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Rural Bank Financial Performance: Evidence from Indonesia

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Abstract

This study aims to examine and analyze the influence of managerial ownership level, compliance level of accounting standard implementation, and assurance quality on financial reporting quality. This study also measures the influence of the variables of financial reporting quality, managerial ownership level, and risk management quality on rural bank financial performance. The method used in this research is the verificative research method with the survey approach, statistically processed by using PLS-SEM, with the aim to obtain the facts about the phenomena that occur and to seek information on the actual and systematic financial reporting quality and its impact on the rural bank financial performance. The findings of this study indicated that the compliance level of accounting standard implementation significantly influences financial reporting quality. The variable of managerial ownership level and assurance quality insignificantly influence financial reporting quality. The variables of financial reporting quality, managerial ownership level, and risk management quality also have insignificant influence on the rural bank financial performance.

Keywords: Rural bank financial performance; Managerial ownership level; Risk management quality; Compliance level with accounting standard implementation; Assurance quality; Financial reporting quality.

1. Introduction

According to the Indonesia Banking Statistics-Financial Services Authority (December 2014 & 2015), the number of BPR or rural banks (RBs) tends to decrease, but the number of RB's office continues to increase. The increasing the number of RB's office shows that RBs' services to the society increase, particularly the micro and small enterprise sector. Of the 1,637 RBs in 2015, 1,152 of them or 70.37% of them operated in Java and Bali. In terms of assets, RBs are grouped into four categories. During 2010 until 2015, the number of conventional rural banks with assets of over IDR 10 billion increased. The intermediation function of RBs is quite good. The total assets, loans, deposits collected, and paid up capital of RBs increased very significantly over the period 2010-2015. The increase was double in 2015 compared to that in 2010.

Based on Indonesia Banking statistics-FSA and Conventional RB Statistics-BI, CAR of RBs tend to fluctuate. In 2015, CAR is higher than in 2010 and far above the minimum requirement of 8%. This indicates a capital increase as a response to POJK (FSA rule) relating to minimum capital requirements. But, the increase was not offset by the rapid growth in earning assets quality, resulting in the un-channeled funds, so that profitability was not optimal. RB asset quality (NPL) declined in 2010-2013 but rose in 2014 to 2015. NPL in 2015 was more than the provision of 5%. This indicates a decline in the quality of productive assets or an increase in loan problem, leading to the increase in cost and decrease in income. Thus, the profitability RBs decreased.

Profitability of RBs is indicated by ROA, ROE, and BOPO (Operating Costs on Operating Income). ROA and ROE decreased in 2012-2015. Although ROA was still above the provision of 1.215%, the decrease indicates the decline of profitability. BOPO which is the proxy of performance efficiency tended to decrease in 2010-2013 but rose in 2014-2015. Although BOPO was still under the maximum provision of 93.52%, the increase in BOPO indicates a decrease in efficiency. This can be caused by the decrease in the quality of productive assets and results in a decrease in revenue, increase in the cost of funds and inefficiency in the overhead cost of RBs.

The liquidity which is indicated by LDR tended to fluctuate, and decrease in 2013-2015, but it was still under the terms of healthy provision of 94.75%. This indicates that the growth in lending and raising funds, depicting the intermediary function, does not always run in parallel, so the RBs potentially face the problem of liquidity excess. This means that there are funds that cannot be channeled into productive assets and there is a decline in profitability of the RBs.

BPR performance as an intermediary tends to increase. However, earning performance in 2015 was not better than in 2010. This was caused by the growth of capital and third party funds cannot be offset by the growth in quality productive assets with good profitability. The decline in profitability can be caused by the high credit problems and inefficiencies of operating costs. Profitability can affect CAR, wherein the lower CAR can potentially result in bank fail and under special supervision, or even to be liquidated or closed.

According to the Deposit Insurance Agency (LPS), the number of RBs based on entity and sharia operating in various regions in Indonesia which were closed or liquidated during 2006 to 2016 amounted to 69 RBs. Closing (liquidation) of RBs generally occurs due to the banking practices that are not healthy, ignoring the prudent principle. Thus, this causes banks experience liquidity problems (decrease in cash ratio), while the lending was not collected causing harm to the RBs (CAR decreases).

