

**Analysis of Financial and Non-Financial Annual Reports of Islamic Banks,  
Between Welfare State and Warfare State  
(Comparative Overlook at Bank of London and The Middles East,  
UK and Arab Islamic Bank, Palestine)**

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**Abstract**

This study aims to evaluate two IBs from two different countries i.e. Bank of London and the Middle East (BLME) in UK and Arab Islamic Bank in Palestine on how they perform the annual report. The evaluation will compare both financial and non-financial report of both annual report from three consecutive years from 2013 to 2015. Financial analysis employs financial parameters such as Eikon and Orbis while non financial analysis use diction and LWIC parameters and CSR standards of AAOIFI and Belal et al (2004). As a comparative approach, this study also includes data of World-wide Islamic banks in average for analysis of financial report.

Despite operating in warfare state, AIB shows more distinctive nature of Islamic bank idealism in their financial report. It is indicated from the low rate of LLPs imposed during hurdle time of Palestine decreased economy growth. Meanwhile the opposite policy is employed by BLME as shown by aggressive LLPs in time of economy downward of UK following Brexit. In compliance with Islamic moral objectives such practices are not encouraged in Islam. This finding also confirms Abdelsalam, et.al., 2016 on how LLPs aggressively imposed are indicative of manipulation during negative economy circumstances.

From the analysis of non-financial report this study prevails that as a bank operating in a warfare state, Arab Islamic Bank still try to strive the service for the community as their corporate responsibility. On the other hand BLME as a bank working in a welfare state and a developed country the annual reports provided do not show such corporate responsibility. Furthermore as an Islamic bank, BLME bears the ethical and social requirement to accomplish. Aside from CSR aspect, annual reports of AIB also outweigh BLME in performance of zakah and qard hasan as Islamic instruments in achieving the social justice of Islamic economy goals.

Keyword: Islamic banks, Islamic accounting, CSR

## **1. INTRODUCTION**

Islamic banks (IBs) are identified as a model banking which employs restriction of Riba (usury), Gharar (excessive uncertainty), and Maysir (speculations) and encourages the sharing of profits, losses, and risks in their practices (Abdelsalam, et al., 2016). As ethical and social institutions, IBs should fulfil two requirements of Maqasid Shariah, i.e. legal and social requirements (Ahmed, 2011). Despite such distinctive characteristic, however, IBs seem not capable of performing a distinctive practical financing as it is imitating the existing neo classical institutional framework and organizational structure of the conventional banks (Rethel, 2011). Basically, the initial

proposal of Islamic banking model was based on two tier mudarabah (shared profit from investment) (Anwar, 1987). Nevertheless, the depositors holding investment account cannot freely get access to the profit gains as the managers of the IBs hold full control over the investment account from which one layer of agency problem arises aside from the other layer of agency problem of the shareholder (Abdelsalam, et al., 2016). Therefore it is crucial for IBs to provide a good quality of the annual report to reduce the negative impact of such agency problems.

This study aims to evaluate two IBs from two different countries i.e. Bank of London and the Middle East (BLME) in UK and Arab Islamic Bank in Palestine on how they perform the annual report. The evaluation will compare both financial and non-financial report of both annual report from three consecutive years from 2013 to 2015. The comparison will start from country analyses of both countries. Further the paper will look at the financial performance of both banks. Lastly the comparison analysis will assess non-financial performance of both Islamic banks.

Both countries are significantly different from many aspects. UK is a welfare state which is listed among developed countries with high GDP and located in the northern part of Europe. Palestine, however, is still occupied by Israel and faces many hurdles as a warfare state. As a non-member state of UN, Palestine consequently is discounted from many global scoring such as the World Bank Development Indicator, Transparency International and others. However this paper will try to analyse any comparison possible for Palestine against the UK in order to understand the basis nature of the paper objective.

