Accountability in Islamic Financial institution: The Role of the Shari'ah Supervisory Board Reports

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Abstract

Purpose – The purpose of this paper is to explore whether any discrepancy exists between the disclosed in the Shari'ah Supervisory Board (SSB) Reports of Islamic banks and the disclosure index which was based on stakeholders' expectation.

Design/methodology/approach – This study uses contents analysis as the research method to explore Shariâ'ah audit reporting practices of Islamic Banks.

Findings – The study finds that the level of disclosures overall by IFIs in the sample is rather low compared to the stakeholders' expectations.

Practical implications – This paper has important implications for policy makers as it contributes to the debate on that uniform disclosure standards across the globe need to be implemented to ensure a uniform level of disclosure by Islamic banks.

Originality/value – This study is amongst the few studies that examine and explore the nature and extent of Shari'ah Supervisory Board in Islamic banks.

1. Introduction

The rapid growth of the Islamic financial institutions (IFIs) indicates the global recognition of the emerging role of these institutions in contributing to the development of responsible and ethical banking. However, this growth is not in match with the demand for Islamic finance products. For instance, quoting Ernst & Young, the Financial Times reported in 2012 (3rd November, 2012) that the global supply of sukuk (*Shari'ah*-compliant bonds) is less than half that of investor demand. IFIs operate according to the jurisprudence and the rules of the economic and social order of Islam, by applying the *Shari'ah* business code of conduct. In the early period of development, this type of financial services was used individually between different traders. However, this has been changed and they are now representatives of a new wave of corporations whose social goals are largely as important as profit-making (Haniffa and

Hudaib, 2007b). IFIs have expanded worldwide and the system continues to grow at the rate of 15–20 per cent annually (Hussain et al., 2016).

Islamic banking operates under a different structure of corporate governance from the one used in conventional banking. IFIs aim to promote and develop the application of Islamic principles, laws and traditions to finance, banking transactions and related business affairs. An Islamic bank is obliged to appoint a board of Islamic scholars called the *Shari'ah* Supervisory Board (SSB) or the *Shari'ah* Advisory Council (SAC) to monitor the bank's operations and transactions. By doing so, the Islamic bank ensures that business activities are acceptable on the basis of fair and its legitimate profits and operations are consistent with the *Shari'ah*'s principles, such as the prohibitions of interest usury, monopoly and hoarding. Islam wishes to exterminate all traces of Zulm[1] from human society (Rahman et al., 2010). It has been generally accepted in the literature that a banking system in the Islamic society expects to contribute fully to the achievement of key socio-economic goals of Islam (Haniffa and Hudaib, 2007a; Aribi and Gao, 2015). Some of the most important goals and functions under Islamic banking are socio-economic justice and equitable distribution of income and wealth (Aribi and Gao, 2010). Justice is an indispensable ingredient of the Islamic banking system.

The SSB or *Shari'ah* committee is one of the most important governance mechanisms applied in IFIs to ensure the financial services business to comply with *Shari'ah* (Besar et al., 2009). The establishment of the SSB is imperative to instill public confidence on the purity of the operations of IFIs, as it serves as a mechanism to safeguard the management and operations of IFIs in order to comply with the Islamic principles in the formulation of the policies and strategies of the institutions. Although corporate governance in IFIs has attracted much attention in the literature (e.g., Safieddine, 2009; Paino et al., 2011; Alnasser and Muhammed, 2012), very little is written on *Shari'ah* audit (Yaacob and Donglah, 2012) and *Shari'ah* audit reports in IFIs. While *Shari'ah* audit is a very important part of corporate governance in IFIs, which is required under the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) standards, *Shari'ah* audit in IFIs is basically an under-researched area (Besar et al., 2009; Yaacob and Donglah, 2012). Little has been known of the disclosure of *Shari'ah audit reports* and whether such reports meet stakeholder expectations.

[1] Zulm is an Islamic term that refers to all forms of inequity injustice, exploitation, oppression and wrongdoing.

The aim of this paper is to explore whether any discrepancy exists between the disclosures in SSB reports of Islamic banks and the disclosure index that was developed following the AAOIFI and previous literature. Our disclosure index was developed covering five areas: the format of the report, the background of SSB, audit process, unlawful transactions and Zakah. Some of these disclosures are the requirements of the financial reporting standard promulgated by the AAOIFI (2015). It is worth mentioning that AAOIFI standards are deemed the most outstanding reference for Islamic banking industry and it serve as guideline (Sarea and Hanefah, 2013). It has been argued that AAOIFI standards can be used as a starting point that may help lead to an improved IFIs system of reporting (Harahap, 2003). Nevertheless, it has been the only complete standards on audit we have so far. Currently, AAOIFI standards are officially adopted by a number of central banks and financial authorities on a mandatory basis or as guidance (AAOIFI, 2015). However, this study does not aim to investigate IFIs' compliance with standards; rather it examines whether the SSB reports have disclosed relevant information to stakeholders. The study finds that the level of disclosures by IFIs in the sample is rather low compared to our index benchmark. Many institutions that claim to adopt the AAOIFI standards actually do not comply with the disclosure requirements. Using the *Shari'ah* audit reporting index developed in this study we reveal that the score for all categories within the index are well below the assumed expectation. The remainder of this paper is structured as follows. The next section discusses the theoretical background and presents a literature review. Section three explains the research methodology used for this study. Section four provides the results and analysis. Section five concludes the paper and outlines policy recommendations.

