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## Financial Performance Mediation in the Influence of Islamic Corporate Governance Disclosure on the Islamic Social Reporting

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**Abstract:** The results of the research on the social role of Islamic banks show inconsistency both domestically and abroad; this is the basis for conducting this research to re-explain the Islamic Corporate Governance (ICG) and Islamic Social Reporting (ISR) relationship, models. This study aims to examine the indirect effect of ICG disclosure on ISR disclosure with financial performance as a mediating variable in Islamic Banking in Indonesia. This study uses secondary data with annual report data sources and financial statements on Islamic banking in Indonesia. They are testing this study using stepwise regression analysis with data for the annual reporting period of 2011 through 2014. The result that financial performance mediates the effect of disclosure of ICG on ISR; this shows that proper management of Islamic banks will produce high financial performance so that they can carry out their social roles well too. The contribution of this study is to develop a new model of the part of financial performance mediating the effect of ICG disclosure on ISR so that it is beneficial for the development of science.

**Keywords:** financial performance, Islamic corporate governance, Islamic social reporting.

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## INTRODUCTION

The concept of CSR in Islam involves a broader meaning into the God consciousness in which firms have roles and responsibilities as servants in all situations, and this is part of the belief system within Islam as the basis of



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social behavior (Elasrag, 2015). According to Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI, 2010), corporate social responsibility is in responsibility discretionary as a financial intermediary for individuals and institutions referred to as Islamic Corporate Social Responsibility (ICSR). Responsible in Islamic institutions is reflected in the operations of Islamic banking, which must play a role in addressing social problems, which are also expected to be responsible for the impact of their activities in society (Maali et al., 2006).

Companies face pressure to maintain profitability and social responsibility (Mohr et al., 2001), such pressure is also experienced by Islamic banks, because Islamic banks do not just focus on the economic benefits alone, but must also be socially responsible in their business activities (Malik & Nadeem, 2014). On the other hand, stakeholders are entitled to information on how far the company carries out ICSR is required to report it in the Annual Report. Haniffa (2002) argues that the reporting of social responsibility can be seen as a corporate response to meet the expectations of society, for Islamic institutions such as Islamic banking reporting expanded social responsibility by incorporating a spiritual perspective called Islamic Social Reporting (ISR). Disclosure of ISR by Islamic banks is a form of responsibility to stakeholders, which is in line with Islamic views aimed at protecting the rights and interests of all stakeholders as a whole (Iqbal & Mirakhor, 2004).

Hasan (2009) states that Islam encourages good corporate governance within the company, because in Islamic concepts, corporate governance aimed at protecting the interests of stakeholders who adheres to sharia principles, this concept is called Islamic Corporate Governance (ICG). Islamic banking is considered to have an ICG model with a high degree of accountability to protect and safeguard the rights and interests of stakeholders (Sairally, 2013). ICG value such as responsibility, transparency, independence, fairness, discipline, professional, caring is a value that has been integrated with the morals of Islam and a Muslims in their activities (Dusuki & Abdullah, 2007). That value is following Islamic Sharia; its implementation can be known by the disclosure (Abu-Tapanjeh, 2009). The existence of ICG disclosures is useful for measuring conformity to sharia values and the resulting impact of Islamic banking governance on social responsibility commitments (Musibah & Alfattani, 2014).

The phenomenon of this research is the inconsistency of research results that effect of ICG on ISR in Islamic banking. The results of study indicating that there is no effect of ICG on ISR or Islamic banking does not pay attention to its social function, namely: Maali et al. (2006); Othman & Thani (2010); Hassan & Harahap (2010); Bukair & Rahman (2015). On the contrary, the results of research indicating that there is influence of ICG on ISR or Islamic banking pay attention to its social function, namely: Othman et al. (2009); Khan et al. (2013); Musibah & Alfattani (2014); Giannarakis (2014); Habbash (2016).

This inconsistency motivates to propose financial performance mediation variable on the effect of ICG disclosure on ISR disclosure in this study, and this is very interesting to do research. Submission of mediation variables in this study for several reasons, namely: the results of previous research indicate the existence of empirical reasons to propose such mediation variables, namely research effect of ICG on the financial performance of Islamic banking and provide positive findings, such as: Al-Tamimi (2012); Hamza (2013); Mollah & Zaman (2015). Further research that found the results of positive influence of financial performance with social responsibility are: Othman et al. (2009); Rahman et al. (2011); Giannarakis (2014); Anas et al. (2015). The positive influence of ICG on financial performance in Islamic bankings and the financial performance of the ISR support mediation existence of financial performance in the effect of ICG on ISR.

