



# INTERNATIONAL JOURNAL OF ACADEMIC RESEARCH IN BUSINESS & SOCIAL SCIENCES



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To Link this Article: <http://dx.doi.org/10.6007/IJARBSS/v9-i5/5886>

DOI: 10.6007/IJARBSS/v9-i5/5886

*Received: 12 March 2019, Revised: 01 April 2019, Accepted: 18 April 2019*

Published Online: 19 May 2019

**In-Text Citation:** (Harun, Aziz, Noor, & R, 2019)

**To Cite this Article:** Harun, M. S., Aziz, M. R. A., Noor, M. N. M., & R, S. N. M. (2019). The Determinants of CSR disclosure: A Study of Malaysian Islamic Banks. *International Journal of Academic Research Business and Social Sciences*, 9(5), 441–449.

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Vol. 9, No. 5, 2019, Pg. 441 - 449

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## The Determinants of CSR disclosure: A Study of Malaysian Islamic Banks

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### Abstract

**Background:** Purpose -The purpose of this paper is to contribute to the existing disclosure literature by examining the determinants of Corporate Social responsibility disclosure (CSR) of Islamic banks in Malaysia for the year 2011-2015. -This study uses the manual content analysis to measure the level of CSR information in 50 annual report prepared by 10 local Islamic banks. An ordinary least square regression is used to examine the relationship of corporate governance mechanisms and firm characteristics on CSR disclosures. Findings- We found a significant positive association between the board of director size and CSR disclosure practice among Islamic banks.

### Introduction

IFIs (Islamic financial institutions) can be defined as any institution that plays the role of the financial intermediary that strictly abides by the provisions of the Shariah, and it is not limited to Islamic banks and Islamic insurance (AAOIFI, 2010). , its covers the whole aspects of Islamic financial industry. In general, Islamic banking offers a banking products and services which are based on Shariah (Islamic Law) principles and represent the absolute ethical codes of Islamic religion and code of conduct. These Islamic codes impose strong social obligations on Muslim individuals and organizations (Maali, et al ,2003) For the purpose of this study, we decide to narrowly focus in Islamic banks which operate in Malaysia. According to the data release by the Central Bank of Malaysia (BNM), over the past two decades, the global Islamic financial industry has grown to register overall total assets of US\$1.88 trillion (RM8.08 trillion) as at end-2015, as per the Islamic Financial Services Industry Stability Report 2016. Without denying the rapid growth of Islamic Finance industry, in term of CSR, both Islamic and

conventional, have a significant role in the society and they are expected to be more socially responsible to their stakeholders. The last few decades have witnessed increased interest in corporate social responsibility (CSR), due to religious identity; Islamic banks are expected to be more socially responsible to the community or society rather than conventional financial institution (Frag, et al., 2014).

Disclosure is an ideal tool for Islamic banks to bring their social benefits to their stakeholders. It was argued by Farook, that disclosure provides evidence about contribution in social activities of Islamic banks. (Farook et al., 2011). They are anticipated to disclose comprehensive related information to their customers about how their activities and their compliance with Shariah (Islamic Law) (Maali, et al., 2006); Islamic banks also are described as having a "social face" which promoting social justice in the society.

The existing body of the CSR literature in Islamic banks focuses on either the level of CSR disclosure or the determinants of CSR disclosure. Most of previous studies that explore CSR disclosure practice are conducted before the issuance of an updated AAOIFI governance standard No.7 which represents a clear benchmark of CSR disclosure practice in Islamic banks. In fulfilling prior research gap, we are motivated to explore the CSR disclosure score of Islamic banks in Malaysia and its potential determinants using a comprehensive CSR disclosure which develop based on AAOIFI, 2010 and previous literature (Maali, et al., 2006.).