2. Accountability in Islam

From an Islamic perspective, the perceived relationship of individuals and firms with God affects the concept of accountability (Maali et al., 2006). To a Muslim, all resources are God-given, and ownership of wealth belongs to God. Individuals are only trustees and it is to God that accountability is ultimately due. Muslims, as required by Islam, have to question their actions or hold themselves accountable before being held accountable by Allah in the Day of Judgment for what they have done in their life (Abdul-Rahman and Goddard, 1998). The word *Hesab* in Arabic that is synonym to "account" repeated more than eight times in different verses the *Holy Qur'an* (Askary and Clarke, 1997). According to Lewis (2001 & 2005), the basic similarity between *Hesab* or account and accounting lies in the responsibility of individuals and businesses to carry out duties as described by Islam. Accountability in this context means an obligation of businesses to provide an account to the Islamic community at large, which has the right to know about the effects of operations of organisations on its well-being (Lewis, 2005). This presumes to influence the way of conducting business in an Islam society and Islamic firms are therefore expected to report on their fulfillment of such a responsibility (Aribi and Gao, 2012).

One of the major characteristics of the Islamic corporate governance system is the SSB to guarantee that all the operations, contracts and procedures of a business organisation conform to the Islamic code (Lewis, 2005; Grais and Pellegrini, 2006). It is very critical for IFIs to emphasise the compliance with Islamic principles in all their transactions and products. In fact, one of the primary objectives of accounting and reporting from an Islamic perspective is to ensure that the business discharges the Islamic concept of accountability (Haniffa, 2001; Maali et al. 2006). The emphasis on accountability from an Islamic perspective would render Islamic corporate reports to include information that meet *Shari'ah* ethics and morals. Since Islamic IFIs need to continually maintain the confidence of ethically conscious stakeholders who require assurance on the compliance of their products and operations with *Shari'ah*, the SSB audit report in Islamic bank is important as it reflects the accountability of IFIs not only to the users of the financial statements, but more important, to the Creator, Allah S.W.T (Kasim and Sanusi, 2013). The purpose of the religious audit is to assure both insiders and outsiders that God's laws are being followed by a business organisation in its business dealings. Such processes involved in *Shari'ah* audit and supervision are widely observed in IFIs (Algaoud and Lewis, 1999; Lewis, 2001), although the governance principles adopted differ across the full range of business activities. The roles of *Sharia'ah* auditors are basically threefold. First, they give advice to the board and management of a business organisation about the *Sharia'ah* acceptability of business contractual arrangements and new product development. Second, they provide an independent report to inform shareholders on the compliance of management with Islamic principles and to the extent that the business is run Islamically. Third, they carry out an audit of the *Zakah* with a view to establishing that the *Zakah* fund is being correctly assessed and properly administered (Shafii et al., 2013 a).

The most obvious purpose of the SSB is to certify for practicing Muslim consumers that a financial product or service being offered is acceptable from the Islamic legal perspective and is therefore lawful. Such certification, generally documented in a formal *Fatwa* (i.e., *Shari'ah* position paper), may be thought of as a form of due diligence. In effect, the *Shari'ah* supervisor or SSB, performs this due diligence on behalf of consumers who lack access to the details of what is offered to them and, who don't have the experience or qualifications to evaluate those details in light of *Shari'ah* teachings (Lewis, 2005). By assuming responsibility for the *Shari'ah* compliance of an IFI, including its policies and practices, *Shari'ah* supervision places itself in a position of directly representing the religious interests of the Muslim investors or consumers (Karim, 2001; Kammla et al., 2006; Besar et al., 2009; Aribi and Gao; 2012). The Shari'ah advisors' audit report is now mandated as a component of the Islamic banks' annual reports (Karim, 2001; Maali et al., 2006; Aribi and Gao, 2010). It certifies that the operations of a bank and transactions undertaken during the year are in compliance with *Shari'ah* principles (Haniffa and Hudaib, 2007b). There are instances where a *Shari'ah* audit of transactions reveals a discrepancy and then the advisors are required to report it as part of their certification, providing the details of the amount that, for example, was transferred to a charity account to offset the value of the said transaction (Lewis and Algaoud, 2001).

Islamic finance is one of the fastest growing segments of the global financial industry (Hussain et al., 2016). Their distinctive corporate culture generates a collective morality and spirituality combined with the production of goods and services, which sustains the growth and advancement of the Islamic way of life. The employees of IFIs are expected to follow: for instance, "....all the staff of such banks and customers dealing with them must be reformed Islamically and act within the framework of an Islamic formula, so that any person approaching an Islamic Bank should be given the impression that he is entering a sacred place to perform a religious ritual, that is the use and employment of capital for what is acceptable and satisfactory to God" (Janahi, 1995, p.42).

