

# Malaysian Islamic Banks Ethical Disclosure Level

By:

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## ABSTRACT

The main objective of this paper is to examine the ethical disclosure level of Islamic banks (IBs) in Malaysian context through their 2008 annual reports. This study in Malaysia is motivated by the common beliefs that Malaysian IBs are different from those practiced in other parts of the world in which prior studies have addressed. The study developed an ideal ethical disclosure index from two prior studies ([Haniffa and Hudaib, 2007](#); [Maali et al., 2006](#)) by examining the actual disclosure level of Islamic Banks in Malaysia. The examination involves a comparison of the actual disclosures of 10 local Islamic Banks in their 2008 annual reports against the ideal ethical disclosure index. The findings consistency with prior studies reveals that IBs operating in Malaysia fall short in comparison with the ideal benchmark of the study. Areas they appear to fall very short include among others such as *qard hasan* and *zakah* related disclosures. The findings of the study give an important implication for the stakeholders of Islamic banks. It demands for better annual report disclosures. Despite that the study empirically extends the area of Islamic banking literature in Malaysia, yet it is subjected to several limitations. One of the main limitations is due to a relatively small sample size, thus, extra attention should be exercised in drawing conclusions to the wider population.

**Key Words:** Islamic Banks; Ideal Disclosure Index Benchmark; *Qard Hassan*; *Zakah*

## 1.0 Introduction

The Islamic Banking as it appears today originated in the modern global financial sector in the 1963 in Egypt, Mit-Ghamr ([Mokhtar, Abdullah and Alhabshi, 2008](#)). Islamic banks have been through political, economical and social blows. Since then, the new industry has gained momentum from Europe to America and from Asia to Africa where Islamic banking system has been growing very fast at a double digit average annual rate of growth in serving the community ([Iqbal and Molyneux, 2006](#)). In other words, Islamic banking services have operated their business outside the Muslim world too. “Islamic banking assets are currently estimated at US\$750 billion in value and will top the US\$1-trillion mark by the year 2010 ([Islamic Finance News, 2008](#)).

Islamic banks can be defined as “a financial and social institution whose objectives and operations as well as principles and practices must conform to the principles of Islamic Shari’ah (Jurisprudence) and must avoid the interest charge in any of its operations” ([Ali and Ahmed, 2007](#)). The key point here is that there should be no interest (*riba*) paid or charged for any transaction or service to ensure justice, welfare and non-exploitation (*ibid*). Islamic banking system is seen as an alternative for the conventional banking (CV) system to the Muslims.

In fulfilling this banking image and Muslims’ expectations, every IB may need to follow *shariah* principles in all activities since it is the distinguishing characteristics of IBs from their counterparts (CV). For instance, this could be done in the form of transparency by providing full disclosure to users as suggested by [Baydoun and Willet \(2000\)](#). However, prior studies in some parts of the world have shown that IBs failed to

provide full disclosure and adhere the ideal Islamic ethical identities in their annual report disclosures (e.g., [Haniffa and Hudaib, 2007](#); [Maali et al., 2003](#); [Adnan and Arifin, 2010](#)).

In line with the above studies, this study focuses on the Islamic banks in Malaysia which experienced its first Islamic bank in the year of 1983 with the establishment of Bank Islam ([Mokhtar et al., 2008](#)). Currently, Malaysia hosts seventeen (17) fully-fledged Islamic banks (as listed in Bank Negara Malaysia). Malaysia is a Muslim country and with the growing of economy, the demand for Islamic banking has been increasing rapidly ([Dusuki and Abdullah, 2007](#)). Several past studies examined the disclosure level of IBs in comparison with an ideal Islamic benchmark index ([Haniffa and Hudaib, 2007](#); [Maali et al., 2003](#)).

This study extends this line of research and compares an ideal benchmark of ethical disclosures through the annual reports of 10 Islamic Banks in Malaysia and their actual disclosure practices. The study of Islamic banking ethical disclosure practices in Malaysia is motivated by two factors. First, Islamic banking practices used by Malaysian IBs appear to be different from those practiced in other parts of the world (Gulf) in which prior studies have focused. While the empirical results of prior studies provided evidence from a poor level of ethical disclosure of Banks in the Gulf ([Haniffa and Hudaib, 2007](#)) and also cross country study ([Maali et al., 2006](#)); only a small number of research has been undertaken in Malaysia (e.g., [Hassan and Christopher, 2005](#); [Adnan and Arifin, 2010](#)) where conventional banks appear to dominate and research on IBs is slightly less. In addition, institutional differences may exist between Malaysia, and other countries which prior studies have mainly addressed (Gulf region). These institutional differences

may arguably affect the disclosure practices of IBs. Therefore, this study addresses the scarcity of researches in this field and its true nature in the Malaysian context.

Second, the Malaysian environment offers identifiable differences in religious segments that are divided by the ethnic lines. These religious differences may influence IBs in Malaysia to employ a high ranked top manager from other religious beliefs other than Muslims as it principally operates in Islam which may in turn cause the IBs to function in a different worldview. Given this unique Islamic banking environment, this study extends the Islamic banking literature by examining the ethical disclosure level of IBs in Malaysia in opposition to a benchmark. To the best of my knowledge, no prior research in terms of sample size and context in this area has been undertaken in Malaysia.

