

The Effect of Shariah Governance Implementation on Financial Performance via Corporate Social Responsibility

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Abstract

Islamic banks demonstrate economic stability through the implementation of shariah-based business models and operational principles, particularly in reporting, especially in shariah governance implementation and corporate social responsibility (CSR) reporting. This study investigates how disclosures by the board of directors (BOD), shariah supervisory board (SSB), and audit committee (AC) impact financial performance, with CSR acting as a mediating variable. The research sample comprises Islamic banks in Indonesia from 2019 to 2023, the research sample consist of 12 Islamic banks in Indonesia, resulting in a total of 60 observations. Findings indicate that the BOD positively influences financial performance, while the supervisory board and audit committee exert an adverse effect. Additionally, CSR acts as a mediating variable between shariah governance implementation and financial performance. Institutions that acknowledge this importance are more inclined to dedicate adequate resources and focus to the development of effective CSR programs.

Keywords: shariah governance implementation, the board of directors (BOD), shariah supervisory board (SSB), and audit committee (AC), CSR, financial performance.

I. INTRODUCTION

The global financial crisis has affected conventional and Islamic banks differently, with the implementation of business models and operational principles providing better protection against various economic challenges. The analysis on the impact of global crisis in the 2007 until 2008, Islamic banks in Malaysia maintained a higher proportion of liquid assets compared to conventional banks, which made them less vulnerable to liquidity risks during the financial crisis (Mat Rahim & Zakaria, 2013; Abdulle & Kassim, 2015). Farooq and Zaheer (2015) and Putri and Puspita (2024) show that Islamic banking, as one of the fastest-growing sectors in developing countries, is often associated with claims of greater resilience to financial crises compared to conventional banking. In contrast to their performance during the 2007-2008 global financial crisis, Islamic banks failed to exhibit relative resilience in the recent crisis induced by the Covid-19 pandemic (Chazi et al., 2024). During the global crisis of 2022, characterized by elevated inflation, heightened geopolitical tensions, and volatility in energy markets, Islamic banks demonstrated stability through robust capitalization, strong liquidity, and improved asset quality; however, ensuring long-term resilience necessitates greater diversification, the development of innovative shari'ah-compliant liquidity instruments, and expansion into non-traditional markets (Islamic Financial Standard Board, 2024).

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Islamic banks have demonstrated greater stability in terms of income levels compared to conventional banks, which are more affected by rising interest rates (Hasan & Dridi, 2011; Ghassan & Krichene, 2017). Rising interest rates expose conventional banks to greater interest rate risk by increasing volatility in profitability and funding costs, thereby pushing them to reinforce risk management strategies like asset-liability management and stricter credit evaluation. Findings from the crisis indicate that, due to their higher sensitivity to interest rate shifts, conventional banks had to implement more proactive risk control measures than Islamic banks, whose business models offered them relative protection from such fluctuations (Hasan & Dridi, 2011). In practice, Islamic and conventional banks have different focuses in terms of risk-sharing and interest, but both should fulfill customer objectives for long-term benefits (Mushafiq & Sehar, 2021). An increase in interest rates will make risk management more effective compared to conventional banks, particularly in addressing the link between liquidity risk and financial stability. Islamic banking financing relies more on equity rather than debt, resulting in a more transparent reporting system for certain items (Ben Abdallah & Bahloul, 2021). The concepts applied in the implementation of the Islamic financial system in Islamic banks minimize the shortcomings of conventional financial practices, such as the implementation of *riba* (interest), *gharar* (uncertainty related to the object and price), as well as *maysir* and *qimār* (speculation or gambling based on chance) (Ayub, 2015). The implementation of these principles by Islamic banks has placed Indonesia among the countries with the most significant Islamic banking assets, after Bahrain, Türkiye, and Bangladesh (Raihan, 2023).

