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The Effect of the Board of Directors' Characteristics on Corporate Social Responsibility Disclosure by Islamic Banks

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Abstract

This study aims to explore the influence of the board of directors' characteristics on corporate social responsibility (CSR) disclosure of Islamic banks operating in Gulf Cooperation Council (GCC) countries. A sample of 53 Islamic banks was collected from five GCC countries in 2008. An ordinary least square regression is used to examine the relationship between CSR disclosure and board of directors' attributes. The results indicate that there is no significant relationship between selected board of directors' characteristics (board size, board composition, and CEO duality) and CSR disclosure. The results of board size and CEO duality are consistent with the Islamic viewpoint, while board composition is not. This study suggests the need for improving the current practice of corporate governance for Islamic financial institutions by imposing additional constraints on the board of directors' characteristics. The findings of this study are useful for policy makers in evaluating the present corporate governance standards and whether these requirements are sufficient for users of CSR information, such as investors in making investment decisions. This is the first CSR study on Islamic financial institutions using a legitimacy theory to fill the gap in the literature regarding the influence of the board of directors' attributes on CSR disclosure by Islamic banks.

Keywords: Islamic banks, Corporate governance, Board of directors' characteristics, Corporate social responsibility disclosure

1. Introduction

Corporate governance has become a hotly debated topic throughout the last twenty years due to high incidence of corporate collapses such as Enron, WorldCom, HIH Insurance, and Global Crossing, together with the increased global awareness of the need for sound corporate governance based on stakeholder's accountability and financial transparency (Chapra and Ahmed, 2002; McLaren, 2004).

Most of the previous studies have generally examined the impact of corporate governance mechanisms including board of directors' characteristics on voluntary disclosure (Li et al., 2008; Akhtaruddin et al., 2009). Other studies have investigated the association between the board of directors' structure and CSR disclosure in non-financial industry (Said et al., 2009; Abdur Rouf, 2011). However, very few studies have examined the influence of the board of directors' attributes on CSR disclosure in the financial sector, especially within the Islamic banking industry (Barako and Brown, 2008; Khan, 2010).

This paper contributes to the international literature by addressing this issue in the unique sector - Islamic banking. This study contributes to the extant international literature on determinants of CSR disclosure in three ways. First, it investigates the issue of whether the non-association between board size and CSR disclosure observed in many other industries is apparent within the context of Islamic banking. Second, it also explores whether having a greater proportion of non-executive directors on the board is positively related to CSR disclosure as shown in previous studies. Third, it empirically examines whether the separation of roles between CEO and chairman has the same impact on CSR disclosure among Islamic banks as evidenced in the extant literature.

The remainder of this paper is organized as follows. Section 2 briefly provides an overview of Islamic banking in GCC countries and describes the concept and model of corporate governance within Islamic banks and provides a review of Islamic social reporting. Section 3 presents the theoretical framework and hypotheses development. Section 4 explains the research design, while section 5 presents the results and discussion. Section 6 summarizes and concludes the paper.

2. Literature review

2.1 Heading Islamic corporate governance

The GCC comprises of six oil-producing countries located in the Middle East: Qatar, the United Arab Emirates (UAE), Saudi Arabia, Kuwait, Bahrain, and Oman. The total population of GCC countries is around 42 millions. The banking industry in GCC countries is widely owned by native companies due to the restrictions on foreign ownership. Today, there are more than 300 Islamic financial institutions operating in 75 countries. The highest proportion of these financial institutions came from GCC countries. This is because the Gulf region is the main source of financing for Islamic banking transactions. More than 40% (\$262.6 billion) of the total Shariah-compliant financial assets at the end of 2007 (\$640 billion) was invested in GCC countries (Wilson, 2009).

