**Al-Iqtishad:** Jurnal Ilmu Ekonomi Syariah (Journal of Islamic Economics)
Volume 12 (2), Jul-Dec 2020
P-ISSN: 2087-135X; E-ISSN: 2407-8654
Page 265 - 282

# Islamic Social Reporting and *Halal* Business Performance

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***Abstract.*** *Islamic social reporting (ISR) is used to assess a company's social performance based on Islamic principles. Islamic social performance reports will influence investors' decisions in investing. This research is to analyze factors influencing the Islamic Corporate Social Responsibility report. Data is obtained from the annual reports of 44 companies in the halal industry sector from 2013-2018, and analyzed using the Random Effect Model (REM) method. In this research, interest on debt-based Sharia Screening (SS) is divided by total assets with a maximum tolerance of 45 percent; the companies' net-based Profitability (PRV) is divided by the total assets (ROA), and total debt-based leverage (LEV) is divided by equity (DER). The result is that Sharia Screening, Profitability, and Leverage affect ISR reporting. Increasing sharia screening and leverage will decrease ISR reporting, while increasing profitability will increase ISR reporting. Thus, the increase and decrease in this variable affect the companies' decision to report the ISR. Therefore, companies must improve their financial performance to improve corporate social responsibility disclosure quality, which is very important for stakeholders in investing.*

**Keywords:** *Islamic Social Reporting, Random Effect Model, Sharia Screening, Profitability, Leverage*

***Abstrak.*** *Pelaporan sosial Islam digunakan untuk menilai kinerja sosial perusahaan berdasarkan prinsip-prinsip Islam. Laporan kinerja sosial Islam akan mempengaruhi keputusan investor dalam berinvestasi. Penelitian ini dilakukan untuk menganalisis faktor-faktor apa saja yang mempengaruhi laporan sosial Islam dengan menggunakan 44 perusahaan sektor industri halal, data tahunan tahun 2013-2018, dan menggunakan metode random effect model (REM). Syariah Screening (SS) berbasis pada hutang bunga dibagi total aset dengan toleransi maksimal 45 persen, Profitabilitas (PRV) berbasis pada laba bersih perusahaan dibagi total aset (ROA), dan leverage (LEV) berbasis pada total hutang dibagi ekuitas (DER). Hasilnya adalah syariah screening, profitabilitas, dan leverage mempengaruhi pelaporan sosial Islam. Peningkatan syariah screening dan leverage akan menurunkan pelaporan ISR, sedangkan peningkatan profitabilitas akan meningkatkan pelaporan ISR.*

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*Dengan demikian kenaikan dan penurunan variabel ini mempengaruhi keputusan perusahaan untuk melaporkan ISR. Oleh karena itu, perusahaan harus meningkatkan kinerja keuangannya untuk meningkatkan kualitas pelaporan sosial Islam yang sangat penting bagi stakeholders dalam berinvestasi.*

**Kata kunci:** *Pelaporan Sosial Islam, Random Effect Model, Syaria Screening, Profitabilitas, Leverage*

## Introduction

In addition to providing information about financial statements, companies are also required to give information on a company's social activities (Chen, Hung, & Wang, 2018; Dagilienė, 2013; Leitoniene & Sapkauskiene, 2015). This is a form of corporate responsibility in voluntarily disclosing its responsibility for the environment (Nazari, Hrazdil, & Mahmoudian, 2017; Zheng & Ren, 2019). Information regarding corporate social responsibility (CSR) is made in a single annual report or a separate report (Wuttichindanon, 2017). The company's annual report reflects social responsibility which includes the field of business activities carried out and the natural resources used so that it is necessary to carry out social responsibility (Boubakary & Moskolaï, 2016; Castejón & López, 2016; Sanclemente-Téllez, 2017). Otherwise, they will be subject to sanctions following statutory provisions. With this, companies are increasingly encouraged to report their CSR activities.

The number of companies that disclose CSR information in financial statements from year to year is increasing. Many companies are starting to realize that the implementation of CSR programs can be used as a business strategy in the company (Gorski, Fuciu, & Croitor, 2014; Šontaitė-Petkevičienė, 2015). Investors from various organizations and officials from each company make CSR an important consideration in making decisions (Frederiksen, 2018; Gras-Gil, Manzano, & Fernández, 2016). CSR activities carried out by the company can show that the company is also concerned with the environment and the welfare of the surrounding community and its employees' wellbeing (Rodriguez-Fernandez, 2016; Sarkis & Daou, 2013). Furthermore, it can improve organizational accountability, corporate image, and provide information to investors where there is a social contract between the organization and the community. (Dyck, Lins, Roth, & Wagner, 2019; Sila & Cek, 2017).

