

**THE IMPLEMENTATION OF GOOD CORPORATE  
GOVERNANCE AND ITS IMPACT ON THE FINANCIAL  
PERFORMANCE OF BANKING INDUSTRY LISTED IN IDX**

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**Abstract**

A lot of researches have studied good corporate governance implementation in manufacturing companies; this research, however, is more focusing in banking industry. Since bank holds important key role in the economics, bank needs a good governance to get a good reputation to play its role well. This research was conducted using secondary data obtained from annual reports of banking companies listed in the Indonesia Stock Exchange for the year 2008 until 2012. The data was analyzed using multiple regression method. The result showed that foreign ownership, board size, and external auditor, as corporate governance variables, partially and significantly affect bank financial performance, while large shareholders, government ownership, commissioner size, independent commissioner proportion, and capital adequacy ratio are found to insignificantly affect bank financial performance. Furthermore, firm size as controlling variable, is insignificantly affect the relationship between corporate governance variables and bank financial performance.

**Keywords: Corporate governance, financial performance, banking industry, agency theory**

## **I. Introduction**

Banks hold important key roles in economics as an intermediary role between a creditor and debtor. Bank also gives both creditors and debtors assurance. Bank assures the creditors that the money they have invested will go back to them and also there is incentive for investing their money. By having the assurance and incentives people willing to invest their money in bank. Bank also helps debtors in giving loan to them. Of course the debtors must pass investigation before they get the loan to make sure that they will responsible with and pay for the loan.

In doing their roles perfectly, banks must get people to trusts them. People will not easily invest their money unless they know of the bank reputation. People may put interest rate as their consideration but mainly and firstly they will look at the bank's reputation, whether there is criminal case pertaining to the bank or other case that affects bank's reputation. In order to have good reputation, bank has to implement what it is called as good corporate governance. Corporate governance refers to by how the companies are governed or run (Bevir, 2007:165). It includes the principles used as the basis in governing or running a company. If the principles are not fit with the company, then the company cannot run well; or if the principles are not well created, then there will be a lot of problems occur when the business process is going. Corporate governance also refers to the ways of a company or a firm is governed in which the shareholders of the firm can assure themselves that they will get an adequate return on their investment (Clegg and Bailey, 2008:297). Furthermore, shareholders must make sure that the company performs well in all aspects.

Asian Development Bank (ADB) stated that the crisis happened in Indonesia, Malaysia, Thailand, the Philippine, and South Korea were caused by the failure in implementing good corporate governance. The research was conducted by the Asian Development Bank resulted that the implementation of good corporate governance in Indonesia still relatively low. Indonesia got 43.4% for the average score, in a range of 75.4% for the maximum and 20.8% for the minimum score. This low score is caused by few things. First, the companies only do what it has been mandated, and most of the companies may not refer to the code and thus they are not aware to the corporate governance. Second, the majority of the companies do not comply with the rules. (ADB, 2013)

There is a regulation for bank especially concerning about good corporate governance published by the Bank Indonesia (the Indonesian Central Bank) namely Peraturan Bank Indonesia (the Bank Indonesia Regulation) No. 8/4/PBI/2006 about the Implementation of Good Corporate Governance for Conventional Bank. Another regulation is the Peraturan Bank Indonesia (the Bank Indonesia Regulation) No. 11/33/PBI/2009 about the Implementation of Good Corporate Governance for Syariah Conventional Bank and Syariah Unit Business. These regulations are published in order to increase bank's performance, safeguard the stakeholders, and increase the conformity with the law and regulations. If bank performs in conformity with the law and regulations, the bank will not get included in criminal cases, and the bank gained more customers because people know that the bank is healthy. The more customers come to invest the money, the higher performance of the bank would be.

Many previous researches were conducted concerning the relationship between good corporate governance and financial performance, and most of them were done in manufacturing industry or using go public companies. Research by Ujiyantho and Pramuka (2007) about The Mechanism of Corporate Management, Earnings Management and Financial Performance concluded that there is no significant influence in the relationship between institutional and earnings management and also the relationship between board size and earnings management. Moreover, managerial ownership and the presence of independent director had significant influence to earnings management. Simultaneously, institutional ownership, managerial ownership, the presence of independent director, and board size had significant influence to earnings management, and earnings management had not significant influence to financial performance.

CheHaat et al. (2008) conducted a research on corporate governance, transparency and performance of Malaysian Companies. This research used transparency as mediating variable between corporate governance and performance. The research found that corporate governance factors are significantly affect company performance, and that performance is not associated with the level of disclosure and timeliness of reporting.

