Formation of Allowance for Credit Losses (AFCL): Credit Risk Mitigation or Earnings Management in Village Credit Institution (LPD)

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Abstract. This study examines whether the formation of Allowance for Credit Losses (AFCL) in Village Credit Institutions (LPDs) primarily reflects credit-risk mitigation or provides discretion for earnings management. A qualitative multiple-case study was conducted in six LPDs in Badung Regency, involving eight purposively selected informants representing management, finance, credit operations, and supervision. Data from semi-structured interviews and institutional documents were analyzed through iterative coding and thematic analysis. The findings identify three AFCL formation patterns: prudential, mixed, and situational earnings management. Regulation and deteriorating credit quality generally anchor AFCL as a risk buffer; however, institutional capacity, managerial judgment over collectibility and recognition timing, profit targets, customary-village contributions, community trust, and uneven supervision can redirect that discretion. The study proposes an institutionally embedded provisioning model in which socio-cultural legitimacy pressures interact with agency incentives and accounting-policy choices. This extends credit-loss allowance research beyond formal banks and capital-market incentives by showing that discretion in community-based financial institutions may be opportunistic, prudential, or socially adaptive. The results imply that stronger documentation, transparent collectibility review, and proportionate supervision are necessary to preserve AFCL's prudential function.

Keywords: Allowance for Credit Losses, Credit Risk Mitigation, Earnings Management, Village Credit Institution

1 Introduction

Village Credit Institutions (*Lembaga Perkreditan Desa* or LPDs) are financial institutions owned by customary village in Bali that support local economic, social, and cultural activities. Beyond their role as financial intermediaries, LPDs are embedded in customary governance, local wisdom, public trust, and social responsibility. Therefore, their sustainability depends on the ability to maintain trust, manage credit risk, and present fair financial reports (Putra et al., 2024; Sadiartha, 2020). Bali Provincial Regulation No. 3 of 2017 and Bali Governor Regulation No. 44 of 2017 emphasize prudence, governance, supervision, and accountability. A central prudential mechanism is the Allowance for Credit Losses (AFCL), which anticipates losses arising from

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declining loan quality. In this study, AFCL formation refers to the recognition or adjustment of the allowance and the related expense that affects current earnings.

Conceptually, AFCL protects the fairness of reported loan values and provides a buffer against non-performing loans. Adequate allowances prevent overstated assets and profits, encourage timely recognition of credit deterioration, and can restrain excessive risk-taking (Beatty & Liao, 2014; Bushman & Williams, 2012; Ozili & Outa, 2017). Nevertheless, allowance measurement is not fully mechanical. Managers assess collectibility, debtor prospects, collateral, recovery expectations, and recognition timing. Loan loss provisions therefore contain both non-discretionary components associated with observable credit risk and discretionary components that may communicate private information or alter reported performance (Ahmed et al., 1999; Curcio & Hasan, 2015; Ozili & Outa, 2017).

Agency theory suggests that this discretion becomes consequential when managers possess better information about loan quality than customary villages, depositors, and supervisors. Information asymmetry can permit delayed loss recognition, optimistic classification, or reserve adjustments that protect reported performance (Jensen & Meckling, 1976). Positive Accounting Theory further predicts that accounting-policy choices respond to contractual and political incentives, including performance targets and wealth-transfer consequences (Watts & Zimmerman, 1978). In LPDs, however, the relevant incentives differ from those normally examined in listed banks. Profit influences contributions to customary villages, social funds, internal rewards, annual work-plan achievement, and management legitimacy. Thus, AFCL decisions may be shaped simultaneously by risk, accounting incentives, and community expectations.

