Governance Committee and Governance Audit Model in Islamic Banks: How will it Resolve the Problem of Information Asymmetry?

Fatima Abdul Hamid[1]
Department of Accounting
Kulliyyah of Economics and Management Sciences (KENMS)
International Islamic University
P.O. Box 10, 50728 Kuala Lumpur Malaysia
afatimah@iiu.edu.my

Sigit Pramono[2]
School of Islamic Economics – SEBI
Komplek Ciputat Indah Permai
Blok C25 – 26 JL. IR H. Juanda No 50
154199 Ciputat Indonesia
msigit_p@yahoo.com

ABSTRACT

The banking industry faces the problem of information asymmetry due to the opacity of banks' business processes (Levine, 2003). However, Islamic banks have a higher likelihood of potential information asymmetry problems because of the unique characteristics inherently attached to Islamic banks (Archer and Karim 1997; Chapra and Ahmed, 2002; Li, 2003). Therefore, the importance of good corporate governance practices in Islamic banks has been recognized by scholars (Algoud and Lewis, 1999). Meanwhile, AAOIFI (2002) has promulgated Governance Standards for Islamic Financial Institutions (GSIFI) and later IFSB (2005) issued Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial Services. The objective of this paper is to contribute a review on the Governance Committee issues as an organ of ensuring corporate governance and propose a model for governance audit which is suitable for Islamic banks' circumstances. This paper will also discuss possible means of resolving the problem of information asymmetry in Islamic banks, specifically bringing in some Islamic perspective into context.

[1] Dr. Fatima Abdul Hamid is a lecturer at the Department of Accounting, Kulliyyah of Economics and Management Sciences (KENMS), International Islamic University of Malaysia.
[2] Sigit Pramono, SE. Ak. MSACC is a lecturer at the School of Islamic Economics SEBI and Executive Director of *IIIF Research and Business Advisory*, Jakarta - Indonesia

1.0. INTRODUCTION

Corporate governance has been an element of corporations, since their formation. However, it has only been over the last two decades that the issue of corporate governance gained prominence (Wright, 2002). It entered the realm of public interest, and consequently the researchers' of various countries, due to the publicised corporate scandals in huge corporations such as Enron and Worldcom.

In order to alleviate the reoccurrence of such corporate failures, and as a result of the outcry from the public and the business world, many countries have drawn up their own rules and codes of practice to improve governance (McConomy and Bujaki, 2000; Goodwin and Seow, 2002). This is equally true in the arena of Islamic Financial Institutions, as Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) (2002) and Islamic Financial Services Board (IFSB) (2005) have issued the Governance Standards for Islamic Financial Institutions (GSIFI) and Guiding Principles on Corporate Governance for Institutions Offering only Islamic Financial Services, respectively.

Although the rules and standards for corporate governance have been established, the on-going debate is on the effectiveness of corporate governance in improving the quality of corporate reporting, hence reducing the level of information asymmetry between the managers and the external stakeholders of the corporations. This issue of the effectiveness of corporate governance is an even more crucial issue in the banking sector as the banking system is a critical element of the economy, as evidenced by the fact that it is highly regulated (Basel Committee on Banking Supervision, 1999). Moreover, according to Solomon and Solomon (2004) the experience of the banking crisis in many countries was largely due to poor corporate governance. Similarly, this issue of the effectiveness of corporate governance is as fundamental in Islamic banks.

The corporate governance in Islamic banks becomes of greater significance as an expanding number of Islamic financial institutions mushroom all over the world, as seen over the last 25 years (Chapra and Ahmed, 2002). In fact, according to Kahf (as cited in Iqbal and Mirakhor, 2007), at the end of the 1990s there are 176 financial institutions worldwide which comply with Islamic principles, and the total assets in aggregate, for these Islamic banks is not less than US$ 839 million. Also, even though it is obvious that the asymmetry of information is larger in banks, than other industries, due to the opacity of banks' business processes (Levine, 2003), Islamic banks have an even higher likelihood of potential information asymmetry problems because of the unique characteristics inherently attached to Islamic banks (Archer and Karim 1997; Chapra and Ahmed, 2002; Li, 2003). Furthermore, there is scarce, albeit growing literature, on corporate governance in Islamic banks (Suleiman, 2000). However, the issue of governance committee in relation to corporate governance is not highlighted in this literature, particularly in the context of Islamic banks.

The lack of discussion on the issue of governance committee in relation to improving corporate governance of Islamic banks is a serious drawback even if there is such a discussion, although limited, in conventional banks. This is because corporate governance issues in Islamic banks are quite different compared to conventional banks, as Algaoud and Lewis (1999) and Suleiman (2000) assert, consequently resulting in a variant discussion on governance committee. Therefore there is a need for such a discussion on governance committee issues in relation to corporate governance in Islamic banks.

In addition to having a governance committee, there are further steps that can be taken to improve corporate governance in Islamic banks, and that is to have a governance audit. Again, literature on governance audit, particularly in the context of Islamic banks, is lacking. Thus, this paper not only discusses the issues in terms of encouraging governance audit, but attempts to propose a model with regards to governance audit that will be appropriate for Islamic banks.

