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# The relationship between Shari'ah Supervisory Board and Zakat disclosure among Islamic banks in Malaysia

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## Abstract

The purpose of this paper is to review the literature on the relationship between Shari'ah Supervisory Board (SSB) and Zakat disclosure in the financial statement of Islamic banks in Malaysia. It is based on the hypothesis that SSB relates positively to Zakat disclosure. The design of the paper is based on stakeholder theory and agency theory. Both of the theories discussed the need on the part of Islamic banks as the agent to stakeholders to provide sufficient information about the operation of the banks. The information which is communicated through the financial statements will assist the stakeholders in their decision making processes. Discussion in this paper attempts to shed lights on the importance of SSB in enhancing disclosure on Zakat. For SSB to be able to do that, we review literature on the education background of members (Islamic and non-Islamic) and size (number of members) of SSB. This paper is a conceptual paper with the aim of contributing towards a better understanding of the local reporting framework for Zakat and the paper also attempts to clarify that the Zakat structure in Malaysia is unique therefore foreign standard may not be appropriate for local adoption.

**Keywords:** Islamic banks, Stakeholder Theory, Shariah Supervisory Board, Zakat Disclosure

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## 1. INTRODUCTION

Islamic banks apply different accounting practices particularly in relation to Zakat disclosure in the financial statements. As a result of the inconsistency in reporting, it would be difficult to facilitate and enhance the credibility and reliability of annual reports (Sarea & Hanefah, 2013; Zaini, 2007). Consistency in the application of accounting treatments and in the disclosure of accounting policies by different entities would make information presented in the financial statements becomes comparable (Lovett, 2002; Calloa & Lainez, 2007; Mutter, 1993). Comparability is a feature that enhanced the qualitative characteristics in the preparation of financial statements. This characteristic is absence when there is variation in the accounting practices which lead to the lack of harmonization of accounting practices.

This paper attempts to review literature on the relationship between Shari'ah Supervisory Board (SSB) and Zakat disclosure. The measurement items for SSB are educational background of members (Islamic and non-Islamic) and size (number of members) of SSB. The measurement items for Zakat disclosure is based on the three financial reporting framework for Zakat in Malaysia namely MASB: TR *i*-1 Accounting on Business Zakat, GP8-*i* (BNM) and financial accounting standard on Zakat (AAOIFI FAS 9). Discussion in this paper is divided into two sections namely the two theories (stakeholder and agency) which govern the construct of the

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paper, the second part is on the literature review comprising Shari'ah Supervisory Board, Zakat disclosure and the relationship between Shari'ah Supervisory Board and Zakat.

## **2. THEORIES**

Islamic Banks has an obligation to communicate to its stakeholders. The formal communication is in the form of financial statements in the annual reports. This paper adopts stakeholder theory and agency theory to explain the importance of the relationship between SSB and Zakat disclosure. According to agency theory as stated by Heath and Norman (2004), managers of Islamic banks have a duty to serve and promote the interests of stakeholder. The theory emphasizes on the need of corporate social responsibility and to ensure transparency through disclosure in the financial statements (Sarea *et al.*, 2013). The theory is used as underlying theory because of its ability and richness in explaining the need of accounting standards by Islamic banks as argued by Sarea *et al.* (2013).

To further strengthen the argument on the importance of transparency and disclosure in the annual reports of Islamic banks, the paper is also discussed in the context of agency relationship theory. The separation between owners (principal) and managers creates an agency relationship. This agency relationship creates a lot of problems due to different interests and goals. The managers (Islamic banks) may act in their own interests and not in the best interests of the principal (stakeholders). To curb such acts, the principal establishes governance and control to protect their interest in the organization. This is evidence by the need of sufficient disclosure to promote transparency practices in the agency relationship.

## **3. LITERATURE REVIEW**

### **3.1 Shari'ah Supervisory Board (SSB)**

Bank Negara Malaysia through BNM/GPS 1<sup>1</sup> (para 7) requires every Islamic financial institution to establish a Shari'ah Committee. The Shari'ah Committee is an independent body and it reports directly to the Board of Directors. The committee, as spelt out by BNM/GPS 1 (para 21) has six (6) duties and responsibilities namely to advise the board on Shari'ah matters in its business operation, to endorse Shari'ah compliance manuals, to endorse and validate relevant documentations, to assist related parties on Shari'ah matters for advice upon request, to advise on matters to be referred to Shari'ah Advisory Committee (SAC) of Bank Negara Malaysia, to provide written Shari'ah opinion and to assist the SAC on reference for advice.

