Sharia Governance and Compliance Towards the Financial Statement Quality of Islamic Banking

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Abstract. The study aims to investigate whether governance and compliance in term of sharia affect the financial statement quality of Islamic banking in Indonesia using the AAOIDI Index standard remodelling as disclosure in Islamic banking financial statement. The sample of this study used 14 Islamic banks in Indonesia for six years. This study uses multiple linear regression to analyse the data. The results explain that sharia governance consisting of the Audit Committee does affect the financial statement quality of Islamic Banking. Yet, the Sharia Supervisory Board does not affect the financial statement quality of Islamic Banking. In addition, Sharia compliance which consists of profit-sharing ratio affects the financial statement quality. However, the audit quality does not affect the financial statements quality of Islamic Banking in Indonesia.

Keywords: sharia governance · sharia compliance · quality of financial statement · AAOIFI · islamic banking

1 Introduction

The financial statements quality of Islamic Banking (IB) is different from conventional banking because of the diversity in the understanding of Sharia [1]. One of these differences refers to the disclosure of the development of AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) as a standard-setter [2, 3]. The AAOIFI standard is considered the most prominent reference for the Islamic banking industry and serves as a guide [4]. However, the implementation of AAOIFI in Indonesia has not been fully implemented, even though the goal of the growth of Islamic banking is to be able to compete globally, and AAOIFI has the goal of disseminating accounting and auditing guidelines relevant to Islamic Financial Institutions [5].

The application of AAOIFI as a standard in financial statements has results disclosed differently in each country. The countries of the Middle East and North Africa that have mandatory fully adopted believe that AAOIFI does not have the power to compel Islamic banks to implement its standards [6]. In addition, countries with Muslim-majority populations, such as Malaysia, which have long implemented AAOIFI, have not explained

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the problem of the need for sharia accounting standards in their financial reporting [7]. Indonesia itself still refers to the Statement of Financial Accounting Standards (PSAK), which results from the harmonization of PSAK with the sharia concept [8].

Different criteria will have implications for the measurement, recognition, presentation, and disclosure of the quality of financial statements [3]. Financial statement prepared based on different accounting standards are likely to create problems in the comparability, credibility and reliability of financial statement prepared globally [4]. In addition, the governance mechanism and the lack of fully supportive regulations are also one of the drawbacks of ineffective standard implementation. Governance mechanisms are needed to gain the trust of the public. Governance's rule itself is to ensure compliance with applicable regulations and to maintain the credibility of the company's financial statements [9]. Besides, the goals of green economics need to empower society and strengthen economic stability [10].

The operation of Islamic banking governance shows a different structure from conventional banking. Sharia banking has several aspects that must be complied with related to sharia principles, different transactions, and applicable legal traditions [2]. The Sharia Supervisory Board (SSB) is one of the determinants of good corporate governance, and the proper framework helps ensure the effectiveness of the SSB [11]. Structural arrangements and frameworks that are in line with government regulations must be able to monitor, supervise, control, and evaluate SSB so that sharia compliance is maintained.

All interested aspects must support Sharia compliance to maximize the resulting goals. Not only the SSB has the authority in the governance of Islamic financial institutions, but the presence of the audit committee, the composition of the board and the credibility of the board of directors can provide control over the company's cash flow [12]. It is hoped that the complete formation of the board will result in the need for sharia governance for the benefit of Islamic Financial Institutions.

The need for sharia compliance also influences the interests of governance. It revolves not only around products but also mechanisms, systems and techniques, and corporate identity [13]. It was explained in the study that the problems brought on by sharia compliance lie in the lack of understanding of Sharia, unstandardized auditing standards from the government, conventional dominance wrapped by Sharia, the low level of Public Accounting Firms (PAF) with the Sharia label which eventually leads to the Sharia Supervisory Board and competent PAF. The selection of sharia auditors is also required to have competence and performance that leads to effectiveness in audit work, as explained in the emphasis of AAOIFI [14] to support sharia compliance needs.

Compliance with shariah criteria depends on financial ratios as well as business activities. According to the Qur'an (Al-Mutaffifin [83:1–5], Al-A'raf [7:85], fair trade and business presentations have always been a must for Muslims. The requirements stated in Al-Qur'an are also explained. The Qur'an that the company's compliance with the financial statement framework has always been a problem that has been left blank in the compliance criteria [15]. Sharia compliance does not depend on the country but on specific criteria that follow Islamic teachings. One is that Islamic financial instruments provide ethical returns and are free from sin [16].

