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The Impact of Corporate Governance on the Financial, Governance and Social Disclosure at Islamic Banks in Malaysia

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Abstract

The study examines the impact of board and audit committee on the disclosure of Islamic financial and social reporting (IFSR) among Islamic banks in Malaysia**.** Drawing on surveys this study seeks the views of accountants working in Islamic banks regarding the importance of items in the IFSR index developed by Marsidi et al. (2016). The annual reports are thereafter used to examine the score of the IFSR for the Islamic banks as well as to collect the data for the related variables. The multivariate regression findings suggest that board size is a significant factor in explaining the IFSR at Islamic banks in Malaysia. Such finding indicates that the size of board, which is represented by the number of directors who sit on the board of directors, is a crucial governance mechanism in achieving the aims of Islamic banks. The result also meets the role of corporate governance from the perspective of Islamic agency theory. The results of the study should not be generalised to year's prior, or after, the years of examination. The finding is perceived as contributing towards the suitable formation of board of directors specifically in terms of the total number of directors with respect to the financial, governance and social disclosures at Islamic banks. The study uses the Islamic agency theory to explain the governance practices and IFSR disclosures within the context of Malaysian Islamic banks. As such, the paper contributes towards the development and sustainability of Islamic banks both in Malaysia and throughout the globe.

Keywords: Board of Directors, Audit Committee, Islamic Agency Theory, IFSR Index, Disclosures, Islamic Banks

1. Introduction

The growing importance of Islamic banking industry reflects the need to understand issues associated to the relationship between the disclosure (i.e. financial and social) and corporate governance practices. In this respect, the board and audit committee are perceived as the governance mechanisms responsible to ensure appropriate discharge of corporate accountability through effective corporate financial disclosures (Vafeas, 2005).

Hence, it is necessary to examine the corporate governance practices on the financial and social disclosure at Islamic banks considering the important roles of the board and audit committee on corporate financial disclosure. The findings are expected to provide valuable insights on the effects of the board and audit committee on the financial and social reporting practices at Islamic banks. The results may also be used as a platform to understand the relationship and provide useful information for the formation of the board and audit committee in Islamic banks.

The issues concerning corporate financial reporting are also vital to be tackled due to the information asymmetry problems and the agency conflicts that exist between corporate managements and stakeholders (Healy & Palepu, 2001). Corporate disclosures are hence considered as a bridge between corporations and users of corporate financial information. Corporate financial reporting denotes the disclosure of both financial and non-financial information (Gibbin et al., 1990).

The information can be in the form of quantitative or qualitative, mandatory or voluntary and released through formal or informal channels. The issues of quantitative, qualitative, mandatory, and voluntary disclosure are all considered of equal importance at Islamic banks due to the fact that they are not only established to maximise the wealth of its owners but also exist to ensure that the welfare or benefits of the society are enhanced (Haniffa & Hudaib, 2007). These reporting requirements are also perceived to ensure the Islamic banks moving towards achieving the overall aims (*maqasid*) of the *Shari'ah*.

According to Ahmed (2011), the overall *maqasid* of *Shari'ah* is to promote welfare as well as to prevent harm among mankind. At this juncture, the financial aspects of reporting represent the quantitative, qualitative, and mandatory parts whereas the social reporting requirements signify the voluntary part. Moreover, the examination of mandatory reporting requirements within the context of developing economies is deemed relevant because of their more relax or less stringent enforcement policy (Ali et al., 2004). Meanwhile, the issue concerning voluntary disclosure, i.e. social reporting, needs to be addressed due to the spirit of the establishment of the Islamic banks themselves (Haniffa, 2002).

The examination pertaining to the issues of financial and social disclosures will therefore provide findings or insights on the overall reporting practices at Islamic banks. As noted by Lambert et al. (2007), an improved version of disclosure is seen as central since it can mitigate or alleviate the issues of information asymmetry as well as the agency conflicts that arise between the managements and the stakeholders. This is because an enhanced or an improved version of disclosure considers all relevant existing disclosure requirements concerning organisations.

The study is therefore carried out to examine the effects of board of directors' characteristics and audit committee attributes on the Islamic financial and social reporting (IFSR) at Islamic banks in Malaysia. The next sections discuss the theoretical framework as well as the hypothesis development of the study. In the subsequent section, the research methods of the study are presented and discussed. Thereafter, the paper discusses the multivariate regression results. The paper ends with the conclusion.

2. Theoretical Framework

The research framework focuses on the issue of Islamic financial and social reporting (IFSR) disclosure within the context of Islamic banks in Malaysia. In addition, it is the emphasis of the study to examine the impact of board of directors' characteristics as well as audit committee attributes on the IFSR disclosure. Finally, the study also examines the effects of profitability and size on the IFSR disclosure among several Islamic banks, which are considered as the control variables in the study. The areas of concern in this study are as portrayed in the Figure 1 below.