According to Chapra and Ahmed (2002), corporate governance is defined as a “set of relationships between a company's management, its board, its shareholders and other stakeholders” (p. 13), which aims to achieve justice to all stakeholders by increasing transparency and accountability. It also aims to monitor and control management in order to maximize company value. The main components of corporate governance include investors’ relations as well as relationships within stakeholders such as employees, clients, customers, etc.

From the Islamic perspective, the framework of corporate governance for Islamic banks is quite unique because the institutions must follow a different set of principles based on the Holy Qur’an and the Sunnah, which contains principles of social justice and accountability (Bhatti and Bhatti, 2009). Accordingly, Hassan & Abdul Latiff (2009) assert that CSR is the primary condition of Islamic banking transactions. Due to that, CSR has been embodied in the Corporate Governance Standard for Islamic Financial Institutions, The Code of Best Practices for Corporate Governance in Islamic Financial institutions, and Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services (IFSB, 2006) to improve transparency and accountability in Islamic banks. Besides, each Islamic financial institution has its own Shariah board to provides guidelines for new kinds of transactions.

From the Islamic viewpoint, the major objective of Islamic financial institutions’ reporting is to show that their transactions are in compliance with Shariah principles and rules (Haniffa, 2002). Hence, financial reporting should emphasize the principles of full disclosure and accountability in meeting the needs of the society. The meaning of full disclosure is that Islamic banks should provide all the necessary information to the society regarding their transactions (Maali et al., 2006). Based on this concept, the community (Ummah) has the right to know the effect of the banks’ operations on the welfare of society, and to ensure that they are in compliance with the requirements of Shariah.

3. Theoretical framework and hypotheses development

Legitimacy theory has become one of the major quoted theories in the area of social and environmental accounting. According to legitimacy theory, a corporation discloses CSR information in order to establish or sustain its legitimacy by obtaining the community acceptance of its actions (Deegan, 2002).

In the literature of social and environmental accounting, a number of researchers agree that CSR disclosure can be used by companies to mitigate legitimacy threat and reduces the legitimacy gap (e.g., Chen, Patten, and Roberts, 2008; Deegan et al., 2002). Consequently, legitimacy theory suggests that the top management of organizations is responsible to narrow the legitimacy gap, and undertakes the necessary social activities to the different groups of stakeholders. Therefore, the corporate governance structure of board of directors (board size, board composition, and CEO duality) is expected to play an important function in reducing the legitimacy gap by expanding the disclosures of CSR.

Board Size

Empirical evidence in corporate governance suggests that the board size impact the level of controlling, monitoring, and disclosure. The benefit of having a larger board is that it can increase company's value, because they provide a firm with members from different fields of expertise. In contrast, having a large board can have a negative impact on decision making, the costs could outweigh the advantages (Akhatruddin et al., 2009), lead to problems in coordination (Jensen, 1993), and less effective to monitor top managers (Yermack, 1996).

In the context of Islamic banks, it is expected that the board size will not affect CSR disclosure. This is due to the teachings of Shariah that Muslim individuals and business organizations are responsible to perform their duty in the best way. So, there should be no differences in disclosure level between banks that have small or large board's size. Hence, the first hypothesis developed is:

Hypothesis 1: Board size has no effect on CSR disclosure.

Board Composition

It is opined that directors' independence can strengthen the board by monitoring, advising and counselling the top management (Anderson, Mansi, and Reeb, 2004), protecting the investors' interests (Petra, 2005), as well as reducing agency cost (Choe and Lee, 2003). From an Islamic perspective, the members of the board of directors must have a high reputation of moral integrity and technically qualified in the banking business to play their role effectively. They must also understand the principles and rules of Shariah related to business and finance (Khan, Muttakin, and Siddiqui, 2013).

Furthermore, a higher percentage of independent directors on the board will lead to higher CSR disclosure of Islamic banks, and increase transparency level, since the independent directors will be able to motivate the management to provide more social disclosure. Many studies indicate that board independence has a significant impact on CSR disclosure, which are in line with the theoretical expectation (see, for example, Htay et al., 2012). Therefore, the second hypothesis to be tested is:

Hypothesis 2: Board composition has positive influence on CSR disclosure.

