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**THE PERCEIVED IMPORTANCE AND FACTORS  
INFLUENCING DISCLOSURE IN THE  
FINANCIAL REPORTS OF COMMERCIAL  
BANKS IN MALAYSIA**

**BY**

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**A dissertation submitted in partial fulfilment of the  
requirement for the degree of Master of Science in  
Accounting**

**Kulliyyah of Economics and Management Sciences  
International Islamic University  
Malaysia**

**APRIL 2006**

## ABSTRACT

There are relatively few studies conducted to examine the extent of disclosure practices in the annual financial reports of banking institutions. Besides, there is very minimal research observing professional opinion of the regulators and the practitioners on the importance and the usefulness of the disclosure items that were required to be disclosed in the annual financial report. Hence, three underlying objectives were determined in this study. First, the research will examine the perceptions of regulators and rating agencies of the importance of the disclosure items as disclosed in the financial reports of the Malaysian Islamic banking institutions and the conventional banks that provide Islamic banking products and services. The second objective is to examine the banks' disclosure practices as required by the presentation of the disclosure requirements and guidelines issued by the Central Bank of Malaysia and applicable approved accounting standards such as AAOIFI and MASB *i* – 1. The third research objective then is to examine the factors influencing the disclosure practices in the Islamic banking institutions and conventional banks that offer the Islamic products and services. The research examines the regulators' and the rating agencies' perceptions of the importance of the disclosure items and subsequently assign the weight to the disclosure index items. The sample banks annual reports were scrutinized and were rated based on the weighted disclosure index result. Secondly, the research also examines the banks' disclosure practices as required by the presentation of the disclosure requirements and guidelines issued by Central Bank of Malaysia and applicable approved accounting standards such as AAOIFI and MASB *i* – 1. The research then examines the relationship of firm-specific characteristics which are size, profitability, liquidity, composition of non-executive directors sitting in the board of directors and board of directors' size on the extent of disclosure practices. The study shows that the respondents perceived all disclosure items in the index developed as important at 2.451 mean score out of 3.000 maximum score. However, lower scores were recorded for the disclosure on the Islamic related information. The finding also shows that large conventional banks such as Public Bank are leading in terms of the disclosure in the compared to the small banks including Islamic banks in the four consecutive years (2000 – 2003). Finally, all independent variables which are size, profitability, liquidity, composition of non-executive directors and board size show a positive relationship on the extent of disclosure. However, the finding indicates that only size and the higher composition of non-executive directors positively and significantly influence the disclosure level.

