



**INTELLECTUAL CAPITAL DISCLOSURE IN ANNUAL  
REPORTS OF ISLAMIC BANKS: A COMPARATIVE  
STUDY OF MALAYSIA AND INDONESIA**

**BY**

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## ABSTRACT

This study focuses on four specific objectives. Firstly, the study examines the extent and quality of the Intellectual Capital Disclosure (ICD) in the annual reports of Malaysian and Indonesian Islamic banks from 2009 until 2013. Secondly, it aims to examine the categories of ICD (extent and quality) in both Malaysian and Indonesian Islamic banks over time. Thirdly, this study also focuses on the comparison of the ICD of Malaysian and Indonesian Islamic banks during the study period of five years. Fourthly, the study determines the factors that influence the ICD in the annual reports of Malaysian and Indonesian Islamic banks. The study adopted the quantitative research method. The extent of disclosure was measured by applying a checklist of 33 items. Differences in the extent of disclosure between the two countries were assessed by using independent sample t-test. Multiple regression analysis was performed to determine the factors that influence disclosure of IC. The data are from the annual reports on the websites of Islamic banks in Indonesia and Malaysia over five years from 2009 to 2013. The total sample of this study is 122 annual reports from these two countries. The results showed that the trend of ICD in the annual reports of Malaysian and Indonesian Islamic banks increased over the five years. In addition, the empirical results indicated that, for both countries the highest disclosure was for external capital, while the lowest was for human capital. Furthermore, Indonesian Islamic banks have a higher ICD compared to Malaysian Islamic banks. In addition, based on the multivariate regression results of determinants, the number of members with experience on other *Shari'ah* Committees (SC) has a significant positive effect on the extent of ICD (i.e. overall) in the annual reports of Malaysian Islamic banks, while the numbers of SC has a significant negative association with the quality of ICD in Indonesian Islamic banks. In addition, board size, leverage and ROE have significant positive influence on the quality of ICD in Indonesian Islamic banks. Thus, this study provides several contributions to the study area of ICD. Firstly, it is beneficial for stakeholders to invest their money in banks with higher ICD. Secondly, it helps to identify the trend of Malaysian and Indonesian Islamic banks to encourage the accounting regulators to pay more attention to ICD and simultaneously, it can be helpful for other users to understand the components of IC in Islamic banks. Thirdly, this study focuses on comparison between Indonesian and Malaysian Islamic banks; therefore, this study depicts a picture of which country has better ICD in the annual reports of Islamic banks. Regulation should take these findings into consideration, particularly on the effects on attracting investors, since both Malaysia and Indonesia aim to be Islamic financial hubs.

