



Shariah Supervisory Board (SSB) and Performance of Islamic Banks in Malaysia

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Abstract

The purpose of this paper is to examine the extent to which the Shariah governance through Shariah Supervisory Board (SSB) functions of Malaysian Islamic banks is affected by their financial performance. Content analysis is used to identify such governance of SSB. A checklist instrument outlining the criteria for determining SSB governance is developed to codify the SSB information contained in the annual reports. The governance consists of five measures; these are: Shariah committee attributes, Shariah risk, Shariah audit, Shariah review and disclosure & transparency. Meanwhile, financial performance is measured for profitability and gearing using return on assets (ROA) and Debt-equity (D/E) ratio of the Islamic banks. The findings suggested that Shariah governance, namely Shariah committee attributes and disclosure & transparency is affected by the bank profitability, indicating that higher trust of Islamic banks with the Shariah committee members encourage them to be more transparent. However, control function system under Shariah governance needs to be enhanced. The awareness on the importance of Shariah review, Shariah audit and Shariah risk should be reinforced. Moreover, officers in Shariah and audit department respectively should be fully equipped with necessary knowledge on cross disciplines of Shariah, auditing and risk management. While the challenge of integrating such knowledge is undeniable, the underlying forces of those cross disciplines are essential. This empirical findings complement the expectations of previous studies, which highlight the importance of Shariah governance functions. As such, this study might be of interest to top management in Islamic banking, industry players, SSB members and regulators.

Keywords: Shariah Supervisory Board; Islamic Banks, Financial Performance

1 Introduction

Islamic banks are obliged to operate in conformity with the principles of Shariah. The prohibition of *riba* (usury) is the main principle to justify the needs of Islamic banks (IBs). Indeed, the existence of Shariah governance through Shariah Supervisory Board (SSB) is essential to monitor and govern the operations of IBs for ensuring the integrity, credibility and transparency of IBs. In this regard, the Shariah governance is used as a control and direct the SSB to ensure such conformity with Shariah. Shariah governance acts as a cornerstone of Islamic Banks to ensure Shariah compliance of the Islamic Banks (Zulkafli et al., 2010). Indeed, it is crucial for SSB members to understand the Shariah requirements in relation to various products being offered by the Islamic Banks and their operations are implemented according to Shariah (Hassan et al., 2011).

Ironically, Islamic Banks are required to establish SSB with the aiming at supervising the operation of Islamic banks to abide by the Shariah principles. The SSB in fact has power to prohibit any operations and activities against the Shariah (Mollah & Zaman, 2015), even SSB take precedence over the Board of Directors (BOD). This indicates that having an efficient SSB is a serious concern for Islamic Banks or otherwise, this may affect Islamic Banks and Islamic Finance industry at large. Depositors may lose their trust to Islamic Banks and this may affect investment decision making among existing and future investors of Islamic banks. Consequently, image of the Islamic Banks could be

impaired and their credibility is questionable (Grassa, 2013). Thus, this paper views that the Shariah governance refers to a system that controls, guides and directs the SSB to ensure adherence to the Shariah.

SSB play important roles in Islamic Banks, which differentiate them from other conventional banks. The main feature of Islamic banks is to ensure their operations are not involved in any prohibited activities. The existence of SSB is to provide a sound advice to the Islamic Banks, ensuring Banks' operations, affairs and activities are in compliance with Shariah. Other responsibilities include advising the BOD on Shariah matters in business operations, endorsing Shariah compliance manuals, advising related parties on Shariah aspects upon request, assisting the Shariah Advisory Councils (SAC) on reference for advice and providing a decision and advice on the operations which may trigger a Shariah non-compliance event (Bank Negara, 2017).