Islamic banking that operates under the profit-and-loss sharing mode, purchases and sells goods and services, and offers services for fees (Archer and Karim, 2012; Kettell, 2010, (Archer and Karim, 2012). It is quite different from the one common to conventional banking. A bank operating in Islamic surroundings is expected to be conscious of the impact of its activities on the community (Rahman et al., 2010). *Shari'ah* is based on Islamic teachings and provides guidance for the way Muslims should live their lives. The banking activities based on the *Shari'ah* principles represent the absolute ethical codes of Islamic religion and culture, which impose strong social obligations on Muslim individuals and organisations (Maali et al., 2006). *Shari'ah* supervision is the process of ensuring that a financial product or service complies with Islamic legal precepts and principles, either by conforming (to one degree or another) to a recognised Islamic legal norm or by not violating the norm.

The objectives of corporate reporting in an IFI are to show the institution's compliance with *Shari'ah* and also to assist users in making economic decisions. According to the AAOIFI (2015), IFIs should disclose all information necessary to inform the community about their operations and this requirement is related to the concept of accountability where the user community has the right to know how the operational activities of an institution are affecting their wellbeing. A number of studies have attempted to investigate the disclosures of the Shari'ah board in Islamic banks (e.g., Besar et al., 2009; Paino et al., 2011; Puad et al., 2015; Ramli et al., 2015). Besar et al. (2009) critically analyse the *Shari'ah* review and *Shari'ah* reporting practice in Malaysia. Their findings indicate there is an expectation gap between the standards issued by the AAOIFI and the actual Shari'ah review practice in those Islamic banks. Paino et al. (2011) study Shari'ah social responsibilities and corporate governance in IFIs by analysing 17 Islamic banks in Malaysia. Their results provide preliminary findings on the disclosures of these matters pertaining to improving corporate image and discharging their responsibility as an Islamic entity. Puad et al. (2015) analyse how the *Shari'ah* review and *Shari'ah* reporting are practiced of Islamic banks in three different countries including Malaysia, Pakistan and Bahrain. They find the Shari'ah audit report has been prepared based on different guidelines in each country, resulting in different presentations and disclosures among these countries. Ramli et al. (2015) assess the *Shari'ah* governance disclosure of seven Islamic banks in Malaysia based on a developed *Shari'ah* governance index. They also analyse whether there are differences in the Shari'ah governance disclosure between institutional owned and non-institutional owned IFIs as well as between domestic-owned IFIs and foreign-owned IFIs. To the best of our knowledge, no studies have specifically investigated the SSB disclosure across countries. This study contributes to the literature by examining the SSB disclosures contained in the annual reports published by 12 IFIs in the Gulf region and Malaysia. Malaysia is widely regarded as a leading country in developing IFIs and promoting *Shari'ah* governance.

3. Research Methods

Since *Shari'ah* audit information is predominately presented in the annual report of an institution, this study will use annual reports as a source of data. This study examines 12 IFIs operating in the Gulf Cooperation Council (GCC) countries and Malaysia. We focus mainly on Malaysia and GCC countries as they are the most significant players, which account for the vast majority of Islamic finance assets (GIFR, 2016). Our sample was initially based on 24 fully flagged IFIs in these countries listed on the website of the World Database for Islamic Banking and Finance (WDIBF). We exclude any Islamic bank with missing annual report during 2008-2010. Our final sample consists of 12 IFIs whose annual reports for the years 2008, 2009, and 2010 were available in English on the website.

To explore the communication practices of SSB reports in our sample, we used content analysis, which is a widely employed tool in accounting research through codifying texts into various themes (or categories) in line with selected criteria (Krippendorff, 1980). Content analysis provides the objective, systematic and quantitative description of the manifest content of communication (Berelson, 1952, p. 18). An essential element of content analysis is the selection and development of categories into which content units can be classified. The categories and items of this study were mainly drawn from our understanding of Islamic literature as discussed in the previous section and the Islamic perspective of accountability (see e.g., Baydoun and Willett, 1997& 2000; Gambling and Karim, 1986 &1991; Lewis, 2001). We also considered items required to be disclosed by the AAOIFI (20015) and adopted in the previous research of Islamic banking disclosure (e.g., Maali et al., 2006; Haniffa and Hudaib, 2007b; Williams and Zinkin, 2010). Since our interest is to assess the degree of congruence between the expected and disclosed information, we designed our research instrument (checklist) to cover five themes constituting the stakeholder expectations such as report format, background of the SSB, audit process, unlawful transactions and Zakah.

Report format: Under the standard format theme, we expect a SSB report to include a report title and the date of report, contact details and signatures of SSB members.

Background of the SSB: It is vital that SSB members to have knowledge and competence in relevant fields associated with banking as well as knowledge of *Shar'ah*, especially those areas related to business transactions. Hence, we expect a SSB report to communicate full information on the SSB member's background.