Based on the discussion above, the primary objectives of this paper are:

i) To review the issues on governance committee as a channel to improve corporate governance.
ii) To propose a model in relation to governance audit, which will be applicable to the circumstances in Islamic banks.
iii) To suggest alleviating information asymmetry in Islamic banks, particularly through establishing governance committee and conducting governance audit.

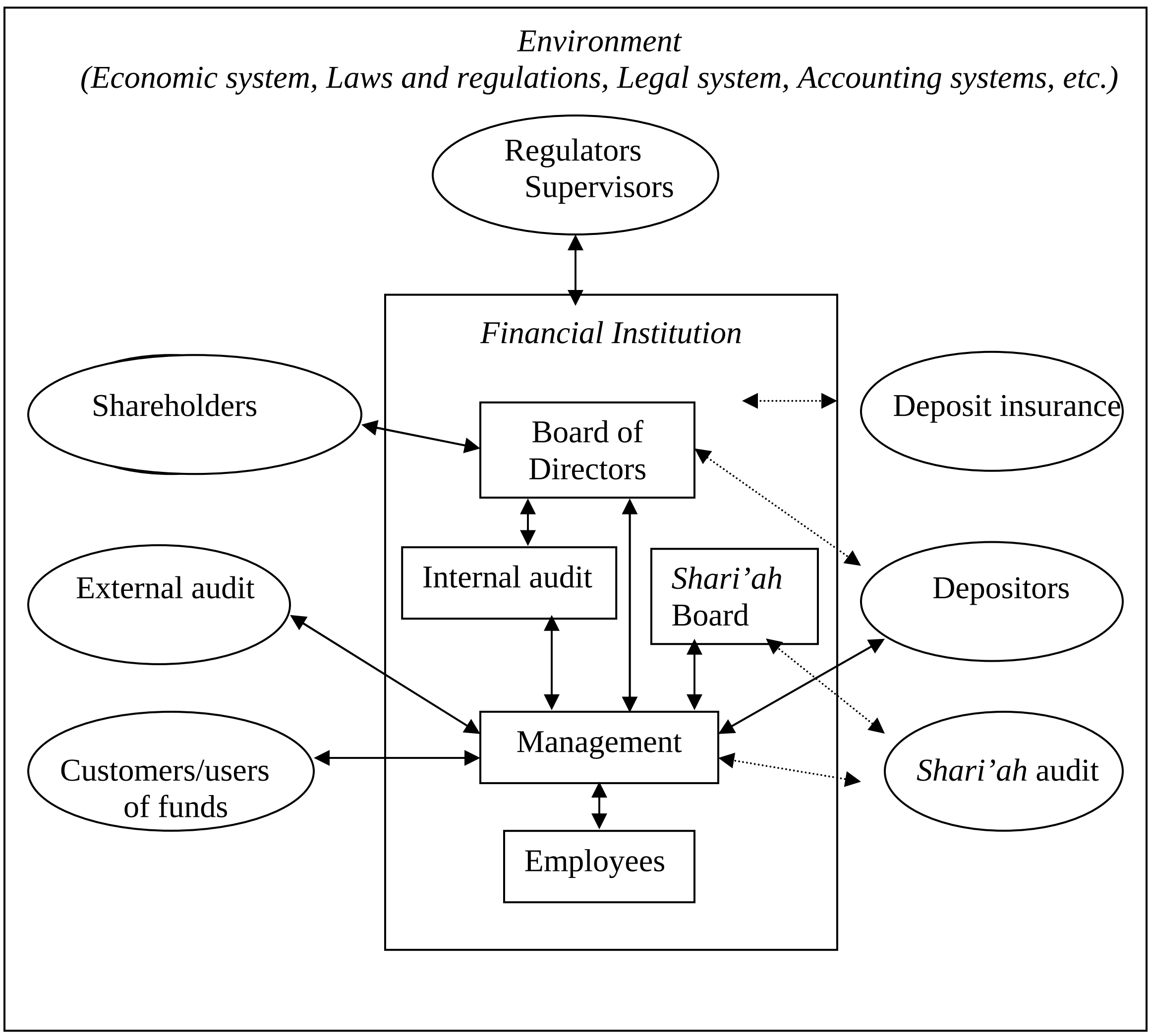
Although, much of today's literature have turned towards positivism, there is still a need for normative discussion as well as the theoretical, especially when development of a model is required. This is the stance taken by this paper. Also, attempts by contemporary authors to remain objective and detached from their arguments, although admirable, may not be appropriate in all circumstances. This is because when a discussion is involved, particularly in relation to bringing in the context of religion, as in Islamic banks, very few can remain completely detached. And should they? Practical steps towards better governance through governance committee and governance audit, as well as other measures, consequently reducing information asymmetry, can only take place if the individuals involved are internally inspired to make a shift from current practice. And the discussion can hardly seek to be inspiring if the authors remain detached from it.

The structure of the paper will be as follows: The next section discusses the unique characteristics of Islamic banks, which affect corporate governance, leading on to the problem of information asymmetry. Then, in the following section, the paper will review the issues related to corporate governance committee that will assist in improving corporate governance of Islamic banks. Next, a brief discussion on governance audit will ensue with a proposal of a model on governance audit that is relevant to Islamic banks. Finally, this paper will discuss possible means of resolving the problem of information asymmetry in Islamic banks, in the context of having a corporate governance committee and corporate governance audit. The Islamic perspective is incorporated throughout the discussion.

