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CORPORATE GOVERNANCE MECHANISM AND PROFITABILITY (INDONESIAN BANKING COMPANY CASE)

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Abstract
This study aims to examine the effect of good corporate governance mechanisms on the profitability of banks in Indonesia. The population of this research is the banking sector companies listed on the Indonesia Stock Exchange (IDX) in 2013-2018. The sampling method is purposive sampling, there are 186 banking companies used as samples. The analytical method used is multiple linear regression method. The results of this study indicate that the independent board of commissioners has a positive effect on bank profitability. The board of directors, the audit committee, and institutional ownership has no effect on bank profitability. The size of the company has a positive effect on bank profitability.

Keywords: Corporate governance; independent board of commissioners; board of directors; the audit committee; institutional ownership; firm size; and Return on Equity (ROE)

1. Introduction

Firm Theory underlies the formation of a modern corporation. In some companies that involve managers, employees, customers, creditors, suppliers, and investors, each party has different interests, so the question arises: On whose behalf is the company run? According to Theory of Contracts from Professor Coase (1937), a company is a "collection of contracts," and the shareholders provide funds for the company to run its business. Therefore they need a guarantee to receive a proper imbalance. They assume to invest for a lifetime and most of their property. This assumption makes share ownership a top priority.

Agency theory decides the dilemma between management and shareholders. Corporate governance in the wrong agreement only for the interests held by shareholders in the long run. Although it can help make contracts offered by management that function properly, it is not easy to make a complete and perfect contract.

Jensen and Meckling (1976) explained that the agency problem explained the company's value erosion. That is why governments in various countries support GCG propaganda for the benefit of corporate health, including the banking sector as a financial intermediary. BI Regulation on GCG guided by Bank Indonesia Regulation Number 8/4/PBI/2006 concerning Implementation of

Good Corporate Governance for Commercial Banks, for Health Banks, BI has adopted the RGEC method. Based on Bank Indonesia Regulation Number 13/1/PBI/2011 article 6, RGEC indicators consist of Risk (R), Good Corporate Governance (G), Income (E), and Capital (C). Based on the description above, the writer is interested in implementing the implementation of governance in the banking sector in Indonesia as a research topic.

2. Literature Review

2.1 Agency Theory

Jensen and Meckling (1976) suggest that agency interactions occur between principals who hire other individuals, namely agents, to perform some services when making decisions on these agents (Brigham and Houston, 2006:26). Agency problems are motivated by asymmetric information (Fama and Jensen, 1983). Managers, as internal parties, consider having better information than investors who are external parties to the company. Managers can explore profits by organizing information to investors. According to Pangeran and Salaunaung (2016), asymmetric information can provide managers with opportunistic behavior regarding company profits that are detrimental to owners. Managers are motivated to take these actions for personal gain without the consent of the owner.

2.2 Corporate Governance

The definition of corporate governance, according to FCGI (2001) namely the rules regarding interactions between shareholders, managers, creditors, government, employees, as well as internal and external stakeholders relating to their needs. GCG becomes a system to direct an organization to its goals. Corporate governance aims to foster an added value for all stakeholders. GCG provides security guarantees for funds invested. In order to avoid an economic crisis, corporate banking governance in Indonesia needs to be continuously improved. To support this improvement, National Governance Policy Committee (KNKG) issue GCG general guidelines. Any organizations that collect and manage public funds, and organizations that have an impact on the environment to be able to implement the principles GCG.

The principles of good corporate governance proposed by the KNKG are transparency, accountability, responsibility, independence, and fairness. Implementation of GCG in the banking sector is an advanced implementation because BI has required bank health, then the banking sector has followed GCG regulations (Martin, 2014).

This study uses a corporate governance mechanism. Agrawal and Knoeber (1996) stated if the division of corporate governance controls mechanisms into 2, namely internal and external. The internal mechanism is a system needed in an organization and plays an active role in controlling the organization (Widyati, 2013). This internal control procedure is directly related to the organization's decision-making process. An external procedure is a step to operate the company in addition to using the company's internal procedures. External factors are intended to regulate the actions of insider parties to be open in controlling the corporation; as an external factor, institutional ownership generally applies to the party that monitors it (Darwis, 2009).

