

# Banking on Islam? Determinants of Corporate Social Responsibility Disclosure

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*Islamic banks offer distinct financial services and as such have grown significantly in Bahrain, Bangladesh, Jordan, Kuwait, Malaysia, Qatar, Turkey and U.A.E over the past two decades. They are unique in the sense that they are accountable to fulfil a social and ethical role inherent in their character as an 'Islamic' institution. They also have a duty to discharge their accountability through disclosing corporate social responsibility (CSR) information consistent with the principles of Islam. However, recent anecdotal evidence finds that Islamic banks may not be fulfilling their social role in accordance with the prescriptions of Islam because they disclose less CSR information than expected. It has been suggested that disclosure may also be driven by the extant economic incentives. Hence, the exact nature of the CSR disclosure process by Islamic banks remains unclear due to a paucity of a priori research and statistical analysis of extant data. In light of that, this study develops an a priori model linking CSR disclosure to socio-political influences and corporate governance factors. Then resultant hypotheses are tested on a sample of 47 Islamic banks' annual reports from 14 countries.*

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JEL Classification: F23, G21, I31, M14, M41, P48, Z12, Z13

## 1. Introduction

A combination of political, economic and demographic factors, including and not limited to the impact of the Iranian revolution, a growing Muslim middle class, the rise of Asian tigers, increased deregulation and the oil shocks of the 1970's; have stimulated the development of Islamic banks (Akacem and Gilliam 2002).<sup>1</sup> Some reports suggest that Islamic banks are growing at an annual rate of more than 15% making them the fastest growing segment of the credit market in Muslim countries (Zaher and Hassan 2001; Bahrain Monetary Agency 2004). The latest figures suggest that the assets of Islamic banks worldwide stand at over US\$260

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<sup>1</sup> In this paper, Islamic Banks are synonymous with Islamic Financial Institutions namely commercial banks, investment banks, and *muḍārabah* companies.

billion, while the number of Islamic banks have increased from 176 in 1997 to 267 in 2004 operating in over 60 countries throughout the world (Bahrain Monetary Agency 2004).

Islamic Banks should ideally operate in accordance with the principles laid down by Islamic law (Sharī‘ah).<sup>2</sup> The primary contributing factor that hastened the need for Islamic Banks is the prohibition of usury (*ribā*).<sup>3</sup> Merged with this function is the social role of Islamic Banks that entails social justice and accountability, requiring the banks to disclose corporate social responsibility (CSR) information. Usmani asserts that the philosophy behind Islamic banking was “aimed at establishing distributive justice free from all sorts of exploitation” (2002, p. 113). According to Islamic principles, business transactions can never be separated from the moral objectives of society (Usmani 2002). As such, a number of scholars have developed a normative standard for reporting (Gambling and Karim 1986, 1991; baydoun and Willett 2000; Lewis 2001) and indeed social reporting for Islamic businesses based on Islamic principles (Haniffa 2001; Maali, Casson and Napier 2003). Governments in Muslim populated countries such as Malaysia and international regulatory institutions such as the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) have also voiced their support for the development and adoption of such CSR reporting standards encouraged and propagated by Islam (Sharani 2004; Yunus 2004).

Recent ad hoc studies indicate that Islamic banks are not completely fulfilling their social role in accordance with the prescriptions of Islam (Metwally 1992; Aggarwal and Youssef 2000; Maali et al. 2003). Usmani emphasises that Islamic banks “were supposed to adopt new financing policies and to explore new channels of investment which may encourage development and support of small scale traders to lift up their economic level” (2002, p. 116). Islamic banks should have advanced towards profit and loss sharing (*mushārah*) in gradual phases and should have increased the size of *mushārah* financing (Usmani 2002). However, it remains that very few Islamic banks and financial institutions have paid attention to this social aspect. Usmani (2002) further highlights that in a number of Islamic banks, other permitted forms of financing are not effected according to the procedures required by the Sharī‘ah.

Additionally, Aggarwal and Youssef find that while Islamic banks are expected to “favour small entrepreneurs who do not have access to credit in the conventional banking system” (2000, p. 99), they rarely offer finance to these segments of the market, contrary to Islamic injunctions to promote the development of the under-privileged echelons of society. They infer that this is a rational response by Islamic

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<sup>2</sup> The Sharī‘ah is the sacred law of Islam derived from the Muslim holy book (*Qur’an*), the sayings and deeds of the Prophet Muhammad (*Sunnah*), consensus (*ijma*), reasoning by analogy (*qiyās*), and public interest (*maslahā*).

<sup>3</sup> *Ribā* is translated strictly as usury; however Islamic scholars equate it as being equivalent to interest.

banks in the face of severe agency problems in their attempts to provide funds to entrepreneurs. This leads them to conclude that “economic incentives shape the structure of Islamic banking more so than religious norms” (Aggarwal and Youssef 2000, p. 99).

Maali et al.’s (2003) rudimentary analysis also suggests that Islamic banks’ CSR reporting falls short of the benchmark for entities whose operations are founded on Islamic principles. Based on an Islamic perspective, they develop a pragmatic benchmark for social disclosures that they would expect Islamic Banks to provide. They find that there is considerable variation in the voluntary social reporting of Islamic banks, from some banks reporting 35% of expected social disclosure to others disclosing almost no social information (Maali et al. 2003). In addition, they find that the annual reports of Islamic banks present elements in the process of constructing an Islamic reality (Hines 1988; Maali et al. 2003). As such, Maali et al. Conclude that “with a few exceptions, Islamic banks have a long way to go to meeting expectations of the Islamic community” (2003, p. 31). However, they fail to provide an a priori basis to support their results. In addition, their sampling and statistical analyses are rudimentary leaving their conclusions theoretically inexplicable (Maali et al. 2003).

Consistent with Maali et al. (2003), the first objective of this study is to measure the annual report social disclosure levels of Islamic banks based on a benchmark derived from Islamic principles. More importantly, the second objective of this paper is to ascertain a priori the determinants of Islamic banks’ social disclosures which will subsequently be tested utilising the disclosure measures obtained. In particular, tests for the determinants of social disclosure from a legitimacy and political economy perspectives are to be performed (Gray, Kouhy and Lavers 1995; Williams 1999). Departing from previous research, this study also tests for the relationship between corporate governance mechanisms and CSR disclosure.

This study contributes to the limited literature in the area of international accounting research and to the growing literature on Islam and its impact on corporate disclosure. It does so by providing empirical evidence on the nature and determinants of social disclosures by Islamic Banks. Further, this paper contributes to the empirical research exploring corporate governance mechanisms and their effect on social disclosures and corporate transparency.

The balance of this paper is structured as follows. The next section highlights the deficiency in research regarding Islamic banks and their CSR disclosures. Section 3 develops the hypotheses to be tested. Section 4 elaborates on the data and research design while section 5 discusses the results and section 6 concludes the study and states the limitations.

## 2. Prior research

Despite the growth of Islamic banks in size and complexity, little research has addressed the issue of social responsibility in the context of Islamic banks. While a number of researchers have explored Islamic accounting and corporate reporting of Islamic institutions and banks, they have generally been either normative or analytical papers, without any empirical testing of the actual disclosure Practices of Islamic organisations.

Gambling and Karim's (1986) seminal work developed a theoretical foundation for the analysis of Islamic accounting elaborating on its peculiarities and analysing its social orientation. Hamid, Craig and Clarke (1993), Karim (1995) and Lewis (2001) subsequently detailed the intricacies of the influence of Islam in all areas of accounting from Practice through to disclosure paving the path for developing a conceptual framework for Islamic accounting and disclosure requirements particularly for Islamic banks. Sadeghzadeh (1995) enhances the structure of an Islamic perspective of social responsibility and sustainability accounting by giving it theoretical depth and contrasting it with conventional theories relating to the area. Baydoun and Willett (2000) supplement Sadeghzadeh (1995) by developing normative Islamic reporting standards comprising value added statements following the two complementary principles of full disclosure and social disclosure based on Islamic ethical values. The studies above provide the overall theoretical framework and practical application of Islamic accounting.

