

Voluntary Disclosure and Earnings Management at Bank Companies Listed in Indonesia Stock Exchange

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The objective of this research is to empirically investigate whether voluntary disclosure affects earnings management at the banks which is listed in Indonesian Stock Exchange. Bank is more regulated industry Indonesia by Bank Indonesia (Central Bank). Mandatory disclosure is the minimum disclosures that must be disclosed. Voluntary disclosure is a disclosure beyond which is required. This disclosure is a free choice of management of company to provide accounting information and other information considered relevant for users to make decision. Sample of this study is bank companies which are listed in Indonesia Stock Exchange. This study use purposive sampling to collect data. There are 145 observations. Analysis of the data used in this study is the multiple linear regressions to examine the influence of voluntary disclosure on practice of earnings management practices. The result of this study is voluntary disclosure negatively affects earnings management. The result indicates that more increased voluntary disclosure influences more decreased earnings management. Therefore, voluntary disclosure is very important for users of financial statements.

Keywords: voluntary disclosure, earnings management, financial statement, bank

Banking Phenomena in Indonesia

Case of Bank Century gives learning for many parties in Indonesia about how to manage company properly and correctly. The case demonstrates the weakness of governance at the company. News in Kontan Online on Friday, June 12, 2009, stated the role of Robert Tantular as the controlling shareholder of Century Bank on disbursement of bank credit to two companies namely PT Wibowo Wadah Rezeki and PT Accent Investment Indonesia. The companies are still affiliated with him.

“Until now, they are unable to pay interest”, said Monalisa Suratman, Head of Region II of Century Bank in testimony on Court in Central Jakarta on Thursday (11/6). PT Wibowo had gotten credit Rp 121.3 billion in December 2007. The company could not pay starting in June 2008. PT Accent had gotten credit Rp 60 billion in April 2008. According to Kontan Online, Monalisa signed Credit Application Form without properly credit analysis according to Banking Act. Her testimonies suggest that the credit disbursement is not in accordance with good banking procedures.

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Based on this case, banks in Indonesia should improve the information either required or not required for the users. The users need more information than just information published in financial statement. Therefore, the bank should provide other information in form of annual financial reporting. The information is disclosed in the report which can be grouped into mandatory disclosure and voluntary disclosure. Voluntary disclosure is more disclosures than required. It will inform to the public about the company's performance. In such cases, management may be able to choose and apply accounting methods that are not misleading for its users. It explains that management can use his/her discretionary to provide properly information to users.

This study aims to investigate empirically whether voluntary disclosures affect earnings management. The motivations of this research are: First, the case of Century Bank. Second, capital market regulator has set rules regarding mandatory disclosure. Third, the banking companies have various regulations set by Bank Indonesia as central bank of Indonesia. The regulations encourage the banking to provide more information than nonbank. The regulation is expected to prevent a bad earnings management in the banking. Fourth, there is still little research in Indonesia researching on this topic by using banks as samples in Indonesia.

The remainder of this paper is organized as follows. In section 2, this paper discusses the relevant literature and hypothesis development. In section 3, this paper explains research method. Section 4 will provide the results of hypothesis test. The final, section 5 will explain conclusions of this research.

Theory and Hypothesis

An Agency-Creditor/Debtor Relation

Control of the banking is not only the shareholders, but control is also conducted by the creditors or investors or depositors. In banking terms it is called market discipline. While from the agency perspective it can be explained through a debt-agency relationship. The use of debt by banks would be a tool for managers to work hard to avoid the bankruptcy risk.

Agent-Regulator Relations

The role of Bank Indonesia is a regulator to lead agency relationship in banking companies become more complex. Regulator as external influences decisions of bank management. Therefore, shareholders and managers will also pay attention to regulatory compliance. Moral hazard arises as information asymmetry. Moral hazard can occur if one or more parties who hold business transaction observing their actions in the settlement of their transactions, while the others do not.

Regulators Control the Banking Companies

Bank Indonesia as the central bank and a regulator for commercial banks has authority and supervision arrangements as follows:

- (1) The authority to establish licensing procedures and the establishment of banks;
- (2) The authority to establish provisions concerning aspects of the business and banking activities in order to create a good banking system;
- (3) The authority to oversee supervises banks through direct and indirect supervision;
- (4) The authority to impose sanctions if the bank did not meet regulatory requirements.

