

The Effect of Corporate Governance on Financial Performance: Evidence from Islamic Banks in Indonesia

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ABSTRACT

This study aims to examine the effect of corporate governance on financial performance of Islamic banking in Indonesia. Corporate governance mechanism determined by board of director, independent commissioner, and sharia supervisory board, meanwhile the financial performance is calculated by using Return on Assets (ROA) and Economic Value Added (EVA). The data were collected from each bank's annual report in a period 2014-2018, thus 9 Islamic Banks were taken by purposive sampling. The analysis method is path analysis and applied by WarpPLS 6.0 tool. This study reveals that board of director had significant influence to ROA, however independent commissioner and sharia supervisory board had no significant influence to ROA, on the other hand only independent commissioner and ROA had significant influence to EVA. The findings can be a consideration for banking management to control financial performance, by improving good corporate governance therefore the financial performance will increase.

Keywords: Corporate Governance, Return on Asset, Economic Value Added.

1. INTRODUCTION

The main objective of the company is to increase welfare and maximize the owner's or shareholder's wealth through increasing the value of the company [1], to prosper the shareholders, the company must strive for profits, this gain will indirectly add to the value of the company. Subramanyam (2010) states that adding company value can be seen from the company's ability to achieve the goals of the company, namely maximize shareholder wealth by providing added value from the invested capital [2]. To increase company value, Good Corporate Governance (GCG) is needed, Kaihatu (2006) states that it is not enough for management to only ensure that the company's management process runs efficiently but also requires GCG to ensure that management in the company runs well [3]. GCG is a concept that emphasizes the importance of the rights of shareholders to obtain information correctly, accurately, and in a timely manner, in addition to disclosing all information on the financial performance of companies, both public and private companies as an effort to improve company performance and value [4]. Herawaty (2008) adds that corporate governance is related to how investors believe that managers will provide benefits for investors, believe managers will not steal, embezzle or invest in unprofitable projects related to funds or capital that have been invested by investors, GCG. it also has to do with how investors control their managers [5]. The implementation of

GCG is not only carried out by companies but also by Sharia Commercial Banks, Undang-Undang Perbankan Syariah (UUPS) of 2008 explains that Sharia Commercial Banks is a business entity whose function is to collect funds from the public and channel funds to the community, which has a system and the mechanism of business activities based on Islamic law, as regulated in the Qur'an and Hadith. Aldira (2014) states that the concept of GCG between Islamic banks and conventional banks basically the same, but what makes the difference between the two is the existence of sharia compliance, namely compliance with sharia [6]. According to Brigham & Houston (2010) in the concept of value based management, namely the increase in company value can be seen by using an economic value added (EVA) approach [7]. EVA is a financial management method for measuring economic profit in a company which states that welfare can only be created if the company is able to meet all operating costs and capital costs [8]. EVA according to Winarto (2005) explains how much wealth a company can create or otherwise lose during its operational activities. this company value can be used as a better reference for the owner of capital to consider whether the company will provide a gain or loss on the invested capital. In the end, the owners of capital will be able to calculate the increase or decrease in the actual value of the real condition [9].

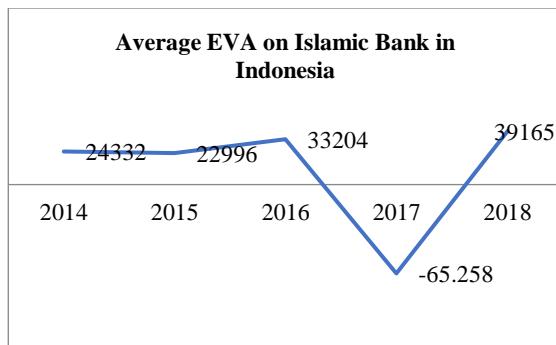


Figure 1. Average EVA on Islamic Bank in Indonesia

Based on the table above, Islamic Commercial Banks in Indonesia have fluctuating company values, where in 2016 to 2017 the average EVA of Islamic Commercial Banks has decreased drastically to a negative value of -65,258. The achievement of management / GCG can be measured from a financial point of view, namely maximizing company value, from this explanation, the fluctuating phenomenon and drastic decline in 2017 illustrates that Islamic Bank in Indonesia has not been able to achieve its company's goals properly, namely maximizing company value. GCG structure in this study can be measured through directors, independent commissioners, and sharia supervisory board

