

THE ANALYSIS OF CAPITAL STRUCTURE ON FINANCIAL PERFORMANCE USING CAPITAL, ASSETS, EARNINGS, AND LIQUIDITY RATIOS IN ISLAMIC BANKS LISTED ON THE INDONESIA STOCK EXCHANGE (IDX) IN 2014

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ABSTRACT

Capital structure refers to the sources of financing of a company. Financing can range from relatively permanent equity capital to more risky or temporary short-term financing sources. This study aims to analyze the impact of capital structure on financial performance in Islamic banks listed on the Indonesia Stock Exchange (IDX) in 2014. Capital structure is calculated by using total debt to equity capital ratio, whereas financial performance is calculated by using capital, assets, earnings, and liquidity ratios. The population of this study is all Islamic banks listed on the IDX in 2014. Total sample is seven Islamic banks which are determined by purposive sampling. Secondary data is collected from published financial statements of the Islamic banks in 2014, 2013, 2012, 2011, and 2010. The analyses used are descriptive method which describes data objectively and verification method which uses simple linear regression, where the independent variable is capital structure and the dependent variable is financial performance. Tests are carried out with 95% confidence level. The results show that capital structure affects financial performance of the Islamic banks significantly by 69%. This implies that the greater the capital structure of the Indonesian Islamic banks is, the higher the Indonesian Islamic banks performance will be, or vice versa.

Key words: Indonesian Islamic Banks, Capital Structure, Financial Performance, Capital Ratio, Assets Ratio, Earnings Ratio, Liquidity Ratio.

Introduction

As with many companies today that periodically carry out an analysis of their performance – the same applies to banks or Islamic banks in particular – where they analyze their performance for the interest of the management, the stakeholders, or the government (Bank Indonesia) as an attempt to assess the business conditions and to help determine its business policy for the foreseeable future. Indonesia started to tap into Islamic financial sector in 1992, after acclaiming dual-banking system which allows the establishment of Bank Muamalat Indonesia as the first full-fledged Islamic bank in November of that year. Islamic finance has recently received growing attention in Indonesia. Its resilience during the global financial crisis has positioned the sharia-based financial system as a strong alternative to commonly acceptable conventional banking system. In the realm of banking, capital structure is one of the major topics among scholars in finance. The ability of banks to carry out their stakeholders' needs is closely related to capital structure. Saad (2010) argued that capital structure in finance means a way in which a firm finances his assets across the blend of debt, equity, or hybrid securities (as cited in Impact of Capital Structure on Banking Performance, *Interdisciplinary Journal of Contemporary Research in Business*, Vol 4, No. 10). Previous studies found positive impact of capital structure on financial performance (Morita, S., (2010); Pranasakti, A., (2013); Rajha, K. S., & Alslehat, Z. A. F., (2014); Saeed, M. M., Gull, A. A., Rasheed, M. Y., (2013); Nikoo, S. F. (2015)). Based on the previous research done by other researchers regarding the relationship between capital structure and financial performance – as the author – I am interested to further study what is the relationship between capital structure and financial performance of Islamic banks in Indonesia. The results of this study can provide input to improve financial performance of Islamic banks in Indonesia. For this study, the author employs only seven out of 11 Islamic banks listed on the IDX during the period from 2010 to 2014 as the sample. The current study aims at investigating the relationship between capital structure and financial performance of Islamic banks in Indonesia. It is expected that the results of this study can provide insights into how Islamic banks in Indonesia can increase their financial performance. Finally, the results can also be used as a reference for the management of Islamic banks in Indonesia in order to improve their financial performance.

