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Review of Ghaffar's Article (2014) and Research Opportunities on Islamic Governance

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Abstract

This paper criticizes articles written by Ghaffar published in the *Interdisciplinary Journal of Contemporary Research in Business* in 2014. Ghaffar's (2014) study examines the impact of governance practices on the profitability of Islamic banks. Corporate governance variables in the study were measured by board size and board independence, while bank profitability was measured using the ratio of return on assets and return on equity. The results of Ghaffar (2014) found that all variables of corporate governance (board size and board independence) have a significant influence on bank profitability. Criticism of the article relates to the use of governance that is generally applicable in companies. In the article, governance variables that have not been specifically used in sharia entities, especially Islamic banking, have not been used, for example in the presence of the Sharia Supervisory Board and disclosures regarding compliance with sharia principles. Future research can be focused on 3 aspects, namely (1) testing the influence of governance on company value and credit risk; (2) examine the impact of governance on social performance and dimensions of corporate spirituality; and (3) testing the impact of governance on earnings management.

Keywords: board size, board independence, return on assets, return on equity, Islamic bank

Introduction

Corporate governance has become a very interesting and important issue especially after the rampant cases of bankruptcy of public companies with accounting fraud scandals such as Polly Peck (1990), International Credit and Commercial Banks (1991), Barings Bank (1995), Enron (2001) and WorldCom (2004) (Qureshi & Qurashi, 2014). This encourages an increase in the level of concepts and empirical findings that examine various matters concerning corporate governance and their impact on company performance.

There are two views on corporate governance. A narrow view, interpreting corporate governance as a formal system of senior management accountability to shareholders. The broad view states that corporate governance encompasses all formal networks and informal relationships that involve the corporate sector and its consequences for society in general (Hasan, 2009). In line with the development of the concept of corporate governance, empirical studies also experienced a significant increase. Empirical studies have been carried out in assessing corporate governance and their effects on performance as Black et al. (2003), Klapper & Love (2002), Darmawati et al. (2005), and Adnan et al. (2011). In addition, other empirical studies study the determinants that affect the quality of corporate governance implementation such as Gillan et al. (2003), Drobetz et al. (2004), Barucci & Valini (2004), and Black & Kim (2003) in Darmawati (2006).

The Importance of Islamic Governance

The emergence of governance in Islam is inseparable from the number of Muslim populations in the world and the growth of Islamic financial institutions. At present it is estimated that the Muslim population in the world is 1.6 billion or about one third of the total

world population. The size of Islamic financial institutions is estimated at US \$ 1,631 trillion with an annual growth rate of 20.4% over the last five years at the end of March 2012. The total size of Islamic financial institutions is smaller than the size of the world's largest financial institution, with 18 banks in the world that have assets more than US \$ 1,631 trillion, according to the magazine "The Banker" concerning the ranking of the world bank in 2013 (Mizushima, 2014). Islamic financial institutions such as Islamic banking, takaful insurance and the sharia capital market not only grow rapidly in Muslim countries, but also grow rapidly in non-Muslim countries (Kasim et al., 2013).

Islamic governance is an important element in Islamic Financial Institutions. In carrying out this governance, Islamic financial institutions (IFI) refer to the principle of "IFSB Guiding Principles on Corporate Governance" where the principle states that the right mechanism must be made to ensure compliance with Sharia principles. In the IFSB guidelines, it is stated that IFI must have adequate systems and controls, including the existence of the Sharia Supervisory Board (SSB) to ensure compliance with Sharia principles. SSB must have several criteria including competence, independence, confidentiality, and consistency. Compliance with Islamic principles is a principle that must always be held by the IFI.

Concept of Islamic Governance

Islamic governance has four characteristics, namely accountability, transparency, fairness and responsibility (Qureshi & Qurashi 2013). Governance in Islam emphasizes on maqashid sharia. Hasan (2009) and Choudhury & Hoque (2006) emphasize that the maqashid syariah element that lies in the difference between Islamic governance and governance in the west. Maqashid sharia refers to the goals or intentions of business entities in the perspective of Islamic law. Imam al-Ghazali in Dusuki & Abdullah (2007) explains that the purpose of Sharia (maqashid syariah) is to create the welfare of all mankind, which includes guarding the faith (din), guarding the human soul (nafs), intellectual care or reason ('aql), descent (nasl) and guarding of property (maal).

Islamic governance strongly emphasizes the concept of Tawhid as one of the philosophical pillars in Islamic economics. Choudhury & Hoque (2004), Hasan (2009) and Qureshi & Qurashi (2013) describe the Tawhid and Shura approach in corporate governance models. The Tawhid principle will be the basis for the model of Islamic governance as a form of accountability to God (Hasan, 2009). All elements within the company such as directors, employees, and commissioners must put the principle of tawhid in every activity of their duties and responsibilities. There are four principles and instruments that govern the Tawhid extension of Islamic governance, namely the principle of unity of knowledge through an interactive, integrative and evolutionary process to interact with environmental factors, the principle of justice; the principle of productive involvement of resources in social; principles of economic activity; and the recursive principle of intent between the above stages. All of these principles are the main premise of Islamic governance where the rules of the Shari'a are embedded in the Quran and Sunnah which make Islamic corporations market driven and at the same time uphold the principles of social justice (Choudury & Hoque 2004).

