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INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA
بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ

**THE EXTENT OF VOLUNTARY DISCLOSURE
IN THE ANNUAL REPORTS AND
FIRM-SPECIFIC CHARACTERISTICS:
A STUDY OF *SHARĪ'AH* APPROVED
COMPANIES OF BURSA MALAYSIA**

BY

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**INTERNATIONAL ISLAMIC UNIVERSITY
MALAYSIA**

MAY 2005

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OF THE REQUIREMENTS FOR THE DEGREE OF
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ABSTRACT

In Malaysia, the Islamic capital market (ICM), with its activities and transactions which are according with *Shari'ah* principles and rules, has become an important part in the overall capital market. *Shari'ah* approved companies (*ShAC*) is one of the components of the ICM. Generally, companies try to convey to their stakeholders that they are good investments via disclosure. The disclosure of information in the annual reports is considered as a channel of communication between companies and their stakeholders. One of the objectives of the current study is to investigate the extent of voluntary disclosure (i.e. overall disclosure items, conventional disclosure items and Islamic disclosure items) in the annual reports of *ShAC*. Second, is to examine the relationship between the extent of voluntary disclosure and firm-specific characteristics (i.e. firm size, ownership structure, type of audit firm and industry type) of *ShAC*. The sample consists of top 50 *ShAC*. The data were collected from the 2003 annual reports of these companies. The study used a disclosure index which consists of 59 items, to measure the extent of voluntary disclosure in the annual reports. The main statistical tests conducted in this study are: descriptive statistics, univariate test and multivariate regression. Generally, the results show that the extent of voluntary disclosure in the annual reports of *ShAC* is low for the three categories: overall, conventional and Islamic voluntary disclosure. However, the extent of voluntary disclosure of conventional items is higher than Islamic Items. The results of the multivariate regressions reveal that firm size is statistically associated with the extent of voluntary disclosure in all three categories. Whereas, the ownership structure is significant with overall and conventional voluntary disclosure, but the type of audit firm is significant with the overall and Islamic voluntary disclosure. Moreover, both the univariate test and multivariate regression results point to the fact that non-manufacturing *ShAC* seem to voluntarily disclose more Islamic items than manufacturing companies.

ملخص البحث

أصبح سوق رأس المال الإسلامي بأنشطته ومعاملاته المتفقه مع مبادئ الشريعة الإسلامية جزءاً هاماً من سوق رأس المال عموماً في ماليزيا، وتعتبر الشركات المصنفة إسلامياً إحدى المقومات الهامة في هذا السوق. عموماً، تحاول الشركات عن طريق الإفصاح المحاسبي أن توصل إلى المساهمين أنها تمثل مكاناً جيداً للاستثمار. هذا و يعتبر الإفصاح المحاسبي للمعلومات في التقارير السنوية إحدى قنوات الإتصال بين الشركة والمساهمين فيها. وتهدف الدراسة الحالية، أولاً، لمعرفة مدى الإفصاح الإختياري للمعلومات (المتمثل في الإفصاح الإختياري العام، التقليدي، والإسلامي) في التقارير السنوية للشركات المصنفة إسلامياً. ثانياً، لدراسة العلاقة بين مدى الإفصاح الإختياري للمعلومات والسمات أو المميزات الذاتية للشركات المصنفة إسلامياً (المتتمثلة في حجم الشركة، هيكلية الملكية، نوعية مراجعي الحسابات، و نوع أو قطاع الصناعة). واشتملت عينة الدراسة على خمسين شركة من كبرى الشركات المصنفة إسلامياً. وقد تم تجميع بيانات الدراسة من التقارير السنوية لتلك الشركات للعام ٢٠٠٣. واستخدمت الدراسة لائحة للإفصاح المحاسبي تألفت من ٥٩ عنصر إفصاح وذلك لقياس مدى الإفصاح الإختياري للمعلومات في التقارير السنوية. و من ضمن طرق التحليل الإحصائي التي تم إستخدامها في هذه الدراسة: طريقة الإحصاء الوصفي، طريقة إختبارالعوامل وحيدة المتغير، و طريقة تحليل الإنحدار متعدد العوامل. وبشكل عام، أشارت النتائج إلى أن مدى الإفصاح الإختياري للمعلومات في التقارير السنوية للشركات المصنفة إسلامياً يعتبر منخفض بالنسبة للمستويات الثلاثة للإفصاح (المتتمثلة في المستوى العام، التقليدي، والإسلامي). وعلى الرغم من ذلك، فإن مدى الإفصاح الإختياري للمعلومات التقليدية أعلى من مدى الإفصاح الإختياري للمعلومات الإسلامية. كما أظهرت نتائج تحليل الإنحدار متعدد العوامل، أن عامل حجم الشركة له علاقة في تحديد مدى الإفصاح الإختياري للمعلومات بالنسبة للمستويات الثلاثة للإفصاح. في حين أن عامل هيكلية الملكية له علاقة في تحديد مدى الإفصاح الإختياري للمعلومات بالنسبة للمستوى العام والتقليدي، أما عامل نوعية مراجعي الحسابات فله علاقة في تحديد مدى الإفصاح الإختياري للمعلومات بالنسبة للمستوى العام و الإسلامي. إضافة إلى ذلك، فقد أشارت نتائج إختبارالعوامل وحيدة المتغير و تحليل الإنحدار متعدد العوامل إلى حقيقة أن الشركات الغير صناعية من الشركات المصنفة إسلامياً تفصح عن كثير من المعلومات على المستوى الإسلامي مقارنة بغيرها من الشركات الصناعية.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a thesis for the degree of Master of Science in Accounting.