## ملخص البحث

تُعَدُّ الدراسات التي أُجريت لفحص التقارير المالية السنوية للمؤسسات المصرفية ضئيلة نسبياً. فضلاً عن أن هنالك محدودية في البحوث التي تفحص الآراء المهنية المرتبطة بأهمية وفائدة بعض البنود المطلوب توضيحها في التقرير المالي السنوي والمتعلقة بمنظمي ومزاوي المهنة. لهذا السبب وضعت هذه الدراسة ثلاثة أهداف محددة، أولاً: ستفحص الدراسة ملاحظات المنظمين والوكالات التجارية لأهمية توضيح البنود كما هو موضح في التقارير المالية للمصارف الإسلامية الماليزية، والمصارف التجارية التي تقدم خدمات ومنتجات مصرفية إسلامية. أما الهدف الثاني فهو فحص نشاطات المصارف البيانية المتطلبة، وذلك بعرض المتطلبات والإرشادات الصادرة من المصرف المركزي الماليزي، وحساب معياري معتمد قابل للتطبيق مثل: MASBi-1 و AAOIFI. والهدف الثالث هو فحص العوامل المؤثرة في النشاطات البيانية للمصارف والمؤسسات الإسلامية، والمؤسسات المصرفية التقليدية التي تقدم منتجات، وخدمات إسلامية. وتفحص الدراسة المنظمات والمؤسسات التجارية لقياس ملاحظاتهم عن أهمية البيانات أو البنود الموضحة، ومن ثم تحديد الوزن للائحة البيانية. وتقارير المصارف العينية الثانوية تم فحصها وتقييمها وفقاً لوزن اللائحة البيانية، وتفحص الدراسة أيضاً نشاطات المصارف البيانية كما هو متطلب في عرض البيانات والإرشادات الصادرة من المصرف المركزي الماليزي، وحساب معياري معتمد قابل للتطبيق، مثل: MASBi-1 و AAOIFI ثم عمدت الدراسة إلى فحص علاقة الشركة بصفة خاصة الحجم، والفائدة، والسيولة، والمجموعة المتضمنة لغير الإداريين التنفيذيين في مجلس الإداريين، وحجم مجلس الإداريين وفقاً للنشاطات. وبيّنت الدراسة أن المستجيبين، أدركوا أهمية البنود البيانية الموجودة في اللائحة بنسبة ٢,٤٥١ من المجموع الكلي، وهو ٣,٠٠٠. على كل حال سُجّلت درجات كثيرة للبيانات المتعلقة بالمصارف الإسلامية، وتشير النتائج أيضاً إلى أن المصارف التقليدية الكبرى مثل المصرف العام. Public Bank هو الرائد في البيانات التوضيحية مقارنة بالمصارف الصغرى بما فيها المصارف الإسلامية في السنوات ٢٠٠٠-٢٠٠٣ م. وأخيراً العناصر المستقلة الحجم، والفائدة، والسيولة، والمجموعة المتضمنة لغير الإداريين التنفيذيين، فإنها تؤثر إيجاباً، وبوضوح على مستوى البيانات التوضيحية.

## **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 the IIUM or other institutions.

**FARAHYAH BINTI BADRI**

Signature : \_\_\_\_\_

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DISCLOSURE IN THE FINANCIAL REPORTS COMMERCIAL BANKS  
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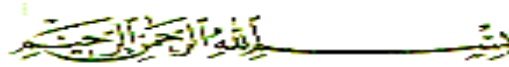
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# ACKNOWLEDGEMENTS



## **In the Name of Allah, Most Gracious, Most Merciful**

Praise be to Allah SWT the Most Gracious and the Most Merciful, who gave me the strength and blessings to complete this thesis. Peace and blessings be upon Prophet Muhammad SAW (peace be upon him) the prophet and the ideal role model for human beings.

First and foremost, I would like to thank my supervisor, Assoc. Prof. Dr. Abdul Rahim Abdul Rahman, to whom I am greatly indebted for his inspiring guidance and advice throughout the completion of this thesis. I could only pray that the best rewards may come from Almighty Allah SWT.

Special thanks to Dr Hafiz Majdi Abdul Rashid for his assistance in the statistical analyses which are the critical part of the research as well as for his valuable comments given to improve this research. My everlasting thanks are also due to all the lecturers of the IIUM, especially my undergraduate and postgraduate lecturers for sharing their knowledge and valuable thoughts. Not forgetting all my family members and friends, for their concern and support as well as their willingness to just listen.

Finally, my utmost and heartfelt appreciation goes to my beloved parents, Badri Abdul Hamid and Faezah Ismail Mukhtar for their endless love and prayers, and also for their support and continuous encouragement throughout my study. With love, I dedicate this thesis to them.