Theoretical framework and literature review argued that despite of many theories dealing with disclosure agency theory and stakeholder theory would be of great help in explaining a particular phenomenon by providing clear insights in the understanding the corporate CSR disclosure practices, and it can be considered as a complementary aspects of disclosure discussions (Elzahar, & Hussainey, 2012) Prior argues that there is a consistency between both of agency theory and stakeholder theory. (Farook, et al., 2011) Therefore, agency and stakeholder can be considered as interrelated theories to explain the determinants of CSR disclosure.

### **Agency Theory**

The most dominant of all the disclosure studies is agency theory and it has been referred widely in many disclosure studies. This theory refers to a principal and agent relationship, Jensen and Meckling (Jensen, et al., 1976) defined the agency relationship as a contract under which a principal or more engage an agent to perform a service on their behalf. They also identified the three types of agency costs, which associated with agency problem. First: monitoring costs that incur by giving certain incentives to the agent, which motivates him to act for the principal interests. Second: bonding costs, which occur when using additional resources by the agent to make sure that his actions will not be against the principal's interests. Third, the residual loss: that results by the reduction of principal's welfare.

Agency theory suggests that there is a separation of ownership and control of a firm, the potential for agency costs exists from the conflicts of interest between principals and the agents (managers). Each party makes a decision based on its self-determined goals (Safieddine, 2009). Therefore, agency costs, which include the cost of monitoring and controlling, are incurred by the principal, and bonding costs are incurred by the agent. From the agency theory perspectives, companies (management) are motivated to disclose more CSR information to convince the stakeholders that they are behaving

optimally on the stakeholder's behalf, their concern on CSR issues and as a result its can reduce an agency cost.

Agency theory also provides a framework for explaining disclosure practices by different firms such as financial and unit-trust companies (Hill, et al., 1992). It is claimed that agency theory predicts that agency costs are associated with different corporate characteristics, such as size, advantage and listing status. (Wang, et al., 2008) .Furthermore, corporate governance (CG) mechanisms are introduced by shareholders in order to make managers' actions aligned with shareholder's interests. As a result, many empirical studies used firm characteristics and CG mechanisms as determinants of corporate social disclosure; in accordance with agency theory. The implication of this theory has given rise to several hypotheses such as the influence of Shariah Supervisory Board (SSB) who act as an agent on behalf of banks in promoting CSR disclosure practice.

### **Hypothesis development**

According to prior studies (Rahman & Bukair, 2015) it is expected that various factors could drive variances between Islamic banks and its CSR disclosure practices. Thus, in developing the research hypothesis, we use corporate governance characteristics as a main explanatory variables and firm characteristics as a control variables in measuring the determinants of CSR disclosure practice in Islamic banks in Malaysia.

#### **Corporate Governance Characteristics-Explanatory variables**

Exploring the determinants of CSR reporting quantity is a main objective of the analyses in this study. This study will examine the CG determinants and CSR disclosure practice among Islamic banks. This study takes into consideration most of the CG mechanisms as potential determinants of CSR disclosure of Islamic banks. The Organization for Economic Co-operation and Development (OECD) indicated that corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders.

In fact, CG mechanisms are introduced - based on the agency theory framework - to mitigate managers' opportunistic behaviors and reduce information asymmetry. CG mechanisms should facilitate corporate monitoring as they lead to an improvement in companies' internal control (Ho & Wong, 2001). Accordingly, it could be predicted that CG mechanisms could improve CSR reporting. Most of the previous research has focused on CG mechanisms that are related to the monitoring role of corporate board of directors. But we are not tested the influence of the board and its sub-committee characteristics on the amount of information disclosed such as SSB related variables. Thus, this study will fulfill the gap by testing the board related and SSB related variable in CSR disclosure among Islamic banks in Malaysia.

H1: There is a positive relationship exists between CSR disclosure and board size SSB (Shariah Supervisory Board) size and cross membership.

