

# Sharia Compliance, Islamic Corporate Governance, Intellectual Capital, and Earning Management toward Financial Performance in Indonesia Islamic Banks

IQTISHADIA  
14,2

251

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## Abstract

This research aims to analyze the effect of Sharia Compliance, Islamic corporate Governance, Intellectual Capital, and Earnings Management on the Financial Performance of Islamic Banks. The research method uses a quantitative approach with secondary data. Data were obtained from 12 (twelve) Islamic Commercial Banks in Indonesia selected using the purposive sampling technique. The analysis technique used is Partial Least Square (PLS). The results showed that Sharia compliance affects the financial performances of Islamic banks. Islamic corporate governance affects the earnings management and financial performance of Islamic banks, and intellectual capital affects the financial performance of Islamic banks. Meanwhile, earnings management does not affect the financial performance of Islamic banks. The findings of this study provide evidence that the variables of Sharia compliance, Islamic corporate governance, and intellectual capital can help Islamic banks in Indonesia improve their financial performance. In addition, these findings will contribute to the literature on the determinants of Islamic bank financial performance.

**Keywords:** Sharia Compliance, Islamic Governance, Intellectual Capital, Earning Management, Financial Performance.

## INTRODUCTION

Since the Islamic banking system development in Indonesia, the expansion of National Islamic finance in the past two decades has made significant progress and improvements, both in the aspects of institutions, regulations, supporting infrastructure, supervision systems, as well as public awareness and literacy (Otoritas Jasa Keuangan, 2019). This increase could have implications for the challenges that must be faced by Islamic banks, such as challenges to customers and public trust in Islamic banking (Meslier *et al.*, 2020). It will encourage Islamic Banks to maintain their performance, both in management and financial performance. The quality and level of financial



IQTISHADIA

Vol. 14 (2) 2021

PP. 251 - 279

P-ISSN: 1979 - 0724

E-ISSN: 2502 - 3993

DOI : 10.21043/iqtishadia.v14i2.10152

performance of Islamic banks illustrate how the bank's business activities and operations are optimal (Anwar *et al.*, 2020). According to data from the Financial Services Authority, the market share for Islamic banks in 2019 reached 5.95% and continuously increased and reached 6.18%. However, Islamic Bank assets in nominal rupiahs experienced a decline (y-o-y) growth in 2016-2019 (Snapshot Perbankan Syariah, 2019).

The financial performance of Islamic banks, indicated by the ROA (Return On Asset) ratio in 2018-2019, experienced a decline where the ROA growth in 2018 was 0.64%, while in 2019, it was 0.45% (sps ojk, 2020). The financial performance of Islamic banks can further increase with the influence of sharia compliance variables (Djuwita *et al.*, 2019; Hamsyi, 2019), intellectual capital (Ousama *et al.*, 2019; Setyawati *et al.*, 2019), corporate governance, and earnings management (Aslam & Haron, 2020; Kolsi & Grassa, 2017; Mersni & Ben Othman, 2016; Umoren, 2018). Sharia Compliance is important as a differentiator for Islamic banks that operate based on sharia principles with companies in general in the orientation of improving banking performance (Dewanata *et al.*, 2016). According to research by Djuwita *et al.*, (2019); Hamsyi, (2019) that sharia compliance has a significant effect on the financial performance of Islamic banks, while according to Ratnaputri (2013) research the fulfillment of sharia compliance aspects is still low in several Islamic banks in Indonesia, so the results show that sharia compliance does not affect the financial performance of Islamic banks.

An organization needs good corporate governance mechanisms because an optimal corporate governance system can increase trust. It will build a good image for the company (Mahrani & Soewarno, 2018). According to research by Aslam & Haron, (2020) Islamic corporate governance has a significant effect on the performance of Islamic banks because effective governance will improve the quality of financial reports so that they can improve the financial performance of Islamic banks. However research by Ajili & Bouri (2018) on Islamic banking in Saudi Arabia states that corporate governance with Islamic principles is low, and it cannot improve the financial performance of Islamic banking. Intellectual capital is seen as part of the overall company in the value creation process and plays a role in maintaining competitive advantage (Setyawati *et al.*, 2019). According to the research results of Ousama *et al.* (2019), intellectual capital has a positive and significant effect on the financial performance of Islamic banks with the components of human capital and capital employed that also have a positive effect on the financial performance of Islamic banks. However, research by Rahajeng & Hasibuan

(2020) shows different results, that intellectual capital has no effect on the financial performance of Islamic banks.

Furthermore, earnings management practices are found in several Islamic banks. Based on research by Kolsi & Grassa (2017) and Mersni & Ben Othman (2016), the practice of earnings management in Islamic banks is influenced by corporate governance, especially the role of sharia supervisory board in overseeing managers' discretion in manipulating financial performance reports. However, other results found in research by Alam *et al.* (2020), the role of the sharia supervisory board is not sufficient in limiting earnings management practices. It shows that Islamic values in the organization have not been fully considered. Umoren (2018) and Mahrani & Soewarno (2018), earnings management affects banking financial performance, where earnings management activities aim to gain profits. Meanwhile, Saidu *et al.* (2017) fail to prove that earnings management affects banking financial performance as measured by the bank's financial performance ratio.

Based on the previous explanation that shows the inconsistency of previous research, further research is needed to analyze the influence of sharia compliance, Islamic corporate governance, intellectual capital, and earnings management variables on the financial performance of Islamic banks. In addition, research on the effect of earnings management and Islamic corporate governance on Islamic financial performance is still limited, so it is important to do further. The findings of this study are expected to provide benefits and insights regarding the importance of Islamic bank financial performance, contribute to developing research, and support the results of previous studies.

