



EXAMINING CORPORATE GOVERNANCE
DISCLOSURE PRACTICES
OF ISLAMIC FINANCIAL INSTITUTIONS IN
MALAYSIA

BY

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ABSTRACT

This study documents the quality of corporate governance (CG) in Islamic Financial Institutions (IFIs) operating in Malaysia. Following the consideration of the stewardship approach, it is assumed that CG disclosure can be considered as a direct expression of IFIs to gain trust from stakeholders. This study constructs a comprehensive CG disclosure index reflecting the specificities of institutions subjected to *Shariah*-based operations in particular. This study bases the index on a number of widely recognised sources mentioned in the debates concerning governance in IFIs. Additionally, the study sets out to identify any significant differences in compliance between locally and foreign owned IFIs. Using the most recently publicly available data for 2009, which was hand-collected, the current study calculates an overall CG disclosure score for IFIs in Malaysia. The study identifies some weak areas of general governance related information (GCGi), such as internal audit and control and non-adherence to guidelines. For specific governance related information (SCGi), areas, such as *Shariah* compliance and customers/investment account holders (IAHs), could be enhanced to portray the capability of IFIs as trustworthy banks that can be relied upon by their stakeholders. In the future, the IFIs may also consider setting up a governance committee (GC), as this committee is currently not a common practice for any of the IFIs in Malaysia. On comparing the score, this study finds evidence that some CG practices are better/ (worse) in locally owned IFIs (Foreign owned IFIs). However, the difference in the quality of governance across this institutional ownership structure is not statistically significant. The finding of this study reveals that CG disclosure in IFIs is currently prioritised to focus more on general kinds of governance information, such as the Risk management committee and Nominating committee.

خلاصة البحث

تسعى هذه الدراسة إلى توثيق جودة حكومة الشركات في المؤسسات المالية الإسلامية التي تعمل في ماليزيا. واتباعا في اعتبار المنهج الإشرافي، يفترض بأن حكومة الشركات يمكن اعتبارها كانطباع مباشر للمؤسسات المالية الإسلامية، لكسب الثقة من أصحاب الحصص. وتقوم الدراسة بتركب مؤشر شامل لحكومة الشركات، وذلك لعكس الخصوصيات الموضوعية للمؤسسات في الإجراءات المستندة إلى شريعة على وجه الخصوص. وتعتمد الدراسة على مؤشر رقمي لمصادر واسعة ومعترفة تطرقت إلى مناظرات تهتم بالحكومة في المؤسسات المالية الإسلامية. إضافة إلى ذلك، تعتمد الدراسة على التعريف بأي اختلاف مهم في الشريعة بين المؤسسات المالية الإسلامية المحلية والأجنبية. وتستخدم الدراسة أحدث المنشورات المتاحة في عام ٢٠٠٩، والتي جمعت بشكل يدوي، بحيث تقوم الدراسة بحساب الدرجات الكلية لحكومة الشركات للمؤسسات المالية الإسلامية بماليزيا. وأظهرت الدراسة بعض مناطق الضعف في الحكومة العامة المتعلقة بالمعلومات، مثل التدقيق الداخلي، والتحكم، وعدم التقيد بإرشادات. وللحكومة الخاصة المتعلقة بالمعلومات تشكيل الشريعة وحاملي حساب استثماري/ عميل مجالات في تحسين إظهار الكفاءات بالمؤسسات المالية الإسلامية كبنوك موثوقة، يعتمد على أصحاب الحصص. وفي المستقبل، قد تعتبر المؤسسات المالية الإسلامية تأسيس الحكومة كلجنة لا تطبق بشكل عام في أي من المؤسسات المالية الإسلامية بماليزيا. وفي المقابل، أوجدت الدراسة الشواهد التي تطبق حكومة الشركات بأنها أفضل من المؤسسات المالية الإسلامية المحلية. ومهما كان، يعد الاختلاف في جودة الحوكمة عبر تركيبة التملك المؤسسي ليست ذات اهتمام كبير احصائيا. وكشفت نتائج البحث بأن حكومة الشركات في المؤسسات المالية الإسلامية حاليا تفضل التركيز بشكل كبير على الأنواع العامة من حكومة المعلومات، مثل لجنة إدارة المخاطر، ولجنة الترشيح

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 dissertation for the degree of Master of Science in Accounting.

