

**THE ROLE OF CONSISTENCY IN SHARIA  
STATUS ON THE RELATIONSHIP BETWEEN  
INTERNAL CORPORATE GOVERNANCE  
MECHANISMS AND INVESTORS'  
CONFIDENCE: EVIDENCE AMONG  
INDONESIAN SHARIA COMPLIANT  
COMPANIES**

**RISNA WIJAYANTI**

**UNIVERSITY SAINS MALAYSIA  
2016**

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COMPANIES**

by

**RISNA WIJAYANTI**

**Thesis submitted in fulfillment of the requirements  
for the degree of  
Doctor of Philosophy**

**March 2016**

## DEDICATION

With all my spirit and love to

Abdul Sufiani, my beloved husband, my companion and my life's encouragement

Thank you for your confidence, your sacrifice, your sincerity, and  
your never ending prayers

Abdul Rifani Praja Nurrahman

Annisa Oktafianti Nurlatifah

Abdul Rofi Alfian Nurrahman

My lovely children, my precious jewels, and my soulmates

Thank you for your support, spirit, sacrifice and prayers

My Mom and Papa, H. Rukayah and H. Andi Sukandi Priyatna Angkadjaja

Thank you for your prayers and your struggles to make my life better

## ACKNOWLEDGEMENT

بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ

اللَّهُمَّ صَلِّ عَلَى مُحَمَّدٍ

All praise to Allah S.W.T who has provided his blessings and grace and guidance to enable this dissertation to be completed and submitted to meet the requirements for a degree in doctor of philosophy.

My deepest gratitude and highest appreciation go to my Main Supervisor Assoc. Prof. Sofri B. Yahya, Ph.D, MMIM and Co-supervisor Md. Harashid Haron, Ph.D, for all your guidance, assistance, support, and prayers. I will never be able to repay your kindness and understanding. May Allah S.W.T. bless both of you always with His grace and guidance, and reward both of you with happiness and abundant prosperity in the world and in *akhirat*.

I am also indebted to Prof. Dr. Ir. Yogi Sugito, Prof. Dr. Ir. Mohammad Bisri, MS., Gugus Irianto, Ph.D., Prof Dr Bambang Subroto SE Ak., Prof, Candra Fajri Ananda, S.E., M.Sc., Ph.D., and Dr. Aulia Fuad Rahman, Ak., SAS., who provided me the opportunity and means and the moral and financial support which contributed immeasurably in helping me complete this study.

My gratitude also to Prof. Madya Dr. Tajul Ariffin Masron and Prof. Dr. Azlan Amran who provided useful advice and inputs for my proposal defense. All your suggestions were extremely helpful. I would also like to say thank you so much to Prof. Dr. Solimun. Ir. MS., and Prof. Dr. Djumilah Zain, SE who provided me invaluable inputs for the statistical discussions and my research result development which helped me successfully complete this dissertation.

I also acknowledge with many thanks the assistance of Noor Azlina Binti Khalid and Ayeza Ab Aziz, secretary of Assoc. Prof. Sofri B. Yahya, PhD, MMIM, who helped smoothen and ease my supervision schedule, as well as all lecturers and staff of the School of Management that provided excellent service in the completion of my studies.

Big thanks to my beloved husband and children for your support and sacrifice to help me complete this dissertation. Also to mama and papa who had been praying, guiding and allowing me to pursue this Doctorate programme. May God bless your patience, sacrifice, and prayer with happiness and abundant prosperity in the world and *akhirat*.

I would also like to convey my many thanks to my brothers and sisters, brothers- and sisters-in-law, and all other family members for the moral and financial support during this journey. Thanks also to all my beloved friends, Dr Azizah Nasution, Dr Izwani Sahardin, Dr Farida, Dr Hamidah Harahap, Norhayati Zainol Abidin, Dr Dodi Setiawan, Vina, and Eki for their warmth and loveable friendships. Special thanks also to my best friends Dr Sumiati who is head of my department, Dr Susilo, and Dr Nurmijati, who provided moral and financial support during the completion of my study, further, Dr Diden Rostika and Dr Husmiyati Yusuf who gave me lots of moral and facility support during our discussions in Bandung. May Allah S.W.T. always bless you with happiness, good health and prosperity in the world and *akhirat*.

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**PERANAN KONSISTENSI DALAM STATUS SHARIAH ATAS  
PERHUBUNGAN ANTARA MEKANISME TADBIR URUS KORPORAT  
DALAMAN DAN KEYAKINAN PELABUR: BUKTI DI KALANGAN  
SYARIKAT-SYARIKAT PATUH SHARIAH INDONESIA**

**ABSTRAK**

Kegawatan pasaran saham yang dicetuskan oleh skandal perniagaan, penipuan perdagangan, dan kegagalan bank telah menyebabkan keyakinan pelabur menjunam. Berdasarkan latar belakang ini, syarikat-syarikat yang mematuhi Shariah, walaupun bahagian pasaran modalnya adalah kecil berbanding pelaburan konvensional, mengalami pertumbuhan luar biasa akibat daripada permintaan pelabur yang tinggi bagi pematuhan korporat dengan standard etika dan tadbir urus korporat yang lebih baik. Untuk menangani jurang perbezaan ini, kajian ini memeriksa pengaruh maklumat mengenai kualiti kawalan dalaman (proses lembaga pengarah, struktur lembaga pengarah, komposisi lembaga pengarah, dan karakteristik lembaga pengarah) keatas keyakinan pelabur, serta kesan interaksi yang konsisten dalam status patuh Shariah keatas kualiti hubungan antara mekanisme dalaman tadbir urus korporat (proses lembaga pengarah, struktur lembaga pengarah, komposisi lembaga pengarah, dan karakteristik lembaga pengarah) dan keyakinan pelabur. Kajian ini menganalisa 227 sampel syarikat bukan kewangan yang terdapat dalam Senarai Shariah Sekuriti (DES) di Indonesia dengan menggunakan descriptive statistics, t-tests, and moderated multiple regressions. Hasil kesan utama menunjukkan bahawa struktur lembaga pengarah dan komposisi lembaga pengarah mempunyai kaitan yang positif dengan keyakinan pelabur, manakala proses lembaga pengarah dan karakteristik lembaga pengarah mempunyai impak yang negatif keatas