## خلاصة البحث

تركز هذه الدراسة على تحقيق أربعة أهداف محددة، يتمثل أولها في تحديد مدى الإفصاح عن رأس المال الفكر ونوعيته (ICD)، في التقارير السنوية للبنوك الإسلامية الماليزية والإندونيسية من عام 2009 وحتى عام 2013. وثانيها: فحص أنواعها أو فئاتها على المستويين النوعي والامتدادي وفقاً لتصنيف الدولي لرأس المال الفكري (ICD) في كل من البنوك الإسلامية الماليزية والإندونيسية، إضافة إلى ذلك فإن ثالث الأهداف يتمثل في مقارنة المعلومات المتعلقة برأس المال الفكري (ICD) بين البنوك الإسلامية الماليزية والبنوك الإسلامية الإندونيسية، وبالتحديد خلال فترة زمنية حددتها الدراسة بالخمس سنوات المذكورة، أما آخر الأهداف فينصب على تحديد العوامل التي تؤثر على مدى الإفصاح عن رأس المال الفكر ونوعيته (ICD) في التقارير السنوية للبنوك الإسلامية الماليزية والإندونيسية. وقد اعتمدت هذه الدراسة على المنهج الكمي، وقد تمّ قياس مدى هذا التوضيح عن طريق تطبيق قائمة ثلاثة وثلاثين مادة. وتمّ تقدير حجم الاختلافات في مدى الإفصاح بين البلدين باستخدام اختبار تيلعينة المستقلة (t-test). وتم إجراء تحليل الانحدار المتعدد لتحديد العوامل التي تؤثر في الكشف عن IC. وقد تمّ أخذ البيانات الواردة في التقارير السنوية، والمتوفرة على مواقع البنوك الإسلامية في إندونيسيا وماليزيا على مدى السنوات الخمس، من 2009-2013. وقد احتوت العينة الإجمالية لهذه الدراسة على مائة واثنين وعشرين تقريراً سنوياً لهذين البلدين. وأظهرت النتائج أنّ اتجاه الإفصاح عن رأس المال الفكري (ICD) في التقارير السنوية للبنوك الإسلامية الماليزية والإندونيسية قد زاد على مدار السنوات الخمس المذكورة. وبالإضافة إلى ذلك، فقد أشارت النتائج التجريبية أنّ مستوى الإفصاح في كلا البلدين كان على درجة أعلى فيما يتعلق برأس المال الخارجي، في حين كان مستوى الإفصاح عن رأس المال البشري في مستويات دنيا في كلا البلدين. فضلاً عن ذلك فإنّ البنوك الإسلامية الإندونيسية حازت على مستوى إفصاح في رأس المال الفكري (ICD) أعلى مقارنة بالبنوك الإسلامية الماليزية. إضافة إلى ذلك، واستناداً إلى نتائج الانحدار الخطي للمحددات متعددة المتغيرات، فإنّ عدد الأعضاء الممثلين للمجلس التشريعي الإسلامي (SC) له أثر كبير على تحديد مدى الإفصاح لرأس المال الفكري بشكل عام. وفي التقارير السنوية للبنوك الإسلامية الماليزية، يتضح أنّ أعداد المجلس التشريعي (SC) لها قيمة سلبية مؤثرة على نوعية مستوى الإفصاح عن رأس المال الفكري (ICD) في المصارف الإسلامية الإندونيسية. بالإضافة إلى ذلك، فإنّ حجم هذا المجلس، والنفوذ، وعوائد المساهمين، تؤثر بشكل إيجابي على الجانب النوعي لمستوى الإفصاح عن رأس المال الفكري (ICD) في البنوك الإسلامية الإندونيسية؛ وعليه فإنّ هذه الدراسة قد خلصت إلى العديد من النتائج وثيقة الصلة بموضوع البحث، والتي تتمثل في: أولاً، من المفيد لأصحاب رؤوس الأموال استثمار أموالهم في البنوك التي تتمتع بارتفاع معدل الإفصاح عن رأس المال الفكري (ICD). ثانياً، يساعد هذا البحث في تحديد توجه البنوك الإسلامية الماليزية والإندونيسية، والذي يؤدي بدوره إلى تشجيع القائمين على النظام المحاسبي على السير قدماً نحو تحقيق المزيد من الاهتمام بالإفصاح عن رأس المال الفكري (ICD)، وفي الوقت نفسه، فإنه قد يكون مفيداً للمستخدمين الآخرين الذي يريدون فهم مكونات نظام (IC) في البنوك الإسلامية. وثالثاً، فقد ركزت هذه الدراسة على المقارنة بين البنوك الإسلامية الإندونيسية والماليزية. وبالتالي، فإنّ هذه الدراسة بمثابة صورة قابلة للتطبيق على أي بلد لديه نظام (ICD)، والتفاهع به بصورة أفضل من الاكتفاء بالتقارير السنوية للمصارف الإسلامية. وينبغي على اللاحقة التنظيمية أن تنظر إلى هذه النتائج بعين الاعتبار، ولا سيما فيما يتعلق بالآثار المترتبة على جذب المستثمرين؛ لأنّ كلا من البلدين: ماليزيا وإندونيسيا تحدفان إلى أن تكون مركزاً للصيرفة الإسلامية.

## APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science in Accounting.

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Management Science

## DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degree at IIUM or other institutions.

Agusdiwana Suarni

Signature .....

Date .....

INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA

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MALAYSIA AND INDONESIA**

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## LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
e.g.	(exempligrantia): for example
et al.	(et alia): and others
BSC	Balance Scorecard
BNM	Bank Negara Malaysia
BI	Bank Indonesia
BV	Book Value
EVA	Economic Value added
IC	Intellectual Capital
ICI	Intellectual Capital Index
ICD	Intellectual Capital Disclosure
IFI	Islamic Financial Institution
IFSA	Islamic Financial Services Act
IAM	Intangible Asset Monitor
GCG	Good Corporate Governance
MCCG	Malaysian Code on Corporate Governance
MBV	Market to Book Value
MV	Market Value
OECD	Organization for Economic Cooperation and Development
ROE	Return on Assets
SC	<i>Shari'ah</i> Committee
SMVC	Skandia Market Value Scheme
SN	Skandia Navigator
SGF	<i>Shari'ah</i> Governance Framework
TB	The Technology Broker
VA	Value Added
VAIC	Value Added Intellectual Capital
VF	Value Platform

