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## Non-Performing Financing and Islamic Corporate Governance Influence on Fraud in Sharia Commercial Banks

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### Abstract

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Audit Committee;

This study investigates the impact of Non-Performing Financing (NPF) and Islamic Corporate Governance (ICG) on fraud within Islamic commercial banks in Indonesia. The independent variables examined are NPF and ICG, with the latter proxied by the duties and authority of the Sharia supervisory board and audit committee. The dependent variable in this study is fraud. Secondary data, sourced from the annual reports and good corporate governance reports of Islamic banks in Indonesia, were utilized. The data were analyzed using logistic regression with SPSS statistical tools. The findings reveal that Non-Performing Financing has a significant influence on fraud occurrences within these banks. Conversely, Islamic Corporate Governance, as represented by the activities and oversight of the Sharia supervisory board and audit committee, does not exhibit a significant impact on fraud. These results suggest that while financial health, as indicated by NPF, is a critical factor in preventing fraud, the current mechanisms of Islamic Corporate Governance may require enhancement to effectively mitigate fraudulent activities. Future research should consider incorporating additional variables to provide a more comprehensive understanding of the factors influencing fraud in Islamic banking. This study highlights the need for improved governance structures and stricter oversight to enhance the integrity and trustworthiness of Islamic financial institutions.

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## INTRODUCTION

The banking sector has an important role in the economy of a country and has an impact on all aspects of people's lives. In 1997 Indonesia experienced a monetary crisis in which many banks experienced negative spreads so that many conventional banks were liquidated and had an impact on the difficulties of the people's economy. However, liquidation did not occur at the time of Sharia banks so that it was academically interesting to do further research on Sharia banks related to the stability of Sharia banks in times of crisis whether better than conventional banks (Alim, 2014);(Nugroho & Husnadi, 2014).

Developing Sharia banking in Indonesia must also be accompanied by an increase in the quality of Islamic banks, in order to gain public trust. One effort to preserve and maintain public

trust that banks can do is to maintain the level of health or the low level of problem financing ratio (Soekapdjo, Nugroho, Badawi, & Utami, 2018).

Along with the development of Sharia banks, the greater the challenges that must be faced by Islamic banks. Even though Sharia banks carry out their duties based on sharia principles, this does not guarantee Islamic banks are free from fraud.

Fraud is an act of a general nature and encompasses a variety of meanings in the form of someone's clever way that is designed to benefit from the wrong presentation (Albrecht, W. Steve, 2011). Fraudulent financial statements are intentional actions that result in material misstatements in the financial statements. While (Sihombing & Rahardjo, 2014) Fraudulent financial statements are intentional or negligence in the financial statements presented are not in accordance with generally accepted accounting principles. This negligence or intentionality is material in nature so that it can influence the decisions to be taken by the Non Performing Financing (NPF) ratio that is used to measure the ability of banks to cover the risk of failure to repay loans by debtors. Suhartatik & Kusumaningtyas, (2013) stated that Non Performing Financing (NPF) can be measured through a comparison between the amount of problem financing with total financing.

The development of the increasingly complex business world and the occurrence of various cases of fraud in modern companies, encourages business people to present a mechanism of good corporate management and is able to guarantee the implementation of commitments agreed upon by all parties who conduct business relations.

(Elghuweei, Opong, Ntim, & Avison Lynn, 2017) states that better managed companies tend not to be significantly involved in earnings management compared to companies that are not well managed. Companies that incorporate Islamic religious beliefs and values into company operations through the establishment of Islamic Governance committees tend to be less involved in earnings management.

This research was conducted with reference to the studies conducted by Asrori (2014), Anugerah (2014), Astutik (2014), and Najib & Rini (2016). The difference of this research with the research conducted by Asrori (2014) is located in the dependent variable, where the performance of Sharia banks becomes the dependent variable and Islamic Corporate Governance as an independent variable, while in this study the dependent variable used is fraud. The difference between this study and the research conducted by Anugerah (2014) is the population used where Anugerah (2014) examines the role of Good Corporate Governance in preventing fraud in conventional institutions while this study examines the influence of Islamic Corporate Governance on fraud in Sharia banks. The difference between the research conducted by Astutik (2014) and this research is the dependent variable where Astutik (2014) uses the level of bank health while the researcher uses fraud as the dependent variable. (Najib & Rini (2016) research on shariah compliance and Islamic corporate governance as an independent variable, while researchers used NPF and Islamic Corporate Governance as independent variables.

