

THE BENEFITS OF ZAKAT IN MITIGATING FINANCIAL DISTRESS: EVIDENCE FROM INDONESIAN SHARIAH BANKS

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Abstract

The primary objective of this study is to examine the relationship between zakat and financial distress within the context of Islamic banking. The research methodology employed in this study involves employing linear regression analysis based on data extracted from the annual reports of Islamic banks in Indonesia spanning the years 2015 to 2019. The findings indicate that zakat constitutes a significant variable capable of mitigating the financial distress experienced by Islamic banking institutions in Indonesia. The findings of this study offer valuable practical and empirical insights. On the empirical front, this research provides evidence that supports the reliability and effectiveness of the Springate Model in predicting financial distress. By demonstrating the model's robustness, this study contributes to the empirical literature in the field. On the practical side, the study offers practical considerations and implications for bankers and financial professionals. Specifically, it highlights the significance of monitoring and analyzing key financial ratios as a proactive measure to anticipate and address potential financial threats within their respective firms. These practical insights can inform decision-making processes and help banking professionals take appropriate actions to safeguard their institutions against financial distress.

Keywords: *Corporate Performance; Banking, Profitability; Profit-loos Sharing; Financial Accounting.*

INTRODUCTION

Financial failure is a crucial determinant leading to a company's bankruptcy. Within the realm of banking institutions, non-performing loans emerge as a vital financial indicator influencing such failures. Sharia banking, however, emphasizes a holistic financial performance guided by Islamic principles, encompassing not only financial considerations but also the incorporation of zakat as a critical aspect. Furthermore, Sharia banking strives to generate profits in a manner that aligns with Sharia principles.

According to data from the Financial Services Authority of Indonesia (OJK), the Islamic Banking (IB) sector in Indonesia has experienced a favorable trajectory over the past decade. This growth can be attributed to the increasing public trust, a pivotal factor that consistently propels the advancement of Islamic Banking (Antonio et al., 2012). In contrast to conventional banking practices in Indonesia, IB distinguishes itself by prioritizing social responsibility, such as poverty reduction and the equitable allocation and distribution of resources (Raimi et al., 2014; Shibani & De Fuentes, 2017). Notably, IB's corporate governance entails distinct decision-making processes. For instance, in addition to conventional financial obligations, IB adheres to the religious and social obligation of paying zakat, which is annually reported in their financial statements. Such practices are absent in the business operations of conventional banking.

Wahab, Rahim, and Rahman (2011) emphasize that zakat serves as an instrument that facilitates resource allocation and stimulates overall economic growth. In Indonesia, the zakat sector has experienced positive growth in recent years. As evidenced by data from the National Zakat Amil Agency (BAZNAS), zakat payments have exhibited exponential growth on an annual basis. Based on data cited from the National Zakat Agency (BAZNAS) in the Indicators for Mapping Zakat Potential (IPPZ) book for the year 2019, the zakat potential in Indonesia amounted to 233.846 trillion (BAZNAS, 2019). As a comparison based on data from the Central Statistics Agency (BPS) for the first quarter of 2019, the zakat potential represents 6% of the total Gross Domestic Product (GDP) for the corresponding year. For instance, assuming a marginal propensity to consume (MPC) of 0.5, the zakat potential in Indonesia could stimulate a 31% growth in Indonesia's GDP, reaching Rp4,951.6 trillion.

Zakat plays a significant role in contributing to the economy as a whole. Firstly, zakat serves as a wealth redistribution mechanism that helps address income inequality and poverty. By collecting a portion of wealth from the affluent and distributing it to those in need, zakat promotes a more equitable distribution of resources, stimulating economic growth and reducing poverty rates. This redistribution of

wealth injects additional purchasing power into the economy, enabling individuals to meet their basic needs and participate in economic activities. Secondly, zakat encourages responsible and ethical business practices. The requirement to pay zakat motivates businesses and individuals to generate income through legitimate means, discouraging fraudulent or unethical practices. This fosters a conducive environment for economic development, attracting investments and promoting sustainable economic growth. Additionally, zakat funds can be utilized to support productive sectors such as education, healthcare, and infrastructure, enhancing human capital development and improving the overall economic productivity. Overall, zakat's contribution to the economy goes beyond addressing social welfare concerns; it actively contributes to the creation of a more inclusive, sustainable, and prosperous economy for the benefit of society as a whole.