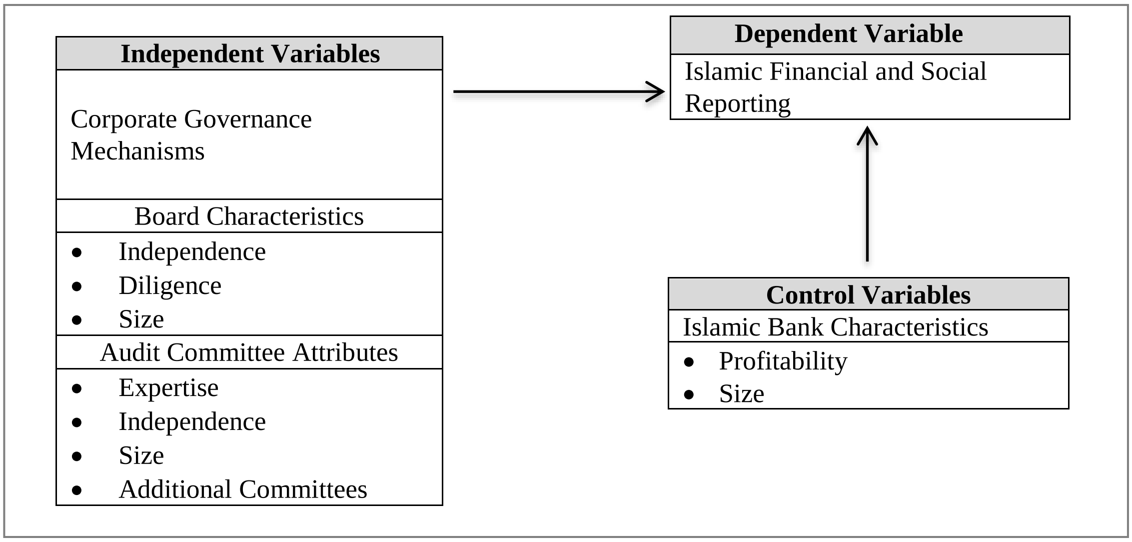

Figure 1: Theoretical Framework

This study adopts the agency theory as the research framework. Jensen and Meckling (1976) argue that the agency theory assists in explaining the relationship between corporate governance structures or mechanisms and corporate financial performance. In the context of discussion, corporate financial performance is viewed as having direct relationship with corporate financial and non-financial reporting.

In this regard, the agency theory argues that the corporate governance at Islamic banks has the responsibility to ensure that the agents i.e. managements at Islamic banks produce sound corporate financial and non-financial reports (i.e. IFSR). The reports will thereafter be used by the principle i.e. the stakeholders at Islamic banks who are not involved in managing the Islamic banks to make more informed economic decisions.

The agency theory is also used to explain the act of governance mechanism in ensuring the compliance of financial operations and activities at Islamic banks with the *Shari'ah* in addition to aligning or tailoring the objectives of the Islamic banks with the objectives of the stakeholders. As noted by Safieddine (2009), in terms of nature of operation, while the IFIs are entrusted to maximise the shareholders' wealth, the Islamic banks also have the responsibility to ensure that their operations and activities are in compliance with the *Shari'ah* rules and principles at the same time.

In this respect, while carrying out their operations and activities, the Islamic banks need to observe not only the regulations set by the supervisors but also the principles outlined by the *Shari'ah* at all times (Archer et al., 1998). From the viewpoint of Islam, the compliance with the *Shari'ah* is indeed perceived as crucial since it will determine the status and nature of the income earned by the Islamic banks i.e. whether it is allowable or non-allowable earnings. Therefore, the shareholders and investors at Islamic banks are very concerned that their monies are invested according to the *Shari'ah* (Chapra & Ahmad, 2002).

Nevertheless, in the context of IFIs, as asserted by Safieddin (2009) the two main characteristics of agency theory are (i) the need to comply with *Shari'ah* and (ii) the rights of depositors and IAHs - the separation of cash flow and control rights. According to Safieddin (2009), the establishment of *Shari'ah* board as well as the access to information on such board including the governance structure and *fatwa* is the crucial mechanisms to mitigate the issue of *Shari'ah* compliance.

In this viewpoint, the principal-agent (PA) relationship in IFIs needs to be comprehended as it affects the performance of IFIs. The agency contract from the perspective of Islam is known as *wakalah* (agency). According to Mansuri (2006), this act that admits representation describes an agent who has taken over the roles of the principal to perform on behalf of that principal. An understanding on the PA relationship or conflict is essential and therefore mitigated as it assists towards the success on an IFI.

Banchit et al. (2013) found that PA conflicts lead to lower profitability or performance of Islamic banks. The study concluded that PA conflicts are much more inherent in the Islamic banks and other research in capital markets. As such, in order to explain the state of agency theory at IFIs for better understanding, Safieddin (2009) formulated four propositions through the literature as well as the findings of his study.

First, proposition 1 asserts that due to the regulations conflicts between *Shari'ah* and conventional financial market, secular agency mitigating agency may not be applicable to the IFIs. Next, proposition 2 states that the lack of sufficient control over the implementation of governance at IFIs is the result of agency mitigating mechanism conflict with the *Shari'ah* principles. Proposition 3 pertains to examining the effects of IFIs' governance practices on the mitigation of agency issues in two areas such as disclosure and audit and control. Finally, proposition 4 reflects the effectiveness of IFIs' operations depending on the governance models or practices which are able to establish the balance between the compliance with *Shari'ah* and the protection of IAHs.

Hence, an effective structure of corporate governance with sound corporate governance practices enables the Islamic banks to provide more relevant information disclosure through IFSR. This is consistent with Rao et al. (2012) as well as Haniffa and Cooke (2005), which asserted corporate governance structures or mechanisms have been associated with greater corporate disclosure to date.

