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INTELLECTUAL CAPITAL AND ISLAMIC SOCIAL REPORTING INDEX: THE CASE OF INDONESIAN ISLAMIC BANKING

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Abstract

Purpose of the study: This study aims to explain the effect of Islamic Banking Intellectual Capital and Islamic Social Reporting on the Islamic Financial Performance Index of Sharia Bank Indonesia.

Methodology: The data obtained in this study consisted of a total of 368 from annual financial reports and sustainability reports that were officially published by each Islamic bank in Indonesia. The analytical method used in this study is the Partial Least Square (PLS) method which is processed with SmartPLS 3 software.

Main Findings: There is an essential influence on the implementation of Islamic Banking Intellectual Capital and Islamic Social Reporting on Islamic Financial Performance in Islamic Banking in Indonesia. This finding also shows that intellectual capital and social reporting by Islamic banks have a significant positive effect on the financial performance of Islamic banks in Indonesia.

Applications of this study: This research will help next researchers to develop research in the banking world and can be used by banking institutions to become scientific input. Besides, mobilizing and using intangible resources properly will improve the financial performance of an organization.

Novelty / Originality of this study: The existence of Islamic Banking Intellectual Capital combined with Islamic Social Reporting can affect and improve the competitiveness of Islamic Banking in Indonesia. This study will be a complete research and provide clear information for practitioners and academics.

Keywords: *Intellectual Capital, Islamic Social Reporting, Islamic Financial Performance, Islamic Banking.*

INTRODUCTION

Research on the development of banking and finance in the current era is very important to do, according to Ratnasari & Rahmandani (2020), understanding the role of financial development is crucial because it allows a country to promote banking and stock market activities along with attracting the inflows of foreign direct investment that will increase the economic efficiency of a country's financial system.

Knowledge is a power that has a very important role and can be the key to success. One sector that needs to develop intellectual capital is the Islamic banking sector. Given that Indonesia adheres to a dual banking system that requires each bank to be able to increase its competitive advantage. Intellectual capital in general can be developed through the development of human capital, structural capital, and consumer capital to produce a potential value. Intangible value creation must get enough attention because this has a very large impact on company performance (Ulum, 2008). Mustika, et al (2020) in their study stated that currently the development of existing businesses marked by their intense competition and uncertainty that has organizations to continue to develop innovative environments. This is corroborated with the results of study conducted by Zin, Adnan & Abdullah (2017) that stated in this knowledge-based economic era, intellectual capital is considered an important component in an organization's efforts to emphasize the achievement of competitive advantage and increase added value for organizations. Hence, the implementation of a business is no longer rely on physical capital only. It has become common knowledge that the development of Islamic economics is identical to the development of Islamic financial institutions. Islamic banks, as the main motor of financial institutions, have become a locomotive for the development of Islamic economic theory and practice in-depth (Karim, 2004). The World Islamic Banking Competitiveness Report in 2017 stated that Indonesia, with the population approaching the number of 250 million and a stable positive economic outlook, will allow to have a large market growth for Islamic banking. The World Islamic Banking Competitiveness Report explains that Indonesia is a promising market for growth in the field of banking participation, but its national market share is decelerating. Without the initiative of the authorities to maintain and foster banking participation, this sector will remain trapped in a period of growth for years. The banking participation in Indonesia is 3.7% (The World Islamic Banking Competitiveness Report, 2017). The latest data according to research released in 2010 shows that the Muslim population in Indonesia reaches more than 87.17% of the total population of Indonesia and in 2020 is predicted to experience a significant increase (Global Religious Future, 2010). Hence, it is necessary to have more strategies to attract people to use Islamic banks so that they can improve their financial performance.



Intellectual Capital positively and significantly influences financial performance (Akbari, Rostami & Veismoradi, 2013). However, research by Kuryanto (2008) shows that Intellectual Capital does not significantly influence company performance. So there are differences in the results of previous studies. The difference in the results of research by previous researchers is also the reason for the taking of this research title. Financial performance in this study will be measured using the Islamic Financial Performance Index.