Another researcher whose finding support the mediation argument is Xiaowen (2012), where it is explained that well-performing companies choose to disclose more information to differentiate it from poorly performing companies. This is consistent with the results of Janggu et al. (2007); Hossain (2012) studies concluding that sharia business institutions with higher profits will have greater social liability than those with

small profits. The explanation provides an understanding that financial performance mediates the effect of ICG on ISR.

From the explanation above, it can be assumed that proper management of Islamic banks can create excellent financial performance so that it will be able to carry out social responsibility well. The pattern of the relationship between ICG and ISR with the mediation of financial performance is one of the innovations in this study. Another renewal is the use of disclosure indexes with content analysis in annual reports for measurement of ICG and ISR variables. The use of disclosures will provide more quality information that guarantees essential information will be explained.

The contribution of this research is to develop a new model and to test the model whether financial performance mediates the effect of ICG disclosure on ISR so that it is beneficial for the development of science in accounting and stakeholder theory in Islamic concepts. Another contribution is to provide input for the regulation of social responsibility obligations specifically for Islamic banks because the current rules are general, specific laws will put pressure on the management of Islamic banks to better comply with these obligations.

## METHODS

The sample of this study is a full sample, in which the entire population is used as a sample. According to Islamic banking statistics published by Bank Indonesia as of April 2015, the number of Islamic banking in Indonesia is 11, and that submits the full Annual Report for the period of research as much as 10. The source of this research data is the Annual Report published from 2011 to 2014.

The dependent variable of this study is the level of ISR disclosure measured using the index of Islamic Social Reporting (ISR) compiled by Hassan & Harahap (2010) consisting of 78 items of disclosures that have been adapted to AAOIFI guidelines. The ISR index classifies its indicators into eight disclosures themes: 1) Ethical behavior, stakeholders' engagement, and customer relations; 2) Corporate governance-board of directors and top management (CG-BD and TM); 3) Shari'ah compliant corporate governance-SSB; 4) The product, services, and fair dealing with supply chain (PS and FDSC); 5) Environment; 6) Employees; 7) Strategic social development; and 8) Research, development, and training. Further assessment is done using scoring where: a) Value 0 if there is no related disclosure of the item. b) Value 1 if there is a disclosure related to the item, if all items have been disclosed, then the maximum value that can be reached is 78.

Independent variable of this research is ICG as for the measurement variable is previous research (Darmadi, 2013). The ICG disclosure index is calculated in the presence of disclosures for each CG mechanism grouped into seven dimensions: 1) Sharia Supervisory Board (SSB); 2) Board of Commissioners; 3) Board of Directors; 4) Board of Committees; 5) Internal control and external auditing; 6) Risk management; and 7) Reporting of CG implementation. Altogether consists of 72 items of disclosures, and then scoring is done as done on the dependent variable.

Financial performance of ROE, as a mediation variable.  $ROE = \text{Net Income} / \text{Total Equity}$ . Previous studies this ratio to analyze performance bank finance or any other type of company (Suteja & Gunardi, 2016). Data analysis in this study is stepwise regression for mediation analysis.

## RESULTS AND DISCUSSION

The following is a descriptive statistic that describes the number of respondents, the minimum and maximum, the average, and the deviation value, and also the coefficient value of variance.

**Table 1 Descriptive Statistics Test Results**

	N	Minimum	Maximum	Mean	Std. Deviation	Variance
ISR	40	0.5666	0.8846	0.7536	0.0808	0.007
ICG	40	0.7778	0.9723	0.9032	0.0459	0.002
ROE	40	0.0229	0.3313	0.1187	0.0915	0.008
Valid N (listwise)	40					

Table 1 explains that for the ISR variable with a minimum value of the ISR disclosure index of 0.5666 and a maximum of 0.8846. The average ISR disclosure index is 0.7536 with a standard deviation of 0.0808; this indicates that the ISR disclosure index value does not experience deviations that are far from the average range. This is supported by the variance coefficient value for the ISR variable of 0.007, which indicates that the variation in the value of the ISR disclosure index in Islamic banks in Indonesia is almost the same. ICG variable with a minimum value of ICG disclosure index of 0.7778 and a maximum of 0.9723. The average ICG disclosure index is 0.9032 with a standard deviation of 0.0459, indicating that the ICG disclosure index value does not experience deviations far from the average range. This is supported by the variance coefficient value for the ICGDI variable of 0.002, which indicates that the variation in the ICG disclosure index value for Islamic banks in Indonesia is almost the same. ROE variable with a minimum value of 0.0229 or 2.3% and a maximum of 0.3313 or 33.1%. The average ROE value in Islamic banks in Indonesia is 0.1187 with a standard deviation of 0.0915; this indicates that the ROE value does not experience a deviation that is far from the average range. This is supported by the variance coefficient value for the ROE variable of 0.008, which indicates that the variation in the value of ROE in Islamic banks in Indonesia is almost the same.