# **CHAPTER ONE**

## **INTRODUCTION**

### **1.0 BACKGROUND OF THE STUDY**

In the era of rapidly changing technology and massive competition, Intellectual Capital (IC) has become an important factor to be considered by companies in the formulation of their organisation (Soedaryono et al., 2012). In a knowledge-based economy, intellectual assets such as skilled employees, sound infrastructures, networking systems, information systems, innovations, brand names, trademarks and knowledge bases bring competitive advantages for companies. These intellectual assets are a company's IC. In defining IC, intellectual material consists of knowledge, information, and intellectual property, as well as experience that can be put to use to create wealth (Stewart, 1997). This is because the basis for competition has shifted from traditional physical and financial resources to intangible resources (Khan and Ali, 2010). Thus, a company's intangible properties (typically displayed in the form of skilled people, processes, competencies, and knowledge) provide core foundations of its current and prospective wealth (Khan and Ali, 2010). As a result, these intellectual properties or IC have become a growing research interest in the recent years.

Currently, in a knowledge-based economy, IC has secured overwhelming attention from researchers, academicians, practitioners and entrepreneurs. There are many researchers, such as Bontis et al. (2000); Pablos (2002 and 2003); Ismail (2005); Goh (2005); De Castro and Saez (2008); Khalique (2012); Khalique et al. (2012); and Sharabati et al. (2010) who have found IC to be the most vital intangible asset for the success of organisations. They have argued that IC will help organisations to sustain

competitive advantage, enhance financial performance, and create value. Therefore, IC is important for companies to achieve economic success (Saleh and Gan, 2008).

In addition, Sveiby and Stewart (1997) classified IC into three categories, which are human capital, internal capital, and external capital. Human capital refers to innovation, flexibility, tolerance, motivation, satisfaction, learning capacity, loyalty, and training. Meanwhile, the internal capital of the organisation could be defined as the knowledge within the organisation, such as intellectual properties, contracts, database, information systems, culture, procedures, manuals, administrative routines and best practices. On the other hand, external capital is the information of brands, customer base, and partnership. After a brief introduction about IC, the following section will provide the problem statement of this study prior to identifying the research objectives and research questions.

## **1.1 PROBLEM STATEMENT**

In order to thrive, the banks need to be innovative. The banking sector is also considered a knowledge-intensive sector, as it has to offer innovative and competitive financial products and services. Although IC is crucial in the banking sector, as a whole, this study focuses only on Islamic banks. IC may be considered even more important in Islamic banks as these banks have to offer financial products and services that are not only able to compete with conventional banks, but are also *Shari'ah* compliant.

Since IC creates value (Bontis et al., 2000; Khalique et al., 2012 and Sharabati et al., 2010), it is important for Islamic banks to relay this information to the investors and stakeholders. It is even more crucial when both Indonesia and Malaysia aim to become international Islamic financial hubs (*Live Trading News, 2012*;



*PricewaterhouseCoopers, 2008*). This is because both Indonesia and Malaysia have large Muslim populations, and hence are prospective financial markets (Schmit, 2007). The opinion is in line with Coopers (2009, p. 5): “Perhaps the single most important factor behind the powerful growth of the *Shari’ah* compliant funds industries lies in the simple fact that the Muslims represent about a quarter of the world’s population”. For instance, in Indonesia, being the largest Muslim country in the world, Indonesia experiences rapid growth in its Islamic banking industry (Darmadi, 2013).

Regardless of the rapid growth locally, it is uncertain whether the Islamic banks in these two countries are making sufficient disclosure, particularly on IC, which will signal their value creation. Also, due to their aim of becoming an international Islamic financial hub, these two countries seem to be in competition to attract investors. So far, there are no evidences to suggest the extent of quality of their Intellectual Capital Disclosure (ICD) which would allow a comparison of their signalling ability to create value.

Islamic banks are founded on the basis of the *Shari’ah*: thus, these banks are accountable not only to their stakeholders, but also to the *Ummah* and ultimately to the Creator (Haniffa and Hudaib, 2002). Therefore, these banks need to disclose information regarding their performance to society to discharge their accountability. This is also true in the case of ICD. However, Haniffa and Hudaib (2007), Harahap (2003), Ahmed Haji and Mohd Ghazali (2013), Darmadi (2013) and Farook et al. (2011) all found that the levels of transparency in annual reports of Islamic banks are quite low. Low ICD may also be true in Islamic banks. Since Indonesia and Malaysia aim to become Islamic financial hubs, it would be disadvantageous if it is found that Islamic banks in these countries have low ICD.