Recent evidence from aboard confirms that credit-loss provisioning continues to be an important site of managerial judgement. Institutional and regulatory conditions influence earnings and capital management decisions (Casciello et al., 2024), while dividends and institutional factors affect bank's use of discretionary provisions (Haq et al., 2024). Greater disclosure transparency disciplines income smoothing in privately held banks (Bischof et al., 2025), and individual manager characteristics explain a substantial proportion of variation in loan-loss provisions (Bischof & Rudolf, 2025). Evidence from Asia-Pacific banks also links managerial ability to income smoothing through provisions (Le & Dinh, 2025). Community-bank evidence is especially relevant because it shows that local economic and institutional conditions affect provisioning behavior outside large capital-market-oriented banks (He et al., 2025). Organizational culture likewise shapes discretionary loan-loss provisioning, indicating that accounting choices are embedded in institutional norms rather than driven by financial incentives alone (Zampella & Ferri, 2025).

A systematic comparison of prior research reveals four unresolved issues. First, the setting gap is substantial: most provisioning studies examine commercial, listed, or regulated banks, whereas community-owned institutions with customary governance remain underexplored. Second, the motivational gap persists because previous studies commonly distinguish risk provisioning from opportunistic earnings management, but provide limited explanation of how both motives coexist and shift across institutional conditions. Third, the theoretical gap concerns context: agency and positive-accounting explanations generally emphasize shareholders, capital regulation, compensation, or

market pressure, while socio-cultural legitimacy and community distribution obligations receive little attention. Fourth, the process gap remains because quantitative models identify discretionary provisions but rarely reveal how managers classify credit, negotiate institutional capacity, respond to supervisors, and justify the final allowance. Recent reviews therefore call for research that links provisioning choices to governance and institutional context (Mittal et al., 2026).

This study addresses these gaps through a qualitative multiple-case analysis of six LPDs. Its novelty lies in conceptualizing AFCL formation as institutionally embedded accounting discretion. The study asks: (1) what considerations underlie AFCL formation in LPDs; (2) under what conditions does AFCL remain a risk-mitigation instrument or become an earnings-management mechanism; and (3) how does the customary-village context reshape conventional theoretical explanations of accounting discretion?

2 Methodology

This study employed a qualitative approach with a multiple case design to explore the research question about the meanings, judgments, and institutional processes underlying AFCL formation rather than only the statistical association between provisions and earnings. Six LPDs in Badung Regency were selected through purposive maximum-variation sampling. Badung was chosen because its LPDs operate across heterogeneous economic environments and display differences in asset scale, credit quality, managerial capacity, and governance conditions. This variation enabled comparison between relatively prudential cases and cases facing greater credit, profitability, or supervisory pressure. Eight informants were recruited based on direct involvement in credit management, financial reporting, AFCL calculation, decision-making, or supervision. To preserve confidentiality, institutions are identified as LPD A–F and informants are described by functional perspective rather than personal title. Table 1 summarizes the case coverage. The combination of management, operational, accounting, and supervisory perspectives reduced reliance on a single organizational narrative.

Table 1. Case & Informant Coverage

Case	Informants	Functional perspectives represented
LPD A	2	Management/financial reporting and supervisory board
LPD B	1	Management & credit operation
LPD C	1	Management & financial reporting
LPD D	2	Management and operational/credit perspective
LPD E	1	Management and financial capacity perspective
LPD F	1	Management and supervisory risk perspective

Source: Processed data, 2026

Primary data were obtained through semi-structured interviews covering the basis of AFCL calculation, credit collectibility, non-performing-loan handling, profit targets,

customary-village contributions, internal control, and supervision. Interviews were conducted face-to-face, audio-recorded with permission, and generally lasted approximately 90-120 minutes. Document review covered the applicable provincial regulations, internal policies or *perarem* when available, and financial statements.