## **LITERATURE REVIEW**

### *Islamic Financial Performance*

Financial performance is a description of every economic result achieved by banks in a certain period through company activities to generate profits efficiently and effectively. The development of financial performance can be measured by analyzing financial data reflected in the financial statements. Information on company performance, especially profitability, is needed to assess changes in potential economic resources controlled in the future (Ikatan Akuntansi Indonesia, 2007). Financial performance in Islamic banks describes the financial condition of the bank and the success

of Islamic banks in managing finances. Financial performance assessment is needed for many parties such as regulators, the public, and the bank concerned as a benchmark in seeing the real condition of the financial health of banks (Danupranata, 2016).

The measuring instrument used in determining the financial performance of Islamic banking is bank financial ratios, where financial performance can be measured according to the needs of those who need it (Danupranata, 2016). The measuring instrument used in determining the financial performance of Islamic banking is bank financial ratios, where financial performance can be measured according to the needs of those who need it (Fahmi, 2015). The profitability aspect is to determine the ability of Islamic banks to generate profits during a specific period (IBI, 2018). Then the indicator of the financial performance of Islamic banks is the profitability ratio, which consists of the ratio of earnings per total assets (ROA) as the rate of return on assets and the ratio of earnings per equity (ROE) as the rate of return on the average capital owned by Islamic banks (Aslam & Haron, 2020; Buallay, 2019; Hakimi *et al.*, 2018).

### *Sharia Compliance*

Sharia Compliance is the concept of ensuring the fulfillment of sharia principles in Islamic banks (Azam *et al.*, 2019). Sharia Compliance is a form of bank implementation in fulfilling sharia values, a fundamental aspect that distinguishes conventional Islamic banking (Basov & Bhatti, 2014; Ratnaputri, 2013). Evaluating the performance of Islamic banking is as important as measuring individual achievement. The roles and responsibilities of Islamic banking are not only limited to the financial needs of various parties, but how the institution runs its business, and how it acts to ensure that all activities are in line with sharia (Lidyah, 2018). Conceptually, sharia compliance is the consistent application of sharia principles inbound financial transactions, thus making sharia principles a framework for the banking system in resource allocation, management, capital market activities, and wealth distribution (Dewanata *et al.*, 2016).

The role of sharia compliance in improving the financial performance of Islamic banking can use an alternative index proposed by Hameed *et al.* (2004), namely the Sharia Conformity Index or in several studies referred to as the sharia compliance index. The sharia compliance index is used as an indicator to assess the performance of Islamic banking based on Islamic

finance criteria. The use of sharia compliance indicators adjusts to the conditions of sharia banking in each region. So in this study, the researcher will use three indicators of sharia compliance, the Islamic Income Ratio (IsIR), the Profit Sharing Ratio (PSR), which refers to the research of Hamsyi (2019), and Zakat Performing Ratio (ZPR) which refers to the research of Dewanata *et al.*, (2016).

### *Islamic Corporate Governance*

Islamic Corporate Governance is a concept of good corporate governance (GCG) in Islam. It is a company direction and control system to fulfill company objectives in protecting the rights and interests of all stakeholders, using the basic concept of decision-making based on Islamic principles (Rustam, 2018). The main objective of Islamic Corporate Governance is the *Maqasid Sharia*, with Islamic Corporate Governance considering the effects of sharia law, economic, and financial principles on practice and policy (Magalhães & Al-Saad, 2013). Islamic Corporate Governance or sharia governance refers to ISFB-10 (2009) regarding the main component in sharia governance, namely the Sharia Supervisory Board in the organizational structure. The existence of the Sharia Supervisory Board is a component that differentiates Islamic banking corporate governance from conventional banking (Lidyah, 2018; Nomran *et al.*, 2018).

The regulations for implementing Islamic Corporate Governance for Islamic banks in Indonesia are in line with Bank Indonesia Regulation Number 11/33/2009 concerning the GCG of Islamic commercial banks and sharia business units. It explains that the implementation of Islamic Corporate Governance to the public shows that Islamic banks are well managed, professional, and prudent, and continue to strive to increase shareholder value without neglecting the interests of other shareholders (PBI, 2009). Islamic Corporate Governance application is realized through the implementation of the duties and responsibilities of the Sharia Supervisory Board as an advisory and supervisory board for the implementation of sharia principles in the collection and distribution and banking services, an independent board of commissioners as the supervisor of banking managers, and an audit committee whose role is to evaluate the implementation of internal audit. in the financial reporting process (Muhamad, 2016).

### *Intellectual Capital*

Intellectual Capital is the total value of a company that describes intangible assets in the form of information and knowledge resources that function to increase the company and improve its performance (Nazari & Herremans, 2007). Intellectual capital is an important resource in creating a company's competitive advantage. Intellectual capital includes all employee knowledge, organization, and ability to create added value so that it can create a sustainable competitive advantage for the company (Buallay *et al.*, 2019). Intellectual capital has been identified as a set of intangible assets in the form of resources, capabilities, and competencies that drive organizational performance and long-term value creation (Ozkan *et al.*, 2017).

According to the International Federation of Accountants (IFAC), intellectual capital is synonymous with intellectual property, intellectual assets, and knowledge assets. The meaning of capital is defined as the knowledge-based capital a company has. IFAC estimates that currently the company's value is determined more toward intellectual capital management, not fixed assets. Therefore, intellectual capital in the balance sheet can be categorized as non-capital assets or equity (Chen & Zhu, 2004). Based on Pulic (2004), intellectual capital can be measured quantitatively by four main components, namely human capital (HC), structural capital (SC), and employed capital (CE), as well as the Value Added Intellectual Coefficient (VAIC) as a modified measurement of intellectual capital.

