THE INFLUENCE OF IMPLEMENTING CORPORATE GOVERNANCE PRINCIPLES TOWARDS CORPORATE FINANCIAL PERFORMANCE IN BANKING SECTOR

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ABSTRACT

History has recorded that banking scandals have never ceased to happen. It implies that the urgency for banking sector to manage banks prudently by implementing good governance practice. The good government practice is designed to improve bank performance, protect stakeholder interest, and increase adherence to prescribed regulations, legislations and also generally accepted ethical values. The implementation of good corporate governance in long period of time has an impact on bank performance because good corporate governance principles are the foundation of banking organizing process. This research aims to test the impact of corporate governance principle implementation on financial performance of banking sector. The secondary data were obtained from Indonesian Capital Market Directory (ICMD) and Annual Report from the Faculty Data Centre. The result shows that the implementation of corporate governance has positive impact on financial performance of banking sector as measured by Return on Equity (ROE). This suggests that in the future, the banking sector should proceed to implement corporate governance principle especially on disclosing some aspects such as environment, quality, and standardization.

***Key words**: Corporate governance, banking financial performance, ROE*

INTRODUCTION

The economic crises in mid-1997 has put Indonesia in its worst economic turmoil since ever. For example, a study by Johnson (Darmawati et.al 2005) stated that lacking of corporate governance contributed to causing the crises lingered in Asian countries, which is characterized by managers who acted on their sole interests. Managers performed actions ignoring the facts that it might have jeopardized the interests of stockholders for whom managers should generate return on shares they have invested. This interest gap led to a conflict called agency problem.

Unexceptionally, banks as intermediary institution that are supposedly to be under the demand to always perform their tasks prudently shared the same corporate governance issues. They play an important part as institutions that carry out the public trust and economic pillars of the nation. Nonetheless, there are still many misconducts due to being lack of corporate governance in the banking sector itself. From many cases in the banking sector, most occured in the form of fraud involving primary internal parties because of the information asymmetry they benefit from (Rico 2006). In response to the misconducts occured in the banking sector, the government had issued *Peraturan Bank Indonesia* (Regulation issued by Central Bank of Indonesia) No.8/4/PBI/2006 concerning implementation of Good Corporate Governance in Banking Industry.

Based on the evaluation conducted by Bank Indonesia, only 30.7% of banks in the nation had fulfilled the major points of concern in Good Corporate Governance principles. While a total of 69.3%, others would still need to grow goodwill to meet such

requirements. Senior Researcher of Indonesian Banking Architecture team of Bank Indonesia, Emmy Prabawani, noted that the most violated corporate governance principles in banking are the necessary role of an independent commissioner board and the banking audit committee. The evaluation also revealed that 101 banks in the period of September 2007 showed 53.5% in vacant of independent commisioner, and 30.7% of them in lack of complete structured committee. This became one of the main inhibitors in developing national banking, apart from risk and capital management.

The implementation of good corporate governance in the long term is relevant to company's performance because the principles apply the ground rule for the process of organizing companies in their accountability to the public. Beasly et al. (Isgiyarta and Tristiarini 2005) pointed out that companies that carry out good corporate governance tend to improve their performance. Therefore, this study aims to examine the impact of implementing corporate governance principles towards the performance of the banking sector, so it is to provide an empirical support for the benefit of implementing good corporate governance in banking industry.

THEORETICAL FRAMEWORK

Corporate Governance

The Forum for Corporate Governance Indonesia (FCGI) defines corporate governance as a set of rules to govern the relationship between shareholders, management (managers), the company, creditors, government, employees, and other internal or external stakeholders regarding their particular rights and obligations. The purpose of corporate governance is to create added value of the company for every stakeholders associated with it. According to *Bank Indonesia* Regulation No.8/4/PBI/2006, good corporate governance is banking governance principles to implement transparency, accountability, responsibility, independence, and fairness. According to BEINEWS (2004), these principles are described as follows:

Transparency
The banking sector should provide timely, adequate, clear, accurate, and comparable information. Such information should also easily be accessible to stakeholders in accordance with their rights.