According to Herianingrum, et al. (2019) in the results of their study show that the sharia bank will have a significant positive impact on the business tendency or the real sector. The findings of this research are among others that business tendency influences on Syariah banks, and supported by other research results, which stated the importance of the development of sharia banks because their characteristics are different from conventional banks, it is necessary to support its existence as it is proven to be able to move the real sector in various business lines. Islamic banking in the operational process does not only prioritize profit alone, this can be seen from the results sharing system used, which is known as the profit-loss sharing system. Hence, it can be seen that Islamic banking does not only pursue profit but also pays attention to social aspects in providing banking services to the public so that Islamic banks have not only a business function, but also a social function. Haniffa (2002) added that the report must have a social responsibility, there must be a spiritual aspect and the main focus in corporate social responsibility reporting. This index was developed with reporting standards based on AAOIFI, the index that will be used to measure social performance in this study is the Islamic Social Reporting Index. According to Herwanti (2017) that the level of disclosure of Islamic Social Reporting has a positive effect on profitability. While according to Dawam (2016) his research shows empirical results in 2013-2014 showing that the quality of information disclosure of the Islamic Social Reporting Index has a positive influence on corporate finance and the quality of information on Intellectual Capital has a negative influence on financial performance in the financial sector in Indonesia.

This reality shows that the influence of social performance on financial performance in Islamic banks still needs to be re-examined whether it has a positive or negative effect. With the existence of the research gaps and phenomena above, the authors are interested to know the Effect of Islamic Banking Intellectual Capital and Islamic Social Reporting on Islamic Financial Performance Index of Islamic Banks of Indonesia.

LITERATURE REVIEW

Since there is not much research on this topic, this study categorizes the available literature based on several relevant themes, such as resource-based theory, intellectual capital, Islamic Financial Performance Index, and the Islamic Social Reporting Index.

Resource-based theory

Resource-based theory (RBT) suggests that company resources are heterogeneous and productive services derived from company resources provide a unique character for each company. This theory was first put forward by Wernerfelt (1984) in his work entitled "A Resource-based view of the firm". Competitive advantage in a company or banking can be enhanced by instilling an understanding that the company consists of heterogeneous and immovable elements. Penrose (1959) suggested that company resources are heterogeneous. Within the field of human resources management, the resources based view has made important contributions in the rapidly growing area of strategic human resources management. (Wright, Drunford & Snell, 2001).

Intellectual Capital

Intellectual Capital definitions found in various kinds of literature are very diverse. Pulic (1998) explained the Value Added Intellectual Coefficient (VAICTM) to provide information about the value creation efficiency of tangible and intangible assets within a company. VAICTM is an analytical procedure designed to enable management. Intellectual Capital consists of three main dimensions, namely: human capital, structural capital, and customer or relationship capital. Although the terms are not always used in each research, the terms are the same depending on the concept of each research (Nazari & Herremans, 2007). VAICTM also used by researchers to examine the relationship between Intellectual Capital and market value and financial performance of companies using a sample of public companies in Taiwan (Chen, Cheng, & Hwang, 2005). Furthermore, Tan, H.P., Plowman, D., & Hancock, P. (2007) used 150 companies listed on the Singapore stock exchange as a research sample. Investors will assess the company's performance well if the company has large or efficient intellectual capital. (Rezaei & Zahra, 2015) in the result of their study showed that intellectual capital is significant to the performance of the Islamic banking industry and the highest level of positive impact is related to human capital, structural capital and customer capital.

According to Berg, A.V.D & Herman (2002), Intellectual Capital consists of 3 main dimensions, these dimensions will affect business process capital, business renewal, and development capital. Business process capital is the value for a company derived from techniques, procedures, and programs that implement and enhance the delivery of goods and services. Process capital is one of the three components of structural capital, which is a component of intellectual capital. Consists of mapping business processes and modeling business processes. While business reform is a change in the system and management to improve business activities. Capital development here is a business in providing a significant impact on the economic development of a country. Marr & Roos (2005) identify intangible resources in the form of

intellectual capital. Intellectual capital consists of human capital, structural capital, and relational capital (Pulic, 1998; Bontis, 1996a, 1998b, 1999c; Roos, Roos, Dragonetti, & Edvinsson, 1997).