The separation of roles between CEO and Chairman

Another aspect to examine the independence of the board is the "dominant personality" phenomenon. The issue refers to role duality, in which the same person undertakes both the roles of chief executive officer and chairman. Segregation of the two roles gives the necessary checks and balances of power and authority on management behavior. From an Islamic perspective, one of the key elements in Islamic banks' management is that key decisions made should not be done by one person (Chapra and Ahmed, 2002).

However, research findings have been mixed. Huafang and Jianguo (2007) and Al-Arusi, Selamat, and Hanefah (2009) found a significant negative association between duality and disclosure. On the other hand, Li et al. (2008) and Said et al. (2009) found an insignificant relationship between duality and disclosure. Previous evidence also show that there are numerous firms that have a combined role of the chairman and CEO on their boards, yet they are working successfully, and have the capacity to keep the top management in check (Haniffa and Cooke, 2002).

In the context of Islamic banks, the separation of the roles of the CEO and chairman may have no effect on disclosure of CSR information since the majority of these banks are family owned. Therefore, the following hypothesis is developed:

Hypothesis 3: The separation roles of the CEO and chairman has no influence on CSR disclosure.

4. Research method

The study used cross-sectional data from the annual reports of Islamic banks in GCC countries for the year 2008. From the screening of all Islamic banks operating in GCC countrie, only 53 firms provided their annual reports for the purpose of analysis. This sample size is quite acceptable and comparable with the samples used in most other CSR disclosure studies (such as the studies by Said et al., 2009; and Li et al., 2008).

Specification of the Model

The following regression model was used to examine the association between the structure of board of directors and the CSR disclosure level.

$$CSRD = \alpha + \beta 1\ BOARDSIZE + \beta 2\ BCOM + \beta 3\ SCEO + \beta 4\ BSIZE + \beta 5\ BPERFOR + \beta 6\ REVPUB + \varepsilon$$

Where:

CSRD	=	corporate social responsibility disclosure index
BOARDSIZE	=	size of board of directors
BCOM	=	proportion of non-executive directors to total directors on the board
SCEO	=	dummy variable, 1 if CEO $\neq$ chairman, 0 otherwise
BSIZE	=	natural logarithm of total employees
BPERFOR	=	return on equity (net profit divided by total assets)
REVPUB	=	percentage of Muslim population to total population in a country
ε	=	error term

The board of directors characteristics were size of board of directors (BOARDSIZE), board composition (BCOM), and CEO duality (SCEO). Furthermore, the study employed control variables consisting of bank size (BSIZE), bank performance (BPERFOR), and relevant public (REVPUB).

Dependent Variable - Corporate Social Responsibility Disclosure

This study employed a content analysis approach in order to gather data from the annual reports of Islamic banks. This method has been widely used in previous studies of social disclosure (Abdul Rahman, Md. Hashim, and Abu Bakar, 2010; Menassa, 2010).

The researchers developed a self constructed disclosure index to measure the level of CSR disclosure. The items contained in the disclosure index were identified based on the Islamic literature review related to CSR disclosure (Haniffa and Hudaib, 2007; Muwazir et al., 2006). 14 themes were derived from previous studies, as follows: 1) vision and mission statement; 2) top management; 3) SSB 4) unlawful transactions; 5) Zakah; 6) Quard Hassan; 7) charitable and social activities; 8) employees; 9) late repayments and insolvent clients; 10) environment; 11) products and consumer; 12) customers; 13) poverty; 14) other aspects of community involvement.