Dealing specifically with Islamic banks, Archer, Karim and Al-Deehani (1998) detail the contractual basis of Islamic banks to outline the special need for corporate governance and disclosure by Islamic banks due to the monitoring weaknesses inherent in the Islamic banking system. They recommend a number of solutions ranging from tighter ex ante contractual conditions to improving transparency of financial reporting and monitoring. Their analysis is a significant attempt to extrapolate the various contracting issues inherent in Islamic banks.

The only noteworthy exceptions to these normative or analytical papers in the area of Islamic corporate reporting and social reporting are the works of Askary (2001) and Maali et al. (2003). Askary (2001) draws on research examining the influence of culture on accounting to classify accounting Practices in different Muslim countries according to cultural variables developed by Hofstede (1980), Gray (1988) and Perera (1989). He compares the actual disclosure Practices of companies in Muslim countries to the benchmark of Islamic accounting Practices as measured by those cultural variables. However, his research focuses on all companies in Muslim countries rather than on Islamic banks specifically and measures overall disclosure rather than CSR disclosure.

Lastly, Maali et al. (2003) make a significant attempt to substantiate the actual social disclosure Practices of Islamic banks. They utilize a sample of 29 Islamic banks from a number of different countries and compare CSR disclosure to a

pragmatic benchmark based on Islamic values. They find that Islamic banks are disclosing CSR information far below the expected level. However, their rudimentary analysis makes only vague inferences as to what may drive the social disclosure Practices of these banks. They conjecture as to a number of possible explanations from the CSR literature (Maali et al. 2003). Alluding to economic incentives that may drive CSR disclosure, Maali et al. (2003) also suggest that Islamic banks may only disclose CSR information to construct an Islamic reality while not subscribing to that reality and its resultant obligations.

### **3. Theory Development**

#### **3.1 Theoretical Framework**

Corporate social responsibility disclosure has been the subject of substantial academic accounting research. Gray, Owen and Maunders define CSR disclosure:

...as the process of providing information designed to discharge social accountability. Typically this act would...be undertaken by the accountable organisation and thus might include information in the annual report, special publications or even socially oriented advertising (1987, p. 4).

To that effect, a number of theories have been proposed to explain why corporations voluntarily disclose CSR information.

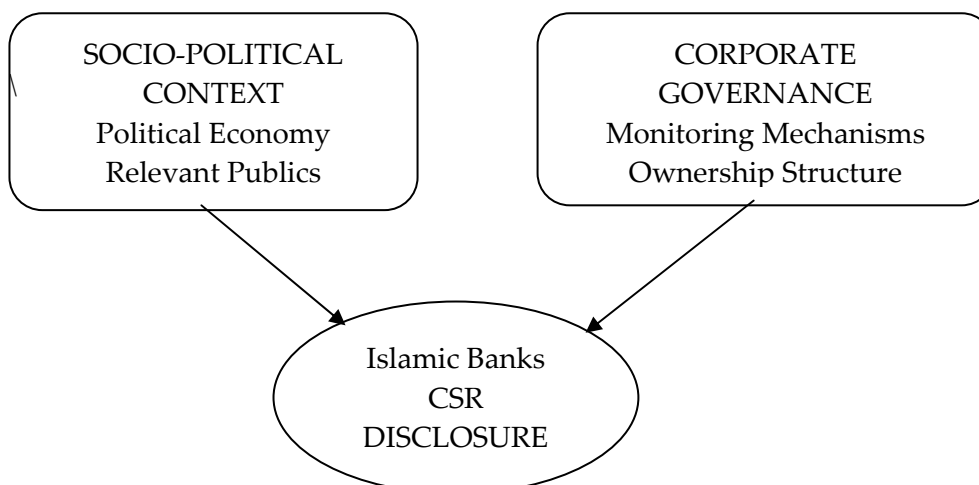
A review of accounting research indicates that theory development related to CSR disclosure in general is fragmented and rudimentary, while almost no theory development has occurred in relation to CSR disclosure of Islamic banks (Maali et al. 2003; Sadeghzadeh 1995). At most, the literature on Islamic banks suggests that a priori there are two major influences on the Islamic banks CSR disclosure:

1. socio-political context within which the banks operate; and
2. economic opportunities available to Islamic banks.

In the CSR literature, the former influence is identified with systems oriented theories such as political economy, legitimacy and stakeholder theories (Wilmhurst and Frost 1999; Deegan 2002; Campbell, Craven and Shrives 2002). As part of that programme, the political and social contexts have been found to be important determinants of the decision to disclose CSR information (Roberts 1992; Williams 1999).

The economic incentives viewpoint is consistent with research that explains CSR disclosure in the context of agency theory (Cowen, Ferreri and Parker 1987; Adams 2002; Campbell 2000). Thus, the theoretical framework development here will incorporate both influences. The proposed model is presented in Figure 1.

FIGURE 1. Diagrammatic portrayal of the influences on CSR disclosure by Islamic banks



The diagrammatic portrayal is an endeavour to capture the two major possible influences. The socio-political context variables, as derived from systems oriented theories, measure cross-national differences whereas the corporate governance variables measure organisation specific differences that may influence the CSR disclosure of Islamic banks.

### 3.2 Systems theories, social responsibility and Islam

Systems oriented theories such as political economy, stakeholder and legitimacy propose that individuals, institutions and organizations, seeking to preserve their own self-interest, attempt to operate and interact within the system through various relationships with others (Williams 1999). The theories also emphasise 'that the actors, whether they are individuals or organisations, in this system have the right to pursue their own goals and self-interests' (Williams 1999, p. 211). However, these rights to self-interest are moderated by the social and political environment in which they interact (Williams 1999).

This idea is consistent with Islam where the concept of Unity (*tawhīd*) prevails. According to this concept, God is the Creator, Owner and Source of all things (Maali et al. 2003).<sup>4</sup> In light of God's ownership of everything, it is believed that God has entrusted mankind to the use of resources.<sup>5</sup> Thus, in return for the use of the physical universe, mankind agrees to be accountable for how the universe is

<sup>4</sup> Ali 1989, The Holy Qur'an 2:116; 2:107; 3:189; 5:17; 18:40.

<sup>5</sup> Ali 1989, The Holy Qur'an 33:72. Vicegerency (*istikhlaf*) or trusteeship is similar to the concept of Stewardship in Christianity.

used (DeLorenzo 2002). This position of trust is the source of accountability for individuals and consequently organisations.<sup>6</sup> The trusteeship requires a total commitment to the will of God and therefore “involves both submission and a mission to follow the Sharī‘ah in all aspects of life”, including economic aspects (Baydoun and Willett 2000, p. 80).

However, Islam does not deny individual rights to self-interest. Enjoyment of self-interest is only conditioned by the permanent needs of greater society (Umma) (Sadeghzadeh 1995). As such, individual freedom is sacred only as long as it does not conflict with the larger societal interest or as long as the individual does not transgress the rights of others (*huquq-al-ibād*). Some Practical examples of this concept are demonstrated by the forbiddance of a number of activities such as drinking alcohol, adultery and gambling because of their contributory effects to families and societies. The conceptual basis of this implicit contract between the individual and greater society are emphasised in great lengths in the Qur’ān and the teachings of Prophet Muhammad.

Similarly defined by the proponents of political economy, stakeholder and legitimacy theories, the relationship between individuals, organisations and society is consequently viewed as a ‘social contract’ (Ramānathan 1976; Deegan 2002; Williams 1999).

Organisations themselves play a large role in society and have responsibilities assigned to them based on their status in society. As such, they “...exist only to the extent that the particular society considers that they are legitimate” (Deegan 2002, p 292).

Accordingly, organisational legitimacy is defined as:

...a status, which exists when an entity’s value system is congruent with the value system of the larger social system of which an entity is a part. When a disparity, actual or potential exists between the two value systems there is a threat to the entity’s legitimacy (Lindblom 1994 cited by Newson and Deegan 2002, p. 184).

