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Determinants of Disclosure Quality in Islamic Banks

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Abstract

In 2003, the Bank Negara Malaysia introduced a guideline on disclosure specific to Islamic banks (GP8-i). The objectives of this guideline, among others, are to ensure consistent disclosure and provide a basis for preparing financial statements in the banks annual report. The way it is presented and disclosed is to determine the quality of information received by stakeholders particularly shareholders, depositors and other users. Besides the GP8i, several measures such as the *shari'ah* compliant statement, FRSi-1 and AAOIFI are meant to govern and improve the quality of disclosure of Islamic banks' annual report. However, less effort has yet been done to examine the quality of information disclosed by Islamic banks. This study is conducted to find the determining factors that may influence the quality of disclosure by Islamic banks. Our methodology incorporates a variety of cross sections and time series data, therefore panel estimation technique is utilized to take into account the heterogeneity of these data. Using eleven samples of full-fledged Islamic banks and Islamic banking windows over the period between years 2002 to 2006, this study found that size and financing are significant in determining the quality of disclosure in Islamic banks annual report. The results may provide additional information in which such specific banks characteristics can be used to indicate the likelihood of quality disclosure provided by Islamic banks.

Keywords: Islamic banking, Disclosures, Financial Reporting for Financial Institutions.

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Keywords: Banks and regulations; Disclosure; Financial reporting for Islamic Financial Institutions

1. Introduction

Agency problem as a result of separation of ownership and control is theoretically an established aspect in agency theory literature. The agency problem arises due to the relationship among the contracting agents. Agents are expected to fulfill their obligations to the best interest of the owner as principal. However, conflict is more likely to happen as agents and as individuals have their own utility maximization which might not be as what is required in contract. Therefore, the proper monitoring mechanisms are needed to such opportunistic behavior of agents and determine their incentives in disclosing quality information.

The likelihood of disclosing more information as a measure of quality of disclosure in agency theory has become an established study. Further, quality or high level of disclosure reduces information asymmetries and signals firms' good value. By not just following the requirements (mandatory disclosure) but also exceed that level (voluntary disclosure), the firm's annual report disclosure can play their important role as a monitor to mitigate agency problem.

What determine the disclosure level is important. Hence, studies on the relationship of disclosure to certain firm's characteristics are done by many researchers. Several studies have identified the following firm' characteristics: industry and audit (McNally et al (1981)), sizes (Kahl and Belkaoui (1981)), leverage (Chow and Wong-Boren (1987)), listing status (Cooke (1993)), leverage and asset in place (Hossain et al (1994)), profit margin (Wallace and Nasser (1995)), liquidity and industry (Owusu-Ansah (1998)), total assets (Raffaournier (1995)), cost of capital (Botosan (1997)), governance (Rashid (2000)), firms ages (Akhataruddin (2005)), Foreign verses local firms (Ahmed (2006) and Ghazali and Weetman (2006)). In addition, they also use other proxies for disclosure quality such as the extent, comprehensiveness and extensiveness of information.

However, size, profitability and capital structure are among the most frequent characteristics of firms used in disclosure study (see, Ahmed and Courtis (1999)). Size is considered as the basic characteristics of firms. This variable is reported by most of the earlier research like Singhvi and Desai (1971); Buzby (1975); McNally et al. (1982); Chow and Boren (1997). They support the positive relationship between size and disclosure quality where the larger the firms, the level of information disclose increases. Due to the high expectations of society from the big size firms, agency theory recognizes that disclosure as a monitoring mechanism is needed and more information is demanded. Profitable firms are more likely to disclose more as supported by Singhvi and Desai (1971), Wallace and Naser (1995) and Meek et al(1995). However, in contrast findings is found by Wallace et al (1994) where the profitability ratios is reduced with an increase in disclosure. Signaling theory can explain such relations as information to support such unfavorable situations is needed. Finally capital structure of the firms was found to be another factor that determines disclosure quality. The proportions of outside capital, high or low concentration of the firms ownership and leverages of firms related to the structure of capital. Cooke (1989) found larger number of shareholders as a significant factor which determines disclosure while Meek et al (1995) found significantly negative relationship between them. On the other hand, Wallace et al (1994) found no relationship between those variables.

