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Implementing Islamic Corporate Governance (ICG) And Islamic Social Reporting (ISR) In Islamic Financial Institution (IFI)

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Abstract

Today CSR also growing in Islamic Financial Institution (IFI). This study aims to explain ICG relations with the ISR on its Islamic banking in Indonesia based on the study of literature and research results on similar theme. Various studies have been conducted to assess the effectiveness and determinants of ICG in Indonesia. Determinant of ICG, among others existence and composition of the membership of the Shariah Supervisory Board, the size and composition of the Board of Commissioners, Board of Commissioners frequency, size and composition of the audit committee, and the number of audit committee meetings.

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1. Introduction

Lately, CSR is not only growing in the conventional economy, but also on the Islamic economics, namely the Islamic bank as one of the Islamic Financial Institution (IFI). Shariah-based industries are experiencing rapid development is the banking industry. Based on data from Statistics Islamic Banking (Bank Indonesia, 2012) stated that the number of Islamic Banks in 2006 amounted to 3 (three) banks 349 offices. Meanwhile, until the end of 2012

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the number of Islamic banks which experienced significant increase is 11 (eleven) banks higher than in 2006 with 1745 offices.

It shows that the growth of Islamic banks in Indonesia is quite rapid. According to surveys conducted and reported in Global Islamic Finance Report (CIMB Islamic, 2012) Indonesia ranked the seventh in the development of Islamic banking in the world (Wardayati and Wulandari, 2014). Islamic banking firm as a service company whose one of the success depends on the trust of customers would have to implement corporate governance and CSR which is in accordance with the principles of Islamic teachings. In Islamic principles, God Almighty is also one the company's stakeholders.

Various studies with Islamic Corporate Governance and Islamic Social Reporting topic have been carried out. Maali, *et al.* (2006), which used samples from 29 Islamic banks in Muslim countries, showed that only eleven banks (38%) that express its social responsibility in accordance with the standards set by AAOIFI. Results of this study indicated that 62% of Islamic banks do not disclose their social responsibility as expected.

The research of Wardayati and Wulandari (2014) who did comparison of CSR between Indonesia and Malaysia with content analysis explains that there is no Islamic bank in Indonesia and Malaysia implementing social responsibility perfectly or achieve score of 100% based ISR index model. Several factors causing is the limit understanding of the concept of Islamic Social Reporting in the Islamic banking industry in Indonesia and Malaysia. Another factor is due to the development of ISR indexes in Indonesia and Malaysia are still slow, because the index ISR is new and is still not widely known by the Sharia Company. Generally, disclosure standards which are often used by companies in the world is the index of the Global Reporting Initiative (GRI). Moreover, as there are no more detailed regulations regarding the ISR and ISR indexes, the disclosures made by Islamic banks are still less specific.

Maali *et al.* (2006) also found that social issues are not priority for the majority of Islamic banks in CSR reporting. This may reflect the fact that most Islamic banks operating in developing countries, where social concerns, especially environmental issues, are considered as less important (Belal, 2000 in Maali, 2006).

Based on the background above, this study aims to explain the relationship between Islamic Corporate Governance and Islamic Social Reporting (ISR) on Islamic banking in Indonesia. This study used qualitative approach with the method of literature review, such us book and journal or article with the topic ICG and ISR research.

2. Literature Review

2.1. Islamic Social Reporting (ISR)

In the context of Islam, social responsibility of individuals mentioned in the Quran and Sunnah also applied to the company. In line with this concept, the main goal of Islamic bussiness is to obtain the pleasure of God (Allah SWT) by obeying the Quran and Sunnah. Islam considers work or business as a form of worship to Allah SWT. Business aim for making profit is recognized, but this aim must be achieved in sharia ways (Maali *et al.*, 2006). ISR Index is an extension of the conventional reporting framework which does not only contains material aspects, moral, or social, but also reveals some matters relating to Islamic principles such as zakat, compliance status on sharia, and the transaction is free from elements of riba and gharar as well as social aspects such as sodaqoh, waqof, qordul hasan, until the disclosure of worship in the corporate environment. There are six themes in the ISR index (Othman, *et.al*, 2010), namely: (a) Investment and Finance, (b) Products and Services, (c) Employee, (d) Social, (e) environment, and (f) Organizational Governance.

