The Influence of Company Fundamentals and Director Characteristic towards Fair Value Measurement in the Indonesian Banking Industry

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Abstract

Fair value is part of the International Financial Reporting Standards (IFRS) which attract attention of researchers due to its controversial issues. Studies investigating factors influencing opportunistic behaviour through fair value figures in developing countries are limited. This study aims to investigate the effect of company fundamental factors on fair value. This research applies multiple regression of banking companies listed on the Indonesia Stock Exchange from 2018 to 2022. The fundamental factors, as independent variables are return on equity (ROE), ratio of operating expense on operating income (OEOI), capital adequacy ratio (CAR) and the proportion of female directors. Meanwhile, the dependent variable is fair value through modelling calculation i.e. fair value level 3 inputs. This study found that only OEOI significantly influence fair value level 3 inputs. Meanwhile, ROE, CAR, and the proportion of female in the board of directors do not significantly influence fair value level 3 inputs. The implications of the study on the Indonesian banking industry is that the industry should prioritize fair value disclosure, especially at level 3, as it provides crucial information about a company's performance and condition, potentially enabling investors to evaluate its performance.

Keywords: fair value level 3, ROE, CAR, proportion of female directors, opportunistic behavior

INTRODUCTION

Previous studies have investigated factors that influence management discretion to use fair value as the basis for reporting assets and liabilities (Aluy et al., 2017; Botosan et al., 2011; Chong et al., 2012; Dechow et al., 2010; Fitriyah et al., 2023; Fitroni & Feliana, 2022; Kusumaningrum & Achmad, 2022; Nugraheni, 2023; Šodan, 2015; Velte, 2017; Wilestari & Afriani, 2019; Yao et al., 2018). As part of the implementation of International Financial Reporting Standards (IFRS), fair value is one of the issues that has received attention. IFRS

gives companies the option to use fair value for asset and liability measurement. The IASB publishes rules governing fair value, namely IFRS 13: fair value measurement, where fair value is defined as the price that would be received to sell an asset or the price that would be paid to transfer a liability in a normal transaction between market participants at the valuation date in a major market. Indonesia implements the regulation and fair value measurement is regulated in *Pernyataan Standar Akuntansi Keuangan* (PSAK) [Indonesia Financial Accounting Standards] 68.

This study aims to investigate factors affecting opportunistic behaviour through fair value measurement including company fundamentals. This study uses profitability, ratio of operating expense on operating income (OEOI), capital adequacy ratio, and the proportion of female directors as company fundamentals.

One of the way of opportunistic behaviour is engaging in earnings management. One way to accomplish earnings management is through adopting income-increasing accounting policies (Butar-Butar, 2020). High company profitability can cause the opportunistic behaviour of using level 3 to decrease. Companies with low performance or profitability tend to have higher level 3 fair value inputs. Banks that have poor performance will be greater to classify their financial assets as level 3 assets and provide greater discretion to manipulate performance and the use of level 3 can be used to disguise poor company performance (Yao et al., 2018; Zhang et al., 2020)

One way to determine the efficiency and potential of banks in carrying out their business activities is to look at the OEOI ratio i.e. ratio of operating expenses on operating income. The lower the OEOI, the better the bank's management performance, because the bank is more efficient in controlling its operating expenses so that the profit growth obtained increases (Fitriyah et al., 2023; Putri Aulia, 2023). Badolato et al., (2014) revealed that high

OEOI tends to encourage managers to carry out earnings management to hide poor company performance.

The capital adequacy ratio in banking is an indicator of the strength of the company. Maintaining the capital adequacy ratio is one of the main factors of banking. Companies with a high capital adequacy ratio will tend to maintain their performance by using opportunistic means (Yao et al., 2018). Manipulating level 3 fair value estimates can have economically meaningful consequences for capital management purposes. Because the realized and unrealized gains/losses of level 3 financial assets will increase or decrease net income, which ultimately impacts capital ratios (Beatty et al., 1996; Jin et al., 2018; Yao et al., 2018).

