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The Influence of Islamic Governance Disclosure on Islamic Bank’s Financial Performance in Malaysia

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Abstract

The influence of Islamic governance disclosure on Islamic banking financial performance in Malaysia is investigated in this study. Islamic banking is gaining popularity as a result of its ability to meet the needs of specific customers. However, as Islamic banking has grown, various new risks have evolved, such as the Shari’ah non-compliance risk. Such occurrences are due to a lack of oversight, control, and disclosed information, particularly in non-compliant matters. Every action, transaction, and procedure carried out by an Islamic bank should be compliant with the Shari’ah laws. These issues include incomplete disclosure of information, lax oversight, and weak governance, all of which influence businesses. The goal of this study is to determine the extent of influence the disclosure of Shari’ah governance has had on the financial performance of Islamic banks. This study used a sample size of 16 Islamic banks and is concentrated on Malaysia. Using a checklist created from the Shari’ah governance framework, secondary data is used and collected from yearly reports for the years 2017 through 2021. The checklist consists of five methods that are crucial for ensuring Shari’ah compliance and high-quality transparency in Islamic banking. The method used to gauge financial performance is the return on assets (ROA). In response to the research topic, this study also performed multiple regression analysis. According to this study, the only factors that significantly affect financial performance are the Shari’ah Committee and Shari’ah Risk. Both these processes are crucial in guaranteeing Islamic banking compliance in Malaysia.

Keywords: Islamic Governance, Islamic Bank, Financial Performance, Shari’ah, Governance

Introduction

A Muslim will surely believe that Islam is the way of life. It covers the concepts of faith, law, nationhood, sociability, personality, and so on. It is a comprehensive system (syumul). Islam also believes that Islamic jurisprudence is universal for all human beings, perfect and comprehensive for all things and affairs, eternal for all ties and indivisible and inseparable. It should be used as a whole system. Islam does not recognize the separation between spiritual
and world affair and regards trade as a moral matter and subject to Shari’ah law. Therefore, Islamic banks (and any Islamic business organization) must comply with Shari’ah rules in all business transactions financially. In line with the basics of Islamic economics, namely, the value-oriented system towards the Quran and Sunnah. Because life on earth is merely one phase of life as a human being towards the hereafter. As such, one needs to strive for virtue during life in the world. Islamic banks are supposed to adhere to Shari’ah standards in their activities and operations.

However, due to a lack of norms and controls on modern transactions, Islamic banks may unwittingly depart from the Shari’ah. To address this issue, Bank Negara Malaysia produced the Shari’ah Governance Framework Guidelines in 2010, which have since been replaced by the Shar’iah Governance Policy Document 2019. In 2013, Malaysia passed the Islamic Financial Services Act (IFSA) to regulate Islamic Financial Institutions (IFIs). The importance of Shari’ah conformity was emphasized by this Act. In particular, Islamic banks must ensure that they are devoid of all forms of interest (riba), uncertainty (gharar), and gambling (maysir), as well as any other activities that harm society.

Each Islamic finance institution has a Shari’ah Supervisory Board (SSB), also known as a Shari’ah committee in Malaysia. The board must have at least three jurists, but according to Bank Negara guidelines, it must have at least five members. They are paid by the bank but work independently. Their role is consultative in nature as well as regulatory. Their responsibilities are responding to staff inquiries, providing advice on charitable contributions (zakat), verifying operations, certifying and products. The two main sources of Islamic law, the Quran and the Sunnah, or what the Prophet Muhammad reportedly said and did during his lifetime, are used by SSBs to determine what is permissible (halal) and forbidden (haram). Board decisions are made by a majority vote and are legally binding on the bank. Members of the SSB are typically religious scholars who specialize in Islamic law. They can also be non-Muslim experts who have studied such issues extensively in Western countries such as the United Kingdom.

