THE IMPACT OF CORPORATE GOVERNANCE ON CORPORATE SOCIAL RESPONSIBILITY DISCLOSURE: EMPIRICAL EVIDENCE FROM GCC COUNTRIES

BY

HANAN ABDULAZIZ M. ALAGEELY

A research paper submitted in partial fulfilment of the requirement for the degree of Master of Science in Islamic Banking and Finance

International Institute of Islamic Banking and Finance
International Islamic University Malaysia

JULY 2013

ABSTRACT

Although the recent years have witnessed several corporate governance reform initiatives in the Arabian Gulf Cooperate Council Countries (GCC), corporate governance structure is not yet well established in that region. Moreover, lack of transparency and disclosure in areas like corporate social responsibility is prevalent among the Islamic banking practitioners in those countries. Hence, it is believed that regulators and industry players should work together in enhancing corporate governance practices and level of disclosure. This research examines whether there is an impact of corporate governance mechanisms on corporate social responsibility disclosure in the Islamic banks of GCC countries. To achieve this objective, an empirical approach was adopted by conducting descriptive statistics tests, correlation test, and regression analysis. In addition, a corporate social responsibility disclosure index was developed based mainly on the AAOIFI corporate governance standards for Islamic financial institutions and corporate social responsibility conduct and disclosure for Islamic financial institutions, OECD principles for corporate governance, Basel principles for enhancing corporate governance, and ten related articles that have developed social and environmental disclosure indexes. The empirical results of this study indicate that out of the five variables three only was found to have a significant impact on CSR disclosure which are: board leadership structure, board composition, and firm size. Board size and leverage did not have a significant impact on CSR disclosure. As a result, it could be viable if more binding in nature and flexible corporate governance framework is developed by regulators in GCC to allow the industry players to enhance their corporate governance structure and disclosure practices. In future, more in-depth research could be undertaken by analyzing other corporate governance mechanism.

ملخص البحث

على الرغم من أن السنوات الأخيرة شهدت عددا من مبادرات الإصلاح المتعلقة بحوكمة الشركات في دول مجلس التعاون الخليجي إلا أن حوكمة الشركات لازالت تفتقد لمعايير أعلى في الشفافية و الإفصاح خصوصا ما يتعلق بالمسؤولية الاجتماعية للشركات بين البنوك الإسلامية في دول الخليج العربي. لذا يعتقد أنه من الواجب على المشرعين و ممارسي الصناعة العمل معا لتطوير و تحسين الممارسات المتعلقة بحوكمة الشركات و مستوى الإفصاح. هذا البحث يهدف إلى التحقيق في إمكانية وجود علاقة بين متغيرات حوكمة الشركات و الافصاح الخاص بالمسؤولية الاجتماعية للشركات في البنوك الإسلامية بدول الخليج العربي. و لتحقيق هذا الهدف تم تبني النهج العلمي بإجراء اختبارات الإحصاء الوصفي و معامل الإرتباط و تحليل الإنحدار. بالإضافة إلى ذلك تم تطوير مؤشر إفصاح المسؤولية الاجتماعية للشركات و الذي بني بالاعتماد على معايير هيئة المحاسبة والمراجعة للمؤسسات المالية الإسلامية لحوكمة المؤسسات المالية الإسلامية و المسؤولية الاجتماعية للشركات و الإفصاح ، و معايير حوكمة الشركات لمنظمة التعاون الاقتصادي و التنمية الأوربية، و معايير بازل لتحسين اجراءات الحوكمة. بالإضافة إلى عشرة بحوث منشورة و التي قامت بتطوير مؤشرات خاصة بالإفصاح الاجتماعي و البيئي. النتائج العلمية لهذا البحث تشير إلى أن من بين الخمس المتغيرات المعتمدة ثلاثة فقط هي ذات تأثير على الإفصاح الخاص بالمسؤولية الاجتماعية للشركات و هي: هيكل قيادة مجلس الإدارة، و تكوين مجلس الإدارة، و حجم أصول الشركة. أما متغير حجم مجلس الإدارة, و نسبة الديون إلى حقوق الملاك فهي لم تكن ذات تأثير على الإفصاح الخاص بالمسؤولية الاجتماعية. لذا من الممكن القول بأن تفعيل إطارا أكثر إلزامية لحوكمة الشركات و الذي يتمتع بمرونة كافية لإعطاء المساحة الازمه للبنوك لتطبيق هذه المعاير و تحسين هيكلة الحوكمة و الإفصاح دون تأثير على أعمال هذ البنوك. في المستقبل من الممكن القيام بإجراء دراسات تتضمن متغيرات أخرى.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion; it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a research paper for the degree of Master of Science in Islamic Banking and Finance.

