



SHARI'AH DISCLOSURE PRACTICES IN MALAYSIAN  
ISLAMIC BANKS

BY

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## **ABSTRACT**

This study examined the level of compliance on Shari'ah disclosure in the Malaysian Islamic banks' annual reports. This study also determined the gap in perception between the Shari'ah practitioners and customers on the importance of Shari'ah disclosure. Shari'ah practitioners consist of Shari'ah committees and officers while customers were lecturers and final year Islamic accounting students. The study used the Institutional Theory and Theory of Reasoned Action (TRA) to develop the hypotheses. Two instruments were developed to collect data. The first instrument was the Shari'ah disclosure index checklist based on Bank Negara Malaysia guidelines and Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) standards for mandatory and voluntary disclosure items. Annual reports for 2016 of 16 Islamic banks were used to determine the level of Shari'ah disclosure. The second instrument was a questionnaire survey. A total of 64 and 200 questionnaires were distributed to the Shari'ah practitioners and customers, respectively. The response rate was 41% and 65% respectively. The results indicated that the highest level of mandatory Shari'ah disclosure among 16 Islamic banks was about 96.29%. Only one item was not disclosed by the bank. Moreover, some of these banks disclose the voluntary items. Further results show that, the Shari'ah practitioners and customers perceive all Shari'ah disclosure items are important to be disclosed. Particularly, the perception of Shari'ah practitioners on Shari'ah items is positively correlated with the level of disclosure. Another result shows that the customers perceive Shari'ah disclosure to be important due to the Shari'ah perception towards Islamic banks. Moreover, customers perceive that the mandatory Shari'ah disclosure items are more important than voluntary items. Finally, the result shows that there is some significant difference between both groups. However, the least gap between the selected customers and practitioners may be reasonable, as the group of customers are informed customers. The results provide useful insight to the regulators as well as Islamic banks itself on the importance of Shari'ah disclosure items from the customers' and Shari'ah practitioners' point of view.

## ملخص البحث

بحثت هذه الدراسة على مستوى الامتثال الإفصاح عن الشريعة في التقارير المالية السنوية للمصارف الإسلامية الماليزية. وأيضاً هذه الدراسة ركزت على تحديد الفجوة التصورية بين ممارسي الشريعة والذباثن. ويتألف الممارسون الشرعيون من اللجان الشرعية والمسؤولين بينما كان الذباثن يتألفون من المحاضرين في الجامعات وطلاب السنة الأخيرة الذين يدرسون المحاسبة الإسلامية. استخدمت الدراسة النظرية المؤسسية ونظرية الفعل المعقول (TRA) لتطوير فرضيات الدراسة، وبعد ذلك تم تطوير أداتين من الأدوات الخاصة لجمع البيانات. حيث تتمثل في مؤشر الإفصاح عن الشريعة على أساس مبادئ البنك المركزي الماليزي ومعايير المحاسبة والمراجعة للمؤسسات المالية الإسلامية (AAOIFI) لعناصر الإفصاح الإلزامية والطوعية. الأداة الأولى هي استخدام التقارير السنوية لعام 2016م لستة عشر مصرفاً إسلامياً لتحديد مستوى الإفصاح عن الشريعة. الأداة الثانية كانت استخدام الاستبيان. تم توزيع ما مجموعه 64 استبياناً و 200 استبيان على ممارسي الشريعة والذباثن على التوالي. كان معدل الاستجابة على الاستبان 41 ٪ و 65 ٪. أشارت النتائج إلى أن أعلى مستوى من الإفصاح الإلزامي للشريعة كان حوالي 97.26 ٪. لم يتم الإفصاح إلا عن بند واحد فقط من قبل البنك، وهو رسوم الغرامة (الغرامة). علاوة على ذلك، فإن بعض البنوك تفصح عن البنود الطوعية. وتظهر نتائج أخرى وبشكل عام يعتبر ممارسو الشريعة والذباثن أن جميع بنود الإفصاح عن الشريعة مهمة للكشف عنها. وبشكل خاص، يرتبط مفهوم إدراك ممارسي الشريعة حول بنود الشريعة بشكل إيجابي بمستوى إفصاحهم. وتظهر نتيجة أخرى أن الذباثن يرون أن الإفصاح عن الشريعة هو أمر مهم بسبب نظرة الشريعة تجاه البنوك الإسلامية. علاوة على ذلك، يرى الذباثن أن بنود الإفصاح الإلزامية عن الشريعة هي أكثر أهمية من البنود الطوعية. وأخيراً، تُظهر النتيجة وجود فرق كبير بين المجموعتين (مجموعة ممارسي الشريعة ومجموعة الذباثن). ومع ذلك، قد تكون الفجوة معقولة بين مجموعة ممارسي الشريعة ومجموعة الذباثن، نظراً لأن مجموعة الذباثن على علم بالذباثن. توفر النتائج نظرة مفيدة للهيئات التنظيمية والبنوك الإسلامية نفسها على أهمية بنود الإفصاح عن الشريعة من وجهة نظر الذباثن وممارسي الشريعة.

