



## Financial Reporting Quality on Indonesia Islamic Banks: An Internal Stakeholders Perception

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**Abstract:** This study describes financial reporting quality of 33 Islamic Banks in Indonesia. The data was taken by questionnaires from 173 respondents, consist of employees (head of group, head of division, and internal auditor), audit committee members, and sharia supervisory board members. The questionnaires consist of 24 questions with eight dimensions of research instruments, they are financial reporting quality (ie. timeliness, verifiability, completeness, representation faithfulness, neutrality, comparability, consistency and clarity). This research is qualitative, therefore using interpretive analysis as data analysis. The result shows that representative faithfulness is considered as the most important component by internal party of Islamic banks.

**Keywords:** Islamic bank, financial reporting quality, representative faithfulness.

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### Introduction

Islamic bank is a form of Islamic financial institutions. Chapra and Khan (2000) stated that Islamic banks are applying Islamic sharia banks in all aspects of belief and practice. In 2013, the world economic growth decreased. The World Bank lowered its economic growth prediction in 2013 and 2014 for the state of China and some developing countries in East Asia. World Bank cites the China's economic slowdown and the falling of commodity prices can hit exports and investment in several countries including Indonesia. East Asia continues to be the engine of economic growth, contributing for 40% of world economic growth (Rendra, 2013). Otherwise, International Monetary Fund (IMF) lowered its forecast for world economic growth to 3.3 percent and 3.4 percent in 2013 and 2014.

Senior Economist Mandiri Securities, Aldian Taloputra said that the downward trend of world economic growth forecast will be good but the recovery will be ramp. Aldi explained that until now the European economy contraction is still occurs because small countries such as Spain and Greece make savings and unemployment rate in Europe is 10.9 percent (Berita Lampung, 2013). However, the growth of Islamic banking in the world, and in Indonesia in particular, was still continues to rise in 2013. It was indicated by the increasing number of bank branches by 8% compared to 2012 in Indonesia. Meanwhile, there was increasing in terms of total assets of the Islamic banking penetration, around outstanding countries: Malaysia 200%, the United Arab Emirates and Qatar (100 %), and Indonesia 55% (Hamzah, 2014).

Deputy Governor of Bank Indonesia, Halim Alamsyah on June 22, 2011 said that a bank in Indonesia should learn from the case of Barings Bank and Enron. Barings Bank is one of the oldest banks in London, England. However, the bank finally collapsed in 1995, after suffering losses of up to U.S. \$ 1.3 billion due to speculative investments made by employees in futures contracts. Enron Corporation was an American energy company based in Houston, Texas, United States. Enron became the public spotlight in late 2001, when the disclosure of

accounting fraud was being done systematically, institutionally, and creatively planned in financial reporting (Purnomo, 2011).

The occurrence of important issues related to financial accounting and reporting system which resulted in the bankruptcy of big companies, such as Enron, WorldCom and Global Crossing in the early 21st century, makes the business world aware of the importance of the quality of financial reporting (Kintzele, 2008). Fogarty (2009) also found that the bankruptcy was because of financial reporting issues. Robinson and Munter (2004) revealed that based on a survey conducted by the Association for Investment Management and Research (AIMR) on portfolio managers and securities, analysts found that the quality of financial reporting is very important (43%), important (30%) and somewhat important (22%) for the user.

Here are the cases related to the quality of financial reporting occurred in Indonesia and the world. The cases show that some Islamic banks have not implemented sharia principles well and doing financial reporting violations.

