Voluntary Corporate Governance Disclosure Practices of Islamic Banks in the Southeast Asian and the Gulf Cooperation Council Regions

ABSTRACT

This study explores the determinants of voluntary corporate governance disclosure practices of Islamic banks in the Southeast Asian and Gulf Cooperation Council regions. The empirical procedures involve a cross-sectional analysis of the annual reports of 67 Islamic banks from these two regions in 2009. We find that the level of corporate governance disclosures in annual reports is less than 50 percent. The findings from our study also reveal that a combined corporate governance index is positively related to voluntary corporate governance disclosures. Additionally, voluntary corporate governance disclosures are also found to be negatively associated with the level of political and civil repression, and positively associated with Islamic banks located in code law countries. 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.

Key words: Corporate governance; Shari’ah Supervisory Board; Islamic Banks; Disclosure

JEL classification: M14, M40, M41, M48, P48, Z12
1. Introduction

In the years 2008 and 2009, while the finance world was in crisis due to banking failures, the Islamic banking systems were said to have remained resilient (Perry, 2011). Perry (2011) suggests that elements in the governance systems of Islamic banks may have protected them from the problems faced by conventional banks. However, at the same time, it has been argued that Islamic banks are not immune to corporate governance failures due to incidences of collusion between the board of directors and management, audit failure and excessive risk-taking by management (Grais and Pellegrini, 2006a, Ginena, 2014). Of further concern is the additional layer of corporate governance in Islamic banks in the form of Shari’ah governance, which has raised questions of efficiency (Van Gruening and Iqbal, 2008). Added to this, the use of mudarabah investment accounts (IAs) as a form of financing based on profit sharing, imposes a unique set of risks not present in conventional banking.

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...
Organisation for Islamic Financial Institutions (AAOIFI) is drafting a standard to regulate them (Richter, 2010). However, as yet, no standard has been released.

Given the unique characteristics of Islamic banks, the quality of corporate governance disclosure is extremely important in order 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). Hence, the objective of this study is to examine the extent of corporate governance disclosures in the annual reports of Islamic banks and to explore the determinants of such disclosures.

Our sample comprises 67 Islamic banks in the Southeast Asian (SEA) and the Gulf Cooperation Council (GCC) regions. The selection of these regions is justified on a number of grounds. They are among the most progressive regions in Islamic finance, being among the first to establish Islamic banks. Moreover, in these two regions, organisations such as the AAOIFI, the Institute of Corporate Governance and other bodies\(^4\) have been established to support the development of Islamic finance (Matoussi and Grassa, 2012). As a result, it is expected that Islamic banks in these regions should have relatively high standards of disclosure. In fact, the AAOIFI standards have been adopted, adapted, or recommended in most of the countries in the SEA and GCC regions, for instance, Malaysia, Indonesia, the United Arab Emirates (UAE), Saudi Arabia, Bahrain and Qatar (Grais and Pellegrini, 2006b).

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 (Abdeldayem, 2009; Abuhmaira, 2006, Majid et al., 2011) although similar characteristics and values are upheld by Islamic banks worldwide. We extend prior studies by developing corporate governance disclosure indices specific to Islamic banks which can be applied across jurisdictions. Subsequently, we explore the association between the extent of these disclosures and the characteristics of Islamic banks as well as societal variables\(^5\) surrounding the banks. Among

\(^4\) The Liquidity Management Centre, the International Islamic Financial Market, the Islamic International Rating Agency, the Islamic Financial Services Board (IFSB) and the Hawkamah (the Institute for Corporate Governance).

\(^5\) Thomas (1991, p.42) defines societal variables as “factors to which all enterprises within a particular country are subject and which vary between nations”.

the factors that make our study different from past studies is our focus on corporate governance, Shari’ah governance and mudarabah investment account holders (IAHs).

Our findings reveal that the level of voluntary corporate governance disclosure of Islamic banks in the SEA and GCC regions averages only 37.007 percent. 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 a number of key contributions. It provides evidence on the extent of corporate governance disclosures and their relationship with Islamic bank characteristics and societal variables. We also develop a corporate governance disclosure index specifically for Islamic banks. Our findings have 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\textsuperscript{6} payers, zakat beneficiaries, IAHs, creditors, customers and the Muslim population) should also benefit from the findings of this study in their demand for useful information.

The remainder of the paper is structured as follows. Section 2 discusses the need for different Islamic accounting practices and corporate governance structures for Islamic banks. Section 3 develops the hypotheses. Section 4 outlines the research method while section 5 discusses the results. Section 6 contains some concluding comments.

\textsuperscript{6}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.
2. The need for different Islamic accounting practices and corporate governance structure for Islamic banks

Islamic banks are established to fulfill the need of Muslims to conduct transactions under the framework of the Shari’ah (Gambling and Karim, 1986; Antonio, 2001). Accordingly, interest is avoided in the operation of such institutions. The main concept that underlies the existence of Islamic banks is the prohibition of riba. Riba has a broader meaning than merely “usury” or “interest” (Tamer, 2005). Due to the stringent prohibition of riba in Islamic finance, the capital structure of an Islamic financial institution must preclude riba-bearing financing, such as preference shares, debentures, riba-leasing transactions, notes payable, notes receivable and bonds (Haniffa and Hudaib, 2004; Sulaiman, 2003). These interest-bearing instruments are replaced by profit and loss sharing agreements such as mudarabah. The existence of these financial instruments leads to the requirement for different reporting practices by Islamic banks.

Islamic banks self-regulate their financial reporting to avoid attempts by the regulatory bodies to mandate accounting standards for their banking operations (Karim, 1990). Concern that a regulatory board might issue accounting standards and rules that were incompatible with Islamic banking operations led to the establishment of the AAOIFI to develop accounting standards for Islamic banks. AAOIFI standards aim to promote comparability and transparency of financial statements in order to enhance public trust in Shari’ah investment vehicles. Prior to the issuance of the AAOIFI standards, Islamic banking faced problems of inconsistent accounting practices, lack of transparency and non-comparability. Even the International Accounting Standards (IASs) are considered inadequate to cope with the demands of Islamic bank financial statement users (Hameed, 2007). Indeed, the AAOIFI has contributed to the development of an accounting system that is more in line with the precepts of Shari’ah, particularly with regards to promulgating accounting standards to be adopted by Islamic banks.

From a corporate governance perspective, Safieddine (2009) argues that Islamic financial institutions face additional agency problems beyond what is normally encountered in traditional banks. The need for good corporate governance is even more relevant for Islamic banks due to a number of factors. First, the issue of the separation of ownership and control, which underlies agency theory, becomes greater for Islamic banks as compared to conventional banks. In addition to their responsibility to maximise shareholders’ wealth,
managers of Islamic banks must make sure that they carry out their dealings in compliance with Shari’ah (Archer et al., 1998; Safieddine, 2009; Sarker, 2000). Shari’ah non-compliance could impair the reputation of the bank and potentially lead to a loss of customers. Chapra and Ahmed (2002) reveal that depositors in Islamic banks in Bahrain and Sudan are willing to withdraw their deposits if they find cases of non-compliance. According to Hasan (2008), and Bhatti and Bhatti (2009), the corporate governance model for Islamic banks should be based on: 1) the Islamic principle of property rights and contracts; 2) compliance with Islamic law; and 3) the protection of the rights of stakeholders, including management, shareholders, employees, suppliers, depositors and also the community. The distinctive characteristics of Islamic banks must be acknowledged in order to provide regulatory infrastructure that supports the growth of corporate governance mechanisms in the institution (Grais and Pellegrini, 2006a).

Islam recognises that individuals are accountable to God for the resources entrusted to them and they therefore need access to information that enables them to make sound economic and business decisions (Abu-Tapanjeh, 2009). Following the broader stakeholder model of Islamic corporate governance, we argue that the accountability of financial institutions to a broad group of stakeholders requires an ethos of enhanced disclosure and transparency in their corporate reports (Deegan, 2002; Islam and Deegan, 2008). Further, a lack of transparency in this regard could lead to information asymmetry between the bank and its stakeholders, exposing the bank to the risk of gharar.8

AAOIFI GSIFI 2: Shari’ah Review, particularly emphasises the role of the SSB in corporate reporting reviews, which include the review of “contracts, agreements, policies, products, transactions, memorandum and articles of association, financial statements, reports (especially internal audit and central bank inspection), circulars, etc.” (paragraph 3). By reviewing the financial reports, the SSB is expected to exert some influence on the disclosure aspects of Islamic banks. Farook et al. (2011) found that the combined characteristics of the SSB (proxied by the existence of the SSB, SSB size, SSB’s multiple memberships, doctoral

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7The fundamental principles of property rights in Islam are that (1) the rights to the property must be in accordance with Shari’ah, (2) the enjoyment of the right to the property must be balanced with the rights of the society, community and the state on the property (Hasan, 2008), (3) individuals and society are regarded as stakeholders to the property, and (4) the Islamic law recognises the rights of the stakeholders (Hasan, 2008, 2009; Iqbal and Mirakhor, 2004).