Data were analysed through an iterative thematic procedure informed by Braun & Clarke (2021). The analysis involved repeated familiarization with the interview transcripts, initial coding of relevant excerpts, comparison of codes across participants and LPD cases, development of broader analytical categories, and the iterative review, definition, and integration of themes. ChatGPT developed by OpenAI (used in July 2026) was used solely as an assistive tool during the preliminary coding stage. The tool was prompted to suggest candidate codes, identify possible similarities and differences among selected interview excerpts, and assist in organizing related codes into provisional categories. Before being entered into the tool, interview excerpts were de-identified by removing participant's names and other directly identifying information. The AI-generated suggestions were not treated as research findings, accepted automatically, or used as decisions made by an independent coder. The authors reviewed the AI-generated suggestions against the original transcripts and, where relevant, supporting documents. Suggested labels were revised, combined, or rejected when they were unsupported by the data, overly general, or inconsistent with the regulatory, institutional, sociocultural, and customary context of LPDs. The codes retained following author review were subsequently organized through initial coding, category development, and thematic integration. This iterative process led to the development of three interpretive patterns, labelled prudential, mixed, and situational earnings-management patterns. Final decisions concerning code definitions, category boundaries, themes, pattern labels, and theoretical interpretations were made exclusively by the authors.

The analytical adequacy of the dataset was evaluated concurrently through ongoing coding and cross-case comparison. In the final stages of data collection, the identified categories recurred across the participating LPDs, and no substantively new category emerged that altered the three-pattern interpretation. This assessment was based on category recurrence and explanatory adequacy rather than on a claim that all possible meanings within the data had been exhausted. Credibility was strengthened through triangulation of interview accounts from different informant positions and comparison with relevant financial, credit, and regulatory documents. Dependability and confirmability were supported by maintaining an audit trail containing the coding matrix, revisions to code definitions, supporting interview excerpts, provisional categories, AI-generated suggestions, and the author's final analytical decisions. Contradictory and divergent evidence was retained and examined rather than being removed or forced into the dominant interpretation. Transferability was supported by providing a contextual description of the regulatory, institutional, and socio-customary characteristics of LPDs.

3 Result and Discussion

3.1 Result

The interview findings show that the establishment of AFCLs in LPDs cannot be viewed solely as either a risk mitigation mechanism or an earnings management practice. Regulation and credit deterioration provide the formal basis for the allowance, but the final amount and timing are filtered through institutional capacity, managerial judgment, social expectations, and supervisory strength. Three recurring patterns emerged.

First, the prudential pattern appeared where collectibility classification and reserve percentages were applied consistently, management treated lower profit as an acceptable consequence of fair reporting, and supervisory review constrained subjective adjustment. A supervisory informant in LPD A stated, "We follow the Governor's Regulation; the allowance is a buffer when a loan becomes problematic." In this pattern, AFCL is understood as protection of community funds rather than a discretionary means of achieving profit targets.

Seconds, the mixed pattern was more common. Managers recognized AFCL as necessary but adjusted its completeness or timing to the LPD's financial capacity, recovery expectations, and annual performance. One management informant explained that "the amount is adjusted to the institution's financial capacity." Judgement also entered through collectibility classification. Loans with uncertain recovery could remain in special mention rather than immediately becoming substandard, reducing the required allowance. These adjustments were not always intended to mislead; some reflected cash-flow constraints, incomplete documentation, or efforts to avoid destabilizing the institution. Nevertheless, the result was an allowance that did not fully track credit risk.

Third, situational earnings management was evident when AFCL decisions were explicitly connected to profit availability, work-plan realization, village contributions, or the presentation of institutional health. An informant from LPD F referred to the possibility of "phantom profit" when losses were not recognized adequately. The phrase captures the core reporting risk: an apparently satisfactory profit can coexist with insufficient protection against impaired loans. Earnings management in this setting was situational because it intensified when declining profits threatened customary-village contributions, management legitimacy, or public confidence, rather than operating as a uniform policy in every period.

Two cross-cutting conditions affected all three patterns. First, supervision determined whether managerial judgment remained evidence-based. Where supervisory boards and the LPD empowerment agency could challenge collectibility and request documentation, discretion was more likely to remain prudential. Where supervisory capacity was limited relative to the number and complexity of LPDs, classification and allowance decisions became less contestable. Second, customary approaches to loan settlement could support collection but could not substitute for AFCL. Informants observed that "customary sanctions are becoming less effective," particularly where community attachment weakened or debtor problems were

economically complex. Accordingly, social enforcement and accounting loss recognition performed different functions. AFCL formation pattern and supporting evidence stated on Table 2.

