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Profit targets, prospect theory, and earnings management: Evidence from the banking industry in ASEAN

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Abstract

This study estimates and analyzes profit targets that motivate managers to engage in earnings management (EM) practices in ASEAN banks. This study uses prospect theory to explain profit targets that motivate managers to engage in EM practices by determining certain thresholds to identify whether banks are practicing EM or not. The approach in this study is quantitative, using data from 74 banks in several ASEAN countries between 2012 and 2024. The data analysis method used in this study is a dummy variable regression model. The results show a significant positive relationship between profit targets and earnings management in several ASEAN countries. The empirical findings indicate that profit targets with a threshold of EPS targets indicate that managers are motivated to engage in EM practices to achieve profit targets. Managers will increase current period profits by borrowing future profits through reducing loan loss provisions. In addition, company size has a positive and significant effect on EM, but profitability has a negative and significant effect. This study also provides evidence that the level of EM practices in the Philippines, Thailand, and Vietnam is lower than in Indonesia.

Keywords: Earnings management, profit targets, the prospect theory.

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1. Introduction

A scandal in Thailand in 2015 involved Krungthai Bank providing unhealthy loans to a large Thai real estate company. The loans were not managed properly, and the bank's financial statements allegedly did not reflect the actual level of risk [1]. Southern Bank Berhad Malaysia was found to have committed financial reporting irregularities and poor corporate governance [2]. In 2018, Bank Bukopin Indonesia restated its financial statements for the past three years, namely 2015,

2016, and 2017. This was allegedly due to the manipulation of credit card data to increase credit positions and commission-based income [3]. The cases of EM that have occurred in banks in several ASEAN countries can have a negative impact on other countries [4, 5].

Managers often manipulate earnings to achieve profit targets for various reasons, which are generally related to personal incentives, shareholder expectations, and the need to maintain the company's reputation. When managers fall short of profit targets, they will suffer personal losses, namely not receiving bonus compensation. This situation will motivate managers to take risks to manage earnings so that profit targets are achieved. Conversely, when managers achieve the profit targets, they will gain benefits, namely receiving bonus compensation, so they will avoid the risk of managing earnings [2, 6-8]. The prospect theory proposed by Kahneman and Tversky [9] can explain the behavior of these managers. This theory posits that decision makers will avoid risks above the reference point and seek risks below it Harris et al. [10]. When corporate managers fail to achieve their targets, they have an incentive to manipulate earnings upwards to meet their predetermined targets [11]. Therefore, this study contributes to the existing literature on EM practices in banks by empirically testing the relationship between earnings targets and EM in several ASEAN countries.

2. Literature Review

Clearly, managers engage in earnings management (EM) practices because of certain goals or motivations. Some motivations for EM practices include bonuses, politics, taxes, CEO changes, initial public offerings, and the importance of providing information to investors. The managers' motivation to receive a bonus means that they will act opportunistically to engage in EM by maximizing current profits. Political motivation causes managers to engage in EM by reducing reported profits due to public pressure that results in the government setting stricter regulations. Reducing the tax paid is the most obvious motivation for EM [12].

Various accounting methods are used for the purpose of reducing income tax. The motivation due to a change in the CEO is when he or she is approaching retirement; this tends to lead to an increase in profits to increase the CEO's bonus. Therefore, if the company's performance is poor, the CEO will maximize profits to avoid being dismissed. The motivation of managers to engage in earnings management (EM) during an initial public offering is that the company going public does not yet have a market value, so engaging in EM is expected to increase the company's stock price [13].

The prospect theory was developed by Kahneman and Tversky [9]. it assumes that individuals focus more on the prospect of profit and the prospect of loss. Another assumption is that there is a reference point for calculating profit or loss and the value of that reference point can change. Then, it is known that individuals prefer risk when in the loss domain and avoid risk in the profit domain [14]. The prospect theory also helps explain the threat of the desire of top managers to manage earnings. This theory suggests that individuals derive values from profits and losses in relation to a reference point, rather than from an absolute level of wealth. It also shows that the individual value function is concave in gains and convex in losses (S-shaped) [8]. Thus, the increase in value is greatest when the relative individual wealth increases from losses to gains at the reference point. If stakeholder preferences are consistent with the prospect theory, then managers have an incentive to report earnings above a threshold, or reference point, such as zero earnings level or zero earnings change to earn more bonuses. The S-shape in the prospect theory suggests that decision-makers will avoid risks above the reference point and take risks below the reference point. Here, executives have an incentive to manage earnings to avoid declining earnings. Of course, the same is true for an executive whose compensation is tied to the company's performance [10].