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DECLARATION

I hereby declare that this dissertation 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 any other degrees at IIUM or other institutions.

Norakma binti Abd Majid

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I wish to dedicate this thesis to my beloved parents, Abd Majid bin Abd Rahman and Patimah@Kamariah Ibrahim, and also my siblings, Mohd Nizan, Noraini, Nor Maziah, Nor Johaidah, Norhatikah and Shukri

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LIST OF ABBREVIATIONS

AAOIFI	: The Accounting and Auditing Organization for Islamic Financial Institutions
AFB	: Asian Finance Bank Berhad
AFF	: Affin Islamic Bank Berhad
AIMs	: Alternatives investment markets
ALI	: Alliances Islamic Bank Berhad
ARB	: Al Rajhi banking & Investment Corporation (Malaysia) Berhad
ASX	: Australia Stock Exchange
BIM	: Bank Islam Malaysia Berhad
BMM	: Bank Muamalat Malaysia Berhad
BNM	: Bank Negara Malaysia
BODs	: Board of directors
CG	: Corporate governance
CGDs	: Corporate governance disclosures
CIM	: CIMB Islamic Bank Berhad
e.g.	: (<i>exempligrantia</i>): for example
EON	: EONCAP Islamic Bank Berhad
et al.	: (<i>et alia</i>): and others
etc.	: (<i>et cetera</i>): and others
FSMP	: Financial Sector Master Plan
GCGi	: General governance related information
GP1-i	: The guidelines on Corporate Governance for Licensed Islamic banks.
GSIFI	: Governance Standards for Islamic Financial Institutions
HLI	: Hong Leong Islamic Bank Berhad
HSB	: HSBC Amanah Malaysia Berhad
i.e.	: (<i>id est</i>): that is
IAHs	: Investment Account Holders
IB(s)	: Islamic bank (s).
IFIs	: Islamic financial institutions
IFSB	: The Islamic Financial Services Boards
IFSB-3	: The Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services
<i>inter alia</i>	: among other things
KFH	: Kuwait Finance House (Malaysia) Berhad
MIB	: Maybank Islamic Bank Berhad
OCB	: OCBC Al-Amin Bank Bhd
OECD	: Organization for Economic Co-operation and Development
PIB	: Public Islamic Bank Berhad
PLS	: Profit and Loss Sharing system
RHB	: RHB Islamic Bank Berhad
SCGi	: Specific governance related information
SCS	: Standard Chartered Saadiq Berhad

SMEs : Small and medium enterprises
SSB : *Shariah* Supervisory Board

CHAPTER ONE

INTRODUCTION

Worldwide attention on corporate governance (CG) has heightened as a result of a series of corporate failures reported in the media. Inevitably, discussions on CG have arisen out of the accounting irregularities uncovered at prominent organizations, such as Enron, Tyco and WorldCom, Parmalat, Ahold, ABB and many others. Closer to home are cases such as Perwaja and Pan Electric Incorporation. These have really shaken the confidence (trust) of stakeholders in businesses. Consequently, CG has increasingly been a subject of stakeholder scrutiny. Most importantly, CG and the issue of transparency are the focus of businesses, particularly for companies operating in emerging economies (Ray and Das, 2009).

Furthermore, examining the quality of CG reporting practices is useful for stakeholders. According to Bhat, Hope and Kang (2006: 716), the knowledge of a firm's governance practices is useful in assessing the credibility of the financial information presented in its annual report. Governance-related disclosure aids users in assessing the quality of information and guides stakeholders in setting expectations about the future of a company's performance more accurately (Bhat et al., 2006). Specific to Islamic Financial Institutions (IFIs), one observes a proactive stance on the part of regulators to improve the regulatory and supervisory framework in supporting higher CG standards for IFIs.