**Table 1. Cases related Banking Financial Reporting problems**

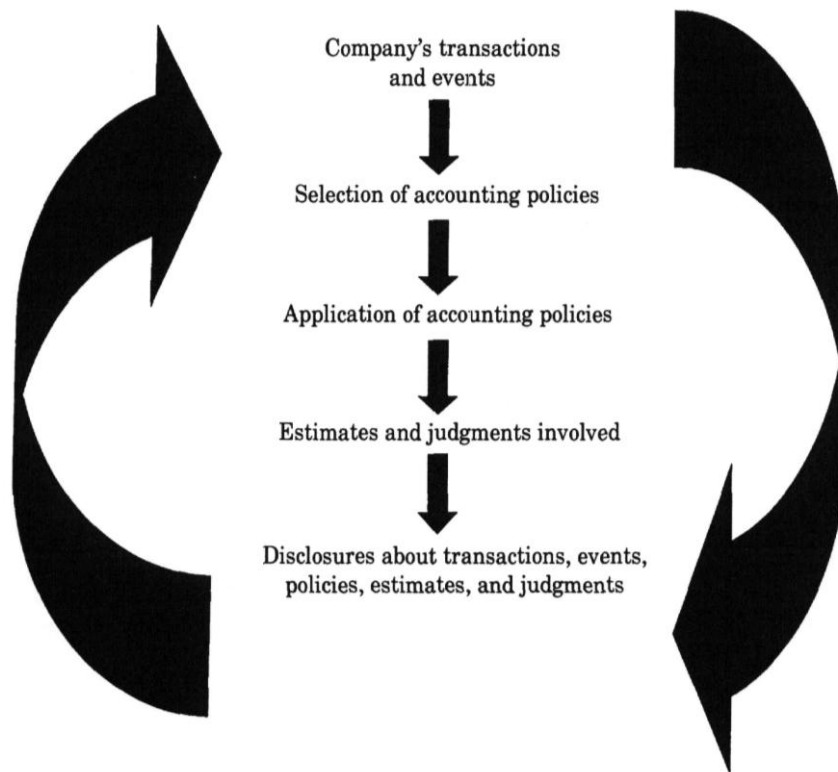
No.	Cases
1.	Bank Syariah Mandiri (BSM) and BNI Syariah Business Division participate in syndicated loans project of Indosat Multimedia Mobile (IM3) and earned interest on the financing of 19% per year. Islamic banks can not use the concept of interest, so that the advantages of this financing should not be reported in the income statement.
2.	Islamic Bank of South Africa went bankrupt in November 1997 with debts between R50-R70 million, this happens due to the poor management and accounting systems and improper management, the internal party unsecured loans in large amounts causes the amount of bad loans in the balance sheet.
3.	Dubai Islamic Bank fraud suffered nearly U.S. \$ 300 million in 1998. This happens due to the poor financial reporting banks.
4.	Bank Piety and the Islamic Money Management Companies in Egypt bankrupt, whereas before financial statements are not problematic.
5.	Incomplete financial statements by Islamic banks in Indonesia. Some banks do not present the sources and uses of qardhul hasan funds and report the source and uses of zakah.

Sources: Processed from Agustianto (2008), Rajhi & Hasairi (2011) and annual reports from Islamic Banking in Indonesia.

Based on table 1, Bank Syariah Mandiri (BSM) and BNI Syariah Business Division used interest rate system in syndicated loans project Indosat Multimedia Mobile (IM3). It was not complied with syaria principles due to the 19% of interest rate per year. Section 2 – 4 showed some Islamic bank in South Africa, Dubai and Egypt experinced bankruptcy because of financial reporting problems.

## Literature Review

In contrast to the financial statements which is the output of accounting, Financial reporting is not an end product, it is a process that starts from the transaction / event, selection of accounting policies and implementation of the policy. Financial reporting also involves estimation and judgments as well as disclosures about transactions, events, policies, estimates and judgments that have been made. The quality of financial reporting depends on the quality of each part of the financial reporting process (Jonas and Blanchet, 2000).

**Figure 1. Process of Financial Reporting**

Source: Jonas and Blanchet (2000)

There are several approaches to assess the quality of financial reporting (Jonas and Blanchet: 2000), namely:

- a) *FASB Conceptual Framework*
- b) *1994 AICPA Special Committee on Financial Reporting (Jenkins Committee)*
- c) *Earning Persistence Model*
- d) *1994 POB Advisory Panel on Auditor Independence (Kirk Committee)*
- e) *SEC model in evaluating the quality of International Accounting Standard (IAS)*
- f) *Blue Ribbon Committee Recommendation No.8*
- g) *SAS No.61*

These approaches divided into two categories, namely: the needs of users and the protection of shareholders / investors. Three initial approach focuses on the needs of users, while the other four approaches focus on the protection of shareholders / investors. The focus of existing approaches in defining the quality of accounting and financial reporting.