Literature review

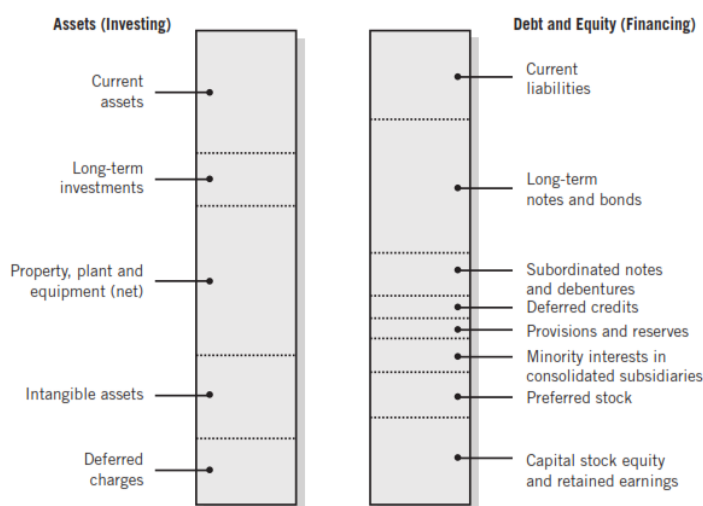
Saeed, M. M., Gull, A. A., Rasheed, M. Y., (2013) validated a positive relationship between determinants of capital structure and performance of Pakistani banking industry in their paper. The study extended empirical work on capital structure determinants of banks in Pakistan over the period of five years from 2007-2011 by utilizing data of banks listed on the Karachi Stock Exchange (KSE). Multiple regression models were applied to estimate the relationship between capital structure and banking performance. All banks operating in Pakistan were the population of the study. The sample of study included 25 banks listed on KSE or schedule banks in State Bank of Pakistan (SBP) over the period of 2007, 2008, 2009, 2010, and 2011. Performance was measured by return on assets, return on equity, and earnings per share. Determinants of capital structure included long-term debt to capital ratio, short-term debt to capital ratio, and total debt to capital ratio.

Similarly, Morita, S., (2010) conducted a research to obtain empirical evidence regarding the significant influence of capital structure in relation to the increase of companies' financial performance in the food and beverage industry listed on the Jakarta Stock Exchange (JSE). In addition, her research aimed to find out how big the influence of capital structure on the financial performance of the companies. Data used in her research was secondary data derived from financial statements of the food and beverage companies listed on JSE from the period of 2002, 2003, 2004, 2005, and 2006 sourced from the JSE website. Data was processed by using simple linear regression analysis, where the independent variable was capital structure, and the dependent variable was the companies' financial performance. The analysis employed instruments such as t-test to see if there was significant relationship between the independent variable and the dependent variable. Tests were carried out with 95% confidence level and degrees of freedom was 48. Based on the regression analysis performed, a significant difference between the capital structure and companies' financial performance, in which capital structure affects companies' financial performance by 55.9% can be interpreted as a fairly strong positive linear relations. Thus, the greater the value of the companies' capital structure is, the greater the companies' financial performance will be, or vice versa.

According to Pranasakti, A., (2013) the purpose of his research was to examine the effect of the companies' financial structure that consists of short-term debt to companies' financial performance as measured by gross profit, net profit, return on assets, and return on equity. The research used a sample of 22 manufacturing companies that were included as sector three listed on the IDX from 2007 until 2011. Sampling technique used in the research was purposive sampling with criteria that have been established. The results show that the capital structure variables affect the companies' financial performance. This research also used the control variables firm size. Test of controls variable has a positive effect on the financial performance of the companies.

Capital structure is the equity and debt financing of a company. It is often measured in terms of the relative magnitude of the various financing sources. A company's financial stability and risk of insolvency depend on its financial sources and the types and amounts of various assets it owns. Figure 1 below portrays a typical company's asset distribution and its financing sources. The picture highlights the potential variety and financing items that constitute a company – depicted within the accounting framework of assets equal liabilities and equity (Subramanyam, K. R., & Wild, J. J. (2009)).

Figure 1: The typical company's asset distribution and capital structure



Source: Financial statement analysis (10th Edition), 2009

According to (Subramanyam & Wild, 2009, p. 548), the importance of analyzing capital structure derives from several perspective, not the least is the difference between debt and equity. They states that there are differences between debt and equity. Equity refers to the *risk capital* of a company. Characteristics of equity capital include its uncertain or unspecified return and its lack of any repayment pattern. Equity capital contributes to a company's stability and solvency. It is usually characterized by a degree of permanence, persistence in times of adversity, and a lack of any mandatory dividend requirement. A company can confidently invest equity financing in long-term assets and expose them to business risks without threat of recall. Unlike equity capital, both short-term and long-term debt capital must be repaid. The longer the debt period and the less demanding its repayment provisions, the easier it is for a company to service debt capital. Still, debt must be repaid at specified times regardless of a company's financial condition, and so too must periodic interest on most debt. Failure to pay principal and interest typically results in legal proceedings where common shareholders can lose control of the company and all of part of their investment. When the portion of debt in the total capital structure of a company is larger, the higher are the resulting fixed charges and repayment commitments. The likelihood of the company's inability to pay interest and principal when due and potential losses for creditors also increases. In contrast, from a shareholder's perspective, debt is a preferred external financing source for at least two reasons: (1) interest on most debt is fixed and, provided interest cost is less than the return on the operating assets, the excess return is to the benefit of equity investors; (2) interest is a tax-deductible expense whereas dividends are not.