2.0. THE UNIQUE CHARACTERISTICS OF ISLAMIC BANKS, CORPORATE GOVERNANCE AND THE PROBLEM OF INFORMATION ASYMMETRY

Chapra and Ahmed (2002) describe the relationship of key players in the corporate governance structure for Islamic banks (Figure 2.1). Chapra and Ahmed (2002) show that in addition to the normal structures of corporate governance that exist in conventional banks, such as Board of directors, and internal audit mechanisms, which include an audit committee, there is a *Shari'ah* Supervisory Board (SSB) in Islamic banks. Algaoud and Lewis (1999) assert that the SSB is central to the framework of corporate governance for Islamic banks. Their sentiment is shared by Banaga *et al.* (1994), Karim (2002) and Suleiman (2000). The crucial role of the SSB is due to the fact that the motivation of Muslims in establishing Islamic banks was to make certain that their economic activities are in accordance with the tenets of Islam (Ilyas, 2004b), hence Islamic banks' operations must comply with *Shari'ah* principles (IFSB, 2005) which is overseen by the SSB. Therefore, ensuring S*hari'ah* compliance in Islamic banks will lead to the need for additional governance mechanisms in Islamic banks.

Figure 2.1: Relationship of Key Players in Corporate Governance Structure of Islamic Banks



***Source*: Chapra and Ahmed (2002)**
* the solid arrows indicate that a structured link exists between the key players, whereas the dotted arrows indicate that a structured link does not exist.

In addition to the above, another unique characteristic of Islamic banks is with regards to the system of saving and financing activities served to their customers. Since

Islamic banks do not apply interest-bearing deposits, as an alternative, profit and loss sharing (PLS) investment accounts, based on *mudaraba*[3] and *musyaraka* contracts, are available (Archer and Karim, 1997; Ariffin *et al.* 2003). The depositors will get a return based on the profit/loss sharing ratio applied on the investment outcome. Archer *et al.* (1998) explain that, factually, a *mudharaba* contract cannot be perceived either as an equity investment or a liability contract by the Islamic bank. In contrast to the equity instrument, Islamic investment accounts are exchangeable at maturity date or at the willingness of their holders. Also, different from the debt instruments, Islamic investment accounts are not a liability since these types of accounts share in the profit or bear any losses incurred in the banks' investment. Therefore, the Islamic banks have a more complex relationship with their depositors than the conventional banks do with theirs, which will have an impact on the banks' corporate governance.

Based on the PLS contracts, the depositors of Islamic banks are likened to partners, in their role as the owner of the deposits, i.e. *Rabb al-Maal*, instead of mere depositors. Therefore, unlike conventional banks, whose management are only responsible towards their shareholders, management of Islamic banks has a fiduciary duty to two groups: the shareholders and the depositors (Karim, 2004; IFSB, 2005). Due to the added responsibility of Islamic banks' management, this unique situation raises a more complicated circumstance for Islamic banks' corporate governance (Karim, 2004; IFSB, 2005).

In line with the discussion above, Chapra and Ahmed (2002) argue that Islamic banks' corporate governance should give emphasis to protecting depositors' interests. This is in contrast with the conventional bank's corporate governance mechanism, which is focused on protecting shareholders as the main stakeholder. Thus, in conventional banks, the depositors' interests do not receive much attention, except for the banks' effort in attracting deposits. However, as mentioned above, the depositors[4] are affected by the profit and loss performance of the Islamic banks. In fact, it is often the case, that depositors provide a larger portion of funds to the bank than the shareholders (Chapra and Ahmed, 2002). Nevertheless, the Islamic banks' responsibility to shareholders cannot be neglected or become secondary. Therefore, as stated above, this added responsibility of Islamic banks contributes to the additional requirement on corporate governance, in order to discharge their obligation not only to shareholders but depositors as well.

Ilyas (2004b) proposes another argument to provide more attention to protect depositors' interests in Islamic banks. Similar to Chapra and Ahmed (2002), Ilyas (2004b) is of the opinion that depositors of conventional banks are not affected much by the bank's corporate governance structure. This is because: (1) the conventional banks are based on a interest system and debt mechanism, thus they have an obligation to pay back the depositors' fund; (2) there are some guaranteed schemes or deposit insurance for such deposits in conventional banks; and (3) as a highly regulated industry there are some prudential banking regulations from the central bank in conventional banks, e.g. capital

[3] There are two types of *mudharaba* contract, i.e.: (1) unrestricted investment account (*mudharaba mutlaqa*) in which the investors' fund will be placed to finance the Islamic bank's general pool of assets, and (2) restricted investment account (*mudharaba muqayyada*) where the investors' fund is constrained to financing specific projects or assets.