3. Hypothesis Development

3.1 Board Diligence

Vafeas (1999) argues that corporate board effectiveness can be enhanced as the number of board meetings increases. Although Annuar (2012) found out that board members especially independent directors faced difficulty in allocating sufficient time for board meetings, the chances of solving the performance issues are higher when the boards meet more regularly. As suggested by Allegrini and Greco (2011), the more often the board meets, the better the corporate voluntary disclosure. The abovementioned discussions lead to the following hypothesis:

H_1: There is a positive relationship between board diligence and the IFSR.

3.2 Board Independence

The independent directors is important to ensure well-functioning board towards having good corporate governance (Solomon, 2010 and Annuar & Abdul Rashid, 2015) since corporate outside directors play important roles with respect to corporate financial performance (Weishbach, 1988). They are viewed as able to monitor the corporate management pertaining to fraud prevention activities in corporate financial statements (Beasley, 1996; Dechow et al., 1996). As asserted by Fama and Jensen (1983) the existence of independent directors is crucial in protecting the interests of shareholders. Samaha et al. (2012) and Donnelly and Mulcahy (2008) are examples of studies that indicate the positive effects of board independence on the extent of voluntary disclosure.

Nevertheless, there are also studies that demonstrate negative or no relationship between board independence and disclosure. He et al. (2009) for instance suggests that board independence only affect the financial reporting quality in certain countries i.e. Anglo Saxon but not in other countries. Further, Ahmad Zaluki and Wan Hussin (2010), Gul and Leung (2004) and Haniffa and Cooke (2002) also found that board independence does not affect the quality of financial reporting. Based on the aforementioned discussions and considering the nature of operations at Islamic banks the following hypothesis is developed:

H_2: There is an effect of board independence on the IFSR.

3.3 Board Size

Jensen (1993) argues that board of directors is seen as less effective in discharging their duties as the number of board member increases. Similarly, Vafeas (2005) and Yermack (1996) argue that high number of board members has generally been associated to lower firm value and financial reporting quality. This is probably due to less effective monitoring process for companies that have big boards (Vafeas, 2005) since large boards are seen as having difficulties to undertake their roles to supervise and lead the corporations from the perspective of agency theory.

On the other hand, Larmou and Vafeas (2010) asserts that larger boards are crucial for board effectiveness since bigger boards contribute in terms of more knowledge and expertise and enhance the capacity for monitoring but also in terms of sharing the workload. Aktaruddin et al. (2009) as well as Cerbioni and Parbonetti (2007) suggest that board size has positive effect on the corporate voluntary disclosure and accounting disclosure respectively. The above discussions have led to the formation of the following hypothesis:

H_3: There is a relationship between board size and the IFSR.

3.4 Audit Committee Expertise

A well-functioning audit committee is reflected by the ability of its members to understand a variety of financial issues in a firm (PricewaterhouseCoopers/IIA, 2000) in order to analyse corporate financial statements (Dhaliwal et al., 2010). As such, Kent et al. (2010) suggests that financial experts on audit committee have positive impact on the quality of financial reporting while Akhtaruddin and Haron (2010) advocates that audit committee expertise lead to better level of voluntary disclosure. Such discussions lead to the following hypothesis:

H_4: There is a positive effect of audit committee expertise on the IFSR.

3.5 Audit Committee Size

Kalbers and Fogarty (1993) assert that large audit committees are more likely to be respected by the internal and external auditor. As a consequent, larger membership of audit committee enhances governance effectiveness and lead to better financial reporting quality (Ahmad Zaluki & Wan Hussin, 2010). Further, Bedard and Gendron (2010) argue that a larger audit committee enhances effective monitoring with more varieties of views, skills, expertise, and experience. This is an essential factor for the audit committee to supervise corporate disclosure practices sufficiently (Persons, 2009) as bigger audit committees have more opportunities to resolve any issues concerning corporate reporting process (Li et al., 2012). The above discussions lead to the formation of the following hypothesis:

H_5: There is a positive relationship between audit committee size and the IFSR.

3.6 Audit Committee Independence

Ahmad Zaluki and Wan Hussin (2010), Carcello and Neal (2003), and Baysinger and Butler (1985) assert that audit committee independence leads to better or greater monitoring activities at corporations. As noted by Allegrini and Greco (2011), the independent directors in the audit committee have a better control which reduces the room for the management to withhold information from the stakeholders. Hence, independent directors in the audit committee will reduce the information asymmetry through better quality and transparency of financial reporting process (Li et al., 2012) and enhance the quality of financial reporting as well (Ahmad Zaluki & Wan Hussin, 2010). The aforementioned discussions hence lead to the following hypothesis:

H_6: There is a positive relationship between audit committee independence and the IFSR.

3.7 Additional Committee Held by Audit Committee Members

Additional committee service undertaken by the audit committee members is viewed as able to enhance audit committee performance as captured by the earnings quality (Vafeas, 2005). In this respect, the variety of committee seats held by audit committee members provide them with more leverage compared to those without any additional committee. This is probably due to the fact that more committees held by the audit committee members provide the related audit committee members with more essential financial and non-financial information. From such discussions, the following hypothesis is developed:

H_7: There is a positive relationship between additional committee held by audit committee members and the IFSR.