Another research by Haryani et al. (2011) talked about the effect of corporate governance on the performance with transparency as the intervening variable. The result showed that only external mechanism form of audit quality of BIG4/non-BIG4 affects firm performance and

corporate governance transparency. Transparency is not proved to be an intervening variable in the influence of corporate governance mechanisms on firm performance.

This research, moreover, will examine the effect of the implementation of good corporate governance on the financial performance of banking industry. Variables will be tested in are ownership monitoring mechanism consists of large shareholders, foreign ownership and government ownership; internal control monitoring mechanism consists of board of director size, board of commissioner size and independent commissioner proportion. Regulatory monitoring mechanism is shown at capital adequacy ratio (CAR); and disclosure controlling mechanism is shown by external auditor. This research use Cash Flow Return on Assets (CFROA) as a tool to measure the financial performance of bank industry, namely the ability of the company's asset to get operating revenue. The reason why CFROA is used in this research is because CFROA put more focus on current performance measurement and the measurement is pure from the operations, not affected by stock price (Cornett et al., 2006).

This paper is structured as follows: in the next section, the literature review for corporate governance mechanisms, financial performance and the relationship between corporate governance and financial performance will be discussed. The following section will discuss the hypotheses development, followed by the third section that discuss the methodology used in this research. Finally, the fourth section will describe the research result that lead to the conclusion, limitation, and suggestion.

## **II. Literature Review**

### **Agency Theory**

Agency theory is a condition where two parties are engaged in a contract, in which one party authorized the other party to do something related to the firm organization on their behalf (Jensen and Meckling, 1976). Agency theory postulates that a lot of contracts between the principals and agents in the firm exist, in which, the agents are authorized and charged to manage and control the resources that the principals have in the company (Adams, 1994). Moreover, agency problem appears when principal can hardly assure that the agents (managers) do things in order

to maximize principal's (owners) wealth (Midiastuty and Machfoedz, 2003). Managers and principals have their own interest, and most of the times their interests are different to each other. For instance: managers want to get large compensations and salary for their work which will reduce company's profit and of course it will also reduce the dividend that will be distributed to the stockholders. On the contrary, when principals want to gain higher dividend it will reduce the compensations and salary of the managers. Consequently, sometimes managers will do things that fulfill their interest instead of principal's interest. Managers know more information about the company, general information and company's future information than the principal; because the managers are the one who operate the company daily. This causes the imbalanced information possessed by the managers and principals called as asymmetric information which will benefit managers rather than the owners.

Good corporate governance is one of tools to get rid-off conflict of interest between the two (Midiastuty and Machfoedz, 2003). Corporate governance is expected as a tool to give assurance to the investors or principals that they will get return for their investments, and that the managers will not corrupt or invest principal's money to other projects that will not generate profit for the principals, and it relates to how investors or principals control the managers (Shleifer and Vishny, 1997 in Ujiyantho and Pramuka, 2007). Eisenhardt (1989) proposed that agency theory uses three assumptions of human behavior, they are: (1) generally human is a selfinterest, (2) human has bounded rationality which means human has limited rationality to predict about the future, and (3) human always avoid risk. Based on these three assumptions, managers as human being will also do things that will benefit themselves and they will always find a way to fulfill their interest which will lead to a possibility where they will do fraud to fulfill their interests. Furthermore, there will be a cost to prevent or to solve an agency, called agency cost, it consists of monitoring cost, bonding cost, and residual loss. Corporate governance is expected to reduce this agency cost.

### **Corporate Governance**

The Indonesian Institute for Corporate Governance defined corporate governance as a mechanism that controls and monitors a company so that the company's operation goes as stakeholders expected. Good corporate governance is a structure, system, and process used by

each part of the company in order to continuously give added value for the company in the long term, but still put attention for other stakeholder interests, based on moral, ethics, culture and other regulations. La Porta et al. (2000) cited by CheHaat et al. (2008) defined corporate governance as a set of mechanisms that will protect the investors against harmful action done by corporate insiders towards their capital in the company. It can be concluded that corporate governance is a mechanism, set of rules, and system which defines the relationship between managers and stakeholders in order to protect the principal from expropriation by the managers, and to ensure that the business is done due to all stakeholders' interests.