The analysis based on 10 local IBs annual reports in comparison with the ideal benchmark developed from two prior studies ([Haniffa and Hudaib, 2007](#); [Maali et al., 2006](#)), reveal that IBs operating in Malaysia disclose a slightly lower level of actual disclosure against the ideal benchmark of the study. Areas they appear to fall very short include *qard hassan*, and statement of sources and uses of *zakah*. Thus, these findings are consistent with the results of ([Haniffa and Hudaib, 2007](#); [Maali et al., 2006](#); [Adnan and Arifin, 2010](#)).

The structure of this paper is organized as follows. In the next section which is section II, provides literature reviews that are related to Islamic banking. Section III discusses the methodology of the study, the sample selection and sources of data. The results of the study are reported in the fourth section while in the final section, conclusions are drawn and implications of the study are discussed. Limitations of the study as well as suggestion for future research areas are also provided in the final section.

## 2.0 Literature Review

Similar to conventional banks, Islamic banks too can be regarded as an intermediary and trustee of other people's money with the difference being that it shares profit and loss with its depositors (Dusuki, 2008; Ghayad, 2008). In addition to that, Islamic banks ideally do not charge or receive interest from their customers in all aspects of their financial dealings. However, Dar and Presley (2000) argued that most of the Islamic banks have an organizational set-up that is similar to their conventional counterparts. Therefore, there might be a relatively small numbers of Islamic banks that solely involve with the Islamic operations. The reason could be the multi religion environment that they operate in.

Notwithstanding, the last three decades has witnessed the appearance and rapid expansion of Islamic banks both in Islamic countries and non-Islamic countries (Maali et al., 2006). Countries such as Sudan and Pakistan have taken steps to change the whole banking system in order to comply with *sharia* (ibid). Following this, there have been calls for IBs to provide better disclosures in the annual reports (Haniffa, 2004; Baydoun and Willet, 2000), they are not required only to comply and meet minimum requirements of standards and rules but also they should disclose voluntary information which facilitates socio-economic decisions of their stakeholders. Similarly, Chapra and Ahmed (2002) suggest that to sustain the growth and development and international recognition, IB should enhance their corporate governance and voluntary disclosure practices.

As a result, Islamic banking as a new industry lures many researchers to publish articles in the form of both quantitative and qualitative study approaches (e.g., Satkunasingam and Shanmugam, 2004; Hassan and Christopher, 2005; Dusuki and Abdulah, 2007; Chapra and Ahmed, 2002, to mention but few). Reason for this could be

not the new industry joined the financial sector, but rather, Islamic banks are new wave of corporations whose social goals are at least as important as making profit (Haniffa and Hudaib, 2007). Hence, this new wave with the already existed objectives appears to have attracted the interest from academic scholars to embark empirical and non-empirical studies.

The study conducted by Maali et al., (2006) was aimed to investigate the social reporting of 29 IBs located in 16 countries. The authors developed a benchmark set of social disclosures appropriate to such banks and then compared the actual social disclosures published in the annual reports. They used disclosure index to measure the extent to which each bank's social disclosures met the benchmark. The results showed that the social reporting of Islamic Banks fails to meet the researchers' expectations. However, Islamic banks tended to disclose matters related to *zakat* and charity. The reason could be these two items are more positive to enhance the Islamic bank's image compared to other non disclosed items which have negative implications to the IBs, e.g., disclosure of *haram* or inappropriate activities that the Islamic bank may involve.

Similarly, the study conducted by Haniffa and Hudaib (2007) explored whether any discrepancy exists between the communication based on information disclosed in the annual reports and the ideal disclosure of information deemed for vital based on the Islamic ethical business framework. Ethical identities that are measured by the authors are on what they have termed as the "Ethical Identity Index (EII)". Seven Islamic Banks in the Gulf region have been used as the sample for the study. Results show that the overall mean of EII is that there is only one Islamic bank out of seven to be above the

average. This highlights that there is a huge difference between the ideal communication required and the actual ethical identities.

As supported by [Sulaiman \(2005\)](#), there is a huge difference between the ideal theoretical framework and what actually is in practice. The academic discussion of the ideal Islamic concepts that has been published in many journals, like the concept of full disclosure, offers that IBs are prone to failure. A similar gap was also found even though in a different context by a recent paper of ([Kasim, Hameed, and Sulaiman, 2009](#)).

On the other hand, [Dusuki and Abdullah \(2007\)](#) studied the main factors that motivate customers to deal with Islamic banks particularly in a dual banking environment, like in the situation in Malaysia. The study used questionnaires involving a sample of 750 respondents from four different regions in Malaysia. The study revealed that the selection of Islamic banks appears to be predominantly a combination of Islamic and financial reputation and quality service offered. Other factors perceived to be important include good social responsibility practices, convenience and product price. The empirical evidence of this paper focuses on two aspects; (1) Islamic banks must offer quality services while maintaining its Islamic credential and reputation; (2) Islamic banks should also embrace good customer services policies to obtain its potential as a strategic tool to achieve competitive advantage, enhance reputation and secure customers allegiance.

[Sufian and Abdul Majid \(2008\)](#) investigated the performance of Malaysian Islamic banking sector during the period of 2001-2005. The findings suggested that during the period of study, scale inefficiency dominated pure technical inefficiency in the Malaysian

Islamic banking sector. The researchers also found that foreign banks have exhibited higher technical efficiency as compared to its domestic peers.