Transparency of Financial Condition

To control banking, Bank Indonesia emphasizes transparency in the financial condition of commercial

banks. Bank Indonesia requires banks to prepare financial statements in accordance with Indonesia-GAAP which are relevant for the banking industry, Indonesian Banking Accounting Guidelines, and other guidelines issued by Bank Indonesia. Banks are required to publish financial statements monthly, quarterly, and annually to Bank Indonesia and released publicly. Each quarter, banks are required to prepare transaction report which is related parties and provision funds. The parties have a special relationship.

Information Asymmetry

Information asymmetry is a condition describing that managers have access to information on the company's prospects which are not owned by outside parties. Previous research is conducted by Richardson (1998). Richardson (1998) suggests a link between information asymmetry with earnings management. When asymmetry is high, stakeholders do not have sufficient resources or access to relevant information to monitor manager's actions. It leads to creation of opportunities for earnings management practices.

Earnings Management

In the Western, some researchers suggest that manager inform the future financial condition by using discretionary accruals. It has been proved empirically by several researchers such as Wahlen (1994), Beaver and Engel (1996), Liu, Ryan, and Wahlen (1997), and Ahmed, Takeda, and Thomas (1999).

Wahlen (1994) finds that bank managers increase the discretionary components of unexpected loan loss provisions when having good prospect of future cash flow. Investors interpret the components of loan loss provisions as good news. This is shown by a positive relationship between provisions and stock returns and future cash flow.

Beaver and Engel (1996) find that the non-discretionary components in the banking industry such as reserves for loan losses valued negatively by the capital market. Components such discretionary reserves for loan losses are positively valued by the capital market. These results indicate that discretionary accruals can be signaling the company's performance in the future than non-discretionary accruals.

Liu, Ryan, and Wahlen (1997) investigate valuation implications of discretionary accruals by focusing whether increased discretionary loan loss provisions seen as good news. Liu, Ryan, and Wahlen (1997) show the discretion leading loan loss provisions as good news. It is showed by a loan loss provisions affecting positively stock returns.

Ahmed, Takeda, and Thomas (1999) investigate the use of loan loss provisions by bank managers for signaling information about future earnings. Ahmed, Takeda, and Thomas (1999) find coefficient of discretionary loan loss provisions has a positive and significant impact on market value equities. Ahmed, Takeda, and Thomas (1999) assert that the discretionary component of loan loss provisions contain relatively good news compared to non-discretionary components.

In Indonesia, some researchers such as Setiawati and Na'im (2001), Rahmawati (2006), and Rahmawati and Baridwan (2006) show that banks in Indonesia manage earnings to meet the regulations of Bank Indonesia. Setiawati and Na'im (2001) suggest that financial statements managed will distort the allocation of funds. Bank is an industry based on trust. Investors will not trust the bank because its financial statements mislead its users. For example, earnings management is conducted by the management only to meet the requirements of Bank Indonesia.

The phenomenon of earnings management in Indonesia has been found by several researchers such as

Sanjaya (2011). Sanjaya (2011) finds that the controlling shareholder to manage earnings. Sanjaya (2011) shows the higher agency problem within company leads the higher earnings management. However, the sample in Sanjaya (2011) is limited to manufacturing industries listed in Indonesia Stock Exchange.

Detection of earnings management in the financial statements of banking companies is calculated using an empirical model based on accrual earnings management specific. In the model of loan loss provisions (Beaver & Engel, 1996), allowance for accounts receivable which is estimated as the regression residual costs from the elimination of losses of receivables is used as a proxy for earnings management. This model is the most accurate model to detect earnings management in corporate banking (Rahmawati, 2006).

Disclosure Information

According to Suwardjono (2008), conceptually the disclosure of information is an integral part of financial reporting. Technically, the disclosure is the final step in the process of accounting to present information in the form of a full set of financial statements. The information is disclosed in annual reports which can be grouped into two general categories mandatory disclosure and voluntary disclosure.

Mandatory disclosure is the minimum disclosures that must be disclosed and compulsory as according to the regulations. The rule regarding mandatory disclosure in annual reports is issued by the Government of Indonesia (Capital Market Supervisory Agency and Financial Institution Kep-38/PM/1996). It is further amended by decision of chairman of the Capital Market Supervisory Agency and Financial Institution Kep-134/BL/2006. Voluntary disclosure is a disclosure beyond that required. This disclosure is a free choice of management to provide accounting information and other relevant information to make decision by users (Meek, Clare, & Gray, 1995).

