Islamic Social Reporting in Shariah Banks in Indonesia

Rafrini Amyulianthy*
Faculty of Economic & Business Universitas Pancasila Jakarta

Widyaningsih Azizah
Faculty of Economic & Business Universitas Pancasila Jakarta

Indra Satria
Faculty of Economic & Business Universitas Pancasila Jakarta

ABSTRACT

From the Islamic perspective, the growth of Corporate Social Responsibility became an additional dimension for financial reporting. Islamic Social Reporting (ISR) is becoming a common practice among Shariah Banks in Indonesia. This study attempted to measure the determinants of ISR as practiced by shariah-approved Indonesian banks listed on the Indonesia Stock Exchange, as stated in their annual reports. The three variables used to test the determinants of ISR were company size, profitability, and leverage. Content analysis was used to evaluate ISR and analyze the annual reports of 11 shariah banks during the period 2014–2016. Multiple regression analysis with panel data showed that company size, profitability, and leverage significantly affected the level of ISR. The findings contribute a new dimension to the knowledge of corporate reporting from the religiousity perspective.

Keywords: ISR, firm’s characteristic, shariah banks, panel data

1. INTRODUCTION

For most investors, income is considered to be important information when making an investment decision (Azizah, 2017). As such, every company focuses on generating high profit. One of the ways a company can achieve this is by creating a good image in the community by paying attention to the environment or to its social responsibility in a practice commonly known as Corporate Social Responsibility (CSR) (Kao, Yeh, Wang, & Fung, 2018). One of the objectives of a company in disclosing its environmental, social, and financial performance, via either its annual reports or separate statements, is to reflect its level of accountability, responsibility, and transparency to investors and stakeholders. Such disclosure is aimed at establishing good and effective communication between the company and the public and other stakeholders in terms of how the company is integrating CSR and the social environment into every aspect of its operations (Darwin, 2007). Paying due regard to CSR reflects a firm’s commitment to the development of a sustainable economy and to focus on attaining a balance between attention to both economic aspects and social and environmental issues (Rama & Meliawati, 2014).

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The CSR concept exists not only in conventional economics but also from the Islamic perspective (Lestari, 2013). Sofyani et al (2012) state that a company that is run based on shariah, which is thus based essentially on the philosophy of the Qur'an and Sunnah, will have a basis for the stakeholders to interact with both the environment and each other. Therefore, under the concept of shariah, the relationship between the company and its environment will be stronger than under the conventional business concept, since the latter is based on a business institution, while shariah is based on religious principles.

According to Othman and Thani (2010), with the resurgence of Islam, Muslim decision-makers expect corporations to disclose greater levels of information that will help them in fulfilling their spiritual needs. This is because the current corporate social reporting initiatives, while fulfilling a user's wider needs, lack the most pertinent items from an Islamic perspective, which may impair the judgment of Muslim decision-makers and adversely affect their spiritual wellbeing (Haniffa & Cooke, 2002). Hassan and Mahlknecht (2011) explained that the definitive parameters of Islamic Social Responsibility must be based on the overall achievement of the objectives of the shariah company; to promote good (justice) and forbid evil (injustice), and to protect faith, life, intellect, posterity, and wealth of mankind. As such, the progress of CSR in Islamic economics has increased the public awareness of shariah-based institutions.

In Indonesia, the concept of CSR was already contained in the shariah economy prior to the issuance of Law No. 21 of 2008 on Shariah Banking. The concept is embodied in the source report and the use of zakat funds and benefaction. Moreover, shariah financial institutions began to develop from the banking sector, as pioneered by Bank Muamalat Indonesia in 1992. After the enactment of Law No. 10 of 1998, which was a renewal of Law No. 7 of 1992, the term "Shariah Principles" was used more openly than "profit sharing" and has since given banks a broad opportunity to develop shariah networks. Furthermore, with the issuance of Law No. 21 of 2008 on Sharia Banking, as defined in Article 1 No. 7, a bank that conducts its business activities based on sharia principles is called a shariah bank (Sjahdeini, 2014).