keyakinan pelabur. Nampaknya usaha ikatan korporat dalam pendedahan maklumat mengenai kualiti struktur lembaga pengarah dan komposisi lembaga pengarah berjaya mempengaruhi keyakinan pelabur. Penemuan kesan interaksi menunjukkan ketekalan dalam status patuh Shariah menguatkan kesan maklumat mengenai kualiti proses lembaga pengarah, komposisi lembaga pengarah, serta karakteristik lembaga pengarah terhadap keyakinan pelabur. Analisis selanjutnya menunjukkan bahawa sebarang maklumat yang tinggi mengenai kualiti komposisi lembaga pengarah, keyakinan pelabur dalam syarikat-syarikat yang konsisten adalah lebih tinggi berbanding dengan syarikat-syarikat yang tidak konsisten. Bagaimanapun, tidak ada keyakinan pelabur yang berbeza antara syarikat-syarikat yang konsisten dan yang tidak konsisten dari aspek maklumat yang tinggi mengenai kualiti proses lembaga pengarah serta karakteristik lembaga pengarah. Sementara itu, dari segi maklumat rendah tentang kualiti proses lembaga pengarah serta karakteristik lembaga pengarah, keyakinan pelabur dalam syarikat-syarikat yang konsisten adalah lebih tinggi berbanding dengan syarikat-syarikat yang tidak konsisten. Penemuan ini menggambarkan bahawa keyakinan pelabur dalam pendedahan maklumat mengenai kualiti komposisi lembaga pengarah, proses lembaga pengarah, serta karakteristik lembaga pengarah dapat dipertingkatkan dengan mengekalkan pematuhan korporat secara konsisten. Dalam erti kata lain, maklumat tentang ketekalan pematuhan korporat kepada prinsip-prinsip Shariah membantu usaha ikatan korporat dalam mendedahkan maklumat mengenai kualiti komposisi lembaga pengarah, proses lembaga pengarah serta karakteristik lembaga pengarah untuk meningkatkan keyakinan pelabur, khususnya dimana pelaporan korporat adalah terhad.

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ON THE RELATIONSHIP BETWEEN INTERNAL CORPORATE  
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EVIDENCE AMONG INDONESIAN SHARIA COMPLIANT COMPANIES**

**ABSTRACT**

Stock market turmoil triggered by business scandals, trading fraud, and bank failures has caused investor confidence to plummet. However, against that background, Sharia-compliant companies though relatively small in terms of market shares compared to their conventional counterparts have experienced phenomenal growth due arguably to high investor requirements for corporate compliance with ethical standards and improved corporate governance. To address this gap, this study examines the influence of information relating to the quality of internal corporate governance mechanisms (board process, board structure, board composition, and board characteristic) on investor confidence, and the influence of consistency in Sharia compliant status on the quality of the relationship between internal corporate governance mechanisms and investor confidence. A total of 227 samples of non-financial companies from the Sharia Securities (DES) in Indonesia was analysed using descriptive statistics, t-tests, and moderated multiple regressions. It was found that board structure and board composition were positively related to investor confidence, whereas board process and board characteristic were negatively related to investor confidence. Apparently, corporate bonding efforts in information disclosure about the quality of board structure as well as board composition succeeded in influencing investor confidence. The findings further reveal that consistency in Sharia-compliant status is an important aspect influencing the

relationship between information about the quality of internal corporate governance mechanisms (board process, board composition, and board characteristics) and investor confidence. Further analysis shows that investor confidence in high information on the quality of board composition is higher for consistent rather than inconsistent Sharia status companies. However, there is no difference in investor confidence in high information about the quality of board process as well as board characteristic between companies with consistent and inconsistent Sharia status. Nevertheless, investor confidence in low information of quality of board process as well as board characteristic was higher in companies' demonstrating consistent Sharia status compared to those that did not. These findings illustrate that investor confidence in information disclosure on quality of board composition, board process, as well as board characteristic could be enhanced by consistently maintaining corporate compliance. In other words, information about consistent compliance with Sharia principles complements corporate bonding efforts in disclosing information about the quality of those three board elements in order to boost investor confidence, particularly where corporate reporting is limited.

# CHAPTER 1

## INTRODUCTION

### 1.1 Introduction

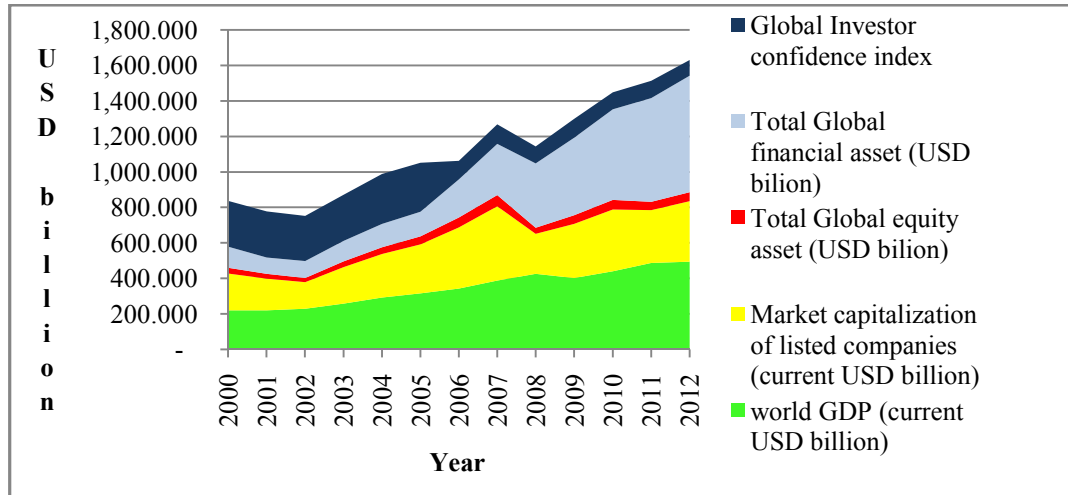
This chapter presents an overview of the study, covering the background, problem statement, research objectives, research questions, significance, definition of key terms, scope of research, and organization of the thesis.

### 1.2 Background of Study

The stock market is an economic institution that aids governments and companies to access long-term capital resources. By making non-debt financial capital accessible, the stock market increases the level of economic production and the prosperity of a country (Osinubi, 2004) The stock market sources funds from investors, who are willing to invest their funds at some level of risk. Thus, this study focuses on an analysis of stock market relationships in the form of investor risk preference, as well as compliance in the modern-day stock market. The specific aim of this study is to explore these areas in the context of *Sharia*-compliant stock and the compliance of *Sharia* compliant companies to *Sharia* principles.

Globally, the market capitalisation of companies contributes over half of the world's gross domestic product (GDP) from 2000 to 2012. Even in 2007 GDP achieved a peak contribution (107.87 percent). It displays continuous levels of growth demonstrating that these types of financial investments are interesting for potential investors (McKinsey, 2007; Lund, Daruvala, Dobbs, Harie, Kwek, & Falcon, 2013).