To paraphrase, organisations continually seek to ensure that they operate within the bounds and norms of their respective societies (Deegan 2002). In this context, CSR is defined broadly as “including the concern for the impact of all of the corporation’s activities on the total welfare of society” (Bowman and Haire 1976, p. 13).

The concept of corporate social responsibility in Islam likewise emerges from this ‘social contract’ that necessarily has to do with the congruency of the value system of the organisation to the larger value system of an Islamic society.<sup>7</sup> In Islam, organisations are similarly, if not more so, accountable to society as are

<sup>6</sup> Ali 1989 The Holy Qur’an 102:8.

<sup>7</sup> Ali 1989, The Holy Qur’an 22:40.

individuals. As Lewis (2001) elaborates, the implications for business enterprises is that “both managers and providers of capital, are accountable for their actions both inside and outside their firms; accountability in this context means accountability to the community” to establish socio-economic justice within their own capacity (2001, p.113). A number of commandments in the Qur’ān and the tradition of the Prophet Muhammad stipulate what must be done in order to establish socio-economic justice and therefore be socially responsible. Some examples of these are the obligatory payment out of income and wealth (*zakāh*), philanthropic trusts (*waqf*), alms, charity (*ṣadaqah*), interest free loans (*qard-al-ḥasan*) (Sadeghzadeh 1995). The forbiddance of *ribā* also stems out of principles of socio-economic justice in Islam in that the objective is to disallow any unjust distribution of wealth through forced or undeserved loss to one party or unearned gain to the other party (fixed interest). Against that background, it is reasonable to conclude that Islamic business values and norms are consistent in general with the definition of corporate social responsibility.

### 3.2.1 CSR disclosure as a means of legitimation

To discharge their corporate social responsibility, political economy, legitimacy and stakeholder theories’ proponents argue that corporations (management) provide CSR information as part of the dialogue between the corporation and greater society (Gray et al. 1995). Even if the organisation is complying with society’s expectations, organisational legitimacy can be threatened if it has failed to make disclosures that show it is complying with societal expectations (Newson and Deegan 2002). Hence, managers need to demonstrate that they are complying with the ‘social contract’ by disclosing information in line with society’s expectations.<sup>8</sup>

Although different obligations and responsibilities are due of different types of organisations in different contexts, the overall general framework for social responsibility and accountability in Islam is derived from Islamic teachings embodied in the detailed jurisprudence surrounding the Qur’ān and the teachings of Prophet Muhammad. Hence, the expectations of an Islamic populace towards any organisation that claims to be Islamic are unambiguous. Islamic banks are expected to disclose relevant CSR information to discharge their responsibility and to earn legitimacy for their continued existence (Sadeghzadeh 1995; Baydoun and Willett 2000; Haniffa 2001; Lewis 2001; Maali et al. 2003). However, the expectation to disclose is only a necessary condition for disclosure.

The disclosure of CSR information by Islamic banks will depend on a number of other factors necessarily “focussing on the role of information and disclosure in the relationships” between the organisations, the State, individuals, groups and

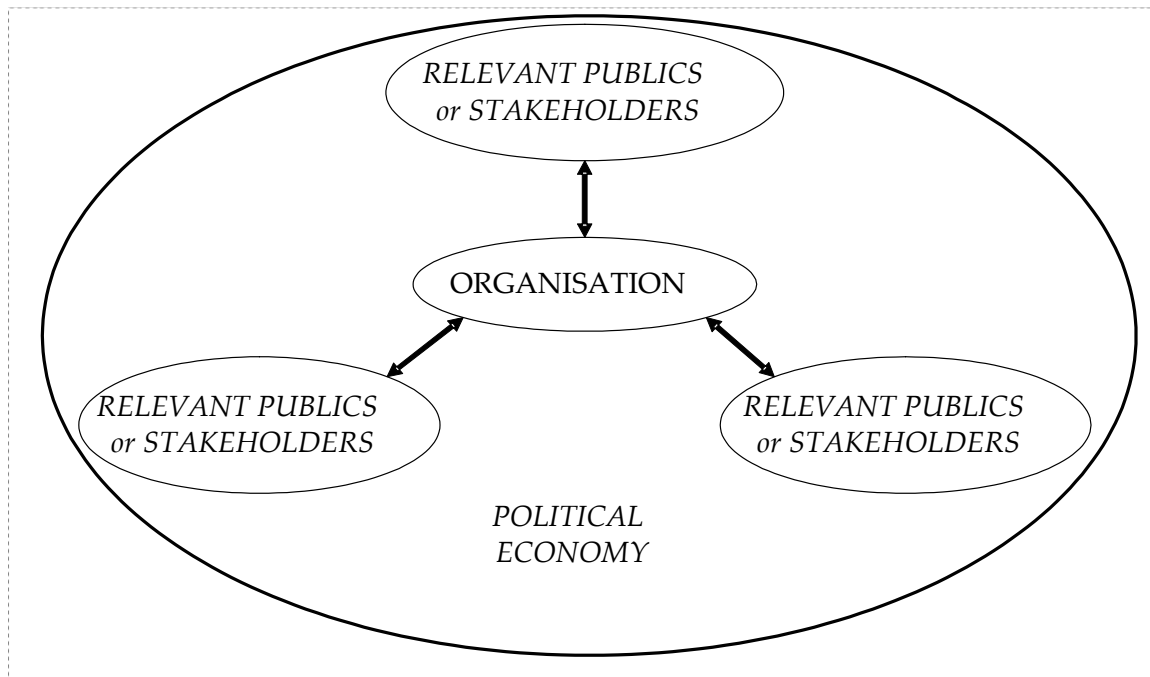
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<sup>8</sup> Dowling and Pfeffer (1975) and Lindblom (1994) elaborate on the number of strategies that organisations undertake to maintain or create congruence between social values implied by the organisation’s operations, and the values embraced by society, all of which require disclosures and all of which may not be genuine attempts at social responsibility.



particularly the Islamic society (Umma) (Gray, Owen and Adams 1996, p.45). In light of this, two factors from systems oriented theories are identified that will directly influence the level of CSR disclosure by Islamic banks. Extracted from political economy theory, the first factor focuses on the broader social and political environments in which organisations interact and is captured by the ‘political rights and civil liberties’ variable (Williams 1999). The second factor, proxied by the ‘relative size of Muslim population’ variable, is derived from legitimacy theory and attempts to capture the concept of the ‘relevant publics’ from which the organisation requires legitimation to exist (Newson and Deegan 2002). Figure 2 indicates the proposed effect of both the socio-political factors on the organisation. The figure demonstrates that multiple groups of ‘relevant publics’ or ‘stakeholders’ influence the organisation within the context of the social, political and economic frameworks represented by the ‘political economy’ (Gray et al. 1995). In addition, Figure 2 indicates that each theory addresses a “different level of resolution of perception” (Gray et al. 1995, p. 52).

Figure 2. Diagrammatic portrayal of the relationship between the organisation and greater society.



### 3.2.2 Hypothesis: Political Economy

As Islamic banks operate in a broader social and political environment, the interplay of power affecting the rights and responsibilities of all actors within this environment will determine the flow of information and dialogue. This will consequently affect the level of CSR disclosure by Islamic banks.

#### *Political rights and civil liberties*

One factor that may influence the interplay of power is the political rights and civil liberties in a country. Williams suggests that “violations of political rights and civil liberties associated with various forms of political structure may restrict political and civil freedom and therefore act as a hindrance to full and fair disclosure” (1999, p. 213). Gastil (1981) points out that as political and civil repression increases, the influence and effectiveness of social interest bodies decrease. For example, repressive governments will restrain the activities of institutions such as the press which ensure a level of accountability through the effective flow of information and dialogue.

Within countries exhibiting limited political rights and civil liberties, societal interest groups, whether Islamic or otherwise, lack the capacity to voice their concerns regarding organisational conduct. Under such repressive regimes, organisations may face lower social expectations and pressure (Williams 1999). On the other hand, organisations and particularly Islamic banks operating in relatively open communities with greater freedom may need to provide further justification to legitimize their existence and hence disclose CSR information. As with Williams (1999), a significant negative relationship is expected between the levels of CSR disclosure presented by Islamic banks and the extent of political and civil repression.

