variables	EM	EBT	CGS	SPOS	AUDQ	GR	SIZE	LEV	CAP
EBT	0.001								
CGS	0.023	0.015							
SPOS	0.010	0.021	0.010						
AUDQ	-0.179	0.330	0.301	0.001					
GR	-0.521	0.015	0.182	0.025	0.027				
SIZE	-0.019	0.204	0.240	0.139	-0.013	-0.012			
LEV	0.112	0.420	0.624	0.112	-0.042	-0.743	-0.002		
CAP	0.007	0.005	0.170	0.040	-1.000	0.033	0.007	0.008	
DACC	0.131	0.010	0.010	0.011	0.500	0.031	-1.883	0.013	0.001

Note: the correlations of the main variables are reported in this table. Variable definitions: EM is the metric of earnings management, predicted as the dissimilarity between discretionary loan loss provisions and discretionary realized security gains and losses, CGS is the general corporate governance score for each bank, SPOS is a dummy obtaining 1 if a bank's income deflated by total assets and 0 otherwise, EBT is earnings before extraordinary items and taxes, AUDQ is a dummy obtaining 1 when the bank is audited by Big-4 audit companies and 0 otherwise, GR is calculated for the ratio of market-to-book value of equity signifying enlargement opportunities, SIZE is the bank size, LEV is the leverage calculated for the ratio of whole money owing to common equity, CAP is the capital adequacy ratio, common stockholders' equity plus qualifying perpetual preferred stock divided by risk-weighted assets, is used to measure the capital position of the sample banks. DACC is the discretionary accruals estimated from model as formulated byYasuda et al.(2004).

Main analysis
Table III presents the results of the earnings management and governance efficiency regression. In model 1, regression reports that the coefficient on the corporate governance index (CGS) negatively related to earnings management (-1.880) and have significant value at the 1 percent level. However, the sign of the relationship, not surprisingly, changes in the coefficient of EBT, where the coefficient on EBT, 0.741, is positively significant at the 5 percent level. Note that, banks with stronger ties between the effective corporate governance and better performing those might further diminish any aggressiveness of earnings management behaviour. Furthermore, by referring to control variables, SIZE is statistically significant with the negative coefficient value -0.019. This means that large banks are potentially associated with high levels of income reporting, for example by delaying writing off bad loans and increasing the recognition of securities gains when feasible. This finding is contrary with previous studies carried out by Cornnet et al., (2009); Leventis and Dimitropoulos, (2012). However, the coefficient on CAP, 1.746, is significant at the 1 percent level. This suggests that bank performance and earnings management are positively related to capital levels.

Table III: Statistical results of earnings management and governance efficiency

Variables	Model 1	Model 2	Model 3
Constant	0.021(0.42)***	0.026(2.89)***	0.036(2.79)***
EBT (α_1)	0.741(2.15)**	0.984(1.82)*	0.804(2.74)**
CGS (α_2)	-1.880(-2.91)***	-2.080(-2.75)***	-1.579(-3.77)***
CGS × EBT (α_3)	0.025(2.55)**	0.007(1.05)	0.019(3.14)***
SIZE (γ_1)	-0.019(-0.90)*	0.0047 (0.79)	0.028(0.45)**
GR (γ_2)	-0.078(-2.28)**	0.827(2.51)**	0.097(3.88)***
LEV(γ_3)	0.006(0.52)	0.001(0.29)	0.007(0.59)

AUDQ (γ_4)	0.082(5.23)***	-0.078(-4.19)***	0.012(3.61)***
CAP (γ_5)	1.746(2.79)***	-2.192(-2.88)***	1.442(3.27)***
Adj-R^2	54.9	48.9	51.3

Note: This table reports the results of running the following regression models:

Model 1: $SPOS_{it}=\alpha_0+\alpha_1 EBT_{it}+\alpha_2 CGS_{it}+\alpha_3 CGS_{it}+EBT_{it}+\gamma Control_{it}+\delta Year\ dummies+\varepsilon_{it}$

Model 2: $EM_{it}=\alpha_0+\alpha_1 EBT_{it}+\alpha_2 CGS_{it}+\alpha_3 CGS_{it}+EBT_{it}+\gamma Control_{it}+\delta Year\ dummies+\varepsilon_{it}$

Model 3: $DACC_{it}=\alpha_0+\alpha_1 EBT_{it}+\alpha_2 CGS_{it}+\alpha_3 CGS_{it}+EBT_{it}+\gamma Control_{it}+\delta Year\ dummies+\varepsilon_{it}$

Where EBT is earnings before extraordinary items and taxes, CGS is the general corporate governance score for each bank, CGS×EBT is the interaction term between CGS and EBT, SIZE is the bank size measured as the natural logarithm of the amount of total assets as at the end of the reporting period. GR is measured as the ratio of market-to-book value of equity indicating growth opportunities, LEV is the leverage measured as the ratio of total debt to common equity, AUDQ is a dummy set to 1 where if the bank is audited by Big-4 audit companies (PwC, KPMG, Delloitte & Touche, Ernst& Young) and 0 otherwise, CAP is the capital adequacy ratio.

* Significant at better than the 10% level.

