

ALTERNATIVE DISCLOSURE & PERFORMANCE MEASURES FOR ISLAMIC BANKS

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ABSTRACT

Despite the increasing disclosure of social and environmental performance and the trend towards multidimensional performance measures and such as the balanced score card, Western developed performance such as the ROI measures are based on the utilitarian positivist paradigm and targets mainly, if not only financial performance. Islamic institutions such as Islamic banks on the other hand, theoretically at least are creatures of the Islamic economic system established to achieve certain socio-economic objectives in line with the notion of establishing justice. This paper presents some alternative reporting and performance measures which could be used by Islamic banks which are more in line with their established objectives. In additions these measures are empirically used (within the constraints of information available) on two Islamic banks to compare their performances.

1. INTRODUCTION

Performance evaluation is a method of measuring a company's achievement based on the targets set earlier. It is a part of control measures that can help company to improve its future performance while identifying the deficiencies of its operation throughout the financial year. To have a sound and appropriate performance measurement system is utmost essential especially in today's borderless world in order to remain competitive and financially strong.

In Islam, performance evaluation is encouraged. Essentially, even each and every Muslim individual is required before going to bed everyday, at least to think about what he or she has been doing all the day. It is a way of *muhasabah*, whereby they can improve themselves while sincerely repenting for their sins.

Evaluating performance of *Islamic* financial institutions is as important as measuring the achievement of individuals. It is obvious that the role and responsibilities of *Islamic* financial institutions are not only confined to the financial needs of various stakeholders, but most importantly is how they conduct their business and the measures used in order to ensure that all the activities are in line with the requirements of *Shari'ah*.

Janachi (1995), cited in Suleiman (1999) is of the view that

Islamic banks have a major responsibility to shoulder...all the staff of such banks and customers dealing with them must be reformed Islamically and act within the framework of an Islamic formula, so that any person approaching an Islamic bank should be given the impression that he is entering a sacred place to perform a religious ritual, that is the use and employment of capital for what is acceptable and satisfactory to God (p. 101)

One way of measuring the performance of the organization is through indices. Even though, there are currently a few indices have been developed to evaluate the performance of organization, unfortunately, as far as the authors are concerned, no serious attempt has been made to develop an index and subsequently apply it to the *Islamic* financial institutions to gauge their performance. Therefore, such a deficiency has motivated the authors to come out with what we call *Islamicity* Index so that the performance of the *Islamic* financial institutions can be thoroughly evaluated.

This paper is organized as follows. In the next section, we review the literature regarding indices that have been previously developed. Next, we will focus on the development of the *Islamicity* Index. Subsequently, there will be a brief description of the *Islamic* financial institutions under study, followed by the application of the index. The limitation of the study will be explained in the separate section, before we conclude the article.

2.0 LITERATURE REVIEW

Before go into the development of our *Islamicity* index, it could be better if we look into indices that have been previously developed. In essence, there are few indices used to examine the various aspects of companies, namely disclosure index, corporate governance index and social responsibility index.

2.1 DISCLOSURE INDEX

Botosan (1997) for instance developed a disclosure index to find out the association between disclosure level and the cost of equity. To get the disclosure index for each sample firms, she has listed several items segregated into 5 groups which are background information, ten-or-five-year summary of historical results, key non-financial statistics, forecast information, and management discussion and analysis. For background information, one point was awarded for each item disclosed, and another point was awarded if there was quantitative information provided outside the basic financial statement. Meanwhile, for summary of historical results, one point is given if the summary is for five years, whereas two points for information of 10 years or more.

As for the disclosure of key non-financial statistics, two points were given to the firms if such information was provided. Specifically, if the firms could provide information pertaining to sales forecast and the likes of profits and capital expenditure forecasts, and disclosure of future opportunities, risks and plans, they were given two points but if they could provide a point estimate, three points were granted. Lastly, in terms of management discussion and analysis, one point was assigned for each item discussed, if only the detailed explanation could not be retrieved from the basic financial statements or there were footnotes to explain the changes from one year to another. Furthermore, another additional point per item was given if the information provided were in quantitative form. To avoid those large firms could

achieve higher scores because they have more disclosure opportunities due to the complexity of their organizational structures, the information provided by firms with multiple segments for instance, projected sales or earnings information of each segment was divided by the total consolidated earnings or sales for fiscal year end 1990 to find out the proportion of contribution. In addition, the disclosure index has been limited to items that all sample firms could choose to disclose and no multiple points were awarded for multiple references to the same disclosure item and importantly, quantitative information was weighted more heavily.

2.2 ENVIRONMENTAL DISCLOSURE INDEX

Another author, Sarah and Stanwick (1998) developed environmental disclosure index to examine the relationship between corporate social responsiveness and organizational characteristics i.e. size, financial performance, capital expenditures and pollution emissions. The environmental index used is basically a ratio comparing the number of environmental disclosures that are made internally by the firm with external environmental disclosures.

$$\text{Environmental Disclosure Index} = \frac{\text{Number of internal disclosures}}{\text{Number of external disclosures}}$$

Internal disclosures include environmental information made through annual reports, SEC Form 10-Ks and Company Reports. Meanwhile, for the external disclosures are environmental information captured from EPA Press Releases, newspapers, journals and magazines.

2.3 CORPORATE GOVERNANCE INDEX

Klapper and Love (2002) are one of the groups of authors who have written on the corporate governance index. According to them, Credit Lyonnais Securities Asia (CLSA) has produced corporate governance rankings for 495 firms across 25 emerging markets and 18 sectors. The corporate governance ranking is based on the 57 qualitative, binary (yes/no) questions. Each yes answer was given one point. The questions are further divided into seven categories, namely discipline (15%), transparency (15%), independence (15%), accountability (15%), responsibility (15%), fairness (15%) and social awareness (10%). For more details, refer to Appendix 1

Meanwhile, Black, Jang and Kim (2003) developed their own corporate governance index based on 123 variables from the survey questions. They have further excluded questions that are subjective, lack clear relevance to corporate governance, ambiguous as to which answer indicates better governance, had minimal variation between firms, overlap highly with another variable or had very few responses. Eventually, they have only 38 elements or questions that are useable for the development of corporate governance index. They classified these variables into four sub-indices: Shareholder Rights (5 elements); Board Structure (4 elements on board composition and the existence of audit and outside director nominating committees); Board Procedure (26 elements); and Disclosure (3 elements). An additional sub-index has been developed pertaining to the Ownership Parity. Subsequently, if the answer is yes, the firms will be given a point, while a 'no' answer will not be awarded any points.

2.4 SOCIAL RESPONSIBILITY INDEX

According to Griffin and Mahon (1997), several ways have been used to measure the social performance of a company. One of them is KLD index, which was developed by Kinder, Lyenberg, Domini & Co., Inc. This financial analysis firm created the index by assessing each company on eight dimensions of corporate social performance which were community relations, employee relations, environment, product, treatment of women and minorities, military contracts, nuclear power, South Africa involvement. The first five dimensions are assessed on a 4-point scale from major strength to major weaknesses. Meanwhile, the last three dimensions are assessed by a dichotomous scale: minor weakness or major weakness. KLD index is measured by summing up all ratings from major strength (+2) to major weaknesses (-2) to create an overall performance score.

3.0 ISLAMICITY INDICES

The development of indices to gauge the performance of *Islamic* financial institutions nowadays is seen important as there is a growing awareness among the Muslim community to assess how far these institutions have successfully achieved their objectives. As far as we are concerned, most Muslims now not only conscious about how much of return they can get at the end of the day, but more importantly, to where their money has been invested. Meanwhile, as for non-Muslims community such indices are beneficial to them in order to compare which bank has performed better, perhaps in terms of returns as well as the social responsibilities.

Therefore, the authors propose two types of indices. One is Islamicity Disclosure Index and another one is Islamicity Performance Index. These indices are developed to help the stakeholders i.e. depositors, shareholders, religious bodies, government etc to evaluate the performance of the Islamic financial institutions. Since the most accessible source of information is the annual report, the authors will try to assist the users of these annual reports so that from the limited information available in them, they can derive some conclusions on how the Islamic financial institutions have performed in the previous year, and how they are going to perform in the near future. Nevertheless, since the indices are developed merely based on what have been made available in annual report, perhaps it might give an inaccurate picture of the actual performance. However, this approach basically might induce the organization to disclose more information, not based only on the regulatory requirements but based on what they should disclose.

The Islamicity disclosure index is meant to examine how well the organization is disclosing the information that might be useful to the stakeholders. All the items chosen as are supported by the literature from various authors and sources. This index meanwhile can be further segregated into three major indicators, namely *Shari'ah* compliance indicator, corporate governance indicator, and social/environment indicator. For each information disclosed, symbol '√' will be given and subsequently will be awarded 1 mark. However, if the item is not disclosed in the annual report, symbol 'X' will be assigned and 0 mark will subsequently be awarded. At the end of the marking process, total information available will be divided by the total information should be reported. Each indicator i.e. *Shari'ah* compliance, corporate government and social/environment will be assigned weights and each respective weight should reflect their level of importance.

Meanwhile, Islamicity Performance Index deals with the performance of the organization. The performance measurement however is based only the information made available in the annual report. It includes the profit-sharing performance, *zakat* performance, equitable distribution performance and etc.

3.1 ISLAMICITY DISCLOSURE INDEX

As mentioned previously, *Islamicity* Disclosure Index consists of three main indicators namely, *Shari'ah* compliance, corporate governance and social/environment. This section will further explain the items that need to be included in the scorecard.