### *Earning Management*

Earning management is an intervention carried out by managers in preparing financial reports for external parties so that managers can level, increase, and decrease earnings reporting. Management can use leeway in accounting methods and make policies that can accelerate or delay costs and revenues, and it makes company profits smaller or larger than expected (Quttainah *et al.*, 2013). One of the earning management practices in the banking industry is income smoothing. Income smoothing is an action taken by management to reduce fluctuations in earnings by using specific accounting methods (Diri, 2017).

Banking managers have special compensation for smoothing income through Loan Loss Provision (LLP) or allowance for credit losses, known as Allowance for Earning Asset Losses (PPAP) which is then changed to the term Allowance for Impairment Losses (CKPN) following PSAK 50/55 of

2006, where it is important to make provision for seeing the actual condition of the bank's financial statements (Zulfikar *et al.*, 2019). Loan Loss Provision (CKPN) is considered as an appropriate proxy in detecting the existence of Islamic banking earnings management (Ben Othman & Mersni, 2014; Chang *et al.*, 2011). Lassoued *et al.*, (2018) stated that Islamic banks are banks with Islamic principles, so earning management is an activity that needs supervision because it can be one of the factors that reduce the credibility of Islamic banks' financial statements and will disturb financial report users.

## **Relations Between Variables**

### *Sharia Compliance toward Financial Performance*

Sharia compliance in Islamic banks with indicators of Islamic Income Ratio (ISIR), Profit-Sharing Financing Ratio (PSR), and Zakat Performing Ratio (ZPR) is a method that can evaluate Islamic financial performance (Hameed *et al.*, 2004). As evidenced in Hamsyi's research (2019), sharia compliance affects financial performance on indicators of halal income and profit-sharing financing. Because the higher the halal income obtained by Islamic banks and the distributed revenue-sharing financing will further improve the financial performance of Islamic banks. So, it's important for Islamic banking to pay attention constantly and maintain sharia principles as part of sharia compliance. Djuwita *et al.* (2019) also stated that sharia compliance affects financial performance in Islamic banks. It means that the fulfillment of the concept of sharia compliance both in the products and services offered, one of which is profit-sharing-based financing, will increase public confidence in Islamic banks to improve the performance of Islamic banks. Based on the explanation, the proposed hypothesis is;

H<sub>1</sub>. Sharia compliance has an effect toward the financial performance of Islamic banks.

### *Islamic Corporate Governance toward Financial Performance*

Islamic Corporate Governance plays a significant role in overcoming agency problems, transparency, and openness. Role of sharia supervisory board, independent commissioners, and audit committee in the structure of effective Islamic corporate governance in improving the quality of financial reporting and transparency as a form of safeguarding the reputation of Islamic banks, which in turn can improve the financial performance of

Islamic banks (Hakimi *et al.*, 2018). Evidenced research by Aslam & Haron (2020) that Islamic corporate governance affects the financial performance of Islamic banks. Because Islamic banks with prudent governance structures are seen as efficient in allocating resources to generate profits. Siswanti *et al.* (2017) said that Islamic Corporate Governance affects Islamic Bank Financial Performance because the implementation of corporate governance in Islamic banks is very important to foster the existence of Islamic banks to maintain the image of Islamic banks in society. Based on this explanation, the proposed hypothesis is;

H<sub>2</sub>. Islamic corporate governance has an effect toward the financial performance of Islamic banks.

#### *Intellectual Capital toward Financial Performance*

Intellectual capital can create value and improve company performance (Pulic, 2004). Efficient use of intellectual capital is necessary to create a long-term competitive advantage (Setianto & Sukmana, 2016). As evidenced in the research of Setyawati (2019) and Ousama *et al.* (2019), Intellectual Capital has a significant effect on the Financial Performance of Islamic Banks. It means that intellectual capital owned by Islamic banks in the form of human resources, information, and efficient use can generate high profits so that the financial performance of Islamic banks increases. Buallay *et al.*, (2019) stated that intellectual capital has a positive effect on the financial performance of Islamic banks because intellectual capital has a significant role and strategy in measuring the development of human resources in the Islamic banking industry. In addition, intellectual capital is an important strategic asset for the success of Islamic banks and can provide added value for Islamic banks in improving financial performance. Based on this explanation, the hypothesis is;

H<sub>3</sub>. Intellectual capital has an effect toward the financial performance of Islamic banks.

#### *Islamic Corporate Governance toward Earning Management*

Corporate Governance (internal and external) are the most effective tools to limit managers' discretionary behavior (Quttainah *et al.*, 2013). As evidenced by the research of Kolsi & Grassa (2017) and Mersni & Ben Othman (2016), Islamic Corporate Governance has an effect on the earnings



management of Islamic Banks. The role of the sharia supervisory board in the governance structure of Islamic companies is effective in preventing and supervising earnings management practices in Islamic banks. Mahrani & Soewarno (2018) stated that corporate governance has an effect on corporate earnings management. Corporate governance can prevent and reduce earnings management because the supervision of the independent board of commissioners and the audit committee is to act as best as possible for the interests of the principal stakeholders and suppress deviant behavior so that they can be accountable for their duties properly. Based on this explanation, the proposed hypothesis is;

H<sub>4</sub>. Islamic corporate governance has an effect toward earning management.