Some argue that SSB influences the performance of Islamic banks, similar notion applies to BOD since the roles of BOD and SSB are the same. Hanefah (2018) has proposed that SSB should be established also in Shariah-indexed companies listed in Bursa Malaysia. This is to ensure that the activities of Shariah-indexed companies are in accordance with the Shariah principles. In this study, Shariah governance is proxy by Shariah disclosure through SSB mechanisms in which SSB consists of five elements as suggested in Shariah Governance Framework, 2010 issued by Central bank of Malaysia. The five elements are Shariah Supervisory Board (SSB) committee, Shariah review, Shariah

risk, Shariah audit and disclosure & accountability. The efficient role of SSB is crucial in order to build confidence among a wide range of stakeholders in relation to Shariah compliance (Safieddine, 2009). As such, this triggers the present study to focus on the existence of Shariah Supervisory Board in Malaysian Islamic Banks.

Performance is central to the discussion of corporate disclosure, including Shariah governance aspects. A number of studies report that performance is capable to influence the extent of information disclosure in their corporate annual reports. Whilst Wallace & Naser (1995) found a positive relationship between profitability and disclosure, others found no relationship (e.g. Galani et al., 2011; Hossain & Taylor, 2007). However, within the purview of Islamic perspectives, Baydoun & Willett (2000) argued that full disclosure is one of the characteristics of Islamic corporate reports, which applies to Islamic banks, making a profit or otherwise is not the reason of lack of disclosure. This paper attempts to respond such notion in order to provide empirical evidence, aiming at examining the extent to which SSB disclosure influences the performance of Malaysian Islamic Banks.

The remainder of this paper is organized as follows. Section 2 reviewed the previous studies, highlighting the development of hypotheses. Section 3 presents the methodology, whereas Section 4 discusses the empirical results. Section 5 concludes this paper.

2 Literature Review and Hypotheses Development

There are limited studies investigating the influence of Shariah governance, in particular Shariah Supervisory Board (SSB) on the performance of Islamic Banks (Nomran et al., 2017). The fact that SSB is similar to Board of Directors (BOD), despite investigating merely the Shariah governance practice, its association with performance also could be investigated. Although Islamic Banks are very concerned on the compliance of Shariah, performance of the banks should be pondered to maintain their sustainability, to increase the confidence of the depositors, other consumers and a wide range of stakeholders. For that reason, numerous literature has linked SSB with financial performance of the banks.

The majority of similar studies used SSB as an explanatory variable, whereas performance is the dependent variable, but this study is different. It attempts to look at factors affecting SSB in relation to financial performance. Indeed, SSB is a dependent variable. Previous studies focused on the extent of accountability disclosure, environment disclosure and CSR disclosure associated with performance (See e.g. Hussainey et al., 2011; Masruki et al., 2017; AlArussi et al., 2009; Smith et al., 2007). In this study, the disclosure highlights the SSB related information, reflecting the Shariah governance practice of Islamic Banks, including five organs of Shariah governance as posits in Shariah Governance Framework (SGF), 2010; namely, Shariah Committee, Shariah review, Shariah risk, Shariah audit and disclosure & transparency. Past research findings are mixed on the association between disclosure and performance. However, the majority of studies found a positive influence of SSB on financial performance of Islamic Banks. In this study, financial performance refers to profitability and gearing. Both were chosen as the data shows normal distribution.

2.1 Profitability

Profitability is a cornerstone of corporate disclosure, indicating that profitability is capable of influencing the extent to which firms are more likely to disclose more information. This has been proven by numerous studies such as Chavent et al., 2006; Aly et al., 2010; Haniffa & Cooke, 2002; Hussainey et al., 2011. In line with the signaling theory, when a firm is profitable, there is intent

to disclose more detailed information for attracting investors. It shows that there is a positive association between disclosure and profitability, which contradicts with a number of studies, revealing no significant association between both variables (See e.g. Galani et al., 2011; Hossain & Taylor, 2007). Whilst signaling theory justifies the positive association between disclosure and performance for investment decisions, agency theory argues such association is essentially, for compensation increment. In a similar vein, this study hypothesizes profitability and Shariah governance as follows:

H1 Profitability has a positive association with disclosure in relation to Shariah governance

