



FINANCIAL AND SOCIAL REPORTING OF ISLAMIC  
BANKS IN MALAYSIA: THE DISCOURSE OF  
CORPORATE GOVERNANCE

BY

ASRI MARSIDI

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International Islamic University Malaysia

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## ABSTRACT

Decent corporate governance practices are important and fundamental in today's corporate world, particularly in the growing and high future prospect of Islamic banking industry. In this respect, its linkages with disclosure at Islamic banks need to be well understood and developed for better sustainability of the industry. This study is hence conducted to examine the impact of corporate governance on the Islamic financial and social reporting (IFSR) of Islamic banks in Malaysia. Drawing on surveys and annual reports, this thesis seeks the views of accountants working in Islamic banks regarding the importance of items in the developed IFSR index. The annual reports are used to examine the score of the IFSR for the Islamic banks as well as to collect the data for the related variables. Multivariate regression is used as the main statistical technique to analyse the data. The findings suggest the importance of the financial part of the IFSR index followed by the importance of auditing and governance items, whereas the social items are viewed as fairly important. The findings on the social items may reflect that accountants are already aware of the need for social reporting components in Islamic banks although it yet to be considered as important as the financial items. The overall weighted score of IFSR have shown an increasing trend from 2007 to 2010. The scores, however, are still considered fair. As for the individual items, the score for finance items is classified as very good while the scores for social and governance items are categorised very poor and good respectively. The main findings suggest that board size is significant to explain the IFSR in Islamic banks in Malaysia. The other results indicate that board independence, board size, audit committee expertise, audit committee size, audit committee independence, and additional service of audit committee members significantly explain the IFSR for finance. Meanwhile, for the social items, the findings show that board size is significant in explaining the IFSR. As for the governance section of the IFSR, the results advocate that board independence and audit committee independence are significant to elucidate the IFSR. Theoretically, the thesis contributes to the body of literature through the use of Islamic agency theory. Further, the combination of quantitative, qualitative, mandatory, and voluntary requirements in the index is seen as capable of improving the disclosure of Islamic banks. The weighted index of IFSR on the other hand contributes towards enhancing the applicability of the disclosure. Moreover, the use of multivariate regression analysis contributes towards enriching the evidence on governance practices in Islamic banks. The findings may be useful to relevant stakeholders including the Islamic banks to review their disclosure level of IFSR to better discharge their accountability. At the same time, the findings contribute towards achieving a healthier formation of corporate governance mechanisms for better accountability and sustainability of Islamic banks in both Malaysia and abroad.