H1: There is a negative association between the level of political and civil repression and the level of CSR disclosure presented in annual reports by Islamic Banks.

### 3.2.3 Hypothesis: Relevant Public

#### *Relative size of Muslim population*

While the broader social and political environment may affect the flow of information and the effectiveness of social interest groups in a particular country, the relative size of the Muslim population as a proxy for the Islamic society will contemporaneously determine the level of CSR disclosure presented by Islamic banks.

Newson and Deegan (2002) point to the crucial factor that is directly relevant to management: the ‘relevant publics’ to which the organisation is accountable. As articulated in the theory development section, it could reasonably be justified that the main ‘relevant public’ in the case of Islamic banks is the Islamic society.

Applying Newson and Deegan's (2002) concept, while there may be limited expectations about social responsibilities within a particular country, if an Islamic bank relies on support from the Islamic public, then it must demonstrate adherence to the expectations thereof.

Newson and Deegan (2002) elaborate that while there may be national differences across countries with regards to disclosure perhaps attributed to cultural and other factors, their notion of a 'global' culture and Islamic culture in this study, should work against the differences in CSR disclosure policies. Reiterating this point, Maali et al. (2003) indicate that Islamic banks claiming to follow Islamic principles are required to make certain universal voluntary disclosures regardless of local standards, because the need to report such items is based on accountability to the Islamic public or society.

However, the extent to which Islamic banks comply with these universal expectations of CSR disclosures depends on the relative power of the 'relevant public' to influence the activities of Islamic banks. Given that the relevant public in the case of Islamic banks is the Islamic society, the proportion of population in a country that adhere to the principles of Islam or in other words, the relative size of the Islamic society could arguably represent the influence of the 'relevant public' for Islamic banks (Karim 1990). If the 'relevant public' comprise a larger proportion of the overall population, there will be increased pressure on the Islamic banks to legitimise their actions to this constituency who enjoy a relatively stronger position in the social and political environment within which Islamic banks operate (Roberts 1992). Hence, a significant positive relationship is expected between the proportion of adherent Muslims and the level of CSR disclosure presented by Islamic banks.

*H2: There is a positive association between the proportion of adherent Muslims (in a Muslim country) and the level of CSR disclosure presented in annual reports by Islamic banks.*

### **3.3 Corporate Governance**

It has been suggested that Islamic banks are also driven by economic realities within which they operate. According to Archer et al. (1998), Islamic banks are an efficient means of contracting for investors and fund users wishing to comply with the laws and principles of Islam. The banks usually comprise a group of shareholders that attract funds for investment using a version of the *muḍārabah* contract. The *muḍārabah* contract is a profit sharing financial instrument with "detailed juristic rules derived from the Sharī'ah which regulates the relationship between investment account holders (IAH) as providers of funds and the bank in its capacity as entrepreneur (*muḍārib*)" (Archer et al. 1998, p. 152).

The aggregate investment portfolio of an Islamic bank is financed by IAHs' funds,<sup>9</sup> shareholder's equity and other sources of funds available to the bank (Archer et al. 1998). The bank's management acts as an agent not only for the shareholders, but also for investment account holders as the *muḍārib*. The Islamic bank then invests these funds in activities acceptable in the Sharī'ah.<sup>10</sup>

Since Islamic banks cannot earn or pay any interest, Islamic banks invest their funds through profit and loss sharing arrangements such as partnership contracting (*muḍārabah* or *mushārahah*) or other acceptable contracts such as mark-up (*murābahah*), deferred payment (*bay' mu'ajjal*), leasing (*ijārah*), forward sale contract (*salām*) and manufacturing contract (*istiṣnā'*) (Usmani 2002).

### 3.3.1 Agency Problems

In light of the above, a number of agency problems are encountered in the contractual structure of Islamic banks which may also affect the CSR disclosure presented by Islamic banks in their annual reports.

The principal problem is that the two types of principals (the IAH and shareholders) have inferior information to that possessed by management, particularly about the application of Islamic laws in relation to the banks' operations. Islamic banks are under an implicit contractual obligation to both their shareholders and IAH to function according to the laws and principles of Islam. Bakar states that "Sharī'ah compliance is the very essence of an Islamic bank and its banking business" (2002, p. 76).

Another agency problem is the fact that investment accounts are not a liability with a fixed claim on the company's assets and hence are only given a residual claim to the bank's earnings or assets *pari passu* with that of shareholders (Archer et al. 1998). The IAH has no formal right to show their disapproval of management actions except to 'vote with their feet' (Archer et al. 1998). Archer et al. (1998) explain that in that case, due to the inherent benefits of higher returns from funds invested by IAH, shareholders may 'vicariously' monitor for their other counterparts: the IAH. They state that the relationship between IAH and shareholders "exhibits some features of bilateral dependency, in that the IAH depend on shareholders for monitoring while the shareholders depend on IAH as a source of profits via the *muḍārib* share" (Archer et al. 1998, p. 164). The IAH, if it is comprised of Islamic investors would also be interested in the level of compliance of the bank with Islamic laws and principles.

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<sup>9</sup> IAH funds usually comprise a mix of *unrestricted* and *restricted muḍārabah* contracts. The IAH who use *unrestricted muḍārabah* authorise their *muḍārib* to invest their funds at its discretion including co-mingling the IAH's funds with those of the shareholders. The *restricted muḍārabah* IAH, on the other hand specify to the bank the type of investment in which their funds should be invested e.g. real estate, currencies or leasing.

<sup>10</sup> An Islamic bank is not allowed to invest in activities that are associated with gambling, alcohol, pork and generally encouraged to invest in social development activities.

Consequently, the extent of Shari‘ah compliance by an Islamic bank will depend on the level of monitoring in place to limit the divergence of interest between the principals who are particularly interested in Shari‘ah compliance of the bank and the agent which is the banks’ management. Karim (1990) broadly classifies the three main types of shareholders of Islamic banks:

- Management
- Islamic investors<sup>11</sup>
- Economic investors<sup>12</sup> (Karim 1990).

The same categorisation could be used for classifying IAH perhaps with the exclusion of management shares. The segment most interested in the banks’ compliance with Islamic laws and principles within this categorisation would be the Islamic investors. The greater the level of monitoring by Islamic investors, the greater the compliance of the Islamic bank with Islamic laws and principles. Hence, the extent of CSR disclosure could arguably depend on the level of monitoring by the Islamic investor group. Two major determinants of the level of monitoring are identified in the literature: monitoring mechanisms and ownership structure.

### 3.3.2 Hypothesis: Monitoring Mechanism

#### *Islamic governance: The shari‘ah supervisory board*

A number of Islamic banks employ a special form of monitoring to limit the divergence of interest between Islamic investors and the management of the Islamic bank. Shari‘ah supervisory boards (SSB) assure investors of the compliance of Islamic banks with Islamic laws and principles. The demand for the services of an SSB arises out of a “perceived need to constantly Cheque innovations in banking Practise [as well as in accounting] against the principles of Islamic orthodoxy” (Karim 1995, p. 287). It is not mandatory for an Islamic bank to have its own SSB. However, the AAOIFI require both the SSB and the financial auditors of Islamic banks to report on compliance with Shari‘ah doctrines (AAOIFI 2004). The AAOIFI standards explicitly state that the Shari‘ah supervision is “intended to investigate to what extent the financial institution has adhered to Shari‘ah rules and principles in all its activities” (Bakar 2002, p. 81). The investigation would include examination of the “bank’s memorandum and articles of association, its contracts...its financial reports and various other reports...” (Bakar 2002, p. 81). Karim stresses that “in most cases, SSB’s authority is equal to those of external auditors” (1995, p. 35).

Ideally, one would expect the SSB to represent orthodox Islamic laws and principles more so than management. The Islamic credentials of the members of

<sup>11</sup> Islamic investors invest in Islamic banks primarily for religious reasons but also for economic reasons.