The increasing monitoring will make the RBs' corporate governance better. Fraud and mismanagement occur because of too much interference of the owners. Before FSA was established, Bank Indonesia already required RBs with assets above IDR 100 billion to have a Director of Compliance so that the RBs have an internal control. Thus, it can prevent the occurrence of fraud in RBs. The roles of governance are to reduce the difference of interest between shareholders and managers and to minimize the agency cost (Hartarska, 2005; Roodposhti and Chashmi, 2010). One of the key mechanisms of effective governance framework is ownership structure, including institutional and managerial ownership (Ghazali and Anum, 2010; Hartarska, 2005).

Financial Services Authority (FSA) assesses GCG as the most important aspect to be applied by RBs. There is a need to set GCG rules for RBs related the availability of directors and commissioners with good qualifications. The implementation of GCG related to work procedures and credit analyze needs to be supported by adequate facilities as well as competent human resources. FSA, as an institution at the forefront of the financial sector micro-prudential, wants the concept of good governance which is more complete, rigorous and integrated. Related to the implementation of corporate governance and risk management for RBs, the FSA has published POJK No.4/POJK.03/2015 on 31 March 2015 on the application of corporate governance and POJK No.13/POJK.03.2015 on 12 November 2015 on the application of risk management.

Based on the phenomenon that has been presented earlier, the author is interested in conducting research related to the level of managerial ownership, quality of risk management, compliance level of accounting standard implementation, and quality assurance affecting the quality of financial reporting of Rural Banks, and its effect on the financial performance.

2. Review of Literature

Some research says that high-quality auditing services increase the confidence of investors in financial reporting and increase the fund to be raised (Beisland *et al.*, 2015). High-quality audit relates to the lower capital costs. Thus, the high-quality audit is very important especially for companies that conduct fundraising such as financial institutions. A microfinance institution is a good example to be researched in terms of audit quality because this institution generally conducts fundraising and represents an industry by challenging highly diverse and voluntary governance structures (Mersland & Strom, 2009) in Beisland *et al.* (2015).

One of the most important functions that can be played by corporate governance is to ensure the quality of the financial reporting process. Several studies have concluded that corporate governance affects the quality of financial reporting. For example, Li and Tielin (2010) concluded that governance has a positive effect on the reliability and relevance of financial reporting. The agency problem between managers and shareholders basically occurs because of the separation between ownership and control, and the solutions to this problem are incentive alignment, monitoring, and discipline. Jensen and Mackling suggested that managerial ownership can help reduce the agency conflict. Managerial ownership has the power to unite the interests of managers and shareholders. The larger the managerial ownership is, the greater the interest unification becomes between managers and shareholders. In addition, this also reduces the agency problem.

LaFond and Sugata (2007), and Roychowdhury found that the high managerial ownership implies a stronger relationship between wealth managers and the company's value so that there is a negative relationship between conservatism and managerial ownership.

Roodposhti and Chashmi concluded that there is a negative and significant relationship between ownership concentrations, board independence in the existence of CEO-Chairman duality with earnings management. Alves (2012), concluded that earnings management is negatively related to managerial ownership and ownership concentration. Managerial ownership and ownership concentration improve the quality of annual earnings by lowering the level of earnings management.

Based on the explanation of the relationship between the level of managerial ownership and the quality of financial reporting, the following hypothesis can be formulated in:

H_1: The level of managerial ownership affects the quality of financial reporting of RBs.

Accounting standards can effectively reduce the asymmetry of information because the extensive disclosure can fairly distribute the benefits of information to investors. The same accounting standards can limit the possibility of distortion of financial information made by the manager.

Gebhardt and Zoltan (2010), concluded that the provisions related to the recognition restriction and the measurement of operating accrual items such as loan provision limit the ability of banks to perform income smoothing. Ogbonna and Ebimobowei concluded that ethical accounting standard is fundamentally necessary for the accountants in order to produce quality financial statements which are free of material misstatements. Accountant compliance with the professional ethics improves the quality of financial reporting and corporate performance. Kasum recommended that the standards should be reviewed periodically so that the quality will be better. The standards must also be complied with by all companies.

Showed that IFRS adoption positively affects the predictive value, feedback value, and reliability of accounting information. Ewert and Wagenhofer concluded that the quality of earnings increases with the more stringent standards, but they identified more consequences than the benefits. While Jara concluded that the quality of financial information is affected by the implementation of financial reporting standards.

Agustami and Suintri (2017), concluded that the implementation of SAK ETAP moderately influences the quality of financial reporting by using relevant, reliable, and comparable elements. While Nedsal *et al.* found that the accounting practices of SMEs in Indonesia are still low, leading to the low utilization of accounting information in the development of SMEs.

