

The Impact of Debt Financing and Equity on Profit Expense Ratio of Islamic Banks in Indonesia

By Isnurhadi

THE IMPACT OF DEBT FINANCING AND EQUITY FINANCING ON PROFIT EXPENSE RATIO OF ISLAMIC BANKS IN INDONESIA

Nenden Siti Mariam¹, Isnurhadi², & Taufik³

ABSTRACT

The purpose of this study is to determine whether Equity Financing and Debt Financing partially and simultaneously have an impact on Profit Expense Ratio, also how the partial effect of each financing systems affect Profit Expense Ratio. This research is causal research, also called explanatory research is the investigation of (research into) cause-and-effect relationships. The number of taken samples is two, such as PT. Bank Muamalat Indonesia (BMI) and PT. Bank Syariah Mandiri (BSM). The data used in this research are secondary data from published financial statements of BMI and BSM. The data analysis technique used is linear regression. The results of data analysis in this research is partially contained direct or positive relationship between Debt Financing and Equity Financing on Profit Expense Ratio. While the effects of Debt Financing and Equity Financing as the independent variables (X) simultaneously affect Profit Expense Ratio as the dependent variable (Y) on Islamic banks, it means that Debt Financing and Equity Financing simultaneously have significant impacts on Profit Expense Ratio of Islamic banks. The obtained value of coefficient of determination (R²) is 0.516 or 51.6%. It means that the variation of these independent variables, namely Debt Financing and Debt Financing, contribute effects on Profit Expense Ratio of Islamic Banks. In accordance with the analysis result of this research, it can be seen that Equity Financing is dominant in affecting Profit Expense Ratio of Islamic Banks compared to Debt Financing. The researcher suggests management of Islamic banks to prioritize Equity Financing system, especially Musharaka, because the said financing system is the most appropriate with Islamic law to apply to muslims.

Keywords : Debt Financing, Equity Financing, Profit Expense Ratio

INTRODUCTION

Islamic Banks is a banking system based on the principles of Islamic law (also known as Shariah) and guided by Islamic economics. Two basic principles behind Islamic banking are the sharing of profit and loss and significantly the prohibition of the collection and payment of interest. This prohibition which distinguishes Islamic banking system compared with the conventional banking system. Islamic bank is established with the goals to promote, develop and apply the principles of Islam, sharia and its traditions into financial transactions and banking, and the other related business. The main principles followed by Islamic banks are: the prohibition of usury (riba), conducting business and trade based on legitimate profits, and giving zakat (charity).

According to UU No. 21 in 2008 concerning about Islamic banking that Islamic banks have three main functions: collecting funds, distributing funds and conducting

¹ Alumni Fakultas Ekonomi Jurusan Manajemen Universitas Sriwijaya

² Dosen Fakultas Ekonomi Jurusan Manajemen Universitas Sriwijaya

³ Dosen Fakultas Ekonomi Jurusan Manajemen Universitas Sriwijaya

social functions. Based on these functions, Islamic bank is expected to be able to increase people's economic activities through the distribution of fund.

The distribution of the fund in banking term is known as financing. In Islamic banking, there are several kinds of financing. In broad outline, the financing in Islamic banking are divided into three, such as financing transaction with the principle of sell and purchase (tijarah), financing transactions in leasing (ijarah), and financing with cooperation system (shirkah) (Muhammad, 2005, p.93).

According to Sani (2010), from the three types of major groups in the financing of Islamic banking, a financing with cooperation system is best suited to the main system of Islamic banking, namely profit-sharing system. This type of financing is divided into two financings, such as Mudharabah and Musharaka. However, these contracts are not contracts that nationally dominate the financing of Islamic banking. Most of the Islamic banks financing are more focused on Murabahah financing. To conduct financing in Islamic banks, the source of fund mostly come from the third party fund (DPK) or derived from the customers of the bank. Islamic banks financing portion generally reach 60% of total assets.