**Figure 2. The criteria for determining the quality of financial reporting**

<u>Recommendation No. 8</u>	<u>SAS No. 61</u>	<u>Kirk Committee</u>	<u>SEC Model to Assess Quality of IAS</u>
Clarity of disclosures	Clarity, consistency, and completeness of accounting information and disclosures	Clarity of financial disclosure practices	Transparency
Degree of aggressiveness or conservatism of accounting principles and underlying estimates	Consistency of application of accounting policies Items that have a significant impact on representational faithfulness, verifiability, neutrality, and consistency of accounting information	Conservative, moderate, or extreme choices of accounting principles Common or minority practices	Comparability  Full disclosure

Source: Jonas and Blanchet (2000:357)

Some following researchers have been stated the concept of the quality of financial reporting. Quality of corporate financial disclosure was proxied by complete, timely and understandable (Miller and Bahnson, 1999). Jonas and Blanchet (2000) defined quality in financial reporting as some quality characteristics of financial information. Financial reporting quality characteristics should meet quality characteristics, such as: earnings persistence, disaggregated information, feedback value, timeliness, verifiability, completeness, comparability, consistency, representational faithfulness, neutrality and clarity.

One way of measuring the quality of financial reporting is to consider the presence/absence of revenue recognition problems (George and Philips, 2001). While Broadley (2007) concludes the discussion of the Hundred Group of Finance Directors that the financial reporting quality measures the fulfillment of the following eight factors: 1) the purpose of the financial statements, 2) financial reporting framework, 3) accounting standards, 4) convergence, 5) reporting performance, 6) basic measurements, 7) narrative reporting and supplemental information, 8) forward looking information.

In Islamic society, the development of accounting theory is based on Islamic law and in line with the principles and postulates that does not opposite with Islamic law. Islamic law has a very clear view of basic principles for financial reporting and accounting practices, therefore, it should be carried out with respect to the goal that is based on the spirit of Islam and its teachings (Lewis, 2001). The fundamental principles of financial reporting (Lewis, 2006):

- a) Full disclosure  
Full disclosure is necessary to predict the obligations in the future and assess the investment risk. Financial institutions also contained a religious obligation of zakat payment for mustahik (QS 2:71; 4:135).
- b) Materiality (QS 5:16; 2:282-283)
- c) Bookkeeping  
In Islam, the necessity of bookkeeping can be seen in QS 2:282.
- d) Reliability  
Askary dan Clarke, 1997 in Lewis, 2001 states there are 19 verses in the Qur'an related to reliability, namely QS 2:283; 3:122,159; 4:58,81; 7:89; 8:2,27,49,61; 12:11,64,66; 23:8; 27:39; 33:72; 65:3; 70:32; 81:21. If the publication of financial information is not reliable, many people can not fulfill his religious responsibility to

pay Zakat accordingly. QS 4:58 indicates that managers must provide honest disclosure of financial information and a complete, reliable to the parties concerned.

e) Transparency (QS 11:84-85)

Isgiyarta (2010:130) stated that there are four characteristics of the primary qualities of accounting information, ie:

a) Useful information in good deeds and forbidding the evil (*amar ma'ruf nahi mungkar*).

The basis of the first characteristic is QS Ali Imran:104; QS At Taubah:71; QS An Nuur:21; QS Al Ashr:2-3. To achieve information that invites to goodness and forbidding the evil, then (Isgiyarta:132) :

1. Accounting information is provided in accordance with the needs of the company and the community in relation to achieving corporate objectives, namely: sustainability efforts and its contributions to society. Accounting information is capable of being the basis for making decisions that increase the benefit of the company in society.
2. Accounting information provided should be able to prevent the destruction of the company, waste and actions that exceed the limit. Accounting information can be corrected over the policies or implementation of corporate management. The correction is due to information that is not in accordance with corporate goals (QS Al Furqaan:67; QS Thaahaa:127).

b) Away information from the action lies

Accounting information will be useful if the information disclosure free from falsehood and slander. Accounting information must be based on objective data and re-testing when there is no material difference. The action that free from lies and slander was explained in QS An Nuur: 7; Surah Al Ankaboot: 68 and Surah Al-Baqarah: 191. While the hadiths pertaining this issue are:

1. People who like to spread slander will not enter Paradise (HR Bukhari).
2. A believer should not accuse, curse, say dirty, and denounced (HR At Tirmidzi)

The information disclosed by lies and slander will cause the injured party. Information containing slander, evil and vile is not only detrimental in the afterlife, but also the world destruction.

c) Impartial information-neutral

Accounting information must be presented in a neutral, impartial. The process of disclosure is not free from subjective interpretation of financial statements over a constituent of certain events. Drafting financial statements trying to keep away from various interested parties. In the Qur'an Surah Al-Baqarah: 282 disclosure must be in writing to be neutral and fair.

d) Information support religious observance of sharia rule

The information disclosed in the financial statements must be able to accommodate the interests of religion sharia rule (QS An Nahl:90).