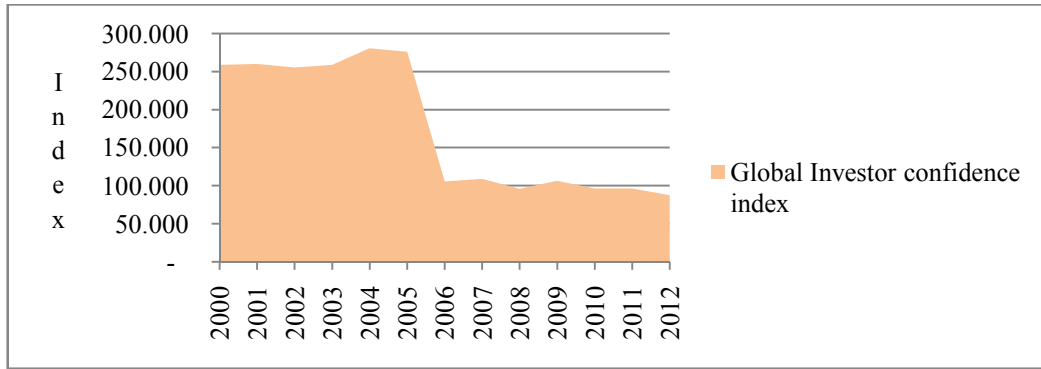
However, the fluctuation of global equity assets and market capitalisation has been directly proportional fluctuations in investors' confidence, as shown in Figure 1.1. From this, it can be implied that stock market development is related to investors' confidence in the stock market.



Source: State Street Corporation (2003, 2012); McKinsey (2007), Lund et al. (2013)

Figure 1.1 Global Market Growth.

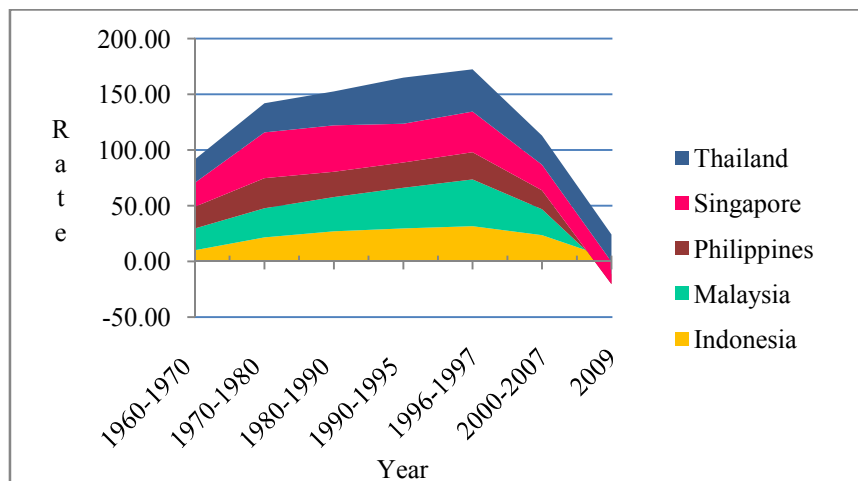
The steady growth of global financial assets held in the stock market during 2000 – 2012 (Figure 1.1) quantitatively reveals that investors found these financial investments attractive (Dodge, 2003; Gordon, 2006; Valiante, 2010) and that the stock market had gained the confidence of investors over this period (Kelly, 2010; Phillips, 2012). However, during this period, corporate scandals, insider trading fraud, and bank failures hit markets and eroded investor confidence. The investor confidence index weakened from 280.75 in 2004, to 87.793 in 2012. The 2007 financial collapse was triggered by the downfall of Enron Company, which was followed by the U.S. subprime mortgage crisis. Figure 1.2 show investor confidence plummeted between 2005 and 2012. Concerned investors exited the market, causing stock prices to decline (Allen, 2002; Dwyer, & Tkac, 2009) by as much as 50 percent.



Source: State Street Corporation (2003, 2012)

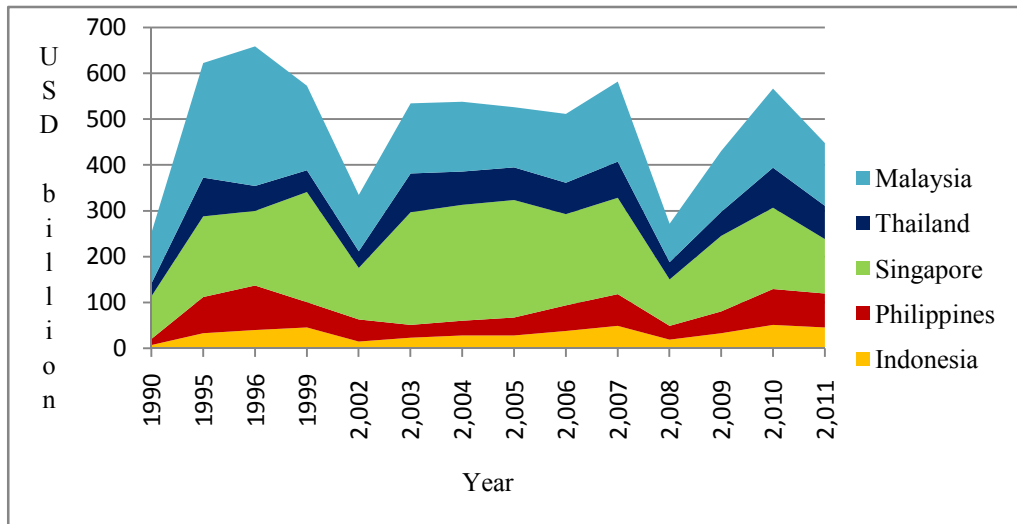
Figure 1.2 Global Investor Confidence Index.

This global stock market crash and financial crisis impacted Asia and especially ASEAN countries, including Indonesia. Investment rates in Indonesia revealed a decline in stock prices and market indexes by more than 100 percent from 2007 to 2008. Indonesia and Vietnam suffered the worst declines, more than 150 percent (Gochoco-Bautista, 2012). The charts below demonstrate the decline in investment rates (Figure 1.3) and stock market capitalisation as a percentage of GDP in the Association of Southeast Asian Nations (ASEAN) countries from 1960 through 2009 (Figure 1.4).



Source: Gochoco-Bautista, & Remolona (2012)

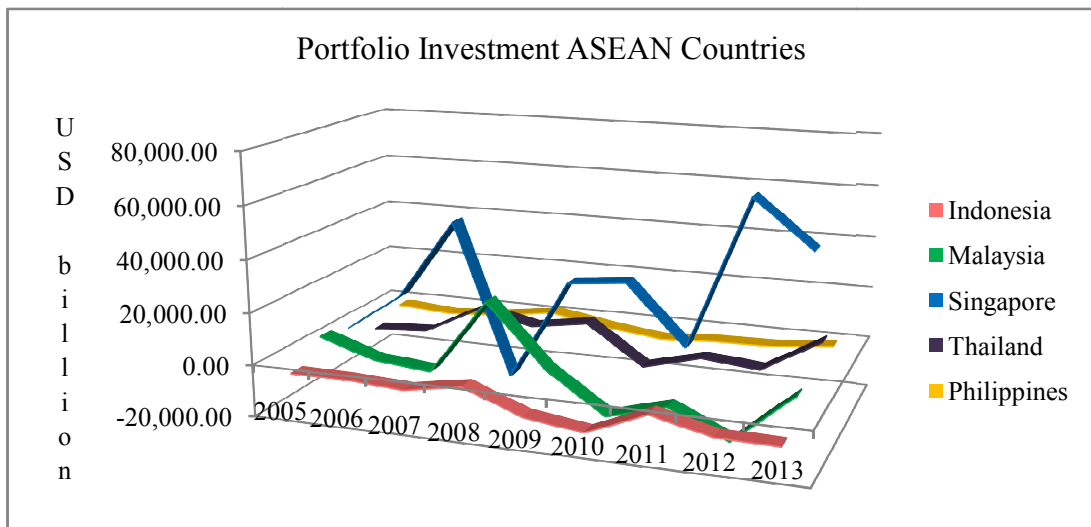
Figure 1.3 Investment Rates in ASEAN.



