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ANALYSIS OF FINANCIAL PERFORMANCE THROUGH SHARIA COMPLIANCE IN THE ISLAMIC BANKING

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Abstract

This study aims to prove that financial performance is influenced by Sharia compliance in the Islamic banking industry. Multiple linear regression analysis uses panel data from the annual Sharia banking reports. Purposive sampling was used to select 40 samples of financial data from the Indonesian Sharia banking sector for four years, from 2019 to 2022. The results prove that Sharia compliance proxied by Islamic income ratio (IsIR), profit-sharing ratio (PSR), and Islamic investment ratio (IIR) has simultaneously impacted financial performance in Islamic banking. It is hoped that this research will help the government enhance the overall performance of Islamic banking. There are some recommendations for 'Bank Indonesia (BI) or the Financial Services Authority to encourage profit-sharing financing by conducting workshops for Sharia banking and businesses to enhance the understanding and implementation of profit-sharing mechanisms. Strengthen regulations and standards for Sharia Compliance by mandating regular Sharia audits for Islamic banks to ensure continuous adherence to Sharia principles. Furthermore, Islamic banks' management must improve Shari'a compliance in banking applications because the higher the Shari'a compliance, the higher the public confidence in Islamic banking apps. It would help other interested parties and potential investors become part of the Islamic banking sector.

Keywords: *Financial Performance, Islamic Income Ratio, Islamic Investment Ratio, Profit Sharing Ratio, Sharia Compliance*

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1. Introduction

Islam strongly rejects all fraudulent activities because it upholds the principle of avoiding all harm to all parties (Sucipto et al.,2021). Building firms and corporations will receive much attention when Islamic ideas are applied. One of these is the Islamic financial sector, and Islamic banks have grown significantly in Indonesia. The financial institutions that practice Shari'a banking are already recognized as Shari'a banks, and laws and fundamental principles of Islamic Sharia govern their operations. The necessity for an alternative banking system in the Indonesian community also contributed to the establishment of Sharia banking and financial institutions in the countries (Hamid et al., 2017). As an alternative, the banks could offer Sharia-compliant financial services or good banking (Maulidar et al., 2020).

The Shariah compliance regulation is among the legal facets of an Islamic financial sector. In terms of administration and operations, Shari'a compliance is a critical component of the Islamic banking sector. These place a strong emphasis on Islamic ideals and practices when conducting business. Usury and other illegal sources are prohibited in the practice. Maintaining a system of trustworthiness and fairness and promoting accountabílity-transparency improves morality and ethics (Md Zain & Shafii, 2018). The requirement that Sharia-compliant financial institutions have a Shari'a Supervisory Board is proof of this. Its primary goal is to ensure compliance with Sharia in all of its operations.

According to Minaryanti (2023), Indonesia's economic performance might be enhanced by Islamic banking. Sharia compliance is one of the factors that determine a bank's sustainability and ultimately serves as a metric for evaluating the organization. Evaluating the financial performances of Islamic institutions is as important as measuring individual achievements (Hameed et al., 2004). Low Sharia compliance and a weak financial sector might impact Islamic banks' performance management and create fraud opportunities (Sucipto et al., 2021). By ensuring compliance with Shariah principles, Islamic banks can gain public trust, manage risk more effectively, and generate sustainable profits. Furthermore, high-performing Sharia banks will be recognized and given preference by clients looking to invest their money here (Maulidar and Majid, 2020). In this instance, the bank's operational success can be gauged by its profit or profitability.