Since, the banking industry is heavily regulated, the study that examines the disclosure levels in banking firm is not many. Up to our knowledge, only a few studies such as Kahl and Belkaoui (1981), and Rashid (2000) and Haniffa and Hudaib (2004) focuses on disclosure levels in which specific to banking sectors. The terms used is adequacy (Kahl and Belkaoui), quality (Rashid) and extent (Haniffa and Hudaib). Kahl and Belkaoui measures adequacy and examine the consensus between management and user on the degree of important of each disclosing items in banks anuual report. Adequacy level of banks across 18 countries is analysed and they found that there is relatively different between countries possibly due to different reporting environment based on the countries traditions, uniquely audience on one country to another, banks ownership and. However such factors are not statistically significant to support its influence in determining disclosure adequacy level. According to Kahl and Belkaoui, those factors on the other hand are supported for non-financial firms industry. Haniffa and Hudaib found the extent of Islamic banks disclosure is minimally practice, inconsistent and lack clarity. Using samples of 5 Islamic banks in gulf region, they argued on the accountability and social functions related to the responsibility in disclosing information. Rashid analyze disclosure quality of banks in UK and study the relationship of the quality with governance practice in pre and post-Cadbury Report.

The empirical study on disclosure with firms characteristics is mostly studies by researchers compared to bank while most of them concentrates on non-financial firms. Thus, samples from banks are eliminated due to the banking industry is considered to be highly regulated, subject to different disclosure requirements and different in nature of business. Meanwhile, empirical disclosure studies for Islamic banks to date considered few as compared to disclosure study on other sectors.

The empirical studies on disclosure in general and determinant for Islamic banks to date considered few[3] as compared to disclosure study on other sectors. Islamic banks as the players in the banking institutions are demanded to fulfill the concept of accountability and ethics in Islam thus, the duty to disclose and the extent of disclosure should be more. This is based on the ethical guidelines in the *shari'ah* principles which highlight justice in which, clearly prevent the condition of information asymmetry (Al Khadash,2001). Issues of disclosure should be more to be emphasized in Islamic banks and inadequate disclosure leads to the wrong indication on the strengths of the Islamic bank. Even though banks in general are known as an industry that is highly regulated, there are still areas that demand improvement particularly Islamic banks that are still considered as at an infancy stage. Meanwhile, annual reports of Islamic banks that are subjected to several standards and guidelines, being verified for supervision and audit, the practice of disclosing information in the annual report are deemed important to be

[3] Example includes study by Haniffa and Hudaib (2004) social disclosure extent; Maali et al (2005) social disclosure and Ariffin (2006) risk disclosure

studied. In a situation where standards and guidelines are yet to be effective or not present at all[4], the disclosure practice by banks may result in higher management discretions. In additions, factors that are influence the practice are of a great concern.

The aim of this paper is to explore the disclosure quality of eleven samples of full-fledged Islamic banks and Islamic windows over the period between year 2002 to 2006. Therefore, the discussion in this paper will be divided to 4 sections. Section two discusses estimations model and methodology. Section three provides an analysis of the findings and the last sections ends this paper with conclusions.

2. The Model

We use the standard model introduced by Cerf[5] however his basic model comprises of sizes, profitability, capital structure and listing status as firms' characteristics As our model utilized the panel estimation technique that regresses the data and compares fixed and random effects, the dummy variables of listing status is not included. The fixed effect which assumes constant error of each bank, hence we analyze all variables in equation as dummy. Thus, we assume the use of dummy variable (listing) considered as inappropriate. Similar characteristics are also used by Singhvi and Desai (1971) and extended by Wallace and Naser (1995) to include profit margin. We modify the model realizing that banks that mainly operate uses financing for funds utilizations. The capital adequacy variable is more appropriate representing the capital structure, leverages and solvency. Hence, the following estimation model that incorporates those banks' characteristics as determining factors of disclosure quality can be written as:

$$DISC_{it} = \alpha_0 + \alpha_1\, SIZE_{i,t} + \alpha_2\, PROF_{i,t} + \alpha_3\, FIN_{,t} + \alpha_2\, CAdeq_{i,t} + \nu_{it} + u_{i,t}$$