3.8 Profitability and Size of Islamic Banks (Control Variables)

The profitability of firm is seen to have some effect on the quality of corporate financial reporting (Owusu-Ansah, 2000). In this respect, the higher the profits earned by the corporations, the better the reputation of the corporate boards as well as the corporate audit committee. Thus, in this study, the profitability of Islamic banks is expected to be positively associated with IFSR disclosure.

On the other hand, Felo et al. (2003) noted that the existence of any fixed financial reporting costs may lead to lower costs as a portion of firm size. As such, this will enable the larger Islamic banks to understand and therefore provide more disclosure with respect to the Islamic financial and social reporting items or components that take place in Islamic banks. This study hence anticipates that the size of Islamic banks will have a positive impact on the IFSR within the context of Islamic banks in Malaysia.

4. Research Methods

4.1 Specification of Model

The study will use a multivariate regression model, which is estimated as follows:

$$
\begin{aligned}
FR = \alpha_0 &+ \beta_1 BDD_i + \beta_2 BDI_i + \beta_3 BDS_i + \beta_4 ACE_i \\
&+ \beta_5 ACS_i + B_6 ACI_i + B_7 ACA_i + B_8 IBP_i \\
&+ B_9 IBS_i + \varepsilon_i
\end{aligned}
$$

Where:

FR	=	IFSR
α_0	=	Constant
BDD	=	Board diligence
BDI	=	Board independence
BDS	=	Board size
ACE	=	Audit committee expertise
ACS	=	Audit committee size
ACI	=	Audit committee independence
ACA	=	Additional committee of audit committee member
IBP	=	Islamic banks profitability
IBS	=	Islamic bank size
ε	=	The residual
i	=	Islamic banks$_{1-48}$

4.2 Variables Measurements

4.2.2 Dependent Variable–IFSR

The IFSR disclosure in this study is based on the IFSR index developed by Marsidi et al. (2016). According to Marsidi et al. (2016), the concept of IFSR generally lies on the blend of reporting requirements from the Islamic financial and social perspectives. The IFSR is developed in order to place greater emphasis on the financial aspects of reporting while at the same time retaining the core components of social reporting. The index is carefully developed to ensure its validity and reliability (Marsidi et al., 2016; Hassan & Harahap, 2010; Haniffa & Hudaib, 2007).

There are altogether thirty-eight (38) index items after taking into account the relevant items as required or outlined by MASB (Tr*i*-3), AAOIFI, IFSB, BNM (GP8-i) ISR as well as the items proposed by Marsidi et al. (2016). The complete IFSR index for Islamic banks developed by Marsidi et al. (2016) is presented in the Table 1 below.

Table 1: IFSR Index

No.	Items of reporting	Basis of Reference
	Finance, accounting and investment	
1.	Reports shall comprise the following: i. Performance overview; ii. Statement of corporate governance; iii. Directors' report; iv. Statement by directors; v. Statutory declaration by director or person responsible for preparation of financial statements of Islamic banks;	GP8-i BNM

	vi. Auditor’s report; and	
	vii. Shari’ah committee’s report.	
2.	Financial statement shall comprise the following:	GP8-i BNM
	i. Balance sheet;	
	ii. Income statement;	
	iii. Statement of changes in equity showing either all changes in equity or changes in equity other than those arising from capital transactions with owners and distributions to owners;	
	iv. Cash flow statement; and	
	v. Accounting policies and explanatory notes.	
3.	Statement of financial position of an IFI shall disclose the following:	Tri-3 MASB; GP8-i BNM
	i. Assets;	
	ii. Liabilities; and	
	iii. Equity.	
4.	Separate reporting on IFI’s assets, liabilities and equity in the notes.	Tri-3 MASB; GP8-i BNM
5.	Income analysis is reported based on types of investment and financing of customers.	Tri-3 MASB; GP8-i BNM
6.	Presentation of dividends recognised:	Tri-3 MASB; GP8-i BNM
	i. Disclosed either in statement of changes in equity or in the notes;	
	ii. Amount distributed to owners during the period; and	
	iii. Related amount per share.	
7.	*Zakat* obligations:	
	i. Method;	Maali et al. (2006); GP8-i BNM
	ii. Amount and beneficiaries; and	Haniffa (2002); GP8-i BNM
	iii. Payment on behalf of depositors, shareholders and others.	Tri-3 MASB; GP8-i BNM
8.	Policy on late repayments and insolvent clients/bad debt written off.	Maali et al. (2006)
9.	Disclosure of non-allowable earnings or expenditure prohibited by *Shari’ah*:	
	i. Amount of earnings realised;	Tr*i*-3 MASB; Haniffa (2002)
	ii. Nature of earnings realised;	Tri-3 MASB; Haniffa (2002)
	iii. Amount of expenses;	Haniffa (2002); Tr*i*-3 MASB
	iv. Nature of expenses; and	Haniffa (2002); Tri-3 MASB
	v. Disposal manner of non-*halal* income.	Tr*i*-3 MASB
10.	Product or service reporting	AAOIFI
	i. Activities and % of profit contribution	Haniffa (2002)

