The effect of corporate governance's application on banks' performance: empirical study of banks listed on the Indonesian Stock Exchange

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Abstract: This study aimed to examine the effect of corporate governance indicators, e.g., the board of directors, audit committee, and audit quality on bank's performance. This study used 30 banks listed on the Indonesia Stock Exchange (IDX) in the year of 2009–2010 as samples. The results reveal that the board of directors as one of the corporate governance indicators has a significantly positive correlation to banks' performance. As for the audit committee indicator, the result reveals a positive but insignificant effect on banks' performance. Meanwhile, a corporate governance indicator of audit quality has a significant positive relationship to the performance of the bank. This is consistent with the previous studies. It is concluded that the higher or better functioning the board of directors, audit committee and audit quality in the bank, the better the performance of the bank.

Keywords: audit committee; audit quality; bank performance; board of directors; corporate governance.

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1 Introduction

The banking industry has always been an object of interest for study since it has two characteristics that distinguish it from other industries. First, it is a highly regulated industry. Every activity must be monitored and regulated according to an agency standard, which is set by the Central Bank of Indonesia. The regulations governing banking business aims to protect the interests of the community. It is a consequence caused by the second characteristics of banks, i.e., the banking industry is an industry that is based on trust, particularly the trust of its customers.

As bank customers, people put their money in banks without a full guarantee from them, even with a rate of return which is determined by the bank. On the basis of its role as an intermediary and being economic-driven, banks channel back the money collected from the public in other forms of investment. In carrying out its activities, banks face a variety of risks such as credit risk, market risk, operational risk and legal risk. Thus, banks need to be managed with good corporate governance (GCG) by professional management with high integrity. Without GCG, the banking industry would collapse, as happened in 1997.

The financial crisis which hit many countries in 1997–1998 was preceded by the financial crisis in Thailand in 1997 followed by crises in Japan, Korea, Indonesia, Malaysia, Hong Kong and Singapore eventually becoming the Asian financial crisis. It was considered as a result of weak practice of GCG such as the close relationship between government and business people, conglomerations and monopolies, protection and market intervention which made these countries unprepared to enter the era of globalisation and free markets (Tjager, 2003).

The 1997 crisis in Indonesia began with the issuance of the Banking Deregulation policy package 1988 (Pakto 88) where the government and the Central Bank of Indonesia tried to go further in regard to banking deregulation which became the turning point of the various banking curbs in 1971–1972. The issuance of new bank licences that had been discontinued since 1971 was reopened by Pakto 88. Similarly, the permit for the opening of a branch office or establishment of the People's Credit Bank (BPR) was easier with lower capital requirements, a facility that had never been granted to the banking sector. One of the fundamental clauses in Pakto 88 is the permission for foreign exchange banks that requires a bank's level of health and assets to be only at least Rp.100 million. This resulted in an increase in the number of banks in Indonesia from around 111 banks in 1988 to as many as 240 banks in 1995. The increase of the number of banks encouraged an increase of credit distributed to the real sector. Thus, it contributed to the improvement of moderate economic growth in the early 1990s.

Nevertheless, this condition had a negative effect and triggered an increase in the number of banks and banking expansions aggressively. Besides this, there are also issues of cross ownership and cross management in Indonesia's financial industry. These two aspects are the cause of the increasing number of ownership concentrations in the banking industry, which will increase the likelihood of violation of legal lending limits to the company's group. These are the underlying causes of the economic crisis which impacted the banking sector severely.

After going through a period of economic crisis, the number of commercial banks in Indonesia decreased (from 237 banks in 1997 to only as many as 130 banks in 2006 or a decrease of 45.2%), resulting from the freezing of 67 banks, as well as mergers and acquisitions. The decrease was a result of the strict standards that must be met for the establishment of a bank, such as capital structure, merger, acquisition and bank closures due to financial problems.