Over the last decade, Islamic finance has rapidly expanded around the world, making it difficult to find qualified people to take on positions in the SSBs. In the world of Islamic finance, reputation is pivotal, and Shari’ah non-compliance can be disastrous for a bank. There are two international Islamic finance supervisory bodies: the Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Malaysian Islamic Financial Services Board (IFSB). These organizations work with institutions, such as the IMF and the World Bank, to promote Shari’ah compliance regulations around the world. The AAOIFI establishes fundamental standards for the Islamic finance industry, whereas the IFSB makes risk-based recommendations (Domat, 2022).

All Islamic finance businesses, particularly Islamic banks, must disclose items in their reports and financial statements to shareholders in order to reduce agency and conflict of interest issues and establish good bank governance (Ben Abdallah & Bahloul, 2021). The problems occur if there are inadequate disclosures in the annual report on Shari’ah governance and the Islamic banking concepts misjudge the financial report and provide a perception of asymmetry of financial information (Tabash, 2019). If there are no sufficient disclosures, there is an assumption that Islamic banks are still practicing the conventional system that is based on riba (interest). Islamic banks could also invest the money saved by consumers through syubhah channels (which are doubtful). Concerns about corporate fairness, transparency, and accountability have come to light as a result of the world’s top financial institutions suffering massive losses (Khan & Zahid, 2020).
(Tabash, 2019) mentioned that, in order to reduce agency and conflict of interest issues and to achieve excellent banking control, it is crucial for all Islamic finance businesses, especially Islamic Banks, to disclose items in their reports and financial statements to shareholders. Most of the past research mostly concerned about Shari’ah audit and lack of Shari’ah risk, which most of the Islamic banks failed to mitigate the risk that occurs.

In this study, the researcher believes that the areas with a lack of attention will now be taken seriously and be analysed with utmost care. Thus, the researcher will focus on the impact of Islamic governance disclosure on Islamic banks’ financial performance in Malaysia.

The objectives of this study are as follows
   a) To measure the difference of level of disclosures for Shari’ah governance mechanism between Islamic banking in Malaysia.
   b) To investigate the impact of Shari’ah Governance Disclosure towards Islamic banking’s performance among Malaysia.

Literature Review
Shari’ah Board Committee

Bank Negara has stated the responsibilities a Shari’ah committee must have, in which a charter that outlines the committee’s mandate, responsibilities, and procedures, as well as any subjects that are subject to its decision or advice. The Shari’ah committee, also known as the supervisory board, is an independent committee that serves as an oversight body for Islamic banks’ operations and business affairs. The SSB assures stakeholders that the activities of Islamic banks are in accordance with Shari’ah rulings (Masruki, Dhar, et al., 2020).

Shari’ah committee has a significant impact on corporate governance and the firm performance of the company. Based on the literature, it can be concluded that the Shari’ah committee has a high influence on the firm performance.

Hypothesis 1: Shari’ah Committee has a significant effect on the financial performance.

Shari’ah Review

Shari’ah review is a periodic examination of the operations of Islamic banks to ensure compliance with Shari’ah rules. It is necessary to ensure that all activities of Islamic banks are in accordance with Shari’ah rules, fatwas, guidelines, and rulings issued by the Supervisory Board. According to the Shari’ah Governance Framework 2010, the Shari’ah review function is recommended as a proper governance practice mechanism for monitoring the activities of Islamic banks. As the Islamic banking industry becomes more complex and dynamic, the possibility of Shari’ah non-compliance contracts of transactions grows. The Shari’ah review function is indeed useful in explaining Shari’ah governance practice (Masruki et al., 2020).

In Islamic financial institutions, assessing operations as part of the regular assessment is a crucial process to guarantee that every activity or transaction is carried out in conformity with Shari’ah regulations, rulings, guidelines, fatwas, and legislation. Shari’ah review also considers Shari’ah conformity with topics relating to the Shari’ah idea and Islamic structures. Hypothesis 2: Shari’ah review has a significant effect on financial performance.
Shari’ah Audit

Shari’ah audit (SA) is an evaluation of how well Islamic financial institutions (IFIs) adhere to Islamic law’s principles and rules. Shari’ah auditing is the process of auditing financial institutions that adhere to Islamic Shari’ah to ensure compliance with all activities, including contracts, risks, and financial statement operations. It is the persistence of financial institutions in carrying out activities in accordance with Islamic Shari’ah principles, policies, instructions, and provisions. Effective internal Shari’ah auditing requires IFIs to invest in internal auditing resources and improve the independence of internal Shari’ah auditors in order to ensure the achievement of organizational objectives. In some countries, the Shari’ah audit function has become mandatory for all IFIs (Khatib et al., 2022).