** Significant at better than the 5% level.

*** Significant at better than the 1% level

Further, in model 2, as also presented in table 3, is our second experiment on earnings management which is based on the difference between discretionary realized security gains-losses (DRSGL) and discretionary loan loss provisions (DLLP). The coefficient on the general corporate governance score (CGS) variable is -2.080, statistically significant at the 1 percent level. This indicates improved governance efficiency might worsen the distance between DRSGL and DLLP (earnings management). Otherwise, the coefficient on EBT, 0.984, is positive and highly significant. Thus, banks with high levels of income – more lucrative banks – are likely to engage in earning management practice. Not surprisingly, the greater the value of CGS × EBT, the less malpractice in earning management and the more profitable would be the bank. As reported in Model 2 of Table 3, the interaction term CGS × EBT has a positive and significant coefficient. The control variables that are significant take the expected signs. For example, GR is positively related to earnings (the coefficient is 0.827, significant at 5 percent), and CAP is highly negatively related to earnings (the coefficient is -2.192, significant at 1 percent Thus, when a banks' market value is relative high to its book value the firm, the holding (book value) capital ratio falls. In other words, larger banks are well known to hold less capital to finance their assets.

In the last test, the estimation of the third model of Table 3 found similar results compared to the other two models. The CGS coefficient was found negative (-1.579) and statistically significant at 1 percent, signifying that banks with improved governance quality report earnings of enhanced quality having smaller discretionary accruals. Generally speaking, control variables in model 3, the coefficient on SIZE is statistically not significant with the coefficient value (0.028), and in other hand, as we expected that the coefficient on AUDQ was found positive (0.012) and significant at 1 percent. This means that banks audited

by Big-4 audit firms are unlikely to take opportunities for managing earnings.

Discussion and Conclusion

The recent study can be considered as alternative measures of corporate governance. The results of the paper suggest that the flawed governance structure at bank holding companies does indeed have an effect on the actions of bank managers to potentially manage earnings smoothing. Specifically, corporate governance plays at least some role in earnings and earnings management at large Indonesian banks. A bank's management has discretion with respect to the size of loan loss provisions as well as realized security gains and losses recorded in any period. Hence, during periods of low profit in other areas of the bank, management can smooth earnings by delaying reporting loan losses and increasing the realization of securities gains. Management discretion in these areas implies that management of commercial bank earnings can impact a bank's performance, cash flows, market value, and capital adequacy. Indeed, despite monitoring and oversight by regulators a bank's reported loan loss provisions and realized securities gains and losses are largely under the control of its managers. Rather than unwaveringly smoothing earnings, managers can use discretion to attain their own goals (i.e., to increase performance based compensation) by putting constant upward pressure on reported earnings, which runs counter to regulators' desires (i.e., earnings management can be used to artificially inflate reported capital adequacy ratios).

Surprisingly, those results explaining behaviours of Indonesia banks' managers are categorised as unethical conducts in reporting financial statement. Recent studies have shown that top managers' compensation is linked to firm performance, which is correlated to greater earnings management (Cornett, et al., 2009; Jiang, et al., 2010). More importantly, managers may manage current earnings upward at the expense of future earnings in order to ensure job

security (DeFond and Park, 1997). Nevertheless, some prior studies provide evidence that changes in top management provide incentives for income-decreasing earnings management. New managers are more likely to engage in income-decreasing earnings management in order to take a "big bath", thus increasing their chances of earning a bonus in the subsequent period (Man et al., 2013).

More significantly, it is more likely that bank with losses or inconsistent earnings growth would be more incentivized to manipulate earnings, as they could gain more utility from management (prospect theory) and might also diminish transaction expenditure with stakeholders, as the terms of transactions tend to be more favourable for bank with higher or positive earnings. This is also overarching to note that earnings management could take place because of loan loss motives. This findings parallel with prior studies as carried out by Beaver and Engel, (1996); Beaver, et al, (2003); Barton, (2001); Bushee, (1998). They have shown that some firms use hedging activities to manage earnings smoothing. These results imply that for a firm with a bank loan, bank monitoring plays an important role in constraining a firm manager's opportunistic financial reporting behaviour.

In response to managers' earning management tactics, according to one of major economic theories explaining managers' behaviours: stewardship theory, powerful managers naturally do not engage in more self-interested behaviours that may hurt the firm and stockholders (Francoeur et al., 2017), and are intrinsically motivated to pursue organizational goals (e.g. Donaldson and Davis, 1991; Davis et al., 1997a; Boivie et al., 2011; Lange et al., 2015). However, in these cases, stewardship theory provides little help in shedding theoretical light on, and even has no ability to explain agent's opportunistic behaviours within a bank. Therefore, investors must take into account the efficiency of each bank's corporate governance and demand supplementary information in order to reach a proper investment decision when earnings are not highly informative. A key prescription of the study is for principals to minimize the likelihood of earnings smoothing by imposing sophisticated corporate governance which is coalesced with auditing conducted by reputable audit companies. However our results are subject to the sensitivity of the public CGS index. Therefore, future research to avoid repetitive or narrowly designed study with often predictable results can extend the current findings by taking into account how well-organized governance apparatus augment the superiority of accounting information – with or without the presence of a culture of fraud.

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