In a more recent study conducted by [Adnan and Arifin \(2010\)](#) entitled as “Local Shariah banks wary of offering *qard*”, examined the *qard alhasn* practices by the Malaysian IBs. The study found that even though local Islamic bankers are in favour of offering *qard hassan*, or benevolent loan, yet they are reluctant to proceed aggressively. This might be because they fear that they may not be able to generate profit or recover their financing cost. In supporting this, a survey study conducted by the two scholars from IIUM Accounting Department also noted that total outstanding *qard hassan* value was very much less than any other products or services rendered by the local Malaysian Islamic banks.

The survey by [Adnan and Arifin \(2010\)](#) also found that majority of its respondents (90.2%) agreed that *qard* “enhances a corporate social responsibility” with 85% of respondents agreed that IBs should offer the *qardh*. When asked what the problems to launch *qard* were, the survey gathered six main reasons. In its order of frequency, they were: not able to generate any profit, not able to cover the financing, high administrative and transaction costs, high risk, no support from top management, and no demand from customers. The reasons given could be a shameful for Islamic banks to argue because such institutions may not expect to generate profit from every transaction they involve as their main objective was supposed to be ‘socio economic’ rather than the profit maximization objective like conventional banks. However, it appears that most transactions of Islamic banks are profit driven. It is hard to find a transaction in general that involves zero profit transactions as implied in the study.



In explaining under what circumstances Islamic banks should offer *qard*, Adnan cited that "In Islamic point of view, profit is not the only thing to be targeted by a commercial company. This view has also been shared now even by capitalistic or conventional companies. It is why the CSR is becoming popular recently among them. The offer of *qard* might be one of forms of CSR."

Islamic organizations in general and Islamic Banks in particular arguably appear to use conventional accounting. This could be the main reason why Islamic Banks failed to meet the society's expectations. [Hameed \(2000\)](#) argued that there could be real world dangers to IBs with the objective to achieve *falah* that use conventional accounting in evaluating their results. [Hameed](#), among others, proposed an "Islamic Accounting" for Islamic Organizations (IBs) that could suit better their operational activities. This is because Islamic accounting holds *shariah* compliant principles unlike conventional accounting that currently dominate the Islamic banking industry and other Islamic industries as well. In another more recent study, [Hameed \(2009\)](#) concerned about the recent calls from International Accounting Standards Board (IFRS) to adopt completely its standards, this may pose problems to Islamic Banks.

Islamic banks also undergo political pressures from the country that they operate in since most of the countries are secular states. Islamic banks face many regulatory, operational and accounting problems which prevent the further realization of its *Shari'a* oriented ethical and social goals ([Hameed, 2009](#)). These are among a couple of reasons provided in the literature as to why the IBs may fall short to the society's expectations.

The current study however, tries to extend the Islamic banking literature by examining the ethical disclosure level of IBs in Malaysia. Prior empirical studies relating

to IBs are conducted majorly in other parts of the world. This paper addresses such scarcity of research in this area and attempts to fill this gap in the literature.

### **3.0 Research Method**

#### **3.1 Sample and Data Selection**

The initial population of the study consisted of all Islamic banks in Malaysia. There are currently 17 Islamic banks listed in Bank Negara Malaysia (BNM) alone of which eleven (11) of them are locally owned while the remaining six (6) are owned by foreigners. As foreign owned Islamic banks might be influenced by other factors from their home country in terms of the way they report. Thus, the study addresses only the 11 local Islamic banks in Malaysia. The annual reports of the Islamic banks are retrieved from their websites. However, there are only 10 annual reports that are available. AmIslamic bank provides its annual report in a group, not in separate report like other Islamic banks. In order to ensure high objectivity in examining the annual reports; the researcher has to drop AmIslamic bank from the study sample. Therefore, the final sample of the study is 10 local IBs in Malaysia. The sample can be regarded as a representative of 59% of Islamic banks operating in Malaysia.

The study involves analysis of bank's annual reports for one year period which is 2008. In exploring the ethical behavior of the sample banks, it is adopted content analysis as prior studies in the area of Islamic Banking did previously ([Maali et al., 2006](#); [Haniffa and Hudaib 2007](#)). Content analysis is defined as "a research technique for making replicable and valid inferences from data according to their context" ([Krippendorff, 1980](#)). Un-weighted disclosure index is used in the study where if the item in the index is

disclosed in the annual report is regarded as 1 and 0 otherwise. Meanwhile, Yes and No are used to represent 1 and 0 respectively later in the findings presentations.

This study, as a similar to prior studies in the context of Islamic banks, limits its analysis on company annual reports. As [Haniffa and Hudaib \(2007\)](#) pointed out, one of the most important things in dealing with content analysis is the selection and development of categories into which content units can be classified. Following that, a self constructed ethical identity disclosure index is constructed based on the extensive literature review. There are 15 items in the index which fall under five broad dimensions. The appendix of the study can be referred to see the detailed list of the disclosure index.

### **3.2 Brief Description on the Disclosure Index**

In line with prior studies, the study develops fifteen (15) disclosure index elements under five broad dimensions that should be disclosed in the Islamic banks' annual reports. The items in the index are derived from two main prior studies which are [Maali et al. \(2006\)](#) and [Haniffa and Hudaib \(2007\)](#). These studies suggest that this benchmark is based on the broader concept of accountability that Islamic banks should follow. As IBs claim to follow Islamic principles, it is ideally expected that these banks to consider ethical issues differently from conventional banks.