Internal Shari’ah audit effectiveness assists Islamic financial institutions (IFIs) in developing their work since financial reports reflect the quality of the internal Shari’ah audit department’s work. AAOIFI (2010) defined effectiveness as the ability to plan, implement, document information and Shari’ah audit findings, make recommendations, follow-up, and evaluate the extent of Shari’ah compliance with Islamic Shari’ah rules and principles, fatwas, guidelines, and instructions by the IFI’s SSB (AAOIFI, 2010) (Khalid et al., 2017).

Hypothesis 4: Shari’ah audit has a significant effect on financial performance.

Shari’ah Risk

Shari’ah risk is a component of operational risk because Islamic banks may suffer financial losses as a result of non-compliant activities. The Shari’ah risk function entails identifying potential risks, assessing risk levels, monitoring, and facilitating effective risk management, and controlling the recurrence of non-compliance risks. Although risk cannot be avoided, the function of Shari’ah risk is to mitigate risk, and the functions of the risk management must be consistent with Shari’ah guidelines (Dhar et al., 2020).

Contract duties are also linked to risk. It is impossible to deny that risk and contract are inextricably linked. Contractual commitments carried out in the framework of Islamic finance may reveal a sort of risk that is not compliant with the Shari’ah. This is known as Shari’ah risk, i.e., violation against Shari’ah principles. Rather than addressing the risk, the theory should be discussed. It is crucial to understand the activities going on behind the scenes of its creation. Evidence from the Qur’an and Hadith that supports the fundamental parts of legal financial transactions, as well as the general rules of financial transactions contracts, for example, can be called into play in this debate. It is critical to have this dialogue because issues of non-compliance with Shari’ah principles have brought to light the uniqueness of the religion. In comparison to conventional financing, Islamic finance has inherent risk elements. In Islamic finance, fulfilling a contractual duty entails the contracting parties adhering to the contract’s terms and conditions in order for the contract to be legitimate transactions. Failure to comply with Shari’ah contractual duties will, of course, result in legal consequences whereby the contracting parties may have to consider executed contracts as void (Noor et al., 2019).

Hypothesis 3: Shari’ah risk has a significant effect on financial performance.

Transparency & Disclosure

Full disclosure in Islamic corporate reports, as well as accountability to various stakeholders, are required. To gain clients’ trust and confidence, a bank’s operations, transactions, and activities should be thoroughly reported. Furthermore, transparency may
help prevent fraud and any potential disputes in transactions. Both disclosure and transparency are mentioned in the 2010’s Shari’ah governance framework as part of the Shari’ah governance mechanisms, and they are significant for improved Shari’ah governance (Dhar et al., 2020). In order to effectively allocate resources in a society and address the issue of information asymmetry between managers and external users, reporting through disclosures is the way of communicating with stakeholders.

The arguments for the necessity of disclosure in the financial industry are as follows: first, the value of accounting reports in assisting stakeholders to evaluate the effectiveness of banks; followed by the fact that risks and cash are important components to banks, in which earnings alone cannot accurately assess their performance; lastly, since aggregated numbers are less beneficial, stakeholders need to be aware of the breakdown of elements. Additionally, more quantitative and qualitative disclosures have been made, notably in banks, as a result of the financial environment’s growing complexity and consumers’ demand for a variety of information (Ariffin et al., 2021).

Corporate openness and disclosure are important components in gaining stakeholders’ trust. Moreover, high-quality corporate transparency and disclosure reduce information asymmetry, promote stakeholder trust, and are linked to favourable capital markets outcomes, such as lower cost of capital, increased shareholder value, improved company performance, and competitive advantage (Zaman et al., 2018). A bank’s performance would be better if it could absorb concealed losses and lower its cost of capital.