In their 2014 study, Rajha, K. S., & Alslehat, Z. A. F., reviewed the impact of capital structure on the Jordanian Islamic banks using multiple regression model. The model included a sample of two Islamic banks: Jordan Islamic Bank (JIB) and Islamic International Arab Bank (IIAB). The sample of the study relied on the annual statements of Islamic banks from the period of

(1998-2012). Using several financial ratios represented by the independent variables: equity ratio, total assets ratio, ratio of financing to total assets, ratio of liquid assets of total assets, concentration ratio “Herfindahl Index,” and the dependent variable used was performance measured by the scale of Tobin Q. The results show positive impact for each variable: equity ratio, total assets ratio, and ratio of financing to total assets on performance, whereas the concentration ratio “Herfindahl Index” has negative impact on performance, and ratio of liquid assets of total assets on the performance of Islamic banks in Jordan has no impact on each other.

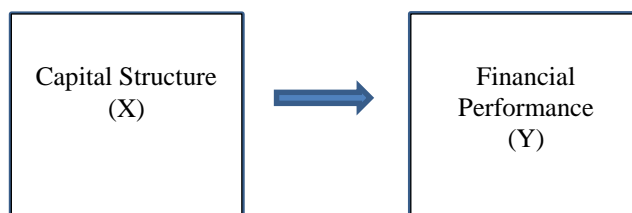
In further support of the previous findings, Nikoo, S. F. (2015) investigated the impact of capital structure on banking performance on the Tehran Stock Exchange (TSE). The research was based on financial statements of Iranian banks from the period of 2009-2014. The study established a model to measure the effect of capital structure on the bank efficiency measured by return on assets (ROA), return on equity (ROE), and earnings per share (EPS). The results reveal that capital structure has positive impact on bank performance. This study used two measures: accounting and market measures of performance. Most researchers use return on equity (ROE) as accounting performance proxy, while Tobin Q is used as a proxy to measure the market performance of the firms. There is a positive significant level between dependent variable and independent variable used in the paper such as ROE, EOA, EPS, and debt to equity.

Research design

This study examines seven Islamic banks listed on the IDX in 2014 selected by using purposive sampling. Selection of these Islamic banks is based on the established criteria; therefore, the following are the criteria: (1) the Islamic banks must be listed on the IDX at least since 2010; (2) the Islamic banks’ total assets must be in the range of Rp1 trillion to Rp65 trillions. The following are the Islamic banks used in this study: Bank Muamalat Indonesia, Bank Bukopin Syariah, Bank Rakyat Indonesia (BRI) Syariah, Bank Negara Indonesia (BNI) Syariah, Bank Victoria Syariah, Maybank Syariah Indonesia, and Bank bjb Syariah. This paper uses the qualitative methods such as searching through academic literature (as cited in Hendrati & Wawan, 2013; *Proceedings of the 8th Asian Business Research Conference*). Data is collected from secondary sources. Secondary data refers to information gathered by someone other than the researcher conducting the current study. Such data can be internal or external to the organization and accessed through the Internet or perusal of recorded or published information. There are several sources of secondary data, including books and periodicals, government publication of economic indicators, census data, statistical, abstracts, database, the media, annual reports of companies, etc., (Sekaran, 2003, p. 222-223). To process the data, the author employs simple linear regression. (Spiegel, M. R, 1975, p. 259) argues that one of the main purposes of curve fitting is to estimate one of the variables (the *dependent variable*) from the other (the *independent variable*). The process of estimation is often referred to as *regression*. This study uses simple linear regression to find out the impact of the independent variable (capital structure) on the dependent variable (financial performance). Statistical Package for the Social Sciences (SPSS) 17.0 is used to process the data. According to Sugiyono (2013, p. 206), there are two research methods which are descriptive and verification methods. This study uses two methods. The first method is descriptive method which describes the condition of the object of research based on the data that has been collected from academic literature, online articles and other resources on the Internet. The second method is verification method which uses simple linear regression.

Below is the research design of the study. Capital structure to financial performance of the Indonesian Islamic banks.