Furthermore supporting qualitative characteristics including (Isgiyarta, 2010):

a) Completeness and materiality

The information disclosed in the financial statements must be completed, even if the financial statement does not able to accommodate all of the data or information, the reduction of data or information that will not change the attitudes, opinions, or decisions, when the person is aware of any reduction or removal of the information. The information disclosed should be no intentional of omission or concealment that can make people change attitudes, opinions, or decisions. Ayah relating to completeness and materiality are explained in QS Al Ahzaab:54 and Ash Syua'raa:181-183.

b) Comparability

Comparison of financial reporting is indispensable for the reader to make easier understanding or interpreting the economic activities of the company. Benchmarking of financial statements is being made to ease the reader to understand the progress of the company's performance. Benchmarking of financial statements is being used for the detection of company's performance, changes in policy, strategy changes, or changes in the information behind the numbers of the results of benchmarking the financial statements. Ayah underlying information can be compared in QS Al Baqarah:185 and QS An Nisa':28.

Syahatah (2001:111) argues Islamic accounting information has attributes of trust, detailed, honest, objective, timely, clear and transparent. Zaid (2004:86) states that the user can optimally utilize the financial statements, then it must meet the qualitative requirements in the financial information. A qualitative term is that when there is no specification of the financial information loses its significance and becomes meaningless. Requirements that must be met in the financial information to realize the optimal benefits are:

a) Relevant

The relevant financial information is the information that meet to user needs.

In order to reach a relevant information, the factors that must be met are:

1. Perfect
2. Substantive
3. Restrictions on the scope of
4. Standards and assumptions used
5. On time

b) Reliable

Reliable financial information is reliable information, thus providing peace of the users who use the information in making decisions. In order to be reliable information, it must fulfill some requirements, such as:

1. Verifiable
2. Honesty
3. Netrality
4. Completeness

c) Comparability

In order to become useful financial information, the information should also be compared with similar companies or different companies but have the same characteristics, or by the company itself in the previous period. In order to be able to make comparison, financial information must use the same standards consistently and have the same periodicity. When there is a change in the method, it must be disclosed.

d) Understandability

Means that the user can understand the financial information without any ambiguity and difficulty. In order to make understandable financial information, the sentence should not complicated and unclear.

## **Methodology**

The method used in this study is a survey method with the approach of the verification method. The type of research is causal relationship, because examining the relationship between the variables under study and to determine the effect of one or more variables to the other variables. Financial reporting quality (FRQ) consists of some dimensions: timeliness, verifiable, complete, honest representation, neutrality, comparability, consistency, and clarity.

Full operationalization of these variables can be found in the appendix. The data used in this study is primary data. Sources of data derived from the questionnaire were distributed to members of the audit committee, member of shariah supervisory board, group head, division head or staff associated with the research topic

## Results and Discussion

The questionnaires had been sent as many as 340 copies, but it returned as many as 179 copies. Of the returned questionnaires, only 173 questionnaires can be used, because 6 is not a completed questionnaire. The rate of return the questionnaire can be seen in Table 2.

**Table 2. Questionnaire Information**

No	Explanation	Item	Percentage
1	Number of Questionnaire which scatter	340	100.00%
2	Number of Questionnaire which return	179	52.65%
3	Number of Questionnaire which cannot be processed	6	3.35%
4	Number of Questionnaire which can be processed	173	50.88%

Source: Data processed

The questionnaire was sent to 34 banks. In December 31, 2011 there are 11 Islamic banks and 23 Islamic business units in Indonesia. The bank is filled out questionnaires as many as 34 banks, but one bank was not filled completely, so that the processed questionnaires from 33 banks. This means that the rate of the questionnaire responses is 97.06%.

Here are the the results of a questionnaire distributed to respondents from various Islamic banks.

