

## An Analysis on Disclosures in the Annual Reports of Islamic Banks in Bahrain

Sutan Emir Hidayat, Nayla Abdulla Abdulrahman

*University College of Bahrain*

*Received: 8 May. 2013, Accepted: 18 Aug. 2013*

*Published online: 1 Jan. 2014*

**Abstract:** The purpose of this study is to evaluate the compliance of Islamic Banks in Bahrain to the mandatory disclosure requirements of the latest AAOIFI accounting standards and to measure the level of voluntary disclosure made by those banks. In order to achieve these objectives, this study conducted a checklist survey in which year 2010 annual reports of 5 Islamic banks are obtained and examined. The level of mandatory and voluntary disclosures by the banks is measured based on the individual scores obtained by each bank through the use of a “disclosure index”. The results show that there is a high level of compliance by the Islamic banks in Bahrain to the mandatory disclosure requirements of the AAOIFI accounting standards. Interestingly, the study also finds that the level of voluntary disclosure by the Islamic banks in Bahrain is high. Last but not the least, the findings of this study provide a useful insight into the practices of Islamic banks with regards to mandatory and voluntary disclosure, a subject matter that has been rarely covered in the previous studies on disclosure as evidenced in the limited numbers of literatures available. Hence, this study adds a new dimension to the previous studies in this area, and also provides a starting point for future research possibilities in the area of financial reporting of Islamic banks.

**Keywords:** Mandatory Disclosures, Voluntary Disclosures, AAOIFI standards, Bahrain.

### 1. Introduction

Unlike their conventional counterparts, Islamic banks have to adhere to Islamic law (shariah) in their dealings. Among the rules that shariah prescribes are the prohibition of paying and charging of interest which is considered as *riba* (usury) and prohibition of speculation (*gharar*) (Hidayat, 2010). As a result, there are differences in the method of presentation and disclosure of transactions between Islamic and conventional banks. The presentation of information is important for the decision making process by parties who deal with the Islamic banks. Investors in Islamic banks want to ensure that their funds are used effectively, which means that they are invested according to shariah principles, and efficiently, which means that they are producing a fair and reasonable rate of return (Al-Baluchi, 2006).

As a consequence of the differences, in 1990 Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was established with the main objectives to develop, spread, prepare, review and amend accounting and auditing thoughts and standards relevant to Islamic financial institutions (AAOIFI, 2010). Therefore, understanding the

AAOIFI standards is very important for teaching and learning processes of both accounting and Islamic finance disciplines since the standards are developed to cater the unique characteristics of Islamic financial institutions which cannot be fully addressed by conventional International financial reporting standards (IFRS) (Hidayat, 2011).

One of the important countries to the development of Islamic banking and finance is Kingdom of Bahrain (Hidayat, 2010). Bahrain is notably considered as the most developed country in term of Islamic finance infrastructure within the Gulf Cooperation Council (GCC) (Wilson, 2009). Bahrain is the host to several Islamic finance infrastructure organizations including the AAOIFI. Bahrain is also the home base to Liquidity Management Centre (LMC), the International Islamic Financial Market (IIFM), and the Islamic International Rating Agency (IIRA).

Being the host to AAOIFI, Islamic banks in Bahrain are required to comply with the AAOIFI accounting standards for the purpose of financial reporting (Hassan and Lewis, 2007). AAOIFI divides the information to be disclosed in the Islamic banks' annual reports into mandatory and voluntary

disclosures (AAOIFI, 2010). Mandatory disclosure means the information that must be disclosed by the Islamic banks. Hence, any disclosure over and above what is mandatorily required is considered as voluntary disclosure.

Based on the above explanations, this study attempts to measure the level of compliance of Islamic banks in Bahrain to the latest AAOIFI accounting standards<sup>1</sup> by evaluating the 2010 annual reports of five Islamic banks operating in the kingdom. This study also attempts to evaluate how far those banks provide extra information above what is required by the regulator. In other words, this study aims to answer the following questions:

1. How compliant the Islamic banks in Bahrain to the requirements of the latest AAOIFI standards?
2. How far is the level of voluntary disclosure in the annual reports of Islamic Banks operating in Bahrain?

This study is one of the few empirical studies conducted on disclosure in the annual reports of Islamic banks operating in Bahrain. Furthermore, a study of this type would be of particular relevance to the accounting policy makers, e.g. AAOIFI, and the CBB because it helps them to understand the disclosure behavior of Islamic banks in Bahrain and why they adopt certain disclosure policies and strategies. This study also shows the concerned parties in Bahrain to which extent the Islamic banks are in compliance to the requirements of the latest AAOIFI accounting standards. This study can also be used as a practical example on how to measure the level of Islamic banks' compliance into AAOIFI accounting standards thus it adds value to the teaching and learning processes of accounting and Islamic finance disciplines. Obviously, it also can be used as a reference for future studies.

