



VOLUNTARY FINANCIAL AND NON-FINANCIAL
DISCLOSURE ON ZAKAT IN THE FINANCIAL REPORTS
OF ISLAMIC BANKS IN MALAYSIA

BY

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ABSTRACT

The objective of the study is to analyse the Islamic banks voluntary disclosure practices on *zakat*. The study examines the relationship between the extent of zakat disclosures and specific characteristics (i.e. amount of zakat, size of the bank, and profitability) of Islamic banks. The study used a zakat disclosure checklist based on AAOIFI FAS 9 and MASB TRi-1, which consist of 5 items of Disclosure Index (DI) and 5 items of Disclosure Length (DL) to measure the extent of zakat disclosure. The data were collected from the 2007 to 2011 of annual reports from the 17 Islamic banks in Malaysia. The main statistical tests conducted were descriptive statistics, correlation and regression analysis. From the findings, Affin Islamic Bank and Kuwait Finance House have sustained good zakat disclosure practices for both DI and DL. This might be due to these banks are among the long-established banks as compared to the others. Generally, the results show that there is still lack of reporting on zakat by the Islamic banks especially on non-financial disclosure in DL. The finding indicates that zakat financial disclosures seem to disclose more than zakat non-financial disclosures. This might be due to there is no specific standard that required them to disclose in detail on the information. Therefore the number of words counted would be less. The results revealed that a zakat amount has the highest correlation coefficient to the Disclosure Length. For the regression analysis, zakat amount has showed positive significant relationship to zakat disclosure. Thus, the hypothesis was accepted. However, total asset has showed positive relationship but not significant either for DI or DL. Thus, hypothesis 2 was rejected. Finally, return on equity has negative relationship to the extent of disclosure and not significant either for DI or DL. Therefore, hypothesis 3 was also rejected.

خلاصة البحث

والهدف من هذه الدراسة هو تحليل ممارسات المصارف الإسلامية الإفصاح الطوعي على الزكاة. وتبحث الدراسة العلاقة بين مدى الكشف عن الزكاة وخصائص محددة (أي مبلغ الزكاة، وحجم البنك، والربحية) للمصارف الإسلامية. استخدمت الدراسة قائمة على أساس الكشف الزكاة FAS AAOIFI 9 و MASB تري-1، والتي تتكون من 5 عناصر من مؤشر الإفشاء (DI) و 5 عناصر من كلمات الإفصاح (DL) لقياس مدى الكشف الزكاة. تم جمع البيانات من 2007 حتى 2011 من التقارير السنوية من المصارف ال 16 الإسلامية في ماليزيا. وكانت التجارب التي أجريت الإحصائية الرئيسية الإحصاء الوصفي، والارتباط وتحليل الانحدار. من نتائج، وقد أصيب Affin البنك الإسلامي وبيت التمويل الكويتي الممارسات الجيدة في كل من الزكاة الكشف DI و DL. وهذا قد يكون لهذه البنوك هي من بين البنوك الراسخة بالمقارنة مع الآخرين. عموما، فقد بينت النتائج أنه لا يزال هناك نقص في الإبلاغ عن الزكاة من قبل البنوك الإسلامية وخاصة على غير المالية الإفصاح في DL. هذا الاكتشاف يشير إلى أن الإفصاحات المالية الزكاة ويبدو أن الكشف عن أكثر من الإفصاحات غير المالية الزكاة. وهذا قد يكون راجعا إلى عدم وجود معيار محدد هو مطلوب منهم الكشف بالتفصيل على هذه المعلومات. ولذلك فإن عدد الكلمات عد تكون أقل من ذلك. كشفت النتائج أن كمية الزكاة لديه معامل ارتباط أعلى إلى كلمات الإفصاح. لتحليل الانحدار والزكاة مبلغ أظهرت علاقة ذات دلالة إيجابية الزكاة الكشف. وهكذا، تم قبول الفرضية. ومع ذلك، فقد أظهرت بلغ مجموع الموجودات علاقة إيجابية ولكن ليس كبيرا سواء ل DI أو DL. وهكذا، تم رفض فرضية². وأخيرا، العائد على حقوق المساهمين وعلاقة سلبية الى حد كبير وليس الكشف عن إما DI أو DL. لذلك، كما رفض فرضية³.