- ***Shari'ah* compliance**

In order to ensure that the practices and activities of *Islamic* banks do not contradict the *Islamic* ethical standards, *Islamic* banks are expected to establish a *Shari'ah* Supervisory Council (Abdala, 1994). Briston and El-Ashker (1986) argue that it is necessary for such a company like *Islamic* bank to establish a Religious Supervisory Council to monitor its performance in complying with the *Shari'ah* principles. In addition, Bucheery and Hood (1997) argue that the Religious auditors are in-house advisors who have responsibility of issuing a report to the users of the financial statements certifying that the *Islamic* banks have adhered to *Islamic* precepts in their financial transactions.

Bucheery and Hood (1997) asked the pertinent question as to whether religious auditors have a set of religious statements to audit analogous to the financial statements of the financial auditors. In addition, AAOIFI (2002) insists that the *Shari'ah* supervisory council are responsible to perform the *ex ante* and the *ex post* audit which enable it to justify to what extent the *Islamic* bank's operation comply with *Shari'ah* principles. According to Karim (1990) *Shari'ah* supervisory council is also involved in the accounting policy pursued by the bank.

Karim (1995) and Abdala (1994) argue that SSB should consist of Muslims scholars from three major disciplines such as *Islamic* jurisprudence, Law and Economics (accounting). Moreover, Karim (1990) opines, in performing their duties, the *Shari'ah* supervisory council members are guided by religious beliefs prescribed in *Qur'an*, *Sunnah* and *Ejma'a* (jurisprudence) which would be more valued than any legal rules and professional codes of ethics.

Based on the discussion among the *Islamic* scholars above, it is very obvious that *Shari'ah* supervisory board has very important role in ensuring the *Islamic* banks' *Shari'ah* compliance. We do believe that the existence of *Shari'ah* supervisory board in *Islamic* banks is a must. Thus, we opine that the existence of *Shari'ah* supervisory board in *Islamic* banks as one of the element of the *Islamic* banks' *Shari'ah* compliance.

According to the AAOIFI standards (2002) on Governance Standard for *Islamic* Financial Institution (GSIFI) No.1 regarding *Shari'ah* supervisory board: Appointment, composition and report, the existence of SSB in *Islamic* banks must be disclosed trough some requirements, such as procedures of the appointment; the composition, selection and dismissal; SSB report, and identification of actual activity conducted of the SSB. In addition,

we propose two others requirements such as the name, educational background and the experiences of the SSB members.

- **Basic information**

Islamic banks are considered as *Islamic* business institutions. Thus, Beekun (1997) opines that all *Islamic* business institution's operation have to follow an *Islamic* code of ethics. In addition, Karim (1990) and Hameed (2000) strongly dictate that the objectives of the establishment of *Islamic* bank are mainly to achieve *falaah* (the success in the world and in here after). It is supported by Mannan (1980) whereby he argues that the *Islamic* bank is intended to create a balanced and just society. Therefore, this particular objective is different from the conventional banks' objectives of maximizing profits for shareholders.

Mannan (1980) opines that the conventional bank is encouraged to earn higher profit rather than rendering services to the economic and social development. On the other hand, he argues that an *Islamic* bank is encouraged to earn profit but not profiteering. He defines further that profiteering is considered as unreasonably high profit and does not conform to general welfare of the society.

As mentioned earlier, the *Islamic* bank has different objectives with the conventional one. Sadeque (1980) claims that the *Islamic* bank is a financial institution, whose status rules and procedures expressly state its commitment to the principles of *Islamic Shari'ah* and to the banning of the receipt and payment of interest on any of its operation. Thus, the *Islamic* bank must be based on the *Islamic faith* and must stay within the limits of *Shari'ah* in all of its actions and deeds (Suleiman, 2000).

In regard to the *Islamic* banks' *Shari'ah* compliance issue, we suggest that the *Islamic* banks must disclose their objective, vision and mission. As argued above, those objectives, vision and mission of the *Islamic* banks must be inline with the ultimate objectives of the establishment of *Islamic* banks which is to achieve *falaah* (the success in the world and in the here after). In addition, the *Islamic* banks must disclose of all their principal activities with must comply with the *Shari'ah* principles (the *maqashid Shari'ah* and the *Islamic fiqh*).

- **Financial reports**

According to Harahap (2000), financial statements or annual reports represent a business language that allow management to communicate the financial condition of their organization, the result of operations, and other information to interested parties. The AICPA (1973, 1974), the FASB (1978), and numerous researchers contend that accounting performs a useful function by serving the needs of investors. The usefulness of accounting stands from a belief that if accounting can provide the information aiding investors in allocating their wealth, the market place would function efficiently and ensure maximum social welfare. APB Statement No 4 (1970) defines the objective for financial statements as follows:

The basic purpose of financial accounting and financial statements is to provide financial information about individual business enterprises that is useful in making decisions. These objectives are to present reliable financial information about an enterprise resource and obligation, economic progress, and other changes in

resources and obligation, to present information helpful in estimating earnings potential, and to present other financial information needed by users, particularly owners and creditors.

Hameed (2000) argues that the decision usefulness objectives are much influenced by the capitalist economic values. Moreover, he claims that the owners of a business separated from the day-to-day management of the business. Professional managers started controlling and managing large-scale business corporations. The interest of shareholders became restricted to dividend. As a result the long-term business objectives are to stay in business as long as possible and be able to generate high profit for company. It is in this economic context that decision usefulness paradigm was arrived.

On the other hand, in Islam, when the companies provide accounting information, they should not emphasize on the needs of certain group only. The accounting information should reflect others stakeholders such as employees, creditors, government and social as a whole. This is because the social aspect of Islam is based on the concepts of *Tawhid* (Unity), *Adalah* (Justice), *Ummah* (Islamic Community) and *Maslahah* (Benefit for the people) (Haniffa, 2002). In addition, she states that the concept of *Tawhid* implies that God (*Allah*) is one and the unique creator of everything in the heaven and earth. He is also the sustainer, beneficent and merciful. Thus, all actions should be directed to Him only.

Haniffa (2002) also claims that the promotion of justice will ensure that all parties in the society get their own right as a creation of Allah and guarantee the achievement of *falaah* (the success in the world and in the here after). Thus, for the *Islamic* business institutions, besides from financial objectives, other information related to the compliance of the organization in applying *Shari'ah* rules is important. It means that the information which concern on the transcendental, ethical, moral, and other religious state of the firm must be included in the annual report.

Hameed and Yaya (2003) claim that as one of the *Islamic* business institutions, the *Islamic* banks are not only obliged to report the information regarding the economic performance of the *Islamic* banks but also the information about the banks' achievements in fulfilling their proper and adequate financial reporting on *Shari'ah* compliance and social and environmental concerns as a whole of their stakeholders. It is supported by SFA (Statement of Financial Accounting) No. 1 on Objectives of Financial Accounting for *Islamic* Banks and Financial Institutions (AAOIFI, 2002). According to this particular statement, the objectives of financial reports of the *Islamic* banks should provide the following types of information:

1. Information about the *Islamic* banks' compliance with the *Shari'ah* principles
2. Information which indicate the prohibited earnings and expenditures in which they occurred and the manner in which they were disposed.
3. Information about the *Islamic* banks economic resources and related obligations to satisfy the right of the owners or the right of others.
4. Information to assist the concerns party in determination of *Zakat* on the *Islamic* bank's funds and the purposes for which it will be disbursed.

5. Information to assist in estimating cash flow that might be realized from dealing with the *Islamic* banks, the timings of those flows and the risk associated with their realization.
6. Information to assist in evaluating *Islamic* bank's discharge of its fiduciary responsibility to safeguard funds and to invest them at reasonable rate of return, and information about rates of returns on the bank's investment and the rate of return accruing to equity and investment account holders
7. Information about the *Islamic* bank's discharge of its social responsibilities.

In conjunction with the above, the AAOIFI standard (2002) has defined the basic elements of financial statements which consist of statement of financial position, income statements, statement of changes in owners equity or statements of retained earnings, statement of cash flows, statement of changes in restricted investments and their equivalent, statement of sources and users of funds in *Zakat* and charity fund, and lastly, statement of sources of fund in *qard* fund.

Siddiqi (1980) argues that in *Islamic* bank recognizes the capital and labor type relationship rather than the debtor and creditor relationship. It means that the *Islamic* banks should be the intermediary institutions for those who have capital (*rabbul 'mal*) and those who have skills (*mudharib/entrepreneurship*). Thus, the *mudharaba* (*silent partnership*) and *musyarakah* (*partnership*) should be the main instruments of the *Islamic* banks as the role of the *Islamic* banks in distributing the wealth to the society.

With regard to the elements of financial reporting, which *Islamic* banks should report, we opine that the *Islamic* banks should not report the same type of reports as the conventional ones do. We opine that the *Islamic* banks financial reporting should consist of several principles elements to attain the ultimate objectives of *Islamic* financial institutions. Basically we propose several elements that the *Islamic* banks should report such as information which identify clearly the *Islamic* investment and the non-*Islamic* investment, information which identify the *halal* (lawfull) and *haram* (unlawful) revenues, information which provide the statement of changes in restricted investments, information which provide the statement of sources and uses of funds in *Zakat* and *sadaqah* (charity) fund, information which provide the statement of sources and uses of funds in the *qard* funds, information which clearly identify the sources of revenue

Another element that can be used in justifying the *Shari'ah* compliance of the financial statements prepared by the *Islamic* banks is the issue of valuation. The valuation method is very essential for business especially for assigning values to assets. Correct valuation is important in order to describe the real financial value and situation of the company. By using historical cost, the company more on conservatism concept and therefore the company sometimes understate their value of assets and income (Carol et. al, 2002). While, Godfrey et. al. (1992) argue that when using current market valuation, the financial statements reflect the current situation.