## 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 (Accounting).

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## DECLARATION

I here 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.

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## LIST OF ABBREVIATIONS

ARRs	Annual Report Recipients'
BNM	Bank Negara Malaysia
CGDI	Corporate Governance Disclosure Index
CSR	Corporate Social Responsibility
ERs	Environmental Reports
GCC	Gulf Cooperation Council
IFRS	International Financial Reporting Standards
IFSA	Islamic Financial Services Act
IIRs	Infrastructure Information Preparer'
IPSASB	International Public Sector Accounting Standard Board
MASB	Malaysian Accounting Standard Board
MFRS	Malaysian Financial Reporting Standards
NGOs	Non-governmental organizations
SG	Shari'ah Governance
SGF	Shari'ah Governance Framework
SSB	Shari'ah Supervisory Board

# CHAPTER ONE

## INTRODUCTION

### 1.1 BACKGROUND OF THE STUDY

Islamic banks are required to ensure their operations and activities comply with the Shari'ah. However, in some cases, it has been observed that Islamic banks are not complying with the Shari'ah due to the lack of rules and regulations on contemporary transactions (Ullah, 2014). Owing to this, the regulation is being strengthened through the introduction of guidelines on Shari'ah Governance Framework (SGF) by Bank Negara Malaysia (BNM) in 2011. The latest development on the regulation related to Shari'ah compliance was in 2013, where the Islamic Financial Services Act (IFSA) was introduced to licence and regulate Islamic banks. Generally, IFSA strengthen the SGF in regards to Shari'ah compliance of Islamic Financial Institutions (IFIs).

Compliance with the Shari'ah refers to all operations and contracts offered by the Islamic banks must comply with the Shari'ah. The Islamic banks must ensure that they are free from any form of interest (*riba*), uncertainty (*gharar*) and any activities that involve gambling (*maysir*), and also activities that cause harm to the society. In practice, these are the important factors considered by the stakeholders, especially Muslim customers in their decision to use Islamic financial products (Ashraf & Lahsasna, 2017). The Annual report is one of the ways Islamic banks use to communicate with their investors and customers that they are Shari'ah-compliance institutions. In addition, disclosure through annual reports enhances the credibility of Islamic banks' business operation as they are having ethical identity since the foundation of their business is closely tied to religion (Haniffa and Hudaib 2007).

Hence, Islamic banks possess greater social accountability towards stakeholders. Therefore, through disclosure, Islamic banks can increase customers' confidence and enhance Islamic banks' accountability and reputation, which then helps promoting Malaysia as an Islamic financial hub.

Bank Negara Malaysia (BNM), which is the regulator of financial institutions in Malaysia, has provided the guidelines on financial reporting for Islamic banks namely the "Financial Reporting for Islamic Banking Institutions". All disclosure items highlighted in the guidelines are mandatory to be disclosed by Islamic banks. Mandatory disclosure refers to the information that must be disclosed because of the laws and regulation. It is the minimum information that should be disclosed in annual reports (Cooke, 1992). Every item in the guidelines is considered useful to the users. This is because the objective of financial reporting as specified in the "Conceptual Framework for Financial Reporting" is to provide useful information to existing and potential investors, lenders, and other creditors in making decision (MASB, 2011). Therefore, Islamic banks should provide sufficient financial and non-financial information so that the customers can make an informed investment decision. However, there might be other information that Islamic banks consider useful to be disclosed, thus they choose to disclose it. This additional disclosure is known as the voluntary disclosure. Meek, Roberts, and Gray (1995) defined the voluntary disclosure as the "free choices on the part of company management to provide accounting and other information deemed relevant to the decision needs of users of their annual reports" (p. 555). Institutions of all industrial sectors have mandatory and voluntary disclosures. Thus, both conventional and Islamic banks also provide both types of disclosure in their annual reports.