There has been a rapid growth of shariah banking in Indonesia. Hakimah, Ibrahim, and Ismail (2013), based on a survey conducted as part of the Global Islamic Finance Report in 2012, stated that the development of Islamic banking in Indonesia was ranked seventh in the world. Islamic banks are thus service companies whose success depends on the trust placed in them by their customers to implement corporate governance and CSR. This is in accordance with the principles of Islamic teachings, where according to the principles of Islam, God Almighty and also stakeholder in the company (Indrawaty & Wardayati, 2016).

The characteristics of a company greatly affect its level of disclosure in the annual report (Lang & Lundholm, 1993). Gray, Javad, Power, and Sinclair (2001) found a significant relationship between company size and corporate social disclosure. There is also wide variation in the results of research into the relationship between corporate social disclosure and profit. For example, Riahi-Belkaoui and Karpik (1989) and Hackston and Milne (1996) found no association between these variables, while Freedman and Jaggi (1988) and O'Donovan and Gibson (2000) identified a negative association between these variables. In contrast, some of the studies mentioned in Hackston and Milne (1996), such as Bowman and Haire (1976) and Preston and O'Bannon (1997), did find significant associations, while Gray et al. (2001) found

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that the association varied each year for both variables. There have also been inconsistent results for the relationship between leverage and social disclosure. Riahi-Belkaoui and Karpik (1989) and Cormier and Magnan (2003) found a significant negative relationship between the two variables. While Suda and Kokubu (1994) and Kokubu, Noda, Shinabe, and Higashida (2001) found no relationship between the two variables.

This research has attempted to identify the factors determining the level of ISR of Shariah banks in Indonesia since the emergence of ISR has led to the dimension of corporate reporting. These studies have mainly provided conceptual or discussion papers on the need to research ISR (Baydoun & Willet, 1997; Haniffa, 2002; Sulaiman & Willet, 2003). This research is focused on firm characteristics of ISR reporting.

2. LITERATURE REVIEW

2.1 Islamic Social Reporting

Many theories have been developed in the social reporting (SR) literature in an effort to answer the question of why firms disclose social information (Agustiningsih, Murni, & Putri, 2017), where such disclosures are not enshrined in legislation (Gray, Kouhy, & Lavers, 1995). With the rapid development of the Islamic perspective in the Indonesian Capital Market, shariah companies are expected to present a religious dimension to their financial statement disclosures for the benefit of Muslim stakeholders. The objectives of Islamic accounting conceived in conceptual framework and should be based on shariah concepts (Haniffa & Hudaib, 2006). In line with the Islamic concept, the main goal of Islamic business is to obtain the pleasure of God Almighty by following Al Quran and Sunnah. According to Maali, Casson, and Napier (2006), Islam views business as a way of worshiping God Almighty where the business goal of making profit must be achieved in accordance with shariah means. Furthermore, shariah requires transactions to be lawful (halal) and prohibits transactions that contain elements of either interest or speculation. It also requires Muslims to pay their lawful dealings, zakat, to beneficiaries, sadaqa (charities/gifts), wages, the objective of any business ventures and initiatives to protect the environment, and others.

The duty to disclose the truth is a very important issue in the Islamic context and applies as much to businesses as it does to individuals. This duty is emphasized in the Qur'an: "and cover not truth with falsehood, nor conceal the truth when you know (2:42)." Askary and Clarke (1997) state that "six verses of the Qur'an refer to relevance; one meaning of the relevance referred to is disclosure of all facts ()." God does not need humans or businesses to show Him what they are doing because He already knows what people have done, are doing, and will do in the future. However, as accountability to God implies accountability to society, the duty to disclose the truth is owed to the Umma as well as to God. The requirement for Muslims to disclose the truth is intended to help the community know the effect of a person or a business on its wellbeing.

