

Good Corporate Governance Mechanism and Bank's Financial Performance:

Evidence In Indonesia

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Abstract—The purpose of this study is to analyze the impact of GCG mechanism on the financial performance of going public banks in Indonesia. 235 observations were conducted based on purposive sampling in the period of 2005-2014. This research uses data analysis technique of Structural Equation Modeling (SEM). The results of this study conclude that: (1) The measurement model showed better fit and convergent validity (2) The measurement model also shows different constructs because the correlation between the constructs is smaller than 0.9; (3) Good Corporate Governance mechanism has a positive and significant effect on the financial performance of going public banks in Indonesia.

Keywords—GCG; financial performance; structural equation modelling

I. INTRODUCTION

Every business enterprise or company will strive to achieve its objectives through a series of business activities. The success of a business entity or a company in carrying out business activities in order to achieve the goals of the company will be greatly influenced by to what extent the company is able to conduct good corporate governance. Good Corporate Governance (GCG) is defined as a set of rules governing the relationships between shareholders, the management of a company, the creditors, the government, employees, and other holders of internal and external interests in relation to their rights and obligations, or in other words, a system that organizes and controls the company [1].

The implementation of GCG in the company will be able to generate the value added for the company. If GCG implementation is run effectively and efficiently, then all of the activities of the company can run well, which in turn results in an improvement in things related to financial and non-financial performance [2].

The Corporation's financial performance can be measured by several financial ratios, one of them is profitability ratio. Profitability ratio is the ratio that indicates a company's ability to generate profits [3].

The concept of GCG theoretically can be applied to many companies; however, in its practice, a lot of companies have

yet to apply GCG. Based on the results of a survey conducted by McKinsey and Co. on 250 global investors from three continents, namely America, Europe and, Asia in mid-2000 as reported in *Bisnis Indonesia*, the implementation of GCG in Indonesia is still low. Furthermore, a survey by Credit Lyonnais Securities Asia (CLSA) in late 2004 ranked Indonesia as the 10th worst country in Southeast Asia for GCG. Standard and Poor's survey also stated that the implementation of GCG in Indonesia is still stagnant.

The absence of GCG implementation is due to the fact that companies believe that GCG is only limited to regulatory compliance and has a little direct effect on financial performance. There is a difference of views here; on one hand, the implementation of GCG is believed to be very important in achieving sustainable corporate goals. On the other hand, there are still many companies that are reluctant to apply to GCG because it has no significant effect on the financial performance of the company [4].

The phenomenon of GCG in Indonesia today has become an issue that has started to be discussed in the business world. Along with the development of the issue, research on GCG have been conducted by research institutes. One of the attempt to study GCG is through this research, which was conducted by The Indonesian Institute for Corporate Governance (IIGC) in cooperation with SWA magazine starting in 2001. There are many companies involved in this research, such as State-Owned Enterprises (BUMN), banks, public companies, and Regional-Owned Enterprises (BUMD). As a result of this research is the existence of Corporate Governance Perception Index (CGPI) to assess the company performance based on GCG, in which a high CGPI value of a company will result in a better implementation of GCG in the company.

There has been several research conducted by previous researchers in relation to GCG implementation. Research conducted by Kyereboah-Coleman on GCG and bank performance indicate that an ownership stake with hired managers can improve bank performance. The result of their research reported that the number of boards of directors had a positive impact on bank performance [5].

Good Corporate Governance can create a supportive environment by improving bank efficiency, mitigating financial risk and improving systemic stability. GCG also would create the lower the cost of capital, which indicates that bank will have lower risks, which in turn shareholders would receive higher profits [6].

Based on the above phenomenon, it can be seen that there is indeed a correlation between GCG and corporate financial performance. It is concluded that the implementation of GCG which in turn will improve the company's financial performance.

Based on the description and phenomenon above, the authors are interested to do further research on the effect of GCG implementation mechanisms on the financial performance of going public banks in Indonesia. This research employs a technique of data analysis using Structural Equation Modeling (SEM) approach.

This research is follow-up research from research conducted by Tasman and Fitra [7]. In SEM analysis, there are two steps that are done by measurement model and structural model. Research conducted by Tasman and Fitra is only done until the measurement model [7]. Research results show that indicators of commissioners, independent commissioners, boards of directors, audit committees and institutional ownership can reflect latent variables of GCG while ROA and ROE indicators can reflect latent variables of financial performance. In this research, we want to analyze how the influence of good corporate governance mechanism on the financial performance of The Indonesian Banking Sector. The research hypothesis is formulated into GCG mechanisms has a positive and significant impact on the financial performance of go public banks in Indonesia.