Financial performance measurement is among the measures of a company's performance against pre-determined targets. It is one of the control methods that can assist the business in identifying the operational activities throughout the year and enhancing the business's performance in the future. Now, maintaining a solid financial position and competitiveness requires having an effective performance measurement system. The financial performance can be shown through financial statements presented to stakeholders such as investors, employees, and the public. Financial performance is related to the company's financial statements, and it is reflected in the information obtained from the statement of financial positions, the comprehensive income, the statement of changes in equity, the cash-flow statement, and also notes to financial statements. Profitability ratios are a valuable tool for evaluating Islamic Commercial Banks' financial performance to generate profits through existing capabilities and sources. The financial performance of Islamic banking in Indonesia is shown in the following table:

Table 1 The Financial Performance of Islamic Bankíng in Indonesia

Ratio	2019	2020	2021	2022
CAR	20,59 %	21,64 %	25,71 %	26,28%
ROA	1,73 %	1,40 %	1,55 %	2,00 %
NPF	1,89 %	1,57 %	0,81 %	0,97 %
FDR	85,27 %	76,36 %	70,12 %	75,19 %
BOPO	84,45 %	85,55 %	84,33 %	77,28 %

Source: Indonesia Syariah Financial Development Report Financial Services Authority

The financial performance of Islamic banks is measured by factors such as growing assets, profitability, liquidity, and efficiency. Thus, Islamic financial success is significantly impacted by Shariah compliance. Profitability ratios are a valuable tool for evaluating the financial performances of Islamic commercial banks. The ability of Islamic banking to make money from current opportunities and sources can be described by profitability ratios. In this study, the researchers used ROA as a measure of financial performance because most of the assets of Sharia banking come from the public. Islamic commercial bank's earnings can be calculated and measured by ROA using their company assets (Dwi & Kurniawati, 2022). Return on assets (ROA) is a metric that shows how effectively a company's assets contribute to generating net income. Essentially, this ratio measures the amount of net profit produced for each unit of funds invested in total assets. A higher return on assets indicates greater net profits from each unit of investment, while a lower return suggests the opposite (Hery, 2018).

Previous research focused on looking at the correlation between performance and Shariah compliance. In the course of the research, Budiman (2017) and Azzahra (2020) assert that the Islamic Income Ratio (IsIR) and Profit-Sharing Ratio (PSR) have a positive effect on the financial performance of Islamic banks. In contrast, Islamic investment does not impact the financial performance of these institutions**.** According to Azizah (2019), the Islamic income Ratio (IsIR) significantly affects financial performance. In contrast, the Profit-Sharing Ratio (PSR) and Islamic Investment Ratio (IIR) do not exhibit such influence. From some of the previous studies mentioned above, there are inconsistencies in the research findings. Therefore, this research will re-analyze the extent of financial performance through Shariah compliance in Islamic banking in Indonesia from 2019 to 2022.

2. Literature Review

2.1 Shari'a Compliance

Shari'a compliance represents the implementation of all Shariah principles inside an institution that embodies the structure, essence, ethical standards, and trustworthiness of Islamic banks. The culture of compliance embodies the principles, actions, and attitudes that empower Islamic banks to conform to all regulations established by Bank Indonesia (BI Rules Number: 13/2/PBI/2011). Shari'a compliance indicates that the business complies with Islamic laws and regulations as well as their limitations (Can, 2020). The management of Shari'a banking must have adequate and reliable internal Shari'a Compliance, Shari'a Risk, and Internal Shari'a audit processes since they are in charge of monitoring the degree of Shari'a compliance (Mohamed et al., 2018). Additionally, this coincides with the internal Shari'a audít, an essential aspect of the AAOIFI (2015) governing bodies.

It is believed that the compliance statement provides a higher degree of assurance regarding the ethical behavior of the business. With the statement, the business is obligated to follow regulations and Islamic principles (Can, 2020). Thus, according to Wan Zainal et al. (2016), current Sharia compliance depends upon governance, company activities, and financial ratios. To be compliant, a company must engage in Sharia-permitted operations. The governance and financial ratio requirements are not entirely relevant for the "Shari'a compliance" certification. For instance, a company can only be certified if it engages in business activities. Based on the requirements of governance, a business needs an SSB, follows Sharia law when conducting business, and is entirely managed by Shari'a law. Meanwhile, based on financial restrictions, income from activities that do not comply with the debt-to-cash and receivables ratio will be below a predetermined level.