The above description motivates researchers to examine Non-Performing Financing (NPF) and Islamic corporate governance, and fraud because first, financing risks and weak corporate governance provide opportunities for fraud in Islamic banks. Second, the researcher wants to find out whether NPF and Islamic corporate governance applied in Islamic Commercial Banks in Indonesia have an influence on fraud that occurs within the institution. Based on this, the researchers conducted a study entitled "The Effect of Non-Performing Financing and Islamic Corporate Governance, Against Indications of Fraud in Sharia Bank in Indonesia".

## LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

According to Jensen & Meckling (1976) Agency theory is the basic thing used to understand the relationship between principals and agents. In this case the agency relationship is a contract between one or more people who employ others to provide a service and then delegate decision making authority to the agent. Based on this theory, there is a separation between the owner (principal) and the manager of the company (agent), causing agency problems. Furthermore, the separation of owner and manager also creates information asymmetry, which is a condition where agents have access to information that is not owned by the principle. Imbalance of information owned by the owner and manager of the company imposes the emergence of information asymmetry. Based on the assumption of human nature, every human being has a tendency to act by prioritizing his personal interests.

According to the Black's Law Dictionary, fraud covers all kinds of things that humans can think of, and that one strives to benefit from others with false suggestions or coercion, and covers all unexpected, tricky, cunning, hidden ways and every way that is not honest that causes others to be deceived.

Fraud includes robbery, extortion / exploitation, embezzlement, fraud, destroying something with the intention, (Tuanakotta, 2010). Fraud can be in the form of Corruption, Asset Abuse and Deception Statement (ACFE). Tuanakotta (2010) explains that fraud is done because of 3 (three) conditions called fraud triangle. First there is a motive or pressure (incentive / pressure), secondly there is an opportunity (opportunity), and thirdly there is a rationalization / attitude (rationalization / attitude) or the tendency of actors to justify their actions.

Asset quality is all total rupiah assets owned by banks with the intention to obtain the expected income. One calculation on the asset quality ratio used according to SEBI / No.7 / 10 / DPNP dated March 13, 2005 concerning Rating and Rating Institutions recognized by Bank Indonesia, one of which is NPF. This ratio shows the quality of credit assets that if the collectibility is substandard, doubtful and loss of the total financing as a whole, then the bank is facing problem loans (Soekapdjo et al., 2018).

Non-Performing Financing (NPF) shows the ability of bank management to manage problem financing provided by banks, the higher the NPF ratio, the worse the quality of bank financing causes the greater number of problem loans.

Credit in this case is lending granted to third parties excluding credit to other banks (Sukmadilaga & Nugroho, 2017). The higher the NPF, the less available capital in banks due to the increasing amount of bad loans will certainly affect the amount of capital available to finance bank operations. Bad credit makes the income that will be received by the bank decrease, so that the bank will use the existing capital to finance its operational activities. The greater the problematic financing that occurs in banks, the bank's capital will be eroded and reduced (Nugroho, Husnadi, Utami, & Hidayah, 2017).

Najib & Rini (2016) who examines the influence of Islamic corporate governance on fraud in Sharia banks states that Islamic corporate governance in Islamic banks at present has not been effective in influencing fraud, so it is necessary to make continuous improvements to the implementation of corporate governance to suit with Islamic principles and effective to apply.

Anugerah, (2014) regarding the role of GCG in fraud prevention also states that the implementation of internal and external mechanisms of corporate governance by taking into account the principles and functions can reduce the occurrence of fraud. Mollah & Zaman

(2015) in their research also stated that the Sharia Supervisory Board had a positive effect on the performance of Islamic banks.