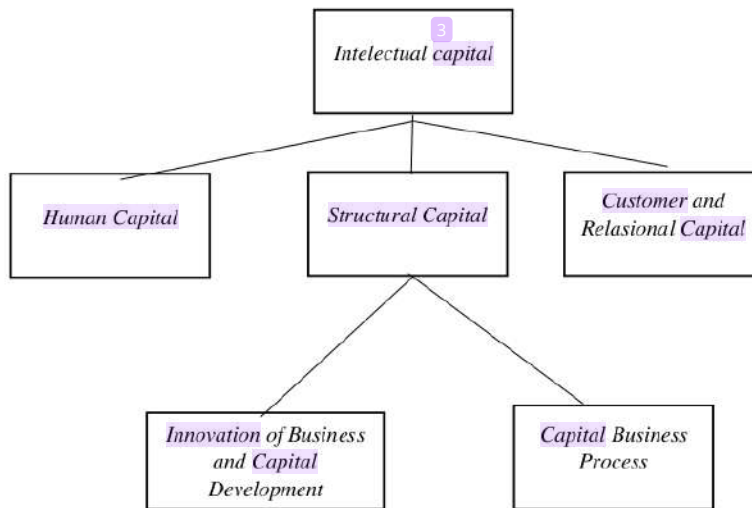


Figure 1: Models of Intellectual Capital Valuation: a Comparative Evaluation

Source: Berg, Herman (2002)

Later Ulum (2013) presents the results of a focus group discussion with experts in economics and accounting that there are special calculations for Islamic banking intellectual capital. The components of Islamic Banking Intellectual Capital include:

1. Human Capital

Human Capital can be used as a key element in increasing productivity and also maintain competitive advantage (Nashtaei, Aghajan, R., Heidarnia, M., Noshaddeh, V., 2013). Human capital in Islamic banks according to Zainal, Basalamah & Muhammad (2014: 31) includes issues of guidance, use, and protection of human resources. The value of employees is determined by their ability to apply their skills and expertise. According to Hery (2017), human capital in intellectual capital includes talent, creativity, and work skills which are very much needed by companies today. According to Fincham, R., & Roslender, R. (2003) human capital is the most dominant form of intellectual capital, something captured in Edison's founding distinction between people and what people leave behind in the organization.

2. Structural Capital

Mouritsen & Larsen (2001) revealed that Structural Capital is always available in organizations. Structural capital is the supporting infrastructure, processes, and database of organizations that enable human capital to carry out its functions. Point to the infrastructure of the organization, both physical and non-physical, including operating systems, strategic plans, processes, routines, databases, and information technology (Walsh, Enz, & Canina, 2008). More generally, the sub-elements of structural capital include infrastructure variables such as organizational culture, management structures and processes, and organizational philosophies (Fincham, R., & Roslender, R. 2003).

3. Relational Capital (Relational Capital)

According to Marr (2008) relational capital is structural capital patents, trademarks, management tools, improvised techniques, information technology systems, or research and development efforts. According to Fincham, R., & Roslender, R. (2003) among the factors that have the consequence of keeping the customers coming back are a company's stock of products, or where its brands are relevant, the level of service that it can deliver to customers, as well as the information systems and databases that increasingly underpin all such relationships. These and similar marketing assets constitute the relational capital of companies.

Islamic Financial Performance Index (IFPI)

Alternative performance measurement for the Islamic Bank through an index is called the Islamic Indices included the Islamic Disclosure Index and the Islamic Performance Index (Hameed et al. 2004). This index aims to help stakeholders assess the performance of Islamic banks. This index is then used in assessing the performance of Islamic financial institutions. Hameed et al. (2004) the Islamic Financial Performance Index consist of four components including the



Profit Sharing Ratio (PSR) and the Zakat Performance Ratio (ZPR) must be based on the payment of Zakat paid by the bank. The ZPR formulation divides the amount of Zakat paid by Islamic banks with the net assets of the bank. The Equitable Distribution Ratio (EDR) attempts to find out how income is received by Islamic banks is distributed to various stakeholders.

Islamic Social Reporting Index (ISRI)

The Islamic Social Reporting Index is an index used to measure social banking performance. Islamic Social Reporting Index is disclosure items that are used as indicators in reporting the social performance of Islamic business institutions. [Haniffa \(2002\)](#) made five Islamic Social Reporting disclosure themes, namely Funding and Investment Themes, Product and Service Themes, Employee Themes, Community Themes, and Environmental Themes. Each disclosure theme has a sub-theme as an indicator of the disclosure of that theme. [Gustani \(2013\)](#) also states that there are 5 similar sub-themes.