Figure 1. Palestine GDP Trend. Source: <http://www.tradingeconomics.com/palestine/gdp>

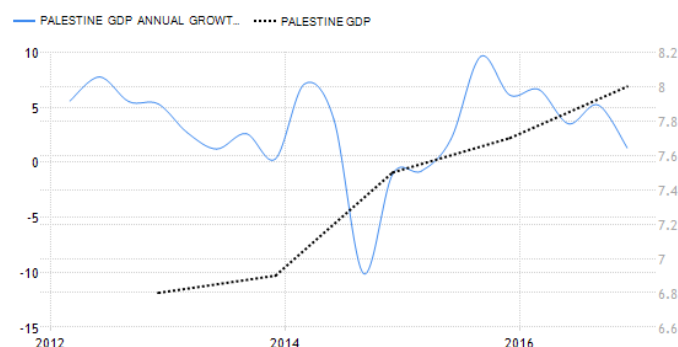
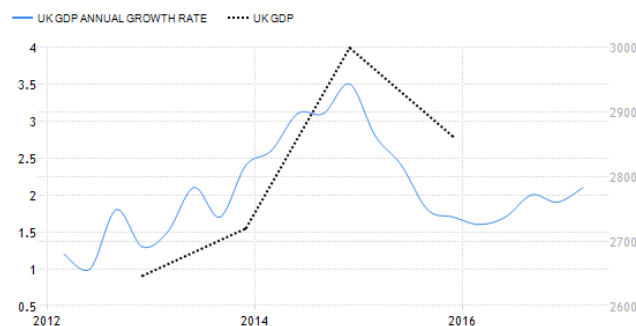


Figure 2. UK GDP Trend. Source: <http://www.tradingeconomics.com/united-kingdom/gdp>



From figure 1 and figure 2 it was recorded that Palestine GDP reached the highest level in the last semester of 2015 with only US \$ 8.2 while UK GDP could reach as high as US \$ 3.000 in the same period. The economy growth showed that Palestine suffered downturn in the last semester of

2014 and gain expansion onward until 2016. Meanwhile UK's economy growth was recorded gain expansion until the beginning of 2015; however it showed the decreased trend until the end of the year along with the GDP.

UK was scored relatively excellent in term of corruption perception index (CPI) with 76, 78 and 81 in the consecutive year as seen in figure 3. As mentioned above there is no data available on CPI for Palestine being recorded by Transparency International, but the CPI of the regional level MENA is scored relatively not convincing for the good governance as it is indicated that 1 in 3 people settling in the region is involved in bribery.

The last country analysis will look at the cultural dimension of Hofstede. Moral code and values of a specific culture can be revealed in institutions and organizations of the particular society which eventually influence the management operated (Hofstede, 1984). Since the Palestine is still not accepted as full member state of UN, it is also not listed in Hofstede cultural dimension. However, Jordan the neighbourhood country will be representing the cultural dimension of Palestine since both nations have long historical background (Omri, 2006).