Sheila Nu Nu Htay
Supervisor

This research was submitted to the IIUM Institute of Islamic Banking and Finance and is accepted as a fulfilment of the requirement for the degree of Master of Science in Islamic Banking and Finance.

Ahamed Kameel Mydin Meera
Dean, IIUM Institute of Islamic Banking and Finance

DECLARATION

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

Hanan Abdulaziz M. Alageely

Signature ………………………….. Date ……………………

INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA

DECLARATION OF COPYRIGHT AND AFFIRMATION OF FAIR USE OF UNPUBLISHED RESEARCH

THE IMPACT OF CORPORATE GOVERNANCE ON CORPORATE SOCIAL RESPONSIBILITY DISCLOSURE: EMPIRICAL EVIDENCE FROM GCC COUNTRIES

Affirmed by Hanan Abdulaziz M. Alageely

....

Signature Date

Dedicated to my beloved mother, my father, my siblings, and all of my family.

ACKNOWLEDGEMENTS

In the name of Allah Subḥānahu ūta'āla the most Gracious, the most Mercifull. All praise is due to Almighty Allah Subḥānahu ūta'āla, the creator and sustainer of the universe for giving me the strength and patience to complete this research. And may His peace and blessings be upon his messenger prophet Muhammad, his family, his companions, and his followers until the day of judjment.

A special thank to my supervisor Dr. Sheila Nu Nu Htay for the advice and guidance in the course of completing this research. I would also like to thank Dr.Syed Musa Bin Syed Jaafar Alhabshi for his valuable comments, and support to complete this research. My exression of gratitude also goes to Dr. Muhamad Abduh for his valuable suggestions. Furthermore, my appreciation goes to Prof. Dr. Ahamed Kameel B. Mydin Meera Dean of IIUM Institute of Islamic Banking and Finance (IIiBF), Dr. Rusni Hassan, Deputy Dean of IIiBF, the entire IIiBF staff,
The cente of postgraduate studies (CPS) and IIUM library.

My utmost and genuine appreciation to my loving mother, my supportive father, my wonderful sister, my dearest brothers, and all members of my immediate and extended family, for their prayers and support.

Last but not least, my gratefulness to my colleagues, my friends in Malaysia and at home, and those who provided me assistance in the course of this research.

TABLE OF CONTENTS

LIST OF TABLES

LIST OF GRAPHS

LIST OF ABBREVIATIONS

GCC	Gulf Cooperation Council
CSR	Corporate Social Responsibility
BLS	Board Leadership Structure
BZ	Board Size
BC	Board Composition
CG	Corporate Governance
OECD	Organization for Economic Co-operation Development.
IFSB	The Islamic Financial Services Board
MCCG	The Malaysian Code on Corporate Governance
AAOIFI	Accounting and Auditing Organization for Islamic Financial Institution.
CSD	Corporate Social Disclosure.
CEO	Chief Executive Officer.
IFI	Islamic Financial Institution.
LM TEST	Lagrange Multiplier Test.
Prob	Probability.
Std.error	Standard Error.
VIF	Viral infectivity factor.
GLS regression	Generalized Least Squares Regression.
FGLS regression	Fixed Generalized Least Squares Regression.

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

With the increasing scale and size of trade and the complexity of corporations globally, the need for internal regulations and codes of corporate governance became substantial. The financial crisis in different countries ravel out how the absence of robust governance practices in financial institutions can lead towards the collapse of financial sectors, causing series and long term damage to the entire economy (Singh and Weisse, 2002; Mitton, 2001).

The term corporate governance is said to be first coined in 1976 (Tricker, Robert, The independence director- a study of the non-executive director and of the audit committee). But it was in the late 20th-early 21st century when the number of codes increased tremendously. The increasing presence of corporate governance codes in different parts of the world had made many corporate entities so eager to correspond to gain the extra degree of confidence from the public. Cadbury committee in UK pioneer work in 1980s had provided other countries with good fundamentals. Later on further consolidations of this work by the Hampel committee resulted in the UK combined code "combined code of the London stock exchange" of 1998 had helped many countries to begin developing their own.