The field of research on zakat's contribution to the economy has witnessed significant development in recent years. Scholars and researchers have recognized the importance of zakat as an Islamic economic instrument and its potential impact on economic growth, poverty alleviation, and wealth redistribution. Numerous studies have explored the relationship between zakat and various economic indicators, such as GDP growth, income inequality, and poverty rates. These studies have employed various methodologies, including econometric models, case studies, and empirical analyses, to examine the economic effects of zakat. The findings have been diverse, providing valuable insights into the mechanisms through which zakat can positively influence the economy. Moreover, researchers have explored the efficiency and effectiveness of zakat collection and distribution systems, examining ways to optimize zakat utilization for maximum socioeconomic impact. This body of research has not only contributed to expanding our understanding of zakat's role in the economy but has also informed policymakers, institutions, and practitioners in developing strategies to enhance the effectiveness and impact of zakat programs. As the field continues to evolve, the research need to delve deeper into specific sectors, regions, and contexts to better comprehend the multifaceted dynamics of zakat's

contribution to the economy and to develop evidence-based policies for sustainable economic development.

In accordance with Islamic law, zakat represents a mandatory and obligatory payment mechanism designed to assist individuals who are unable or in need (*mustahiq*). The requirement to fulfill zakat obligations represents a mechanism of accountability specifically applicable to Islamic banking institutions (IBs), emphasizing their obligation to extend their focus beyond mere revenue generation and emphasizing their dedication to societal well-being. Zakat serves as a conduit through which IBs fulfill their societal responsibilities, actively contributing to the advancement of the community. By designating a portion of their earnings to zakat, IBs proactively engage in the redistribution of wealth, ensuring that essential resources reach those who are in need. This sense of accountability reinforces the ethical framework upon which Islamic finance is constructed, underscoring the significance of economic fairness and social obligation. Consequently, the payment of zakat by IBs not only serves as an indicator of their financial performance but also serves as a manifestation of their unwavering commitment to cultivating a more equitable and socially aware banking system. Prior scholarly investigations have extensively examined the mechanism of zakat within the Islamic banking industry (Rahman, 2015; Oladimeji Abioye Mustafa et al., 2013; Djaghballou et al., 2018; Nahar, 2018; Abd. Wahab et al., 2017; Khadija et al., 2017).

Despite the growing recognition of zakat's potential role in accelerating sharia banking, there is still a significant gap in the existing research. While some studies have explored the general impact of zakat on the economy, there is a need for more specific investigations focusing on its role within the context of sharia banking. This research gap calls for studies that examine the specific mechanisms through which zakat can enhance the performance and stability of sharia banking institutions. Furthermore, there is a dearth of research that examines the relationship between zakat and key performance indicators of sharia banking, such as profitability, asset quality, liquidity, and capital adequacy. Understanding how zakat affects these aspects of sharia banking is crucial for

policymakers, regulators, and banking practitioners in designing strategies that leverage zakat effectively to strengthen and accelerate the growth of sharia banking. Bridging this research gap would not only contribute to the academic literature but also provide practical insights and guidance for stakeholders in the sharia banking industry.

The relationship between zakat and the mitigation of financial distress in financial institutions is grounded in several pivotal factors. Initially, zakat operates as a mechanism for societal wealth redistribution, ensuring that resources are directed towards those who are economically disadvantaged. By incorporating zakat, financial companies actively participate in diminishing financial distress experienced by individuals and households burdened with debt or struggling to fulfill their financial obligations. Secondly, zakat fosters ethical and responsible financial practices by highlighting the significance of fair transactions, discouraging usury (*riba*), and advocating for economic justice. This ethical framework aids financial institutions in establishing a more resilient and sustainable financial system, thereby reducing the likelihood of financial distress. Furthermore, zakat serves as a means of purifying wealth and fostering the fulfillment of social responsibilities, promoting social cohesion and solidarity. Through the systematic distribution of zakat, financial companies contribute to the overall welfare of society and alleviate financial distress by extending financial support to those in need. In summary, the integration of zakat within the practices of financial institutions plays a pivotal role in mitigating financial distress and advancing a more equitable and sustainable financial system.