Information about CSR in Islamic economics can increase investor attention to Islamic institutions or institutions (Zain, Darus, & Ramli, 2015).

In Indonesia, more and more companies are based on *Sharia*; this proves that the Islamic Economy is experiencing rapid development. To fulfill sharia-based reporting, Muslims began to develop corporate social responsibility reporting by sharia principles, also known as Islamic Social Reporting (ISR). ISR disclosure is a refinement of CSR disclosure, which adds some items not included in Islamic social reporting disclosures. The development of companies that disclose CSR information also increases public attention towards Islamic institutions or institutions. The capital market as an institution and profession related to securities, in this case, is the Islamic capital market having an essential role in increasing the market share of Islamic securities in companies wishing to participate in the Islamic capital market.

Research using ISR as a benchmark for CSR has been carried out by Khairiyani and Mubyarto (2019), Hadinata (2019), Rizfani and Lubis (2019), Mubarok (2019), Adlan and Mawardi (2018), Pratama, Muchlis, and Wahyuni (2018), Cahya (2018), Prasetyoningrum (2018), Santoso and Dhiyaul-Haq (2017), Sulistyawati and Yuliani (2017). From previous studies, there is still no specific research in the *halal* industry sector. So this research to analyze what factors influence CSR in the industrial area. This research contributes, first adding a new perspective on CSR factors in the *halal* industry sector. Second, decision making in investing for policymakers. Third, enrich the CSR literature.

## Literature Review

Islamic Social Reporting (ISR) indicators are adopted from corporate social performance reporting based on Islamic principles. This indicator was developed from the accounting reporting standards issued by the Accounting and Auditing Organization for Islamic financial institutions (AAOIFI). Specifically, this indicator is an extension of the social performance reporting standard which includes public expectations regarding the company's role in the economy and the spiritual (Indrawaty & Wardayati, 2016). In addition, it emphasizes social justice for the environment, minority rights, and employees.

Research related to ISR has been conducted by Khairiyani and Mubyarto (2019). They analyzed the influence of Islamic Corporate Social Responsibility (ICSR) on the company's financial performance on the Jakarta Islamic Index (JII). ICSR is measured using indicators of product, community, service, investment, product, environment, employees, and corporate governance. Financial performance using the return on equity and return on assets. The results showed that ICSR was able to improve the business performance of JII companies.

Hadinata (2019) analyzes the effect of ISR on financial performance. Financial performance indicators use the ratio of profit sharing and return on assets. This study used seven Islamic banks during the period 2011-2016 with 42 observations. The results showed that the ISR harms both returns on assets and profit-sharing ratios. Rizfani and Lubis (2019) analyzed the social responsibility disclosure factors of Islamic companies using the company's annual report in the Jakarta Islamic Index from 2012 to 2015. The research results showed that company size has a positive effect, while leverage and company age have a negative effect. The profitability and the number of commissioners did not affect.

Mubarok (2019) analyzes the ISR disclosure and its impact on profitability at Indonesian *Sharia* Commercial Banks. The research results show that Good Corporate Governance (GCG) affects the ISR, financial factors have a positive effect on ISR, GCG is detrimental to profitability, economic factors have a positive effect on profitability, ISR affects profitability, and ISR mediates the relationship between GCG and financial factors with profitability. Adlan and Mawardi (2018) analyze interest-based debt restrictions and non-*halal* income restrictions on company value in companies in the Jakarta Islamic Index for the 2013-2018 period. The research results show that interest-based debt and non-*halal* income do not partially or simultaneously affect firm value.

Pratama, Muchlis, and Wahyuni (2018) analyzed the factors that affect the level of social responsibility disclosure using Islamic Social Reporting (ISR) on 11 Islamic commercial banks during 2013-2016. The research results show that leveraging, institutional ownership, bank size, and profitability affect the level of ISR disclosure. The moderation test is only institutional ownership, profitability, and leverage, which are moderated by independent commissioners in carrying out ISR disclosures.