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Supervisor

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Co-Supervisor

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DECLARATION

I hereby declare that this thesis is the result of my own investigation, except where otherwise stated. Other sources are acknowledged by footnotes giving explicit references and a bibliography is appended.

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INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA

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This thesis is dedicated to:

**All those who have been instrumental in shaping me the way I am, those,
at home,
at school,
at the university,
and to all those who lit a candle on the way of knowledge and science.**

يهدى هذا البحث إلى:

كل من علمني حرفاً،
في البيت،
في المدرسة،
في الجامعة،
وإلى كل من أضاء شمعة على طريق العلم والمعرفة.

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LIST OF ABBREVIATIONS

BAFIA	Banking and Financial Institution Act
D-W	Durbin-Watson
EU	European Union
EVD	Extent of Voluntary Disclosure
FASB	Financial Accounting Standard Board
IASC	International Accounting Standards Committee
ICM	Islamic Capital Market
JSE	Jakarta Stock Exchange
KLSE	Kuala Lumpur Stock Exchange
LSE	London Stock Exchange
MASB	Malaysian Accounting Standards Board
MIA	Malaysian Institute of Accountants
MICPA	Malaysian Institute of Certified Public Accountants
NACRA	National Annual Corporate Report Awards
NZSE	New Zealand Stock Exchange
OLS	Ordinary Least Square
R&D	Research and Development
SAC	<i>Shari'ah</i> Advisory Council
SC	Securities Commission
SFAC	Statement of Financial Accounting Concepts
<i>ShAC</i>	<i>Shari'ah</i> Approved Companies
<i>ShNAC</i>	<i>Shari'ah</i> Non-Approved Companies
SPSS	Statistical Package for Social Sciences
SSE	Stockholm Stock Exchange
TSE	Tokyo Stock Exchange
TSR	Transferable Subscription Right
VIF	Variance Inflation Factor

CHAPTER 1

INTRODUCTION

1.1 BACKGROUND

The purpose of financial reporting is to provide stakeholders with information concerning the financial performance of the firm, and a “true and fair” view of its financial position. According to the Financial Accounting Standard Board (FASB) in the SFAC¹ No.1, financial reporting should provide information that is useful to investors, creditors and other users in making investment, credit and similar decisions². Financial reporting is not limited to financial statements³; it includes other channels of communicating of the information provided by the accounting system, for example including voluntary disclosure (Brownlee et al. 2001).

Financial reporting can be considered as one means of communicating information by companies to their stakeholders, and the disclosure of information includes financial and non financial information. Therefore, disclosure of information can be defined as a communication of economic information including that of financial, non-financial, quantitative, and qualitative, about a company’s financial position and performance (Owusu-Ansah 1998). Disclosure can be categorized into two types, namely: (1) mandatory disclosure, and (2) voluntary disclosure. Mandatory disclosure refers to items of information which companies are obliged to disclose because of statutory

¹ Statement of Financial Accounting Concepts.

² Malaysian Accounting Standard Board (MASB) in its MASB standard No. 1 reflects a similar idea on the purpose of financial reporting. However, the term used by MASB 1 is more specific as it refers directly to “financial statements”. Financial statements are only a subset of financial reporting, thus the reference to FASB’s SFAC No.1 is considered more appropriate here.

