Analysis of the Indication of Islamic Label on Good Corporate Governance (GCG) of Islamic Entities in Indonesia

Khairun Amala[1], Junino Jahja[2]
{khairunamala11@gmail.com[1]}

Universitas Indonesia, Indonesia[1, 2]

Abstract. Researchers examine the Islamic label on corporate governance in Indonesia. Listed companies under the Islamic label (sharia-based entities) are characterized by low debt. Recent evidence shows that leverage can be used as a substitute for good governance. This encourages researchers to see whether these sharia-based entities have better governance than non-Islamic ones. The data of this research are collected through Refinitiv Eikon screener. The selection of observations is based on the financial ratios as stated by IDX Islamic; (1) interest-based liabilities to Total Assets is no more than 45%, and (2) interest income and other non-Islamic income to Total Revenue is no more than 10%. The analytical methods this research used is Panel-based Regression for testing hypothesis (α=5%). After controlling for the variables that affect governance, the results show that the Islamic label on companies with Islamic stocks has no significant effect on governance. This is due to the calculation of the CG score has implicitly accommodated ethical business conduct which is the framework of business based on Islamic values, so that the CG variable contains information similar to the Islamic dummy. This might cause the results of this study is insignificant.

Keywords: Agency Problems, Corporate Governance (CG), Islamic Finance, Leverage

1 Introduction

The Islamic capital market industry has grown rapidly since 2008 in Indonesia. The growth of sharia investors can be seen from the latest OJK publication on the development of Islamic finance in 2018. Based on the report, the number of Islamic capital market investors in 2018 was 44,536. In the latest OJK report (2019), sharia investors showed a growth of 54.03% or equal to 68,599 investors. It means many investors are interested to invest in Islamic companies.

Companies registered as sharia companies have passed the screening conducted by the OJK the *Otoritas Jasa Keuangan* (OJK). The characteristics of Islamic companies can be seen from two sides, namely the business and the financial side. In term of business side, this screening ensure that the company's main business is not included in prohibited categories such as dealing with riba (usury), gambling, selling liquor, and other non-halal products. Based on financial characteristics, total interest-based debt compared to total assets owned by sharia companies should not exceed 45%. In addition, the total non-halal income compared to the total income must not exceed 10% (OJK, 2018). From this screening criteria, it is known

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that the total debt of companies with a sharia label (Islamic label) tends to be lower than the debt of companies without sharia label.

Several studies have tried to clarify the relationship between debt and the quality of corporate governance, namely the better the quality of corporate governance, the lower will be the debt owned by the company. In 1998, Sengupta developed a study that provides evidence that companies with a high disclosure quality ratings of corporate finance have a lower debt. The study of Anderson et al. [1] and Ashbaugh-Skaife [2] also find that firms with strong corporate governance have a lower costs of debt. Because companies with Islamic labels (sharia companies) have low debt (namely Islamic stocks), and low debt indicates good corporate governance quality of a company, so Islamic label may indicate good governance quality indirectly.

If the quality of corporate governance is related to debt and Islamic label for stocks shows that debt is low, then the Islamic label may also improve corporate governance indirectly. The main contribution of this research is to analyze this premise. The researcher will also study the impact of the Islamic label on GCG score, whether it is driven by leverage or not. In the specification where the researcher will control leverage and other criteria used when choosing Islamic stocks, researcher will also see how the influence of the Islamic dummy is. In this specification, the researchers will control for almost all of the variables previously discovered that affect the quality of governance and will also correct for specified industries and time effects. Therefore, the influence behind this Islamic label can be clearly seen.

2 Literature Review

2.1 Panel Data

The type of data used in this study is panel data because the data consists of more than one company (cross-section) and in more than one period of time (time-series). By combining the time series of observations between companies, the analysis on this panel data provides more informative data, more variability, less collinearity between variables, more degree of freedom, and more efficiency. There are three panel data estimation techniques that can be used according to Gujarati and Porter [3].