Source: Gochoco-Bautista (2012)

Figure 1.4 ASEAN Market Capitalisation as a Percentage of GDP.

The stock market turmoil was initially created by a credit crisis for listed companies dependent on bank finance (Gochoco-Bautista & Remolona, 2012). Throughout ASEAN, companies faced loan repayment problems. In Indonesia and Thailand, this represented 50% of total loans, and in Malaysia, 20 percent of total loans (Burton, Tseng, & Kang, 2006). The high number of non-performing loans scared investors, who understood companies to have high bankruptcy risk. In the aftermath of the Asian financial crisis, investors continued to be risk averse in their financial decision-making, which can be seen from Figures 1.3 and 1.4. With investors cautious of investing in ASEAN countries, Indonesia faced negative net flows of portfolio investment, as shown in Figure 1.5.



Source: Asian Development Bank [ADB] (2014)

Figure 1.5 Portfolio Investment of ASEAN Countries (net flow)

Over the last decade, ASEAN countries have experienced highly fluctuating net flows of portfolio investment. The net flow of portfolio investment is the difference between the value of portfolio investment inflow and outflow. The only country to experience a positive value of net flow is Thailand, which has the lowest fluctuation of portfolio investment. Singapore had the highest and positive value of net flow but also high fluctuation, whereas Malaysia showed slightly positive net flow with moderate fluctuation in portfolio investment flows. Philippines and Indonesia experienced negative net flows of portfolio investment. Overall, ASEAN countries saw a larger outflow of portfolio investment. Therefore, it can be implied that investors remain averse to investing funds in ASEAN countries, especially in Indonesia and the Philippines.

Several institutions have conducted anecdotal surveys in an effort to identify the factors that determine and build investor confidence. Table 1.1 shows the results of these surveys undertaken by McKinsey (2002); Ernst and Young (2012); Schwab and Sala-i-Martin (2012); Charter Financial Analyst [CFA] (2013).

Table 1.1: Investors' Demands Based on Investor Survey Results

Selection Criteria	Survey Findings (percentage)	Variables/ Dimensions
McKinsey (2002)		
Higher corporate transparency	52	Corporate Governance
More independent board	44	Corporate Governance
More effective boardroom by improving director selection process, Board evaluation process, and Higher directors' commitment	38	Corporate Governance
Ernst & Young (2012)		
Long-term investment performance (3-5 years)	60	Performance
Management team	82	Corporate Governance
Clarity and consistency of investment philosophy	66	Consistency and Corporate Governance
Risk management policies and oversight	70	Corporate Governance
Recent investment performance (1-2 years)	16	Performance
Fees and liquidity terms	44	Performance
3. CFA (2013)		
Improve corporate governance practices	21	Corporate Governance
Improve transparency	32	Corporate Governance
More corporate compliance with existing regulation	35	Consistency in Compliance
Improve corporate culture	34	Culture
Increase compliance to ethical codes and standards	35	Compliance
4. World Economic Forum (Schwab & Martin, 2012).		
Accountability Strength of auditing and reporting standards Efficacy of corporate Boards Protection of minority shareholders' interests Strength of investor protection (First pillar required for global competitiveness)	50	Corporate Governance

Sources: McKinsey (2002); Ernst and Young (2012); Schwab & Sala-i-Martin, (2012); CFA (2013)

Overall, investors demanded improvements in corporate governance and consistency in a company's compliance. Specifically, investors required improved short- and long-term performance reporting and market liquidity assessments (Ernst & Young, 2012). In addition, investors sought improved corporate governance mechanisms, in particular improvements in disclosure from Boards of directors to provide certainty information about their function (around 30 – 50 percent

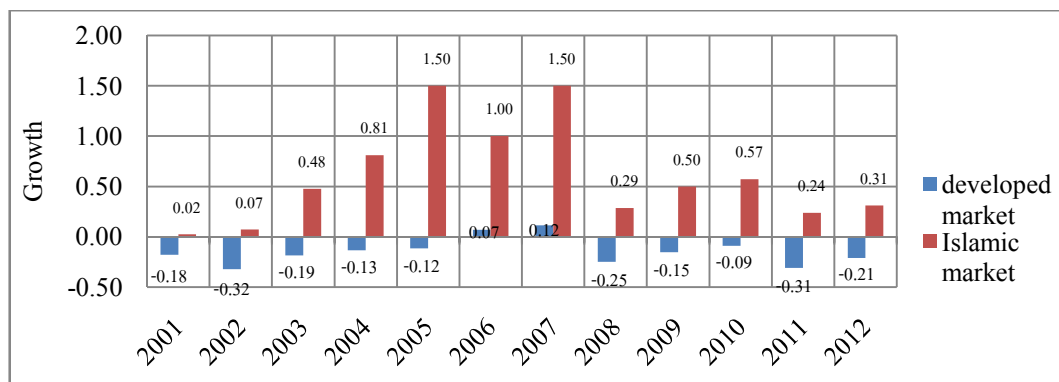
respondents) (McKinsey, 2002; Schwab and Sala-i-Martin, 2012; World Economic Forum [WEF], 2012). Ethical conduct and corporate transparency were the third major concern of investors (30 – 52 percent of total respondents) (CFA, 2013), who cited improving corporate disclosure of the Boards of directors (approximately 50 percent of surveyed investors) (McKinsey, 2002; Ernst & Young, 2012; WEF, 2012; CFA, 2013).

Consistency in a company's compliance, with ethical codes and standards is considered paramount by many investors, who consider these aspects as non-negotiable tools in investment philosophy (Ernst & Young, 2012; CFA, 2013). Accordingly, 35 percent of investors demanded improved attitudes in corporate culture, along with an increased compliance with ethical codes and standards (CFA, 2013). Furthermore, 66 percent of investors sought increased clarity and consistency in meeting future goals, and wanted companies to meet benchmarks (Ernst & Young, 2012). The survey also revealed that investors expected companies to develop a vibrant corporate culture with a disciplined corporate compliance, ethical codes, and standards (35percent of respondents) (CFA, 2013). The World Economic Forum [WEF] survey also reported that investors needed to protect their minority shareholders' interests (approximately 50 ]percent of respondents) (WEF, 2012).