1.1. Board of Directors (BoD)

The board of directors is a party to a corporate entity whose job is to carry out operations and management of the company. Members of the board of directors are appointed by the General Meeting of Shareholders (GMS). The board of directors is fully responsible for all forms of operations and management of the company in order to carry out interests in achieving company goals. The board of directors is also responsible for the company's dealings with external parties such as suppliers, consumers, regulators and legal parties. Playing such a large role in managing the company, directors basically have significant control rights in managing company resources and funds from investors [10]. According to Fama & Jensen (1983) directors have two main functions, namely to function as management decision makers (short-term corporate strategy, investment and financial policies) and function in controlling decisions (managerial compensation, monitoring of capital allocation) [11]. Shakir (2010) states that there are several deficiencies in the size of the board of directors. The large size of the board of directors will result in a lack of meaningful discussion, because expressing opinions in large groups is generally time-consuming, difficult and results in a lack of cohesiveness on the board of directors [12]. Kurnia (2008) found that the large size of the board of directors will lead to a large amount of fraud in the financial statements and a decrease in the ability of the board of directors to monitor so that various problems will be raised such as in terms of coordination,

communication, and decision making [13]. The size of the number of boards of directors itself is adjusted to the operational needs of the company. The more and more complex the company is, to produce maximum performance, of course, requires an appropriate number of boards of directors. If the number of boards of directors is more than one, the regulations regarding the division of duties and powers of each member of the board of directors, as well as the amount and type of income are determined by the RUPS [14].

$$\text{Board of Directors Size} = \text{Number of Directors}$$

1.2. Independent Commissioner (IC)

KNKG (2006) defines the board of commissioners as the highest internal control mechanism that is collectively responsible for supervising and providing input to the board of directors and ensuring that the company is implementing GCG properly. In essence, the Board of Commissioners is a supervisory mechanism as well as a mechanism to provide direction and direction to company managers. Management is responsible for increasing the efficiency and competitiveness of the company, while the board of commissioners is responsible for overseeing management, therefore the board of commissioners is the center of resilience and success in the company. [15]

In PBI (2009) the number of commissioners is at least three people and at most the same as the number of members of the board of directors consisting of the board of commissioners and independent commissioners, the number of independent commissioners is at least 50% of the number of commissioners. All members of the board of commissioners must meet the requirements of having passed the Fit and Proper Test in accordance with the provisions of Bank Indonesia, other than that members of the board of commissioners can only hold positions as members, directors or executive officers in one non-financial institution / company. and has no family relationship with members of the board of commissioners and / or members of the board of directors [16]. According to Puspitasari & Ernawati (2010) independent commissioners are members of the board of commissioners who do not have financial, management, share ownership and / or family relationships with other members of the board of commissioners, directors and / or controlling shareholder or other relationships that may affect their ability to act independent [17].

$$\text{IC Size} = \frac{\text{Independent Commissioners}}{\text{Commissioner}}$$

1.3. Sharia Supervisory Board (SSB)

The Indonesian Banking GCG Guidelines (2004) stated banks that carry out business activities based on

sharia principles; they must have a sharia supervisory board (SSB), namely an independent body in charge of directing, providing consulting, evaluation (evaluation) and supervision (supervising). , this is what distinguishes between Islamic banks and conventional banks. The objective of the SSB is to ensure that all transactions are based on sharia principles. AAOIFI (2008) states that SSB is responsible for supervision and consultation to ensure Islamic banks actually comply with the rules and principles of sharia in the operation of their banks [18]. The role of SSB varies from one sharia institution to another depending on the nature, level, and level of sharia compliance. Banaga et al (1994) state the responsibilities of SSB, namely answering questions and problems, giving opinions, reviewing and improving all business transactions and operations so that they remain within the corridor of sharia [19]. SSB plays an important role in all Islamic financial institutions. SSB plays a strong and authentic role in controlling the activities of financial institutions (El-Khelaifi, 2005) [20]. Grais & Pellegrini (2006) summarizes the functions of SSB, namely calculating and dividing zakat, issuing non-halal profits and being an advisor in income sharing and expenditure. Moreover, DPS functions according to Hasan (2010), namely attending product pre-certification, developing products, composing, product certification through fatwas and directly monitoring the product's sharia compliance [21].