To maintain public trust, the disclosure system of Islamic banks has become a top priority to minimise banking errors, increase liquidity, and improve performance through external oversight or institutional interests in the banking sector (Tabash, 2019). Comprehensive and complete disclosure will reflect Islamic banking standards, especially in reducing agency problems and conflicts of interest. Good corporate governance in Islamic banks should be implemented by sharia law. Sayari and Marcum (2018) stated that effective governance contributes to good financial performance by reducing internal risks and strengthening the institution's resilience to external parties. A strong sharia governance framework in Islamic banks should include a solid governance structure that allows for apparent oversight and accountability by the BOD, audit committee, management, and, most importantly, the sharia supervisory board to ensure compliance and integrity across all operational activities.

Several studies have shown that boards of directors have a positive impact on financial performance (Malik & Makhdoom, 2016; El Hussein, 2018; Darwanto & Chariri, 2019; Ben Abdallah & Bahloul, 2021; and Diana et al., 2024). Conversely, some studies have shown that boards of directors can have a negative impact on financial performance (Grassa & Matoussi, 2014; Mollah & Zaman, 2015; Naushad & Malik, 2015; and Aziz & Haron, 2021). Besides the BOD, the audit committee is another important shariah governance variable. A robust audit committee can mitigate agency problems and increase transparency, thereby boosting financial performance. Empirical research indicates that a stronger audit committee is associated with better financial performance. This finding is supported by the studies of (Mulianita et al., 2019; and Ben Abdallah & Bahloul, 2021).

Another crucial component of shariah governance is the shariah supervisory board (SSB). The SSB plays a crucial role in ensuring that Islamic banks function in complete accordance with shariah principles, supervising that all banking activities and products conform to Islamic law. Studies indicate that firms with a robust SSB typically attain

superior financial performance, as proven by the research of (Alam et al., 2022; Adam & Abubakar, 2023). Conversely, other research has demonstrated no substantial impact of the shariah supervisory board on financial performance, as evidenced by studies conducted by Ben Abdallah and Bahloul (2021), and Amayanti et al. (2021).

The inconsistency in previous research findings indicates the presence of another variable influencing the connection between shariah governance and financial performance namely, corporate social responsibility (CSR) (Musibah & Alfattani, 2014; Arinta & Lailaulfa, 2021; and Aziz & Haron, 2021). CSR and good corporate governance (GCG) complement each other in ensuring transparency, accountability, and corporate responsibility toward stakeholders, thereby supporting the company's enduring sustainability (Jamali et al., 2008; Liu, 2018; and Rahim & Aisyah, 2025). GCG and CSR work hand in hand to improve financial performance through better risk management, enhanced reputation, and operational efficiency. Proper implementation of GCG ensures that CSR activities are carried out transparently and responsibly, which in turn strengthens stakeholder relationships. The collaboration between GCG and CSR enhances a company's sustainability and long-term worth.

This study builds upon prior research. This study analyses sharia governance variables BOD, AC, and SSB concurrently within a unified model. Previous studies have primarily focused on the relationship between BOD, AC, and SSB and financial performance, or between BOD, AC, and SSB and corporate social responsibility (CSR), and CSR's effect on financial performance. In contrast, this study analyses sharia governance variables BOD, AC, and SSB, concurrently within a unified model, integrating both financial performance and CSR as an intermediary variable. This study employs AAOIFI requirements for sharia governance and social responsibility disclosure, which have been infrequently utilised in prior research and given the distinctive characteristics of Islamic banking, it is reasonable to adopt AAOIFI standards as the most appropriate framework.