Many accounting scholars tend to agree with this method (Baydoun and Willet, 2000; Mirza and Baydoun, 2000; Maliah, 2001; Hameed, 1998). Moreover in Islam, since the calculation of *Zakat* emphasizes on current valuation, this method is preferable. In addition, the

encouragement of the fair/market value principle has been enhanced with the establishment of AAOIFI standard. The benchmark standard that is recommended by AAOIFI is fair/market value principle (Para 88 and 89, SFA No. 2, AAOIFI standard, 2002).

However, the adoption of current valuation method is subject to some problems. Ijiri (1971) argues that the current cost valuation is subjective. This condition will create a situation whereby the adoption of current valuation will be becoming very subjective in nature since it will be determined by the managers' discretions although this discretion must be supported by the professionals' (the experts') opinions. Thus, it will lead to manipulation as the managers' uses their own discretion in valuing the asset (Ijiri, 1971). In addition, Ijiri (1971), further, claims that the publication of current value financial statement will cost more expensive than historical financial statements. It is simply because in order to adopt the current valuation method, the managers must hire professionals to provide reasonable opinions in order to value the assets. Another problem raised in the adoption of the current valuation method is that it will make the readers of financial statements become more confused since there are many methods proposed by the *Islamic* (accounting) scholars (Syahatah, 1971, etc.)

Hence, based on the above statements and standards, essentially the *Islamic* benchmark for the preparation of the financial report is the use of fair/market value principle. This particular valuation only can be used if there is strong basis of valuation (i.e. honest professional surveyor) and not just merely based on individual discretion to establish the relevance and reliability of financial report. However, the valuation problem should not be treated as an obstacle for adoption of the principle if it really can improve and make the financial report more in line with *Shari'ah*.

The authors propose the last element of the *Islamic* banks' financial reporting *Shari'ah* compliance is value added report. According to Belkaoui (1999), the Value Added Report differs from conventional accounting by a focus on value added as the measurement as wealth created and value added distribution as wealth distribution. He adds that the real wealth of the firms is value added rather than profit. Therefore, Corporate Report 1975 recommended the issuance of this statement to show how the benefits of the efforts of an enterprise are shared by employees, providers of capital, the state and reinvestment.

In this regard, the Value Added Report provides more progressive atmosphere surrounding the business to put the focus on all the partners rather than simply on the shareholders (Belkaoui, 1999). Further more, Belkaoui (1999) states that the measurement and disclosure of value added should generate a new spirit of cooperation between the workers, investors, governments and a new responsibility of the economic entities to all the members of the production team. Thus, the new responsibility and atmosphere may be fairer, taking into account each individual contribution as a basis for the distribution.

Baydoun and Willet (2000) attempt to discuss this particular issue from *Islamic* view point. They, further, consider that the Value Added Report is one of the elements of *Islamic* Corporate Report. They argue that the Value Added Report places greater emphasis upon the cooperative nature of economic activity and less on its competitive aspects as it is consistent with the religious principle of fair and considerate trading. The other importance of Value Added Report is also in deemphasizing those aspects of commercial behavior which are inconsistent with Islam. It stresses an entity performance from a community viewpoint as

opposed to focusing on an ‘individualistic’ entity performance from the viewpoint of the owners. Also, since Islam encourages the payment of *zakah* and donation for charity, this type of reporting is most likely suitable to be incorporated.

3.2 CORPORATE GOVERNANCE INDEX

Corporate governance has become an important issue especially during the last two decades (Chapra & Ahmed, 2002). Not until the recent corporate scandals involving gigantic corporations such as Enron, WorldCom, Global Crossing and so forth, the response of corporate entities as well as amongst the public themselves towards the significant of corporate governance are very disappointing. Nevertheless, the continuous financial downfall of many leading corporations have made the public especially investors more aware of the importance to demand high level of corporate governance practices from business entities which they have entrusted their money in them.

According to Lannoo (1995) as cited in Algaoud & Lewis (1999), the term corporate governance can be defined as ‘the whole system of rights, processes and controls established internally and externally over the management of a business entity with the objective of protecting the interests of all stakeholders’ (p. 3). In essence, having good corporate governance is now perceived as important in the world of economy as the government of countries (Gregory & Simms, 1999). Such comparison proves that corporate governance nowadays becomes a prerequisite for a business entity to remain competitive in its respective industries.

As compared to the Western conventional corporate governance, governance issues are quite different under *Islamic* financial institution (Algaoud & Lewis, 1999). This is because, since the focus in Islam is on the Unity of God, the institution not only have to obey a different set of rules (*Shari’ah*), but also oblige to meet the expectations of the Muslim community (and non-Muslim in general) by providing *Islamically*-acceptable financing modes. Obviously, without effective corporate governance, it may not be possible to strengthen *Islamic* banks and to enable them to expand rapidly and perform their role effectively (Chapra & Ahmad, 2002). More than that, weak corporate governance systems, together with corruption and cronyism, have been associated with distortion in the efficient allocation of resources, undermine opportunities to compete on a level playing field and ultimately hinder investment and economic development (Gregory Simms, 1999)

Good corporate governance is actually one of the teachings of Islam. The essence of corporate governance is *amanah*, whereby corporations are required to manage the funds entrusted to them in an effective and efficient manner. Furthermore, as there are growing pressure on the role to be played by corporations, they have to be sure that they have to be able to contribute to the development of society as well as to ensure that their business activities do not give adverse impacts towards the environment and community surroundings them. Therefore, it is important to thoroughly evaluate how a particular business organization (in this case, *Islamic* institution) has performed in terms of corporate governance practices.

- **Corporate Governance Indicators**

Weak reporting and disclosure practices might originate from a failure in the corporate governance. This might be true in the sense that reporting is a means of communicating the information to the users so that they can subsequently make an informed decision. Reporting

organizations with problem in corporate governance may tend to disclose less information to avoid any rigorous scrutiny by external parties. Hence, it is worthwhile to determine the level of corporate governance practices of a company by carefully examining the disclosures made in the annual report. Several items as stated in the Code of Best Practices for Corporate Governance in *Islamic* Financial Institutions (Chapra & Ahmed., 2002) and Malaysian Code on Corporate Governance have been cautiously chosen as a checklist to determine the Corporate Governance Indicators.

a. Composition of Board of Directors

The key to good governance lies in getting the right board in place. Thus, each and every *Islamic* financial institution should be headed by an effective board which should lead and control the institution. This is to ensure that the interests of various stakeholders will be protected. However, to have an effective board, few guidelines need to be followed by the institution.

- i. The board of directors comprises at least one-third of independent non-executive director. This is in accordance of Malaysian Code on Corporate Governance, Explanatory Note 4.21. According to Gregory et al. (1999), even most governance guidelines and codes of best practice agree that some degree of director independence is important to a board's ability to exercise objective judgment concerning management practices. The independence, even though might vary in interpretations, most of the definition associate independence with either lack significant family and business relationships with management (Gregory & Simms, 1999; Malaysian Code on Corporate Governance) and independence from a significant shareholder (Malaysian Code on Corporate Governance). However, as compared to the stringent requirement set by the Malaysian Code on Corporate Governance, Item 2.1 of the Code of Best Practices for Corporate Governance in *Islamic* Financial Institutions (CGIFI) just stated that it must be at least one-third of the board members should be non-executive, while Item 2.3 later emphasizes that the majority of non-executive directors should be independent. Mathematically, if both clauses are combined, it only comes out that two out of nine (2/9) directors should be independent non-executive. Since more independent non-executive we believe will ensure high level of corporate governance, Malaysian Code on Corporate Governance, Explanatory Note 4.21 is selected for the criteria.
- ii. The board of directors has representative from *Shari'ah* board. According to Item 1.6 of Code of Best Practices for CGIFI, apart from having a balance of executive directors and non-executive directors, the board of directors should include representatives from the *Shari'ah* board. This is basically to ensure that no individual or small groups of individuals can dominate the board's decision taking and all activities conducted by the entities are compliant to the *Shari'ah* requirements.

b. Appointment and Re-appointment

- i. The directors retire by rotation once in three years and subsequently eligible for re-appointment. Item 1.5 of Code of Best Practices for CGIFI and Malaysian Code on Corporate Governance both stated that each board of director shall assume the position for at most three years. Subsequently, they should be required to submit themselves for re-election. Such practice is basically to ensure that the performance of a particular director can be sufficiently evaluated. If the performance is good, it will be resulted in re-

appointment. However, if the performance throughout the 3 years is not satisfactorily, therefore, the member should be fairly substituted with another candidate who deemed suitable to assume the position.