8Gharar depicts negative elements, such as deceit, dishonesty, fraud, uncertainty, danger, speculation, cheating, risk, peril and hazard that might lead to destruction and loss (Algaoud and Lewis, 2007; El-Gamal, 2006; Iqbal and Molyneux, 2005; Shariff and Abdul Rahman, 2004; Tamer, 2005; Venardos, 2005).
qualifications of SSB members and reputable scholars as SSB members) influence the level of corporate social responsibility (CSR) disclosure in Islamic banks. The authors use both legitimacy theory and agency theory to explain the incentives for CSR disclosures. In Islam, Islamic related information must be disclosed regardless of whether it can be quantified. Thus, to fulfil the objective of enhanced disclosure, social and environmental information, information on zakat and transactions involving riba, information on halal dealings, and information relating to the community, debtors, employees and products should be disclosed (Mirza and Baydoun 2000; Haniffa, 2002). The same applies to corporate governance disclosure, with information about Shari’ah governance being part of an enhanced disclosure concept. The analytical disclosure literature suggests that full disclosure is unlikely to prevail as an equilibrium (Grossman, 1981; Milgrom, 1981; Verrecchia, 1983). Moreover, strengthening stakeholders’ confidence in relation to Shari’ah compliance is important to an Islamic financial institution. In view of the above, if the SSB is to fulfil its role as a Shari’ah review mechanism, it should encourage management to be transparent. An Islamic financial institution has an obligation to disclose relevant information to its stakeholders, regardless of whether the disclosure could lead to a negative impact on the institution’s operations (Maali et al., 2006).

3. Development of research questions and hypotheses

Given the discussion in the previous section, we draw on both agency theory and stakeholder theory to explain the corporate governance disclosure practices of Islamic banks.

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9 The study examined 47 banks from 14 countries as follows: Bahrain (6), Bangladesh (5), Egypt (1), Iran (4), Jordan (2), Kuwait (5), Malaysia (2), Pakistan (8), Qatar (2), Saudi Arabia (5), Sudan (1), Turkey (2), United Arab Emirates (3), and Yemen (1).

10 Chapra and Ahmed (2002) found that 81.7 percent of the surveyed depositors in Islamic banks in Bahrain will punish Islamic banks by moving their funds to another Islamic bank if they find that the bank does not comply with Shari’ah, and 76.8 percent will move to another Islamic bank if they find that the Islamic bank is involved with interest (riba). Safeguarding depositors’ interest is important, not only for the survival of banks, but also to maintain systemic financial stability. Chapra and Ahmed (2002) proposed a few devices for safeguarding depositors’ interests: i) regulatory authorities should select a representative on the board to act for depositors; ii) the establishment of a depositors’ association to protect their rights; iii) specialised Shari’ah expertise firms to watch over the interest of depositors; or iv) appoint external auditors to protect depositors in a similar way to how auditors safeguard the interest of shareholders.
3.1. Corporate governance strength

In this sub-section we discuss some characteristics of corporate governance mechanisms which are expected to influence the level of corporate governance disclosure. Our focus is on board independence, board size, the separation of the roles of board chair and CEO, audit committee independence, audit committee size and audit committee financial expertise.

The composition of the board generally, and the role of outside directors specifically, are frequently examined because they play an important role in controlling owner-manager conflict that will reduce agency costs (Hermalin and Weisbach, 2003). Beasley (1996) provides evidence that the higher the proportion of outside directors on the board, the lower the possible risk of fraud incidence. The evidence of an association between board independence and disclosure is mixed. Board independence is found to be positively associated with corporate governance reporting (Ben-Amar and Boujenoui, 2007; Bujaki and McConomy, 2002; Parsa et al., 2007), suggesting that, as board independence increases, there is a greater awareness of the need to disclose more corporate governance information to investors. Chen and Jaggi (2000), in a Hong Kong study, argue that board independence could increase monitoring capabilities and eventually adoption of disclosure requirements. Accordingly, we hypothesise that board independence will enhance the extent of corporate governance disclosure in Islamic banks.

It is argued that board size influences the monitoring quality of the board of directors (Chiang, 2005; Anderson et al., 2004; Williams et al., 2005). Larger boards could incorporate more representatives from different stakeholders groups and thereby provide a greater breadth of experience, expertise and specialised skills (Chaganti et al., 1985; Klein, 2002; Williams et al., 2005). Chiang (2005) voices concern that issues will not be sufficiently discussed in a small board. In their study of the transition to International Financial Reporting Standards (IFRS) by Australian listed companies, Kent and Stewart (2008) find that a greater level of disclosure information is associated with larger boards. On the other hand, Anderson et al. (2003), in their United States (US) study, find that the market does not react to earnings surprises conditioned on the size of the board. Zaluki and Wan Hussin (2009) reveal that board size is not associated with the quality of financial disclosures in initial public offering (IPO) companies in Malaysia. Beasley (1996) finds that financial statement fraud in US companies increases as board size increases. His result supports the contention of Jensen
(1993) that a smaller board provides a better controlling function while companies with a larger board have a tendency to be controlled by CEOs. However, due to the concerns of Islamic banks in safeguarding stakeholders’ rights, we argue that boards should be larger in order to represent the broader group of stakeholders in accordance with the Islamic corporate governance model, as suggested by Hasan (2008) and Bhatti and Bhatti (2009). In addition, Zahra and Pearce (1989) argue that a larger board would dilute the power of the CEO on the board and increase the independence of the board. Therefore, we maintain that larger boards are better equipped with skills and experience as well as providing greater representation of stakeholders, thereby enhancing monitoring quality in Islamic banks.

It is also argued that separating the roles of CEO and board chair enhances the effectiveness of corporate mechanisms and accordingly improves firm performance. Failure to separate these roles (CEO duality) can lead to a concentration of power (Beasley, 1996; Davidson et al., 2005). For example, the CEO/chair will control board meetings which are supposed to review his/her performance. There is also an increased risk that the CEO/chair could act in his/her own personal interest (Jensen, 1993), creating agency conflicts (Booth et al., 2002). The separation of the roles of board chair and CEO is also considered to be part of the board independence characteristics (Brickley et al., 1997). In addition, arguments regarding separation of CEO and board chair have enhanced applicability to Islamic banks, due to the additional agency relationships. Hence, we argue that separating the roles of CEO and board chair will improve the level of corporate governance disclosure in Islamic banks.

The responsibilities of the audit committee include recommending the appointment of the external auditor, overseeing the audit and assuring the credibility of financial reporting (Menon and Williams, 1994). Beasley et al. (2000) and Abbott et al. (2000) note that ‘fraud’ companies have less independent audit committees than ‘non-fraud’ companies. Similar to Menon and Williams (1994), we posit that an audit committee should comprise entirely of independent directors to be more effective. In fact, the SEC warns that an audit committee with inside directors is worse than no audit committee at all (Collier and Gregory, 1999) because the benefit of an independent check is lost.

DeZoort et al. (2003) suggests that audit committee members with background experience in financial reporting and auditing, especially those who are certified public accountants (CPAs), understand auditors and are more supportive of auditors as compared to audit committee members who have no similar experience. Experience in accounting, internal
control or auditing is therefore considered fundamental to enable the audit committee to understand and oversee the financial reporting system of the company. DeZoort (1998) contends that audit committees with more internal control experience makes decisions or judgments similar to auditors as compared to those without experience. Accordingly, we expect that having an audit committee with financial expertise leads to an improvement in the level of corporate governance disclosure.