[4] Depositors of Islamic banks include all types of depositors e.g.: demand deposit, investment deposit and investment account holders.

adequacy regulations and regulations to avoid an excessive concentration of lending (Ilyas, 2004b). Not all the above circumstances and criteria apply to Islamic banks. Although many precautionary measures are taken by Islamic banks, similar to conventional banks, to guarantee the return of deposits to depositors, in theory, there is a risk involved with being a depositor of Islamic banks, based on the PLS relationship. Because of this risk, depositors of Islamic banks are entitled to information to protect their interests (IFSB, 2005), just as shareholders are entitled to information to protect theirs. Therefore the corporate governance mechanisms of Islamic banks have to ensure that their primary stakeholders' requirements are met. Also, due to the added responsibility of Islamic banks towards depositors, instead of just responsibility to shareholders, as discussed above, Ilyas (2004b) adds that the agency problem is more complex in Islamic banks since instead of just the management as the agent and shareholders as the principal, there are also the depositors in the agency relationship.

Although the discussion above has mainly focused on the obligation of the Islamic banks to shareholders and depositors, the obligations of Islamic banks are also on the stakeholders (IFSB, 2005), based on the requirements of the Shari'ah. This is depicted in Ilyas' (2004a) model (Figure 2.2), as in Chapra and Ahmed's (2002) model (Figure 2.1). It is important to note that, Ilyas (2004b) includes various depositors amongst the stakeholders, however similar to Chapra and Ahmed (2002), other stakeholders are also included in the model to show Islamic banks' relationship and obligation towards them. This is warranted because in Islam, there is always an obligation of each individual and institution to be responsible towards the society at large, which encompasses the other stakeholders. If this is practically applied by Islamic banks, then the corporate governance mechanism must be sophisticated enough to ensure that their responsibility can be discharged effectively.

Figure 2.2: Stakeholders for Islamic Banks in the Agency Theory Perspective
Source: **Ilyas (2004a)**

Agents: Management of Islamic banks

Principals:

Stakeholders	**Based on:**
Government (Law and regulations for Islamic banks)	Law and regulations
Supervisors	
Employees	Explicit and implicit contract
Shareholders	
Depositors	
Investment Account Holders (restricted and unrestricted)	
Current Account Holders	
The community (*ummah*)	Ethics and moral obligations

The discussion above, overall, signals toward added information asymmetry of Islamic banks. For one, because of the increased accountability of Islamic banks even more information is required to discharge their responsibility to the various stakeholders. Therefore the greater need for information means that even by complying with information requirements of conventional banks is not sufficient. Thus, Archer and Karim (1997) conclude that in Islamic banking context, there is an essential role for accounting and auditing standards over and above the case for the conventional banks, which would also apply to governance requirements.

In addition, one of the other stakeholders will include the "borrowers"[5], thus there could be some problems which will affect the accountability and transparency of the financial statements of Islamic banks, hence resulting in information asymmetry. The arguments for this are, firstl*y*, on the liabilities side, the bank has responsibility to the various investment account holders and the shareholders in order to protect their interest and perform the bank's business in a proper manner. Whereas, on the "asset" side, from their financing activities in a number of Islamic financing modes, the bank will face the problem of incorrect project reporting by the customers resulting in the bank failing to prepare a fair financial report for the stakeholders (Archer and Karim, 1997).

[5] "Borrowers" are used in this paper, since under Islamic banking the financing is more in terms of capital investment with PLS, than a pure loan. The term "borrowers" is used interchangeably with customers in this paper.

Furthermore, in relation to information asymmetry, Li (2003) states that Islamic banks face adverse selection and moral hazard problems. The former is due to "borrowers" who expect high non-monetary benefits from their projects, but low realized profits, will select PLS banking. These customers could inflate their profit expectations in the hope that the Islamic bank will require a lower profit share in the investment (Nienhaus, 1983). As for the latter, once the Islamic bank finances the project, the customer could artificially reduce declared profits so that the profit being transferred to the Islamic bank will be less.

Therefore, to recapitulate, the information asymmetry in Islamic banks is two-fold. Firstly, created by the managers of Islamic banks having more information than the shareholders and depositors, as they are internal to the bank. Then, also because of the "borrowers" having more information than the Islamic banks regarding their projects. Thus, there is a need for good governance to ensure that shareholders and depositors are not taken advantage of by the bank (IFSB, 2005) and the "borrowers" do not consider the Islamic bank to be a gullible lender, merely due to information asymmetry. Given that the scope of an Islamic bank encompasses even a wider range of stakeholders and the information asymmetry is more, thus the governance of Islamic banks must take all these elements into consideration.

Since it has been established that information asymmetry can be alleviated with an effective system of financial reporting and this is possible through an effective system of corporate governance (Whittington, 1993; Baker and Wallage, 2000), thus Islamic banks have to find measures to improve its corporate governance. Due to the seriousness[6] of the Islamic banks on discharging their responsibilities by improving their measures on corporate governance, AAOIFI has issued General Presentation and Disclosure in the Financial Statements of Islamic Banks and Islamic Financial Institutions. However, evidence has shown that even with regulation, the problem of information asymmetry still occurs because of inadequate corporate reporting in Islamic banks (Sulaiman and Abdul Latiff, 2003). This is not surprising as just because corporate governance regulations are in place, according to Micheal Daigneault, many people think that governance takes care of itself (quoted in Bartlett, 2006). However, for governance mechanisms to be truly in place, requires added effort by the board of directors and management of Islamic banks. A few of these added measures include the setting up of a governance committee and carrying out a governance audit. In fact, AAOIFI and IFSB has encouraged the setting up of an Audit and Governance Committee and Governance Committee under GSIFI No. 4. and Exposure Draft No. 3, respectively. Hence, the next two sections will be about the corporate governance committee and governance audit, respectively, leading towards a model in the latter.

