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A REVIEW OF CORPORATE GOVERNANCE AND CORPORATE SOCIAL RESPONSIBILITY DISCLOSURE OF ISLAMIC BANKS: A CALL FOR ADDITIONAL TRANSPARENCY

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Abstract: The purpose of this paper is to investigate the validity of the hypothetical expectation of higher corporate governance disclosure and corporate social responsibility disclosure in Islamic banks. Islamic banks are expected to have higher corporate governance disclosure and corporate social responsibility disclosure levels due to the unique characteristic of maintaining requirements for compliance with the *Shariah* in safeguarding stakeholder interests and economic sustainability. In order to achieve this purpose, the theoretical expectations of Islamic banks' practices in relation to corporate governance disclosure and corporate social responsibility disclosure are reviewed and compared with the empirical findings from previous literature. Previous studies published primarily in the major general interest accounting journals are reviewed and the findings are summarised and compared. While comparatively higher transparency levels of corporate governance disclosure and corporate social responsibility disclosure are ideally predicted for Islamic banks, the disclosure levels were surprisingly lower in the annual reports of Islamic banks. In addition, some of the evidence obtained from corporate governance disclosure and corporate social responsibility disclosure of conventional banks has shown that these disclosures were made more extensively than Islamic banks, even though the degree of comparability between conventional and Islamic banks is relative. Furthermore, the evidence provides impressions that Islamic banks were less transparent than conventional banks in providing governance and social information to stakeholders. Accordingly, the implications of these lower disclosures are further discussed and, therefore, some suggestions are recommended to be possible remedies in order to reform corporate governance disclosure and corporate social responsibility disclosure in Islamic banks.

Keywords: Islamic banks, disclosure, sustainable corporate governance, corporate social responsibility.

Introduction

Disclosures of information over statutory and voluntary requirements have become increasingly important among company stakeholders. A transparency of governance and social information are of high concern among investors and corporate regulators because of their contribution in the fulfilment of effective corporate governance (CG) and companies' sustainability objective. In particular, corporate governance disclosure (CGD) and corporate social responsibility disclosure (CSRD) play a significant role in improving levels of corporate transparency, corporate image and firm sustainability (O'Dwyer & Gray, 1998; Alnajjar, 2000; Deegan & Blomquist, 2006; Eweje, 2014). These disclosures reduce the extent of information asymmetry discussed in the context of the agency relationships, which is an outcome of the separation between ownership and management. Accordingly, CGD and CSRD provide useful information for investment decision making (Friedman & Miles, 2001; Deegan & Blomquist, 2006; Aribi & Gao, 2010), which can satisfy the owners' need. In Islamic banks, the risk caused by this information gap is exacerbated by the existence of unrestricted investment account holders. Although the investment account holders partly share risks and rewards with equity owners, they are not often represented in the board. This circumstance restricts their access to Islamic banks' information. Furthermore, previous research has observed that the rights of the unrestricted investment account holders are not properly addressed by the banks and the investment account holders have lack of power to control the management decision in relation to investment activities (Magalhães & Al-Saad, 2013). Therefore, in order to overcome this problem, financial statements of high quality with extensive disclosure are expected by the stakeholders.

Apart from this consideration, corporate transparency is of utmost importance for Islamic banks because of their nature to comply with the requirements of the Shari'a. In addition, 'in the context of Islamic business world, businesses have to demonstrate their accountability to God and fulfilment of social objectives' (Aribi & Gao, 2010, p.76). Therefore, Islamic banks are expected to publish information that reflects the demonstration of the accountabilities in their annual reports. Furthermore, previous CG failures in Islamic banks represent another factor for Islamic banks to strive for more transparency in order to regain stakeholders' confidence (Grais & Pellegrini, 2006). As a result, CGD and CSRD are placed in a crucial role for corporate transparency of Islamic banks. Despite this, in regards to the crucial role of CGD and CSRD in Islamic banks, little is known of CGD and CSRD practices of Islamic banks.