11.	Reporting on significant concentrations of asset risks in the following areas: i. Geographical areas; ii. Customer groups; iii. Industry sectors; or iv. Other concentrations of risk deemed appropriate.	Tr*i*-3 MASB
12.	Bases of profit allocation between owners' equity and investment account holders (IAHs) (Please refer to the note for description on IAHs).	AAOIFI
13.	Reporting of concentration of sources of investment accounts and their equivalent and other accounts.	Tri–3 MASB; GP8-i BNM
14.	Disclosure of investment accounts distribution and their equivalent and other accounts in accordance with respective periods to maturity.	Tri–3 MASB
15.	Reporting on distribution of assets in accordance with respective periods to maturity or expected periods to cash conversion.	Tri–3 MASB; GP8-i BNM
16.	Disclosure of commitment and contingencies: i. Nature of commitments that are irrecoverable; ii. Amount of commitments that are irrecoverable; iii. Nature of contingencies arising from direct credit substitutes, transaction related contingencies, sales and repurchase agreements, and other contingencies of a similar nature; and iv. Amount of contingencies arising from direct credit substitutes, transaction related contingencies, sales and repurchase agreements, and other contingencies of a similar nature.	Tri–3 MASB; GP8-i BNM
17.	Reporting of co-mingling various types of deposit into a single funding pool: i. Method of income allocation among various categories of deposit.	Tri–3 MASB; GP8-i BNM
18.	Disclosure of profit distribution derived from investment of depositors' funds at the gross level: i. After deducting expenditure to the extent that they are directly attributable to the investment of those funds.	Tri–3 MASB; GP8-i BNM
19.	Reporting of specific investment accounts: i. Separate disclosure of profits or losses; and ii. Not to be offset with profits or losses from other items.	Tri–3 MASB; GP8-i BNM
20.	Adequate and timely disclosure: i. Information on investment accounts: ii. Method of calculation of profits; iii. Asset allocation; iv. Investment strategies; and v. Mechanics of smoothing any returns. vi. Information on any related party transactions and treatment of material events.	IFSB

	Employees, society and environment	
21.	Education and training / Human capital development.	Maali et al. (2006); Haniffa (2002)
22.	Recruitment policy.	Marsidi et al. (2016)
23.	Remuneration policy.	Marsidi et al. (2016)
24.	Career advancement policy.	Marsidi et al. (2016)
25.	Retirement policy.	Marsidi et al. (2016)
26.	Charities / gifts.	Maali et al. (2006)
27.	Social activities.	Maali et al. (2006)
28.	Policy on social issues.	Marsidi et al. (2016)
29.	Policy on environmental issues.	Marsidi et al. (2016)
30.	*Saddaqa* / donation.	Haniffa (2002)
	Auditing and governance	
31.	Statement of corporate governance should include the following: i. Board responsibility and oversight; ii. Internal audit and internal control activities; iii. Risk management; and iv. Management reports.	GP8-i BNM
32.	Existence of comprehensive governance policy framework that sets out: i. Strategic roles and functions of each organ of governance and the mechanisms of balancing their accountabilities to various stakeholders; and ii. Roles and authority of *Shari'ah* advisor or *Shari'ah* board in monitoring the IFI's activities pertaining to *Shari'ah* matters.	IFSB Tri-3 MASB; GP8-i BNM
33.	Investment account holders' (IAHs) rights to monitor investment performance, i.e. disclosure of policies and practices in respect of the investment accounts offered.	IFSB
34.	Disclosure of practices, procedures and entitlements that adequately address any undesirable ambiguity that are tantamount to *gharar* with respect to the profit equalization reserve (PER).	IFSB
35.	Disclosure of an appropriate mechanism for obtaining rulings from *Shari'ah* scholars, applying *fatawa* and monitoring *Shari'ah* compliance.	IFSB

36.	Information on compliance with the *Shari'ah* rules and principles as expressed in the rulings of the scholars.	IFSB
37.	Reporting of rulings of the *Shari'ah* scholars that are used to examine compliance with *Shari'ah* rules and principles.	IFSB
38.	Policy of treatment for non-compliant activities.	Marsidi et al. (2016)

Source: Marsidi et al. (2016)

4.2.3 Independent and Control Variables

The independent variables in this research are board diligence, board independence, board size, audit committee expertise, audit committee size, audit committee independence, and other committee held by audit committee members. Board independence denotes the percentage of outside directors on the board of directors. Outside directors also refer to or known as non-executive directors (Haniffa & Cooke, 2002).

The use of the percentage of outside directors to measure independence has been widely acknowledged in the literature (e.g. Samaha et al., 2012 and Ahmad Zaluki & Wan Hussin, 2010). Meanwhile, board size is measured by the number of directors on the board (Larmou & Vafeas, 2010 and Aktaruddin et al., 2009). Board diligence, on the other hand, is defined as the number of board meetings held throughout the year (e.g. Allegrini & Greco, 2011 and Laksmana, 2008).

The audit committee expertise and audit committee size are represented by the percentage of members who possess expertise in accounting or financial management and the number of audit committee members respectively whereas the audit committee independence is measured by the percentage of independent directors on the audit committee (e.g. Dhaliwal et al., 2010; Kent et al., 2010; Abbott et al., 2004; Felo et al., 2003; Raghunandan et al., 2001; Dezoort & Salterio, 2001). Further, additional committee service performed by the audit committee members, which is measured by the average number of other committees held by the audit committee members (Vafeas, 2005).