The audit committee as an extension of the commissioners is an element of corporate governance that can prevent fraud by overseeing the oversight function of the company's internal control system (Anugerah, 2014). The audit committee is in charge of controlling the internal control system to realize good corporate governance (Rustiarini, 2012). The existence of the audit committee is certainly expected to prevent fraud. Al-Najjar, (2011) states that the greater the proportion of audit committees, the better the supervision provided, so that its performance in ensuring the effectiveness of the company's internal control will be better.

Based on a review of the theory and previous studies, the hypotheses proposed in this study are as follows:

- H1 = Non Performing Financing has a significant effect on fraud
- H2 = The Implementation of Duties and Responsibilities of the Sharia Supervisory Board has a significant effect
- H3 = Number of Audit Committees has a significant effect on fraud

## Study Method

The data used in this study are secondary data obtained from the 2013-2017 Indonesia Stock Exchange. The total sample used in this study is 60 Financial Statements and GCG Reports of Sharia Banks.

## RESULTS AND DISCUSSION

### Descriptive Statistics Test Results

Descriptive statistical analysis provides an overview of data seen from the minimum value, maximum value, mean value, and standard deviation of data.

Tabel 5.1  
Statistik Deskriptif

	N	Minimu m	Maximu m	Mean	Std. Deviation
NPF	60	.0000	4.9300	2.605500	1.6762179
RAPAT DPS	60	6	36	14.63	5.358
Komite Audit	60	2	7	3.70	1.169
Penggantian Direksi	60	0	1	.53	.503
Valid N (listwise)	60				

Source: Data Processing 2020

Descriptive Statistics display output shows the number of respondents (N) as many as 60. The minimum NPF is 0.0000 and the maximum is 4.9300, where the average is 2.6055, the DPS meeting is held a minimum of 6 times and the maximum is 36 times, where the average DPS meeting is 14.63 times. The audit committee has a minimum of 2 members and a maximum of

7 members, with an average of 3.70. Replacement of Directors that occurs a minimum of 0 and a maximum of 1, where an average of 0.53.

### Logistic Regression Analysis

This study uses a logistic regression model with a significant method ( $\alpha$ ) 5% (0.05). Logistic regression is used to examine the effect of non-performance financing and Islamic corporate governance on indications of fraud with proxy directors replacement.

### Assessing the Feasibility of the Regression Model (Goodnes of Fit Test)

Goodness of Fit or correlation calculation is used to determine the size of the accuracy of the model used and measure the accuracy of the regression line in explaining the variation in the value of independent variables. Hosmer and Lemeshow's Goodnes of Fit Test was used to test the feasibility of a logistic regression model. To test whether the empirical data fits or fits the model, a hypothesis is used.

H0: If Probability > 0.05 H0 is accepted

HA: If Probability < 0.05 H0 is rejected

If the value of Hosmer and Lemeshow's Goodness of Fit Test is greater than 0.05, then the null hypothesis cannot be rejected and means that the model is able to predict its observation value. Presented the test results on the feasibility of the regression model (Goodnes of Fit Test) on the Hosmer and Lemeshow's Test:

Tabel 5.2

Hosmer and Lemeshow's Goodness of Fit Test  
Results Hosmer and Lemeshow Test

Step	Chi-square	df	Sig.
1	9.237	8	.323

Source : Data Processing 2020

Table 5.2 shows that the Chi-square value of 9.237 and a significant value of 0.323 is greater than  $\alpha$  (0.05) so H0 is accepted, which means there is no difference between the predicted classification and the observed classification. That means the logistic regression model can be used for further analysis.

### Assessing the Overall Model (Overall Model Fit)

To assess the overall model (overall model fit) is shown by the likelihood value (value -2LL), it can be seen by comparing the value of -2 log likelihood (-2LL) on block number = 0 and - 2 log likelihood (-2LL) on block number = 1. If the value of -2LL block number = 0 is greater than the value of -2LL at block number = 1, it means that the regression model is better. The overall model fit test results are presented in the following table:

Tabel 5.3  
Test Results -2Log Likelihood Block - 0 (Initial)  
Iteration History<sup>a,b,c</sup>

Iteration		-2 Log likelihood	Coefficients
			Constant
Step 0	1	82.911	.133
	2	82.911	.134

- a. Constant is included in the model.  
b. Initial -2 Log Likelihood: 82.911  
c. Estimation terminated at iteration number 2 because parameter estimates changed by less than .001.

