# The Role of Islamic Corporate Governance in Preventing Fraud

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Keywords: Bank's Health, Islamic Corporate Governance, Fraud, Moderating Regression Analysis.

Abstract: This research aims to examine the Sharia banks' health, registered at Bank Indonesia, towards fraud through the role of Islamic Corporate Governance. The independent variables were Non-Performance Financing (NPF), Operational Efficiency Ratio (BOPO), and Capital Adequacy Ratio (CAR), with Islamic Corporate Governance (ICG) as a moderating variable. The dependent variable in this research was fraud. The population in this research were all Sharia Banks registered at Bank Indonesia year 2015 to 2018. The sample was selected using purposive sampling method. The total sample used in this study were 60 Sharia Banks. The analytical method of this research used moderation regression analysis. The results showed that, NPF has a significant negative influence toward fraud, CAR has a significant positive influence toward fraud, while BOPO has no influence toward fraud. Islamic Corporate Governance (ICG) played a role in strengthening the influence of NPF and CAR toward fraud. However ICG was unable to strengthen the influence of BOPO toward fraud in Sharia Banks registered at Bank Indonesia.

## 1 INTRODUCTION

Sharia banking in Indonesia has grown rapidly after its legalization of law number 21 of 2008 about Sharia banking (Falikhatun, 2012). The developments are seen from the number of banks and offices of Shariah General Bank (BUS), Sharia Business Unit (UUS), and Sharia People's Financing Bank (BPRS). In this development, sharia banks will face challenges, and the biggest challenge is to maintain their image and name, so that the customers remain confident and loyal to the sharia bank.

Sharia bank is a bank that operates based on Islamic principles, especially those involving ordinances in muamalat (Dendawijaya, 2005). However, the existence of sharia banks does not necessarily guarantee the bank is free from fraud. There is no guarantee that sharia-based financial institutions are free from the possible tendency of fraud behaviour (Sula et al., 2014). Although the bank is known as a strict regulatory institution, but the bank also becomes the target of fraud itself (Rahman and Irda, 2014).

Fraud is an act of deviation or refraction that is deliberately done to deceive or manipulate banks, customers, or other parties, in the bank's environment by using the means of banks. So that it makes the banks, customers or other parties suffer losses and/or perpetrators obtain financial benefit either directly or indirectly (Albrech et al., 2012; Priantara, 2013; SE BI No. 13/28/DPNP). The most widely fraudulent cases are the assets misappropriations (85%), corruption (13%) and the fewest number (5%) is fraudulent statement (Koroy, 2008).

One of cheating that can happen in sharia banking is the cheating on financial statements. Cheating in financial statements causes the information in the financial statements to be invalid and not in accordance with the prescribed mechanisms. Whereby an audit should convince the company that the financial statements are free from misstatement and also can convince about management accountability of the company assets (Koroy, 2008). Cheating in financial statements are a social and economic problem. This will result in decreased public reputation about the company, so that the company can be directed to banckrupty.

One of fraud cases in sharia institutions is the case in Shariah Mandiri Bank. It involved the internal bank, a fictionalized credit distribution in Shariah Mandiri Bank in Bogor, Indonesia around 102 billion rupiah to 197 fictional customers. As the result, BSM was potentially lose 59 billion rupiah. In addition there is a case, where the customer reported BRI Shariah Bank and Mega Syariah Bank, related to shariah mortgage. The customer's lawsuit is caused



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by they felt harmed related to the gold pledge in BRI Sharia and Sharia Mega Bank (Djumena, 2014).

The bank's financial performance level can affect public's trust toward the bank. Basically, the society judgement is seen from implied measures such as facilities, services and profit levels. Therefore, as an institution that in its activities using the society's funds, the bank is required to maintain and improve its performance (Najib, 2016). The Financial Services Authority, as an institution that regulate and supervise the Sharia banks in Indonesia, publishes regulations related with the health procedures of banks. The regulation is reflected on Financial Services Authority number 8/POJK. 03/2014 about the health level assessment of sharia banks and sharia business units. Banks are required to conduct bank health assessments either individually or in consolidation with the scope of assessments towards the factors of risk profile, good corporate governance, earnings, and capital. In other words, it uses Risk-based Bank Rating (RBBR) concept. RBBR concept requires banks to maintain and improve the bank's health level by applying the principles of prudence and risk management in conducting the business activities (Setiawan, 2009; Widyaningrum et al., 2014; Yacheva et al., 2016).

Based on the above background, this research attempts to analyze and empirically test the relationship between non-performing financing, operational efficiency ratio, and capital adequacy ratio on fraud. This research also placed the Islamic corporate governance, as a control mechanism, which is expected to suppress the fraud of sharia bank in Indonesia.