Argüden (2013) stated that there are six main principles of corporate governance: consistency, responsibility, accountability, fairness, transparency, and effectiveness. By deploying those principles throughout the organization, corporate governance holds an important key role in creating a successful business and shaping a good behavior in responding pressure from the environment. Surya and Yustivandana (2008:68) proposed that there are few purposes of implementing good corporate governance, such as, (1). Ease the access to either domestic or foreign investments, (2). Get lower cost of capital, (3). Give better decision in increasing and maintaining company's performance, (4). Get more trust from the stakeholders, and (5). Protect board of directors and board of commissioners from lawsuits. If a company applies good corporate governance well, the company will get trust from the investors. The investors are expecting by investing their money in the company, they will get profit and the investment is safe. So, a good corporate governance implementation is an important key to build trust and encourage the investors to invest their money so that the company will have a stable investment flow. A stable investment flow will lead to a good performance.

Based on the research conducted by Zulkafli and Samad (2007) there are four mechanisms of corporate governance that serve to monitor the banking firms:

1. Ownership Monitoring Mechanism
  - a. Large Shareholders

Large shareholders or block shareholders are the shareholders that have power and they have significant effect in making decisions so that they can benefit from minority shareholders as well as prevent expropriation (Mitton, 2002 in Zulkafli and

Samad, 2007). Based on the BI Regulation No. 12/23/PBI/2010, large shareholders are statutory body or persons and/or business group that own shares equal or more than 25% out of the number of shares that are issued, and has voting rights; or own shares less than 25% out of the number of shares that are issued and has voting rights but they can be proved that they controlled the bank either directly or indirectly.

b. Government Ownership

The extensive government ownership leads to the conflict between government as owners/taxpayers and managers who control the bank. Government is closely related to the politics. The investment invested by the government maybe not a hundred percent pure for the investment. There may be other interest such as political interest. Also the managers may do unfavorably actions in order to support the government to get a political career (Zulkafli and Samad, 2007).

c. Foreign Ownership

It is believed that foreign-owned firms will perform better because the standard they have is nearly the same with the foreign firm's standard which usually is better standard. The existence of foreign owned firm will increase the competition because the local firms try to have better performance so that they can win over foreign owned firms. It is hoped that the presence of foreign ownership as an aspect of governance mechanism would be able to enhance firm performance. (CheHaat et al., 2008)

2. Internal Control Monitoring Mechanism

a. CEO Duality

CEO duality is the condition where CEO of the company is also the Chairman of the board. A separation of the two roles can be effective as a control to check and monitor management's performance. If the role of Chairman and CEO is separated, it will increase monitoring quality so that the performance will be better. (CheHaat et al., 2008)

b. Board size

As the study of Cheng (2008) in Praptiningsih (2009), the existence of agency problems because large number of board size can cause the corporate performance changes. Board of directors can help the company to solve agency problems that may exist in the company. Good corporate governance relies on the board of directors. If the boards can manage the firm well, good corporate governance will be well implemented and it will lead to a better corporate performance (CheHaat et al., 2008).

c. Board Independence

Board independence refers to the entry of outsiders into the board. Board independence means that the boards don't have any shares in the company. They are free from the individual interest to get more profit that can be done by unethical things. The monitoring from independence board should be more fair and effective (Adams and Mehran, 2003 in Zulkafli and Samad, 2007).

3. Regulatory Monitoring Mechanism

The banking industry requires a careful analysis of its risk management function because of its high leverage and high-risk characteristics (Zulkafli and Samad, 2007). According to Brigham and Erhardt (2005) in Praptiningsih (2009), the review from the Basel Committee implies that the regulatory monitoring affects performance especially in profitability, through the reserve requirement and or the capital adequacy ratio. Regulatory monitoring through capital adequacy requirement serves as a governance mechanism tool that used to ensure the banks are well capitalized (Zulkafli and Samad, 2007).

4. Disclosure Monitoring Mechanism

a. Big 4 External Auditors

Audit can help the company to apply corporate governance better because all the information about management in the company should be disclosed in the report (Francis et al., 2003; Sloan, 2001 in CheHaat et al., 2008). Based on OECD principles, an auditor plays an important role as a bank supervisor to control the reporting of financial statement and also to improve the corporate performance (Praptiningsih, 2009).



b. Big 3 Rating Agency

Rating announcement gives information to financial markets about the financial health of a bank and this is being reflected by appropriate valuation of bank's stocks. Rating that is given by reputable agencies will also confirm the reputation of the firm (Zulkafli and Samad, 2007). If the firm gets a good rating, it will boost the firm's reputation and more investors will come to invest so that it will increase the firm performance.

### **The Relationship between Corporate Governance and Financial Performance**

Corporate governance mechanisms help the company to assure investors that an adequate return will be obtained if they invest in the company (Shleifer and Vishny, 1997 in CheHaat et al., 2008). If corporate governance mechanisms investors will doubt whether to invest or not and they will rethink about it. Investors of course do not want to suffer a loss because the company is not managed well. If investors do not invest their money, the company will face difficulties in running the business because they have no sufficient funds to run the business. This difficulty will lead to a decreasing of financial performance of the company.