According to KNKG (2004), the implementation of good corporate governance requires implementation commitment from top management, and according to Septiana et al., (2016), GCG is managed by organs within the company. Thus, the corporate organs used in this study are the independent board of commissioners (IBC), the board of directors (BD), and the audit committee (AC). These organs have an essential task in implementing GCG. Agrawal and Knoeber (1996) suggest that the CG mechanism can reduce agency problems and, simultaneously, increase company profitability. One of it is that there is a concentration of ownership in institutions (majority shareholders) that can increase managerial monitoring and improve company performance, as there are representatives of independent commissioners in the company. This study also added institutional ownership (IO) as an independent variable used in the GCG mechanism.

Implementation of good corporate governance requires a top management commitment, primarily because organs manage it within the company (Septiana et al., (2016)). Therefore, corporate organs such as independent commissioners, the board of directors, and audit committees are an essential part of the successful implementation of GCG. Agrawal and Knoeber (1996) suggested that the CG mechanism that can reduce agency problems while at the same time is expected to increase company profitability is that there is a concentrated share of ownership in institutions (majority shareholders) that can improve managerial monitoring and improve company performance, as there are representatives of independent commissioners in the company.

2.3 Profitability

According to Horne and Wachowicz (2005), profitability is the expertise of organizations to obtain profits within a particular time by using assets or capital (all capital or own capital). Profitability is an indicator of proper company management, so management tries to be open about more information about rising company profitability. Signal theory has shown that management uses earnings information to convey company performance information. Profitability can be measured using various profitability ratios, including ROE (Return on Equity) to calculate profitability because if investors want to know the size of a company can get a return on the investment they provide, the first time that is seen by stakeholders is profitability ratios especially ROE. Return on Equity interprets how effectively the organization gets returns for investors.

2.4 Hypotheses Development

The influence of independent board of commissioners toward profitability

An independent board of commissioners is a board of commissioners that is outside the company. According to Bank Indonesia Regulation Number 8/4/PBI/2006 regarding GCG Implementation, it is mentioned if the number of members of the board of commissioners is a minimum of three people or the same as the number of directors. The board of commissioners consists of commissioners and independent commissioners, at least fifty percent of the total members of the board of commissioners are independent commissioners. An independent commissioner committee has the main task of carrying out monitoring of management. This monitoring to ensure that they have carried out all activities with the best ability for the interests of the company and eliminate decisions that are not beneficial, and play a role in representing the interests of minorities (Pangeran and Salaunaung, 2016) -monitoring that an independent board of commissioners implement can influence managers' actions to improve company performance or profitability. The higher the proportion of independent board of commissioners, the better monitoring of company management, thus organizational profitability increases. So, the first hypothesis in this study are:

H1: The size of the independent board of commissioners has a positive effect on profitability.

The influence of board of directors toward profitability

According to Bank Indonesia Regulation Number 8/4/PBI/2006 regarding the implementation of Good Corporate Governance in the banking sector, the number of members of the board of directors consists of at least three people. The board of directors must ensure that managers behave as expected by the organization. The board of directors is responsible for implementing policies that have been approved by the board of commissioners, maintaining the organizational structure, and asserting authority to run effectively. The strategic planning of the board of directors determines the increase in profitability and company performance. With the board of directors serving the company's operations, the company's financial performance reflect company performance improvement. Thus the second hypothesis is proposed as follows:

H2: The size of the board of directors has a positive effect on profitability.

The influence of audit committee towards profitability

According to Bapepam-LK Regulation No.IX.I.5 regarding the Formation and Guidelines for the Implementation of the Audit Committee's Work, the membership of the audit committee consists of at least three members, one of whom is an independent commissioner who also serves as chairman of the audit committee. In contrast, the other members are external parties; at least one of them has expertise in accounting or finance. The audit committee reports directly to the board of commissioners. If the audit committee's functions and responsibilities are carried out properly, it will put GCG principles in place, which encourage the company to always be accountable to all stakeholders. The higher number of audit committees that an organization has will provide better protection and supervision of the accounting and financial processes, which will have a positive impact on the company's financial performance (Anderson et al., 2004). So, the third hypothesis in this study are:

H3: The size of the audit committee has a positive effect on profitability.