<sup>12</sup> Economic investors invest in Islamic banks purely for economic reasons.

the SSB are considered to be impeccable (Karim 1990). If SSBs are employed to ensure compliance of the Islamic bank to Islamic laws and principles, it can be deduced that they may play a role in mandating CSR activities and also CSR disclosure. However, the extent to which the SSB influences CSR disclosure depends on the function of the SSB in monitoring on behalf of investors.

The extant literature suggests two competing viewpoints: the impact of internal governance mechanisms on corporate disclosures may be complementary or substitutive (Ho and Wong 2001). A greater magnitude of disclosures would be expected if it is complementary as “more governance mechanisms will strengthen the internal control of companies and provide an intensive monitoring package for a firm to reduce opportunistic Behaviour and information asymmetry” (Ho and Wong 2001, p143). Islamic banks would thereby be under greater pressure from the SSB to comply with Islamic laws and principles and hence disclose more CSR information. This view is consonant with the role and function of the SSB described above.

Alternatively, corporate governance mechanisms may be substitutive and may result in lower disclosures (Ho and Wong 2001). Where there is an additional governance mechanism installed that leads to greater monitoring, the need for disclosure as a form of monitoring then decreases (Ho and Wong 2001). The SSB may see no need to emphasize additional CSR disclosures if the bank’s activities are complying with Islamic laws and principles and they assure investors of that through their Shari‘ah compliance report (Maali et al. 2003). If information asymmetry can be reduced because of existing monitoring packages such as the SSB, the need for installing additional monitoring through greater CSR disclosures to assure Islamic investors of the banks commitment to Islamic laws and principles is lower (Ho and Wong 2001).

While these two conflicting viewpoints have not been totally resolved, Hill argues that no single mechanism is a governance panacea and suggests that it “is desirable to have a system of overlapping Cheques and balances” (Ho and Wong 2001, p. 143).

Notwithstanding, it is expected that the former explanation holds true. This is because the nature of compliance with Islamic laws and principles from an Islamic point of view entails not only assurance of compliance through issuing the Shari‘ah report, but also greater involvement in CSR activities and CSR disclosures. The SSB’s function as stated by the AAOIFI also concurs with this rationale. Hence, it is generally expected that the existence of a SSB in an Islamic bank would lead to greater levels of CSR disclosures.

However, while the existence of a SSB may lead to greater monitoring and thereby greater disclosures of CSR information, the degree to which the SSB would influence CSR disclosures may also depend on the characteristics of this corporate governance mechanism (Haniffa and Cooke 2002; Ho and Wong 2001).

Hence, a multitude of factors that relate to the SSB's characteristics may determine how effectively the SSB conducts its function and subsequently the level of CSR information disclosed by Islamic banks. A number of characteristics are elaborated upon, after which a hypothesis is formulated.

#### *Number of board members*

An increase in the number of SSB members may lead to higher levels of CSR disclosure as the capacity for monitoring increases. With regard to the minimum number of members of any SSB, the AAOIFI standards have required at least three members. This is a common requirement in many Islamic banks such as Faysal Islamic Bank of Sudan. The greater the number of members in a SSB, the greater the amount of monitoring, implying a greater level of compliance with Islamic laws and principles. The SSB would be able to allocate its functions across a larger group of members, allowing the SSB to review more aspects of the banks' activities and hence ensure greater compliance. One aspect of this compliance is more CSR disclosure. Further, synergies could also be present in boards with a large number of members pooling their ideas and perspectives to derive better applications of Islamic law, particularly with regards to disclosure. The AAOIFI recommends a number of different people from different professions to sit on the SSB, including bankers, economists and full-time member(s) (AAOIFI 2004). This allows for the implementation of diverse perspectives on the application of the Shari'ah. To enable this to happen, a large SSB would be required to represent these sectional professions. The above analysis suggests that the SSB size should have a positive relationship with CSR disclosure.

#### *Cross memberships*

Cross memberships of SSB members may also lead to higher disclosure of CSR information (Dahya, Lonie and Power, 1996). The literature suggests that cross-directorships increase transparency for two reasons: firstly, members with cross-directorships can make comparisons from knowledge gained in other companies; and secondly "decisions at one board become part of the raw material for decisions at other boards" (Haniffa and Cooke 2002, p. 321). SSB members with cross-memberships will be exposed to more discussions about the application of Islamic law in banking. This increased experience should enhance their knowledge about the application of Islamic principles to corporate reporting and in particular to CSR disclosure.

#### *Secular educational qualifications*

In the extant literature, the director's education has been proposed to influence the level of disclosure. Hambrick and Mason (1984) indicated that the more educated the director, the more likely he/she is to adopt innovative activities and accept ambiguity. The level of education of the SSB members may influence the level of CSR disclosure. Bakar states that "ideally a Shari'ah adviser (board member) must be able to understand not only Shari'ah issues but also issues

pertaining to law and economics, because such issues in many cases are overlapping” (2002, p. 79). SSB members usually comprise scholars of Islamic law who may not be highly educated in secular studies. SSB members who are not highly educated may be undermined in their abilities as Islamic law scholars to fully apply theoretical Islamic laws and principles because of their lack of practical commercial knowledge (Bakar 2002; Bokhari 2002). Hence, scholars with a doctorate degree are arguably better informed of the current implications of Islam for financial institutions, particularly with regards to CSR disclosure.

#### *Reputable scholars*

Some Shari‘ah scholars have a significant amount of tacit knowledge about the application of Islamic law. However, they may not have formally recognised qualifications from secular educational institutions. Hussain and Mallin (2003) report that the factors influencing the appointment of directors in Bahraini companies are relevant skills, business experience and reputation. Following that reasoning, it is expected that reputation is a proxy for industry knowledge and hence reputable scholars are more likely to understand the current implications of Islamic banking, particularly with regards to disclosure. Hence, reputable scholars are more likely to emphasize CSR activities and the subsequent disclosure of CSR information.

#### *IG-Score*

A number of previous studies have combined corporate governance factors into an index which attempts to capture their aggregate effect. Gompers, Ishii and Metrick (2001) and Hanlon, Rajgopal and Shevlin (2003) combine a number of variables as proxy for governance factors to produce a g-score. Applying the same reasoning, this study develops an Islamic governance score (IG-SCORE). In particular, a score is constructed based on the existence and characteristics of the SSB as detailed above. The score sums the value of the dichotomous characteristics of the board, namely the existence of the SSB, the number of board members, the existence of members with cross-memberships, the existence of members with doctoral qualifications and the existence of reputable scholars presiding on the board. The method is elaborated in the research design. A positive relationship is expected between the Islamic governance score (IG-SCORE) and the level of CSR disclosure presented by an Islamic bank.

*H3: There is a positive association between the Islamic governance scores obtained and the level of CSR disclosure presented by Islamic banks in their annual reports.*

### **3.3.3 Hypothesis: Ownership Structure**

#### *Investment Account Holders’ (IAH) rights*

The structure of ownership also determines the level of monitoring and thereby the level of disclosure (Jensen and Meckling 1976). A number of prior studies look



at the effect of ownership structure on voluntary disclosure (Ruland, Tung and George 1990; Eng and Mak 2003; El-Gazzar 1998; Mitchell, Chia and Loh 1995; McKinnon and Dalimunthe, 1993; Schadewitz and Blevins, 1998).

As elaborated above, Islamic investors determine the extent of compliance with Islamic principles and consequently the level of CSR disclosures. Islamic investors are more likely to invest their funds as IAH rather than as shareholders since Islamic investors are primarily interested in the services that Islamic banks offer, rather than share ownership of the Islamic banks per se. Further, investment accounts with Islamic banks are generally more accessible than shares of Islamic banks. In the context of SSB reports, Karim states that:

...If a negative report were to be published, it would be expected that this group (IAH) would begin to doubt management's commitment to Islam. Such a belief would have a detrimental impact on the bank since these clients are likely to refrain from dealing with the bank (1990, p. 41).