- ii. The re-appointment of non-executive directors is not automatic. According to Item 2.7 of Code of Best Practices for CGIFI, non-executive directors should be appointed for specific terms and their reappointment should not be automatic. Meanwhile, Item 2.8 clearly stated that non-executive directors should be appointed through a formal process and their appointment should be a matter for the board as a whole.
- iii. The terms of appointment of the non-executive directors are disclosed. Item 11.6 of Code of Best Practices for CGIFI proposes that the terms of appointment of the non-executive directors should be disclosed in the annual report and accounts of the institution. In addition, non-executive directors who are considered independent should be clearly identified.

c. Board Meetings

- i. Board meetings were conducted at least four times a year. Even though according to Code of Best Practices for CGIFI as stated under Item 10.1 whereby full board meetings should be held no less frequently than every six months, we tend to follow the suggestion made by Black, Jang and Kim (2003) whereby firm should hold four or more regular board meetings per year. Meanwhile, the KLSE/Price Waterhouse Coopers survey committee, it is difficult to imagine how a board is in control of the company if it meets less than four times (Malaysian Code on Corporate Governance, 2000, p. 31)
- ii. Number of board meetings held in a year and the details of attendance of each individual director in respect of meetings held are disclosed. This is in accordance to the guidelines set in Malaysian Code on Corporate Governance whereby Explanatory 4.44 stated that the directors should be required to disclose the number board meetings held a year and the details of the attendance of each individual director to enable shareholders to evaluate the commitment of a particular director to the affairs of the company. It is then for the shareholder to satisfy himself whether the board is in control of the company.
- iii. Directors attend at least 75% of meeting on average. Despite not being mentioned in both Code of Best Practices for CGIFI and Malaysian Code on Corporate Governance, the criteria proposed by Black et al. (2003) seems relevant and important in the sense that it helps the users of annual reports to evaluate the commitment shown by each member of directors. By looking at the attendance, one can sort of examining how responsible and accountable the members in discharging their duties.

d. Directors' fees and remuneration

- i. Directors' remuneration is disclosed. According to Malaysian Code on Corporate Governance, Explanatory Note 4.10 stated that company's annual report should contain the details of remuneration of each director. This practice basically promotes the important principles of fairness and accountability. By disclosing such information, it could enhance transparency and subsequently the issue whether the directors were underpaid or overpaid can be easily identified.

ii. Separate figures for salary and performance-related elements, and the basis on which performance is measured are explained. While the levels of remuneration should be sufficient to attract and retain the directors needed to run the institution successfully, Item 3.3 of Code of Best Practices for CGIFI explicitly demands that separate figures should be given for salary and performance-related elements and the basis on which performance is measured should be explained. Similarly, Item 11.5 requires that there should be full and clear disclosure of the directors' total emoluments and those of the chairman, including pension contributions and stock options, if any.

iii. Shareholders approve directors' aggregate pay. Black et al. (2003) include this criteria as an indicator of good corporate governance. We agree to this in the sense that such practice can be used as a tool to control the level of pay received by directors and subsequently will avoid dissatisfaction among the shareholders.

e. Nomination committee

i. The company has nomination committee. Item 1.4 of Code of Best Practices for CGIFI requires a formal and transparent procedure for the appointment of new directors to the board, by having a nomination committee. Basel (1999) stated that a nomination committee is salient in providing important assessment of board effectiveness and directing the process of renewing and replacing board members. According to Malaysian Code on Corporate Governance, Explanatory Note. 4.33, even though the function can be performed by the board as a whole, as a matter of best practice it recommends the responsibility to be delegated to a committee.

ii. The committee should exclusively consist of non-executive directors which majorities of whom are independent. Malaysian Code on Corporate Governance proposed that the committee of directors composed exclusively of non-executive directors, a majority of whom are independent. Here, the emphasis is on the non-executive and independent criteria so as to avoid any conflict of interests while performing the duties.

f. Remuneration Committee

i. Remuneration Committee in accordance with Items 1.14 and 1.16 of Code of Best Practices for CGIFI, is to be formed to ensure that the compensation policy is consistent with the institution's culture, objectives, and control environments and to provide oversight of the remuneration of senior management and other key personnel.

ii. Remuneration consisting wholly or mainly of non-executive directors. Apart from the need of having remuneration committee to determine remuneration packages of executives, Malaysian Code on Corporate Governance requires the committee to consist wholly or mainly of non-executive directors and urges for outside advice should the need arises. This is definitely for transparent distribution to reflect fair and justice in Islam. However, as for the remuneration for non-executive directors, including non-executive chairman, it should be determined by the board itself.

iii. Membership of the remuneration committee should appear in the directors' report. Remuneration is a serious issue since it involves the use of company's resources. Therefore, stakeholders especially shareholders and the employees should know who is responsible in determining the remuneration scheme. Thus, it is important to list the

members of the committee as per requirements set under Malaysian Code on Corporate Governance, Explanatory Note. 4.59.

g. Audit Committee

- i. There is an audit committee. Audit Committee is responsible to review and supervise the company's financial reporting and to provide oversight of the institution's internal and external auditors and related issues (Item 1.16 of Code of Best Practices for CGIFI). The issues such as auditors' appointment and dismissal, reviewing and approving audit scope and frequency, receiving their reports and ensuring management is taking appropriate corrective actions in a timely manner to address control weaknesses, non-compliance with policies, laws and regulations, and other problems identified by auditors (Basel, 1999, p. 7).
- ii. The Audit Committee consists of at least three non-executive directors, a majority of whom are independent. This is a combination of requirements as set out under Item 4.60 of Malaysian Code on Corporate Governance and Code of Best Practices for CGIFI. Under Malaysian Code on Corporate Governance, Explanatory Note 4.60, it requires the audit committee to comprise of at least three directors without identifying whether such director should be executive or non-executive. However, Item 8.5 of Code of Best Practices for CGIFI uses non-executive criteria as the requirement. Thus, to raise the standards of corporate governance, it should consist of majority of independent non-executive especially the Chairman of Audit Committee.
- iii. Audit committee includes someone with expertise in accounting. According to Black et al. (2003) and Basel (1999), to better enhance the independence of this committee, it should comprise of external board members that have any accounting, banking or financial expertise. This is to ensure that the committee has robust understanding on the business operation.
- iv. Audit committee recommends the external auditor at the annual shareholders meeting. Audit committee needs to recommend external auditor during the annual general meeting (Black et al., 2003). External auditor is important to ensure that the operations of the business entities are being verified by external parties. Such verification will add to the high integrity of corporate governance.
- v. At least, once a year the committee met with the external auditors without executive board members present, to review financial statement. According to Malaysian Code on Corporate Governance, Explanatory Note 4.62, the Finance director, the Head of Internal Audit (where such a function exists) and a representative of the external auditors shall normally attend meetings (p. 39). While other board members may attend such meeting by invitation, it is required that at least, once a year the committee met with the external auditors without the presence of executive board members.
- vi. Details of the activities of audit committees, the number of audit meetings held in a year and details of attendance of each individual director in respect of meetings are disclosed. Such information need to be disclosed in the annual report so that shareholders will be able to evaluate the commitment of a particular director. Besides, by detailing the activities and disclosing the number of meetings held annually will assure that the

committee has been doing their job in ensuring the activities of the organizations are of high integrity.

- vii. Audit committee members attend at least 75% of meetings on average. Likewise the attendance of directors to the meeting, total number of meetings attended by each member of the committee indicates that his/her appointment as the member has paid off. 75% as proposed by Black et al. (2003) is relevant in measuring how serious each member in discharging their duties.

h. *Shari'ah* Supervisory Board

The *Shari'ah* Supervisory Board (SSB) is important to ensure that the current operations of the bank conform to *Shari'ah* principles. Therefore, the indicators as we suggest below could enhance the integrity of the SSB so as to increase the level of confidence among Muslim community towards the *Islamic* financial institutions.

- i. Include someone with expertise in accounting. This criteria is important so that the board has robust understanding in what is happening in the day-to-day operations of the entities. Naser & Pandlebury (1997) expressed their worries that because of lacking in the accounting knowledge, the SSB may be ignorant of the true implications of the very complex financial products and transactions brought before them. Thus, knowledge in *Shari'ah* principle, coupled with knowledge in business, accounting or finance will help the board to be of high independence while making decision.
- ii. SSB meets with audit committee and/or external auditor to review financial statement. As compared to the conventional institutions whereby they only have one type of audit, *Islamic* financial institutions have two types: external audit and *Shari'ah* supervisory audit. Here, the *Shari'ah* Supervisory Board should actually become check and balance with the external auditor. Thus, they have to meet with audit committee and/or external auditor not only to review the financial statement, but also in reviewing the whole operation of the business.
- iii. Details of the activities of SSB, the number of board meetings held in a year and details of attendance of each individual member in respect of meetings are disclosed. Such information need to be disclosed in the annual report so that shareholders will be more confident in having transactions with *Islamic* banks. Besides, by detailing the activities and disclosing the number of meetings held annually will assure that the board has been doing their job in ensuring the activities of the organizations are in line with the *Shari'ah* requirements
- iv. SSB committee members attend at least 75% of meetings on average. Likewise the directors and audit committee, each member of the *Shari'ah* Supervisory Board are expected to attend at least 75% of the meeting held per year. That is why it is important in their report they should disclose how many meetings have been conducted throughout the year, the attendance of each member as well as the description of their duties rather than merely few lines of sentences just to conclude that the activities are in line with *Shari'ah* requirement.
- v. SSB is independent body. According to Karim (1990), cited in Naser and Pandlebury (1997), one of the two problems facing by the financial reporting system of *Islamic* Banks

is the independence of the SSB. This is because, in-house SSB (appointed by the company), may not be independent of the bank's management even though it may try hard to be independent. Chapra et al. (2002) even proposed the necessary to create a centralized *Shari'ah* Board (for each country) to clear the *Shari'ah* compatibility of various modes and instruments of finance used by banks. The existence of decentralized SSB leads to conflicting opinions which creates inconsistency and uncertainty. Thus, if the SSB is appointed and remunerated by the company, we consider it to be dependent.

