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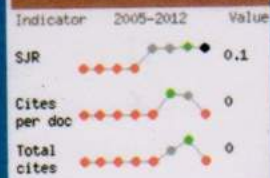
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## The Role of Islamic Corporate Governance in SMEs to Improve the Welfare of Society

Nunung Ghoniyah\* and Sri Hartono\*

*Abstract:* SME's is a sector that contributes a lot to the economic growth and provide jobs for the community. The samples are focused on the SME field convection and food are making use of labor around the company. The purpose of this study is to know and to explain how Islamic corporate governance implementation and impact to financial performance as measured by ROA and ROE, as well as the impact of the financial performance of the local community welfare is supported by Islamic Corporate governance.

The results show that (1) Islamic corporate governance (Siddiq, amanah, tabligh, iathonah, istiqomah and qonaah) effect on financial performance (2) financial performance does not affect the welfare of the community (3) corporate governance of Islamic influence on the local community welfare (4) financial performance supported by Islamic corporate governance affect the local community welfare. This study also demonstrates the role of Islamic corporate governance to improve financial performance and well-being of society.

*Keyword:* Islamic Corporate Governance (ICG), financial performance, Local community welfare.

### 1. INTRODUCTION

Management of companies or SMEs should be able to maximize its stakeholders' prosperity, but some studies suggest that governance (Corporate Governance) only increases shareholder wealth; that is only limited to increase corporate profits. Dean *et al.* (2005) proves the existence of a positive and significant correlation of corporate governance and performance (ROE). Moreover, Utama and Cynthia (2005) conclude that there is a positive and marginally significant correlation of corporate governance performance index (CGPI) and the spread of Economic Value Added (EVA). Similarly, the study conducted by Arsiah (2006) finds evidence that corporate governance significantly and positively influences ROE and ROA. Nevertheless, Utama and Cynthia (2005) find a negative correlation of corporate governance and market value added to invested capital (MV/IC), as well as to spread EVA shows insignificant correlation.

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Expectations of the implementation of good corporate governance system are the achievement of the company's value (Tumirin, 2007 in Tirta, 2009). However, the implementation of corporate governance has faced a lot of failures. It can be seen from some findings indicate that corporate governance cannot increase the price books value (Arsjah, 2006). Similarly, a study conducted by Cynthia (2006) also reveals that corporate governance has no effect on CAR.

Many theories and empirical evidences demonstrate the influence of corporate governance toward corporate performance and value of the company, where the board of directors is a major force in the internal corporate governance (Cerbioni and Parbonetti, 2007; Haat *et al.*, 2008; Khanchel, 2007; Li *et al.*, 2008). However, in a business company that has small number of board of directors, this mechanism is not working (Cerbioni and Parbonetti, 2007) because the CEO performs a dual role as both internal corporate governance and head of the company ((Brickley *et al.*, 1997). This condition shows the role of corporate governance implementation is more caused by force mechanism control that occurs in the company, rather than on awareness of companies' management to implement that good governance (self-control).

The basic principle of good corporate governance as a management tool covers *fairness, transparency, accountability and responsibility*. According to Abdul Ghani (2005: 139), the basic principle is just as a measure of the material. This alternative thinking is based on understanding that human system, how sophisticated it is, has a weakness that can be handled by humans who have *moral hazard*. The essence of the implementation of corporate governance is a form of accountability to trust provider. As representatives of Allah (*Khalifatullah*), humans have a responsibility towards fellow human beings, whereas as *abdullah*, humans have an obligation and responsibility to God. Quran *Surah 2:254 and 267* provide clues that the concept of *amanah* or trust must not only be accounted to fellow human beings in the form of the material but also to God. Therefore, a business activity should be managed by the management of spirituality materially and essentially in order to worship the creature toward the blessed path by God (*Mardhatillah*).

With governance based on Islamic values, it is expected to be the control of the management of company that not only depends on the composition of the board of directors or the principles base material, but also self-control as accountability to God. The material base control often has drawbacks such as a study conducted by Cornett *et al.* (2009) which shows that the condition of the financial crisis, where financial performance has decreased, a corporate governance weaken significantly. This finding shows the weakness of governance base material.