## خلاصة البحث

إن الممارسات الجيدة لحوكمة الشركات تعتبر أمرا هاما ومحوريا في عالم الشركات في عصرنا الحاضر لا سيما في مجال الصيرفة الإسلامية التي تتمتع بنمو متصاعد ومستقبل إيجابي. وفي هذا الصدد يجب فهم علاقات الممارسات المذكورة بمفهوم الإفصاح في البنوك الإسلامية فهما جيدا، كما يجب تنميتها تنمية شاملة من أجل الحفاظ على استدامة صناعة الصيرفة الإسلامية. لذلك يهدف هذا البحث إلى دراسة أثر حوكمة الشركات على مؤشر الإفصاح المالي والاجتماعي في البنوك الإسلامية بماليزيا. بناء على الدراسات الاستقصائية والتقارير السنوية يسعى هذا البحث إلى الحصول على آراء المحاسبين الذين يعملون في البنوك الإسلامية وذلك حول أهمية العناصر الموجودة في المؤشر المذكور. تم استخدام التقارير السنوية لفحص نتائج المؤشر المذكور وجمع المعلومات حول المتغيرات المعنية. تم استخدام تحليل الانحدار المتعدد كأسلوب رئيسي لتحليل المعلومات. تشير النتائج إلى أن الناحية المالية للمؤشر المذكور تحتل المركز الأول من حيث الأهمية وتليها عناصر تدقيق الحسابات والحوكمة، بينما تم اعتبار العناصر الاجتماعية مهما بعض الشيء. وقد تشير النتائج المتعلقة بالعناصر الاجتماعية إلى إن المحاسبين قد يدركون مدى أهمية عناصر الإفصاح الاجتماعي في البنوك الإسلامية رغم أن أهميتها في الوقت الراهن ليست بمثابة أهمية العناصر المالية. ويشير إجمالي النقاط الموزونة للمؤشر إلى وجود نمط متصاعد من عام 2007 إلى عام 2010م وعلى الرغم من ذلك فإن أرقام المؤشر لا زالت تعتبر متوسطة. أما بالنسبة للنتائج التي سجلها كل عنصر على حدة فإن نتائج العناصر المالية كانت جيدة جدا بينما كانت نتائج العناصر الاجتماعية وعناصر الحوكمة ضعيف جدا وجيدا على التوالي. وتشير النتائج العامة إلى أن حجم المجلس له أثر على المؤشر المذكور في البنوك الإسلامية في ماليزيا. وتشير النتائج الأخرى إلى أن استقلالية المجلس وحجم المجلس وخبرة لجنة التدقيق وحجم لجنة التدقيق واستقلالية لجنة التدقيق والخدمات الإضافية لأعضاء لجنة التدقيق تؤثر على الناحية المالية للمؤشر المذكور تأثيرا ملموسا. أما بالنسبة للعناصر الاجتماعية فتشير النتائج إلى أن حجم المجلس له أثر على المؤشر. أما بالنسبة للناحية المتعلقة بالحوكمة فتشير النتائج إلى أن استقلالية المجلس واستقلالية أعضاء لجنة التدقيق تلعب دورا هاما في الإفصاح المالي والاجتماعي. ومن الناحية النظرية فإن البحث يساهم في إثراء المعرفة من خلال استخدامه لنظرية الوكالة الإسلامية. وعلاوة على ذلك فإن المتطلبات الكمية والنوعية والإجبارية والاختيارية بالمؤشر بإمكانها العمل على تحسين نظام الإفصاح للبنوك الإسلامية. أما المؤشر الموزون للإفصاح المالي والاجتماعي للبنوك الإسلامية فإنه يساهم في تعزيز عملية تطبيق نظام الإفصاح. وإضافة إلى ذلك فإن استخدام تحليل الانحدار المتعدد يساهم في إثراء الأدلة حول ممارسات الحوكمة في البنوك الإسلامية. إن هذه النتائج قد تكون مفيدة لأصحاب الشأن مثل البنوك وذلك لإعادة النظر في مستوى الإفصاح لديهم من أجل رفع مستوى المساءلة. وفي الوقت نفسه تساهم النتائج إلى تحقيق آلية أفضل لحوكمة الشركات وذلك ضمن المساعي لتعزيز المساءلة والاستدامة في مجال الصيرفة الإسلامية في ماليزيا خاصة والعالم عموما.

## **APPROVAL PAGE**

The thesis of Asri Marsidi has been approved by the following:

---

Abdul Rahim Abdul Rahman  
Supervisor

---

Hairul Azlan Annuar  
Co-Supervisor

---

Nik Nazli Nik Ahmad  
Internal Examiner

---

Sofri Yahya  
External Examiner

---

Sohirin Mohammad Solihin  
Chairman

## DECLARATION

I hereby declare that this thesis is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Asri Marsidi

Signature .....

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INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA

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IN MALAYSIA: THE DISCOURSE OF CORPORATE  
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## LIST OF ABBREVIATIONS

AAER	Accounting and Auditing Enforcement Releases
AAOIFI	Accounting and Auditing Organisation for Islamic Financial Institutions
ACE	Audit Committee Expertise
ACI	Audit Committee Independence
ACS	Audit Committee Size
AGC	Audit and Governance Committee
AIMR	Association for Investment Management and Research
BDI	Board Independence
BDD	Board diligence
BDS	Board Size
BNM	Bank Negara Malaysia
BOD	Board of Directors
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CSR	Corporate Social Reporting
FP	Firm Profitability
FR	IFSR
FS	Firm Size
GAAP	Generally Accepted Accounting Principle
GP8 - i	Guidelines on Financial Reporting for Licensed Islamic Banks
GSIFI	Governance Standard for Islamic Institutions
H	Hypothesis
ICG	Islamic Corporate Governance
ICGF	Islamic Corporate Governance Framework
IFIs	Islamic Financial Institutions
IIFS	Institutions Offering Islamic Financial Services
IFSB	Islamic Financial Standard Board
IFSR	Islamic Financial and Social Reporting

IO	Institutional Ownership
ISR	Islamic Social Reporting
MASB	Malaysian Accounting Standard Board
PER	Profit Equalization Reserve
RO	Research Objectives
RQ	Research Questions
S&P	Standard and Poor's
SEC	Securities Exchange Commission
SPSS	Statistical Package for Social Sciences
SSB	Shari'ah Supervisory Board
Tri-3	Technical Release <i>i-3</i>

# CHAPTER ONE

## INTRODUCTION

### 1.1 INTRODUCTION

The several objectives of the chapter are to discuss the background of the study, to deliberate the problem statement, to discuss the motivations for the study, to provide discussion on the research objectives and questions as well as to present the organisation of the thesis. In the subsequent sections, the chapter elaborates on the background of the study, discusses the problem statement, deliberates the motivations for the study and presents the research objectives and questions. The chapter concludes by presenting the organisation of the thesis.