Audit process: we expect a SSB report to disclose information on how the audit process is performed in examining the transactions and other activities of the institutions such as whether SSB views were based on either a full or a sample review of transactions, appropriate tests, procedures and review work processes.

Unlawful transactions: *Shari'ah* compliance is the cornerstone of an IFI business and therefore it must avoid transactions that contradict with *Shari'ah* law. However, since IFIs in many cases are operating in a mixed economy they are forced to enter into transactions that are inconsistent with *Shari'ah* law. If such transactions occurred, the SSB report should provide full information on such transactions, income generated from these transactions and the SSB opinion on these transactions.

Zakah: IFIs are required either paying Zakah on behalf of their shareholders or calculating and disclosing the amount payable per share in their annual reports. It is expected that the SSB report to include the SSB opinion and information on the sources of Zakah and the calculation of Zakah payment.

Each theme has a number of sub-themes presented in Appendix 1. Reliability and validity in content analysis refer to a measuring procedure, which provides the same results on repeated processes. The previous studies argue that content analysis is not reliable if it is conducted only once or only by one person (Neuendorf, 2002). The content validity of the initial research instrument for this study was reviewed independently by two researchers followed by a third experienced academic who discussed the ambiguities raised in the review. The final disclosure checklist includes 25 items. To ensure the reliability of the research instrument, the authors and the two independent researchers scored four randomly selected banks. Then, the results from the three researchers were compared. However, given that the final research disclosure index was generally agreed by all researchers, the differences in the compliance scores from the researchers were insignificant.

The approach to scoring items is essentially dichotomous in that an item in the research instrument scores one if communicated, and zero if it is not (Haniffa and Cooke, 2002; Haniffa and Hudib, 2007b), and is additive and equally weighted to avoid potential scoring bias and scaling problems (Cook, 1989). In order to explore *Shari'ah* audit reporting practices of IFIs we attempt to develop a *Shari'ah* audit reporting index (*SAI)*. The score is calculated as follows:

$$\boldsymbol{SAI} = \sum_{i=1}^{N} \frac{Xi}{N}$$

Where: SAI = *Shari'ah* audit reporting index score for Bank *j; N* = number of items expected for Bank j; X_i = 1 if the item is disclosed, 0 if the item is not disclosed; and $0 \leq Xi \leq 1$. The scores for each item were then added and equally weighted to derive a final score for each institution.

4. **Results**

Table 1 presents *Shari'ah* Audit reporting index (SAI) ranking of 12 IFIs for three years. It can be seen from Table 1 that those institutions coming closest to meeting the benchmark were Jordan Islamic Bank (JIB), Capivesta, Albaraka Islamic Bank (AIB), and Faisal Islamic Bank (FIB) while the lowest SAI for three consecutive years were Kuwaiti Finance House (KFH) and Abu Dhabi Islamic Bank (ADIB). Based on the three-year mean of SAI for each bank, it can be seen that the range was 0.21–0.65. This means that JIB scored the highest with 65 per cent of the constructs under the five categories being disclosed in its annual report, while KFH addressed only 21 per cent of the constructs in the research instruments. A summary of the SAI disclosures made by each institution in the sample is presented in Table 2, which presents three-years means on the five categories for each organisation. As showed in Table 2, the level of SAI disclosure varies greatly among categories and the SSBs in general were more inclined to report information on the standard format of the report (such as title, date, addressee and signature) and the background of SSB while showed less attention to unlawful transactions. Many of these expected *Shari'ah* audit items listed in our index are required by the AAOIFI standards. We test whether following AAOIFI standards could explain differences in the extent of disclosure.

[Insert Table 1 here]

[Insert Table 2 here]

As showed in Table 1 nine IFIs in the sample claim to follow the AAOIFI standards. The mean of SAI by institutions that followed the AAOIFI was 0.515 compared to 0.326 by IFIs that did not apply the AAOIFI standards. A *t*-test shows the difference between the two groups is statistically significant.[2] Moreover, the differences in the level of disclosure varied across the different themes between the two groups. It is worth mentioning that many institutions that claimed to adopt the AAOIFI standards did not actually comply with the disclosure requirements as shown in our analysis.

4.1 Standard format of reports

Under the standard format theme, we expect a SSB report to include a title and date of report, contact details and signatures of SSB members. All these items are required by the AAOIFI standards. The results are shown in Table 3. The item disclosed by most IFIs is the title of report. The three-year mean of ASI for this category ranges from 33 per cent to 100 per cent, suggesting variations and inconsistencies between the items among these institutions. The number of IFIs disclosed under this category increased in 2010. Only one bank namely AIB communicated all the items over the three years in their reports and scored the highest SAI with 100 per cent. Despite the requirement of the AAOIFI standards, banks such as TI, IIAB and BIB that claim to follow the AAOIFI did not sign their SSB reports over the three-year period. This perhaps raises the question of whether IFIs truly follow the AAOIFI standards.