i. Others

- i. Directors and senior management are qualified persons in terms of educational background, working experience etc. There are few items discussed in the Code of Best Practices for CGIFI that show how important those who appointed as directors and senior management are really qualified. For instance, item 1.3 whereby board members not only must be qualified person, but also must have a clear understanding of their role in corporate governance. Meanwhile, item 2.2 discusses on the appointment of non-executive directors and claims that the composition of people from a wide range of backgrounds will be able to make a better contribution. Moreover, Basel (1999) stated that the individuals appointed as senior management must have the necessary skills to manage the business under their supervision. The quality, experience and independence of a board's membership directly affect board performance. Such information can be obtained from the background of the board's and management's members.
- ii. Chairman and CEO are different persons. Chairman of the board and CEO perform two distinct jobs in any organization. Therefore, it is preferable to have two different individuals to hold these two positions (Item 1.7 of Code of Best Practices for CGIFI). There should be a clearly accepted division of responsibilities to ensure a balance of power and authority, such that no one individual has unfettered powers of decision. However, if these two positions happen to be held by a single person, according to the Item 1.7, it is essential that there should be a strong and independent element on the board, with a recognized senior member (p. 145). Furthermore, Malaysian Code on Corporate Governance, Explanatory Note 4.18 even requires the decision to combine the roles of Chairman and Chief Executive should be publicly explained. Hence, we consider that the institution would have good corporate governance if the Chairman and CEO are different persons.
- iii. There is a Risk Management Committee. Apart from nomination, remuneration and audit committee, a financial institution should also have Risk Management Committee. Based on Item 1.16 of the Code of Best Practices for CGIFI, the function of Risk Management Committee is to provide oversight of senior management's activities in managing different risks. Such risks will include credit, market, liquidity, operational, legal and other risks of the bank (Basel, 1999). In addition, this role should include receiving from senior management periodic information on risk exposures and risk management activities.
- iv. English disclosure exists. Stakeholders can be from various different races, religions, culture and even languages. Therefore, apart from having annual report written in official language of the countries where the financial institution resides in, there is a necessary to provide English translation as a signal of transparency (Black et al., 2003)

- v. Apart from that, the Code of Best Practices for CGIFI also required few things to be disclosed: a statement on Corporate Governance, the maintenance of an effective system of internal controls, and director's report

3.3 SOCIAL/ENVIRONMENT INDEX

Under this type of indicator, the focus is on the environmental and social disclosure. First and foremost, we have to look at the emergence of the environmental reporting and social reporting. According to Baydoun and Willet (2000), there are differences between Islamic Accounting and conventional accounting in terms of principles and disclosures. Some of the characteristics of Islamic Accounting are profit is not the sole motive, promoting equity between people, providing a fair share for the weak and the strong and serious consideration on environmental impacts.

Meanwhile, the evolution of environmental reporting since the previous 20 years has actually reached a level of emerging common practices based on a shared understanding of environmental processes. At this time, the repeated appearance of certain environmental categories, aspects and indicators provides a foundation for a common information base (GRI, 2000).

Apart from the concern over the environmental issues, another type of accounting which has emerged prior to the environmental accounting is none but social responsibility accounting. It refers to the disclosures of financial and non-financial, quantitative and qualitative information about the activities of an enterprise. Social responsibility accounting in essence, concentrates on the social issues that might include the employee reports, human resource accounting, and industrial democracy issues (Mathews, 1994).

Social responsibility disclosures are even important nowadays in the sense that it actually reflect how the organizations have successful in discharging its contract with a group of stakeholders. Matthews (1994) further claimed that "socially related arguments are used where additional disclosures would be made to establish the moral nature of the corporation, to satisfy the implicit social contract between business and society and to legitimate the organization in the eyes of the public" (p. 9).

Apart from having appropriate mission and targets for environmental and social aspects, each and every organization should disclose on how they go about in achieving the targets and objectives. As for the case of Islamic banks, certain information needs to be disclosed:

1. Energy saving

Energy usage might also be disclosed, in both monetary and non-monetary terms: monetary disclosures as part of the regular accounts, and non-monetary measurements as Social Responsibility Accounting (SRA). The information could also be recognized to demonstrate savings, in the case of a production operation, by means of units of output per unit of energy used. One argument in favour of disclosing non-financial measurements of energy usage is that it avoids the problem of energy pricing and valuation. It is impossible to make monetary comparisons between periods without using an index. "In the absence of a general agreement on indexed financial reporting, the use of non-financial measures would appear to be appropriate" (Mathews, 1994, p.83).

2. Community relation

Measures of community welfare and good neighborliness are often high on any list of social responsibility accounting disclosures discussed in the literature. “Items such as contributions to charity, local rates and taxes paid, training programmes for local employees, recycling of waste products, and contributions to sporting and educational organizations would be good examples. Many US corporations produce social reports to publicize these activities” (Mathews, 1994, p.84).

However, it must be recognized that disclosures under this heading would have to be full and frank, rather than biased towards only the ‘good news’. Furthermore, the public reaction to particular biased information may not be what the organization wants or perhaps expects. This is because previous findings indicated that the voluntary environmental disclosures were rather incomplete and provided inadequate disclosures. Even if we look in the United States, the social responsibility has been defined as the responsibility towards the community in which the organization operated (Gray, Owen and Adams, 1996).

3. Reporting on employee issues

There were significant changes in the labor law, employee empowerment and the strength of trade unions regarding the employees’ rights to the information in the 1970s. (Gray et al., 1996) Thus, companies should take initiative to publish an employment statement which sets out information about its workforce and employment policies which are relevant not only to employees themselves but to shareholders and others concerned with the company. The aim is to provide sufficient information about the workforce and about the way in which the employment resources are managed to give an indication of the effectiveness of management in this crucial area of the company’s activities (HMSO, 1997, cited in Mathews, 1994). For instance, the company should disclose information regarding employee turnover, employment and training policies, trade unions and participation in decision-making, the number of accidents in factory, retirement and sick-pay policies, and equal employment opportunities for the disabled (Mathews, 1994).

4. Compliance with regulation and permit (e.g. fine)

As far as the environmental issues are concerned, company has to take steps in order to ensure that they preserve the environment and does not contribute to the environmental illnesses. Therefore, according to GRI (2000), the company should disclose any penalties which associated with the violation of environmental and social regulations.

4.0 DEVELOPMENT OF FINANCIAL INDEX

4.1 Profit sharing ratio

The main objective of Islamic Banking is profit sharing. Thus, it is important to identify how far the Islamic banks have successfully achieved the objective of their existence. The following formula has been constructed to examine the above mentioned situation:

$$\frac{\text{Mudaraba + Musyarakah}}{\text{Total financing}}$$

The formula will be used for both banks for two accounting periods. Therefore, we can clearly see how the banks have used the profit sharing activities in relation to the total financing as well as look at its trends, whether it is increasing, decreasing or remain unchanged.

4.2 Zakat performance ratio

Zakat, as proposed by various authors (Shahul, 2000; Baydoun & Willet, 2000) should be one of the objectives of Islamic Accounting. Moreover, *Zakat* itself is one of the commandments in Islam. Therefore, we believe Islamic bank performance should be based on the *Zakat* paid by the Bank to replace the conventional performance indicator which is earning per share (EPS). The wealth of the bank should be based on the net worth (net asset) rather than net profit that has been emphasized by conventional method. Therefore, if the bank net worth is higher, definitely it will pay high *Zakat*. As a consequence, we propose the following formula:

$$\frac{\text{Zakat}}{\text{Net asset}}$$

4.3 Equitable distribution ratio

Apart from profit sharing activities, Islamic accounting also seeks for equitable distribution among people. Therefore, this indicator basically trying to find out on how revenue obtained by the Islamic banks have been distributed among various stakeholders which is represented by the amount spent for qard and donation, employees' expenses and etc. For each item, we are going to calculate the amount distributed over the total revenue after deducting *Zakat* and tax paid.

4.4 Directors - Employees welfare ratio

Directors' remuneration has been an important issue. Many claims that directors have been overpaid as compared to the work they have done. Therefore, it is essential to identify how much money has been spent for directors' remuneration as compared to the money spent towards employees' welfare. Employees' welfare here includes salaries, training etc. The following ratio is used:

Average directors' remuneration ¹ :	Average employees' welfare
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4.5 Islamic Investment vs Non-Islamic Investment

As far as we are all concerned, Islamic principles prohibit transactions involving *riba'*, *gharar* and gambling but at the same time encourage *halal* trade. Thus, it is required for the Islamic banks to disclose truthfully any investment which is considered *halal*, and which one is prohibited. Failure to explicitly disclose such information might give misleading and inaccurate picture of the business activities of Islamic banks. The formula is as follows:

¹ Total directors' remuneration per head

$$\frac{\text{Islamic Investments}}{\text{Islamic Investments} + \text{Non Islamic Investment}}$$

4.6 Islamic Income vs Non-Islamic Income

Apart from segregating the investments into Islamic and Non-Islamic, such segregation is also needed for income. Thus, Islamic banks should only receive income from halal sources. In addition, according to Shahul et al. (2003), if the Islamic banks do have income from prohibited transactions, the banks should disclose the information regarding such earnings, their sources, how they were disposed of and more important, any procedures available to prevent entering into transactions prohibited by the *Shari'ah*.

$$\frac{\text{Islamic Income}}{\text{Islamic Income} + \text{Non Islamic Income}}$$

4.7 AAOIFI Index

This index is to measure how far the Islamic financial institutions have complied with the principles laid down in AAOIFI. The calculation is based on the number of principles which followed AAOIFI to the total accounting principles applied.