Table 2. AFCL Formation Pattern and Supporting Evidence

Pattern	Dominant conditions	Representative evidence	Interpretation
Prudential	Regulatory compliance; risk-based collectibility; documented review; effective supervision	"We follow the Governor's Regulation; the allowance is a buffer."	Risk mitigation and fair reporting
Mixed	Credit risk is recognized, but allowance amount/timing reflects capacity, recovery prospects, and profit stability	"The amount is adjusted to the institution's financial capacity."	Risk reserve with constrained or adaptive discretion
Situational Earnings Management	Profit targets, work plans, customary-village contribution, legitimacy, weak challenge of judgments	Insufficient recognition may create "phantom profit."	Discretion influences reported performance under specific pressure

Source: Processed interview & data, 2026

3.2 Discussion

These findings explain why AFCLs can remain prudent in one LPD but become discretionary in another. Credit risk indicators and regulatory percentages establish expected reserves, but they do not eliminate interpretation. Managers still decide how quickly impairments are recognized, how recovery prospects are evaluated, and whether institutional constraints justify partial or delayed establishment. This process is consistent with recent evidence that the regulatory context, individual manager characteristics, managerial ability, and organizational culture shape loan loss provisions (Bischof & Rudolf, 2025; Casciello et al., 2024; Le & Dinh, 2025; Zampella & Ferri, 2025). The LPD evidence further suggests that socio-customary obligations may be part of the decision-making environment.

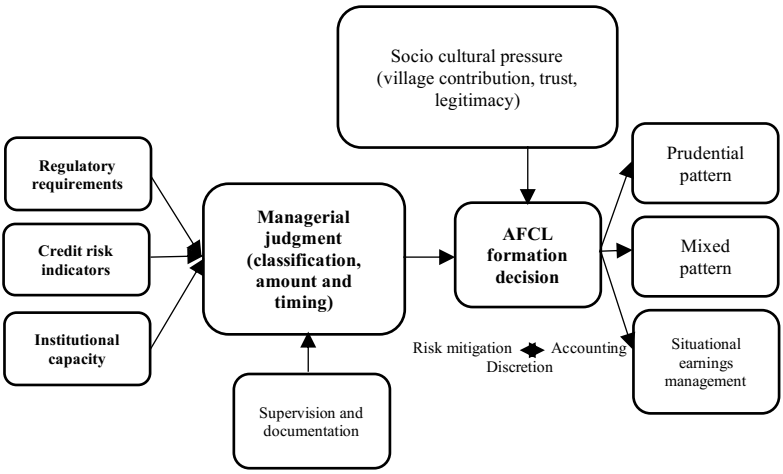


Figure 1. Proposed model of institutionally embedded AFCL formation

Figure 1 summarizes the proposed model. Regulation, observable credit risk, and institutional capacity influence AFCL decisions through managerial considerations of classification, amount, and timing. Oversight and documentation limit such considerations, while socio-cultural pressures may direct them toward stability of reported earnings. The resulting decisions are prudent when evidence of effective risks and challenges dominates; mixed patterns occur when prudence is negotiated with institutional capacity; and situational earnings management occurs when performance or legitimacy pressures dominate credit loss recognition.

The results extend Agency Theory in two respects. First, the relevant principal-agent relationship is plural. LPD managers are accountable not only to an owner but also to customary-village leaders, community depositors, borrowers, supervisory boards, and supporting agencies. These stakeholders have different information and interests. Managers possess superior knowledge about loan recoverability, while community stakeholders observe reported profit, village contributions, and visible institutional continuity. Second, agency costs are not limited to private managerial gain. Delaying AFCL may protect management reputation, but it may also be rationalized as protecting community confidence or preventing an abrupt reduction in village funding. This does not remove the reporting risk; rather, it explains why opportunistic and socially adaptive motives can coexist.