2.2 Gearing

Empirical evidence regarding the association between gearing and disclosure is inconclusive. Jensen & Meckling (1976) assume highly leveraged firms are more likely to disclose more information. Consistent with agency theory, there is a positive association between gearing and disclosure. The increased disclosure can encourage firm to meet obligation for creditors instead for shareholders (Xiao et al., 2004). The positive association also implies that creditors have more information to evaluate the ability of the firm to pay its debts on time and in turn, this will reduce agency cost (Ismail, 2002). On the other hand, Brammer & Pavelin (2008) found a negative association between disclosure and gearing ratio. The low level of gearing ratio allows creditors to reduce their pressure to built trust of credit ability of the firm to pay debts. As such, more disclosure on Shariah governance is important to portray a good governance of the firm since Islam always remind us to pay debt without fail. In fact, regardless whether the firm has low or high debts, they are ought to be transparent through full disclosure. Others failed to prove any association between both variables (See e.g. Aly et al. 2010; Hussainey et al., 2011; Hassan et al., 2006).

H2 Gearing has a positive association with disclosure in relation to Shariah governance

3 Methodology

This study uses the whole population of Islamic Banks in Malaysia for a-five year period through 2012-2016. The data are extracted from the respective website of each Islamic banks.

3.1 Measurement of Variables: Dependent and Explanatory

In this study, following previous similar studies, the dependent variable namely, Shariah governance is measured using content analysis to generate Shariah disclosure score, representing Shariah governance practice. A disclosure checklist is developed based on a review of previous studies, consisting of Shariah Supervisory Board (SSB) committee, Shariah review, Shariah risk, Shariah audit and disclosure & accountability. The checklist outlines characteristics for codifying Shariah governance information contained in the annual reports of Islamic Banks as suggested in previous studies and regulations, including Shariah Governance Framework (SGF) and Islamic Financial Services Act (IFSA). A second coder also analysed the report to check consistency of the disclosure score. A score of 1 is given if item is disclosed or otherwise, 0. Table 1 shows a list of disclosure items with a maximum score of 28, representing Shariah governance practices.

Table 1: Dependent variables - Shariah Governance

Shariah Governance	Number of items (max. = 28)
Shariah Committee	8
Shariah Review	4

Shariah Audit	4
Shariah Risk	4
Disclosure and Transparency	8

A score of 1 is counted if the item is disclosed, or otherwise 0.

3.1 Dependent variables

The dependent variable is Shariah governance measured by the traditional content analysis using the presence of sentences related to Shariah governance information contained in the annual report of Islamic Banks. This study focused on five dimensions of Shariah governance as outlines in Shariah Governance Framework (SGF), 2010.

3.1.1 Shariah Committee

Shariah Committee (SC) or also known as Shariah Supervisory Board (SSB) is an independent committee, which acts as an oversight body to monitor the operations and business affairs of the Islamic banks. SSB provides the assurance to the stakeholders that the activities of Islamic banks are in consistent with Shariah rulings. In fact, a standard policy of SSB refers to the Islamic principles (Almutairi & Quttainah, 2017), directing them to carry out audit and investigate all products and activities of Islamic banks. For that reason, SSB members are appointed among the Shariah scholars in order to lead the Islamic banks with Islamic values and in compliance with Shariah. According to Grassa (2013), SSB is one of the components of Shariah governance to ensure the Shariah compliance in the banks' day-to-day operations and their activities.

3.1.2 Shariah Review

Shariah review is a periodic review of the Islamic banks' operations in compliance with the Shariah rules. It plays a significant role to ensure all activities of Islamic banks are in consistent with Shariah rules, following fatwa, guidelines and ruling issued by Shariah Supervisory Board (Bahari & Baharudin, 2016). Based on the SGF (2010), Shariah review function is highlighted as a mechanism suggested for proper governance practice in monitoring and assurance of Islamic banks' activities. The fact that Islamic banking industry nowadays is getting complex and dynamic, the possibility of Shariah non-compliant contract in transactions may occur (Besar et al., 2009). Indeed, Shariah review function is pertinent to explicate the Shariah Governance practice.