Anderson et al. (2004) find that the cost of debt is negatively related to audit committee size. Audit committees have many responsibilities, for instance, overseeing the audit process, management and internal audit. Similar to the arguments relating to the board of directors, the larger the audit committee, the more responsibility that could be delegated to the committee. Thus, larger audit committees could lead to a higher level of transparency, thus providing stronger monitoring (Davidson et al., 2005; Anderson et al., 2004).

The present study uses a combination of six factors to investigate the role of corporate governance in Islamic banks. By combining the six factors, the study applies a similar methodology to that used by Yeoh and Jubb (2001), Nelson (2007), Brown and Caylor (2006), Gompers and Metrick (2003) and Coulton and Taylor (2001). Arcay and Vazquez (2005) argue that analysing individual corporate governance mechanisms does not provide a full assessment of the corporate governance role in promoting transparency. Furthermore, there are other disadvantages in using individual corporate governance mechanisms because the mechanisms sometimes complement or substitute for each other. A corporate governance measure could offset or interact with other corporate governance measures (O’Sullivan, 2005). For instance, the effectiveness of the audit committee depends on both the board composition and background of directors (Peasnell et al., 2000; Vicknair et al., 1993). Thus, to mitigate the problems, an overall corporate governance score is calculated for Islamic banks (the score will be subsequently referred to as corporate governance strength). This leads to the following hypothesis:

**H1:** A positive association exists between corporate governance strength and the extent of voluntary corporate governance disclosure of Islamic banks.
3.2. **SSB strength**

We can observe three SSB characteristics that may influence corporate governance disclosures, i.e. SSB size, SSB cross memberships and SSB financial expertise. Firstly, we expect the size of the SSB to influence the extent of corporate governance disclosures. Islam encourages discussions, meetings and co-operation in reaching a decision. Therefore, we argue that a larger SSB enables the functions and duties of the SSB to be delegated and allocated among the members. Accordingly, certain members will have the time to review and deliberate on issues relating to corporate reports. Large SSBs, with multiple perspectives as well as educational and industry experience, would be expected to drive better governance on *Shari'ah* and provide a closer review of corporate reporting, including various facets of corporate governance disclosures. By having a larger SSB, Islamic banks should be better able to respond to their diverse stakeholders. As a deterrent mechanisms against *Shari'ah* non-compliance, the SSB plays an important function in monitoring corporate governance disclosures, particularly *Shari'ah* related disclosures. The IFSB (2006a) proposed that the SSB should work together with the audit committee of Islamic banks as well as with the governance committee.

Multiple cross-memberships arise when a SSB member sits on several SSBs. We suggest that cross-memberships provide members of the SSB with more experience, enabling them to make comparisons of best practices among Islamic banks. We acknowledge that sitting on multiple boards can increase the risks of conflict of interest and confidentiality (Unal, 2011) as well restrict the amount of time a SSB member can devote to each board. As a result, the AAOIFI has considered issuing guidelines on the number of boards on which an SSB member can serve (El Baltaji and Anwar, 2010). However, other scholars argue against restricting the membership of the SSB, claiming that the restriction could limit the growth of the $1 trillion Islamic finance market. Currently, regulators are struggling to set-up global standards for the SSB (Richter, 2010). Many argue that Islamic banks do not have a sufficient pool of talent to meet the demand of new *Shari’ah*-compliant instruments (El-Baltaji and Anwar, 2010; Richter, 2010; Van Gruening and Iqbal, 2008). Apprenticeship of junior scholars to senior scholars is a way to train junior scholars until the formal training programs are established (Richter, 2010). As suggested by the proponents of interlocking directorships (Dahya et al., 1996), we suggest that SSB members with multiple memberships will have a better understanding of corporate governance practices, particularly those specific to *Shari’ah*
governance. Hence, we include multiple cross-memberships as a characteristic that should enhance corporate governance disclosures.

We argue that Shari’ah scholars with accounting, banking, economic or finance expertise could influence corporate governance disclosure. Our argument is similar to the arguments on audit committee expertise (Abbott et al., 2003; Bédard et al., 2004; Kent and Stewart, 2008). Members with this type of expertise are more likely to understand the importance of disclosure to stakeholders and would be expected to recommend enhanced disclosure during their Shari’ah review procedure on the financial reports of Islamic banks.

We adopt a similar methodology to that of Farook et al. (2011), using a specific SSB score based on the above-discussed characteristics of the SSB. The following hypothesis is tested:

**H2: A positive association exists between SSB strength and the extent of voluntary corporate governance disclosure of Islamic banks.**

3.3. Mudarabah investment account (IA)

As noted, Mudarabah is a contract between capital owners or financiers (known as rabb al-mal) and an investment manager (known as mudarib). The rabb al-mal entrusts their capital to the mudarib who runs the business using the funds provided. The mudarib returns the investment to the rabb al-mal together with the profit determined by the profit ratio fixed at the time of the contract (Tamer, 2005). The aim of this type of financing is to align the needs of owners of capital (but with no opportunity or expertise to carry out a business) with those of the entrepreneur who has the opportunity, labour and skills but insufficient funds to carry out the project.

An IA contract creates agency problems between Islamic bank managers, shareholders and IAHs, by potentially providing opportunities to manipulate returns at the expense of IAHs (Archer and Karim, 2002, 2006; Errico and Farahbaksh, 1998; Karim, 2001). The fundamental tenet in mudarabah is the segregation between the contribution and management of funds. In the agency structure of an Islamic financial institution, bank managers act as agents of shareholders as well as IAHs. However, the contract of mudarabah does not allow IAHs to intervene in the decision making of Islamic banks. Thus, IAHs have no authority to select or fire the management, the board, the SSB or the external auditors. Although there is a similarity in the agency relationships of management-IAHs and management-shareholders,
IAHs risk more of their investment than shareholders. Additionally, according to Safieddine (2009), the issue of the separation of control rights and cash flows for IAHs affects the agency relationships in Islamic banks. Although the IAs constitute a major part of Islamic bank funds, IAHs are not given the rights to control the behaviour of managers.

Moreover, the capital of IAHs and their return of income are not fixed and guaranteed even though they share the risks as the shareholders do. Dissatisfied IAHs will display their dissatisfaction by withdrawing their funds (Archer et al., 1998). Thus, this situation presents a unique Islamic bank agency theory problem which does not occur in conventional banks because deposits in these banks are generally insured and the interest rate is pre-determined in advance (Chapra and Ahmed, 2002). There are also arguments that management will favour one stakeholder group at the expense of another, for instance, distributing profits to shareholders at the expense of IAHs (Al-Baluchi, 2006). Shareholders are said to be able to influence the decisions of the management of Islamic banks, although the same privilege is not given to IAHs (Archer et al., 1998).

The inability of stakeholders (particularly IAHs) to observe how profit is being calculated in determining distributions presents another fundamental agency problem (Mustafa, 2003). Risk increases when managers are allowed to commingle IAHs’ funds with shareholders’ funds for investment in the same portfolio (Archer and Karim, 2006; Hameed, 2007; Karim, 2001; Safieddine, 2009). This situation further impedes the process of transparency and the reliability of financial information, and hampers the ability of investors to assess the bank’s actual performance (Archer and Karim, 2002; Karim, 2001). Thus, the concern of lack of protection for IAHs necessitates Islamic banks providing more transparent disclosures beyond what is required, as compared to conventional banks (Sundararajan and Errico, 2002). Al-Baluchi (2006) also contends that mudarabah contracts, with features of profit sharing, require disclosure of information above what is normally mandatory. The risks with IAs could be reduced by disclosing relevant information such as profit-and-loss sharing ratios and cost allocations on the IA as well as disclosures on corporate governance mechanisms to

\[\text{(11) In conventional banks, deposits are insured and depositors are guaranteed a positive return on their investment. Thus depositors are safeguarded against any possible loss. However, in Islamic banks, guaranteeing the deposit is in conflict with the basic principles of Islamic finance whereby profit cannot be determined in advance. Investment depositors have to share the profit and loss as the shareholders do. Furthermore, the IA contract disallows insurance protection (Chapra and Ahmed, 2002).}\]
portray the effectiveness of the role played by management in the governance of Islamic banks.

Al-Baluchi (2006) finds that there is a positive relationship between the proportion of the IAHs funds to total financing and voluntary disclosure. Farook et al. (2011) also find a significant positive association (at a 10% level) between the level of CSR disclosure and the ratio of IA funds to paid-up capital. This association reflects the effort of Islamic banks to strengthen their relationship with mudarabah IAHs via more extensive disclosure.