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## LIST OF ABBREVIATIONS

|               |   |
|---------------|---|
| AAOIFI        | Accounting, Auditing and Governance Standards for Islamic Financial Institutions    |
| ABMB          | Alliance Bank Malaysia Berhad   |
| BAFIA         | Banking and Financial Institutions Act  |
| BMMB          | Bank Muamalat Malaysia Berhad   |
| BNM           | Bank Negara Malaysia  |
| BOD           | Board of Directors  |
| CR            | Current Ratio   |
| GP8           | Guidelines on the Specimen Financial Statements for Licensed Financial Institutions |
| GP8- <i>i</i> | Guidelines on the Specimen Financial Statements for Licensed Islamic Banks          |
| EBB           | EON Bank Berhad   |
| IAS           | International Accounting Standard   |
| IBS           | Interest Free Banking Scheme  |
| LUTH          | Lembaga Urusan dan Tabung Haji  |
| MASB          | Malaysian Accounting Standard Board   |
| MASB <i>i</i> | Malaysian Accounting Standard Board for Islamic Accounting Standard                 |
| RAM           | Rating Agency Malaysia  |
| ROA           | Return on Assets  |
| ROE           | Return on Equity  |

# **CHAPTER 1**

## **INTRODUCTION**

The issue of the extent of disclosure in corporate financial reporting has been the focus of the concerned public especially regulators, practitioners and investors. Subsequent to the emerging demand for this information, a number of studies have examined the firms' disclosure practices in the annual financial report. There are also other factors that have motivated past studies in this area. Firstly, the extent of disclosure practices might be due to the pressures from the investors who request more reliable information for their informed judgment on the firm's performance. Secondly, recent accounting scandals which have renewed attention on the firm's corporate governance and financial transparency. For instance, the massive collapse of Enron in the year 2001 created major fears on the part of investors that there were more companies with similar weaknesses and which were potential Enron. Thousands of people had been affected by the collapse of this giant company. The fall of Barings Bank in 1995 had highlighted that corruption and fraudulent activities could take place even in highly regulated industries. The investors were unaware of these situations until it was too late.

As a consequence of the Barings Bank and Enron sagas, countries across the world have to pay more attention to their corporate governance system to avoid potential Enron cases. Therefore, most countries decided to strengthen their corporate governance system and enhance the disclosure requirements of the companies' corporate reporting. This is to ensure that the investors and the shareholders had an

early warning of the companies' unstable economic condition and in order to make better judgments.

Hence, this study seeks to identify the extent of disclosure in the annual corporate reporting of Malaysian banking institutions. In addition, the researcher would like to expand the area of the previous studies by evaluating the regulators', practitioners' and the rating officers' perceptions of the level of importance of the items disclosed in the bank's annual report.

## **1.1 OBJECTIVES OF THE STUDY**

The main aim of this study is to examine the extent of disclosure in the annual reports of the banking institutions in Malaysia, specifically the Islamic banks and the conventional banks that provide Islamic banking services. Therefore, to meet the aim of this study, this research seeks to fulfill the following objectives;

- i. To examine the perceptions of regulators and rating agencies of the importance of the disclosure items as disclosed in the financial reports of the Malaysian Islamic banking institutions and the conventional banks that provide Islamic banking products and services.
- ii. To examine the banks' disclosure practices as required by the presentation of the disclosure requirements and guidelines issued by the Central Bank of Malaysia and applicable approved accounting standards such as AAOIFI and MASB *i* – 1.
- iii. To examine the factors influencing the disclosure practices in the Islamic banking institutions and conventional banks that offers the Islamic products and services.

To meet the first objectives, questionnaires were distributed to the Rating Agency Malaysia (RAM), Central Bank of Malaysia and Bursa Saham Malaysia to be answered by rating personnel or/and compliance officers from these agencies. The main objective is to obtain the opinions or perceptions of the importance of each disclosure item as stated in the disclosure index.

Then, for the second research objective, the disclosure index was developed based on the specific disclosure requirement by the Central Bank of Malaysia namely, Guidelines on the Specimen Financial Statements for Licensed Financial Institutions (BNM, GP8) and Guidelines on the Specimen Reports and Financial Statements for Licensed Islamic Banks (BNM, GP8-*i*). In addition, the researcher also takes into consideration the local and international accounting standard guidelines which were specifically developed for the banking institutions reporting purposes such as MASB *i* – 1 Presentation of Financial Statements of Islamic Financial Institutions (MASB *i* – 1), Accounting, Auditing and Governance Standards For Islamic Financial Institutions (AAOIFI) as well as International Accounting Standard (IAS) 30 Disclosures in the Financial Statements of Banks and Similar Financial Institutions. Had the above banking requirements and accounting standards been taken into consideration, these guidelines will represent the best disclosure practice for the Malaysian banking institutions.