Each CSR item is coded onto coding sheets according to the number of occurrences and their disclosure nature is classified as either quantitative or qualitative. This study uses the number of sentences to determine the disclosure level of CSR for several reasons, namely, a sentence is easily identified, is less subject to inter judge variations than phrases, classes and themes; sentences are more accepted units of written English communication than individual words; a sentence is a conformist unit of speech and writing; and sentence provides perfect, reliable and meaningful data for more analysis (Ingram and Frazier, 1980; Hughes and Anderson, 1995). To examine the internal consistency (the reliability of measurement) of CSR disclosure index, Cronbach coefficient alpha was employed. The Cronbach coefficient alpha in this study is 0.697 for all themes, which exceeded the minimum acceptance level of .60.

5. Empirical Findings

Table 1 shows the descriptive statistics for the dependent and independent variables used in the study. The average CSR disclosure score is 83.3 sentences. This average is more than that of the study by Maali et al., (2006), with only 25 sentences. The mean board size is 8.3 directors, indicating a quite reasonable board size in ensuring its effectiveness. The average board independence value is 81 percent, indicating that a majority of the Islamic banks had a fully independent boards of directors. The mean value of leadership structure (SCEO) is 92 percent, indicating that most banks have separate leadership structure. As for control variables, the sample banks have an average of 917 employees, and an average return on equity of 2.86 percent, which were quite low. Furthermore, the average value for the proportion of Muslim population to the total population was 85.97 percent.

Table 1. Descriptive Statistics (N = 53)

						Skewness		Kurtosis	
	Min	Max	Mean	Med.	Std. Dev.	Statistic	Std. Error	Statistic	Std. Error
CSRD	20.00	166.00	83.30	87.5	39.22	0.276	0.327	-0.863	0.644
BOARDSIZE	4.00	13.00	8.30	9	1.98	0.058	0.327	-.369	0.644
BCOMP	0.14	1.00	0.81	0.88	0.21	-1.540	0.327	1.933	0.644
SCEO	0.00	1.00	0.92	1	0.27	-3.309	0.327	9.297	0.644
BSIZE	18	8299	917.35	250	1700.41	3.374	0.327	13.652	0.644
PERFOR	-30.06	22.87	2.86	11.9	6.76	-1.432	0.327	11.897	0.644
REVPUB	76.20	97.00	85.97	0.75	7.89	0.303	0.327	-1.736	0.644

Table 2. Correlation matrix (N = 53)

Variables	CSRD	BOARDSIZE	BCOMP	SCEO	BSIZE	PERFOR	REVPUB
CSRD	1	0.321**	-0.299**	0.087	0.327**	0.313**	-0.340**
BOARDSIZE	0.321**	1	-0.114	0.190	0.245*	0.255*	-0.078
BCOMP	-0.299**	-0.114	1	-0.069	0.041	-0.173	0.338**
SCEO	0.087	0.190	-0.069	1	-0.060	0.315**	-0.330**
BSIZE	0.327**	0.245*	0.041	-0.060	1	-0.093	0.039
PERFOR	0.313**	0.255*	-0.173	0.315**	-0.093	1	-0.322**
REVPUB	-0.340**	0-.078	0.338**	-0.330**	0.039	-0.322**	1

** , *Statistically significant at the 0.05 and 0.10 levels, respectively.

Table 2 reports the correlation matrix between the dependent and independent variables. CSR disclosure is positively correlated with board size (p=0.321), bank size (p=0.327), and financial performance (p=0.313), but is negatively associated with board composition (p = -0.299), and relevant public (p =0.340). Thus, it can be summarized that firms with larger board size, larger bank size, and lower non-executive members on the board of directors; have higher CSR information disclosure. Furthermore, the correlations among the explanatory variables are below than 0.50, indicating no significant multicollinearity existing among them.