HYPOTHESIS FORMULATION

Intellectual capital positions as a form of accumulated knowledge of individuals in organizations in the form of patents, process management, capability management, technology, information about consumers and suppliers, and past experiences ([Stewart, 1991](#)). Analyzing the intellectual capital performance of regional development banks in Indonesia, such as studies carried out by [Goh \(2005\)](#), [Kamath \(2007\)](#), [Ulum \(2008\)](#).

H1: There is a positive influence on the Intellectual Capital on the Islamic Financial Performance Index of Islamic Banking in Indonesia

VAICTM can examine the relationship between Intellectual Capital and market value and financial performance of a company by using a sample of public companies in Taiwan ([Chen, Cheng, & Hwang, 2005](#)). The urgency of this research on Intellectual Capital is also shown on the results of research by [Rezaei & Zahra \(2015\)](#), the results of the study indicate that Intellectual Capital is significantly related to the organizational performance of the Islamic banking industry and the highest level of positive impact related to human capital, structural capital and customer capital, besides intellectual capital is a phenomenon of interaction. [Setianto & Raditya \(2016\)](#) have also empirically proven in their research that the influence of intellectual capital on the performance of Islamic banking companies is positive. [Sullivan \(2000\)](#) states that Intellectual Capital can increase company profitability.

H2: There is a positive influence on Islamic Social Reporting on Islamic Financial Performance Index of Islamic Banking in Indonesia

According to [Musibah & Wan \(2013\)](#), the relationship between intellectual capital and financial performance is accurate, various previous studies have shown that there is a relationship between intellectual capital and corporate social activities, in this case, the Islamic Social Reporting Index for disclosure of corporate social activities in companies - Islamic based company. Meanwhile According to [Herwanti \(2017\)](#), the level of disclosure of Islamic Social Reporting has a positive effect on profitability.

METHODOLOGY

The population in this study are all Islamic commercial banks registered at Bank Indonesia and the Indonesian Financial Services Authority (Otoritas Jasa Keuangan). The sampling technique used was purposive sampling to obtain representative sample following specified criteria, the criteria of sample are: 1) Sharia Commercial Bank recorded in the Directorate of Bank Indonesia and the Indonesian Financial Services Authority during the study period by considering annual reports issued by the bank in 2014-2017. 2) Sharia Bank that issues financial reports (annual report) and sustainability reports at the Indonesian Financial Services Authority during the research period in 2014-2017. There are 12 Islamic banks that match the sample criteria.

This research depends largely on secondary data notably the financial reports both annual reports and sustainability reports of Islamic banks in Indonesia obtained from the official website of each Islamic bank from 2014-2017. The variables in this study identified two exogenous variables and one endogenous variable as follows.

1. Exogenous Variables: Islamic Banking Intellectual Capital (X1) and Islamic Social Reporting (X2).
2. Endogenous Variables: Islamic Financial Performance Index (Y).

According to [Hair, et al \(2006: 711\)](#), each multivariate technique has been clarified as either an interdependent technique or a dependent technique. SEM can be considered as a unique combination of both types of techniques because the foundation of SEM lies in two multivariate techniques namely factor analysis and multiple regression analysis. In this study, the data is processed with SmartPLS 3 software.



Measurement

Table 1: Variable Measurement

VARIABLES	MEASUREMENT	SOURCE	SCALE
ISLAMIC FINANCIAL PERFORMANCE INDEX (Y)	$\frac{\text{profit sharing ratio} + \text{Mudharabah} + \text{Musyarakah}}{\text{total financing}}$ $\text{performance zakat ratio: } \frac{\text{zakat}}{\text{net asset}}$ $\frac{\text{equitable ratio} : \text{Qard and Donation} + \text{Employee costs} + \text{Shareholders} + \text{Net Profit}}{\text{total revenue}}$	Hameed, <i>et al</i> (2004)	Ratio
INTELLECTUAL CAPITAL (X1)	$\text{iB-VAIC}^{\text{TM}} = \text{iB-VACA} + \text{IB-VAHU} + \text{iB-STVA}$	Ulum (2007)	Ratio
ISLAMIC SOCIAL REPORTING INDEX (X2)	Dummy Variable 0 does not express social performance while 1 expresses social performance	Sofyani, <i>et al</i> (2016)	Dummy