Moreover, a business management is also expected to contribute to the development of the economy. Therefore, the management of the business is expected to have an impact on the achievement of the prosperity of the entire community. Similarly, it is also for the development of the company that wants to improve its performance to achieve the prosperity of shareholders and to the welfare of employees and the

public (*stakeholder*) in the fields of welfare. The benefits perceived are oriented to financial performance, encouraged to

From these findings, it can be seen that corporate governance cannot only provide financial benefits and welfare, but it must put the concept of Corporate Governance may impact on

## 2. LITERATURE

### 2.1. The Principles

Islamic corporate governance is based on spiritual responsibility, accountability, and transparency, the most important principle (*Mardhatillah*). In corporate governance, the shareholders have a responsibility to transparency, accountability to fellow human beings and responsibility to

This alternative thinking is based on understanding that human system, how sophisticated it is, has a weakness that can be handled by humans who have *moral hazard*. Concept of *Islam* *Rassulullah* principles such as: *Shiddiq*

### 2.2. Siddiq

Imam al-Qusairi (1997) defines the soul of an attitude and behavior oriented to value-oriented. Briefly, honest and sincere.

In Islamic corporate governance, the management of the company

public (*stakeholders*). The ability of entrepreneurship for social change, mainly covering the fields of welfare, not only measures the success of its financial performance, but also the benefits perceived by society (Daniel Bell, 1980). Business governance is not only oriented to financial benefit, but also to local community (Fred Hehuwat, 2008) and encouraged to solve the social problems within the community (Nicholls, A., 2010)

From these conditions, it is necessary to develop a model of good governance that cannot only provide a positive influence on the performance of the company, but also benefits and welfare for the entire community within the company. Such governance must put the concept of economic and moral responsibility in the form of *Islamic Corporate Governance (ICG)*. The ICG is expected to improve financial performance and may impact on the welfare of the community.

## 2. LITERATURE REVIEW

### 2.1. The Principles of Islamic corporate Governance

Islamic corporate governance can be defined as a management system that puts spiritual responsibilities with the basic principles of transparency, responsibility, accountability, morality and reliability as a measurement of material nature, while the most important and essential is as worship of beings blessed to the path of Allah (*Mardhatillah*) (Abdul Ghani, 2005:139). This definition suggests that, in corporate governance, the management accountability is not just limited to material liability to shareholders or other stakeholders, but there is more real accountability that is the responsibility to God. The basic principles of good corporate governance cover *fairness, transparency, accountability and responsibility*. As *khalifatullah*, humans have responsibility to fellow human beings, whereas as *abdullah*, humans have an obligation and responsibility to the God.

This alternative thinking is based on understanding that human system, how sophisticated it is, has a weakness that can be handled by humans with *moral hazard*. The Concept of *Islamic corporate Governance* adopts the value system of the Qur'an and *Rassulullah* private practice as *uswatun hasanah* reflected by his glorious personalities such as: *Shiddiq, amanah, tabligh, fathonah, istiqamah* and *qanaah*.

### 2.2. Siddiq

Imam al-Qusairi (in Tasmara, 2002) states that the word *shadiq* means an honest man. The soul of an honest man is always in the side of truth and commendable moral attitude and being proud of being servant of Allah (*abdullah*). *Shiddiq* means *taqwa*, value-oriented, courageous, brave, patient, thoughtful and sincere (Alwan, 2007). Briefly, honesty is the integrity of a person's attitude towards the work mandated to him.

In *Islamic corporate Governance*, *Siddiq* principles reflect the behavior of the manager of the company which is based on the principles of truth, honesty and faith-oriented

values. Qur'an Surah Al-An'am: 152 gives explanation that the Islamic view of *fairness* is the source of truth and justice from the heart to be actualized for self, others and God. Moreover, in *Surah Hud* 18 God gives instructions that to be fair and honest will lead people to be loved by God who will give glory and fortune in the world and the hereafter.

### 2.3. Amanah

*Amanah* means trustworthy, professional, discipline, responsible, independent, skilled, tough, persevering, tenacious, unyielding and confident (Alwan, 2007). The principle of *amanah* is loyalty and commitment to the company's management in carrying out the duties and responsibilities imposed upon him.

Business managers must have good manners. It is a form of liability (*responsibility*) as a trust holder. Quran Surah. 2: 254 and 267 provide clues that the concept of *amanah* is very important, because all treasures are temporary God's deposit which must be used wisely. Therefore, as the manager/owner of the company, one must be able to manage his property wisely, not only for profit oriented, but also must be able to seek wealth in a manner consistent with the provisions of God.