The researcher identified two significant gaps in previous research and literature. First, the researcher identifies the population gap that appears in previous studies where the identified population in countries that adopt AAOIFI standards as an obligation in applying financial statements in their countries such research Ahmed & Khatun [17], Can [15], El-Halaby, Albarrak & Grassa [18]; Second, the researcher identified gaps in previous research. The research Muhammad & Fahmie [3], El-Halaby, Albarrak & Grassa [18] uses different financial quality measurements such as Return on Asset (ROA), Return on Equity (ROE), and earnings management. Therefore, investigating these two issues is necessary when applied to the country with the largest Muslim population, namely Indonesia, using the AAOIFI index, which adopts research Ousama & Hamammi [19] to obtain a common understanding of global standards. This study is the first to adopt the AAOIFI index as a concept of financial statement quality in Indonesia.

This study aims to investigate the financial statement quality of Islamic banking by adopting international standards AAOIFI with sharia governance and compliance as supporting points. This research is essential for two reasons. First, the significant growth of Islamic Banking [20] can compete with the global market, so relevant standards are needed. Second, the difference in results in each country that adopts AAOIFI as the reporting standard for Islamic Financial Institutions and an explanation of the financial statement quality in Indonesia in terms of different criteria.

The contributions that can be made from this research are, first, providing information, reference, and practical contributions to the financial statement quality of Islamic banking using global standards, different from the standards used previously; secondly, as a reference source for further researchers to see comparisons and a broader picture of Islamic banking practices; third, to produce improvements for standard setters of Islamic Banking in Indonesia to produce a better framework.

2 Literature Review and Hypothesis Development

2.1 Sharia Governance

The literature on corporate governance in Islam is driven by faith-based rationalism and social welfare criteria [21]. In Islam, corporate governance is directed at protecting the rights of all stakeholders, including Islam, while at the same time having the oneness of God, or monotheism, which dictates how business transactions are conducted. The main point, another important role of corporate governance from an Islamic perspective is to reduce the risk of Sharia non-compliance by emphasizing the critical role of the Sharia supervisory board in each Islamic Banking [21] which is responsible for ensuring that all transactions in Sharia Banking comply with Sharia law requirements [22].

The standards issued by AAOIFI regarding the Sharia Supervisory Board are detailed, with at least three members appointed by the shareholders at the GMS and at the recommendation of the board of directors [22] to ensure that transactions are following Islamic principles, which allows Islamic Banking to lose the trust of the public [23]. A good corporate governance structure helps ensure that management uses company resources properly in the best interests of absentee owners and fairly reports on the company's financial condition and operating performance. The bodies primarily responsible for management oversight are the board of directors and the committees it appoints. The audit committee, which consists of board members, assists the board in overseeing the financial reporting process [9]. In addition, an influential audit committee and its improved performance can increase the level of financial reporting and transparency [24]. One of the failures in monitoring financial statements is the incompetent role of the audit committee in carrying out its functions and responsibilities [25].

2.2 Sharia Compliance

Sharia compliance is an absolute requirement that must be met by financial institutions that carry out business activities based on Sharia. The importance of compliance has implications for the necessity of monitoring the implementation of such compliance. Shariah compliance is the fulfilment of sharia values in Sharia Financial Institutions that make the DSN-MUI Fatwa and Bank Indonesia Regulations. This sharia principle is one of the differentiating factors between Islamic banks and conventional banks. Sharia compliance is vital in the operation of sharia contracts because it determines whether the practice in sharia financial services is per sharia principles [26]. Sharia compliance must provide accurate and transparent information to reduce information asymmetry, bank credibility, and investor confidence [16]. These objectives identify the position of Islamic banks when successful in achieving their goals. One of the main objectives in Islamic banking is profit-sharing [27] which is seen in its activities related to total financing.

2.3 The Financial Statement Quality

To measure the financial statement quality of Islamic Banking with AAOIFI financial accounting standards. In the unweighted disclosure index, a checklist of requirements from the standard is prepared and checked against sample data using an unweighted approach which means giving (1) if disclosed, and (0) if not. The use of the AAOIFI Index disclosure is intended to see how far the financial statement quality of Islamic Banking can adopt the standards issued by AAOIFI. This study adopts previous research for the AAOIFI index, namely Ousama, Sulaiti & Hamammi [19].