2.2 Pooled Ordinary Least Square (POLS) Model

Pooled OLS Model is a type of model that has a constant coefficient, referring to the intersection and slope. By using POLS, the author assumes that the regression coefficients for all subjects (companies or individuals) are the same. It means, there are no unique differences recognized between one subject and another [3]. The POLS equation model is as follows:

$$Y_{i,t} = \alpha + \beta X_{i,t} + \varepsilon_{i,t}$$

2.3 Fixed Effects Model (FEM)

Unlike the POLS model, the Fixed Effects Model allows heterogeneity among subjects by allowing each subject to have their own intercept value because this model uses a dummy variable technique [3]. This dummy variable can function as a controlling variable so as to reduce the possibility of interaction bias between the dependent and independent variables. The weakness of the fixed effect is that if you use too many dummy variables, the degree of

freedom will decrease a lot, as a result, the model will lack observations to perform meaningful statistical analysis. The equation model for FEM is as follows:

$$Y_{i,t} = \alpha_1 + \alpha_2 D_{2,i} + \alpha_3 D_{3,i} + \cdots + \alpha_n D_{n,i} + \beta_2 X_{i,t} + \beta_3 X_{i,t} + \cdots + \beta_n X_{i,t} + \varepsilon_{i,t}$$

2.4 Random Effect Model

Weaknesses in the Fixed Effects Model that reduce the degree of freedom due to the addition of a dummy variable can be overcome by the Random Effects Model. Instead of making a different intercept for each subject, REM assumes that they have the same mean value for the intercept (=α).

$$Y_{i,t} = \alpha + \beta X_{i,t} + w_{i,t}$$

Where,

$$w_{i,t} = \varepsilon_i + u_{i,t}$$

The combined error, $w_{i,t}$ is an error of two components: ε_i, which is the error component of a cross-section or individual-specific, and $u_{i,t}$, which is a time-series and cross-sectional combined error that is called idiosyncratic because it varies between subjects and time [3].

2.5 Previous Studies

Some studies tend to be very positive about Islamic finance. For example, some are studies have shown that (i) Islamic index have better returns during crisis than non-Islamic ones Bhatt and Sultan [4] and Jouaber-Snoussi et al. [5], (ii) Islamic banks during the crisis are more resilient, but also more profitable [6], (iii) Islamic loans tend to have a lower default rate than non-Islamic loans [7], and (iv) in Muslim countries, Islamic banking has made a positive contribution to the overall banking industry development [8].

Using this assumption, the researcher made a clear addition to the previous study, namely, the researcher wants to find out whether this is true that Islamic label has almost no effect on the quality of governance as written by Hayat and Hassan [9]. With this idea, researchers can come up for the lack of literature on what the Islamic labels mean to CG, thereby bridging the gap between Islamic finance, leverage, and CG research.

2.6 Hypothesis

Based on the previous section, the main hypothesis that has been reviewed regarding how the relationship of the independent variable to the dependent variable is:

H_0: Islamic label has no significant effect on good corporate governance.

H_1: Islamic label has a significant effect on good corporate governance.

3 Method

3.1 Data

The data used in this study was obtained from Refinitiv Eikon data stream namely the financial and governance information of listed firms in 2018-2019. We used the data of Indonesia Sharia Stock Index (ISSI) as performance indicator of Indonesia's Islamic stock market. We exclude companies that do not have a CG Score, the ratio of total interest-based

debt to total assets exceeded 45%, and the ratio of total interest income compared to total operating income and other income exceeded 10%. These criteria are based on OJK rules of a sharia stock. After the screening, there were only 19 sharia and 25 non-sharia firms selected out of 399 firms in 2018 and 429 firms in 2019. The total observations in this study were 88 observations.

3.2 Methodology

Data analysis of this study consists of two steps. First, the researchers only check whether there was a significant difference in the average CG quality of Islamic and non-Islamic constituents. A simple parametric t-test used (assuming unequal variances) to test for statistically significant differences in overall CG quality. Significant differences were also tested for control variables.

Second, we regressed the quality CG on the dummy and control variables. The benefit of the second step is to control for other variables that can affect the quality of CG. In this study, we controlled for *Leverage, Firm Size, Women on the Board, Tobin's Q, Profitability (net profit margin), Dividend Payout, Board Member Term Duration, Board Tenure, CEO Duality, Future Cash Flow, Board Size*, and *Return Volatility*. These control variables are based on previous literature [9]. Researchers used panel-based regression where the dependent variable is the CG quality and the independent variable is Islamic dummy, 12 control variables, industry, and time dummies. The main model used in this study is the following equation:

$$CG_{i,t} = \alpha + \beta_1\, Islamic_i + \beta_2 Controls_{i,(t-1)} + \beta_3 Industry_i + \beta_4 Time_t + \varepsilon_{i,t}$$

Where,

$CG_{i,t}$	=	is the CG quality of firm i at time t.
α	=	is the intercept.
β_1	=	is the CG quality between Islamic and non-Islamic companies.
$Islamic_i$	=	is a dummy variable (1 if a companies is Islamic and 0 is otherwise).
β_2	=	is 12 coefficients that represents the sensitivity of CG quality to a unit change in the 12 control variables.
β_3 (industry) and β_4 (time)	=	fixed-effects are controlled for by adding dummies for these variables.