#### *Earning Management toward Financial Performance*

Earnings management carried out by managers in managing company profits aims to improve the company's financial performance (Mahrani & Soewarno, 2018). As evidenced by the research of Utami *et al.* (2019), earnings management affects banking financial performance. Banking performance will decline if the company performs earnings management in the form of inaccurate financial reporting. Umoren (2018) states that earnings management influences the financial performance of banks. Likewise, according to Mahrani & Soewarno (2018), earnings management affects financial performance because earning management actions can have an impact on the quality of earnings information in financial statements. The low quality of information contained in the financial statements will have a negative impact on the company's financial performance. Based on this explanation, the proposed hypothesis is;

H<sub>5</sub>. Earning management has an effect toward the financial performance of Islamic banks.

## **RESEARCH METHOD**

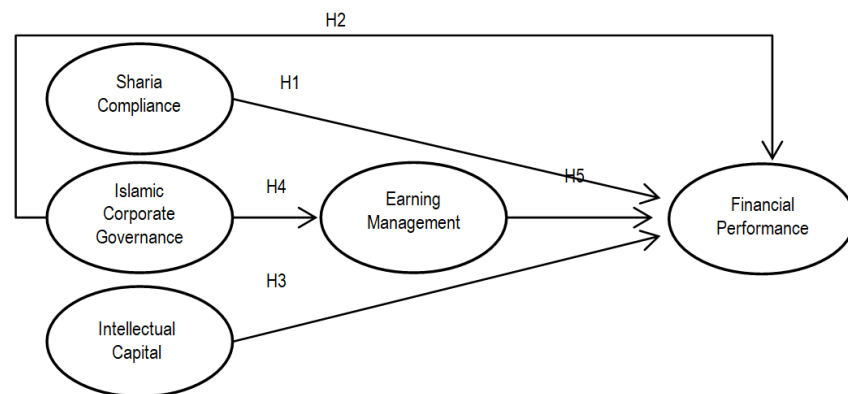
The research method uses a quantitative approach with secondary data. Secondary data is obtained from the annual financial reports of Islamic Commercial Banks in Indonesia for 2014-2019. This study uses panel data, a combination of time series and cross-section data. The research data scale

is the ratio of data on sharia compliance variables and Islamic bank financial performance, and nominal data on the variables of Islamic corporate governance, intellectual capital, and management earnings. The population of this research is Islamic Commercial Banks registered with the Financial Services Authority (OJK) in 2014-2019. Then the sampling used the purposive sampling technique. Purposive sampling is a sampling technique to select samples selectively and with predetermined criteria and follow the objectives of the researcher (Ferdinand, 2014).

The research sample criteria include Islamic Commercial Banks in Indonesia which continuously publish annual financial reports for 2014 to 2019 and Islamic Commercial Banks which provide complete information about the data needed in this study. Based on these criteria, the number of samples used in the study were 12 (twelve) Islamic Commercial Banks with 6 (six) annual financial reports. This study uses the analysis technique of Partial Least Square (PLS). The reason for using the PLS is that the technique can be used to explain the relationship between variables without based on the assumption of the variable measurement scale, data distribution, and the number of samples. In addition, the measurement scale on the PLS can be in the form of nominal, ordinal, interval, and ratio (Ghozali, 2014).

Figure 1 explains the research model showing the influence of exogenous variables, namely sharia compliance, Islamic corporate governance, intellectual capital, and earnings management in the endogenous variables, namely the financial performance of Islamic banks. It explains the influence of Islamic corporate governance variables on earnings management variables.

**Figure 1. Research Framework**



Activate Windows

Source: Author's illustration, based on Hamsyi (2019); Ousama *et al.*, (2019); Mahrani & Soewarno (2018); Mersni & Ben Othman, (2016).

**1. Financial Performance**

Islamic banking financial performance is measured by two indicators based on profitability ratios Buallay, (2019); Hakimi *et al.*, (2018), that is; (1) Return on Asset (ROA) is the ratio between profit before tax and total assets of Islamic banks. (2) Return on Equity (ROE) is the ratio between profit after tax and total equity of Islamic banks.

**2. Sharia Compliance**

The indicators used in this study are based on Dewanata *et al.*, (2016); Djuwita *et al.*, (2019); Hamsyi, (2019). (1) Islamic Income Ratio (ISIR), is the ratio of the ratio of Islamic income to the income obtained by Islamic banks from halal and non-halal transactions. (2) Profit Sharing Ratio (PSR), is the ratio of profit-sharing financing to profit and loss sharing contracts, namely mudharabah and musyarakah with total Islamic bank financing. (3) Zakat Performing Ratio (ZPR), is the ratio of the total distribution of zakat funds in sharia banks to profit before tax.

**3. Islamic Corporate Governance**

- 1) The Sharia Supervisory Board (DPS) is an advisory and supervisory board for the implementation of sharia banking principles which has a background in Islamic banking and banking and finance. Measurement (1) : 1 for BS with 2 or more DPS Members and 0 if not, based on the AAOIFI Governance Standard; PBI Number 6/24 / PBI / 2004 article 26 (1) states that the number of DPS members is at least 2 people and a maximum of 5 (five) people. Measurement (2) : 1 for DPS with 1 or more meetings in a month, 0 if not, according to PBI Number 11/33 / PBI / 2009 Article 49 that SSB meetings are required to be at least (1) times a month. Measurement (3) : 1 for SSB with 1 member with mu'amalah and banking background, 0 if not, based on PBI 2004 article 21 paragraphs 2 and 3, competent SSB are those who have knowledge of mu'amalah and banking.
- 2) The Independent Commissioner (KI) is a member of the board of commissioners who is not affiliated with management, the board of commissioners and shareholders and is free from business relations. Measurement (1) : 1 for BS with 2-3 independent commissioners, 0 otherwise (Ajili & Bouri, 2018; Aslam & Haron, 2020). Measurement

(2) : 1 for BS with at least 6 meetings a year, 0 if not (Ajili & Bouri, 2018; Aslam & Haron, 2020).