# 2 LITERATURE REVIEW

## 2.1 Background Theory and Previous Studies

### 2.1.1 Non-performing Financing and *Fraud*

Non-Performing Financing (NPF) is a financial ratio that is associated with credit risk. It indicates the Bank's management capabilities in managing the problematic financing provided by the Bank. The higher the ratio, the worse credit quality of the bank. Credit in this case is credit given to the third party not included credit to other banks. The problematic credits are credit with less fluent quality, doubtful, and stuck (Kasmir, 2011).

As an entity that has special character, the management of sharia finance business has a high risk, so it takes the prudence principle of the perpetrators. The type of fraud that often occurs in sharia banks is credit card fraud (Rahman and Irda, 2014). If the bank has a lot of problematic credit then the possibility of fraud is greater.

Setiawan (2009) stated that sharia banks can still operate properly if the average NPF is under the maximum limit of Bank Indonesia's regulations without disrupting the level of return received. Triwahyuningtyas and Ismail (2014) showed that sharia banks in Indonesia has healthy conditions with the NPF under 6%.

H1: Non-Performing Financing has positive influence toward fraud

### 2.1.2 Operational Efficiency Ratio and Fraud

Operational efficiency ratio (BOPO) is the company's ability to get revenue based on the operational funds. This ratio is used to measure the level of efficiency and ability of the bank to perform its operations (Dendawijaya, 2005). The small BOPO indicates that the bank's operating costs are smaller than their operating income, so it shows that bank management is very efficient in carrying out the operational activities (Habbe et al., 2012). The lower operational efficiency ratio, indicating that the financial performance of sharia banks is getting better, thus it is expected that there is no fraud.

Kusumo (2008) stated that decreasing operational efficiency ratio indicates a better level of efficiency and the bank's ability to run out the operations. This is because the costs incurred by the bank are able to earn more income. The bank is at a safe position if the operational efficiency ratio is at a position of less than 95%. The management of the company will strive to maximize revenues or minimize costs in order to provide and report good performance to the shareholder (Anugerah, 2014).

H2: Operational efficiency ratio has positive influence toward fraud

### 2.1.3 Capital Adequacy Ratio and Fraud

Capital Adequacy Ratio is the ratio to measure the level of capital adequacy, which shows how far all assets contain risk (financing, inclusion, marketable securities, other bank bills) are financed from the bank's capital funds, besides obtaining funds outside of the bank, such as community funds, loans (debts) and others (Dendawijaya, 2005). Sharia banks that have a high CAR ratio lead to better capital positions, a good capital will increase the public's trust towards banks, and large capital allows the bank to create greater financing. so that it will increase profits (Kusumo, 2008; Setiawan, 2009 Laela, 2012). The results showed that CAR has a positive impact toward the bank's performance, so that the fraud is smaller.

Archer and Rifaat (2009) found that lack of capital adequacy management caused Islamic banks in Qatar, Jordan, Malaysia and UK place the investment share as capital so that the bank's liquidity is problematic. Therefore, the bank must have sufficient capital, maintain the quality of its assets, manage and operate based on the prudence principle in order to perform its functions properly. Najib (2016) added that the level of financial performance of a bank can affect public's trust toward bank. So as an institution in its activities using the funds from the community, the bank is required to maintain and improve its performance.

H3: Capital Adequacy Ratio has negative influence toward fraud

### 2.1.4 Islamic Corporate Governance and Fraud

The operation of sharia banks is not separated with the demands of good corporate governance based on sharia principles called Islamic corporate governance. The governance implementation of of sharia banks is reflected through the existence of sharia supervisory board (SE BI number 12/13/DPbS in 2010). It is stated that the more meetings of sharia supervisory board, the more obedient the bank with on sharia principles in conducting all transactions. This is because sharia supervisory board performs supervision and monitoring functions (Maradita, 2012).

Bhatti and Bhatti (2010); Faozan (2013) stated that Islamic corporate governance (the existence of sharia supervisory boards) in a company could reduce the action of fraud. Cheating will appear when the company is in an unhealthy, but it can happen when companies have high excess funds. The existence of audit committee and sharia supervisory board as an extension of the commissioner is the corporate governance element that may prevent fraud (grace, 2014). Asrori (2014) also shows that Islamic corporate governance positively affects the sharia banks performance. El Junusi (2012), stated that the implementation of sharia governance positively affects the reputation and customers' trust. Ponduri and Syeda (2014) stated that = organization could control fraud through internal audit and internal control. Sherif and Khaled (2016) found that sharia supervisory board is able to minimize fraudulent actions. The better implementation of corporate governance, is expected to strengthen the bank's health in suppressing fraud behavior.