#### **3.2.1 Vision and Mission**

##### **a) Commitments in operating within Shari'ah Principles**

Islamic banks need to differentiate themselves from conventional banks by stating their commitment in operating within the *Shariah* principles and guidelines in their mission and vision statements. Not just to claim that they are committed but more importantly,

they may need to involve islamically acceptable deals and transactions in all their business operations. Provided that the IBs were entrusted with the safekeeping of depositors' savings and shareholders' capital and putting these funds to good use [Haniffa and Hudaib \(2007\)](#), it for that reason could be expected that they will disclose their commitment in operating within the Shari'ah principles in the annual reports.

#### **b) Profile of Shari'ah Supervisory Board (SSB)**

Stakeholders of the IBs may ideally need to know further information about those who conduct the *shariah* review or as it is called "the shariah supervisory board, to judge and evaluate their credentials. The users of Islamic banks' annual reports might be interested in the report of the Sharia'h Supervisory Board because it shows whether the bank has complied with Islamic principles or not, and whether it has dealt justly with different parties ([Maali et al., 2006](#)). The opinion of this board could be seen as the uniqueness of IBs because conventional banks do not seek this type of opinion. Therefore, ideally, the researcher expects that the IBs in Malaysia will disclose the names, positions, and pictures of the Shariah Supervisory Board. More importantly, it is assumed that they will also disclose the profile of shariah supervisory board members as indicators of their knowledge of *fiqh muamalat* and competence in banking and *Shari'ah*.

#### **3.2.2 SSB Opinion: No involvement in non-permissible activities**

As noted above, the opinion of Shariah Supervisory Board regarding the Islamic banks' involvement in non-permissible transactions or activities could be seen as an important element in the Islamic banks' annual reports, and hence, its disclosure may add value to

the company's credibility. Prior studies found that almost all IBs have a Shari'ah Supervisory Board (SSB) whose responsibility is to ensure that any new formulations and modalities are in line with *Shari'ah* principles and within the domain of Islamic norms (Haniffa and Hudaib, 2007). The main issue that SSB provides opinion on appears to be the activities the IB involved. Oftentimes, similar to conventional auditors, they provide reasonable assurance rather than absolute assurance about how the activities of the financial Institution (IB) were permissible according to *shariah* principles (Hameed, 2009). Therefore, I expect that Malaysian IBs also have SSB and that they disclose their annual reports the opinion of the SSB on the subject of non-permissible activities.

Equally important could be the requirement of *ex ante* approval of any new products, investments and financing decisions by the *Shariah* Board. Islamic banks should not enter into any transaction that violates Islamic principles both *ex ante* and *ex post*. As a result, it could be deemed vital whether IBs principally require the existence of such *Shariah* Board *ex ante* approval. The study, however, explores whether IBs in Malaysia disclose such *ex ante* approval in their annual reports.

### **3.2.3 *Qard Hassan***

*Qard Hassan* is an Arabic phrase which literally means benevolent loan. In other words, it could be seen as a non-interest bearing loan provided particularly to help the stakeholders at large who are in need of help that IBs may provide to individuals for socially beneficial purposes. (Adnan and Arifin, 2010; Maali et al., 2006). It could be imperative for users of annual reports to know about the bank's performance in that

particular part, to help them to assess whether the bank is undertaking its social duties and following Islamic principles.

As a result, it might be ideally expected that the IBs operating in Malaysia will have such loans or contributions in their annual reports. Hence, the IBs may better involve such social contributions and disclose to satisfy the full disclosure concept in their annual reports the following elements:

- a) Funds allocated to *qard hassan* in the Balance sheet
- b) The policy of the bank in providing *qard hassan* loans
- c) The policy of dealing with insolvent beneficiaries and clients
- d) The amount charged as late penalty if any

### **3.2.4 Employee Benefits**

Islam puts more emphasis on dealing justly with all sorts of people, be Muslim or non Muslim. Dealings with employees is not an exception but more importantly, the way organizations deal with their employees in terms of remuneration or other matters, might determine the organization's failure or success. [Haniffa and Hudaib, \(2007\)](#) argue that an organization's ethical stand from an Islamic perspective are the ways it treats its employees and debtors as well as its commitments to society because employees arguably are the greatest asset of a firm and their welfare should be given due attention.

The argument asserted above is emphasized by our prophet (s.a.w). The companions of prophet Muhammad (s.a.w) was narrated by Abu Huraira in Hadith as saying: The Prophet said, "Allah said, 'I will be an opponent to three types of people on the Day of Resurrection: one who makes a covenant in my name, but proves treacherous;

2. One who sells a free person and eats his price; and 3. **One who employs a labourer and takes full work from him but does not pay him for his labour"** (Bukhari cited by Haniffa and Hudaib, 2007).

Therefore, it is vital for every organization to deal with its employees rightly and justly. Islamic banks may better double their employee benefits as they claim that they follow the *shariah* principles. Hence, it is ideally expected that the Malaysian IBs will disclose in their annual reports the following employee benefits:

- a) Employees' welfare;
- b) Training and development (especially on Shari'ah awareness),
- c) Amounts spent on training,

### 3.2.5 Zakah

*Zakah* is a religious duty and type of worship levied on only Muslim individuals. In other words, *zakah* is one of the five pillars of Islam, the third pillar of Islam to be precise. The holy Qur'an explicitly mentioned the beneficiaries of *zakah*. When one verse is mentioned more than one time in the holy Qur'an, it shows more emphasis, and *zakah* is repeatedly mentioned in the holy Qur'an. The eight beneficiaries of *zakah* are the poor (*faqir*), the needy (*miskin*), the *zakah* collectors (*amil*), those who reconciled to Islam (*al-mua'lafah gulubahum*), the captives and slaves (*riqab*), debtors (*gharim*), those serving the cause of God (*fi-sabilillah*) and the travelers (*ibn-al-sabil*). The rate is dependent on the type of economic activities (see El-Ashker, 1987).