³ The components of the financial statements include the balance sheet, income statement, statement of changes in equity, cash flow statement and notes to the accounts (MASB 1).

regulations e.g. law and listing requirements (Cooke 1992; Owusu-Ansah 1998). Hence, all companies should disclose this information. Therefore, mandatory disclosure is considered as a minimum level of information to be disclosed in the annual reports. Meanwhile, voluntary disclosure is defined as that which is not mandated (Cooke 1992). In other words, voluntary disclosure is the disclosure of additional items of information which are not required by the statutory regulations. Cooke (1992) argues that when the benefits of voluntary disclosure exceed the costs, companies voluntarily disclose more information than is required. Therefore, companies voluntarily disclose information, usually to assure users that the company is a good company⁴.

In Malaysia, an Islamic Capital Market⁵ (ICM) has been established where transactions and activities are based on *Sharī'ah* principles. The aims of setting up the ICM are to establish Malaysia as a center for international Islamic capital market, in addition to enabling Muslims to recognize *Sharī'ah* compliant investments and increase the level of their confidence while making investment decisions (Securities Commission 2002). One of the components of the ICM is *Sharī'ah* Approved Companies⁶ (*ShAC*), the core activities of which are consistent with the *Sharī'ah* principles. The *ShAC* are listed companies on Bursa Malaysia. Up to 20 July 2004, 441 companies had been classified as *ShAC*, whereas the number of companies was 272 as at 31 December 1998 (Bursa Malaysia 2004). The rate of increase is 62 percent which indicates the importance of these companies as a component of the ICM in

⁴ Please refer to chapter 2 for a more detailed discussion.

⁵ The ICM is discussed in chapter 2.

⁶ Definition of *Sharī'ah* Approved Companies (*ShAC*) and more detail is discussed in chapter 2.

Malaysia. The importance and growth of these companies, also, justify research on them.

1.2 OBJECTIVES OF THE STUDY

The study has two main objectives. Firstly, to determine the extent of voluntary disclosure (i.e. overall disclosure items, conventional disclosure items and Islamic disclosure items) in the annual reports of *ShAC*. Secondly, to empirically examine the relationship between the extent of voluntary disclosure (i.e. overall disclosure items, conventional disclosure items and Islamic disclosure items) and firm-specific characteristics (i.e. firm size, ownership structure, type of audit firm and industry type) of *ShAC*.

1.3 QUESTIONS OF THE STUDY

Based on the objectives of the study, the researcher has formulated the specific research questions as follows:

- (1) What is the extent of voluntary disclosure (i.e. overall disclosure items, conventional disclosure items and Islamic disclosure items) in the annual reports of the *ShAC*?

- (2) Is there a relationship between firm-specific characteristics (i.e. firm size, ownership structure, type of audit firm and industry type) and the extent of voluntary disclosure (i.e. overall disclosure items, conventional disclosure items and Islamic disclosure items) in the annual reports of the *ShAC*?

1.4 MOTIVATION OF THE STUDY

As mentioned above, there is an increase in the number of *ShAC* listed on Bursa Malaysia which reveals the importance of this component in the ICM. Thus, this has motivated the current study to examine the voluntary disclosure practices of the *ShAC*. Furthermore, the study is motivated by the lack of literature on disclosure in the Malaysian context, particularly *ShAC* (discussed in chapter 3), as no studies so far have taken voluntary disclosure (i.e. overall disclosure, conventional disclosure and Islamic disclosure) into consideration and its relation with firm-specific characteristics of *ShAC* per se. That gap in the literature needs to be explored and filled.

1.5 CONTRIBUTION OF THE STUDY

Malaysia aims to strengthen its ICM. In order to do so, it has to ensure that both local and foreign investors are willing to invest in that market, including investment in *ShAC*. The *ShAC* can convince investors that it is a good investment through communicating qualitative and quantitative information (particularly voluntary disclosure) to their users via their annual reports. Therefore, this study aims to contribute towards the knowledge and understanding about the extent of voluntary disclosure in annual reports of *ShAC* in the hope that it will assist in the strengthening of the Malaysian ICM. Another important contribution of the study is the development of the disclosure index which includes Islamic information items which are relevant to all *ShAC*. Next, the study contributes towards extending the Malaysian literature on disclosure, and filling the gap in the lack of empirical studies on disclosure practices of *ShAC*. Furthermore, the study extends our understanding of the firm-specific characteristics of *ShAC* listed in Bursa Malaysia, which influence the extent of their voluntary disclosure.