Considering the background and conditions, one of the main causes of the banking industry experiencing a collapse during the crisis was related to the poor management of the banks. Valuable lessons can be learned from the financial crisis experienced by Indonesia whereas the crisis was caused by the weak implementation of GCG in the banking industry. The implementation of GCG in banks aims to strengthen the internal condition of the national banking system in dealing with increasingly complex risks, protecting the interests of stakeholders and improving compliance with legislation and regulations and ethical values that are generally accepted in the banking industry.

The Organization of Economic Cooperation and Development (OECD) has developed a set of corporate governance principles, better known as The OECD principles of corporate governance. The basic principles of GCG include the principles of transparency, accountability, responsibility, independence and equality or fairness, which aim to ensure the survival and growth of companies in a sustainable manner. These basic principles are certainly very necessary in the bank's management where the public trust is its main components.

One of the factors needed to create effective corporate governance, especially after the financial crisis in Asia is the role of the board of commissioners. The information about the profile of Board of Directors or Board of Commissioners and Senior Management could easily be found in company's annual report. This is consistent with study by Chan and Yeung (2013) whereas the issue of the company's top management profile were consistently reported. Macey and O'Hara (2003) state that the commissioners' role is very important in a bank because of the difference in the governance between banks and non-banks. The main reason for this difference is the existence of banks' other stakeholders such as creditors and regulators. Bank directors should be responsible not only to shareholders, but also to depositors, customers and regulators.

Skully (2002) also states the critical role of the commissioners in the implementation of corporate governance since supervision will reduce the risk of using taxpayers' funds as mitigation or to resolve a crisis. The application of GCG can also play a role in controlling lending practices to parties that still have a relationship with a bank.

Research by Abeysekera (2008) found a significant positive relationship between board size and company performance in Kenya. The number of commissioners are considered effective in the range of more than five and less than 14 people. Large board size is more effective than a small board size (Abeysekera, 2008; Dalton et al., 1999; Nasution and Setiawan, 2007). According to Andres et al. (2005) the number of commissioners greatly affects the activity of controlling and supervising. A larger board size is expected to supervise the management better, so it can improve the performance of banks or companies. However, research by Eisenberg et al. (1998) found a negative relationship between board size and the performance of a company or bank. The varied result from prior literature is caused by the endogenous relationship, i.e., matters resulting from the company itself (Hermalin and Weisbach, 1991) and causality (Kole, 1997) between the composition of a company's board and company's performance.

Another important component that supports the implementation of GCG is the audit committee (FCGI, 2001). In accordance with the Decree of Chairman of Bapepam (Capital Market and Financial Institution Supervisory Agency) Number: Kep.29/PM/2004, the audit committee is a committee established by the board of directors to carry out the task of supervision and management of the company.

According to Dezoort and Salterio (2001) audit committee members who have knowledge of financial reporting and auditing provide support to external auditors who are in disputes with management. Dezoort (1998) also found that knowledge and expertise in the field of accounting and auditing is required by the audit committee members in resolving disagreements between management and the external auditors. A dispute between management and external auditors may affect the performance of the company; therefore it is expected that the existence of an audit committee has a positive effect on resolving disputes which eventually will improve company performance.

Moreover, an audit is a systematic process to obtain and evaluate evidence objectively, relating to the assertion of the economic actions to measure the level of concordance between these assertions with the criteria with communication of the results to the parties concerned (Boynton and Kell, 2001). The result of the audit process is the auditor's report (audit opinion), i.e., the report contains the fairness of the financial statements in accordance with generally accepted accounting principles.

2 Hypothesis and conceptual model

2.1 Hypothesis

A supervision system in a company is divided into two types: namely, two-tier and one-tier systems. In a company that uses a two-tier board system like in Indonesia, the supervisory role of the company in general is carried out by the board of commissioners, while in a company with a one-tier board system the supervisory function is carried out by the board of directors.

In previous studies regarding the importance of corporate governance's implementation, especially in other countries besides Indonesia, the term board of directors was used to describe its supervisory function. For instance, research by Pathan et al. (2007) examines the size and independency of the board of directors and its influence on company performance on several banks in Thailand. Thailand was chosen as a research area since it also experienced a severe financial crisis in 1997, just like Indonesia. The study used a fixed effect model of panel, and found that there is a significant negative relationship between board size and a bank's performance in Thailand. This is consistent with the hypothesis and shows that a smaller board size will be more effective in monitoring the bank manager, while a larger size board is more vulnerable to agency problems between the owners of the company and those who run the company's operational activities (manager).