H 4.a Islamic Corporate Governance strengthen the influence of Non-Performing Finance in suppressing fraud

H 4.b Islamic Corporate Governance strengthen the influence of Capital Adequacy Ratio dalam in suppressing fraud

H 4.c Islamic Corporate Governance strengthen the influence of operational efficiency ratio in suppressing fraud

## 2.2 Conceptual Framework

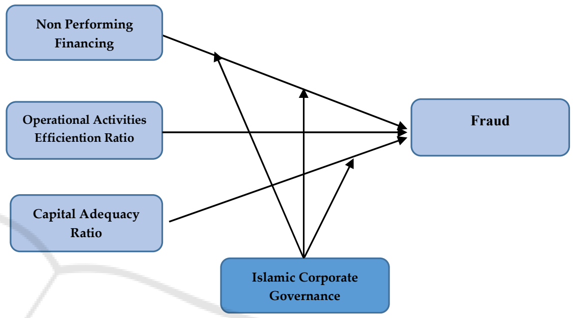


Figure 1: Research Model.

## 2.3 Methodology

The population in this research were all sharia banks registered in Bank Indonesia year 2013-2018. The sample selection method used purposive sampling method, with the criteria: (1) Sharia Bank registered in Bank Indonesia consecutively for the year of 2013-2018; (2) Sharia Bank that published the annual financial statements and the Good Corporate Governance implementation reports on the official website during the observation period; and (3) Sharia Bank which disclosed the complete data related with the research variables. According to the criteria above, the total samples used in this study were 10 sharia banks, 60 observations.

The fraud variable in this research was measured by seeing at the amount of internal fraud in Sharia banks, as stated in the annual report. NPF is a ratio of problematic financing to total financing used to measure the level of financing problems faced by sharia banks. The operational efficiency ratio is a ratio of comparison between operational costs and operating income. CAR is a ratio of comparison between bank capital and total risk weighted assets. Meanwhile, Islamic corporate governance is measured from the meeting frequency of sharia supervisory board.

# 3 DISCUSSION

The result of multiple linear regression test can be seen in table 1 below:

Table 1: The Result of Multiple Linear Regression Test.

| Model | Dependent Variable | Independent Variable | B Standardized | T | Sig |
|---|---|---|---|---|---|
| Model 1 | FRAUD | NPF | -1.143 | -2.581 | .013 |
| | | BOPO | -.312 | -1.035 | .305 |
| | | CAR | 1.036 | 3.308 | .002 |
| | | NPF*ICG | 1.364 | 2.260 | .028 |
| | | BOPO*ICG | .001 | .004 | .997 |
| | | CAR*ICG | -1.580 | -3.446 | .001 |
| | F | 3.409 | | | .006 |
| | Adj. Rsquare | .197 | | | |

Source: Processed secondary data, 2019

Table 1 shows that NPF and CAR variables have significant influence on fraud, while BOPO is not influenced by fraud. Islamic corporate governance can strengthen the influence of NPF and CAR to suppress fraud. However, the ICG is not able to strengthen BOPO on fraud. So it can be concluded, from the six independent variables in the regression model of this research, there are 2 independent variables and two moderation variables which give significant influence toward fraud as the dependent variable. Meanwhile, BOPO variable and BOPO interaction with ICG are not significant

## 3.1 Non-performing Financing and Fraud

Non-Performing Financing (NPF) has a significant negative influence toward fraud. In other words, the higher problematic credit, the higher the amount of fraud. The credit quality of the bank on this research suggests that most of bank credits have a value under 5% (2.84%). This means that NPF in a secure condition is potentially encouraging the moral hazard behavior as shown by the amount of fraud. From this it can be understood that, the increase of NPF sharia banks that are still in healthy category, potentially increase the number of fraudulent behavior in the bank itself, because in fact fraud will still happen in the healthy NPF conditions.

This result in contrast with the research results of Kusumo (2008) which found that NPF does not influence the sharia bank performance. Sharia bank performance with NPF value below the maximum can show that this sharia entity have the potential to commit fraud.

## 3.2 Operational Efficiency Ratio and Fraud

The operational efficiency ratio influences positive insignificant towards fraud in sharia banks. The assessment towards efficiency and ability level of the bank in conducting its operations in this research, show that banks are dominated by poor efficiency level. The proportion of average operational cost in this ratio is 98.37 %. However, the presence of less efficient operational costs does not improve the potential of behavior. This means that cheating behavior is not driven based on the efficiency of sharia bank operations. It is contrary to the COSO Research (2010) found that the most common fraud techniques is the improper revenue confession.