The performance of the bank is directly impacted when the market uses the cost of capital to estimate the potential return on the investment. The influence of greater disclosure levels on capital costs is now being debated in disclosure. However, there is currently little discussion of Islamic banks. Information that businesses disclose has an impact on the cost of capital, while the value of the firm and the cost of capital are directly related. The cost of funding for businesses that provide more information is found to be lower (Tabash, 2019).

Hypothesis 5: Disclosure and transparency have a significant effect on financial performance.

Financial Performance

Good corporate governance boosts performance while safeguarding investors’ faith. The impact of corporate governance on the financial performance of Islamic banks is varied. For example, from 2011 to 2017, the introduction of corporate governance on the profitability of Islamic banks in Indonesia and Malaysia caused several impacts.

The most used indicators in analyses to quantify financial performance are return on asset (ROA) and return on equity (ROE). ROA is used to determine an organization’s profitability based on total assets to profit, whereas ROE is used to determine an organization’s efficiency based on equity employed to profit.

Return On Asset

Return on Asset (ROA) is a measure that assesses a firm’s ability to generate profits from its total assets in the future. A higher ROA indicates a more efficient company. As a result, it might be viewed as a positive indicator for any investors to invest their shares in the company, resulting in a rise in the company’s share price in the capital market. In other words, ROA has an impact on the value of a company (Professor & Ali Al-Qudah, 2016).
Return on assets (ROA) is an indicator of how profitable a company is relative to its total assets. ROA gives an idea as to how efficient management is at using its assets to generate earnings. Calculated by dividing a company’s annual earnings by its total assets, ROA is displayed as a percentage. Sometimes this is referred to as “return on investment” (Ben Abdallah & Bahloul, 2021).

### Method

Having a small number of Islamic banks in Malaysia, the researcher considered all 16 Islamic banks in Malaysia. The list is taken from Bank Negara Malaysia, the sample area is closely related to sample size, whereby determining the sample size will give an idea of the sample area that will be applied to collect data. The determination of sample size can be categorized into probability and non-probability. Probability sampling can be divided into a simple, systematic, stratified, multi-layer area, and group, while non-probability sampling can be categorized into random, purposive, quota, snowball, dimensional, critical case, and maximum variation.

### Results and Discussion

When performing regression analysis, there are a number of steps to be aware of. Check the autocorrelation problem first using the Durbin-Watson value. The value of Durbin-Watsons is supposedly between 2-4 (Ahmad et al., 2018). Yet, the Durbin- Watson value for this study is 2.078. It follows that there is a little auto-correlation problem in this study.
Table 4.11

Model Summary\textsuperscript{b}

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
<th>Durbin-Watson</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.393\textsuperscript{a}</td>
<td>.154</td>
<td>.097</td>
<td>.91916</td>
<td>.620</td>
</tr>
</tbody>
</table>

a. Predictors: (Constant), TD, SC, SA, SRi, SR  
b. Dependent Variable: Q51 - Return on Asset

Table 4.12

ANOVA\textsuperscript{a}

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regression</td>
<td>11.263</td>
<td>5</td>
<td>2.253</td>
<td>2.666</td>
<td>.029\textsuperscript{b}</td>
</tr>
<tr>
<td>Residual</td>
<td>61.674</td>
<td>73</td>
<td>.845</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>72.937</td>
<td>78</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a. Dependent Variable: FP  
b. Predictors: (Constant), TD, SC, SA, SRi, SR

The model R-Square value tells how much of the variance in the DV is explained by the model. In this case, the value is 0.154, which means 1.54% of the variance in the data financial performance can fit for all the regression models. In other words, the findings of this study show only 1.54% fits the whole model used in this research. For ANOVA table significant, the whole model used in this study is statistically not significant, because of the result of 0.029<0.01.

