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## The Role of Governance in Financial Performance at Credit Union

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### **Abstract:**

*Credit Union (CU) is a movement of finance to improve socio-economic conditions of the community. The success of this movement of corporate governance applied in the management of CU. Good governance is expected to improve financial performance, so that its impact will be perceived by the public. This study analyzed the relationship of corporate governance of CU with financial performance. The governance of CU is grouped into external governance, internal governance and governance of individuals. External governance with regard to compliance with regulations and public accountability. Internal governance emphasizes strategies to ensure the sustainability of the Organization in the future. Individual governance emphasizing on integrity, competence and commitment of managers CU. While the financial performance is measured based on the analysis of the PEARLS. Data were collected using a questionnaire filled in by management. The results showed that the internal governance is the factor effect on financial performance. While external governance and governance of individuals does not affect financial performance. This shows that the Manager's responsibility towards the sustainability of the CU organizations is very important in the improvement of financial performance, supported with integrity, competence and commitment. Based on the results of this research are expected to CU can improve the performance through robust improvement on internal governance*

**Keywords:** Credit union, governance, financial performance, PEARLS

### **1. Introduction**

East Java is one of the provinces in Indonesia that its community is growing very rapidly. In an attempt to encourage empowerment of communities, especially low-income communities and micro, small, and medium enterprises (SMEs) need comprehensive support from financial institutions. Credit Union (CU) is a non-bank microfinance institution, can conduct microfinance activities with the provision of financial services to its members in providing save borrowed. Munaldus and Karlena (2015) says that the cause of the slow growth of CU is the quality of human resources where the performance leader, leading and managing aspects not optimal. According to Williamson (1998) the problem of the relationships between the stakeholders in developing a sustainable company needed a good corporate governance. Principles of corporate governance i.e. accountability, transparency, fairness, and accountability, is expected to address the problems of CU and the impact on the improved financial performance. The success of this movement of corporate governance applied in the management of CU. Good governance is expected to improve financial performance, so that its impact will be perceived by the public. This study analyzed the relationship of corporate governance of CU with financial performance.

### **2. Literature Review**

#### *2.1. Corporate Governance*

Good Corporate Governance is the structure formed by all stakeholders. The structure was formed to govern the relationships between stakeholders and prevent the occurrence of errors in determining the company's strategy and to ensure that the mistakes that occurred can be repaired immediately (Zarkasyi, 2008). Munaldus and Karlena (2015) describes the principles of corporate governance of Credit unions, consisting of three parts is external governance, internal governance and individual governance. External governance with regard to transparency in the management of the finances and activities of CU, compliance with regulations as well as public accountability — especially in the understanding of the organizational structure of the Government and the community. While the internal governance structure of the organization emphasizes on CU, the determination of a strategy to ensure sustainability, the balance of the composition of the Executive Board in respect of good things as well as diversity of experience as well as the accountability

of management for all activities do. On individual governance, integrity, competence and commitment of the steward CU became an important element in governance CU.

## 2.2. Financial Performance

Financial performance within an organization should be kept to maintain the sustainability of the company. In assessing the financial performance on CU, WOCCU (World Council of Credit Union) suggested the use of PEARLS to do financial analysis. PEARLS is an analysis tool to find out the level of CU's health by using the indicator of Protection, effective Financial Structure, asset Quality, Rate of Return and Cost, Liquidity and Sign of growth. PEARLS is a dynamic monitoring tool that will continually adjusted by WOCCU to meet the needs of CU. From the viewpoint of benefit, PEARLS is a system monitoring the level of CU's health consisting of financial indicators. Each indicator refers to the principle of prudence. An explanation of each of these indicators is as follows:

- Protection (protection). The main purpose of evaluation indicators of protection, is to ensure that agencies providing or has a reserve fund over the risk of loans outstanding. Allowance for losses on loans is very important since the loan was given, with the aim to provide protection over the risk of lending in order for the permanent member deposits are protected. Protection is measured by 1) comparing the adequacy of the allowances for loan losses against the amount of delinquent loans and 2) comparing the allowances for investment losses with the total amount of non-regulated investments. Protection against loan losses is deemed adequate if a credit union has sufficient provisions to cover 100% of all loans delinquent for more than 12 months, and 35% of all loans delinquent for 1-12 months.
- Effective Financial Structure. Financial structure is a very important factor for CU to find out the growth potential, the capability of obtaining income, and overall financial strength. PEARLS measure asset debt and capital as well as recommend a healthy structure. Some ratios in measuring financial structure is the ratio to the total loan outstanding set, Total deposits non-shares against the total assets, loans on outside parties to the total net assets of the company and capital to total assets.
- Asset Quality. A non-productive or non-earning asset is one that does not generate income. An excess of non-earning assets affects credit union earnings in a negative way. The indicator used delinquency ratio. There is the most important measurement of institutional weakness. The ideal goal is to maintain the delinquency rate below 5% of total loans outstanding. A second key ratio is the percentage of non-earning assets owned by the credit union. The higher the ratio, the more difficult it is to generate sufficient earnings. The goal also limits non-earning assets to a maximum of 5% of the total credit union assets.
- Rates of Return and Cost. On PEARLS's analysis major components of net income used to calculate the results of the investment and operating costs. Comparison of the structure of the financial results of the investments would be used to attempt to save the loan is placed on the sources that generate optimum return. Measure used is ratio operational costs against the asset.
- Liquidity. Effective liquidity management becomes a much more important skill as the credit union shifts its financial structure from member shares to more volatile deposit savings. In many movements following the traditional model, member shares are very illiquid and most external loans have a long payback period, therefore there is little incentive to maintain liquidity reserves. Liquidity is traditionally viewed in terms of cash available to lend--a variable exclusively controlled by the credit union. With the introduction of withdrawable savings deposits, the concept of liquidity is radically changed. Liquidity now refers to the cash needed for withdrawals Ratios are often used in assessing the liquidity of the CU is the ratio of investment to the total deposits of the non-stock.
- The signs of growth are known from the level of members of the population and the growth of the assets of the CU. The best way to maintain the value of the asset is the asset growth through fast and high, along with continuous gain. There are two indicators that will be used in measuring the growth rate i.e. the percentage growth of the members of the current year and the percentage growth in total assets from the current year.