In accordance with UU No. 40 of 2007, commissioners have a supervisory role and provide advice to the board of directors, while the board of directors has role and responsibility for managing the company. Based on this explanation, it can be said that the board of directors is directly involved in the financial reporting process and is responsible for the financial statements that have been reported. Female members of the board of directors will have a positive impact on decision making and can reduce stakeholder conflicts and can produce more appropriate financial accounting and earnings management will decrease (Butar Butar, 2020). According to Siekkinen, 2017 the fair value relevance of IFRS 13 with the Ohlson approach will increase with the presentation of female board members so that profits will also be lower. Literature on board gender diversity and firm performance (Aluy et al., 2017; Fitroni & Feliana, 2022; Kusumaningrum & Achmad, 2022; Post & Byron, 2015; Velte, 2017) broadly support the view that the presence of female representatives on the board of directors will improve corporate financial performance. This study shows that female representation can improve the function and efficiency of the company's board of directors and affect managerial behaviour. It is anticipated that using conservative financial reporting techniques will lessen

managers' opportunistic behaviour and increase the accuracy of financial statements (Butar Butar & Murniati, 2021). This study extends existing research by discussing the potential impact of the proportion of women on the board of directors on fair value level 3 inputs.

Based on previous studies, research in Indonesia focuses on the effect of fair value on indications of financial statement manipulation and the value relevance of fair value. Researchers conducted research with a different focus, namely testing the effect of fundamental factors of the banking industry on fair value. This research refers to the research of Zhang et al. (2019). Research by Zhang et al. (2019) was conducted in the United States with different market conditions from Indonesia, so it is expected to provide different results from research conducted in Indonesia.

LITERATURE REVIEW

Positive Accounting Theory

Positive accounting theory is a theory used to predict the selection of accounting policies made by companies and how companies will respond to new accounting standards. According to Sutrisno in (Sitohang & Nikmah, 2015) explains that this theory can be used to explain and predict accounting phenomena but cannot be proven correct, but thus it will be tested whether its predictions can be rejected by empirical evidence.

According to (Watts & Zimmerman, 1990) positive accounting theory is the basis for setting accounting standards to then be able to ensure that the norms provided by normative theory are correct and feasible to apply. Meanwhile, according to Sitohang and Nikmah (2015) this positive accounting theory seeks to describe and explain what and how financial information is presented until it reaches its current form.

In the context of fair value input level 3, positive accounting theory can be used to understand why managers might choose to use fair value level 3 valuations in financial reporting. This may be related to incentives to influence the financial statements to look better or suit their interests, such as supporting an increase in asset value that may affect their compensation.

Fair Value

Studies show that fair value is more prominent when the diffusion of IFRS happens around the world (Nugraheni et al., 2022). In the US, companies are required to disclose the techniques used to measure fair value based on SFAS 157. The publication of SFAS 157 was then followed by the publication of IFRS 13 which led other countries to adopt fair value and even became a reference for countries to develop reporting standards regarding fair value.

The implementation of fair value that refers to IFRS 13 in Indonesia is contained in PSAK 68. PSAK 68 (2013) explains that fair value is the price that would be received when selling an asset or the price that would be paid when transferring a liability in an orderly transaction between market participants at the measurement date. An orderly transaction means that the transaction occurs generally and not under duress, such as forced liquidation or forced sale (PSAK 68, 2013). Meanwhile, the definition of market participants according to PSAK 68 (2013) is buyers and sellers in the main market who have certain characteristics.

There are three levels of the fair value hierarchy. 1) Input Level 1 inputs are quoted prices for the asset or liability that can be found in active markets and are accessible to the entity at the measurement date. Quoted prices quoted in active markets are the most reliable evidence and do not require adjustment. 2) Level 2 inputs are inputs that are still observable either directly or indirectly but other than quoted prices included in level 1. 3) Level 3 inputs

are inputs that are not observable for the asset or liability. These unobservable inputs represent the conjectures that market participants use when pricing the asset or liability, including conjectures about risk.