**Table 3. Summary of Questionnaire Result**

1.	To meet requirement of stock exchange board in term of timeliness.	4.1098
2.	Bank compare with competitors in the timely publishing of its financial statements.	4.1098
3.	To ensure that it provides the same information to all interested users at the same time.	4.2428
4.	Information in financial statements allows the most judgmental aspects of financial reporting.	4.2312
5.	Information in financial statements communicates the significant estimates and assumption used to develop financial information.	4.2081
6.	Estimates and assumptions based on best information available.	4.0347
7.	The most significant events be communicated to investors.	4.0751
8.	Negative events or unsatisfactory outcomes be presented in financial statement.	4.2428

9. Positive events or outstanding outcomes be presented in financial statement.	4.3179
10. Accounting principles selection appropriately convey the underlying economics of the transactions.	4.3237
11. Valuation for precision in apply principle accounting.	4.3410
12. Accounting is a honesty and clear portraying/description about substance and objective of transaction.	4.3295
13. Bank provide information (in footnotes and others) to supplement the investor understanding.	4.2659
14. Management's assessment of the likely outcome was neutral.	4.1965
15. Management's selection of accounting principle was neutral.	4.2543
16. Accounting policies, disclosures, format of financial statement and other financial communications compare to competitors.	3.8555
17. Accounting policy reflects a specifics industry practice. Practice in accordance with accounting requirement specifically codified as part of GAAP.	4.3237
18. The effect of the changes in accounting policies, or in the application of the policies and the use of estimates and judgments on all periods presented should be appropriately disclosed.	4.2254
19. The changes in accounting policies, or in the application of the policies and the use of estimates and judgments are motivated by management's desire to achieve a specific accounting result.	4.0636
20. Disclosures go beyond complying with the absolute minimum requirements of GAAP.	4.1908
21. The bank's presentation of information (considering the constraints of GAAP) well organized and easy to follow.	4.1387
22. The language used in the financial reports easily understandable by nonaccountants.	4.0636
23. Bank made clear graphs and charts in its financial report, to enhance the understandability of the financial information.	4.1387
24. Financial statement and other disclosures form a comprehensive, cohesive, and coherent set of financial information that describes the whole event in banking.	4.3121

Source: data processed

Based on the results, it is important in the quality of financial reporting stakeholders are perceived appraisal accuracy in applying accounting principles. All indicators in representative faithfulness earn high points from the respondents. It can be said that an honest presentation is very important in financial reporting. While the need to compare accounting policies, disclosures, financial reporting formats and other financial communications with competitors are not important according to internal stakeholders of Islamic banks.

Important findings in this study revealed that the financial reporting quality dimensions, most importantly, are an honest representation (Representation faithfulness). This shows the importance of the application which reads on the Quran surah Al-Baqarah verse 282:



يَتَأْتِيهَا الَّذِينَ ءَامَنُوا إِذَا تَدَايَنْتُمْ بِدِينٍ إِلَىٰ أَجَلٍ مُّسَمًّى فَاكْتُبُوهُ ۚ وَلْيَكْتُب بَيْنَكُمْ كَاتِبٌ بِالْعَدْلِ ۚ وَلَا يَأْب كَاتِبٌ أَنْ يَكْتُبَ كَمَا عَلَّمَهُ اللَّهُ ۚ فَلْيَكْتُبْ وَلْيَمْلِكِ الَّذِي عَلَيْهِ الْحَقُّ وَلْيَتَّقِ اللَّهَ رَبَّهُ ۚ وَلَا يَبْخَسْ مِنْهُ شَيْئًا ۚ فَإِنْ كَانَ الَّذِي عَلَيْهِ الْحَقُّ سَفِيهًا أَوْ ضَعِيفًا أَوْ لَا يَسْتَطِيعُ أَنْ يُمِلَّ هُوَ فَلْيَمْلِكْ وَلِيَّهُ بِالْعَدْلِ ۚ ...

282. O you who believe! when you deal with each other in contracting a debt for a fixed time, then write it down; and let a scribe write it down between you with fairness; and the scribe should not refuse to write as Allah has taught him, so he should write; and let him who owes the debt dictate, and he should be careful of (his duty to) Allah, his Lord, and not diminish anything from it; but if he who owes the debt is unsound in understanding, or weak, or (if) he is not able to dictate himself, let his guardian dictate with fairness;...

These results also relevant to accounting theory, put forward by stating Thaheri, accounting in Islamic financial institutions is primarily a form of accountability to God and should be implemented in accordance with honest Qur'an surah Al-Baqarah verse 282 (QS 2:282), Al-Anfal verse (QS 8:58) and Al Mutaffifin verse 1 (QS 83:1).