3.1.3 Shariah Risk

Ginena (2014) defines Shariah risk as part of operational risk, considering Islamic banks might face financial loss risk as a result of non-compliance activities. Shariah audit function include identifying the possible risk, measuring the level of risk, monitoring and facilitating the effective risk management and controlling the recurrence of non-compliance risk. Although risk is impossible to be avoided, the function of Shariah risk is to mitigate the risk and importantly, the risk management must be consistent with Shariah guidelines. As the risk exposure is more on the Shariah non-compliant risk, Islamic Financial Services Act or IFSA (2013) cautions that any element of Shariah non-compliant in activities of Islamic banks is against the law under Section 28(5) of IFSA. According to the Act, imprisonment of a maximum of eight years or fine up to MYR25,000 or both (Hassan, 2014). As such, this highlights the importance of Shariah risk in Shariah governance practice.

3.1.4 Shariah Audit

Shariah audit is an auditing process; attestation of the Shariah complaint practice by examining financial statements and other related documents and all aspects in an organization including operational activities (Haniffa, 2010). According to Shafii et al. (2013), Shariah audit is an independent assessment conducted periodically to improve the compliance and to ensure the effectiveness of Shariah control systems. Shariah audit function is implemented at three levels, these are: audit of the financial statement, compliance audit on organisational structure, people and process and review on the adequacy of the Shariah governance process (Othman & Ameer, 2015).

3.1.5 Disclosure and Transparency

In consistent with a notion of full disclosure in Islamic corporate report, Islamic banks are required to be seen as being accountable to various stakeholders. The entire bank operations, transactions and activities should be well reported to garner trust and confidence of consumers. Besides that, being transparent also could avoid fraud or any possibility of dispute in transactions. Both disclosure and transparency are mentioned in SGF, 2010 as part of the Shariah governance mechanisms and it is proven in a study conducted by Bijalwan & Madan (2013). They found that disclosure and transparency are important for better Shariah governance.

3.2 Explanatory variables

Based on the reviewed literature, the following financial performance factors are used as indicators that may influence SSB of Islamic Banks in Malaysia. This allows the development of hypothesis for further testing. The financial performance is measured by a) Profitability using Return on assets (ROA); and b) Gearing using Debt-to-equity ratio (D/E). Overall, performance is measured by using the Accounting-based variables.

3.3 Regression Models

In this study, Table 2 presents regression models, which are used to test the above hypotheses.

Table 2: Regression Models

Shariah committee	=	$\alpha + \text{Profitability} + \text{Gearing} + e$	1
Shariah review	=	$\alpha + \text{Profitability} + \text{Gearing} + e$	2
Shariah audit	=	$\alpha + \text{Profitability} + \text{Gearing} + e$	3
Shariah risk	=	$\alpha + \text{Profitability} + \text{Gearing} + e$	4
Disclosure and transparency	=	$\alpha + \text{Profitability} + \text{Gearing} + e$	5

Where:

α = Constant (intercept)

e = Difference between the predicted and observed value of the SSB (the error term)

4 Results and Findings

4.1 Descriptive Statistics

Table 3 shows about the descriptive statistics of the dimensions of independent variables (Shariah committee, Shariah review, Shariah audit, Shariah risk and disclosure, and transparency) and dimensions of dependent variables (return on assets and debt equity ratio) which shows the result among 10 local Islamic banks and 6 foreign Islamic banks¹.

¹ The reliability results show a good level; as the scale was reliable with a Cronbach's (1951) alpha coefficient of 0.7.