According to Neil Cowan (2004) governance codes and laws at first were mainly concerned about risky areas for shareholders funds. Later, government departments and agencies, state-owned industries and many not for profit organizations started to accept these principles which was applied in companies.

One of the earliest definitions of corporate governance by Sir Adrian Cadbury in the UK report of the committee on corporate governance, London 1992 is" The way in which companies are directed and controlled". This definition had to be broadened and widened over time. As the corporate world grow and develop more definitions were needed to clarify what direct and control companies and who is involved in that structure. Consequently, stakeholders are asking for more transparency, openness, integrity, and accountability in the activities of directing and controlling the corporate entity (Cowan, 2004, p.15). Likewise, the evolution of information and communication technology had resulted in people demanding more transparency, people are asking for more information. This is also the situation in the stakeholders of any business industry. People are more aware of the impacts of business activities on the society. This awareness started in the industrialized nations when the economic activities in many situations negatively affected the environment, and now this awareness seems to grow in today financial-zed nations, especially after the recent accounting scandals such as Enron, HealthSouth, Tyco, and worldcome which shaked the confidence of investors (Brennan, 2008).

The OECD definition of corporate governance was considered by the Islamic financial services board (IFSB) gave an unequal focus on the interest of the shareholders over the stakeholders and need to be reviewed. A more comprehensive representation of stakeholders was included in Malaysia code on corporate governance (MCCG) 2012. Several other definitions of corporate governance are available, but most would agree that it involves the set of standards for a business to impact the society in a positive manner (Dusuki & Abdullah, nd).

Undoubtedly, Corporate governance in the financial institutions is receiving a lot of attention lately especially after the financial crisis. The adverse affect of ineffective corporate governance can be more serious in the case of financial institutions because of their enormous number of stakeholders and systematic risk (Chapra and Ahmad, 2002). The strong need for corporate governance in Islamic banks is driven by the support of the current development in banking and finance industry. Naturally, the growing demand for Islamic financial products has resulted in the interested parties wanting to know more than what is currently being disclosed in annual reports.

Notwithstanding, The Corporate governance development in GCC countries is supported by several international organizations such as: the accounting and auditing organization for Islamic financial institutions (AAOIFI), organization for economic and co-operation and development (OECD), and the institute for corporate governance HAWKAMAH. Moreover, the development of corporate governance in GCC is seen to be introduced by the AAIOFI governance standard for Islamic financial institutions 2010, this resulted in both mandatory and recommended standards to implement CSR in all aspects of Islamic financial institutions activities and provided guidance on disclosure of CSR information to the Islamic financial institutions stakeholders. The significance of banking institutions corporate governance is derived from the essential role they play in the development of the economy (Arun and Turner, 2002).

AAIOFI governance standard for Islamic financial institutions No.7 define corporate social responsibility (CSR) for Islamic financial institutions as “all activities carried out by an IFI to fulfill its religious, economic, legal, ethical and discretionary responsibilities as financial intermediaries for individuals and institutions”. The contribution in the betterment of the society has become included in many of business goal together with the profit maximization. Activities of this kind are usually known as corporate social responsibility. The social and environmental aspect side by side with profit maximization was the main motive behind the development of corporate governance development (Clarke, 2007).

In the context of the Muslim societies where religion has a controlling power the concept of CSR should reflect religious values to satisfy *Maqasid ALsharia* and the public good. On the other hand, in GCC region CSR is increasingly being seen by leading companies as more than accumulation of discontinuous initiatives or irregular actions, marketing motivations, public relations. However, more qualified, trained CSR practitioners in the system can help in carrying out CSR implementation in the region.