3.0. THE CORPORATE GOVERNANCE COMMITTEE

A governance committee is a group of non-executive members formally established by the board of directors (GSIFI No. 4). Governance committees are becoming more popular in all industries (Radtke, 2005) in the USA as they are important

[6] The seriousness of poor corporate governance, specifically in the case of Malaysia is explained in Satkunasingam and Shanmugam (2004).

in improving governance in companies, including banks. Basically, according to GSIFI No. 4, the responsibilities of the committee would be to review the internal controls, accounting practices and audit plan, as well as the interim, annual accounts and financial reports in the Islamic banks. Their responsibilities would also include the committee to consider the appointment of the SSB, external auditor and chief internal audit and the audit fee. Thus, in general, the committee is in charge of ensuring the implementation of proper governance. Similar responsibilities are specified by Part 1 of Exposure Draft No. 3 by the IFSB (2005).

According to Harned (as quoted in Radtke, 2005) "Governance committees …make sure that the organization addresses ethical issues and creates policies intended to detect misconduct." The issue of ethics is also incorporated in GSIFI No. 4. Amongst the list under AAOIFI's Code of Ethics for Accountants and Auditors of Islamic Financial Institutions is "faith-driven conduct", which is an extremely important element to true Muslims. If every Muslim's, who is related to Islamic banks, conduct were faith-driven, they would fulfil their accountability and have ingrained in them that ultimately they are answerable to Allah (s.w.t.), hence many problems related to misconduct would be resolved. The Sarbanes-Oxley (SOX) has suggested increasing liability of outside directors as a method of putting pressure towards better corporate governance (Kostal, 2006). However, if faith-driven conduct applies, there would not be a need for increased liability of the governance committee members of Islamic banks.

Also, in relation to main stakeholders in an Islamic bank, Chapra and Ahmed (2002) opine that the Islamic bank should take into account that the most important stakeholder is Islam itself. Thus, Islamic banks actually have greater responsibility to perform well because if the corporate governance mechanism fails in Islamic banks it will have a negative impact on the image of Islam to the public. Thus, the governance committee has to be aware of the heavy responsibility it carries along with the position.

Due to the seriousness of the task, ensuring independence of governance committee is highly important (Comper, 2001) and so is the issue of independence in Islamic banks (Karim, 1993). In order to ensure the committee's independence, their roles must be clearly stated and their obligations made transparent. To be truly independent, members of the governance committee and their business enterprises cannot do business with the Islamic bank that they are in the committee of. For example, a partner of the audit firm that provides services, directly or indirectly, to the Islamic bank may not be a member of the governance committee as his / her independence may become questionable.

Not only does the committee have to comprise of independent individuals, but they must also be qualified and competent (IFSB, 2005) egs. accountants and lawyers, preferably with some background qualification or knowledge of *fiqh* and the *Shari'ah*. It is only with having a committee which has a reputation of being qualified, will they be able to carry out their duties effectively in terms of strengthening the corporate governance of the company. This is because even if the committee is appointed by the board of directors, management, employees and stakeholders will only give them the respect and co-operation that they deserve if they are truly seen to be qualified.

Chapra and Ahmed (2002) clearly show (Figure 2.1) the segregation of the Board of Directors and the SSB. Similarly, the governance committee is separate and distinct from the SSB. Therefore, it is important to segregate the roles of the governance committee and the SSB. The roles of the SSB and governance committee need to be clearly defined to ensure that there is no overlapping of duties and to avoid "stepping on each others' toes" when carrying out their required obligations. Thus, both the SSB and the governance committee would be complementary to each other, as both would carry out their own specified responsibilities to assist in the Islamic bank achieving its company objectives.

Although the governance committee has to remain independent, it is not there to be an antagonist to the management and the board of directors of the Islamic bank. This is because all have similar objectives of protecting shareholders, depositors and stakeholders, hence co-operation is required amongst them to achieve this aim.

After a discussion on the governance committee, the next section proceeds by looking at governance audit.

4.0. THE GOVERNANCE AUDIT AND MODEL

In a corporate governance audit, an independent specialist is appointed to conduct an objective review of the governance procedures and adherence to guidelines of the organisation (Kotz, 1998; Briant, 2006). According to LoBue (2003), the governance audit process also assists in assessing an organisation's strategic focus. The process includes looking at and assessing board practices and governance related documents, as well as documents in the organisation (LoBue, 2003). Therefore, the governance audit process should be carried out following these steps: Review of current corporate governance practices, interviews of officers and directors to attain information about governance procedures, comparison with industry trend and industry standards, additional interviews carried out with other executives to attain additional required information, and finally recommendations are made by the independent governance auditor to improve corporate governance (Kotz, 1998).

A depiction of auditing by Baker and Owsen (2002) portrays the insufficiency of an external audit of ensuring good governance, except for perhaps a look at the internal control system of the client company being audited.