- 3) Audit Committee (KA), is a member of the board of directors who is tasked with evaluating the implementation of internal audit in order to assess the adequacy of internal control including the financial reporting process. Measurement (1): 1 for BS with 3 or more audit committee members, 0 if not, according to PBI Number 11/33 / PBI / 2009 that the Audit Committee membership is at least 3 people. Measurements (2): 1 for BS with a minimum of 4 times a year, 0 otherwise (Ajili & Bouri, 2018; Aslam & Haron, 2020).

#### 4. *Intellectual Capital*

- 1) The first stage, measuring the Value Added (VA), by reducing the Output to the input ( $VA = Output - Input$ ). Where Output is the total revenue of Islamic banks and input is the total cost other than employee costs. Based on Pulic (2004); Ousama *et al.*, (2019); Setianto & Sukmana (2016); and Setyawati *et al.*, (2019).
- 2) The second stage, measuring the value of the VACA, VAHU, and STVA indicators. Value Added Value of Capital Employed (VACA) shows how much Capital Employed produces returns, by comparing the Value Added (VA) with the number of Capital Employed (CE). Where the measurement of CE is the amount of capital.
- 3) Score Value Added Human Capital (VAHU) shows how much VA can be generated with the funds provided for labor needs, namely by comparing VA with the amount of Human Capital (HC). Where HC measurement is employee cost. Score Value Added Structural Capital (STVA) shows the contribution of Structural Capital in creating value, by comparing VA with the amount of Structural Capital (SC). Where the SC measurement is the reduction of VA by HC.
- 4) The third stage, measuring the value of the Value Added Intellectual Coefficient (VAIC) indicator, is used to measure the company's ability to create efficiency from Value Added (VA) or considered as a Business Performance Indicator. The VAIC formula is

$$VAIC = VACA + VAHU + STVA$$

5. *Earning management*

Based on research Ben Othman & Mersni, (2014); Mahrani & Soewarno, (2018); Mersni & Ben Othman, (2016). DCKPN is used to examine Islamic bank managers' discretion in evaluating earnings management activities.

- 1) Calculating allowance for impairment losses (CKPN) of sharia banks, using the formula;

$$CKPN = CKPN \text{ Non diskresioner} - CKPN \text{ Diskresioner}$$

The calculation of CKPN for Islamic banking uses the composition of the allowance for losses on financing value including *qordul hasan*, *murabahah*, *mudharabah*, and *musyarakah* to predict the total allowance for losses of Islamic banks. Then the non-discretionary CKPN component is estimated using informative variables including the initial balance of NPF in year t, changes in NPF, and changes in total sharia bank financing in year t.

- 2) Calculating the discretionary Loan Loss Provision (DCKPN), with the estimated coefficient of forecasting the CKPN model as a deduction for the total CKPN. The DCKPN formula is; .

$$DCKPN = CKPN_{it} - NDCKPN_{it}$$

## RESULTS

### *Model Analysis*

*Outer Model Analysis.* It is conducted based on three tests, namely convergent validity, discriminant validity, and composite reliability (Ghozali, 2014). *Convergent validity.* This test aims to measure the correlation between indicators and their constructs. Based on the test results, the loading factor value of all indicators is greater than 0.70. It indicates that the research indicators are considered valid and meet convergent validity (Table L1).

*Discriminant validity.* This test aims to measure the validity of a construct with other constructs, by looking at the cross-loading value, fornell-lacker criterium, and average variance extracted (AVE). Based on the test results, the cross-loading value of each construct with its indicator is greater than the correlation of each construct with other indicators (Table L1). This shows that each construct is able to predict the indicators in each block better

than the others. Then, the test results through the fornell-lacker criterium show that all constructs in the model meet the discriminant validity criteria, because the value of the AVE root of each construct is greater than the other constructs (Table L2). *Composite reliability.* This test aims to measure construct reliability by looking at the composite reliability and cronbach alpha values. Based on the test results, the composite reliability and cronbach alpha values for all constructs were greater than 0.70, thus indicating that the research construct had good reliability (Table L3).

*Inner Model Analysis.* By looking at the value of R-square (R2) and predictive relevance (Q2) (Ghozali, 2014). R-square (R2) as a goodness-fit model test, which is to measure the ability of exogenous variables to explain endogenous variables. Table 1 shows the results of the R-square (R2) value of the Islamic bank financial performance variables and earnings management of 0.969 and 0.123. This means that the financial performance variable can be explained by 0.969 or 96.9% by the variables of sharia compliance, Islamic corporate governance, intellectual capital, and earnings management. While 0.031 or 3.1% is explained by variables outside the model. Then the earnings management variable can be explained by 0.123 or 12.3% by the Islamic corporate governance variable. Meanwhile, 0.877 or 87.7% is explained by variables outside the model. Based on the calculation of predictive relevance (Q2), namely  $Q2 = 1 - (1-R12)(1-R22)$ , the value is 0.973.

**Table 1. R-square value (R2)**

Construct	R2	Adjusted R Square
Financial Performance	0.969	0.968
Profit management	0.123	0.009

Source: data processed by the author, 2020.

