Shari’a Compliance on Corporate Governance Disclosure: an Empirical Evidence of Malaysian IFIs

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Abstract

This paper intends to examine the extent of the Shari’a corporate governance disclosure compliance in the annual report of Islamic Financial Institutions (IFIs) in Malaysia. All sixteen IFIs in Malaysia were selected and their corporate governance disclosure in the annual reports was analysed. The assessment instrument was constructed from prior literatures. The instrument comprises of 127 items, divided into 14 distinct dimensions. This study found that majority of the IFIs in Malaysia just moderately disclosed the information regarding the Shari’a corporate governance. This study, however, was conducted for one year period only i.e. 2013. In future, a larger number of companies with more years of data analysis should be obtained for more accurate and robust results.

Keywords: Islamic financial institutions, Islamic governance, corporate governance, Malaysia, Shari'a compliance

1. INTRODUCTION

The Islamic Financial Institutions (IFIs) have grown greatly worldwide. This institution is important particularly for the Muslim as they provide services that comply with Shari’a principles such as providing interest-free (riba) based financing and do not involve in transactions that prohibited by Shari’a such as gambling, speculation, interest, drugs, money laundering, alcohol, prostitution and other activities that bring harm to society (Salin et al., 2012). Thus, it crucial for these IFIs to continuously serve the Muslim society free from riba whilst at the same time prospers to great development.

The practice of IFIs services is bounded by Shari’a principles through the observance of tenets, circumstances and principles provided by Shari’a which originated from Quran. Comprehensive compliance with Shari’a principles would convey a sense of confidence to the general community and the financial markets on the trustworthiness of IFIs operations.

Therefore, to further enhance and boost the performance and growth of the industry, it is vital to build on the public confidence through Shari’a compliance approaches. As a backbone to the economic sovereignty, the performance and growth of the bank and financial institutions should be sustainable and shielded from any financial distress and crisis (Manan et al., 2015). This can be realised by upholding transparency in its operations and products which have to be Shari’a compliance. The next possible approach is to the Shari’a audit on the IFI’s operation. In addition, IFIs also have to communicate information on its products and operations as well as its governance practices to the public. Communication and disclosure through annual report allows the public to
evaluate IFIs compliance with the Shari’ah principle, effectiveness of its governance practices and the credibility of financial information.

All these approach actually are based on the good corporate governance practices that have been adopted in many years by the businessman and market players. However, the usual corporate governance practices are implemented based on the western or non-Islamic perspectives which largely come from Europe and US.

In contrast, corporate governance from Islamic perspective is unique and exclusive in which the important aspect of it is the principles of Shari’ah (Sulaiman et al., 2015). Corporate governance in Islamic perspective lays its institution between spiritual and material paradigm connection. It aims not only to preserve the wealth but also to produce a just socio-economic system. IFIs do not just focus on financial matters such as to generate more earning and reduce expenses. In fact, IFIs also have moral and ethical obligations to the society. In other words, while earning profit, IFIs should not ignore society’s interest (Bhatti & Bhatti, 2009).

For the purpose of upholding the principle of accountability, IFIs should disclose all relevant and reliable information. Informing about its operation is critical as the society has the right to know important information that would assist them to make economic and religious decisions. It also assist the management of IFIs in fulfilling their accountability to Allah (God) and the society (Abdul Rahman et al., 2010). In terms of its operation, IFIs have the responsibility to ensure their compliance with the Shari’ah principles in its services, products, practices, instruments and management. Additionally, IFIs is expected to implement good governance through Shari’a-compliant operations in order to protect the interest of the stakeholders. For example, strong internal control able to mitigate fraud (Zakaria et al., 2016; Omar et al., 2016) and reduce errors in the operation of the organization (Rahim et al., 2017). Thus, a strong governance practices will increase public confidence, promote trust among the stakeholders and reflect bank’s image and reputation.

However, little is known about corporate governance that based on the Shari’ah principles and conducted in the developing country like Malaysia as major stream of the research concentrate on the secular based corporate governance system and conducted in the developed countries like in the United Kingdom, United States and Europe. Thus, the purpose of this research is to examine the level of corporate governance disclosure among the IFIs in Malaysia. This study is important and significant as better disclosure by the IFIs showing their high level of transparency. Indirectly, IFIs able to demonstrate their good corporate governance practices and therefore, uphold and sustain the confidence of the various Islamic financial institutions stakeholders.

This study contributes in a way of it help various entities such as regulators, stakeholders, investors and public to determine whether information disclosed in the annual report of IFIs are sufficient and met with the Shari’ah requirements. Also, necessary policies can be formulated by the relevant bodies like Central Bank of Malaysia to enhance its compliance.