There is hot debate in the literature regarding who is liable for the *zakah* payment, whether the organization or the owners of the firm pay it. Gambling and Karim (1991)

are of the view that *zakah* is obligatory to individuals who are Muslims, and therefore, organizations are not liable to pay it. Others argue that not only shareholders should pay the *zakah*, but also entities ought to also pay it. Despite these opposing ideas, [Shihaddeh \(1987\)](#) as cited in [\(Maali et al., 2006\)](#) remarks that the Islamic Fiqh Academy, at its first *Zakah* conference held in Kuwait in 1984, reached the conclusion that businesses are not required to pay *Zakah*, unless such a requirement is imposed by law or agreed by their shareholders.

Regardless of who is liable, what is more important is for the IB to disclose the following details in their annual reports:

- a) Which party is liable for *zakah*;
- b) Statement of sources and uses of *Zakah*
- c) Shariah Board Attestation Regarding the Computation and distribution of *Zakah*

#### **4.0 EMPIRICAL RESULTS**

The disclosure percentages and the results of the content analysis are set out in Table 4.1. the results reveal that some areas (commitments in operating within shariah) are disclosed fully while some other areas are not disclosed entirely. This shows clearly that the overall extent of the ethical disclosure benchmark by the 10 IBs in Malaysia falls short. The overall mean level of disclosure compared to the study's benchmark was 47.33 per cent. The bank coming closest to meeting the benchmark is Bank Islam, the first Islamic Bank in Malaysia. However, bank Islam did not disclose any of the items of *Qard Hassan*. Banks such as Muamalat and Allaince disclosed slightly *Qard Hassan* related disclosures. None of the Banks reviewed disclosed in their annual reports the 'Statement



of sources and uses of *Zakah*'. However, Bank Islam explicitly disclosed SSB Attestation Regarding the Computation and distribution of *Zakah*. Five detailed tables on each dimension in the ethical disclosure benchmark are provided in the appendix of the study.

**Table 4.1 Main Results of the Study**

#	Dimensions	Disclosed (%)	Not Disclosed (%)
<b>1</b>	<b>Vision and Mission</b>		
	Commitment in operating within sharia law	100%	0
	SSB profile	60%	40%
<b>2</b>	<b>SSB Opinion: Involvement of Non Permissible Activities</b>		
	No involvement in non-permissible financing activities	100%	0
	No involvement in non-permissible Investment activities	100%	0
	Approval ex ante by SSB for new product	90%	10%
<b>3</b>	<b>Qard Hassan</b>		
	Funds allocated to qard Hassan in the Balance sheet	20%	80%
	The policy of the bank in providing qard Hassan loans	0%	100%
	The policy of dealing with insolvent CB	0%	100%
	The amount charged as late penalty if any	0%	100%
<b>4</b>	<b>Employee Benefits</b>		
	Employee Welfare	100%	0
	training and development (especially on Shari'ah awareness),	20%	80%
	Amount Spent on Training	10%	90%
<b>5</b>	<b>Zakat</b>		
	Which party is liable for zakah;	100%	0
	Statement of sources and uses of Zakah	0	100%
	SSB Attestation: Computation and distribution of Zakah	10%	90%
	<b>Overall Mean</b>	<b>47.33</b>	<b>52.67</b>

#### 4.1 Vision and Mission Dimension

This dimension focuses specifically on two elements namely, ‘Islamic banks’ commitment in operating within the *Shariah*’ and the disclosure of ‘*Shariah* Supervisory Board profile (SSB)’. The argument behind as to why these two elements were included in the index is that IBs commitment towards the principles of *shariah* could be seen what differentiates them from their counterparts (conventional banks). The disclosure of *shariah* supervisory board profile could be vital as mentioned by the prior studies that the users of IBs are interested in the report of the *Sharia* Supervisory Board because it shows whether the bank has complied with the Islamic principles or not.

The content analysis shows that 6 of the sample Islamic banks operating in Malaysia disclosed these two items fully while the other 4 banks the study reviewed only disclosed one item. In other words, they all disclosed ‘their commitment in operating within *shariah* principles’ but only 6 banks disclosed the profile of SSB. This could be due to little importance given to the disclosure of SSB profile by the IBs. Further illustration is provided in Table I in the appendix.

Following is an example of the annual report from Affin Islamic Bank **with regards** to its commitment in operating within *shariah* principles:

*The Bank’s business activities are subject to Shariah compliance and conformation by the Shariah Committee.....As for Affin Islamic future plans, the Bank will continue to grow beyond the traditional role of Islamic banks by providing more innovative Shariah-based products and services, in particular equity-based financing structures encompassing Musharakah and Mudharabah contracts.... As a full fledged Islamic bank, customers are assured that all banking transactions are free from the elements of interests (riba), uncertainty (gharar), gambling (maisir) and other un-Islamic fundamentals as these are monitored by the Bank’s Shariah Department and supervised by the Shariah Committee.*

#### 4.2 SSB Opinion: Involvement of Non Permissible Activities

Islamic banks are arguably involving with unique products, services, and activities that are expected ideally to be entirely different from those of conventional banks. The investors and the general stakeholders of Islamic banks might not have full information on what is happening inside the organization. Thus, the opinion of *Shariah* Supervisory Board (SSB) is needed to issue a reasonable opinion regarding the Islamic banks' business activities in general and in particular to those that relate to the involvement of non-permissible financing/investing activities. It is also important that the disclosure of SSB can help in approving new products before it is introduced to the IB (ex ante approval of SSB).