1.1. Hypothesis Development

1.1.1. Impact of the board of directors on financial performance

BOD with a greater membership is likely to enhance the efficacy of oversight and assessment of management performance. A larger BOD is perceived to possess varied individuals with varying perspectives and skills, allowing for a more comprehensive and nuanced evaluation of whether management is working in the best interests of the firm and its stakeholders. The BOD serves as a robust internal governance framework that optimises bank profitability, safeguards shareholders, and supports management (Ben Abdallah & Bahloul, 2021). A proficient board possessing pertinent experience and expertise may offer robust strategic guidance and enhance decision-making about investment, risk management, and cost control. Effective strategic decisions can enhance revenue, operational efficiency, and resource usage, hence augmenting profitability and financial performance. Moreover, a proactive and involved BOD can ensure that a company's managerial and financial processes meet high standards, thereby mitigating the risk of errors or fraud that could adversely affect financial performance. Empirical studies by prior researchers indicate that the BOD positively influences financial performance (Malik & Makhdoom, 2016; Darwanto & Chariri, 2019; Ben Abdallah & Bahloul, 2021; and Diana et al., 2024).

H₁: the BOD has an effect on financial performance.

1.1.2. Impact of the SSB on financial performance

The SSB comprises specialists in muamalah jurisprudence and operates autonomously from the board of directors. SSB is entitled to attend board meetings to

evaluate and endorse the sharia compliance of decisions made. Besides its regulatory role, the SSB offers consultancy, conducts audits of financial institutions to verify adherence to sharia, and gives fatwas concerning the legitimacy of new investment and financing techniques about sharia compliance. The SSB is responsible for supervising the execution of the national sharia council's evaluations (Taufiq, 2020). If the SSB in an Islamic bank neglects legal compliance, the institution will forfeit the confidence of investors and clients, ultimately undermining its financial performance (Grassa, 2013). Moreover, an efficient SSB can offer suitable direction in the creation of sharia goods, mitigate financial risks linked to non-compliance, and enhance operational efficiency, thereby eventually augmenting financial performance. Prior studies indicate that firms exhibiting a robust SSB typically achieve superior financial performance (Mollah & Zaman, 2015; Nomran et al., 2018)

H₂: the shariah supervisory board has an effect on financial performance.

1.2.3. Impact of the audit committee size on financial performance

The committee's function is to support and enhance the board of commissioners in supervising the financial reporting process, risk management, audit execution, and the enforcement of corporate governance within corporations. A larger committee membership provides access to more comprehensive information and skills, enabling a more thorough assessment of Islamic banks' financial statements. The impact of audit committees on financial performance is grounded in agency theory, which posits that proficient audit committees can mitigate information asymmetry and agency issues by enhancing internal oversight and control. By maintaining an appropriate audit committee size, possessing highly qualified members, convening regularly, and ensuring substantial independence, audit committees can guarantee the accuracy of a company's financial statements and compliance with standards, thereby enhancing investor confidence and operational efficiency, ultimately leading to improved financial performance. Prior studies indicate that the audit committee positively influences financial performance (Mulianita et al., 2019 and Ben Abdallah & Bahloul, 2021)

H₃: the audit committee effects on financial performance.

1.1.4. The influence of the BOD on financial performance and the mediating role of CSR

BOD impact a company's financial success through CSR by formulating and endorsing CSR plans that align with the company's commercial objectives and values. A proficient board can spearhead CSR activities that bolster the company's brand, draw customers, and fortify stakeholder connections, subsequently augmenting revenue and profitability (Arshad et al., 2012). Moreover, effectively implemented CSR initiatives can enhance operational efficiency, mitigate legal or reputational risks, and foster loyalty among employees and investors. By incorporating CSR into business strategy, BOD enhance financial performance through elevated brand value, improved risk management, and a competitive edge derived from a dedication to social and environmental responsibility. Khaireddine et al., 2020 discovered that corporate social responsibility mediates the association between the board of directors and financial performance.

H₄: the BOD influences on financial performance through CSR.

1.1.5. Impact of the Sharia Supervisory Board on Financial Performance and Corporate Social Responsibility (CSR) as mediator

The SSB affects a company's financial performance via CSR by ensuring that CSR programs align with sharia values, which prioritise fairness, transparency, and social responsibility. This board provides guidance and oversight to ensure sharia compliance

in CSR implementation, thereby enhancing the company’s reputation among stakeholders and the community. Adherence to sharia principles in corporate social responsibility mitigates legal and reputational concerns while enhancing customer and investor confidence, so bolstering sharia-compliant products and services and subsequently improving financial performance. Consequently, the quantity of supervisory boards will enhance the quality of disclosure. Prior studies indicate that SSB affects financial performance via CSR (Arshad et al., 2012; Mallin et al., 2014; and Nomran et al., 2018).