Accountability
The banking sector should establish clear responsibilities for each component of the organization supporting the vision, mission, business objectives and strategy of the company. Each component is competent with their specific responsibilities and able to understand its role in implementing good corporate governance.

Responsibility
The banking sector must uphold the principle of prudential banking practices. This principle is conducted within framework of current law and regulations. In addition, the banking sector should be a role model of a good corporate citizen.

Independence
The banking sector ought to avoid the unfair domination among stakeholders. Bank managers should not take one side of interests and should prevent conflict of interest of any kind.

Fairness
The banking sector must consider and take into account of interests of all stakeholders under the principles of equality and fairness. However, it also needs to open chances for stakeholders to deliver inputs for the benefit of the banking sector.

The following are the four main principles of Good Corporate Governance by the OECD (Organization for Cooperation and Economic Development) as stated by the *Bank Indonesia* in 2005 (http://www.sdpconsulting.com).

These are them used as reference in this study.

Transparency
Transparency is associated with the quality of information provided by the company. Investors' trust will depend much on the quality of information the company gave. Therefore, companies are required to provide clear, accurate, timely and comparable information. Delivering information to the public in an open, actual, credible and timely way will simplify the assessment performance and risks facing the company.
Accountability
Accountability is associated with the application of system that controls the relationship between components of the company. Accountability is required as a solution to overcoming agency problems that arise among shareholders and directors with the commissioner in between. Therefore, accountability is essential to encourage all sections in the company to be aware of their responsibility, authority and rights-obligations.
Responsibility
The principle of responsibility emphasizes the existence of a coherent system in governing mechanisms of corporate accountability towards its shareholders and stakeholders. It is to realize the objective to accommodate the interests of parties attached to the company such as societies, government, business associates and etc.
Fairness
This principle emphasizes the assurance of protected rights of shareholders, including the rights of minority shareholders and foreign shareholders as well as equal treatment to all investors. Fairness practice also includes the support from law and regulations system, as well as their enforcement all parties. It is important to protect the interests of shareholders, particularly minority shareholders from fraudulent and insider trading practices.

According to FCGI (2007), the benefits gained from the implementation of good corporate governance are as the following: 1) Improvement of performance through better process of decision making, improvement of operational efficiency as well as service quality to stakeholders; 2) Facilitating less costly and not rigid (of trust factor) funding source and, which eventually would increase the corporate value; 3) Restoring investors' trust to invest their fund in Indonesia; 4)

Satisfying shareholders as corporate performance increases by improving shareholders' value and dividend payments.

Corporate Performance

Corporate performance defines the periodic measurement of progress on the long-term and short-term objectives, and of reports supporting the decision makers in an effort to improve programs. It can also be measured by financial ratios, which are based on financial reports. For that reason, banking crises in mid 1997 which resulted in downturn of the banking sector in Indonesia might be triggered by the lack quality of corporate governance, particularly in the management practices as reflected by the fragile internal condition – caused by excessive credit concentration, poor bank management, lack of transparency, weak accounting system, lack of internal control and rather ineffective supervision and law enforcement (Bank Indonesia 2005).

Influence of Corporate Governance towards Operational Performance

Basically, the companies in banking sector perform their operational activities as financial intermediaries by mobilizing and distributing funds. Thus, banking business shall be established on a foundation of trust. To maintain that trust, not only banking industry does need to comply with strict regulations (highly regulated), but also they have to grasp the spirit embodied in Good Corporate Governance (Masassya 2004). Corporate governance is the control mechanism to govern and manage businesses as a mean to improve prosperity and corporate accountability, which ultimately aim to deliver

shareholder value. This argument is supported by Newel and Wilson (2002) in Tjager et al. (2003) which stated that theoretically corporate governance practices could improve shareholder value, such as improving financial performance, reducing the risks upon managers' own interest misconducts, and improving investors' trust. Consequently, the implementation of corporate governance could bring about values for the company e.g good financial performance and a positive market reaction due to increased investors' trust in corporate performance (Lastanti 2005). In addition, good corporate governance could improve corporate performance through better process of decision making, operational efficiency and service quality to stakeholders (Priambodo and Supriyatno 2007).