1.1 BACKGROUND OF THE STUDY

The Islamic finance system embodied in IFIs represents a radical departure from conventional banking, and from the viewpoint of CG, it embodies a number of interesting features since equity participation, risk and profit-and-loss sharing (PLS) arrangements form the basis of its financing system. This poses an important challenge to IFIs to improve all critical aspects of CG (Chapra, 2007: 338). Thus, any attempt to assess the CG performance in IFIs needs to be aligned with the concern and issues of the PLS system.

The CG Guidelines introduced by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Islamic Financial Services Board (IFSB) and the Central Bank of Malaysia (BNM) may well assist IFIs to improve their governance practices and enhance their transparency. The measures of CG, particularly the effectiveness of specific issues pertaining to the role and conduct of *Shariah* Supervisory Board (SSB) promulgated in the CG standard, may help IFIs to improve the level of trust and confidence in the Islamic finance industry (Iqbal and Greuning, 2008). More importantly, AAOIFI claims that the development of strong governance practices will win public confidence and thereby promote trust amongst their equity holders, investors and other parties dealing with them. This would also lead to a better *Shariah* compliance structure.

The guidelines just mentioned may well assist IFIs to establish their governing structures. Consequently, such guidelines may improve the governance practices of IFIs, and, thus, enhance their transparency. Accordingly, there is good reason to expect a high quality of CG disclosure in the IFIs industry in the 2009 reporting year. In addition to this general reason for a high quality of CG disclosure practices, two other disclosure issues arise. First, is there any difference in the industry resulting

from the effect of the general and specific kind of governance information introduced in national and international governance guidelines? Second, is there a difference between the level of CG quality of the local and foreign IFIs?

The first issue is linked to the direction of the regulatory bodies' movement in the recommendations made in the CG guidelines. Some governance policies, such as *Board structure and functioning*, *Nominating committee*, *Remuneration committee*, *Risk management committee*, *Audit committee* or *Audit and governance committee*, *Risk management*, *Internal audit and control*, *Related parties transaction*, *Management report* and *Non-adherence to guidelines* can be considered as a general type of governance information as it is common to generic firms. Their focus is generally more on the commercial performance of maximizing the operational efficiency, and, hence, profitability.

Other policies in the guidelines have specifically focused on the specificity of IFIs, such as *Shariah committee* or *Shariah Supervisory board*, *Customers/Investment account holders*, *Governance committee* and other information related to *Shariah compliance*. These are of significant importance as the disclosure of such information can lead to improvement in the *Shariah* compliance structure in IFIs. Hence, both types of general and specific kind of governance information have been recognised in CG guidelines for IFIs at the national (i.e., The guidelines on corporate governance for licensed Islamic banks (GP1-i) and international level (i.e., The guiding principles on corporate governance for institutions offering only Islamic financial services (excluding Islamic insurance (Takaful) (IFSB-3) and The governance standard for Islamic financial institutions (GSIFI, no. 1 to 6). The examination of general governance related information (GCGi) and specific-governance related information (SCGi) is a means of unbundling the effect of CG reform for IFIs.

Arguably, an expected difference between local and foreign IFIs will exist. Because of the fiduciary duties towards ‘global stakeholders’, foreign IFIs are more likely than local IFIs to voluntarily disclose CG information. The reliance on national and international guidelines may provide a stimulus for more CG disclosure to be made available to their wide array of stakeholders. For local IFIs, there is an expectation that provision in national guidelines and the consideration of cost and benefits of disclosures are the focus of their attention. Thus, local IFIs will be less willing to disclose CG information. Thus, it might be expected that there would be a disclosure difference between local and foreign IFIs. Scant previous examination of quality CG disclosure in IFIs in Malaysia provides the motivation for this endeavour.

