Islamic Corporate Governance and Sharia Compliance on Financial Performance

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Abstract. The financial performance of the Sharia industry has increased during unfavorable economic times due to the Covid-19 pandemic. The increase in financial performance, especially in Islamic banking, shows that company management is generally running well, but the high financial performance of Islamic banking does not necessarily meet the level of Sharia compliance. Sharia compliance is the level of compliance with company operations based on Sharia principles. This study aims to examine and analyze the influence of Islamic Corporate Governance (ICG) and sharia compliance on financial performance. The population in this study is Islamic banking in Indonesia, with the category of Islamic Commercial Banks (BUS). The sample criteria are BUS that publish annual reports and Good Corporate Governance reports for 5 consecutive years 2015-2019. The analytical method used is multiple regression analysis. The results of the study show that ICG and sharia compliance from the Profit-Sharing indicator have a positive effect on financial performance. The results of the study show that sharia compliance with the Islamic Income and Equitable Distribution indicators has no effect on financial performance. This research has implications for Islamic banking to pay attention to aspects of sharia compliance in achieving company goals, so as to create corporate governance that is in accordance with Sharia principles.

Keywords: Financial Performance, Islamic Corporate Governance, Sharia Compliance

1 Introduction

The company's performance in banking is seen from two aspects, namely financial and non-financial. Non-financial performance, namely the ability to maintain and manage company management well to achieve goals. This non-financial aspect includes corporate governance. And financial performance, namely the company's ability to develop its assets to increase the quantity and quality of its finances such as being able to generate profits, increase liquidity, and pay receivables in accordance with the existing timeframe.

According to Wimboh Santoso, Chairman of the OJK Board of Commissioners, Islamic finance has outperformed conventional finance on a number of different metrics, according to his presentation at the Sharia Economic Outlook 2021 Webinar. One of

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them is that assets expanded significantly in 2020, from 13.84% in 2019 to 21.48% in 2020. The overall value of nominal sharia financial assets is Rp 1,770.32 trillion, which comprises Rp 593.35 trillion for sharia banking, Rp 1,063.81 trillion for sharia mutual funds, and Rp 113.16 trillion for sharia IKNB (Non-Bank Financial Industry). When compared to the national banking, which is really down 2.41% as of December 2020, sharia commercial bank financing has seen growth of 9.5% (https://www.cnbcindonesia.com). This shows that the financial performance of the Sharia industry has increased during the Covid-19 pandemic. The company's management is performing well, as seen by the improvement in financial performance.

The increase in financial performance is of course also supported by the growth of Sharia industry players. The 2019 Islamic Finance Development Report shows that there are 14 banks in the Sharia Commercial Bank category with 1919 offices, 20 banks in the Sharia Business Unit category with 381 offices and 114 Sharia People's Credit Banks. with a total of 617 offices [1]. This number shows that the Sharia industry continues to grow rapidly.

Growing Sharia economic activity followed the growth of the Sharia sector, particularly banking. According to Mohamad Nur Yasin, a lecturer at UIN Maulana Malik Ibrahim Malang in East Java, stated that the increase in sharia industry business actors was also accompanied by non-compliance by sharia economic industry players. The rise in cases heard by religious courts over the past four years is evidence of this. 312 sharia economic cases were reported in 2019. From 2016, when there were 146 cases, to 2017, when there were 229 cases, and to 2018, when there were 287 cases, this figure has climbed. The majority, he claimed, involved default and acts against the law. According to PT Bank BNI Syariah Tribuana Tunggadewi, director of risk and compliance, there are numerous instances of legal wrongdoing and fraud in Islamic financial institutions, but no regulations that expressly control them [2].

The justification provided above shows that Sharia compliance does not always equate to excellent financial performance in Islamic banking. Sharia compliance is the degree to which business activities are carried out in accordance with Sharia standards. Here, transactions free of usury, *gharar*, *maysir*, and *riswah* are covered under sharia principles. Additionally, transactions and operational activities comply with Sharia law; halal ingredients must be used in the production of any goods or services. The importance of *maslahah*, or giving benefits to society (justice for all stakeholders), as well as being accountable to all interested parties and to Allah SWT, must be given top priority by organizations operating according to Sharia principles. To do this, corporate governance based on Sharia principles, namely Islamic Corporate Governance (ICG), as well as sharia compliance with Sharia principles are required. These aims should be both financial and non-financial for the company.