*Rasulullah* said in HR al-Dailami (tt.: 1/121) that a business managed by *amanah* (trust) will bring sustenance, increase profit and ultimately lead to *rahmatan lil alamin* i.e. welfare of the entire universe including that the welfare of society.

### 2.4. Fathanah

Alwan (2007) states that *fathanah* can be interpreted as intelligent, clever, innovative, creative, and strategic. Businessman should manage his business in a professional manner not only with honesty and responsibility, but also intelligence (skills), so that what has been entrusted to him is not neglected. One day, a friend asked: "How can a trust be lost?" and *Rasulullah* replied: "If the matter submitted to the person who is not an expert on it, then wait its destruction" Bukhari (tt.: 1/103).

*Fathanah* personality (a blend of 'alim and hafidz') had led the Prophet Yusuf and his economic team to rebuild the land of Egypt. Quran *surah* Yusuf: 55 provides guidance that intelligence brings success, luck and community welfare.

### 2.5. Tabliq

Alwan (2007) interprets *Tabliq* as friendly, courteous, polite, communicative, transparent, vibrant, and highly-motivated. Businessman or managers who apply the principles of *tabligh* (sermons) will convey information correctly; describe tasks, responsibilities and authorities with polite, courteous and transparent, so that it can be easily-understood by all stakeholders. *Surah Al-Ahzab* (33): 70.71 hints that God will fix any deeds and forgive sins for those who believe, pious and telling the truth (*qaulan Sadidan*), and those who obey Allah and His Messenger, then Indeed he has got a great

victory. Therefore, it indicates that to manage business with the principle of *tabligh* will bring luck.

## 2.6. Istiqamah

*Istiqamah* means powerful stand (consistent). Tasmara (2002: 86) states that a Muslim with a good professional and moral value has a consistent attitude and never give up the principle of *constancy*. As a result, he will be able to control himself, manage his emotions effectively, remain firm on commitments, and not fragile despite dealing with stressful situations.

This firmness is manifested in the form of constancy to hold promise, being consequent and consistent on the intention of truth that has been agreed upon. The Word of God in the Qur'an Surah Al-Ahqaaf (46) verse 13 hints that managers who apply the principles of *istiqamah*, will not dissolve in the conspiracy, association or conspiracy of any behavior that does not comply with the spiritual outlook. Commitment is embodied by the truth of the Righteous, not only to the person, institution or company, but also to employees, communities and other *stakeholders* (Abdul Ghani, 2005).

## 2.7. Qana'ah

*Qana'ah* is simplicity, efficiency and effective in doing the job. Humans basically have greed; no limit sufficiency, except for those who have spiritual control. Someone who has *qana'ah* personality, will able to manage his desire not to be greedy and have a commitment to the Almighty and be alert to the flow of life (Abdul Ghani, 2005).

The implementation of *corporate governance* with *qana'ah* principle requires managers to manage funds effectively and efficiently. In Surah An-Kabuut (29) verse 7 "And those who believe and do good thing, we really will do away from them their sins and truly will reward them better than what they do". That verse gives hint that there is a correlation of the principle of *qanaah* and outcome of what is done (performance).

The implementation of the various dimensions of corporate governance has an impact on the performance of the company. The study on *Corporate Governance of manufacturing company listed in BEI* by Ghoniyah & Mega (2007) concludes that managerial ownership influences *corporate governance* mechanism through the company's debt policy. Moreover, Ghoniyah (2010) on Islamic corporate governance gives the result that the Islamic corporate governance influences financial performance and employee welfare.