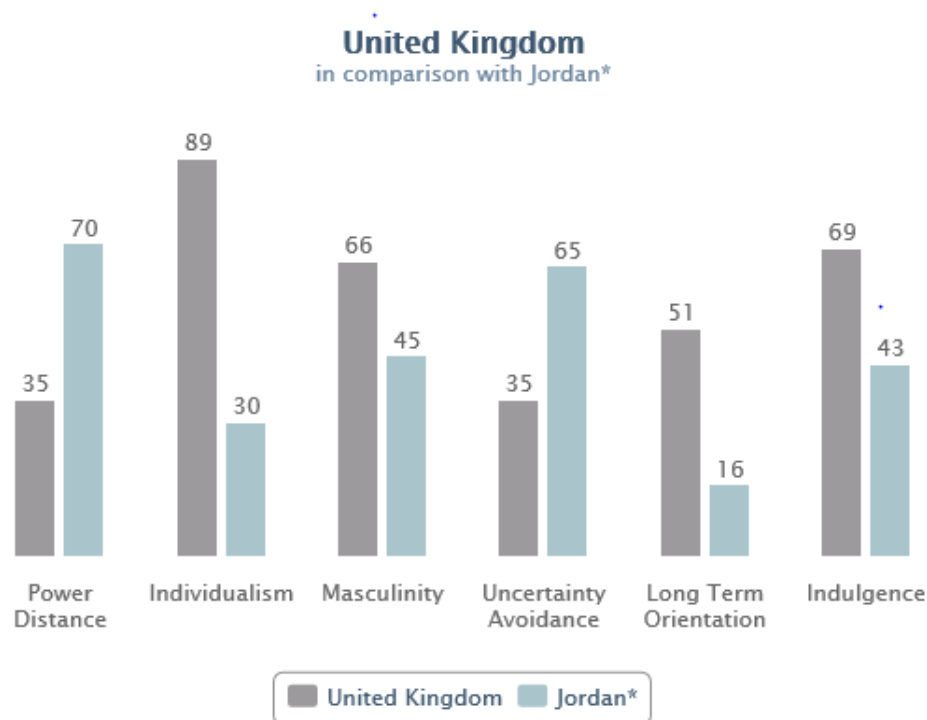


Figure 4. Hofstede's Cultural Dimension. Source: <https://geert-hofstede.com/united-kingdom.html>.

Both countries are identified significantly different from all cultural dimension as seen in Figure. 4. Palestine is indicated high in Uncertainty Avoidance and more collectivist society. Meanwhile, UK is categorized as low Uncertainty avoidance and more individualists while collectivist cultural dimension tends to lead to secrecy thus a lack of disclosure in accounting while the individualist cultural dimension seems more transparent. (Salter & Niswander, 1995). High Avoidance Uncertainty is low high risk taking and the opposite tendency is associated to the low avoidance uncertainty (Salter & Niswander, 1995). Likewise, Kanagaretnam, et al., 2014 found in their empirical research that report earnings low individualist and high uncertainty avoidance societies are more conservatively than those of banks in the opposite cultural dimensions. Thus the report earnings of Arab Islamic Bank is preliminarily as assumed as more conservative.

From internationalisation dimension, BLME is more global in term of subsidiaries and representative office comprised of. It has 12 subsidiaries across UK and 1 in Luxembourg and 1 representative office in Dubai. It is also listed in Nasdaq Dubai. This means that despite being located in a high individualist and uncertainty avoidance culture, such cultural dimension could be transformed in the opposite way. Meanwhile, Arab Islamic Bank only has branches inside home country which means that it is unlikely to shift to the other cultural dimensions.

## 2. FINANCIAL PERFORMANCE

### 2.1. Camel Analysis

BLME is currently ranked 130 nationally in the UK, while Arab Islamic Bank which is also the first Islamic bank in Palestine is ranked 4. For the financial analysis the paper will use CAMEL parameters which will deeply evaluate the performance of both banks financially. To provide in-depth analysis, CAMEL analysis will be employed which includes capital adequacy, asset quality, management quality, earnings, and liquidity to gauge the solvency of the banks (Roman & Sargu, 2013; Ferrouhi, 2014; Rostami, 2015). Irrespective of different geographical factors Camel is capable of moderately performing an objective assessment on the financial analysis of the banks (Sarker, 2006; Roman & Sargu, 2013). The data is taken from Orbis Bank Focus as seen in table 1.

Ratio	IBs Worldwide (Average)			BLME			Arab Islamic Bank		
	2015	2014	2013	2015	2014	2013	2015	2014	2013
Capital Adequacy									
Equity/total asset %	21.95	22.13	22.59	18.29	17.64	19.68	10.61	12.05	13.27
Asset Quality									
Loan loss prov / Net int rev %	50.79	25.07	2.90	132.92	87.36	51.54	0.17	0.23	0.33
Management Adequacy									
Cost to income ratio %	71.78	73.81	76.17	77.16	78.73	84.25	69.53	71.32	68.67
Earnings Ability									
Net interest margin %	6.06	5.46	4.37	1.87	1.32	0.48	3.09	3.31	3.65
Return On Avg Assets (ROAA) %	1.03	0.69	1.31	- 0.39	0.17	0.38	0.86	0.80	0.83
Return On Avg Equity (ROAE) %	8.29	7.71	8.30	- 2.15	0.89	1.94	7.61	6.35	5.84
Liquidity									
Net loans / Dep & ST funding %	89.43	87.71	76.64	61.18	55.64	62.13	54.26	50.94	48.02

Table 1.