II. RESEARCH METHODS

A. Research Object

The population of this research is all go public banks listed on Indonesia Stock Exchange from 2004 until 2014. The sample is selected by purposive sampling, as a result, 235 observations was conducted in the period of 2005 to 2014.

B. Variables and Indicators of Measurement

This research used includes exogenous variables (independent variables) and endogenous variables (dependent variables). The exogenous variables (X) is GCG mechanisms consisting of indicators such as the number of commissioners, the number of independent commissioners, the number of boards of directors, the number of audit committees, managerial ownership and institutional ownership. The endogenous variable (Y) is the financial performance with two indicators, that is ROA and ROE.

TABLE I. VARIABLE AND MEASUREMENT INDICATOR

| No | Latent Variable | Indicator | Measurement of Indicator |
|----|--|---------------------------|---|
| 1 | Good Corporate Governance (GCG) (Exogenous Latent Variable) | Commissioners | number of commissioners |
| | | independent commissioners | number of independent commissioners |
| | | boards of directors | number of boards of directors |
| | | audit committees | number of audit committees |
| | | managerial ownership | Percentage of managerial ownership |
| | | institutional ownership | Percentage of institutional ownership |
| 2 | Financial Performance (Endogenous Latent Variable) | ROA | $\frac{(EAT)}{\text{Total asset}}$ |
| | | ROE | $\frac{EAT}{\text{Total common stock}}$ |

This research used secondary sourced from financial statements and annual report, which data related to GCG mechanisms, such as the number of commissioners, independent commissioners, the number of directors, the number of audit committees, managerial ownership, and institutional ownership and include financial performance data such as ROE and ROA.

C. Research Design

The research design can be illustrated in the model below:

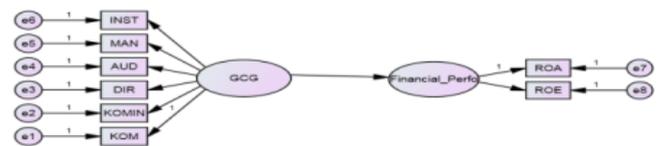


Fig. 1. Research design.

D. The Technique of Data Analysis

In order to look at the effect of the independent variables on the dependent variable, this research used data analysis method of Structural Equation Modeling (SEM). SEM is a multivariate statistical technique that combines factor analysis and regression analysis in order to examine the relationships between variables that exist in a model, either in the form of the indicators and its constructs or the relationship between constructs [8].

Basically, in the SEM model, there are two tests conducted that is the measurement model and structural model that aims to test whether the model fit and feasible. In this research, the software used to analyze data is Amos version 22.

III. RESULTS

A. Assessment of SEM Assumption

Some assumptions have been checked before running the structural equation modeling. The outlier is detected by Mahalanobis distance. Based on the results, this study found that there are 15 outliers since their Mahalanobis values were more than 26.125. The Outlier data were removed from the sample; therefore, the final sample is 235 company-year observations. The Kolmogorov-Smirnov Z was insignificant with a p-value of 0.181 was more than 0.05, it means the data has a normal distribution. Multicollinearity was also assessed. There was no multicollinearity in this study because all the variables had variance inflation factor (VIF) values less than 10 and their Tolerance statistics (TOL) values were more than 0.10 and less than 1. SEM method requires a large number of samples so that the results have sufficient credibility (or a trustworthy result). In the SEM method, the minimum sample size is 15 times the number of indicators. This research uses 8 indicators, so the minimum number of samples is 120. Finally, this research uses 235 samples, which means that it has met the required sample size.

B. CFA for Good Corporate Governance (GCG) and Financial Performance Variables

SEM analysis consists of a measurement model and a structural model. The purpose of the measurement model is to find out how precisely the manifesting variables (indicators) can explain the existing latent variables. If the CFA meets the convergent validity and discriminant validity, then the second stage can be employed, which is the structural model of the financial performance of going public banks, with the purpose of finding out the effect of exogenous variables on endogenous variables. The validity of the measurement model is determined by the goodness of fit (GOF) and the construct validity of the CFA.

CFA is only done to each latent variable (good corporate governance and financial performance). The purpose of CFA for each latent variable is to know how accurately the indicators can explain the existing latent variables. Below are the CFAs for Good Corporate Governance and Financial Performance.

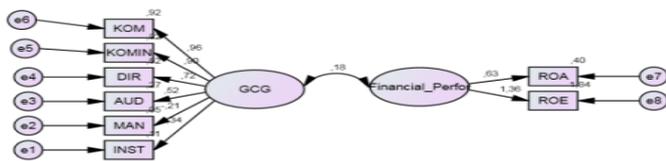


Fig. 2. CFA for GCG and financial performance.