This paper is organised as follows. Next is review of literature, followed by research methodology and discussion of the findings. Last section is conclusion.

2. LITERATURE REVIEW
2.1 Corporate Governance in General

“Governance” in English terminology originates from the Greek word kybernan which means to “steer”, “guide” or “govern”. In broad sense, governance refers to the relationship between the governors and the governed, for example the relationship between the government and the public. However, in the context of business or private sector, Organisation for Economic Co-operation and Development (OCED) has give a very comprehensive definition of corporate governance. Based on OECD (2004), corporate governance involves a set of relationship between a company’s management, its board, its shareholders, and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring the performance are determined. Good corporate governance should provide proper incentives for the board and the management to pursue objectives that are in the interest of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently.

One of the easiest ways to demonstrate a good governance practices by the company is via its financial statements and annual report. As corporate governance facilitates the relationship between company and stakeholders and assists business to attain its objectives, the financial reporting producing by the company can act as an extension of corporate governance structure in an organisation. Organisation usually uses financial reporting as a means of
communication to their stakeholders such as individual investors, institutional investors and financial analysts (Othman & Thani, 2010). For example, voluntary disclosure of appropriate strategic information beneficial for the stakeholders for them to make good decision making (Hashim et al., 2014) while information on directors’ remuneration allow shareholders to evaluate whether the company excessively pay their top executives or not (Ahmad et al., 2016; Jaafar et al., 2014; Salin et al., 2008). The financial information that disclosed in the financial reporting is more credible when it is audited by the big auditing firm (Husnin et al., 2013; Asmuni et al., 2015) which is also part of good governance practices.

In the Malaysia context, the significant milestone in the effort to achieve good corporate governance started with the introduction of the Malaysian Code of Corporate Governance (MCCG) in 2000 (Husnin et al., 2016; Asmuni et al., 2015). The regulatory bodies like Bursa Malaysia (Malaysian stock exchange administrator), Securities Commission of Malaysia and the Malaysian Institute of Corporate Governance also have issued many guidelines and announcing recommended best practices that requires additional information to be included in the organisation’s annual report, in line with the demand of users for social, environmental (Mohamed Zain, 1999) and ethical information (Salin an Ismail, 2015) as it will assist their stakeholders in making better informed economic decisions (Zulkifli & Amran, 2006), ensure them understand the business and avoid any misrepresentation (Salin et al., 2008, 2010).

This is consistent with the spirit of good corporate governance as defined in the Malaysian Code of Corporate Governance 2012 (MCCG). The Finance Committee Report on Corporate Governance (2000) described corporate governance as a process and structure applied to direct and handle business and dealings of the institutions towards improving prosperity of a business and accountability of corporation with the final goal to realise long term shareholder’s value at the same time taking into consideration the concern of other stakeholder. This definition indicate that corporate governance practices is a critical to the business success because it involves relationships between institution’s management, board of directors, shareholders and other stakeholders, in a manner in which the transactions and dealings of institution are governed by its board of directors and senior management.

2.2 Corporate Governance from Islamic Perspectives

While the current corporate governance reporting widely practices and adopted by many companies, it lacks the pertinent aspects from Islamic perspective. Arguably, current western based corporate governance practices lack of spiritual and divine soul in which it still unable to prevent and curb corporate fraud and malpractices (Salin et al., 2014). There are many financial fraud and scandals that occurred previously which involved big financial institutions such as Lehman Brothers, Anglo Irish Bank, Bernard Madoff Investment, AIG and Meryll Linch (Manan et al., 2013). Recently, three giant financial market players namely JPMorgan Chase & Co., HSBC Holdings Plc and Credit Agricole SA were fined a total of 485.5 million Euros for manipulating Euribor benchmarks in order for them profiting from the movement of Euribor rate (Sebag, 2016). The other four financial institutions namely Royal Bank of Scotland, Barclays, Deutsche Bank and Societe Generale has agreed to settle with the EU Competition Commissioner for amount combined of 820 million Euros in 2013 for the same conviction. This is not new as previously, world was shocked with the Libor (London Interbank Offered Rate) scandals that also involved well known global financial institutions such as Barclays Bank, Citigroup, JPMorgan Chase, Royal Bank of Scotland, UBS, Bank of America and Swiss Bank.