The panel data estimations for ν and u assume that each bank has its own behavior and influenced by different factors represented by the slope and intercepts that is constant across individuals and time. For each variable, the following definition is applied to each in which t represents years and i represents the individual banks as follows: *SIZE* is natural log of total Islamic banks asset; *PROF* is the ratio of Islamic banks net profit before tax and zakat to total equity; *FIN* is natural log of total Islamic banks financing; and *CAdeq* is Capital Adequacy using the Risk-weighted capital adequacy ratios; and *DISC* is Disclosure Quality

The extent of disclosure by the sample banks is measured by scores using dichotomous procedures as follows, i.e., we find: (a) the total numbers of items disclosed; (b) total maximum numbers of items applicable. Both can be calculated from the following equations:-

[4] Guidelines for disclosure and presentation in Islamic banks annual report published in year 2004
[5] Cerf introduced the disclosure index methodology to measure extent of information in annual report (Singhvi and Desai (1971))

$$TD_{it} = \sum_{i=1}^{n} d_{it}$$

and,

$$MS_{it} = \sum_{i=1}^{m} D_{it}$$

where,

TD	=	Total numbers of items disclosed
MS	=	Total maximum numbers of items applicable
d	=	scores of item disclose, 1 (disclosed) and 0 (not disclosed)
D	=	scores for each applicable items, 1 for each items
n	=	the number of disclose item
m	=	the number of applicable items which the company expected to disclose

For applicable item, where an item is not disclose due to it is not applicable, it is concluded that the item is not relevant to the index. Therefore it is not expected to disclose and not calculated as the number of applicable items. On the other hand, if an item is applicable, stated somewhere in the annual report, but has not been disclosed, the item falls under the item which is applicable (m), given scores of 1 for D for the total maximum numbers of items applicable and given 0 scores for item disclosed (d).

The relative level of disclosure to measure quality of disclosure by each banks is measured by a score that can be calculated by dividing the total numbers of items disclosure (TD) by the maximum numbers of items applicable (MS).

$$DISC_{it} = TD_{it}/MS_{it}$$

DISC	=	Disclosure level
TD	=	Total numbers of items disclosed
MS	=	Total maximum numbers of items applicable

The sign of each independent variable is discussed below:

Size

Based on agency theory, disclosure associated with a decrease in agency cost as it serves as a monitoring mechanism for the owners. With more information, firms can convince stakeholders on their functions to fulfill stakeholders' objective. Sizes that are associated with increase disclosures as suggested in several disclosure studies (such as in Cooke (1992) and Akhtarudin (2005)). It is due to the high demand expectations of society for more information as a monitoring mechanism and significant of the big firms in the industry or to one country. In additions, the cost associated with producing more information by large firms is smaller due to availability of necessary resources as compared to small firms in disseminating and collecting information. Thus, big firms have more incentives to disclose more information. Meanwhile, another argument is according to political cost hypothesis where smaller firms might probably disclose more information to show visibility of them to the public. The big however disclosing less information that might necessarily reduce government intervention to them such as price controls, higher tax and any other restricting policy (Jensen and Meckling (1976) and Watts and Zimmermann (1989). We expect the disclosure quality are positively related to banks' size according to the agency theory which represents the monitoring mechanism. Banks which also having an objectives in maximizing returns to the stakeholders are having much more broader objectives as they also deal with depositors and borrowing customers. Total assets are use as proxy for size as in banks in one country are always been associated with large assets owned as with that, more resources for banks to services their customers.

Profitability

High profitability signals firms successful and by disclosing more information, they support such favorable conditions. Profitability of banks is essential as they should perform to meet objectives of diverse stakeholders such as shareholders, depositors, borrowing customers and employees. Based on signaling theory, by adding more information to supports their profitable conditions, it can convince the stakeholder where they are actually in that favorable condition. As explained in signaling theory, by adding more information to supports their profitable conditions, positive relationship is expected Net profit before tax and zakat to total equity measures profitability. It also represents shareholder gains for each investment of share they made for the banks.

Capital adequacy ratio

The use of capital structure to promote public confidence as cushion against risk of failure is known in banks management. The capital structure of banks is monitored by regulatory requirement through the capital adequacy standards. Banks capital is considered unique as the portions of capital to assets are maintained at minimum around 8% of the total assets. The reason provided is to limit the risk of bank failure as more capital leads to greater risk. As explained in signaling theory, by adding more information that considers relevant to supports that they are well monitored even though the ratio is higher, banks tries to gain customers confidence which their adequacy ratio is at acceptable risk condition. Thus, it is expected that positive relationship will be found.