$$\text{SBB Size} = \text{Number of SBBs}$$

1.4. Financial performance

The company's financial performance is the company's ability to manage and allocate its resources in order to achieve its goals (goal ending). Performance appraisal aims to motivate employees to achieve organizational goals and objectives and comply with company behavior standards reflected in the corporate culture produce the expected action and work performance [22]. Company performance can be measured using ratio analysis; ratio analysis is a number that shows the relationship between the elements in the financial statements, the relationship is expressed in a simple mathematical form [23]. One of the financial ratios that measure performance is profitability, according to Kasimir (2012), the profitability is a ratio to assess a company's ability to seek profit. This ratio also provides a measure of the level of management effectiveness of a company; this is indicated by the profit generated from sales and investment income [24]. Measurement of the profitability ratio can be measured by Return on Assets (ROA), ROA shows the ability of capital invested in all assets owned to generate profits [25]

$$\text{ROA} = \frac{\text{Net Profit After Tax}}{\text{Total Asset}}$$

Firm value is the selling price of a company that is worth paying by investors if the company is sold or the community's appreciation for the company's performance and achievements in serving stakeholders [26]. The measuring instrument used to measure firm value is the economic value added (EVA) method. This method can be used to value a company from investment. Positive EVA shows that management has succeeded in increasing firm value and vice versa, EVA is a method of financial management to measure economic profit in a company which states that welfare can only be created when the company is able to meet all operating costs and capital costs [27]. According to O 'Byrne and Young (2001), EVA measures the difference between returns on firm capital and cost of capital. EVA is the company's goal to increase the value or value added of the capital invested by shareholders in the company's operations. Therefore, EVA is the difference in operating profit after tax (Net Operating Profit After Tax or NOPAT) with the cost of capital (Cost of Capital), the concept of Economic Value Added (EVA) is able to cover the weaknesses of financial ratio analysis so that the two financial performance measuring tools can help parties- the concerned [28].

$$\text{EVA} = \text{NOPAT} - \text{Cost of Capital}$$

2. RELATED WORK AND HYPOTHESIS

2.1. Board of Directors, Bank Performance and Company Value

The board of directors is fully responsible for the implementation of sharia commercial bank management based on prudential principles and sharia principles. The higher the composition of the board of directors, the better in managing the bank in carrying out its duties and increasing the profitability of the bank. The independence of the board of directors will encourage company transparency to all stakeholders through improving company performance and mitigating the risks it faces [29]. The board of directors in a bank will determine the policies taken in the long and short term, so if there are many boards of directors it will make it easier to coordinate in decision making. Board of directors' policies can significantly affect BUS finances and have an impact on the budget, human resources and organizational structure [30]. Also supported by Addiyah & Chariri (2014), that states that the board of directors has a positive and significant effect on the profitability of BUS as measured by ROA [30]. However, if the board of directors is associated with firm value according to Wulandari (2006), shareholders will be more careful in choosing the optimal number of boards of directors because increasing the number of boards of directors will have an effect on increasing agency costs. In addition, there is a tendency that shareholders only consider the return factor they get which results in a lack of attention and

supervision on the performance of company management so that it is very possible for management to deviate from it [31]. It is also supported by research by Hidayati & Setiawan (2012) which states that the board of directors has a negative effect on firm value as measured by using EVA [32].