Cahya (2018) analyzes the presentation of sharia-based accountability to corporate stakeholders in the concept of Islamic Social Reporting (ISR) as an effort to provide relevant information following the spiritual needs of users of financial statements. The research results provide evidence that accountability is essential to make responsive attitudes towards the entity obtained and realize that there must be an attitude of responsibility that must be done. The application of ISR as a form of accountability is based on principles and philosophy based on the Al Quran and Sunnah as guidelines in carrying out various life activities.

Therefore, the implementation of ISR which is based on spiritual and intellectual elements is believed to be able to solve and overcome social problems, both within the company and in the community, especially for the empowerment of the community's economy.

Prasetyoningrum (2018) analyzes the factors that influence the disclosure of CSR reporting in Islamic banking in Indonesia. The results showed that company size, profitability, leverage, and cost efficiency did not affect ISR, while its age factor statistically affected ISR. Santoso and Dhiyaul-Haq (2017) analyzed the factors that influence ISR in Islamic banking in Indonesia using rewards, profitability, and ownership types. Profitability using the return on assets, grants are identified with multiple CSR performance awards over one year. Types of ownership are classified into four, namely family, government, institutional and foreign ownership. The research results show that profitability, rewards, and type of property do not affect the ISR disclosure.

Sulistyawati and Yuliani (2017) analyzed profitability, company size, the board of commissioners, and leverage on ISR. The results showed that the board of commissioners had a significant and positive effect on ISR, while leverage and profitability did not affect. Handayani (2017) analyzes the extent to which Islamic Social Reporting (ISR) is practiced by Islamic banks in Malaysia and examines the ISR factors that are most often disclosed in annual reports. This study uses 10 Islamic banks in Malaysia as the research sample. The results showed that the average level of ISR disclosure of Islamic banks in Malaysia was 32.81% and the one with the highest exposure level was the public with 10.77%.

Kurniawati and Yaya (2017) analyzed the effect of the number of audit committees, boards of commissioners, environmental performance, and profitability on Islamic Social Reporting (ISR) during 2011 to 2015 in 31 companies. The research results show that profitability, the board size, and environmental performance have a positive effect on ISR disclosure. On the other hand, the audit committee and the board of commissioners do not affect. Widayati and Sukmana (2017) analyzed the differences in the level of disclosure of Islamic Social Reporting (ISR) in Islamic banking in Indonesia and Malaysia based on the ISR indicator. The research results show that the level of ISR exposure of Islamic banking in Indonesia is better than the level of ISR disclosure of Islamic banking in Malaysia. Other results show that there is a significant difference in the level of exposure between Islamic banking in Indonesia and Malaysia.

Darus et al. (2014) analyzed the ISR of Islamic commercial banks in Indonesia from 2007 to 2011. The results showed that only two banks experienced an increase in ISR disclosure continuously. These results also reveal that the highest exposure is the company's vision, the board of directors, and top management. At the same time, the lowest disclosures are product, environment, agreement and service. Mallin, Farag, and Ow-Yong (2014) analyzed the relationship between corporate social responsibility (CSR) and the financial performance of Islamic banks using the ISR indicator which includes ten dimensions with a sample of 90 Islamic banks in 13 countries. The ISR indicator shows that Islamic banks are involved in various social activities. There is a positive relationship between ISR disclosure and financial performance. Thus, ISR exposure is determined by financial performance. El-Halaby and Hussainey (2015) analyzed the ISR disclosure factors for Islamic banks in 25 countries. The results found a low disclosure rate of 26%. In addition, there is a positive relationship between the ISR level and accounting standards, the type of auditor, the size of the bank, and the existence of the sharia audit department.

## Method

This study uses annual data from the company's financial statements from 2013 to 2018, consisting of 44 companies engaged in the *halal* industry sector. This study uses a panel data approach that combines time-series data and crosses sections.

$$ISR_{it} = \alpha_0 + \beta_1 SS_{it} + \beta_2 PRV_{it} + \beta_3 LEV_{it} + \varepsilon_{it}$$

Where it represents the company, and t represents time. The data used in this study are Corporate Social Responsibility (CSR) using Islamic Social Reporting (ISR) indicators cover underlying philosophy and values, management profile, interest-free and Islamically acceptable deals, development and social goals, employees, debtors, community, environment, shariah supervisory, wellbeing. *Sharia* Screening (SS) using interest-based debt compared to total assets with a maximum tolerance limit of 45 percent, Profitability (PRV) using the return on assets (ROA) where the company's net profit is divided by total assets, and leverage (LEV) uses debt to equity ratio (DER) where total debt is divided by equity.