[Insert Table 3 here]

4.2 Background of SSB members

Bassens et al. (2012) explain the importance of having extensive knowledge of *Shari'ah* Law in assessing the 'Islamic' character of an institution's operations and assisting the development of *Shari'ah* compliant products and services. As they embody necessary entry-points into Islamic circuits of knowledge and authority, members of the SSB can be regarded as 'gatekeepers' of Islamic financial circuits (Bassens et al., 2012). Therefore, the SSB is

[2] To determine the robustness of the results, a non-parametric Mann-Whitney U test was also performed. The result of U-test supports the findings with p-value <0.05.

entrusted with the responsibility of monitoring the conduct of those trusted and providing assurance that the operation of the institutions is conducted in accordance with Islamic principles. Stakeholders may need to assess the profile of those who provide this assurance.

In this study we expect IFIs to disclose a set of aspects on their SSB, including the description of board members (e.g., name, position, picture, profile and remuneration). Table 4 indicates that none of the items in this category are required by the AAOIFI. Table 2 shows that all institutions in the sample communicated information on the background of SSB. The three-year mean of SAI ranges from 0.25 to 1.00. Six IFIs communicated more than 50 per cent of the constructs under this dimension: BIB, JIB, IIAB, MT, and Capivesta. Only one institution (i.e., MT) consistently disclosed all the items and scored 100 per cent. We observe a downward trend in communication on this category by KFH that disclosed only one item over the three-year period. All IFIs under this study seem to disclose the names of their SSB members, but only three institutions (i.e., BIB, JIB, and MT) consistently disclosed the pictures of their SSB members over the three years. There is inconsistency for institutions among KFH, IIAB, FBS, and TI. It should be noted that a *Shari'ah* auditor must have a good knowledge in accounting and also in *Shari'ah* to be able to understand and audit IFIs and their operations as the 'gatekeeper' (Shafii et al., 2013b). Following on this, IFIs are expected to disclose the qualifications held by their SSB members to assure stakeholders that their SSB have the competence and required knowledge deemed necessary for their job (i.e. specialised *Shari'ah* knowledge as applied in Islamic banking and finance, and accounting and auditing knowledge and skills). However, only four IFIs (i.e., GFH, Arcapita, MT and Capivesta) disclosed the qualifications of their SSB members over the period. It is also expected that remunerations of SSB members to be disclosed as part of transparency by IFIs. Remunerations of SSB members were only disclosed by six institutions and all were in the notes to the account section of the annual report. The low level of disclosure was not expected as transparency in Islam is viewed as an integrated part of the general meritorious and ethical tendency of business practice and the faith (Maali et al., 2006; Haniffa and Hudib, 2007a). In general, the low level of disclosure under this category could be due to the fact that all items under this category are not required by the AAOIFI.

[Insert Table 4 here]

4.3 Audit process

All institutions in the sample disclosed some sorts of audit process related information as shown in Table 5. Table 2 reveals the scores of disclosure under this category. The mean level of disclosure was 42.75 per cent. Three IFIs disclosed more than 50% of the constructs under this dimension: BIB, JIB and FIB. The three-year mean ASI ranges from 0.23 to 0.67, with the lowest being KFH and the highest being Capivesta. KFH only disclosed one item under this category over three years. Table 5 shows only two banks in the sample, JIB and FIB, consistently reported on the number of meetings held. In expressing an opinion on the operations of an Islamic bank, the SSB reports of three banks, ADIB, BIB and FIB over three years state that their reviews were based on auditing of all transactions. This statement emphasizes the importance of *Shari'ah* compliance. The SSB reports of KFH 2010, GFH 2010, and MT 2010 declare that their reviews were based on samples. For instance, MT examined *'on a test basis, each type of transaction, the relevant documentation and procedures adopted by Takaful Malaysia' (MT, 2010, p. 97).* Without exception, all IFIs in the sample disclosed the scope of audit, and opinions on compliance with *Shari'ah* in operation and the distribution of profit and loss. The high level of disclosure under these items are expected, since the main purpose of the *Shari'ah* review is to ensure all the activities are carried out in compliance with the *Shari'ah*.

The following quotations provide an inside perspective from a few examples of these statements:

> *We have planned and performed our review so as to obtain all information and explanations considered necessary by us for the purpose of providing us with sufficient evidence to provide reasonable assurance that the bank has not violated Islamic Shari'ah rules and principles (BIB, 2010, p. 48).*
>
> *By following up the performance of Kuwait Finance House during the year ended 31 December 2009, we certify confidently that all activities were practiced in compliance with Islamic Shari'ah and no violations have occurred, to the best of our knowledge (KFH, 2010, p.19).*

Profits distribution and charging losses to investment accounts is in conformity with the bases approved by the Board in accordance with Islamic jurisprudence (FIB, 2008, p. 38).