5.0 IMPLEMENTATION OF ISLAMICITY DISCLOSURE INDEX

The authors have agreed to choose two banks which are Bank Islam Malaysia Berhad (BIMB) and Bahrain *Islamic* Bank (BIB). The selection of these two banks are basically based on the argument that they are established in two different countries where the *Islamic* banking and finance has been immensely developed.

5.1 *Shari'ah* compliance Indicator

	Item	BIMB	BIB
1	<i>Shari'ah</i> Supervisory Board		
	a. The appointment of SSB	X	X
	b. The report of SSB	√	√
	c. Identification the actual activity conducted	X	√
	d. The SSB members' background (Name, Educational background, experiences)	√	√
2	Basic of Information		
	a. The Vision, mission and objectives	X	√
	b. Principal activity	X	√
3	Financial Statement		
	a. Identification of <i>Islamic</i> investment	√	√
	b. Identification of non- <i>Islamic</i> investment	√	√
	c. Identification of <i>Islamic</i> revenue	√	√
	d. Identification of non- <i>Islamic</i> revenue	√	√
	e. Provide the statement of sources and uses of funds in <i>Zakat</i> and charity	X	√
	f. Provide the statement of sources and uses of funds in the qard funds	X	√
	g. Identification sources of revenue :		
	a. excluded revenue attributable to depositors	√	√
	b. excluded revenue attributable to <i>Murabaha</i> financing	√	√
	h. The adoption of current value whenever it is possible	√	√
	i. Value added statement	X	X

Analysis on the *Shari'ah* Compliance Indicator

Based on the table above, we may conclude that the Bahrain *Islamic* Bank (BIB) has fulfilled most of *Shari'ah* compliance indicators. In regard to the *Shari'ah* Supervisory Board (SSB) section, the BIB has failed to disclose the appointment of SSB members. This particular disclosure will inform the reader about the mechanism of selection and discharge of SSB members. This is similar with the Bank Islam Malaysia Berhad (BIMB) as it does not disclose either the appointment mechanism of its SSB members.

We argue to include the appointment mechanism of SSB members as part of the SSB section because from this information it will be seen clearly the independence of SSB members in performing their role. The SSB members will not be able to perceive to be independent in appearance if the appointment of SSB members is determined by the *Islamic* banks board of directors unless they are appointed by the shareholders in the Annual General Meeting (AGM) (GSIFI No. 1 Para 3-6, AAOIFI, 2002). Yet, regardless the mechanism of SSB members' appointments, Karim (1990) argues that the SSB members are perceived to be independent in mind in performing their role because they are guided by *Qur'an*, *hadith*, and *Ejma'* (consensus among the *Islamic* jurists).

However, compare to the BIB, the SSB of BIMB issues a short form of SSB report which does not fit with type and form of report as prescribed in the AAOIFI Accounting, Auditing and Governance standard (2002) (GSIFI NO.1 Para 10-20). Thus, the SSB of BIMB's type of report does not disclose the actual activity conducted in performing their role. This particular report is signed only by two of SSB members where as the BIB SSB report is signed by all of the SSB members. Thus, we conclude that in SSB section; the BIB annual report has disclosed more as compared to the BIMB annual report.

Lastly in this particular section, the BIB has disclosed the SSB members' background (name, educational background and experiences) in its annual report. Yet, the BIMB has disclosed its SSB members' background in its holding annual report. We opine that this particular disclosure is considered important in enhancing the reliability of SSB members in performing their role. In addition, by providing this disclosure, the users of annual report are able to find out whether the SSB of the *Islamic* banks' educational backgrounds met the requirements prescribed by AAOIFI (2002). We conclude that based on their backgrounds provided in the annual statements, both SSB members of BIB and BIMB are met with the AAOIFI (2002) requirements.

As argued by several authors (Mannan, 1980; Karim, 1995; Hameed, 2000) the objectives of *Islamic* banks are mainly to achieve *falaah* (the success in the world and in the here after). It is not meant that the *Islamic* banks are prohibited to generate profit form their activities. In addition, the *Islamic* banks are allowed to generate profit but not profiteering (Mannan, 1980). These philosophical objectives must be reflected in the *Islamic* banks' vision, mission and objectives. In addition, the *Islamic* banks are obliged to conduct their activities, which are inline with their vision, mission and objectives.

In the BIB annual report, it is clearly stated that their vision is to be a leading and a diversified domestic and regional *Islamic* banks. In addition, the BIB states that their mission is to be a leading *Islamic* bank which provides innovative retail and corporate banking products and services to their customers with continues development of human and technology resources. It is interesting to elaborate the BIB's objectives whereby the first objective clearly state to be fully comply with *Islamic* values. In addition, the BIB also states that one of its objectives is to give contribution towards the development of an *Islamic* economic model. However, the BIB still includes the maximization of shareholders value as one of its objectives. In this regard, we conclude that the BIB has recognized the *Islamic* values and ethics in their objectives, but the BIB cannot be escaped from the capitalism environment values in defining its objectives. However, the BIMB's financial reporting does not mention any information regarding its vision, mission, objectives and principal activity.

Last section in the *Shari'ah* compliance indicator is the financial reporting. As argued that the objectives of financial reporting of *Islamic* banks are not only dominated by the spirit of decision usefulness. It means that the information content in the financial reporting is only meant for the shareholders' interest. Rather it is concern on the stakeholders' interest as a whole. It is considered as the *Islamic* banks' accountability to the society. Yet, Hameed (2000) claims that Islam recognizes dual accountability; the fulfillment of accountability to human (society) is part of the fulfillment accountability to Allah.

Based on the arguments above, we review the information content in the BIB's financial reporting. The BIB's financial statement has sufficient disclosure regarding the identification

of *Islamic* investment, *Islamic* revenue and sources of revenue. In addition, the financial statement has provided the statement of changes and uses of funds in *Zakat* and charity and the statement of sources and uses of funds in the *qard* funds.

However, the BIB's financial statement has not properly disclosed the identification of non-*Islamic* investment and non-*Islamic* revenue. The BIB financial statements report that BIB has invested their cash on Bahrain Monetary Agency (BMA) and the other bank accounts. These particular investments can be considered *halal* or *haram* investments since to the best of our knowledge we cannot identify the characteristics of these particular investments. However, we argue that since the BIB has used the *Islamic* term in some of their investments, we argue that the other investments without using the *Islamic* term as non-*Islamic* investment.

In regard to this issue, BIMB has provided sufficient information and disclosure on its *Islamic* investment as well as its *Islamic* revenue. Yet, the BIMB has failed to provide information on its non-*Islamic* investment as well as non-*Islamic* revenue. Since the both banks identify clearly the *Islamic* investment and *Islamic* revenue, we argue that others investments and revenues which are not clearly justify *Islamic* as non-*Islamic* investment and non-*Islamic* revenue. In addition, the BIMB has failed to disclose properly on the information about the sources and uses of *Zakat* and charity fund and the sources and uses of *qard hasan* fund.

In reviewing both banks' financial reports, we find that they have provided proper information regarding the banks revenue, which exclude the revenue for deposit holders. By providing this information, the banks have clearly informed, disclosed and ensured the right of the deposit holder as well as the right of the banks.

Since the *Islamic* banks are expected to perform the role in achieving the equitable distribution of wealth among the *ummah* (*Islamic* society), we argue that the *Islamic* banks should provide information, which clearly segregate the revenue generated from *murabaha* (cost plus mark up) instruments. It is simply because the *murabaha* instruments is just an instruments provided by the *Islamic* banks for fulfilling the consumerism needs which do not have direct implication to the improvement of the *ummah* economic development.

As suggested by various authors, the *Islamic* banks should provide bigger financing on the *mudharaba* and *musyarakah* financing rather than on the *murabaha* financing. Thus, by providing this information, the users of both banks financial reporting may identify the bank's revenue, which are generated from other financing except the *murabaha* financing.

Another element that we review in the both banks annual report is the adoption of current valuation whenever it is possible. As discussed earlier, the *Islamic* accounting scholars tend to agree to adopt the current valuation method. Yet, since the adoption current valuation may produce a high cost and may find difficulties since not all of the assets, which have their current value (market price), we argue that the *Islamic* banks must adopt the current valuation whenever it is possible.

The BIB financial statements are prepared under the historical convention as modified as measurement at fair value of some investments. These are stated clearly on the investments in

real estate and non-trading investment “available for sale”. Thus, the BIB’s financial statements are prepared based on the combination of historical cost and current valuation.

On the other hand, the BIMB financial statements are prepared under the historical convention per se. It is clearly stated that the BIMB will treat the investment securities on basis the cost or market which is lower. If the market is lower than the cost, the investments must be valued based on the market value. But the banks must provide provision for diminution in value. Yet, if the cost is higher than the market value, the investment will be valued at the cost.