Figure 4.1: The Presently Accepted Role of Auditing in Corporate Governance (Approximately 1850AD-present)
Source: **Baker and Owsen (2002)**

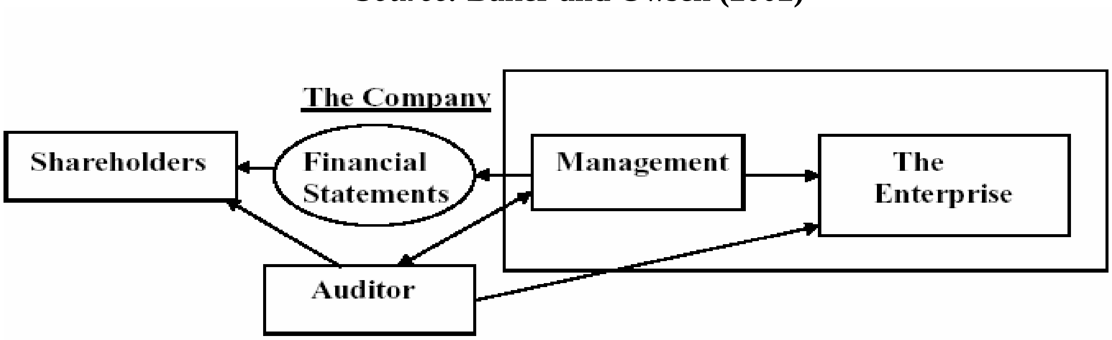
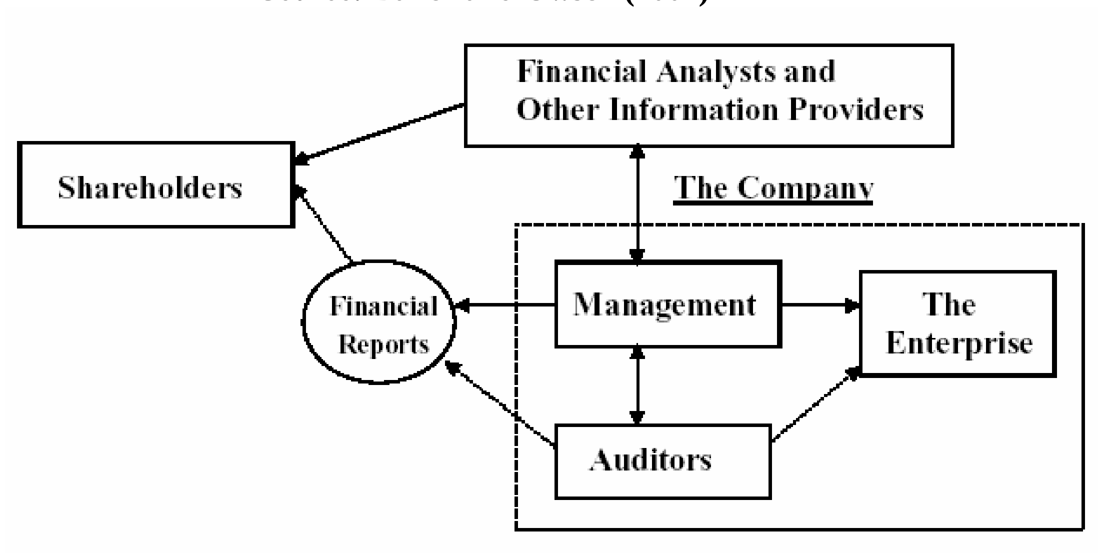


Figure 4.1 shows that historically and ideally, the auditor should be independent of the company being audited, and has a direct responsibility to shareholders. However,

the boundaries are more complicated in the depiction of the actual role of contemporary auditing, as shown in Figure 4.2.

Figure 4.2: The Actual Role of Auditing in Corporate Governance

***Source:* Baker and Owsen (2002)**



Therefore, unlike the concept of traditional audit, including financial and operational audit, the corporate governance audit will be focused on assessing the fairness of management in conducting the business and having the assurance that the business is run properly (Sunarsip, 2001; Orlikoff and Totten, 2002). Moreover, the governance audit could include assessing the professional ethics, integrity and values in an organisation as well as the accountability of management[7]. According to Orlikoff and Totten (2002), a governance audit is more focused and demanding than a board self-evaluation, as difficult questions will be raised and strategic situations assessed, including uncovering processes which are inconsistent with legal and regulatory standards. Due to the benefits of a governance audit, many companies (Feinberg, 1998; Orlikoff and Totten, 2002; Briant, 2006) support it in the West and even in countries like South Africa (Vermeulen, 2003).

Believing in the importance of Islamic banks conducting regular governance audits, this paper has proposed a model to reflect key players and relationships that frames a governance audit. The governance committee is also portrayed in the model to obtain an overview of the respective relationships.