Hypothesis Development

Financial statements are prepared by management to provide useful information for its users. But the practice of earnings management performed by the management can make information in financial statements to be misleading. Earnings management in banking arises because there is information asymmetry and accrual basis in the preparation of financial statements.

The increasing on presentation of voluntary disclosure, information asymmetry can be reduced so that earnings management can be prevented. Previous research conducted by Rahmawati, Suparno, and Qomariyah (2007) shows that the asymmetry of information in banking positively influences on earnings management. Research conducted by Halim, Meiden, and Tobing (2005) about the impact of earnings management at the level of disclosure of financial statements of manufacturing companies. Halim, Meiden, and Tobing (2005) shows that level of disclosure negatively affect on earnings management.

Researchers suppose that the increasing voluntary disclosure can reduce earnings management in banking. There is strict supervision in the business. Operationally the business is supervised by Bank Indonesia as the central bank of Indonesia. Therefore, the bank will prepare a lot of information to the public. They also show themselves to the public that they do not manipulate the financial statements. To prove the estimate, researchers formulate hypotheses as follows:

H_a: Voluntary disclosure negatively affect on earnings management.

Research Method

Sample

Period of this study is from 2005 to 2009. Purposive sampling is used to collect data. There are 29 banks to become samples on this study. The data are obtained from financial statements, annual reports, and stock price data banking companies listed on the Indonesia Stock Exchange during 2005-2009.

Variables and Measurement

Earnings management is a dependent variable of this study. Loan Loss Provision (LLP) discretionary earnings management in banking is calculated using empirical models of specific accruals-based earnings management.

The basic model of earnings management using the allowance for losses is as follows. Reported LLP = LLP nondiscretionary + LLP discretionary. Discretionary LLP is earnings management proxy. Discretionary LLP is a residual between the reported LLP and LLP non-discretionary. Analysis of earnings management using the LLP will be done in three steps.

Step 1: Linear regression to obtain the required value of β in calculating the value of discretionary LLP through the following equation.

$$LLP_{i,t} = \left[\frac{LOAN_{i,t}}{TA_{i,t}} \right] + \left[\frac{CLOAN_{i,t}}{TA_{i,t}} \right] + \left[\frac{NPL_{i,t}}{TA_{i,t}} \right] + \left[\frac{CNPL_{i,t}}{TA_{i,t}} \right] + \left[\frac{PD90_{i,t}}{TA_{i,t}} \right] + \left[\frac{CO_{i,t}}{TA_{i,t}} \right] + \left[\frac{CCO_{i,t}}{TA_{i,t}} \right] + \varepsilon_{i,t}$$

Step 2: Calculate the value of LLP non-discretionary through the following equation.

$$LLPnd_{i,t} = \beta_1 \left[\frac{LOAN_{i,t}}{TA_{i,t}} \right] + \beta_2 \left[\frac{CLOAN_{i,t}}{TA_{i,t}} \right] + \beta_3 \left[\frac{NPL_{i,t}}{TA_{i,t}} \right] + \beta_4 \left[\frac{CNPL_{i,t}}{TA_{i,t}} \right] + \beta_5 \left[\frac{PD90_{i,t}}{TA_{i,t}} \right] + \beta_6 \left[\frac{CO_{i,t}}{TA_{i,t}} \right] + \beta_7 \left[\frac{CCO_{i,t}}{TA_{i,t}} \right]$$

Step 3: Calculate the value of discretionary LLP in the following equation.

$$LLPd_{i,t} = LLP_{i,t} - LLPnd_{i,t}$$

Voluntary disclosure is an independent variable of this study. Extensive voluntary disclosures are measured by total score. Mandatory disclosure has been governed by the Chairman of the Capital Market Supervisory Agency and Financial Institution Kep-38/PM/1996 which is further amended by Capital Market Supervisory Agency and Financial Institution Kep-134/BL/2006. If the annual report contained disclosure exceeds mandatory disclosure, the company is getting a score. It will obtain a total score on each company's voluntary disclosure sample.

Score for voluntary disclosure on this study is limited to voluntary disclosures relating to accounts receivable and allowance for losses. As earnings management is calculated using accrual-specific models that specifically highlight the accounts receivable policy.