In ownership monitoring mechanism, large shareholders can benefit from minority shareholders by tunneling by means transferring the minority shareholders out of the firm for their own benefits because of their power in the firm. Tunneling harms not only the minority shareholders, but also the whole firm. This of course affects the financial performance of the firms. Government ownership also can lead the manager to do unethical conduct for their own benefit (political position) and the manager may do unfavorable things that will affect firm's performance. Foreign ownership will encourage the firm to do better so that the performance can be better. A lot of research found that foreign-owned firm performs better than local-owned firm.

The boards are responsible to make sure that top managers do things that can create optimal value for shareholders. There are three major duties of board which are creating the business strategy, appointment of senior management, and making sure that information, control, and audit systems are available to monitor and review company's

performance and making decisions (Zulkaflī and Samad, 2007). Looking at the role played by the board of directors, they will also affect the firm performance. If the board of directors can play their role well, the performance of the firm will increase.

Regulatory monitoring mechanism and disclosure monitoring mechanism will encourage the firm to perform better. The firm wants to get a good reputation so the firm will work hard to maintain their performance. The firm also wants to get an unqualified opinion given by the external auditors, so the firm will maintain their performance and will disclose the information needed completely.

### **III. Hypothesis Development**

#### **The Effect of Large Shareholders Ownership to Bank Financial Performance**

Large shareholders can take advantages of controlling rights through tunneling to expropriate minority shareholders, but under certain circumstances large shareholders also exhibit propping behavior (Tang et al., 2012). If the firm does not run well, large shareholders tend to invest more to the company. They will inject funds to the firm so that the firm performance increases. Large shareholders also can use their incentive and power to prevent expropriation (Zulkaflī and Samad, 2007). By using their power they can give significant influence in making policies or other decisions. All shareholders expect to get more return on their investment. So, shareholders including large shareholders will make a good policy that can increase firm's performance so that they can get more return. Large shareholders as board of directors can monitor managers' performance so they know whether the managers work well and if something is wrong they can give advice and they can give influence to the managers' decision. By doing this the firm performance will increase. Shleifer and Vishny (1986) found that large shareholders can do more monitoring to the management of the firm, thus can increase the value of the firm. The presence of large shareholders can reduce free-rider problem for minority shareholder. Mitton (2002) stated that large shareholders can prevent expropriation and higher ownership concentration relates to better stock price performance especially during crisis. From the explanation above, thus the hypothesis is formulated as follows:

**H1: Large shareholders has significant effect on bank financial performance**

**The Effect of Foreign Ownership to Bank Financial Performance**

Foreign ownership is expected to be one of the ways to make firms in developing countries become better and better by doing direct import of new capital and new technologies (Benfratello and Sembenelli, 2002; Kozlov et al., 2000 in CheHaat et al., 2008). In a developing country like Indonesia, the influence from the firms of developed countries can help domestic countries to be better. New technologies from developed country can make business process more effective and efficient. Effectiveness and efficiency of the business of firms will result in better performance. Boubakri et al. (2003) in CheHaat et al. (2008) found that profitability and efficiency gains are affected by the existence of foreign ownership. Thus the hypothesis can be formulated as:

**H2: Foreign ownership has significant effect on bank financial performance**

**The Effect of Government Ownership to Bank Financial Performance**

According to Zulkafli and Samad (2007), the extensive government ownership leads to the conflict between government/taxpayers as owners and the bureaucrats/managers who control the bank. Government often uses its power over the firm to do things in order to reach its political goals which sometimes is not the same as other shareholders' interest which may lead to a conflict. A conflict can lead to the decreasing of firm's financial performance. Conflicts can also appear if the managers do things for the sake of the other shareholders that may not be the same with government's interest. Government ownership manages resources allocation, softens budget constraints, and hinders economic efficiency only for political benefits. Government ownership facilitates the financing of politically attractive projects (Barth et al., 2002). The research conducted by Barth et al. (2002) found that government-owned banks are related to positive outcomes. Thus, the hypothesis formulated for this research is:

### **H3: Government ownership has significant effect on bank financial performance**

#### **The Effect of Board of Directors Size to Bank Financial Performance**

Jensen (1983) in Zulkafli and Samad (2007) suggested that having less than seven or eight directors can help the company to have better performance. It is hard to get into conclusion when there are more people join a discussion or meeting. It also happens when a firm has big board of director size. It will take more time to reach a conclusion and to make decisions. It makes the firm perform less efficient and may led to a decreasing performance. Jensen (1983) in Zulkafli and Samad (2007) further argued that increasing in board of director member will make it less effective because of free-riding problem. Makand Li (2001) in Saiful et al. (2012) found that small board size effectively monitor management behavior. A good monitoring of management behavior can lead to a better performance. Thus, the hypothesis can be formulated as:

**H4: Board of Directors Size has significant effecton bank financial performance**

#### **The Effect of Board of Commissioners Size to Bank Financial Performance**

Just like board of director size, the bigger size of board of commissioners, the less effective it is in monitoring managers and firm performance. Larger size of board of commissioners makes it harder to do its function because it is hard to communicate, coordinate and make decisions (Belkhir, 2009). Yermarck (1996) also Lorderer and Preyer (2002) in Pudjiastuti and Mardiyah (2007) found that board size is negatively related to firm performance and firm value. The bigger board size, the firm is less effective. If board size is too big the agency problem tends to be higher. Pudjiastuti and Mardiyah (2007) in their research also found that board of commissioner size negatively affects firm performance. So the hypothesis formulated in this research is:

**H5: Board of Commissioners Size has significant effectonbank financial performance**

## **The Effect of Independent Commissioner Proportion to Bank Financial Performance**

Independent commissioners are expected to create a balance for various parties' interests such as shareholders, directors, managers, employees, and others. Theoretically and practically, the main job of independent commissioners is to monitor management and make sure that management has done their job well and not make unfavorable decisions and also management has done their job accordingly to shareholders' interests. The result of Barnhart and Rosenstein (1998) in Haryani et al. (2011) proved that the higher independent commissioners, the higher firm performance that is shown by Tobin's Q. Having independent directors can reduce agency costs, it can also gain access to the capital market as well as to ensure accountability in executive remuneration (Lawrence and Stapledon, 1999 in Zulkafli and Samad, 2007). The increasing proportion of independent commissioners on the board will lead to the increasing of firm performance because the independent commissioners can provide effective monitoring of managers (Adams and Mehran, 2003 in Zulkafli and Samad, 2007). Thus, the hypothesis formulated for this research is:

**H6: Independent commissioner proportion has significant effect on bank financial performance**

## **The Effect of Capital Adequacy Ratio to Bank Financial Performance**

Government plays role as a regulator and supervisor of bank solvability and as an incentive for stakeholders in maintaining the bank performance or implementing corporate governance. Government needs to set rules so that competition between banks can go well. Government also creates investment climate to encourage investors to invest more. Government governs business and transactions to minimize information asymmetry and avoid monopoly. Bank Indonesia as a government representation interfere bank industry using its regulations and policies to monitor bank performance in order to protect depositors and debt holders. Bank firm should disclose various financial ratios in their annual report. This regulation is one of ways to monitor bank performance. One of the ratios that is required to be disclosed is Capital Adequacy Ratio (CAR). This ratio shows whether a bank can absorb a reasonable amount

of loss and complies with statutory capital requirements. Based on the elaboration above, the hypothesis for this research is:

