The Effect of Board of Directors on Financial Performances Through Earnings Management In Islamic Banking

An Empirical Study of Indonesia and Pakistan

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***Abstract*—This study aims to determine the effect of a board of directors on financial performances through earnings management in Islamic banking: an empirical study of Indonesia and Pakistan. This research was conducted in the context of comparative countries. Using a quantitative approach with Partial Least Square test equipment, these variables will be tested with the Structural Equation Model (PLS-SEM) model. The samples used in this study were twelve banks registered in the Financial Services Authority and five banks registered in the State Bank of Pakistan (SBP) from 2015 to 2020. The result of this study indicates the board of directors has no effect on earnings management and financial performance in Indonesia. Meanwhile, the board of directors has a positive effect on earnings management and financial performances in Pakistan. Empirical evidence for Indonesia, earnings management can mediate the effect of the board of directors. This result contradicts with Pakistan earning management is not able to mediate this effect.**

Keywords—The Board of Directors; Earnings Management; Financial Performances

I. Introduction

The development of Islamic banking has become a benchmark for the successful existence of the Islamic economy globally, especially in Muslim countries over the past thirty-five years [1]. This development is marked by a significant new phenomenon, namely the growth of Islamic banking assets reaching the level of 13%-25% in the last five years. Although globally Islamic banking often experiences a decline in financial performance compared to conventional banking [2].

Financial performance proxied by the ROA can provide an overview of a bank's financial performance [3]. The development and growth of the financial performance calculated by the ROA of Islamic banking in five countries, namely Malaysia, Indonesia, Pakistan, Saudi Arabia and Pakistan in the last five years (2016-2020) are shown in the following figure 1.1.

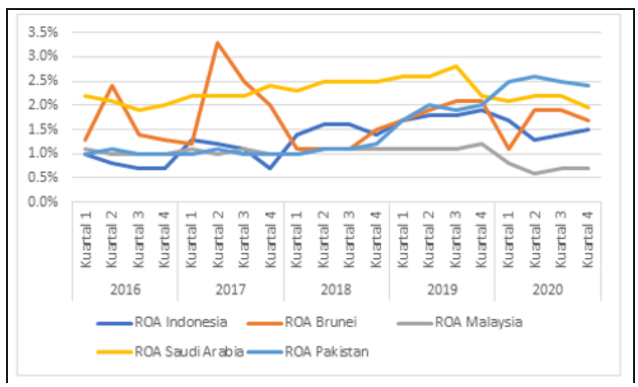

Figure 1.1 ROA Comparison in Islamic Banks (*Source: IFSB,2021)*

Referring to figure 1.1 at the beginning of 2020, Pakistan's financial performance is very good and still dominates the Islamic banking industry where Pakistan is the center for Islamic banking in other Muslim countries. As seen in the first quarter of 2017, Pakistan's ROA was only 1.2% while Indonesia managed to obtain a ROA of 1.3% in the same year, Saudi Arabia managed to become the country that had the most consistent ROA because it was in the range of 2.2% to 2.4%. Pakistan continued to strive to improve its financial performance, and was evidenced by the very rapid increase in ROA that even outperformed Saudi Arabia with a ROA of 2.6%, of course, it had exceeded the limit of the healthy ROA value of Islamic banking. This reversed in Indonesia,

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throughout 2016 to 2020, the highest ROA of Bank Syariah Indonesia was only 1.5% and finally ROA Indonesia was successfully overtaken by Bank Syariah Pakistan.

There is an interesting fact if we do head to head between the two banks that have a similar organizational structure composition between Bank Muamalat and Bank Islamic Pakistan Limited. Bank Muamalat with a total audit committee of 4 people, a board of directors of 7 people, and DPS as many as 3 people, only managed to obtain a ROA of 0.14% in 2016. Islamic Pakistan Limited managed to record a ROA of 2.14% and was in the top three positions of all Islamic banks in Pakistan. If you look at it, Islamic Pakistan Limited has a similar composition to Bank Muamalat and differs by only one person on the number of directors with 8 people. However, Islamic Pakistan Limited can remain consistent in scoring ROA. Even in 2020, Islamic Pakistan Limited managed to get a ROA of 3.7% and occupied the position of one of all Islamic banks in Pakistan.

Among a number of factors that can affect the financial performance of Islamic banking, one of them is Good Corporate Governance (GCG). Banks must have a strong commitment to ensuring that good governance practices are part of the lifeblood of daily activities. In this context, banks are expected to get a maximum profit because profit is a key indicator of success. Given that profit is generally used as an indicator of management success, the manager may have a strong intention to carry out various means that will positively affect the reported profit. Profit management is one of the possible ways to influence profits [4].

This is proven by various empirical studies, [5] which state that GCG and management are related to the company's financial performances. Likewise, [4] and [6] found that the relationship between GCG and Profit management was in line with the company's financial performances. Meanwhile [7] found that the implementation of the company's GCG will change the point of view of financial reporting based on the results of existing observations compared to existing accounting standards. This has an impact on the difficulty of analyzing financial statements and will hinder the evaluation process.