This research used a ratio that utilized three indicators to evaluate Shariah compliance: Islamic income ratios (IsIR), Profit-Sharing Ratio (PSR), and Islamic-Investment Ratio (IIR), as demonstrated in the works of Desta et al. (2022), Azzahra (2020), Falikhatun (2012) and Hameed et al. (2004). The Islamic income ratio comes from activities that adhere to Sharia principles. Sharia law promotes halal transactions while prohibiting usury, gambling, gharar, and various other illegal activities. The Islamic Income Ratio (IsIR) measures the contribution of Islamic income to an Islamic bank's overall income, which includes both halal and non-halal income (Azzahra, 2020). The profit-sharing ratío is a measure of the extent to which Islamic banks have profit-sharing activities as part of their total financing activities. Mudharabah and musyarakah are two ratios that are used to determine the profit share of loans offered by Islamic banks. By adding up all of the money from musyarakah and mudharabah contracts and then comparing it to the entire amount of current finance (Dewanáta et al., 2016), the PSR may be determined. Meanwhile, the Islamic investment ratio is used to determine the bank's Islamic investments as a percentage of the total. This ratio is intended to determine the extent of halal investments that an Islamic bank has made in all its investments (Hameed et al., 2004). Then, Sharia compliance is used as a strategy to improve the financial performance of Islamic banking through public trust in operations based on Sharia principles (Murtiyani, 2012).

2.2 Financial Performance

Financial performance, also known as the performance of an entity (Al-Amosh et al., 2023), is widely used to measure an organization's income, profitability, and productivity (Huselid, 1995). Fahmi (2012) analyzed a company's financial performance by applying financial implementation principles to determine its level of performance. Meanwhile, IAI (2007) says that financial performance is an entity's ability to manage and control its resources. Financial performance has previously been measured using two indicators: return on equity (ROE) and return on assets (ROA). According to Al Amosh et al. (2023), return on equity measures an organization's efficiency in terms of profit earned by equity used. In contrast, ROA provides information on the profitability produced by the ratio of total assets to profit. The return on assets (ROA) can be used to gauge how well asset management generates revenue (Nommran et al., 2018). Given that assets' are characterized as material and financial resources, a high ROA indicates the organization's capacity to turn a profit. The more effectively an organization manages its assets, the greater the ROA. Return' on the asset is a ratio that illustrates the performance of the asset utilized in the business. The following formula can be used to determine ROA:

$$ROA = \frac{Net\ incame\ before\ tax}{Total\ Asset} \times 100\%$$

Return on asset (ROA) is a ratio that illustrates the performance of the asset utilized in the business. In this study, the ROA will be used to assess the financial performance of Islamic banking from 2019 to 2022.