Source :<https://orbisbanks.bvdinfo.com/version-2017420/home.serv?product=orbisbanks&loginfromcontext=ipaddress>

From risk management, both banks implement different standards. BLME uses Basel III, while Arab Islamic Bank employs Basel I and Basel II partly. Different overviews will be looked at the respective standards accordingly.

#### 2.1.1. Capital

Instead of using total capital ratio or known as Capital Adequacy Ratio (CAR) this paper will use equity/total asset ratio. The calculation parameter of equity/total asset within the framework of Camel is applicable and can be utilized to achieve the same objective as CAR (Roman & Sargu, 2013). However the initial attempt to use the total capital ratio in this paper is not applicable since BLME does not provide the total capital ratio (CAR) either in Eikon or Orbis. The Eikon data showing the CAR of BLME not available as can be looked at figure 5.

**Bank of London and The Middle East PLC | Ratios - Key Metrics | Thomson Reuters Eikon**  
**08-May-2017 03:19**

Ratios - Key Metrics

Annual Standardised in Millions of British Pound Sterling

	Industry Median	2010	2011	2012	2013	2014	2015
<b>Profitability</b>							
Net Interest Margin	2.88%	-	-	-	-	-	-
Efficiency Ratio	61.3%	87.1%	124.6%	88.8%	89.4%	98.5%	112.7%
Operating Leverage	(1.0%)	56.4%	(48.9%)	32.0%	(0.8%)	(11.8%)	(14.5%)
Non-interest Income / Op Inc	0.44	1.82	-	1.67	1.29	1.46	2.08
% Fee Revenue	28.9%	2.7%	1.7%	4.1%	5.6%	4.4%	3.9%
Loan Growth	8.3%	6.6%	(7.7%)	70.9%	55.2%	8.9%	3.7%
Deposit Growth	7.6%	(10.6%)	23.0%	39.6%	24.3%	14.8%	(8.7%)
<b>Risk</b>							
Loan Loss Provision (% of Avg. Loans)	1.10%	-	-	-	-	-	-
Nonperforming Loans (% of Total Loans)	2.21%	-	-	-	-	-	-
OREO (% of Total Loans)	0.11%	-	-	-	-	-	-
<b>Other Bank</b>							
Tier 1 Risk-Adjusted Capital Ratio	12.62%	-	-	-	-	-	-
EOP Loans / EOP Deposits	0.82	0.72	0.54	0.66	0.83	0.79	0.89
Securities % Avg. Earning Assets	20.3%	7.5%	20.7%	16.3%	13.5%	17.4%	17.4%
<b>DuPont/Earning Power</b>							
Asset Turnover	0.04	-	-	-	-	-	-
x Pretax Margin	35.2%	-	-	-	-	-	-
Pretax ROA	1.6%	0.7%	(1.4%)	0.6%	0.5%	0.1%	(0.6%)
x Leverage (Assets/Equity)	10.88	2.88	3.38	4.34	5.08	5.67	5.47
Pretax ROE	15.8%	2.0%	(4.5%)	2.3%	2.5%	0.4%	(3.5%)
x Tax Complement	0.78	0.70	-	0.70	0.71	0.98	-
ROE	12.6%	-	-	-	-	-	-
x Earnings Retention	0.69	1.00	-	1.00	1.00	1.00	-
Reinvestment Rate	7.9%	1.4%	(3.7%)	1.6%	1.8%	0.4%	(2.8%)

Data source: Eikon, 8 May 2017, 03:19 GMT

Compliant with the Basel standards employed, both banks have maintained the minimum capital adequacy based on Basel I and Basel III with the ratios above 8 % and 12 % respectively as seen in figure 6. However both ratios are still below that of IBs Worldwide average.