H5: SSB influences financial performance through CSR.

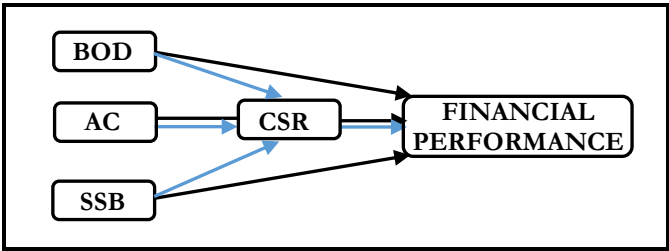
1.1.6. Impact of the Audit Committee on Financial Performance and Corporate Social Responsibility (CSR) as mediator

A broader audit committee possesses greater diversity in capacity, skills, and perspectives, hence enhancing the effectiveness of monitoring regarding CSR disclosures (Bédard et al., 2004). Jizi (2015), Helfaya & Moussa (2017), Al-Shaer & Zaman (2018), and Setiany (2018) discovered that audit committees enhance CSR disclosures. Effective CSR procedures illustrate a company’s dedication to social and environmental accountability, enhance its reputation, and draw investors focused on ethics and sustainability. Arshad et al. (2012), Mallin et al. (2014), and Nomran et al. (2018), adherence to compliance and openness in CSR reporting can bolster a company’s brand, draw in investors, and augment consumer loyalty, directly enhancing financial performance.

H6: the audit committee influences financial performance with CSR as a mediator.

Based on the above background, this study presents the conceptual research model shown in Figure 1 below.

Figure 1
Research Model



II. RESEARCH AND METHODOLOGY

This study focuses on Islamic banks in Indonesia operating during the period 2019 to 2023, using secondary data in the form of historical financial statements, annual reports, shariah governance reports, and CSR reports. The sample consists of 12 Islamic banks in Indonesia, with a total of 60 observations over five years. The dependent variable is financial performance. In this research, financial performance is assessed through return on assets (ROA). The independent variables include three elements of good corporate governance: the BOD, the audit committee, and the SSB. BOD is quantified by counting the number of its members. The audit committee is measured by its existence, referring to the establishment or presence of an audit committee within the organizational structure. SSB is evaluated according to how many members it has (Mollah & Zaman, 2015; Ajili & Bouri, 2018). CSR is divided into six dimensions: vision and mission statements, products and services, zakah, charity and benevolent funds, commitment to employees, commitment to debtors, and commitment to the community. The CSR disclosure index is measured as a dummy variable, coded 1 if the company

discloses CSR activities and 0 if it does not. The overall CSR disclosure index is then calculated by taking the weighted average ratio of these scores.

III. RESULTS AND DISCUSSION

The results of the inferential statistics can be illustrated in Figure 2 as follows.