Archer and Karim (2001) identified that Islamic banks use forms of financial instruments in both mobilizing funds for their operations and in providing finance for their clients, and that these instruments comply with the principles and rules of Shariah. The Islamic Social Reporting (ISR) Index was thus created in line with the need for the disclosure of social

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performance in sharia banking (Sofyani, Ulum, Syam, & Wahjuni, 2012). The ISR index is an experimental benchmark for the social performance of sharia banking that contains a compilation of standard items of CSR as specified by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), which was then further developed by researchers to include additional CSR items that should be disclosed by an Islamic entity (Othman, Thani, & Ghani, 2009). In particular, the ISR index is an extension of the social performance reporting standards that include public expectations not only of the company's role in the economy but also from the company perspective. In addition, the ISR index emphasizes social justice regarding the environment, minority rights, and employees. Fitria and Hartanti (2010) explained that there are six dimensions in the ISR index, namely: (a) Investment and Finance, (b) Products and Services, (c) Employee, (d) Social, (e) Environment, and (f) Organizational Governance.

2.2 Firm's Characteristics & Islamic Social Reporting

2.2.1 Size

Larger firms face higher agency costs due to the greater information asymmetries that exist between managers and shareholders (Amyulianthy et al, 2016). Therefore, to reduce agency costs, large companies disclose more information than small companies and they also have greater sources that enable them to disclose at a higher level. According to Cormier and Magnan (2003), larger firms tend to have lower ownership costs of information disclosure as their activities are also exposed via other sources of information. Furthermore, the political cost hypothesis states that larger firms have a strong incentive to improve their reputation.

Company size affects the decision taken by a company to include the information in its annual report. Larger firms also attract the attention of government agencies, and increased disclosure generally reduces government intervention (Andrikopoulos & Diakidis, 2007). Given the need for greater disclosure from large firms, it is expected that larger firms will tend to adopt various methods of disclosure, including the disclosure of financial statements on shariah principles, thereby enabling high levels of disclosure for their Muslim stakeholders (Lestari, 2013; Othman & Thani, 2010).

H_1: Size positively affects Islamic Social Reporting

2.2.2 Profitability

Cormier and Magnan (2003) state that well-performing firms have a greater incentive to disclose more information than firms that are performing less well. In their research on the dissemination of information, Andrikopoulos and Diakidis (2007) showed a negative but not significant relationship. With this result, it is not clear whether the relationship between firm performance and the dissemination of information is positive or negative. Firms that were larger, more profitable, and less access to credit had more specific intellectual information disclosure, in the sense that firms achieving good results tend to publicize their performance. They may thus reveal more information than is required by regulatory agencies and regulations in a bid to connect with investors; for example, to participate in conference meetings.

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On the other hand, companies also pay attention to their position in the competitive market and will thus tend to withhold information that may benefit them. Information disclosure can also result in a company losing its competitive advantage if it provides the market with too much information. This is another reason why managers will be less willing to disclose. As such, it still cannot be determined whether the performance of the company will have a positive or negative influence on information disclosure dissemination.

H_2: Profitability has no effect on Islamic Social Reporting

2.2.3 Leverage

According to Jensen and Meckling (1976), the debt–equity ratio creates agency costs. Francis and Schipper (1999) asserted that explicit restrictive covenants can mitigate potential conflicts between bondholders and shareholders. Management may disclose voluntarily for monitoring purposes and reassure debt holders about the ability of the company to pay its obligations. Almilia (2009), in her research, confirmed that explicit restrictions can reduce the potential for conflict between bondholders and shareholders. Management thus voluntarily discloses for monitoring purposes and to satisfy lenders as to the company's ability to pay its obligations.

In line with the increase in debt, management may use additional measures of ISR, such as providing information on debt payments, information on debtor debt amounts, and other information, so as to enable lenders to continue to monitor and interact with the company. Riahi-Belkaoui and Karpik (1989) showed that leverage has a negative and significant relationship with social reporting. This is based on agency theory wherein management with high leverage will seek to reduce its social activities in order to avoid creditor scrutiny.

H_3: Leverage negatively affects Islamic Social Reporting

3. METHODOLOGY

3.1 Samples

A total of 11 (eleven) Syariah Banks in Indonesia published annual reports for 3 (three) consecutive years during the period 2014–2016. Data were collected from the Indonesia Stock Exchange directory using the documentation technique.