Islamic governance is based on a stakeholder-oriented approach. In a stakeholder-oriented model, there are two basic concepts, namely ownership rights and contractual frameworks. Corporate governance in Islam regulates the rights of each party such as shareholders, management, and other stakeholders such as employees, suppliers, depositors and the public. The Sharia Supervisory Board is the role of advising and supervising corporate operations to ensure compliance with sharia principles. The board of directors acts on behalf of the shareholders and is tasked with monitoring and supervising business activities as a whole,

² while managers have a fiduciary duty to manage the company as a form of trust from stakeholders and not for shareholders only. Other stakeholders such as employees, depositors, customers have an obligation to do all their contractual obligations (Hasan, 2009). Each stakeholder has different duties and responsibilities in carrying out their obligations in accordance with a mutually agreed contract.

Ghaffar's (2014) Article Overview

The article to be reviewed is Ghaffar's article entitled "Corporate Governance and Profitability of Islamic Banks Operating in Pakistan" published by the Interdisciplinary Journal of Contemporary Research in Business in 2014. The purpose of this article is to see the impact of governance practices on profitability Islamic Bank. This article is motivated by the lack of research examining corporate governance in Islamic banking in Pakistan. Corporate governance variables in this study were measured by board size and board independence, while bank profitability was measured using the ratio of return on assets (ROA) and return on equity (ROE). The sample used in this study is an Islamic bank in Pakistan and the data is done using regression analysis. The findings of this study are that all variables of corporate governance (board size and board independence) have a significant influence on bank profitability. The profitability of Islamic banks in Pakistan tends to increase in line with the implementation of good corporate governance. This study suggests that corporate governance must be adopted by all banks because it affects the profitability of banks and the government plays a role in encouraging good corporate governance practices in all sectors. Awareness about corporate governance is pushed to the level of employees through various trainings to improve understanding of corporate governance.

Criticism of Ghaffar's Article (2014)

Ghaffar (2014) studies corporate governance and its impact on corporate performance in Islamic banking. In the context of Islamic banking, Ghaffar (2014) should focus more on Islamic governance in Islamic banks. This article should use the disclosure index of Islamic governance because the assessment of the index better reflects the characteristics of Islamic banking through the existence and role of the Sharia Supervisory Board and the disclosure of shariah compliance.

Ghaffar's research (2014) has been widely investigated by previous researchers such as Fallatah & Dickins (2012), Rezaei & Jalilmehr (2012), Magalhaes & Al-Saad (2013), Qureshi & Qurashi (2013), Hamdi & Zarai (2014), and Disaster & Alfattani (2014). Ghaffar (2014) should examine the role of Islamic governance in a broader context, for example related to earnings management mitigation, social performance in the form of CSR, protection of stakeholder interests as Eliada, Ratu & Ayu (2015) conducted to examine the effect of financial performance on Islamic governance disclosure. In the study of Eliada et al. (2015), Islamic governance variables are used as the dependent variable, while financial performance variables such as profitability and leverage are independent variables. Likewise in Magalhaes & Al-Saad (2013) and Qureshi & Qurashi (2013) who examine the relationship of Islamic governance with the protection of stakeholder interests. Hamdi & Zarai (2014) who examined the effect of the characteristics of the Sharia Supervisory Board (SSB) on earnings management behavior. Musibah & Alfattani (2014) tested the effect of the effectiveness of the Sharia Supervisory Board (SSB) on Corporate Social Responsibility (CSR).

Future Research Opportunities

The relationship between Islamic governance and corporate value and credit risk

Most research has examined the impact of the implementation of Islamic governance on corporate performance as did previous researchers. But there are still relatively few who examine the influence of Islamic governance on corporate value and credit risk. Similarly, research examining the impact of financial performance on the disclosure of Islamic governance is still very rare. Future research is expected to find other independent variables besides financial performance that can affect the disclosure of Islamic governance.

The relationship between Islamic governance and social performance and dimensions of spirituality

The study of Islamic corporate governance relations and other topics makes research in this field more rich and interesting. From the exposure of previous research, it can be understood that there is still little research examining Islamic governance relations with other topics such as social performance as measured by corporate social responsibility (CSR) as Musibah & Alfattani (2014). Similarly, research examining the relationship between the dimensions of spirituality and the performance of the boards of microfinance institutions as Tsafe & Rahman (2013) is still relatively small. Future research can be directed to Islamic governance relations with social performance and dimensions of spirituality.

The relationship between Islamic governance and earnings management

The results of Hamdi & Zarai (2014) show unexpected findings, namely the characteristics of the Sharia Supervisory Board (SSB) such as the size of the SSB, the objectivity of SSB members and the competence of SSB members does not significantly influence earnings management behavior. If the research of Hamdi & Zarai (2014) uses a sample of Islamic banking companies in Saudi Arabia and Middle Eastern countries, future research can be done using samples in other countries.

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