This study utilizes the Springate Model to assess corporate financial distress. This model incorporates four key performance indicators derived from the company's financial ratios, which serve as critical measures in evaluating financial distress. Similar to the Altman model, the Springate Model employs a range of values to determine a company's financial distress status. The sum of the four ratios serves as a cut-off value for the Springate Model, enabling the determination of bankruptcy likelihood. Edi and Tania (2018) demonstrated that the Springate Model

outperforms other models such as Altman, Zmijewski, and Gover when it comes to predicting financial distress.

This research paper is structured into five main sections. Firstly, it provides an overview of the research background, along with highlighting some issues prevalent in zakat research. The second section offers a literature review specifically focusing on the role of zakat within the economic system and its impact on the development of Islamic banking institutions. The third section elaborates on the research methodology employed. Finally, the fourth section presents the research findings, concluding with potential directions for future research.

RESEARCH METHODS

Data and sample

This study utilizes the purposive sampling technique to collect data, specifically focusing on the secondary data pertaining to Islamic banking in Indonesia from the period spanning 2015 to 2019. The rationale for selecting this timeframe is attributed to the observed stability in the growth and progress of Islamic banking in Indonesia throughout these years. Consequently, a total of thirteen banking institutions are included in this research, covering a continuous five-year duration.

Data Analysis

This research employs multiple regression analysis to examine the hypothesis. The regression model utilized in this study is presented as follows:

$$SMFD_i = \alpha_i + \beta_1 ZK_i + \beta_2 CD_i + \beta_3 PLS \varepsilon_i$$

where,

SMFD : Springate model for financial distress

ZK : Zakat

CD : Capital distribution

PLS : Profit loss sharing

To measure the variable of capital distribution, this study utilizes the following proxy measurement:

$$\text{capital distribution} = \frac{\text{qardhul hasan}}{(\text{total Income} - (\text{zakat} + \text{taxes}))}$$

Meanwhile, to measure the variable of profit-loss sharing, this study employs the proxy measurement of profit-loss sharing financing. The formula used for its measurement is as follows:

$$\text{profit loss sharing financing} = \frac{(\text{mudharabah} + \text{musyarakah})}{\text{total financing}}$$

In order to assess financial distress, this study adopts the Springate model as a measurement tool. The mechanism for measuring the model is outlined as follows:

$$Z = 1,3A + 3,07B + 0,66C + 0,4D$$

where,

A : Working Capital to total Assets

B : Earnings Before Interest And Taxes/ Total Assets

C : Earning Before Taxes to Current Liabilities

D : Total Sales to Total Assets

While evaluating the level of zakat distribution, this research employs a formula that involves dividing the amount of zakat paid by the total net profit generated by the company. This approach considers zakat as a proportion of the annual net profit earned by the company. Furthermore, the study incorporates two additional variables, namely capital distribution and profit-loss sharing, as control variables. These variables are included in the analysis to account for their potential influence on the research outcomes.

DISCUSSION

Springate Model Financial Distress

Financial distress poses significant risks to corporations and their stakeholders, warranting the development of reliable predictive models.

The Springate Model, named after its creator Professor R. C. Springate, emerged as a prominent tool in the realm of financial distress prediction. The Springate Model explores the concept of financial distress, discusses the relevance of financial ratios in assessing corporate performance, and elucidates the rationale behind the selection of specific ratios in the Springate Model.

The Springate Model integrates four essential financial ratios as key performance indicators. The ratios encompass liquidity, profitability, leverage, and solvency aspects, enabling a comprehensive evaluation of a company's financial health. The Springate Model stands as a robust and reliable approach to predict corporate financial distress. Its comprehensive evaluation of key financial ratios provides valuable insights into a company's financial health and bankruptcy probability. By examining the literature and empirical evidence, this study confirms the superiority and practicality of the Springate Model, underscoring its significance for financial decision-making and risk management. As financial distress remains a critical concern in today's business landscape, the Springate Model offers a valuable tool for stakeholders to assess and mitigate financial risks in corporate entities.