The literature on profit management and financial performance in the banking industry has been studied previously. However, there is still little research that examines the profit management of Islamic banks. Based on the background, existing phenomena, and various results of previous research, the authenticity of the research is based on the authenticity of the empirical model. The authenticity of the empirical research model in this study is profit management as an intervening variable in the relationship between profit management and variables that affect financial performances. This is different from previous studies which generally emphasize the causal correlation of profit management and financial performance into endogenous variables as well as exogenous variables.

II. Literature Review

A. Theoretical Review

1) Agency Theory

Agency theory is the basis that underlies the company's business activities that have been used. Agency theory explains the difference in facts obtained between the agent and the principal [8]. Management tends to have more facts about the company's prospects and future, especially information about operations than shareholders as a result of which information asymmetry and conflicts of interest arise between the two. Agency action is a form of profit management [9]

2) Stakeholder Theory

Stakeholder theory describes that managers are obliged to meet the needs of partners rather than building company estimates for the stakeholder support [10]. Therefore, it is necessary to account for company management to stakeholders in the form of CSR activities and financial performances.

3) The Board of Directors

The board of directors is a corporate body that has full external responsibility for the benefit of the company in accordance with the purposes and objectives of the company and formally representing the company in court and in an Association Legislation court. Therefore, the BOD is the owner of the company and acts on behalf of the company.

4) Earning Management

Earnings management is a deliberate attempt by management to manipulate financial statements to the extent permitted by accounting standards [11]. The result that will occur if management practices continue to be carried out is the disclosure of financial statement information that does not reflect the actual facts [12].

5) Financial Performance

The success of a company to manage and control resources is a definition of financial performance. Financial performance can be measured by analyzing the annual report using a financial index [5]. Financial performance evaluation activities are carried out taking into account profitability and efficiency. Return on assets (ROA) is used as a measure of profitability. ROA focuses on the company's ability to make a profit from its operations. The higher the ROA, the higher the return and therefore the better the financial performance [13].

B. Framework

Based on the theoretical foundation, the description of the previous research and the research hypothesis, the authors build a conceptual framework as shown in figure 2.1:

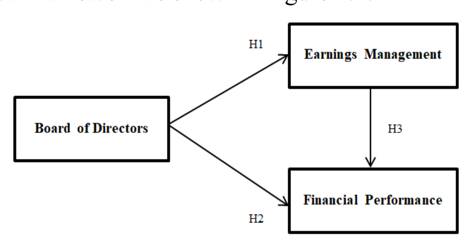

Figure 2.1 Framework (Source: the developed study)

C. Hypothesis

The Effect of Board of Director on Earnings Management

The board of directors is responsible for determining the short-term and long-term direction of the company's resource policies and strategies [14]. The BOD of any organization plays an important role in internal governance mechanisms for resolving agency conflicts by effectively mitigating profit management practices. In addition, the BOD is an integral part of the worldwide corporate governance system [15]. This is in line with research [16], [17] and [18].

H1: The board of directors has an influence on profit management

The Effect of Board of Director on Financial Performances

The board of directors decides which policies the company should implement long-term and short-term. In order for the implementation of the duties of the BOD to be effective, an independent composition of the BOD must be fulfilled so that the selection of decisions is right. The decisions made and taken by managers can be viewed as an overview of the company's performance at that time. This is in line with studies [19], [20] and [21] that state something similar.

H2: The board of directors has an influence on financial performances

The Effect of Earnings Management on Financial Performances

Profit management is a choice available to managers when choosing policies or accounting methods, therefore, often profit does not reflect the real profit, even though the resulting profit is a benchmark for estimating financial performance. This is one of the reasons for profit management. Profit management actions can degrade the quality of information related to profit. Research by [22] and [4] concluded that profit management actions can degrade financial performance.

H3: Profit management has an impact on financial performances

The Effect of Board of Directors on Financial Performances Mediated by Earnings Management

Good internal governance is proposed as an effort to improve company performance by monitoring management performance and ensuring accountability in accordance with regulations. Interested parties prepare financial statements as desired. This is prevalent and considered to be closely integrated into management as a result of weak supervision and regulation of the application of accounting standards. Therefore, one party is needed to monitor and control to prevent fraud [23].

H4: The board of directors has an influence on financial performances mediated by the profit management.

III. METHOD OF RESEARCH

A. Research Design and Data Analysis

This research is categorized as quantitative research, namely research that utilizes panel data in the form of data sets in the form of time series and cross sections [24]. With this quantitative method, it would be able to show the relationships that occur between the variables contained in this study. Moreover, this study used data in the form of numbers so it was very suitable for research using quantitative methods. As for data analysis and data testing, this research used PLS-SEM.

B. Population and Sample Reserach

Islamic commercial banks in Indonesia and Pakistan were research populations. Meanwhile, purposive sampling was a technique for taking samples. The following are the criteria: (1) BUS recorded at the Financial Services Authority and The SBP from 2015 to 2020, (2) BUS had published the annual report of BUS Indonesia and Pakistan and there were research variables in the annual report, (3) During the research period, BUS was still recorded and did not experience delisting (unregistered) from the OJK and SBP.

