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بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ

THE SOCIAL REPORTING PRACTICES OF  
ISLAMIC BANKS IN MALAYSIA

BY

UMARU MUSTAPHA ZUBAIRU

INTERNATIONAL ISLAMIC UNIVERSITY  
MALAYSIA

2008

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UMARU MUSTAPHA ZUBAIRU

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requirement for the degree of Master of Science in  
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International Islamic University  
Malaysia

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## ABSTRACT

Islamic banks are said to possess *ethical identity* (Haniffa and Hudaib, 2007) because their social goals are just as important if not more important than financial goals because of the fact that they are based on religious foundations, i.e. the Islamic *Shari'ah* which has as its ultimate goal, the betterment of society. Islamic banks are thus expected to portray a high level of corporate social responsibility which would be evident in their social reporting practices as evidenced in their annual reports. However, two prominent studies of the social reporting practices of Islamic banks have shown otherwise (Maali et.al, 2003; Haniffa and Hudaib, 2007). This study replicated the Haniffa and Hudaib study by examining the social reporting practices of Islamic Banks in Malaysia. This examination involves a comparison of the social disclosures of 7 Islamic banks made through their annual reports against an ideal level of social disclosures that Islamic banks ought to make, over the years 2004-2007. This comparison was accomplished using the Ethical Identity Index (EII) developed by Haniffa and Hudaib (2007). The findings revealed that at present, Islamic banks in Malaysia have much more in common with their conventional counterparts than they do with banks that are supposedly based on *Shari'ah*. This is because they disclose a reasonable amount of information on their debtors and their corporate governance practices which is what one would expect from conventional banks. However, in areas that would demonstrate their ethical identity and ultimate goal of betterment of society that separates them from their conventional counterparts, they disclose very little information in this regard in their annual reports.

## ملخص البحث

وُضعت البنوك الإسلامية لتحديد الهوية الأخلاقية (حنيفة و هديب، ٢٠٠٧) وذلك لأهداف اجتماعية تمثل أهمية قد تكون أكبر من أهمية الأهداف المالية، لأن حقيقتها تترتب عليها أولويات دينية، على سبيل المثال الشريعة الإسلامية التي جعلت من أقصى غاياتها تحسين الوضع الاجتماعي. ويتوقع من البنوك الإسلامية تصوير أعلى المستويات في المسؤولية التعاونية بالمجتمع والتي ستتوضح في تقرير التطبيقات الاجتماعية كدليل في تقاريرهم السنوية. على أية حال، هناك دراستان بارزتان لتقرير التطبيقات الاجتماعية في البنوك الإسلامية قد أظهرتا استكشافات أخرى (ماعلي وآخرون ٢٠٠٣، حنيف وهديب، ٢٠٠٧). هذه الدراسة تنطوي على دراسة حنيف وهديب عن طريق امتحان تقرير التطبيقات الاجتماعية للبنوك الإسلامية في ماليزيا. وهذا الإمتحان يشمل مقارنة في الكشوفات الاجتماعية لسبع بنوك إسلامية وُضعت من خلال التقارير السنوية ضد المستويات المثالية للكشوفات الاجتماعية التي طبقت من سنة ٢٠٠٤ إلى ٢٠٠٧. وأنجزت هذه المقارنة باستخدام دليل الهوية الأخلاقية المطورة من قبل حنيف و هديب (٢٠٠٧). كما كشفت النتائج أن البنوك الإسلامية الماليزية الحالية مشاعة مع النظائر التقليدية، أكثر من البنوك التي يفترض أن تكون وفق الشريعة. هذا لأن ذلك يكشف الكمية المعقولة من معلومات الدائنين و المتعاونين مع التطبيقات الحكومية التي من المفترض دخولها ضمن البنوك التقليدية. على أية حال، المجالات التي تكشف الهوية الأخلاقية والأهداف الجوهرية لتحسين المجتمع قد فرقهم عن نظائرهم التقليدية كما كشفت معلومات نسبية بهذا الخصوص في التقارير السنوية.

## 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.

.....  
Siti Normala Sheikh Obid  
Supervisor

I certify that I have 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.

.....  
Nazli Anum Mohd. Ghazali  
Examiner

This dissertation was submitted to the Department of Economics and Management Sciences and is accepted as a partial fulfilment of the requirements for the degree of Master of Science in Accounting.