To meet investors' demands that companies comply with ethical standards, capital markets attempted to build ethical investment indices (such as ACT Australian Cleantech Index; FTSE Environmental Technology Index Series; FTSE4 Good Index Series; Dow Jones Islamic Market Index; India Islamic Index; Social Responsibility Index; FTSE Islamic Index). The indexes comprise companies that operate to ethical standards with the aim to protect investors from unethical behaviour and enhance confidence.

Islamic investment and securities are now widely recognised as an alternative ethical investment. Driven by investors' need for Sharia compliant investment, Islamic funds are increasingly sought after. The growth rate in Islamic equity funds has exploded, with a mere USD 800 million in 1996 increasing to USD 3.6 billion in 2003, USD 17.33 billion in 2007 (Abderrezak, 2008) and USD 56 billion in 2014 (Thomson Reuters, 2014).

Moreover, Islamic market performance in several ASEAN countries also provided better market capitalisation growth compared to developed, western markets, especially before the global financial crisis in 2008, see Figure 1.6. The figure compares market capitalisation between the top 11 markets and traded volumes of OIC countries, including Indonesia and ASEAN countries, and the growth of market capitalisation in developed countries, indicated by the 20 top market capitalisation and traded volume. Islamic market capitalisation in countries included in Organization of Islamic Countries (OIC) showed that growth of the Islamic market capitalisations is higher than developed market capitalisations (Rizvi, Dewandaru, Bacha, & Masih, 2014).

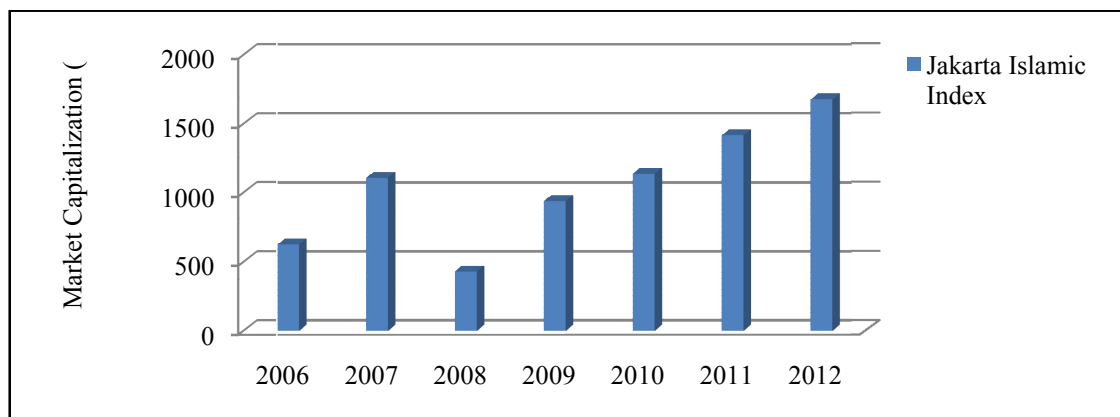


Source: Rizvi et al. (2014)

Figure 1.6 Growth of Average of Market Capitalisation to GDP, Islamic Markets Versus Developed Markets.

Figure 1.6 highlights that Islamic capital markets showed positive growth while the developed markets showed negative growth, except in 2006 and 2007. Even in 2007-08 financial crisis, Islamic capital markets showed positive growth, whereas developed markets experienced negative growth (Rizvi et al., 2014).

Furthermore, Indonesia, with Muslims accounting for 85 percent of the 305.6 million citizens, exhibits a great potential market for Sharia compliant securities, (*Badan Pusat Statistik [BPS], 2010*). With the current market share of Islamic stocks at only 1 percent of the potential market in Indonesia (*Sindonews.com, 2011*), there is a substantial opportunity to continue the market share of Sharia compliant companies. The current investment companies have maintained positive growth over the last decade. Figure 1.7 highlights the positive market capitalisation of Islamic investment in Indonesian Stock exchange.

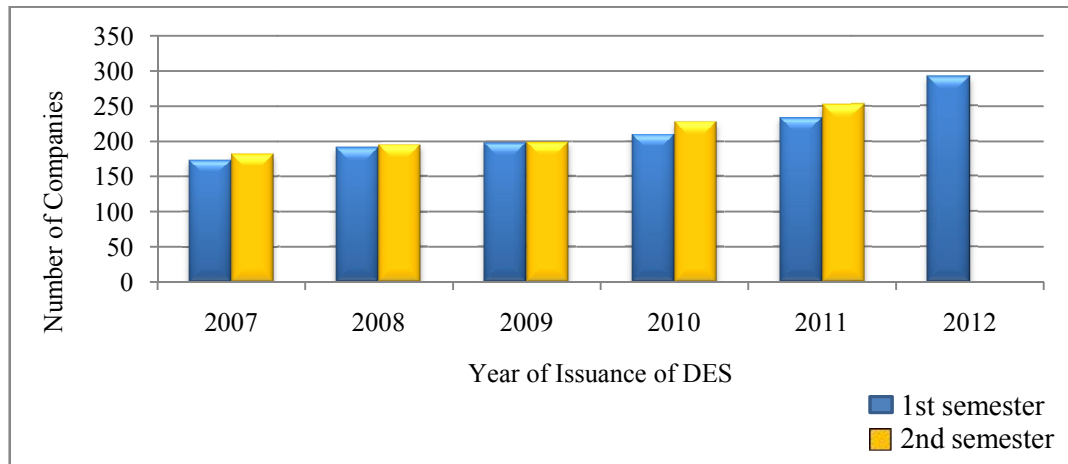


Source: :*Badan Pengawas Pasar Modal [Bapepam] (2012)*

Figure 1.7 Market Capitalisation of Jakarta Islamic Index in Indonesia Stock Exchange (IDX).

The strength and positive sentiment in the Indonesian market means the number of Sharia compliant companies on the list of Sharia securities (*Daftar Efek Syariah [DES]*) has grown in size from 174 in 2007, to 291, or 49.3 percent of the total number of stocks traded, in 2012. The below graph (Figure 1.8) shows the

growth in the number of Sharia compliant companies in Indonesia from 2007 to 2012 (Bapepam, 2012).



Source: :*Badan Pengawas Pasar Modal* [Bapepam] (2012)

Figure 1.8 The Number of Sharia Compliant Companies in Indonesia.