Qur'an Surah Al-Anfal verse 58 (QS 8:58)

وَأِمَّا تَخَافُ مِنْ قَوْمٍ خِيَانَةً فَانْبِذْ إِلَيْهِمْ عَلَىٰ سَوَاءٍ ۚ إِنَّ اللَّهَ لَا يُحِبُّ الْخَائِبِينَ ﴿٥٨﴾

58. And if you fear treachery on the part of a people, then throw back to them on terms of equality; surely Allah does not love the treacherous.

Qur'an Surah Al Mutaffifin verse 1(QS 83:1)

وَيْلٌ لِّلْمُطَفِّفِينَ ﴿١﴾

1. Woe to the defrauders,

These three verses show the importance of honesty in the transaction and make record of property mandated, so that in the end, the actual obligation of zakat which is the purpose of accounting in Islamic financial institutions can be calculated (Karim, 1987).

## Conclusion

Based on questionnaires distributed to the internal bank, it can be concluded that the honesty in disclosing financial information to stakeholders is the most important thing in financial reporting. Financial information has an important impact on the accuracy of the profit sharing, zakat calculation, and so forth.

Due to the results of this research, there are several recommendations to regulators. To improve the quality of financial reporting, preferably in the financial reporting of Islamic banks, certain conditions should be met, such as: 1) the most significant events are communicated to the investor; 2) the bank's accounting policies, disclosures, financial reporting formats, and other financial communications compared with competitors; and 3) the use of language in the financial statements that can easily understood by non-accountants.

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## APPENDICES

Table 4. Operationalization of Variable

<p>FRQ=Financial Reporting Quality Jonas &amp; Blanchet, 2000; Pomeroy &amp; Thornton, 2007; Labelle et.al, 2007; Syahatah, 2001; Zaid, 2004; Isgiyarta, 2010.</p>	<p>1. <i>Timeliness</i></p> <p>2. <i>Verifiability</i></p> <p>3. <i>Completeness</i></p> <p>4. <i>Representation faithfulness</i></p> <p>5. <i>Neutrality</i></p> <p>6. <i>Comparability</i></p>	<p>1. To meet requirement of stock exchange board in term of timeliness.</p> <p>2. Bank compare with competitors in the timely publishing of its financial statements.</p> <p>3. To ensure that it provides the same information to all interested users at the same time.</p> <p>4. Information in financial statements allow the most judgmental aspects of financial reporting.</p> <p>5. Information in financial statements communicates the significant estimates and assumption used to develop financial information.</p> <p>6. Estimates and assumptions based on best information available.</p> <p>7. The most significant events be communicated to investors.</p> <p>8. Negative events or unsatisfactory outcomes be presented in financial statement.</p> <p>9. Positive events or outstanding outcomes be presented in financial statement.</p> <p>10. Accounting principles selection appropriately convey the underlying economics of the transactions.</p> <p>11. Valuation for precision in apply principle accounting.</p> <p>12. Accounting is a honesty and clear portraying/description about substance and objective of transaction.</p> <p>13. Bank provide information (in footnotes and others) to supplement the investor understanding.</p> <p>14. Management's assesment of the likely outcome was neutral.</p> <p>15. Management's selection of accounting principle was neutral.</p> <p>16. Accounting policies, disclosures, format of financial statement and other financial communications compare to competitors.</p> <p>17. Accounting policy reflects a specifics industry practice. Practice in accordance with accounting requirement specifically codified as part of GAAP.</p>
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	<p>7. <i>Consistency</i></p>         <p>8. <i>Clarity</i></p>	<p>18. The effect of the changes in accounting policies, or in the application of the policies and the use of estimates and judgments on all periods presented should be appropriately disclosed.</p> <p>19. The changes in accounting policies, or in the application of the policies and the use of estimates and judgments are motivated by management's desire to achieve a specific accounting result.</p> <p>20. Disclosures go beyond complying with the absolute minimum requirements of GAAP.</p> <p>21. The bank's presentation of information (considering the constraints of GAAP) well organized and easy to follow.</p> <p>22. The language used in the financial reports easily understandable by nonaccountants.</p> <p>23. Bank made clear graphs and charts in its financial report, to enhance the understandability of the financial information.</p> <p>24. Financial statement and other disclosures form a comprehensive, cohesive, and coherent set of financial information that describe the whole event in banking.</p>
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Source: processed from many literatures