

**THE EXTENT OF INFORMATION DISCLOSED IN THE  
PRACTICE OF ISLAMIC BANKING ANNUAL REPORTS**

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**THE EXTENT OF INFORMATION DISCLOSED IN THE PRACTICE OF  
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**By**

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**Thesis Submitted to  
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## ABSTRACT

This research investigates the extent of disclosure in Islamic banking annual reports. The period of study is from year 1997 to 2006, a period after the regulations for financial reporting rapidly developed. This study reviews the issues on disclosure extent and the *Shari'ah* perspectives related to contracts, governance and disclosure. Information disclosure can be divided into two categories - voluntary and regulated. The traditional view on disclosure highlighted that the added value of information can be used to reduce conflicts. Meanwhile, from the perspective of the *Shari'ah*, the contracting parties need to observe the *Shari'ah* principles in identifying the information that need to be disclosed. This study examined the disclosure practice of 95 annual reports of full-fledged Islamic banks (IB) and windows (Islamic banking scheme or IBS). Comparative analysis on the practices of IB and IBS indicated that information disclosed in the IB's and IBS's annual reports are slightly different especially for voluntary disclosure and in the period before and immediately after the enforcement of disclosure regulations (2000-2003). Furthermore, this study found that: i) bank size, board independence and the number of *Shari'ah* committee members significantly determine the extent of voluntary disclosure; ii) bank size, liquidity, board committee, board independence and audit committee independence significantly determine the extent of regulated disclosure; iii) size and board independence significantly determine the extent of all type of disclosure; and iv) there is an evident of co-integrated relationship among a few sets of variables in the long run. Overall, the minimum best practices are not satisfactorily met judging from both voluntary disclosure and the level of conformity to regulations. Regulators may find these findings to be useful for *Shari'ah* governance and monitoring purposes as well as in promoting transparency, 'market discipline' and the social functions of this industry to the Muslims.

**Keywords:** Disclosure, Islamic Banking, Financial Reporting, Index Construction

## ABSTRAK

Penyelidikan ini mengkaji tahap pendedahan maklumat di dalam penyata kewangan perbankan Islam. Tempoh kajian adalah daripada tahun 1997 hingga 2006 iaitu di awal tempoh pesatnya perubahan bagi perundangan atas pelaporan kewangan. Kajian ini membincangkan isu-isu berkenaan tahap pendedahan dan kaitannya dengan perspektif shari'ah dan kontrak serta tadbir urus shari'ah. Pendedahan maklumat dikaji mengikut dua kategori; maklumat sukarela dan mandatori. Kajian ini mengupas pandangan yang pada dasarnya peningkatan maklumat boleh menambah kepada nilai sesebuah firma dan mampu mengurangkan konflik. Dalam Islam, pihak-pihak yang berkontrak perlu menghalusi syarat-syarat dalam kontrak dan pendedahan maklumat dengan mengambilkira prinsip-prinsip shari'ah kontrak. Kajian ini juga menganalisa praktis pendedahan 95 penyata kewangan bank Islam (IB) dan khidmat perbankan Islam melalui jendela (IBS). Analisis perbezaan mendapati pendedahan maklumat adalah sedikit berbeza antara IB dan IBS terutamanya bagi pendedahan maklumat sukarela dan bagi tempoh analisis tahun 2000-2003, iaitu sejurus sebelum dan selepas tempoh penguatkuasaan perundangan atas pelaporan kewangan. Dapatan seterusnya menunjukkan: i) saiz, pengarah bebas dan bilangan penasihat shari'ah bank adalah signifikan dalam menentukan tahap pendedahan maklumat sukarela; ii) saiz, kecairan, bilangan jawatankuasa, pengarah bebas dan pengarah audit bebas bank adalah signifikan dalam menentukan tahap pendedahan maklumat mandatori; iii) saiz dan pengarah bebas bank adalah signifikan dalam menentukan setiap jenis pendedahan; dan iv) terdapat bukti menunjukkan adanya hubungan ko-integrasi jangka panjang antara beberapa faktor tersebut. Secara keseluruhan, dapatan berkaitan '*minimum best practices*' agak kurang memuaskan melihat kepada praktis maklumat sukarela dan kebergantungan yang tinggi terhadap kehendak perundangan. Kajian juga mendapati bahawa wujud perbezaan faktor penentu ke atas tahap pendedahan setiap kategori maklumat. Pihak pembuat dasar boleh mengambilkira dapatan kajian ini untuk tujuan tadbir urus Shari'ah dan kawal selia juga bagi mewujudkan praktis pendedahan yang telus ke arah mengekalkan disiplin pasaran, dan fungsi sosial bank untuk masyarakat Islam yang seharusnya didokong oleh industri perbankan Islam.