The main objective of this study is to investigate the validity of the hypothetical expectation of higher CGD and CSRD in Islamic banks. In order to achieve this purpose, the theoretical expectations of Islamic banks' practices, in relation to CGD and CSRD are reviewed and compared with the empirical findings of previous literature. This study reviews previous studies published primarily in the major general interest accounting journals. CGD, CSRD, conventional banks and Islamic banks are used as dominant keywords in searching for relevant articles because the study focuses on corporate disclosures. The study considers all published papers and working papers available up to 2016. Subsequently, the finding of previous studies concerning disclosure levels and less disclosed areas are deliberated. In addition, the study provides comparisons of previous findings for corporate disclosures of Islamic banks and conventional banks. In this regard, Aribi and Gao (2010) provided evidence that Islamic banks have greater CSRD than conventional banks. However, several studies that were made in the context of governance and social reporting disclosure in Islamic banks showed surprisingly that this is not the case. The disclosure of these aspects in annual reports was considerably low (e.g., Maali *et al.,* 2006; Hassan & Harahap, 2010; Farook *et al.,* 2011; Sulaiman *et al.* 2015; Darmadi, 2013; Abdulrahman & Bukair, 2013; Wan Abdullah *et al.,* 2013; Kamla & Rammal, 2013; Yussof *et al.,* 2013; Wan Abdullah *et al.,* 2015). Another observed problem is the discrepancy between the risks faced by Islamic banks and their actual practices regarding CGD and CSRD. These risks emanate from the complexity of Islamic banking financial innovations and the severity of reputation risks for their activities (El-Hawary *et al.,* 2004).

While this study does not primarily investigate all the literature, to a certain extent, the results of the review highlights the low disclosures and, therefore, shows the need for a reform for more transparency in these respects. In addition, this paper adds to the literature by providing a collective review of the CGD and CSRD studies.

Islamic banks have become an important sector that contributes to economic prosperity and development in many countries. The recently issued competitiveness report of world Islamic banks, showed that the sector achieved a growth of 16% in terms of assets in the period between 2010 and 2014 (Ernst & Young, 2016). Interestingly, the growth was significantly higher for Islamic banks than for conventional banks, and is expected to reach an estimated value of USD 1.8 trillion in 2020 in the major important markets, which are the Gulf Cooperation Council (GCC) countries, Malaysia, Indonesia, Pakistan, and Turkey (Ernst & Young, 2016).

Furthermore, the higher growth is partially a consequence of the strong loyalty of Islamic banks' customers to their services, because Muslims perceive these institutions from the perspective of their faith and therefore, place a higher degree of confidence in them (Maali *et al.* 2006). As a result, this consideration leads the study to presume that Islamic banks should, in exchange, be well governed and provide the social responsibility that they undertake by the rule of *Shariah* and expectations of the population. Alternatively stated, they should be accountable to Allah first, and then to the community *(ummah)* (Yusoff *et al.,* 2013). The wider accountability concept is an indication of the concepts of CG and social responsibilities, which are different from conventional institutions, and therefore, have *Shariah* implications on Islamic banks.

In general, if any organisation has good governance and takes part in the provision of social services to the community in which it operates, it is expected to reflect its achievements in the annual report, which is provided to their stakeholders. Therefore, the transparency of information on the governance and social support is likely to be associated with the extent of its quality in the entity. Likewise, if an Islamic bank is well-governed and actually does participate in social activities, it would be expected to disclose that to the respective stakeholders.

Corporate Governance, Social Responsibility and Transparency

CG is simply defined to be, 'the system by which companies are directed and controlled' (Cadbury, 2000). Therefore, CG is a tool that enables investors, who are the providers of the organisation's capital, to assure that their investments are well-managed and make a return on their capital (Shleifer & Vishney, 1997). The appropriate form, structure, and relationships of corporations' boards, shareholders, managers, and other stakeholders form the point of concentration for CG. For this reason, good CG practices is associated with higher information transparency, lower capital costs, higher operational efficiency and better allocation of resources (Maher & Anderson, 2000; Barako *et al.,* 2006; Aksu & Kosedag, 2006).