The second result obtained from the research was the finding of a positive relation between a bank's board independency and banks performance in Thailand. The result revealed that independent directors perform monitoring better (especially in Thailand), because they have a market reputation that needs to be maintained. Findings in these studies suggest that banks can improve their performance by reducing the number or size of the board and adding a few more independent commissioners.

Meanwhile, Rosenstein and Wyatt (1990) found a positive and significant relationship between stock prices and the proportion of independent boards. Bai and Nam (2009) suggest that there is a strong relationship between corporate governance and bank performance. More specifically, the fraction of shares owned by the state has significant and negative effects on bank performance and the proportion of outside directors on the board of directors has positive effects on bank performance.

Another study regarding the impact of corporate governance on banks' performance was conducted by Bai and Nam (2009) on 12 Chinese banks operating during the period 2003–2006. The result also suggests that the proportion of outside directors on the board of directors has positive effects on bank performance.

In line with this, Adams and Mehran (2003) and Belkhir (2005) state that for US Bank Holding Companies, it was found that the size of the board and its performance has a positive relationship. This study suggests that the surveillance conducted by the board with a large number of members will have the advantage that it would exceed the costs incurred. The positive relationship between the size of the board and the performance of the companies in the USA can further be explained due to the mergers and acquisitions in the banking industry in the USA.

However, research by Hermalin and Weisbach (2003) revealed that a board with a smaller size would is more effective and can provide added value because it is easier to coordinate. Similarly, a negative correlation between board size and bank performance in terms of both cost and profit efficiency was also found by Agoraki et al. (2010). The study examined a panel of large European banks over the 2002–2008 period. It revealed that a smaller board structure is associated with better bank efficiency through better management of credit risk.

A larger sample of data in the European banking industry was examined by Busta and Hobdari (2015) of banks in France, Germany, Italy, Spain and the UK. The study showed that the independency of the directors has a positive effect on financial performance in Continental Europe while the opposite result was found in the UK. The size of the bank, however, does not have any effect on bank performance. The same result was also found by Salloum et al. (2013) in research of 54 banks in Lebanon from 2005 to 2010. It reveals that the presence of outside directors has no statistical impact on the performance of banks.

The results of several empirical studies can be used as bases to propose the following hypothesis:

H1: The board of commissioners has an influence on banks' performance.

According to Dezoort and Salterio (2001), audit committee members who have knowledge of financial reporting and auditing provide support to external auditors in disputes with management. Dezoort (1998) also found that knowledge and expertise in the field of accounting and auditing is required by the audit committee members for resolving disagreements between management and external auditors. A dispute between management and external auditors may affect the performance of the company; therefore, it is expected that the existence of an audit committee has a positive effect on resolving disputes which eventually will improve the company's performance.

Research conducted by Xie et al. (2003) found that the audit committee is an important factor in supervising the management. In that study, the average audit committee in a company comprised five members with a range of 2–12 members. The number of audit committee members affects the level of influence over a company, and a larger audit committee is expected to enable banks to have better performance.

Meanwhile, a study examining the effect of independent audit committee members on a company or bank's performance was performed by Nasution and Setiawan (2007) and Lie et al. (2008). The results of their study revealed that an independent audit committee member has a positive effect on company performance. Thus the independent audit committee is expected to improve company performance.

On the other hand, Alijoyo (2003) states that the audit committee should be transparent, starting with the necessity for an audit charter and written agenda of annual work programs of the audit committee which is further supported by regular audit committee meetings. In carrying out the obligations and responsibilities concerning the financial reporting system, the audit committee should hold meetings three to four times a year (FCGI, 2001). The more often the audit committee meetings are conducted the better the performance of the audit committee. A regular meeting of the audit committee is expected to improve banks' performance.