Level 1 fair value is also known as mark-to-market because it is traded in active markets while level 2 and level 3 assets are illiquid assets and are known as mark-to-model because their value cannot be found in active markets (Zhang et al., 2019). Based on research conducted by Ehalaiye et al., (2020) the three levels of hierarchy have different levels of objectivity, namely level 1 has the highest level of objectivity because it is found in active markets, level 2 is less objective because prices are obtained from similar assets or liabilities found in active markets, while level 3 is considered the least objective because it only relies on information contained in the market as input for fair value estimation.

According to Zhang et al. (2019), fair value disclosure is mandatory for companies, but companies are given the option to adopt the level or levels used in fair value measurement. Furthermore, fair value is used to measure the accounts, which is frequently missing from the market (Hastuti et al., 2016). The opinion of assessment professionals is required in order to calculate fair value. The measurement of assets using level 3 inputs provides special attention, because level 3 inputs depend on the manager's discretion. The managers of the organization are expected to execute to the highest standard in order to meet the predetermined financial goals (Indarto & Ghozali, 2014). Managers may feel compelled to conceal real financial performance through improper financial reporting decisions due to their superior information (Butar-Butar, 2022). Therefore, this level 3 fair value valuation gives managers the flexibility to manipulate earnings because the valuation is estimated internally (Yao et al., 2018).

Profitability

Profitability is used to measure the company's performance and ability to earn profits within a certain period of time. The proxy for this variable is ROE because it is the main measure of performance in the banking industry used to allocate capital within and across divisions (Moussu & Petit-Romec, 2014).

Underperforming banks will be more likely to classify their financial assets as level 3 assets and give them greater discretion to influence reported earnings (Chong et al., 2012; Yao et al., 2018; Zhang et al., 2020).

H1: Profitability has a negative effect on level 3 fair value inputs

Operating Expenses – Operating Income (OEOI)

The Operating Expenses-Operating Income (OEOI) ratio is a metric used as a measure to compare operating costs and operating profit to determine the level of efficiency and potential of financial institutions in carrying out their business activities. The lower the OEOI ratio value, the better the management performance of the company.

There has not been much research on the effect of OEOI on level 3 fair value input. However, broader research on the effect of OEOI on earnings management practices has been carried out. Companies that have high OEOI tend to have a gap to carry out earnings management to hide the company's poor performance (Badolato et al., 2014; Fitriyah et al., 2023; Aulia, 2023). High OEOI tends to use higher fair value level 3 inputs for assets, which suggests that these companies may utilize subjectivity in fair value research.

H2: OEOI has a positive effect on fair value input level 3

Capital Adequacy Ratio

The capital adequacy ratio is an indicator used to measure the extent to which a bank or financial institution has sufficient capital to withstand the risk of losses that may occur due to operational and credit activities (Yogi & Damayanthi, 2016). Based on Bank Indonesia Regulation Number 15/12/PBI/20213, it is stated that a bank is said to be healthy if it has a minimum CAR of 8%.

Companies with a high capital adequacy ratio will tend to maintain their performance by using opportunistic means through level 3 fair value inputs (Chong et al., 2012; Yao et al., 2018; Yogi & Damayanthi, 2016).

H3: Capital adequacy ratio has a positive effect on level 3 fair value inputs

The Proportions Of Female Directors

Some research literature on gender diversity and financial performance such as (Kusumaningrum & Achmad, 2022; Peni & Vähämaa, 2010; Post & Byron, 2015; Velte, 2017) generally states that the presence of women on the board of directors improves financial performance.

Siekkinen (2016) explains that the fair value relevance of IFRS 13 with the Ohlson approach will increase with the presentation of female board members so that profits will also be lower. Female members in the board of directors will have a positive impact on decision making and can reduce stakeholder conflicts and can produce more appropriate financial accounting and earnings management will decrease (Peni & Vähämaa, 2010; Velte, 2017).