Finally, for the third research objective, the study has identified five independent variables to represent the factors that may influence the disclosure practices which are best represented by the firm-specific characteristics. The characteristics are size, profitability, liquidity, the higher composition of non-executive directors sitting on the board and size of board of directors. Thus, the hypotheses were developed to discover whether there are significant associations between these variables and the extent of banks' financial disclosures.

## **1.2 MOTIVATIONS OF THE STUDY**

There is a lack of empirical research focusing on the financial or banking institutions. This might be due to the perceptions that the financial industry is a highly regulated industry. Due to these facts, the researcher feels motivated to begin the study in this field. In addition, the research attempts to assign weighting to the disclosure index since it had not been used widely in prior studies.

## **1.3 CONTRIBUTIONS OF THE STUDY**

The study examines the disclosure items in the annual reports and the regulators' perceptions of the level of importance of each disclosure item in the annual reports. This study will hopefully contribute to knowledge and will provide some initiatives for those preparing the annual report, various groups of accounting standard setter organizations as well as statutory bodies such as Bank Negara Malaysia and rating agencies.

Specifically, the findings on the level of importance of each disclosure item generated from the survey might help those preparing the annual reports especially those in the banking institutions, to enhance the quality of the information disclosed in their annual reports. In addition, the findings of the survey might constitute a further contribution to the area of the study and narrow the gap in the accounting literature.

Furthermore, the study attempts to explain the corporate disclosure behavior and why banks have adopted certain disclosure strategies. Therefore, the findings might be beneficial to the regulators and the authoritative bodies to be used as a reference to review the guidelines on the mandatory and voluntary disclosure practices by the financial institutions.

Another essential contribution of this study is to raise the awareness for the preparers' of the financial statements on the importance of disclosing truthful and reliable information in the firm's annual report. Those who prepare the annual report are duty-bound to disclose the material and useful information to the users at large.

There are some contributions from this study towards the corporate disclosure strategies literature. Firstly, this study analyzes the banks' disclosure strategies by using both an un-weighted and a weighted disclosure index which is rarely used in the previous literature. Secondly, the findings on the regulators', practitioners' and the listing officers' perceptions of the level of importance of each disclosure item in the annual financial reporting will add to the literature in this area.

#### **1.4 ORGANIZATION OF THE CHAPTER**

This thesis consists of six chapters, including this chapter. The first chapter is the introductory part of the thesis which explains the objectives, motivations and contributions of the study. Then, the following chapter provides the literature review. The study begins by reviewing the literature on the financial reporting disclosure and accountability concepts.

Chapter three represents the hypotheses developments. This chapter examines five firm-specific characteristics and the relationships to the extent of disclosure of the sample banking institutions. Thus, the firm-specific characteristics are the independent variables.

Chapter four will thoroughly explain the research methodology of the thesis. This chapter discusses the sample selection, the development and design of the disclosure index and questionnaires as well as the statistical tests to examine the relationships of the dependent and independent variables with the extent of disclosure.



Chapter five discusses the findings on the statistical tests performed. Finally, chapter six provides conclusions and discusses the findings for each of the research objectives and research questions as well as the limitations of the study.

## **CHAPTER 2**

### **A REVIEW OF LITERATURE**

The chapter provides a review of the literature covering several areas of the disclosure practices in the banking institutions. The chapter is organized in the following manner. Firstly, it provides a discussion of the financial reporting in terms of the disclosure and accountability factors, followed by the relationship of corporate governance theory with the corporate disclosure strategies. Secondly, the disclosure practices will be discussed in terms of the Islamic point of view. Thirdly, the chapter discusses the development of the Islamic accounting standard to cater for the needs of the Islamic banks. Fourthly, the chapter continues the discussion of the prior studies on the disclosure practices in the annual financial reports of various industries and finally discusses the literature on the disclosure practices by the banking institutions.