IV. RESULT AND DISCUSSION

A. Model Fit

Table I. Model Fit

Quality Indices	Result	*P-values*	Status	Result	*P-values*	Status
	Indonesia			Pakistan		
APC	0.150	0.047	Fit	0.247	0.034	Fit
ARS	0.128	0.065	Not Fit	0.401	0.003	Fit
AARS	0.084	0.117	Not Fit	0.323	0.012	Fit
AVIF	1.194	-	Fit	1.094	-	Fit
AFVIF	1.300	-	Fit	1.612	-	Fit
GoF	0.358	-	Fit	0.633	-	Fit
SPR	0.857	-	Fit	0.857	-	Fit
RSCR	0.995	-	Fit	0.978	-	Fit
SSR	0.857	-	Fit	0.714	-	Fit
NLBCDR	1.000	-	Fit	0.929	-	Fit

Source: Dataprocessed, 2022

B. Modeling Analysis and Hypothesis Testing

1) Direct Effect Hypothesis Testing

Table II. Direct Effect

Hypothesis	Construct	Path Coef.	P-Value	Information
Indonesia				
H1	X->Z	0.043	0.357	Rejected
H2	X->Y	-0.160	0.079	Rejected
H3	Z->Y	-0.301	0.003	Accepted
Pakistan				
H1	X->Z	-0.418	0.004	Accepted
H2	X->Y	0.604	<0,001	Accepted
H3	Z->Y	-0.203	0.114	Rejected

Source: Output WarpPLSVer. 7.0, 2022

2) Indirect Effect Hypothesis Testing

Table III. Indirect Effect

Hypothesis	Construct	P-Value	Information
Indonesia			
H4	X -> Z -> Y	-0.013	Mediated
Pakistan			
H4	X -> Z -> Y	-0.085	Unmediated

Source: Output WarpPLSVer. 7.0, 2022

The Effect of Board of Directors on Earnings Management

Statistical analysis shows that hypothesis 1 is rejected for Indonesia. This is in contrast to what happened to the Pakistani state which states that hypothesis 1 is accepted. The board of directors of Pakistani Islamic banks has 8 to 13 members of the BOD. Meanwhile, Indonesia has an average of 3 to 7 people because based on POJK NUMBER 55 / POJK.03 / 2016 banks are required to have at least 3 members of the BOD [25]. This evidence suggests that a larger size of the BOD can reduce profit management practices. According to regulations in the Syariah Governance Framework for Islamic Banking Institutions issued by the SBP that the board of directors is responsible for ensuring the full conformity of the operations of Islamic banks with the principles of Syariah. To that end, the BOD shall introduce effective mechanisms including careful oversight of the functions of the framework and compliance with SBP fatwas, instructions, and guidelines [26]. Based on the above SBP rules, the BOD of Pakistan Islamic banks carries out very strict supervision, especially on Syariah compliance in accordance with existing regulations so that it has an impact on reducing profit management behaviours.

The Effect of Board of Directors on Financial Performances

Statistical analysis shows that hypothesis 2 is rejected for Indonesia. The number of members of the BOD will affect the difference in the characteristics of the company in the level of effectiveness of each BOD in producing less optima resource management performance [27]. Meanwhile hypothesis 2 is accepted for Pakistan where the BOD is obliged to formulate the operational policy of the company. If the number is relatively large, his decisions set are not only focused on one party. Generally, many directors realized by the placement of each director in a specific area that each manager controls. Therefore, the director has more obligations and authority to focus on being able to improve the company's performance.

The Effect of Earnings Management on Financial Performances

Statistical analysis shows that hypothesis 3 is accepted for Indonesia. This means that the influence resulting from profit management practices has an impact on reducing the financial performance of Islamic banks in Indonesia. This is in contrast to what happened to the Pakistani state where profit management does not affect financial performances. Good financial performances will reduce the risk of profit management practices. In Pakistan, Islamic banks are the only major financial institutions. Pakistan has changed their financial system entirely to a banking system that runs on the basis of Islam, which is set out in the constitutions of each country. Pakistan has chosen Islamic Banking as a constitutionally legitimate banking system [28]. In addition, many other factors, such as company growth, company size and assets, can affect financial performance [4].

The Effect of Board of Directors on Financial Performances Mediated by Earnings Management

The results of statistical tests show that Pakistan rejects hypothesis 4 because profit management is unmediated while by Indonesia it is accepted because profit management mediates. A country with good internal governance as an effort to improve company performance by monitoring management performance and ensuring accountability in accordance with regulations. For this reason, management is careful in carrying out profit management actions so as not to lead to fraud on profits [23].

V. CONCLUSION

The results in this study indicate the board of directors has no effect on earnings management and financial performances in Indonesia. Meanwhile, the board of directors has positive effect on earnings management and financial performances in Pakistan. Empirical evidence for Indonesia, earnings management can mediate the effect of board of directors. This result contradicts with Pakistan earning management is not able to mediate this effect.

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