Zakat and its indirect benefits for Islamic banking institutions

As commonly recognized, the foundational economic principles of Islamic Banking (IB), including its governance principles, are derived from the Al-Qur'an and Al-Hadith. The management of Islamic banking must adhere to at least four fundamental principles, which are as follows:

1. Prohibition of Riba: All transactions must be free from any form of interest-based elements.
2. Elimination of Gharar: Every transaction must be conducted with clarity and certainty, without ambiguity or excessive risk.
3. Fulfillment of Zakat: Obligatory payment of Zakat, which involves giving a portion of one's assets to designated beneficiaries.

These four principles are indispensable conditions that must be fulfilled for an institution, specifically a banking entity, to be recognized as a Sharia-compliant financial institution. This study will specifically focus on the fourth principle, namely Zakat. Zakat is a compulsory

obligation for all Muslims, requiring the payment of a portion of their assets to deserving recipients. In Islam, income generated by individuals or institutions is not solely their own, but rather it includes provisions for others. Therefore, it is necessary to purify one's income by reducing it through the payment of Zakat. This demonstrates that in Islam, business endeavors are not solely driven by profit motives, but also aim to achieve economic equity, justice, and social welfare in society. Numerous studies have substantiated the significant economic value of Zakat.

The relevance of Zakat in banking institutions is crucial, particularly in terms of its appropriate distribution. According to the Qur'an (At-Taubah:60), gharim (those burdened with debt) is one of the seven categories eligible to receive Zakat. It is well-known that high levels of non-performing loans are among the factors leading to financial distress in banking institutions. These loans result from debtors' inability to repay their credit installments. If banking institutions implement a Zakat mechanism and distribute it to individuals unable to repay their debts (gharim), it would alleviate the burden of non-performing loans. Consequently, the financial distress faced by these institutions can be mitigated. This aligns with previous research that has identified Zakat as a potential variable with advantageous implications for the financial performance of both states and companies (Noor et al., 2015; Javaid & Al-Malkawi, 2018; Sanusi et al., 2018; Rizki et al., 2019). In light of these considerations, this research proposes the following hypothesis:

H1 : Zakat has negative significant relation to financial distress

Table 1 below presents the descriptive statistical data for the following indicators and variables used in this study. The descriptive statistical data used include the mean, standard deviation, maximum and minimum value.

Tabel 1. Descriptive Statistic

	Mean	Standar Dev	Max	Min
Mudharabah*	525,605,765	829,379,404	3,398,751,000	0
Musyarakah*	3,617,797,237	5,728,015,447	20,192,427,340	0
Total financing*	12,075,719,368	15,981,751,029	60,584,000,000	1,234,571
Current asset*	6,492,193,742	8,949,247,198	34,450,897,000	2,123,216
Total asset*	23,511,971,266	31,484,190,529	114,980,168,000	2,126,019
Qardhul Hasan*	283,636,199	601,359,829	2,609,571,000	0
Current liability*	8,773,268,210	21,580,370,735	96,572,255,000	1,829,846
Total debt*	9,144,011,905	21,943,328,581	98,820,526,000	1,834,770
Total income*	2,154,652,398	2,370,871,228	8,275,127,000	273,003
Halal income*	1,589,939,123	1,849,796,414	7,286,674,000	271,735
Non-Halal income*	247,202	375,105	1,460,868	0
Zakat*	2,108,015	3,629,063	12,488,000	0
Tax*	69,739,821	99,284,583	420,560,000	(19,191,000)
Dividen*	175,715,821	48,686,397	251,026,000	0
(CA - CL)/TA	(3.01)	19.16	0.40	-119.62
EBT/Total Asset	0.581	3.62	22.59	-0.22
EBIT/Current liability	(0.02)	0.41	0.64	-1.64
Total income/Total asset	2.59	15.43	96.48	0.06
Profit loss sharing financing	0.35	0.26	0.92	0
Capital distribution	0.07	0.12	0.46	0

*in thousand Rupiah
 CA : current asset
 CL : current liability
 TA : total asset

