# Corporate Governance Disclosure Practices: Evidence from Indonesian Islamic Banks

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***ABSTRACT***

*The purpose of this study is to investigate corporate governance disclosure practices of Islamic banking in Indonesia. We content analyse the annual reports of Islamic banks in Indonesia in 2010 to 2013. This study used a disclosure index developed by Darmadi (2011) to calculate the extent of corporate governance disclosure. The composite index construction uses 7 dimension of corporate governance mechanism including shariah governance namely shariah supervisory board, board of commissionair, board director, board committee, internal control and external audit, risk management, corporate governance implementaion reporting.*

*The results conclude that the 11islamic banks in 3 years adhere to 71% of attributes of the corporate governance disclosure index.*

Keywords: corporate governance disclosure, Islamic banking

## INTRODUCTION

After a series of corporate scandals occured in the early 2000s, attention to corporate governance increased sinificantly. Questions was raised about the strength of governance in corporations especially in financial sector. Weak governance in those financial institutions have contributed to financal scandals and financial crisis (Srairi, 2015)

To gain the trust of stakeholders, companies are constantly required to increase transparency in their management. One of the efforts of the companies is to reveal their corporate governance practice. As Bhat, Hope and Kang (2006) mentioned, knowledge about the governance structure of the company is useful to assess the credibility of financial information. This is due to governance related disclosures to help users of financial information in assessing the quality of information and guide the stakeholders establish performance expectations in the future.

Related to corporate governance, Islamic banking has its own uniqueness in terms of agency relationships that exist therein (Safieddin, 2009). The first problem is the necessity to comply with the sharia. The second problem is related to Islamic banking operations where Islamic banking has the authority to determine policy on payment of returns to depositors that depends on bank profitability. From here arises the potential for manipulation of the yield to the depositors.

Mudaraba investment accounts that exist in Islamic banking Islamic banking add to the risk profile compared to conventional banking. Strong corporate governance is expected to address the problem of investor confidence in respect of this risk (Abdullah, Percy and Stewart, 2014).

However, corporate governance on Islamic banking was also not immune to the problems faced by conventional banks. Failure corporate governance on Islamic banking even has features similar to the conventional banking for example collusion between commissioners with management, failure of internal and external audits, a disregard for the interests of minority shareholders, unprudent lending decisions, excessive risk taking by management (Grais and Pelegrini , 2006b). Grais and Pellegrini (2006b) using a sample of 13 Islamic financial institutions of various countries have also found problems in the internal arrangement specific to Islamic financial institutions. Internal corporate governance arrangement presents challenges in Islamic banking product in question is a collection of funds (funding) in the form of Unrestricted Investments Account / UIA (Magalhaes and Al Saad, 2011). In the UIA, the owner of the funds as well as shareholders who entrust their funds to investors. There are several studies on corporate governance inIslamic financial institutions. However, in general those studies were carried out in the context of the countries of Southeast Asia and the Middle East, for example, Abdullah, Percy, Stewart (2014); Sulaiman Majid, Arifin (2013); Majid, Sulaiman, Ariffin (2011); Abdullah, (2013); Mizushima, (2014).

Darmadi (2011) to the best of authors' knowledge is the first to investigate the disclosure of corporate governance on Islamic banking in Indonesia according to the Bank Indonesia rules on corporate governance for Islamic Banking year 2009. Study conducted by Darmadi (2011) concluded that for some disclosure dimensions he found a strong example of the board members and risk management. However for another dimensions such as internal control and board committee he found weak disclosure.

This sudy investigate corporate governance disclosure practices of Islamic banking in Indonesia. We content analyse the annual reports of Islamic banks in Indonesia in 2010 to 2013. This study used a disclosure index developed by Darmadi (2011) to calculate the extent of corporate governance disclosure.This research is important to do for several reasons. The first, this research will reveal how far Islamic banking in Indonesia CG disclosure activity, particularly related to CG issues specific to the Islamic banking. Secondly, this study focuses on Indonesia, which has differet characteristics of corporate governance. Indonesia is adopting two-tier board system where companies must have a dual board structure governance, the board of commisioners as well as the management board (board of directors).

## LITERATURE REVIEW

### Corporate Governance

The Indonesian Forum for Corporate Governance (FCGI) in its explanation of the meaning of the corporate governance used the definition developed by the Cadbury Committee: "a set of rules that govern the relationship between shareholders, managers of the company, the creditors, governments, employees and stakeholders internal and external to other related rights and their obligations, or in other words a system to regulate and control the company."

