Determinants of voluntary corporate governance disclosure: Evidence from Islamic banks in the Southeast Asian and the Gulf Cooperation Council regions

Wan Amalina Wan Abdullah a, Majella Percy b,*, Jenny Stewart b

a Department of Accounting, Faculty of Business Management and Accountancy, Universiti Sultan Zainal Abidin, Kampus Gong Badak, 21300 Kuala Terengganu, Malaysia
b Department of Accounting, Finance and Economics, Griffith Business School, Griffith University, Nathan Campus, 170 Kessels Road, Nathan, Qld 4111, Australia

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ABSTRACT

We investigate the determinants of voluntary corporate governance disclosure practices of 67 Islamic banks in the Southeast Asian and Gulf Cooperation Council regions. We expect that the risks inherent in Islamic banking will lead to a demand for greater corporate governance disclosures. However, we find that the mean level of voluntary governance disclosure is less than 40 per cent. We provide evidence that stronger corporate governance is associated with a higher level of voluntary corporate governance disclosure. Other factors that influence voluntary governance disclosures are the size of Islamic banks, the level of political and civil repression and the legal system. Our results inform the global debate on the need for corporate governance reform by Islamic banks by providing insights on the part played by corporate governance mechanisms in encouraging enhanced disclosure in the annual reports of Islamic banks.

1. Introduction

The assets of Islamic banks are increasing exponentially. For example, according to a recent study by Ernst & Young (2015), global Islamic banking assets witnessed a compounded annual growth rate of around 17 per cent from 2009 to 2013. Furthermore, these assets in six core markets1 are expected to reach US$1.8 trillion by 2019. Of concern, however, is that customer satisfaction levels are low (Ernst & Young, 2015). While Islamic banking systems were said to have remained resilient during the Global Financial Crisis (GFC) (Perry, 2011), they have not been immune to corporate governance failures due to incidences of collusion between directors and management, audit failure and excessive risk-taking (Ginena, 2014; Grais and Pellegrini, 2006a).2

As with traditional banks, the capital adequacy ratio is used by Islamic banks to measure the sufficiency of the bank’s buffer against its credit risk exposure (Ariffin, 2005). However, in addition to credit risk, Islamic banks are exposed to risks...
associated with the need to comply with Shari'ah. In particular, the use of mudarabah investment accounts, as a form of financing based on profit sharing, imposes a unique set of risks not present in conventional banking. These risks, together with the related increase in accountability, have led Islamic banks to establish an extra layer of governance known as Shari'ah governance.

A key mechanism of Shari'ah governance is the Shari'ah Supervisory Board (SSB) (Grais and Pellegrini, 2006a). The SSB assists Islamic banks to manage their funds efficiently while at all times complying with Shari'ah (Khir et al., 2008). Failure to comply with the principles of Islamic finance could expose Islamic financial institutions to reputational risk, not only to that institution, but also to the Islamic finance industry as a whole (Besar et al., 2009; Grais and Pellegrini, 2006a). Stakeholders, such as investors and depositors, rely on the SSB to make sure that their investments are mobilised in accordance with Shari'ah (Van Gruening and Iqbal, 2008). While SSBs are currently self-regulating, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is drafting a standard to regulate them (Richter, 2010).

Given the unique characteristics of Islamic banks, the quality of corporate governance disclosure is extremely important to maintain stakeholders’ confidence in their financial systems. Failure to maintain this confidence can lead to stakeholders reacting negatively, for example, depositors and investors withdrawing their investment (Chapra and Ahmed, 2002). We expect that the need for stronger governance and greater transparency, to address the additional risks in Islamic banking as compared to traditional banks, will lead to extensive voluntary corporate governance disclosures in annual reports. Therefore, we investigate the extent of these disclosures and explore their determinants. The consequences of the lack of disclosure (including corporate governance disclosure) have been observed in the GFC. However, the determinants of corporate governance disclosure in Islamic banks in the context of developing countries have not (to our knowledge) been studied.

Our study is also motivated by the fact that most prior research on corporate governance disclosures of Islamic banks is based on samples from a single country (Abeldayem, 2009; Sulaiman et al., 2015), although similar characteristics and values are upheld by Islamic banks worldwide. We extend prior studies by developing a corporate governance disclosure index specific to Islamic banks, which can be applied across jurisdictions. Subsequently, we explore the association between the extent of governance disclosures and the characteristics of Islamic banks as well as societal variables surrounding the banks. Among the factors that make our study different from past studies is our focus on corporate governance, Shari'ah governance and mudarabah investment account holders.

Our findings reveal that the level of voluntary corporate governance disclosure of Islamic banks in the SEA and GCC regions averages only 37.007 per cent. We also find that strong corporate governance, measured by a corporate governance index, is positively associated with the level of voluntary disclosure. Further, the results reveal that banks in code law countries have higher levels of voluntary corporate governance disclosures while voluntary disclosures are negatively associated with the level of political and civil repression. Generally, the results suggest that agency theory can be used to partially explain the relationship between Islamic bank characteristics such as governance strength and managerial decisions on voluntary corporate governance disclosures.

The study makes an important contribution to the corporate governance and Islamic banking literatures. It provides evidence on the extent of corporate governance disclosures in Islamic banks and their relationship with key determinants including bank characteristics and societal variables. In addition, our corporate governance disclosure index developed specifically for Islamic banks can be used in future studies. Our findings also have practical implications for several stakeholder groups. The results should be of interest to Islamic bank managers, central banks, and regulators and accounting policy makers internationally and in the nine countries in the study. Other stakeholders (for instance, zakat payers, zakat beneficiaries, mudarabah

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3 Shari’ah is Islamic religious law derived from the Qur'an and the teaching of the Prophet Muhammad. Shari’ah is regarded as the legal and ethical rules to guide a Muslim in life (Thani et al., 2003).

4 Mudarabah is identified as trust financing, trustee profit sharing, equity sharing, sleeping partnership, dormant partnership or profit sharing (Thani et al., 2003; Venardos, 2006). The mudarib, as an entrepreneur, runs the business using the money or property provided by the rabb al-mal (capital provider). The mudarib returns the investment to the rabb al-mal together with a share of the profit according to the profit ratio that is fixed at the time of the contract (Tamer, 2005). To avoid inefficiency, the rabb al-mal is not allowed to intervene in the business operations. However, they are able to perform follow-up or supervisory tasks (Mirakhor and Zaidi, 2007; Thani et al., 2003; Venardos, 2006) to oversee their investment venture.

5 The Liquidity Management Centre, the International Islamic Financial Market, the Islamic International Rating Agency, the Islamic Financial Services Board and the Hawkamah (the Institute for Corporate Governance).

6 Thomas (1991, p. 42) defines societal variables as “factors to which all enterprises within a particular country are subject and which vary between nations”.

7 Zakat is a compulsory levy that must be allocated from the well-to-do among the Muslim society to the beneficiaries specified according to Shari’ah.
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