[Insert Table 5 here]

Although there was generally a lack of disclosure about *Fatwa* provided by the SSB to the management, five reports stated that they followed up their *Fatwa*, indicating some SSBs attest whether the management followed the guidance provided by the *Shari'ah* Board regarding new products and projects to ensure that the institution meets the ethical values of *Shari'ah.* For instance, the SSB of GFH reviewed the institution's investment activities and compared them with the previously issued *Fatwas* and rulings during the financial year ended 31st December 2009 and found them compatible with the already issued *Fatwas* and rulings credentials. Only the SBB reports of BIB and MT disclosed the approval of new products as found in the following statement: *The Shari'ah Advisory Body (SAB) held six meetings to review various products, transactions and processes in line with the Shari'ah requirements and approved the profit rate declaration for Family and General takaful products (MT, 2010, p.07)*

Internal *Shari'ah* audit is an independent department examining and evaluating the extent of compliance with *Shari'ah* rule, *Fatwas*, instructions etc. It is expected that the SSB would cooperate with the *Shari'ah* internal auditor in order to enhance shareholders' value and the confidence of stakeholders. Only two institutions, BIB and Cpivesta, disclosed information under this sub-theme over three years. JIB disclosed information in 2010 only. In the case of BIB (Annual Report 2010, p.36), the SSB verifies the documents and procedures to scrutinize either directly or through the *Shari'ah* Internal Audit department. The *Shari'ah* Internal Audit department carries out monitoring functions by obtaining information that were deemed necessary to confirm that the Bank did not violate the principles and provisions of Islamic *Shari'ah*.

4.4 Unlawful transactions

As described in the AAOIFI *Shari'ah* Review, the main purpose of the requirement of *Shari'ah* review in Islamic banks is to ensure that banks conduct their business in compliance with the

Shari'ah rules and regulations. 10 IFIs disclosed information under this category as shown in Table 6. There is a lack of disclosure made by KFH and FIB over the three years. As can be seen from Table 6 the level of disclosure under this category is very low comparing to other categories and the mean level of disclosure ranges from 0.0 to 0.19. Based on the three-year mean, BIB scored the highest. IFIs mainly disclose information related to two sub-themes: 1) gains resulted from sources prohibited by *Shari'ah*, and 2) the disposal of, or intend to dispose, such gains. In terms of identifying whether there were any defects in the income that they examined, the *Shari'ah* reports of BIB 2008, IIAB 2009 and 2008 and TI over 3 years, reveal that there was no gain resulted from sources prohibited by *Shari'ah*. In spite of the reporting of no defects in the transactions, eight *Shari'ah* Boards reported how the management had disposed or intended to dispose the unlawful revenue. However, none of the SSB reports disclose their view about the necessity of the transactions that generated unlawful income, recommendations to rectify defects in products, and actions taken by management to rectify defects in products. This is consistent with the results of previous studies (e.g., Maali et al., 2006; Hanifa and Hudaib, 2007a).

[Insert Table 6 here]

4.5 Zakah

As shown in Table 7, the total number of companies disclosed information under this category is 7. Revealed in Table 2, the mean level of disclosure ranges from 0.33 to 1.00, the lowest being MT. Overall, there is a lack of disclosure from five institutions AIB, GFH, KHF, Arcapita and IIAB.

[Insert Table 7 here]

Most of the disclosures are attestations from the SSB that the sources and uses of *Zaka*h and the amount computed for *Zakah* were in line with the Islamic principles, as evidenced in the following statement:

> *Zakah was calculated according to the provisions and principles of Islamic Shari'ah. The Bank distributed Zakah on the statutory reserve, general reserve and retained earnings. The shareholders should pay their portion of Zakah on their shares as stated in the financial report* (BIB, 2010, p. 37).

Auditing of the information on Zakah is deemed important to the users of Islamic annual reports and it is consistent with disclosure practices of Islamic law. The SSB opinion on Zakah sources and calculation should be disclosed in the SSB report to determine whether Zakah is not understated. Stakeholders expect the SSB to review Zakah calculations, Zakah distributions and report on its compliance with Shari'ah (Abu Baker and Naser, 2000; Maali et al., 2006; Yaacob and Donglah, 2012).

In sum, our results indicate that discrepancy in terms of the level and the extent of disclosure exists between the disclosed information in SSB reports of Islamic banks and the disclosure index developed in this study. We also found that the disclosure of each Islamic bank varies across the 3-year period, suggesting that disclosed information are not static, thereby contradicting the principles of full and comprehensive disclosure and accountability. The findings are surprising because IFIs, as an institutions follow *Shari'ah*, are expected to disclose more on those information to reflect accountability and not only to society, but also ultimately to God (Hanifa and Hudaib, 2007b) . In fact, the establishment of the SSB report is to provide assurance and maintain the confidence of stakeholders on the compliance of their products and operations with Shari'ah, therefore the content of the information in SBB reports should reflect the importance of the report for Stakeholder.

5. Conclusions

This study reports on the findings of content analysis of SSB reports made by IFIs. We investigate the nature and extent of IFIs disclosed SSB reports and the elements of information contained in those reports. Specifically this study focuses on the disclosures of SSB reports in terms of five categories, including report format, the background of SSB, audit process, unlawful transactions and *Zakah*. The study finds that the level of disclosures made overall by IFIs in the sample is rather low compared to the stakeholder expectations measured by the designed *Shari'ah* reporting index. The *Shari'ah* audit reporting index adopted in the study reveals the score for report format of 0.7, SSB background of 0.58, audit process of 0.4, unlawful transaction of 0.11 and *Zakah* of 04, are all below the benchmark of 1.