For control variables, the Islamic banks' profitability is represented by return on asset (ROA). ROA is a common measure for accounting performance (Mahoney & Roberts (2007). It is computed as earnings before interest and tax divided by total assets. As noted by Bozec and Laurin (2008) such a measure captures the return obtained by all capital suppliers. In this study, profitability is anticipated to have a positive effect on the IFSR.

The Islamic banks' size is also included as a control variable since the existence of any fixed financial reporting costs may lead to lower costs as a portion of firm size (Felo et al., 2003). Big Islamic banks will normally have more resources in terms of competent workers in the field of accounting that enable them to understand and disclose more with respect to the financial and social reporting items or components take place in Islamic banks. The present study hence anticipates firm size to have a positive relationship with the IFSR. The firm size in this study is measured by total assets.

4.3 Selection of Sample and Data Collection

This research examines 48 annual reports of the Islamic banks for the year ended 2007, 2008, 2009, and 2010 from the total of 12 Islamic banks i.e. Affin Islamic Bank Bhd, Al Rajhi Banking & Investment Corporation (Malaysia) Bhd, AmIslamic Bank Bhd, Asian Finance Bank Bhd, Bank Islam Malaysia Bhd, Bank Muamalat Malaysia Bhd, CIMB Islamic Bank Bhd, EONCAP Islamic Bank Bhd, Hong Leong Islamic Bank Bhd, Kuwait Finance House (M) Bhd, RHB Islamic Bank Bhd, and Bank Kerjasama Malaysia Bhd. The above Islamic banks are chosen because they have all the annual reports within the examination years.

To measure the weighted score of IFSR, each of the index items will bring 1 point to the Islamic banks. This is consistent with the scoring approach used by Hassan and Harahap (2010), Haniffa and Hudaib (2007), Haniffa and Cooke (2002), as well as Inchausti (1997). Altogether there are 38 points for the developed index items. Hence, the score of 1 is also given to items that have a few sub-items.

In this case, the final score for the main item, i.e. 1, is derived by first dividing the number of items scored with the total number of sub-items and then multiply by 1. The total number of sub-item is based on its relevancy to the respective Islamic banks. If it is not related to the Islamic banks or not provided by the Islamic banks, then the sub-item is not counted.

The issue of reliability and validity is also considered in this study. Therefore, to enhance the validity and reliability, the categories or items has been carefully developed from all relevant sources and thereafter carefully examined on the related documents (Hassan & Harahap, 2010; Haniffa & Hudaib, 2007 and Maali et al., 2006).

Further, the items of the index have been examined and decided with regard to the specific item that the items are intended to measure (Beattie & Thomson, 2007). In the context of this study, the items of index are developed from the MASB (i.e. Tr*i*-3), AAOIFI, IFSB and BNM (GP8-i) and the relevant contents of ISR developed and proposed by Maali et al. (2006) and Haniffa (2002).

In terms of reliability enhancement, the index items are coded and checked twice. Any possible discrepancy is taken into account and resolved. As asserted by Beattie and Thomson (2007), it is important to make sure that the same coder is consistent over the time when he or she is coding the same item of the index not only for stability but also for reproducibility (i.e. come out with the similar results when coding the same item) as well as accuracy.

To avoid bias in terms of judgement, the annual reports have been read entirely before coming out with any decision. The use of the standards, guidelines and established literature of ISR that are related and relevant to the context of this study is viewed as to enhance the validity of the index. And, the use of opinions from the practitioners (i.e. accountants) in giving the importance of items in the index is not only perceived as able to improve the validity of the index but also the results with respect to IFSR disclosure.

In addition to the annual reports, the study also adopts a questionnaire designed to collect the data regarding the views of the importance of items in the IFSR index. Each of the above Islamic banks is given 5 questionnaires. The questionnaires are specifically designed for accountants who are directly involved in financial accounting and reporting requirements at Islamic banks.

The questionnaire uses five (5) point scales because it is commonly found or used in research. This is perhaps due to its ability to produce slightly better mean scores relative to the highest possible scores achievable (Dawes, 2008). Number one (1) represents strongly not important whereas number five (5) denotes strongly important. The remaining numbers such as two (2), three (3) and four (4) represent not important, fairly important and important respectively.

4.4 Data Analyses Techniques and Reporting

This study makes use of descriptive statistics, namely, mean, median, and mode, to measure the central tendency of the data. Descriptive statistics such as standard deviation, skewness, and kurtosis are also used in order to measure the dispersion of the data. Before conducting multiple regression analysis, multicollinearity analysis is carried out to ensure the tested variables are free from the multicollinearity problem. In this study, data is analysed by using the Statistical Package for Social Sciences (SPSS).

The multiple regression analysis is suitable to be used as the main statistical technique in the research as it will ensure that all of the independent variables examined in this study will be measured or examined against the dependent variable i.e. IFSR. The use of other technique for instance the stepwise regression may possibly cause one or more independent variables to not be examined against the IFSR, which will lead to deviation from the main objectives of the research.

Moreover, the use of multiple regression is also viewed as more relevant over for instance another method namely ANOVA repeated measurement. In this study the pooled regression is utilised considering the nature of the Islamic banks, which are still in the early stage of their establishment except for Bank Islam Malaysia Berhad and Bank Muammalat Malaysia Berhad.