Regression Analysis

Table 3 presents the empirical findings of regressing the independent variables on the CSR disclosure index. The coefficient of R2 is 35 percent, and the adjusted R2 is 27 percent, indicating a reasonable variance proportion. The table also shows that the p-value of the model is significant at 0.2 per cent. The values of Tolerance are higher than 0.10, and the variance inflation factor (VIF) for all independent variables did not exceed 10, indicating that there is no multicollinearity problems between the variables (Kennedy, 1998). Table 3 also shows that bank size and relevant public have significant effects on CSR disclosure at the 0.05 and 0.10 levels, respectively. This means that both variables are considered important factors by Islamic banks in deciding whether to disclose CSR information.

Board size has no significant impact on CSR disclosure, and thus supporting hypothesis 1. This finding is consistent with previous studies (Arcay and Vázquez, 2005; Said et al., 2009). The same applies for board composition, which surprisingly shows a negative relationship with CSR disclosure. Thus, hypothesis 2 is rejected. This result is also supported by previous studies by Barako et al. (2006) and Eng and Mak (2003). Further, the result shows no significant relationship between CEO duality and CSR disclosure. It implies that the separation of function between the CEO and the chairman does not affect CSR disclosure, thus supporting hypothesis 3. This finding is consistent with the studies by Li et al. (2008) and Said et al. (2009). A possible explanation is that the role duality allows the CEO to better manage the company in achieving its objectives and also in enhancing its leadership quality (Dahya et al., 1996).

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Table 3. Regression results (N = 53)

Variables	Pred. Sig.	Beta coefficient	t	Sig.	Collinearity Statistics	
					Tolerance	VIF
CSRD			3.027	.004***		
BOARDSIZE	No	0.164	1.264	0.213	0.837	1.194
BCOM	+	-0.182	-1.427	0.160	0.868	1.152
SCEO	No	-0.085	-0.645	0.522	0.820	1.219
BSIZE	+	0.319	2.562	0.014**	0.907	1.103
PERFOR	+	0.220	1.652	0.105	0.791	1.264
REVPUB	+	-0.235	-1.721	0.092*	0.755	1.325
R Square	0.353					
Adjusted R Square	0.269					
F-value	4.181 (0.002***)					

***, ** and * Significant at the 0.01, 0.05 and 0.10 level respectively.

With regards to control variables, the results show that bank size has a positive significant effect on CSR disclosure. It implies that larger Islamic banks provide more CSR information because they have more resources, such as human capital and larger investments. This result is consistent with previous studies (Akhtaruddin et al., 2009; and Othman et al., 2009). In conrast, there is no significant association between financial performance and CSR disclosure. This is consistent with the findings by Barako et al., (2006) and Barako (2008), indicating that the decision to provide CSR information is not affected by the financial performance. Interestingly, the results document that the relevant public has a significant negative impact on CSR disclosure at the 0.10 level. This result is in contrast with the findings of Farook et al., (2011). It implies that there is no specific reason why an Islamic bank operating in a country with a greater Muslim population would necessarily have provided more CSR information than an Islamic bank operating in a country with a lower Muslim population, since all Islamic banks must comply with Shariah principles and rules in whichever country they are operating.

6. Conclusion

The objective of this study was to examine the effect of board of directors characteristics (board size, board composition, and CEO duality) on CSR disclosure by Islamic banks in GCC countries. The study found that all three board of directors attributes have no impact on CSR disclosure, which may be due to the absence of some other important aspects of corporate governance elements. The main conclusions from the empirical results indicate that the decision to provide CSR disclosure is guided by bank size, and relevant public, but not by governance structure.

The results of this study are subject to several limitations. This study focuses only on disclosures in corporate annual reports although it is known that management may use other media of communication. Therefore, future research may consider disclosures in other media such as newspapers, the internet, etc. Additionally, companies that were involved in socially responsible activities may not have disclosed those activities unless they are required by regulations. Hence it should not be concluded that companies which did not disclose CSR information were not engaged in any CSR activities. Finally, this study adopts the perspective of legitimacy theory in order to see whether it is applicable for Islamic banks, against the prior studies that employs agency theory for conventional banks. Future research may use the agency theory to test its applicability for Islamic banks as well.

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