**H7: Capital Adequacy Ratio has significant effect on the bank financial performance**

### **The Effect of External Auditor to the Bank Financial Performance**

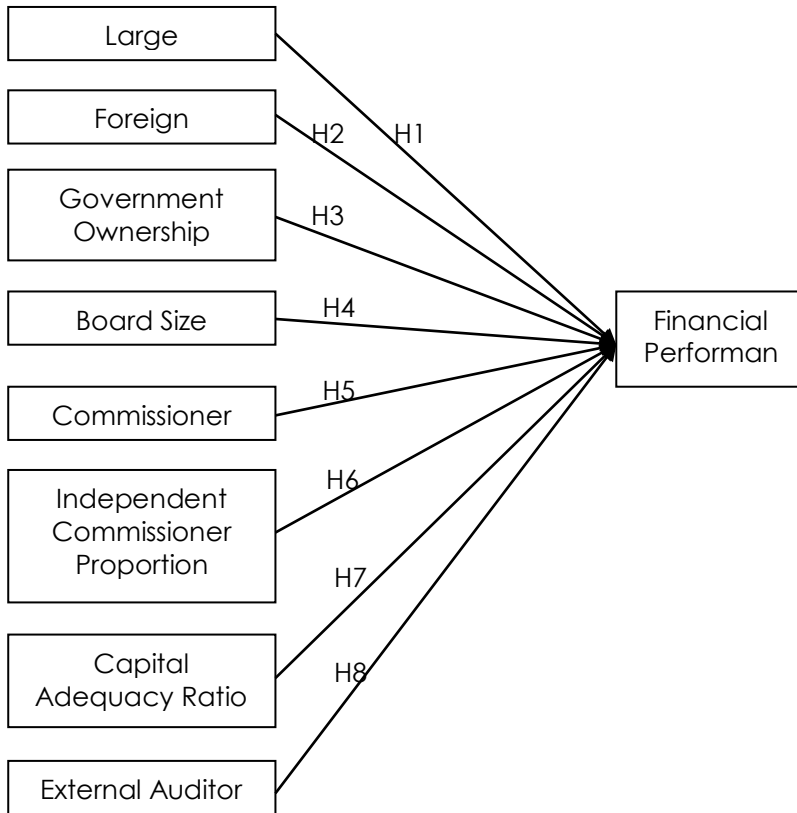
External auditor is not included in the organization structure of a bank or the internal control system, but external auditor affect internal control quality by auditing a firm financial statement, discussing with managers and give recommendation in order to increase internal control quality. According to OECD principles, external auditor plays important role as bank supervisor to make sure that the financial reporting is good. To produce good and reliable financial information, bank should have good system. Good systems in bank will lead to an increase of the financial performance. So, indirectly external auditor affects financial performance. According to Niimimaki (2001) in Zulkafli and Samad (2007), an auditor plays an important role as a bank supervisor to ensure that depositors are informed on financial difficulties that may lead to bank runs. Information asymmetry is identified as one of the unique characteristics in the banking industry. In dealing with asymmetry problem, information disclosures have always played an important role to serve the purpose of monitoring by depositors (Zulkafli and Samad, 2007). Higher disclosure quality may be achieved by appointing reputable external auditors (Mitton, 2002 in Zulkafli and Samad, 2007). From the elaboration above, the hypothesis of this research is:

**H8: External auditors has significant effect to the bank financial performance**

Based on the hypothesis formulation above, an analysis model can be made to give a conceptual framework for the research so that it can be analyzed and final results can be generated which is has relationship or has no relationship.

**Picture 2.1**

**The Effect of Good Corporate Governance Mechanism to Bank Financial Performance**



**Controlling variable: Firm size**

## **II. Research Methodology**

### **Sample Selection**

Population of this research is all banking companies listed in Indonesia Stock Exchange for the year 2008 – 2012 that fulfill few requirements. The requirements used to determine the sample are:

- a. Banking companies that go public or listed in Indonesia Stock Exchange for the year 2008 – 2012.
- b. The banking companies still operate until 2012.

- c. The banking companies published audited annual financial statement for the year ended December 31 starting from 2008 – 2012.
- d. The bank companies are not determined as bank failure by Bank Indonesia during the research period which is 2008 – 2012.
- e. The bank companies disclose information about corporate governance, ownership structure, financial ratios, and external auditor in the annual report.

**Table 3.1: Sample Selection**

| DESCRIPTION  | TOTAL     |
|--|-----------|
| Banking companies listed in IDX for the year 2008 – 2012   | 32        |
| The banking companies not included as sample:  |           |
| 1. Not publish or delisted in 2008   | 1         |
| 2. Not publish or delisted in 2009   | -         |
| 3. Not publish or delisted in 2010   | -         |
| 4. Not publish or delisted in 2011   | -         |
| 5. Not publish or delisted in 2012   | -         |
| 6. The bank companies determined as bank failure during research period which is starting from 2008 – 2012 | -         |
| 7. Not disclose information about corporate governance, ownership structure, CAR, CFROA, total asset       | -         |
| <b>TARGET POPULATION</b>   | <b>31</b> |

### Variables Operational Definition

Variables operational definitions of this research are as follow:

- 1. Large Shareholders (LS)** : Large shareholder is measured by dummy variable. If there is an ownership which is equal or more than 5% than the value is 1, else the value is 0.
- 2. Foreign Ownership (FO)** : Foreign ownership is measured by dummy variable. If there is a foreign ownership which is equal or more than 5% than the value is 1, else the value is 0.
- 3. Government Ownership (GO)** : Foreign ownership is measured by dummy variable. If



there is a foreign ownership which is equal or more than 5% than the value is 1, else the value is 0.

**4. Board of Directors Size (BS)** : Board of director size is a total number of board of directors members in the company.

**5. Commissioners Size (CS)** : Commissioners size is the total number of board of commissioner members in the company.

**6. Independent commissioner (IC)** : Independent commissioner proportion is the ratio of the total numbers independent commissioners in a company to the total number of board of commissioners.