On top of the above six (6) duties and responsibilities BNM through Shari'ah Governance Framework for Islamic Financial Institutions<sup>2</sup> (appendix 4) added two more items into the list of duties and responsibilities of Shari'ah Committee. The two items are the Shari'ah committee members are responsible and accountable for all Shari'ah decisions, opinions and views provided by them and the committee is also responsible to assess the work carried out by Shari'ah review and Shari'ah audit. The Shari'ah Committee which is also known as Shari'ah Supervisory Board (Kasim & Sanusi 2013), basically, has both supervisory and consultative functions.

The SSBs are part of Shari'ah governance mechanism of Islamic financial institutions. Shari'ah governance is unique to the Islamic banking system and adds an additional layer of governance to the existing corporate governance structure of the banking industry (Chik, 2012). SSBs play a significant role in determining compliance to Shari'ah law (Lahasansa, 2010; Hassan & Chaowdhury, 2004).

### **3.2 Zakat**

Zakat is an item under Shari'ah law which is very important and significant from Islamic perspective. MASB: TRi-1 defines Zakat as an obligatory contribution assessed based on certain assets owned by a Muslim that satisfy certain conditions and is to be distributed to specified categories of beneficiaries. Administration of Zakat in Malaysia is handled by 14 states. Each state has its own State Islamic Religious Council (SIRC) which is responsible for the administration of Zakat. Zakat administration in Malaysia includes Zakat collection as well as Zakat distribution. Bakar (1998) stated that each state has its own Zakat law. According to Abd. Wahab and Abd Rahman (2011), SIRCs are also known as Zakat institutions and the approach in managing Zakat varies from one state to another.

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<sup>1</sup> BNM/GPS 1: Guidelines on the Governance of Shari'ah Committee for the Islamic Financial Institution, 2004, (Bank Negara Malaysia).

<sup>2</sup> Shariah Governance Framework for Islamic Financial Institutions, 2011, (Bank Negara Malaysia).

### 3.2.1 Reporting Framework for Zakat

Islamic banks in Malaysia are regulated by Bank Negara Malaysia (BNM). BNM had issued guideline on financial reporting for licensed Islamic Banks called GP8-i. This guideline is to provide the basis for presentation and disclosure of the annual reports and financial statements of Islamic banks in carrying out its banking activities. The importance of this GP8-i is to ensure consistency and comparability of these statements among the Islamic banks and to facilitate users in their evaluation and assessment of the financial position and performance of the banks. The GP8-i (2004)<sup>3</sup> provided specimen report and disclosure for Zakat which is under directors' report and in the notes accompanying the financial statements. Under para 3.4 of the GP8-i (2004), Islamic banks are required to comply with the requirements of the applicable accounting standards. However, the guideline had not specifically defined what is the applicable accounting standards that need to be observed by the Islamic banks.

As a result, some Islamic banks adopted AAOIFI and others GP8-i for Zakat disclosure. BNM in December 2012, issued the revised GP8-i. The GP8-i (2012)<sup>4</sup> under para 7.1 specifically requires Islamic banks to prepare their financial statements in accordance with Malaysian Financial Reporting Standards (MFRSs). MFRSs are issued by Malaysian Accounting Standard Board (MASB). This guideline is to take effect for the financial year beginning on or after 1 January 2014. However, Islamic banks are encouraged to early adopt the guideline (para 4.1). The requirement to comply with MFRSs is further enhanced by Malaysian Companies Act 1965. Islamic banks, apart from having to comply with regulation issued by BNM, they are also governed by the Malaysian Companies Act 1965. As Islamic banks are also companies therefore they are also subjected to the requirements of the act that is to comply with the MFRSs when preparing their financial statements.

In Malaysia through the Financial Reporting Act 1997, two (2) independent bodies were created under the act namely Financial Reporting Foundation and Malaysian Accounting Standard Board (MASB). The operation of MASB is overseen by Financial Reporting Foundation and MASB is responsible for issuing accounting standards. MASB has not issued any standard on Zakat instead a technical release Islamic – 1 (TR *i-1*) Accounting for business Zakat was issued to standardize the recognition, measurement, presentation and disclosure on business Zakat. The disclosure requirements are set out in paragraph 16 and 17 of MASB TR *i-1* which includes disclosure on method used in the determination of Zakat base, its responsibility towards payment of Zakat on business and major components of Zakat such as current Zakat expense, Zakat payment, Zakat liability, adjustment recognized. The requirement of Zakat disclosure of MASB TR *i-1* is simpler in relation to FAS 9 of AAOIFI.