From these various studies, it can be concluded that good corporate governance will have an impact on financial performance. Corporate governance is represented with honest nature, truth and *fairness (Siddiq)*; responsibility and trustworthy (*amanah*); smart, innovative, and creative (*fathanah*); communicative and transparent (*tabligh*); consistent and holds the promise (*istiqamah*); and simplicity,



efficiency, and be able to control the desire (*qonaah*). Therefore, from the various forms of the implementation of Islamic governance, the hypotheses proposed are as follows:

- 1a Hypothesis: the Dimensions of *Siddiq* as an implementation form of Islamic Corporate governance positively influence financial performance.
- 1b Hypothesis: the Dimensions of *Amanah* as an implementation form of Islamic Corporate governance positively influence financial performance.
- 1c Hypothesis: the Dimensions of *Tabligh* as an implementation form of Islamic Corporate governance positively influence financial performance.
- 1d Hypothesis: the Dimensions of *Fathanah* as an implementation form of Islamic Corporate governance positively influence financial performance.
- 1e Hypothesis: the Dimensions of *Istiqamah* as an implementation form of Islamic Corporate governance positively influence financial performance.
- 1f Hypothesis: the Dimensions of *Qana'ah* as an implementation form of Islamic Corporate governance positively influence financial performance.

### 2.8. Corporate Performance

The measurement of performance can be measured by: (1) growth and (2) profitability. Both of these dimensions can reflect the company's ability to achieve certain efficiencies of scale without having to measure the dimensions of efficiency. The indicators of growth can be seen from the increase in sales and market share growth (Bhargava *et al.*, 1994).

The second dimension is the profitability. Profitability is also referred as financial performance. Profitability is the company's ability to generate profits or how well the company can be managed effectively. The indicators of profitability by Beal (2000) are the *Return on Investment* (ROI) and *Return on Assets* (ROA). The use of ROI and ROA indicators are widely used in empirical studies in the field of strategic management and financial management (Davis and Schul, 1993). Therefore, the hypothesis proposed is as follows:

- 2<sup>nd</sup> Hypothesis: The better the financial performance of SMEs is, the better the improvement of social welfare around will become.

### 2.9. Public Welfare

Operational goal of the company is to provide welfare to the stakeholders that consist of the owners, employees, customers, suppliers and the community. In fact, the company tends to pay more attention to shareholders or owners of the company and ignore other *stakeholders*. Federick (in Balabanis, Hugo, and Lyall, 1998), argues that companies must carry responsibilities for all actions related to people, communities and the environment in which people and communities live. Meanwhile, the others perceive that social responsibility is a positive awareness of the company or as a form of role and commitment to the company. Balabanis, *et al.* (1998), finds that *corporate social responsibility* (CSR) is a real role to support the welfare of society.

Carroll (Vos, 2003; Pearce and Robinson, 2005) identified four forms of corporate responsibility to its external *stakeholders*, namely: *economic, legal, ethical, discretionary*. *Economic responsibility* refers to the pursuit of maximum *profit*. *Legal responsibility* is to be the company's efforts to comply applicable law. *Ethical responsibility* is a fair reflection of the attitude appropriate to be given to *stakeholders*, such as the issues of racism and gender. While *discretionary responsibility* is a voluntary act of the company in establishing good relations with the community, in this case, the company becomes a good citizen (Pearce and Robinson, 2005). Business must be fair, honest, trust, benevolence and balance for all *stakeholders* (Rafik I Bekun, 2003). Furthermore, the company has the obligation to serve the interests of *stakeholders* and always be considered in any decision-making (Umer Chapra, 1980).

According to Pearce and Robinson (2005), the good relations between employers, employees and the environment is the obligation of company as good citizen that will have an impact on the performance of the company in the long run. Therefore, the governance model using the principles of *Islamic Corporate Governance* as a form of more comprehensive governance will have a positive impact on the community welfare around the company. From the explanations, it can be concluded that *corporate governance* should give impact to the betterment of society around. Therefore, the hypothesis is as follows:

3<sup>rd</sup> Hypothesis: the good implementation of *Islamic corporate governance* will give positive impact to improve the welfare of society around the company.

Business management capabilities not only focus on financial performance, but also on social change that mainly covers the fields of welfare (*welfare*) perceived by society (Daniel Bell, 1980). Besides, business governance is not only oriented to financial profit, but also to the local community (Fred Hehuwat, 2008) and encouraged to solve the social problems that exist within the community (Nicholls, A., 2010). Good Financial Performance needs to be supported by good governance that has implication to the betterment of society. Therefore, the hypothesis proposed is as follows:

4<sup>th</sup> Hypothesis: The financial performance supported by good implementation of *Islamic corporate governance* has a positive impact on improving the welfare of society around the company.