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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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 degrees at IIUM or other institutions.

Salehah Zafirah binti Zulkepli

Signature.....

Date.....

INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA

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**VOLUNTARY FINANCIAL AND NON-FINANCIAL DISCLOSURE ON
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LIST OF ABBREVIATIONS

AAOIFI	Accounting, Auditing of Islamic Financial Institutions
BNM	Bank Negara Malaysia
DI	Disclosure Index
DL	Disclosure Length
FAS	Financial Accounting Standard
GP8- <i>i</i>	Guidelines on the Specimen Financial Statements for Licensed Islamic Banks
IFIs	Islamic Financial Institutions
IFRS	International Financial Reporting Standard
MASB	Malaysian Accounting Standard Board
TR <i>i</i> -1	Technical Release <i>i</i> -1
ROE	Return on Equity
SIRC	State Islamic Religious Council
SSB	Shariah Supervisory Board
ZAS	Zakat Accounting Standard

CHAPTER 1

INTRODUCTION

1.0 BACKGROUND OF THE STUDY

One of the distinctive features of Islamic banks is the payment of *zakat*. *Zakat* is one of the five pillars of Islam and is obligatory upon every entity if preconditions are fulfilled. Islamic banks as a business entities possess and create wealth for the economy, thus it is obliged to pay *zakat*. Obligations to pay *zakat* should be charged directly to the shareholders and depositors. The shareholders and depositors, however, could authorise the Islamic banks to do so on their behalf. The Islamic *Fiqh* Academy recognised *zakat* due to be paid by the Islamic banks as a corporate entity (Nur Barizah and Abdul Rahim, 2007).

Currently, there are no specific accounting standards for the *zakat* used by the Islamic banks in Malaysia. However, Islamic banks have referred to AAOIFI FAS 9 (Financial Accounting Standard for *Zakat*) and the MASB Technical Release *i-1*, as a guideline to the *zakat* matters. Assuming AAOIFI FAS 9 and MASB TR *i-1* are the valid guidelines applied by the Islamic banks, nonetheless, there are certain requirements of *zakat* that have not been fulfilled by banks.

Due to the absence of a standard, the practices vary from one bank to another in terms of recognition, measurement, presentation and disclosures of *zakat* in the financial statements of the Islamic banks. As a consequence, there is lack of comparability, consistency and compliance of the *zakat* treatments by the Islamic banks. This is supported by Hajj Abdalhaqq Bewley in his book “*Zakat: The Fallen Pillar of Islam*” as cited in *The Halal Journal* (2006):

“...the truth is that the obligation of *Zakat*, as it has always been

understood by the Muslims, is not being correctly discharged anywhere.

In an Islamic context, the main objective of Islamic entities is to show their accountability first and foremost to Allah Almighty (Haniffa and Hudaib, 2004). Therefore, the compliance to the *zakat* should be considered vital in order to help the Islamic banks to properly recognise measures and disclose the relevant information relating to *zakat* in their financial reports. One of the avenues to demonstrate the accountability and commitments in serving the needs of the Muslim community and society is via disclosure of relevant and reliable information in their annual reports. (Haniffa and Hudaib, 2004).

Based on the principle of full disclosure, the Islamic banks should disclose both quantitative and qualitative information in the financial statements. In the case of Islamic banks, they should fully disclose the treatments of *zakat* properly and truthfully to their users. The full disclosure would assist users in their reports when making economy- religious decisions while demonstrating their accountability to *Allah* and society in general. Therefore, there is a need for an accounting standard for *zakat* that would help to improve the quality of disclosure on *zakat* information in the financial statements of the Islamic banks and business entities (Abdul Rahim, 2010).