#### **2.1 FINANCIAL REPORTING: DISCLOSURE AND ACCOUNTABILITY**

Recently, numerous accounting scandals have renewed the people's attention to firm's corporate governance practices and financial accounting transparency. The attention to these scandals began when giant firms such as Enron and World Com collapsed due to poor corporate governance practices, fraud, material misstatement and the practice of creative accounting. Due to these scandals, there has been a huge public outcry about the weak corporate governance practices and the lack of financial reporting disclosure which might cause the occurrence of another Enron.

Accounting scandals provide lessons to the regulators and the accounting practitioners on the importance of financial reporting disclosure and accountability in

preparing the financial statements. The importance of transparent and reliable financial reporting is then due to the following underlying factors. Firstly, the financial statement is not only the main reference to the firms' current economic performance but at the same time it represents firms' use of resources (Càrbaca-García et al., 2002) as well as the distribution of wealth. Secondly, the benefit of being more transparent in the firms' financial reporting is to prevent information asymmetries in the market. If information asymmetry exists, there will be a gap in investors' understanding of the real situation of the firm's operations. This situation might lead the investors to make uninformed judgments. Thirdly, the disclosure of the relevant and reliable information in the firms' annual report might become one of the avenues to demonstrate the firms' commitment and accountability to the public at large. For example, the disclosure of more product information will create confidence among depositors, investors and the public to invest their money in the institutions and, subsequently, might become one of the factors to maintain the firm's goodwill (Abdul Hamid, 2004).

In addition, the disclosure strategies might vary from one firm to another. According to Adrem (1997), the firm's disclosure strategies might depend on the demand and supply forces. Following the mandated rules and regulations, the regulatory bodies seem to be one of the powerful demanders. For example, the Malaysian public listed companies might provide more information to the public compared to the unlisted firms due to the adherence to the listing requirements of Bursa Malaysia Berhad. Hence, the major challenges to the regulators and the accounting standard setting organization is to formulate and improve the regulatory framework on the public disclosure and supervisory reporting. For instance, they have

to determine the types and nature of information that should be included in the financial reports in order to assist various types of users to make a sound decision.

According to Chiang (2005), firms with better practices of corporate governance might signal the better performance. He then conducted a study on the relationship between the information transparency and corporate governance in Taiwan's high-tech industry. In order to examine the firms' information transparency, Chiang (2005) was considering all the firms' published information such as their annual report, website, Taiwan Security Exchange Committee and Taiwan Economic Journal database. As a result, he proved that there is a significant relationship between information transparency and corporate governance.

Good corporate governance practices have been emphasized in all economic sectors especially the banking institutions. This might be due to the fact that the banking sector plays a major role in the economic development. Therefore, to ensure the firms' compliance to corporate governance, the enforcement should come from the governments and must be supported by the regulators and accounting standard setting bodies. Subsequently, a number of guidelines and standards had been introduced due to the emerging needs for more corporate governance guidelines for the banking institutions. For example, the Basle Committee on Banking Supervision was established in 1975 in order to supervise the banking industry. This committee was formed from the group of Central banks from the following 10 countries; Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom (UK) and United States of America (USA) (Basle Committee, 1998).

There are 6 types of information as suggested by the Basle Committee on Banking Supervision (1998) to be reported in the annual financial report in order to

achieve the adequate level of bank transparency. This information includes financial performance, financial position, risk management strategies and practices, risk exposures, accounting policies as well as basic business, management and corporate governance information. On the other hand, the reported information in the annual report should be comprehensive, relevant and timely, reliable, comparable and material in order to represent the true and fair financial condition and performance of the firms.