In resolving using panel data, several stages are carried out, starting with the classical assumption testing, including the autocorrelation test, the multicollinearity test data, the data normality test, and the heteroscedasticity test data. A normality test is conducted to test whether the standardized residual values in the regression model are normally distributed or not. The heteroscedasticity test aims to test whether, in the former model, there is an inequality of variance from the residual regression model. The multicollinearity test seeks to check whether there is a high or perfect correlation between the independent variables in the regression model formed. The autocorrelation test aims to determine whether there is a correlation between members of a series of observational data ordered by time or space. After examination, the conventional assumptions proceed with selecting the best model out of 3 trials, including random effect models, fixed-effect models, and pooled least square models.

## Result and Discussion

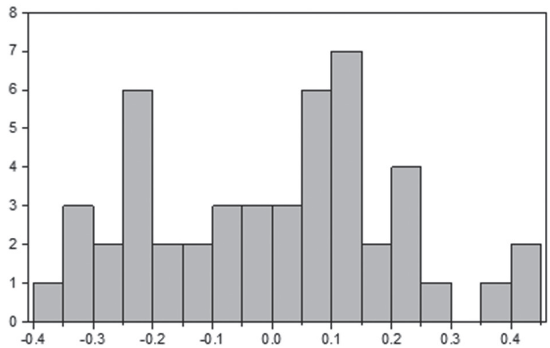
Before testing the results to answer the study's objectives, examining the classical assumptions, based on the normality test histogram, it can be seen that the probability of Jarque-Bera> 0.05 (0.600756> 0.05) so that the data in this study have been distributed normally.

Table 1. Data Normality Test Results

| Indicator | Result |
|---|---|
| Mean | -3.77e-16 |
| Median | .032759 |
| Maximum | .421115 |
| Minimum | -.353119 |
| Std. Dev. | .203282 |
| Skewness | .040511 |
| Kurtosis | 2.290773 |
| Jarque-Bera | 1.019134 |
| Probability | 0.600756 |


https://doi.org/ 10.15408/aiq.v12i2.16808

Figure 1. Data Normality Test Results (Histogram)



The multicollinearity test results use the value of Centered VIF, where the importance of all variables is smaller than the tolerance limit set, i.e., 10. Thus, the data used do not contain symptoms of multicollinearity.

Table 2. Multicollinearity Test Results

| Variable | Coefficient Variance | Centered VIF |
|---|---|---|
| CSR | 2.546668 | 1.039800 |
| HLS | 2.480050 | 1.048778 |
| PRV | 0.269971 | 1.064200 |
| LEV | 7.800342 | 1.017449 |

Heteroscedastic i ty test results using the Breusch-Pagan-Godfrey test obtained Obs*$R^2$ value of 17.69433 with a probability of 0.2305. This result shows that the probability> level of significance ($\alpha$ = 5%). This means that residuals have a homogeneous variety. Thus, the variables used do not contain heteroscedasticity.

Table 3. Heteroscedasticity Test Results

| | | | |
|---|---|---|---|
| F-statistic | 8.563309 | Prob. F(3,44) | 0.2101 |
| Obs*R-squared | 17.69433 | Prob. Chi-Square(3) | 0.2305 |
| Scaled explained SS | 9.595706 | Prob. Chi-Square(3) | 0.2223 |


https://doi.org/ 10.15408/aiq.v12i2.16808

The autocorrelation test using the Lagrange multiplier is obtained from the Obs*$R^2$ value of 23.49744 with a probability of 0.5470. This result means the probability is more than the real level used (level $\alpha$ = 5%). Thus, residual observations do not correlate with each other, so the variables do not contain autocorrelation.

Table 4. Autocorrelation Test Results

| | | | |
|---|---|---|---|
| F-statistic | 20.13856 | Prob. F(2,42) | 0.6320 |
| Obs*R-squared | 23.49744 | Prob. Chi-Square(2) | 0.5470 |

After testing the classical assumptions, select the best model by conducting a Hausman test and chow test. The model chosen from the panel data used is the random effect model, evidenced by the probability > 0.05 in the chow test and the Hausman test (1,0000> 0.05).