However, problem arises when every customer has their own perceptions and expectations on what should be disclosed in relation to Shari'ah information. The Islamic banks usually disclose information that is required, according to BNM. However, there are other items that customers may look for in the Islamic banks' annual reports. Therefore, there is a possibility of expectation gap between the demand of customers and what Shari'ah practitioners' perceive would be useful for stakeholders on Shari'ah disclosure. The term used for the gap identified in this study is the Shari'ah disclosure expectation gap. This gap is defined as the difference between customers' and Shari'ah practitioners' expectations on Shari'ah disclosure. In this study, the customers are the lecturers and Islamic accounting students while the Shari'ah practitioners are the Shari'ah officers and committees.

## **1.2 PROBLEM STATEMENT**

The concept of Shari'ah compliance applies to all aspects of Muslims including economic or business dealings. To be Shari'ah compliant, Islamic banks must meet the criterion of economic and social justice. They should not engage in interest-based transactions, not participate in a transaction where there is exploitation of any party and not participate in activities which harm the society. Stakeholders expect that Islamic banks operate in line with the Shari'ah. Thus, stakeholders would want to be assured that Islamic banks are indeed Shari'ah compliant in all aspects of their activities. One means of communicating with stakeholders is through the annual report. Therefore, they would have interest in the Shari'ah related information from Islamic banks' annual reports. Shari'ah disclosure would strengthen the credibility of the products and services offered by the Islamic banks, and substantiate that they are indeed different from conventional banks. The BNM has developed the guidelines on



financial reporting for Islamic banking institutions. It is expected that the Islamic banks disclose all Shari'ah disclosure items highlighted in the guidelines because it is mandatory to be disclosed. However, as these guidelines are relatively new, the extent of disclosure based on these mandatory guidelines has not been examined. Failure to fully comply with these new reporting requirements from BNM could lead to non-compliance and they may be penalized by the regulators. In addition, the voluntary disclosure items, which are not in the list of mandatory disclosure, also need to be considered. For example, the item highlighted by Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), like the opening and closing balance of zakat funds. According to AAOIFI, it is mandatory to be disclosed. In Malaysia, since this item is voluntary, some of the Islamic banks might disclose it. Therefore, this study attempts to examine the level of compliance on Shari'ah disclosure in Islamic banks' annual reports which includes both mandatory and voluntary disclosure.

Shari'ah practitioners are aware about the Shari'ah reporting guidelines and their perception towards the mandatory items is likely to be influenced by these guidelines. However, their perception towards the voluntary items is also important but it has not been studied yet. Hence, this study is an effort to determine the perception of Shari'ah practitioners in relation to Shari'ah disclosure for both mandatory and voluntary items.

Customers can be divided into two groups which are those who are knowledgeable about the Shari'ah and reporting practices as well as the less knowledgeable one. The perception of these customers on the importance of disclosure practices could influence their perception on the Islamic banks itself. Particularly, when it comes to the issue of Shari'ah, Muslims are concerned about the

practices within the Islamic banks. Generally, they may expect Islamic banks to be more transparent. However, the contemporary perception on Shari'ah disclosure is unknown, unless information is gathered from them. Therefore, this study aimed to determine the perception of customers, specifically knowledgeable customers on the importance of Shari'ah disclosure.

Shari'ah practitioners and customers might have different perception on the importance of Shari'ah disclosure items, including the items highlighted in the guidelines. Hence, a perception gap is expected from both parties. This is because the perceptions of Shari'ah practitioners will most likely to be influenced by the guidelines because they are more knowledgeable in regards to the guidelines issued and they are directly involved with the Shari'ah reporting. However, customers might expect more in terms of Shari'ah disclosure. Customers may desire other items that are not listed in the guidelines. Hence, if the customers are not happy with the information provided by Islamic banks, they may decide to not using the Islamic banks' services, which later results in deposits withdrawal (Chapra & Ahmed, 2002). Thus, it is important to measure the perception gap between the Shari'ah practitioners and customers.