[7] http://www.tagi.com/site_content.aspx?page_key=corporate_governance_audit&lang=en and http://www.quovadx.com/assets/resources

Figure 4.3:
The Relationships of the Important Key Players in Conducting Governance Audit in Islamic Bank

***Source:* adapted from Baker and Owsen (2002)**

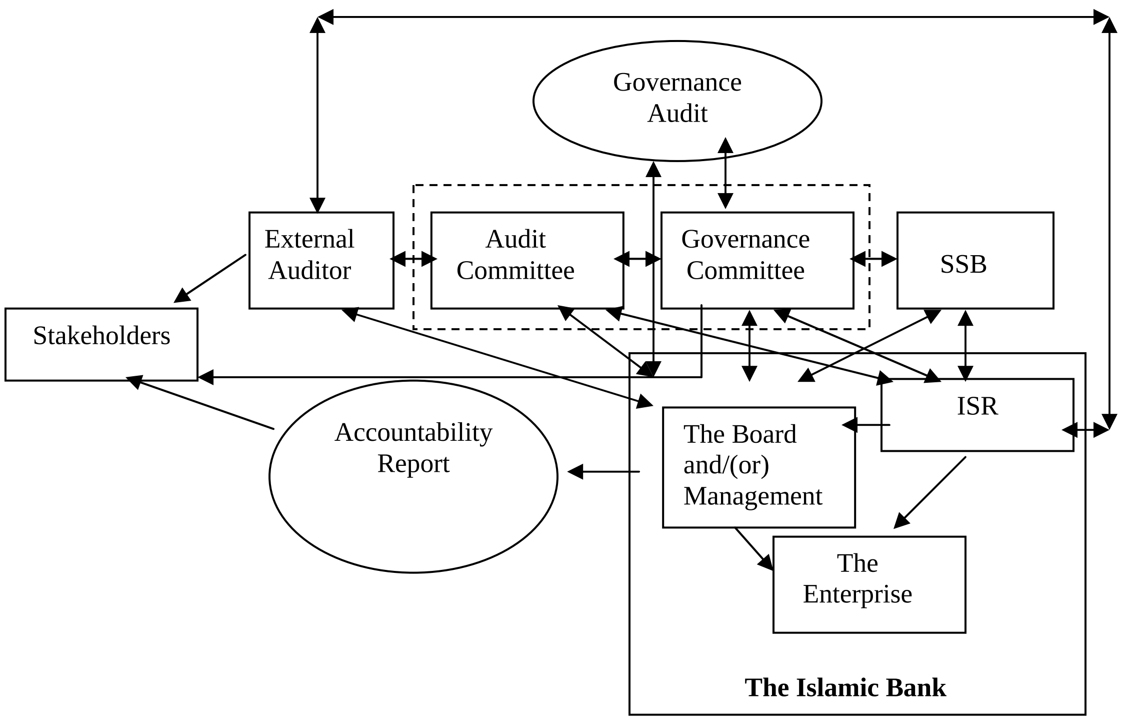


Figure 4.3 shows that as recommended by AAOIFI (2002) and IFSB (2005), Islamic banks should set up the facets of corporate governance. These include the SSB, Internal *Shari'ah* Review (ISR), Governance Committee and Audit Committee. These facets, together with the external auditor, the board and the management, have significant roles to enhance the corporate governance in Islamic banks. Due to the required co-operation amongst all these elements in the model, the arrows between them are in both directions as a signal of mutual assistance and support.

GSIFI No. 4 suggests the setting up of an Audit and Governance Committee, however, IFSB (2005) clearly distinguishes between the Audit Committee and Governance Committee. Thus the Islamic bank may choose to have a separate or combined committee for audit and governance, depending on the roles that are assigned to each. The audit committee is basically responsible to oversee the effectiveness of the internal audit functions and internal control in the Islamic banks, whereas the governance committee is responsible for the overall effectiveness of the governance mechanism in the Islamic bank. Hence, depending on the size of the Islamic bank, segregation of the functions and the weighing the cost and benefits, the Islamic bank may choose to have a single or separate committees, thus the inclusion of a dotted box around audit committee and governance committee in the model in Figure 4.3.

Since the governance committee is responsible for the effectiveness of the governance mechanism in the Islamic bank, this committee should be responsible for appointing an external governance auditor to conduct governance audits at regular intervals of between three to five years. The governance committee should be in charge of appointing the governance auditor since the members of the committee are independent. Although Figure 4.3 has depicted the Audit Committee as being independent, in certain organisations the Audit Committee is part of the Board of Directors. The outcome of the governance audit should be reported to the governance committee first before being disclosed to the board of directors and management of the Islamic banks to ensure its independence.

The governance auditors, however, will need to attain co-operation from the management and employees of the Islamic banks to be able to carry out their task successfully. This is because in an Islamic bank, the governance audit would include:

- reviewing the adequacy of corporate governance mechanism in order to provide the assurance of Islamic bank's *shari'ah* compliance,
- reviewing of the fairness of the accounting policy changes,
- reviewing the fairness of disclosure and transparency policies within Islamic bank's corporate reporting,
- scrutinizing of the fairness of ownership and cross-holding of the business entity,
- reviewing of business ethics and code of conduct of corporate governance,
- evaluating the fairness of policies to manage the risks faced by the Islamic bank, and
- evaluating the fairness of policies to handle the legal and litigation issues faced by the Islamic bank.