Financing

Regarding the financial services provided by banks, large banks are more likely to have more resources in servicing customers. More financing involving an increase number of customers, thus the needs for information is varied and more likely to be wider. According to information asymmetry, meetings the needs for more customers increase information asymmetry problem therefore disclosure is increased with more financing. Therefore, we expect positive relationship with disclosure quality.

To test the above hypothesis, we use annual report of full-fledged Islamic banks and Islamic banks windows from 2002 to 2006. All of the 11 selected banks are subjected to the requirements of Bank Negara Malaysia thus, their financial reporting are under specific disclosure requirements which is the GP8-i guideline. However the guideline is available in 2003 which is be effective for the annual report of 2004 onwards. This study serves to measure the quality of the disclosure based on index of information items needs to disclose by banks.

An index is developed consisting of items in the GP8-i guidelines taking into consideration additional disclosures that are made discretionary (voluntary disclosure) by Islamic banks. One component out of 11 that are identified as the minimum requirements is examined that is the Balance Sheet. The balance sheet function is crucial as it present the banks position in which the management of assets and liability is reported.

3. Results and Discussions

The empirical distributions of the data from samples at initial analysis comprises of 55 observations. Considering the unbalance panel observation from eleven samples banks, we manage to analyse 51 out of 55 observations due to some cross sections units need to be dropped. Table 1 present the results of descriptive statistics including the mean differences of variables under estimations by differentiating the full fledges and windows. The probability of F-stat of ANOVA is employed on the data to test for the differences in mean disclosure and mean for each variables between Islamic banks full fledged samples and Islamic windows. The result of the test of shows there is statistically significant difference between the two samples in size and capital adequacy at 99% and 85% confidence level each (size 0.0001, CAdeq 0.0143). The quality disclosure (DISC) results shows that there are no statistically significant difference between Islamic full-fledges and Islamic windows.

Table 1: Descriptive Statistics

Variables		SIZE	PROF	Fin	CAdeq	DISC
Mean		4764140.	0.2426	3847185.	13.5644	0.9495
Median		3509064.	0.1630	2793342.	12.3800	0.9500
Std. Dev		3920452.	0.3555	3928897.	5.6634	0.0585
Skewness		1.1262	3.6041	1.5145	1.6271	-1.1675
Kurtosis		3.4454	19.0686	5.1317	7.4663	4.1699
Jarque-Bera		11.2032	659.0924	29.1529	64.8945	14.4947
		(0.0036)	(0.0000)	(0.0000)	(0.0000)	(0.0007)
Mean differrence	Islamic full fledges	0.2283	7916563.	3606670	11.7587	0.9578
	Window	0.2486	3450631.	3947399	14.3169	0.9461
Anove F-stat (Prob.)		0.0001	0.8543	0.7810	0.0143	0.5231
Observations		51	51	51	51	51

Number in parenthesis refers to the *p* value

The results of each variable's mean, median, standard deviations, skewness, kurtosis and Jarque-Bera are also shows in table 1. The data for each variable are not normally distributed which represents that the pooled least square distributions is inappropriate to test the estimation model. The normality test provided by the value of skewness and curtosis should be around 0 and 3 to fulfill the normality distributions data. Thus, the utilization of panel data is well suited for this type of samples based on such data.

The model estimations results for the panel regression analysis are shown in table 2. The analysis used generalized least square (GLS) for none effect, fixed effect and random effect. The results of GLS fixed effects shows better relative for the significance of estimation model and R-square results which stood at 0.4768. It indicates 47.68 % variations in disclosure is explained by the independent variables in the fixed effect regression model. The F-test of overall fitness of the model rejects the null hypothesis in the fixed and random effect model. It is suggested that at least one or more of the tested variables influence disclosure quality in fixed and random effect estimation model.

In order to test the best model between the fixed and the random effect, we utilized Haussmann test. Table 3 provides the results where the GLS with fixed effects explain better relative to the random effects where the hypothesis null for the random effect is not rejected (P>0.1%). Thus, the following discussion focuses on the fixed effects result.