4 Results and Discussions

4.1 Descriptive Statistics

Table 1 shows that Islamic firms have higher average and standard deviation of CG score, Tobin's Q, and Dividend Payout than non-Islamic firms. Meanwhile, non-Islamic firms have higher average of leverage, firm size, woman on board, profitability, board member term duration, board tenure, CEO duality, free cash flow, board size, and volatility than Islamic firms.

Table 1. Descriptive Statistic

Variable	Corporate	Mean	SD
Corporate Governance	Syariah	51.85384	21.807882
	Non-Syariah	47.059764	22.677603
Islamic Dummy	Syariah	1	0
	Non-Syariah	0	0
Leverage	Syariah	0.7902098	0.8271044
	Non-Syariah	2.3726457	3.0418069
Firm Size	Syariah	17.388924	0.8118251
	Non-Syariah	18.357526	1.3956748
Woman on Board	Syariah	8.4252297	12.33123
	Non-Syariah	9.3547619	11.038688
Tobin's Q	Syariah	2.7632684	3.5325684
	Non-Syariah	1.6166943	1.4163042
Profitability	Syariah	0.0856516	0.0786306
	Non-Syariah	0.3487885	1.3889614
Dividend Payout Ratio	Syariah	0.5513552	0.5992823
	Non-Syariah	0.3045833	0.2865832
Board Member Term Duration	Syariah	3.7368421	1.291352
	Non-Syariah	3.84	1.3303368
Board Tenure	Syariah	6.4930353	3.2069445
	Non-Syariah	7.2753415	4.3693218
CEO Duality	Syariah	0	0
	Non-Syariah	0.04	0.1979487
Free Cash Flow (FCF)	Syariah	622903.72	1559042.7
	Non-Syariah	3289626.1	7818617.3
Board Size	Syariah	6.1315789	2.0153497
	Non-Syariah	6.34	2.0663485
Volatility	Syariah	54.219785	10.140064
	Non-Syariah	55.705364	11.009825

The results of the correlation test in Table 2 shows that the correlation coefficient is lower than 0.5, so there is no issue of collinearity between the independent variables used [3]. Collinearity test was conducted to identify the direction and strength of the relationship or correlation between independent variables. This is done to avoid a correlation that is too high between the independent variables.

Table 2. Correlation Test Table

	CG	DIslamic	Leverage	SIZE	WOB	TobinsQ	PROF	DPR	BMTD	BT	CEODual	FCF	BoardS~e	Volati~y
CG	1													
DIslamic	0.1065	1												
Leverage	0.1855	-0.3107	1											
SIZE	0.2565	-0.3794	0.3513	1										
WOB	0.0564	**-0.0398**	-0.1521	-0.1493	1									
TobinsQ	0.1466	0.2173	-0.2524	-0.2671	0.0702	1								
PROF	0.2039	-0.1246	0.2836	**0.0281**	-0.0768	**-0.0253**	1							
DPR	**-0.0081**	0.2632	-0.2928	-0.0988	-0.1435	0.2975	-0.0894	1						
BMTD	-0.0748	**-0.0391**	0.1896	**0.0066**	**-0.01**	**-0.0113**	0.1049	-0.086	1					
BT	-0.2175	-0.0993	-0.1728	-0.1753	0.4323	**-0.0247**	**-0.0442**	**-0.0296**	0.0687	1				
CEODual	-0.0872	-0.1329	-0.0596	-0.1557	0.1017	**-0.0482**	**-0.0182**	**-0.0421**	-0.0928	-0.0879	1			
FCF	0.2342	-0.2176	**-0.0291**	0.5879	-0.0959	-0.0839	0.0654	**-0.001**	**-0.0203**	**0.0228**	**-0.0411**	1		
BoardSize	0.3300	-0.0507	0.3635	0.4270	-0.0922	-0.1372	0.1394	-0.1524	0.1047	-0.3758	-0.0187	0.2429	1	
Volatility	-0.1921	-0.0694	0.2903	-0.181	**-0.0437**	-0.3481	**0.0384**	-0.3497	0.0859	**-0.0408**	-0.2684	-0.276	0.0511	1

Description: The box marked in blue is the independent variable (control) which has a relationship with the other independent variable (control). Meanwhile, in bold, the independent variables are smaller than the 5% significant level.