The SSB has social influence and authority in monitoring the Islamic banks compliance with Shariah principles, and provides the confidence to stakeholders about the legitimacy of the business transactions. Disclosure by the SSB may be seen as a key aspect of accountability by the Islamic banks to its stakeholders. However, the degree to which social activities are disclosed depends on the underlying rationale of the SSB monitoring role on behalf of the Islamic bank's investors. Moreover,

the degree to which the SSB influences the level of CSR disclosure may depend on characteristics such as its board size. Therefore, SSB size is expected to have a positive impact on CSR disclosure (Farook, et al 2011 )

On other hand, the governance literature indicates the level of disclosures could increase or decrease depending on whether mechanisms substitute or complement each other. (S. S. M. & Wong, 2001). When governance mechanisms substitute each other, firms may not provide additional disclosures since the multiple governance mechanisms should have increased the level of monitoring. Therefore, the SSB size may see no need to urge for additional CSR disclosure if investors are already assured of the Islamic bank's compliance in the Shariah compliance report (Aribi & Gao, 2012 ). From AAOIFI perspectives, they are recommends that SSB board should be appointed by a number of different people from different professions such as: bankers and economists which can enhance the effectiveness of SSB. (AAOIFI, 2004). This allows for the implementation of diverse perspectives on the application of the Shariah. To enable this to happen, a large SSB would be required to represent these sectional professions. Thus we hypothesise that:

H2: There is a positive relationship between SSB size and CSR disclosure practice in Islamic banks.

Firms characteristics and country specific characteristics as a control variables

As the sample contains Islamic banks from 4 different countries, the researcher used firm characteristics as a control variable such as firm size, firm age, profitability and liquidity. It is argued that bank size has an impact on the level of corporate social activities. A large strand of the literature on CSR finds an association between firm size and CSR activities .Roberts finds that's a positive relationship between size and CSR; he argues that the bigger and older the company the more involvement there will be in CSR activities which given a positive impact on its reputation. (Hossain, 2008.)

Prior research finds that there is an association between company age and disclosure practice . (Haniffa, & Cooke, et al , 2002). They argued that the age of corporation effects on CSR involvement of the firm and that long-established firms are likely to make greater voluntary social disclosures. For example, Roberts reported a positive relationship between CSR and age of firms. This relationship may exist because long-established companies have received more benefits from society than newly established firms and the link matures and the firm undertakes a greater leadership role, developing an increased sense of social responsibility. It also found that older companies tend to disclose more information than young companies. (Hossain & Hammami, 2009).

The influence of profitability on voluntary disclosure in previous studies received mixed reactions. Singhvi and Desai argued that when the rate of return is high, managers are motivated to disclose more detailed information to support the continuance of their positions and remuneration. (Marston & Shrivs, 1991). On the other hand, when the rate of return is low, managers may disclose less information in order to conceal the reasons for the effects. The last control variable of CSR information disclosure is liquidity and it might be argue that corporate managers of companies with low liquidity ratio may publish more voluntary information in their annual reports to satisfy the information required by the stakeholders.



### **Methodology**

For the purpose of this study, the researcher retrieved Islamic banks information from Bank scope databases and DataStream, the sample banks are selected based on a criteria of full -fledged Islamic banks or banks which are 100% comply with Shariah as sated by Central Bank of Malaysia (BNM). According to BNM database on June, 2016 there are 16 full-fledged licensed Islamic banks in Malaysia, consist of local and foreign Islamic banks. For the sake of consistency in research sample, the researcher excluded foreign Islamic banks which have not publish an English version of financial report. Therefore, the researcher excluded 6 banks. Thus, the final sample of this study consists of 10 Islamic banks. This represents 63 % of the total sample, and it is in line with the minimum size required for multiple regressions (Green, 1991). This data set provides sufficient information of disclosure practices across Islamic banks operating in Malaysia for the year 2011-2015; involve 50 observations throughout the year.

### **Measuring CSR disclosure quantity**

An un-weighted disclosure index is commonly used to determine CSR disclosure. Previous researcher such as Elzahar & Hussainey 2012 and Haniffa & Hudaib 2007 are commonly used this method in measuring disclosure practices, Thus, we adopted this method in measuring the CSR disclosure quantity of Islamic banks in Malaysia, an item scores one if it is disclosed and zero if it is not.