While the IAH do not have any formal voting rights, they nevertheless influence the level of monitoring of management 'vicariously' through shareholders (Archer et al. 1998). This is due to the fact that the profits of shareholders are determined by the profits earned through the utilisation of IAH funds.

If the IAH are more interested than the shareholders in the bank's compliance with Islamic laws and principles, then the relative influence of the IAH will determine the extent to which the bank complies with Islamic laws and principles and consequently the level of disclosure presented by the bank. This suggests that CSR disclosure is positively related to the relative size of IAH funds as a proportion of shareholder funds.

*H4: There is a positive association between the proportion of IAH funds to shareholder funds and the level of CSR disclosure presented by Islamic banks in their annual reports.*

## 4. Data and Research Design

### 4.1 Sample and Data Description

In order to test the hypotheses, annual reports<sup>13</sup> of fully fledged Islamic banks from a number of countries were collected for the years ending 2002 or 2003. The collection of two years of annual reports improved the chances of achieving a

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<sup>13</sup> Annual reports may not be the only means by which Islamic banks communicate their CSR information. They may utilize other means such as advertising, public relations and internet sites to convey social information. Notwithstanding, Gray *et al.* (1995) state that the annual report is the only document produced regularly to comply with regulatory requirements and more importantly is central to the organisations construction of its own external image. Hence, this study only considers the information disclosed in annual reports.

larger sample size as a number of the banks had not published their 2003 annual report at the time of data collection.

Islamic banks are classified as any financial intermediary that claims to operate according to the laws and principles of Islam (IAIB, 2001). Therefore, the sample of Islamic banks contains service banks, investment banks, mortgage companies and leasing companies operating as either publicly listed companies, private companies or as government owned institutions. The structure of the banks and the types of services they offer are not significant in determining CSR disclosure, as the expectation to disclose CSR information is based on the fact that the banks claim to be Islamic. Hence, mission statements and/or information on their websites are used to verify the banks' claim to operate according to Islamic laws and principles.

The initial sample population for the study comprised all Islamic banks in the world derived from a comprehensive list compiled by Archer and Karim (2002). These were cross-checked with the International Directory of Islamic Banks and Institutions (2000) issued by the Institute of Islamic Banking and Insurance in London and the relevant stock exchanges. Approximately 187 fully fledged Islamic banks in 29 countries were identified. The annual reports for Islamic banks were primarily obtained from their websites and the relevant stock exchange web-sites. Approximately 33 banks' annual reports were collected in this manner. To enlarge the sample size, another 48 banks were identified in the sample for which mailing addresses were available. Each bank was sent a letter requesting their 2002 and 2003 annual reports. In total, 14 Islamic banks' annual reports were received giving an overall response rate of 29.8%. This is somewhat lower than the response rates achieved for studies in which Islamic banks annual reports were used. Maali et al. (2003) achieved a response rate of 37.5% with an initial sample of 88 banks. The final sample consists of 47 banks from 14 countries with the distribution as follows: Bahrain (6), Bangladesh (5), Egypt (1), Iran (4), Jordan (2), Kuwait (5), Malaysia (2), Pakistan (8), Qatar (2), Saudi Arabia (5), Sudan (1), Turkey (2), United Arab Emirates (3), and Yemen (1).

## 4.2 Research Design

Ordinary least squares (OLS) regression is used to examine the relationship between CSR disclosure and the explanatory variables.<sup>14</sup> The regression equation is as follows:

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<sup>14</sup> A number of tests were conducted to confirm the normality of the distribution. Normal probability plots and histograms of the distribution of the dependent variable (CSRDIS) and scatter plots of standardized residuals against standardized estimates of CSRDIS were reviewed on all models to verify that the normality and homoscedasticity assumptions were valid. Multicollinearity tests are also conducted on all models. The variance inflation factors (VIF) range from 1-2 and eigenvalues and condition indices were checked to ensure there was no excessive multicollinearity. However, caution must nonetheless be drawn in

$$\text{CSRDIS} = \alpha + \beta_1\text{PRCL} + \beta_2\text{MUSPOP} + \beta_3\text{IG-SCORE} + \beta_4\text{IAH} + \beta_5\text{SIZE} + \varepsilon$$

CSRDIS is the CSR disclosure index score of the bank. Table 1 provides a summary of the operationalisation of the independent variables.

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generalizing from these results as sample size may limit the significant findings in this study. Further, an expert statistician from the University of Technology, Sydney, was consulted to ensure that the data did not violate any assumptions that are usually sacrificed with small sample sizes.

Table 1: summary of the source and operationalisation of independent variables

| Hypothesis                                      | Independent Variables | Operationalisation                   | Source of information of information   |   |
|---|-----------------------|--------------------------------------|--|---|
| Socio-political context- Political economy      |                       |                                      |  |   |
| H <sub>1</sub>                                  | PRCL                  | Political rights and civil liberties | Overall combined index scores of political rights and civil liberties based on work of Gastil (1978) for the given nation: 1 (freedom) to 14 (repression)                    | Freedom House 'freedom in the world' Index<br><a href="http://www.freedomhouse.org/ratings/allscore04.xls">http://www.freedomhouse.org/ratings/allscore04.xls</a> |
| Socio-political context- Relevant publics       |                       |                                      |  |   |
| H <sub>2</sub>                                  | MUSPOP                | Proportion of Muslim population      | Ratio of Muslim population to total population   | CIA World Factbook, 2004<br><a href="http://www.odci.gov/cia/publications/factbook/geos/">http://www.odci.gov/cia/publications/factbook/geos/</a>                 |
| Corporate Governance- Shari'a Supervisory Board |                       |                                      |  |   |
| H <sub>3</sub>                                  | IG-SCORE              | Islamic governance score             | Existence of SSB + Number of SSB members + Cross memberships + Doctorate qualification of SSB member + Reputable scholars on SSB   | Derived from sub-variables below  |
|   | SSB                   | Existence of SSB                     | Dichotomous; yes/no  | Bank Annual Report  |
|   | NUM                   | Number of SSB members                | Dichotomous; 1 for banks with 7 or more members and 0 otherwise  | Bank Annual Report  |
|   | CROSS                 | Cross Memberships                    | Dichotomous; If any SSB member with cross-directorship: 1, otherwise: 0.   | Bank Annual Report  |
|   | PHD                   | Doctoral qualification of SSB member | Dichotomous; If any SSB member with doctorate qualification: 1, otherwise: 0   | Bank Annual Report and website  |
|   | REP                   | Reputable Scholars on SSB            | Dichotomous; If any reputable SSB member: 1; otherwise: 0. Reputable scholar is one that has a position in the SSB of the AAOIFI and at least two Shari'a board memberships. | AAOIFI Standards and Bank Annual Report   |
| Corporate Governance- Ownership Structure       |                       |                                      |  |   |
| H <sub>4</sub>                                  | IAH                   | Investment Account Holders           | Ratio of total amount of investment account funds to paid up capital in shareholders equity.   | Bank Annual Report  |
| Control   |                       |                                      |  |   |
|   | SIZE                  | Size                                 | Natural Log of Book value of assets translated into USD  | Bank Annual Report  |

### *Dependent Variable*

The dependent variable was constructed using an index of expected CSR disclosure of Islamic banks operating in Muslim countries. The index was derived from Maali et al. (2003) and contains 32 items.<sup>15</sup> Following Inchausti (1997) and Maali et al. (2003), each item in the disclosure index was given the same weight (Barrett 1997). Items disclosed were given a weight of 1 while undisclosed items were weighted 0. The annual report of each bank was reviewed and a Judgement made by the author as to which items were relevant to each bank. Irrelevant items were not considered as part of the overall score for the respective bank. For instance, some banks are required by law to pay *zakāh*, while others are not. Hence, the CSR disclosure score was constructed as a ratio of the actual score achieved by the bank to the maximum possible value for each bank from the 32 disclosure items (Maali et al. 2003).

### *Independent Variables*

The independent variables are categorized into three groups: socio-political context, corporate governance and control. Since a number of the variables were never considered in previously published research on disclosure and particularly CSR disclosure, the appropriateness of these variables was discussed with and confirmed by a managing director and a Sharī'ah supervisory board member of an Islamic bank in Australia.