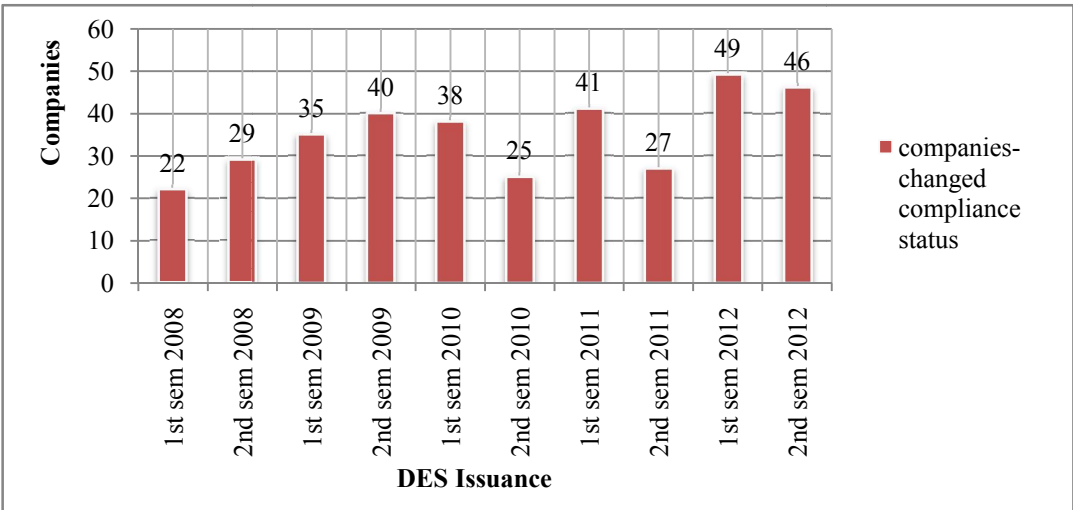
Although the number of Sharia compliant companies, as well as market capitalisation of Islamic Index, in Indonesia grew, the current market share of Islamic finance remains 1 percent of the potential market in Indonesia (Sindonews.com, 2011). This indicates that Sharia compliant companies have not been able to attract Islamic investment, even though Islamic equity funds manage approximately 26 percent of global Islamic financial assets (Islamic Corporation for the Development of the Private Sector [ICD], 2014). Therefore, identifying the factors that significantly enhance investor confidence in Sharia compliant companies could have a major impact on Islamic investment growth.

Grais and Pellegrini (2006) argued that company's compliance essentially relies on internal control mechanisms to monitor and evaluate corporate Sharia compliance. In Indonesia, quality corporate governance or control mechanisms are lacking, compared with other countries, especially ASEAN countries (ADB, 2014).

Attribution theory states that perceivers (in the context of the study, investors) rely on actors' attributes to interpret and understand actors' actions, leading to an increase in perceivers' confidence in decision making (Kelley, 1967; Rotter, 1967; Tyler, 1990). Previous empirical evidence showed that investors attributed information about corporate failure as a reflection of ineffective and inefficient corporate management to undertake and supervise corporate actions (Keasey, Thompson, & Wright, 2005). With Islamic investments, investors may attribute information about the poor quality of internal corporate mechanisms as a reflection ineffective internal control mechanisms in companies with Sharia status, lowering investor confidence in Sharia compliant companies.

Moreover, Sharia compliant companies' are required to comply with Sharia principles, a faith-based control mechanism on corporate activities (Shukri, 2008; Hassan, Triyanta, & Yusoff, 2011). In the context of Islam, faith is closely related to *istiqamah* (consistent in faith-based deeds) (QS. Hud 11:112; Al-Fussilat 41:30). *Istiqamah* is positive attitude reflecting work under the direction of Sharia principles (Khadijah, Kamaluddin, & Salin, 2015). Combined with attribution theory, which asserts that consistent information about consistent actions of an actor lead a perceiver to attribute the information as a reflection of consistent behavior (Kelley & Michela, 1980), the attribution of consistent Sharia compliance could be an important source to enhance a perceiver's confidence in decision-making. Vodicka (2006) argued that consistency was a key element for building trust or confidence, but that consistency could not work alone. Consequently, information about consistent inclusion in *list of Sharia* securities should assist other key elements of faith-based activities to build investor confidence.

In Indonesia, to be a registered Sharia compliant company, and on the list of Sharia Securities or *Daftar Efek Syariah* (DES), a company needs to comply with Sharia criteria determined by the capital market authority. *Bapepam-LK* has strict rules governing companies' inclusion in DES, and companies who fail to meet the criteria should be excluded. For example, in 2011, four Sharia compliant companies were excluded from DES because of a high debt ratio, and another ten companies were excluded due to a high ratio of interest income (Lia, 2012). Nevertheless, excluded firms can enroll for re-inclusion in DES if they can meet the Islamic screening criteria requirements approved by capital market authority (Bapepam\_LK along with National Sharia Council or *Dewan Syariah Nasional* [DSN]). This process enables a company to exit and re-enter DES, so long as the company can meet the established screening criteria, without any penalty. Figure 1.9 shows the number of Sharia-compliant companies with exchange status in the stock market and each DES issuance, from the first issuance in 2007 until 2012.



Source: Bapepam (2012)

Figure 1.9 The Number of Companies Changed-Sharia Status.

Given poor internal corporate governance mechanisms of Indonesia Listed Companies (ADB, 2014), as well as the existence of companies whose DES status have been changed by capital market authority (Bapepam, 2012), investors may be less confident about corporate insiders' oversight of corporate activities. This area is not well understood, because few studies have investigated the relationships between internal corporate governance mechanisms and investor confidence for Sharia compliant companies, or the role of information about consistent Sharia compliance.

In addition, despite investigation links between internal corporate governance mechanism and investor behavior for conventional companies, the findings are inconclusive (Brickley, 1986; Morck, Shleifer, & Vishny, 1988; Gaver, Gaver, & Battistel, 1992; Rosenstein, & Wyatt, 1997; Holderness, Kroszner, & Sheehan, 1999; Lawler III, Finegold, Benson, & Conger, 2001; Gompers, Ishii, & Metrick, 2003; Karamanou & Vafeas, 2005; Choi, J., Han, & Lee, 2010; Chatterjee, 2011; Danoshana & Ravivathani, 2013). Specifically, for Sharia compliant companies, previous literature focused on developing conceptual models, effectiveness of corporate actions (Bakhtiar & Nazli, 2003; Grais & Pellegrini, 2006), and identifying the fundamental principles controlling the actions of Sharia compliant companies (i.e., Islamic Financial Services Board [IFSB], 2009; Rahim, Shith, & Osman, 2012; Mizushima & Mizushima, 2014). Some empirical evidence is available, but these studies focused on financial performance of Sharia compliant companies (i.e., Hussein, 2004;2007, Elfakhani & Hassan, 2005; Setiawan & Oktariza, 2013) and the influence of internal corporate governance mechanism on the effectiveness of corporate actions (i.e., Haniffa & Cooke, 2002; Rahman & Bukair, 2013). To address these limitations, the present study investigated the link between information about

the quality of internal corporate governance mechanisms and investor confidence in Sharia compliant companies.

It is of no surprise to note that there is a lack of literature investigating the role of information on consistent Sharia compliance, or DES status, as a driver. Further, previous literature on the role of consistency in building trust or confidence was still in form of normative perspective. These studies suggested that consistency served as a driver (Argandoña, 2008), or a moderator (Das & Teng, 1998) for building trust or confidence in an organization or partner cooperation.