A disclosure index has been developed for this study to measure CSR disclosure quantity. A comprehensive CSR disclosure index have been develop based on based on prior research, such as Maali et al. 2006 , Farag et al. 2014; and AAOIFI,2010 guideline. Manual content analysis method has been used to record the data.

### **Dependent variable (CSR score)**

We use CSR disclosure level as our independent variable. Adopted prior studies (Aribi & Gao 2012) ,manual content analysis has been employed to measure the level of CSR disclosure among Islamic banks in the sample countries through their annual report and website. To ensure the validity and the reliability of our analysis; we took precautionary measures in coding our data. To enhance the reliability, the index items are coded and checked twice and we discussed any potential discrepancies. We make sure that the same coder is consistent overtime when coding the same item of the indices (stability), the coders produce the same results when coding the same item(reproducibility) and accuracy as well (Beattie & Thomson,. 2007). Following the approach used by Haniffa Haniffa and Hudaib , 2007 items specifically disclosed have been given a score 1, and 0 if it is not. Each item in the CSR disclosure is given equal weight. To ensure that the judgement of relevance is not biased, the entire annual report was read before any decision is made.

### **Independent variables (CG mechanisms)**

To examine the determinants of CSR, we collect CG information of the banks consists of board and SSB related variables from sample banks annual reports.

### **Control Variables (Firm Characteristics)**

We use firm characteristics as our control variables. Firm characteristics variables of sample Islamic banks have been collected from Bank scope Database, DataStream Database and annual report.

### **Result and Analysis**

We found that board size has a positive significant impact on levels of social disclosure reporting. Therefore H1 is accepted. It shows that the board size have a positive impact of the CSR disclosure score of the sample Islamic banks. This result is consistent with a study by Lakhal, 2005. Therefore, organizations with a higher size of board of directors do engage in greater extent of CSR disclosure practices and CSR activities such as charitable activities as stated by Haniffa & Hudaib, 2007

From result above, we can conclude that board of director's size plays an important role in the Malaysia Islamic banks. It is consistent with the agency theory which predicts that larger boards incorporate a variety of expertise which results in more effectiveness in boards' monitoring role which could affect managers CSR disclosure decisions and the extend CSR disclosure level by Lakhal . Finally, looking at the coefficients of our control variables (firm and country specific characteristics), our analysis shows that only firm profitability have a positive relationship with the level of CSR disclosure and it is in line with a study by Hussainey and Elsayed in 2011.

### **Conclusions, limitations and Future Research**

Our paper contributed to existing CSR reporting literature by being the first to examine the determinants of CSR disclosure in Malaysian Islamic banks for the year 2011-2015. We test the degree to which CG mechanisms (board related variables and SSB related variables) affect Islamic banks decision to disclose their CSR information in their annual report. We used quantitative methods to test our research hypotheses. We develops a comprehensive CSR disclosure index based on previous literature and AAOIFI guideline, and we used the manual content analysis find the CSR disclosure information in a sample 10 Islamic banks its involves 50 annual reports observation. OLS regression analysis is also used for the empirical analysis. Our dependent variable was the total number of CSR disclosure score, while the independent variables were a set of CG mechanisms and our control variables consists of a set of firm characteristics and country specific characteristics variables.

Our empirical analysis shows that the board size is positively significant (0.050) with CSR disclosure practice among Malaysian Islamic banks. This result is consistent with a study by Lakhal and Cheng and Courtenay in 2006 which also find that's a positive association between disclosure and board composition in their study. It can be stated that board size is positively associated with CSR disclosure practice. Therefore, organizations with a higher size of board of directors do engage in greater extent of CSR disclosure practices and CSR activities such as charitable activities as stated by Williams, 2003.

### **Acknowledgement**

This research is benefited from the funding of the YTI Research Grant of Permodalan Nasional Berhad under the Academic Chair in Islamic Finance and Banking-USIM

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