The result of this study is also different from the research by Anugerah (2014); Setiawan (2009); Kusumo (2008), stated that the BOPO positively impacts the financial performance, thus it opens opportunities for fraud. Similarly, the opinion that sharia bank is healthy in the aspect of operational efficiency can reduce the occurrence of fraud in the banking operations itself (Habbe et al., 2012). In line with the reseatch by Najib (2016), which stated that the income has been made in accordance with sharia provisions is not able to contribute greatly in reducing or increasing the amount of fraud in sharia banks.

## 3.3 Capital Adequacy Ratio and Fraud

Capital Adequacy Ratio has a significant positive impact toward fraud in sharia banks. It can be interpreted that the higher the Capital Adequacy Ratio, the amount of fraud will be high as well. It means that the better level of the bank's capital adequacy could potentially create fraud. CAR becomes a measurement of risk assets (financing, inclusion, marketable securities, bills on other banks financed) from capital funds can describe the health bank performance. The average of CAR sharia bank is currently at 22.23%. This indicates a high level of health, because it is far above 8% (the minimum standard of Bank Indonesia). This means that with a high level of health, it raises the potential for cheating.

These findings are in contrast to the research of Setiawan (2009); Kusumo (2008) which stated that the CAR ratio negatively influences the problematic condition. In other words, the lower the CAR ratio, the problem of bank will be higher. It is also stated by Najib (2016), when the CAR Sharia Bank is good, the financial performance of the bank is in good condition as well. This indicates that sharia banks with CAR value are increasingly influence the low fraud in the bank.

## 3.4 Islamic Corporate Governance, Bank's Health and Fraud

Islamic Corporate Governance can suppress the behavior of moral hazard in banks that have a healthy non-performing finance. This means that. an increase of NPF in a healthy bank can be suppressed by the support of Islamic Corporate governance.

Employees or managers have an opportunity to do fraud. Sula et al., (2014); Triwahyuningtyas and Ismail (2014) demonstrated good bank's financial performance cannot guarantee that the bank is free from fraud. However, with the Islamic corporate governance in form of meeting frequency of sharia supervisory board can significantly suppress fraud in Sharia banks.

The result of this research support the research conducted by Bhatti and Bhatti (2010); Faozan (2013); Anugerah (2014); Ponduri and Syeda (2014); Rahman and Irda (2014); Sherif and Khaled (2016) stated that corporate governance can reduce fraud level. Asrori (2014) added that Islamic corporate governance positively affects the performance of Sharia banks. El Junusi (2012) also showed that the implementation of Sharia governance positively affects the reputation and customer's trust. However, this is not in line with the research of In'airat (2015) which stated that the existence and implementation of corporate governance is insufficient to reduce the level of fraud.

Islamic corporate governance cannot support the operational efficiency in suppressing fraud. The efficiency of shariah bank is not the stimulant of cheating behavior, so the existence of Islamic corporate governance also does not strengthen or weaken the relationship between Islamic corporate governance and fraud. It means that the existence of Islamic corporate governance in form of supervisor's meeting frequency is ineffective control mechanism to operational efficiency. This is different from the opinion that, the corporate governance implementation is a must for an institution including sharia banks, it becomes the public's responsibility regarding the bank's operations which are expected to comply with the outlined regulations (Maradita, 2014).

Islamic Corporate Governance can strengthen the impact of CAR to suppress the number of frauds. CAR without supported by the existence of Islamic corporate governance is potential to improve fraud. It means that the existence of Islamic corporate governance can suppress fraud behavior in a good CAR condition.

This finding can also be used as a signal that Islamic corporate governance supports the healthy capital adequacy in suppressing fraud. This finding is in accordance with the opinion which stated that the implementation of company's governance, including considering all principles and functions itself and the role of the audit Committee, will be able to prevent or reduce fraud (Anugerah, 2014). This shows that, the healthy CAR is not enough to be a good signal, when the Islamic corporate governance is not supported by the meeting frequency of the sharia supervisory board. The frequency of the sharia supervisory board can be used as a signal that fraud will not happen.

# 4 CONCLUSION

Non-performing financing has influence toward fraud. The influence will be better when supported by Islamic corporate governance. Meanwhile, Capital Adequacy Ratio can potentially increase fraud, but CAR which is supported by an adequate Islamic corporate governance will suppress fraud.

The operational efficiency ratio has no influence toward fraud in sharia banks, so the existence of Islamic corporate governance is also unable to support the operational efficiency to suppress fraud. Thus, the level of operational efficiency cannot be used as a signal for fraud. The limitation of this research is the ability of independent variables to explain the dependent variables is only 19.7%.

Further research is recommended to add the population by using other types of sharia financial institutions such as Sharia Business Unit (UUS), Sharia People's Financing Bank (BPRS) or Sharia insurance, using sharia banks outside Indonesia such as Malaysia, Saudi Arabia and others. It also needs to add other variables that may have an influence toward fraud in sharia banks, such as Sharia compliance.

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