.....  
Nazli Anum Mohm Ghazali  
Head, Department of Accounting

This dissertation was submitted to the Kulliyah of Economics and Management Sciences and is accepted as a partial fulfilment of the requirements for the degree of Master of Science in Accounting.

.....  
Mansor. H.Ibrahim  
Dean, Kulliyah of Economics and  
Management Sciences

## DECLARATION PAGE

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

Umaru Mustapha Zubairu

Signature.....

Date.....

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## LIST OF ABBREVIATIONS

H&H	Haniffa and Hudaib
BIMB	Bank Islam Malaysia Berhad
BM	Bank Muamalat
KFH	Kuwait Finance House
RHB	RHB Islamic Bank
CIMB	CIMB Islamic Bank
HGL	Hong Leong Islamic Bank
EON	Eoncap Islamic Bank
EII	Ethical Identity Index
ADE	Annual Dimension EII
AMDE	Annual Mean Dimension EII
ABE	Annual Bank EII
OMDE	Overall Mean Dimension EII
OMBE	Overall Mean Bank EII

## TRANSLITERATION TABLE

Arabic Term	Transliteration	Arabic Term	Transliteration	Arabic term	Transliteration
ء	‘	ر	r	ف	f
ب	B	ز	z	ق	q
ت	T	س	s	ك	k
ث	Th	ص	ṣ	ل	l
ج	J	ض	ḍ	م	m
ح	ḥ	ط	ṭ	ن	n
خ	Kh	ظ	ẓ	ه	h
د	D	ع		و	w
ذ	dh	غ	gh	ي	y
ـَ	a	ـِ	i	ـُ	u
ـَـ	ā	ـِـ	ī	ـُـ	ū



# CHAPTER ONE

## INTRODUCTION

### INTRODUCTION

After many centuries of domination by the West, and the subservience and adoption of Western culture and values as a result of this domination, there has been a revival of Islamic principles and values in Muslim countries. This revival was a result of a growing discontent among the Muslims with the values of the West. This discontent spread to all aspects of life, including the economic aspect. Specifically, there were grave concerns for the conventional banking practices present in these Muslim countries. These banks were involved in the charging and collection of interest (*riba*) which is strictly prohibited in Islam. “The desirability of abolishing fixed interest rates and the Islamization of financial systems” (Haqiqi and Pomeranz, n.d.) is one of the main reasons for the establishment of Islamic banks.

Ideally, Islamic banks and other Islamic financial institutions are supposed to adhere strictly with the precepts of the *Shari’ah*, the Islamic code of law “derived from the Holy Qur’an, *Hadith* of the Prophet Muhammad (Peace be upon him), and juristic reasoning (*ijtihad*) of Islamic scholars” (Kamali, 2000: 1). Due to the prohibition of interest in Islam, they could not offer conventional financial services and had to offer those in compliance with the *Shari’ah*. Examples of such services include *Mudarabah*, *Musharakah*, and *Ijarah*. Whereas the goal of conventional banks is to make as much profit as possible and at any means; for Islamic banks, whereas profit is a part of its goals, it isn’t the most important goal. To understand the goal of an Islamic bank, one has to understand the objectives of the *Shari’ah*. Imam

Ghazali (as cited by Dusuki n.d.) states that “*the objective of the Shari’ah is to promote the well-being of all mankind, which lies in safeguarding their faith (din), their human self (nafs), their intellect (‘aql), their posterity (nasl) and their wealth (mal). Whatever ensures the safety of these five serves public interest and is desirable*”. From these noble objectives, it can be gathered that the most important role of Islamic banks is to promote the betterment of the society in which they are set up by providing means by which members of the society can better themselves, particularly improving their posterity and wealth.

Allah says in the Holy Quran, “*O you who believe, why do you say that which you do not do? Greivously odious is it in the sight of Allah that you say that you do not do.*” ( *as-Saff: 2-3*) and the researcher’s study had as an goal, a determination of whether Islamic banks in Malaysia were fulfilling their claim of complying with the *Shari’ah* by comparing their disclosures as reported in their annual reports against an ideal level of disclosure as measured by the “Ethical Identity Index” developed by Haniffa and Hudaib (2007).