2.2. The Teory of Legitimacy

Theory of legitimacy is one of the theories that underline the CSR disclosure. Davis (1973) in Wood (1991) states that "society gives legitimacy and authority on business" In the long-term business that do not use power in a way that is deemed responsible by the community, will tend to lose these powers".

There are some works need to be done in managing the company's legitimacy to be effective (Dowling and Pfeffer, in Hadi, 2011):

- a) Doing Identification, communication and dialogue with the public.
- b) Communicating social values, environmental, and building the perception of the company.
- c) Doing strategy of legitimacy and disclosures regarding to CSR.

2.3 Islamic Corporate Governance

2.3.1 Sharia Supervisory Board (SSB)

Dewan Pengawas Syariah (DPS) is a general term used in Indonesia to describe sharia internal control institution in Islamic banks. In other countries, DPS is also known as Sharia Supervisory Board (SSB), or Sharia Committee, or Sharia Council, and so on. Arrangement of the membership numbers of SSB is different for each country, but has the same functions and duties (Akbar, 2008 in Charles and Chariri, 2012). SSB position in the organizational structure of Islamic banks is equivalent to the board of commissioners. In Indonesia SSB is responsible to the Dewan Syariah Nasional (DSN) or National Sharia Board (NSB) and Indonesian Bank. SSB plays an important role in the regulatory process in Islamic banks. They also have the authority to give advice and warn the management of Islamic banks on the management and manajamen policy in relation with the compliance on Islamic principles. Karim, 1995 (in Farook and Lanis, 2005) illustrates that the authority of the SSB is the same as the authority of the external auditor.

2.3.2 Compositition of SSB Expertise

The principal duty and the main concern of the SSB is in sharia compliant. So it can not be denied that the expertise in Islamic law is required for SSB. But the competencies in finance or banking are also necessary (Akbar, 2008 in Charles and Chariri, 2012). Cetainly, it would be difficult to determine (*istimbat*) the lawful and unlawful activities or even bank product, if SSB is only competence in Islamic law without understanding banking practices.

GSFI 1 of "the Sharia Supervisory Board: Appointment, composition, and reports", particularly the second paragraph providing recommendations on the composition of the membership of SSB. Sharia bank must demonstrate and raise SSB with primary competencies in *fiqh muamalah*, However an expert of Islamic financial institutions, financial expert or banking with knowledge of *fiqh muamalah*, need to be promoted. Regarding with the disclosure of CSR, allegedly that Islamic bank with SSB that has competence in the field of finance and banking will perform better CSR disclosure (Charles and Chariri, 2012).

2.3.3 Size and Composition of the Board of Commissioners

Said, et al., (2009), in the publication of his research suggested that the Boards of Commissioners is one of the most important elements in the corporate governance mechanism. Boards of Commissioners play an important role in controlling the implementation of the company's business which is managed by their Boards of Directors as well as possible. Said, et al. (2009) also found no significant association of those two variables. Meanwhile, previous studies (Sembiring, 2003) found positive and significant relationship between Board Size and CSR disclosure. Sembiring (2003) states that the greater size of the board of directors, the more extensive the disclosure of company's cosial responsibility will be. The larger size of boards of commisioners, the more easily to control the CEO (top management) and monitoring activities will be more effective. If it is linked to CSR disclosure, the pressure on management will be hihger (Charles and Chariri, 2012).

2.3.4 Frequency of Meetings of the Board of Commissioners

Charles and Chariri (2012) states that the board of directors as the topof the company's internal management system has a role to oversight activities. Therefore, the Boards of Commissioners should be able to oversee the performance of the board of directors, so the performance meets the interests of stockholders. The most important point is the independence of the Boards of Commissioners, in the sense that the commissioners should have the ability to discuss issues without management interference, complited with sufficient information to make decisions, and participate actively in setting the agenda and strategy. According to the study (Murniati 2010, in Charles and Chariri, 2012) the frequency of commisioners' meetings affects the performance of the company's market value. This proves that the more frequent of the commissioners meeting, the better of company's performance stimulated.

