# RISK MANAGEMENT AND EARNINGS MANAGEMENT ON FINANCIAL PERFORMANCE IN ISLAMIC BANKING: AN EMPIRICAL STUDY OF INDONESIA

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***Abstract***

*This study aims to determine the effect of risk management and earnings management on financial performances in Islamic banking: an empirical study of Indonesia. This study uses a quantitative research method. As for the sampling technique, we used purposive sampling. The type of data is secondary data. The samples used in this study were ten banks registered with the Financial Services Authority from 2015 to 2020. Data analysis in this study used the application of the SEM-PL). The result of this research indicates that risk management and earnings management affect financial performance.*

**Keywords**: Risk Management, Earnings Management, Financial Performance

## Introduction

The Islamic banking industry around the world has recently developed rapidly and is increasingly important in the global financial scenario (Noraini Mohd Ariffin & Saliha Hj Kassim, 2001). The development of Islamic banking is characterized by a new phenomenon, namely the growth of Islamic bank assets reaching a level of 13% -25% in the last five years (Hardianto & Wulandari, 2016). So that, Islamic banking plays a role in creating economic progress for various industrial sectors (Alsharari & Alhmoud, 2019). To carry out this role, banks must first ensure that they run their business properly which has an impact on their ability to maximize stability and increase profits (Saiful & Dea Puspita Ayu, 2019). However,it is not easy for banks to always maintain maximum profits because banks are faced with various types of risks, which affect the performance and activities of these banks.

The banking sector in Indonesia is aware that every risk mentioned in the Financial Services Authority Circular Letter No.14/SEOJK.03/2017 can affect its financial position and performance. The amount of funds regulated and managed by the bank is not small, so the risks faced are also large. Therefore, the application of risk management is considered mandatory because it can detect risks that allow the company to suffer losses. According to Bank Indonesia Regulation 5/8/PBI/20083, risk management is carried out through several stages, such as identification, measurement, monitoring, and control (Dwi Yanti & Setiyanto, 2021).

Risk management acts as a basis for banks in taking, determining, and implementing appropriate steps. Risk management is one of the obstacles to progress, extending the company's internal processes and burdening the company's finances and several other negative things (Mardiana, 2018). However, afterexperiencing the global financial crisis, economic actors finally recognized that the implementation of a goodrisk management system can control risk because of its ability to influence the performance, existence,e and financial growth of the bank (Alshatti, 2015). From some of these explanations, it can be concluded that risk management is very important to redreducingtential losses and retrieving organizational goals. Risk management in banking is carried out on the risks of several things, namely credit, liquidity, capital, and operational risks (Setiawaty, 2016).

The rapid development of Islamic banks also has an impact on the transparency and accountability of financial reports, where banks as trusted institutions are required to account for their financial reports in a transparent and accountable manner. Financial reports must present information that can be understood because it is a medium of communication between banks and users of financial reports. The true financial report for reporting financial performance is inseparable from the interests of the management itself. Earnings management is a common practice carried out by many companies around the world, even in Indonesia itself. Several cases due to earnings management that were revealed to the public include PT. Asuransi Jiwasraya and PT. Kimia Farma is indicated to make engineering in financial reporting. Earnings management then reduces the transparency of a company's financial presentation. Profit manipulation is highly unethical in Islamic banks (Anggreni et al., 2020).

## Literature Review

### Agency Theory

Agency theory is the basis that underlies the company's business activities that have been used so far. Agency theory explains the differences in facts obtained between agents and principals (Lidyah et al., 2019). Management tends to have more facts about the prospects and future of the company, especially information about operations than shareholders as a result of which information asymmetry or conflict of interest arises between the two. Agency action is a form of earnings management (Lidyah et al., 2020).

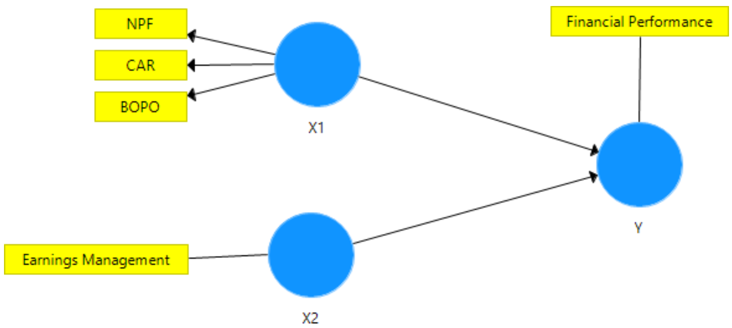
If it is related to the issue of Risk Management, Internal Control, and Corporate Governance, then agency theory is more relevaTor to overcominge agency problems, it is deemed necessary to create a control design strategy to ensure the achievement of organizational goals that provides maximum results for agents and principals. This strategy uses tools designed in the form of Risk Management processes, Internal Control, Corporate Governance, and, the establishment of the Internal Audit function, taking into account costs and benefits (Pratiwi & Kurniawan, 2018).