The influence of institutional ownership towards profitability

Institutional ownership is the number of shares owned by institutions in the company. High institutional ownership will provide incentive monitoring and be a useful monitoring tool in management decisions. The existence of institutional investors is expected to maximize the control of management through the activities of monitoring every decision making by management as the manager of the company to increase profitability. Institutional share ownership has a positive impact on where the owner's control function determines the improvement of the company's performance. Theoretically, the higher institutional ownership, the more robust control over the company, performance, and corporate value if the owner of the company can control management behavior under the objectives of the company (Darwis, 2009). So this research proposes the fourth hypothesis as follows:

H4: The proportion of institutional ownership has a positive effect on profitability.

3. Method

The type of research used is explanatory research with a quantitative approach to explain the effect of the GCG mechanism on profitability. The data source of this research is secondary data obtained historically from annual reports and financial reports presented at banking companies listed on the Indonesia Stock Exchange in 2013-2018.

3.1 Sample

The population of this study uses all banking companies on the Indonesia Stock Exchange in 2013-2018. This population is then selected again according to the criteria established as follows:

Tabel 1. Research Sample

No	Criteria	Total
1	Banking sector population listed on the Indonesia Stock Exchange in 2013-2018	43
2	Does not include the number of Independent Commissioners, Directors, Audit Committees or Institutional Ownership in the annual financial statements	(12)
Total per year		31
Total (31 x 6 years)		186

3.2 Analysis Technique

The analytical method used in this study is multiple linear regression analysis where the regression equation used is:

$Y = \alpha + \beta_1 x_1 + \beta_2 x_2 + \beta_3 x_3 + \beta_4 x_4 + e$

Where:

Y = ROE

α = Constant

β = Regression Coefficient

X1 = Independent Board of Commissioner (IBC)

X2 = Board of Director (BD)

X3 = Audit Committee (AC)

X4 = Institutional Ownership (IO)

e = *Error*

4. Results and Discussions

4.1 Classical Assumption Test

This classic assumption test consists of a normality test, multicollinearity test, autocorrelation test, and heteroscedasticity test. From the normality test shows the results of the data in this study were distribute normally. Meanwhile, for testing other assumptions such as multicollinearity tests that have met the tolerance value requirements and VIF, then the autocorrelation test has been symptomatic of autocorrelation, and for the results of the heteroscedasticity test showed the absence of heteroscedasticity in the regression model used.

4.2 Hypotheses Testing

The value of the coefficient of determination (R2) in percentages ranging from 0 <(R2) <1, which states that the higher the possessed, then this shows the more information that can be provided by the independent variable to predict variations in the dependent variable.

Table 2. Determination Coefficient

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.548[a]	.300	.276	4.39030

Based on the test results, the coefficient of determination presented in table 2 shows that the Adjusted R Square value of 0.276. This value means that all independent variables consisting of an independent board of commissioners, a board of directors, an audit committee, institutional ownership, and company size can explain the variable return on equity (ROE) of 27.6%. Whereas other variables explain the remaining 72.4%.

F-test

The criterion taken in his decision is if the non-probability value of significance is less than 0.05, so it can be concluded that all independent variables simultaneously affect the dependent variable.

Table 3. Simultaneous test (F-test)

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	1183.542	5	236.708	12.281	.000[b]
	Residual	2756.285	143	19.275		
	Total	3939.827	148			

Table 3 above shows that the F test results get a probability value of 0,000 or less than the 0.05 significance level. So it can be concluded that all GCG independent variables, including independent commissioners, a board of directors, audit committee, institutional ownership, and company size, simultaneously influence the dependent variable profitability (ROE).

T-test

Decision-making criteria if the probability value of each variable is less than the standard significance of 0.05, so the independent variable has a partially significant effect on the dependent variable.