2.3.5 The size and composition of the Audit Committee

Sembiring (2003) found positive and significant relationship between the size of the audit committee with the disclosure of corporate social responsibility. The larger size of the audit committee, the wider disclosure of CSR will

be. This is because the larger size of the audit committee, the more effective the audit committee's role in controlling and monitoring the top management.

2.3.6 Number of Meetings of Audit Committee

The more intense the Audit Committee to conduct a meeting or conference, the better coordination of committee will be and the more effective duty the audit committee will have. Putri (2009) in Charles and Chariri (2012) states that the number of meetings of the Audit Committee has significantly affect the disclosure of company's profits. Means that the more frequent the Audit Committee's meeting conducted the more transparent corporate profits disclosure will be, including the company's CSR disclosure.

3. Research Method

This study used qualitative approach with the method of literature review. Literature-based research is a form of research that uses literature as an object of study. The literature reviewed is books and journals or articles with ICG and ISR research topics.

4. Result and Disussion

Corporate governance in Islamic perspective always associates the concepts of the behavior in the business governance with things that are transcendental and faith. This is a consequence of Muslim's faith to *Allah SWT*. So, the value of *Tauhid* (monotheism) is the basis for any belief, thought and behavior of a Muslim, including in the understanding of corporate governance. One of the principles of *Tauhid* (monotheism) is the principle of accountability and justice. The value of Islam always encourages its people to be fair in every aspect, both in the matters of faith, Sharia, or morals as the consequence of faith and to achieve the degree of piety. As written in *Surah Al-Maidah* verse 8, namely:

" O you who have believed, be persistently standing firm for Allah, witnesses in justice, and do not let the hatred of people prevent you from being just. Be just; that is nearer to righteousness. And fear Allah; indeed, Allah acquainted what you do. "(Qur'an, 5: 8).

In line with the above verse, one of the principles in the implementation of corporate governance is accountability and fairness (equality or justice) which is intended to bring the management of the company fair to all stakeholders. If it is associated with sharia, justice should include spiritual and material aspects. Then the meaning of fair can be expanded at any principles contained in the Corporate Governance and other values that can be raised over the implementation of justice. Khoirudin (2013) argues that legitimacy theory can be used to explain the relationship between good corporate governance structure with CSR disclosure of Islamic banking, the Board of Commissioners, Audit Committee, the existence of the Sharia Supervisory Board, and the composition of the Sharia Supervisory Board's expertise. Good corporate governance can encourage management to disclose CSR, to fulfill the regulation of Indonesian Bank and the functioning Islamic banks to seek the welfare of society.

Haniffa (2002) suggest that the Islamic Social Reporting (ISR) is needed by the Muslim community as form of responsibility to Allah and society, as well as to improve the transparency of business activities by providing relevant information concerning the suitability for the spiritual needs of Muslim stakeholders. ISR index contains CSR standards items set by AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions). Fitria and Hartanti (2010) states that the ISR index is believed to be a starting point in terms of CSR disclosure standards in accordance with the Islamic perspective.

According to Haniffa (2002) the purpose of social reporting in Islamic perspective is as follows:

- Demonstrating accountability to God and the community.
- Improving the transparency of business activities by providing relevant information watching the spiritual needs of Muslim investors in decision-making.

Regarding to the CSR practices in Islamic banking institutions, according to Ahmad (2002) in Fitria and Hartanti (2010), an institution that does business based on sharia is essentially based on the philosophy of Al Qur'an and As-Sunnah, so it can be the basis for the business in interacting with the environment and others. CSR in Islamic banking

must be believed and understood as integral part in being consistent to Islamic principles of Islamic banking operations. Islamic CRS program should be touching the basic needs of society for economic empowerment to be better (Joseph, 2010 in Charles and Chariri, 2012). The basic philosophy is religious, so it should be believed that the relationship with the community (stakeholders) will be more sustainable than the conventional one CSR pattern (Assegaf, et al. 2012).