Figure 2
Structural Model

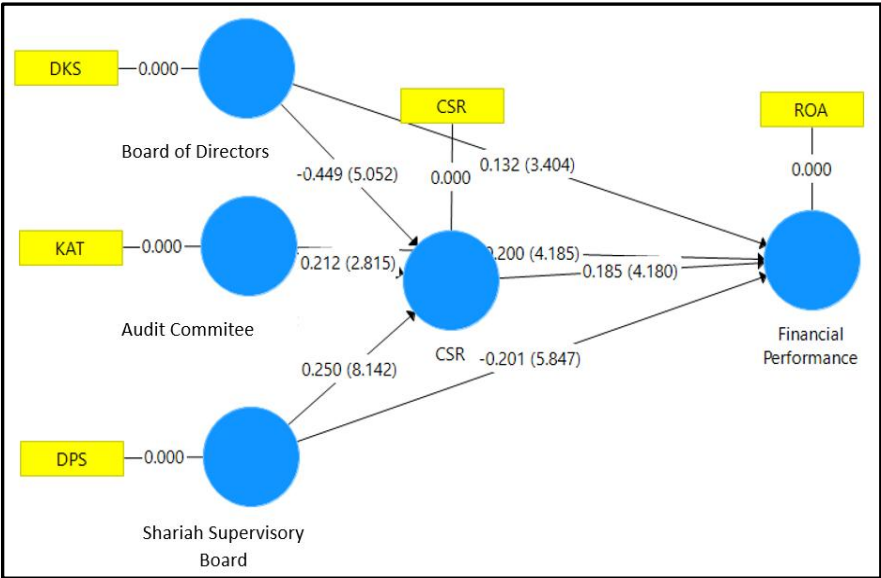


Table 1 below displays the outcomes of the statistical analyses employed to evaluate the study hypothesis.

Tabel 1
Path Coefficient

Variable			Information of Influence			t Statistic (t0/SIDEV)	P Values
Independent	Mediating	Dependent	Direct	Indirect	Total		
BOD		ROA	.132			3.240	.001
SSB		ROA	-.201			5.862	.000
AC		ROA	-.200			4.226	.000
BOD	CSR	ROA	.132	-.083	.049	3.230	.001
SSB	CSR	ROA	-.201	.046	-.155	3.568	.000
AC	CSR	ROA	-.200	.039	-.161	2.129	.034

Source: secondary data processed using SmartPLS 3.0.

3.1 Impact of the Board of Directors on Financial Performance

The BOD exerts a substantial and favourable impact on financial success. The t-statistic shows a value of 3.240>1.96, with a positive relationship, with the original sample value being 0.136, and a significant P-value of 0.001. Consequently, an expanded BOD results in enhanced financial performance. Consequently, H₁ is affirmed.

An effective BOD in carrying out its role can control risks and ensure compliance with sharia principles, make better strategic decisions, and enhance investor trust due to the credibility of financial reports. In this study, Islamic banks in Indonesia have BOD members who meet the qualifications required by sharia banking regulations, thereby improving bank performance and overseeing management effectively (Ben Abdallah & Bahloul, 2021). Thus, Islamic banks in Indonesia are able to optimize their performance thanks to the effective role of the BOD in managing risks and ensuring compliance with

sharia principles. Through their strategic decision-making abilities, the BOD also contributes to promoting growth and innovation in the sector, which in turn increases investor confidence. According to agency theory, when BOD maximizes its functions and roles effectively, their supervision can reduce agency problems between principals and agents, as well as minimize conflicts of interest among shareholders (Jensen & Meckling, 1976)

3.2. The Effect of the SSB on Financial Performance

The SSB impacts financial performance. The t-statistic shows a value of $5.862 > 1.96$, with a negative relationship, with the original sample value being -0.201 , and a significant P-value of 0.000 . Therefore, a SSB leads to lower financial performance. Consequently, H_2 is affirmed.

According to AAOIFI, the SSB consists of experts in *fiqh muamalah* who operate independently from the board of directors. The SSB provides consultation, reviews operational activities to ensure compliance with sharia principles, and issues fatwas regarding the legitimacy of sharia-compliant methods. However, when the number of SSB members is excessive, coordination and communication among members become more complex, potentially slowing down decision-making processes. Delayed or ineffective decisions can hinder the institution's responsiveness to market opportunities or operational challenges, ultimately harming the profitability and efficiency of the Islamic financial institution.