In this research, increasing in asset and funding will indirectly increase the financing committed by Islamic banks through financing products such as financing with sale and purchase system (debt financing) and financing with profit-sharing system (equity financing). Financing with the principle of sell and purchase conducted by Islamic banks dominate far above the financing with profit-sharing system (Sukanto, 2010). The reason why Islamic banks prefer to choose Debt Financing in deciding the provision of financing because there is no high cost needed and a review process in advance by the bank regarding of business prospects is unnecessary, also small risk of loss because profit margins have been set in advance so Islamic banks already could estimate the profit generated on the financing. Otherwise in deciding the provision of Equity Financing, first Islamic banks should conduct a review about the parties who will be given a financing.

The review concerns the business prospects to see profitability, the condition of business to assess the ability of Islamic banks in returning a financing that results a cost and it will be an expense for Islamic banks in financing, also the profit which generated by Islamic banks can not be calculated because it depends on the business profit, and only the amount of profit percentage that can be specified. There is no risk of loss that should be shared by Islamic banks and their customers which causes the profit generated by Islamic banks decreased.

Statement¹ of Research Problem

Do Debt Financing and Equity Financing partially and simultaneously have the effects on Profit Expense Ratio of Islamic Banks in Indonesia?

RESEARCH METHODS

Research¹ Methodology and Research Design

This research is causal research, also called explanatory research. is the investigation of (research into) cause-and-effect relationships. In order to determine causality, it is important to observe variation in the variable that is assumed to cause the change in the other variable(s), and then measure the changes in the other variable(s).

This research is explanatory research and associative approach. According to Gray (2015, p.23.), an explanatory study sets out to explain and account for the descriptive information.

Research Objectives

The objects used in this study is Islamic Banks in Indonesia that have been determined through purposive sampling, such as Muamalat Indonesia Bank and Syariah Mandiri Bank.

Population and Sample

The population is Islamic banks listed on Bank Indonesia as official banks and authorized to operate in Indonesia, also Islamic Banks in Indonesia that have been determined through purposive sampling. Objects used in this study are Debt Financing, Equity Financing and Profit Expense Ratio (PER) of Islamic banks' financial statements published by Bank Indonesia and banks' websites. There are 11 islamic banks in Indonesia.

Technique sampling used in this study is Purposive Sampling. The purposive sampling technique, also called judgment sampling, is the deliberate choice of an informant due to the qualities the informant possesses. It is a nonrandom technique that does not need underlying theories or a set number of informants (Tongco, 2007, p. 147.).

The criteria of samples used in this study such as:

- a. Islamic Banks which operate in Indonesia during 2011-2013.
- b. Islamic Banks which publish annual financial statements of 2011 to 2013, with this regard the author use quarterly data.
- c. Have at least 30% of total financing in Indonesia. Agus D.W. Martowardojo, Governor of BI, stated that sharia economic has the potential to continue to grow. In the long term, banking or sharia economic should be able to reach 30% compared to the total financing of the existing financial.

Based on the criteria above, there are two Islamic Bank that meet the criteria that Muamalat Indonesia Bank and Syariah Mandiri Bank.

Data Collection Technique

Library research is conducted by studying literatures with data collection that equipped by reading, studying and analyzing the literatures, they are sourced from books and journals related to this research.

The type of data used in this research is secondary data that the type of quantitative data that has already been collected by someone else for a different purpose to yours. The data used in this research are the data of financial statements concerning to the contribution of financing products that affect the Profit Expense Ratio. Internet site as the source of this research is www.bi.go.id.

Operational Definition and Research Variables

1. Independent Variables

- a. Debt Financing (X1)

$$\text{The rate of Debt Financing} = \frac{\text{Total Debt Financing}}{\text{Total Financing}}$$

- b. Equity Financing (X2)

$$\text{The rate of Equity Financing} = \frac{\text{Total Equity Financing}}{\text{Total Financing}}$$

2. Dependent Variable

$$\text{Profit Expense Ratio (Y) Profit Expense Ratio} = \frac{\text{Profit}}{\text{Total Expense}}$$

H0: Debt Financing and Equity Financing have no effect on Profit Expense Ratio of Islamic Banks in Indonesia.

H1: Debt Financing has an effect on Profit Expense Ratio of Islamic Banks in Indonesia.

H2: Equity Financing has an impact on Profit Expense Ratio of Islamic Banks in Indonesia.

H3: Debt Financing and Equity Financing simultaneously have an impact on Profit Expense Ratio of Islamic Banks in Indonesia.