1.2 PROBLEM STATEMENT

The global financial crisis that came forth in 2008 with the collapse of several large financial firms in the US spread rapidly causing global uncertainty (Kamara Abdul .B and Vencatachellum, 2009). Inevitably, this has attracted the attention to corporate governance in the affected countries including GCC. Moreover, the issue of corporate governance had gained a lot of focus after the financial crisis in 2007 and was indicated by many as one of the causes, the importance of corporate governance is a more of significant in the banking industry that is because of the special characteristics financial institutions have like the vast number of stakeholders and the systematic risk resulted in maximizing the undesirable effects that weak corporate governance can carry (Chapra and Ahmed, 2002) in addition to the sensitivity of stakeholders trust on the management abilities which can cause liquidity problem for the bank. On the other hand, Disclosure is acknowledge as complementary to corporate governance and associated with transparency and stakeholders trust, the inadequacy of disclosure and transparency in the annual reports in the business world and the banking industry in particular was acknowledged as one of the main causes to the financial scandals. The voluntary non-financial disclosure in general and corporate social responsibility in particular is very important for banks because it will reflect in the shareholder value. Islamic banks respond to corporate social responsibility activates motivated by their Islamic nature and the Islamic accountability and to fulfill their responsibilities towards applying *Maqasid Alsharia* (Dusuki and Abdullah).

Despite the growing importance of corporate governance in the MENA region in general, and GCC countries in particular, GCC ranks in the corruption perception index 2011 was not that impressive. The best among GCC was the United Arab Emirates placed at 28th of the world listing. In the global competiveness report 2011, Qatar was ranked 14 of the world and first of GCC. In the Gulf Cooperation Council (GCC) countries context, studies regarding the association between corporate governance variables and disclosure are rare. However, to the knowledge of the writer no empirical study was conducted on the association between corporate governance variables and corporate social responsibility (CSR) disclosure in Islamic banks operating in GCC countries.

In In the absence of any prior empirical study on GCC Islamic bank's CSR disclosure and its relation with the corporate governance variables. This study aim to fill this research gap by examining the extent of linkage and impact between corporate governance mechanisms and corporate social responsibility disclosure practiced in Islamic banks in the Gulf Cooperation Council countries (GCC).

1.3 RESEARCH OBJECTIVES

The main objective of this study is to examine whether there is any effect of corporate governance mechanisms on CSR disclosure of Islamic banks in GCC countries for the period of 2007 to 2011. The research objective can be broken into three points:

1- To investigate whether there is any effect of the duality of CEO on the CSR disclosure score of Islamic banks in GCC countries for the period of 2007 to 2011.

2- To investigate whether there is any effect of the numbers of directors on the board on CSR disclosure score of Islamic banks in GCC countries for the period of 2007 to 2011.

3- To investigate whether there is any effect of the proportion of the independent directors on the board on CSR disclosure score of Islamic banks in GCC countries for the period of 2007 to 2011

1.4 RESEARCH QUESTIONS

The research question is to what extent, could banks with better corporate governance mechanisms contribute towards better CSR disclosure?

1.5 MOTIVATION AND SIGNIFICANT OF THE STUDY

The study will emphasize on the importance of corporate governance role on enhancing the disclosure of CSR, and illustrate the level of CSR disclosure in Islamic banks operating in GCC countries. This study will also show how a better corporate governance mechanism can enhance the CSR disclosure, and the effect of the current corporate governance mechanisms adopted by Islamic banks on the corporate social responsibility disclosure quality. The importance of this study comes from its effect on raising the level of trust in the annual reports of Islamic bank among the stakeholders and investors which will benefit the economy of the region as a whole.

Additionally, the study will hopefully contribute in leveling up the awareness of the importance and the enrollment of Islamic banks in CSR plus the benefits they are going to get from it. Applying sound corporate governance structure in the Islamic financial institutions will help involving the benefits of all stakeholders (chapra and Ahmed, 2002).

1.6 LIMITATIONS OF THE STUDY

The study as its adopting a quantitative approach will be focusing only on measuring and testing the corporate governance mechanisms that can be represented and tested statically. The study also suffers the limited availability and disclosure of information about the level of implementation and enforcement of the corporate governance mechanisms in the banking industry. The study period is limited to five years only from 2007 till 2011 due to the time and cost constraints. Finally, the study is also constraint on one type of disclosure which is the corporate social responsibility disclosure as one of the not yet well developed areas disclosed in the annual reports.

1.7 ORGANIZATION OF THE RESEARCH

This study consists of five chapters including this chapter. Chapter one provides a general idea of the study, covering the background, problem statement, research objectives, questions, motivation, and limitations. It is followed by the theoretical framework and a literature review of the previous studies particularly on corporate governance mechanisms, disclosures and agency theory in chapter two. Subsequently, Chapter three will focus on the research methodology, which discusses hypotheses development, sample selection, data collection and data analysis procedure. The discussion and analysis of findings are explained in Chapter four. Finally, summary, conclusion, and recommendations of the study will be covered in Chapter five.