So far, researches on the relationship between corporate performance and corporate governance still result an inconsistencies. Daily et. al (1998) and CBI survey, Deloitte and Touche, (1996) found no empirical evidence regarding the relationship between corporate governance and corporate performance. Supatmi (2007) concluded that there is no assurance if high-rated companies in good corporate governance will be supported by a good performance as well. However, in the opposite, Gompers et. al (2003) found a positive relationship between corporate governance index and a long-term corporate performance. This supports the statement of Berghe and Ridder that companies experiencing poor performance did suffer from poor corporate governance as well (Darmawati et al 2004). Milton (2000) showed that corporate governance variables strongly influenced towards corporate performance. It implied that companies directed in good corporate governance will be prudently managed and consider any implication towards all parties associated with the company. Thus, it can transparently be accountable for. In addition, by implementing corporate governance, a company can direct its investment resources into highly profitable projects which ultimately can increase Return on Equity.

The implementation of corporate governance principles will improve public trust towards the company. The greater the public trust towards banking sector, the greater interest of the society to use banking products and services and in turn, it will have an impact on the improvement of banking performance. Thus, the hypothesis is formulated as:

H_1*: There is an influence of implementing corporate governance towards corporate performance in the banking sector.*

RESEARCH METHODS

Population and Sample

The population in this study is the entire companies operating in banking sector listed in Indonesia Stock Exchange (*Bursa Efek Indones*/BEI) during 2004-2006. Non-probability sampling technique with purposive sampling defines the sampling methods as shown in Table 1 below,

Table 1
Sampling Method

Description	Number of companies
Banking companies listed in BEI within year 2004-2006	26
Banking companies issuing consecutive annual report from year 2004 to 2006	17
Banking companies not-issuing consecutive annual report from year 2004 to 2006	(9)
Number of samples with fulfilled criteria	**17**

Type and Source of Data

The data required in this research are total equity, net income and items of the Corporate Governance implementation which are acquired from Indonesian Capital Market Directory (ICMD), the online publication of company's annual report and Data Center of the faculty of Economics, Universitas Kristen Satya Wacana.

Techniques and Steps of Analysis

This study employs quantitative analysis by using pooling data or panel data regression analysis which are processed by Limdep program. Two methods examined are the Fixed Effect and Random Effect methods. Hausman test is performed with base probability of 0.10 to determine which of both methods is applied.

Instead of using classical assumption with OLS method (Ordinary Least Square), this study employed GLS (Generalized Least Square) method in which it explicitly considers the heterogeneity contained in the independent variables, thus this method is capable of producing estimators fulfilling the criteria of BLUE (Best Linear Unbiased Estimator).

Sequence of analysis is described as follows:

Calculating *Return on Equity* (ROE)

Return on Equity (ROE) as a measure of operating performance calculated using the formula used by Klapper and Love (2002) in Darmawati (2004) as follows:

$$ROE = \frac{Laba\ Bersih}{Total\ Equity}$$

Measuring variables of *corporate governance*, referring to Isgiyarta dan Tristiarini (2005) which are:

Transparency

This consists of the completeness of information in financial statements, timely financial reporting and completeness of the information outside the financial statements. Overally, principle of transparency is assessed with a total maximum value of nine (9).

Fairness

This means as fairness of disclosure provided by an independent auditor upon the company financial statements. An independent auditor remarks will be given the following weights:

a. a disclaimer opinion statement will weigh 1.
b. an adverse opinion statement will weigh 2.
c. unqualified statement with exceptions will weigh 3.
d. unqualified opinion statement will weigh 4.

Therefore, the overall principle of fairness is assessed with a total maximum value of four (4).

Accountability

Accountability, in this research, is measured by following three viewpoints of weights:

a. The existence an audit committee; weigh one (1) if exists, and zero (0) if none.
b. Audit Committee report, weigh one (1) if exists, and zero (0) if none.
c. Frequency of Audit Committee meetings, weigh one (1) if according to applicable law/regulations, and zero (0) if not.

Therefore, the overall principle of accountability is assessed with a total maximum value of three (3).