H₁: The Board of Directors (BoD) has a positive effect on Bank Performance (ROA)

H₂: The Board of Directors (BoD) has a negative effect on Company Value (EVA)

2.2. Independent Commissioner, Financial Performance and Company Value

The presence of independent commissioners is the key to better company business performance [33]. In general, the board of commissioners is given the responsibility for monitoring the quality of information contained in financial reports, this is important given the management's interest in monitoring financial performance, in this case profit [34]. Research by Choe and Lee (2003) shows that the presence of independent commissioners has a positive effect on financial performance [35], this result is also supported by research by Al-Manaseer et al (2012) and Muttakin & Ullah (2012) which states that there is a positive relationship between GCG and financial performance [36] [37]. Small boards of commissioners are more effective in carrying out supervisory actions than large boards of commissioners which are considered less effective in carrying out their function as a monitoring tool for management activities because it is difficult to communicate, coordinate and make decisions in this case will have an impact on company value [38]. Supported by Tertijs & Christiawan (2015), that states that independent commissioners have a negative effect on firm value [39].

H₃: Independent Commissioners (IC) have a positive effect on Bank Performance (ROA)

H₄: Independent Commissioner (IC) has a negative effect on Company Value (EVA)

2.3. Sharia Supervisory Board, Bank Performance and Company Value

Each member of the Sharia Supervisory Board (SSB) must have good scientific qualifications, namely in the field of muamalah fiqh science and Islamic economics so that when performing their duties, Islamic banks can implement sharia principles properly and accordingly. If the members of the sharia supervisory board do not meet the appropriate scientific specifications and do not understand banking techniques, it will result in suboptimal supervision and other strategic roles, besides that SSB must master knowledge related to Islamic banking such as monetary economics, for example the impact of interest on investment, production, unemployment, and so on [40]. This is supported by the results of research conducted by Hassan et al (2017) and Srairi (2015) showing that

the SSB has a positive effect on the performance of Islamic banks, the more the number of DPS members who have experience, expertise and professionalism will encourage better company performance. If the bank's performance is good, it will affect the value of the company [41] [42].

H₅: Sharia Supervisory Board (SSB) has a positive effect on financial performance (ROA)

H₆: Sharia Supervisory Board (SSB) has a positive effect on Firm Value (EVA)

2.4. Financial Performance and Company Value

According to Karamoy (2016), positive EVA value shows management's ability to create an increase in the value of company / capital owner assets, and becomes a benchmark for investors or potential investors in making investment decisions. Negative EVA value implies a decrease in the value of wealth, and is followed by the desire of investors to sell shares of the company. Companies are considered to have better performance if they are able to produce positive EVA values. This shows that management has carried out its duties properly. Companies that have high profitability every year tend to be in demand by many investors. Investors think that if the company has a large profit, it will generate a large profit. This is captured by investors as a positive signal from the company, which will increase investor confidence and will facilitate company management to attract capital in shares. Thus, it can be explained that the company's value can be reflected in its ability to generate profits. The higher the level of profitability, the higher the firm value and vice versa, the lower the level of profitability, the lower the firm value [43]. Monoarfa's research (2018) found that profitability has a significant positive effect on firm value. This shows that the higher the profitability, the higher the firm value [44].

H₇: Financial performance has a positive effect on Firm Value

3. METHOD

This research is a quantitative study using panel data, namely a combination of time series (time series) and cross section (number of banks). Quantitative research can be interpreted as a research method based on the philosophy of positivism, used to examine specific populations and samples, data collection using research instruments, quantitative or statistical data analysis, with the aim of testing predetermined hypotheses [45]. The population in this study was Sharia Commercial Banks registered with the OJK for the last 5 years from 2014 to 2018, the number of Sharia Commercial Banks registered until 2018 were 14 banks. Population is a combination of all elements in the form of events, things or people who have similar characteristics which become the center of attention of a researcher because it is seen as a research universe. The sampling technique used in this research is

purposive sampling technique, because the information required can be obtained from a certain target group who is able to provide information and meet the specified criteria [46]. The sample criteria for this study are:

1. Sharia Commercial Banks registered with the OJK (Financial Services Authority) during 2014-2018.
2. Have annual financial reports for the observed study period.
3. Has complete data and information relating to the value of all observed research variables.