CHAPTER TWO

THEORETICAL FRAMEWORK AND LITERATURE REVIEW

2.1 INTRODUCTION

Corporate social reporting has been the centre of attention recently as a part of the development process. Likewise, the intermediary function of banking institutions had rise the significance of disclosure in these institutions (Htay, Rshid, Adnan, Meera, 2012). Section two will discuss the theoretical framework which is based on the agency theory. Section three will discuss the prior empirical studies about the relationship between corporate governance and corporate social responsibility.

2.2 THEORETICAL FRAMEWORK

The Agency theory was adopted for this theoretical framework to discuss the corporate governance variables that might affect corporate social disclosure. And to what extent the study variables and corporate governance mechanisms may influence the social reporting disclosure.

It is important when discussing corporate social disclosure (CSD) extent to consider the structure, size and composition of those involved in taking the decision in the organization. Hence, consideration of corporate governance, including board composition in the organization cannot be ignored because it is the people in board responsible for the management of information disclosure in annual reports (Gibbins, Richardson, and Waterhouse, 1990).

Agency theory is based on the agent-principal relationship, Agency theory analysis “situations in which one individual (the agent) acts on behalf of another (the principal) and is supposed to advance the principal's goals." (Milgrom and Roberts, 1992). Managing agency relationships plays an important role in corporate governance because corporate governance is often defined as a principal-agent relation (Petri, 2008). The agency theory evolve around the principle-agent relationship, this relationship can be developed between anyone who can be referred to as a stakeholder and its agent. As an illustration, shareholders, banks, other stakeholders like a company employees, creditors, and customers can be the agent of their firms. Similarly, an agent-principle relationship can develop between the management as the agent of the firm. On the contrary, stakeholders can assign managers as agents. "Whether somebody can be regarded as somebody else's agent depends on who the principal is. As any stakeholder can be chosen as principal, principals can range from minority shareholders to the society at large and from the environment to the government." (Mantysaari, 2008).

Agency theory analysis "situations in which one individual (the agent) acts on behalf another (the principle) and is supposed to advance the principal's goals." (Milgrom and Roberts, 1992). Mangers as agents are held responsible for acting in the interest of their principals and in order to prove that they need annual reports to prove acting in such manner (Watts and Zimmerman, 1979).

Principal are generally interested in maximizing their share value whereas agents may aim to more personal goals which do not necessary lead to shareholder wealth maximization. In many cases The agent goals and their principle's can compete and interests can conflicts. Agency conflicts have its implication for corporate governance and corporate social responsibility (Germanova, 2008). According to agency theory, managers will tends to voluntarily disclose detailed information when it believed to lower agency costs (Naser, Al-Hussaini, AL-

Kawari, Nuseibah, 2006). In other words, corporate social disclosure (CSD) can be a tool to reduce agency cost by the management (Jensen & Meckling, 1976; Rozef, 1982; Easterbrook, 1984). More disclosure is believed to be associated with lower agency costs and as a result raise fund which is a priority for mangers.

The separation of ownership and control in the new cooperation may cause the firm behavior to diverge from the shareholders interest which is the profit maximization, cost minimizing (Hutton, 1995). The relationship arises between shareholders as the principal and managers as agents who is assigned by principle and delegated the authority of decision making is called the agency relationship (Frama and Jensen, 1983). The agency relationship generate problems that are known as the agency problem, the first is the conflict of interest between principal and agent e.g. goals and desire as well as the cost and difficult to monitor, the second is the different risk appetite between agent and principal.

To manage the fiduciary agency relationship the agency problem must be solved, in other words to minimize the agency cost of monitoring, and the conflict of interest. Corporate governance plays an essential role in aligning the interest of managers and shareholders by developing a mechanism to penalize agents for violating the interest of principle and reward the serving of principal goals.

The agency problem that arises from the divergence of the interests of the principal and the delegation of the decision making authority results in the conflict of interest between agents and principles, the agency cost of monitoring the actions and behavior of agent, and the cost of acquiring the information possessed by agents, in this matter the corporate social responsibility can contribute in solving this problem and minimize agency cost. CSR disclosure increases the shareholders value because the markets positively respond to voluntary CSR disclosure, in the same way financial