RESULTS/FINDINGS

Descriptive Statistic

Table 2: Descriptive Statistic

	N	Minimum	Maximum	Mean	Std. Deviation
ISR	44	0,14	0,74	0,56	0,19
IB.VACA	44	-0,47	0,89	0,23	0,28
IB.VAHU	44	-11,80	3,65	0,84	2,29
IB.STVA	44	-1,58	6,79	0,64	1,19
IFPLPSR	44	0,00	1,00	0,84	0,29
IFPLZPR	44	0,00	0,00	0,00	0,00
IFPLEDR	44	-1,52	0,90	0,28	0,43
Valid N (listwise)	44				

Source: Processed data

Based on Table 1, the result shows that the observations in the study were 44 samples and data is 368. Islamic Banking Intellectual Capital (IB Intellectual Capital) has three dimensions namely IB VACA (customer capital), IB VAHU (human capital), and IB STVA (structured capital).

Outer Model Test

The outer model in this study was evaluated based on looking at the significance of the weight. The significance value of the weight must exceed 1.96. If there are invalid indicators, they must be removed from the model to get a valid model. For VIF values recommended <10 or <5 and tolerance values > 0.10 or > 0.20. Data processing results that all indicators contribute value to Islamic Banking Intellectual Capital.

Table 3: Outer Model

	IB.VAIC	Information
IFPI	1,000	Valid
ISR	1,000	Valid

Source: Processed data

From the table above it can be seen that all construct indicators produce a loading factor value > 0.5. This shows that all construct indicators are valid. The above results show that the Islamic Financial Performance Index can be explained with one indicator after that, the other two indicators must be included.



Inner Model Test

The inner model test aims to predict the relationship between latent variables hypothesized by looking at the magnitude of the variance percentage that is explained by the R-square value.

Table 4: R-Square

	R Square	R Square Adjusted
IFPI	0,822	0,814

Source: Processed data

Hypothesis Test Result

Table 5: Hypothesis Test

	Original Sample (O)	Sample Mean (M)	Standard Deviation (STDEV)	T Statistics (O/STDEV)	P Values	Information
IB.VAIC -> IFPI	0,762	0,750	0,085	8,977	0,000	Significant
ISR -> IFPI	0,244	0,244	0,071	3,430	0,001	Significant

Source: Processed data

Based on the table above, it can be seen that the influence of Intellectual Capital on the Islamic Financial Performance Index has a p-value <0.05, which is 0.000, then H1 is accepted. This means that Intellectual Capital has a positive effect on the Islamic Financial Performance Index. And the influence of the Islamic Social Reporting Index on the Islamic Financial Performance Index has a p-value <0.05 which is 0.001, then H2 is accepted. This means that the Islamic Social Reporting Index has a positive effect on the Islamic Financial Performance Index.

DISCUSSION/ANALYSIS

Influence of Intellectual Capital on Islamic Financial Performance of Islamic Banking in Indonesia

Improving the competitiveness of Islamic banking can be done in line with the development of the Islamic banking sector, which is focused on increasing the quantity and quality of Human Resource and IT. So Islamic Human Capital is the key. Empowerment of employees' abilities and knowledge is part of intellectual capital. In the current era, the direction of business development is no longer referring to the ability of physical capital alone but rather the ability in all non-physical fields. The development of the Islamic banking sector needs to be encouraged in order to be able to show its superiority. Convincing investors to invest their capital in Islamic banks is one of the keys so that the capital structure becomes better, and this can occur through increased competitive advantage through the development of intellectual capital.

The results show how the three dimensions of Intellectual Capital have a role in improving financial performance, which in this case is Islamic Financial Performance. The banking sector is a service sector that relies more on human resources. These results reinforce the results of empirical research by Ekwe (2012) showing that intellectual capital has a positive effect on bank financial performance. If the company can empower intellectual capital effectively and efficiently, it can reduce the company's costs. According to Sieng & Ishak (2014), Some research that still exists utilizes human capital investment, most of which suggest education as a determinant of economic growth. According to Sieng & Ishak (2014), human capital through education contributes to Malaysia's economic growth and is the second most important input factor after physical capital in promoting economic growth. Ramesh & Jani (2009) concluded that education affects economic growth in Malaysia by strengthening and improving human quality. Islam teaches humans to always work and produce something beneficial to everyone. The work can be in the form of objects or services. In creating mutual benefits, humans must have the abilities and skills possessed by using the knowledge they have learned. God gives the gift of every human being the ability that humans must use as a useful source of capital for everyone.