DATA ANALYSIS AND DISCUSSION

Normality Test

Table 1. The Result of Normality Test
One-Sample Kolmogorov-Smirnov Test

		Unstandardized Residual
N		16
Normal Parameters ^a	Mean	.0000000
	Std. Deviation	.11400766
Most Extreme Differences	Absolute	.367
	Positive	.367
	Negative	-.228
Kolmogorov-Smirnov Z		1.468
Asymp. Sig. (2-tailed)		.027

a. Test distribution is Normal.
b. Calculated from data.

According to the test result above, the significance of Kolmogorov-Smirnov test statistic is $2 \times 0.027 = 0.054$. Value of 0.054 is higher than $\alpha = 0.05$, so it may be concluded that the error of the regression analysis is normally distributed. The assumption of normal error is met.

Multicollinearity Test

Table 2. The Result of Multicollinearity Test
Coefficients^a

Model	Collinearity Statistics	
	Tolerance	VIF
1 (Constant)		
Equity	.257	3.891
Debt	.257	3.891

a. Dependent Variable: PER

As shown in table 2 of Multicolinearity test results above, the value of VIF <10, which are Equity Financing and Debt Financing, is 3.891 while the value of Tolerance > 0.1 is 0.257, thus it can be concluded that between predictor variables (Debt Financing and Equity Financing), there is no multicollinearity and the assumption of non-multicollinearity between predictor variables are met.

Autocorrelation Test

Table 3. The Result of Autocorrelation Test

Model Summary ^b					
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.718 ^a	.516	.441	.15537	2.039

a. Predictors: (Constant), Debt_Financing, Equity_Financing

b. Dependent Variable: PER

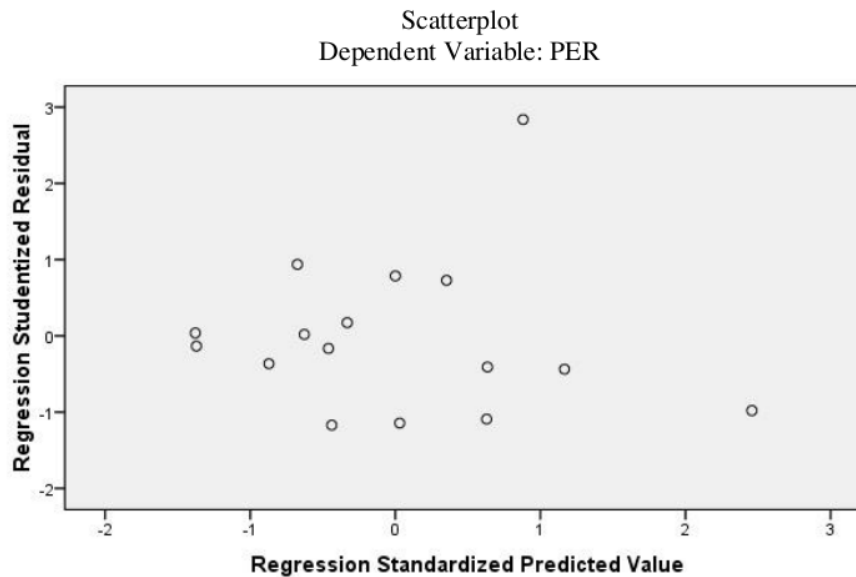
dL = 1.45

dU = 1.6231

1.4500 < 2.039 < 2.3769

Based on the calculation, number of Durbin Watson (DW) obtained is 2.039, because 2.039 is in the range of dU < d < 4 - dU thus it is concluded that there is no autocorrelation serial errors, or the assumption of Non autocorrelation is met.

Heterocedasticity Test



Picture 1. The Result of Heterocedasticity Test

Based on the output of scatterplots above, it appears that the dots spreading and clearly not forming any specific pattern. It may be concluded that there is no heterocedasticity.