The goal of corporate governance according to FCGI is "to create added value for all stakeholders." Corporate governance term is often used to describe the role and behavior of the parties in the management structure, the shareholders, the Board of Directors, Board of Commissioners.

Historically, there are two generations in the development of the conception of corporate governance (Syakhroza, 2005). The first generation was developed by Berle and Means (1932) (in Syakhroza, 2005) which describes the separation between those who manage the company party company that raises the need for a mechanism to ensure that the management company to perform its functions in accordance with the interests of the owners. The second generation is marked by the work LLSV (La Porta, Lopez de Silanes, Shleiver da Vishny) in 1988 (Dennis and McConnell, 2003 in Syakhroza, 2005). LLSV found the tendency of concentration of ownership on certain parties.

## Islamic Banking

Historically, Muslims do not know the vocabulary word "bank" in Islamic jurisprudence. However, the functions of modern banking has been practiced Muslims even since the time of Prophet Muhammad SAW (Karim, 2006).

Development of Islamic banking is under the "umbrella" of Islamic finance (Islamic finance). In Islamic finance, there are three main principles that can not be ignored, namely the prohibition of usury, banning of gharar transaction and provision of social services.

As explained by Karim (2006), basically there are three major parts of Islamic banking products, namely funding, financing and services. For funding, the principles of wadi'ah and revenue sharing /mudaraba is applied. There are two kinds of mudaraba contract: mudaraba mutlaqah (Unrestricted Investment Account) and Mudharaba muqayyadah (Restricted Investment Accounts). For financing the principles of purchase / bai ', lease (Ijara), revenue (syirkah) as well as other complementary contract are applied. In Islamic banking services the principle of Sharf (sale and purchase of foreign exchange) and Ijara (lease) are applied.

Indonesia currently has a dual banking system which together run the conventional banking and Islamic banking. Development of Islamic banking in Indonesia already has a legal basis to the Law No. 21, 2008. The legal basis is expected to accelerate the development of Islamic banking.

## Corporate Governance in Islamic Banking

CG in banking has its own uniqueness compared to other sectors. CG mechanism is not only intended to align the interests of management and shareholders to protect the interests of minority owners of the majority owner alone. In banking, the manager served to protect the funds entrusted by the various parties in the bank, including by depositors. Banking has a high level of risk because of high levels of leverage in its capital structure. Banks also have a wider range of stakeholders, as well as play an important role in the economy. Systemic risk in the banking shown by the problems in one bank can spread to other banks. This can bring about economic instability and also complicate the problems of the banking agency (Grand, 2011; Safieddin, 2009).

Meanwhile CG on Islamic banking requires special attention for several reasons. The first is the obligation for banks to comply with the rules of Islamic sharia. Islamic rules governed by the Sharia Supervisory Board prohibits transactions that are usurious, gharar (speculative) trading. Islamic banking, which serves as the investment manager must ensure that the funds deposited in Islamic banking is not invested in instruments that contain elements against sharia as mentioned above. Any deviation from this obedience led to a new source of agency problem. The second is that Islamic banking has the depositors which is Unrestricted Investment Account Holder. The total of Unrestricted Investment Accounts are generally higher than shareholders' equity but do not have voting rights in the company. The third is Islamic banking in emerging markets generally are where institutionally weaker than developed markets (Safieddin, 2009; Darmadi, 2011; Grais and Pellegrini, 2006a).

## Disclosure CG on Islamic Banking

With regards to their unique role in the economy, banks have extensive stakeholder including employees, customers, depositors, suppliers, regulators, and government (Basel Committee, 2006). In the context of relationship between bank and its stakeholders, Hossain (2007) in Wan Abdullah (2013) states that there are problems, especially related to information asymmetry in asset quality and risk. Banks also have complicated operations resulting in a tendency to be transparent in its disclosure activities compared to practices in other industries or even other financial institutions (Wan Abdullah, 2013).

Principles of CG which is adopted by many countries is the OECD's principles of Good Corporate Governance. In banking, the most widely accepted standard regulation is issued by Bassel Comittee on Banking Supervision (BCBS), the global standard setter for banking regulation, which published "Principles for Enhancing Corporate Governance" in 2006 and then revised in

2010. For Islamic banking, AAOIFI ( Accounting and Auditing Organization for Islamic financial institutions) issued a governance standards which are applicable to Islamic financial institutions. On the other hand, The International Financial Services Board (IFSB) also issued a CG principles which adopted OECD corporate governance principles and internationally accepted BCBS as well as incorporate the characteristics of Islamic banking in it.