The results of several empirical studies can be used as bases to propose the following hypothesis:

H2: The audit committee has an influence on banks' performance.

From the agency theory perspective, the role of external auditors is viewed as a means of control that can be used to eliminate or at least provide a signal of opportunistic practices or fraud committed by management such as earnings management (Jensen and Meckling, 1976; Watts and Zimmerman, 1986). Audits will reduce the information asymmetry that exists between management and stakeholders of a company by allowing outsiders to verify the validity of the financial statements. Kinney and Martin (1994) examined nine studies and found that auditing reduces the positive bias on net income and net assets before auditing.

Another study that examined the effect of audit quality on the performance of banks conducted by Boynton and Kell (2001) proved that auditing is a systematic process to obtain and evaluate evidence objectively, relating to the assertion of the economic actions to measure the level of concordance between the assertion with the criteria that has been established with communication of the results to the parties concerned.

A good-quality audit should be able to detect fraud committed by management such as profit management and report the actual performance of the company so as not to deceive investors. The size of public accounting firms could be expected to affect the quality of audits because big firms usually will not take risks of performing audits on the financial performance of its clients, and tend to report the actual performance of the company, which thus could trigger the company to really improve the performance of its operations.

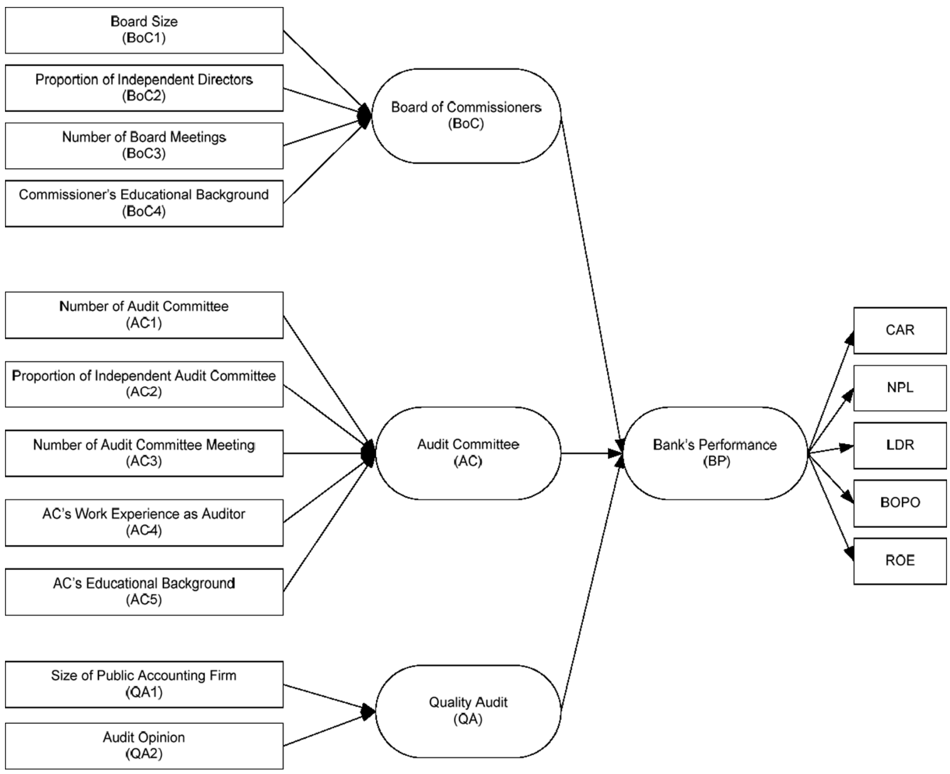
The results of several empirical studies can be used as bases to propose the following hypothesis:

H3: Audit quality has an influence on banks' performance.