In relation to the company's performance in the capital market, its existence can be in the form of expectations, and investors' expectations of the company's performance. This can be related to the company's profit with criteria such as (i) positive profit; (ii) profit greater than the previous year, and (iii) profit higher than analysts' estimates. According to the prospect theory, a small loss is much more unpleasant than a small profit, which is the same as the loss. This is because reporting small profits is expected to produce higher premium valuations. The phenomenon of investors in the capital market punishing companies that report negative profits, even though the value is very small can cause management to do something to avoid negative profits, especially if the value is small. Thus, profit exposure has been widely used as one of the main performance indicators of a company's commercial activities and has also become the main target of management [15].

The prospect theory explains decision-making by someone in uncertain or risky circumstances. The prospect theory states that a person generally tends to act in a risk-averse way if all changes related to prosperity are perceived as benefits; conversely, the person will engage in a risk-taking way when all changes related to prosperity are perceived as losses [15, 16]. The decision-maker in this study engages in earnings management (EM) in the form of increasing profits with the aim of achieving the profit targets and getting bonus compensation. The application of the prospect theory in relation to EM motivation is when the managers operate in conditions above the specified profit targets, they are in a profitable position (gain), so they will make decisions by avoiding risks (risk-averse) to engage in EM. Conversely, when the managers operate in conditions below the specified profit targets, they are at a disadvantage (loss), so they will make decisions by seeking risks (risk taking) to engage in EM. Managers have incentives to manipulate earnings upward to meet predetermined targets [11].

Several studies have found that firms use past performance information in setting earnings targets in annual bonus plans. A survey of AICPA members working at the corporate or business unit level with the titles of CEO, CFO, COO, controller, vice president of finance, president director, director, or manager in 2009 showed that 13% set the same earnings targets in 2009 as in 2008, 7% set the same 2009 earnings targets as the actual 2008 earnings, and 4% did both; that is to say, the 2009 and 2008 earnings targets were the same as the actual 2008 earnings. These findings suggest that firms are reluctant to set negative earnings targets and instead prefer to stretch earnings targets to zero, even if it makes such a zero-target difficult for the firm to achieve. The reluctance to set earnings targets below zero can also be interpreted as a firm's commitment to avoid negative earnings targets [17].

Furthermore, the results of a study conducted on the S&P 1500 in 2013 found that boards were more likely to adjust earnings when firms had more volatile earnings or reported losses (i.e., when unadjusted earnings were less informative about firm performance) and when CEOs had shorter tenures (i.e., when CEOs had less control over firm operations). It was also found that firms with independent chairmen or president directors were less likely to correlate with the use of adjusted earnings, whereas firms with CEOs who also serve as chairmen were more likely to use adjusted earnings. Specifically, a positive relationship between the use of adjusted earnings and meeting or beating bonus targets would be consistent with opportunistic CEOs exploiting the discretion inherent in adjusted earnings. Similarly, a positive relationship between the use of adjusted earnings and CEO compensation would be consistent with opportunistic CEOs being able to artificially increase their pay. Higher bonus compensation is contingent on firm performance when CEOs are compensated based on adjusted earnings. These results are consistent with the popular view that CEOs exploit policies in adjusted earnings to earn "big salaries" [18].

In summary, these findings establish the foundation for hypotheses formulated to guide the investigation into the interconnected pathways influencing earnings management practices, as follows:

H_1: Profit targets have a positive effect on banks' earnings management practices.

3. Methodology

This study uses a population of all banking companies listed on ASEAN stock exchanges, namely those in Indonesia, Malaysia, Vietnam, the Philippines, Thailand, and Singapore. The research data was taken from the Refinitiv database for the period up to 2024. The research sample was determined using a purposive sampling technique using criteria based on certain considerations. The research sample is displayed in Table 1.

Table 1.
Summary of the research sample.