**7. Capital Adequacy Ratio (CAR)** : 
$$CAR = \frac{EQUITY}{RISK\ WEIGHTED\ ASSETS} \times 100\%$$
  
(disclosed in annual report)

**8. External Auditor (BIG4)** : External auditor is measured by dummy variable. If the bank is audited by BIG4 public accountant company than the value is 1, else the value is 0.

**9. Financial performance (CFROA):**

$$CFROA = \frac{EBIT + Dep}{Assets}$$

Description:

- a. CFROA = Cash Flow Return on Asset
- b. EBIT = Earnings Before Interest and Tax
- c. Dep = Depreciation

**10. Firm Size (SIZE):** Firm size is measured by using natural logarithm of total asset of the bank.

## Data Analysis Technique

Multiple linier regression analysis is used to test the effects of large shareholders, foreign ownership and government ownership, board size, commissioner size and independent commissioners, capital adequacy ratio (CAR), and external auditor on financial performance with firm size as controlling variable. But before performing the regression, the classic assumption testing is done to make sure that the regression model is BLUE (Best Linear Unbiased Estimator). The significance level used in this research is 10%. The regression model for this research is:

$$\text{CFROA} = a + b_1\text{LS} + b_2\text{FO} + b_3\text{GO} + b_4\text{BS} + b_5\text{CS} + b_6\text{IC} + b_7\text{CAR} + b_8\text{BIG4} + b_9\text{SIZE} + e$$

where:

|   |  |
|---|--|
| CFROA   | : Cash Flow Return on Asset (dependent variable)             |
| LS  | : Large shareholders (independent variable)                  |
| FO  | : Foreign ownership (independent variable)                   |
| GO  | : Government ownership (independent variable)                |
| BS  | : Board of directors size (independent variable)             |
| CS  | : Board of commissioner size (independent variable)          |
| IC  | : Independent commissioner proportion (independent variable) |
| CAR   | : Capital adequacy ratio (independent variable)              |
| BIG4  | : External auditor (independent variable)                    |
| SIZE  | : Firm size (controlling variable)                           |
| a   | : Constanta  |
| $b_1, b_2, b_3, b_4, b_5, b_6, b_7, b_8, b_9$ | : Coefficients of regressions                                |
| e   | : Standard error   |

## IV. Result and Discussion

### Classic Assumption Testing

Regression model is used to know the effect of corporate governance mechanism which is represented with 8 variables to banks' financial performance (CFROA). In order to get the best regression model, classic assumptions should be tested, there are: normality, multi-collinearity, autocorrelation, and heteroscedasticity tests. The four tests have being done and pass all the requirements.

Normality test on the residual is done by using normal probability plot graph and Kolmogorov- Smirnov test. Based on the

normal probability plot graph as seen in the picture 4.1 (attachment), all residual values are located along the diagonal line. This means that regression model of financial performance has met normality assumption.

To ensure that the normality assumption has been met, Kolmogorov-Smirnov test is performed. The result of Kolmogorov-Smirnov test shown in table 4.1(attachment).The result shows that the the regression model used in this study has met normality assumption.

Multicollinearity test is done by looking at the VIF and tolerance value. According to table 4.2, all tolerance values are greater than 0.10 and all VIF values are smaller than 10. From the result of the test, it can be concluded that the regression model is free from multicollinearity. Thus, non-multicollinearity assumption has been met. Moreover, Durbin-Watson value is used to detect autocorrelation. Based on the result of Durbin-Watson test in table 4.3(attachment), the value of 2.129 is between 1.86142 and 2.31858 which is the critical value ( $1.86142 < DW < 2.31858$ ), means that there is no autocorrelation cases in the regression model. Thus, it can be concluded that the non autocorrelation assumption has been met.

To detect the existence of heteroscedasticity, scatterplot between ZPRED value on x-axis and SRESID value on y-axis. The result of heteroscedasticity test depicted in scatterplot graph shown in Picture 4.2(attachment). It can be seen that the plots do not form a certain pattern and they scatter randomly above and below zero on y-axis; and scatter randomly on the left and right of zero on x-axis. Thus, we can conclude that non-heteroscedasticity assumption has been met.

Based on table 4.4, there is only foreign ownership, board size, and external auditor found to have a significant relationship with bank financial performance. The other variables do not have significant effect on bank financial performance. The significance value of LS is greater than 0.1, means that the first hypothesis is rejected. This happens perhaps because the large shareholders do not really use their power to affect management. As long as they get profit, they will just stay still. Also share ownership of 5% may be not enough for the shareholder to affect the company. This result is consistent with Zulkafli and Samad (2007) who show that large shareholders have no significant effect to bank financial performance.