2.1.1 The conceptual model

To determine the influence of the independent variables of: Board of Commissioners, Audit Committee and Audit Quality on the dependent variable of Bank Performance (CAR, NPL, LDR, BOPO, and ROE) a structural equation modelling (SEM) was used. Meanwhile, for the measurement model, confirmatory factor analysis (CFA) was used to indicate a latent variable which was measured by one or more variables observed. In this case, the latent variable was banks' performance while the observed variables used to measure the bank performance variable was the variable of the board of commissioners, audit committee and audit quality. So the research model using CFA is shown in Figure 1.

Figure 1 Research model using CFA



3 Discussion

On the basis of the data in Table 1, the descriptive statistics for each variable in this study were as follows.

Table 1 Descriptive statistics

	N	*Minimum*	*Maximum*	*Mean*	*Std. deviation*
BoC 1	30	3.000	8.000	4.000	2.5000
BoC 2	30	0.667	0.750	0.500	0.6552
BoC 3	30	4.000	43.000	10.000	1.3607
BoC 4	30	0.000	1.000	0.330	0.48918
AC 1	30	3.000	6.000	4.000	0.38824
AC 2	30	0.000	0.750	0.500	0.6801
AC 3	30	2.000	16.000	13.000	7.8925
AC 4	30	0.000	0.667	0.330	0.3423
AC 5	30	0.000	0.667	0.330	0.2197
QA 1	30	0.000	1.000	0.700	0.50855
QA 2	30	0.000	1.000	0.600	0.49827
Valid *N* (listwise)	30				

Source: Author

The structural equation model for testing the hypothesis was as follows:

$$\begin{array}{l} \text{KNJ} = 0.56 \times \text{BoC} + 0.033 \times \text{AC} + 0.44 \times \text{QA}, \text{ Errorvar.} = 0.066, R^2 = 0.93 \\ \qquad (0.13) \qquad\quad (0.100) \qquad (0.10) \qquad (0.057) \\ \qquad 4.40 \qquad\quad\; 0.33 \qquad\quad 4.26 \qquad\; 1.17 \end{array}$$

The structural model above shows that hypotheses H1 and H3 showed a significant result, while H2 showed an insignificant result.

The insignificant result of H2 can be proven from the descriptive statistics of the audit committee meeting variable that reached a maximum value of 16 times which exceeds the government requirement. The result also shows that the accounting education background and experience as an auditor does not have a significant effect on the performance of the audit committee regarding bank performance.

To determine the coefficient of determination of the structural equation, the value of R^2 should be calculated (Wijanto, 2008). Lisrel test results which can be seen in equation reduced form obtained the value of R^2 for the structural equation in this study. The value of R^2 in this research model was 0.93, which means the model was able to explain 93% of the change in the latent variable of banks' performance. Overall *t*-value results of the three hypotheses proposed in this study can be summarised as shown in Table 2.

Table 2 *t*-value result for each hypothesis

Hypothesis	*Path*	*Estimates*	*t-value*	*Conclusion*
1	BoC → BP	0.56	4.40	Significant
2	AC → BP	0.033	0.33	Insignificant
3	QA → BP	0.44	4.26	Significant

Source: Author

The SEM confirmed that the commissioner has a positive influence on bank performance significantly. It means that the greater the supervision by the board of commissioners on banking operations, the higher the performance of banks. The results of this study reinforce the results of the previous studies by Abeysekera (2008), Dalton et al. (1999), Nasution and Setiawan (2007) and Rosentein and Wyatt (1990).

The second hypothesis which examined the effect of the audit committee on bank performance also found a positive but insignificant result. These results reinforce the results of previous studies of Abeysekera (2008), Herwidayatmo (2000) and Xie et al. (2003).

This can be explained by the fact that banks with a large number of audit committee members have better performance and the member of the audit committee exceeds the requirement set by central Bank of Indonesia and, Capital Market and Financial Institutions. There are also banks that hold audit committee meetings up to 16 times in one year which exceeds that required by the government.

The third hypothesis that evaluated the effect of audit quality on banks' performance showed a positive and significant result. This means that the greater the quality of the audit of a bank, the better the performance of the bank. These results reinforce the results of previous studies such as research by Jensen and Meckling (1976) and Watts and Zimmerman (1986).

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