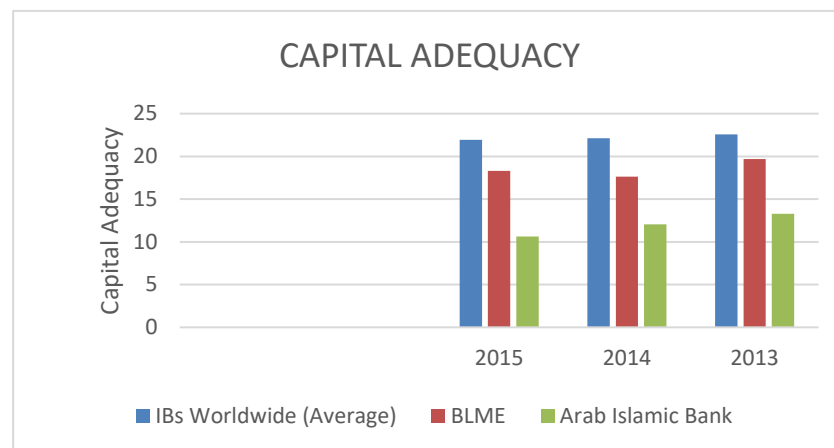


Figure 6. Capital Adequacy. Source: <https://orbisbanks.bvdinfo.com>

### Asset Quality

Ideally the loan loss provision (LLP) should be maintained as low as possible, however a wide range of studies reveal that LLPs could be used as aggressive earnings (manipulation) aside from a risk mitigation tool in downturn times (Abdelsalam, et al., 2016). Further their empirical study prevail that Islamic banks see the LLPs as non-performing loans and loan charge-offs thus they are managed conservatively.

As seen in figure 7, BLME seems aggressive in utilizing the LLPs compared to IBs Worldwide and Arab Islamic Bank which reached 132.92 % in 2015. As illustrated above that the economy growth and GDP of UK suffered downward in 2015, nevertheless employing the LLPs to such ratio can be seen as aggressive.

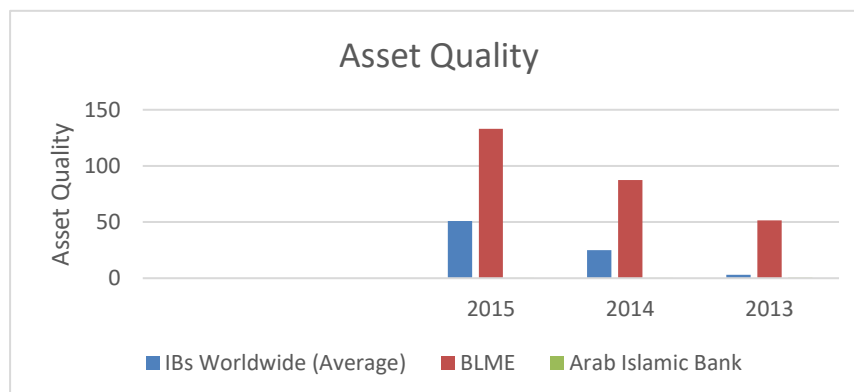


Figure 7. Asset Quality. Source: <https://orbisbanks.bvdinfo.com>

### 2.1.2. Management

Management quality is appraised by over viewing the cost to income ratio which can indicate the business' efficiency of both banks as seen from figure 8. The cost to income ratios of both banks are relatively efficient with BLME slightly out weighted Arab Islamic Bank. The relative ratio level of efficiency is also shown by IBs worldwide in the three consecutive years.