F-test

Table 4. The Result of F-test

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.051	2	.025	3.944	.046 ^a
	Residual	.084	13	.006		
	Total	.134	15			

a. Predictors: (Constant), Debt_Financing, Equity_Financing

b. Dependent Variable: PER

Based on the simultaneous test result above, it shows the statistical value of F-test is 3.944. The value is higher than the critical point of $F_{1,44, 0.05} = 4.06$ and the statistical significance value of F-test is 0.046 where the value is smaller than $\alpha = 0.05$ thus it can be decided to reject H_0 and simultaneously **Debt Financing and Equity Financing have significant impacts on Profit Expense Ratio.**

T-test (Partial)

Table 5. The Result of T-test (Partial)

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.151	.058		2.602	.022
	Equity_Financing	.763	.057	.970	13.316	.000
	Debt_Financing	1.053	.337	1.029	3.129	.008

a. Dependent Variable: PER

Based on the T-test (partial) result above, it is known that the variable of Debt Financing:

$H_0: \beta_1 = 0$

$H_1: \beta_1 \neq 0$

T-test statistics obtained is 13.316. This value is higher than the critical point of $T_{0.05;48} = 2.014$ thus it can be decided to reject H_0 and partially concluded that Debt Financing has a significant impact on Profit Expense Ratio.

Based on the T-test (partial) result above, it is known that the variable of Equity Financing:

$H_0: \beta_2 = 0$

$H_1: \beta_2 \neq 0$

T-test statistics obtained is 3.129. This value is higher than the critical point of $T_{0.05;48} = 2.014$ thus it can be decided to reject H_0 and partially concluded that Equity Financing has a significant impact on Profit Expense Ratio.

After conducting a partial test, the regression model obtained as follows:

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \varepsilon$$

$$PER = 0.151 + 0.763 \text{ DEBT} + 1.053 \text{ EQUITY}$$

Interpretation of model equation:

- a) By assuming that the influence of constant Equity, Debt unit rise, thus it will cause a rise in 0.763 of Profit Expense Ratio unit.
- b) By assuming that the influence of constant DEBT, EQUITY unit rise, thus it will be followed by a rise in 1.053 of Profit Expense Ratio unit.
- c) When the influence of DEBT and EQUITY are constant, thus the value of Profit Expense Ratio is 0.151.

* The constant influence means that EQUITY and DEBT are assumed to be 0.

Determination Test

Table 6. The Result of Coefficient Determination and Multiple Coefficient of Determination Test

Model Summary ^b					
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.718 ^a	.516	.441	.15537	2.039

a. Predictors: (Constant), Debt_Financing, Equity_Financing

b. Dependent Variable: PER

The coefficient of determination (R^2) is 0.516 and it means that the amount of profit sharing ratio which can be explained by the value of profit sharing ratio and Financing to Deposit Ratio is 51.6% and the inexplicable amount is 48.4%.

Discussions

Broadly speaking, people know two types of banks in Indonesia, namely conventional banks and Islamic banks. The emergence of Islamic banks is in 1992 with the establishment of Muamalat Bank as the pioneer of Islamic bank in Indonesia. This is warmly welcomed by the people of Indonesia who are predominantly moeslims because Islamic banks adhere to Islamic law or sharia as the foundation of the banking activities and operations.

Along with its development, Islamic banks have many kinds of financing products to be offered to customers. The focus of this study is to determine the impact of Debt Financing (buying and selling systems) and Equity Financing (profit sharing system) to the efficiency of Islamic banks in gaining profits.

How debt financing affects the Profit Expense Ratio is by determining the rate of profit before the financing granted and become the part of price of the goods or services sold.

Debt financing is highly favored by customers of Islamic Banks, due to Islamic Banks which accentuate this type of financing more than another type of financings. The risk borne by Islamic Banks is relatively small though not fully in accordance with the beginning of establishment because Debt Financing is the type of financing in which the profit margin is determined at the beginning of the contract. Murabaha as the biggest contributor to finance Debt Financing.

According to Zandi (2011), the basic principle used in the practice of Murabaha is buying and selling, while akad used is a contract of sale and purchase. The implications of sale and purchase contracts require the sellers, the buyers, and the goods sold. Islamic Banks as the seller must provide the goods to their customers, in this case is as the buyers, so the customer are obliged to pay for goods that have been submitted by Islamic Banks and with the high amount of Debt Financing, operational and non operational sales charges will affect Profit Expense Ratio of Islamic Banks. It can be interpreted that the higher Debt Financing, the higher Profit Expense Ratio as well. Debt financing almost always costs less than equity financing. Equity ownership is risky, so the premium charged by possible equity investors tends to be quite high. The only exception is when a business is so overleveraged that creditors do not offer competitive rates. The temptation to use a lot of debt financing needs to be counterbalanced by business discipline and understanding (Ross, 2015).