Similar to the arguments of Farook et al. (2011) relating to CSR disclosure, we argue that Islamic banks will increase corporate governance disclosures in order to strengthen their relationship with IAHs. Thus, we hypothesise that the extent of corporate governance disclosure will be an increasing function of the ratio of IA to equity:

H3: A positive association exists between the ratio of mudarabah IA to equity and the extent of voluntary corporate governance disclosure of Islamic banks.

3.4. Size of Islamic banks

There is evidence of a positive relationship between disclosure and the size of the firm (Ahmed and Courtis, 1999; Buzby, 1975; Chow and Wong-Boren, 1987; Cooke, 1989; Hamid, 2004; Hossain et al., 1995; Raffournier, 1995). These positive relationships are mainly due to the economies of scale enjoyed by larger firms, which indicate the ability of larger firms to publish information at a lower cost (Ben-Amar and Boujenoui, 2007; Buzby, 1975; Singhvi and Desai, 1971; Watts and Zimmerman, 1978). The relationship between firm size and corporate governance disclosures are expected to be positive as evidenced in Andersson and Daoud (2005), Ben-Amar and Boujenoui (2007), Bujaki and McConomy (2002) and others. With respect to the association between corporate governance disclosure quality and size, Islamic banks are predicted to behave similarly to other types of entities. This leads to the following hypothesis:

H4: A positive association exists between bank size and the extent of voluntary corporate governance disclosure of Islamic banks.

3.5. Level of political and civil repression

According to Iqbal (2002), accounting is influenced by environmental factors such as the economic system, the political system, the legal system, the education system and religion. In turn, the economic, political and civil systems are closely related and could be influenced by the educational system. Williams (1999) and Farook et al. (2011) found that the political system explains variations in corporate social and environmental disclosures between countries. Both studies report the existence of significant relationships between political rights\textsuperscript{13} and civil liberties\textsuperscript{14} variables (proxied by political rights and civil liberties index scores from Freedom House) and the extent of disclosure. Stakeholders are bound to expect more disclosure from countries with more political freedom and open communities. Thus, we hypothesise that a higher level of corporate governance disclosures by Islamic banks are associated with countries with more freedom and less repression.

H5: A negative association exists between the level of political and civil repression and the extent of voluntary corporate governance disclosure of Islamic banks.

3.6. Legal system

The legal system could influence accounting and disclosure practices in a country. According to Alrazi et al. (2011) and Van der Laan Smith et al. (2005), stakeholder relations are reflected in the corporate governance structure of companies in code law countries. Ball et al. (2000) also argue that companies in code law countries have objectives beyond wealth maximisation (Alrazi et al., 2011; Kolk and Perego, 2010) and implement “a stakeholder governance model” in their corporate governance structures (Ball et al., 2000, p.3), to meet the demands for representation by stakeholder groups such as labour unions, banks and

\textsuperscript{13} Political rights are defined as “the rights of people to take a guaranteed role in deciding the political future of their own society. In large states, this means voting directly on legislation or, more generally, electing representatives to legislate for the people, and executives to administer the laws decided by such representatives (Gastil, 1981, p. 3).”

\textsuperscript{14} Civil liberties are defined as “the guaranteed immunities of citizens from government interference with the expression of opinion, or with political, religious, business, or labour organisations, and immunity from arbitrary imprisonment, torture, or execution. Civil liberties imply the rule of law and the right to defend oneself before a court both from government and other citizens (Gastil, 1981, p. 3).”
business partners (Ball et al., 2000). Therefore, the corporate governance structure of Islamic banks in code law countries should reflect the importance of other stakeholder groups in addition to shareholders and this, in turn, should impact the level of corporate governance disclosure.

Given the arguments discussed above, it is expected that Islamic banks in code law countries will disclose more corporate governance information compared to Islamic banks in common law countries. We therefore test the following hypothesis:

H6: A positive association exists between Islamic banks located in code law countries and the extent of voluntary corporate governance disclosure of Islamic banks.

4. Research method

The following model is used to test our hypotheses:

\[ VCGDINDEX = \alpha + \beta_1 CG\_STRENGTH + \beta_2 SSB\_STRENGTH + \beta_3 IAHEQUITY + \beta_4 SIZE + \beta_5 POLICIV + \beta_6 LEGAL + \varepsilon \]

The variables are defined in Appendix A and explained in more detail below.

4.1. Dependent variable - VCGDINDEX

The extent of corporate governance disclosure is assessed against a disclosure index developed based on a number of international corporate governance benchmarks including the Organisation for Economic Co-operation and Development’s (OECD) Principles of Corporate Governance (2004), the Basel Committee on Bank Supervision (BCBS) (2006) Report, the AAOIFI’s Governance Standards for Islamic Financial Institutions (GSIFI) and the IFSB’s “Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services (excluding Islamic Insurance (Takaful) Institutions and Islamic mutual funds)”, other standards, codes, guidelines and past literature on corporate governance.

\[^{15}\text{Takaful is an Islamic insurance company.}\]
disclosures (See Appendix B). These disclosure items cover most aspects of corporate governance disclosure, which are relevant to Islamic banks. While our focus is on those disclosures that are not mandated in the respective countries in our study, we acknowledge that the distinction between mandatory and voluntary disclosure is imprecise (Brown et al., 1999).

**Independent variables**

Given the small sample size, the corporate governance characteristics are given equal weighting and combined into a single score \((CG\_STRENGTH)\) in order to test H1. It is argued that combined factors are able to provide a more complete picture of the corporate governance mechanisms as a package and their effect on disclosure transparency (Arcay and Vazquez, 2005). Each individual factor has been coded either as “0” or “1”. It is coded in such a way to reflect that the higher the score, the stronger the corporate governance mechanism. The \(SSB\_STRENGTH\) score is similarly developed by combining SSB size, SSB cross-memberships and SSB expertise in accounting, banking, finance or economics, enabling us to test H2. To test H3, \(IAHEQUITY\) is measured as the ratio of IA to equity while H4 is tested using the natural log of total assets \(SIZE\). In order to test H5, we use a combined index score of political rights and civil liberties \((POLICIV)\) for the country where each Islamic bank is located. The study utilises the scoring system by Freedom House (ranges from 1 (freedom) to 14 (repression)), which is derived from the Universal Declaration of Human Rights, adopted by the UN General Assembly in 1948. The research methodology was developed by Raymond Gastil, a Havard-trained specialist in regional studies from the University of Washington, Seattle in 1972. The scores are reviewed and modified every year (Freedom House 2014a and 2014b). Finally, H6 is tested using the dichotomous variable \(LEGAL\) which is coded 1 if the country of location is a code law country and 0 if it is a common law country. This is based on the classification by Salter and Doupnik (1992).

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16 An Islamic bank’s principal point of reference for corporate governance disclosure is the Governance Standards issued by the AAOIFI. The governance standards on “Shari’ah Supervisory Board: Appointment, Composition and Report (GSIFI No. 1)” and the governance standard on “Shari’ah Review (GSIFI No. 2)” became effective starting from 1 January 1999; the governance standard on “Internal Shari’ah Review (GSIFI No. 3)” became effective on 1 January 2000; the governance standard on “Audit and Governance Committee for Islamic Financial Institutions (GSIFI No. 4)” has been applied from 1 January 2002; the governance standard on the “Independence of the Shari’ah Supervisory Board for Islamic Financial Institutions (GSIFI No. 5)” has been applied from 1 January 2008; the Statement on Governance Principles for Islamic financial institutions (GSIFI No. 6) was applied with effect from 21 November 2005 and the governance standard on “Corporate Social Responsibility Conduct and Disclosure for Islamic Financial Institutions (GSIFI No. 7)” became effective from 1 January 2010.
4.2. Sample and data description

According to Lee and Menon (2010), as at 2009, there were 628 Islamic financial institutions globally. In this study, the sample of Islamic banks is selected from BANKSCOPE, which provides a database of banks worldwide. This list is then compared to a list extracted from the Islamic Financial Information Services (IFIS) database, which provides data for Islamic banks. However, the combined BANKSCOPE and IFIS databases only generated a total of 157 Islamic banks in the listing\textsuperscript{17}. Of the 157 Islamic banks worldwide, there are 25 in the SEA region and 52 in the GCC region. Similar to Farook et al. (2011), our definition of Islamic banks includes commercial banks, service banks, investment banks, mortgage companies, and mudarabah companies. These banks operate either as publicly listed companies, private companies or government-linked companies. In the present study, no distinction is drawn between the types of banks because all Islamic banks claim to comply with \textit{Shari’ah}.