Table 3: Descriptive Statistics

	N	Minimum	Maximum	Mean
Shariah Committee	80	1.00	2.00	1.6975
Shariah Review	80	1.00	2.00	1.4969
Shariah Audit	80	1.00	2.00	1.5031
Shariah Risk	80	1.00	2.00	1.5156
Disclosure & Transparency	80	1.00	1.71	1.4994
Return on Assets (ROA)	80	.28	2.61	1.0544
Debt-to-Equity (D/E) Ratio	80	.00	2.54	.3663

Note: This table presents for the full sample the descriptive statistics for the variables used in the model. N = Number of observations

Based on Table 3, the dependent variables for the full sample, the mean of Shariah governance, consisting of SSB, Shariah review, Shariah risk, Shariah audit and disclosure & transparency are ranged from 1.50-1.70. The findings suggested that IBs are more likely to disclose SSB committee attributes, whereas Shariah compliance items, namely Shariah review, Shariah risk and Shariah audit are less likely to be disclosed, indicating that IBs seem to heavily depend on the competency of SSB members in comparison with the Shariah compliance mechanisms. Due to that, Shafii et al. (2013) strongly suggest human capital development in Shariah governance. This study might be of interest to IBs and SSB members themselves to consider various mechanisms of Shariah governance practices to increase trust and confidence of a wide range of stakeholders. Future studies can be carried out to suggest the recommended practices of Shariah compliance mechanisms in conjunction with Shariah Governance Framework issued by Central Bank of Malaysia. For the explanatory variables, the mean for the profitability; ROA is 1.05, whereas for gearing is 0.34. This suggests that Islamic banks seem to be more profitable and less leverage.

4.2 Diagnostic test

Prior to conducting the regression, screening test was carried out to address any multicollinearity issue by using Variance Inflation Factor (VIF). The data set was tested, and it show that the VIF for all variables are between 1.04-1.55, not exceeding 10, indicating that multicollinearity is not a problem.

4.3 Regression Results

Table 4 details the correlation coefficient between disclosure scores on Shariah governance and the potential explanatory variables of profitability and gearing.

Table 4: Association between Shariah Governance and Performance

Shariah Governance	ROA	ig.	D/E	Sig.
Shariah Committee	0.485	.042	0.186	0.216
Shariah Review	0.415	.075	0.273	0.080
Shariah Audit	0.316	.225	0.269	0.130
Shariah Risk	0.390	.127	0.300	0.084
Disclosure and Transparency	0.488	.006	0.152	0.149

Table 4 shows the relationship among the dimensions of IVs and DVs; indicating that there is a significant relationship among Shariah committee and disclosure & transparency with Return on Assets (ROA). However, there is no significant relationship with Debt-to-Equity (D/E) ratio. The R and R^2 values have also been computed. The R value represents the simple correlation and R^2 value indicates how much is the total variation in the dependent variable. In this case, the values of R^2 (0.71-0.77) are more than 0.7, indicating that about 70% of the Shariah Governance practice can be explained by performance, except Shariah audit (0.18).

Table 5: Summary of the Hypotheses and their Outcomes

Hypotheses		Outcomes
H1a	ROA has a positive association with Shariah committee	Accept
H1b	ROA has a positive association with Shariah review	Reject
H1c	ROA has a positive association with Shariah audit	Reject
H1d	ROA has a positive association with Shariah risk	Reject
H1e	ROA has a positive association with disclosure and transparency	Accept
H2a	Gearing has a positive association with Shariah committee	Reject
H2b	Gearing has a positive association with Shariah review	Reject
H2c	Gearing has a positive association with Shariah audit	Reject
H2d	Gearing has a positive association with Shariah risk	Reject
H2e	Gearing has a positive association with disclosure and transparency	Reject

Although a number of studies suggest the existence of a relationship between disclosure and profitability, the results of these studies vary. Likewise, based on Table 5, this study did not find significant relationship for ROA in relation to Shariah review, Shariah audit and Shariah risk ($r=0.415$, $sig.=0.075$; $r=0.316$, $sig.=0.225$; $r=0.390$, $sig.=0.127$). These three Shariah governance functions are grouped into Shariah compliance mechanism. It shows that Islamic banks in Malaysia may not place any great value in Shariah compliance disclosure, which contradicts Baydoun and Willett (2000). They argue that Islamic corporate report should emphasise on full disclosure to portray the practice of Shariah compliance in the business operations. The H1b, H1c and H1d can be rejected at the 5 percent level of significance.