Number	Criteria	Total
1	Banks listed on ASEAN stock exchanges from 2012-2024	151
2	Banks that have yet to publish consecutive annual reports from 2012-2024	(29)
3	Non-conventional banks	(4)
4	Banks have not complete data related to the research	(3)
Companies used in the research sample		74
Total research observation data for 13 years		962

The proxy used for the dependent variable is discretionary loan loss provisions (DLLP). DLLP is the flexibility possessed by bank management in managing or evaluating loan loss provisions (LLP). DLLP can be identified through two stages. The first stage uses special accruals to measure artificial earnings management (EM), which more specifically uses the main accruals in the banking sector, namely LLP. LLP consists of two components, namely non-discretionary LLP (NDLLP) and discretionary LLP (DLLP) [19]. NDLLP is estimated using the following equation.

$$LLP_{it} = \beta_0 + \beta_1 NPL_{it-1} + \beta_2 \Delta NPL_{it} + \beta_3 \Delta TL_{it} + \varepsilon_{it} \quad (1)$$

LLP_{it} is the total LLP at bank i in year t. $NPL_{it} - 1$ is the initial NPL at bank i in year t. ΔNPLit is the change in the value of NPL at bank i in year t. ΔNPL_{it} is the change in the value of total financing at bank i in year t. DLLP consists of LLP prediction errors estimated through residuals obtained from Equation 1. The next stage evaluates the non-discretionary LLP (NDLLP) component:

$$NDLLP_{it} = \beta_0 + \beta_1 NPL_{it-1} + \beta_2 \Delta NPL_{it} + \beta_3 \Delta TL_{it} \quad (2)$$

In the last stage, the DLLP component is obtained by calculating the difference between the total LLP and the estimated NDLLP. The basic estimation equation becomes:

$$DLLP_{it} = LLP_{it} - NDLLP_{it} \quad (3)$$

The independent variable is the profit targets using a dummy variable from the EPS value. This study applies the EPS value referring to the magnitude of the change in the EPS value in the current year compared to the previous year. Several practitioners in banking say that companies determine profit targets based on the previous year's profit. The targeted profit is usually around 10% higher than the previous year's profit. Based on these conditions, the researchers estimate that the profit limit managed by managers is 5% higher than the specified profit targets. This is because managers are more careful when they are going to engage in earnings management (EM). This means that samples that have the realized EPS for one year greater than the EPS targets are 5% excess, and those that are 5% less are samples identified as practicing EM.

This study will use two control variables that consistently affect EM and are quite often used in previous studies, Bai and Chu [20]; Ceccobelli and Giosi [21]; Leventis and Dimitropoulos [22], and Vo et al. [23], namely bank size and profitability. Bank size (SIZE) is calculated as the natural logarithm of total assets at the end of the year. The larger the bank, the stricter the supervision by the public, and therefore, larger banks tend to be less involved in EM [20-22]. Bank financial performance can be seen from the profitability ratio. The profitability ratio in this study uses return on assets (ROA). Several studies have shown that ROA has a negative effect on EM [22, 24, 25]. A negative relationship with LLP is expected because higher levels of provisions should be considered if the economic situation declines [21].

Based on the research model that has been explained, the regression model of this research is as follows.

$$DLLP_{it} = \alpha + \beta_1 DUM\_EPS_{it} + \beta_2 SIZE_{it} + \beta_3 ROA_{it} + \varepsilon_{it} \quad (4)$$

$DLLP_{it}$ is EM with a proxy of discretionary loan loss provisions in company i and year t. DUM_EPS_{it} is a dummy variable, 1 is scored for samples suspected of conducting EM and 0 is scored otherwise in company i and year t. Profit targets

are hypothesized to have a positive effect on motivating managers to conduct EM. $SIZE_{it}$ is the size of the bank in company i and year t. ROA_{it} is profitability with a proxy of ROA in company i and year t.

4. Results

Before testing the hypothesis, a panel data regression estimation method was used first to ascertain the best regression model in this study. This study uses a panel data regression model consisting of three models, namely the common effect model (CEM), the fixed effect model (FEM), and the random effect model (REM). Based on the test results presented in Table 1, the model used in this study is REM.

Table 2.
Testing Methods for Panel Data Regression Estimation.

Test Results	Chow Test	Hausman Test	LM Test
Chi Square	54.190	5.117	189.972
Prob.	0.251	0.163	0.000
Decision	COM	REM	REM

Note: * significant at 10%; ** significant at 5%; *** significant at 1%.