The study reviews specifically the IBs disclosure regarding to the involvement of 'non permissible investing activities', 'involvement of non permissible financing activities', and 'approval ex ante by SSB for new products'.

The results indicate that all the IBs reviewed provide the report of *Shariah* Supervisory Board. The results further show that all the IBs the study reviewed have a clean *Shariah* Supervisory Opinion in their annual reports as for the year of 2008. It states that the IBs do not involve in any non-permissible activities according to the *Shariah* principles. However, *Shariah* Supervisory Council as Bank Islam calls it, disclosed that Bank Islam during the financial year has tracked non-*halal* income from various sources amounting to **RM10, 466** to be disposed off to the charity with the approval of the Council is obtained.

On the other side, only one bank, Bank Islam, is subjected to ex ante approval by SSB as revealed by the content analysis. Bank Islam disclosed in its 2008 annual report

that one of the primary duties of *Shariah* Council is ”*endorsing and validating relevant documentations in the proposal of new products and services including contracts, agreements or other legal documentations used in executing banking transactions*”.

Following is a short summary of the CIMB Islamic Bank’s report on the *Shariah* Supervisory Board:

*We, Professor Dr Mohammad Hashim Kamali and Associate Professor Dr. Shafaai bin Musa, being two of the members of the Shariah Committee of CIMB Islamic Bank Berhad, do hereby confirm on behalf of the Shariah Committee, that in our opinion, the operations of the Islamic banking and finance business of the Bank and the Group for the financial year ended 31 December 2008 have been conducted in conformity with the Shariah principles.*

#### **4.3 *Qard Hassan***

*Qard Hassan* as described above is an interest free loan that Islamic banks particularly and Islamic organizations at large may give to their stakeholders. It could be largely argued that *qard hassan* is a kind of community involvement of Islamic banks. In the contrary, Western banks that do not operate within the boundaries of *shariah Islamiyah* give their customers’ interest free loans but it is within the specific maximum threshold (say \$500). Banks that operate in UK can be regarded as a graphical example where banks in Western country allow their customers to loan 500 pounds of interest free. As a result, it might be expected that Islamic banks have a large portion of such loans in their balance sheet. It might also be anticipated that Islamic banks have specific policy in dealing with *Qard Hassan*. For example, customers that cannot pay back on time or cannot pay back at all.

It could be easy to expect positive behaviors from Islamic banks usually than to confirm such positive anticipations. Contrary to what one might expect from IBs, and

similar to prior studies conclusions, the results of the current study reveal that there is low level of disclosure of *qard Hassan* of the selected IBs operating in Malaysia. Only two (e.g., Alliance and Muamalat) IBs in Malaysia relatively disclosed *qard Hassan* in their annual reports. It is important to note that only these two IBs have disclosed amounts in their balance sheet. However, it appears that even these two banks are lacking in the policy dealings with insolvent clients/beneficiaries. The other eight IBs did not even have small amounts in their balance sheet nor disclosed any policy of *qard Hassan's* dealing. These findings are consistent with prior studies that found a low level of *qard Hassan* both in Malaysian IBs [Adnan and Arifin \(2010\)](#) and outside Malaysia ([Maali et al., 2006](#)). Prior studies also found that *qard hasan* appears to be lower compared to other assets. This remarks that Islamic banks in Malaysia forgot *qard Hassan* as a product.

The result might imply that IBs in Malaysia fear that they may not generate profit from *qard Hassan* since their main objective is to generate profit [Adnan and Arifin, 2010](#)). It is surprising that the majority of the IBs reviewed in this study did not mention such benevolent loans at all in their annual reports. [Adnan and Arifin \(2010\)](#) explained the reason why IBs do not involve in *qard hasan* is due to six main reasons such as for instance 'not able to generate any profit'.

#### **4.4 Employee Benefits**

Employee welfare could be regarded as a crucial aspect in which IBs have to maintain and improve better. On Contrary, the results of the study show that selected IBs in Malaysia disclosed only primary items such as employee wages, and pension plans. However, as [Haniffa and Hudaib \(2007\)](#) found from the Gulf, IBs in Malaysia have low levels of disclosure on items related to training and development (e.g. especially on

*Shari'ah* awareness). Table 4 in the appendix shows that only two banks (e.g. Bank Islam and RHB) which constitute 20% of those IBs reviewed, disclosed that they provide their staff training on *shariah* awareness. In addition, only one bank (e.g. Bank Islam) constitutes 1% of the sample of IBs disclose the exact amount spent on employee's training. Bank Islam stated clearly in the annual report that:

*During the financial year, more than 25 Shariah training sessions and courses were organized which mainly aimed at enhancing the level of understanding of Shariah application in the banking business among the staff..... "In FY2008, over **RM6.5 million** was spent on training as part of our commitment towards human resource optimization".*

Bank Islam scores 100% of disclosure level with regard to employee benefits benchmark that the study has developed. In this dimension, the other IB which is next to Bank Islam is the RHB Islamic bank which discloses up to 67% against the study's employee disclosure benchmark. The other eight IBs relatively have low disclosure level of 33%. As noted above, items that these banks disclosed appear to be primary in nature. This low level of employees training on *shariah* matters is also found in IBs operating in other countries as in the study of (Haniffa and Hudaib, 2007). It could be argued that IBs give little attention to the employee training in general and especially Shariah related trainings.