### 3. RESEARCH METHOD

#### 3.1. Population and Sample

The population of this study is all SMEs having more than 10 employees. The population consists of managers of SMEs and community around. The sampling technique uses proportional and purposive sampling carried out in two phases. The *first* phase is selecting 100 SMEs based on local employee and the outputs are intended to surrounding community. The *second* is picking SMEs having more than 10 employees and they have been in operation for at least 5 years. In addition, Community samples

are taken from community leaders and members who directly or indirectly interact with SMEs.

### 3.2. Types of Data and Collection Procedures

The data in this study are the data subject. Data subjects are in the form of opinions and attitudes of respondents (managers of SMEs and the public about the company) associated with variables studied. The data are obtained by questionnaire about the implementation of *Islamic corporate governance* and financial performance and the welfare of the people around SMEs in Semarang.

### 3.3. The Definition of Operational Variables

In order to limit the problems of research, operational definition of research variables are composed. Measurement of all variables cannot be done directly; it requires some indicators that serve as a measure. The following is the definitions operational variables:

1. *Islamic Corporate Governance* is a management system that puts accountability spirituality by the principle of *Siddiq, Amanah, Tablig, fathanah, istiqamah and qanaah*. *Islamic Corporate Governance* in this study is good or bad (quality of the implementation of Islamic corporate governance. The measurement is used the *Likert* scale from 1 to 5. A score of 5 means it is very good and a score of 1 means it is very bad. The variables of *Islamic Corporate Governance* (X1) consist of 6 indicators, *Siddiq, amanah, tabliq, fathanah, istiqamah and qanaah*.
2. Performance of companies is measured by market growth, ROA and sales growth. The variable of the performance of the company (Y1) is measured by market growth, ROA and Sales Growth.
3. The welfare of society is measured by the increase in quality of life, reducing unemployment and increasing social activity. The measurement is used the *Likert* scale from 1 to 5. A score of 5 means very prosperous and a score of 1 means very in-prosperous. The variables of the Welfare of society (Y3) consist of three indicators: the increase in life quality of society, the decrease of unemployment and the increase of social activities.

Variables and indicators to measure the variables in this study can be seen in table 3.3 (see appendix).

### 3.4. Analysis Method

To analyze the correlation of the variables of *corporate governance*, financial performance and welfare of the people is by using regression approach gradually and moderated. The regression is used due to the consideration of complex pattern of correlation. Moreover, this model is more appropriate to be used for predication as implications of the results of theory test through hypotheses.

## 4. FINDINGS

### 4.1. Findings

The result of the SMEs based on local (local output) shows of SMEs and corporate governance is demonstrated of SMEs as a stakeholder oriented (*shareholder*) also demonstrate accountability (*paradigm*). Briefly performance of SMEs (see appendix).

The results of SMEs performance of *Islamic Corporate Governance* indicates the level of Corporate Governance.

The results of welfare of the community adoption of ICG is the influence of ICG on the welfare of the community. In fact, significant correlation between the company. Unit of society. It is the performance of the company. Briefly, the presence of prosperous SMEs indicated by the community. How *Islamic corporate governance* can be proven by  $p < 0.05$ . Therefore, the results are supported by the

### 4.2. Discussion

From the findings, Islam has an impact

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## 4. FINDINGS AND DISCUSSION

### 4.1. Findings

The result of the analysis on the implementation of Islamic corporate governance on SMEs based on local employees and output intended for the surrounding community (local output) shows relatively good governance and gives impact on the development of SMEs and community prosperity. The good implementation of *Islamic corporate governance* is demonstrated by the impact of governance on the financial performance of SMEs as a form of business success in the management of material-oriented (*shareholder paradigm*). On the other hand, *the Islamic corporate governance* is also demonstrated by the impact of governance on the welfare of society as a form of accountability for the management of the local community (*Stakeholder paradigm*). Briefly, the influence of Islamic Corporate Governance toward the performance of SMEs and the welfare of society can be seen in the table 4.1 (see appendix).

The results of the analysis on the influence of *Islamic Corporate Governance* toward SMEs performance show a significant correlation. It can be seen that all the dimensions of *Islamic Corporate Governance (Siddiq, Amanah, Tabligh, Fathonah, Istiqomah and qanaah)* indicates the level of sig of  $<0.05$ . Therefore, it can be concluded that the Islamic Corporate Governance influences the performance of SMEs.

