The Corporate Ethical Identity Disclosure and Its Impact on Financial Performance:

Evidence From Islamic Banks Globally

By:

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The importance of ethics in the corporate world has received much attention in the 21st century, after a series of major financial fiascos. In fact, most of the performance of companies in the market have a new dimension of qualitative analysis besides the usual financial analysis that generate quantitative information to ascertain their performance (Guthrie and Farneti, 2008). Dhaliwal et al. (2011) point out that greater disclosure and transparency aligned with non-financial disclosures (social, ethical and environmental) play a complimentary role to financial transparency, leading to lower analyst forecast errors. Therefore, a more objective assessment of expected financial performance is achieved.

Proponents of ethical reporting argue that organizational transparency through such reporting is the strategy for achieving a better corporate accountability and the key to meaningful stakeholder engagement. In response to stakeholders' concerns about corporate ethics, many firms are increasing their level of ethical, social and environmental disclosure through different means on a periodical basis.

Following this rationality, Islamic financial institutions (IFIs) are expected to embed ethics and social responsibility in their business model by default (Baydoun and Willett, 2000; Lewis, 2001). Furthermore, the shariah governance of IFIs' ensures their conformity with the Islamic fundamentals, with the expectation that it would translate into more transparent and adequate disclosure. However, preliminary evidence does not support this notion, as IFIs fail to maintain their unique identity (ideal) and their current state seems to be controversial (Haniffa and Hudaib, 2007).

Despite all the initiatives to improve governance after every crisis event, corporate ethical identity (CEI) reporting has not gained much attention, compared to corporate social reporting in the Islamic finance industry. The documented evidence on CEI disclosure is limited and focuses on either the determinants (e.g., Farook et al., 2011) or on a micro level of such a reporting (e.g., Maali et al., 2006; Haniffa and Hudaib, 2007; Hassan and Harahap, 2010; Aribi and Gao, 2012). In addition, most previous studies explored the ethical or socially responsible identity disclosure before the issuance of AAOIFI governance standard No.7 (2010). The standard provides a template for IBs to adopt ethical and social reporting. Though the AAOIFI standards are not legally binding for the IBs to follow, it will be interesting to note the effectiveness of these standards in promoting ethical behavior among the IBs.

In addition, there is an empirical question of whether ethical identity in Islamic banks has value or improves financial performance. This article summarize the findings on this issue and provides information on whether investors value ethics in their investment decisions.

Based on the Banker's and World Bank's databases, data was collected for 56 banks in South-East Asia, South Asia and Middle East and North Africa (MENA) regions, for the period 2010-2015. Then, the ethical identity index (EII) was applied to classify the sampled banks based on 4 themes, 7 dimensions and 44 constructs.

The 'content analysis' was used to determine the disclosure level of ethical identity in the selected IBs. The relationship between the corporate ethical identity disclosure and firm specific-characteristics (factors motivating IBs to be ethical) was ascertained. Since not all IBs in various locations apply AAOIFI standards, the sampling of IBs based on those that apply and don't apply AAOIFI standards was done to determine the effectiveness of AAOIFI standards in promoting the level of Ethical Identity Disclosure at IBs.

The issue of whether IBs' ethical Identity affects financial performance was investigated using accounting-based measures such as Returns on Assets (ROA) and Returns on Equity (ROE), since the majority of IBs are not listed and market-based measures cannot be used.

The findings suggest that ethical issues are not of major concern for most Islamic banks as their level of information disclosure is far below the expectations set by the regulators. This could be due to the fact that most Islamic banks' managers are trained in conventional bank administration, and thus do not give due importance to the ethical and

social implications (Maali et al., 2006). Also, the low level of disclosure might be because IBs operate in an environment where governance is not strictly enforced and not much attention is given by its stakeholders on the issue of disclosure. The little impact of ethical and social ideals and the huge gap between theory and practice provides evidence of the capitalistic nature of the Islamic banking system in general (Khan, 2006). In other words, the attempts to emphasise the religious and spiritual dimensions of the bank through disclosing their vision and mission and their commitment to shariah rulings are flawed, from the perspective of achieving the proclaimed goals and roles they aspire to. The implication of the poor disclosure practices will be high reputational risks and the likelihood of loss of customers and investor confidence, which will certainly affect the long-term growth of the IB industry.

> **"The findings indicate no association between ethical identity disclosures and Islamic banks' financial performance"**

In addition, the results reveal that following AAOIFI standards or otherwise, have no impact on the ethical disclosure practices of Islamic banks.

The findings suggest that firms do voluntarily disclose information in their annual reports as a strategy to manage their legitimacy. This is in support of the legitimacy theory, indicating a highly significant positive association between the age of IB and ethical identity disclosure. This suggests that older companies with longer societal existence may have taken relatively more legitimacy and may have a higher reputation and involvement of social responsibility than younger companies. This relationship exists because long-established companies have received more benefits from society than newly established firms. Furthermore, the more mature firm undertakes a greater leadership role, developing an increased sense of ethical and social responsibility (Hossain and Hammami, 2009; and Haniffa and Cooke, 2002).

Finally, the findings indicate no association between ethical identity disclosures and Islamic banks' financial performance. The difficulty to find a direct link between the corporate ethical identity disclosure and financial performance may be due to the lack of proper measurement (McWilliam and Siegel, 2001) and limits concerning concepts, methodologies and data used (Allouche and Laroche, 2006).