Responsibility

Responsibilities are given with the following weights:

a. Quality control and standardization, weigh one (1) if exists, and zero (0) if none.
b. Description of corporate participation in community service activities and programs, weigh one (1) if exists, and zero (0) if none.
c. Human resources development, weigh one (1) if exists, and zero (0) if none.
d. Natural environment development, weigh one (1) if exists, and zero (0) if none.

Thus, the overall principle of responsibility is assessed with a total maximum value of (4).

Development of research model by employing the regression equation formula as follows:

$ROE = \alpha + \beta 1$ *corporate governance*

Table 2
Descriptive Statistics of Variables

Variables	Mean	Standard of Deviation	Minimum	Maximum
Corporate Governance	15,94	1,68	12,00	18,00
Return On Equity	14,85	14,20	-36,14	42,76

Source: Limdep Output Summary, 2008

DATA ANALYSIS AND DISCUSSION

Descriptive Statistics and Normality Test of Variables

This research took the sample of 17 companies operating in the banking sector. These were taken purposively based on the criteria: listed on the Indonesia Stock Exchange during the years 2004-2006 and published consecutive annual report from year 2004 to 2006. The descriptive statistics analysed from the study variables is shown in following Table 2.

From the corporate governance variables shown in Table 2 above, the analysis presents a mean value at 15.94 with standard deviation of 1.68, indicating low variation of corporate governance scores. This less variation in data pattern provides a good data distribution because the overall individual score would proximate around the mean score of Corporate Governance. On the contrary, Return on Equity variable seemed varied widely.

Normality test towards ROE, as a proxy for corporate operational performance (dependent variable), is performed prior to conducting hypothesis test. This is because prior to parametric hypothesis test (panel data regression), the dependent variables must first be normally distributed (Anonymous, 2004). The results of normality tests are presented in Table 3.

Table 3
Normality Test Result on Variable Return on Equity (ROE)

One-Sample Kolmogorov-Smirnov Test

		ROE
N		51
Normal Parameters a,b	Mean	14,8529
	Std. Deviation	14,20332
Most Extreme Differences	Absolute	,135
	Positive	,077
	Negative	-,135
Kolmogorov-Smirnov Z		,964
Asymp. Sig. (2-tailed)		,311

a. Test distribution is Normal.

b. Calculated from data.

Sumber: Ringkasan Output SPSS, 2008

Source: SPSS Output Summary, 2008

Based on Table 3, it is presented that the significance value of corporate operating performance variable is normally distributed as it is reflected in Return of Equity (ROE) greater than 0.05. Because normally distributed hypothesis testing can then use parametric tests.

Test of the Influence of Implementing Corporate Governance towards the Corporate Financial Performance in Banking Sector

To analyse and acknowledge the existence of the influence of implementing corporate governance towards corporate financial performance in banking sector, this study employs panel data regression test. The test produced two testing models of Fixed Effect Model (FEM) and Random Effects Model (REM). The following Hausman test, with the base probability of 0.10, produced a probability value at 0.62 which is higher than 0.10 (0.62 > 0.10). Of this Hausman test result, the hypothesis test would refer to the use of Random Effect Model (REM). This showed that the time-series and cross-section data is considered not constant. Referring to Random Effect Model (REM), the results of regression analysis on the influence of implementing corporate governance towards the corporate financial performance in banking sector are shown in Table 4.

Table 4
Regression Analysis Results

Variable	Regression Coefficient	p-value
Corporate Governance	2,4612	0,0226**

Source: Limdep Output Summary, 2008
Note: ** p-value significant at level 5%

As presented in Table 4, the corporate governance variable on the Random Effects Model (REM) showed a significant result at the level 5% with the regression coefficient is positive, thus the hypothesis is accepted. This means that corporate governance has a positive influence towards corporate financial performance in the banking sector as indicated by Return on Equity (ROE). This implies that the higher a company's corporate governance score, the higher corporate financial performance, with Return on Equity (ROE) as a proxy. This positive influence is assumed to be associated with the highly strict regulated environment of the banking sector as to ensure the maintained stability of banking industries. Sets of laws and regulations issued by *Bank Indonesia* required banks to meet all necessary rules. By implementing the principles of Corporate Governance, public trust towards the banking sector will increase, and this also could encourage public to rely on variety of banking services offered. The more public uses banking services, the more the bank will benefit from, as it is shown in increased financial performance proxied by the increased Return on Equity.