Figure 2: The relationship between capital structure and financial performance



Hypotheses

Very often in practice we are called upon to make decisions about populations on the basis of sample information. Such decisions are called *statistical decisions*. In attempting to reach decisions, it is useful to make assumptions or guesses about the populations involved. Such assumptions, which may or may not be true, are called *statistical hypotheses* and in general are statements about the probability distributions of the populations. There are two types of hypotheses, the null hypotheses denoted by H_0 and alternative hypotheses denoted by H_1 (Spiegel, M. R. (1975)).

H_0 : $\beta = 0$, and Capital Structure does not influence Financial Performance

H_1 : $\beta \neq 0$, and Capital Structure influences Financial Performance

Reject H_1 , If alpha is greater than (0.05) and accept H_1 , if alpha is less than (0.05).

Capital Structure

Capital structure refers to the sources of financing for a company. Financing can range from relatively permanent equity capital to more risky or temporary short-term financing sources. Once a company obtains financing, it subsequently invests it in various assets. Assets represent secondary sources of security for lenders and range from loans secured by specific assets to assets available as general security for unsecured creditors. These and other factors yield different risks associated with different assets

and financing sources (Subramanyam & Wild, 2009, p. 547). The author only uses one ratio, which is total debt to equity capital ratio to measure the capital structure. The following is the formula:

$$\text{Total Debt to Equity Capital Ratio} = \frac{\text{Total Debt}}{\text{Shareholders' Equity}}$$

$$= \frac{\text{Current Liabilities} + \text{Long Term Debt} + \text{Other Liabilities}}{\text{Shareholders' Equity}}$$

Financial Performance

(Weygandt, Kimmel, & Kieso, 2011, p. 667) states that ratio analysis expresses the relationship among selected items of financial statement data. A ratio expresses the mathematical relationship between one quantity and another. The relationship is expressed in terms of either a percentage, a rate, or a simple proportion. In calculating the financial performance of the Islamic banks, the author employs four ratios which are: capital ratio, assets ratio, earnings ratio, and liquidity ratio. These four ratios are taken from published financial statements of the seven Islamic banks studied which are: Bank Muamalat Indonesia, Bank Bukopin Syariah, Bank Rakyat Indonesia (BRI) Syariah, Bank Negara Indonesia (BNI) Syariah, Bank Victoria Syariah, Maybank Syariah Indonesia, and Bank bjb Syariah. To calculate the financial performance, the author only uses data from 2010, 2011, 2012, 2013, and 2014. According to (Rivai & Indroes, 2007, p. 709-722), the following ratios are used to measure the financial performance:

➤ Capital

Capital signals the institution's ability to maintain capital commensurate with the nature and extent of all types of risk, and the ability of management to identify, measure, monitor, and control these risks.

Ratios include:

- 1) Capital Adequacy Ratio (CAR) dengan memperhitungkan risiko penyaluran dana
- 2) Capital Adequacy Ratio (CAR) dengan memperhitungkan risiko pasar
- 3) Aktiva tetap terhadap modal

➤ Assets

Assets reflect the amount of existing credit risk associated with the loan and investment portfolio, as well as off balance sheet activities.

Ratios include:

- 1) Aktiva produktif bermasalah (NPA)
- 2) Non Performing Financing (NPF) Gross
Non Performing Financing (NPF) Net
- 3) PPA Produktif terhadap aktiva produktif
- 4) Pemenuhan PPA Produktif

➤ Earnings

Earnings reflect not only the quantity and trend in earnings, but also the factors that may affect the sustainability or quality of earnings.

Ratios include:

- 1) Return on Assets (ROA)
- 2) Return on Equity (ROE)
- 3) Net Interest Margin (NIM)
- 4) Operational Efficiency Ratio (OER)

➤ Liquidity

Liquidity reflects the adequacy of the institution's current and prospective sources of liquidity and funds management practices.

Ratios include:

- 1) Quick Ratio
- 2) Sertifikat Investasi Mudharabah Antarbank (SIMA) terhadap DPK
- 3) Deposasi inti terhadap DPK
- 4) Financing to Deposit Ratio (FDR)

Data analysis

Variables Entered/Removed^b

Model	Variables Entered	Variables Removed	Method
1	Capital_Structure ^a	.	Enter

a. All requested variables entered.