#### **4.5 Zakah**

All the matters discussed so far in the study might be insignificant compared to *zakah*. It is the third pillar of Islam. Since it is such an important pillar, IBs should better involve its payment as well as its full disclosure. The first item included in the benchmark of the study is whether the IB is liable to pay *zakah* or the owners of the IB have to pay it.

Secondly, if the IB pays the *zakah*, it is ideal to anticipate that the IB may provide statement of sources and the uses of *zakah*. Finally, it could be expected that IBs rely on SSB attestation regarding the computation and distribution of *Zakah*.

The result as is indicated in table 5 shows all IBs the study reviewed in Malaysia disclosing their liability to pay the *zakah*. Further analysis shows that 9 IBs are liable to pay the *zakah* while the remaining banks do not pay the *zakah* as an entity, but it is the shareholders who are paying the *zakah* on behalf of their shareholding. The IB mentioned is RHB Islamic Bank. In the annual report, the bank states that “*The Bank is not required to pay Zakat. This should be paid by shareholders on their shareholding*”.

As regarded to the statement of sources and uses of *zakah*, table 5 in the appendix shows that none of the IBs in Malaysia surveyed in this study disclosed in their annual reports statement of sources and uses of *zakah*. As indicated above, one Islamic bank is not liable to pay *zakah*. Therefore, this bank does not necessarily have to provide such statement. However, the remaining nine IBs did not provide the statement. Surprisingly, those banks combine the *zakah* and tax together. This could be implied that the IBs involved regard *zakah* as similar to tax, rather than recognizing it as a religious levy. It is arguably that IBs appear to use *zakah* as a public relation strategy instead of trying to reduce the level of poverty in most Muslim countries through this religious obligation.

Only Bank Islam disclosed SSB attestation regarding the computation and distribution of *Zakah* in its annual report. Other nine IBs do not explicitly or implicitly communicate such SSB role in computing and distributing the amount of *zakah*. Bank Islam has clearly mentioned in the 2008’s annual report of this particular element

specifically in the report of *Shariah* Supervisory Council as Banks Islam called it the SSB:

*The Council reviewed the financial statements of the Bank and confirmed that the financial statements and calculation of Zakat is in compliance with the Shariah requirements.*

The result of this study appears to be consistent with prior studies in this area. It reveals that IBs have failed to disclose how *zakah* funds are distributed. More importantly, it seems that they also failed to disclose of how *zakah* is computed.

## **5.0 Conclusion, Discussion, and Limitation of the Study**

The study reviews the annual reports of 10 local Islamic banks in Malaysia to explore their ethical identity in terms of disclosure and aims to extend the literature of Islamic banking. The paper develops disclosure benchmark from two prior works of (Maali et al., 2006; Haniffa and Hudaib, 2007). This benchmark consists of what Islamic banks ought to disclose according to the percepts of *Shariah* principles and it is compared with their actual disclosures in the annual reports of 2008. Islamic banks ideally are expected to possess a high ethical identity because as Haniffa and Hudaib (2007) remarked, IBs have social goals which is equally important to their financial goals.

Contrary with the researchers' expectations, the empirical findings show that the reviewed IBs in Malaysia have low level of disclosure practices especially for banks that claimed to be operating within the *Shariah* principles. This is startling but it may be due to the fact that many managers of IBs are trained with the Western-type banks administration, thus, not fully aware of the social implications of Islamic banking (Maali et al., 2006). A second reason might be the fact that IBs (especially Malaysian IBs) operate in an environment where the economy is under the domination of conventional



banks. Such a situation might influence the IBs reporting. A third reason could be the accounting standards in which they comply, because Malaysia adopts International Financial Reporting Standards (IFRS), which may also equally influence the IBs reporting practices.

There are 15 elements that are comprised for the benchmark of the study. The 15 elements are further grouped into five main dimensions. The first dimension is “vision and mission” which contains two elements namely, ‘IBs commitments in operating within the *shariah* law’ and the ‘SSB profile’. Results indicate that only 6 IBs had disclosed the profile of SSB. The reason might be SSB is not regarded as vital as the board of directors because all the IBs disclosed their profile and also their pictures. However, all the IBs in the study disclosed their commitment in operating accordingly to the *shariah* law. This differentiates IBs from their conventional counterparts.

The second dimension is “SSB Opinion: Involvement of Non Permissible Activities” with 3 constructs. SSB opinion is very crucial to this report. It relies to the IBs stakeholders on issues related to whether the IB operated within the *shariah* principles or not. The findings show that all of the IBs had SSB and they all received a clean opinion from their *Shariah* supervisors. This result indicates that the role of SSB is restricted to give only ex post opinion rather than ex ante. Only Bank Islam disclosed SSB’s role of ex ante approval of the banks’ products. It is important to mention here the unqualified report all the banks received from their SSB did not contain detailed information as to how such conclusion was reached. Concerns surface and resurface regarding the independence of the *shariah* supervisory members.