On the other hand, CSR activities are concerned with the provision of social services to the community in which their company operates. Dahlsrud (2008) claims that the social service definition is not comprehensive enough and accordingly, analysed thirty-seven different definitions of CSR. The study has provided five-dimensional descriptions for CSR, which are environmental, social, economic, stakeholder, and voluntariness. Therefore, it is expected that when a company provides social activities to the community, the disclosures of such activities are normally made in annual reports, which show the extent of social responsibility performance in any organisation (Cochran & Wood, 1984).

Even though good CG and CSR practices are highly encouraged in both Islamic and non-Islamic models, Islam places greater emphasis on them, which would make Muslims liable by religious rules rather than human-set regulations. More importantly, Islam provides further requirements through the five-dimensional concept of *Maqasid al-Shariah,* which protects both self and public interests and does not allow any deviation from ethics (Hassan, 2009; Choudhury & Alam, 2013). In this section, the theoretical aspects of CG, CSR and transparency are briefly presented.

Firstly, governance in Islam emanates from the very concepts of *Tawhid* (oneness of Allah), the *Shurah* (consultation) principle, and *Amana* (integrity), which are articulated in the *Quran* and *Sunnah* (Hassan, 2009). Therefore, compliance with *Shariah* is a major element that makes corporate governance in Islamic banks very unique. As a result, the *Shariah* Supervisory Board (SSB) is required to govern *Shariah* compliance in Islamic banks, in addition to the role of board of directors. Another component of ownership that exists in Islamic banks also adds to the uniqueness of CG in this sector, which is the ownership of unrestricted investment account holders. The critical issue for these types of owners is that their capital is mixed with the shareholder's capital, because it is unlikely that there funds are invested in isolation. Additionally, they are not represented in the board, a matter that creates a greater need for good governance. Collectively, it can be said that the nature of being an Islamic bank is certainly enough to make its CG different.

Secondly, a focus on developmental and social goals is considered one of the fundamental features of Islamic institutions, based on the rule of *Shariah*. This can be observed for example, from the obligatory requirement of *Zakah* in Islam, the encouragement of voluntary charities *(Sadaqa)* and the provision of interest-free loans (Haniffa & Hudaib, 2007). Furthermore, self-interest and public interest must be in balance, and whenever contradictions exist, public interest has to be given a priority. This highlights a higher concern given to society in Islam.

Therefore, as a result of these unique attributes, higher corporate transparency becomes important for Islamic banks in order to enhance their corporate ethical nature and accountability (Haniffa & Hudaib, 2007; Smolo & Mirakhor, 2010). In general, transparency is an essential *Shariah* aspect in Islam, which is required by the *Quran* and *Hadith* as well as the industry-specific regulators, such as the statement of Islamic Financial Services Board (IFSB) stating that 'any form of concealment, fraud or attempt at misrepresentation violates the principles of justice and fairness in *Shariah* (IFSB, 2007). Therefore, disclosure on governance and social responsibilities should be of utmost priority, because as mentioned above, Islam gives more consideration to these aspects (Alsaati, 2003).

Where true and fair disclosures are not made, the fulfilment of a *Shariah*-compliant contract is violated. The prophet said: 'Both parties in a business transaction have a right to annul it so long as they have not separated; and if they tell the truth and make everything clear to each other they will be blessed in their transaction, but if they conceal anything and lie, the blessing on their transaction will be eliminated'. In addition, *Gharar,* which means uncertainty and misrepresentation, is one of the constraints of contracts and dealings in Islam that may lead to a transaction being invalidated and cancelled.

The managers and owners of a business are often not the same, and an entity is managed by a delegated manager 'agent' who is supposed to be accountable for an owner's investment. Therefore, it would be difficult to inform the owner 'principal' about every transaction and event that takes place. Consequently, owners are communicated through a periodic disclosure of summarised information.

Generally, the most used disclosure instrument in literature is an annual report, because it is a formal communication of information to stakeholders and can be easily accessed (e.g., Collet & Hrasky, 2005; Barako, 2007; Farook *et al.,* 2011). However, the use of other instruments was also observed, such as internet reporting (e.g., Kelton & Yang, 2008), although these were not utilised in Islamic banks thus far.