### 1.2 BACKGROUND OF THE STUDY

The Islamic banking industry was introduced during the 1970s. The aim of its establishment is to uphold socio economic equality as promulgated and urged by Islamic teachings. As noted by Siddiqi (1995), Islamic banks are perceived as not only vital in economic regeneration but also essential in promoting and upholding social justice.

Indeed, Islamic finance has been regarded as part of an Islamic economic system that has inherent social relations (Ahmed, 2011). The focal objective of Islamic finance as asserted by Siddiqi (2004) therefore is to achieve the *maqasid* of Shari'ah which should be reflected in the economy as enabling and promoting not only growth but also justice throughout the society or *Ummah*.

To achieve the main objective of its existence and the overall *maqasid* of Shari'ah, the Islamic banks' products or services have to be offered to all customers or

clients within the framework of the Shari'ah. This is to ensure that customers will only use the products or receive the services that are in line with Islamic teachings. At the same time, the Islamic banks will earn revenue from the permitted business activities only.

In order to comply with the Shari'ah, the Islamic banks are not allowed to become involved in any kind of interest (*riba*) bearing borrowing or lending contracts (Archer & Karim, 2007) since *riba* is prohibited in Islam. The prohibition of *riba* is seen as one of the uniqueness of business operations or activities of Islamic banks. This uniqueness may have become the catalyst for the Islamic banking and finance industry to grow rapidly worldwide.

The unique philosophy of Islamic banks can hence be viewed as closely linked to the religion (i.e. Islam). Consequently, as asserted by Haniffa and Hudaib (2007) Islamic banks are regarded as having an ethical identity. From this perspective, Islamic banks are seen as an institution that promote good behaviour or practice in their business operations and activities.

In time to come, as noted by Khan and Bhatti (2008), the Islamic banks are expected to capture the majority of Muslim customers throughout the globe, which is approximately more than 1.3 billion or around 24 percent of the world population. This anticipation is made after considering the growth trends as well as the acceptance of customers who have used the products or received Islamic banking services.

For instance, by 2014, Ernst & Young through the World Islamic Banking Competitiveness Report 2013 project that the Islamic banking assets to grow beyond the milestone of 2 trillion dollars. Locally, in Malaysia, the total Islamic banking assets are reported to have grown by 20.6 percent to RM469.5 billion as of July 2012 (Economic Report of Malaysia, 2012/2013).

The overwhelming acceptance of Islamic banks' products or services throughout the world could be due to the fact that, thus far, the Islamic banking and finance industry has made a series of breakthrough improvements on its way to becoming a truly viable and competitive alternative to the conventional system (Khan & Bhatti, 2008).

In the local scene, Bank Islam Malaysia Berhad (BIMB) is well recognised to be the first Islamic bank established in 1983. As of today, the bank has 133 branches nationwide (BIMB at [www.bankislam.com.my](http://www.bankislam.com.my)). This has demonstrated the success of the bank to build confidence among customers in Malaysia of Islamic banking products and services.

According to the Central Bank of Malaysia ([www.bnm.gov.my](http://www.bnm.gov.my)), there are currently 16 banks that operate as either full-fledged or subsidiary Islamic banks in Malaysia. The main objective and the rapid growth of Islamic banks indeed demonstrate the importance of ensuring the practices and development Islamic banks are steady and within the parameters of the Shari'ah.

From another perspective, good practices as well as steady growth or development of Islamic banks can be seen as a means to ensure that Islamic banks are always ready and continue to serve the customers according to their needs (See Archer & Karim, 2007). These are also perceived as significant to ensure the objective of the Islamic banks to promote socio economic fairness.

It is thus worthwhile to examine the issues of corporate accountability and governance in Islamic banks since these can be considered central to ensuring their direction and success. The issue concerning corporate accountability and governance are indeed of immense concern in today's business world. This has been proven by the demise of huge and well established corporations throughout the world in recent

years. Enron, Parmalat, and WorldCom are a few examples of such classical collapses in the history of corporations. The Enron and WorldCom cases are considered the most prominent because of the scope and boldness of their financial reporting deficiencies (Ball, 2009).

These cases reflect examples of an acute level of accountability from those who run, manage, administer, as well as control the business towards the interest of the owners i.e. shareholders and other stakeholders of corporations. As noted by Geriessh (2006), among the similarities of the causes of the scandals are gross lack of integrity and character.