In conducting the governance audit, the management and board of the company should be assured that the purpose of the audit is to strengthen the company's position, for the benefit of the company, and not to find fault (Kotz, 1998). In practice, some companies in the USA, for example CalPERS, require the governance auditor to report to the shareholders (Feinberg, 1998). However, as mentioned above, if a governance committee is set up in the Islamic bank, the independent auditor that has performed a governance audit can report to the governance committee. The governance committee will be obligated to report to the shareholders and depositors of Islamic banks eventually.

The next section focuses on the discussion of the governance committee and governance audit's role in reducing information asymmetry specifically before it concludes.

5.0. CONCLUSION

In order to alleviate information asymmetry, literature (Whittington, 1993; Baker and Wallage, 2000) has suggested that improved corporate governance measures be taken to enhance the effectiveness of corporate reporting. The measures suggested in this paper to improve corporate governance are establishing a governance committee and conducting governance audits. How each of the suggested measures will assist in reducing information asymmetry will be discussed in this section.

As mentioned above, the governance committee is made up of independent individuals who are responsible for the effectiveness of the corporate governance mechanism in the Islamic banks. Only if the system of corporate governance is effective, will the information generated within the system be reliable. Only if the information is reliable in the corporate reports, will there be a reduction in information asymmetry, at least on the part of the Islamic banks towards the shareholders, depositors and other stakeholders.

The governance committee is also specifically assigned to ensure the governance of the Islamic banks. This is their main priority, hence as members of the committee, they are responsible to carry out their duty to the fullest and be accountable for their roles. In Islam, individuals who are selected because of their capabilities, which are a blessing from Allah (s.w.t), have to shoulder this heavy responsibility with full commitment as they know that others are counting on them. This can be seen in the times of the Khalifah, who were the companions of the Prophet Muhammad (s.a.w.). Few wanted to become Khalifah because of the heavy burden of responsibility that accompanied such a position, but they had to due to the trust placed by the community on them. Similar is the role of a member of the governance committee, as not only are Islamic banks responsible towards the shareholders, but also the depositors, stakeholders and community (IFSB, 2005), since Islamic banks have a socio-economic responsibility (Chapra, 1985), thus extends the responsibility of the governance committee. Only when their responsibilities are discharged properly, will the governance in Islamic banks improve, hence affecting corporate reporting and consequently resulting in reduced information asymmetry.

In the Islamic bank, the governance committee will also have the authority to appoint independent governance auditors to conduct governance audits regularly. The outcome of governance audit will make it more transparent to the stakeholders of the Islamic bank regarding the way an Islamic bank manages and governs (Ariffin *et. al*, 2003), hence reducing information asymmetry. Also, according to Li (2003), the creation of better governance circumstance in Islamic banks by having governance audit will comprehensively enhance the reliability of Islamic bank's corporate report in terms of S*hari'ah* compliance and financial and accounting aspects, thus ultimately alleviating information asymmetry.

In analysing the literature related to governance committee and governance audit, both stress the importance of two elements: independence and ethics. In both cases, i.e. the members of the governance committee and governance auditors, they are required to be independent so as to be able to carry out the duties assigned to them in the Islamic bank objectively. Again, only if they are truly effective, will the ball towards reduced information asymmetry start to roll. Similarly, in terms of ethics. As mentioned before, the requirement of these individuals, and others in the Islamic bank, in relation to ethics and conduct is that it should be "faith-driven". Hence, their behaviour would always be self-monitored by their belief that every movement and thought would be assessed by Allah (s.w.t.) in the Hereafter. Only with this notion ingrained in them would each member involved strive to put forward their best effort in carrying out their responsibilities and not let other motivations distract them. Only then will the corporate governance mechanism be really in place to ensure the problem of information asymmetry is lessened.

The discussion above of ensuring proper governance is not only applicable to reduce information asymmetry from the side of the Islamic banks towards its stakeholders, but also only if good mechanisms are in place can the Islamic bank monitor any discrepancies in the information proposed by the "borrowers", hence reduce the information asymmetry from that side.

Although, not within the scope of this paper, another area to consider in improving corporate governance is audit governance. Audit governance is the scrutiny of the company board and management by shareholders regarding audit structure and processes, including the audit committee, to ensure that the audits are independent[8]. In Islamic banks, this responsibility do not only fall to the shareholders but the depositors as well as a means to oversee their investment. Other stakeholders have elements of responsibility too, as the comprehensive success of Islamic banks is also the responsibility of the Muslim society at large. Although the Muslim community is bound to favour Islamic banks over conventional banks due to their religious obligations, however Islamic banks should not think of this as their right for protection. Therefore, Islamic banks should strive to reduce information asymmetry, not only to discharge their obligation but to ensure there continued success. Also, since the success of Islamic banks is the responsibility of the Islamic community, Muslim academics and researchers should conduct more in depth research in this arena, in collaboration with the Islamic banks, which will have practical application to further enhance the status of Islamic banks as well as assist in reducing information asymmetry.

In summary, the paper suggests the establishment of a governance committee and conducting of governance audit to improve corporate governance hence reduce information asymmetry. A model to portray the relationships with regards to governance audit has been proposed. Nevertheless, this paper is merely an initial step. It is hoped that it will be a lunch pad for research in this area, with the aim of the betterment of Islamic banks as well as the ultimate benefit of the society.

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