The results of the analysis presented in Table 3 show the number and distribution of samples in the group of companies that practice EM. On average, banks in several ASEAN countries are identified as practicing EM. The country with the highest number of banks identified as practicing EM is Thailand, while the country with the lowest number is the Philippines. This empirical finding suggests that managers in the banking sector today may have a greater tendency to dress up their company's performance due to the increasingly fierce competition in the region. Economists who intend to promote economic prosperity in their country may ignore this, namely EM. Manipulated financial reports may ultimately lead to financial disasters that destroy the company, and if the company is large enough, the world economy will be affected [26].

Table 3.
Linear regression analysis results.

Variables N= 962	Results
Constant	-0.199
DUM_EPS	0.018**
The Size of the Firm	0.007***
ROA	-0.038**
R^2	0.1812
F	0.001

Note: * significant at 10%; ** significant at 5%; *** significant at 1%.

Table 3 presents the results of the hypothesis testing and these show that profit targets motivate managers to practice EM in banking in several ASEAN countries. The results indicate that bank managers in several ASEAN countries were identified as managers practicing EM when the EPS change value was at a threshold of around 0.1 and up to 0.35. This empirical finding is in line with several previous studies, which stated that the existence of EPS targets is associated with short-term behavior to see company performance [27]. Other research results show evidence of EM related to EPS targets that are explicitly stated in compensation contracts [28]. Compensation jumps if performance is just above the targets specified in the contract. In addition, targets are most often based on EPS (46% of bonuses are related to EPS targets), although this contract offers strong incentives, managers are also motivated to manipulate their performance [27, 28]. Investor interest in EPS can motivate managers to engage in EM to exceed the previously set EPS target limit [15].

These empirical findings also support prospect theory, which states that when managers operate in conditions above the specified profit targets, they are in a profitable position (gain), meaning that they will make decisions by avoiding risk (risk-averse) to engage in EM. Conversely, when managers operate in conditions below the specified profit targets, they are in a disadvantageous position (loss), meaning that they will make decisions by seeking risk (risk-taking) to engage in EM.

Managers have an incentive to engage in EM by increasing profits according to predetermined targets to get compensation or bonuses from the company [11, 29]. Companies do not want to set negative profit targets and instead prefer to stretch profit targets to zero even if it makes such zero targets difficult for the company to achieve. The unwillingness to set profit targets below zero can also be interpreted as the company's commitment to avoiding negative profit targets [17].

When a bank performs well, that is to say, it has a fairly high profit or gains in the current period and predicts poor performance in the future, the bank's managers will tend to save or reduce current period profits for use in the future by reducing profits through increasing LLP. However, when a bank performs poorly in the current period and predicts good performance in the future, the bank will increase current period profits by borrowing future profits through reducing LLP [19, 30, 31].

This study incorporates two control variables into the research model, namely company size (SIZE), and profitability (ROA). The results of the analysis (Table 3) show that company size is positive and significant. This finding indicates that the larger the size of a bank, the greater EM practices there are. This is in contrast to the results of the ROA analysis, which indicate a negative and significant effect. This finding indicates that the larger the ROA of the bank, the fewer EM practices there are.

This study applies a sensitivity analysis in testing the previous hypothesis, namely, adding a country dummy variable where Indonesia is the base country. This sensitivity analysis seeks to determine the consistency of the research results in each country. The results of the sensitivity analysis are presented in Table 4.

Table 4.
Sensitivity Test.

	1	2	3	4	5
Variables N = 962	**Philippines**	**Malaysia**	**Singapore**	**Thailand**	**Vietnam**
Constant	-0.203***	-0.199**	-0.199***	-0.200***	-0.199***
DUM_EPS	0.019**	0.019**	0.018**	0.018**	0.018**
The Size of Firm	0.007***	0.007***	0.007***	0.007***	0.007***
ROA	-0.037**	-0.039**	-0.039	-0.037**	-0.038**
DUM_ Philippines	-0.009***				
DUM_Malaysia		-0.003			
DUM_Singapore			-0.004		
DUM_Thailand				-0.010***	
DUM_Vietnam					-0.009
R^2	0.1873	0.1816	0.1829	0.1894	0.1830
N	730	730	730	730	730
F	0.000	0.000	0.001	0.000	0.001

Note: * significant at 10%; ** significant at 5%; *** significant at 1%.