**Katakunci:** Pendedahan, Perbankan Islam, Pelaporan Kewangan, Pembangunan Indeks

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## LISTS OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organisations of Islamic Financial Inst.
AIMR	Association for Investments Management and Research
BIMB	Bank Islam Malaysia Berhad
BNM	Bank Negara Malaysia
BNM/GP	Bank Negara Malaysia Guiding Principle
BMI	Bank Muamalat Indonesia
BMMB	Bank Muamalat Malaysia Berhad
CEO	Chief executive officer
DI	Disclosure Index
FRSi-1	Financial Reporting Standards for Islamic Financial Institutions
GLS	Generalised least squares
GP8	Guidelines on the Specimen Financial Statements
GP8-i	Guidelines on the Specimen Financial Statements for Licensed Islamic Banks
IASB	International Accounting Standard Board
IB	Islamic Banks
IBS	Islamic Banking Scheme
MASB	Malaysian Accounting Standards Boards
MD	Maximum Disclosure
OLS	Ordinary least squares
PMGE	Pooled Mean Group Estimator
RD	Regulated Disclosure Items
SC	Shari'ah Committee
SPTF	Skim Perbankan Tanpa Faedah
TD	Overall Disclosure Items
TRi-1	Accounting for Zakat on Business
TRi-3	Presentation of Financial Statements of Islamic Financial Institutions
TRi-4	Ijarah
TRi-4	Shari'ah Compliant Sale Contract
VD	Voluntary Disclosure Items
WTO	World Trade Organisation
DI_IB	Index of Islamic bank full-fledge
DI_IBS	Index of Islamic banking scheme

## Glossary of Islamic Terms

This section explains some of the Islamic words and terms occurring in this study to avoid misconceptions .

- Allah: Although the word Allah is often translated as “God”, there are some significant differences between the two words. According to Islamic belief, Allah is the Creator, and sovereign ruler of the universe.
- Bai Bithamin
- Ajil: Deferred payment sale.
- Fikh: Understanding of Shariah. In Islamic jurisprudence, it is the science of interpretation of Shariah.
- Gharar: Uncertainty or speculation.
- Ijarah: Leasing.
- Islam: Submission or surrender to the will of God.
- Kafalah: Guarantee
- Mudharabah: Investor -entrepreneur profit sharing contract
- Mudarib: Entrepreneur.
- Murabahah: Cost plus mark-up sale
- Musharakah: Joint venture profit and loss sharing
- Qardh al-hassan: Benevolent or interest-free loan.
- Quran: The holy Book of the Muslims consisting of the revelations made by God to the Prophet Muhammad, peace be upon him (pbuh). The Quran lays down the fundamentals of the Islamic faith, including beliefs and all aspects of the Muslim way of life. In all references to the Quran in the text (20:45), the first number refers to the surah or chapter and the second refers to the ayat or verse.
- RabbulMal: Beneficial owner, the owner of capital or financier in a mudharabah partnership agreement.
- Riba’: A ‘premium’ that must be paid by the borrower to the lender along with the principal amount as a condition for loan. It is equivalent to interest.
- Shari’ah: Refers to the divine guidance as given by (i) the Quran (the original source form which all principles and ordinances of Islam are drawn, (ii) the Sunnah (the sayings and actions of the Prophet, (iii) the Ijtihad (exercise of judgement based on the Quran and Sunnah and (v) the Ijma’ (the legal consensus).
- Wadiah: Safe custody or deposit.
- Wakalah: Agency
- Zakat: The amount payable by a Muslim on his networth as a part of his religious obligations, mainly for the benefit of the poor and the needy.

## CHAPTER ONE

### INTRODUCTION

#### 1.1 Introduction

The development of Islamic banks in Malaysia has been proven with several benchmarks. Among those are the percentage of Islamic banking assets from the total assets in banking industry, the number of Islamic banking institutions and the wide range of financial instruments introduced by Islamic banks. The rapid growth of Islamic banking industry is supported by many factors especially strong government supports and prudent regulatory frameworks. The industry has been recognised as one of the emerging sectors in the Malaysian economy.

In line with the development of universal banking stature, Islamic banks are permitted to offer various forms of banking products and services ranging from the more sophisticated investment banking activities such as corporate finance and private equity management to a variety of wealth management services in the vein of unit trusts and structured products for customers. At the same time, conforming with the World Trade Organisation (WTO) requirements, and as part of the liberalisations of financial services, foreign participants are also allowed to take part in Malaysia to promote the growth of the Islamic banking industry.

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