## **RESEARCH BACKGROUND**

As far as the researcher was aware, there were two studies in the literature that had explored the social reporting practices of Islamic banks by comparing the amount of disclosure in their annual reports against an ideal level of disclosure based on the *Shari’ah*. The aim in both studies was to determine if any discrepancy existed between what Islamic banks actually disclose regarding their activities, and what they ought to disclose based on their claim of being founded on *Shari’ah* principles.

The first study was that undertaken by Maali, Casson and Napier (2003). The authors developed a benchmark set of social disclosures appropriate to Islamic banks

based on three fundamental concepts of “accountability, social justice, and ownership that are central to social relations” (Maali et.al, 2003: 11) in Islam. They then compared the actual social disclosures of 29 Islamic banks around the world as reported in their annual reports. The comparison was to determine the extent to which each of the examined Islamic banks’ social disclosures measured up to the developed benchmark. Their findings suggested that social reporting by Islamic banks fell “significantly short” (Maali et.al, 2003: 26) of the authors’ “expectations for entities whose operations are based on Islamic principles” (Maali et.al, 2003: 26).

The second study, undertaken by Haniffa and Hudaib (2007), undertook a longitudinal study over a 3 year period of the annual reports of 7 Islamic banks in the Arab Gulf region. They compared the “communicated disclosures” of these banks with the “ideal disclosures based on the Islamic ethical business framework” as measured by what the authors termed the “Ethical Identity Index” (EII), (Haniffa and Hudaib, 2007: 97). Their results indicated that the overall mean EII of only one Islamic bank out of 7 surveyed to be above average, and the largest incongruence was found to be related to four dimensions: (1) commitments to society, (2) disclosure of corporate vision and mission, (3) contribution to and management of *Zakāt*, charity and benevolent loans, and (4) information regarding top management.

The researcher hoped to contribute to this body of literature by examining the social reporting practices of Islamic banks in Malaysia.

## **MOTIVATION FOR RESEARCH**

The researcher was motivated to engage in the study for two reasons. Firstly, an attempt by the researcher to fulfill a religious obligation of enjoining the good and forbidding the evil as conveyed by Almighty Allah in the Holy Quran in many verses.

An example of such a verse can be found in the Quran (*al-imran*: 104), “*Let there arise out of you a band of people inviting to all that is good, enjoining what is right, and forbidding what is wrong: They are the ones to attain felicity*”. It is the fervent hope of the researcher that by exposing an incongruence between the actual practices of Islamic banks in Malaysia as reported in their annual reports, and what they ought to be doing in accordance to *Shari’ah*, Islamic bank managers and their primary stakeholders will be convinced of the need to improve their practices and move closer to the ideal as demanded by *Shari’ah*.

The second reason that motivated the researcher was an attempt to answer a call for further research made by Haniffa and Hudaib (2007). They stated that since their sample was only restricted to Islamic banks in the Arabian Gulf region, “future studies can be extended to Islamic banks in other countries as well” (Haniffa and Hudaib, 2007:111). To answer this call, the researcher’s study explored the social reporting practices of Islamic banks in Malaysia by comparing their social disclosures made through annual reports against an ideal level of social disclosures that Islamic banks ought to make. This comparison was accomplished using the Ethical Identity Index (EII) developed by Haniffa and Hudaib (2007). The EII will be discussed fully in chapter 3 of the researcher’s study.

## **RESEARCH QUESTION**

The study had one central research question, which led to the development of three aims in order to answer this central research question. The central research question was as follows:

**Do the social disclosures of Islamic Banks in Malaysia meet the *Shari’ah* requirement of full disclosure?**

The aims of the research were:

1. To ascertain the level of social reporting by Islamic banks in Malaysia through an examination of their annual reports.
2. To compare the level of social reporting by Islamic banks in Malaysia with an ideal level of social reporting expected by *Shari'ah*-based organizations using a benchmark developed by Haniffa and Hudaib (2007)
3. To determine whether any discrepancy existed between the actual level of social disclosures made by these Islamic banks in Malaysia and the ideal level as measured by the Ethical Identity Index (EII) developed by Haniffa and Hudaib (2007).

## **RESEARCH METHOD**

The researcher's study used as a guide the study undertaken by Haniffa and Hudaib (2007) by using the Ethical Identity Index (EII) they developed, to determine the social reporting practices of Islamic banks in Malaysia. Haniffa and Hudaib (2007) explored whether any discrepancy existed between the communicated and ideal ethical identities of Islamic banks in the Arab Gulf region. For this reason, this researcher adopted their research method, which was a longitudinal survey of the annual reports of 7 Islamic banks over a period of time. Content analysis was used to explore the social reporting practices of 7 Islamic banks in Malaysia, and then compared with the checklist instrument developed by Haniffa and Hudaib (2007) to constitute the ideal ethical identity of Islamic banks (Haniffa and Hudaib, 2007: 103).