2.3 The Conceptual Framework

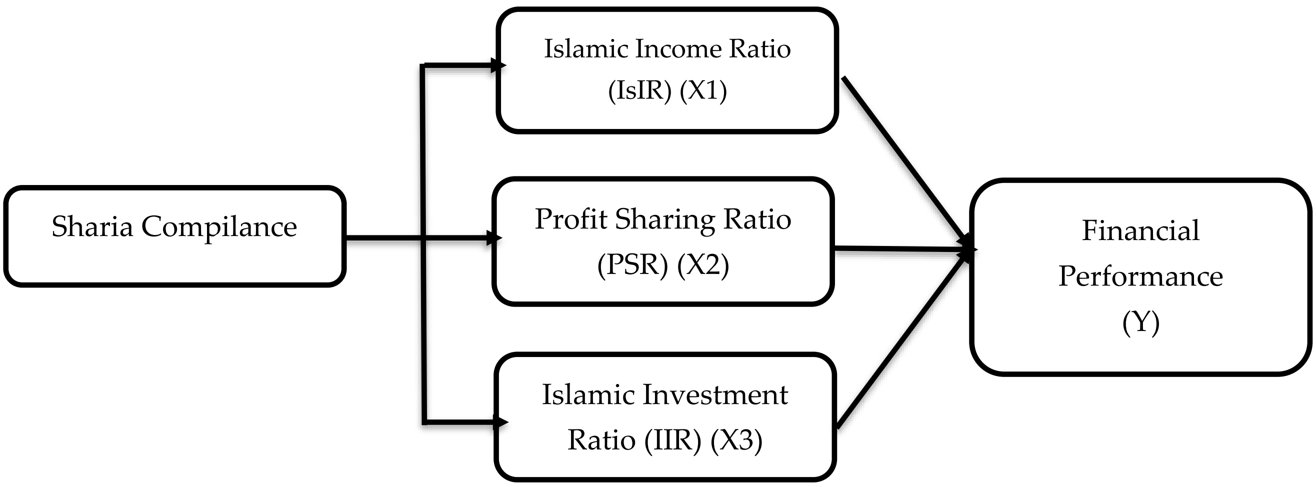

Figure 1 The Conceptual Framework

The framework explains the pattern of relationships between the variables to be studied, namely the relationship between the independent (X) and dependent (Y) variables. In this study, the independent variable to be examined is Sharia compliance, including the Islamic Investment Ratios (IIR), the Islamic Income Ratios(IsIR), and the Profit-Sharing Ratios (PSR). Financial Performance is the dependent variable.

Based on the relationship between the theoretical study, the framework for thinking about the formula of the problems, the hypothesis or preliminary answer to the problem of this research is:

H_1 : Shari'a compliance, as measured by the Islamic-Income Ratio (IsIR), positively impacts the financial performance.

H_2 : Shari'a compliance, as measured by the Profit-Sharing Ratio (PSR'), positively impacts the financial performance.

H_3: Shari'a compliance, as measured by the Islamic Investment Ratio (IiR), positively impacts financial performance.

3. Research Methods

The study's data, which used a quantitative approach, were obtained from Indonesian Islamic banks' annual financial reports filed with the Financial Services Authoríty. Forty samples of financial data from Indonesian Sharia banking that satisfied the researcher's criteria were gathered over four years, from 2019 to 2022, using the purposive sampling approach. The criteria were Syariah Bank registered with Bank Indonesia for the period 2019-2022, BUS, whose annual financial reports are available and published for three consecutive years. The data analysis used multiple lienar regression analysis, partial test, simultaneous test and determination coefficient test.

4. Results and Discussion

4.1 Result

4.1.1 Multiple Linear-Regression Results

Table 2 Multiple Linear Regression Test Result

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	T	Sig.
1	(Constant)	-6,727	5,155		-1,305	,020
	IsIR	6,757	5,150	,215	1,312	,098
	PSR	2,5408	,000	,036	4,218	,008
	IIR	,036	,088	,068	3,416	,016
a. Dependent Variabel: ROA						

Source: Data Processing Result (SPSS-25)

According to the above table, with the following computations, the equation displays the outcomes of the multiple-linear regression tests:

ROA = -6.727 + 6.757 X1 + 2.5408 X2 + 0.36 X3 + E

The above regression equation can be explained as the following: the constant has a negative value, which means that if the variable X = 0, then Y = -6.727, the value is negative because there is a negative relationship / no effect correlation between the independent variables and the dependent variable. About the constant term, negative values may arise when the independent variable is zero, resulting in the dependent variables equating to a negative value. The IsIR (X1) has a regression coefficient value of 6.757. This proves that a 1% increase in the IsIR variable will reduce ROA by 6.757. The PSR′ (X2) has a regression coefficient value of 2.5408. This proves that a 1% increase in the PSR variable reduces ROA by 2.5408. The IIR′ (X3) has a regresion coeficient values of 0.036. This proves that a 1% increase in the PSR variable reduces ROA by 0.036

4.1.2 Partial Test

Table 3 Partial Test Results

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	-6,727	5,155		-1,305	,020
	IsIR	6,757	5,150	,215	1,312	,098
	PSR	2,5408	,000	,036	4,218	,008
	IIR	,036	,088	,068	3,416	,016