Emails were sent to the banks to request their annual reports. Due to time and cost constraints, only annual reports that are published in English are selected for the sample. Ten annual reports from the GCC region were unavailable in English, reducing the sample from this region to 42.

The year 2009 has been selected based on a few significant events in recent years that have been argued to influence the corporate governance disclosure practices of Islamic banks. First, the recent events involving the issuance of the various standards and guidelines by the AAOIFI, the Basel Committee of Banking Supervision (BCBS) (2006) Paper, the OECD, the IFSB and working papers by the OECD on corporate governance in the Middle East and North Africa. Second, is the process of convergence with IFRS and third, is the 2008 global financial crisis which is expected to have raised awareness concerning disclosure and transparency.

\textsuperscript{17}Islamic financial institutions comprise Islamic banks and \textit{takaful} (Islamic insurance) companies. Thus, the total of Islamic financial institutions stated by Lee and Menon (2010) might comprise the entire Islamic financial services industry, which includes Islamic banks, \textit{takaful} (insurance) companies and investment funds. However, the focus of the current study is only Islamic banks.
5. Results and discussion

5.1. The nature and extent of corporate governance disclosures in Islamic banks

Table 1 reports the nature and extent of voluntary corporate governance disclosure for the full sample, for the two regions and for the countries within each region. Panel A shows that the mean voluntary corporate governance disclosure for all the Islamic banks in the study is 37.007 percent. Panel B reveals that the minimum disclosure level in the SEA banks is slightly higher (10.000 per cent) than for those in the GCC region (5.900 percent). Similarly, the maximum level is higher for the SEA region (82.000 percent) than for the GCC region (76.500 per cent). However, the means for the two regions are similar at 36.011 and 37.600 percent respectively.\(^\text{18}\)

Panels C and D report the disclosure levels for each country in the two regions. Indonesia has the highest mean of 51.468 percent. The high disclosure relative to other Islamic banks might be due to the fact that the Indonesian government has produced measures to increase the transparency of disclosure to shareholders as well as other stakeholders (eStandardsForum, 2009a). Bank Indonesia and Ikatan Akuntan Indonesia have played a prominent role in strengthening the corporate governance of Indonesian Islamic banks by issuing circular letters as well as promulgating acts, regulations and standards. Our results are consistent with those of Askary and Jackling (2004) who found that Indonesian publicly listed companies have the highest financial disclosure levels among all the Middle East and Asian countries. In contrast, Brunei, with only one Islamic bank, has the lowest level of voluntary corporate governance disclosure at 10.000 percent. The result for Brunei is not unexpected given that the country has no capital market (Yapa, 1999) and has been slow to adopt IFRS.\(^\text{19}\)

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\(^{18}\) When we divide the sample into the two regions, we found that there is a lack of normality in the distribution of VCGD data of both regions. Hence, we use a Mann-Whitney U test to compare the means from the two regions. This test (untabulated) indicates that the level of voluntary corporate governance in the GCC region (Mean Rank = 34.850, n = 42), is not significantly higher than the SEA region (Mean Rank = 32.580, n = 25), U = 489.500, z = -0.460, p=0.892.

\(^{19}\) The Accounting Standards Order of Brunei was established to improve Brunei’s image in the eyes of foreign investors. The move was also made to assure investors that sufficient monitoring is made of their investment to increase investor confidence. Among the objectives of the Order is to regulate the public accountants who provide public accountancy services (Too, 2011). The Brunei Darussalam Accounting Standard Council announced the full adoption of IFRS effective from 1 January 2014 (The Brunei Times, 2012).
Table 2 reports the mean extent of corporate governance disclosures for each category for the full sample and for the two regions. The “General” category has the highest mean disclosure among all the categories (69.403 percent). The high disclosure in the “General” component is expected due to the fact that this component is regarded as financial information normally presented to highlight achievements to shareholders. On the other hand, the disclosure on “Avoidance of Conflict of Interest” has a low mean disclosure at 11.940 percent while no disclosure is made at all on “Code of Conduct and Ethics”. The paucity of information on these two categories might be due to the limited guidance on how to provide such disclosure in the annual reports. Islamic banks in the SEA region disclose significantly more information on “Fair treatment of equity holders” and “Appropriate enforcement of governance principles and standards” while Islamic banks in the GCC region disclose more on “Equitable treatment of fund providers and other significant stakeholders”, “Audit and governance committee”, “Risk Management”, “Avoidance of conflicts of interest” and “Appropriate compensation policy oversight”.

Insert Table 2 about here

5.2. Descriptive statistics for independent variables

Table 3 reports the descriptive statistics for the independent variables used in the model, including those used to calculate both CG_STRENGTH and SSB_STRENGTH. Mean CG_STRENGTH is 2.239, with a minimum of zero and a maximum of six. On average, only 19.379 percent of board members and 26.845 percent of audit committee members are independent. Average board size is 8.426 members while the average AC size is 2.164 members. Only 13.760 percent of the audit committee members have skills in accounting, banking, economics or finance. Most of the Islamic banks separate the roles of CEO and board chair (71.60 percent). To oversee the Shari’ah compliance, the banks are supported by an SSB with an average size of 3.388 members. SSB members hold an average of eight SSB positions in other financial institutions. Only 22.992 percent of the SSB members have expertise in accounting, banking, economics or finance.

20Although reference has been made by the OECD (2004), Annotation, Part VA(5) and the United Nations Conference on Trade and Development (UNCTAD) (2006), Paragraph E, 5, examples have not been provided on how to disclose this type of information.
Most of the Islamic banks in our study are located in countries with a high level of political and civil repression (average score of 9.412) and are located in code law countries (70.10 percent).

**Insert Table 3 about here**

5.3. *Multiple regression analysis*

Prior to the multiple regression analysis, several assumptions were evaluated, including the existence of significant multicollinearity between explanatory variables, homoscedasticity, the existence of measurement and specification errors and also the data distribution. There is no correlation which is above 0.80 giving an indication of the absence of multicollinearity in the model (Field, 2009). In relation to the above problems, analysis of the residuals was undertaken. Further examination of the data indicated that the variables are free from univariate outliers except for the ratio of IA to equity which has been corrected for outliers by winsorising. Second, inspection of the normal probability plot of standardised residuals against standardised predicted values, indicated that the assumptions of linearity and homoscedasticity of residuals were met. Third, Mahalanobis distance did not exceed the critical chi-square value for any case in the data for all the models, indicating that multivariate outliers were not of concern. We also ran normality tests on the data. Some of the independent variables which did not achieve normality after various types of transformation (log, square root, inverse transformation) were undertaken have been winsorised or recoded as dichotomous variables to correct their distribution. We have run distribution tests on the residuals and noted that after the transformation of variables, all the residuals of the variables showed normality of distribution. The dependent variable VCGD, is found to be normally distributed (except when the data is split between regions as discussed in Note 18.

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21 The common law was expanded in Brunei and Malaysia during the expansion of the British Empire whilst undergoing several changes due to geographical location and the influence of indigenous civilisation. Thailand as a non-British Asian country adopted code law as did most other non-British Asian countries such as Japan, South Korea and Taiwan. In the Arab countries (GCC region), a mixed version of the Romano-Germanic-Islamic legal system (a sub-branch of the Romano-Germanic family) is adopted (Salter and Doupnik, 1992). By virtue of its Dutch colonisation, Indonesia uses code law with the influence of Indonesian cultural law.

22 Winsorising has been used on IA/EQUITY and MUSPOP with a cut-off of 5 percent.

23 CG_STRENGTH and POLICIV variables are recoded.
The regression results are reported in Table 4. The model has an adjusted $R^2$ of 0.384. 

$CG\_STRENGTH$ is found to have a highly significant and positive association with voluntary corporate governance disclosures (at the 1 percent significance level), providing strong support for H1. This result is consistent with many studies on board independence (Ben-Amar and Boujenoui, 2007; Bujaki and McConomy, 2002; Parsa et al., 2007), board size (Adawi and Rwegasira, 2011; Anderson et al., 2004), AC size (Zaluki and Wan Hussin, 2009; Anderson et al., 2004), audit committee independence (Abbott et al., 2000; Beasley et al., 2000 and Menon and Williams, 1994), audit committee financial expertise (DeZoort, 1998 and DeZoort et al., 2003) and CEO duality (Beasley et al., 1999; Ben-Amar and Boujenoui, 2007; Carcello and Nagy, 2004a).