## 2.3. Hypothesis

This research aims to identify governance applied by CU in the province of East Java and its impact on financial performance. CU as a non-profit financial institutions are very interested in the improvement of social performance. But social performance will be achieved when the CU as the Organization has good continuity. The sustainability of the CU as organizations need to be supported by good financial performance. The system of governance is an aspect that is becoming the target of research results are expected to strengthen institutional CU. As a small company that has a goal of community empowerment, governance requires a CU in the operational process. The governance of CU is grouped into external governance, internal governance and governance of individuals. External governance with regard to compliance with regulations and public accountability. Internal governance emphasizes strategies to ensure the sustainability of the Organization in the future. While individual governance refers to the integrity, competence and commitment of management. Operational processes that run with the good governance will produce good financial performance so that the hypothesis to be tested was:

- H1. External governance has a positive impact on performance financial CU
- H2. Internal governance has a positive impact on performance financial CU
- H3. Individual governance has a positive impact on financial performance CU

#### 2.4. Data set and Variables

The population of Indonesia is at 921 CU. This research will use the sample CU located in East Java Province, namely, Surabaya, Tulungagung, Madiun, Blitar and Tuban. To 5 cities were selected as the sample is based on the consideration of the development of CU in the cities. There are 15 CU as a sampels. Financial data collected from financial reports in 5 years i.e. 2013-2017. Data about the governance of CU, is collected based on a survey through questionnaires answered by management CU

##### 2.4.1. Variables

###### 2.4.1.1. Dependent Variables

This research uses financial performance as the dependent variable, by using indicators of PEARS. Table 1 is the indicators of Financial Performance.

No	PEARLS	Ratio
1	Protection (P)	Allowance for Loan Losses / Delinquency >12 months
2	Effective Financial Structure (EFS)	Net Loans/Total Assets
		Savings Deposits / Total Assets
		External Credit / Total Assets
3	Asset Quality (AQ)	Total Loan Delinquency / Gross Loan Portfolio
		Non-Earning Assets / Total Assets
4	Rate of Return and Cost (R&C)	Total Operating Expenses / Avg. Total Assets
5	Liquidity (L)	S.T Investments + Liquid Assets - S.T. Payables / Savings Deposits
		Non-Earning Liquid Assets / Total Assets
6	Sign of Growth (SG)	Growth in Membership
		Growth in Total Assets

Table 1: Indicators of Financial Performance

###### 2.4.1.2. Independent Variables

The independent variables are external governance, internal governance and individual governance. External governance with regard to compliance with regulations and public accountability. Internal governance emphasizes strategies to ensure the sustainability of the organization in the future. Individual governance emphasizing on integrity, competence and commitment of managers CU. All governance indicators developed into questionnaire.

### 3. Result and Discussion

Data analysis using Structural Equation Models (SEM), because the variable is measured by several indicators. The data was processed using SMART PLS program. The program is able to accommodate a small data and different types of data.

#### 3.1. Descriptive Statistic

Table 2 is descriptive statistic of governance variables. According to the following table, we are able to understand the change in the number of data distribution situation through descriptive statistics analysis.

	External Governance	Internal Governance	Individual Governance
Minimum	3.67	3.96	3.75
Maximum	4.67	4.75	4.75
Mean	4.22	4.32	4.29
Std. Deviation	0.346	0.27	0.321

Table 2: Descriptive Statistic of Governance Variables

Answers of the respondents for external governance indicates the average value of 4.22. minimum value of 3.67. This shows that in general, management stated that the CU already did they manage transparency in financial management and activities of CU, dutifully against regulation, has been conducting a public accountability but external governance has not been fully implemented. On internal governance, the average answer agree that was implemented with a score of 4.33. This indicates the stakeholders understand and implement the organizational structure of CU with a good, set the strategy for sustainability, has been keeping the balance of the composition of the Executive Board and has conducted management accountability of all the activities. While on the individual governance average score of 4.29 meaning management agree that individual managers have the integrity, competence and commitment are good enough to manage CU. While statistical description of the financial performance variables shown in table 3.