### ***Hypothesis test***

Based on Table 2, it explains the results of hypothesis testing from the relationship between research variables by looking at the value of the parameter coefficient ( $\beta$ ), t-statistic, and the significance value (p).

*H1.* The value of the parameter coefficient ( $\beta$ ) of sharia compliance on the financial performance of Islamic banks is 0.508. The positive

coefficient shows that the higher the sharia compliance, the higher the financial performance of Islamic banks. In other words, any increase in the value of sharia compliance will have an impact on improving the financial performance of Islamic banks. Based on the t-statistic of 2.836, a significance value of 0.005 ( $p < 0.05$ ) indicates that there is a significant influence between sharia compliance and the financial performance of Islamic banks.

*H2.* The value of the parameter coefficient ( $\beta$ ) of Islamic corporate governance on the financial performance of Islamic banks is 0.169. The positive coefficient shows that the higher the Islamic corporate governance, the higher the financial performance of Islamic banks. In other words, any increase in the value of Islamic corporate governance will have an impact on improving financial performance. Based on the t-statistic of 3.242, the significance value of 0.001 ( $p < 0.05$ ) indicates that there is a significant influence between Islamic corporate governance and the financial performance of Islamic banks.

*H3.* The value of the intellectual capital parameter coefficient ( $\beta$ ) on Islamic bank financial performance is 0.584. The positive coefficient shows that the higher the intellectual capital value, the higher the financial performance of Islamic banks. In other words, any increase in the value of intellectual capital will have an impact on improving the financial performance of Islamic banks. Based on the t-statistic of 4.807, the significance value of 0.000 ( $p < 0.05$ ) indicates that there is a significant influence between intellectual capital and the financial performance of Islamic banks.

*H4.* The value of the parameter coefficient ( $\beta$ ) of Islamic corporate governance on earnings management is -0.153. The negative coefficient indicates the higher the Islamic corporate governance, the lower the level of earnings management. In other words, any increase in the value of Islamic corporate governance will have an impact on decreasing earnings management in Islamic banks. Based on the t-statistic 1.987, with a significance value of 0.028 ( $p < 0.05$ ), it indicates a significant influence between Islamic corporate governance and earnings management.

*H5.* The value of the parameter coefficient ( $\beta$ ) of earnings management on the financial performance of Islamic banks is -0.041. The negative

coefficient shows that the higher the earnings management, the lower the financial performance of Islamic banks. In other words, an increase in the level of earnings management will have an impact on the decline in the financial performance of Islamic banks. Based on the 1.950 t-statistic, the significance value of 0.052 ( $p > 0.05$ ) indicates no significant influence between earnings management on the financial performance of Islamic banks.

**Table 2. Hypothesis test**

Hypothesis	$\beta$ -value	t-Statistics	P-value	Information
H1 Sharia Compliance → Financial Performance	0.508	2,836	0.005	Received
H2 Islamic Corporate Governance → Financial Performance	0.169	3,242	0.001	Received
H3 Intellectual Capital → Financial Performance	0.584	4,807	0.000	Received
H4 Islamic Corporate Governance → Earnings Management	-0.153	1,987	0.028	Received
H5 Earnings Management → Financial Performance	-0.041	1,950	0.052	Rejected

Source: data processed by the author, 2020.

**Table 3. Value of Variable and Indicator Coefficients**

Variable	Indicator	ROA		ROE		Profit management	
		$\beta$ -value	t-Statistics	$\beta$ -value	t-Statistics	$\beta$ -value	t- Statistics
Sharia Compliance	ISIR	0.105	2,676	0.127	4,694		
	ZPR	0.734	2,632	0.698	3,988	-	-
	PSR	0.168	2,154	0.226	2,659		
	UDPS	0.071	6,455	0.100	5,556	-0,395	3,559
	MDPS	0.131	6,895	0.170	5,484	0.328	3,280
Islamic Corporate Governance	LDPS	0.184	3,067	0.157	2,617	-0,429	4,423
	UKI	0.033	4,125	0.145	8,056	0.025	3,125
	MKI	0.157	8,722	0.095	9,500	-0,220	4,400
	UKA	0.184	2,629	0.139	8,176	0.569	5,471
	UKA	0.139	15,444	0.298	3,311	0.276	2,532



Intellectual Capital	VACA	0.292	9,733	0.952	8,734	-	-
	VAHU	0.952	7,933	0.561	9,350	-	-
	STVA	0.249	2,075	0.149	7,450	-	-
	VAIC	0.255	2,277	0.326	2,717	-	-
Profit management	DCKPN	-0.045	0.385	-0.071	0.578	-	-

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Source: data processed by the author, 2020.

## **Discussion**

### *The effect of sharia compliance toward financial performance*

The results showed that the effect of sharia compliance on the financial performance of Islamic banks is positive and significant, with indicators of Islamic Income Ratio (ISIR), Profit-Sharing Financing Ratio (PSR), and Zakat Performing Ratio (ZPR). The results of the effect of each indicator on the financial performance of Islamic banks show a positive and significant effect (Table 3). This indicates that the higher the Islamic Income (ISIR), the higher the financial performance of Islamic banks, both on ROA and ROE. Based on empirical data for 2014-2019 Islamic income / Islamic bank income 99.99% comes from halal income so it will increase public confidence in partnering with Islamic banks and will increase bank profitability (Hamsyi, 2019).