### **1.3 RESEARCH OBJECTIVES AND QUESTIONS**

The first objective of the study is to examine the level of compliance with Shari'ah disclosure in the Islamic banks' annual reports. Secondly, is to determine the perception of Shari'ah practitioners of Islamic banks on Shari'ah disclosure. Thirdly, is to determine the perception of customers of Islamic banks on Shari'ah disclosure and finally, is to measure the expectation gap between the Shari'ah practitioners and customers of Islamic banks on Shari'ah disclosure.

In line with the research objectives stated above, the research questions (RQ) are as follow:

RQ1: What is the level of compliance with Shari'ah disclosure in the Islamic banks' annual reports?

In order to answer this research question and examine the Shari'ah disclosure of Islamic banks, the 2016 annual reports of 16 Islamic banks in Malaysia were used.

RQ2: What is the perception of Shari'ah practitioners on Shari'ah disclosure?

The perception of Shari'ah practitioners were collected through the questionnaire. The questionnaire was distributed to Shari'ah officers and Shari'ah committee members as they are the practitioners in Islamic banks.

RQ3: What is the perception of customers on Shari'ah disclosure?

Questionnaires were also used to gather data on the perception of customers, who are lecturers and Islamic accounting students, as they are deemed to be knowledgeable about the Shari'ah disclosure.

RQ4: Is there any expectation gap between the Shari'ah practitioners and customers on Shari'ah disclosure?

The perception gap between the Shari'ah practitioners and customers are examined and analysed using the independent sample *t*-test to determine any significant difference of perceptions among the two groups.

#### **1.4 MOTIVATION OF THE STUDY**

Shari'ah compliance is the very core of an Islamic bank. A bank is only 'Islamic' if it complies to the Shariah. Any act of Shari'ah non-compliance in their operations and transaction would cause damage to the Islamic bank as it is exposed to Shari'ah non-

compliance risk. Shari'ah non-compliance risk refers to possible failures to meet the obligation to Shari'ah principles (SGF, 2011). Failure to comply with Shari'ah will expose the Islamic bank to reputational risks which include failure to provide transparency and full disclosure (SGF, 2011). Frequent occurrences of Shari'ah non-compliance by Islamic banks would lead to the loss in credibility of the whole Islamic banking system. Therefore, adequate disclosure on the Shari'ah compliance of Islamic banks is vital. In 2016, BNM introduced the revised version of financial reporting guidelines for Islamic banking institutions. This motivates the study to determine the level of compliance on Shari'ah disclosure in the latest annual reports of Islamic banks. Because of the detailed guidelines provided by BNM, the study intends to investigate the impact of the revised guideline on the level of Shari'ah disclosure among Islamic banks in Malaysia. It is expected that the level of compliance on Shari'ah disclosure among Islamic banks is high in order to discharge their accountability to stakeholders so that they could sustain in the industry.

In addition, Shari'ah practitioners are the one who involved in Shari'ah reporting. They have to follow the guidelines of Shari'ah reporting issued by the regulator. However, there might be a difference in the perceptions towards the importance of Shari'ah disclosure among them, particularly on the voluntary items. Based on the Shari'ah practitioners' actual practical experience, they may perceive some of the mandatory items required by BNM to be less important, whereas, some of the voluntary items may be deemed important. Thus, this study is motivationally driven to determine the perception of Shari'ah practitioners in this regard.

This study was also motivated by the results found by Chapra and Ahmed (2002) which was most of the customer withdraws their deposits due to non-Shari'ah compliance. If Islamic banks are more transparent in its Shari'ah compliance

reporting, this would increase the confidence level of customers towards Islamic banks. Therefore, this study is motivated to determine the expectation of customers towards Islamic banks in terms of Shari'ah compliance reporting. Hence, this study will give input to Islamic banks on items to be disclosed which will increase the level of trust or confidence of the public.

With the different level of knowledge on the guidelines and experience between Shari'ah practitioners and customers on Shari'ah reporting, this study motivates to find the perception gap between both parties on the importance of Shari'ah disclosure.

### **1.5 SIGNIFICANCE OF THE STUDY**

The findings of the study might be useful to the regulator, specifically the BNM. This is because the issue of non-compliance can be detected through the findings of incomplete disclosure of all mandatory items. Hence, the regulator could strengthen the regulation and take a necessary action to non-complying Islamic Banks. In addition, the regulators may want to know if there is any difference in terms of Shari'ah practitioners' perception towards the guidelines. Therefore, the findings of the study provide the feedback to BNM on the perception of practitioners, as their perception could affect the reporting.