To measure voluntary disclosure in the period of 2005-2006, this study refers to the Chairman of the Capital Market Supervisory Agency and Financial Institution Kep-38/PM/1996. As for the broad measure voluntary disclosure of the sample firms in 2007-2009, this study refers to the Capital Market Supervisory Agency and Financial Institution Kep-134/BL/2006.

Results

Descriptive Statistics

In Table 1 the numbers of observations in this study were as many as 125 observations. The number of

observations was obtained from 29 companies in the period of 2005-2009. The mean value of discretionary loan loss provision is positive. It means that there is an indication of earnings management.

Table 1

Results of Descriptive Statistics

	No.	Minimum	Maximum	Mean	Std. Deviation
Discretionary loan loss provision	125	-0.0909	0.0511	0.0039	0.0302
Voluntary disclosure	125	2	6	4.4320	0.9447
Variance of cash flow	125	3,407	13,505,725	1,092,911.2160	1,931,871.9532
Growth of company	125	-780,032	3,398,441	405,327.5280	778,976.1865
Debt to equity ratio	125	-32	35	9.8240	5.5953
Size	125	40,272	118,381,026	12,025,200.8480	23,030,118.5431
Market to book value	125	-6,267,279	8,887,451	1,571,437.4320	1,785,256.5642

Test of Hypothesis

Based on the analysis in Table 2, the results show that value of variable voluntary disclosure is significant and negative at alpha 1%. The results confirm the negative effect of voluntary disclosure on earnings management. It shows the increasing in voluntary disclosure will reduce earnings management occurred in banking.

Based on the analysis, the research hypothesis is supported. The results support the role of disclosure. The disclosure will prevent and reduce the opportunity for managers to make mistake.

Fraudulent will be detrimental to the users of the information provided by the company. Therefore, Capital Market Supervisory Agency and Financial Institution and Bank Indonesia should introduce legislation again to renew the disclosures required by banks. Controlling by Bank Indonesia to commercial banks in Indonesia is really done because it can prevent and reduce mismanagement of business practice.

This mismanagement will affect the people especially for the depositors in the bank. The investors in these banks will also have a negative impact. A concrete example that occurred in Indonesia according to Solomon (2010, p. 222) is diverted funds case managers in order to finance a political party in the Indonesian PT Bank Bali, between 1997 and 1998. Further, group managers transferred the currency losses from a manufacturing company to a group-controlled bank in the Sinar Mas Group between 1997 and 1998. PT Bank Century is the cases in 2009 which is still much talked until now. One of cases is the disbursement of credit to the two companies which are still affiliated with the controlling shareholder.

Table 2

Regression Result

Predictor	Coefficient	t-statistic
Voluntary disclosure	-0.010	-3.748***
Variance of cash flow	1.4E-009	0.826
Growth	1.91E-009	0.356
Debt to equity ratio	0.000	0.875
Size	5.02E-011	0.283
Market to book value	-7.9E-010	-0.542

Notes. *** Significant at the 1% level. $Discretionary\ loan\ loss\ provision_{it} = \alpha + \beta_1 Voluntary\ disclosure_{it} + \beta_2 Variance\ of\ cash\ flow_{it} + \beta_3 Growth_{it} + \beta_4 Debt\ to\ equity\ ratio_{it} + \beta_5 Size_{it} + \beta_6 Market\ to\ book\ value_{it} + e$.

Based on the facts and the empirical results, this study indicates the importance of encouraging banks to

disclose the business practices. This disclosure will describe the seriousness of the government and private sector to implement good corporate governance for investor protection and the public from bad business practices.

Conclusion

This study concludes that voluntary disclosure significantly and negatively influence on earnings management of banking companies in Indonesia. Negative direction means that an increasing of corporate voluntary disclosure will reduce opportunity to manage earnings.

This study has several limitations. First, this study does not classify the pattern of earnings management (taking a bath, minimization income, income maximization, and income smoothing) used by the companies in the study. Second, the study can not detect with the detailed regulations of Bank Indonesia and the Ministry of Finance which have a significant effect on the earnings management.

This research can be developed by subsequent researchers to consider the pattern of earnings management which is carried out. The next researchers can investigate the other forms of earnings management such as real activity or core shifting. Core shifting is interesting to be studied in banking because the management has opportunity to shift the post of non-core to core or vice versa.

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