3.2 Measurement of Variables

Islamic Social Reporting Index

The ISR index comprised 38 items grouped into 6 (six) topics that were adapted from Othman and Thani (2010). In the content analysis, an item had a value of 1 if it was disclosed by the company, otherwise it was 0.

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The following formula was used for the scoring of the ISR index:

$$\text{Islamic Social Reporting Index} = \frac{\text{Number of items disclosed}}{\text{Number expected to be disclosed}}$$

Size

Size was measured using the Ln of Total Assets as obtained from the year-end financial report of the company. Ln of Total Assets has frequently been used to determine company size (Botosan & Plumlee, 2002; Francis & Schipper, 1999; Siregar & Bachtiar, 2010).

Profitability

Profitability in this research was measured using Return On Equity (ROE), which is the ratio between net income after taxes and total equity (Leuz & Verrecchia, 2000; Lundholm & Myers, 2002).

Leverage

Leverage was measured using the debt to asset ratio (DAR), which indicates the ratio of total debt to total assets (Lundholm & Myers, 2002).

3.3 Research Model

Following assumption testing, multiple linear regression analysis was conducted to test the hypotheses in this research. The regression model used in this research is given as follows:

$$\textbf{Islamic Social Reporting Index} = \alpha + \beta_1\textbf{Size} + \beta_2\textbf{Profit} + \beta_3\textbf{Leverage} + \textbf{e} \qquad \textbf{(1)}$$

3.4 Data Analysis

The data analysis procedure used in the multiple regression analysis was Ordinary Least Squares (OLS) using the panel data approach. When using panel data, the following three approaches may be used: common effect, fixed effect, and random effects. This research was conducted using random effects.

4. RESULTS & DISCUSSION

4.1 Descriptive Statistics

Table 1 Panel A shows the descriptive statistics for ISR. The mean ISR disclosure is 19.5, with the most disclosed item being finance and investment. This indicates that firms considered finance and investment to be the most important item for disclosure. This is not surprising since finance and investment signify whether a firm is interest-free (*riba*) and speculative-free (*gharar*) as these are strongly forbidden (*haram*) in Islam, as mentioned in the Quran. In addition, shariah principles must be obeyed and this has a direct relationship with

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the economic benefit that a firm will receive, which is increasing in customers of credits borrowers.

The descriptive statistics for the other variables used in this study are presented in Table 1 Panel B. The mean leverage is 0.158, and there is only a small variation within samples. Profitability and firm size are 7.533 and 30.215, respectively, with little variation shown within the sample. On average, our samples are profitable firms; hence, it may not be possible to generalize our results to loss-making firms and also produce positive returns.

Table 1. Descriptive Statistics
Panel A: Islamic Social Reporting

Item Disclosed	Mean	Max.	Min.	St.Dev
A. FINANCE AND INVESTMENT				
1. Riba activities	1.000	1.000	1.000	
2. Gharar	1.000	1.000	1.000	
3. Zakat: method used, zakatable amount, beneficiaries	0.879	1.000	0.000	
4. Policy on late repayment and insolvent clients/ bad debts written off	0.848	1.000	0.000	
5. Current value balance sheet	0.848	1.000	0.000	
6. Value added statement	0.424	1.000	0.000	
Total	**0.833**	**1.000**	**0.000**	
B. PRODUCTS AND SERVICES THEME				
7. Halal status of the product	0.879	1.000	0.000	
8. Product safety and quality	0.879	1.000	0.000	
9. Customer complaints/incidents of non-compliance with regulation and voluntary codes (if any)	0.727	1.000	0.000	
Total	**0.828**	**1.000**	**0.333**	
C. EMPLOYEES THEME				
10. Nature of work: working hours, holidays, other benefit	0.636	1.000	0.000	
11. Education and training	1.000	1.000	1.000	
12. Equal opportunities	0.818	1.000	0.000	
13. Employee involvement	0.818	1.000	0.000	
14. Health and safety	0.818	1.000	0.000	
15. Working environment	0.788	1.000	0.000	
16. Employment of other special interest groups (i.e., handicapped, ex-convicts, former drug addicts)	0.000	0.000	0.000	
17. Higher echelons in the company perform the congregational prayers with lower- & middle-level managers	0,000	0.000	0.000	
18. Muslim employees are allowed to perform their obligatory prayers during specific times & fast during Ramadhan on their work days	0.000	0.000	0.000	
19. Proper place of worship for employees	0.000	0.000	0.000	
Total	**0.488**	**0.600**	**0.100**	