On the indicator of profit-sharing financing (PSR), the results of the study indicate that the greater the financing distributed to the public in the form of *mudharabah* and *musyarakah* contracts, the greater the financial performance of Islamic banks originating from ROA and ROE. It is because the types of *mudharabah* and *musyarakah* financing provide higher benefits to the community in driving the real sector (Djuwita *et al.*, 2019). Therefore, the higher the *mudharabah* and *musyarakah* financing, it will have an impact on increasing the community's business capital. Thus, it will then increase the level of public trust in Islamic banks and lead to an increase in the financial performance of Islamic banks. Then on the zakat performing indicator (ZPR), the study indicates that the higher the Islamic bank in paying zakat companies will improve the financial performance of Islamic banks. Based on empirical data on the annual financial statements of Islamic banks for 2014-2019, it shows that several Islamic banks in the allocation and management of zakat funds are not carried out independently, but in collaboration with partners from Amil zakat institutions or institutions because zakat funds in Islamic banks come from entities and customers.

The results of this study are in line with the researches by Dewanata *et al.* (2016); Djuwita *et al.* (2019); and Hamsyi (2019) which state that sharia compliance has a positive and significant effect on the financial performance of Islamic banks. The results of this study are not in line with the researches by Ramdhoni & Fauzi (2020); and Ratnaputri (2013) which state that sharia compliance does not have a significant effect on the financial performance of Islamic banks.

#### *The influence of Islamic corporate governance toward financial performance*

The results showed that the influence of Islamic corporate governance on the financial performance of Islamic banks is positive and significant. The indicators used include the number of members and the number of annual meetings of the sharia supervisory board, the independent board of commissioners, and the audit committee, as well as the sharia financial and banking background of the sharia supervisory board, (Table 3) respectively showing a positive and significant impact on financial performance. Based on this data, the larger the members and the number of annual meetings of the sharia supervisory board, independent commissioners, and audit committee in Islamic banks can provide strong management supervision in improving financial performance.

The Islamic concept of corporate governance is the role of the sharia supervisory board, which differentiates it from conventional banking. So that the greater the number of members of the sharia supervisory board, the more effective the supervision and consistency of corporate governance mechanisms will be in accordance with sharia principles. The reputation of the sharia supervisory board is getting better with the knowledge and experience of the sharia supervisory board, which is shown by its educational background in the fields of finance, banking and sharia. It will encourage an increase in the monitoring function in management and financial policies (Nomran *et al.*, 2018).

The role of the independent board of commissioners can minimize problems of internal interest that arise between directors and shareholders. The independent board of commissioners can carry out its function to oversee the performance of the board of directors so that the resulting performance is in accordance with the interests of shareholders (Siswanti *et al.*, 2017). In addition, the reputation of public accountants as independent external auditors can help management performance by providing the right opinion

on the condition of the company. So that the opinions issued by reputable public accountants can serve as guidelines for improving the performance of Islamic bank companies (Buallay, 2019). So it can be said that the corporate governance mechanism with Islamic principles implemented in Islamic banks through the implementation of the duties and responsibilities of the sharia supervisory board, independent board of commissioners, and audit committee shows a positive impact on improving the financial performance of Islamic banks.

The results of this study are in line with the research by Aslam & Haron (2020); Buallay (2019); Darwanto & Chariri (2019); Siswanti *et al.* (2017) which state that it has a positive and significant effect on financial performance. While the results of this study are not in line with the research by Ajili & Bouri (2018); Khan & Zahid (2020) which states that it has no significant effect on financial performance.

#### *The influence of intellectual capital toward financial performance*

The results show that the effect of intellectual capital on Islamic bank financial performance is positive and significant. With the indicators of human capital (HC), structural capital (SC), and capital employed (CE), as well as the value added intellectual coefficient (VAIC) (Pulic, 2004) each of which has a positive and significant effect on the financial performance of Islamic banks, as measured by ROA and ROE (Table 3). It indicates that an increase in the intellectual capital of Islamic banks has an impact on improving the financial performance of Islamic banks. Based on empirical data of Islamic banks in Indonesia in 2014-2019, intellectual capital as measured by human capital, structural capital, employed capital, and capital that provide added value shows growth in line with financial performance growth. In other words, Islamic banks have managed intellectual capital properly so as to increase its value and financial performance. A company can use and utilize intangible assets to create added value. It can manage its intellectual resources properly, which can generate added value and competitive advantage. Therefore, it will improve the company's financial performance (Buallay *et al.*, 2019).

Human capital (HC) as capital comes from the knowledge, expertise, skills, and superior competencies of employees, so with a positive and significant impact, it means that HC can improve the financial performance of Islamic banks in achieving competitive advantage. Structural capital (SC) as capital in terms of infrastructure that meets employee productivity, with a positive and significant

impact on financial performance means that SC can be managed properly by Islamic banks, thereby helping to improve financial performance. Then, capital employed (CE) as a resource in the form of assets, with a positive and significant effect, it means that Islamic banks are able to manage these resources well, so that it can improve financial performance (Ousama *et al.*, 2019).

The results of this study are in line with the research by Buallay *et al.*, (2019); Mahrani & Soewarno, (2018); Ousama *et al.*, (2019); Setyawati *et al.*, (2019) which state that intellectual capital has a positive and significant effect on the financial performance of Islamic banks. While the results of this study are not in line with the research Rahajeng & Hasibuan, (2020) which states that intellectual capital does not have a significant effect on the financial performance of Islamic banks.

#### *The influence of Islamic corporate governance on earnings management*

The results showed that the influence of Islamic corporate governance on earnings management is negative and significant. The indicators of Islamic corporate governance include the number of members and the number of annual meetings of the sharia supervisory board, the independent board of commissioners, and the audit committee, as well as the background of Islamic finance and banking from the sharia supervisory board, (Table 3) each of which shows a significant influence on earnings management. It shows that the role of the sharia supervisory board, independent board of commissioners, and audit committee can reduce earnings management actions or activities in Islamic banks. The size and background of the sharia supervisory board has a negative effect on earnings management, which means that there are more members with educational backgrounds in finance, banking, and sharia, the less profit management actions in Islamic banks. The size of the independent board of commissioners and the audit committee has a positive effect on earnings management, which means that the smaller the members, the less the earnings management action.

