

DISCLOSURE FOR SOCIAL CAPITAL, FINANCIAL
AND NON-FINANCIAL INFORMATION IN THE
ANNUAL REPORTS FOR *BAITULMAL WAT TAMWIL*
INSTITUTIONS IN INDONESIA

BY

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the degree of Doctor of Philosophy (Accounting)

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ABSTRACT

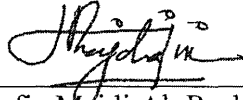
The significant growth of *Baitul Mal wat Tamwil* institutions (BMTIs), a renowned Indonesian Islamic microfinance institution, has planted a prominent position in the industry, albeit their accountability has been questioned. Thus, this study analysed three objectives concerning the BMTIs' accountability issue by investigating their current financial reporting practices, as higher disclosure increases their prospects. Notably, this study is among the few studies on the accountability of BMTIs in Indonesia and internationally. The empirical data were obtained from 206 annual reports of BMTIs throughout 2012-2017, used to examine the disclosure score derived from the disclosure index, developed according to the current accounting regulations. The findings showed the extent and quality of BMTIs obtained through annual report data, in which the mean score for the extent of disclosure was at the medium level (49.56 per cent), while the quality of disclosure was at a lower level (31.81 per cent). Based on the four dimensions of annual reports, the social disclosure scored higher than the financial disclosure, while the extent of *Shariah* compliance disclosure exhibited the lowest score (37.6 per cent). Second, since BMTIs have different capacities, this study examined the differences in the extent and quality of financial and non-financial disclosures between micro, small, and medium BMTIs. The findings showed differences in the extent and quality of financial and non-financial disclosure between micro, small, and medium BMTIs. The third objective aimed to fill the research gap in Islamic social capital (ISC) applied to BMTI. The types of ISC information are considered essential to disclose in BMTIs' annual reports. Ultimately, this crucial information provides empirical evidence for the stakeholders. Subsequently, questionnaires were sent to 117 participants to explore the stakeholders' perceptions of the importance of disclosing Islamic social capital information in the annual reports of BMTIs. The result was then used for factor analysis, examining 36 proposed ISC information disclosed in the annual reports. Furthermore, the study highlighted that it is presumptively critical to disclose ISC information in the annual reports, which are valued drivers of BMTIs' success. Most respondents perceived ISC components and the crucial information as essential in increasing its accountability level towards the community. Interviews further strengthened the data to complement the view on the importance of ISC information in annual reports of BMTIs, which its stakeholders agreed. BMTIs should be accountable for *Shariah* compliance and consider *halal*, *haram*, *Toyyib*, and religious activities as part of the belief system of the members and communities. Furthermore, BMTIs should provide significant attention to ISC to potentially strengthen the institution's capacity and increase transparency by disclosing ISC information. Ultimately, this idea can enhance the members' and non-members' contribution to BMTIs. This study contributes to the understanding of the importance of social capital disclosure in BMTI annual reports. Overall, the findings contribute towards strengthening BMTIs for better accountability and sustainability of BMTIs in Indonesia.