Corporate governance from Islamic perspective is unique in which an aspects that is important is the principles of Shari’a (Sulaiman et al., 2015). Compliance with Shari’a principles is distinctive of for the private companies, particularly for IFIs as compared to other conventional financial and non-financial institutions. Corporate governance in Islamic perspective lays its institution between spiritual and material paradigm connection, not either one. It takes a balance of allowing human to accumulate wealth but at the same time do not forget the right of other people. In short, corporate governance from Islamic worldview aims to produce a just socio-economic system which is market driven but at the same time uphold the principle of social justice (Hamid et al., 2011).

Islam not only requires businessman and companies to focus on financial matters such as to generate more profit, minimising cost and reduce expenses but also to have moral and ethical obligations to the society. IFIs should not ignore society’ interest (Bhatti & Bhatti, 2009) while conducting business and earning high profit. For example IFIs should exercise transparency by disclosing all relevant and reliable information. This is important because right and relevant information assist the users of financial reporting to make good decision making. Thus, strong governance practices via transparency will increase public confidence, promote trust among the stakeholders and reflect bank’s image and reputation. As a result, IFIs able to fulfil its fundamental objectives of not only achieving sustainable and sound financial performance and operation but also at the same time comply and fulfil the maqasid syariah and in line with the normative ethical practices.
3. RESEARCH METHODOLOGY

3.1 Sample

This The sample of this study consists of the whole population of IFIs which contains sixteen IFIs in Malaysia. The total samples selected for this study is includes Affin Islamic Bank Berhad, Al-Rajhi Banking & Investment Corporation (Malaysia) Berhad, Alliance Islamic Bank Berhad, AmIslamic Bank Berhad, Asian Finance Bank Berhad, Bank Islam Malaysia Berhad, Bank Muamalat Malaysia Berhad, CIMB Islamic Bank Berhad, Hong Leong Islamic Bank Berhad, HSBC Amanah Malaysia Berhad, Kuwait Finance House (Malaysia) Berhad, Maybank Islamic Berhad, OCBC Al-Amin Bank Berhad, Public Islamic Bank Berhad, RHB Islamic Bank Berhad and Standard Chartered Saadiq Berhad.

3.2 Data Collection Method

The annual reports for the year 2013 were used in this study. The year before 2013 is not considered because there were several regulations, framework and guidelines were revised and updated that made the examination of the annual report before 2013 not feasible and may lead to bias. For example, the Shari’a Governance Framework was introduced in 2010, hence superseding the previous guideline. The GP1-i was introduced in 2007 and further updated in 2011.

3.3 Research Instrument

The Shari’a compliance on corporate governance disclosure of IFIs in this study was developed and modified from the previous study conducted by Sulaiman et al. (2015). The research instrument contained 127 items divided in 14 broad dimensions as follows:

a. Board Structure and Functioning
b. Nominating Committee
c. Remuneration Committee
d. Risk Management Committee
e. Audit Committee
f. Shari’a Supervisory Board/Shari’a Committee
g. Risk Management
h. Internal Audit and Control
i. Related Parties Transaction
j. Management Report
k. Non-adherence to Guidelines
l. Customers/Investment Account Holders
m. Governance Committee
n. Shari’a Compliance.

Sulaiman et al. (2015) summarised 123 items based on three guidelines namely the guidelines on the Corporate Governance for Licensed Islamic Banks (GP1-i) issued by the Central Bank of Malaysia in 2007, Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Services (Excluding Islamic insurance (Takaful) Institutions and Islamic Mutual Funds), known as IFSB-3 introduced by the Islamic Financial Services Board (IFSB) in 2006, and Governance Standard for Islamic Financial Institutions or GFIFI No.1 to No.6, issued by The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in 2008.

In contrast to Sulaiman et al. (2015), this study added four items namely Shari’a review, Shari’a audit, Shari’a risk management and Shari’a research functions. These fell under the Shari’a Compliance dimension. This addition was to take into consideration of the updated Shari’a Governance Framework issues by Central Bank of Malaysia in 2011.

The annual reports of the IFIs were evaluated and an item scored “1” if it was disclosed and “0” if it was not disclosed in the annual report. Each item was given an equal weight to avoid bias and subjectivity of assigning the weights of importance to items adopted by different scholars (Ousama & Fatima, 2010), consistent with other research conducted by Darmadi (2013) and Sulaiman et al., (2015).

The annual report of each IFI was reviewed and a judgment was made as to which items disclosed in the annual reports were relevant in the disclosure requirement. After all items were scored, an index was used to measure the extent of disclosure by an IFI. The Shari’a corporate governance disclosure index was constructed as a percentage.
of the actual score achieved by each IFI to the maximum possible value for each IFI. The index could range from 0 to 100 per cent.