Table 5. Selection of the Best Model

| **Chow Test** | | | |
|---|---|---|---|
| **Effects Test** | **Statistic** | **d.f.** | **Prob.** |
| Cross-section F | 11.339768 | (7,153) | 0.1000 |
| Cross-section Chi-square | 63.107442 | 7 | 0.1000 |
| Hausman Test | | | |
| Test Summary | Chi-Sq. Statistic | Chi-Sq. d.f | Prob. |
| Cross-section random | 0.000000 | 2 | 1.0000 |

Based on the results of the Random Effect Model, conclusions can be drawn.

$$ISR_{it} = 0.934587 - 0.096629SS_{it} + 2.280007PRV_{it} - 0.001524LEV_{it} + \varepsilon_{it}$$

The regression equation constant is positive at 0.934587, meaning that if the value of the independent variables is 0, then the value of the dependent variable (ISR) is 0.934587. The regression coefficient for the *Sharia* Screening (SS) variable is -0.096629. This means that one unit's *Sharia* Screening decrease in the company's *Sharia* Screening will increase ISR disclosure of 0.096629, assuming the other independent variables are constant. The regression coefficient of the profitability variable (PRV) is 2.280007, meaning that one unit's increase in company profitability will increase ISR disclosure of 2.280007, assuming the other independent variables are constant. The regression coefficient of the leverage variable (LEV) is negative at 0.001524, meaning that one unit's increase in leverage will result in a decrease in ISR disclosure of 0.001524, assuming the other independent variables are constant. The F statistical test is used to predict the regression parameters together. The F statistical test shows whether the sharia screening (SS), leverage (LEV), and profitability (PRV) variables have a simultaneous influence on the Islamic social reporting (ISR) variable. Based on the REM regression model (Table 5), the significance value of 0.000049 is less than 0.05, meaning that the *Sharia* Screening, profitability, and company leverage variables have a significant effect on ISR disclosure.

The t-test is used to determine whether the independent variable partially affects the dependent variable. The t-count value of *Sharia* Screening (SS) is -0.272507, with a probability value of 0.0055, which is less than 0.05. This shows that *Sharia* Screening has a negative and significant effect on ISR disclosure. The lower the sharia screening ratio will lead to an increase in the value of the company's shares, which will improve the ISR report's quality. This proves that companies' decision to manage interest-based debt is highly considered by companies in ISR disclosure (Adlan & Mawardi, 2018). The regulation on limiting interest-based transactions on financial ratios is the limit point for the issuer to be declared as sharia-compliant or not (Soemitra, 2016). When referring to sharia rules in The Quran and hadith, usury-based transactions should not exist at all. However, if we see to the fiqh rule that what cannot be done thoroughly, do not entirely abandon it. So, limiting the number of usury-based transactions can be done. However, it must also be understood that these rules require the implementation of *Sharia* to the maximum extent possible. If it is related to the regulation of restrictions on riba-based transactions in the *halal* industry, the less interest-based debt and non-*halal* income levels the company has, it can be said that the company is getting better at applying the Islamic aspect in its activities (Alam, Akbar, Shahriar, & Elahi, 2017; Ayedh, Shaharuddin, & Kamaruddin, 2019; Md. Hashim, Habib, Isaacs, & Gadhoum, 2017). The implementation of the Islamic elements that are getting better by the company will be a positive signal for investors who pay attention to the Islamic aspects of investing to increase company value and disclosure of corporate CSR reporting (Lys, Naughton, & Wang, 2015). This means a negative relationship between the number of interest-based transactions and the disclosure of the company's ISR reporting.