ملخص البحث

لمؤسسة بيت المال الإندونيسية للتمويل الأصغر - أو "وات تامويل" (BMTIs) - مكانة بارزة في الصناعة؛ على الرغم من أن مساءلتها كانت محلّ نظر؛ لذا يهدف هذا البحث إلى تحليل ثلاثة أهداف تتعلق بمساءلة مؤشر الكتلة الهيكلية من خلال التحقيق في الممارسات الحالية لإعداد التقارير المالية؛ إذ يؤدي الإفصاح الأعلى إلى زيادة احتمالاتها، وقد جُمعت البيانات من (206) تقارير سنوية لمؤشرات الكتلة الهيكلية بين عامي (2012-2017)، ولفحص مدى الإفصاح وجودته استخدم مؤشر الإفصاح الذي طُوّر وفق اللوائح الحالية للمحاسبة، وأظهرت النتائج أن مدى الإفصاح كان بمستوى متوسط (49.56٪)، أما جودة الإفصاح فبمستوى أدنى (31.81٪)، واستنادًا إلى الأبعاد الأربعة للتقارير السنوية؛ سجّل الإفصاح الاجتماعي درجات أعلى من مستوى الذمة المالية، وسجّل مدى الالتزام بأحكام الشريعة أدنى درجة (37.6٪)، ونظرًا إلى أن مؤشرات الكتلة الهيكلية قدرات مختلفة؛ فحصر البحث الفروق في مدى الإفصاح المالي وغيره وجودته بين مؤشرات الكتلة الهيكلية؛ الجزئي والصغير والمتوسط، وأظهرت النتائج اختلافات فيما بينها، ولسدّ الفجوة البحثية في رأس المال الاجتماعي الإسلامي المطبق على مؤشرات الكتلة الهيكلية؛ تبين أن معلومات الدعم غير المباشر (ISC) ضروريّ الإفصاح عنها في التقارير السنوية لمؤشرات مؤسسة بيت المال؛ إذ توفر هذه المعلومات أدلة تجريبية لأصحاب المصلحة؛ لذا أرسلت استبانة إلى (117) مشاركًا منهم للتحقيق في تصوراتهم لأهمية (36) معلومة كُشف عنها في التقارير السنوية، ومن ثم تحليل العوامل المؤثرة، واتضح أن تلك المعلومات تُعدّ عوامل قيمة لنجاح مؤشر الكتلة الهيكلية، ورأى معظم المستجيبين أنها ضرورية لزيادة مستوى المساءلة تجاه المجتمع، ثم إن المقابلات عزّزت هذه النتائج، وحددت وجهة النظر تجاه أهمية معلومات تكاليف الدعم غير المباشر في التقارير السنوية لمؤشرات الكتلة الهيكلية، ولا سيما أن تكون المؤسسة مسؤولة عن التوافق مع الشريعة الإسلامية، وأن تكون نشاطات الحلال والحرام وغيرها من النشاطات الدينية؛ جزءًا من نظام معتقدات الأعضاء والمجتمع، وأن تولى مؤشرات المؤسسة اهتمامًا بالغًا لتكاليف الدعم غير المباشر، وذلك لتعزيز قدرتها وزيادة الشفافية من خلال الكشف عن معلوماتها، وهكذا يمكن تعزيز إسهام الأعضاء وغيرهم في مؤشرات الكتلة الهيكلية، وعليه؛ يسهم البحث في فهم أهمية الإفصاح عن رأس المال الاجتماعي في التقارير السنوية لمؤشرات الكتلة الهيكلية، وتسهم النتائج في استدامة مؤشرات الكتلة الهيكلية وتعزيزها للمساءلة في إندونيسيا.