Based on the explanation of the relationship between accounting standards using the SAK ETAP and RBs' accounting guidelines and the quality of financial reporting, the following hypothesis can be formulated:

H_2: Compliance with the accounting standards implementation affects the quality of financial reporting of RBs.

The main purpose of the external financial reporting is to reduce information asymmetry. The users of financial statements believe that the audit should provide assurance of no material misstatement or fraud in the financial statements and the audited financial statements are monitoring mechanisms to provide assurance. The users receive audited financial statements as absolute assurance that the financial statements do not contain material misstatements and there is no cheating.

The high-quality audit should be measured through the external "product" called auditor's report and the "process" that can be assessed by internal audit procedures. Several studies were conducted to obtain empirical evidence of the relationship between assurance quality and earnings management. The influence of audit firm tenure on earnings management was investigated by Thuneibat *et al.* (2011) and Lin and Hwang (2010). The influence of auditor size on earnings management was examined by Arie and Hilda (2009), Chen *et al.* (2013), Gerayli *et al.* (2011), Lin and Hwang (2010), and Jeong and Rho (2004). (Gerayli *et al.*, 2011; Lin and Hwang, 2010; Riski Rudiantoro dan Sylvia Veronica Siregar, 2012; Thuneibat *et al.*, 2011) and Sylvia examined the influence of auditor independence on earnings management. While the influence of auditor's specialization on earnings management was studied by Lin and Hwang (2010), Gerayli *et al.* (2011). and Tirta and Sholihin (2004). Naslmosavi found that some human capital factors such as experience, education, skills, and competencies of employees influence the quality of auditors and their opinion.

Based on the explanation of the relationship between the assurance quality and the quality of financial reporting, the following hypothesis can be formulated:

H_3: Assurance Quality affects the quality of financial reporting of RBs.

The financial reportings have a good quality if the information contained are relevant, reliable, understandable, comparable, can be tested and on time. For the financial statements to be useful, they must have certain attributes. The qualitative characteristics of the useful financial information identify the types of information expected to be most useful for investors, lenders and other creditors for making decisions related to the reporting entity on the basis of the information presented in its financial statements.

Some research suggested that the quality of financial reporting can improve investment efficiency by reducing the information asymmetry that causes friction such as moral hazard and adverse selection. Costello and Regina (2009), concluded that the lenders at the company with a weak internal control (measuring the quality of financial reporting) do not rely on performance based on financial covenants and financial ratios when determining the amount of interest charged.

Based on the explanation of the relationship between the quality of financial reporting and RBs financial performance, the following hypothesis can be formulated.

H4: The quality of financial reporting affects the financial performance of RBs.

According to the incentive effect, there is a positive relationship between managerial ownership and corporate performance. However, if the entrenchment effect is greater than incentive effect, the managerial ownership can decrease company's performance. The relationship between managerial ownership and corporate performance is not monotonous because at a certain level of ownership there will be takeover rather than improvement, and there will be a reverse relationship between managerial ownership at a certain level and the company's performance.

Din and Javid (2011), found that performance was positively affected by managerial ownership only at a low level and moderate level, while managerial ownership at the level of more than 25% negatively relates to performance and supports the entrenchment theory. Hu and Zhou (2008), also found that the relationship between managerial ownership and performance is not linear, and the negative relationship occurred on managerial ownership more than 50%. Mueller and Alexandra (2006), found that company's performance increases at the managerial ownership up to 40% and did not reveal any significant entrenchment effect.

Gugong *et al.* (2014), studying the effect of ownership structure (managerial and institutional shareholding) on the performance of the company, concluded a positive relationship between ownership structure and corporate performance. While Jusoh *et al.* (2013), concluded that managerial ownership does not affect the company's performance in Malaysia, and the problem of principal-agent cannot be solved by simply increasing managerial ownership.

Based on the explanation of the relationship between the level of managerial ownership and RBs' financial performance, the following hypothesis can be formulated:

H_5: The level of managerial ownership affects the financial performance of RBs.

Risk management is an effective technique for minimizing the risk of unwanted impacts and optimizing benefits in a risky situation. Risk management has a positive influence on the company's financial performance and therefore should be followed. Corporate governance and a sound risk management do not automatically guarantee the success of the company, however, the absence of both of them can indicate business failure.

Risk management can be seen as a procedure or mechanism placed to reduce or avoid risks. Risk management becomes one of the main functions of the banking industry. Risk management includes the identification of risks, understanding the risks and their impacts, risk control to reduce the likelihood or impact, and trying to keep the risk at an acceptable level.