Accounting and Auditing Organizations of Islamic Financial Institution (AAOIFI) an international body based in Bahrain has issued Financial Accounting Standards (FAS) No. 9 which specifically governs accounting treatments of Zakat for Islamic banks. Adnan and Abu Bakar (2009) listed out the eight (8) requirements for Zakat disclosure in the notes accompanying the financial statements. The eight (8) requirements are as follows:

- 1) Method used for determining the zakat base and the items included in the base (para 13).
- 2) The ruling of the Shariah's committee of the Islamic bank on issues related to zakat that are not included in the standards (para 14).
- 3) Whether or not the Islamic bank as a holding company pays its share of zakat obligations in its subsidiaries (para 15).
- 4) The amount of zakat that is due from each share (if the bank does not pay zakat) (para 16).
- 5) The amount of zakat that is due from the equity of investment account holders (para 17).
- 6) Whether or not the Islamic bank collects and pays zakat on behalf of holders of investment accounts and other accounts (para 18).
- 7) The restriction imposed by the Shariah committee of the Islamic bank in determining the zakat based (para 19).
- 8) The need to observe the requirement of FAS No. 1: General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions (para 20).

The significant difference between the two is that MASB TR *i-1* is suitable for entity that pays Zakat whereas AAOIFI FAS 9 is more appropriate for Islamic banks which are allowed to collect Zakat (from their customers and employees) and to distribute Zakat (Adnan *et al.*, 2009).

<sup>3</sup> Guidelines on The Specimen reports and Financial Statements for Licensed Islamic Banks (2004, BNM)

<sup>4</sup> Guidelines on Financial Reporting for Islamic Banking Institution (2012, BNM)

### 3.2.2 Zakat Disclosure

Sufficient information on Zakat should be made available in the annual report as it would assist stakeholders in their decision making processes. Wan Abdullah, Percy and Stewart (2013) argued that the lack of transparency would result in information asymmetry. He further elaborated that the existence of information asymmetry between the bank and its stakeholders would expose the bank to the risk of *gharar*<sup>5</sup>. On the other hand, Adnan *et al.* (2009) suggested that an accounting standard on Zakat to be issued to govern the accounting treatment for business Zakat. According to Abu Bakar (2007) and Abdul Rahman (2002), accounting standard on zakat will enhance the uniformity and comparability of the financial statements of Islamic banks. Abu Bakar (2007) agreed that the uniformity and comparability will facilitate the process of auditing on zakat in the accounts. Another significant contribution of Zakat accounting standard as stressed by Abu Bakar (2007) is that it will increase the collection of business Zakat.

The findings of several research suggested that there is a lack of disclosure on Zakat and this is attributed to the fact that the Zakat accounting standard available is not appropriate for the Zakat administration environment in Malaysia (Wan Abdullah *et al.*, 2013; Abdul Rahman, 2002; Abu Bakar, 2007). Wan Abdullah *et al.* (2013) suggested the enforcement of accounting standards particularly on Zakat disclosures should be made mandatory. Abdul Rahman (2002) supported the suggestion by saying that the enforcement of standards on Zakat would reduce the differences in Zakat calculation methods and consequently enhance the quality of Zakat disclosure. It was also noted that Islamic banks lacked motivation to increase disclosure on Zakat. This lack of motivation could be attributed to the indifferent attitude of the stakeholders (stakeholders do not demand for more information on Zakat). However, according to Wan Abdullah *et al.*, (2013), Shari'ah Supervisory Board as the Shari'ah governance mechanism needs to educate the managers of Islamic banks on the importance of Zakat disclosures for stakeholders and to fulfil their stewardship function.

The literature review on Zakat disclosure suggested that there are guidelines and standards issued for Islamic Banks. However, it can be seen that there is a variation in reporting and the adoption on the guidelines are at a minimum level. The researchers contributed this to the fact that the standard available on Zakat (AAOIFI FAS 9) is not suitable for Zakat structure in Malaysian (Wan Abdullah *et al.*, 2013). MASB cited two reasons for the inappropriateness of the standard in the Malaysian context. The first reason given by MASB is that FAS 9 is for the application by Islamic banks that collect and distribute Zakat and secondly it might run contrary to state or federal legislation in Malaysia (MASB: TR *i*-1 BC6). Another important factor which contributes to the lack of disclosure on Zakat is due to the indifferent attitude of stakeholder (users of financial statement in Malaysia) on the amount of information disclosed on Zakat (Zaini, 2007).