Based on the sample criteria, 9 Islamic Commercial Banks will be examined in this study, namely:

Table 1. 9 Islamic commercial banks base on the sample criteria

No	Islamic Banks
1	PT. Bank Muamalat Indonesia
2	PT. Bank Mega Syariah
3	PT. Bank BRI Syariah
4	PT. Bank Syariah Bukopin
5	PT. Panin Dubai Syariah
6	PT. Bank Victoria Syariah
7	PT. BCA Syariah
8	PT. Bank BNI Syariah
9	PT. Bank Maybank Syariah Indonesia

This study uses path analysis. Path analysis is the development of a regression model so that analysis can be said to be a special form of path analysis (regression is a special case of path analysis) [47]. Path analysis is used to describe and test the causal model of the relationship between variables. Through this path analysis, it will be possible to find the most appropriate and shortest path for an independent variable to the last dependent variable. The analytical tool in data processing in this study uses Warp PLS. The analytical tool in data processing in this study uses Warp PLS.

4. RESULT

4.1. Model Fit

Table 2. Model fit

Description	Value	P-value	Result
Average Path Coefficient (APC)	0,225	0.026	Fit
Average R-squared (ARS)	0,320	0.005	Fit
Average adjusted R-squared (AARS)	0,264	0.014	Fit
Average block VIF (AVIF)	1,100	-	Fit
Average full collinearity VIF (AFVIF)	1,517	-	Fit
Tenenhaus GoF (GoF)	0,565	-	Fit
Sympson's Paradox Ratio (SPR)	1,000	-	Fit
R-squared Contribution Ratio (RSCR)	1,000	-	Fit
Statisti Supression Ratio (SSR)	0,857	-	Fit
Nonlinear bivariate causality direction ratio (NLBCDR)	0,929	-	Fit

Based on the results of the fit model above, it is explained that the fit model of this study obtains 10 (ten) criteria which are all accepted, thus this research model fits the research data

4.2. Path Analysis

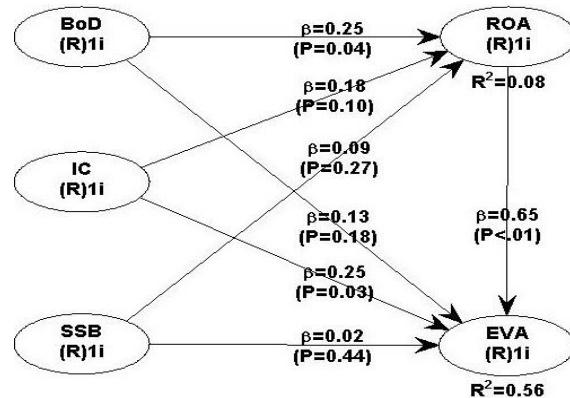


Figure 2. Path analysis

Table 3. Path analysis

Independent Variable	Dependent Variable	Path Coef.	p-value	Result
BoD (X ₁)	ROA (Y ₁)	0,25	0,04	Significant
BoD (X ₁)	EVA (Y ₁)	0,13	0,18	Not Significant
IC (X ₂)	ROA (Y ₁)	0,18	0,10	Not Significant
IC (X ₂)	EVA (Y ₂)	0,25	0,03	Significant
SSB (X ₃)	ROA (Y ₁)	0,09	0,27	Not Significant
SSB (X ₃)	EVA (Y ₂)	0,02	0,44	Not Significant
ROA (Y ₁)	EVA (Y ₂)	0,65	0,01	Significant