ICG is corporate governance based on Sharia principles. This concept covers general operational management as well as corporate financial management based on Sharia principles. Research [3] and [4] shows that ICG is able to improve performance.. In contrast to the research by [5]-[7] shows that ICG does not contribute to financial performance. This means that good corporate governance has no impact on financial performance. According to [8] Large Islamic Corporate Governance will reduce financial performance in Islamic commercial banks.

The achievement of ICG implementation is of course also supported by the level of Sharia compliance of a company. Sharia compliance covers the company's operations and finances. Sharia compliance in this study includes financial aspects, namely the profit-sharing system which is reflected in profit and loss sharing, Islamic investment, halal income, distribution of funds to stakeholders and also the performance of zakat. Some research results, namely [3] shows the zakat performing ratio (ZPR) is able to optimize financial performance. Islamic Income Ratio (IsIR) and Profit-Sharing Ratio (PSR) have no effect on financial performance. And the results of other studies show that increasing Sharia compliance actually decreases financial performance [8].

The goal of this study is to examine how sharia compliance and ICG affect financial performance. This study is an extension of [3] investigation of the impact of Sharia compliance and Islamic corporate governance on the financial performance of Islamic commercial banks. The equation is that the sharia compliance indicator uses the indicator namely Islamic Income Ratio and the Profit-Sharing Ratio. In order to quantify Sharia compliance, this study added the Islamic Investment Ratio indicator from research [10] and the Equitable Distribution Ratio from research [11]. The study's time frame was five years, from 2015 to 2019.

2 Method

Islamic commercial banks that have been listed on the Indonesia Stock Exchange for the years 2015 through 2019 are the population of this study, provided that they have continuously released annual reports and reports on good corporate governance (GCG) and have not experienced losses during the observation period. The measurement of the dependent variable in this study is shown in Table 1.

A sample of 7 Islamic commercial banks with a total sample of 35 samples. Data analysis uses classic assumptions, namely normality, multicollinearity, heteroscedasticity and autocorrelation. The analytical tool used is Multiple Linear Regression to determine the effect of the independent variable to the dependent.

3 Result and Discussion

The results of the classical assumption test suggest that the data do not experience multicollinearity, homoscedastic, autocorrelation, and normal distribution. Thus, the regression model formed is suitable to be used to solve this research problem

3.1 Multiple Linear Regression Analysis

The results of the multiple linear regression test showed that the calculated F value was 5.096 with a significance level of 0.02 <0.05 so that the model is good (fit). And the results of hypothesis testing are obtained from the calculated t value and the significance value. ICG variable obtained t count of 2.072 and p value $0.04 < \alpha = 0.05$ so that the hypothesis is accepted. The PSR variable t count is 3.96 and the p value is $0.00 < \alpha$

= 0.05, so the hypothesis is accepted. Then for the IIR variable t count -1.01 p value 0.21> α = 0.05, ISIIR t count is -0.69 with a p value 0.49 > α = 0.05 and EDR t count is -1, 52 with a p value of 0.13 > α = 0.05, so the hypothesis is not accepted. The hypothesis testing results are presented in Table 2.

Table 1. Measurement Variable

No	Variable	Definition	Measurement
1	Financial performance	An overview of the company's financial condition in one accounting period. This financial performance is proxied in profitability because it is able to show the company's most prominent financial performance [8]	$ROA = \frac{\text{Profit before tax}}{\text{Total Assets}}$
2	Islamic Corporate Governance (ICG)	Specifically, corporate governance based on Islamic principles, in which operations and economic dealings must adhere to sharia standards and values [4]	Measured by 11 minimum Corporate Governance Assessment criteria disclosed in Islamic bank GCG reports [9]. By examining how the composite predicate was determined: - < 1.5 is excellent (PREDICATE 1) - 1.5 - 2.5 is good (PREDICATE 2) - 2.5 - 3.5 is acceptable (PREDICATE 3) - 3.5 - 4.5 is not excellent (PREDICATE 4) - 4.5 - 5 is not good (PREDICATE 5)
3	Sharia Compliance		
a.	Profit Sharing Ratio (PSR)	Namely the financing of *mudharabah* and *musyarakah* contracts issued by banks [10]	$PSR = \frac{\text{Mudharabah+Musyarakat}}{\text{Total Financing}}$ [11]
b.	Islamic Invesment Ratio (IIR)	Is a halal investment made by Islamic banks [10].	$IRR = \frac{\text{Islamic Investment}}{\text{Islamic Invest + non islamic invest}}$
c.	Islamic Income Ratio (IsIR)	This is the amount of halal income to total income, both halal and non-halal [10].	$IsIR = \frac{\text{Islamic income}}{\text{islamic income + non islamic income}}$ [11]
d.	Equitable Distribution Ratio (EDR)	The amount of funds issued for *qardh*, charity funds, wages and salaries, shareholders and net profit [11].	$EDR = \frac{\text{Average of distribution stakeholders}}{\text{Total Income}}$ [11]