APPROVAL PAGE

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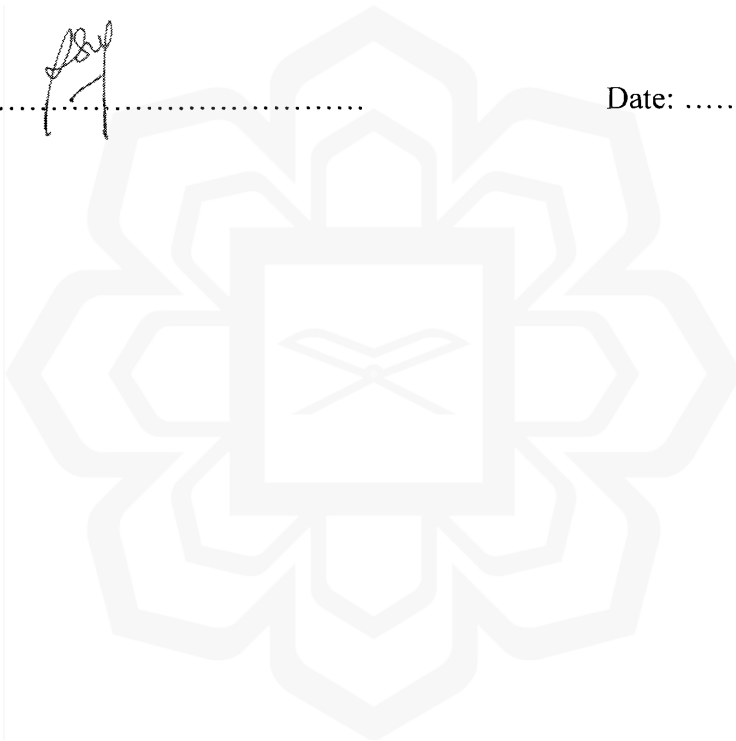
I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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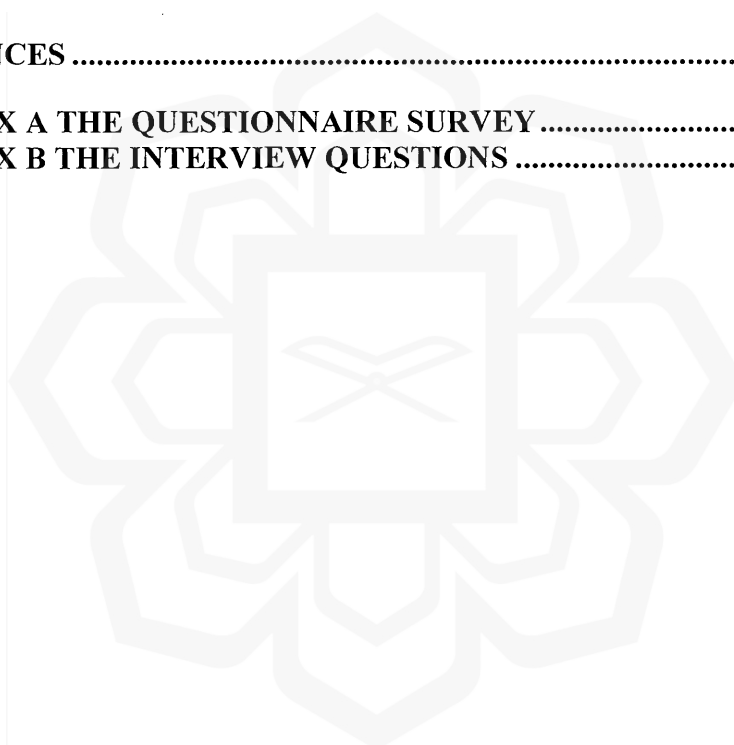
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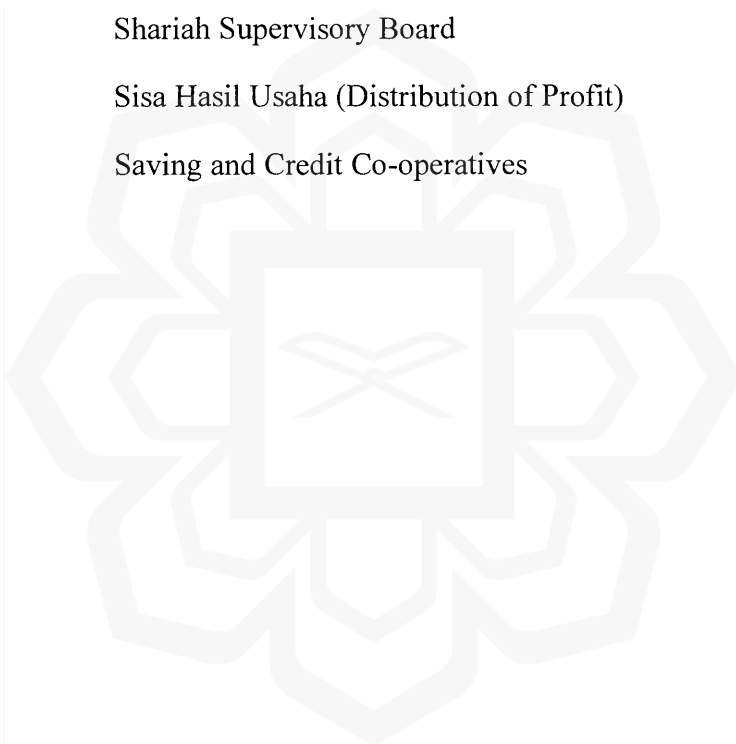
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LIST OF ABBREVIATIONS