Normally, the measurement financial statement quality using Return on Asset [3] or Return on Equity [18] however in this research, financial statement quality is using another measurement which remodeling based on AAOIFI Index such as Murabaha, Mudaraba and Musyaraka. Murabaha is an Arabic noun that means gaining profit [19]. In other side, a valid form of equity investment and profit sharing uses Mudaraba [28] which is quite like Musyaraka. In Musyaraka, the capital owners enter partnership by contributing equity with others in return for sharing profit and losses at a predetermined ratio [19]. The remodelling of financial statement given based on AAOIFI Index can be seen in appendixes.

Table 1. Test of Normality

	Kolmogorov – Smirnov^{a}			Shapiro Wilk		
Unstandardized Residual	Statistic	df	Sig	Statistic	df	Sig
a. Liliefors sig Correction	0.094	84	0.066	0.924	84	0.000

This study uses an active population of Islamic banking registered with the Financial Services Authority. Sampling in this study was carried out using the purposive sampling method, which is a sampling method based on specific characteristics or characteristics that are considered to have a close relationship with the known characteristics of the population. The operation variable table can be seen in appendixes (Table 1).

3 Results and Discussion

3.1 Statistic Test

The coefficient of determination test is seen in the Adjusted R Square column, which has a value of 0.278. The independent variable influences the dependent variable by 27.8%, and the remaining 72.8% is influenced by other variables not examined in this study. This is explained in Table 2.

The results of the multicollinearity test can be seen in Table 3, where all VIF values > 10, which implies that all independent variables do not have multicollinearity.

The amount of partial % received by each variable that affects the dependent variable is determined using the practical and relative contributions [29]. The practical contribution is used to determine the amount of the effective contribution of each predictor/dependent variable from the overall prediction. In contrast, the relative contribution is used to determine the contribution of each independent variable to the dependent and can be seen in appendixes.

Table 2. Model Summary

Model	R	R Square	Adjusted R Square	Std Error of the estimate
1	.528[a]	0,278	0,242	16,31708

[a]Predictors: (Constant) Size SSB, Meeting AC, PSR, Big 10

Table 3. Coefficients[a]

			Standardize Coefficient	t	Sig	Collinearity Statistic	
			Beta			Tolerance	VIF
Constant	46,131	9,024		5,112	0,000		
Size SSB X_1	2,508	3,559	0,070	0,705	0,483	0,926	1,080
Meeting X_2	0,401	0,201	0,198	1,996	0,049	0,931	1,074
PSR X_3	0,347	0,066	0,518	5,250	0,000	0,937	1,067
Big 10 X_4	6,455	3,857	0,165	1,674	0,098	0,943	1,061

[a]Dependent Variable: Index AAOIFI

3.2 Hypothesis Testing

Hypothesis testing is carried out to see whether the independent variable influences the dependent variable. This study uses multiple linear regression analysis (multiple linear regression). Variable X_1 is measured using the profile of the Sharia Supervisory Board; variable X_2 uses the measurement of the frequency of audit committee meetings, variable X_3 uses the measurement of profit-sharing ratio, and variable X_4 uses the measurement of the Big 10 Public Accounting Firm dummy test. Based on Table 3, it can be concluded that the regression model is as follows:

AAOIFI Index = 46.131 + 0.0036 Size SSB + 0.0295 Meeting AC + 0.2833 PSR + 0.0087 Big10.

Hypothesis testing compares the significance level (sig) with the error rate (α) = 5%. Based on Table 2, the interpretation is as follows:

3.2.1 Testing the First Hypothesis (H_1)

The first hypothesis states that the Sharia Supervisory Board variable does not affect the financial statement quality of Islamic banking. Based on this, it can be concluded that the SSB variable has no significant effect on the financial statement quality of Islamic banking. In other words, H_1 is rejected. The advice given in the AAOIFI standard does not have an apparent influence on the size of the SSB that can ensure transactions that follow Islamic principles. Indonesian Sharia Banking has two Sharia Supervisory Boards, namely the Chairman and members under the regulation of the Chairman of the Capital Market and Financial Institution Supervisory Agency PER.06/2012, which has a minimum of two people a maximum of concurrent positions in three other financing companies. The experience and skills possessed by each SSB profile are considered sufficient to represent the supervision of Islamic banking in general. This is in line with the research conducted by Mukhibad, Nurkhin, & Rohman [30] but different from the research conducted by Budiyono & Sabilla [25] that indeed the role of SSB must be able to work together with the role of the audit committee to improve the financial statement quality of Islamic banking.