The number of annual meetings of the supervisory board and audit committee has a positive effect on earnings management, meaning that more frequent meetings will actually increase earnings management actions. While the number of annual meetings of the independent board of commissioners has a negative effect on earnings management, it means that the more frequent holding of independent board of commissioners meetings will reduce earnings management actions in Islamic banks. So the results of this

study mean that Islamic corporate governance of Islamic banks is able to play an efficient role in reducing earnings management actions in Islamic banks. The size of the independent board of commissioners and the audit committee has a positive effect on earnings management, meaning that the smaller the members, the less the earnings management action.

While the number of annual meetings of the independent board of commissioners has a negative effect on earnings management, it means that the more frequent holding of an independent board of commissioners' meetings will reduce earnings management actions in Islamic banks. So the results of this study states that Islamic corporate governance of Islamic banks can play an efficient role in reducing earnings management actions in Islamic banks, or the more frequent holding of meetings actually increases earnings management actions. While the number of annual meetings of the independent board of commissioners has a negative effect on earnings management, it means that the more frequent holding of an independent board of commissioners' meetings will reduce earnings management actions in Islamic banks. So the results of this study mean that Islamic corporate governance of Islamic banks can play an efficient role in reducing earnings management actions in Islamic banks.

It is relevant to agency theory that management considers independent commissioners more aware of agency problems because independent commissioners are fully dedicated to overseeing management's performance, especially corporate profits. Supervision can prevent or reduce earnings management actions because such supervision becomes an impetus for management as an agent to act as best as possible for the benefit of the principal and suppress deviant behavior to account for its roles and duties (Ben Othman & Mersni, 2014).

The results of this study are in line with the research by Kolsi & Grassa, (2017); Mersni & Ben Othman, (2016); Setianto & Sukmana, (2016); Setyawati *et al.*, (2019) which state that Islamic corporate governance has a negative and significant effect on earnings management. The results of this study are not in line with the research by (Alam *et al.*, 2020) which states that Islamic corporate governance has no significant effect on earnings management.

#### *The effect of earnings management toward financial performance*

The results showed that there was no effect of earnings management on the financial performance of Islamic banks. Measurement of earnings

management actions in Islamic banks is measured by discretionary Loan Loss Provision (DCKPN), which is used to examine the discretion of Islamic bank managers in evaluating earnings management activities. It indicates that earnings management actions in Islamic banks have no impact on financial performance in the form of ROA or ROE (Table 3). The lower the level of activity or earnings management actions at Islamic banks, the higher the financial performance of Islamic banks (Saidu *et al.*, 2017). This condition is relevant to the results of testing the hypothesis of the relationship between Islamic corporate governance variables on earnings management and Islamic corporate governance on financial performance (H2 and H4), where the Islamic corporate governance mechanism in Islamic banks is through the sharia supervisory board, independent board of commissioners, and committees. The audit has played a strong role and can perform optimally in preventing to reduce earnings management actions so that earnings management actions do not affect financial performance.

Based on the results of the indirect effect test (Table L4) with a coefficient of ( $\beta$ ) 0.006, t-statistic 1.7309, and a significance value of 0.425 ( $p > 0.05$ ), which indicates that Islamic corporate governance does not affect the financial performance of Islamic banks by mediating earnings management, or Islamic corporate governance can improve the financial performance of Islamic banks directly, without any earnings management action to increase the value of earnings on the financial statements. The results of this study are in line with Saidu *et al.*, (2017) which states that earnings management has no significant effect on financial performance. While this study is not in line with Mahrani & Soewarno (2018) and Umoren (2018) which state earnings management has a significant effect on financial performance.

## **CONCLUSION**

The results show that sharia compliance, Islamic corporate governance, intellectual capital have a positive and significant effect on the financial performance of Islamic banks. Meanwhile, the results of research on earnings management do not have a significant effect on the financial performance of Islamic banks. It indicates that improving the financial performance of Islamic banks by measuring ROA and ROE can optimize the variables of sharia compliance, Islamic corporate governance, intellectual capital. So the results of this study provide policy implications for financial authorities, especially Islamic banking in Indonesia, because the aspects of sharia compliance through halal income, distribution of profit-sharing financing, and zakat

fund allocation are criteria for Islamic banks in fulfilling Islamic principles. The aspect of Islamic corporate governance is a criterion for good health and protection for Islamic banks with the active role of the sharia supervisory board, the independent board of commissioners, and the audit committee. Then, the aspect of intellectual capital is a strategic asset in providing added value for Islamic banks for long-term benefits.

This research focuses on the research object of Islamic commercial banks in Indonesia. Therefore, it is hoped that further research can apply the determinants of Islamic bank financial performance variables in other banking entities such as Islamic finance banks and Islamic business units, or it could also be in non-bank Islamic financial institutions. Another recommendation, further research can add to the measuring indicator of the sharia compliance variable, namely the Islamic investment ratio so that the research will be more in-depth in terms of halal transactions and can maximize financial performance. In addition, the research can be expanded by adding interviews with Islamic finance and banking experts or Islamic financial entities to assess the effectiveness of Islamic corporate governance and intellectual capital in Islamic banks as the influence variables of financial performance.

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