AAOFI	Accounting and Auditing Organisation for Islamic Financial Institution
BAZNAS	Badan Amil Zakat Nasional
BMTI	Baitul Maal Wat Tamwil Institutions
CSR	Corporate Social Responsibility
DPS	Dewan Pengawas Syariah (Shariah Supervisory Board)
DVMGI	General Visions, Mission and General Information
FASB	Financial Accounting Standards Board
FS	Financial Statement
GAAP	Generally Accepted Accounting Principle
HR	Health Ratio
IMFI	Islamic Microfinance Institution
IASB	International Accounting Standar Board
IFRS	International Financial Repoting Standards
IBS-MBTs	Information about Board and Supervisor of BMTI
IAI	Institute of Indonesian Chartered Accountants
ICA	International Alliance Cooperative
IP	Information about Product
IPSAS	International Public Sector Accounting Standards
IE	Information about Employee
IM	Information about Members
MSM	Micro, Small, and Medium-sized
MFI	Microfinance Institutions
MUI	Majelis Ulama Indonesia
No	Number

OJK	Otoritas Jasa Keuangan
PSAK Syariah	Pernyataan Standar Akuntansi Syariah (Accounting standards for Islamic Institutions)
PSAK ETAP	Pernyataan Standar Akuntansi Keuangan Untuk Entities Tanpa Akuntabilitas Publik (Accounting standards for non-public interest entities)
PSAK EMKM	Pernyataan Standar Akuntansi Entitas Mikro, Kecil, dan Menengah (Accounting Standard for Micro, Small and Medium Institutions)
PSAK 27	Pernyataan Standar Akuntansi Koperasi (Cooperative Accounting Standards)
SSB	Shariah Supervisory Board
SHU	Sisa Hasil Usaha (Distribution of Profit)
SACCOs	Saving and Credit Co-operatives



CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

Islamic microfinance institutions (IMFIs) encompass the Islamic economic system built upon several distinctive and unique characteristics. They contribute to the social relationship through economic development and equitable distribution of income and wealth (Chapra, 1988). The principles of IMFIs are based on social welfare and justice, fixed prepayment rates, and profit-sharing, which must be devoided of activities prohibited by Islam (Dusuki, 2008). Furthermore, these institutions provide collateral-free loans for the poor and destitute by using charitable assistance such as *Qard Hasan*, *Sadaqah*, *Infak*, and *Zakat* through social collateral matters, which consists of social capital (Adnan & Ajija, 2015; Hadi & Kamaluddin, 2015; Hassan & Harahap, 2010; Wilson, 2007). In essence, the existence of IMFIs is to compensate for the weaknesses of non-Islamic MFIs (Ahmed, 2002).

The principles of IMFIs are better than Islamic banks as most do not offer specific financing schemes for the poor. Accordingly, this idea addresses the social problems marginalised citizens face and extends financial services for the financially-excluded citizens. Due to limitations in the level of risk-taking and collateral conditions fulfilment, Islamic banks cannot fulfil their responsibility to provide social welfare and provisional credit for the poor (Hassan, 2015; Rahman, 2007). Ultimately, Islamic banks have failed to fulfil their underlying objectives of uplifting the poor to a better economic status, which is one of the crucial objectives of Islamic financing (Shahinpoor, 2009; Rahman, 2007). In Indonesia, IMFIs, which were first established

in 1990, is commonly known as *Baitul Mal wat Tamwil* institutions (BMTIs) (Adnan & Ajija, 2015) that provide financial access to impoverished people and Small and Medium Enterprises (SMEs).