1.6 ORGANIZATION OF THE STUDY

The study has been organized into six chapters and they are structured as follows:

CHAPTER 1: INTRODUCTION

This chapter consists of the background, objectives, research questions, motivation of the study, contribution, and the organization of the study.

CHAPTER 2: INSTITUTIONAL BACKGROUND AND THEORETICAL FRAMEWORK

Chapter two discusses several issues. Firstly, the discussion is regarding the Islamic capital market in Malaysia. Secondly, it gives a background of *Shari'ah* approved companies. Thirdly, the chapter provides the theoretical framework of the study. Finally, an Islamic perspective on Islamic disclosure items is elaborated.

CHAPTER 3: LITERATURE REVIEW

This chapter reviews the literature of voluntary disclosure in the annual reports. Basically, it starts by discussing some of the literature on voluntary disclosure and firm-specific characteristics which have been conducted internationally. Next, the chapter reviews some of the previous studies on the disclosure of annual reports in the Malaysian environment. Finally, it highlights the gap in the literature.

CHAPTER 4: HYPOTHESES DEVELOPMENT AND RESEARCH METHOD

Chapter four consists of two sections. The first section discusses the hypotheses development. The second section elaborates on the research method which includes:

sample selection, data collection, variables measurement, statistical techniques, and the regression model.

CHAPTER 5: EMPIRICAL RESULTS AND DISCUSSION

This chapter analyzes the data and provides results and findings of the statistical analyses. Then, the findings from this study are discussed.

CHAPTER 6: CONCLUSION, LIMITATIONS AND SUGGESTIONS FOR FUTURE RESEARCH

Chapter six concludes the study and underlines some limitations of the study. It also offers some suggestions for future research.

CHAPTER 2

INSTITUTIONAL BACKGROUND AND THEORETICAL FRAMEWORK

2.1 INTRODUCTION

Malaysia is one of the Muslim countries which realized the needs of investors who aim to invest in a capital market where the activities are consistent with the *Sharī'ah*⁷ rules and principles. Thus, the Securities Commission (SC) established the full form of ICM where transactions and activities are not prohibited by the *Sharī'ah* and they are free from non-permissible elements such as interest (*Ribā*), gambling (*Maysir/Qimār*), and ambiguity (*Gharar*). As a result of the existence of the ICM, several products or instruments have been approved including a list of *Sharī'ah* securities (i.e. *ShAC*).

This chapter addresses a number of issues. First, the chapter discusses the ICM in Malaysia. Second, the *ShAC* is explained in this chapter. Third, the chapter provides the theoretical framework for this study. Fourth, the Islamic perspective on disclosure is discussed later in the chapter. Finally, the chapter ends with a summary.

⁷ The *Sharī'ah* is “the Islamic law of human conduct, which regulates all matters of the lives of Muslims. It is based on God’s [*Allah*’s (s.w.t.)] holy word in the *Qur’ān*, the deeds and sayings of the prophet Mohammed [p.b.u.h.], and the consensus of Islamic religious scholars” (Maali et al. 2003: 1-2).

2.2 ISLAMIC CAPITAL MARKET (ICM) IN MALAYSIA

The ICM in Malaysia has become an important component in the overall Malaysian capital market. The ICM plays a similar role to that of the conventional capital market, except that it only deals with securities and transactions which are permitted by the *Shari'ah*. Accordingly, the SC established the *Shari'ah* Advisory Council (SAC) on 16 May 1996 under section 18 of the Securities Commission Act 1993. The authorities of the SAC are: (1) to ensure that the running of the ICM is consistent and complies with *Shari'ah* principles, (2) to advise the Commission on all *Shari'ah* matters related to the ICM, (3) to function as a reference center for issues related to the ICM (Securities Commission 2002). The SAC's members consist of Islamic scholars or jurists who have experience in the application of the *Shari'ah*, especially in the areas of Islamic economics, Islamic commercial law and Islamic financial system. The ICM consists of a variety of capital market products or instruments which have been evaluated and approved by the SAC. Such products include (Securities Commission 2004):

- (1) List of *Shari'ah* approved securities (companies);
- (2) Ordinary shares;
- (3) Transferable Subscription Rights (TSR's);
- (4) Call warrants;
- (5) Non-cumulative preference shares;
- (6) Crude palm oil futures contracts;
- (7) Crude palm kernel oil futures contracts;
- (8) *Khazānah* zero-coupon bonds (Islamic benchmark bond);
- (9) Composite Index futures contract (if underlying is *Shari'ah* approved) and