	Pearls Indicators										
	P	EFS			AQ		R&C	L		SG	
Minimum	0	0.15	0	0	0	0	0	0	0	0	-0.03
Maximum	2.42	0.99	0.79	0.71	1.24	0.16	0.11	1.76	0.12	1.79	0.25
Mean	0.92	0.64	0.52	0.08	0.24	0.08	0.07	0.27	0.03	0.29	0.08
Std. Deviation	0.86	0.2	0.24	0.19	0.36	0.05	0.03	0.47	0.04	0.46	0.8

Table 3: Statistic Descriptive of Financial Performance indicators

Based on the statistical description of the financial performance, the average financial performance analyzed using criteria of WOCCU. The results of the analysis are shown in table 4.

No	Pearls	Norm	Average result	Categories
1	P	100%	0.92	Fair
2	EFS	70%-80%	0.64	Fair
		70%-80%	0.52	Fair
		≤ 5%	0.08	Fair
3	AQ	≤ 5%	0.24	Poor
		≤ 5%	0.08	Fair
4	R&C	3% - 10%	0.07	Good
5	L	≥15%	0.27	Poor
		≥1%	0.03	Fair
6	SG	≥12%	0.08	Fair
		≥ inflasi (7%)	0.29	Good

Table 4: The Analysis of the Financial Performance Using Criteria of WOCCU

In general, an indicator of financial performance on CU in East Java province, on average are fair. There are only 2 indicators of a good category i.e. the growth rate of assets above the inflation rate. Other indicators that are in the good category is the Rate of Return and Cost are calculated based on operating costs divided by total assets, shows that CU able to keep its operational efficiency in ideal position. The indicators are on bad categories (poor) is the asset quality and liquidity. This means that CU has not been able to manage its assets and have an impact on liquidity.

### 3.2. Empirical Result

Empirical evidence from testing the correlation of variables External Governance (EG), Internal Governance (IG) and Individual Governance (PG) on Financial Performance (FP) is shown in table 5.

Correlation	Original Sample	Sample Mean	Standard Deviation	T Statistics	P Value
EG→FP	0.028	0.141	0.401	0.069	0.945
IG→FP	1.020	0.844	0.468	2.180	0.030
PG→FP	0.367	0.192	0.493	0.744	0.458

Table 5: Correlation of External Governance, Internal Governance and Individual Governance on Financial Performance

Table 5 shows that the external governance (EG) and Individual governance (PG) does not affect the financial performance of CU (FP). The t value on each variable of 0.069 and 0.744, both smaller than 1.98 which is cut off with a confidence interval of 95%. The p value is greater than 5% which means that both variables have no effect on financial performance of CU (FP). While internal governance (IG) has a significant effect on financial performance of CU (FP) which is shown through the t value is greater than 1.98 and the p value is less than 5%. Thus, the hypothesis 1: the external governance has a positive impact on the financial performance of CU and hypothesis 3: Individual governance has a positive impact on financial performance of CU is not proven. While the hypothesis 2: internal governance has a positive impact on the financial performance of the CU is proven.

## 4. Discussion

Governance of CU had applied appropriate and meets the rules of good governance. Management as stakeholders, understand and implement the organizational structure of CU with a good, the determination of a strategy to ensure sustainability, has been keeping a good balance of the composition of the Executive Board and has made accountability management of all activities. Based on their financial performance, asset management are still at category poor (bad). While on the performance of growth are in the category of good. This indicates that CU has a good prospect, but need for improvements in the management of its assets. The findings suggest asset management need to get attention by management to improve the sustainability of the CU.

The results of the analysis using Smart PLS and hypothesis testing shows the internal governance is an influential factor on performance financial CU. While external governance and individual governance does not affect financial performance. It shows responsibility management on the sustainability of the organisation is crucial in order for financial performance, supported with integrity, competence and commitment (Munaldus and Karlena (2015)). Based on the results of this research are expected to CU can improve the financial performance through improvements in its internal governance. In addition individual governance has no effect on the financial performance. This is because CU is a nonprofit institution that in principle the board and management have had a high integrity and commitment towards the welfare of community through CU. According to Lowe (1995) commitment and integrity are considered to have been attached to the self-management of CU so that financial performance is no longer influenced by individual governance.

## 5. Conclusion

The purpose of this research is to explore the role of governance in financial performance on CU in East Java Province. The results showed that the governance of CU has been in accordance with the regulations. While the financial performance is at a sufficient condition. Only on the management of assets and liquidity on the category poor (bad). While the growth performance in the category of good. This means CU has a good prospect but needs improvement on the management of its assets. While testing the influence of corporate governance on financial performance, obtained an internal governance that is factors that have an effect on the financial performance of CU. While external governance and individual governance have no effect on the financial performance. This shows that management responsibility on the sustainability of the organization is essential, through improved financial performance, supported with integrity, competence and commitment. Expected Credit Union can improve their financial performance through improvements in its internal governance.

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