4.2 Panel Data Regression

4.2.1 Chow Test

The Chow Test is a test to determine whether the Pooled Least Square (PLS) or Fixed Effect (FE) model is the most appropriate for estimating panel data. The Table 3 shows the decision making for this test is as follows.

Table 3. Chow Test Results

Estimation Model	Prob. > F
Pooled Least Square	0.0024
Fixed Effect Model	0.0000

Because $Prob > F$ is smaller than the value of α which is $0.0000\% < 0.05$, then H_0 is rejected and H_1 is accepted. In other words, with the Chow Test estimation method, FE was chosen as the best model.

4.2.2 Hausman Test

Hausman Test is a statistical test to choose whether the Fixed Effect (FE) or Random Effect (RE) Model is the most appropriate to use. The decision making for this test is based on Table 4 below.

Table 4. Hausman Test Results

Estimation Model	Prob. > Chi^2
Fixed Effect Model	0.0024
Random Effect Model	0.9897

Table 4 shows that the $Prob > Chi-square = 0.9897$ or greater than the 5% significance degree. It can be concluded that the alternative hypothesis is accepted, so that, the RE Model is a better model to use than the FE Model in this study.

4.2.3 T-test (Partial Significance Test)

This test is to see partially, whether each independent variable significantly affects the dependent variable. From all of the control variables used in this study, the *BoardSize* variables has a significant effect on CG. This can be seen from the results of {p>|z|} *BoardSize* which is 0.044. It means that {p>|z|} is smaller than the value of α (0.05). Other variables have no significant effect on CG. The results of {p>|z|} for all these variables are in the range of 0.067 to 0.834. It means {p>|z|} is greater than the α value (0.05).

4.2.4 Coefficient of Determination (R^2) Test Results

The summary of the panel data regression results for this study is shown in Table 5 below.

Table 5. The Summary of the Data Panel Regression

Var.	Coef.	P>|z|
DIslamic	6.413534	0.374
Leverage	1.137393	0.272
SIZE	2.221472	0.529
WOB	0.1577345	0.408
TobinsQ	0.4953435	0.643
PROF	1.151984	0.215
DPR	-0.8588724	0.754
BMTD	1.166217	0.489
BT	-1.085301	0.094**
CEODual	-20.62316	0.377
FCF	-1.04E-07	0.834
BoardSize	2.279029	0.044*
Volatility	-0.55821	0.067**
DIND	(omitted)	
DTime	(omitted)	
Cons	31.3513	0.668
R-sq within	0.1867	
R-sq overall	0.2678	
*significant at 5%; **significant at 10%		

The R^2 shows the degree to which variation percentage of the independent variable used in the model can explain the variation of the dependent variable. The the R^2 value of the cross-sectional time series using the feasible generalized least square method in this study can be seen from the R^2, which is 0.2678 or 26,78%, which means the ability of *DIslamic, Leverage, SIZE, WOB, TobinsQ, PROF, DPR, BMTD, BT, CEODual, FCF, BoardSize,* and *Volatility* in explaining the CG variable is 26.78%. While the remaining 73.22% is explained by other variables not mentioned in this study.

4.3 Discussions

Table 1 shows that non-Sharia firms have a higher debt ratio average than Islamic firms. It can be understood because of the regulations related to the management of capital structure in Islamic firms and includes the ratio limits. Based on the average of profitability, non-sharia firms outperform the Islamic ones. This shows the level of profitability on non-Sharia firms is better than Islamic ones. This is consistent with the results of Sutama's research [10] because high leverage can encourage the firm operations so that it will increase sales and result in increased profitability and firm value.

In term of company size, non-sharia companies have a larger average of size than sharia firms based on the natural logarithm of total sales. In term of performance, Islamic companies have a higher Tobin's Q value than non-Islamic firms, which is 1.7 times the Tobin's Q value of non-Islamic firms. This means that the management performance of Islamic companies in managing company assets is better than non-Islamic ones.