Adeusi *et al.* (2013), found a significant association between risk management and bank's performance. There is an inverse relationship between financial performance and doubt loans, while capital assets ratio was found to be positive and significant, and the higher the funds managed by the bank is, the higher the performance of the bank becomes. Channar *et al.* (2015), concluded that risk management has a negative insignificant relationship with operational performance, but has a positive relationship with financial performance. Olamide *et al.* (2015), concluded that risk management has a negative insignificant relationship with performance.

Fredrick (2012), using CAMEL indicators for credit risk management and ROE for the bank's financial performance, found that the indicators of capital adequacy, asset quality, management efficiency, and liquidity have a weak influence on financial performance (ROE), while the indicator of earnings has a strong influence on the financial performance. Magali and Qiong (2014); Gatuhu (2013); Afriyie and Akotey (2013) and Akotey concluded that the practice of effective credit risk management improves the financial performance of the bank, microfinance, and rural banks.

Based on the explanation of the relationship between the quality of risk management and RBs' financial performance, the following hypothesis can be formulated:

H6: The quality of risk management affects the financial performance of RBs.

3. Methodology

The method used in this research is descriptive research method, namely data collection to test the hypotheses or answer questions about the current status of research subjects (Mudrajad, 2013). This study is aimed at testing the hypotheses about the influences of managerial ownership, quality of risk management, compliance with the implementation of accounting standards, and quality assurance on the quality of financial reportings and their impact on the financial performance of RBs.

This research is verification research characterized as explanatory research or causality (causal study). In addition to measuring the strength of the relationship between two or more variables, this study aims to show the direction of the relationship between independent variables and the dependent variable (Mudrajad, 2013). In other words, this study raises the question of causation. This research explains the degree of influence of the variable of managerial ownership, quality of risk management, compliance with the implementation of accounting standards, quality assurance, and the quality of financial reporting on the financial performance of RBs.

In this research, there are two types of data, namely primary data and secondary data. Primary data are the first-hand data (information) obtained regarding the variables which become the main concern of a certain study purpose (Sekaran and Roger, 2013). In the context of this study, the primary data are data or information collected through a list of questions or statements (questionnaires) addressed to the respondents in order to obtain the facts and factual information. Thus, in this study, the questionnaire is also referred to as a research instrument, namely a research tool used to measure the natural and social phenomena being observed (Sugiyono, 2015).

Secondary data are data or information gathered from the existing or available sources (Sekaran and Roger, 2013). Secondary data in this study are obtained from textbooks, previous research reports, magazines, and other sources which are used as theories and concepts to build the framework model.

Because the population chosen in this study is conventional rural banks in Java and Bali with different number of RBs in each region and different entity (incorporated as PT, PD or a cooperative), so the design of the sampling is carried out by random sampling. The number of sampling is adjusted to the number of RBs for each region by taking into account their legal form. While the sample size is determined based on the data analysis technique which is used. To test the hypothesis of the study, the statistical analysis technique uses structural equation modeling (SEM).

4. Result and Discussion

The result of the first test for the reliability indicator indicates that the reliability value of rural banks in Java and Bali ranges from -0.926 until 1.453 with an average value of 1.000 and a standard deviation of 0.077. From the average value and standard deviation of the data, it can be explained that the predictive value of rural banks in Java and Bali examined (52 rural banks) is relatively homogeneous. It is shown from the average value which is greater than the value of the standard deviation. Reliability value is 1.000 explaining that reliability value is high enough, so the value of quality of financial reporting is quite high.

Hypothesis testing result showed that the level of managerial ownership positively influences the quality of financial reporting, but the effect is not significant. Thus, the result of this study provides empirical evidence that the quality of financial reporting is positively influenced by the level of managerial ownership but not significantly. Managerial ownership is determined by the stock ownership level and engagement level of management in conducting the duties and responsibilities. The description of the result showed that the dimension of stock ownership level by management provides more contribution on the variable of managerial ownership than the dimension of management involvement level in the duties and responsibilities. The average level of stock ownership by directors is less than 5%, while the stock ownership by the commissioner is 11.58% (from 5% to 25%). While the involvement level of the Board of Directors and Commissioners in performing their duties is high.

The result of hypothesis testing showed that the compliance with the implementation of accounting standards positively and significantly influences the quality of financial reporting. The level of compliance with accounting standard implementation is determined by the level of compliance of rural banks in (a) providing loans, (b) managing third party funds, (c) disclosing non-financial information, and the degree of compliance with professional ethics. The description of research result showed that the accountant compliance level with professional ethics provides the highest contribution to the variable of compliance with accounting standard implementation. Thus, the employees running the accounting function perform their duties honestly, independently, credibly, professionally. They are also qualified and confident, have specific skills in their respective sectors, maintain the confidentiality of information obtained during their duties, do not use or disclose any information without authorization, have compliance with standards and regulations, maintain the reputation and professional ethics.