Based on figure 2, GCG has five indicators with the standardized loading (SL) above 0.3 include KOM, KOMIN, DIR, AUD and, INST, while the MAN indicator has SL below 0.3, so this indicator must be removed from the model. The greater the SL of an indicator indicates that this indicator is better for reflecting its latent variables. Meanwhile, all the financial performance indicators, both of ROA and ROE have SL above 0.3 so that these two indicators automatically reflect the latent variables of financial performance.

In the measurement model, it is necessary to achieve a low chi-square, because of the lower the chi-square value, the better the model. In order to achieve a low chi-square value, modifications are made based on the modification indices suggested by the AMOS program. In this case, the modification is done by correlating the error, so the value of chi-square will decrease at least as much as the value of the modification. On other hands, in this research, there is a negative variance value in the notes for the model that requires the AMOS program to give a value of 0 on the error as suggested by the program. In the measurement model, e7 (ROA) is rated variance 0.

The modification of the measurement model is done by correlating e1 with e8 (INST and ROE). INST is a GCG indicator of institutional ownership and ROE is an indicator of financial performance. This is supported by Jensen and Meckling argue that institutional ownership required to minimize agency conflict between manager and shareholder [9]. Because institutional ownership is involved in strategic decision making, it is expected that this will make managers more effective in making decisions. Thus, it is concluded that the existence of institutional ownership will be able to effectively encourage managers to carry out their duties, which is to evaluate and control the management of the company so that the financial performance of the company increases.

The modification of the measurement model is also done by correlating e7 (ROA) with GCG. This is applied by using the logic that the implementation of GCG mechanism is expected to improve the financial performance of the company. GCG is a system that organizes and manages the company so that the company has value added. Correlating GCG to ROA, which is the company's ability to generate profits using total assets, means that GCG will encourage companies to generate higher ROA because a higher the ROA will result in a better company's ability to generate profits.

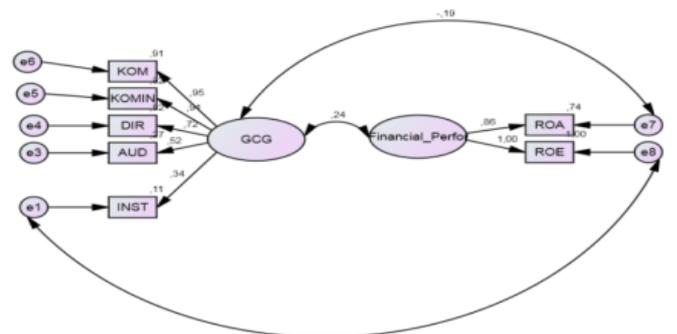


Fig. 3. The modification of measurement model of GCG and financial performance.

Based on figure 3, it is concluded that the measurement model of Good Corporate Governance and Financial Performance meets the required values of convergent validity. All of the indicators can also reflect the latent variables. All of the indicators have standardized loading of (SL) above 0.3, namely KOM (SL 0.95), COMIN (SL 0.91), DIR (SL 0.72), AUD (SL 0.52), INST (SL 0.33), ROA (0.86) and ROE 1.00).

The CFA of Good Corporate Governance and Financial Performance not only meets standardized loading but also

meets the acceptable fit as indicated by the GOF value in table 2 below.

TABLE II. GOODNESS OF FIT INDICES OF CFA GCG AND FINANCIAL PERFORMANCE

| Goodness of Fit Indices | Statistik | Cut off Value | Conclusion |
|-------------------------|-----------|---------------|------------|
| Chi Square | 15,05 | Lowest | |
| Df | 12 | | |
| Probability (p-Value) | 0.239 | ≥ 0.05 | |
| Ratio | | ≤ 3.00 | Better Fit |
| GFI | 0.983 | ≥ 0.90 | Better Fit |
| AGFI | 0.961 | ≥ 0.90 | Better Fit |
| CFI | 0.997 | ≥ 0.94 | Better Fit |
| TLI | 0.994 | ≥ 0.95 | Better Fit |
| RMSEA | 0.03 | ≤ 0.08 | Better Fit |

Based on table 2, it can be seen that the GOF score shows a better fit because the value of each GOF meets its cut off value. Thus, we can conclude that the measurement model is fit and the overall measurement model could be done.

The measurement model not only meets the assumption of convergent validity but also meets the discriminant validity assumption shown by the correlation value between latent variables smaller than 0.9. The correlation between GCG and Financial Performance is $0.24 < 0.9$.

C. The Structural Model and Hypothesis Testing

The Structural model is the second step in SEM analysis. The structural model describes the relationship between exogenous variables that are good corporate governance mechanism with the endogenous variable that is financial performance. The purpose of structural model is to test the fit data model and the relationship between variables based on hypothesis.