Based on the data presented in Table 1, the mean values of mudarabah and musyarakah in Indonesian Islamic banking institutions (IBs) between 2015 and 2019 were 526 billion and 3.6 trillion, respectively. Comparatively, these figures appear relatively small when compared to the average total financing disbursed by IBs during the same period, which amounted to 12.1 trillion. In terms of percentage, the mudarabah and musyarakah-to-total financing ratio for IBs from 2015 to 2019 is 35%, falling below the 50% mark. This comparison is denoted by the profit-loss sharing financing variable in Table 1. Interestingly, a closer examination of the standard deviation value for this variable, which stands at 0.26 (26%), reveals a relatively high deviation. This suggests that certain Islamic banking institutions in Indonesia have a mudarabah and musyarakah-to-total financing ratio below 10%. Addressing this issue is of utmost importance as such a low ratio could pose a threat to the fundamental principles that underpin Islamic banking institutions ideologically. In other words, if the ratio of mudarabah and musyarakah to total financing disbursed remains exceedingly small, it may raise critical questions about the distinction between Islamic banking and conventional banking.

Furthermore, Table 1 demonstrates that the average total assets held by Indonesian Islamic banking institutions from 2015 to 2019 amount to 23.5 trillion. This value is significantly smaller compared to the total assets held by conventional banks in Indonesia. However, this discrepancy can be rationalized by considering the recent substantial growth of the Islamic finance industry in Indonesia. Notably, the observation of the standard deviation of total assets in Islamic banking, presented as 31.4 trillion in Table 1, is particularly intriguing. This standard deviation value surpasses the average total assets, highlighting a remarkable disparity among Islamic banking institutions in Indonesia. In essence, there are Islamic banks that possess considerable wealth, as indicated by their high total assets, while others are relatively impoverished, evidenced by their low total assets.

The aforementioned imbalance can have implications for market accessibility for each institution. Naturally, relatively affluent institutions enjoy greater access to acquiring a larger market share compared to relatively smaller Islamic banking institutions. This situation directly influences the competitive landscape within Indonesia's Islamic banking industry. In other words, there is a potential for a few dominant players to monopolize the Islamic banking industry in Indonesia. Such an unhealthy competition hampers the dynamic growth and rapid development of the industry.

Shifting focus to the value of zakat disbursed by Indonesian Islamic banking institutions, according to the information in Table 1, the average amount of zakat distributed by these institutions from 2015 to 2019 is 2.1 billion, with a standard deviation of 3.6 billion. When compared to the average total income recorded during that period, this amount represents a mere 0.1%. Implicitly, this figure is exceptionally small, considering that Islamic banking institutions are not solely profit-oriented but also have a social orientation. Zakat can play a vital role in fulfilling this social responsibility. However, with such a relatively meager percentage, it is reasonable to conclude that Islamic banking in Indonesia has not fully optimized its social role. Moreover, a closer examination of the relatively high standard deviation value of 3.6 billion (above the mean value) for

zakat instruments highlights notable disparities in the distribution of zakat among Islamic banking institutions in Indonesia. Moreover, as indicated by the study's analysis of the gathered data, a number of Islamic banking institutions in Indonesia have not been able to effectively allocate zakat. This observation is evident in Table 1, where the minimum value in the zakat instrument highlights the institutions that have not fulfilled their zakat distribution obligations.

Table 2 presents the outcomes of the data analysis, wherein the hypothesis of this investigation receives empirical support. This affirmation is substantiated by the obtained t-test value of 2.38, which surpasses the critical threshold of 1.96. Such a finding implies that an augmented distribution of zakat correlates with an amplified generation of the Springate model. Consequently, an elevation in the Springate model value signifies a reduced likelihood of encountering financial distress. Consequently, this study posits a negative association between zakat and the occurrence of financial distress within Indonesian banking institutions.

Based on the data in Table 2, high standard deviation values are indeed found in several components, not only in the variables of total assets and zakat. Other variables, such as mudarabah, musyarakah, total financing, current assets, total debt, current liabilities, and qardhul hasan, also exhibit relatively high standard deviation values. This warrants serious attention, as mentioned in the preceding paragraph, as it relates to the quality of competition within the Islamic banking industry. The significant disparities among institutions indicate that there have been substantial differences in quality among these institutions.