## **SIGNIFICANCE OF RESEARCH**

The first reason why the study was significant relates to the role of business in society, particularly one occupied by Muslims. According to the social contract theory, business and society are equal partners, each enjoying a set of rights and reciprocal responsibilities. In other words, there is a direct and indirect mutual need between business corporations and society (Lantos 2001).

Based on this theory, Islamic Banks have a duty to help the society in which they operate in, in order to fulfill their responsibility as good corporate citizens. In addition, and perhaps more importantly, the fact that these banks are founded on *Shari'ah* makes it even more pertinent that they act as excellent corporate citizens. This is because the ultimate purpose of the *Shari'ah* is betterment of the society. The researcher's study hoped to remind Islamic bank managers and their stakeholders of their responsibility to improve their practices by aligning them with the true objectives of *Shari'ah*.

## **ORGANIZATION OF CHAPTERS**

This dissertation presenting the researcher's study was organized into six chapters. These are as follows:

**Chapter 1: Introduction:** This chapter provided a background of the researcher's study, and outlined the motivation of the study, the central research question and aims of the study, the research methodology, the significance of the study, and finally provided an organization of chapters in the dissertation.

**Chapter 2: Islamic Banking – theories and practices:** This chapter provided an overview of Islamic banking, followed by a discussion of the Islamic law (*Shari'ah*) which is the foundation for Islamic Banking Laws and Regulation. The

principles of *Shari'ah* in the Islamic banking system are expounded, followed by a discussion of *Shari'ah* Supervisory Boards and the role they play in Islamic banking. Finally, criticisms leveled against current Islamic banks are examined.

**Chapter 3: Social reporting:** This chapter examined the various theories of social reporting expounded in the literature to explain why firms disclose social information. This was followed by a discussion of an Islamic perspective on social reporting. Methods used in the literature to measure ideal levels of social disclosure were then discussed from a conventional as well as an Islamic perspective, and finally the Haniffa and Hudaib (2007) study is discussed in great detail as it served as a useful guide for the researcher's study.

**Chapter 4: Research Methodology:** This chapter described the research methodology used in answering the central research question. A discussion of the research method utilized for this study which was content analysis was first described followed by the process of sample selection. A discussion on how the original ideal ethical identity index (EII) benchmark developed by Haniffa and Hudaib (2007) was modified and adopted for the researcher's study followed, and then, the data collection and analyses procedures for the study were expounded.

**Chapter 5: Findings and Discussion:** This chapter provided the findings of the results of the researcher's study, and discussed the implications and significance of these results.

**Chapter 6: Conclusion:** The chapter provided general conclusions of the researcher's study, and presented some limitations of the study as well. Suggestions for future research were also made in this final chapter.

## CHAPTER TWO

### ISLAMIC BANKING, THEORIES AND PRACTICES

#### INTRODUCTION

Islamic banking refers to a system of banking activity that is in conformance with the Islamic law (*Sharī'ah*) in all aspects. “Among other things, *Sharī'ah* prohibits dealing in interest and undertaking transactions with unknown fate, while it requires transactions to be lawful (*halal*), and also requires Muslims to pay the religious [levy] *Zakāt*. Abolishing interest from their dealings is the fundamental principle on which Islamic banks are based” (Maali et.al, 2003: 3). This chapter examined the concept of Islamic banking. First off, an overview of Islamic banking was provided, followed by a discussion of the Islamic law (*Sharī'ah*) which is the foundation for Islamic Banking Laws and Regulation. The principles of *Sharī'ah* in the Islamic banking system were then expounded, followed by a discussion of *Sharī'ah* Supervisory Boards and the role they play in Islamic banking. Criticisms leveled against current Islamic banks are examined, and the chapter concluded with a summary.

#### AN OVERVIEW OF ISLAMIC BANKING

In this section, a brief history and development of Islamic banking was provided, followed by a discussion on the objectives and philosophy of Islamic banking. The sources and uses of funds for Islamic banks were then discussed to end this section.