1. Hypothesis 1 states that board of directors (BoD) have a positive effect on ROA. Based on the results of the path coefficients or the path coefficient of the directors of 0.25 and a significance of 0.04 (P-value <0.05), it means that the directors have a positive effect on ROA. Thus hypothesis 1 which states that "Directors have a positive effect on ROA" is accepted.
2. Hypothesis 2 states that board of directors (BoD) have a negative effect on EVA. Based on the results of the path coefficients of the directors of 0.13 and a significance of 0.18 (P-value> 0.05), it means that the directors have no effect on EVA. Thus, hypothesis 2 which states that "Directors have a negative effect on EVA" is rejected.
3. Hypothesis 3 states that independent commissioners (IC) have a positive effect on ROA. Based on the results of the path coefficients for independent commissioners of 0.18 and a significance of 0.10 (P-value> 0.05), which means that independent commissioners have no effect on ROA. Thus, hypothesis 3 which states that "independent commissioners have a positive effect on ROA" is rejected
4. Hypothesis 4 states that the independent commissioner (IC) has a negative effect on EVA. Based on the results of the path coefficients of the independent commissioner of 0.25 and a significance of 0.03 (P-value <0.05), it means that the independent commissioner has a positive effect on EVA. Thus, hypothesis 4 which states that "independent commissioners have a negative effect on EVA" is rejected
5. Hypothesis 5 states that the sharia supervisory board (SSB) has a positive effect on ROA. Based on

the results of the path coefficients of the sharia supervisory board, it is 0.09 and a significance of 0.27 (P-value> 0.05), which means that the sharia supervisory board has no effect on ROA. Thus, hypothesis 5 which states that "the Islamic supervisory board has a positive effect on ROA" is rejected

6. Hypothesis 6 which states that the sharia supervisory board (SSB) has a positive effect on EVA. Based on the results of the path coefficients of the sharia supervisory board of 0.02 and a significance of 0.44 (P-value> 0.05), which means that the sharia supervisory board has no effect on ROA. Thus, hypothesis 6 which states that "the sharia supervisory board has a positive effect on EVA" is rejected
7. Hypothesis 7 which states that "ROA has a positive effect on EVA. Based on the results of the path coefficients ROA of 0.65 and a significance of 0.01 (P-value <0.05), which means ROA has a positive effect on EVA. Thus, hypothesis 7 which states that "ROA has a positive effect on EVA" is accepted.

5. DISCUSSION

Directors have an effect on financial performance on financial performance, this means that the more directors, the work and time required will be more efficient by dividing tasks among units under the directors, therefore the performance will be more effective. Directors have no effect on firm value, because directors still prioritize improving financial performance rather than company value, even though company value is very important to attract new investors, where the new paid-up capital will increase the income that will be obtained automatically improves financial performance. Independent commissioners have no effect on performance, this means that the supervision carried out by the commissioners has a small impact on improving financial performance because everything has been managed directly by the board of directors and their ranks. Independent commissioners have an effect on firm value, supervisory actions taken by commissioners will have an impact on company value, investors / shareholders feel that the presence of these independent commissioners in overseeing their corporate governance is very important in order to avoid agency fees that will have an impact on returns obtained. Sharia supervisory board has no effect on financial performance. This means that the duties and responsibilities of the Sharia supervisory board are limited to making products / contracts that are based on Sharia principles and have nothing to do with financial performance. The Sharia supervisory board has no effect on firm value, the Sharia supervisory board does not have the authority to manage company returns / profit sharing for shareholders, its only job is to

supervise Islamic commercial banks so that they do not leave Sharia principles. Financial performance has an effect on firm value; this is because if the financial performance increases, it will automatically lead new investors to embed their model in Islamic Commercial Banks because of the high return that will be obtained later, from this return the company value in the eyes of investors and shareholders increases. Good Corporate Governance has no effect on firm value mediated by financial performance, meaning that good corporate governance that increases firm value does not necessarily increase financial performance; this is the possibility that other factors are stronger in mediating the influence between good corporate governance and firm value.

6. RECOMMENDATIONS

For further research, first the independent variables used in this study are only the directors, independent commissioners, and Sharia supervisory board, other variable of corporate governance that affect financial performance can be added, such as internal audit, board meeting, and financial expert, that additional can have a greater understanding on good corporate governance in Islamic banking industry for improving financial performance. Second, the sample of this study only uses Islamic Commercial Banks, it would be better if the samples were added from Sharia Business Units (UUS) and Sharia Rural Banks (BPRS) so that it can be seen further how good corporate governance has an impact on Sharia companies in Indonesia.

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