Table 4.13

The Main Factor of the Effect of Shari‘ah Governance Disclosure Towards Financial Performance (Multiple Regression)

<table>
<thead>
<tr>
<th></th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
<th>Collinearity Statistics</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Constant)</td>
<td>Beta</td>
<td>0.917</td>
<td>0.362</td>
<td></td>
</tr>
<tr>
<td>S.Committee</td>
<td>-0.265</td>
<td>-2.016</td>
<td>0.047</td>
<td>0.671</td>
</tr>
<tr>
<td>S.Review</td>
<td>0.326</td>
<td>0.278</td>
<td>0.782</td>
<td>0.008</td>
</tr>
<tr>
<td>S.Audit</td>
<td>-0.630</td>
<td>-1.363</td>
<td>0.177</td>
<td>0.054</td>
</tr>
<tr>
<td>S.Risk</td>
<td>0.568</td>
<td>0.637</td>
<td>0.526</td>
<td>0.015</td>
</tr>
<tr>
<td>TD</td>
<td>-0.314</td>
<td>-2.344</td>
<td>0.022</td>
<td>0.645</td>
</tr>
</tbody>
</table>

As stated in Table 4.11, the researcher has found such findings based on Coefficients Table. The p-value is a probability value that is frequently used in hypothesis testing as a measure of the strength of the evidence. The result is deemed “statistically significant” when
the p-value is less than 0.05. The result is deemed “highly significant” when the p-value is less than 0.01 (Foong et al., 2018). In the Coefficients Table, to find the independent values influence the dependent value, a check must be carried out. According to Table 4.11, one main factor that contributes, involving Shari’ah committee, transparency, and disclosure toward financial performance, is when the significance value, p-value, must be below 0.01 and has an outcome of 0.047 and 0.022. In the above table, the significance values are higher than such results for all variables.

Conclusions

In this research, 16 Islamic banks in Malaysia over a five-year period, from 2017 to 2021, were used as the sample size, using data from each bank’s annual reports. The sampling data comprises 80 samples that must be observed in total. This study used five Shari’ah Supervisory Board dimensions, including a Shari’ah committee, a Shari’ah review, a Shari’ah audit, a Shari’ah risk assessment, and transparency and disclosure, to analyze the Shari’ah governance disclosure of local Islamic banks in Malaysia. These criteria were taken from the 2010 and 2017 versions of the Malaysia Shari’ah Governance Framework published by Bank Negara Malaysia.

There were a few constraints to the study that the researcher had to deal with while it was being conducted. The study’s first limitation is the study’s sample size, as Malaysia only has 16 Islamic banks (IBs).

Although this research satisfies its objectives and yields important results, it does have several drawbacks that future research should address. Because this study only looked at the demographics of Islamic banks in Malaysia, the findings cannot be applied to other Islamic Financial Institutions (IFIs) in Malaysia, such as insurance, where the majority of Malaysians prefer takaful insurance.

The first recommendation for further research, the researcher, may take into account is to make sure that regulatory organizations strictly enforce and monitor the application of the rules or standards. This is due to the fact that having all the regulations in writing alone is not sufficient, they also need to be effectively enforced and monitored. Looking at the Malaysian situation, Malaysia has consistently ignored these issues.

The next recommendation for future studies could look into other Islamic Financial Institutions, such as insurance takaful. The second recommendation is to improve Shari’ah governance practices by educating and training key management personnel in Islamic banks, especially for Shari’ah committee. This recommendation also calls for greater transparency in reporting Shari’ah governance practices. The key management personnel should be able to address the issue and make a wise decision to practice good Shari’ah governance and generate a high level of disclosure practice in the annual report because they are the ones in charge of management and have the necessary capacity to make decisions. Furthermore, this research is dependent on secondary data content analysis.

As a result, future studies could undertake qualitative data from interviews to gather more clarity and understanding about Shari’ah disclosure in Islamic Financial Institutions. By examining the updated Shari’ah Governance Framework, future studies may be able to modify the measurement of Shari’ah governance disclosure. Explanatory variables may also take into account other facets of financial performance, such as the liquidity, effectiveness, and solvency of Islamic banks.

Other aspects of Islamic finance, such as Islamic insurance, Islamic microfinance, and Halal industries were not covered by the researchers. As a result, future academics will be
able to apply institutional theory to Shari’ah governance practices and implementations of rulemaking by regulators and institutions.

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