In addition, consistent DES status can also be perceived as a representation of an external control mechanisms, because DES status can be a disciplinary force on corporate insiders to satisfy Sharia principles. While previous literature did discuss the function of external control mechanisms in an effort to assist internal control mechanisms to reduce agency problems, the results were debatable. For example, on one side, external control mechanisms were perceived as complementary for internal control mechanisms (Walsh & Seward, 1990; Chenhall, 2003). On the other hand, external control mechanisms were suggested as a substitute for internal control mechanisms due to the failure of internal control mechanisms in the era global financial crisis (Jensen, 1993).

The output of this research produced a number of integrated theoretical frameworks and research agendas for interconnectedness between internal and external controls (Walsh & Seward, 1990; Chenhall, 2003). Several studies attempted to investigate the integrative relationship between internal and external control mechanisms and corporate performance, but the studies focused on conventional companies and the findings were inconclusive (Jensen & Murphy, 1990; Weir, Laing, & McKnight, 2002; Waymire, & Stanley, 2008). For Islamic investment and

companies, there is a dearth of empirical research investigating an integrated relationship between internal controls, represented by internal corporate governance mechanisms, and external controls, represented by consistent compliance with Sharia principles.

### **1.3 Problem Statement**

As a result of the corporate and financial scandals that have occurred in the last 20 years, corporate governance mechanisms have experienced a confidence crisis with investors (Allen, 2002). Governments have put in place mechanisms to improve corporate governance, such as the US Sarbanes–Oxley Act of 2002, but the real practices in corporate governance, financial management, and supervision are still questionable (Lee & McKibbin, 2007). As a result, investor confidence fluctuates and has even descended over the last decade (State Street Corporation, 2003, 2012).

One area of increasing interest to investors, as a device of internal corporate governance, is measuring and reporting the integrity of the board of commissioners or directors. Previous studies have identified that investors not only place improved internal corporate governance mechanisms as their top priority, but also expect companies to have a consistent corporate philosophy, compliance with ethical standards, and high transparency (McKinsey, 2002; Ernst & Young, 2012; Schwab & Martin, 2012; CFA, 2013).

Another trend is the increasing demand for Sharia compliant companies and investments from Muslim investors. The rapid growth in these new financial structures is supported by the fact that Islamic market capitalisation is growing at a faster rate than developed markets. This implies that investors are becoming more interested in Islamic investment instruments, rather than existing products in

developed markets (Rizvi et al., 2014). In Indonesia, the Islamic capital market has continued to grow following the 2008 global financial crisis (Bapepam,2012), but its market share is still relatively small, approximately 1.5 percent of the total global market share of Islamic assets (Kusuma, 2013).

Given great potential market of Sharia compliant companies in Indonesia, Islamic investments faced challenges to attract investors especially Muslim investors to invest in Sharia compliant companies in Indonesia. This phenomena motivated this study to embark on question how to attract investors to invest in Sharia compliant companies in Indonesia.

An essential task is for companies to implement corporate transparency, institutional frameworks with rule-enforcement procedures for Islamic business and financial architectures. Once in place, these structures enable a company to clearly disclose that Sharia principles underlie day-to-day activities, and public and private economic and social affairs (Akhtar, 2008). However, previous studies have found that Sharia compliant companies release limited information related to procedures and structures that control company activities and keep them compliant with Sharia principles (Haniffa & Hudaib, 2007). Even Darmadi (2011), who investigated the Islamic Bank of Indonesia, which had a thorough implementation of Islamic ideological and legal frameworks, found that the bank disclosed limited information about Sharia supervision, internal control mechanisms, and corporate governance implementation.

Achieving a high level of corporate transparency is highly dependent on the quality of internal control mechanisms around Sharia principles and companies disclosing adequate information. Rahman & Bukair (2013) confirmed that internal control mechanism significantly impact the level of corporate disclosure when they

investigated the link between internal legal structures represented by Sharia supervisory board and the level of corporate social responsibility disclosure.

Although many academicians have noted the significant role of internal control mechanisms (Jensen & Meckling, 1976; Jensen, 1994; Taylor & Walker, 1994; Beccerra & Gupta, 1999; Greller & Simpson, 1999; Lui & Ngo, 2004; Ng & Feldman, 2008; Rivas, Hamori, & Mayo, 2009) on effective corporate control, corporate performance (Ruigrok, Peck, Tacheva, Greve, & Hu, 2006; Wu & Tuttle, 2009), as well as on market reaction (Baysinger & Butler, 1985; Murphy, 1985; Karamanou & Vafeas, 2005; Iqbal, Wang, & Sewon, 2011; Francis, Hasan, & Wu, 2012). However, other findings show inconclusive results, especially on the market reaction to internal corporate governance mechanisms (Brickley, 1986; Gaver et al., 1992; Conyon & Peck, 1998; Mak & Li, 2001; Choi, Choe, & Kwak, 2010; Uadiale, 2010). These studies suggested that internal corporate governance mechanisms still required further investigation to find attributes that boost investor confidence. This is especially true for ASEAN countries that have poor internal corporate governance disclosure, which includes Indonesia (CLSA, 2007, 2012; 2010; ADB, 2014).

The second challenge for companies is to build an integrated framework that establishes sustainable Islamic capital market growth. Previous literature attempted to build theoretical framework that explained the integrated relationship between the attributes of the board of directors, the external environment and their influence on corporate performance (Zahra & Pearce, 1989; Walsh & Seward, 1990). The integrated model was expected to overcome the problem of corporate bonding effort, in the form of corporate governance disclosure reporting, to build stronger investor confidence in business and financial cooperation. In addition, empirical studies that examined the integrated relationship between internal and external control

mechanisms and corporate performance (Gompers et al., 2003; Moustafa, 2004; Li, Rupley, & Johnstone, 2007; Waymire & Stanley, 2008; Dharmastuti & Wahyudi, 2013) presented mixed results, such as Li et al. (2007), who questioned the effectiveness of an integrated relationship.

Some studies have examined the influence of other external control mechanisms on corporate performance, such as market for corporate control (Gompers et al., 2003), corporate governance standards (Heenetigala & Armstrong, 2011), other standards/provisions/regulations (Agrawal & Chadha, 2003), analyst following, blockholders/major shareholders (Li et al., 2007; Dharmastuti & Wahyudi, 2013), and the labour market (Fama & Jensen, 1983; Conyon & Peck, 1998) in conventional companies. Whereas, studies that investigated Sharia compliant companies built conceptual frameworks, as suggested by Grais and Pellegrini (2006). Their integrative framework contained internal and external features of Islamic financial services and corporate reputation. However, studies of external control mechanisms, represented by consistency in companies' compliance with Sharia principles, have not, to the author's knowledge, been conducted. Furthermore, empirical evidence of the integrative framework for Sharia compliant companies is still rare.