The summary of the hypothesis test results of ICG disclosure influence on ISR disclosure are as follows:

**Table 2 Summary of H1 Testing**

ISR = a <sub>0</sub> + a <sub>1</sub> (ICG) + e			
Description	Results	Sig.	
ICG	0.995717	0.0000	
t-Stat	6.167683		
Adjusted R <sup>2</sup>	0.487114		

Table 2 presents the result that statistically significant levels of 5% of ICG disclosure affect the disclosure of ISR with coefficient of determination of 0.487114, which means independent variables of ICG disclosure can explain the dependent variable of ISR disclosure of 48.7%, with positive coefficient 0.995717, this means that statistically hypothesis one (H1) is accepted.

The summary of the hypothesis test results of ICG disclosure influence on financial performance (ROE) is as follows:

**Table 3 Summary of H2 Testing**

ROE = $b_0 + b_1 (ICG) + e$			
Description	Results		Sig.
ICG	0.861062		0.0054
t-Stat	2.948444		
Adjusted R <sup>2</sup>	0.164763		

Table 3 presents the result that statistically, the disclosure of ICG affects the financial performance (ROE) at the 5% significance level with coefficient of determination of 0.164763, which means the disclosure of ICG can explain the financial performance variable of 16.47% and with the positive coefficient of 0.861062, thus hypothesis two (H2) statistically accepted.

Table 4 shows that it is statistically significant at 5% level that ROE has an effect on ISR disclosure with coefficient of determination of 0.358914 which means that independent variable of financial performance of ROE able to explain dependent variable of ISR disclosure equal to 35.89% and with positive coefficient 0.540716, thus hypothesis three (H3) statistically accepted.

**Table 4 Summary of H3 Testing**

ISR = $c_0 + c_1 (ROE) + e$			
Description	Results		Sig.
ROE	0.540716		0.0000
t-Stat	4.778521		
Adjusted R <sup>2</sup>	0.358914		

Table 5 is a summary of test results whether the financial performance of ROE mediates the effect of ICG on ISR disclosure.

**Table 5 Summary of Hypothesis Testing**

Description	Regression 1		Regression 2		Regression 3		Regression 4	
	ICG → ISR		ICG → ROE		ROE → ISR		ICG → ROE → ISR	
ICG	0.995717	0.0000	0.861062	0.0054			0.958597	0.0000
ROE					0.540716	0.0000	0.333448	0.0019
t-Stat	6.167683		2.948444		4.778521			
F-stat							29.73144	
Adjusted R <sup>2</sup>	0.487114		0.164763		0.358914		0.595699	

Table 5 shows that ICG affects ISR (Sig. < 0.05) under conditions of 0.995717. Regression analysis on ROE (Sig. < 0.05) with disease 0.8610, a higher index of ICG disclosure will improve the financial performance of ROE. Regression analysis of disclosure of ROE (Sig. < 0.05) with the condition as follows: 0.5407. The result of the regression analysis of ICR disclosure on ISR disclosure (Sig. < 0.05) with disease 0.958597. The coefficient of direct influence between ICG disclosure on ISR disclosure is 0.995717, but after the financial performance, ROE controls the relationship with a decrease to 0.958597, then there is partial mediation. From the results of this hypothesis test can be concluded by hypothesis four (H4) is acceptable, which means the performance of ROE mediate the influence of ICG disclosure on ISR disclosure.

The disclosure of ICG has a significant effect on the ISR disclosure, which means that professional Islamic banking management with a high level of compliance with Islamic law and government regulation will increase

the level of social awareness. The top social knowledge on Islamic banking is already reasonable because Islamic banks, in addition to functioning as a profit-oriented institution in its operations, are also required to perform social functions. It also can stimulate banks to become more socially responsible towards the stakeholders in the community. Therefore, Islamic banks, as financial intermediaries are in a unique position in society to encourage activities within it and among its clients and customers. This is because they are capable of directing funds from depositors and customers and allocating them to purposes that require them the most (Musibah & Alfattani, 2014). This positive influence between corporate governance on social responsibility is consistent with the results of previous studies conducted by Othman et al. (2009); Khan et al. (2013); Musibah & Alfattani (2014); Giannarakis (2014); Habbash (2016).