### *Control Variable*

Firm size (SIZE) – Log of total assets. This measure has been consistently found to influence CSR disclosure (Belkaoui and Karpik 1989; Roberts 1992; Williams 1999; Patten 1991). The arguments for larger firms disclosing higher levels of CSR flow from a number of different theoretical perspectives. Agency and positive accounting theories predict that managers use CSR disclosure as part of their overall strategy to reduce agency costs and in particular political costs (Watts & Zimmerman 1978). Large firms are more politically visible and therefore disclose more information. The legitimacy theory argument is that the more social exposure a firm receives by being larger, the greater the need to legitimize its existence to its relevant publics (Patten 1991). Hence, a significant positive relation is expected between firm size and voluntary disclosure.

### *Alternative definitions of explanatory variables*

There are a number of alternative definitions for the explanatory variables stated above. Therefore, sensitivity testing is carried out, the results of which are reported subsequent to the main regression model.

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<sup>15</sup> Refer to Maali *et al.* (2003) for details on the construction of the disclosure index.

## 5. Results

### 5.1 Descriptive Statistics

The mean CSR disclosure for the 47 banks in the sample is approximately 16.8% of expected disclosure, representing an increase from Maali et al. (2003) who reported a mean disclosure of 13.3%. This is perhaps due to the fact that there are more banks in the sample used in this study. The maximum reported disclosure was 48.3% of expected disclosure, still falling significantly below expectations of the bank's Islamic stakeholders or any Islamic society. A number of the banks had no CSR disclosures.

The Pearson parametric and Spearman non-parametric correlation tests indicate that CSR disclosure is significantly related to size (SIZE), the Islamic governance score (IG-SCORE) and investment account holders' rights (IAH). Size is also significantly related to the Islamic governance score (IG-SCORE) and investment account holders' rights (IAH). This is intuitively appropriate since larger banks would have better monitoring mechanisms in place and would be funded to a greater extent by investment account holders rather than shareholders. The proportion of Muslim population (MUSPOP) is significantly related to the level of political rights and civil liberties (PRCL) in a country.

### 5.2 Main Regression Model

Table 2 shows the results of the multivariate regression analysis. The model is statistically significant at the 1% level and has an adjusted R-square of approximately 0.393, indicating that the model explains a significant amount of the variation in disclosure. The control variable SIZE (log total assets) is not statistically significant. This is inconsistent with prior studies which find size to be significantly related to CSR disclosure (Williams 1999). This may be due partly to the fact that the study is cross-national and log total assets is not a relative measure which captures the differences in relative size between countries.

Table 2 displays the regression results for the determinants of CSR disclosure. The coefficients are based on the following equation:

$$CSRDIS = \alpha + \beta_1 PRCL + \beta_2 MUSPOP + \beta_3 IG-SCORE + \beta_4 IAH + \beta_5 SIZE + \varepsilon$$

Table 2: regression analysis main model

| Independent Variables          | Predicted Sign | Coefficients | <i>t</i> -statistics | <i>p</i> -value | VIF   |
|--------------------------------|----------------|--------------|----------------------|-----------------|-------|
| Intercept                      |                | -0.517       | -2.457               | 0.018           |       |
| PRCL                           | -              | -0.001       | -0.105               | 0.917           | 1.148 |
| MUSPOP                         | +              | 0.373        | 2.298                | 0.027 *         | 1.168 |
| IG-SCORE                       | +              | 0.046        | 3.625                | 0.001 **        | 1.376 |
| IAH                            | +              | 0.003        | 1.927                | 0.061           | 1.362 |
| SIZE                           | +              | 0.023        | 1.258                | 0.215           | 1.591 |
| Std Error                      | 0.100          |              |                      |                 |       |
| <i>F</i> value                 | 6.950          |              |                      |                 |       |
| <i>Sig. F</i> (p-value)        | 0.000          |              |                      |                 |       |
| <i>R</i>                       | 0.677          |              |                      |                 |       |
| <i>R</i> <sup>2</sup>          | 0.459          |              |                      |                 |       |
| Adjusted <i>R</i> <sup>2</sup> | 0.393          |              |                      |                 |       |

\*\* Coefficient is significant at the 0.01 level (2-tailed).

\* Coefficient is significant at the 0.05 level (2-tailed).

#### Variable Definitions:

|                       |   |
|-----------------------|---|
| PRCL                  | Political rights and civil liberties index scores from Freedom House ranging from 1 (highest amount of political rights and civil liberties) to 14 (lowest amount of political rights and civil liberties). |
| MUS POP               | Proportion of Muslim population to total population of the given nation.  |
| IG-SCORE              | (SSB+NUM+CROSS+PHD+REP).  |
| IAH                   | Ratio of investment account holders' funds to paid-up capital.  |
| SIZE                  | Natural log of the bank's total assets.   |
| CSR DIS               | CSR disclosure index score of bank.   |
| IG-SCORE consists of: |   |
| SSB                   | 1 for Islamic banks with <i>Shari'a</i> Supervisory boards and 0 otherwise.   |
| NUM                   | 2 for Islamic banks with 7 or more SSB members and 1 otherwise.   |
| CROSS                 | 1 for Islamic banks with one or more cross-members and 0 otherwise.   |
| PHD                   | 1 for Islamic banks with one or more members with doctorate qualifications and 0 otherwise.   |
| REP                   | 1 for Islamic banks with one or more reputable scholars as members of the SSB and 0 otherwise.  |

The political rights and civil liberties (PRCL) variable is in the predicted direction. However, it is not statistically significant ( $p$ -value=0.917), which is inconsistent with prior studies on disclosure and CSR disclosure (Archambault and Archambault 2003; Williams 1999). The proportion of Muslim population (MUSPOP) variable is in the predicted direction and statistically significant at the 5% level ( $p$ -value=0.027). This indicates that the size of the relative publics'

proxying for their ability to influence and apply pressure on Islamic banks is a significant factor in determining the level of CSR disclosure presented by these banks.

One of the corporate governance factors is significant at or below the 5% level. The combination of the SSB characteristics (IG-SCORE) is highly significant at the 1% level and in the predicted direction ( $p$ -value=0.001) while the investment account holders' rights (IAH) variable is in the predicted direction but only marginally significant at the 10% level ( $p$ -value=0.061). The highly significant IG-SCORE indicates that the SSB and its characteristics are important in influencing CSR disclosures. The insignificance of the IAH variable is contrary to H4.

Overall, the preliminary results suggest that the relevant publics and monitoring mechanisms such as the SSB increase the level of CSR disclosure by Islamic banks.

### 5.3 Sensitivity Testing

Since there is a degree of arbitrariness in selecting the proxies for the model variables, sensitivity tests are conducted to ensure the robustness of the results and to further enhance the empirical model. Replacing the measure of political rights and civil liberties with a relatively simpler index ranking countries from 'free' (1) to 'partially free' (2) to 'not free' (3), increases the adjusted R-square from 0.393 in the original model to 0.452 and the variable PRCL becomes significant at the 5% level ( $p$ -value=0.042). Since size was found to be insignificant contrary to expectations, a relative measure of size was used by dividing the total assets of the bank by the gross domestic product of countries and then logging the value. While this was done to adjust for the relative differences in size between countries, no significant results were found.

Two alternative measures of IAH were utilised. The first measure utilised was the ratio of total investment account holders' fund to total assets. The IAH variable increases in significance to the 5% level ( $p$ -value=0.029) and the adjusted R-square increases from 0.393 in the original model to 0.411. The second measure utilised is the ratio of the total investment account holders' funds to total shareholders' equity. The IAH variable loses its significance using this measure and the R-square decreases from 0.393 in the original model to 0.348. There are no significant changes in the other variables. Further, to ensure that the significant correlation between IAH rights and size is not introducing noise into the regression, tests were conducted excluding either IAH rights or size from the regression model. While each of the variables increase in significance when one of them are excluded from the model, excluding IAH from the model reduces the total R-square more than excluding size, indicating that the IAH contributes more significantly in explaining disclosure than SIZE. Hence, it may be inferred that the significance of the SIZE variable in the test conducted without IAH was only capturing the effect of an omitted correlated variable.