Based on this result, the second hypothesis is accepted at significance level of 10%. Foreign ownership is negatively related to bank financial performance at significance level of 10%. This result is not

consistent with the research conducted by Zulkafli and Samad (2007). Their research found that foreign ownership is negatively related to financial performance. According to the theory, foreign institutions will bring good effect for the bank financial performance through their standard and their good systems but the culture between one and other countries are different. The culture difference may cause conflicts. Too many conflicts in an organization will lead to the decreasing of the performance.

The significance value of GO is 0.383 which is greater than 0.1; this means that the third hypothesis is rejected. This may be caused by the small number of government-owned bank in the sample so that the government ownership cannot affect the financial performance. This result is consistent with Zulkafli and Samad (2007) that the government ownership has no significant relationship to the bank financial performance with ROA as the financial performance proxy.

The significance value of BS is 0.047 which is lower than 0.1, this means that the fourth hypothesis is accepted. This result depicts that board size has significant relationship to financial performance. This result is consistent with Mahmood and Abbas (2011) that board size has significant relationship to the bank financial performance. But this result is not consistent with Zulkafli and Samad (2007) who found that board size is negatively related to financial performance. The positive significant relationship result may indicate that as long as the number of directors in the company is equitable, it will help the company to get better financial performance. Too least directors in a company will also lead to a problem, thus Bank Indonesia set the requirement for minimum number of board of directors member which is 3 directors.

The significance value of CS is 0.849 which is higher than 0.1. This means that the fifth hypothesis is rejected. This result depicts that commissioner size has no significant relationship to financial performance and it has positive relationship with bank financial performance. This result does not support Pudjiastuti and Mardiyah's (2007) research. Commissioners do not directly involve in operational activities. They role is only supervising and giving advice to the directors. Most of decisions are made by directors and management. So, commissioners may not have significant relationship to the bank financial performance.

The significance value of IC is 0.530 which is greater than significance value of 10%. This result shows that independent

commissioner has no significant relationship to the bank financial performance. The small number of independent commissioner may be the cause of the insignificance of the relationship. With the small number of independent commissioner, it is not strong enough to affect other parties in the company. This result is consistent with Zulkafli and Samad (2007) who also found that independent board does not significantly related to bank financial performance. But this result is not consistent with Haryani et al. (2011) who found that independent commissioner has significant relationship with financial performance of all companies including bank.

The significance value of CAR is 0.826 which is greater than significance value of 10%. This result shows that capital adequacy ratio has no significant relationship to the bank financial performance. Almost all banks included in this research sample during the observation period has capital adequacy ratio above minimum requirement set by Bank Indonesia. So, the changes in the regulation do not really affect bank financial performance. This result is not consistent with Zulkafli and Samad (2007) who found that capital adequacy ratio significantly related to bank financial performance.

The significance value of BIG4 is 0.022 which is lower than significance value of 10%. This result shows that external auditor has significant relationship to the bank financial performance and it has positive relationship with bank financial performance. This result is consistent with Zulkafli and Samad (2007) who also found that external auditor significantly positively related to bank financial performance. External auditor through the auditing process encourage bank to have better system, thus lead to a better financial performance.

Firm size as control variable is expected to have a significant effect to the relationship of corporate governance mechanisms and bank financial performance. The larger size of the bank means that more people invest their money to that bank. It means that this bank gain more trust from people and this bank implements good corporate governance, thus this bank has good system and management. The significance level of firm size is 0.382 and the t-value is 0.876. This means that firm size is not significantly positively affect the relationship between corporate governance mechanism and financial performance.

## **V. Conclusion, Limitation, and Suggestion**

Based on the discussion in the previous chapter, it can be concluded that only foreign ownership, board size and external auditor found to have significant effect on bank financial performance. While the

other variables namely large shareholders, government ownership, commissioner size, independent commissioner proportion, and capital adequacy ratio (CAR) do not significantly affect bank financial performance. Firm size as controlling variable does not affect the relationship between large shareholders, foreign ownership, government ownership, board size, commissioner size, independent commissioner proportion, capital adequacy ratio (CAR), and external auditor and financial performance.

This research has limitation that can affect the result. The research limitation is that the proxy used to measure financial performance may not good enough to capture the relationship between large shareholders, foreign ownership, government ownership, board size, commissioner size, independent commissioner proportion, CAR, external auditor and bank financial performance. So it is expected for the further research to find a better proxy such as ROA, ROE or Tobin's Q that may depict bank financial performance better, hence so a better result might be gained in defining the relationship between corporate governance mechanisms to bank financial performance.

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