No significant association is found between $SSB\_STRENGTH$ and voluntary corporate governance disclosure, providing no support for H2. Our results suggest that SSBs may not be committed to reviewing financial reports (including corporate governance disclosure). The AAOIFI has provided standards on Shari’ah review and internal Shari’ah review but, with the exception of Bahrain, these standards have not been mandated in the countries in our study. The lack of evidence on Shari’ah review might stem from the fact that many Shari’ah scholars sit on multiple boards. While we argued that multiple cross-memberships should strengthen governance disclosures, we acknowledged that such memberships may mean that scholars have insufficient time to devote to corporate reporting issues. Hence, further research is needed to fully explore the reasons for our result which is in contrast to that of Farook et al. (2011) with respect to SSB influence on CSR disclosures.

There is also no significant association between voluntary corporate governance disclosures and $IA\_HEQUITY$. Hence, there is no support for H3. This result is inconsistent with the findings of Al-Baluchi (2006) and Farook et al. (2011). Al-Baluchi (2006) reports a positive and significant association between the level of IA and voluntary disclosures in Bahrain and Sudan. Similarly, Farook et al. (2011) find that the ratio of IA to paid-up capital is positively associated with CSR disclosures. The current result seems to reflect a lack of demand for corporate governance disclosure by IAHs. Al-Sadah (2007) argues that IAHs are passive in dealing with Islamic banks. His findings indicate that IAHs do not use the financial statements to evaluate bank performance. In fact, IAHs are less equipped with basic knowledge on the nature of their own contracts and their transactions with Islamic banks. Therefore, IAHs are mostly inactive in demanding information relevant to them. Moreover,
most of the Islamic banks are located in weak information environments with lack of financial intermediaries for instance, financial analysts and rating agencies.

We find a positive relationship between disclosure and \textit{SIZE} banks, providing support for H4. This result is consistent with studies by Ahmed and Courtis (1999), Buzby (1975), Chow and Wong-Boren (1987), Cooke (1989), Hamid (2004), Hossain et al. (1995) and Raffournier (1995). This positive relationship is likely to be due to the economies of scale enjoyed by larger firms, which provide sufficient resources to publish information such as voluntary disclosure at a lower cost (Ben-Amar and Boujenoui, 2007; Buzby, 1975; Singhvi and Desai, 1971; Watts and Zimmerman, 1978). The results may also partially be due to the fact that larger firms are more exposed to political costs and regulatory control, as suggested by Cooke (1989), Singhvi and Desai (1971) and Watts and Zimmerman (1978). Larger firms attempt to reduce political costs and regulatory control by providing more disclosures (Watts and Zimmerman, 1978). In some corporate governance disclosure studies, such as Andersson and Daoud (2005), Ben-Amar and Boujenoui (2007), Bujaki and McConomy (2002), Carson (1996) and others\textsuperscript{24}, the association between firm size and corporate governance disclosure is also found to be positive.

The level of political and civil repression (\textit{POLICIV}) is negative and significant in its relationship with voluntary corporate governance disclosures. Islamic banks located in countries with more freedom in their political and civil systems tend to provide more corporate governance disclosures. Thus, H5 is supported. This result is consistent with Farook et al. (2011) and Williams (1999) with respect to CSR disclosures. Farook et al. (2011) find that the level of political rights and civil repression explains part of the variation in CSR disclosures while Williams (1999) reports that political and civil repression in Asia Pacific countries is negatively related to voluntary environmental and social accounting disclosure practices.

The result with respect to \textit{LEGAL} provides evidence that stakeholder-oriented, code law countries have a significant and positive association with the extent of voluntary corporate governance disclosure compared to common law countries. Ball et al. (2000) contend that companies in code law countries implement the “stakeholder governance model” while

companies in common law countries apply the “shareholder governance model”. This result provides support for H6 and is consistent with studies on CSR disclosures (Alrazi et al., 2011; Van der Laan Smith et al., 2005). Alrazi et al. (2011), Kolk and Perego (2010) and Van der Laan Smith et al. (2005) argue that code law countries with stakeholder-orientation have corporate responsibility which extends beyond wealth maximisation and efficiency unlike the common-law countries with shareholder-orientation.

**Insert Table 4 about here**

### 5.4. Additional analysis

We conduct additional analyses (non-parametric tests using rank regression and transformation of data into normal scores utilising the van der Waerden approach suggested by Haniffa and Cooke, 2002) and note similar results with the exception of SSB strength. The rank regression and the normal scores models reveal that SSB strength has a significant relationship with voluntary corporate governance disclosure. However, being non-parametric test statistics, rank regression and normal scores model are generally weaker than parametric tests (OLS). Therefore, we are satisfied that the OLS regression showed the best results with the findings that the SSB strength does not have a significant relationship with voluntary corporate governance disclosure. Moreover, the data (after transformation) satisfies the assumptions needed to run the OLS.

### 6. Concluding comments

The higher risks imposed on Islamic banks, as compared to traditional banks, suggest the need for stronger corporate governance mechanisms, and, accordingly, a higher level of corporate governance disclosure in their annual reports. At the core of Islamic banking are risks associated with equity participation, interest-free financial instruments and profit sharing contracts. Islamic banks are accountable to multiple stakeholders, namely, investors, creditors, owners and shareholders, management, *zakat*\(^{25}\) beneficiaries, government, community, employees, customers and *zakat* payers. Therefore, stronger governance and

\(^{25}\) *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*. 
transparent disclosures about corporate governance should enhance the confidence of these stakeholders in the Islamic banking industry.

In view of the above-mentioned issues, our study investigates the extent of voluntary corporate governance disclosures and the determinants of such disclosures by Islamic banks in the SEA and the GCC regions. The findings of our study provide support for the influence of corporate governance strength on the extent of voluntary corporate governance disclosure. Stronger sets of corporate governance mechanisms in Islamic banks are more likely to be associated with a higher level of voluntary corporate governance disclosures. 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 with respect to the association between corporate governance disclosures and firm size suggest that some conclusions from other settings are generalisable to Islamic banks.

The results of our study suggest a need for improvement in corporate governance disclosures by Islamic banks. There are troubling gaps, for instance, in the disclosure of shareholder related information and mudarabah investment account-related information. The reason for the lack of disclosure in some countries (Brunei, Bahrain and Qatar) might also be linked to the absence of an established professional accounting and auditing environment in these countries. Bahrain and Qatar are found to have weak law enforcement, low audit quality and also low accounting and auditing enforcement activities (Al-Shammari et al., 2008). Some regulatory interventions, such as legal backing, incentives, sanctions for violations of disclosure rules and proper enforcement mechanisms, might be considered as good steps to encourage compliance with accounting and corporate governance standards, and could eventually lead to an increase in corporate governance disclosures (Al-Sadah, 2007; Setyadi et al., 2011).

Our study is not without limitations, and thus caution must be taken in interpreting the results. First, the number of annual reports available for the sample analysis is relatively small, which may limit the power of the statistical tests conducted on the data. Second, our study is restricted to Islamic banks in the SEA and GCC regions and our results may not be generalisable to banks in other regions or to other sectors of the Islamic financial services industry. Third, the study is a cross-sectional study with data for a single period. However, in the absence of significant events that could influence disclosure levels, the extent of
disclosure is not expected to vary significantly over time. Fourth, our dependent variable is a voluntary corporate governance disclosure index which we developed by referring to a number of key corporate governance benchmarks and guidelines. Inevitably, there is a degree of subjectivity in constructing such an index and this could have impacted our results. Fifth, we also developed our own measures of corporate governance strength and SSB strength and these were limited by data availability. Finally, an assumption of our study is that the corporate governance strength of Islamic banks influences corporate governance disclosure behaviour. However, it is possible that the relation between corporate governance disclosures and governance strength is an endogenous one, with disclosures influencing the strength of the corporate governance in place (Hermalin and Weisbach, 2003).