Table 4. Partial Test (T-test)

Model		t	Sig.
1	(Constant)	-3.591	.000
	IBC	2.263	.025
	BD	.082	.935
	AC	-1.641	.103
	IO	-1.068	.287
	SIZE	3.742	.000

The t-test results above indicate that the independent commissioner variable has a significance value of 0.025 or smaller than the significance standard of 0.05. Thus, it can be concluded that the independent commissioner variable significantly influences the dependent variable, namely, profitability (ROE). Furthermore, the control variable in the form of company size has a probability value of 0.000 or smaller than the significance standard of 0.05. It can be concluded that the firm size control variable has a partially significant effect on profitability (ROE).
However, for the board of directors, audit committee and institutional ownership variables have probability values of 0.935, 0.103, and 0.287 or higher than the significance standard of 0.05. These results show that the three variables have no significant effect on the dependent variable, namely, profitability (ROE).

The influence of independent board of commissioners toward profitability
The size of the independent board of commissioners has a positive effect on profitability (ROE). That is, the more the number of independent commissioners will further increase the company's profitability. The existence of this independent board of commissioners supports agency theory in preventing agency problems arising from information asymmetry. An independent board of commissioners that has better and tighter supervision of management can further reduce the possibility of fraud in presenting financial statements by managers and ensure the implementation of corporate strategy with abandon unfavorable decisions and play a role in representing minority interests. According to Pangeran and Salaunaung (2016), companies that commit fraud have a significantly lower percentage of external commissioners than companies that do not commit fraud. Ghana Code of best practices also suggest that the board attributes caused improvements in banks performance (Halidu and Kuutol, 2015).

The influence of board of directors toward profitability
The number of boards of directors does not affect profitability (ROE). Agency relationship that occurs between the principal and the agent according to agency theory raises a conflict of interest (moral hazard), which causes the greater size of the board of directors will provide opportunities and more encouragement in abusing the funds of shareholders for their interests. Moreover, the higher the number of boards of directors in a company, the more differences of opinion in determining company policies and often encountered difficulties in coordinating and making the right decisions in carrying out better control functions in order to increase company profitability. Banking management is not only about the number but more on skill and expertise to manage rapid changes (Chinhema, 2020). The results of this study are not under the shareholder theory, which states that the most fundamental responsibility of directors is to act to maximize welfare and increase the value (value) of the owner or shareholder. This result is in line with a study in India, where corporate governance in smaller banks already focuses on governance, yet the board members' vision and objectives alignment (Munjal, 2015).

The influence of audit committee towards profitability
The size of the audit committee does not affect profitability (ROE). According to Law No. 19 of 2003 article 70 concerning State-Owned Enterprises states that commissioners are required to form an audit committee that is tasked with evaluating the implementation of activities and

results of audits conducted by internal oversight units and external auditors. Then the Indonesian Audit Committee Association (IKAI) defines the audit committee as a committee that works professionally and independently and whose job is to assist and strengthen the function of the commissioners in carrying out the oversight function of the financial reporting process, risk management, audit implementation, and implementation of good corporate governance in companies. Based on the above definition, we can conclude if the audit committee in a company is only limited to overseeing whether the company's operational process has run according to regulations and does not try to improve the company (Putra dan Nuzula, 2017).

The influence of institutional ownership towards profitability

The proportion of institutional ownership does not affect profitability (ROE). This result is because the institution does not have direct authority to influence and monitor the company, not directly to increase its profitability. The results of this study are not in line with agency theory, which states that the majority shareholder (concentration of institutional ownership) will try to increase its profitability. According to Mariana (2016), this increase is caused by the influence of institutional share ownership that is too large to act in the interests of personal interests at the expense of minority shareholders' interests. Given this tendency, the direction of company policy is unbalanced, which will only benefit the institution, or there is a possibility that accounting information generated by management is based on the interests of the majority shareholder. This might be the cause of the insignificant influence of institutional ownership on profitability.

5. Conclusion

This study shows that the independent board of commissioners has a positive effect on bank profitability. In contrast, the board of directors, audit committee, and institutional ownership do not affect bank profitability, and the size of the company as a control variable has a positive effect on profitability.

At the end of this research, the company's suggestion is to know what GCG factors affect the bank's profitability, and then the company can improve these factors so that the company can operate sustainably. Investors should be able to see companies that have implemented GCG practices as a consideration when making investment decisions because, with the implementation of GCG, investor rights will be protected. For future researchers, this research is expected to add references or knowledge about the effect of GCG on profitability in subsequent research work by adding other independent, dependent, and control variables.

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