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D. SOCIETY THEME			
20. Shadaqah / donation	0.879	1.000	0.000
21. Wakaf	0.242	1.000	0.000
22. Qard hassan	1.000	1.000	1.000
23. Employee volunteerism	0.182	1.000	0.000
24. Education school adoption scheme scholarships	0.515	1.000	0.000
25. Graduate employment	0.788	1.000	0.000
26. Youth development	0.697	1.000	0.000
27. Underprivileged community	0.758	1.000	0.000
28. Childcare	0.758	1.000	0.000
29. Charities / gifts / social activities	0.758	1.000	0.000
30. Sponsoring public health / recreational projects/ sports / cultural events	0.758	1.000	0.000
Total	**0.667**	**1.000**	**0.091**
E. ENVIRONMENT			
31. Conservation of environment	0.303	1.000	0.000
32. Endangered wildlife	0.000	0.000	0.000
33. Environmental education	0.212	1.000	0.000
Total	**0.172**	**0.667**	**0.000**
F. CORPORATE GOVERNANCE			
34. Shariah compliance status	0.879	1.000	0.000
35. Ownership structure: number of Muslim shareholders and their shareholdings	0.000	0.000	0.000
36. Board structure: Muslim vs. non-Muslim	0.000	0.000	0.000
37. Forbidden activities: monopolistic practice, hoarding necessary goods, price manipulation, fraudulent business practice, gambling	0.939	1.000	0.000
38. Anti-corruption policies	0.424	1.000	0.000
Total	**0.448**	**0.600**	**0.000**
Total Islamic Corporate Index	**19.50**	**0.816**	**0.105**

Panel B: Variable Used

Variables	Mean	Max.	Min.	Std. Dev
Islamic Social Reporting Index	19.50	0.816	0.105	0.290
Size (Total Assets)	30.215	31.765	28.728	28.980
Profitability (Return on Equity)	7.533	49.050	0.440	9.082
Leverage (Debt to Asset Ratio)	0.158	0.306	0.082	0.066

4.2 Normality

A normality test was performed to determine the normality of the data based on the principal assumption that the residuals have a normal distribution if all points lie on the line. The results show that the residuals are normally distributed; therefore, all of the assumptions are met for the three years of the study. After satisfying both assumptions, this study concluded that the data were normally distributed and regression analysis could be performed (*refer to Appendix*).

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Correlation among the independent variables was computed using the variance inflation factor (VIF) and tolerance statistic to determine the existence of multicollinearity. The test results revealed no tolerance less than 0.2 and no VIF greater than 10. Such results indicate that there is no problem of multicollinearity between company size, profitability, and leverage (*refer to Appendix*).

4.3 Factors determining Islamic Social Reporting

The regression results are presented in Table 2 (with ISR as the dependent variable). The F-statistic indicates that all of the independent variables affecting ISR are significant and are able to significantly explain the variation of the dependent variable.

The table shows relatively consistent results. Firm size, as measured by total assets, has a positive and significant effect on ISR (thus H_1 is not rejected). This suggests that larger firms have more resources to devote to shariah social activities and a larger asset base over which to spread the costs of social responsibility (Lerner, 1991). Larger shariah firms also face more pressure to disclose their shariah social activities from various groups in society. This result is consistent with Hackston and Milne (1996), Gray et al. (2001), and Sembiring (2005). Profitability, measured by ROE, also has a positive and significant effect on ISR (thus H_2 is rejected). This means that that well-performing firms have an incentive to disclose more information. Firms that were larger, more profitable, and had less credit had more specific intellectual information disclosure. Companies with good performance tend to publicize it as a means of connecting with investors. This is consistent with Edwards (1999), who found a positive relationship between environmental and financial performance.