b. Dependent Variable: Financial_Performance

Model Summary^b

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.831 ^a	.690	.628	1.914968289907E 2

a. Predictors: (Constant), Capital_Structure

b. Dependent Variable: Financial_Performance

ANOVA^b

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	408627.159	1	408627.159	11.143	.021 ^a
	Residual	183355.178	5	36671.036		
	Total	591982.336	6			

a. Predictors: (Constant), Capital_Structure

b. Dependent Variable: Financial_Performance

Coefficients^a

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	2893.512	163.241		17.725	.000
	Capital_Structure	769.601	230.549	.831	3.338	.021

a. Dependent Variable: Financial_Performance

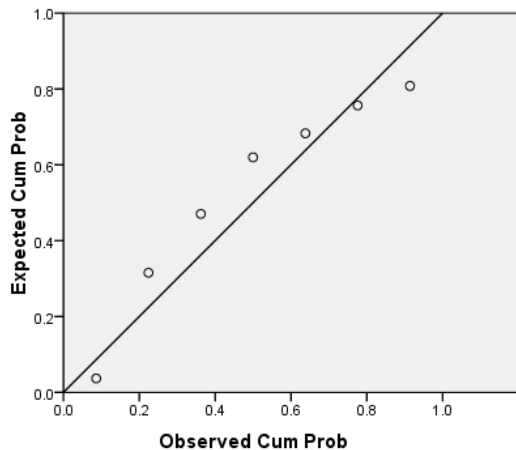
Residuals Statistics^a

	Minimum	Maximum	Mean	Std. Deviation	N
Predicted Value	2.998724853 52E3	3.7340285644 5E3	3.381939821 43E3	2.609684396203E 2	7
Residual	- 3.428058166 504E2	1.6657321166 99E2	- 4.709883277 038E-13	1.748118882149E 2	7
Std. Predicted Value	-1.468	1.349	.000	1.000	7
Std. Residual	-1.790	.870	.000	.913	7

a. Dependent Variable: Financial_Performance

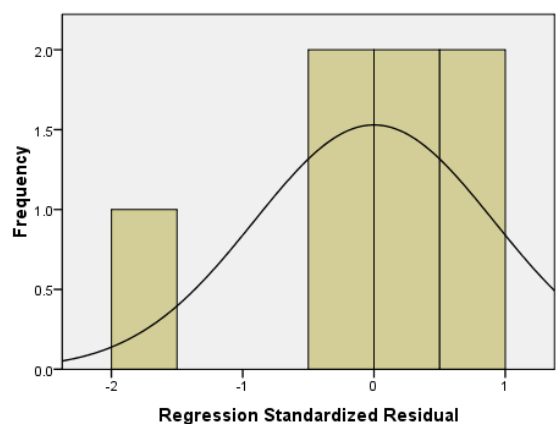
Normal P-P Plot of Regression Standardized Residual

Dependent Variable: Financial_Performance



Histogram

Dependent Variable: Financial_Performance



Mean = -2.54E-15
Std. Dev. = 0.913
N = 7

Discussion

The Normal P-P Plot of Regression Standardized Residual and the Histogram in data analysis section of the paper show that the collected and processed data is not normal. This abnormality is caused by the lack of available data. Because of its abnormality, the author suggests that future study to include at least 30 samples, so that data collected can be more representative and can produce more accurate results. According to the statistical results using SPSS 17.0, applying the simple linear regression where the independent variable is capital structure and the dependent variable is financial performance, the results show that (p-value) is less than alpha (0.05), then the model is perceived to be significant. The results show that alpha (0.021) which is less than alpha (0.05); therefore, X has impact on Y. In addition to alpha, the R^2 (R Square or determination) shows 0.69 or 69%, which means that the influence of the independent variable (capital structure) on the dependent variable (financial performance) can only be explained by 69% and the remaining 31% are influenced by other factors not included in the model of this study. This implies that the condition of capital structure and financial performance is a positive linear relationship, although there are many other influences outside that are not calculated in this study.

Table 1: Rankings based on the value of capital structure and financial performance

No	Indonesian Islamic Banks	Capital Structure (X)	Financial Performance (Y)
1.	Bank Muamalat Indonesia	1.092146557 = 109.21%	3792.356250 = 38.92%
2.	Bank Bukopin Syariah	0.835693602 = 83.56%	3669.724167 = 37.69%
3.	BRI Syariah	0.767520213 = 76.75%	3650.769167 = 36.50%
4.	BNI Syariah	0.643808566 = 64.38%	3296.895833 = 33.96%
5.	Bank Victoria Syariah	0.737034545 = 73.70%	3117.928333 = 31.17%
6.	Maybank Syariah Indonesia	0.229643345 = 22.96%	3056.059167 = 30.56%
7.	Bank bjb Syariah	0.13671131 = 13.67%	3089.845833 = 30.89%