Considering the Islamic banks are still focusing on the issue of performance and survival rather than the issue of disclosure the study hence does not expect any form of differences among the Islamic banks within the years of examination. As noted by Abatecola (2012) as well as Carmelli and Markman (2011), only 33.33% of new born businesses survive during the first three years of establishment. As argued by Stinchcombe (1965), although declining with time or with age, the failure rates of businesses are much higher in the early years of operation.

5. Discussions on Multiple Regression Results

The Bivariate Pearson's Correlation test is conducted prior to the multivariate regression test. This is to ensure that the data are free from the multicollinearity problems. Based on the results, the data in this study is from the multicollinearity problem. The data is also free from the heteroscedasticity problem. Table 2 below presents the results of multiple regression analysis for the variables studied. As shown in the Table, the overall satisfactory fit of the regression is significant at 5% significance level. This is mirrored by the value of F-statistics i.e. 2.179 significant at 0.046.

Of the R square finding, the result points out that the regressed factors explain 34.0 % of the variation in the dependent variable. The figure suggests that the model can be considered as a good predictor for the dependent variable, which is the weighted IFSR score. This reflects that several variables used in this study can be considered good predictors for the dependent variable.

Table 2: Multiple regression results

Variables	Coefficients	t-statistic	Significance
Board Independence (Log Percentage of Ind. Outside Directors)	-0.134	-1.587	0.121
Board Diligence (Number of Board Meetings)	0.001	0.265	0.793
Board Size (Total Directors)	0.012	2.512	0.016**
Audit Committee Expertise (Percentage of Experts in Audit Committee)	-0.041	-1.065	0.294
Audit Committee Size (Rank No. of Audit Committee Members)	0.001	1.015	0.317
Audit Committee Independence (Rank Percentage of Independent Audit Committee Members)	0.000	0.316	0.754
Average Number of Other Committee Held by Audit Committee Members	0.004	0.446	0.658
Profitability (Rank of Profitability)	0.000	0.160	0.873
Size (Log Total Assets)	0.015	1.383	0.175
R Square	.34		
Adjusted R Square	.184		
F-Statistics	2.179 (.046)		

** Significant at 0.05 level

The significant positive relationship between board size and IFSR score could be an indication that there are differences in terms of the nature of works as well as how the directors at Islamic banks discharge their duties and responsibilities. At this juncture, the works of all directors may have required more time due to the uniqueness nature with regard to operations, products and services at Islamic banks.

As asserted by Safieddin (2009), within the context of Islamic banks in addition to the issue of performance, the Islamic banks need to ensure that the operations and activities are complied with the *Shari'ah*. This would require different nature of works from the perspective of the boards of directors. The boards hence need to ensure that the operations and activities carried out by the managements are in line with the interests of the stakeholders as well as the principles outlined by the *Shari'ah*.

This certainly requires Islamic banks to have more directors or to have big boards in order to effectively and efficiently undertake all the necessary responsibilities. In this regard, the significant relationship between board size and IFSR is consistent with the agency theory from an Islamic perspective whereby the Islamic banks need to ensure that all related information required by the respected stakeholders is disclosed. This would thus require meticulous work from more directors to ensure an appropriate level of accountability can be discharged.

Considering the different agency perspective of Islamic banks, the oversight roles of the directors of Islamic banks are dissimilar from their counterparts at the conventional banks. The main objective of the establishment of the Islamic banks to uphold socio economic justice reflects the importance for all of the directors of Islamic banks to carry out and execute their given duties or *amanah* at their very best.

The primary principle of business in Islam is regarding the prohibition of interest (*riba*). In this regard, the Islamic banks are not allowed to engage in any form of interest bearing borrowing or lending contracts (Archer & Karim, 2007). Thus, it is the responsibility of the directors to ensure that there are no elements of *riba* and any other prohibited fundamentals in any business transactions at their respective Islamic banks, which may require more time to complete the process.

Besides, the significant impact of board size on IFSR score could be also due to the newness of most of the Islamic banks except for BIMB and BMMB. In this context, the Islamic banks that have bigger board size enhance the IFSR score considering that more directors assist the Islamic banks in carrying out many of their monitoring roles that can be regarded as new particularly on the issues of performance, disclosure and compliance with the *Shari'ah*.

Moreover, many of the Islamic banks are classified as either subsidiaries or non full-fledged Islamic banks except for a few such as BIMB, BMMB, KFH and Al-Rajhi. Certainly, this kind of Islamic banks will need more directors in order to execute all the related duties effectively and efficiently that lead to better IFSR disclosure. The result pertaining to the board size is consistent with the assertion of Larmou and Vafeas (2010) that note the influence of bigger boards on board effectiveness.

The negative effect of the board independence on the IFSR score implies the acceptance of hypothesis two (2). The result could mean that the quality of work performed by all of the directors in Islamic banks is more or less the same regardless of whether they are executive, non-executive, or independent non-executive directors. This finding is in line with agency theory from an Islamic perspective that requires all operations and products and services to be in compliance with the *Shari'ah* at all time (Archer & Karim, 2007). In this respect, they have a common view in mind that all of their stakeholders are concerned that their monies are used in compliance with the *Shari'ah*.