In line with the increasing of CSR implementation in the context of Islam, the desire to create Islamic Social Reporting or ISR is also increasing. One of ways to assess corporate social responsibility reports by sharia is using Islamic Social Reporting (ISR) Index. Islamic Social Reporting (ISR) uses the Islamic principles as a basic foundation. Islamic principles in the ISR produce the material, moral, and spiritual aspects that became the main focus of social reporting companies (Gestari, 2014).

The theory on the relationship between Islamic Corporate Governance and Islamic Social Reporting formed from variety of opinions and empirical evidence of research results with related themes. The following table summarizes some of the research related to good corporate governance and disclosure of ISR is presented in the following table:

Table 1. Research Summary of ICG and ISR Result.

No	Researcher and Year	Findings
1	Ningrum, Fachrurrozie, and Jayanto (2013)	<ol style="list-style-type: none"> 1) Simultaneously financial performance, institutional ownership, and the size of the sharia supervisory board affect on the disclosure of ISR. 2) Partially institutional ownership and the size of the sharia supervisory board affect on the disclosure of ISR. 3) Financial performance variable does not affect on the disclosure of ISR.
2	Amirul Khoirudin (2013)	<ol style="list-style-type: none"> 1) The size of the board of commissioners proved to have significant positive effect on the disclosure of ISR. 2) The size of the sharia supervisory board does not affect to the disclosure of ISR.
3	Charles dan Chariri (2012)	<ol style="list-style-type: none"> 1) Variable Islamic Governance, board size, and the audit committee meeting have significant positive effects on the level of CSR disclosure. 2) Variable composition of the independent board and profitability does not significantly affect to the level of CSR disclosure. 3) While the variable frequency of board meetings, audit committee size and composition of the independent audit committee have significant negative effects on the level of CSR disclosure.
5	Assegaf, Falikhatun, dan Wahyuni (2012).	<ol style="list-style-type: none"> 1) Variable board size has significant positive effect on the volume of disclosure of ISR. 2) Variable managerial ownership has significant negative effect on variation of ISR disclosure. 3) While the variable cross-Directorship and ownership diffusion do not affect the volume and variety disclosure of ISR.

From the results of these studies we can conclude that Islamic corporate governance which is proxied by the Sharia Supervisory Board affects the Islamic Social Reporting. Sharia Supervisory Board in considerable amounts with various perspectives and experience can lead to a review on better corporate reporting, especially in terms of corporate governance and corporate social reporting.

Nevertheless, some research results also indicate that the presence of the Sharia Supervisory Board does not affect the variety and broad disclosure of Islamic Social Reporting. This indicates that not all Islamic banks operating in Indonesia reveal its Islamic social activities. Therefore, the authors suggest to Islamic banks to be more concerned with social program activities and express it in the annual report completely. It is even better, if the Islamic Social Reporting is separately reported, apart from the company's annual report.

The complete, clear, and adequate ISR reporting will make it accessible, which will have an impact on improving the company's image. This will ultimately improve the financial performance of banks, which would impact the increase in profits and variety of social activities. So in the end it will create a shared value between banks and mutual societies. Shared value is also in line with the concept of "Falah" in Islamic economics.

Conclusion

Today CSR is not only growing in the conventional economy, but also on the Islamic economics, namely the Islamic bank as one of the Islamic Financial Institution (IFI). Islamic banks as service companies whose success depends on the customer's trust should implement corporate governance in accordance with the teachings of Islam, the Islamic corporate governance (ICG). The effectiveness of the implementation of ICG is reflected in the Islamic Social Reporting, an index of social activity reporting of Islamic banks. Various studies have been conducted to assess the effectiveness and determinants of ICG. Determinant of ICG, among others existence and composition of the membership of the Sharia Supervisory Board, the size and composition of the Board of Commissioners, Board of Commissioners frequency, size and composition of the audit committee, and the number of audit committee meetings. The results of these studies are inconsistent, which indicates that the implementation of the ICG in Islamic banks in Indonesia have not been standardized and optimal.

Limitations of this study is the number of studies reviewed were relatively few, and mostly come from Indonesia. Further research will be better if the number of literature or research reviewed is from various countries, so deeper analysis of the implementation of the ICG and ISR in various countries with different conditions can be done.

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