BMTIs can uphold equal socioeconomic status by providing access to finance, thereby reducing poverty significantly (Khan, 2008). Furthermore, Rokhman (2013) reported that the institution positively increased its members' income level (wealth), family education, healthcare, and business progress, significantly contributing to the country's economic development (Nasution, 2013). Correspondingly, its financing scheme can effectively improve micro-enterprises business performance and household income through financial self-sufficiency (Nasution, 2013). Thus, several studies suggested that BMTIs can become an alternative solution to resolve the capital deficiency issue and foster local economic development (Adnan & Ajija, 2015; Hadisumarto & Ismail, 2010; Cokro & Ismail, 2008). Evidently, these institutions significantly reduce the prevalence of illegal money lenders that trap poor citizens by providing cheap products and accessible services.

BMTIs is also known as Islamic cooperatives as its uniqueness in which their basis and characteristics are derived from Islamic and cooperative principles. They have grown considerably over 25 years and have contributed substantially to the development of Islamic finance in Indonesia. There are 300 institutions documented in 1995, which has substantially expanded to 2470 over the subsequent three years. This number grew over 3.000 (Adnan & Ajija, 2015) and 5.000 in 2013 and 2017, respectively. This data indicates that BMTIs received positive responses from multiple sections of society in Indonesia that showed tremendous growth in BMTIs. Furthermore, this growth has shown a substantial confidence level of their stakeholders, despite their small-sized

institutions relative to Islamic banks. In this study, the terms IMFIs and BMTIs are used interchangeably.

The BMTIs' primary objective ensures the provision of products and services to members and non-members who adhere to *Shariah* and cooperative principles. The institutions should comply with *Shariah* principles and prohibit any *Ribawi* in their activities. Principally, the institutions are formed and operated by people of similar interests in which the institution must abide by the rules and regulations. Thus, BMTIs must comply with cooperative principles of serving the members (Kassim & Wulandari, 2016) who can obtain credit, services, advice, and guidance at reasonable costs (Adnan & Ajija, 2015). Simultaneously, the institution must comply based on both principles in carrying out activities.

Despite its noble roles, BMTIs have central issues that require urgent attention, where accountability is identified as one of the significant issues for its growth (Wahyuni, 2008). The accountability predicament revolves around the general, financial, social, and *Shariah* compliance aspects of BMTIs that ensures the institution's direction and success. Case in point, there are multiple embezzlement cases committed by the BMTIs' management (Wahyuningsih, 2016); a well-documented case includes the embezzlement of US\$80,000 from US\$2,000,000 total public funds by the BMT PSU Malang (Wulandari, 2015). Other cases include US\$158,000 from customer funds, which BMTI charges against *Al Furqan*.

Notably, both cases are considered the most prominent due to inadequate governance and deficiencies in financial reporting practices (Wahyuni, 2008). These cases may indicate low accountability, potentially caused by weak transparency and disclosure of information by the institutions' top management to its stakeholders (Wahyuni, 2008). Therefore, there is a need to extend the accountability practices in

BMTIs in Indonesia. Most BMTIs have not complied with the standardised rules (Siswantoro, 2013), influencing the quality of their financial reporting (Wahyuni, 2008). However, the size of the institutions does not correlate to their compliance with the financial regulations to mitigate mismanagement costs (Eierle & Haller, 2009). Nevertheless, the recently released accounting standards for SMEs is incompatible with the nature and characteristics of BMTIs.