In measuring the extent of disclosure, these instruments are either compared with a constructive index, which is built based on accounting standards, prior studies and observation, or with an index developed by financial companies, such as the Standard and Poor's. For scoring purposes, an unweighted method, in which '1' is given if the item is disclosed and '0' if not, is the most prevalent method of scoring in the literature (e.g., Craig & Diga, 1998; Barako, 2007; Mainghot & Zeighal, 2008; Samaha & Dahawy, 2010; Farook *et al.,* 2011; Wan Abdullah *et al.,* 2015). Furthermore, a weighted method is used in some studies, in which the scores are weighted accordingly to the extent of its disclosure (Botosan 1997; Barako *et al.,* 2006). Nevertheless, the results of the two methods were found to be consistent (Barako *et al.,* 2006).

In this section, the disclosure studies relating to CG and CSR are briefly explored. It is important to note that CGD and CSRD have *Shariah* components in Islamic banks. Therefore, there are *Shariah* requirements in both CGD and CSRD in Islamic banks.

Corporate Governance Disclosure Studies

Despite the rapid growth of Islamic banks in the past decades, the studies of CGD are still limited and very few. In addition, even though good corporate and *Shariah* governance practices are expected as a result of the uniqueness referred above, levels of CGD disclosure were significantly lower (Sulaiman *et al.* 2015; Wan Abdullah *et al.,* 2015).

Hassan and Christopher (2005) investigated the 2003 annual reports of three banks in Malaysia, one full-fledged Islamic bank and two banks providing both conventional and Islamic banking in order to find out the relationship between the extent of CGD and the fact of being an Islamic bank. Their findings revealed that CGDs in the Islamic bank were not comparatively different from those of conventional banks. Additionally, they found that the existence of Muslim directors in the board has no impact on CGD practices.

Using a larger sample than this study, Sulaiman *et al.* (2015) studied the CGD practices of sixteen Islamic Financial Institutions (IFIs) operating in Malaysia. They found that their CGD level was only 51% on average in regards to the items contained in the index they used. Wan Abdullah *et al.* (2015) used cross-country data from 67 Islamic banks in Southeast-Asian and GCC regions in 2009. She found that the disclosure of CG was less than 40% of the items contained in the checklist. Similarly, Wan Abdullah *et al.* (2013) examined *Shariah* governance disclosures in the annual reports of 23 Islamic banks in Malaysia and Indonesia for the year 2009, and they found that *Shariah* disclosure levels were less than half.

The most favourable empirical finding is the study of Darmadi (2013) on seven Indonesian banks in 2010, in which the sample banks disclosed about 60% of the study's disclosure checklist. However, it was observed that the checklist used was less detailed than the ones used by Sulaiman *et al.* (2015) and Wan Abdullah *et al.* (2015). More recently, Srairi (2015) investigated the CGD practices of 27 Islamic banks located in five GCC countries in the period from 2011 to 2013. From the CGD checklist constructed for the study, the average disclosure level was just above half, at 54% with *Shariah* governance information being the most repeatedly disclosed. Again, the index used for the study was comparatively less detailed.

Table 1 summarises the disclosure levels of these studies and the less disclosed areas. It was observed that the disclosures related to investment account holders were identified to be a less disclosed category of CG by both Sulaiman *et al.* (2015) and Srairi (2015). Given the prescribed risks embodied in this ownership type, it would be very important to carefully consider this area. Moreover, the disclosures of internal controls and the methods used to avoid any conflicts of interest, which are necessary to protect owners' investments and form significant instruments for effective governance, were the least disclosed categories identified by Darmadi (2013) and Wan Abdullah *et al.* (2015).

Table 1: Summary of corporate governance disclosure studies

Study	Avg. Disclosure Level	Less Disclosed Area
Sulaiman *et al.* (2015)	51%	Investment account holders
Darmadi (2013)	60%	Internal control and external audit
Wan Abdullah *et al.* (2015)	43%	Avoidance of conflicts of interest
Srairi (2015)	54%	Investment account holders

Corporate Social Responsibility Disclosure Studies

The study by Maali *et al.* (2006) was a pioneer in the literature of CSRD in Islamic banks. The study's sample covered the 2000 annual reports in twenty-nine Islamic banks located in sixteen countries. The study concluded that no concern was given to social reporting, where the average disclosure was only around 13% with a maximum score of about 35%.