A. Dependent Variabel: ROA

Source: Data Processing Result (SPSS-25)

According to the t-test (partial), which is examined using the coefficients test, The Shari'a Compliance variable exhibits a significant value exceeding 0.05, while the Islamic Income Ratio stands at 0.98. The Sharia Compliance variable shows a significant value exceeding 0.05, so hypothesis 1 is rejected. This means that IsIR does not significantly impact ROA. Meanwhile, hypothesis 2 is approved because the profit-sharing ratio, serving as a proxy for the Sharia compliance variable, has a critical value of 0.008, which is less than the threshold of 0.05. This indicates that PSR has a significant effect on ROA. The significant value of the Shari'a Compliance variable proxied by the Islamic Investment Ratio of 0.16 is smaller than 0.05, meaning that the Islamic Investment Ratio has a positive and significant effect on Return On Asset. Therefore, hypothesis 3 is accepted. This indicates that the Islamic investment ratio significantly and favorably affects return on assets.

4.1.3 Simultaneously Test

Table 4 Simultaneously Test

ANOVA[a.]						
Model		Sum of Squares	df	Mean. & Square.	F..	Sig:
1	Regression	,106	3	,002	,602	,004[b]
	Ressidual	,121	36	,003		
	Total	,127	39			

a. Dependent Variable ROA
b. Predictors: (constant)

From the above table, the F-count is determined to be 0.602. At the same time, the F-table is derived from the parameters (k: n-k = 3: 37). where in this study, there are three independent variables (k) in total, and the number of research samples is 40, so the F-table = k: n-k = 3: 37. So it can be seen that the F-table in this study is 0.122. Therefore, the F-count> F-table (0.602> 0.122) with a significance value of 0.006 <0.005.

4.1.4 Coefficient of Determination (R Square)

Table 5 Determination Coefficient Test Results

Model	R	R Square	Adjusted R Square	Std Error of the Estimate
1	,219[a]	,480	-,322	,05789

a. Predictors: (Constant), IIR, PSR, IsIR
Source: Data Processing Results (SPSS-25)

The table shows that the Shari'a compliance variable, characterized by the Islamic Income Ratios, Profit-Sharing Ratio, and Islamic Investment Ratio, has a 48.0% impact on the return on assets, with a coefficient of determination (R-squared) value of 0.480. Other unstudied factors influence the remaining.

4.2 Discussion

This study examines the effect of Sharia compliance on the financial performance of Islamic banks in Indonesia using the analysis of multiple linear regression. The findings show that Sharia compliance, proxied by the Islamic Income Ratio (IsIR), has no significant effect on the financial performance of Islamic banks. This is evidenced by the results of the regression calculations, which show a regressìon coefficìent value of 6.757 and a significance of 0.98. Where 0.98 is more significant than 0.05. Hypothesis 1 is therefore rejected. This means that the financial performance of Islamic banking is not affected by the Shari'a compliance variable with the IIR indicator. This indicates that an increase in the Islamic income ratio does not always increase the amount of financial performance in Islamic banking. This happens because the IIR' is a ratío that balances between halal income and the total income earned by Islamic banks in the form of the sum of halal and non-halal income. Shariah banking has generated non-halal income from conventional activities, proving that the banking sector has not conducted its activities by Islamic principles, which is then channeled to other institutions as charitable funds. In the notes to the financial statements, it is stated that the income of benevolent funds in Islamic banks is income derived from fines from financing customers and current account services from conventional banks. Therefore, an increase in the Islamic income ratio will not necessarily improve the financial performance of Islamic banks.