The severity of BMTIs' inadequate disclosure has critically impacted the impoverished members; however, only a few studies have empirically analysed the accounting practices and reporting systems of BMTIs in Indonesia (Wahyuni, 2008). In their yearly report, Islamic institutions' accountability disclosure is still below the expected standards from the economic and social aspects (Maali, Casson, & Napier, 2006). Notably, social justice and social accountability are issues of concern to Muslim society (Kamla & Rammal, 2013). As IMFIs have survived in rural communities (Obaidullah & Khan, 2008), social aspects are critical considerations in accountability disclosure.

The accountability of IMFIs must not exclusively be limited to their stakeholders but also extended to society. These institutions must contribute to poverty alleviation by strengthening social capital (Choudhury & Hassan, 2014; Farooqi, 2006). Meanwhile, IMFIs deficiency in enhancing the social capital value in their activities (Dieter & Seibel, 2000) may lack social capital disclosure. In essence, transparency and accountability provide assurances for users and open a way of communication by institutions, which align with their nature and characteristics.

Accountability should be given greater attention in providing appropriate financial and social reporting. Consequently, the increased transparency of the financial reporting can ultimately result in better prospects for BMTIs. Thus, this study fills in

the research gap concerning the accountability practices and stakeholders' perception of the weak social reporting by BMTIs, especially in Indonesia. Furthermore, this study is motivated to explore stakeholders' perceptions on the weakness of social capital information by BMTIs in the context of Indonesia.

1.2 STATEMENT OF THE PROBLEM

The BMTI, a *Shariah*-based cooperative, should comply with *Shariah* and cooperative principles (Adnan & Ajija, 2015), and this distinct characteristic presents a significant challenge in this area (Nasution, 2013). In fact, Indonesia's *Shariah*-based cooperative industry is still in its infancy that needs proper accountability measures (Shafii et al., 2017). Hence, the institution must provide adequate information on their activities to enhance the accountability level, albeit it is still shown to be insignificant (Wahyuni, 2008). Thus, this situation justifies the need to examine the accountability of BMTIs, providing valuable insight into their transparency effort to the communities.

The institutions function not only as a financial intermediary but also as the social intermediary and spiritual intermediary that deals with a substantial range of stakeholders, including the destitute and the poor (Ascarya, 2017; Hassan, 2015; Mawardi & Widiastuti, 2018; Muttaqin, 2012; Rulindo & Mardhatillah, 2011; Rulindo & Pramanik, 2013; Wediawati et al., 2018). Thus, BMTI must accommodate the stakeholders' interest in achieving the institutions' social and financial objectives (Adnan & Ajija, 2015; Ascarya, 2017; and Nasution, 2013). Furthermore, the MFIs' management ensures the appropriate discharge of accountability through financial and social information (Ismail, 2015). However, most MFIs focus on disclosing financial information rather than social information, and certain institutions cannot provide social information in their annual reports (Copestake, 2007).

Specifically, financial information is used to measure if financial objectives have been achieved, while non-financial information is used to measure the effectiveness of the MFIs (Blackburn et al., 2013). In the effort to evaluate their development and performance, BMTIs must periodically disclose their financial and non-financial information in their annual reports. Therefore, it is justified that more measures must be implemented to ensure financial and non-financial disclosure. BMTIs provide products and financial services to members and non-members that must be accountable and strictly comply with *Shariah* principles (Wardiwiyo, 2012). These products and services are meant to help them grow out of poverty (Ascarya et al., 2015; Kassim & Wulandari, 2016). However, *Shariah* compliance in BMTIs operations is low due to the lack of SSB (Siebel and Agung, 2006).

Based on the Ministry Cooperative Act No.11/PER/M.KUKM/XII/2017, Islamic cooperatives should provide SSB responsible for monitoring *Shariah*-compliant BMTIs operations. The institution should provide *Shariah*-compliance related information to strengthen public confidence in their system and protect their Islamic identity. Thus, enforcing reporting requirements ensures the institutions' compliance with the *Shariah* principles. As suggested by Wardiwiyo (2012), the present study utilised the urgency of investigating the impact of the SSB's inexistence and authorisation in most BMTs in Indonesia on the *Shariah* compliance disclosure.