Hassan and Harahap (2010) surveyed the CSR reporting levels of seven Islamic banks, using reports from 2006 and found an average score of less than 50%. In a more comprehensive survey, Farook *et al.* (2011) investigated the CSRD of 47 Islamic banks in 19 different countries, and found a disclosure score of about 17% on average. Similarly, the results of a few other studies that included CSRD in Islamic banks were not significantly different from these studies, which were Ousama and Fatima (2010), Zubairu *et al.* (2011), Kamla and Rammal (2013), Yusoff *et al.* (2013), Mallin *et al.* (2014), and Platonova *et al.* (2016).

Table 2 presents a summary of some of the studies discussed above. As shown in the table, information about insolvent clients, which is crucial to financial institutions, was the least disclosed area of CSRD in Maali *et al.* (2006). Additionally, environmental disclosures were the areas which contribute the smallest amount of information that was made available in the annual reports in Hassan and Harahap (2010), Yusoff *et al.* (2013), and Mallin *et al.* (2014). This may be because of the relative irrelevance of this category to financial services' entities. However, information about the expenditures made on the social awareness of a community about environmental aspects and environment-harming industries funded by a bank would be of a major significance.

Table 2: Summary of corporate social responsibility disclosure studies

Study	Avg. Disclosure Level	Less Disclosed Area
Maali *et al.* (2006)	13.0%	Information on insolvent clients
Hassan and Harahap (2010)	37.6%	Environment
Farook *et al.* (2011)	17.0%	Not detailed
Yusoff *et al.* (2013)	37.5%	Environment
Mallin *et al.* (2014)	44.4%	Environment
Platonova *et al.* (2016)	49.9%	Not detailed

Some Evidences on Corporate Governance Disclosure and Corporate Social Responsibility Disclosure in Conventional Banks

Although the disclosure levels in conventional banks were not absolutely comparable to those of Islamic banks, because of the material differences stated above, it would however, provide some indication of their status in non-Islamic banks. Therefore, some empirical findings were explored in order to provide some evidence about the CGD and CSRD in conventional banks.

Mainghot and Zeghal (2008) investigated CGD scores in the annual reports of 8 Canadian banks and found a disclosure level of about 89% on average. In a different setting, Sharma (2014) surveyed the CGD scores of 59 financial institutions listed on the Nepal stock exchange and found that the sample banks disclosed about 71% on average of the disclosure index, which contains both mandatory and voluntary requirements.

For the CSRD, Doughlas *et al.* (2004) surveyed six Irish financial institutions and found that that they disclosed most of the checklist requirements, which was a combination of four European codes of 'good practices'. Moreover, the evidence of CSRD in a developing country has been shown by a study by Khan (2010) on 30 banks in Bangladesh. He found that the sample banks disclosed about 47% of the used index. However, it is important to note that the sample they used included a few Islamic banks.

In summary, the CGD and CSRD scores seem to be higher in conventional banks. Notwithstanding, these scores cannot be compared directly with the disclosure levels in Islamic banks, because of massive divergences emanating from the nature of their operations, however, it still can be indicated that these practices were relatively of higher quality in conventional banks than in Islamic banks. Recent research by Wan Abdullah *et al.* (2015) suggests that the level of voluntary corporate disclosure of Islamic banks is positively associated with strong corporate governance. Thus, using the same premise we posit that lower disclosure among Islamic banks is possibly due to weak corporate governance. In addition, the Islamic banks are considered emerging and less regulated as compared to conventional banks. Therefore, lower corporate disclosure among Islamic banks is justified.

Implications of the Literature and Directions to Future Research

Regardless of the theoretical predictions of Islamic banks' transparency, the disclosure levels of CG and CSR were low. Therefore, this would have theoretical and practical implications which need to be carefully studied in order to obtain further understanding as well as improve CGD and CSRD practices in Islamic banks.