## 2. Literature review

There have been extensive researches in the advanced and developing countries to measure the corporate disclosure in financial and non-financial companies. However, there are very limited studies that focus on disclosure analysis of Islamic banks.

Al Baluchi (2006) conducted a study on disclosures of Islamic banks operating in Bahrain, Sudan, Jordan and Qatar. The data sets of years 1997-2002 for Islamic Banks were analyzed using a disclosure index. The study addresses the specificities

of Islamic banking and uses AAOIFI accounting standards as the main reference. A disclosure index was constructed as a yardstick to measure the level of disclosure in the annual reports of those banks, and the unweighted method is used, where a score of 1 is given if the item is disclosed and a score of 0 is given if it is not.

Results indicate that the level of voluntary disclosure increased after the implementation of the AAOIFI accounting standards. Results also indicate that the level of voluntary disclosure in Sudan was significantly lower than that in the three other countries (Bahrain, Qatar and Jordan) both before and (even more) after the implementation of AAOIFI accounting standards. This appears to be associated with the influence of government ownership and weaker market discipline in Sudan.

Ibrahim et al (2011) conducted a study that provides a panel data analysis of the interrelationship among disclosure, risk and performance and also discusses the possible of endogeneity and exogeneity of dependent variables. In order to find the interrelations among these variables, 11 samples of full-fledged Islamic banks and Islamic windows between the years 2002 to 2006 were used.

A disclosure index was constructed as a yardstick to measure the level of disclosure in the annual reports of those banks, and the un-weighted method is used, where a score of 1 is given if the item is disclosed and a score of 0 is given if it is not. The disclosure index consisted of the items of a list of items of information that are disclosed in the annual reports of the banks. The results indicate that all equations are almost efficient and the findings suggest that leverage and profit are statistically significant in determining disclosure. Meanwhile, the result also suggests that disclosure and profit are significant in explaining leverage. For the last equation which treats profit as an endogenous variable, shows that disclosure is significant in explaining profit among samples of Islamic banks.

Sarea (2012) conducted a survey questionnaire to evaluate the perceptions of accountants of Islamic banks in Bahrain on the level of the banks' compliance with AAOIFI accounting standard. The results of the study reveal that 85% of the respondents agree that their Islamic banks have high compliance with AAOIFI accounting standards. 5% of the respondents believe that their Islamic banks have moderate compliance with AAOIFI accounting standards. The remaining 10% of the respondents agree that their Islamic banks have low compliance with AAOIFI accounting standard.

<sup>1</sup> Until the completion of the study, the latest version of AAOIFI standard was released in 2010.

The results of the study also reveal that out of 20 AAOIFI accounting standards, 17 items obtained high scores indicating the accountants' belief in their banks' compliance towards most items in the AAOIFI accounting standards. 1 item obtained moderate scores and 2 items related to treatment of zakah obtained low level of compliance.

With relatively limited number of previous studies in this area, this study aims to fill the gap and enrich the teaching and learning processes of accounting and Islamic finance disciplines

### 3. Research methodology

#### 3.1 Research method

Based on the previous literatures reviewed, it is found that most studies related to the measurement of the level of voluntary and mandatory disclosures in the annual reports of Islamic banks, used the "disclosure index" as a mean to measure the level of the banks' compliance towards accounting standards (Al-Baluchi, 2006; Ibrahim et al, 2011). Therefore, this study adopts the same method as the previous studies.

The level of disclosure by Islamic banks is based on the individual scores received by each bank through the use of a disclosure index. The following paragraphs describe the construction of the disclosure index and how the items in the index are scored. The first step towards measuring the level of disclosure is to decide upon the most suitable disclosure index to be used for this research.

Based on the previous studies, there are many different items in the disclosure indexes constructed. For this study, the most suitable disclosure index is the one used by Al-Baluchi (2006) who constructed and used the disclosure index developed based on AAOIFI accounting standards and answered similar research questions to the research questions of this study. In other words this study is somewhat similar to Al-Baluchi (2006) in term of method but it is different from Al-Baluchi (2006) in term of periods and countries covered. Furthermore, this study adjusts some items in Al-Baluchi (2006) lists in accordance to the latest AAOIFI accounting standard. In addition, this study focuses on Islamic retail banks in Bahrain only.

Literatures reveal that there are two methods of using the disclosure index namely, weighted<sup>2</sup> and un-weighted. Al-Baluchi (2006) and Ibrahim et al (2011)

used the un-weighted method. There are many reasons for not giving a weight to items disclosed, for example, each item of disclosure is equally important, and to avoid subjectivity because weighting reflects the perception rather than actual information needs of the users of financial information. As a result, the use of un-weighted index method is more suitable for this study since it is not concerned with any specific user group and there are large numbers of items in the index.