An optimal number of SSB members can reduce conflict and maximize performance, as unresolved conflicts may generate agency costs and create tension between principals and agents within the organization (Jensen & Meckling, 1976). Furthermore, having too many SSB members may increase operational costs such as remuneration and related facilities thereby reducing profit margins, especially if individual contributions are not proportional to their costs. Additionally, excessive members increase the likelihood of significant differences in opinion, which, if not managed properly, may cause uncertainty in sharia policy implementation and negatively affect financial performance. Consistent with prior studies, Anggreni et al. (1970), Ben Abdallah and Bahloul (2021), and Diana et al. (2024) identified an inverse correlation between the SSB and financial performance.

3.3. The Effect of the Audit Committee on Financial Performance

The audit committee also shows a significant negative effect on financial performance. The t-statistic value is $4.226 > 1.96$, with a negative relationship, with the original sample value being -0.200 . The p-value signifies a significant outcome of 0.000 . Therefore, the larger the number of audit committees, the lower the financial performance. Therefore, H_3 is accepted.

Audit committees are typically formed to improve supervision of financial reporting and internal control mechanisms. Nonetheless, in specific instances, their existence may adversely affect corporate performance, mainly when they operate ineffectively or impede decision-making. Excessively stringent or bureaucratic oversight may impede strategic decisions, such as investments or innovations, which can be detrimental to the company's performance. Furthermore, if the audit committee possesses inadequate experience or insufficient sector knowledge, it may result in suboptimal decision making for the organization. A failure to accurately evaluate risks or recognize suitable opportunities may lead to lost prospects or involvement in unprofitable ventures. When such decisions do not facilitate financial growth or stability, the result is a deterioration in financial performance.

Inadequate knowledge, experience, and skill can undermine financial and audit oversight, thereby adversely affecting firm performance. Moreover, operational expenditures linked to the audit committee—such as member compensation and other associated costs—can impose an additional financial strain on the organization. If the committee fails to deliver substantial enhancements in openness and corporate governance while utilizing firm resources, it may diminish profit margins and operational efficiency. An incompetent or excessively intrusive audit committee may adversely impact the firm's financial performance.

3.4. The Effect of the BOD on Financial Performance through CSR

The path coefficient between the BOD and financial performance, with CSR as a moderating variable, shows a t-statistic value of $3.230 > 1.96$ and a significant P-value of 0.001. This indicates that the BOD influences financial performance through CSR, and thus, H₄ is accepted.

This study illustrates that while the BOD significantly influences financial success, CSR initiatives serve as a crucial mechanism that enables the Board to achieve positive financial outcomes. An active Board that advocates for CSR policy can guarantee the company prioritizes not only immediate profitability but also enduring sustainability. By encouraging ethical, environmentally friendly, and socially responsible business practices, the Board helps manage reputational risks and meet stakeholder expectations, ultimately supporting more stable and sustainable financial performance. The mediating function of CSR highlights the necessity of incorporating CSR into the whole corporate strategy under the oversight of the Board. Boards that recognize CSR's role in creating long-term value are more likely to allocate sufficient resources and attention to impactful CSR programs. When CSR is embedded in the company's vision and mission, it can generate competitive advantages, strengthen customer loyalty, and open new market opportunities. These factors contribute to improved financial performance, showing that CSR is not merely a marketing tool but a key element of business strategy guided by the Board.

3.5. The Effect of the Sharia Supervisory Board on Financial Performance through CSR

The path coefficient between the SSB and financial performance, with CSR as a moderating variable, shows a t-statistic value of $3.230 > 1.96$ and a significant P-value of 0.001. This indicates that the SSB influences financial performance through CSR, and thus, H₄ is accepted.