From the Malaysian's perspective, the disclosure of corporate governance information was influenced by the Malaysian Code of Corporate Governance (Abdul Rashid et al., 2001), the Company's Act 1965 and other statutory requirements produced by the regulatory bodies and the accounting standard setting organizations. For instance, the Central Bank of Malaysia, the Malaysian Accounting Standards Board and Bursa Malaysia Berhad had taken a rigorous approach in order to ensure firms' compliance to the corporate governance practices, producing high quality in the firm's annual financial reporting and maintaining elevated standards of disclosure.

Then, in the year 2002, the Central Bank of Malaysia issued the new guidelines on the presentation of the annual financial report which were specifically designed for the financial institutions. The guidelines are known as Guidelines on the Specimen Financial Statements for Licensed Financial Institutions (GP8) which was designed to ensure the consistency of reporting and compliance to the provisions of the Companies Act 1965 and the approved Malaysian accounting standards. Subsequently, in order to cater for the needs for the Islamic financial institutions, the second guidelines, the Guidelines on the Specimen Reports and Financial Statements for Licensed Islamic Banks, known as GP8 – *i* was produced in the year 2003.

On the other hand, being aware of the current economic situation and the investors' concern, several new requirements had been introduced by Bursa Malaysia Berhad to ensure transparency. For example, the requirement to publish the firms' financial statements on a quarterly basis and new rules on related party and interested party transactions. This is to ensure that the shareholders are aware of the firms' current financial condition and the information is well circulated. In addition, another duty of Bursa Malaysia Berhad is to undertake the financial review of firms' financial statements in order to ensure compliance with the Bursa Malaysia's listing requirement, approved accounting standards and other statutory reporting requirements.

Furthermore, there are external and internal factors that might affect the firm's disclosure practices. The enforcement from the regulators such as the Central Bank of Malaysia, Bursa Malaysia Berhad and the accounting standard regulators to comply with the rules and the issued accounting standard could be considered as external factors that might contribute to the higher level of firms' disclosure practices. On the other hand, the research suggests that there are a few internal factors that might increase the extent of a firm's disclosure. As such, the larger composition of non-executive directors in the board and the bigger board size might be internal factors that could contribute to the higher level of a firm's disclosure.

Nevertheless, some of the prior studies used the Agency theory in order to explain the firm's disclosure practices. Hence, the research would further the discussion on the relationship of the Agency theory and the level of corporate disclosure.

A number of theoretical frameworks such as the agency theory and stakeholder theory had been discussed in the previous study in relation to the corporate

governance perspective. The research then intends to outline the agency theory framework and how it relates to the firm's disclosure strategy. First, in terms of definition, according to the principle-agent relationship the owners are principals and the managers are agents which had been entrusted to manage the resources in a wise manner and be held responsible for the conduct of the business (Jensen and Meckling, 1976 as quoted by Donaldson and Davis, 1991). In addition, Haniffa and Hudaib (2004) suggest that the agents must possess certain qualities to enable them to carry out their duties and achieve the principle expectations.

The relationship between the agency theory and the corporate disclosure was then further discussed from the prior researcher perspective such as Watts and Zimmerman (1979) and Peasnell (1982). The principal-agency problems might occur from the asymmetric information and costly monitoring. According to Watts and Zimmerman (1979), agency costs arise because there are conflicts of interest between the managers (the agents) and the shareholders or bond holders (the principals). The managers have superior information about the firms' current and future performance than the shareholders since they get this information from the primary resources. On the other hand, the shareholders are bearing the risks that the financial reporting had been manipulated and might not represent the firms' true economic condition. Therefore, the disclosure issues were arising due to the urgent demands of the shareholders for reliable and relevant information in order to make a wise investment.

Furthermore, another suggestion to reduce the agency conflict between the shareholders and managers is via acquiring a quality Board of Directors (Abdul Rashid et al., 2001). The quality Board of Directors might be explained in terms of their knowledge, experience or their capability to handle the business. The shareholders might be secure if the firms were organized by competent personnel and