Table 2: Panel estimation results

	None-Effect	Fixed Effects	Random Effects
C		1.1593	0.9680
		(5.1050)	(5.9643)
LN_SIZE	-0.0012	-0.0432**	-0.0135
	(-0.0963)	(-1.7606)	(-0.8439)
PROF	0.0253	0.2297	0.0195
	(1.0714)	(0.9800)	(0.9112)
LN_FIN	0.0056	0.0301**	0.0127**
	(0.7244)	(1.9325)	(1.3218)
CAdeq	-0.0006	-0.0001	-0.0002
	(-0.4302)	(-0.0892)	(-0.1844)
R2	0.0515	0.4768	0.1764
F	0.6249	2.3439	0.1764
P	0.6470	0.0199	0.0582
DW	1.4966	2.5359	1.9926

Number in parenthesis is the t-test
** indicate significant at 10% level

Table 3 : Hausman test of the Random effects model

Tested model	Chi-Sq. Statistic	F Statistics
Random effect model	4.8707	0.3008

The individual coefficient of the estimated model where the computed t test suggests that *SIZE* and *FIN* are significant at 10% level in determining disclosure quality of Islamic banks (full fledge and windows). The other two variables *CAdeq* and *PROF* are not statistically significant. Thus, the predictions in signaling theory are not supported for these Islamic banks characteristics that determine their quality disclosure.

The predicted direction in table 2 representing *SIZE* is negatively correlated and *FIN* positively correlated with disclosure quality. Such coefficient result shows that size direction is inconsistent with the expectations in agency theory. The role of disclosure as a monitoring mechanism which big firms disclose more is based on agency theory. Meanwhile, it is not necessary happens in Islamic banks. Smaller size has shown their willingness to disclose more might indicate that they tend to position themselves for competitive advantages and by informing public on their visibilities. Referring to the mean difference result (table 1), assets that being as proxy for *SIZE* produce significant results where assets held by Islamic windows is smaller. The results that tests the agency theory for sizes which produce in contrast directions might probably be contributed due to the use of assets as proxy. Islamic window holds fewer assets are found in this sample. It is known, they are more established in conventional banks players compared to full fledge which is still at an infancy stages. Coupled with their efficient information system due to their established positions, cost to produce more information is minimizes. The needs for them to position themselves in the competitive cost advantages might probably be the reason why they tend to disclose more and able to disclose at minimum cost. Hence, size as determining factor and having a negative relationship with disclosure quality is found.

On the other hand, positive correlation of financing with disclosure supports the predictions for directions in information asymmetry theory. According to information asymmetry theory, with more customers to be served, the needs for information varied which leads to information asymmetry problems. Thus, financing that can be associated with more customers to be served leads to an increase in disclosure quality provided by firms. Thus banks are expected to produce quality disclosure to reduce such problems.

4. Conclusion

The empirical results support that quality of disclosure in Islamic banks annual report is determined by size and financing but not the adequacy level and profitability. Meanwhile, size is negatively correlated and financing positively correlated with quality. Thus, size and financing as banks characteristics determine quality disclosure in banks annual report. The smaller the banks, the better quality the disclosure they made in annual report. On the other hand, the more financing the banks provide, the better quality of disclosure is found in their annual report. The results may provide an input on the specific banks characteristics that can be used to indicate the likelihood of quality disclosure provided by the bank. Customer or depositor of these Islamic banks might look at these characteristics in order to know the extent of information provided by them and might prefer the one that is better informed, upon the other. Based on our findings, smaller size banks disclose quality disclosure but the less amount of financing the banks has, the more quality of information they provide.

In addition to that, by knowing the determinant factor that characterized the banks with quality disclosure, it can inform the regulatory agency on the effort to enhance transparency. Quality information that is associated with transparent reporting is fulfilled by some characteristics of Islamic banks in Malaysia. Cautious should be made if on their expectations, big size banks could be a bench mark for transparency. This findings show such characteristics provides some concerns as such banks is not to the expectation of them. In additions, there are no different between quality disclosure provided by Islamic banks full fledges and windows and on the establishment of the guidelines. However, this result might not be generalized to the overall disclosure quality of Islamic banks as the limitation in this result that is focuses on information items disclose in balance sheet due to time limitations and samples constraints. Such partial finding serves as the motivations for us and others to study on disclosure quality so that the entire annual report is empirically analysed. In part, the inclusion of more banks such as foreign-based banks that also consist of full fledged and Islamic banks windows can be an added benefit to the findings.

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