Source: Data was collected from published financial statements and processed using SPSS 17.0

The computation reveals that out of the seven Islamic banks, in terms of the capital structure and the financial performance, Bank Muamalat takes the first place, followed by Bank Bukopin Syariah in the second place, Bank Rakyat Indonesia (BRI) Syariah in the third place, Bank Negara Indonesia (BNI) Syariah in the fourth place, Bank Victoria Syariah in the fifth place, Maybank Syariah Indonesia in the sixth place, and Bank bjb Syariah in the seventh place. The intended aim of conducting this study is to provide the empirical evidence regarding the impact of capital structure on financial performance of Islamic banks in Indonesia. The findings of the study validate a positive relations between capital structure that employs total debt to total equity ratio as the independent variable against capital, assets, earnings, and liquidity ratios which represent the financial performance of Islamic banks as the dependent variable. The results have revealed that both variables, the capital structure and financial performance have impact on each other because the alpha is (0.021) which is less than (0.05). It is based on the acceptance of the null hypotheses where the alpha is less than (0.05) which implies that capital structure influences financial performance. Also, the R Square is 69%. This finding corresponds with the previous studies by (Morita, S., (2010); Pranasakti, A., (2013); Rajha, K. S., & Alslehat, Z. A. F., (2014); Saeed, M. M., Gull, A. A., Rasheed, M. Y., (2013); Nikoo, S. F. (2015)) who also found a positive relationship between capital structure and financial performance. Specifically, Saeed, M. M., Gull, A. A., Rasheed, M. Y., in their 2013 study, they argued that total debt to total capital ratio experienced a strong optimistic connection with all dependent variables: ROA, ROE, and EPS. Based on the above explanation, it can be inferred that capital structure does have an impact on financial performance of Islamic banks in Indonesia. This implies that the greater the capital structure of the Indonesian Islamic banks is, the higher the Indonesian Islamic banks performance will be, or vice versa.

Conclusions

To conclude based on the elaboration above, the author withdraws two points:

1. Capital structure does have an impact on financial performance of Islamic banks in Indonesia by 69%, while the remaining 31% of the relationships between the two variables is influenced by other factors which are not included in this study. It is based on the acceptance of the null hypotheses where the alpha is less than (0.05) which implies that capital structure influences financial performance. This conclusion does not bode well for the view that says when the portion of debt in the total capital structure of a company is larger, the higher are the resulting fixed charges and repayment commitments. This leads to the likelihood of the company's inability to pay interest and principal when due and potential losses for creditors also increases. Reasons for using this ratio include its simplicity in computation and its data availability. It is not the author's intent to reject the aforementioned view. What the author expects is that by increasing the total debt compared to the stakeholders' equity, Islamic banks will have more capital to serve its customers' needs and in return can increase their financial performance. In addition to this view, the author supports the shareholders' perspective where debt is a preferred external financing source for at least two reasons: (1) interest on most debt is fixed and, provided interest cost is less than the return on the operating assets, the excess return is to the benefit of equity investors; (2) interest is a tax-deductible expense whereas dividends are not.
2. This study has limitations in terms of numbers of Islamic banks studied. Out of 11 Islamic banks that are listed on the Indonesia Stock Exchange (IDX) in 2014, only seven that are included in this study because the author uses purposive sampling method. Another limitation is that this study only concerns with the Islamic banks in Indonesia. Therefore, the applicability is also limited to only Indonesia.

Recommendations

To recommend based on the elaboration above, the author recommends two points:

1. The author believes that in order to boost the financial performance of Islamic banks in Indonesia, capital structure needs to be managed well. The management of Indonesian Islamic banks could maintain their capital structure by making sure that the total debt to equity capital ratio has total debt (as numerator) which is greater than the shareholders' equity (as denominator); thus, the ratio would be higher compared to when the shareholders' equity is greater than the total debt.
2. The Normal P-P Plot of Regression Standardized Residual and the Histogram in data analysis section of the paper show that the collected and processed data is not normal. This abnormality is caused by the lack of available data. Because of its abnormality, the author suggests that future study to include at least 30 samples, so that data collected can be more representative and can produce more accurate results. Further study addressing a longer period of time and having a broader selection of capital structure and financial performance measures can expose some new ideas and insights. This study can be extended by adding more Islamic banks – not just in Indonesia – but worldwide. By conducting the study with a larger number of samples from many different countries where Islamic banks are thriving, it is expected that the findings could be more applicable to many countries as well as for the advancement of Islamic banks throughout the world.

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