Since the IG-SCORE attempts to combine the effect of five difference sub-variables, it is not informative as to the effect of each sub-variable. Tests are run excluding each one of the sub-variables one at a time from the IG-SCORE to review the consequent effect on the significance of the IG-SCORE and the adjusted R-square of the total model. The IG-SCORE variable drops in significance and the R-square is vastly reduced at every instance a sub-variable is dropped except for when the sub-variable NUM is dropped indicating that the number of scholars is not an important factor in contributing to higher CSR disclosure.

Table 3 displays the optimal regression model derived from the sensitivity tests conducted utilising alternative measures of political rights and civil liberties (PRCL) and IAH rights (IAH).

The coefficients are based on the following equation:

$$\text{CSRDIS} = \alpha + \beta_1 \text{PRCL} + \beta_2 \text{MUSPOP} + \beta_3 \text{IG-SCORE} + \beta_4 \text{IAH} + \beta_5 \text{SIZE} + \varepsilon$$

Table 3: Optimal regression model

| Independent Variables          | Predicted Sign | Coefficients | <i>t</i> -statistics | <i>p</i> -value |    | VIF   |
|--------------------------------|----------------|--------------|----------------------|-----------------|----|-------|
| Intercept                      |                | -0.412       | -2.092               | 0.043           |    |       |
| <b>PRCL</b>                    | -              | -0.072       | -2.187               | 0.034           | *  | 1.448 |
| MUSPOP                         | +              | 0.481        | 3.091                | 0.004           | ** | 1.231 |
| IG-SCORE                       | +              | 0.035        | 2.823                | 0.007           | ** | 1.547 |
| <b>IAH</b>                     | +              | 0.096        | 2.136                | 0.039           | *  | 1.333 |
| SIZE                           | +              | 0.020        | 1.166                | 0.250           |    | 1.629 |
| Std Error                      | 0.093          |              |                      |                 |    |       |
| <i>F</i> value                 | 9.187          |              |                      |                 |    |       |
| <i>Sig. F</i> (p-value)        | 0.000          |              |                      |                 |    |       |
| <i>R</i>                       | 0.727          |              |                      |                 |    |       |
| <i>R</i> <sup>2</sup>          | 0.528          |              |                      |                 |    |       |
| Adjusted <i>R</i> <sup>2</sup> | 0.471          |              |                      |                 |    |       |

\*\* Coefficient is significant at the 0.01 level (2-tailed).

\* Coefficient is significant at the 0.05 level (2-tailed).

Variable Definitions:

|                       |   |
|-----------------------|---|
| PRCL                  | Political rights and civil liberties index scores from Freedom House. 1: for countries classified free, 2: for countries classified partially free, 3: for countries classified not free. |
| MUSPOP                | Proportion of Muslim population to total population of the given nation.  |
| IG-SCORE              | (SSB+NUM+CROSS+PHD+REP).  |
| IAH                   | Ratio of investment account holders' funds to total assets.   |
| SIZE                  | Natural log of the bank's total assets.   |
| CSR DIS               | CSR disclosure index score of bank.   |
| IG-SCORE consists of: |   |
| SSB                   | 1 for Islamic banks with <i>Shari'a</i> Supervisory boards and 0 otherwise.   |
| NUM                   | 1 for Islamic banks with 7 or more SSB members and 0 otherwise.   |
| CROSS                 | 1 for Islamic banks with one or more cross-members and 0 otherwise.   |
| PHD                   | 1 for Islamic banks with one or more members with doctorate qualifications and 0 otherwise.   |
| REP                   | 1 for Islamic banks with one or more reputable scholars as members of the SSB and 0 otherwise.  |

### 5.3.1 Optimal Regression Model

Based on the sensitivity analysis conducted above, an optimal regression model is formed utilising two alternative measures derived from the sensitivity testing. The original political rights and civil liberties variable (PRCL) is replaced by the

measure elaborated in section 5.3.2. The IAH variable is replaced by the alternative IAH rights' measure elaborated in section 5.3.4.: the ratio of total IAH funds to total assets. The results are reported in table 3. The model provides an adjusted R-square of approximately 0.471 recording a significant increase from the original model which had an adjusted R-square of approximately 0.393. All variables except SIZE are significant with PRCL (p-value=0.034) and IAH (p-value=0.039) being significant at the 5% level and MUSPOP (p-value=0.005) and IG-SCORE (p-value=0.007) being significant at the 1% level.

## 6. Conclusions

Islamic banks have grown in size and significance in the past three decades. In line with Islamic principles, Islamic banks should fulfil an ethical role inherent in their character as an 'Islamic' bank. The objective of this study was to measure the CSR disclosure levels of Islamic banks and subsequently ascertain the likely determinants of that disclosure. Contrary to expectations of full disclosure and accountability, it was found that the majority of Islamic banks disclose significantly less than expected, with apparent differences in the levels of disclosure. To explain these differences a number of hypotheses were derived and subsequently tested.

The significance of the variable PRCL suggests that the extent of political and civil repression influences the level of CSR disclosure by Islamic banks. This gives weight to the view consistent with Williams (1999) that organisations operating in relatively repressed societies face lower social expectations while organisations operating in relatively open communities need to provide further justification to legitimize their existence. The significance of the variable MUSPOP lends weight to the hypothesis that the level of CSR activities and consequently disclosure will depend on the extent of influence that the 'relevant publics' have on the organisation. The combined results of these two hypotheses demonstrate the theoretical significance of applying 'levels of resolution of perception' to understand the complex interactions between organisations and society in the broader socio-political environment.

The significance of the corporate governance variables lends support to the view that Islamic banks are also driven by economic realities. In particular, the existence of Shari'ah board members with cross memberships, doctorate qualifications and/or international repute results in greater monitoring and hence greater compliance with Islamic laws and principles, an output of which is higher levels of CSR disclosure. This implies that skilled scholars are required to decipher Islamic law to apply it to modern Islamic banks, particularly with regards to CSR disclosure. Further, the significance of IAH rights in influencing CSR disclosures imply that Islamic banks disclose CSR in order to bond their activities to their 'Islamic' investors.

Overall, the results suggest that there are a number of factors which contemporaneously influence CSR disclosure of Islamic banks including socio-political pressures and economic incentives.

The results here have a number of potential policy implications for Islamic banks and regulators. While socio-political factors may restrain the level of CSR disclosure presented by Islamic banks, increasing the level of monitoring within the banks, such as the installation of a SSB can counter that and lead to greater CSR disclosure. As highlighted in the literature, these results further emphasize the need for Islamic banks to invest more in monitoring mechanisms, such as greater training of SSB members to increase the confidence of the Islamic investors and society (Bakar 2002). Furthermore, these results also give weight to the contention that uniform accounting standards and Shari'ah rulings across the globe need to be implemented in order to ensure a uniform level of disclosure by Islamic banks (Dudley 2004; Karim 2001).

A number of limitations are expressed about the generalisability of the results. The sample size of 47 observations is one such limitation. While a number of tests were conducted to ensure that the sample represented a normal distribution, there is the likelihood that the results represent a random occurrence or are biased towards the variables. Further, this study only uses Islamic banks' annual reports to measure CSR disclosure. It is likely that Islamic banks also use other forms of media to communicate with investors and greater society such as company websites, press releases, annual general meetings, special booklets and pamphlets detailing their contribution to society.

Using larger samples and a larger set of information or variables about the operating environment and individual characteristics of Islamic banks, future research can attempt to further generalise these results and enhance knowledge about the affect of other factors not theorised in this study, particularly regarding transparency and social responsibility and the ensuing CSR disclosures. Lastly, future research could also attempt to generalise the results of this study about the potential impact of the socio-political environment in determining the level of CSR disclosure using conventional organisations operating in diverse cross-national contexts rather than solely Islamic banks.

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