Our study provides results on the level of disclosures of SSB audit reports as part of corporate governance attempted by IFIs to fulfill their ethical and religion obligations and to demonstrate their responsibility as Islamic financial organizations. In line with Islamic principles, IFIs need to fulfill an ethical role inherent in their character as an 'Islamic' entity. Clearly the significance of SSB audit reporting should be seen along with the broader institutional development of corporate governance in IFIs. While socio-political factors may restrain the level of disclosure concerning SSB reporting, increasing of the level of monitoring within banks and organizations can lead to greater disclosure (Paino et al., 2011). Also, these results may suggest that uniform disclosure standards such as the AAOIFI standards across the globe need to be implemented in order to ensure a uniform level of disclosure by IFIs (Karim, 2001; Paino et al., 2011). In summary, although SSBs are envisaged to provoke greater monitoring function and play a strategic role in the process of ensuring greater compliance with Islamic laws and principles, current SSB audit reporting is far below the stakeholder expectations based on the requirements of the AAOIFI and findings of the prior literature. However, since the study is based on annual reports, it does not capture other forms of disclosure through company websites, press releases, special booklets and pamphlets.

The findings of this study provide some implications for further research and policy development. First, it would be interesting to investigate motivations of the IFIs for not complying with the requirement of the AAOIFI on *Shari'ah* report, resulting in the gap in disclosure. An understanding of the motives would help both policy makers and practitioners to identify appropriate policies and strategies in the future with a view to raising the compliance. Second, there seems to be a need to set up an enforcement agent ensuring the IFIs follow the AAOIFI standards. Our study shows although the AAOIFI standards have emphasized the importance of providing SSB audit reports, the implementation of reporting practice seems to be lower than the expectation. Obligatory reporting requires a system to monitor and supervise the behaviors of individual institutions. At the moment there is a lack of such a system. It is also relevant for policy makers to look at the coordination of governance mechanisms across the countries to ensure the consistency of SSB audit reporting among IFIs. Third, policy makers and researcher should further investigate if such a gap in disclosures is the result of difference of corporate governance among countries; such a difference can be caused by the varying levels of social, economic and regulatory developments among the Gulf countries and Malaysia.

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Table 1: *Shari'ah* audit reporting index (SAI) ranking of 12 IFIs

IFIs	Country	AAOIFI Requirement	SAI			Rank
			2010	2009	2008	
Abu Dhabi Islamic Bank (ADIB)	UAE	No	0.33	0.33	0.33	11
Bahrain Islamic Bank (BIB)	Bahrain	Yes	0.60	0.60	0.60	4
Gulf Finance House (GFH)	Bahrain	Yes	0.38	0.32	0.32	10
Albaraka Islamic Bank (AIB)	Bahrain	Yes	0.61	0.61	0.61	3
Kuwait Finance House (KFH)	Kuwait	No	0.35	0.17	0.12	12
Arcapita	Bahrain	Yes	0.36	0.34	0.34	9
Jordan Islamic Bank (JIB)	Jordan	Yes	0.70	0.63	0.63	1
Islamic International Arab Bank (IIAB)	Jordan	Yes	0.38	0.33	0.41	8
Malaysian Takaful (MT)	Malaysia	No	0.67	0.32	0.32	7
Capivista	Bahrain	Yes	0.67	0.62	0.57	2
Faisal Islamic Bank (FIB)	Sudan	Yes	0.57	0.57	0.62	5
Takaful International (TI)	Bahrain	Yes	0.49	0.53	0.54	6

Table 2: A summary of the SAI disclosures

	Report Format				*Background of the SSB*				*Audit Process*				*Unlawful Transaction*				*Zakah*			
	2010	2009	2008	mean	2010	2009	2008	mean	2010	2009	2008	mean	2010	2009	2008	mean	2010	2009	2008	mean
ADIB	0.75	0.75	0.75	0.75	0.25	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.14	0.14	0.14	0.14	0.00	0.00	0.00	0.00
BIB	0.50	0.50	0.50	0.5	0.75	0.75	0.75	0.75	0.60	0.60	0.60	0.6	0.14	0.14	0.29	0.19	1.00	1.00	1.00	1.00
GFH	0.75	0.75	0.75	0.75	0.50	0.50	0.50	0.5	0.50	0.20	0.20	0.3	0.14	0.14	0.14	0.14	0.00	0.00	0.00	0
AIB	1.00	1.00	1.00	1	0.50	0.50	0.50	0.5	0.40	0.40	0.40	0.4	0.14	0.14	0.14	0.14	1.00	1.00	1.00	1
KFH	0.75	0.25	0.25	0.42	0.50	0.50	0.25	0.42	0.50	0.10	0.10	0.23	0.00	0.00	0.00	0	0.00	0.00	0.00	0
Arcapita	0.75	0.75	0.75	0.75	0.5	0.5	0.5	0.5	0.40	0.30	0.30	0.33	0.14	0.14	0.14	0.14	0.00	0.00	0.00	0
JIB	1.00	0.75	0.75	0.83	0.75	0.75	0.75	0.75	0.60	0.50	0.50	0.53	0.14	0.14	0.14	0.14	1.00	1.00	1.00	1
IIAB	0.75	0.50	0.75	0.67	0.75	0.75	0.75	0.75	0.40	0.40	0.40	0.4	0.00	0.00	0.14	0.05	0.00	0.00	0.00	0
MT	0.50	0.50	0.50	0.5	1.00	1.00	1.00	1.00	0.60	0.10	0.10	0.27	0.14	0.00	0.00	0.05	1.00	0.00	0.00	0.33
Capivista	0.75	0.75	0.75	0.75	0.75	0.50	0.50	0.58	0.70	0.30	0.30	0.33	0.14	0.14	0.14	0.14	0.00	0.00	0.00	0
FIB	0.75	0.75	0.75	0.75	0.50	0.50	0.75	0.58	0.60	0.60	0.60	0.6	0.00	0.00	0.00	0.00	1.00	1.00	1.00	1.00
TI	0.75	0.75	0.75	0.75	0.25	0.50	0.50	0.42	0.30	0.30	0.30	0.30	0.14	0.14	0.14	0.14	1.00	1.00	1.00	1.00