As previously noted, the scant research on the determinations of BMTIs' accountability justifies the investigation on the specific topic in this present study. It is documented that BMTIs' accountability practices in Indonesia are based on a statutory requirement under the Ministry of Cooperative act No.20/PER/M.KUKM/IX. This act regulates the BMTIs to provide complete annual reports, albeit there are no specific accounting standards for BMTIs (Wahyuni, 2008). Thus, most BMTIs have not

produced appropriate financial reporting and only provide their financial position and income statement. Notably, financial reporting requirements may impose a significant burden on smaller enterprises (Keasey & Short, 1990).

Financial reporting requirements for distinctive types of entities should be modified (Ceustermans et al., 2012) as there are perceivably different forms of financial reporting (Albu et al., 2013; Wright et al., 2012; Love, 2011; Stainbank, 2011; Collis, 2008; and Collis & Jarvis, 2002). Incidentally, firm size criterion is related to financial reporting disclosure (Karim et al., 2013; Khlif & Souissi, 2010; Shibia & Barako, 2017), used to develop different financial requirement regulations in various jurisdictions (Eierle & Haller, 2009). Additionally, micro, small, and medium-sized (MSM) present different obstacles to business development, impacting the gap of providing information by MSM. These obstacles include deficiency in funding, technical knowledge, planning, market research confidence, training, and inadequate managerial skills (Ahmad, 2012). Based on these findings, it is necessary to investigate firm size and disclosure level in BMTs as Islamic microfinance institutions in Indonesia. Furthermore, it is imperative to identify the significant differences in disclosure quality among the three firm categories, i.e., MSM, BMTIs, and address the issues.

Cooperative institutions such as BMTIs are organised, owned, and democratically controlled by their members (Birchall, 2012). Hence, they must provide adequate information that aligns with cooperative principles. Under the Ministry of Cooperative Act No. Nr.19/PER/M.KUKM/IX/2015 stated that the institution should continuously provide their members with empowerment activities and disclose their activities in their reporting. Meanwhile, most cooperatives in operations do not align strategically with cooperative principles, case in point, ignoring members' participation in cooperative activities (Rixon, 2013). Notably, members' participation and

engagement with institutions influence social development and cooperative growth (Mason, 2014), fostering independence, creativity, and innovation in the society (Abdullah & Ismail, 2014; Sanrego & Taufik, 2016).

BMTIs is expected to ensure benefits for the members and community by providing social programs (Cokro & Ismail, 2008). Thus, the cooperative should provide financial reporting accounts focusing on its objectives, such as social information (Webb, 2017). Nevertheless, the positive expectations from BMTIs have not been realised, thus, amplifying the need for the institutions' social accountability. In the MFIs' operations, the function of social intermediations has existed (Kamukama & Natamba, 2013). However, they cannot change from a purely social institution to a commercial institution (mission drift) (Mersland & Strom, 2008; Shaven, 2015).

Social intermediation is a process by which investments are made in human resources and institutional capital to increase the marginalised groups' self-reliance and prepare them to engage with formal financial services (Hassan, 2014). In other words, it is the idea of supporting people who lack access to savings and borrowing facilities, mediated by social capital (Kamukama & Natamba, 2013). According to Dusuki (2006), social capital is essential for enhancing community members' aspirations, loyalty, trust, norms, and devotion. Hence, the process is concerned with investing in social capital, which influences the financial access to the MFIs. This intermediation provides the capacity for building, networking, and training on business management among members (Wairimu & Mwilaria, 2017). The process achieves its aim by creating social capital, compensating for the lack of material assets (Kamukama & Natamba, 2013). Ultimately, the critical influence of social capital is investigated in the present study.

Previous studies focused on social capital from a western perspective (Huang & Aaltio, 2014). According to Jahar (2018) and Wediawati (2018), BMTIs was