1.1 PROBLEM STATEMENT

Currently, there is a lack of financial and non-financial disclosures on *zakat* information in the financial report of the Islamic financial institutions. Most of the institutions and business entities in Malaysia including Islamic banks only disclosed the *zakat* amount paid for the year with some general clarification stating the *zakat* that had been paid by the institutions involved (Abdul Rahim, 2007). Abdul Rahim

(2007) argued that the users of *zakat* information have been denied of the right to know information which includes the method of *zakat* measurements adopted, where the *zakat* money had been distributed, and so on and so forth. However, if there is a lack of disclosure, it will deny the true rights of the stakeholders. As a result, it will cause lack of information to be revealed to the users.

Besides, this departs from the concept of Islamic accountability. The concept of Islamic accountability in Islam is also related to the principle of full disclosure. The implications of Islamic accountability on accounting is that the management and providers of capital need to be accountable for their actions (or in-action) both within and outside the firm by providing proper accounting and reporting in the financial statements (Abdul Rahim, 2007). Thus, in addition to the current disclosure, the Islamic financial institutions and business entities should at least disclose the methods and items included the calculation of the *zakat* base in the notes of financial statements, the ruling of the Shariah Supervisory board on matters pertaining to *zakat*, and its responsibility towards the payment of *zakat* on behalf of its depositors, shareholders and others involved. The information is important especially for State Islamic Religious Council (SIRC) (to know how the companies measure *zakat* and where it was distributed); the inland board revenue (whom need to be informed on *zakat* liability and corporate tax rebate); Muslim shareholders and investors (who need to be informed of their *zakat* obligations) and the public as a whole (Abdul Rahim, 2007).

Moreover, users of Islamic financial institutions' financial statements (shareholders, potential investors, *zakat* beneficiaries, *zakat* payers, creditors, management, employees, customers, government and community) call for more information than what is normally required by conventional accounting standards

because it has a religious obligation and more social responsibility towards the society. For example, *zakat* is claimed to influence the disclosure level of an Islamic banks. This is supported by Maali (2006) who suggested that banks which required the payment of *zakat* should provide more social disclosures than non-*zakat* paying banks. This is because *zakat*-paying banks have their own *zakat* beneficiaries who are the stakeholders of the banks. They are more likely to expect the *zakat* information provided by the banks. Thus, Islamic banks should disclose more on the social information especially relating to *zakat* as it is one of the essences of Islamic bank's social responsibility. The social roles are very important for Islamic banks in order to be accountable to the society and ultimately accountable to God (Maali, 2006). Thus, the concept of social accountability in Islam can be achieved through full disclosure.

In light of the above matters, the study attempts to gain insight on the *zakat* disclosures in recognition, measurements and reporting in each of the Islamic banks in Malaysia. *Zakat* information is deemed important for Islamic banks to disclose in their annual reports since *zakat* is an obligatory to any Islamic business entities (i.e Islamic banks) and the true measurements should be given consideration as it is part and parcel of our accountability.

Hence, the paper attempts to analyse the Islamic banks voluntary disclosure practices (financial and non-financial) on *zakat* disclosures in the financial statements of Islamic banks as recommended by the AAOIFI FAS 9 and MASB TRi-1 (Accounting for zakat on business) in order to ensure the attention is given on the need for proper disclosure on each *zakat* accounting recognition, measurements and reporting, as recommended by the AAOIFI FAS 9 and MASB TRi-1 (Accounting for *zakat* on business). Besides, the paper also aims to examine the relationship between the extent of *zakat* disclosures and specific characteristics of Islamic banks. It is hoped

that this research will be able to provide recommendations to improve the quality of disclosures on *zakat* information in the financial statements of Islamic banks.