H4: The proportion of female directors has a positive effect on level 3 fair value inputs

METHODS

Population and Samples

The population of this study are all banking sector companies that are listed on the Indonesia Stock Exchange (IDX) in 2018 - 2022. This study uses banking sector companies applying PSAK 68 as the basis for measuring the fair value of their financial assets. The sample was obtained using a purposive sampling method. According to Sugiyono (2015), purposive sampling is a method of determining samples using certain considerations or criteria including banking companies listed on the IDX in 2018 – 2022, use the fair value hierarchy level 3 in accordance with PSAK 68, and have positive return on equity (ROE).

Table 1. Data Sample

No	Description	2018	2019	2020	2021	2022	Total
1	Banking sector companies listed in the IDX from 2018 – 2022	43	43	46	47	47	226
2	Companies that do not use level 3 of the fair value hierarchy	(18)	(18)	(18)	(22)	(19)	(95)
3	Companies that have negative ROE data	(1)	(52	(5)	(5)	(2)	(15)
Total Sampel							116

Fair Value Level 3

The fair value input percentage of level 3 financial assets is the sum of the fair value of the company's assets classified as level 3 compared to the total fair value (Chong et al., 2012). The fair value input percentage of level 3 financial assets can be measured by the following formula:

$$Input\ FV\ Lv\ 3 = \frac{Total\ Fair\ Value\ Level\ 3}{Total\ Fair\ Value}\ x\ 100\%$$

Profitability

Profitability is a ratio to assess the company's ability and seek profit. In addition, the profitability ratio provides the level of management effectiveness of a company (Agustia &

Suryani, 2021). Profitability in this study is measured using Return on Equity (ROE) with the following formula:

$$ROE = \frac{Net\ Profit}{Total\ Equity}\ x\ 100\%$$

Operating Expenses – Operating Income (OEOI) Ratio

The OEOI ratio aims to measure the level of efficiency of company management, especially banking, in controlling operating costs against operating income (Fitriyah et al., 2023). OEOI is also accompanied by an efficiency index used to measure the company's potential in controlling operating costs to operating profit. The formula used in measuring OEOI in this study is:

$$OEOI = \frac{Operating\ Expense}{Operating\ Income}$$

Capital Adequacy Ratio (CAR)

CAR (Capital Adequacy Ratio) is a capital adequacy ratio that serves to accommodate the risk of loss that will be faced by the bank. The higher the CAR, the better the bank's ability to bear the risk of each risky credit / productive asset. Based on the above interpretation, it can be concluded that the Capital Adequacy Ratio (CAR) is an indicator of the bank's ability to provide reserves to overcome the residual risk of loss (Fitriyah et al., 2023). The capotal adequacy ratio can be measured by the following formula :

$$CAR = \frac{Capital}{ATMR}\ x\ 100\%$$

The Proportion of Female Directors

The female proportion of directors is the percentage of female directors in the company (Fitroni & Feliana, 2022; Kusumaningrum & Achmad, 2022). The female proportion of directors is measured by the following formula:

$$Female\ Proportions = \frac{Female\ Director}{Total\ BOD}\ x\ 100\%$$

Hypothesis Testing

Hypothesis testing in this study was carried out using multiple linear regression tests, with the following equation model:

$$FV\ LV\ 3 = \alpha + \beta 1ROE + \beta 2OEOI + \beta 3CAR + \beta 4FP + \varepsilon$$

where:

FV Lv 3: Percentage of fair value inputs level 3

ROE : Return on Equity ratio

OEOI : Operating expense on operating income

CAR : Capital Adequacy Ratio

FP : Female proportion of director

ε : Error

RESULTS AND DISCUSSION

Descriptive Statistic

Initially, 116 firms met the research criteria, but this number decreased to 96 during the classical assumption tests. Below is the descriptive statistics of 96 research samples.