3.2.2 Testing the Second Hypothesis (H_2)

The second hypothesis states that the audit committee variable affects the financial statement quality of Islamic banking. Based on this, it can be concluded that the audit committee variable significantly affects the financial statement quality of Islamic banking. In other words, H_2 is accepted. The audit committee's duties are significant to the financial statement quality issued by Islamic Banking because the joint functions and responsibilities of the Board of Commissioners can oversee financial information, internal control systems, and the effectiveness of internal-external audits. So that with the higher the frequency of meetings, it is hoped that they will be able to carry out their duties according to their roles. This study is in line with Abdallah & Bahloul's [24] research that an effective audit committee can increase financial statement and transparency, showing the quality of financial statement by increasing its reputation.

3.2.3 Testing the Third Hypothesis (H_3)

The third hypothesis states that the variable profit-sharing ratio affects the financial statement quality of Islamic banking. Based on this, it can be concluded that the PSR variable has a significant effect on the financial statement quality of Islamic banking. In other words, H_3 is accepted. Following the main objective that distinguishes Islamic banking and conventional banking is the contribution of profit sharing for partners who cooperate with Islamic Banking. This goal brings an understanding that Islamic Banking in Indonesia has succeeded in bringing benefits to the public in terms of financing under Sharia compliance. This is in line with Hayati & Ramadhani [31] research states that provides aspects of justice with entirely satisfactory criteria in Islamic banking, which is the core and identity of Islamic Banking outside of the financing of buying and selling contracts.

3.2.4 Testing the Fourth Hypothesis (H_4)

The fourth hypothesis states that the audit quality variable does not affect the financial statement quality of Islamic banking. Based on this, it can be concluded that the PAF variable has no significant effect on the financial statement quality. In other words, H_4 is rejected. Audit quality is determined not from where the Public Accounting Firm comes from but rather from the auditor partners who have obtained the Islamic banking education and training certification and are allowed to audit sharia banking [32]. This study is in line with research conducted by Mardian [16] and Prakosa & Zuchri [33] that it is not a place where auditors take shelter but rather an appraiser or opinion provider on business practices carried out by management, namely Certified Sharia Public Accountants.

4 Conclusion

First, the audit committee and profit-sharing ratio affect the financial statement quality of Islamic banking because the intensity of coordinating with the committee explains that the supervision of sharia compliance in Islamic banking has been carried out correctly. One of the crucial points is the resulting product, namely profit-sharing financing, which affects the financial statement quality of Islamic banking. This goal finally convinced Islamic banking to accelerate the growth of Islamic banking at the national level and become a new direction for the Indonesian economy and for green economic. Second, Sharia Supervisory Board and the determination of the top 10 affiliated KAPs in Indonesia do not affect the financial statement quality of Islamic banking. This needs to be an essential concern considering banks in Indonesia that have merged (Bank Syariah Mandiri, Bank Negara Indonesia Syariah and Bank Rakyat Indonesia Syariah) aim to compete globally, and these two things are critical points in Islamic banking, especially on the financial statement quality based on a global basis by applying AAOIFI index as remodelling in its regulations. Third, the financial statement quality that adopt AAOIFI index as a financial statement standard in Indonesian Islamic Banking requires several adjustments in its application that are adapted to the culture in Islamic Banking.

The results and implications of this study also point to its limitations. The limitation is using financial statement quality with the remodelling AAOIFI index as global standard needs adjustment to be used as benchmark to Indonesian standard. Several aspects that are not covered in the standard make this reasonable because Indonesia is one of the countries that is not obliged to adopt the standard. The Sharia PSAK refers to several aspects of the AAOIFI standard as a baseline for determining regulations. Future research can accommodate these limitations. One example is comparing the quality of financial reports in a sample of Islamic banking that will merge from 2021 onwards.

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