Table 2. Multiple Regression Analysis

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.	Result
		B	Std. Error	Beta			
1	(Constant)	39.159	56.192		0.697	0.491	
	ICG	0.289	0.140	0.296	2.072	0.047	H1 supported
	PSR	5.137	1.297	0.653	3.959	0.000	H2 supported
	IIR	-0.384	0.379	-0.159	-1.012	0.320	H3 not supported
	ISIR	-38.915	56.218	-0.094	-0.692	0.494	H4 not supported
	EDR	-0.264	0.173	-0.222	-1.523	0.139	H5 not supported

3.2 Discussion

The Effect of Islamic Corporate Governance on Financial Performance. ICG improves financial performance. That is, the higher the ICG, the higher the financial performance. ICG is corporate governance based on Sharia principles. Where this concept regulates that the company's operations run properly and correctly in accordance with syairah principles in achieving company goals, so that this ICG directly has a good impact on improving financial performance. The results of this study are supported by [3], [4], namely ICG is able to optimize the performance of sharia banking. In contrast to the results of research [5], [6] that ICG is related to performance and [8] that an increase in ICG reduces Financial Performance.

The Effect of Profit-Sharing Ratio (PSR) on Financial Performance. The results of the study are that PSR is able to improve financial performance. The higher the PSR, the higher the financial performance. This shows that the company (Islamic banking) has fulfilled the rights of the stakeholders. High financial performance shows that the company is able to provide returns to investors, customers and other parties. Consistent with research ([12], [13] that PSR is able to optimize financial performance. And inconsistent with research [3] that PSR has no effect on financial performance, and serta [8] and [14] states that a high PSR will reduce financial performance

The Effect of Islamic Investment Ratio (IIR) on Financial Performance. The results of the study are that IIR has no effect on financial performance. investment applied in Islamic banking is real sector investment. This real sector will improve the profit-sharing system implemented by banks, so that the focus of Islamic banking performance is not only financial performance but also compliance with sharia principles. This research is supported by [3], namely Sharia compliance has no effect on financial performance. In contrast to [14] and [8] namely the magnitude of Sharia compliance will reduce performance.

The Effect of Islamic Income Ratio (IsIR) on Financial Performance. IsIR has no effect on financial performance. Sharia compliant income is all income that does not conflict with Sharia principles. meaning that if there is non-halal income then it will not be included in the company's operating income and will be included in the benevolence fund for the social needs of the community. And financial performance with the Return on Assets measuring instrument, shows the components of all assets owned both by the acquisition of capital and debt. With assets originating from debt, the company will pay an interest expense, resulting in lower operating income [15]. This research is consistent with [3], namely ISIR has no effect on financial performance. Meanwhile [14] stated that an increase in IsIR would decrease financial performance.

The Effect of Equitable Distribution Ratio (EDR) on Financial Performance. EDR has no effect on financial performance. EDR is distribution to all stakeholders. Stakeholders that are prioritized in EDR are qardh and benevolent funds, employee wages, shareholders and net income [11]. And ROA is a measurement of the financial performance of assets owned in generating company profits. this shows that the coverage in EDR and ROA is different, so it has no effect on financial performance. The results of this study are inconsistent with [14] which states that high Sharia compliance will actually reduce financial performance.

4 Conclusion

This study aims to analyze the effect of ICG and Sharia compliance on financial performance in Islamic commercial banks in Indonesia. The results of the study show that ICG and Sharia compliance by proxies Profit sharing ratios have a positive effect on financial performance. And Sharia compliance with proxies' Islamic investment ratio, Islamic income ratio and equitable distribution ratio has no effect on financial performance. The limitations of this study are that the measurement of financial performance still uses the general conventional concept, namely ROA and the sample is only limited to the category of Islamic commercial banks. Future research is expected to use performance measurement tools according to Sharia principles, for example using the *maqasid* index and adding other categories such as Sharia business units and Sharia Credit Banks.

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