In contrast, Shariah committee and disclosure & transparency were found to be significantly associated with ROA ($r=0.485$, $sig.=0.042$ and $r=0.488$, $sig.=0.006$ respectively). This implies that Islamic banks in Malaysia heavily rely on the expertise of their Shariah committee members. Almutairi & Quttainah (2017) urge that the Shariah committee even set standards based on Shariah principles. For that reason, there is no doubt also on the transparency of the banks due to high trust placed with the religious people (Yasmin et al., 2014). Hypotheses H1a and H1e can be accepted at the 5 percent significance level.

Overall, significant relationships between profitability and both Shariah committee and disclosure & transparency are evident from the return on assets (ROA) variables. However, that is not the case for Shariah compliance functions, which make up the Shariah review, Shariah audit and Shariah risk. This result is consistent with a study conducted by Shafii et al. (2013), which found a lack of practice on the internal control system, involving Shariah review, Shariah audit and Shariah risk. In fact, this area is still at the infancy level in Malaysia unlike in some of the Middle East countries like Bahrain.

With regards to gearing, findings show no significant association between gearing and Shariah governance (coefficient $r=0.152$ - 0.30 , $sig.=0.08$ - 0.22), supporting numerous disclosure studies such as Aly et al. (2010), Hussainey et al. (2011) and Hassan et al. (2006). Hypotheses H2 can be rejected at the 5 percent level of significance.

5 Conclusion

This paper analysed Shariah governance practices of Islamic banks in Malaysia. Financial performance, namely profitability and gearing have been examined as determinants of Shariah governance practices; using five Shariah Supervisory Board functions (SSB), these are: Shariah Committee, Shariah review, Shariah audit, Shariah risk and disclosure & transparency. The five functions were extracted from the Malaysian Shariah

Governance Framework (SGF), 2010 issued by Central Bank of Malaysia. This study sample comprised the entire sixteen Islamic banks in Malaysia over a five year period through 2012-2016. The practice of Shariah governance through Shariah Supervisory Board (SSB) was analysed to look at the factors influencing of Shariah governance in relation to financial performance. The SSB were evaluated based on the presence of the disclosure items in the banks annual reports, using a self-developed disclosure index. The SSB index was developed mainly from relevant regulations on Shariah governance framework and previous related studies.

Of the two explanatory variables examined, namely profitability and gearing, the former was found to be significant. Profitability is positively associated with both Shariah committee attributes and transparency, indicating high trust of Islamic banks with the Shariah committee members. This encourages them to be more transparent. However, internal control system in Islamic banks related to Shariah need to be enhanced. The awareness on the importance of Shariah review, Shariah audit and Shariah risk should be increased and further equip the relevant officers in the Shariah and audit departments with necessary knowledge. The fact that internal control system is synonym in business-related fields such as Accounting and Finance, Islamic scholars are still required. Such uniqueness makes this Shariah control function more challenging. Due to that, recently Central Bank of Malaysia has released an Exposure Draft on Shariah Governance Framework (2017), which revised the initial framework in 2010. Those three functions, namely Shariah review, Shariah audit and Shariah risk are explained separately in Part E of the Exposure Draft (Bank Negara Malaysia, 2017).

Future studies might be able to revise the measurement of Shariah governance disclosure by looking at the revised Shariah Governance Framework. Explanatory variables also can be considered to include other financial performance aspects such as liquidity, efficiency and solvency of the Islamic banks. Findings in this study, while contrary to the majority of Shariah governance studies, are consistent with other disclosure studies on corporate governance, accountability and corporate social responsibility. All the explanatory variables related to SSB, such as attributes, expertise, qualifications of SSB on the impact on financial performance are studied. We might anticipate that future research studies might expand the evaluation of SSB report by using more detailed rating scheme to differentiate whether the SSB report is quantitative/qualitative or general/specific, reflecting better Shariah governance practices among Islamic banks.

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