5.2 Corporate Governance Indicator

	Item	BIMB	BIB
1	Composition of board of directors		
	e. The board of directors comprises at least one-third of independent non-executive director	X	X
	f. The board of directors has representative from <i>Shari'ah</i> board	X	X
2	Appointment and Re-appointment		
	c. The directors retire by rotation once in three years and subsequently eligible for re-appointment	√	X
	d. The reappointment of non-executive directors is not automatic	√	X
	e. The terms of appointment of the non-executive directors are disclosed	√	X
3	Board meetings		
	j. Board meetings were conducted at least four times a year	√	X
	k. Number of board meetings held in a year and the details of attendance of each individual director in respect of meetings held are disclosed	√	X
	l. Directors attend at least 75% of meeting on average	X	X
4	Directors' fees and remuneration		
	a. Directors remuneration is disclosed	√	√
	b. Separate figures for salary and performance-related elements, and the basis on which performance is measured are explained	X	X
	c. Shareholder approve directors aggregate pay	√	X
5	Nomination committee		
	a. The company has nomination committee	√	X
	b. The committee should exclusively consists of non-executive directors which majority are independent	√	X
6	Remuneration Committee		
	a. There is a Remuneration Committee	√	X
	b. Remuneration consisting wholly or mainly of		

	Item	BIMB	BIB
	non-executive directors	√	X
	c. Membership of the remuneration committee should appear in the directors' report	√	X
7	Audit Committee		
	a. There is an audit committee	√	√
	b. The Audit Committee consists of at least three non-executive directors, whom majority are independent	√	X
	c. Audit committee include someone with expertise in accounting	√	X
	d. Audit committee recommends the external auditor at the annual shareholders meeting	√	X
	e. At least, once a year the committee met with the external auditors without executive board members present, to review financial statement	√	X
	f. Details of the activities of audit committees, the number of audit meetings held in a year and details of attendance of each individual director in respect of meetings are disclosed	√	X
	g. Audit committee members attend at least 75% of meetings on average	√	X
8	Shari'ah Supervisory Board		
	a. Include someone with expertise in accounting	√	X
	b. SSB meets with audit committee and/or external auditor to review financial statement	X	X
	c. Details of the activities of SSB, the number of board meetings held in a year and details of attendance of each individual member in respect of meetings are disclosed	X	√
	d. SSB committee members attend at least 75% of meetings on average	X	X
	e. SSB is independent body	X	X
9	Others		
	a. Directors, senior management are qualified persons in terms of educational background, working experience etc	√	X
	b. Chairman and CEO are different persons	X	√
	c. There is a Risk Management Committee	√	X
	d. English disclosure exists	√	√
	e. There is a statement on Corporate Governance	√	X
	f. The maintenance of an effective system of internal controls is disclosed	√	X
	g. There is director's report	√	√

Analysis on the Corporate Governance Indicator

From the table above, we can see that BIMB still has few aspects in Corporate Governance, either in terms of its conduct or reporting that are lacking. Its board of directors does not achieve one-third of independent non-executive member as required by the Malaysian Code on Corporate Governance. Of 10 directors and 1 alternate director, only two of them are independent non-executive directors. Interestingly, even though by virtue of paragraph 15.26 of the KLSE Listing requirements requires the company to disclose the reasons for any areas of con-compliance, as far as we are concerned, no such information is provided and available from the annual report. In addition, none of the board members is representative from *Shari'ah* Supervisory Board.

Regarding the attendance of the board members to the meeting, we have found that two of the members failed to attend at least 75% of the meetings held throughout the financial year. From 6 meetings held, he only attended a total of 4 which represents 66.67%. Nevertheless, his alternate director did attend one of the remaining two meetings. Meanwhile, another board member who is also Saudi Arabian did not attend any meetings. However, no further information disclosed regarding this matter.

Next, it has not made any distinct disclosure on the amount of directors' remuneration. There is no separate figures given for salary and performance-related elements and the basis on which performance is measured has not been explained.

As compared to auditors' report, report made by the *Shari'ah* Supervisory Board was really brief and uninformative. The SSB's report briefly stated that the activities of BIMB are in line with *Shari'ah* requirements but did not mention what activities have been conducted during the year as for them to arrive with such conclusion. By doing this, the reliability of the comments made by the SSB is really questionable. By right, SSB should act as an auditor and become check and balances with the external auditor. Moreover, since the SSB is appointed and remunerated by the management of BIMB coupled with uninformative report prepared by the SSB, we conclude here that SSB is not independent.

BIMB does only have chairman, who is the non-independent and non-executive director. Nevertheless, the bank has a managing director who is one of the non-independent and non-executive directors. The issue that can be raised here is that why a non-independent and non-executive can become a managing director which directly involves in management activities? This is to show that even though the company is headed by non-executive chairman, but still it has non-executive director who is appointed as a managing director.

Meanwhile, there is not much information regarding corporate governance practices from the annual report of *Islamic Bank of Bahrain*. Out of 35 items, only 6 items which are clearly made available in the annual report, namely the directors' remuneration, there is an audit committee, details of the activities of SSB (even though without disclosing the number of meetings held and the attendance of the SSB's members), Chairman and CEO are different persons, there is English disclosure, and there is a directors' report.

Likewise BIMB, its board of directors has no representative from *Shari'ah* Supervisory Board. Furthermore, it does not even disclose whether the composition of the members in the board of directors is comprised of independent or dependent, executive or non-executive director. Such information is important to ensure that the decision making process in the

bank, from the eyes of the users of financial information, is not dominated by certain people only. The failure to disclose the background information of each and every director especially in terms of educational background, previous working experiences etc, might raise the issue of transparency of the bank as well as the credibility of the directors. The establishment of several committees like remuneration committee, nomination committee and risk management committee has no place in the annual report even though these disclosures are required under Code of Best Practices for CGIFIs. In addition, this situation might leave the users of financial report to wonder how the bank is basically operated.

Nevertheless, the comparison between BIMB and *Islamic* Bank of Bahrain in terms of corporate governance practices has to be thoroughly concluded. This is because both banks as we know are operating in different countries and subsequently are bound to follow different regulatory and accounting requirements. For instance, for BIMB (or rather Bank Islam Holding Berhad), as required by virtue of paragraph 15.26 of the KLSE Listing Requirements to disclose on the information pertaining to the extent that the code on corporate governance has been practiced in the company. Furthermore, since BIMB itself is a subsidiary of the BHB, therefore we tend to use annual reports of both institutions to find out the possible information disclosed. In essence, the statement of corporate governance is only made available in the annual report of holding company rather than from the bank itself. Thus, it is quite difficult to make direct comparison between both banks. Meanwhile, as for the *Islamic* Bank of Bahrain, despite the fact that maintaining the highest international standards of corporate governance and regulatory compliance as the one of the objectives, it is found that such commitment is not represented in terms of disclosure.

However, the authors need to stress here that the concept of disclosure in Islam is not just merely based on the regulatory requirements. The most important aspect that needs to be borne in mind is that they should disclose whatever they feel accountable to (Baydoun & Willet, 2000).

5.3 Social/Environment Indicator

SOCIAL AND ENVIRONMENTAL				
			BIMB	BIB
1.	Policy and objective			
	a)	Mission statement/statement of environmental policy	X	X
	b)	Mission statement/statement of social policy	X	√
	c)	Environmental target and objective	X	X
	d)	Social target and objective	X	√
2.	Community issues			
	a)	Consumer care	√	√
	b)	Community involvement	√	√
3.	Employees issues			
	a)	Health and safety	X	X
	b)	Employee training	√	√
	c)	Reporting on other issues	X	√
4.	Environmental issues			
	a)	Environmental protection	X	X
	c)	View on environmental issues	X	X
	d)	Environmental Management System	X	X
	e)	Energy saving	X	X
	f)	Environmental indicators and target	X	X

Analysis on the Social/Environment Indicator

From the scorecard above, the authors can clearly see that the level of social/environmental reporting for both banks is still unsatisfactory. BIMB, out of 14 items, only three items are disclosed in the annual report. All information could be obtained in the Chairman's statement. As for consumer care, he did clearly mention about the strategic business initiatives whereby the focus is on the:

“Meeting customers needs through the creation of innovative and competitive financial products and services, enhancing customers convenience through effective and efficient service and delivery channels, and providing excellent service to customers by means of upgrading the skills, abilities and expertise of our staff members”

There is also paragraph which mentioned about the employee training.

“The development of human capital has never been more important to us in supporting our business growth and current business focus. Various training programmes were organized to equip our staff with necessary skills and knowledge and improve their competency, efficiency and performance in key business and operational areas”

BIMB even though did not directly involve in educational training to public (since the task has been delegated to another BHB's subsidiaries, IBFIM), the authors believe that BIMB still indirectly involve in organizing such educational training. They have developed a comprehensive range of training programs which include seminars and workshops, locally

and abroad to cater for the needs of the *Islamic* financial industry with regard to the enhancement of knowledge an expertise in *Islamic* banking and finance.

Meanwhile, BIB has performed better in terms of this social/environment disclosure as compared to BIMB. It did disclose 6 out of 14 items listed. BIB in its vision and mission statement included a value statement to stakeholders which comprised of shareholders, customers, management, employees, regulators, Bahrain government, *Islamic* financial institutes and local community. For each type of stakeholder, there are few visions addressed to them as a sign of social responsibility upheld by the bank. Apart from that, there is a page allocated for social responsibility message whereby BIB claimed that they are planning to open a separate branch for ladies in 2003, dedicated to serve ladies and businesswomen.

In terms of employee development, the bank has allowed many of its employees to join training courses to develop the skills and to keep them abreast of the latest banking development. Several field visits to other *Islamic* banks also conducted to familiarize the employees with *Islamic* banking development and products. Furthermore, staffs were extensively educated about the *Shari'ah* aspects related to the bank's business activities to enhance their understanding of *Islamic* banking transactions.