### Stakeholder Theory

According to Freeman (2004), stakeholders are individuals or groups that can influence or be affected by the achievement of company goals. Stakeholder theory describes that managers are obliged to meet the needs of partners rather than building company estimates to gain stakeholder support (Ayu et al., 2020). Therefore, corporate management accountability is required for stakeholders in the form of financial performance.

### Methods

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. With this quantitative method, it would be able to show the relationships that occur between the variables contained in this study. Moreover, this study useddata in the form of numbers so it was very suitable for research using quantitative methods. Secondary data was used in this research because the data had been published by relevant institutions and was relevant to the data needed. As for data analysis and data testing, this research used PLS-SEM.




Source: developed for this study (2022)

**Figure 1.** Research Models

### Result and Discussssion

### Test Models

The suitability of the model built in this study can be determined through the research model test. In a good research model, the description of the suitability of the research model relationship can be seen from theresults obtained through the analysis used, namely Smart PLS 3 with the following results:

**Table 1.** Research Model Test Results

| Information | Ideal | Results |
|---|---|---|
| **Evaluation of Formative Measurement Models** | | |
| Multicollinearity | VIF < 10.00 | VIF value = 1,000 |
| **Structural Model Evaluation** | | |
| R2 for Endogenous Variables | 0.19 = weak<br>0.33 = moderate<br>0.67 = good | R-Square = 0.932 |
| Fit models | SRMR < 0.05 | Saturated Model = 0.000<br>Estimated Model = 0.000 |
| Significance and Estimation of Path Coefficients | T Statistics 1.96 ≥ | It ranges from 2,643 to 7,450 |

Source: SmartPLS Outputs. 3.0, 2022

Based on table 1 the value of VIF is less than 10.00, so in this study, there was no multicollinearity between exogenous variables in all the equation models used. The value of R-Square is 0.932, so that it is included in the good category, which means that the effect of exogenous variables on endogenous variables is93.2% while the remaining is 6.8 % can be explained by other variables not examined in this study. Table 1 also shows that the fit model as a whole is considered to have good quality (fit) because it has an SRMR value of <0. 05 Evaluation of the model is carried out to see the significant value and influence between variables through a bootstrapping procedure. In this study, a significance value (two-tailed) t-value was used > 1.96.

**Hypothesis testing**

The bootstrapping results show the results of the hypotheses proposed in the study. Hypothesis testing is done by looking at the value of the coefficient which produces a level of significance in hypothesis testing.

**Table 2.** Direct Effects

| | Original Sample (O) | Sample Mean (M) | Standard Deviation (STDEV) | T Statistics (\|O/STDEV\|) | P Values |
|---|---|---|---|---|---|
| X1 -> Y | -0.622 | -0.592 | 0.235 | 2.643 | 0.008 |
| X2 -> Y | 0.996 | 0.960 | 0.134 | 7.450 | 0.000 |

Source: SmartPLS Outputs. 3.0, 2022

**Risk Management on Financial Performance**

Based on statistical analysis showing significant P-values, it can be concluded that risk management affects financial performance in Islamic Commercial Banks. The original sample value is -0.622, with a negative original value indicating that risk management has a negative relationship with the company's financial performance. Implementation of a good risk management system can control risks and improve a bank's financial performance. The high NPF value will reduce financial performance, as well as what happens to BOPO, the higher the ratio, the less good it is for improving financial performance. what happens next is the CAR ratio which shows that a smaller CAR number can reduce financial performance because it shows the bank's s inability to cover bank operational activities that contain risks so with the position of financial ratios representing risk management remaining at maximum conditions, sharia commercial bank business activities will continue to run smoothly and the bank's financial performance will not decrease. The application of the process of risk management has been carried out consistently at every stage of the process of business and operational activities in banking. Theoretically, risk management is a series of methodologiesin carrying out risk management that may occur from bank activities. The application of the process of risk management has been carried out consistently at every stage of the process of business and operational activities in banking. Theoretically, risk management is a series of methodologies in carrying out risk management that may occur from bank activities. The application of the process of risk management has been carried out consistently at every stage of the process of business and operational activities in banking. Theoretically, risk management is a series of methodologies in carrying out risk management that may occur from bank activities.

**Profit Management on Financial Performance**

Results management impacts financial performance as it has a significant P-value based on statistical analysis. Management's actions may degrade the quality of information related to earnings disclosed in our financial statements. Poor quality of this information can impact a company's financial performance (Faisal & Syafruddin, 2020). Practicing profit manipulation is an expensive strategy, as the increase in profit manipulation must match the level of cash flow. Revenue management can therefore lead to reduced profits in the long run due to increased costs such as funding costs.

**Conclusion**

The results of this study indicate that risk management and earnings management have an effect on financial performance in Islamic commercial banks which proves that the implementation of a good risk management system can control risks and improve bank financial performance. As well as minimizing the occurrence of earnings management has an impact on the quality of financial reporting, so investors are interested in companies or banks which results in increased financial performance.

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