Overcoming the above limitations provides a number of avenues for future research. First, aspects of corporate governance not examined in the study, such as board sub-committees in addition to the audit committee, high family concentration of ownership, as well as share ownership by directors, managers and SSB members, could be examined in detail. Second, studies across other jurisdictions (for instance, Africa, Europe, North and South America, Middle East and South Asia) could generate stronger results and enable additional factors or theories to be explored. Third, a longitudinal study could be undertaken, which would provide evidence of changes in levels and patterns of corporate governance disclosures in Islamic banks. Fourth, the possibility of an endogenous association between corporate governance strength and disclosure could be explored in future research. Fifth, alternative measures of SSB strength may add further insight on the relation between the SSB and governance disclosures. Sixth, disclosure indices are unlikely to be able to fully explain the issues on corporate governance and Shari’ah governance systems. Hence, other research methods, such as interviews and surveys, are needed to enhance the understanding of the importance of such disclosures (Akacem and Gilliam, 2002). Finally, future studies could be extended to include other Islamic financial institutions, such as insurance companies and investment funds.
7. References


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Lee, J., Menon, A., 2010. Islamic Finance - The Year that was and the Outlook for 2010. <http://rd.kpmg.co.uk/WhatWeDo/20939.htm> (accessed 05.05.2010)


Parsa, S., Gin, C., Ewere, I., 2007. Disclosure of governance information by small and medium-sized companies. Corporate Governance. 7(5), 635-635.


## Appendix A: Measurement of variables

<table>
<thead>
<tr>
<th>Variable</th>
<th>Measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>VCGDINDEX</strong></td>
<td>Total number of voluntary corporate governance disclosures made divided by total possible number of voluntary corporate governance disclosures</td>
</tr>
</tbody>
</table>
| **CG_STRENGTH**   | \( BODINDEP + BODSIZE + ACSIZE + ACINDEP + ACEXP + INDCHAIR \) where \( BODINDEP = 1 \) for percentage of independent non-executive directors on the board of directors (board) above the median of 0 members, 0 otherwise  
\( BODSIZE = 1 \) for number of directors on the board above the median of 9 members, 0 otherwise  
\( ACSIZE = 1 \) for number of directors in the audit committee (AC) above the median of 3 members, 0 otherwise  
\( ACINDEP = 1 \) for percentage of independent non-executive directors on the AC above the median of 0 members, 0 otherwise  
\( ACEXP = 1 \) for the number of AC members formally trained in accounting, banking, economics or finance above the median of 0, 0 otherwise  
\( INDCHAIR = 1 \) when the CEO and the Chairman of the Board are separate people and 0 otherwise |
| **SSB_STRENGTH**  | \( SSBCRMEMB + SSBSIZE + SSBEXP \)  
\( SSBCRMEMB = 1 \) for the average number of cross-memberships of the SSB member in institutions offering Islamic financial services above the median of 5.5, 0 otherwise  
\( SSBSIZE = 1 \) for the number of SSB members above the median of 3, 0 otherwise  
\( SSBEXP = 1 \) for the number of SSB members formally trained in accounting, banking, economics and finance above the median of 0.286, 0 otherwise |
| **IAHEQUITY**     | The ratio of IA to equity                                                                                                                                                                                  |
| **SIZE**          | Total assets of Islamic bank (natural log)                                                                                                                                                                |
| **POLICIV**       | Overall combined index scores of political rights and civil liberties based on the work of Gastil (1981) and Freedom House (2009) for the given nation: 1 (freedom) to 14 (repression)                                      |
| **LEGAL**         | 1 if code law, 0 if common law (Salter and Doupnik, 1992)                                                                                                                                             |
### Appendix B: Guidelines for Scoring of the Corporate Governance Reporting

<table>
<thead>
<tr>
<th>No</th>
<th>Section</th>
<th>Item no</th>
<th>Reference/Scoring system</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.</td>
<td>Effective Shari’ah compliance structures</td>
<td>10 items</td>
<td>AAOIFI Standards; IFSB Guidelines; BCBS (2006); Pramono (2005)</td>
</tr>
<tr>
<td>4.</td>
<td>Equitable treatment of fund providers and other significant stakeholders</td>
<td>9 items</td>
<td>AAOIFI Standards, ACCA Australia and New Zealand (2009); IFSB Guidelines</td>
</tr>
<tr>
<td>5.</td>
<td>Fit and proper conditions for board and management</td>
<td>3 items</td>
<td>ACCA Australia and New Zealand (2009); Andersson and Daoud (2005); Bhasin (2010); BCBS (2006); Bujaki and McConomy (2002); IFSB Guidelines; Standard &amp; Poor’s (2004); UNCTAD (2006)</td>
</tr>
<tr>
<td>6.</td>
<td>Effective oversight</td>
<td>16 items</td>
<td>AAOIFI Standards; ACCA Australia and New Zealand (2009); Andersson and Daoud (2005); BCBS (2006); Ben-Amar and Andersson and Daoud (2005); BCBS (2006); Ben-Amar and (2002); IFSB Guidelines; Muhamad et al. (2009); OECD (2004); Pramono (2005); Standard &amp; Poor’s (2004); UNCTAD (2006)</td>
</tr>
<tr>
<td>7.</td>
<td>Audit and governance committee</td>
<td>3 items</td>
<td>ACCA Australia and New Zealand (2009); Andersson and Daoud (2005); BCBS (2006); Bhasin (2010); Bujaki and McConomy (2002); IFSB Guidelines; Muhamad et al. (2009); Standard &amp; Poor’s (2004); UNCTAD (2006)</td>
</tr>
<tr>
<td>8.</td>
<td>Risk management</td>
<td>10 items</td>
<td>AAOIFI Standards; ACCA Australia and New Zealand (2009); BCBS (2006); Bhasin (2010); IFSB Guidelines; ; OECD (2004); UNCTAD (2006)</td>
</tr>
<tr>
<td>9.</td>
<td>Avoidance of conflicts of interest</td>
<td>1 item</td>
<td>OECD, (2004); UNCTAD (2006)</td>
</tr>
<tr>
<td>10.</td>
<td>Appropriate compensation policy oversight</td>
<td>6 items</td>
<td>BCBS (2006); OECD, (2004); IFSB Guidelines</td>
</tr>
<tr>
<td>12.</td>
<td>Code of conduct and ethics</td>
<td>1 item</td>
<td>AAOIFI Standards</td>
</tr>
</tbody>
</table>

**Notes:**
Based on our research methodology specified in Section 4, in Malaysia, out of the 81 disclosures, 36 items were regarded as voluntary, Indonesia (37 items); Thailand (70 items); Brunei (73 items); Bahrain (53 items); UAE (72 items), KSA (47 items); Qatar (51 items) and Kuwait (72 items).
### Table 1

The nature and extent of voluntary corporate governance disclosure

#### Panel A: All countries (in Percentage)

<table>
<thead>
<tr>
<th></th>
<th>Minimum</th>
<th>Maximum</th>
<th>Mean</th>
<th>Standard deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>All countries (N=67)</td>
<td>5.900</td>
<td>80.000</td>
<td>37.007</td>
<td>0.184</td>
</tr>
</tbody>
</table>

#### Panel B: Region

<table>
<thead>
<tr>
<th>Extent of disclosure</th>
<th>SEA (N=25)</th>
<th>GCC (N=42)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum</td>
<td>10.000</td>
<td>5.900</td>
</tr>
<tr>
<td>Maximum</td>
<td>80.000</td>
<td>76.500</td>
</tr>
<tr>
<td>Mean disclosure</td>
<td>36.011</td>
<td>37.600</td>
</tr>
</tbody>
</table>

#### Panel C: SEA

<table>
<thead>
<tr>
<th>Extent of disclosure</th>
<th>Malaysia (N=19)</th>
<th>Indonesia (N=4)</th>
<th>Brunei (N=1)</th>
<th>Thailand (N=1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum</td>
<td>17.600</td>
<td>31.430</td>
<td>10.000</td>
<td>45.500</td>
</tr>
<tr>
<td>Maximum</td>
<td>60.600</td>
<td>80.000</td>
<td>10.000</td>
<td>45.500</td>
</tr>
<tr>
<td>Mean disclosure</td>
<td>33.626</td>
<td>51.468</td>
<td>10.000</td>
<td>45.500</td>
</tr>
</tbody>
</table>