#### 3.2 Data collection and sample selection

According to central bank of Bahrain (CBB), there are 27 Islamic banks as at 12th February 2012. Out of the 27 banks, there are only 7 banks which are in the retail industry. Out of 7 retail Islamic banks 5 banks are chosen as samples in this study.

The reason why the 5 retail banks are chosen is because they have relatively long history of operations in Bahrain, with almost similar size and many branches. More importantly, their 2010 annual reports are accessible. In addition, it would be more realistic to compare the disclosure level of banks in the same industry which means "comparing apple with apple". The followings are the list of Islamic retail banks covered in the study:

1. Al-Baraka Islamic bank (AIB).
2. Al-Salam bank.
3. Bahrain Islamic bank (BISB).
4. Ithmaar bank.
5. Kuwait finance house (KFH).

The annual reports for the year 2010 are then obtained from the websites of the above mentioned banks. During data collection, not all the above banks completed their 2011 annual reports thus prevents this study to compute the disclosure index of the banks beyond 2010.

#### 3.3 Scoring the Disclosure Items

Once the list of disclosure items is finished, the next step is to develop a scoring scheme. In the calculation of the disclosure index, a dichotomous procedure is used (Al-Baluchi, 2006), in which an item scores 1 if it is disclosed in the annual report and 0 if not.

The approach of scoring the banks is additive and equally weighted.

<sup>2</sup> This method gives different weights to the different disclosure items in the annual reports.

### 3.4 Disclosure Indexes

Once all the items have been scored, a disclosure index is created to measure the relative level of mandatory disclosure by each bank so as to enable answering the research questions.

Wallace (1988) defines a disclosure index as "a measure by which the level of financial reporting of an item of information by enterprises within a country and is the ratio of actual scores awarded to the company and the scores which that company is expected to earn".

Hence, the index is the ratio of the actual scores awarded to a bank to the scores which that bank is supposed to earn. Consequently, the calculation of the mandatory disclosure index (MDI) is as following (Al-Baluchi, 2006):

$$MDI = MDS/Em$$

Where:

MDS = Mandatory disclosure score for each bank.  
Em = Expected Mandatory score possible for the individual bank.

Accordingly, the calculation of the voluntary disclosure index (VDI) is as following (Al-Baluchi, 2006):

$$VDI = VDS/Mv$$

Where:

VDS = Voluntary disclosure score for each bank.  
Mv = Maximum voluntary score possible for the individual bank.

And finally, the calculation of the aggregate disclosure index (ADI) is as following:

$$ADI = MDI + VDI$$

## 4. Findings and Discussions

### 4.1 Scoring the Disclosure Index

Table 4.1 summarizes the scores obtained by each bank related to the level of Mandatory, Voluntary, and Aggregate disclosure.

**Table 4.1: Summary of Disclosure Scores**

Bank	Mandatory Score (%)	Voluntary Score (%)	Aggregate Score (%)
BISB	90	87	88
AIB	97	84	91
Ithmar	95	62	81
KFH	88	81	85
Al Salam	89	79	85

Based on the results of the disclosure scores, it is found that the level of disclosure is generally high, as the lowest aggregate disclosure level percentage was 81% scored by Ithmar bank, whereas the highest percentage was 91% scored by Al Baraka Islamic bank (AIB). The level of mandatory disclosure is high for all the banks in the sample. The result shows that there is a high level of compliance by the Islamic banks in Bahrain to the requirements of AAOIFI accounting standards. Those results are as expected because of the following reasons:

1. Bahrain market is seen as a fairly developed one, with a strong regulatory authority represented by the Central Bank of Bahrain and Bahrain Stock Exchange who are closely monitoring and controlling the activities of the Islamic banks (Al-Baluchi, 2006).
2. Bahrain is considered as a major centre for Islamic banks (CBB Review, 2012).
3. Bahrain has a fairly strong accounting and auditing profession because of the availability of the big auditing firms and in addition to the fact that AAOIFI is located in Bahrain (Sarea, 2012).
4. Listed companies are induced by the market to disclose more information in order to raise capital at a lower cost (CBB Review, 2012).
5. CBB makes it mandatory for all Islamic banks in Bahrain to adopt AAOIFI accounting standards (Hassan and Lewis, 2007; Sarea, 2012).

The adoption of AAOIFI accounting standards means that there are comparable financial statements, reliable and useful information that can help the users of the financial statements, for example the Investment Account Holders, to make well-founded decisions. Comparable financial statements allow users to identify and analyze the bank's performance over a period of time and in comparison with other banks. It is in the interest of those bodies, especially the regulators and AAOIFI, to set policies and roles that promote comparability and relevance of the information disclosed in the annual reports of Islamic banks. In addition, it also adds values to the teaching and learning processes of accounting and Islamic finance disciplines.