Specifically, the research will examine the CG disclosure practices of IFIs in Malaysia using a two-stage process. The first stage is the development of a comprehensive CG index. Consistent with prior studies, the index acts as a proxy for disclosure quality. The comprehensive corporate governance disclosure (CGD) Index used in this study is based on three governance guidelines and Codes promulgated by the AAOIFI, IFSB and the BNM (later on collectively referred to as ‘Guidelines’). The CG index developed is then used to assess the quality of CG of IFIs in Malaysia. This constitutes the second stage of the study.

1.2 OBJECTIVES OF THE STUDY

The primary objective of this study is to examine the disclosure quality of governance information in the annual report of IFIs in Malaysia. Consistent with prior studies examining disclosure quality, a CGD Index will first be developed from the guidelines and standards issued by the AAOIFI, the IFSB and the BNM. The CGD Index developed is then used to assess the disclosure quality of CG information of IFIs in

Malaysia using content analysis on the annual reports of 2009. Specifically, the study aims to provide the answers to the following research questions:

- i. To what extent are IFIs in Malaysia disclosing corporate governance information.
- ii. Are IFIs in Malaysia disclosing more specific governance information compared to general governance information? Given that IFIs are unique in their philosophy and operations, one would expect such institutions to disclose more information that focuses on their specificity, for example, more disclosure on *Shariah* compliance, the *Shariah* committee, its governance committee (specifically indicated in the IFSB guidelines) and information on investment account holders (IAHs).
- iii. Do foreign owned IFIs have better CG disclosure quality compared to locally owned IFIs? The expectation is that the former would have better CG disclosure primarily because foreign owned IFIs operate at a global level. Accordingly, in trying to satisfy the needs of stakeholders at home and abroad, such IFIs tend to disclose more CG information compared to their locally owned counterparts.

1.3 MOTIVATION FOR THE STUDY

The negative effects emanating from the business scandals that have shaken the trust and confidence amongst stakeholders have raised interest in conducting an in-depth research on the capacity of governance information in IFIs, as measured by the quality of its reporting practices. Consequently, examining CG practices in IFIs is regarded as timely and relevant for several important reasons. First, so far, the debate over CG has been waged without so much concern for stewardship roles as there should be for

IFIs. The contemporary business environment is in need of management and organizations that endeavour to achieve an ethically responsible, innovative and profitable business. Thus, the stewardship paradigm and trust can be competitive assets for IFIs in securing a competitive advantage in today's business. Second, a major component of the banking sector reform, as espoused in the launching of the Financial Sector Master Plan (FSMP) in March 2001, was the necessity for an improvement in CG amongst IFIs. More importantly, it is of practical relevance since a study of CG disclosure practices may help inform bank supervisors concerning the degree of governance disclosure, thus, becoming more effective in overseeing the operations of banks as they are in a better position to foresee the potential problems that may arise therein. Furthermore, the increased supply of governance information across the banking sector would, in turn, create more stability within the industry. This would, in turn, bring about a healthy Malaysian economy. Third, the results of the study may provide evidence concerning the extent that specific issues of CG have been emphasized by IFIs. In respect of the findings of a lack of disclosure on particular issues of CG that are relevant to stakeholders, the regulatory authorities may consider mandating such disclosures.

Theoretically, the implementation of an appropriate CG mechanism should benefit the owners financially, as they would have a general idea of the course of action of the stewards (Mills and Keast, 2009). More specifically, stewardship theory espouses that managers, in the spirit of stewardship, would make decisions in the best interest of the organization, thus putting collectivist needs above self-serving option. It appears that stewards exhibit "pro-organizational and collectivistic behaviours" in order to achieve the objectives of the organization (Davis, Schoorman and Donaldson, 1997: 24). Given the importance of the stewardship spirit to the operators of IFIs, this

study used the stewardship theory. The myriad objectives may have a bearing on whether the IFIs industry recognises CG disclosure as part of its accountability as a steward, and of the regulatory bodies to encourage such disclosure. Information about CG disclosure would enable further review of whether these factors have led to an improvement in the discharge of the obligations of IFIs and the effectiveness of regulatory policy in CG matters.