The results of analysis on the influence of the implementation of ICG toward the welfare of the community show a significant influence. The table shows that the adoption of ICG is expected to have an impact on the welfare of society. Analysis on the influence of ICG toward the welfare of the community shows a significant influence. In fact, it can be seen from the p value of  $0.000 < 0.05$  which indicates a significant correlation of the implementation of ICG and the welfare of society around the company. Unfortunately, the performance of SMEs does not influence the welfare of society. It is indicated by the p value of  $0.660 > 0.005$  which means that the performance of SMEs does not influence the welfare of society around the company. Briefly, this shows that the performance of SMEs does not guarantee the presence of prosperity within the society. This condition indicates that the progress of SMEs indicated with good financial performance does not affect the welfare of the community. However, financial performance supported by good implementation of *Islamic corporate governance* shows a significant influence on the welfare of society. This can be proven by the performance of SMEs supported ICG shows p value of  $0.00 < 0.05$ . Therefore, the performance of SMEs will influence the welfare of the employees if supported by good *Islamic corporate governance*.

### 4.2. Discussion

From the findings, it indicates that the governance of SMEs based on the values of Islam has an impact on the performance of SMEs as a form of accountability to

shareholders. Similarly, a good governance of SMEs also has positive impact on the welfare of the people around, as accountability to external stakeholders. However, the performance of SMEs does not always have a positive impact on the welfare of employees. This means that governance based on Islamic values does not depend on the financial condition of the company. A company that has responsibility to the local community does not have to wait for better financial performance, but this is a consequence of the responsibility of the company's operations.

## 5. CONCLUSION

The management of SMEs with a local employee-base and output intended for local communities needs to implement the ICG in its activities to produce good performance, welfare of employees and provide benefits to the surrounding community.

The findings show that:

- a. The implementation of ICG influence the financial performance and the welfare of society at SMEs based on local employees and output.
- b. The performance of SMEs needs support of ICG in order to give impact on the welfare of the community.
- c. The performance of SMEs without ICG support has no impact on the welfare of the community

## 6. LIMITATION

- a. The indicators are measured by using a Likert scale, so there is a tendency to answer on a particular scale, it needs more open indicator. So that respondents can give more perceived value corresponding to the specific range.
- b. This study uses only the welfare of society as a form company's accountability to stakeholders, it is necessary to develop the impact on others stakeholders.
- c. The indicators of the welfare of the community need to be developed by using more indicators representing the welfare of society as implication of company's operation.
- d. The assessment on public welfare indicator is based on public perception in which its subjectivity is relatively high; it needs a more appropriate indicator for the development of further study.

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No.	Variables
1	Islamic Corporate Governance

2 Social Entrepreneur

3 Company Performa

5 Public Welfare

#### The Impact of Islam

##### Variables

Siddiq  
Amanah  
Tabligh  
Fathonah  
Istiqomah  
Qonaah  
ICG  
SMEs Perf.  
SMEs Perf,\* ICG

## APPENDIX

Table 3.3  
Variables and Indicators of Research

No.	Variables	Dimension	Indicator
1	Islamic Corporate Governance	Siddiq	a. Honest
			b. Fair
		Amanah	c. High integrity
			a. trusted (responsible to God)
		Tabligh	b. obey the law (fellow responsibility)
			c. Bowing to deal
Fathonah	a. informative,		
	b. open		
Qonaah	a. intelligent quotient,		
	b. emotional intelligence,		
Istiqomah	c. spiritual intelligence		
	a. efficient,		
2	Social Entrepreneurship	b. effective	
		a. consistent,	
3	Company Performance	b. unyielding	
		a. Human resource development	
		b. Exploiting the potential environmental	
5	Public Welfare	c. Provision of Affordable needs	
		a. Growth in market share	
		b. Return on assets (ROA)	
		c. Sales Growth	
		a. Improving standards of living	
		b. Reducing unemployment	
		c. Increase of social activity (and public)	

Table 4.1  
The Impact of Islamic Corporate Governance for SMEs Performance and Public Welfare

Variables	SMEs		Community Welfare	
	B	Sig	B	Sig
Siddiq	.237	.004		
Amanah	.242	.039		
Tabligh	.128	.040		
Fathonah	.202	.014		
Istiqomah	.152	.034		
Qonaah	.231	.006		
ICG			.658	.000
SMEs Perf.			.043	.660
SMEs Perf, * ICG			.395	.000