Therefore, referring to the research results, it is essential for banking companies to uphold and continue implementing the principles of corporate governance by improving quality control and standardization of products as well as developing its natural environment. The results of this study support the findings of previous researches conducted by: Gompers et. al (2003) who found a positive relationship between corporate governance index with a long-term corporate performance; by Berghe and Ridder who found that poor performance is caused by poor governance (Darmawati, et al, 2004); as well as the findings of Milton (2000) which showed that the variables associated with corporate

Table 5
Regression Analysis Results with Different Models

Model	Variable	Regression Coefficient
Fixed Effect Model (FEM)	Corporate Governance	2,4825 (0,258)**
Pooled model	Corporate Governance	2,4041 (0,0434)**

Source: Limdep Output Summary, 2008
Note : (…….)** p-value significant at level 5%

governance had a strong impact on the corporate performance.
Afterwards, sensitivity test is performed by using different model. It aimed to determine whether a different model could provide the same results with the Random Effect Model (REM). Table 5 below shows the results of analysis using the exact same proxy but tested using different models which are Fixed Effect Model (FEM) and the Pooled Model. Table 5 above shows that by the same proxy, different models of the Fixed Effect Model (FEM) and the pooled model proved to provide the same results as for corporate governance variable present a significant result at level 5% with positive regression coefficient, thus the hypothesis is accepted. This has provided a consistent result despite using different testing model.

CONCLUSION, IMPLICATION, LIMITATION AND SUGGESTION

Conclusion

The empirical tests of the analysis revealed that there is a positive influence of implementing corporate governance principles towards the performance operations in banking sector, which is indicated by Return On Equity (ROE).

Applicative Implication

In response to the positive influences towards corporate performance, banking companies shall continue and improve their efforts in implementing all principles of Corporate Governance. Considering the Corporate Governance disclosure checklist, banking companies needs to advance more on Responsibility disclosure, particularly those related to quality control, standardization and natural environment development. With those aspects more disclosed, it is expected that public trust towards banking services will get higher.

Research Limitations

Some limitations in this study include:

1. Sample is limited to only banking companies, thus the results could not be generally applied to other types of business.
2. Operational performance parameter is solely based on the size of Return on Equity (ROE).
3. There are elements of subjectivity in interpreting the points of Corporate Governance and this could have an impact on the analysis results.
4. In the analysis, the effect of time lag was not considered; as the impact of implementing Corporate Governance

principles towards the performance certainly could not immediately be expected.

Further Research

For further researches, it is suggested to consider the following aspects:

1. Extending samples into other industries besides banking such as manufacturing, insurance, telecommunications, and etc, thus the analysis will have higher level of generalization.
2. Extending parameters of operating performance such as liquidity, solvency, or other profitability indicators besides Return on Equity (ROE) .
3. Accommodate the time-lag factor in assessing the impact of the implementation of corporate governance on the performance of banking companies.

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Appendix 1

List of Sample Banking Companies

No	Nama Sektor Perbankan	Kode Emiten
1.	Bank Buana Indonesia Tbk	BBIA
2.	Bank Bumiputera Indonesia Tbk	BABP
3.	Bank Central Asia Tbk	BBCA
4.	Bank Eksekutif Internasional Tbk	BEKS
5.	Bank Kesawan Tbk	BKSW
6.	Bank Lippo Tbk	LPBN
7.	Bank Mandiri (Persero) Tbk	BMRI
8.	Bank Mega Tbk	MEGA
9.	Bank Niaga Tbk	BNGA
10.	Bank NISP Tbk	NISP
11.	Bank Nusantara Parahyangan Tbk	BBNP
12.	Bank Pan Indonesia (Panin Bank) Tbk	PNBN
13.	Bank Permata Tbk	BNLI
14.	Bank Rakyat Indonesia (Persero) Tbk	BBRI
15.	Bank Swadesi Tbk	BSWD
16.	Bank Danamon Tbk	BDMN
17.	Bank Internasional Indonesia Tbk	BNII