The main advantage of equity financing compared to debt financing is that there is no obligation to repay the money acquired through equity financing. Of course a company's owners want it to be very successful and provide equity investors a good return on their investment in the company, but there are no required payments or interest charges as is the case with debt financing. Equity financing places no additional financial burden on the company. Since there are no required monthly payments associated with equity financing, the company has more capital available to invest in growing the business (Maverick, 2015).

The total amount of Equity Financing is less than the total amount of Debt Financing. This is due to public awareness gradually increasing to comprehend the concept of banking which is in accordance with Islamic Shari'a. In addition, debt financing has proven to have very good prospects in the future with the prospect of total funding that has experienced annual increases every year. Contract scheme (transactions) always use the real scheme which is suitable for its intended use, as known as the system of profit sharing ratio. The use of this real transaction scheme can facilitate the parties who conduct transactions to easily observe and understand the consequence of their rights and obligations.

Based on the analysis above, it is known that the customers who use Equity Financing system are more oriented towards working capital. They use it to finance their business ventures with hopes that loss or profits incurred jointly thus the risk of bankruptcy can be minimized with the provision of both sides apply fairness in its implementation. Equity financing is the type of financing in which if the customer can develop their business so that Islamic Banks will make profits from the ratio agreed, but if the customer's business failed to make profits then mostly of the losses will be borne by Islamic Banks.

The customers of Debt Financing and Equity Financing have different orientations, namely investment and working capital. Equity Financing is also related to Profit Expense Ratio, considering to the amount of financing that rapidly increasing every year, which also resulting the rise of operational and non operational load.

Equity Financing use a fair system that sharing loss and profits, thus spurring the the businessmen to improve their business performance because they realized that the business responsibility is jointly incurred and the group control in which the Islamic Banks will be the parties who supervise their business performance so that the business operation is controlled, this is in contrast to Debt Financing which rely only on the borrowers without the supervision of Islamic Banks.

However in practice, Musharaka financing system that is included in equity financing have not been applied fully to society. This is caused by Islamic banks which considered this type of financing is risky in bearing loss that can occur and reduce the profit. Musharaka is not only to share profits but also share the loss but if the loss is not an error/negligence on behalf of the financing. This is exactly what become external constraints because of the character of financing that require a very high level of honesty of the parties to be financed. To obtain reasonable assurance that the business financed will gain profits and also has a good prospect to, Islamic banks have to do some careful research and it will increase operational cost. Therefore in assessing the performance, Islamic banks are not only focused on the ability to generate profits but also on adherence to Islamic principles and objectives of the Islamic bank.

Explanations above show the improvement of Equity Financing in terms of financing and the total number of new customers is increasing every year. It is probable that there may be a mindset change of people to prefer entrusting their business financing to Islamic Banks rather than Conventional Banks.

CONCLUCIONS AND SUGGESTIONS

Conclusions

Debt Financing partially has a positive impact on Profit Expense Ratio. Based on the charts in the early chapter, the value of Debt Financing (sell and purchase systems) is lower than the value of Equity Financing (profit sharing system). Equity Financing partially has a significant impact on Profit Expense Ratio. High values of financing that use profit sharing system show that the expense incurred by Islamic Banks in financing is more efficient and resulting Islamic banks able to gain profits maximally. Also, Debt Financing and Equity Financing simultaneously have significant impacts on Profit Expense Ratio.

Suggestions

1. The researcher suggests management of Islamic banks to improve their performance in financing through Debt Financing because a good and efficient performance will be followed by a rise in profit. This is due to the Debt Financing that almost widely used in Islamic banking activities.
2. The researcher suggests the management of Islamic banks to accentuate this type of financing in the community, also improve oversight of business development that financed by Islamic banks so that the business operation can be monitored properly.
3. For any parties who interested in conducting further researches about this issue are advised to observe another factor that has impacts on Profit Expense Ratio of Islamic Banks for example; interest rates of conventional banks, the quality of financing, the finance portfolio and so forth.

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