The findings of this study are also significant to the Islamic banks itself. Generally, this study addresses the perceptions of customers in terms of Shari'ah disclosure. However, instead of gathering the perception of all customers, this study first focuses on the knowledgeable customers. Hence, these customers are able to provide informed insight on Shari'ah disclosure. Therefore, these findings might be

helpful for Islamic banks to improve their Shari'ah reporting which at the end, they could retain the customers from withdrawing their deposits from the banks.

It is important to find out the gap between the practitioners and customers because if the customers have similar perceptions as the practitioners, generally the Islamic banks would be reporting the disclosures that are deemed important by the customers. However, if there is any gap, the Islamic banks would have to consider whether it is worthwhile to disclose items perceived as important by the customers in addition to those required by regulation.

Lastly, this study will contribute knowledge to the existing literature. There is no prior study that determines the perceptions of customers on the Shari'ah disclosure. Generally, the previous studies focused on the level of Shari'ah disclosure in annual reports of Islamic banks. This study examines the actual Shari'ah disclosure based on the guidelines from the Financial Reporting for Islamic Banking Institutions. This study also measures the Shari'ah disclosure expectation gap between the Shari'ah practitioners and customers. Thus, the findings could be the interest for future researchers.

## **1.6 STRUCTURE OF THE DISSERTATION**

Chapter 1 is the introduction to the thesis. It provides the background of the study and problem statement. It also elaborates the motivation and significance of the study. Chapter 2 contains the review of literature. It provides an overview of Islamic banking and the review of literature related to Shari'ah compliance in Islamic banks, reporting and disclosure practices in Islamic banks, perception of customers towards Islamic banks and expectation gap. Lastly, the chapter addresses the gap in the literature.

Chapter 3 focuses on the theoretical framework, hypotheses development and research method. The Institutional Theory and Theory of Reasoned Action (TRA) were used to explain and develop the relevant hypotheses. This chapter proposes five hypotheses to be tested. The methods include the method used to collect data, questionnaire design and distribution, and sample selection. This chapter also explains the statistical techniques used in order to analyse data collected in this study. This study used Shari'ah disclosure index formula in order to determine the compliance level of Shari'ah disclosure among Islamic banks. Besides, the main measure used in this study is the mean. It indicates the average perception of Shari'ah practitioners and customers in relation to Shari'ah disclosure. Then, the independent sample *t*-test is used to test the difference between both perceptions.

Chapter 4 is the chapter of findings and analysis. It presents the results of statistical tests for each study objectives and discusses the findings. Finally, the Chapter 5 concludes the study. This chapter summarises the main findings, highlights the limitations of the study, and makes suggestions for future research.

## **1.7 CHAPTER SUMMARY**

This chapter provides background and overview of this study, including the research objectives and questions, motivation, and significance of the study. The next chapter is the chapter of literature review.

## **CHAPTER TWO**

### **OVERVIEW OF ISLAMIC BANKING AND LITERATURE REVIEW**

#### **2.1 INTRODUCTION**

The current chapter reviews the literature in relation to disclosure in Islamic banking as well as expectation gap studies. Before moving into the literature review section, a brief background on Islamic banks is provided. This background includes the history and concept of Islamic banks, governance structure of Islamic banks and source of authority. Then, this chapter reviews prior studies in relation to Shari'ah compliance and Shari'ah Supervisory Board (SSB) and reporting and disclosure practices among Islamic banks. This will be followed by a section on the expectation gap and the last section will address the gap in the literature.

#### **2.2 OVERVIEW OF ISLAMIC BANKING**

##### **2.2.1 History and Concepts of Islamic Banking**

Although other forms of Islamic banking existed during the Islamic civilisation, the revival of Islamic banks only emerged in the early 1970s. The first establishment of commercial Islamic bank was the Dubai Islamic Bank (DIB) in 1975, which is located in the United Arab Emirates (Iqbal & Molyneux, 2006). Then, it was followed by the establishment of a few commercial Islamic banks in Egypt, Kuwait, and Bahrain (Iqbal & Molyneux, 2006).

Since then, the Islamic banking industry grew rapidly, from a mere few hundred thousand dollars in 1975 to reach hundred billions of dollars by 2005 (Iqbal & Molyneux, 2006). This indicates that Islamic banks will continue to expand and