1.4 SIGNIFICANCE OF THE STUDY

Despite the voluntary nature of CG disclosure in the annual reports of IFIs, this research is still relevant and can contribute to the accounting literature for several reasons. First, this study expects to contribute to banking literature, policies and practices by focusing on the IFI industry in Malaysia. To the best knowledge of the researcher, to date, only Hameed and Sigit (2005), and Hassan and Christopher (2005) have empirically examined governance disclosure in the annual reports using content analysis on a limited sample of IFIs.

The second is directly related to the self-developed comprehensive CGD Index. While prior studies used just one CG guideline when developing the CG index, this study used three, incorporating both domestic and international guidelines/standards promulgated by AAOIFI, IFSB and the BNM. The split of governance elements in the index into general-governance related information and specific-governance (specific to IFIs) related information is an extension by this study.

Third, while previous studies used agency theory to help clarify issues pertaining to CG disclosure, the present study adopts stewardship theory as the framework to explain CG disclosure practices of IFIs in Malaysia. The stewardship theory is particularly useful as it serves “to build trust, elicit cooperation and create a

shared vision amongst those involved in the firms” (Lewis and Algaoud, 2001: 160). Furthermore, the evidence reported in this paper is important not only for IFIs in Malaysia, but also for other Islamic-based institutions in attempting to improve their CG practices.

The results here will add to the growing literature on CG disclosure in the IFIs and related finance industry and provide evidence concerning the extent IFIs communicate their specific governance practice to stakeholders. It is hoped that the findings would help stimulate further debate on governance issues in IFIs and provide a basis for a more extensive survey on CG disclosure.

In the scientific accounting literature, this study is important because it provides a sound basis for future research like Islamic capital market research and behavioural studies in relation to CG disclosure practices in IFIs. Next to its relevance from the scientific perspective, the topic is also socially important and interesting for preparers, auditors, regulators and users that are either directly or indirectly involved with the annual reports of IFIs. As for the preparer, the empirical results inform them of the scores in respect of the Guidelines, and for the auditors, the results might be of interest to them as they are closely involved in auditing and recommending high quality annual reports to clients. For the regulators, the results will help inform the Central Bank of Malaysia whether the Guidelines have the desirable effect on governance reporting practices of IFIs and also alert them concerning areas where governance disclosure is abundant and where it is lacking. Subsequently, this may help the Central Bank to formulate policies and regulations, which will further enhance the CG of IFIs. Finally, users of annual reports of IFIs can get a picture of governance practices in IFIs that will educate and enable them to develop a firm opinion concerning their needs.

1.5 STRUCTURE OF THE THESIS

The study comprises seven chapters. This chapter is the introductory part of the study and explains the main objective of this thesis, which is to examine the quality of CG disclosure amongst IFIs in Malaysia. The quality of CG disclosure will be evaluated using a self-developed index. Using content analysis, the annual report of sixteen IFIs will be assessed. The remainder of the thesis is structured as follows. Chapter Two will provide the definition of corporate governance. A review of previous empirical research in the area will also be undertaken to provide insights into the methodological differences in assessing the CG quality. Additionally, the peculiarity of governance issues in IFIs and the theoretical perspective are also emphasized in this chapter. Chapter Three describes the construction of the CGD index. The theoretical framework is discussed in Chapter Four. The theory used in the study is the stewardship theory. The issues on accountability and stewardship responsibility will be detailed in the chapter. Chapter Five focuses on the research methodology. This chapter discusses the research questions and presents the research design. The findings will be discussed in Chapter Six. A brief summary of the results, limitations and contributions of the study will be discussed in Chapter Seven. This study is concluded by pointing out the current prioritization on the general-governance information and discussing the implications of its findings for future research. In this sense, a proposal for introducing a standardized form of CG reporting in order to overcome the imbalance of convergence in the area of governance focus and CG reporting practices among IFIs.