Based on table 5.3, it shows that the comparison between the initial -2LL and the final -2LL is 82.911.

Tabel 5.4  
Test Results -2Log Likelihood Block - 1 (Final)  
Iteration History<sup>a,b,c,d</sup>

Iteration		-2 Log likelihood	Constant	Coefficients		
				NPF	RAPATDP S	KomiteAudit
	1	75.540	-1.162	.384	-.014	.136
Ste	2	75.505	-1.249	.411	-.016	.152
p 1	3	75.505	-1.251	.411	-.016	.152
	4	75.505	-1.251	.411	-.016	.152

- a. Method: Enter  
b. Constant is included in the model.  
c. Initial -2 Log Likelihood: 82.911  
d. Estimation terminated at iteration number 4 because parameter estimates changed by less than .001.

Based on table 5.4 shows the value of -2 Log likelihood block -1 (Final) is 75.505.

Based on the overall fit model, the two tables above show two values of -2LL, namely BlockNumber = 0 and BlockNumber = 1. In BlockNumber = 0 has a value of -2LL of 82.911 which is greater than the value of -2LL in BlockNumber = 1 which is 75.505. A decrease of 7,406 indicates a better regression model or in other words the model hypothesized fit with the data. This shows the addition of independent variables, NPF, Number of DPS Meetings and Number of Audit Committees to the model to improve the fit model. The decrease can be seen in table 5.5 below:

Table 5.5  
Omnibus Test Results Model of Coefficients  
of Model Coefficients

		Chi-square	df	Sig.
	Step	7.406	3	.060
Step 1	Block	7.406	3	.060
	Model	7.406	3	.060

Source: Data Processing 2020

### Determinant Coefficient (Model Summary)

The summary model in logistic regression is the same as testing R<sup>2</sup> in the linear regression equation. The purpose of this model is to find out how much the combination of independent variables consisting of NPF, Number of DPS Meetings and Number of Audit Committees is able to explain the dependent variable, namely fraud.

Table 5.6  
Determinant Coefficient Test Results  
Model Summary

Step	-2 Log likelihood	Cox & Snell R Square	Nagelkerke R Square
1	75.505 <sup>a</sup>	.116	.155

a. Estimation terminated at iteration number 4 because parameter estimates changed by less than .001.

Based on table 5.6 above, the Nagelkerke R Square value = 0.155 or 15.5% means that the combination of independent variables namely NPF, Number of DPS Meetings and Number of Audit Committees is able to explain variations of the dependent variable fraud by 15.5% while the remaining 84.5% explained by other variables not included in this model.

### Partial Testing (Wald Test)

This test is conducted to determine whether each independent variable (NPF, Number of DPS Meetings and Number of Audit Committees) influences the dependent variable, namely fraud. In testing this hypothesis is done using partial / individual test. Partial testing uses a significant 5% (0.05) for the NPF variable, Number of DPS Meetings and Number of Audit Committees.

Table 5.7  
Logistic Regression Coefficient Test Results - Wald Test  
Variables in the Equation

		B	S.E.	Wald	df	Sig.	Exp(B)
	NPF	.411	.172	5.708	1	.017	1.508
Step 1 <sup>a</sup>	RAPATDPS	-.016	.053	.095	1	.758	.984
	KomiteAudit	.152	.246	.384	1	.536	1.165
	Constant	-1.251	1.315	.904	1	.342	.286

a. Variable(s) entered on step 1: NPF, RAPATDPS, KomiteAudit.

Based on table 5.7 above the partial test results (Wald test) can be seen that the NPF probability value of 0.017 with a significant 5% (0.05) then H1 is accepted. This means that NPF has a significant effect on fraud.