The study also refines Positive Accounting Theory. Conventional applications emphasize bonus plans, debt covenants, taxation, regulatory capital, and political costs. In LPDs, the accounting-policy choice is connected to a community distribution mechanism: AFCL expense reduces profit, and profit affects contributions and perceived institutional success. The three patterns therefore show that accounting choices respond to both economic contracts and socially embedded expectations. The mixed pattern is theoretically important because it occupies the space between faithful risk recognition and deliberate manipulation. It represents constrained discretion, where

managers acknowledge the risk but negotiate the speed or completeness of recognition against the institution's capacity to absorb the expense.

The socio-cultural finding should not be interpreted as evidence that customary values inherently cause earnings management. Culture can support repayment discipline, collective monitoring, and long-term orientation. The risk arises when the expectation to maintain village contributions and public trust is translated into pressure to preserve accounting profit. Recent evidence that organizational culture affects discretionary provisioning supports the broader proposition that the meaning and use of accounting judgment depend on institutional norms (Zampella & Ferri, 2025). The contribution of this study is to identify community legitimacy as a specific channel through which those norms influence AFCL.

The results further explain why transparency and supervision matter. Privately held banks reduce income smoothing when provisioning choices become more transparent (Bischof et al., 2025), and governance can limit the influence of individual managers on provisions (Bischof & Rudolf, 2025). Similar mechanisms are necessary in LPDs, but they must be proportionate to institutional capacity. A standardized AFCL working paper should document collectibility status, payment history, restructuring, collateral and recovery evidence, the regulatory percentage, management adjustments, and supervisory approval. Exceptions should be separately disclosed and revisited. This approach preserves legitimate judgment while making deviations from risk-based provisioning visible.

Practically, the proposed model implies three interventions. First, LPDs need written policies that distinguish the AFCL balance from the related provision expense and prescribe consistent recognition and reversal. Second, supervisory boards and LPLPD should prioritize risk-based review of institutions with rapid NPL deterioration, repeated under-provisioning, or large unexplained changes in AFCL. Third, communication with customary villages should frame adequate allowances as protection of community wealth rather than evidence of management failure. Such communication reduces the incentive to maintain nominal profit at the expense of future resilience.

These findings contribute to the literature by moving beyond the proposition that credit loss allowances are either prudent reserves or opportunistic accruals. The typology and model show how accounting discretion is transformed by an institution's governance and social purpose. For community-based financial institutions, the same judgment can carry three meanings: disciplined anticipation of loss, adaptive response to institutional constraints, or situational management of reported performance. This conceptual distinction helps explain inconsistent provisioning without treating every deviation as equivalent.

4 Conclusion

AFCL in the six LPD cases primarily functioned as a credit-risk mitigation mechanism, but its operation depended on how formal requirements were filtered through managerial judgment and institutional context. The study identifies a prudential pattern,

a mixed pattern, and situational earnings management. The first aligns allowance formation with documented credit deterioration; the second negotiates risk recognition with financial capacity and recovery expectations; and the third arises when profit targets, customary-village contributions, community trust, or management legitimacy materially influence the amount or timing of recognition.

The theoretical contribution is an institutionally embedded provisioning model that extends Agency Theory and Positive Accounting Theory to a community-owned, socio-cultural setting. Information asymmetry remains important, but the incentives surrounding accounting discretion include collective legitimacy and social distribution obligations in addition to conventional managerial or market incentives. The mixed pattern further demonstrates that discretion is not necessarily purely prudent or opportunistic.

The study implies the need to strengthen AFCL governance through written guidelines, consistent documentation, and stronger supervision by supervisory board. Communication with customary villages should also emphasize that adequate AFCL formation is not a sign of institutional weakness, but a protective mechanism for public funds and LPD sustainability. The study is limited to eight informants in six LPDs in Badung Regency and relies primarily on interview interpretation supported by documents. Future studies may test the proposed model using longitudinal AFCL, NPL, profitability, governance, and village-contribution data; compare districts; and examine whether supervisory transparency shifts LPDs from mixed or situational patterns toward prudential provisioning

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