In Indonesia, the National Committee on Governance (NCG) issued the Code of the Bank Indonesia issued a regulation to support the CG framework for conventional and Islamic banking. This authority then switch from Bank Indonesia to the Financial Services Authority. It is important to note that Indonesian business environment is characterized by a high concentration of ownership, ownership and shareholder family-run. In turn, this situtation is potential to make the gap between the existing rules and reality (Wan Abdullah, 2013; http://knkg-indonesia.com/home/ accessed at 20 April 2015; www.ojk.go.id accessed on 20 April 2015).

Specifically, the rules relating to Islamic banking CG stated in BI regulation No. 11/33 / PBI / 2009. Further provisions on this subject in the Circular No. 12/13 / DPbS governing the implementation of Good Corporate Governance for Islamic Banks and Sharia Business Unit in Indonesia.

## RESEARCH METHODOLOGY

The population of this study is Islamic Banking in Indonesia. We chose Islamic Banks' annual report from year 2010-2013 since the BI regulation No 11/33/PBI/2009 was effective since 2010.

We content analyse the annual reports of Islamic Banks to measure the extent of level of disclosure of those companies. CG disclosure is measured using the level of disclosure used an index developed Darmadi (2011). Index CG obtained from the total disclosure made bank divided by the total disclosure CG possible.

The list below show seven dimension of corporate governance reporting for Islamic Banks.

**A. Dimension: *Shariah* Supervisory Board**

1. Names of members
2. Positions of members
3. Pictures of members
4. Profiles of members
5. Number of meetings held
6. Members' attendance in meetings
7. Remuneration of members
8. Duties and responsibilities of the board
9. Compliance of products and services with *shariah*
10. Compliance of profit or loss with *shariah*
11. Examination procedures
12. Recommendation to management

**B. Dimension: Board of Commissioners**

1. Names of members

3. Existence of a risk-monitoring committee
4. Existence of a corporate governance committee
5. Duties and responsibilities of each committee
6. Committee reports in the annual report
7. Names of members
8. Positions of members
9. Pictures of members
10. Profiles of members
11. Most members being independent
12. Number of meetings held
13. Members' attendance in meetings
14. Remuneration of members
15. Performance of each committee

**E. Dimension: Internal control and external audit**

2. Positions of members
3. Pictures of members
4. Profiles of members
5. Independence of members
6. At least 50% of members being independent
7. Multiple commissionership/directorship held by members
8. Number of meetings held
9. Members' attendance in meetings
10. Remuneration of members
11. Duties and responsibilities of the board
12. Shareholdings of members
13. Recommendation to management

**C. Dimension: Board of Directors**

1. Names of members
2. Positions of members
3. Pictures of members
4. Profiles of members
5. Number of meetings held
6. Members' attendance in meetings
7. Remuneration of members
8. Duties and responsibilities of the board
9. Shareholdings of members

**D. Dimension: Board committees**

1. Existence of an audit committee
2. Existence of a remuneration and nomination committee

1. Internal control report in the annual report
2. Existence of an internal audit division
3. Internal audit framework
4. Duties and responsibilities of internal audit division
5. Internal audit certification held by employees
6. Policies on the appointment of external auditor
7. External auditor appointed by the bank
8. Performance of internal audit division

**F. Dimension: Risk management**

1. Risk management report in the annual report
2. Existence of a risk management division
3. Risk management framework
4. Duties and responsibilities of risk management division
5. Risk management certification held by employees
6. Market risk management
7. Credit risk management
8. Liquidity risk management
9. Operational risk management
10. Risk profile

**G. Dimension: Corporate governance implementation reporting**

1. Corporate governance implementation report in the annual report
2. GCG framework
3. Code of conduct
4. GCG self-assessment
5. GCG assessment by an external party

Sumber: Darmadi (2011)

## RESULT AND DISCUSSION

In this study, there are 11 Islamic banks as research objects. To eleven banks are as follows:

| No. | Bank |
|---|---|
| 1 | PT. Bank BCA Syariah |
| 2 | PT. Bank BNI Syariah |

| | |
|---|---|
| 3 | PT. Bank BRI Syariah |
| 4 | PT. Bank Jabar Banten Syariah |
| 5 | PT. Maybank Syariah |
| 6 | PT. Muamalat Syariah |
| 7 | PT. Panin Syariah |
| 8 | PT . Bukopin Syariah |
| 9 | PT. Syariah Mandiri |
| 10 | PT. Syariah Mega Indonesia |
| 11 | PT. Victoria Syariah |

**A. Dimension: Shariah Supervisory Board**

This dimension reflects the unique characteristics of Islamic Financial Institution which have to comply with shariah. In this dimension companies should disclose the details of the members of the board as well as how the board perform their job. There are 12 checklist in this dimension.