4. FINDINGS AND DISCUSSION

The descriptive statistics of the respondents are as follows:

<table>
<thead>
<tr>
<th>Dimensions</th>
<th>No. of items</th>
<th>Compliance (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Board Structuring and Functioning</td>
<td>24</td>
<td>71.1</td>
</tr>
<tr>
<td>Nominating Committee</td>
<td>8</td>
<td>65.6</td>
</tr>
<tr>
<td>Remuneration Committee</td>
<td>8</td>
<td>62.5</td>
</tr>
<tr>
<td>Risk Management Committee</td>
<td>8</td>
<td>75.8</td>
</tr>
<tr>
<td>Audit Committee</td>
<td>12</td>
<td>68.2</td>
</tr>
<tr>
<td>Shari’a Supervisory Board/Shari’a Committee</td>
<td>16</td>
<td>57.0</td>
</tr>
<tr>
<td>Risk Management</td>
<td>9</td>
<td>100.0</td>
</tr>
<tr>
<td>Internal Audit and Control</td>
<td>8</td>
<td>39.1</td>
</tr>
<tr>
<td>Related Parties Transactions</td>
<td>2</td>
<td>100.0</td>
</tr>
<tr>
<td>Management Reports</td>
<td>2</td>
<td>90.6</td>
</tr>
<tr>
<td>Non-adherence to Guidelines</td>
<td>2</td>
<td>65.6</td>
</tr>
<tr>
<td>Investment Account Holders</td>
<td>14</td>
<td>8.5</td>
</tr>
<tr>
<td>Governance Committee</td>
<td>6</td>
<td>0.0</td>
</tr>
<tr>
<td>Shari’a Compliance</td>
<td>8</td>
<td>75.8</td>
</tr>
</tbody>
</table>

Table 1 shows the overall compliance of the IFIs on the 127 items that classified into 14 dimensions. Two dimensions namely Risk Management and Related Party Transactions were fully complied by all the IFIs as they scored 100 percent. This indicates that IFIs have good risk management practices as required by the guidelines to ensure their operation is protected and safeguarded from unnecessary risks. Furthermore, as IFIs also subject to close monitoring by Central Bank of Malaysia, their risk management practices also subject to many other international standards like Basel Accord.

The other dimensions that scored between 70 percent to 99 percent include Management Reports (90.6 percent), Risk Management Committee (75.8 percent), Shari’a Compliance (75.8 percent) and Board Structuring and Functioning (71.1 percent). Five dimensions show a moderate level of compliance of between 50 percent to 69 percent scores. These include Audit Committee (68.2 percent), Nominating Committee (65.6 percent), Non-adherence to Guidelines (65.6 percent), Remuneration Committee (62.5 percent) and Shari’a Supervisory Board/Shari’a Committee (57.0 percent). With the exception to Shari’a Compliance and Shari’a Supervisory Board/Shari’a Committee, all other dimensions are the usual requirements in the code of corporate governance and various banking act and guidelines such as Islamic Financial Services Act 2013 which is also need to be complied by the IFIs. Thus, more information can be found from the annual report of IFIs with this regards of requirements.

There are three dimensions have failed to achieve a minimum of 50 percent or half of the required guidelines. These include Internal Audit and Control (39.1 percent), Investment Account Holders (8.5 percent) and Governance Committee (0 percent). In contrast to other dimensions, Internal Audit and Control is a usual practice that needs to be executed not only by the IFIs but also non-IFIs. The only different is for IFIs, there is an additional disclosure required for “The performance of internal Shariah review by internal audit department” and “A charter of internal Shariah review”. The non-compliance with other usual Internal Audit and Controls requirements is subject to further investigation of the future research.

The other two dimensions namely Investment Account Holders and Governance Committee are specific to IFIs. Thus, possibly IFIs in Malaysia needing more time to familiarise and then, fulfil these requirements.
Table 2. Compliance by individual Islamic Financial Institutions