Corporate governance is essentially a process by which groups of people administer and control corporate systems. Such groups that encompass for instance the board of directors and audit committee etc. have duties to ensure that corporate resources are utilised in line with the needs and interests of the shareholders and stakeholders. The board and audit committee in this context have the responsibility to monitor and supervise all corporate activities and operations.

Nevertheless, a number of high profile failures, cases, and scandals in the corporate world have raised the question of how the components of corporate governance are structured and practiced (See Farber, 2005). As such, issues of corporate accountability have eventually captured the attention of many parties and individuals. It has further triggered or continued the search for an avenue through which to improve the structure and practice of corporate governance towards a better discharge of corporate accountability.

The centre of corporate accountability discharge should have been towards the true owners rather than surrounding the management or corporate 'elites'. Many corporate failures to date have been linked to the quality of corporate financial

statements. This is precisely what happened in the case of Enron where auditors failed to perform their duties in accordance with profession standard and ethics.

There is little difference for local companies whereby accounting irregularities are found to exist in companies like Transmile, Energo, Welli Multi, Megan Media, and GP Ocean (Securities Commission of Malaysia, 2010). The corporate demise or scandals normally caused by accounting irregularities is a sign of poor credibility, integrity, and independence.

As a result, this has severely diminished the status or standing of the accounting profession in the public eye. For instance, Ball (2009) asserts that the scandals have caused a drop in the global reputation of various US institutions including the US GAAP, auditors, regulators, security analysts, as well as the financial markets in general.

This could also be seen as a negative reaction from the public on how accountants perform their professional duty to provide a true and fair view of the corporate financial position. As such, the roles of accountants nowadays have changed. In addition to providing a true and fair view of the corporate financial position, accountants are now accountable for providing audit assurance.

Within this perspective, accountants have to give surety on the accuracy and reliability for what they have audited. This is part of the efforts to rebuild the trust or confidence amongst the users of corporate financial statements which includes the public as a whole. The improvement in corporate reporting is one of the reflections for good corporate governance practice.

In this context, good corporate governance practice is essential since poor corporate governance practice has been regarded as one of the reasons for fraudulent corporate financial reporting (Farber, 2005). The elements of accounting and auditing

in corporate governance structure are tied with other components that will determine their level of efficacy.

At this juncture, whether their roles are to be well appreciated or well demised will be mutually dependent upon the other components within the corporate governance system. For instance, at this juncture, the roles of board of directors and audit committee are perceived as vital to ensure that corporate financial statements meet its objectives and vice versa.

At this point, the proper attributes of board of directors and audit committee need to be properly addressed. Nevertheless, many issues with respect to these components of corporate governance are still subsisting and inconclusive. As in the perspective of Islamic banks, these areas are considerably new and therefore call for further research to provide facts or evidence in order to improve their development and practice.

The above discussions may have raised the issue of how corporate governance can lead to better quality of corporate financial and social reporting. Good corporate governance which is reflected by means of better functioning of board of directors and audit committee (Vafeas, 2005) contribute towards enhancing the financial and social reporting through a better monitoring and supervising process.

In this regard, the board and audit committee are well recognised as the ones responsible to monitor the contents of the corporate annual reports. The boards in general, particularly audit committees are given the mandate to ensure that the corporate annual reports disclose the truth and reliable information about corporations (Vafeas, 2005).

Nonetheless, given the importance of financial and social reporting, the high future prospect of the Islamic banking industry and corporate governance structures

i.e. board, audit committee, the corporate governance practices particularly on the effects of board and audit committee within the context of IFSR of Islamic banks in Malaysia have yet to be examined or studied thus far.

### **1.3 PROBLEM STATEMENT**

The growing importance of the Islamic banking industry reflects the need to understand issues pertaining to the relationship between the financial and social reporting and corporate governance practice. In this respect, the board and audit committee are perceived as the governance mechanisms responsible to ensure appropriate discharge of corporate accountability through effective corporate financial reporting practices (Vafeas, 2005).

From this point of view, it is perceived as necessary to examine the corporate governance practices on the financial and social disclosure at Islamic banks considering the important roles of corporate governance i.e. the board and audit committee on corporate financial disclosure. The findings are expected to provide valuable insights on the effects of the board and audit committee practices on the financial and social reporting practices of Islamic banks.

In another perspective, the findings from such an examination are important since the evidence with respect to the impact of corporate governance practices i.e. the board and audit committee on financial reporting within the context of Islamic banks are considered remote and rare. As such, the results may be used as a platform to understand the relationship and provide useful information for the formation of the board and audit committee in Islamic banks.

The issues concerning corporate financial reporting are also vital to be tackled due to its effects or roles to stakeholders. It is regarded as having an important role