Index for this dimension show 63% adherence to the disclosure checklist.

Exerpts of disclosure on shariah supervisory board are as follows:

*Referring to Bank Indonesia Regulation (PBI) No. 11/33/PBI/2009 on the Implementation of Good Corporate Governance for Sharia Commercial Banks and Sharia Business Units, PBI No. 11/3/ PBI/2009, on Sharia Commercial Banks, and the Circular (SE) BI No.8/19/DPbS/2006, on the Sharia Supervisory Guidelines and Procedures for Reporting and Monitoring Results for Sharia Supervisory Board, and after conducting supervision and observation of:*

*1. Operational and product guidelines issued by PT Bank BRISyariah;*

*2. The operations of PT Bank BRISyariah;*

*3. Financial Statements of PT Bank BRISyariah for the year ended 31 December 2014*

*The Sharia Supervisory Board herewith submits*
*the following opinions:*

1. *Guidelines for the operations and products covering the mobilization and distribution of funds of PT Bank BRISyariah have conformed to the Advices of the National Sharia Council – Indonesian Council of Ulama (DSN-MUI) as well as the opinions of Sharia Supervisory Board of PT Bank BRI Syariah.*
2. *The operation of PT Bank BRISyariah has complied with the Advices of the National Sharia Council – Indonesian Council of Ulama (DSN-MUI) as well as opinions of the Sharia Supervisory Board of PT Bank BRISyariah,*
3. *Financial Statements of PT Bank BRISyariah ended 31 December 2014 has been prepared and presented according to the Sharia Principles.*
4. *The opinion is submitted, assuming that the documents presented to the Sharia Supervisory Board are correctt and complete*
5. *The opinion may change in case of discrepancies or data submitted in the documents are proven incorrect or there is a material information not submitted*
6. *The accountability to the opinion is limited to the copy of documents submitted to the Sharia Supervisory Board*

*In witness thereof, this opinion is submitted, hoping that Allah SWT would always guide us to walk through the right corridor and give us strength to carry out Islamic principles with all His righteousness, Amin.*

**B. Dimension: Board of Commissioners**

In this dimension, companies should disclose background, performance including remuneration of the member of the Board. The adherence level to the disclosure checklist rose to 87% in this dimension. This explains that most companies are transparent about their Board of

Commissioner. Exerpts of disclosure on board of commisioners are as follows:

*Independence of the Board of Commissioners*

*i. Concurrent Positions*

*In order to apply the principles of Transparency and Independency in the implementation of good corporate governance, the members of the Board of Commissioners have revealed the concurrent positions, as described the following table. The concurrent positions of the members of the Board of Commissioners are not contrary to the statutory of the applicable provisions. There are no independent members of the Board of Commissioners who have concurrent positions at the financial institutions and/ or companies that are customers of the Bank. Other concorrent positions were only possessed by the Commissioner whobecomes the representative of the controlling shareholder. This makes the BOC more independent and able to avoid conflicts of interest.*

**C. Dimension: Board of Directors**

This dimension's checklist are almost the same with Board of Commissioner, it should contains explanation regarding background, performance including remuneration of the member of the Board. 81% of compliance to the checklist is found from the disclosure. Exerpts of disclosure on board of directors are as follows:

*In the application of their duties and responsibilities, as well as in deciding strategic issues, the Board of Directors during the period of 2014 has conducted 44 meetings which were performed by quorum (meeting the requirement of minimum number of participants) and decisions were taken by consensus without setting aside the dynamics that occur during the meetings..*

**D. Dimension: Board committees**

The fourth dimension, Board Committees extend the discussion about committees inside the Board structure. These committees are in place to help the board with their expertise such us accounting, islamic banking, HRM expertise. The committees include audit committee, remuneration committee etc. The percentage of adherence of the banks tin this dimension reach 73%. Exerpts of disclosure on board committees are as follows:

*The Audit Committee has generally been carrying out their duties according to the applicable regulations, namely to assist the Board of Commissioners in performing oversight functions, which include:*

*i. Monitor and evaluate the planning and execution of audit and monitor the follow-up of the results of the audit in order to assess the adequacy of internal control, including the adequacy of the financial reporting process;*

*ii. To evaluate the:*

*a. Implementation of the duties of the Internal Audit Unit (SKAI);*

*b. Compliance of the audit performed by the KAP (Public Accounting Firm) with the applicable auditing standards;*

*c. Financial Statements Compliance to the applicable accounting standards; and.....*

**E. Dimension: Internal control and external audit**

In this corporate governance dimension, banks should disclose their internal control, internal audit and external audit environment. Indonesian Islamic Banks adhere to at at only 51%. Not much can be drawn by financial report reader with regards to those bank's disclosure in this dimension. Exerpts of disclosure on internal control and external audit are as follows:

*The implementation of the External Audit Function of on the Financial Statements for the financial year 2014 has complied with Bank Indonesia regulation related to the transparency of financial condition of the Bank, and the Generally Accepted Accounting Standards, as well as the employment agreement and scope of the audit that has been set. Taking into account the recommendations from the Audit Committee, the appointment of the* *same public accounting firm shall be conducted at a maximum of only five (5) consecutive fiscal years and the same accountant of the Public Accounting Firm (KAP) is allowed to perform audit for four (4) consecutive fiscal years. To meet professional standards, the Bank has appointed a Public Accounting Firm which is registered in Bank Indonesia and included as the 5 best KAP, namely Purwantono, Suherman, Surja, member of the Ernst & Young Global. This Public Accounting Firm has audited BRIS for 4 years in a row. Thus the implementation of the external audit function complies with the provisions of the relevant regulations.*

**F. Dimension: Risk management**

Risk management is one of the most critical part of financial institution's management. In this dimension, banks are hoped to disclose information regarding existance, framework, certification, report on risk management; include report on specific areas of risk management and risk profile. The banks adhere to 64% of the disclosure checklist. Exerpts of disclosure on risk management are as follows:

*BRISyariah has applied the three line of defense principle to identify, measure, monitor, and to ensure the availability of adequate reports in managing risks comprehensively and consistently. The Business Units and The Support Units serve as the first line of defense and are having primary responsibility for the day to day management of the risk exposures of the business. They are accountable for identifying, assessing, controlling and mitigating the risks in business.*

**G. Dimension: Corporate governance implementation reporting**

Companies should disclose the implementation of corporate governance in their corporate structure. This include structure, mechanism and the practice of corporate governance. 46% of the corporate governance implementation reporting checklist has been disclosed by Indonesian Islamic Banks. Exerpts of disclosure on corporate governance implementation reporting are as follows:

*Bank BRISyariah (BRIS) has made the implementation of Good Corporate Governance(GCG) as one of the Company's foundations to achieve its vision and mission, as well as for sustainable growth in the future.*

*First: Transparency, namely the openness in expressing material and relevant information and openness in the decision-making process. The application of this principle requires the Bank to provide adequate, accurate, timely information to all of its stakeholders.*

*Second: Accountability, namely the clarity of functions and implementation, as well as the accountability of the Bank's organs thus its management becomes effective. Effective application of this will lead to the clarity of functions, rights, obligations and authorities and responsibilities between the shareholders, the Board of Commissioners and the Board of Directors and the ranks below.*

*Third: Responsibility, namely the conformity of the Bank's management with the legislations in force and the principles of sound bank management, among others; tax issues, industrial relations, work health and safety, environmental protection, maintaining a conducive business environment with the community and so on. Thus, the Bank realizes that in its operations, the Bank is responsible not only to the shareholders but also to other stakeholders.*

*Fourth: Professional, namely possessing competence, able to act objectively, and free from the influence/ pressure from all parties(independent) and possess a strong commitment to develop the Islamic bank.*

## CONCLUSION

It can be concluded that the level of disclosure of corporate governance has an average index of 66% so that it can be said that the disclosure level is quite low. However, some corporate governance dimension shown high level of disclosure namely Board of Commissioners and Board of Directors.

Islamic Banks should put more effort to disclose information with regard to the practice of corporate governance inside their companies. This is important to gain more level of credibility from stakeholder.

We call for further research to deeply investigate more about corporate governance disclosure in islamic banks, and find its relationship with factors contribute to it; its effect on performance and the relevance of corporate governance information.

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