Table 4 presents results that are consistent with the results of the hypothesis testing, namely, the DUM_EPS coefficient in the Philippines and Malaysia are 0.019, Singapore, Thailand, and Vietnam are 0.018 and all are significant at the 5% level. This empirical finding indicates that banks in each country use profit targets with a reference to the realized value of EPS, more than the excess EPS targets of 5% and less than 5%, which is appropriate.

Furthermore, it is known that the differential cutoff points of the coefficient values in Malaysia and Singapore are not statistically significant, meaning that there is no statistical difference between the average EM practices in Malaysia, Singapore, and Indonesia. The differential cutoff point of the Philippines' coefficient value is statistically significant, indicating that, on average, EM practices in the Philippines are 0.009 less prevalent; meanwhile, the differential cutoff points of the coefficient values of Thailand and Vietnam are statistically significant, indicating that, on average, EM practices in Thailand and Vietnam are 0.010 and 0.009 less prevalent, respectively.

On average, EM practices in banking in Thailand are less prevalent because the country has had corporate governance reforms whereby it has increased board independence and strengthened audit committees to increase transparency in corporate activities and the reliability of published accounting information [32]. In addition, the Thai system of government is a constitutional monarchy in which the king serves as head of state, exercising legislative power through parliament, executive power through the cabinet, and judicial power through the courts [33]. Thus, the decision to make regulations and laws rests solely with the king, making him more assertive in regulating regulations, especially regulations for the protection of investors.

This is in contrast to the Philippines and Vietnam, whose forms of government are the same as Indonesia; namely, they are republics. Despite this, the practice of EM in both countries is still slightly less prevalent than in Indonesia. The reason for this may be Vietnam’s implementation of a one-party government system, where the Communist Party of Vietnam (CPV) is the only political party allowed. This party has full control over the government and society, and all policies and political decisions come from this party structure, thus providing quite high protection for investors who invest their funds in companies, especially banking in Vietnam.

Furthermore, the Philippines, in developing human resources and capacity building, uses the principle of decentralization applied to local governments to provide freedom for each agency to carry out training and education processes for its employees. For this reason, the Civil Service Commission (CSC) guarantees the legal authority of various agency programs with monitoring and evaluation mechanisms. There are also various scholarship programs offered by the CSC to employees who are deemed capable and worthy of participating [34]. Thus, managers in banking are very unlikely to behave opportunistically.

5. Conclusion

This study focuses on profit targets as a motivation for managers to practice earnings management (EM) and the influence of corporate governance in reducing EM practices in banking in several ASEAN countries. Based on the analysis and discussion in the previous section, the conclusions of the research results are as follows. First, profit targets motivate managers to practice EM. This finding indicates that managers in the banking sector today may have a greater tendency to dress up their company's performance due to increasingly fierce competition. Managers tend to practice EM by increasing profits according to predetermined targets to get compensation or bonuses from the company [11, 29]. Second, on average, banking EM practices in the Philippines, Thailand, and Vietnam are less prevalent than in Indonesia. This empirical finding indicates that the governance and corporate governance systems in each country are different, meaning that regulations for investor protection will also vary greatly.

The results of this study contribute to the literature by providing significant empirical evidence on the development of prospect theory [9], especially in explaining the motivation of managers to practice earnings management (EM). Managers in banks in several ASEAN countries are motivated to practice EM so that the predetermined profit targets are achieved, which means that managers will receive bonuses for their performance. The second contribution is that the results of this study provide benefits for investors and potential investors by enabling them to understand and analyze the financial performance of banks more comprehensively before making investment decisions. In addition, the results of this study can also improve the efficiency of corporate governance in the banking industry to encourage confidence among investors and potential investors in making investment decisions. Finally, it provides information for regulators such as Qualified ASEAN Banking (QAB), Financial Services Authority (OJK) Indonesia, Securities Commission (SC) Malaysia, Securities and Exchange Commission (SEC) Philippines, Hochiminh Stock Exchange (HOSE) Vietnam, Securities and Exchange Commission Thailand, and the Monetary Authority of Singapore regarding corporate governance and EM, meaning that they can create policies and regulations that can protect investors when investing their funds in the banking industry in the ASEAN region.

This study has its limitations. The independent variables that influence EM are limited in number; there are still many other factors that have the potential to influence EM. Future research could explore more deeply the role of corporate governance and corporate culture in each country, as this could provide a more comprehensive understanding of EM in banking.

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