Table 6. Random Effect Model Results

| Variable | Coefficient | Standard Error | t-statistic | Probability |
|---|---|---|---|---|
| C | 0.934587 | 0.135167 | 6.914311 | 0.0000 |
| SS | -0.096629 | 0.354592 | -0.272507 | 0.0055 |
| PRV | 2.280007 | 4.810005 | 0.004734 | 0.0002 |
| LEV | -0.001524 | 0.004073 | -0.374240 | 0.0000 |
| R-squared | 0.963378 | Durbin-Watson stat | | 0.439016 |
| Adjusted R-squared | 0.962450 | Prob(F-statistic) | | 0.000049 |

The t-value of profitability (PRV) is 0.004734, with a probability value of 0.0002 less than 0.05. This shows that profitability has a positive and significant effect on ISR disclosure. Profitability is a factor that makes management free and flexible to disclose social responsibility to shareholders. Companies that are in an advantageous position will tend to disclose more extensive information in the ISR report. The higher the company profitability, the greater the disclosure of Islamic-based social information (ISR). This follows the theory of legitimacy, which explains that if an entity is operating following the prevailing norms in society, it will create a positive image and impact its financial performance, one of which is profit (Mandina, Maravire, & Masere, 2014). This result is in line with Kurniawati and Yaya (2017) research that profitability is closely related to a company's management's effectiveness in determining strategic steps to gain profit. Companies with a higher profit rate will attract investors by providing better information to the public and other stakeholders by increasing social responsibility disclosure (Nainggolan & Handoyo, 2019; Platonova, Asutay, Dixon, & Mohammad, 2018; Salehi, Tarighi, & Rezanezhad, 2019). This means that the higher the profitability, the more full the ISR disclosure will be (Mukhtaruddin, Saftiana, & Dwikatama, 2018). High profitability means that companies will be more flexible and free in managing profits to disclose social responsibility to stakeholders (Hermawan & Mulyawan, 2014). Hadinata (2019) also stated that the company's social performance would be viewed well by stakeholders to support its operational activities, which will increase its profits.


https://doi.org/ 10.15408/aiq.v12i2.16808

The t-value of leverage (LEV) is -0.374240, with a probability value of 0.0000, which is less than 0.05. This shows that advantage has a negative and significant effect on the ISR disclosure. Leverage arises because the company, in its operations, uses assets and sources of funds that cause fixed expenses for the company. Thus, the company has high-interest debt, so the management's ability to invest more in the ISR reporting program will decrease. Leverage is a tool to measure how much a company is to creditors in financing company assets (Cheng, Business, Iowa, & Campus, 2014). Companies with a high degree of leverage mean that they are very dependent on external loans to finance their assets (Onofrei, Tudose, Durdureanu, & Anton, 2015).

Meanwhile, companies with a low level of force are more likely to finance their assets with their capital (Dyck et al., 2019). Thus, the degree of corporate leverage reflects the company's financial risk (Innocent, Ikechukwu, & Nnagbogu, 2014)Pearson correlation and regressions were employed and used for this study. The results of the analysis showed that debt ratio (DR. Agency theory predicts that companies with higher leverage ratios will disclose more information because firms' agency costs with such capital structures are higher (Riantani & Nurzamzam, 2015). Social responsibility reporting using the Islamic Social Reporting index is a strategy used by Islamic banks to convince and gain legitimacy from creditors regarding company compliance (Pratama et al., 2018). This study's results are in line with research conducted by (Rizfani & Lubis, 2019), which states that a small debt company will influence its decision to improve *Sharia's* social performance reporting.

## Conclusion

Based on the research results, it can be concluded that the *Sharia* Screening, profitability, and leverage in the *halal* industry sector have a significant effect both simultaneously and partially. That interest-based debt and non-*halal* income have an impact on firm value, either partially or simultaneously. These results indicate that investors pay more attention to religiousness in choosing investments made in the *halal* industry sector. Companies in the *halal* industry sector are also still considering leverage conditions to determine the extent to which ISR disclosures are made. When the level of leverage is high, the company's focus is to show excellent financial performance in the eyes of creditors by generating high profits so that activities that require many costs are tried to be reduced, including the cost of disclosing the ISR.

This research implies that companies making ISR disclosures are influenced by several factors, including sharia screening, profitability, and leverage. This study's results can be used as consideration for companies to make ISR disclosures following sharia principles. The company's ISR disclosure level will be of high value if it has low interest-based debt, has a high profitability level, and has little leverage. Besides, companies can improve their financial performance to improve the quality of corporate social responsibility disclosure. For stakeholders, this study will provide information on the level of corporate social responsibility disclosure that can influence the decision making of Muslim stakeholders. Muslim stakeholders can be encouraged to invest in companies with a high level of ISR disclosure because it indicates that they have carried out and managed the company adequately and following sharia principles.

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