This study shows that SSBs that encourage and oversee CSR implementation in accordance with sharia principles can generate a significant positive impact on the company's financial performance. sharia-based CSR not only enhances the company's reputation as a socially and religiously responsible entity but also builds trust and loyalty among customers and stakeholders. By ensuring CSR compliance with sharia principles, the SSB helps the company avoid reputational and legal risks while capitalizing on market opportunities among ethically conscious consumers. The positive influence of the SSB on CSR is supported by studies such as (El Hussein, 2018; Wijayanti & Setiawan, 2023)

Furthermore, the integration of CSR into sharia business strategy under the SSB's oversight can enhance overall financial performance. When the SSB ensures that CSR initiatives are not only sharia-compliant but also designed to deliver tangible social and economic benefits, long-term profitability is more likely. In line with legitimacy theory, organizations must adopt societal values and norms while avoiding threats to their survival (Dowling & Pfeffer, 1975; Guthrie & Abeysekera, 2006). For example, CSR

initiatives focusing on community economic empowerment, sustainable environmental management, and high ethical standards can open new markets, reduce operational costs through resource efficiency, and strengthen local community relations.

Signaling theory (Stiglitz, 2002) further explains that companies use certain signals to convey otherwise hidden information to investors, thereby reducing information asymmetry and improving financial outcomes. In this case, effective CSR serves as a positive signal that the company is committed not only to financial gains but also to social responsibility and sustainability. Thus, the SSB functions not only as a sharia compliance overseer but also as a key driver in creating sustainable financial performance through effective CSR initiatives. The positive link between CSR and financial performance is supported by (Mallin et al., 2014; Alam et al., 2022).

3.6. The Effect of the Audit Committee on Financial Performance through CSR

The path coefficient between the audit committee and ROA, with CSR as a mediating variable, is 0.039, with a t-statistic value of $2.129 > 1.96$ and a significant P-value of 0.034. This indicates that the audit committee influences financial performance through CSR, and thus, H_6 is accepted.

The audit committee oversees the accuracy of financial statements, regulatory compliance, and internal controls. However, its oversight also extends to monitoring corporate policies and practices related to social responsibility. When the audit committee actively promotes and supervises effective CSR implementation, it can generate a positive impact that ultimately enhances the company's financial performance. The significant positive influence of the audit committee on CSR is supported by (Jizi, 2015; Mollah & Zaman, 2015; Helfaya & Moussa, 2017; and Al-Shaer & Zaman, 2018). These findings underscore the significance of incorporating CSR within corporate governance procedures under the supervision of the audit committee. When the audit committee recognizes that CSR is not solely a compliance requirement but also a strategic component that enhances the company's long-term worth, its influence on financial performance becomes more evident. This suggests that CSR can serve as a tool to enhance the beneficial relationship between governance supervision and financial performance. The results align with previous research conducted by (Mallin et al., 2014; Alam et al., 2022).

IV. CONCLUSION

This study investigates the direct and indirect impacts of shariah governance implementation on financial performance, with a focus on the latter's mediation by CSR. The adoption of shariah governance, indicated by the BOD, the SSB, and the audit committee, demonstrates differing effects. The BOD positively impacts financial success. A proficient BOD may manage risks and ensure adherence to sharia principles, ultimately optimizing financial performance. The SSB and the audit committee exert a detrimental effect; an excessive number of members in either entity can complicate coordination and communication, hence potentially impeding decision-making procedures. Protracted or poor decision-making may impede the institution's ability to respond to market opportunities or operational issues, ultimately adversely affecting the profitability of Islamic financial institutions. CSR mediates the relationship between the implementation of shariah governance and financial performance. The incorporation of CSR into the company's overarching strategy, overseen by the board of directors, sharia supervisory board, and audit committee augments the comprehension of CSR's significance in generating long-term value. Institutions that acknowledge this importance are more

inclined to dedicate adequate resources and focus to the development of effective CSR programs.

This study has multiple limitations. The research sample is relatively small, consisting of only 12 Islamic banks in Indonesia, resulting in a total of 60 observations. The data used are secondary data bound by predetermined reporting guidelines. This study exclusively employed CSR as a mediating variable, neglecting other potential mediators. Further study could extend the temporal and spatial parameters to yield more representative findings and incorporate mixed methodologies, integrating quantitative and qualitative analyses for enhanced comprehension. Researchers may incorporate additional mediating or moderating variables and evaluate the impact of external factors, such as macroeconomic conditions or laws.

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