These results support the Stakeholder theory developed by Freeman (1984), in which the argument needs to emphasize the importance of investment in relationships with those who have interests in the company and the stability of this relationship depends on the willingness to share. The leading theory that influences the development of corporate governance is the stakeholder theory that takes into account broader environmental groups of constituents (Mallin et al., 2014). This result also supports the Islamic perspective on social responsibility is that activities carried out must help individuals or communities to improve their living conditions or environment or help them to better comply with religious rules and norms (AAOIFI, 2010).

The disclosure of ICG has a significant effect on the financial performance of ROE; it shows that ICG to Islamic banking in Indonesia will have an impact on increasing ROE. The results of these statistical tests show that extensive ICG disclosure indicates transparency in Islamic banking management, and this will further provide confidence to Islamic banking equity holders. The positive influence of ICG and financial performance is consistent with the results of previous studies conducted by Al-Tamimi (2012); Hamza (2013); Mollah & Zaman (2015). This result also shows that Islamic banking that is run by sharia principles (ICG) which avoids exploitation based on interest, uncertainty, or contracts involving risk or speculation will be able to produce excellent financial performance. When associated with theory, this result supports agency theory, as a relationship between management and owners, ICG which is managed as a morally responsible agent is to optimize the profits of the owners (principal).

Financial performance has a positive effect on ISR; it shows that Islamic banks with excellent financial performance or sufficient funds will quickly carry out social responsibility well. In this case, Inchausti (1997) explains that three theories are used as the basis of a positive relationship between profitability and CSR disclosure. The argument can be used as the basis of the relationship between financial performance and ISR. These theories are agency theory suggesting that companies that make a profit provide more detailed information to support their compensation positions and arrangements. Signaling theory helps that company owners offer good news to avoid undervaluation of their shareholders' value, and political process theory states that companies that make a profit will provide more information in disclosure for their profit recognition. The results of this study support these theories. The results of this study are also consistent with the findings of previous studies, namely: Haniffa & Cooke (2002); Janggu et al. (2007); Othman et al. (2009); Giannarakis (2014); Anas et al. (2015).

The financial performance of ROE mediates the effect of ICG disclosure on ISR disclosure partially. These findings indicate that the management of Islamic banking with high adherence to all shariah regulations, and it will play a role to increase social contribution in Islamic banks. Financial performance plays a role in enhancing the activities offered by Islamic banks to the community but banks focusing on the capacity and efficiency to create value from physical and financial assets carry out more CSR due to their short life and newness of incorporation. This explains that ICG with a good understanding of the science of banking and the economy in general with the support of good understanding also on Islamic laws and muamalat will result in higher financial

performance and higher social responsibility as well. The fulfillment of this mediation also shows that the management of Islamic banking in Indonesia has been able to create a fair financial policy for the operating profit of Islamic banking for the benefit of equity holders and needs such as zakat, qardul Hasan, and other social needs. The findings of this mediation support Resources-based Theory (RBT) which suggests that company resources are heterogeneous, not homogeneous, available productive services come from company resources that provide unique characteristics for each company (Kor & Mahoney, 2004). The uniqueness of character is one of the criteria for the resources of a company in achieving a sustainable competitive advantage (Fahy & Smithee, 1999). ICG is a unique character in the management of Islamic banks, where the uniqueness lies in the existence of Sharia Supervisory Board (Hasan, 2009). In this case, Mollah & Zaman (2015) found the role of the Supervisory Board and its influence on the performance of Islamic banks and reported that performance increased along with the task of the Supervisory Board.

## CONCLUSION

There is an influence of ICG disclosure on ISR disclosure, ICG disclosure effects on the financial performance of ROE, and ROE has an impact on ISR disclosure. The financial performance of ROE mediates the effect of ICG disclosure on ISR disclosure. Thus ROE plays an essential role in the relationship between ICG and ISR in Islamic banking in Indonesia. This study provides several implications, namely: building a new model that results in the financial performance of ROE mediating the influence of ICG on ISR, so it is used as additional knowledge for accounting literature, as a reference to assess the governance of Islamic banking in Indonesia. Another implication is as a reference for stakeholders in evaluating the extent of social responsibility of Islamic banking in carrying out the mandate. To gain a stronger generalization and because the number of population of Islamic banking in Indonesia is still small, subsequent research does not limit only the banking sector, but also in other areas such as insurance. It should be tried with other financial performance that may be fully mediated, not just profitability performance, but liquidity, because it is possible to be more flexible in implementing social programs.

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