According to Starovic & Marr (2004) said that structural capital is the knowledge that remains in the company that provides the company's ability to meet the company's routine processes and structures that support the efforts of employees to produce optimal intellectual performance and overall business performance. The resource-based theory concludes that the resources and knowledge managed by the company well will result in an increased competitive advantage owned by the company and will affect the company's performance. Banks with good Intellectual Capital management show good financial performance (Onyekwelu, Okoh & Iyidiobi, 2017). Intellectual Capital has a positive effect on the financial performance of banking companies. This is in line with the Resource-Based Theory where if the company can empower intellectual capital effectively and efficiently, the company's costs can be reduced, the reduction in costs will increase profits for the company so that the company's financial performance will also increase. Improved management of intellectual capital will no longer depend on capital investment or physical assets. With that, growth can be driven by productivity and innovation that are effectively supported.



Influence of Islamic Social Reporting Index on Islamic Financial Performance Index of Islamic Banking in Indonesia

Application of Islamic Social Reporting in Islamic banking can not be separated from the concept of maqashid sharia which is the goal of Islamic law contained in every rule. Indonesia is the country with the largest Muslim population in the world, nearly 13% of the world's Muslims are in Indonesia. According to gomuslim.co.id, 13% of the world's Muslims are in Indonesia 2020. Widiastuti, et al (2019) in their research found that the average score of maqasid dimension in Indonesia is good. This shows the commitment of the Muslim community in Indonesia will be able to run the maqashid sharia in various aspects of life very well including in socioeconomic life.

The Islamic Social Reporting Index criteria include the number of donations in spending years for staff training, improvement of working conditions, Zakat, endowments, donations, training expenses, social savings, and investment and donations. The results of this study stated that the Islamic Social Reporting Index has a positive influence on the Islamic Financial Performance Index. The results of the study are following stakeholder theory which states that the better the Islamic Social Reporting Index is carried out, the more satisfied the stakeholders will be and will provide full support to all company activities aimed at improving financial performance. The results of this study are in line with the results of research conducted by Othman, et al (2009) which proves that profitability has a positive influence on the disclosure of social responsibility in accordance with Islamic principles. Profitability is the ratio used to measure profits. And in line with research by Herwanti (2017), the purpose of this study is to examine the effect of the Islamic Social Reporting Index on profitability and the amount of Zakat paid by Islamic banks in Indonesia. The results show that the level of disclosure of the Islamic Social Reporting Index has a positive effect on profitability. One component of Islamic social reporting is the disclosure of Zakat. Zakat, infaq, shdaqoh and waqaf are income distribution instruments that must be considered. Abdeldayem (2009) examined the testing of sharia social disclosures in the United Arab Emirates showing that banks that are required to pay Zakat tend to provide more social disclosure compared to banks that do not have the obligation to pay Zakat.

Business is an effort to create a problem not just for profit. Business in Islam has a very noble and strategic position. However, it should be remembered that everything must be carried out following the Shari'a even in carrying out an economic and business life that must pay attention to social problems for the benefit. The Islamic Social Reporting Index in an Islamic perspective is a business practice that has Islamic ethical responsibilities by including Islamic religious norms that are marked by a commitment to sincerity in maintaining social contracts in its operations.

CONCLUSION

Overall the results of this study indicate that Islamic Banking Intellectual Capital has a positive influence on Financial Performance as measured by the Islamic Financial Performance Index of Islamic banking in Indonesia. This indicates that the use of physical and financial assets no longer dominates to contribute to the performance of Islamic banks. Overall, the findings of this study indicate that Intellectual Capital can be used to improve financial performance in Islamic banking. Intellectual Capital consists of three elements that are all related to the ability of human intellect. Islam teaches humans to always work and produce something beneficial to everyone. The work can be in the form of products or services. In creating mutual benefits, humans must possess the ability and skills by using the knowledge they already have.

That the existence of the Islamic Social Reporting Index has a positive effect on financial performance as measured by the Islamic Financial Performance Index of Islamic banking in Indonesia. This indicates that social performance is very important to be carried out by the Islamic banking industry because it is empirically proven to improve financial performance.

LIMITATION AND STUDY FORWARD

Researchers are very aware that there is still much that needs to be developed for the benefit of future scientific development. This research needs to be developed by further researchers because this research only examines one scope, namely Islamic banking in Indonesia. The next research can further analyze the influence of each dimension on an intellectual and social performance that exists in other sectors.

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