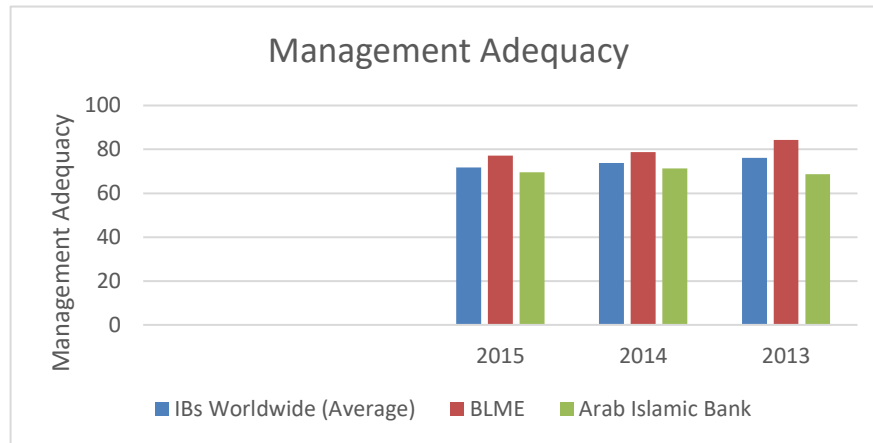


Figure 8. Management Adequacy. Source: <https://orbisbanks.bvdinfo.com>

### 2.1.3. Earnings

Earnings measurement can be scaled by 3 dimensions: Net Interest Margin (NIM), Return on Asset (ROAA) and Return on Equity (ROAE). The key issue as seen from figure 9, figure 10 and figure 11 is that the negative earnings BLME gained in 2015 from ROAA and ROAE. It is understandable since 2015 is the year when Brexit impact contributed to the negative economy growth of UK. This also explains the aggressive LLPs in the respective year. However, Palestine also suffered from decreased economy growth in last semester of 2014 nevertheless the gains from ROAA and ROAE were relatively stable.

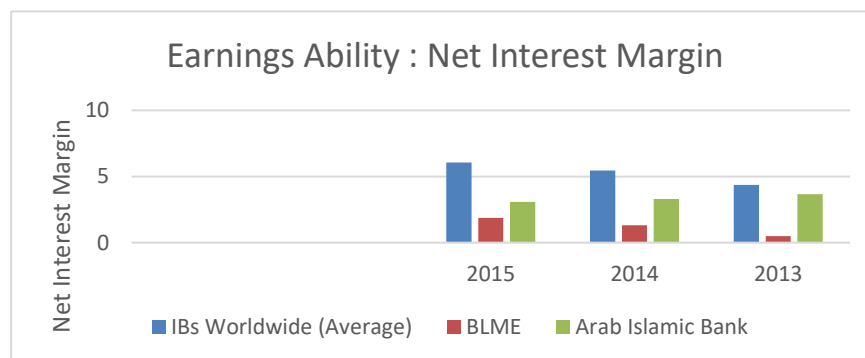


Figure 9. Net Interest Margin. Source: <https://orbisbanks.bvdinfo.com>

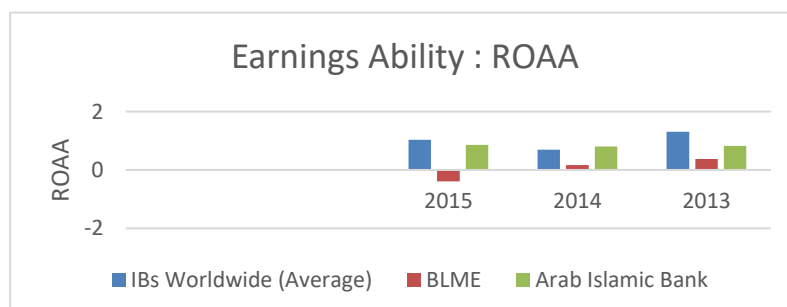


Figure 10. ROAA. Source : <https://orbisbanks.bvdinfo.com>

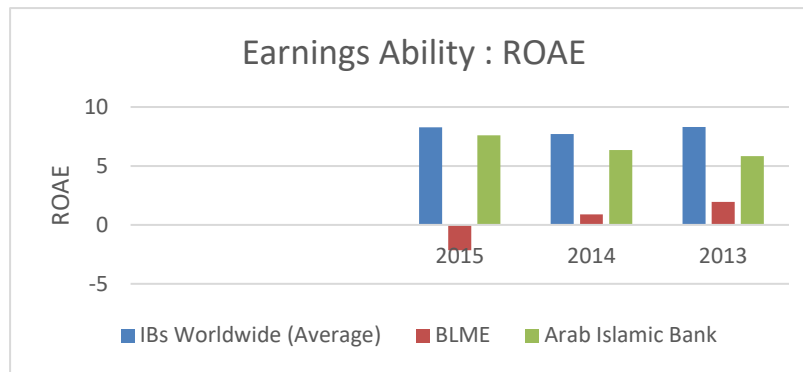


Figure 11. ROAE. Source : <https://orbisbanks.bvdinfo.com>

#### 2.1.4. Liquidity

Net loans to deposit & short-term funding indicate that the higher the figure, the less liquid the banks (Ferrouhi, 2014). As seen from figure 12, both banks outperformed IBs worldwide for maintaining better liquidity.