In the implementation, the structural model is also modified based on modification indices. This is done by correlating the latent construct or indicator that has the highest value in order to decrease the chi-square value.

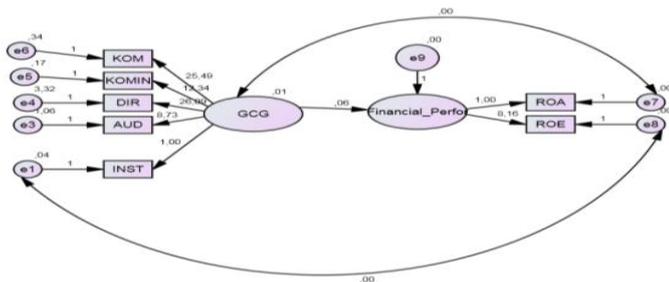


Fig. 4. Structural model of GCG and financial performance.

After modification based on the modification indices suggested by the AMOS program, the structural statistical output of the model indicates that the model meets the acceptable fit as indicated by the GOF value in table 3 below.

TABLE III. GOODNESS OF FIT INDICES OF STRUCTURAL MODEL

| Goodness of Fit Indices | Statistik | Cut off Value | Conclusion |
|-------------------------|-----------|---------------|------------|
| Chi Square | 15,05 | Lowest | |
| Df | 12 | | |
| Probability (p-Value) | 0.239 | ≥ 0.05 | |
| Ratio | | ≤ 3.00 | Better Fit |
| GFI | 0.983 | ≥ 0.90 | Better Fit |
| AGFI | 0.961 | ≥ 0.90 | Better Fit |
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| TLI | 0.994 | ≥ 0.95 | Better Fit |
| RMSEA | 0.03 | ≤ 0.08 | Better Fit |

The following is a summary table testing the hypothesis.

TABLE IV. THE RESULT OF HYPOTHESIS TESTING

| H | Exogenous Variable | Endogenous Variable | Estimate | P | Decision |
|---|--------------------|-----------------------|----------|-------|----------|
| 1 | GCG | Financial Performance | 0,057 | 0.004 | Accepted |

IV. DISCUSSION

The results of this study indicate that the mechanism of Good Corporate Governance has a positive and significant impact on the financial performance of going public banks in Indonesia. It can be seen from $\beta = 0,057$ $p = 0,004 < 0,05$, t (C.R) = 2,903.

The Good Corporate Governance mechanism of this study is based on the number of boards of commissioners, the number of independent commissioners, the number of boards of directors, the number of audit committees and institutional ownership. A high number of boards of commissioners, the number of independent commissioners, the number of boards of directors and the number of audit committees and the greater number of ownership owned by the institutional group will lead to an improvement in financial performance of going public banks in Indonesia.

An increasing number of boards of commissioners, independent commissioners, boards of directors, audit committees, and a higher percentage of institutional ownership will create more effective monitoring and control within the company. The implementation of all indicators of good corporate governance mechanism will encourage the managers to be more effective and efficient in carrying out their duties as the managers of the company, which will result in a better financial performance of the bank.

The results of this study are in line with the other researchers on the effect of GCG mechanisms on bank financial performance during the crisis using samples of 300 banks in the United States [10]. A well-performed GCG, such as a large number of independent commissioners, high incentive payouts to CEOs and increased insider ownership, have a positive effect on bank performance during the crisis.

Managers and bank owners who demonstrate the effort and intent to implement GCG will increase the credibility of the market and then raise funds on lower costs and risks. It is implied that better corporate governance will lead to better

performance [11]. This is reinforced by an empirical finding by Porta et al. who conducts research on 27 developing countries and finds that there is a higher rating on firms with better protection from minority shareholders [12].

There is a significant relationship between corporate governance and financial performance of banks. Better corporate governance will lead to better financial performance [13].

The result of this study is in contrast with the research by [5] who conducted research in banks in Africa. Coleman found that the number of independent commissioners negatively affects the performance of banks and the intensity of the activity of the director of influence on bank earnings, due to a large number of boards of directors and their policies that generate a lot of debt.

There is no evidence that CEO incentives and share ownership lead to better performance [14]. Financial firms with a large number of independent commissioners and higher institutional ownership had poor stock returns during the crisis period. They assumed that companies with institutional ownership were at higher risk during the crisis resulting in higher shareholder losses during the crisis period [15].

V. CONCLUSION

The results of this study conclude that the measurement model showed better fit and convergent validity. Moreover, the measurement model also shows different constructs because the correlation between the constructs is smaller than 0.9. Good Corporate Governance mechanism has a positive and significant effect on the financial performance of going public banks in Indonesia.

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