<table>
<thead>
<tr>
<th>IFIs</th>
<th>Compliance (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Affin Islamic Bank Berhad</td>
<td>66.1</td>
</tr>
<tr>
<td>Al-Rajhi Banking &amp; Investment Corporation (Malaysia) Berhad</td>
<td>74.8</td>
</tr>
<tr>
<td>Alliance Islamic Bank Berhad</td>
<td>67.7</td>
</tr>
<tr>
<td>AmIslamic Bank Berhad</td>
<td>66.9</td>
</tr>
<tr>
<td>Asian Finance Bank Berhad</td>
<td>59.8</td>
</tr>
<tr>
<td>Bank Islam Malaysia Berhad</td>
<td>72.4</td>
</tr>
<tr>
<td>Bank Muamalat Malaysia Berhad</td>
<td>70.1</td>
</tr>
<tr>
<td>CIMB Islamic Bank Berhad</td>
<td>35.4</td>
</tr>
<tr>
<td>Hong Leong Islamic Bank Berhad</td>
<td>61.4</td>
</tr>
<tr>
<td>HSBC Amanah Malaysia Berhad</td>
<td>57.5</td>
</tr>
<tr>
<td>Kuwait Finance House (Malaysia) Berhad</td>
<td>60.6</td>
</tr>
<tr>
<td>Maybank Islamic Berhad</td>
<td>36.2</td>
</tr>
<tr>
<td>OCBC Al-Amin Bank Berhad</td>
<td>62.2</td>
</tr>
<tr>
<td>Public Islamic Bank Berhad</td>
<td>31.5</td>
</tr>
<tr>
<td>RHB Islamic Bank Berhad</td>
<td>69.3</td>
</tr>
<tr>
<td>Standard Chartered Saadiq Berhad</td>
<td>55.1</td>
</tr>
</tbody>
</table>

Table 2 shows the level of disclosure compliance based on the individual IFIs. Al-Rajhi Banking & Investment top the list with the scores of 74.8 percent followed by Bank Islam Malaysia Berhad with the score of 72.4 percent and Bank Muamalat Malaysia with the score of 70.1 percent. This result is not a surprise because all these banks are the fully fledged IFIs, meaning the bank and its group, either holding company or its subsidiary also offers a full Islamic-based financial product and services.

The other ten IFIs attained more than 50 percent but less than 70 percent score, which can be considered as a moderate level of disclosure compliance. These IFIs includes RHB Islamic Bank Berhad (69.3 percent), Alliance Islamic Bank Berhad (67.7 percent), AmIslamic Bank Berhad (66.9 percent), Affin Islamic Bank Berhad (66.1 percent), OCBC Al-Amin Bank Berhad (62.2 percent), Hong Leong Islamic Bank Berhad (61.4 percent), Kuwait Finance House (Malaysia) Berhad (60.6 percent), Asian Finance Bank Berhad (59.8 percent), HSBC Amanah Malaysia Berhad (57.5 percent) and Standard Chartered Saadiq Berhad (55.1 percent). These groups of IFIs may yet to acquired sufficient practical experience and Shari’a practices in this field.

There were three IFIs that failed to meet the minimum score of 50 percent. They are Maybank Islamic Berhad (36.2 percent), CIMB Islamic Bank Berhad (35.4 percent) and Public Islamic Bank Berhad (31.5 percent). The similarities of these institutions is they are locally incorporated banks and not a fully fledged Islamic financial institutions. Their holding or group company like Maybank Group, Public Bank Group and CIMB Group largely offered conventional product and services. Thus, it is suggested that these financial institutions hardly to disclose and meet the recommended disclosure as these conventional banks only offered an Islamic product and services at its premises. This practice popularly known as opening an “Islamic window” at its premises. Although this group may establish a subsidiary or set up private Islamic bank, the size is very small as compared to their counterpart in conventional banking.

5. CONCLUSIONS

This study attempts to examine the extent of corporate governance disclosure in the annual reports of IFIs in Malaysia. This paper seeks to contribute by reviewing corporate governance disclosures using current guidelines and examine its compliance. It is an extension of a study undertaken by Sulaiman et.al (2015) and comprises of the whole population of IFIs in Malaysia which is only sixteen. This study found that two dimensions namely Risk Management and Related Party Transactions were fully complied by the all the IFIs while five dimensions that includes Shari’a Supervisory Board/Shari’a Committee, Internal Audit and Control, Nominating Committee, Investment Account Holders, and Governance Committee fail to achieve a minimum of 50 percent or half of the required guidelines. In addition, three IFIs namely Al-Rajhi Banking & Investment, Bank Islam Malaysia Berhad and Bank Muamalat Malaysia demonstrated the highest level of compliance with the score of more than 70 percent while three local IFIs namely Maybank Islamic Berhad, CIMB Islamic Bank Berhad and Public Islamic Bank Berhad fail to meet 50 percent of minimum score.

This study has a few limitations that provide opportunities for future research. The sample is small that comprise only sixteen IFIs. In addition, this study also only conducted in the single year of observation which makes it hard to run statistical tests. Further, this study only uses annual reports to measure corporate governance disclosure. Future research can be conducted by enlarging the sample size such as expanding the countries to include IFIs from ASEAN countries. Other data collection method such as surveys and interviews are recommended to
understand the practices of IFIs. If archival analysis is used, longer time frame is suggested so that more robust and thorough analysis can be conducted which provide more valid and reliable results.

REFERENCES