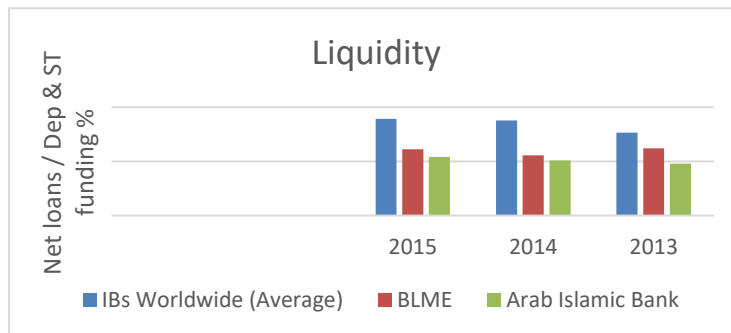


Figure 12. Liquidity. Source : <https://orbisbanks.bvdinfo.com>

## 2.2. Islamic Financial Reporting (Zakah, Qard-Hassan, Charity Fund)

### BLME

SSB do not require the banks to pay zakah and even it is ruled that over the consecutive years that the obligation on zakah lies on the shareholders to pay by themselves. However provision on paying zakah is presented every year. The annual report also does not provide any information on Qard-Hassan. Social contribution was only disbursed once in 2013 and there is no either detailed information or disclosure on the activity of the social donation distributed. Additionally, there is no description on the sources of social contribution in 2013.

### Arab Islamic Bank

SSB oblige the shareholder to pay zakah annually and the amount of zakah to be paid due on each share is announced annually. There is no information on qard hasan available on all annual reports throughout the years. Unlike BLME, in every annual report charity fund and the amount being disbursed was available. However, there is no detailed information on activity and disclosure. The fund was taken from impermissible income.



### 3. NON-FINANCIAL PERFORMANCE

#### 3.1. Narrative Reporting Analysis

Diction and LIWC applications are used to identify as to whether both banks have performed effective and good management by prevailing emotions to describe the interpretation behind the information given (Merkel-Davies, et al., 2011). Islamic Banks should operate their management based on amanah (trust) within the framework of tauhidi axioms as the key principle for the ethical and social institutions (Asutay, 2007)

#### 3.2. Optimism and Certainty

As seen from table 2, certainty in BLME CEO in 2015 was decreased from 2013. This indicates that the hurdles of Brexit effect which led to negative gains are expressed in the statement. The similar identification is also shown in BLME CEO's statement in 2015 which prevails pessimistic expression compared to that of 2014. Meanwhile when the economy growth of Palestine suffered from negative trend in 2014, the uncertainty and pessimism are also identified in the statements.

DICTION RESULT						
	OPTIMISM			CERTAINTY		
	2013	2014	2015	2013	2014	2015
CHAIRMAN BLME	54.19	57.07	54.47	49.2	43.53	46.51
CEO BLME	53.94	52.7	45.16	49.36	47.17	51.01
CHAIRMAN AIB	53.01	53.44	57.66	43.6	43.31	46.26
BOD AIB	50.2	51.26	52.47	44.22	43.85	44.64

Table 2. Diction. Source : Diction

#### 3.3. Positive & Negative Emotion (LIWC)

From table 3, it is prevailed that there is indication of impression management employed by the CEO of both banks as it is shown that positive emotion is increased during the years they suffered economic downturn.

LIWC												
	POSITIVE EMOTION			NEGATIVE POSITION			COGNITIVE COMPLEXITY			WORD COUNT		
	2013	2014	2015	2013	2014	2015	2013	2014	2015	2013	2014	2015
CHAIRMAN BLME	4.74	5.56	5.04	0.12	0.16	1.03	3.32	4.60	6.85	843	630	774
CEO BLME	4.14	3.34	4.72	0.20	0.93	1.18	5.02	4.65	7.08	1475	1826	1101
CHAIRMAN AIB	3.73	4.01	5.18	0.00	0.00	0.16	3.55	4.37	5.18	563	549	637
BOD AIB	1.77	2.26	2.61	0.13	0.16	0.16	3.42	4.12	3.41	1579	1286	1262

Table 3. LIWC. Source : LIWC

#### 3.4. Word Count & Complexity (LIWC)

In order to cover underperformance the chairman and the CEO also used complex words during bad periods. The similar indication can also be seen in statements of Arab Islamic Bank CEO as presented in table 3.