The result of hypothesis testing showed that the quality assurance provides a negative and insignificant effect on the quality of financial reporting. The higher the quality assurance is, the lower the quality of financial reporting becomes. Quality assurance is determined by the quality assurance both from external and internal. The external quality assurance is determined by audit tenure, audit fees, the number of auditors and other services, while the quality of the internal assurance is determined by competence, independence, and measurement of SKAI and SKAI performance. The description of the result showed that the dimension of internal quality assurance provides a higher contribution to the variable quality assurance than the dimension of external quality assurance. This internal quality assurance should properly monitor the effectiveness of control, risk management, and governance as well as ensure the reliability of financial reporting. The descriptive value of internal quality assurance averagely showed the high-performance value (82.05%), while the descriptive values of competence indicator (54.62%) and independence (65.38%) are sufficient. The descriptive value of audit measure is low (37.5%).

The result of hypothesis testing showed that the quality of financial reporting has a positive but not significant effect on the financial performance of the rural banks. The quality of financial reporting is determined by the predicted value, feedback value, and reliability. The description of the result showed that the dimension of the predicted value has a higher contribution to the variable of financial reporting quality than other dimensions i.e. feedback value and reliability. A high-quality financial reporting should reduce the asymmetry of information, thereby will reduce the financing costs and increase efficiency and improve financial performance. The insignificant effect of the financial reporting quality on financial performance quality was found because by the capital providers, especially the depositors, do not utilize financial information of rural banks to base their decisions. Nonetheless, they use other considerations such as deposit insurance regulation by LPS. For depositors, financial information of rural bank is not the factor influencing their decision for saving their funds in the rural bank. Assurance regulation and depositor closeness with the management of rural bank have a stronger influence in their decision making.

The results of hypothesis testing showed that the level of managerial ownership has a significant effect on the financial performance of the rural banks. Thus, the result of this study provides empirical evidence that the financial performance is positively affected by the level of managerial ownership but not significant. The level of managerial ownership is determined by the level of management's stock ownership and the level of management's engagement in conducting their duties and responsibilities. The description of the result showed that the dimension of stock ownership level by management provides more contribution on the variable of managerial ownership than the dimension of management involvement level in conducting their the duties and responsibilities. The average level of stock ownership by directors is less than 5%, while the stock ownership by the commissioner is 11.58% (from 5% to 25%). While the involvement level of the Board of Directors and Commissioners in performing their duties is high.

The result of hypothesis testing showed that the quality of risk management has a positive but insignificant effect on the financial performance of the rural banks. Thus, the result of this study provides an empirical evidence that the financial performance of rural banks was positively affected by the quality of risk management, but the effect is not significant. The quality of risk management is determined by the effectiveness of the supervision of the Board of Directors/Commissioners and the adequacy of policies, procedures, processes, and risk management system.

The description of the result showed that the dimension of supervision of Directors and Commissioners has a higher contribution to the financial performance of rural banks than the dimensions of policies, procedures, processes, and risk management system. The quality of this supervision relates to the implementation of the policy and risk management guidelines which have been set by the board of directors and agreed by the board of commissioners. The policy and guidelines should be reviewed and evaluated regularly and reported to the board of commissioners. The training in risk management and the separation of risk management function are needed.

5. Conclusion

Based on the problem formulation, hypothesis, results and discussion outlined, the conclusions can be drawn as follows:

The level of managerial ownership in the form of stock needs to be limited both of the board of directors and board of commissioners. The level of stock ownership needs to be strengthened by the management's involvement in conducting their duties and responsibilities.

The effectiveness of supervision of BOD and BOC on the implementation of policies, procedures, processes, and risk management system will improve the quality of risk management. The competency of BOD and BOC must be improved through training and certification of risk management. The compliance function and committee of risk management supervisor needs to be improved in terms of their effectiveness.

The competency of human resources performing accounting function and reporting needs to be improved so the level of compliance with the accounting standard implementation will be better. The compliance with profession ethics must also be improved.

The competence of internal auditors needs to be improved by conducting training, certification and profession membership. The competences of internal auditors needed to be improved are governance, risk management, internal control, information technology, and accounting standards for rural banks.

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