Table 2. Descriptive Statistic

	N	Minimum	Maximum	Mean	Deviation Standard
ROE	96	0.0010	0.8460	0.9386	0.0995
OEOI	96	0.4659	2.2400	0.842	0.1807
CAR	96	0.1110	0.8490	0.2604	0.1150
FDP	96	0.0000	0.7500	0.2211	0.1923
FV_LV3	96	0.0006	1.0000	0.3902	0.3494

where:

ROE : Return on Equity Ratio

OEOI : Operating Expenses Operating Income

CAR : Capital Adequacy Ratio

FDP : Female Directors Proportion

FV_LV3 : Input fair value level 3

Return on Equity (ROE) is obtained from net profit divided by total equity. The minimum value of this variable is 0.0010 with a maximum value of 0.8460. The mean of the ROE variable is 0.9386, this explains that the mean net profit of the company in this research data is 93.86% of the company's total equity. Standard deviation of this return on equity variable is 0.0995.

Operating Expenses Operating Income (OEOI) is obtained by calculating operating expenses divided by operating income. The minimum value of this variable is 0.4650 while the maximum value is 2.2400. The Mean value of the OEOI variable is 0.8462, this explains that the mean value of operating expenses in this research data is 84.62% of the company's operating income. The standard deviation of this OEOI is 0.1807.

Capital Adequacy Ratio (CAR) is obtained from the calculation of the percentage between capital divided by risk-weighted assets (RWA). Meanwhile, RWA itself can be obtained by summing core capital with complementary capital and multiplying by risk weight.

The minimum value of the CAR variable is 0.1110 with a maximum value of 0.8490. The mean value of the CAR variable is 0.2604, this explains that the mean value of capital is 26.04% of RWA. The standard deviation of this variable is 0.1150.

The female proportion of directors is a comparison between the number of female board of directors and the total board of directors in the company. The minimum value of this variable is 0.000 with a maximum value of 0.7500. The mean value of this variable is 0.2211, this means that the mean value of the total board of directors with female gender is only 22.11% of the total board of directors. The standard deviation of this variable is 0.1923.

Fit Model Test and Coefficient of Determination

Based on the results of the coefficient of determination test, the adjusted R-square (R2) value obtained is 0.085 or 8.5%. This means that the independent variables in this research model can explain 8.5% of the dependent variable while the rest is explained by other variables

Table 3. Coefficient Determination Test

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.346[a]	0.120	0.085	0.321526

a. Predictors : (Constant), FDP, OEOI, ROE, CAR

b. Dependent variable : Fair Value Level 3

Hypotheses Testing

Table 4 shows the result of the hypothesis testing.

Hypothesis 1: return on equity (ROE) to input fair value level 3

Based on table 3, the return on equity (ROE) variable has a p-value of 0.028 and a t-value of 2.225. The p-value is significant at the 1% level but the direction of the coefficient contradicts hypothesis 1 which states that profitability proxied by ROE has a negative effect

on fair value level 3 input of financial assets. Interestingly, this result shows a positive and significant correlation between ROE and fair value level 3 inputs.

Table 4. Hypothesis Testing

ROE	0.028 *
	2.225
OEOI	0.100 **
	1.659
CAR	0.636
	0.475
FDP	0.716
	0.365
R2	0.085

** Significant at the 0.05 level; * Significant at the 0.1 It is a 2-tailed test

where:

ROE : Return on Equity Ratio

OEOI : Operating Expenses Operating Income

CAR : Capital Adequacy Ratio

FP : Female Directors Proportion

Good company performance will result in higher ROE and can result in high fair value level 3 inputs. explains that banks that have poor performance will be greater to classify their financial assets as level 3 assets and give them greater discretion to influence reported income and the existence of fair value level 3 inputs can be used to disguise poor company performance (Yao et al., 2018; Zhang et al., 2020).