Meanwhile, leverage, as measured by the DAR ratio, has both a negative sign and significant effect on ISR (meaning H_3 is not rejected). These results confirm our prediction that too much debt will lead to greater scrutiny from creditors; hence, a reduction in both the amount of information disclosed and DAR are good measures of the power of creditors to monitor management, and this result is in line with Riahi-Belkaoui and Karpik (1989), who found that leverage has a negative and significant relationship with social disclosure.

Table 2. Factors Determining Islamic Social Reporting

Variables	Hypothesis	Coefficient	t-statistic	p-value
C		-0.325200	-0.390104	0.2324
TASSETS	+	0.025080	4.002.998	0.0002***
ROE	n.a	0.020187	5.854.942	0.0246**
DAR	-	0.008391	-2.520.643	0.1002*
Adjusted R-squared	0.3401			
F-statistic	6.8254			
Prob(F-statistic)	0.0010			

Notes: Significant at *10, **5, and ***1 percent, respectively; see equation (1); ISRI, Islamic Social Reporting Index; TASSETS, natural logarithm of total assets; ROE, return on equity; DAR, debt to asset ratio

5. CONCLUSION

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Recently, there has been a growing awareness of the need to put more pressure on firms to engage in social reporting. By paying due attention to their environmental and/or social responsibility, firms are able to construct a good image in the community. Eventually, this pressure will result in them undertaking social activities that they disclose in their annual report. Islamic banks have grown in size and significance during the past decades. In line with Islamic principles, Islamic banks should fulfill the ethical role inherent in their character. However, since social reporting continues to be based on voluntary disclosure, it is interesting to observe the factors that determine the level of social reporting within shariah firms.

This paper intended to investigate the effect of firm size, profitability, and leverage on ISR. We have found consistent evidence that firm size has a positive and significant relationship with ISR. These results confirm our prediction that larger firms have more resources to devote to social activities and a larger asset base over which to spread the costs of social responsibility. Larger firms also face greater pressure to disclose their social activities from various groups in society. Profitability was also found to have a positive and significant relationship with ISR. Well-performing firms have an incentive to disclose more information as they can publicize their good performance as a means of connecting with investors. However, leverage has both a negative sign and a significant effect on ISR, which confirms our prediction that too much debt will lead to greater scrutiny from creditors and hence reduce the amount of information that is disclosed.

This study has several limitations. First, the factors affecting ISR were limited to firm size, profitability, and leverage. Second, our observations were drawn from only a very limited period of time. Third, this study used only the annual reports of Islamic banks to measure ISR disclosure. It is likely that Islamic banks also use other forms of media to communicate with both investors and wider society, such as company websites, press releases, annual general meetings, special booklets, and pamphlets detailing their contribution to society. Thus, by employing a larger sample and a wider set of information or variables about the operating environment and individual characteristics of Islamic banks, future research can attempt to further generalize these results and enhance knowledge about the effect of other factors not theorized in this study, particularly regarding transparency and social responsibility and the ensuing disclosure of Islamic social activity.

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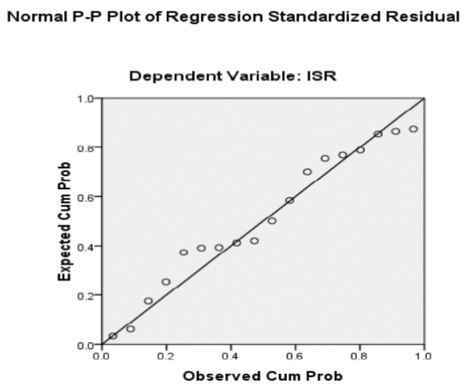
APPENDIX

Normality test – P-Plot test



Multicollinearity Test

Variable	Collinearity Statistics	
	Tolerance	VIF
SIZE	0.430	2.326
PROFIT	0.455	2.199
LEVERAGE	0.950	1.052

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