#### Panel D: GCC

<table>
<thead>
<tr>
<th>Extent of disclosure</th>
<th>Bahrain (N=22)</th>
<th>Kuwait (N=3)</th>
<th>Qatar (N=5)</th>
<th>KSA (N=4)</th>
<th>UAE (N=8)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum</td>
<td>9.800</td>
<td>23.400</td>
<td>8.500</td>
<td>27.500</td>
<td>5.900</td>
</tr>
<tr>
<td>Maximum</td>
<td>76.500</td>
<td>29.000</td>
<td>54.000</td>
<td>39.600</td>
<td>44.300</td>
</tr>
<tr>
<td>Mean disclosure</td>
<td>47.677</td>
<td>27.300</td>
<td>31.700</td>
<td>33.625</td>
<td>19.425</td>
</tr>
</tbody>
</table>
Table 2
Extent of voluntary corporate governance disclosure (Category Classification)

<table>
<thead>
<tr>
<th>Categories of disclosure</th>
<th>Full Sample</th>
<th>SEA Region</th>
<th>GCC Region</th>
<th>Significance tests</th>
</tr>
</thead>
<tbody>
<tr>
<td>General</td>
<td>69.403</td>
<td>68.000</td>
<td>70.238</td>
<td></td>
</tr>
<tr>
<td>Effective Shari’ah compliance structures</td>
<td>37.235</td>
<td>32.768</td>
<td>39.893</td>
<td></td>
</tr>
<tr>
<td>Fair treatment of equity-holders</td>
<td>27.388</td>
<td>38.600</td>
<td>20.714</td>
<td>0.007***</td>
</tr>
<tr>
<td>Equitable treatment of fund providers and other significant stakeholders</td>
<td>35.861</td>
<td>20.886</td>
<td>44.775</td>
<td>0.050*</td>
</tr>
<tr>
<td>Fair treatment of equity-holders</td>
<td>14.925</td>
<td>10.667</td>
<td>17.460</td>
<td></td>
</tr>
<tr>
<td>Effective oversight</td>
<td>40.237</td>
<td>34.752</td>
<td>43.502</td>
<td></td>
</tr>
<tr>
<td>Audit and governance committee</td>
<td>25.373</td>
<td>14.6667</td>
<td>31.746</td>
<td>0.008***</td>
</tr>
<tr>
<td>Risk management</td>
<td>33.333</td>
<td>11.332</td>
<td>46.429</td>
<td>0.000***</td>
</tr>
<tr>
<td>Avoidance of conflicts of interest</td>
<td>11.940</td>
<td>24.0000</td>
<td>4.762</td>
<td>0.020**</td>
</tr>
<tr>
<td>Appropriate compensation policy oversight</td>
<td>24.179</td>
<td>12.800</td>
<td>30.952</td>
<td>0.004***</td>
</tr>
<tr>
<td>Public disclosures</td>
<td>30.449</td>
<td>28.868</td>
<td>31.390</td>
<td></td>
</tr>
<tr>
<td>Code of conduct and ethics</td>
<td>38.806</td>
<td>40.000</td>
<td>38.095</td>
<td></td>
</tr>
<tr>
<td>Appropriate enforcement of governance principles and standards</td>
<td>47.761</td>
<td>76.000</td>
<td>30.952</td>
<td>0.000***</td>
</tr>
</tbody>
</table>

**Notes:**

a Islamic banks in the SEA region disclose significantly more information.
b Islamic banks in the GCC region disclose significantly more information.

***significant at 1 percent level (two-tailed)
**significant at 5 percent level (two-tailed)
* significant at 10 percent level (two-tailed)
### Table 3
Descriptive statistics for all the variables in the study

#### Panel A: Descriptive statistics for independent continuous variables

<table>
<thead>
<tr>
<th>Variable</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Mean</th>
<th>Standard deviation</th>
<th>Median</th>
</tr>
</thead>
<tbody>
<tr>
<td>CG_STRENGTH</td>
<td>0</td>
<td>6</td>
<td>2.239</td>
<td>1.724</td>
<td>2.000</td>
</tr>
<tr>
<td>BoardIndep</td>
<td>0</td>
<td>91.667%</td>
<td>19.379%</td>
<td>0.271</td>
<td>0</td>
</tr>
<tr>
<td>BoardSize</td>
<td>4</td>
<td>13</td>
<td>8.426</td>
<td>2.217</td>
<td>9.000</td>
</tr>
<tr>
<td>ACSize</td>
<td>0</td>
<td>5</td>
<td>2.164</td>
<td>1.720</td>
<td>3.000</td>
</tr>
<tr>
<td>ACIndep</td>
<td>0</td>
<td>1</td>
<td>26.841%</td>
<td>0.387</td>
<td>0</td>
</tr>
<tr>
<td>ACExpertise</td>
<td>0</td>
<td>1</td>
<td>13.731%</td>
<td>0.259</td>
<td>0</td>
</tr>
<tr>
<td>SSB_STRENGTH</td>
<td>0</td>
<td>3</td>
<td>1.373</td>
<td>0.998</td>
<td>2.000</td>
</tr>
<tr>
<td>SSBSize</td>
<td>0</td>
<td>7</td>
<td>3.388</td>
<td>1.660</td>
<td>3.000</td>
</tr>
<tr>
<td>SSBCrossMember</td>
<td>0</td>
<td>34.667%</td>
<td>7.919%</td>
<td>9.912</td>
<td>2.667</td>
</tr>
<tr>
<td>SSBExpertise</td>
<td>0</td>
<td>100%</td>
<td>22.992%</td>
<td>0.249</td>
<td>20%</td>
</tr>
<tr>
<td>IAHEQUITY</td>
<td>0</td>
<td>10.990</td>
<td>3.730</td>
<td>3.577</td>
<td>2.844</td>
</tr>
<tr>
<td>SIZE (USD million)</td>
<td>12.086</td>
<td>45,527.922</td>
<td>4,655.686</td>
<td>7,888.998</td>
<td>2,344.310</td>
</tr>
<tr>
<td>POLICIV</td>
<td>5</td>
<td>13</td>
<td>9.418</td>
<td>1.810</td>
<td>10.000</td>
</tr>
</tbody>
</table>

#### Panel B: Frequencies for dichotomous variables

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coding</th>
<th>No. of firms in sample</th>
<th>Percentage of sample</th>
</tr>
</thead>
<tbody>
<tr>
<td>INDChair</td>
<td>0</td>
<td>19</td>
<td>28.400</td>
</tr>
<tr>
<td></td>
<td>1</td>
<td>48</td>
<td>71.600</td>
</tr>
<tr>
<td>LEGAL</td>
<td>0</td>
<td>47</td>
<td>70.100</td>
</tr>
<tr>
<td></td>
<td>1</td>
<td>20</td>
<td>29.900</td>
</tr>
</tbody>
</table>

Variables as defined in Appendix A.
Table 4
Regression analysis of determinants of voluntary corporate governance disclosure

<table>
<thead>
<tr>
<th>Independent variable</th>
<th>Predicted sign</th>
<th>Coefficients</th>
<th>t-statistics</th>
<th>VIF</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>-</td>
<td>-0.250</td>
<td>-0.920</td>
<td></td>
</tr>
<tr>
<td>CG_STRENGTH</td>
<td>+</td>
<td>0.142</td>
<td>2.972***</td>
<td>1.802</td>
</tr>
<tr>
<td>SSB_STRENGTH</td>
<td>+</td>
<td>0.080</td>
<td>1.440</td>
<td>1.040</td>
</tr>
<tr>
<td>IAHEQUITY</td>
<td>+</td>
<td>-0.034</td>
<td>-0.752</td>
<td>1.622</td>
</tr>
<tr>
<td>SIZE</td>
<td>+</td>
<td>0.074</td>
<td>2.383**</td>
<td>1.437</td>
</tr>
<tr>
<td>POLICIV</td>
<td>-</td>
<td>-0.205</td>
<td>-4.063***</td>
<td>1.606</td>
</tr>
<tr>
<td>LEGAL</td>
<td>+</td>
<td>0.207</td>
<td>3.698***</td>
<td>2.121</td>
</tr>
</tbody>
</table>

Std. error 0.144
F-value 7.847
Sig. F 0.000***
Adj. R Square 0.384

Notes:
***significant at 1 percent level (two-tailed)
**significant at 5 percent level (two-tailed)
*significant at 10 percent level (two-tailed)
Variables as defined in Appendix A.