Theoretically, the bases on which the predictions of higher disclosures are made are still limited to the general concepts of Islam rather than specific requirements, and, therefore, might have led to lower consideration given to CGD and CSRD. In addition, since the unique products of Islamic finance would be accompanied with higher risks, transparency of information is necessary in order to reduce these risks. Therefore, the lack of transparency, especially for CG, may increase the risks embodied in Islamic instruments.

Practically, the consistency of low scores of CGD and CSR among the literature may highlight that the standards of disclosure, issued by regulators of Islamic banking, are still limited and need to be more comprehensive than its current status.

There are many limitations that could be taken into consideration when interpreting the results of the empirical literature stated above. Firstly, the use of different indices or checklists might probably culminate in massive differences between these studies. As a consequence, the lack of a united disclosure checklist would limit the comparability of these studies. Therefore, for future research purposes, it is suggested that consideration has to be taken in using more standardised checklist for a representative sample taken from Islamic banks.

Secondly, the implicit assumption of 'one size fits all', embodied in the checklists used for cross-country studies may be invalid, because of the differences in environment, culture, regulations and needs of stakeholders among different countries. Accordingly, there is a need for considering these differences when comparing between banks in different countries in future research.

Thirdly, relatively small samples, which were concentrated in Southeast Asian and GCC countries, were used by most of the literature; this would limit the generalisation of these studies to the whole Islamic banking sector. Similarly, there is a lack of a longer trending analysis of transparency levels. Therefore, it would be useful for future researchers to expand samples and the studied period in order to reduce the sampling error, which would reduce the generalisability of the study.

Conclusion

The purpose of the paper is to study the degree of agreement between the ideal transparency level of CGD and CSRD in Islamic banks, given by Islamic principles, and the findings of the previous literature. We conclude that the expectations of higher disclosure, which emanates from the nature of being an Islamic bank, did not match the available empirical results of CGD and CSRD studies. Even though there are ideological motives of higher CGD and CSRD transparency, the disclosures of CG and CSRD, which are critical for Islamic banks, were found to be low. This may hinder Islamic banks to be competitive and sustainable in the economic development. Therefore, reforms need to be made by the regulators of Islamic banking and directors.

Accordingly, we recommend a number of suggestions. Firstly, the harmonisation of requirements and the invention of a standard code of good practices of CGD and CSRD in Islamic banking sector may improve the degree of transparency and adoption. In this regard, Kasim *et al.* (2013) conducted a comparative study on *Shariah* governance standards, issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), IFSB and Bank Negara Malaysia and found that there were many discrepancies between these standards. Consequently, they emphasized the need for standard *Shariah* governance framework in Islamic banks.

Secondly, the currently issued codes need to be revised in order to give more consideration to these issues. As it is clearly stated in the study by Maali *et al.* (2006), where many banks followed the requirements of AAOIFI, whilst the conceptually expected CSRD levels were still lower. Therefore, it may be useful to increase the obligatory requirements of CGD and CSRD, because of their significance in Islamic banks.

Thirdly, the regulatory agencies at the national and global levels may establish a committee to provide an annual rating of CGD and CSRD in Islamic banks, and thereby grant awards to banks with the highest transparency.

In summary, CGD and CSRD practices seem to be understated in Islamic banks regardless of the theoretical considerations discussed, and therefore, an improvement should be made as referred to above through sustainability initiatives for a prosperous economy. However, the review we undertook may have some limitations. Firstly, there may be undetected CGD and CSRD studies in the literature that were not taken into consideration; this would limit the degree of generalising the findings of the paper. Secondly, most of the studies in the literature used the checklist and mark-off procedure, which would have resulted in comparable percentages of disclosure. However, some studies used the number of sentences disclosed on a specific item as a measure of disclosure level, such as Abdulrahman and Bukair (2013) and Kamla and Rammal (2013). This would make it difficult to be considered in a comparative analysis where the level of disclosure was not determined by the study to be either low or high. Accordingly, the investigation of CGD and CSRD using a large representative sample and similar scoring method would be of the utmost importance in order to give a better understanding.

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