Also lacking are studies investigating the relationship between internal and external control mechanisms and investor confidence. To the author's knowledge, this area has not been tested. Ishi, Gompers and Metrick (2003) argued that if corporate governance mechanisms (as a device for corporate control mechanism) substantially affected corporate performance, then the market would integrate this through stock price movements. They suggested that stock price movements were driven by investors' investment decisions; hence capital market development would

be determined by investor confidence. Therefore, it is necessary to investigate the integrated relationship between internal and external corporate governance mechanisms and their influence on investor confidence in Sharia compliant companies.

To address the issues, challenges, and problems faced by Sharia compliant companies in Indonesia, as well as the lack of studies examining consistency in Sharia status, the current study examined whether the integrated relationship between internal corporate governance mechanism and consistency in Sharia status, as a representation of external control mechanisms, can overcome these problems. Hence, this study investigated the relationship between internal corporate governance mechanisms and investor confidence and considered consistency in Sharia status as a moderator strengthening the relationship between internal control mechanisms and investor confidence.

#### **1.4 Research Objectives**

This study examined four dimensions of internal corporate governance mechanisms, namely board process, board structure, board composition, and board characteristics. The main objective of this study is to examine relationship between the four dimensions and investor confidence, and interaction relationship between consistency in Sharia status and the four dimensions on investor confidence. To achieve the study objectives, the following eight objectives were developed:

##### **1.4.1 Main Effect**

1. To examine the relationship between information about the quality of board processes and investor confidence;

2. To determine the relationship between information about the quality of board structure and investor confidence;
3. To investigate the relationship between information about the quality of board composition and investor confidence; and
4. To examine the relationship between information about the quality of board characteristics and investor confidence

#### **1.4.2 Interaction Effect**

1. To determine the existence of moderating effect of consistency in Sharia status on the relationship between information about the quality of board process and investor confidence;
2. To examine the presence of moderating effect of consistency in Sharia status on the relationship between information about the quality of board structure and investor confidence;
3. To investigate the existence moderating effect of consistency in Sharia status on the relationship between information about the quality of board composition and investor confidence; and
4. To determine the presence moderating effect of consistency in Sharia status on the relationship between information about the quality of board characteristics and investor confidence.

#### **1.5 Research Questions**

The current study has developed the following research questions:

### **1.5.1 Main Effect**

1. What is the relationship between information about the quality of board process and investor confidence?
2. What is the relationship between information about the quality of board structure and investor confidence?
3. What is the relationship between information about the quality of board composition and investor confidence?
4. What is the relationship between information about the quality of board characteristics and investor confidence?

### **1.5.2 Interaction Effect**

1. To what extent does consistency in Sharia status moderate the relationship between information about the quality of board process and investor confidence?
2. To what extent does consistency in Sharia status moderate the relationship between information about the quality of board structure and investor confidence?
3. To what extent does consistency in Sharia status moderate the relationship between information about the quality of board composition and investor confidence?
4. To what extent does consistency in Sharia status moderate the relationship between information about the quality of board characteristic and investor confidence?

## **1.6 Significance of the Study**

This study makes valuable contributions to the following practical and theoretical statutes, as outlined below:

### **1.6.1 Theoretical Contribution**

Due to the global financial crisis, corporate governance mechanisms have experienced an investor confidence crisis (Allen, 2002). Previous surveys identified investor expectation to a number of improvements in internal corporate governance mechanisms, such as consistent corporate philosophy, compliance with ethical standards, and high transparency (McKinsey & Company, 2002; Ernst & Young, 2012; Schwab & Martin, 2012; CFA 2013) that were expected to help boosting investor confidence. Numerous study relating internal corporate governance and corporate performance as well as likelihood of corporate fraud have been undertaken (e.g., La Porta, Lopez, Shleifer, & Vishny, 2000; Mitton, 2002; Bastaman & Hertanto, 2003; Farber, 2004; Kouki, Elkhaldi, Atri, & Soudi, 2011; Suvankulov & Ogucu, 2012). Despite there have been numerous efforts to improve corporate governance, the effect of real practices of corporate governance on effectiveness of corporate supervision and corporate performance are still in questionable (Lee & McKibbin, 2007).

Further, even though Islamic capital markets have experienced rapid growth as high expectation toward ethical investment, Islamic investments also face challenges (Kammer et al., 2015) in increasing investor confidence that Islamic businesses understand Islamic ideological and legal frameworks, and in carrying out principles and rules of conduct (Akhtar, 2008). The majority of studies in this area investigated conventional companies; few studies of Sharia compliant companies

exist. The current study overcomes the lack of research on Sharia compliant companies by examining the relationship between internal corporate governance mechanisms and investor confidence, and whether consistency in status acts as a moderator strengthening the relationship between internal corporate governance mechanism and investor confidence.

## **1.6.2 Practical Contribution**

### **1.6.2.1 To Investors**

This study presents information about investors' behavior toward Sharia compliant companies. This can assist investors in investment decision-making processes. It also outlines the critical elements of corporate governance that impact performance and investor confidence and, hence, are of primary consideration to investors in capital markets.

### **1.6.2.2 To Corporate Managers**

This study assists corporate managers to understand investors' interest on the attributes of Boards of directors, internal corporate governance mechanisms, and the consistency of Sharia status of a company. This information, in turn, can inform a company's policies and corporate operational systems for Sharia compliance.

### **1.6.2.3 To Policy Makers**

Regulators, bureaucrats, reserve banks, IMF analysts, NGOs, and other sponsored entities, who draft policies related to corporate governance can benefit from these findings. The consistency of Sharia status can be considered as a major criterion in determining the level of company compliance to Sharia principles, and therefore, this study helps policy makers to make better informed decisions.

## 1.7 Definition of Key Terms

The main terms used in this study are defined as follows:

**Investor confidence** is equivalent to risk preference, representing investors' willingness to take risks or investors' optimism about their risky asset (Wise, 2002).

**Corporate Governance** is a structural and functional system, which attempts to ensure a firm is managed and controlled in a strategic, integrative, entrepreneurial, and holistic fashion and meets ethical guidelines (Cadbury, 1992; Hilb, 2006).

**Corporate Governance Mechanism** is defined, for the purposes of this study, as a mechanism controlling an organization, or a firm, in achieving its goals, which is designed to maximize the long-term benefits to the shareholders (Abu-Tapanjeh, 2006).

**Internal Corporate Governance Mechanism** is factor operating inside a company. It is commonly a supervisory board of commission, or a committee engaging in performing controlling and monitoring activities to protect investors' interests and public interests (Huson, Parrino, & Starks, 2001; Weir et al., 2002; Nuryanah & Islam, 2011).

**Board Process** is the method used by a board of directors in decision making (Zahra & Pearce, 1989).

**Board Structure** separates the power of directors holding management position in a company (executive), and directors (non-executive) who perform controlling and monitoring functions to protect investors' interests (Tricker, as cited in