6.0 RESULTS

6.1 Islamicity Disclosure Index

Based on the findings above, the results can be summarized as follows:

Indicator	BIMB	BIB
<i>Shari'ah</i> Compliance	9/16	14/16
Corporate Governance	26/35	6/35
Social/Environmental	3/14	6/14

The number of items disclosed now will be assigned different weightage for each type of indicator. For *Shari'ah* compliance indicator, the authors assign 50%, whereas the corporate governance indicator and social/environmental indicator are assigned 30% and 20% respectively. *Shari'ah* compliance is given the highest weightage since it shows the greatest priority is to ensure that the banks' activities do not violate the *Shari'ah* requirements. Similarly, corporate governance is ranked second due to its nature which cannot easily be separated from the *Shari'ah* itself. It means that the higher level of corporate governance practices reflects the higher integrity, accountability and transparency of the organization. Social/environmental aspect is given the lowest weightage because part of the social/environmental aspect itself has been included in the other two indicators.

Applying the weightage, the following results are obtained:

Bank	(a) SC %	(b) At 50%	(c) CG %	(d) At 30%	(e) S/E %	(f) At 20%	(g) Total % (b) + (d) + (f)
BIMB	56	28	74	22	21	4	54
BIB	88	44	17	5	43	9	58

From the above calculation, BIB performed better in terms of *Islamicity* Disclosure Index with at least 58% of disclosure as compared to BIMB which only disclosed at least 54%.

6.2 Islamic Quantitative Index

1. Profit - sharing financing ratio

Bank	2002
Bank Islam Malaysia Berhad (BIMB) (Ringgit Malaysia)	$= \frac{(40,306 + 18,770)/2 + (177,075 + 216,934)/2}{(6,144,323 + 5,452,885)/2}$ $= \frac{29,538 + 197,005}{5,798,604}$ $= \underline{3.9\%}$
Islamic Bank of Bahrain (Bahraini Dinar))	$= \frac{(15,381 + 7,065)/2 + (3,561 + 3,894)/2}{(159,248 + 152,766)/2}$ $= \frac{11,223 + 3,728}{156,007} = \underline{9.6\%}$

Based on the above ratio, BIB has greater portions on the Profit – Sharing mode of Islamic financing in its activities (9.6%) compared to BIMB that just only 3.9%. It shows that BIB had focused more to the Islamic primary principle (profit sharing) rather than BIMB. However, in overall, the percentage of profit-sharing financing of both banks is relatively small compared to the cost-plus mark-up financing. Cost-plus-mark-up financing is represented by 90.4% for BIB and 96.1% for BIMB. It shows that both banks emphasized

more on the secondary mode of Islamic financing which is based on cost-plus-mark-up transaction.

2. Zakat Performance Ratio

Applying the above formula, we have;

Bank	2002	2001
Bank Islam Malaysia Berhad (BIMB)	= $\frac{1,125}{1,027,236}$ = <u>0.01%</u>	= $\frac{2,699}{997,288}$ = <u>0.03%</u>
Islamic Bank of Bahrain	= $\frac{134}{185,739}$ = <u>0.07%</u>	= $\frac{106}{174,568}$ = <u>0.06%</u>

We use net worth (total assets minus total liabilities) as the denominator for this ratio to reflect the wealth performance of the Islamic banks. The authors assume that the amount of *Zakat* payment will increase in line with the increasing of the wealth of the banks.

With regard to this ratio, the authors see that there is increasing of *Zakat* performance indicator of the BIB amounting to 0.01%. This indicates that the BIB's performance is better as compared to the previous year. However, as for BIMB, it shows the decline in the *Zakat* performance indicator although the company wealth has increased.

1. Equitable distribution ratio

	BIMB	Islamic Bank of Bahrain
1. Qard and Donation	= Nil	$\frac{41+40}{(7,884 - 134)}$ = <u>1.04%</u>
2. Employees' expenses	= $\frac{75,172}{226,047 - (1125+ 35,116)}$ = <u>40%</u>	$\frac{2,274}{(7,884 - 134)}$ = <u>29. %</u>
3. Shareholders	= $\frac{7,500}{226,047 - (1125+ 35,116)}$ = <u>4%</u>	$\frac{2,300}{(7,884 - 134)}$ = <u>30%</u>
4. Net Profit	= $\frac{29,948}{226,047 - (1125+ 35,116)}$ = <u>16%</u>	$\frac{2,053}{(7,884 - 134)}$ = <u>26 %</u>

Based on the above table, the equitability ratio shows that BIB has equally allocated its revenue among the main stakeholder which are employees (29%), shareholder (30%), community (1.04%) and company itself (26%). Unfortunately, for the BIMB, it seems put more emphasis on the employee (40%) and less distribution of the revenue to the shareholders (4%) and company itself (4%). However, due to the lack of the information in the BIMB's annual report, we are not able to get the information regarding the revenue distribution to the community because of the bank not provided the "Statement of Qard Fund" as done by the BIB.

Therefore, based on the above result, the authors feel that BIB upheld greater equitability in their revenue distribution compared to the BIMB which is in line with the Islamic business values.

4. Directors - Employees Welfare Ratio

BIMB	BIB
= 51 : 39 = <u>1.31 times</u>	= 7 : 12 = <u>0.58 times</u>

This ratio shows that BIB (0.58 times) is better than BIMB (1.31 times) with regard to the allocation of the benefit to directors and employees. In other words, the authors can say that for the BIB, the benefits allocated. For BIB, the directors are paid 0.58 time more than the

employees, whereas BIMB's directors are paid 1.31 times more than a particular employee received. On the other hand, as for BIMB, this result is inconsistent with the equitable distribution ratio which the authors have calculated previously.

5. Islamic Investment vs Non-Islamic Investment

As applied to the banks²,

BIMB	Islamic Bank of Bahrain
=	=
$\frac{1,368,247}{5,777,696}$	$\frac{28,483}{39,671}$
= <u>23%</u>	= <u>72%</u>

Based on the above result, it shows that the BIB has better complied with the Islamic bank principle whereby they should only involve in the Islamic investment. Meanwhile the BIMB by looking at the disclosure per se, the authors can conclude that the majority of the investments (77%) are non-Islamic

6. Islamic Income vs Non-Islamic Income

BIMB	BIB
=	=
$\frac{192,829}{288,165}$	$\frac{7,327}{7,884}$
= <u>67%</u>	= <u>93%</u>

The result of this ratio is parallel with the result of the Islamic investment ratio. Both of the banks have generated the income mostly from Islamic transactions, however they also generate their income from the non-Islamic transaction especially BIMB (33%).

7. AAOIFI Index

BIMB	BIB
=	=
$\frac{2}{13}$	$\frac{11}{18}$
= <u>15%</u>	= <u>61</u>

As far as we are concerned, AAOIFI is the Islamic Accounting Standard for the Islamic Financial Institution. Thus, the Islamic Bank should comply with it although it is not required by law. In Bahrain however, the AAOIFI standard is mandatory for Islamic Financial Institution. Therefore, BIB in its accounting policy has stated that its financial statements are prepared in accordance with the AAOIFI. Nevertheless, the BIB also followed the

² For detailed calculation, refer to Appendix 2.

International Accounting Standard for the harmonization practices purposes that might not be in line with the Islamic principles.

On the other hand, since the AAOIFI standards are not mandatory in Malaysia, BIMB did not fully adopt it as the main accounting standard. BIMB in its report only stated two of the principles are in accordance with AAOIFI which represented 15% of the total principle.

7.0 LIMITATIONS

Our study however has several limitations that need to be carefully understood. Such a limitation we believe might affect our generalization. Followings are the limitations have been identified:

1. The study is based on ‘backward analysis’. This is because we develop the index based on what medium we are going to use in our evaluation process. Specifically, we have identified annual report as a sole medium and then only we develop the index.
2. Since the only medium used is annual report, therefore the discussion has been confined only to what has been disclosed as well as what should be disclosed. Thus, we consequently exclude any information which we consider highly operational which requires us to perform on-site investigation.
3. The conclusion for each finding excludes any regulatory consideration of each company which the bank resides. For instance, we might not aware on the disclosure requirements that have been imposed to the Islamic Bank of Bahrain.

8.0 CONCLUSIONS

The performance of Islamic banks nowadays is under critical public scrutiny. The banks do not only have to serve the needs of various stakeholders, but more importantly they have to make sure that their activities are in line with the Shariah requirements. Thus, this effort of coming out with Islamicity indices are very timely in the sense that it may help the interested parties to possibly evaluate the performance of the banks simply by looking at the annual reports.

In terms of Islamicity disclosure index, it comprises of three indicators which are *Shariah* compliance indicator, corporate governance indicator and social/environment indicator. Overall, we can say that Bahrain Islamic Bank (BIB) seemed to disclose more information as compared to Bank Islam Malaysia Berhad (BIMB) even though the corporate governance indicator has dragged down its overall Islamicity disclosure index. Another index, which is Islamicity performance index, deals more with the financial aspects especially how effectively the banks have managed the resources entrusted to them. The introduction of this index is basically trying to run away from the conventional way of measuring performance which solely focuses on the needs of shareholders and creditors.

Thus, based on our findings regarding the performance of two banks, we found that there are still much needed to be done especially in terms of quality and level of disclosure. Since general public has limited access to the information regarding the company of interest, annual report therefore can be seen as the most suitable indicator of the performance of the Islamic banks. Hence, to avoid any grievances about the “islamicity” of the Islamic banks, we urge

the Islamic banks to disclose more information in the future even to the extent that it might disclose negative activities conducted by the banks during the financial year.

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