Further, the submission and obedience to God are one of the meanings of the word Islam, which need to be upheld by all Muslims in all their activities (Al-Faruqi, 1982). The concept of corporate governance and accountability in Islam either in business or in other aspects of life therefore requires a total devotion to the will of God and involves both submission and a mission to follow the *Shari'ah* in all aspects of life (Baydoun & Willet, 2000).

The result pertaining to board diligence i.e. positive effect on the IFSR is in accordance with the prediction of the research, which suggests that hypothesis two (2) of the study is accepted. This result is consistent with the agency theory. In this respect, as argued by agency theory, the more the board meets in a year, the more issues can be resolved which includes the issue of disclosure.

Such finding reflects that the higher the number of the directors meets in a year, the better the IFSR score. The results thus show that board diligence is able to reduce the information asymmetry between the Islamic banks and the stakeholders through better IFSR disclosure. The finding is consistent with Allegrini and Greco (2011) and Laksmana (2008) which asserted that diligent boards that frequently meet are more likely to undertake their responsibilities diligently thereby leading to better disclosure.

On the other hand, the negative effect of audit committee expertise on the IFSR indicates that hypothesis four (4) needs to be rejected. The negative sign means that more experts in the audit committee will lead to a lower IFSR score. This result (i.e. negative relationship) could be due to the focus of the experts in the audit committee. In this regard, the findings indicate that the experts preferred the banks to emphasise on the issues that might or could have been affecting their performance rather than focusing on the issues of disclosure. As noted by PricewaterhouseCoopers/IIA (2000) the understanding on the variety of financial issues is, indeed, crucial for an effective audit committee.

The positive relationship between audit committee size and IFSR score shows that hypothesis five (5) is accepted. Such a result is consistent with the agency theory. The finding reflects that more audit committee members will enhance the IFSR score. The result supports the argument of Kalbers and Fogarty (1993) that large audit committees are more likely to be respected by the internal and external auditor which probably due to the more substantial effect of large audit committees

The finding on audit committee independence means that hypothesis six (6) is also accepted. The positive effect indicates that the higher the audit committee independence, the higher the IFSR score. The result is in line with the agency theory that argues that the more independent directors, offers more objective auditing processes in Islamic banks. This therefore enhances the amount of information disclosed i.e. IFSR by the Islamic banks. As noted by Allegrini and Greco (2011), more independent audit committees are able to reduce the information withheld by the management.

Finally, the positive relationship between the additional committee services and IFSR score is consistent with the anticipation of the research. The result is also consistent with the finding of Vafeas (2005), which implies that high number of other committees held by the audit committee members will lead to better IFSR score. Similarly, the positive relationship between profitability and IFSR score also points out the anticipation of the study is consistent with the result obtained. The positive sign suggests that the higher the return of the Islamic banks in terms of ROA the better the IFSR score will be. As noted by Owusu-Ansah (2000), the profitability of a firm may have some influenced on the quality of reporting.

The positive effect of the size of Islamic banks on the IFSR score is in line with the expectations of the study. This shows that the bigger the Islamic banks in terms of the total assets, the higher the IFSR score. The finding reflects that the bigger the assets possessed by the Islamic banks, the better their IFSR disclosure.

6. Conclusion

The results of the study denote that the board size is significant in explaining the IFSR score. The positive effect of the board size on the IFSR score indicates that the hypothesis three (3) of the research is to be accepted. The positive relationship of the board size on the IFSR score reflects that high number of directors will lead to better or higher IFSR score. Such a significant positive relationship could be mainly due to the differences in terms of the nature of works as well as how the directors at Islamic banks discharge their duties and responsibilities.

In this perspective, the directors at Islamic banks are not only responsible for managing the issue of performance but also on the issues of compliance of operations and activities with the *Shari'ah* as well (Safieddine, 2009). Hence, this increases the workload and the time taken for the directors to implement their duties and responsibilities. As a consequent, more directors have led to more effective segregation of duties among the directors that enable them to work more efficient in enhancing the IFSR disclosure.

The finding on the significant positive impact of board size on IFSR is perceived to have several implications on the theory, literature as well as the practice of Islamic finance and/or economics. Theoretically, the use of Islamic agency theory in this study suggests the importance of board size in ensuring that the Malaysian Islamic banks can disclose more information with respect to IFSR.

As such, this finding does not only contribute towards the use of Islamic agency theory but also contributes towards developing the structure of board of directors particularly in terms of the total number of directors on the board. The total number of directors should specifically be based on the nature and amount of supervision and monitoring that are required or needed at the respective Islamic banks.

Moreover, such a significant positive relationship between board size and the IFSR score also contributes towards the development of literature in the areas of corporate governance, disclosures and Islamic banks. In this respect, the result enriches the literature by highlighting and suggesting the essential aspect of board size as a governance mechanism that able to improve the financial and social disclosure practices at Islamic banks.

In terms of practice of Islamic finance and/or economics, the finding indicates that the size of board, which is represented by the number of directors who sit on the board, is a crucial governance mechanism in achieving the aims of Islamic banks. In this regard, it is viewed as to ensure that the Islamic banks properly discharge their accountability as mirrored through good IFSR disclosure.

Therefore, practically, this result of the study also contributes towards the development and sustainability of Islamic finance and economics in general and Islamic banks in particular both in Malaysia and internationally.

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