1.2 ZAKAT ACCOUNTING RECOGNITION, MEASUREMENT AND REPORTING

According to definition in Statement of Financial Accounting No. 2 (SFA 2), accounting recognition refers to recording the basic elements of the financial statements. This concept defines the basic principles that determine the timing of revenue, expense, gain, loss, assets and liabilities recognition in the bank's income statements (SFA 2, Para 81).

In the recognition concept it explains when is the right time to recognise the specific accounting treatments as it is related to a certain period. On the other hand, the accounting measurement concept defines the broad principles that determine the amount or amounts at which those elements are recognised (SFA 2, Para 82). The measurement concept explains on the right amount that should be measured in the income statement. Lastly, disclosure or reporting means the financial statements should contain all material information necessary to be of ready use for users in their decision-making. The information disclosure is included whether in the financial statements, the notes accompanying them or in additional presentations (SFA 2, Para 30). Furthermore, greater transparency and corporate disclosure keep the stakeholders better informed about the way a bank is being managed and governed. Due to the issues highlighted above, the current study is going to focus on several objectives.

1.3 OBJECTIVES OF THE STUDY

The main aim of this study is to analyse the extent of voluntary disclosure practices on *zakat* disclosures in the financial statements of Islamic banks in Malaysia. Besides that, the study also attempts to examine the relationship between the extent of *zakat* disclosures and specific characteristics of Islamic banks. Therefore, this research seeks to fulfil the following objectives:

- RO1** To analyse the Islamic banks voluntary disclosure practices on *zakat* disclosures in the financial statements as recommended by the AAOIFI FAS 9 and MASB TR*i*-1 (Accounting for *zakat* on business).
- RO2** To examine the relationship between the extent of *zakat* disclosures and specific characteristics of Islamic banks.

The above objectives derive the following questions, which are as follows:

- RQ1** To what extent do Islamic banks provide disclosures on *zakat* recognition in their annual reports?
- RQ2** To what extent do Islamic banks provide disclosures on *zakat* measurements in their annual reports?
- RQ3** To what extent do Islamic banks provide disclosures on *zakat* reporting in their annual reports?
- RQ4** What is the relationship between amount of *zakat* and the extent of *zakat* disclosure?
- RQ5** What is the relationship between size of the bank and the extent of *zakat* disclosure?
- RQ6** What is the relationship between profitability and the extent of *zakat* disclosure?

1.4 MOTIVATIONS OF THE STUDY

First and foremost, this study is motivated from a study conducted by Muhammad Akhyar and Nur Barizah (2009) entitled “Accounting treatment for Corporate Zakat: A critical review”, and a study by Abdul Rahim (2007) on the “Pre-requisites for effective integration of *zakat* into mainstream Islamic Financial system in Malaysia”. Based on analysis of these studies, the researcher found that the importance of proper *zakat* accounting practices is due to an absence of *Zakat* Accounting Standard (ZAS) in Malaysia. Hence, the researcher felt motivated to carry out further study on it, specifically with regards to *zakat* disclosures in recognition, measurements and reporting that was being practiced by the Islamic banks in Malaysia.

Moreover, social reporting is considered an important element in the Islamic banks disclosure because it is in accordance with the objectives of the Islamic banking which is to serve the public *maslahah*. One of the ways for Islamic banks to serve their social responsibility is through adequate, reliable and relevant social reporting information to the users in the financial statements. It has stated in Para. 1 of Statements of Financial Accounting No.1 (AAOIFI, 2010):

The emergence of Islamic banks and financial institutions as relatively new organizations and the great challenge they face to successfully serve the societies in which they operate, have led them, together with specialists in Islamic *Shariah* and in accounting, to seek the most appropriate means through which accounting standards could be developed and implemented in order to present adequate, reliable, and relevant information to users of the financial statements of such organisations.