### 3.3 SSB and Zakat

Wan Abdullah *et al.* (2013) argued that SSBs have a significant role to play in encouraging management to disclose information on Shari'ah related items. As a result, SSBs have influence on the disclosure of Shari'ah related items in the financial reports of Islamic banks. Sufficient information on Zakat need to be provided by Islamic banks through the financial statements in order to satisfy stakeholders' needs for assurance that the bank has complied with Shari'ah. Such an argument is deemed necessary as it is the basis on stakeholder theory which promotes transparency through disclosures. Sufficient disclosures provided by the institutions would enable them to win and maintain the support of key stakeholders (Islam and Deegan, 2008).

Islamic Banks are required to adhere to Shari'ah law<sup>6</sup> and SSBs are responsible to ensure adherence. The study is focusing on the role of SSBs and the amount of information on Zakat that is released to the public based on the requirement of MASB TR *i* -1. The measurement items for SSBs include educational background of members (Islamic or non-Islamic) and size of SSBs. The study tries to establish a pattern between SSBs and Zakat disclosure. The findings of Wan Abdullah *et al* (2013) on Shari'ah governance and Zakat disclosure suggested limited relationship which supported the findings of Ibrahim *et al* (2012).

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<sup>5</sup> *Gharar* means uncertainty and ignorance of one or both parties to a contract over the existence, substance or attributes of the subject matter of the sale or purchase at the time of contract (Iqbal & Molyneux, 2005).

<sup>6</sup> *Shariah* is Islamic law derived from Al-Quran and the teaching of the Prophet Muhammad (peace be upon him). Shariah is regarded as the legal and ethical rules to guide a Muslim in life (Thani *et al.*, 2003).

### 3.3.1 Educational Background of Members of SSB

The guideline of BNM (BNM/GPS1- Para 11, 12) on qualification states that a member shall be an individual. BNM neither permit a company, an institution nor a body to be a member of SSB. The guideline requires that the individual possesses qualification or necessary knowledge, expertise or experience in the area of Islamic jurisprudence (Usul al-Fiqh) or Islamic transaction/commercial law (Fiqh al-Mu'amalat). This guideline provides minimum qualification of SSBs' members. Wan Abdullah *et al.* (2013) stated that members of SSBs may possess different educational background, for example, Islamic law, common law, banking, finance, economics and accounting.

The effectiveness of the SSBs in ensuring disclosure in the annual reports is dependent very much on the expertise of its members in the areas of accounting, financial reporting, banking, economic or finance. Abbott *et al.* (2003); Bedard *et al.* (2004); Kent & Stewart, (2008) agreed that members of SSBs with financial educational background would be able to influence the extent of disclosure. This is because of the high level of awareness they possess on the importance of transparent reporting. Therefore, members of SSBs with strong financial background are more likely to understand the importance of disclosure to stakeholders.

### 3.3.2 Size of SSB

Wan Abdullah *et al.* (2013) argued that the size of SSBs is significant as it would influence the extent of disclosure on Zakat. The argument is based on the fact that when the size is big the function and duties of the SSB could be divided among the members, SSBs can afford to allow certain members to focus on corporate reporting. Large SSBs with diverse perspective and experience would be expected to drive better compliance with Shari'ah and enhance corporate reporting including aspects of Shari'ah disclosure (Wan Abdullah *et al.*, 2013). The minimum number of SSBs' members is three (3) and there is no maximum number as prescribed by para 14 of BNM/GPS1.

## 4. CONCLUSION

The construct of the paper is based on the stakeholder theory and agency theory. According to the stakeholder theory, the interest of the stakeholder is better served by the managers when there is sufficient disclosure in the annual reports. The transparency through disclosure would be able to assist the stakeholders to make informed decision. This is further supported by agency theory which claim that as an agent (Islamic banks), they have an obligation to uphold the interest of the principal (stakeholders) at all times and this can be achieved by having sufficient disclosure in the annual reports.

After reviewing the literature on zakat disclosure, it was noted that there are guidelines and standards, local and international, issued for Islamic Banks. The findings suggested that there is a variation in reporting and the adoption level on the guidelines and standards are at a minimum level. The scholars contributed this to the fact that the standard available on zakat is not suitable for zakat structure in Malaysian and another factor is due to the indifferent attitude of stakeholder on the amount of information disclosed on zakat. However, the variation in reporting may change in the near future with the revision of GP8-i in 2012 by BNM. The revised GP8-i (2012) which is effective for reporting in 2014 onwards, specifically requires Islamic banks to adopt accounting standards and guidelines issued by MASB (para 1.1, 1.3).

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