Hypothesis 2: operating expenses to operating income (OEOI) to input fair value level 3

Based on table 3, the Operating Expenses Operating Income variable has a p-value of 1.100 and a t-value of 1.659. The p-value is significant at the 5% level. Based on the results of the regression calculation, hypothesis 2 is accepted.

These results are in line with previous research which states that OEOI has a significant effect on the earnings growth variable and high OEOI tends to encourage managers to carry out earnings management to hide poor company performance (Badolato et al., 2014; Fitriyah et al., 2023).

Hypothesis 3: Capital Adequacy Ratio (CAR) to Input Fair Value Level 3

CAR has a p-value of 0.636 and a t-value of 0.475. The p-value is significant at the 10% level and the coefficient is consistent with hypothesis 3, CAR has a positive effect on fair value level 3 inputs. Banks with lower capital ratios have greater stock market incentives to report opportunistically because low capital ratios indicate poor financial health (Yao et al., 2018).

Manipulating level 3 fair value estimates can have economically meaningful consequences for capital management purposes. This is because realized and unrealized gains/losses on level 3 financial assets will increase/decrease net income and ultimately impact capital ratios. One of the things that shows that banking companies carry out earnings management is motivated by the minimum CAR ratio determined by Bank Indonesia, which is 8% (Siregar & Anggraini, 2019; Yao et al., 2018; Yuyun et al., 2021).

Hypothesis 4: The proportions of female directors to input fair value level 3

The proportion of female directors' variable has a p-value of 0.716 and a t-value of 0.365. The p-value is significant at the 10% level. Based on the regression results, hypothesis 4 in this study is rejected.

The results of this regression are in line with research conducted by Velte, (2017) which explains that the presence of women on the management board has a positive impact on the relevance of accounting fair value assessed at level 1 and 2 ("mark to market") but not significantly at level 3 ("mark to model"). Gender diversity is not the only factor in the

occurrence of fraud, but it is also necessary to look at other things such as conservatism, risk aversion, and managerial opportunism (Peni & Vähämaa, 2010; Post & Byron, 2015; Butar Butar, 2019). The fair value relevance of IFRS 13 with the Ohlson approach will increase with the presentation of female board members so that earnings will also be lower (Siekkinen, 2017).

CONCLUSION AND IMPLICATIONS

Conclusion

This study aims to determine the effect of company fundamentals, i.e. profitability proxied by ROE, OEOI, CAR, and the proportion of women on the board of directors on fair value level 3 inputs. The results of this study are: 1) Return on equity (ROE) has a effect on fair value level 3 inputs; 2) OEOI has an influence on fair value level 3 inputs; 3) CAR has a not influence on fair value level 3 inputs; and 4) the proportion of women in the board of directors has a not influence on fair value level 3 inputs.

The results of this study are different from previous studies, because the average previous study was conducted in developed countries such as the US, Australia, New York, New Zealand, Pennsylvania, China with the results that there is a negative influence between ROE, OEOI, CAR, and the proportion of female directors towards fair value level 3 inputs. Similar research, especially in developing countries such as Indonesia, has not been widely conducted due to the complexity and challenges associated with different economic, business, regulatory, and infrastructure environments compared to developed countries. Firm business environment may affect the reliability of financial statements to reflect firm economic reality (Butar-Butar & Lily Indarto, 2018). The challenge of fair value implementation in Indonesia itself, among others, is that not all financial instruments are traded in the capital market

coupled with the absence of active markets for both financial and non-financial assets, making it difficult to determine fair value using market data or using direct market quotes.

Recommendations

This study has some implications as well. First, Indonesian banking industries should focus more on measuring and disclosing fair value, particularly at level 3. This is because fair value disclosure may contain significant information about a company's performance and state. Second, since the disclosure of fair value may potentially contain pertinent information to ascertain a company's performance and condition, investors in Indonesia may utilize level 3 fair value as an extra indicator to evaluate a company's performance.

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