One of the most important social reporting in Islam is to maintain its accountability through *zakat* (Maali, 2006). Proper *zakat* disclosures on recognition, measurements and reporting of *zakat*, would help the stakeholders to be informed about their rights and obligations on *zakat*. Besides, proper and fair accounting

treatment and assessment of a corporate *zakat*, would ensure the institutions can rightly fulfil their *zakat* obligations as well as to have positive and favourable *zakat* behaviour. Thus, this has motivated the researcher to conduct a study on the voluntary disclosure of *zakat*.

A part from that, the researcher felt motivated to provide recommendations on the issues of *zakat* practices that is still lacking in some aspects. This is to ensure for the long preservation of *zakat* obligations. Finally, the study seeks to extend the literature especially on Islamic area since the studies on voluntary disclosure in Islamic banking is still scarce. This is because the study of voluntary disclosure is usually considered of lesser importance than mandatory disclosure. Hence, studies on voluntary disclosure tend to receive lesser recognition in studies conducted. Besides that, the researcher has a deep interest to study in depth about the Islamic banking industry as nowadays it having a rapid growth.

1.5 SIGNIFICANCES OF THE STUDY

Despite of several studies that have been done on social reporting in Islamic banks, this study is another kind of social reporting by Islamic banks which is specifically focus on *zakat*. The study expects several contributions to the betterment of Islamic banking reporting in terms of *zakat* matters. Firstly, it is expected that this study will contribute towards a better disclosure on *zakat* in the recognition, measurements and reporting in the financial statements of the Islamic banks and reduce the differences which exist on the various methods used by Islamic banks. In addition, through this study it is hoped that it will further provide recommendations on the need for adequate disclosure information on *zakat* matters in financial statements for the Islamic banks. The study also hopes to contribute towards extending the literature on Islamic banking

disclosure especially a case from Malaysia. Since published research on voluntary disclosure by Islamic Banks is sparse.

1.6 ORGANIZATIONS OF THE CHAPTER

The thesis consists of six chapters. The structure of the thesis will be as follows:

Chapter 1: Introduction. The introductory part covers the issues and problem statement, objectives of the study, motivations of the study, significances of the study and the organization of the thesis.

Chapter 2: Literature Review. This chapter includes some of the prior literature that has been done in prior studies. The chapter discusses a brief introduction on the reporting and disclosure followed by a discussion on mandatory versus voluntary disclosure. Then, the chapter also discuss in details on several studies on voluntary disclosure theory and empirical findings. Secondly, the chapter discusses about financial reporting which regards to Islamic Banks, followed by the empirical findings on disclosure in Islamic banks. Lastly, the chapter discusses on the social reporting in Islamic banks and its empirical findings.

Chapter 3: *Zakat* Accounting for Islamic banks: A review of literature. This chapter covers content pertaining to *zakat* particularly in the Islamic banks. It covers the philosophy of *zakat*, background of *zakat* practices in Malaysia, *Zakat* Accounting for Islamic banks, and some prior studies on *Zakat* Accounting for Islamic banks with related to the topic of this study. At the end of the literature review process, this chapter will include some of the gaps from the prior studies.

Chapter 4: Research Methodology. This chapter covers research objectives and related research questions, sample selection, and data collection method. It discusses in details on the secondary data collection method. Finally, it discusses on the data analysis of the collected data. This chapter will discuss in detail how the research question of this study will be answered through the research method.

Chapter 5: Findings and Analysis. In this chapter, findings will be analyzed and interpreted. The results will be analyzed based on content analysis and statistical tests.

Chapter 6: Conclusions and Limitations. This chapter will conclude the whole thesis and some of the limitations of the study will be included. Beside concluding and providing the limitations of the study, this chapter will also discuss the implications of the study and provide some future research suggestions.

CHAPTER 2

A REVIEW OF LITERATURE

2.0 INTRODUCTION

This chapter provides an introduction on the reporting and disclosure followed by a discussion on mandatory versus voluntary disclosure. Then, the chapter also discuss in details on several studies on voluntary disclosure theory and empirical findings. Secondly, the chapter discusses about financial reporting which regards to Islamic Banks, followed by the empirical findings on disclosure in Islamic banks. Lastly, the chapter discusses on the social reporting in Islamic banks and its empirical findings. At the end of the literature review process, this chapter will include some of the gaps from the prior studies.