The third dimension of the study is “*Qard Hassan*” and it contains 4 constructs. The study reveals that those IBs reviewed in Malaysia had a very poor low level of *qard hasan* disclosure. Only two banks have had slight amounts of *qard Hassan* in the balance sheet. Meanwhile, the other banks do not disclose any construct as compared to the benchmark of the study nor had amounts in the annual reports. The results of this study are consistent with a recent study conducted by [Adnan and Arifin \(2010\)](#) which concluded that IBs in Malaysia forgot the *qard hasan* at all.

The fourth dimension is the ‘employee benefits’. This dimension has 3 constructs which one of them could be regarded as a primary employee benefit. This particular construct which relates to employee wages are disclosed by all of the 10 IBs in the study. However, training on *shariah* awareness and the amount spent are only disclosed by one IB which is Bank Islam. These low levels of employee benefit disclosure are observed similarly by prior studies of [\(Haniffa and Hudaib, 2007\)](#).

Last but not least, ‘*zakah*’ has 3 constructs. The analysis indicates that 9 IBs in Malaysia are liable to pay the *zakah* while the remaining banks do not pay it as an entity but rather the owners who are paying the *zakah*. Even though the IBs disclosed the amount of *zakah* they had paid, they failed to disclose the sources and uses of such amount. Only one IB manages to disclose whether attestation is received from SSB or not. This particular bank disclosed such attestation regarding the computation by the SSC is Bank Islam. Bank Islam is the only one bank that has the most score in the benchmark of the study.

### **5.1 Limitation of the study and suggestion for future research**

Despite the fact that the study may contribute to the existing literature in the IBs area, yet the study is subject to several limitations. Firstly, the use of content analysis could raise more questions than answers. There is lots of subjectivity involved in such analysis especially in terms of the determination of the quality of the information disclosed. Secondly, the study used only annual reports in exploring the disclosures of IBs. This could also be a problem as the study did not explore other means of information disclosure such as press releases and bank websites. Finally, the relatively small sample of the study could make generalizability to the wider population more difficult.

Future research may employ larger sample size by including all the IBs in Malaysia or cross country study which may involve comparing the IBs in different countries. In addition, future studies may also employ a different methodology other than reviewing just the annual reports. For example, using questionnaire and interview with both management of IBs and the stakeholders may come up with a different findings.

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## Appendix

**Vision and mission (Table I)**

Banks	Commitment in operating within sharia law	SSB profile	Disclosure level
Affin IB	Yes	Yes	100%
Alliance	Yes	No	50%
CIMB IB	Yes	Yes	100%
ECONCAP	Yes	No	50%
HL IB	Yes	Yes	100%
BankIslam	Yes	Yes	100%
MayBank	Yes	No	50%
Muamalat	Yes	Yes	100%
Public IB	Yes	No	50%
RHB IB	Yes	Yes	100%

**SSB Opinion: Involvement of Non Permissible Activities (Table II)**

Banks	No involvement in non-permissible financing activities	No involvement in non-permissible Investment activities	Approval ex ante by SSB for new product	Disclosure level
Affin IB	Yes	Yes	No	67%
Alliance	Yes	Yes	No	67%
CIMB IB	Yes	Yes	No	67%
ECONCAP	Yes	Yes	No	67%
HL IB	Yes	Yes	No	67%
BankIslam	Yes	Yes	Yes	100%
MayBank	Yes	Yes	No	67%
Muamalat	Yes	Yes	No	67%
Public IB	Yes	Yes	No	67%
RHB IB	Yes	Yes	No	67%

**Qard Hassan (Table III)**

Banks	Funds allocated to qard Hassan in the Balance sheet	The policy of the bank in providing qard Hassan loans	The policy of dealing with insolvent CB	The amount charged as late penalty if any	Disclosure level

Affin IB	No	No	No	No	0%
Alliance	Yes	No	No	No	25%
CIMB IB	No	No	No	No	0%
ECONCAP	No	No	No	No	0%
HL IB	No	No	No	No	0%
BankIslam	No	No	No	No	0%
MayBank	No	No	No	No	0%
Muamalat	Yes	No	No	No	25%
Public IB	No	No	No	No	0%
RHB IB	No	No	No	No	0%

**Employee Benefits (Table IV)**

Banks	Employee Welfare	Training and development (especially on Shari'ah	Amount spent on training,	Disclosure level
Affin IB	Yes	No	No	33%
Alliance	Yes	No	No	33%
CIMB IB	Yes	No	No	33%
ECONCAP	Yes	No	No	33%
HL IB	Yes	No	No	33%
BankIslam	Yes	Yes	Yes	100%
MayBank	Yes	No	No	33%
Muamalat	Yes	No	No	33%
Public IB	Yes	No	No	33%
RHB IB	Yes	Yes	No	67%

**Zakah (Table V)**

Banks	Which party is liable for zakah;	Statement of sources and uses of Zakah	SSB Attestation Regarding the Computation and distribution of Zakah,	Disclosure level
Affin IB	Yes	No	No	33%
Alliance	Yes	No	No	33%
CIMB IB	Yes	No	No	33%
ECONCAP	Yes	No	No	33%
HL IB	Yes	No	No	33%
BankIslam	Yes	No	Yes	67%
MayBank	Yes	No	No	33%
Muamalat	Yes	No	No	33%

Public IB	Yes	No	No	33%
RHB IB	Yes	NA	No	33%