DPS Meeting probability value of 0.758 with a significant 5% (0.05) then H2 is rejected. This means that DPS has no significant influence on fraud.

Audit committee probability value of 0.536 with a significant 5% (0.05) then H3 is rejected. This shows that the audit committee has no significant influence on fraud.

The influence of each NPF variable, the number of DPS meetings and the number of audit committees on fraud can be seen from the value of the Wald and the p-value. Based on the results of the regression coefficient test in the table above, the decision making is as follows:

1. Hypothesis 1 states that NPF has a significant effect on fraud. Based on the results of the study, the NPF variable has a Wald value of 5,076 with a p-value of 0.017 smaller than 0.05, so H3 is accepted, meaning that the NPF variable has a significant effect on fraud.
2. Hypothesis 2 states that the DPS Meeting has an effect on fraud. Based on the results of the study, it can be seen that the DPS Meeting has a wald value of 0.095 with a p-value of 0.758 greater than 0.05 thus H1 is rejected, meaning that the DPS meeting variable has no significant effect on fraud.
3. Hypothesis 3 states that the audit committee influences fraud. Based on the results of the study, the audit committee variable has a Wald value of 0.384 with a p-value of 0.536 greater than 0.05, so H2 is rejected, meaning the audit committee variable has no significant effect on fraud.

## CONCLUSION

The regression analysis conducted in this study leads to several important conclusions regarding the impact of Non-Performing Financing (NPF) and Islamic Corporate Governance on fraud within Sharia Banks in Indonesia. Firstly, the analysis reveals that NPF has a significant influence on the occurrence of fraud. Specifically, a lower NPF value is associated with a reduced incidence of fraud in Sharia Banks. This finding underscores the critical importance of maintaining low levels of non-performing financing to minimize fraudulent activities. It suggests that effective management and stringent monitoring of financing can play a pivotal role in safeguarding the integrity of Sharia Banks. On the other hand, the study finds that the implementation of duties and responsibilities by the Sharia Supervisory Board (SSB), as measured by the frequency of their meetings, does not have a significant impact on fraud prevention. This result indicates that merely increasing the number of SSB meetings is insufficient to curb fraudulent activities. It points to the need for more substantive measures within the supervisory framework rather than just an increase in the frequency of oversight meetings. The effectiveness of SSBs might be enhanced by focusing on the quality of discussions, decision-making processes, and the implementation of robust monitoring mechanisms during their meetings. Similarly, the presence of an audit committee, as measured by the number of its members, does not significantly affect the level of fraud at Sharia Banks.

This finding suggests that simply having a larger audit committee does not necessarily equate to better fraud prevention. It implies that the effectiveness of an audit committee in detecting and preventing fraud is not solely dependent on its size but rather on the expertise, vigilance, and thoroughness of its members. Therefore, enhancing the capabilities and operational efficiency of audit committees should be prioritized over expanding their size. These conclusions highlight a critical insight: structural elements alone, such as the number of supervisory meetings or the size of audit committees, are insufficient to combat fraud effectively. Instead, the focus should be on the qualitative aspects of governance practices. For instance, improving the competency and effectiveness of both the Sharia Supervisory Board and audit committees through rigorous training, clearer guidelines, and enhanced accountability measures could be more beneficial. Moreover, the significant impact of NPF on fraud underscores the necessity for Sharia Banks to prioritize financial health and risk management. Ensuring robust credit assessment procedures, continuous monitoring of financing activities, and swift actions to address emerging non-performing financing issues are essential strategies that Sharia Banks should adopt to mitigate fraud risks. In summary, while the quantitative aspects of governance structures, such as the frequency of meetings and the number of committee members, show limited effectiveness in preventing fraud, the qualitative aspects, including the strategic management of NPF and the operational effectiveness of governance bodies, play a crucial role. Future research could further explore these qualitative dimensions, potentially examining the impact of specific governance practices, the role of technological interventions, and the cultural aspects of fraud prevention within Sharia Banks. Addressing these areas could provide a more comprehensive understanding and lead to more effective strategies for minimizing fraud in the Islamic banking sector.

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