Tabel 2. The Result of Regression Analysis

Springate model for financial distress (SMFD)	
Zakat	-8.56 (-2.38)***
Capital Distribution	-0.199 (-1.906)***
Profit loss sharing	0.90 (0.75)
F Test	12.56
Adjusted R square	0.37

***significant at 5%

Based on the regression analysis results in Table 2, the zakat variable has a significant negative impact on financial distress at a 5% significance level, with a coefficient value of -8.56. This indicates that a one-unit change in zakat will result in a decrease in financial distress by -8.56 units. Furthermore, the variable that significantly affects financial distress is capital distribution, exhibiting a negative influence with a coefficient value of -0.199. This implies that a one-unit change in the capital distribution variable will lead to a decrease in financial distress by 0.199 units. Based on these findings, this research supports the formulated hypothesis.

This study reveals that the magnitude of capital distribution exerts a positive and substantial impact on the Springate model's magnitude. This signifies that as banking institutions channel a greater level of capital distribution, the likelihood of alleviating financial distress within Indonesian banking institutions diminishes. On the other hand, when considering the subsequent control variable, namely profit-loss sharing, the investigation establishes that this particular variable does not exert any influence on the financial distress experienced by banking institutions in Indonesia.

CONCLUSION AND RECOMMENDATION

As deliberated in the preceding session, the outcomes of this investigation demonstrate a substantial correlation between zakat performance and financial distress. Specifically, the study posits that the quantum of zakat disbursed by a company exerts an influence on its vulnerability to bankruptcy. This signifies that the presence of zakat companies holds the potential to avert financial distress. Consequently, the research formulates a hypothesis that accentuates the importance of judicious zakat allocation in mitigating prospective financial losses, particularly pertaining to weak credit performance within the banking sector. Put differently, Islamic banks could allocate their zakat funds to debtors who are unable to meet their monthly installment payments, thereby diminishing non-performing loans, a pivotal factor in banking insolvency.

Zakat Maal represents a payment made on a portion of assets owned within a year, subject to specific criteria such as Haul and Nisab. Corporations disburse zakat if they generate substantial profits, with the minimum amount being 2.5% of the earned profits. In this context, the concept of financial distress pertains to a company's obligation to be accountable to interested parties, including stakeholders and other relevant entities. Zakat, as a concept, exemplifies one of the manifestations of sharia enterprise theory, wherein zakat serves as a form of responsibility towards God, resulting in direct benefits for the community. Through the concept of zakat, the study sheds light on how companies strike a balance between their accountability towards humanity and their accountability towards God (horizontal-vertical relations). Evidence obtained from reports of Islamic Commercial Banks demonstrates that zakat has been allocated in accordance with Sharia principles, encompassing mustahiq zakat recipients such as the poor, 'amil, mualaf, riqob, gharim, fiisabilillah, and ibnu sabil. The allocation and management of zakat conform to the provisions of Law number 23 of 2011, which governs zakat management, as well as MUI Fatwa No. 15/2011 dated March 17, 2011, focusing on the withdrawal, maintenance, and distribution of zakat funds. Furthermore, this study contributes novel insights by presenting divergent findings in comparison to several previous studies.

Moreover, the study's results indicate that the distribution of capital has a bearing on financial distress. This implies that various facets of capital allocation, encompassing qardul hasan financing, company operational costs, shareholder interests manifested through dividends, and net income (profits after zakat and taxes), can impact a company's likelihood of encountering bankruptcy. Additionally, sharia enterprise theory underscores that a Sharia-compliant entity must pay heed to all levels of its operations and remain accountable to all interested parties, including shareholders, stakeholders, and God. According to the principles of Sharia, all activities must adhere to its tenets, and the distribution of capital must align with the Sharia concept. Consequently, each component of capital that pertains to shareholder rights and

stakeholder interests must consistently conform to the payment of zakat, which serves as a means of accountability to God. This ensures that the operational activities of the company are in line with the concept of Sharia compliance.

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