2.1 DISCLOSURE: MANDATORY VERSUS VOLUNTARY

Disclosure practices can be categorized into mandatory and voluntary disclosure. Mandatory disclosures are items that companies must disclose because of statutory regulations (Ousama and Fatima, 2010) therefore, it is the minimum level of information to be disclosed in the annual reports. While, voluntary disclosure can best be defined as any additional piece of information apart from what is required by any guidelines or standards (Skogsvik, 1998). According to Yuen et al (2009), voluntary disclosure is an extension of the disclosure of the basic information that annual reports must contain, reflecting the economic realities of an entity in a meaningful, transparent, and comparable manner. Voluntary disclosure acts as an option for the companies to reveal the extra information to the users. Even though voluntary disclosure is not compulsory but it is highly encouraged to disclose as to assure the

users that it is a good company.

In addition to the regulated financial report, some companies include voluntary communications such as management forecast, analyst's presentation and conference calls, press releases, internet and other corporate reports as well as voluntary disclosures such as financial analysts, industry experts and the financial press (Healy and Palepu, 2001). Some companies may choose to voluntarily disclose more information than what is required by the regulation for many reasons. While, there also have some of them refuse to voluntarily disclose due to certain factors. In its simplest form, the managers having an incentive to disclose voluntary disclosure decision if the benefits of disclosure exceed the related costs.

Basically, the major reasons for companies to voluntarily disclose the information are to enhance the transparency and credibility. It reveals more information either good news or bad news. Besides, it could lower the risk and uncertainty of the companies, as a consequence would attract more investment (Cooke, 1989). The voluntary disclosure also helps to attract new investors as well as maintain a demand in the company's shares and a stock price in the high level (Cooke, 1989). In addition, the voluntary disclosure could fit the additional information for the companies. Can accounting standards determine a definitive list of all important aspects to disclose in any particular industry? A one-size-fit all accounting standard approach will not work for all companies' disclosure demands.

Besides that, the other critical aspect of voluntary disclosure is to enhance corporate governance. It is proven in the one of Best Hong Kong Corporate Governance Disclosure award 2001; the winners are all successful companies that do make a lot of voluntary disclosures in their annual reports. Based on the above, voluntary disclosure portrays good transparency of the company, reduce information

asymmetry, attract more investors, and giving more credibility which could signal better corporate governance. Accordingly, this research will focus in details on voluntary disclosure since the competitive dynamics of the products and services markets play a restrictive role regarding the firms' voluntary disclosure policies (Adina and Ion, 2008).

2.2 VOLUNTARY DISCLOSURE

2.2.1 Theory

In this study, the study explores two theoretical perspectives to aid in the understanding of the managers' incentives to voluntarily disclose information, i.e (1) Accountability theory and (2) Stakeholder theory. Firstly, Accountability theory concerned with the relationships between groups, individuals, organizations and the rights to information that such relationships entail. Besides, accountability is the duty to provide an account of the actions for which one is held responsible (Grey et al, 1997). According to Zubairu (2011), accountability from the Western concept refers to the process through which an organization makes a commitment to balance the needs of stakeholders in its decision-making processes and activities, and delivers against this commitment. The concept of accountability only restricted to the human needs. However, from the Islamic viewpoint the concept of accountability is much broader and transcends the human needs. In Islam, accountability is first and foremost to Almighty Allah. As mentioned in the *Surah Al-Zalzalah*, verses 6-8 which means:

“On that Day will men proceed in companies sorted out, to be shown the deeds that they (had done). Then shall anyone who has done an atom's weight of good, see it! And anyone who has done an atom's weight of evil, shall see it”