Interestingly, the level of voluntary disclosure is also considered to be high for all banks in the sample. This might indicate that all banks are trying to be 'market leaders' with regard to voluntary disclosure. Although some of the voluntary disclosures became mandatory according to the latest AAOIFI's standards, those banks are making even more voluntary disclosures than previous years. However, despite the good scores for voluntary disclosures, there are several concerns that need to be highlighted:

1. There is one voluntary item that all the banks in the sample did not disclose, which is related to the Directors Remunerations.
2. All the banks (except Al Salam bank) did not disclose any information related to the "Social Contributions (Charity)".
3. All the banks (except Bahrain Islamic bank) did not disclose any information related to the "restricted investment accounts".
4. All the banks (except Bahrain Islamic bank and KFH) did not disclose any information related to the "commitments and contingent liabilities".
5. All the banks (except Bahrain Islamic bank) did not disclose any information related to the "capital adequacy ratio compared to the minimum ratio accepted by CBB".

The above observations provide evidence that there might be a need for the relevant authorities such as the CBB and AAOIFI to consider making some of the items that are voluntarily disclosed now to be mandatory, especially items such as the "directors remunerations" and "capital adequacy ratio compared to the minimum ratio accepted by CBB", to meet the expectations of various users of the annual reports of those banks.

## 5. Conclusions and recommendations

The results of the study show that there is a high level of compliance by the Islamic banks in Bahrain to the disclosure requirements of the latest AAOIFI standards. The results are as expected since all Islamic banks are required by the banking regulator to comply with AAOIFI accounting standards and in line with the results of the previous studies (Al-Baluchi, 2006; Sarea, 2012). Interestingly, the results of the study show that the level of voluntary disclosure by the Islamic banks operating in Bahrain is also high.

Last but not the least, the findings of this study provides a useful insight into the practices of Islamic banks with regards to mandatory and voluntary disclosure according the latest AAOIFI standard, a subject matter that has been rarely covered in the previous studies on disclosure as evidenced in the literature review section of this study. Hence, this adds a new dimension to the teaching and learning processes of accounting and Islamic finance disciplines, and also provides a starting point for future research possibilities in the area of financial reporting of Islamic banks.

The following are some recommended areas for future researches. This study focused on the disclosure in the annual reports of Islamic banks. Future

researches could cover other mediums of disclosure such as interim reports, prospectuses and press releases. This study considered only Islamic banks, future researches could replicate this study using other types of institutions doing their business according to Islamic Shari'a rules and principals, such as Takaful (Insurance) and Ijara (Leasing) companies. The effect of certain characteristics and factors on the level of disclosure could be tested, such as the profitability of the bank, listing status, rating, qualifications and experience of the top management in the bank, and audit firm. Future researches may also compare the disclosure level in the annual reports of Islamic banks in different countries that made it mandatory to implement AAOIFI accounting standards, such as Sudan and Jordan.

## 6. References

- AAOIFI. (2010). *Accounting, Auditing and Governance Standards for Islamic Financial Institutions*. Manama: AAOIFI.
- Al-Baluchi, A. E. (2006). The Impact of AAOIFI Standards and Other Bank Characteristics on the Level of Voluntary Disclosure in the Annual Reports of Islamic Banks . *Doctoral thesis, University of Surrey*.
- CBB. (2011). *Central Bank of Bahrain Review*. Manama, Kingdom of Bahrain: CBB.
- Hassan, M.K and Lewis, M.K. (2007). *Handbook of Islamic Banking*. Edward Elgar Publishing.
- Hidayat, S. E. (2010). *Bahraini Islamic Finance Outlook 2010: A Mixed Picture*. Islamic Finance News, Vol 7, Issue 46, 13-14.
- Hidayat, S.E. (2011). Challenges in Applying Conventional International Accounting Standards for Islamic Finance. 13th AAOIFI-WORLD BANK Annual Conference on Islamic Banking and Finance. Manama: AAOIFI.
- Ibrahim. W, Ismail. A and Zarabia. W. (2011). Disclosure, Risk and Performance in Islamic Banking: A Panel Data Analysis. *International Research Journal of Finance and Economics*, 100-114.
- Sarea, A. M. (2012). The Level of Compliance with AAOIFI Accounting Standards: The Evidence of Bahrain. *International Management Review Vol.8 No. 2*.
- Wallace, R.S.O (1988). *Corporate Financial Reporting in Nigeria. Accounting and Business Research Vol. 18 , 352-362*.
- Wilson, R. (2009). *The Development of Islamic Finance in the GCC*. [PowerPoint slides]. Retrieved from: <http://www.cimaglobal.com/Study-with-us/Islamic-finance-qualifications/Islamic-finance-resources/Islamic-finance-articles/Development-of-Islamic-finance-in-the-GCC/>