In order to possibly alleviate the problem of low disclosure, some corporate governance mechanisms may be able to monitor the transparency of disclosure, including of IC. However, these mechanisms, specifically of *Shari'ah* Committee (SC), which is directly relevant to Islamic banks, as well as audit committee and board of directors, have not been tested in the context of ICD of Malaysian and Indonesian Islamic banks. Thus, there is no empirical evidence to suggest which of these mechanisms may be effective in enhancing ICD. This study attempts to address some of the problems stated above. Hence, the next section specifies the objectives and research questions of this study.

## **1.2 RESEARCH OBJECTIVES AND RESEARCH QUESTIONS**

This study has the following research objectives:

- RO 1: To examine the extent and quality of ICD in the annual reports of Malaysian and Indonesian Islamic banks from the years 2009 to 2013.
- RO 2: To examine the categories of ICD (extent and quality) in both Malaysian and Indonesian Islamic banks over time.
- RO 3: To compare between ICD in annual reports of Malaysian and Indonesian Islamic banks from 2009 until 2013.
- RO 4: To identify the determinants ICD in the annual reports of Malaysian and Indonesian Islamic banks.

Based on the research objectives, this study is undertaken to answer the research questions of the study, which are formulated as follows:

- RQ 1: What is the extent and quality of ICDs in the annual reports of Malaysian and Indonesian Islamic banks from the years 2009 to 2013?

RQ 2: What are the categories of ICD (extent and quality) in Malaysian and Indonesian Islamic banks?

RQ 3: Is there any differences in ICD of Malaysian and Indonesian Islamic banks?

RQ 4: What are the determinants of ICD in the annual reports of Malaysian and Indonesian Islamic banks?

### **1.3 MOTIVATION OF THE STUDY**

This study is motivated to examine the current level of ICD in Islamic banks that can provide the latest picture of the banking sector in Indonesia and Malaysia. Since IC creates value, the growth of Islamic banks is reliant on IC. Thus, the researcher is motivated to find out to what extent IC is being disclosed by these banks to signal their value creation.

In addition, there are many studies which have been conducted on the issues in relation to ICD or reporting in different countries such as Australia (i.e. Guthrie and Petty, 2000; Sujan and Abeysekera, 2007; White et al., 2007; Bruggen et al., 2009), Sri Lanka (i.e. Abeysekera and Guthrie, 2005), Sweden (i.e. Bealieu et al), Italy (i.e. Bozzolan et al., 2003), Canada (i.e. Bontis, 2003), Indonesia (Sihontang and Winata, 2008; Darmayanti and Budiyanawati, 2009 and Falikhatun et al., 2011) and Malaysia (i.e. Ahmed Haji and Mohd Ghazali, 2013 and Husin et al., 2012). However, the IC literature, particularly the ICD literature, suffers from a dearth of studies that provide a comparative examination (e.g. Abeysekera, 2008). Therefore, there is a lack of studies that investigated the ICD practices of Islamic banks, particularly in a comparative setting of two countries with significant Islamic banking operations.

The motivation of the study is also fuelled by the fact that it is important to find empirical evidence of ICD in Indonesian Islamic banks in comparison to

Malaysian Islamic banks. This is because, as mentioned before, both countries may indirectly be competitors in their aim to be an international Islamic financial hub.

#### **1.4 CONTRIBUTION OF THE STUDY**

This study shows the trend of Malaysian and Indonesian Islamic banks from 2009 to 2013. The empirical evidence offered in this study contributes in several ways. Firstly, the trend of ICD is an indication of whether the Islamic banks have been discharging their accountability by improving their ICD practices over the years. The stakeholders may be interested to know whether there has been gradual or rapid improvement in disclosure. Rapid improvement indirectly reflects the Islamic banks' willingness to reduce information asymmetry between the management and the stakeholders, including the shareholders.

Secondly, this study provides evidence of the categories of ICD in both Malaysian and Indonesian Islamic banks over time. This may be useful to regulators and the Islamic banks themselves, as they may want to know which category of IC is still lacking in terms of disclosure. Thus, both regulators and Islamic banks can cooperate in order to improve the disclosure of IC category.