#### Disclosure

Despite operating in UK with high individualist cultural dimension leading to transparency and sufficient disclosures in the annual report, the reporting structure does not represent such assumed

cultural dimension. This might be caused by internationalisation which transform the cultural dimension of the country by the other cultural dimension.

### **3.5. Voluntary Disclosure Discussion**

“Voluntary disclosure, in excess of the minimum, may arise where corporate perceptions of the benefits arising outweigh the costs.” (Rizk, et al., 2008). No voluntary disclosure available in the annual reports of both banks over the years.

#### **3.5.1. Corporate Social Responsibility**

The annual reports of BLME only provide CSR indication in 2013 but there is no disclosure available to describe the activity. Meanwhile Arab Islamic Bank provided the CSR activities in all the annual reports of the consecutive years ranging from social, religious, communal to educational activities. However, the detail disclosure of those activities are not available in the annual reports. Thus it can be indicated if the assessment relies on the annual reports solely that Arab Islamic Bank might cover the CSR activities for the artificial purposes as justified in legitimacy theory (Lanis, 2012). Nevertheless, disclosures of the activities could also be found from the website.

It is interesting to find out that as a bank operating in a warfare state, Arab Islamic Bank still try to strive the service for the community as their corporate responsibility. On the other hand BLME as a bank working in a welfare state and a developed country the annual reports provided do not show such corporate responsibility. Furthermore as an Islamic bank, BLME bears the ethical and social requirement to accomplish.

#### **3.5.2. Corporate Governance**

##### **Board**

The independency of board in BLME is identified by the membership of one third of the independent members of the board. However such independency are not prevailed in Arab Islamic Bank. Some board members of both banks are also identified to be in duality role and cross dictatorship. This practice can jeopardize the independence of the board members.

##### **Committee**

BLME has remuneration committee while Arab Islamic Bank does not have such committee. In BLME, nomination is managed more professional and limited to 3 years shifting. Additionally, BLME also has nomination committee while Arab Islamic Bank does not impose such guideline. Nevertheless both banks own audit committees.

##### **3.5.2.1. Shareholder**

The majority shareholder of BLME is by private entity while Arab Islamic Bank is entitled by the Government of Palestine. As owned by government, Arab Islamic Bank might face inefficiency due to large organizational structure.

##### **3.5.2.2. SSB**

SSB members of both banks are PhD holder in relevant knowledge of shariah and own relatively good experience in finance industry. SSB members of BLME are identified to work for the other financial institutions. SSB of both banks should be more focus on the disclosure and Loan Loss Provision (LLPs) assumed aggressively by BLME during the economy downturn in UK in 2015 as such practices are not encouraged in Islam (Abdelsalam, et al., 2016).

### 3.5.2.3. Audit Quality

BLME and Arab Islamic Banks use different standards of accounting. BLME uses IFRS while Arab Islamic Bank uses AAOFI. Despite using different standard of accounting the comparison assessment can be scaled as universal standard is used for measurement as can be seen from Belal et. al (2014) Check list. Both banks use one of big four auditing agencies. BLME elects KPMG while Arab Islamic Bank chooses Ernst & Young. There is no rotation of the auditing agencies within the three consecutive years. The Auditing agency should take into consideration legal and social aspects of the objectives of Islamic finance into the assessment, evaluation and auditing process of IBs (Abdelsalam, et al., 2016; Ahmed, 2011).

## 4. Conclusion

Despite operating in warfare state, AIB shows more distinctive nature of Islamic bank idealism in their financial report. It is indicated from the low rate of LLPs imposed during hurdle time of Palestine decreased economy growth. Meanwhile the opposite policy is employed by BLME as shown by aggressive LLPs in time of economy downward of UK following Brexit. In compliance with Islamic moral objectives such practices are not encouraged in Islam. This finding also confirms Abdelsalam, et.al., 2016 on how LLPs aggressively imposed are indicative of manipulation during negative economy circumstances.

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