Generally, the FCF of non-Islamic companies is higher than Islamic ones. With this appropriate FCF, non-Islamic companies can expand, develop new products, pay dividends, pay off their debts, or seek the business opportunities that companies may need to expand. Table 1 also shows that the dividend payout ratio of Islamic companies is higher than non-Islamic companies. This is in line with the sharia label where management has a good governance by implementing corporate transparency seen from several dimensions, namely the disclosure of complete and timely annual reports, accountability as sees from the quality of the audit committee, fairness seen in the auditor's opinion on the published financial statements by the company, and the responsibility that can be seen from the CSR to its human resources and society.

Table 2 contains the correlation matrix of the variables used in this study. This shows that the correlation between the Islamic dummy and CG is low. In this study, leverage does not have a strong relationship with governance. This positive correlation is consistent with the opinions of Berger *et al*. [11] and Jiraporn and Gleason [12]. These simple correlations must be considered carefully, but they provide an early clue that Islamic labels do not convey information about corporate governance as a whole. The significant and quite high relationship between independent variables is the relationship between FCF and Size. However, the correlation value is still at the threshold, which is 0.58.

From the Table 5, we found that after controlling for 12 variables, there is no strong evidence that the Islamic label has an effect on CG, or that the Islamic dummy coefficient does not have a significant effect on CG. Hence, it can be seen that the Islamic label has no influence on good governance. The CG index has implicitly accommodated ethical business conduct which is a business framework based on Islamic values. Thus, the CG variable contains the similar information to the Islamic dummy. This might cause the results of this study being insignificant. In addition, CEO performance is the most important thing to achieve GCG. This is in accordance with what was conveyed by Choiriyah [13] about the principles

that underlie GCG in Islamic companies, including transparency, accountability, responsibility, independency, and fairness. If these five principles can be implemented properly by the CEO (management) of a company, then the CEO will be able to manage the company well, whether it is sharia or non-sharia companies.

Previous studies have also shown that the implementation of GCG principles has an effect on company performance. Darwis [14] found that the higher the implementation of CG as measured by the perception index, the higher the level of company compliance and resulted in good company's performance. Darwis' findings are consistent with the research conducted by Gompers, et al. [15] which found that the GCG index has a positive relationship with a long-term firm performance.

The regression results show that *Board Tenure* and *Volatility* have a strong effect on CG and are significant at 10%. A negative coefficient means that they have a negative relationship to CG. In addition, Table 5 also shows that *Board Size* (BS) has a strong positive correlation to CG and is significant at 5%. This makes sense because BS has an important role in corporate governance, such as defining corporate strategy and corporate philosophy, overseeing executive management, implementing internal controls, and requiring accountability [16]. This is important considering the interests of the company's management to carry out earnings management which has an impact on reducing investor income.

5 Conclusions

Based on the research results and discussions, the following conclusions can be drawn: (1) this research examines whether the Islamic label of listed companies also shows good corporate governance. (2) After controlling for 12 variables, the researchers did not find a significant difference in the dummy variable used (Islamic dummy) on the quality of governance. (3) Based on the regression results, we obtained that *Board Tenure* and *Volatility* have a strong negative effect on CG. In addition, the regression results also show that *Board Size* (BS) has a strong positive correlation to CG.

5.1 Research Limitations

There are several limitations that we realize and recommend that further research can be developed. They are (1) focusing only on listed firms in Indonesia, (2) using the 2018 and 2019 constituents, (3) replicating the official sharia index and considering this replication a fairly close estimate, and (4) assuming that Islamic companies will stay Islamic in the short term. Therefore, the potential development of this research has to solve this problem.

5.2 Research Implications

This research can provide implications for several parties such as academics, company managers, and investors. (1) This research leads to the lack of literature on what the Islamic label means for stocks and bridges the gap between Islamic finance, leverage, and corporate governance research because there are few studies specifically linking leverage, governance, and Islamic finance is almost does not exist. (2) For the management in the company, it can be a material consideration in carrying out their duties as top management of the company. These leaders should carefully understand the principles of GCG and the positive impact of implementing them well in the company. (3) Through this research, investors can understand that in making decision before investing. They should check on the firms' CG that will be the

target where they will invest. Investors can find out the GCG score of the company. The GCG score can provide investors with an idea of the good or bad governance of a company. The higher the GCG score, the better the governance in a company.

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