Thus, in this study, the Islamic Income Ratio (IsIR) variable does not have a significant effect on financial performance. The results of this research are consistent with Anita Nur Khasanah's 2016 research. The results of the regression analysis indicate, which shows a regression coefficient value of 2.5048 and a significance of 0.008 that the financial-performance of Indonesia's Sharia banking industry is positively impacted by the Shari’a compliance variable with the profit-sharing ratio (PSR) indicator. Where 0.008 is less than 0.05. Therefore, hypothesis 2 is accepted. This result can be interpreted to mean that the better the implementation of Sharia compliance, the more it will have an impact on improving the financial performance of Islamic banking. The findings of this study are in line with the Sharia business theory, which states that Islamic banks aim to prioritize Sharia principles in every business activity. Therefore, Islamic banks must derive their income only from halal sources and follow Sharia principles. This is consistent with the findings of Yuniasary & Nurdin (2019), Maisaroh (2015), Khasanah (2016), and Nurdin & Suyudi (2019), who claimed that when the profit-sharing ratio value increases, Islamic banks' financial performance improves.

The financial performance of the Sharia banking industry in Indonesia is positively impacted by the Sharia compliance variable with the Islamic investment ratio (IIR) indicator, according to the regression calculation's results, which display a regressìon coefficiènt value of 0.036 and a significance of 0.016. Where 0.016 is less than 0.05. Therefore, hypothesis 3 is accepted. The results of Shari'a-compliant investments can help reduce the level of fraud, thus contributing to the financial performance of Shari'a banks. This is consistent with the findings of Yuniasary and Nurdin (2019), who stated that the Islamic Investment Ratio (IIR) variable has a significant effect on financial performance.

5 Conclusions

Considering the findings of the study, data testing, and the discussion, it can be concluded that the research results obtained show Sharia compliance proxied by Islamic Income-Ratio (IsIR) partially does not affect financial performance, the influence of Sharia compliance, as indicated by the Profit-Sharing Ratio (PSR), has a partial effect on financial performance. At the same time, the Islamic Investment Ratio (IIR) also demonstrates a partial impact on financial performance. Then, the variable of Shari’a compliance, as measured by the Islamíc Income Ratio (IsIR), the Profít-Sharing Ratio (PSR), and the

Islamíc-Investment Ratio (IIR), all three simultaneously affect financial- performance. The study indicates that Shari'a compliance affects the financial performance of Islamic banking. Therefore, it is expected that this research can provide ideas to the government to improve the performance of Islamic banking in general. For instance, Bank Indonesia plays a significant part in Indonesia's Islamic banking sector and can implement regulations that will improve the growth of Sharia. Encourage Profit-Sharing financing by conducting workshops for banks and businesses to enhance understanding and implementation of profit-sharing mechanisms. For Financial Services Authority, regulations, and standards for Sharia Compliance should be strengthened by mandating regular Sharia audits for Islamic banks to ensure continuous adherence to Sharia principles. A few efforts are needed from the management of Islamic banks to improve Sharia compliance in banking applications. This may also make it more accessible for future investors and other stakeholders to become involved in the Islamic banking sector.

Based on the phenomenon of Islamic banking in Indonesía, the level of Shariah compliance is still at the stage of implementing government standards, where Islamic banks must have a Shariah supervisory board (DPS), so this only gives the impression that Islamic banks are making efforts to comply with these regulations. Islamic banks should apply Shariah principles in all aspects and activities. Sharia compliance must be implemented in the Islamic banking sector since it will improve its financial performance. The public trusts Islamic banking applications more when Shariah compliance is better. The higher the level of Shari'a compliance, the higher the level of public confidence in Islamic banking applications, which in turn will improve the financial performance and market share of Islamic banks. For the DPS to be competent in conducting supervision in the Islamic banking sector, it must, therefore, possess a high degree of professionalism in education, knowledge, and a wealth of Shariah-related experience.

A limitation of this study is that the most recent year was not used because the OJK's financial reports were not published at the time of the research. Furthermore, we recommend extending the reporting period for the research sample through further research. Future study plans could enhance or incorporate shariah compliance indicators. Other research topics could include using other proxies or independent variables that have a more significant effect on the financial performance of Islamic banks and doing more research on other Islamic institutions, such as Zakat and wakaf institutions.

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