Average	*0.75*	*0.67*	*0.69*	***0.70***	*0.58*	*0.58*	*0.58*	***0.58***	*0.51*	*0.36*	***0.36***	*0.40*	*0.11*	*0.09*	*0.12*	***0.11***	*0.50*	*0.42*	*0.42*	***0.44***

Table 3: Disclosures of standard format of reports

Sub-theme	AAOIFI Requirement	No of IFIs Disclosed		
		2010	2009	2008
Title of the report	Yes	12	11	11
Addressee	Yes	7	6	6
Date of the report	Yes	10	10	10
Report signed by all members	Yes	7	6	6
Mean		9	8.25	8.25

Table 4: Disclosure of the background of SSB members

Sub-theme	AAOIFI Requirement	No of IFIs		
		2010	2009	2008
Name of SSB	No	12	12	12
Pictures of members	No	5	5	4
Qualification and background of members	No	4	4	4
Remuneration of members	No	6	6	6

Table 5: Disclosure of audit process related information

Sub-theme	AAOIFI Requirement	No of IFIs		
		2010	2009	2008
Number of meetings held	No	4	3	2
Examination of documents based on sample	Yes	3	-	-
Examination of all documents	No	3	3	3
Opinion on compliance to *Shari'ah* principles	Yes	12	11	11
Scope of audit	Yes	12	10	10
Certification of the distribution of profits/loss complying to *Shari'ah*	Yes	12	8	8
Provision of fatwa (consultancy) on new products	Yes	-	-	-
Follow up fatwa	Yes	7	6	6
Liaise with *Shari'ah* internal auditor	No	2	2	2

Table 6: Disclosure of unlawful transactions

Sub-theme	AAOIFI requirement	No of IFIs		
		2010	2009	2008
No gains resulted from any sources or means prohibited	Yes	1	2	3
Nature and amount of unlawful transactions	No	0	0	0
Reasons for undertaking such transactions	No	0	0	0
The *Shari'ah* Board's view about the necessity of these transactions	No	0	0	0
How an institution disposed, or intends to dispose of such revenues	Yes	8	7	6
Recommendation to rectify product defects	No	0	0	0

Table 7: Disclosure of *Zakah*

Sub-theme	AAOIFI requirement	No of IFIs		
		2010	2009	2008
SSB attestation that *Zakah* has been computed according to *Shari'ah*	Yes	7	6	6
SSB verification of compliance to *Shari'ah* of sources and uses of *Zakah*	Yes	7	6	6

Appendix 1

Themes	AAOIFI Requirement
1.Sub-theme	
Title of the report	Yes
Addressee	Yes
Date of the report	Yes
Report signed by all members	Yes
2.Background of SSB members	
Name of SSB	No
Pictures of members	No
Qualification and background of members	No
Remuneration of members	No
3.Audit process	
Number of meetings held	No
Examination of documents based on sample	Yes
Examination of all documents	No
Opinion on compliance to Shari'ah principles	Yes
Scope of audit	Yes
Certification of the distribution of profits/loss complying *Shari'ah*	Yes
Provision of *Fatwa* (consultancy) on new products	Yes
Follow up *Fatwa*	Yes
Liaise with Shari'ah internal auditor	No
4.Unlawful transactions	
No gains resulted from any sources or means prohibited	Yes
Nature and amount of unlawful transactions	No
Reasons for undertaking such transactions	No
The *Shari'ah* Board's view about the necessity of these transactions	No
How an institution disposed, or intends to dispose of such revenues	Yes
Recommendation to rectify product defects	No
5.Zakah	
SSB attestation that *Zakah* has been computed according to *Shari'ah*	Yes
SSB verification of compliance to *Shari'ah* of sources and uses of *Zakah*	Yes