Thirdly, this study focuses on a comparison between two countries which are Indonesia and Malaysia. Indeed, this study reveals which country has better ICD in the annual reports of Islamic banks. Malaysia and Indonesia aim to become international Islamic financial hubs. Therefore, this study will also be beneficial to shareholders and potential investors as they may want to invest in banks with higher ICD.

Fourthly, this study also investigates the factors that may influence ICD, including the SC. These findings are important to indicate which of the corporate

governance mechanisms have been effective in enhancing ICD. This information could be useful to regulators for the improvement of ICD practices by Islamic banks in Malaysia and Indonesia. In addition, the Malaysian and Indonesian regulators may also consider issuing guidelines on ICD to enable comparability between Islamic banks. This is because Malaysia and Indonesia are the most progressive countries in the development of Islamic finance.

Finally, this study extends the IC literature, particularly in relation to Islamic banks, and provides findings and new evidence that may be referred to by future researchers and academicians.

## **1.5 THE ORGANIZATION OF THE DISSERTATION**

This study has been organised into seven chapters:

Chapter 1 provides the introduction. It highlights the background of the study, objectives of the study, problem statement, motivation of the study, contribution of the study, and organisation of the chapters in the dissertation.

Chapter 2 focuses on the development of the Islamic banking sector in Indonesia and Malaysia. Firstly, it gives a general discussion of the overview of Islamic banks, followed by a general explanation of the origins of Islamic banks in Indonesia and Malaysia, and the development of Islamic banking in both countries. Next, it presents the IC and corporate governance in Malaysian and Indonesian Islamic banks. This chapter is concluded with a summary of the chapter.

Chapter 3 is the literature review. This chapter discusses definition and classification of IC. The next section provides IC performance in banks. It is followed by a brief overview of IC measurement. In addition, the review focuses on ICD

studies, determinants and trends of ICD. The gaps in the literature are presented in the last section of the chapter.

Chapter 4 discusses the theoretical framework and hypotheses development. This chapter is divided into three sections. The first section covers the theoretical framework of the study, which consists of the theories that are used to develop the hypotheses. The second section discusses the development of the hypotheses. Finally, the chapter ends with a summary.

Chapter 5 is on research methodology. This chapter focuses on the methodology used in the study. The discussion includes an explanation of the sample selection, data collection method, research design, and statistical analyses.

In chapter 6, the findings are analysed and discussed. Firstly, the descriptive statistics provide details of the variables and samples examined in the study. The next section explains the preliminary tests which were carried out. Regression results are analysed in the following section. Finally, this chapter discusses the results of the hypotheses testing.

Chapter 7 concludes the overall study. It provides a brief summary of the results and findings. Implications, limitations and contributions of the study are also presented. This chapter also provides some recommendations for future research in the area of ICD in the banking industry.

## **1.6 SUMMARY OF THE CHAPTER**

This chapter provides an introduction to this research by identifying problem statements, objectives and research questions of the research, motivations and the contributions of the study. It also provides an overview of the seven chapters of this thesis. The next chapter will provide a description of the development of the Islamic

banking sector in Indonesia and Malaysia, and also discusses the corporate governance in Islamic banks in both countries.

## **CHAPTER TWO**

### **DEVELOPMENT OF ISLAMIC BANKING IN MALAYSIA AND INDONESIA**

#### **2.0 INTRODUCTION**

This chapter reviews the development of the Islamic banks in Malaysia and Indonesia. Section 2.1 gives a general discussion of the overview of Islamic banking. This is followed by a general explanation of the origins of Islamic banks in Indonesia and Malaysia, and the development of Islamic banking in both countries in Sections 2.2 and 2.3, respectively. Section 2.4 presents the IC and corporate governance in Malaysian and Indonesian Islamic banks. Finally, Section 2.5 provides a summary of the chapter.

#### **2.1 OVERVIEW OF ISLAMIC BANKING**

According to the Islamic Financial Services Act (IFSA) 2013, “The bank means a person who carries on the banking business that includes the activity of receiving deposits (on the current account, deposit account, savings account and other similar accounts), collecting checks drawn by the customers, and the provision of finance”. The genuine role of the banking and financial institutions is acting as an intermediary institution that channels savings (from the depositors) in a large scale for the productions and other uses (Ahmad, 2000).

In addition, Islamic banking refers to a system of banking that complies to Islamic law also known as *Shari'ah*. The Central Bank of Malaysia or Bank Negara Malaysia (BNM) (2013) mentioned that the principles of Islamic banking are based on a mutual risk and profit sharing between parties, and the assurance of fairness for all