International Journal of Business and Society, Vol. 18 S1, 2017, 45-58

DISCLOSURE OF SHARI'AH NON-COMPLIANCE INCOME BY ISLAMIC BANKS IN MALAYSIA AND BAHRAIN

Romzie Rosman♣
Universiti Islam Malaysia

Anna Che Azmi
Universiti Malaya

Siti Noraini Amin
Universiti Islam Malaysia

ABSTRACT

The reporting of any earnings or expenditures derived from Shari'ah non-compliant activities enhances transparency of business and financial dealings of Islamic banks. The main objectives of this paper are to develop a Shari'ah non-compliance income (SNCI) disclosure index and examine whether there are significant differences in the SNCI disclosure indexes of Islamic banks from Bahrain and Malaysia. The samples used for this study are 17 Islamic banks from Bahrain and 17 Islamic banks from Malaysia for the years 2013, 2014, and 2015. The findings show that Islamic banks in Bahrain and Malaysia made prudent disclosures of SNCI, whereby both countries obtained a high SNCI disclosure index, especially in the year 2014. However, there is still room for improvement for both countries in selected areas of SNCI disclosure. Also, this study found no significant differences of the SNCI disclosure index between these two countries. The contribution of this study is that it establishes a comparable standard disclosure of SNCI, through the SNCI disclosure index, which may assist the users of financial statements in making informed decisions. Subsequently, this study also identifies areas in SNCI disclosures practices that may need further attention from policymakers and standards setters, nationally and globally.

***Keywords*:** Shari'ah Non-Compliance Income; Shari'ah Non-Compliance Risk; AAOIFI; IFRS; Islamic Banks; Bahrain; Malaysia.

1. INTRODUCTION

Islamic banks are exposed to a unique set of risks such as equity investment risk and displaced commercial risk; among the most critical risk is the Shari'ah non-compliance risk. Shari'ah non-compliance risk highlights possible failure to meet obligations or satisfy the Shari'ah principles as prescribed in the relevant jurisdiction's standards and widely accepted international Shari'ah standards. The management of these risks is important because failure to comply with Shari'ah by Islamic banks may have an impact on a bank's sustainability and reputation. These risks, together with the related increase in regulatory requirements to enhance accountability and transparency, have led Islamic

♣Corresponding author: Romzie Rosman, Cyberjaya Graduate School of Management & Finance, Islamic University of Malaysia, Cyberjaya, 63000, Malaysia. Email: romzie@uim.edu.my

banks to improve the quality of their disclosures. Greater disclosures in these areas are important to the users of financial information, including the investment account holders, shareholders, regulators, and public at large. Moreover, among important Shari'ah risk management functions is to provide transparency and full disclosure of Shari'ah non-compliance income (SNCI).

Oz, Ali, Khokher and Rosman (2016) stresses the importance of improving the role of effective Shari'ah governance and disclosure. Hence, the reporting and disclosure of SNCI need to be further strengthened. Moreover, Oz, Ali, Khokher and Rosman (2016) highlighted an absence of consistent and elaborate regulatory disclosure requirements on SNCI; relevant data either remains unreported or is reported in a manner that does not provide sufficient information to stakeholders for assessing Shari'ah non-compliance risk. It was suggested by IFSB-4 that Islamic banks need to disclose the inflows and outflows of Shari'ah non-compliant earnings and expenditures, with an explanation of how they are disposed of by suggesting the disclosure of the nature, size, and number of violations of Shari'ah compliance during the year.

Therefore, the first objective of this study is to develop an SNCI disclosure index of Islamic banks from Bahrain and Malaysia. This index is developed from the guidelines and requirement of regulators in Bahrain and Malaysia. The annual reports of 17 Islamic banks in Bahrain and 17 Islamic banks in Malaysia for the period 2013–2015 are examined in this study. The next objective of this paper is to compare how Islamic banks in Malaysia and Bahrain report and disclose their Shari'ah non-compliance income. A series of parametric and non-parametric analyses were performed to explain the mean difference of the SNCI disclosure index of the Islamic banks in these countries. The *t*-test was adopted for parametric test, whereas Kolmogorov–Smirnov (K-S) and Mann–Whitney (Wilcoxon rank-sum) tests were conducted for the non-parametric test to analyze the differences in the SNCI disclosure index obtained by both countries. By observing these reportings, we are able to gauge the sustainability of these Islamic banks. Islamic banks are seen as important organisations that support efficient allocation of resources such as savings and provide redistributive mechanisms such as *zakat* and *waqf* to the micro- and small business community. Malaysian and Bahrain are among the countries that encourage the development of Islamic banks toward achieving socioeconomic goals for micro- and small businesses (MIFC, 2015).

Bahrain and Malaysia are also chosen for this study because these countries are known to be hubs for the Islamic banking industry operating in a highly regulated Islamic banking system. By examining the SNCI disclosure practices of the Islamic banks in these two countries, a benchmark of good SNCI disclosure practices could be developed and subsequently used by policymakers internationally to examine Islamic banks' SNCI disclosure practices in other countries. Islamic banks in Bahrain have the best Islamic banking affairs worldwide, whereby the Bahrain Monetary Agency has developed internationally recognised standards, regulations, and infrastructure for Islamic financial institutions (Khan & Bhatti, 2008). Importantly, Bahrain has developed a network of Islamic banking research and regulatory institutions such as Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), International Islamic Financial Market, and Islamic International Rating Agency (Khan & Bhatti, 2008). Similarly in Malaysia, Islamic finance also has developed into a comprehensive and sophisticated

Islamic finance market place where it has been characterized by a robust regulatory, supervisory, Shari'ah and legal framework (MIFC, 2016). Countries such as Malaysia and Bahrain are also striving to be regional hubs for Islamic finance services (Ariss, 2010).

The outline of this paper is organised as follows. First, we present a brief overview of the regulatory framework in Malaysia and Bahrain on SNCI. This is followed by the literature review and methodology section. Next, the results are presented, followed by the concluding section.

2. BACKGROUND

2.1. Malaysia

The Islamic banking system in Malaysia is considered more progressive than that of other Muslim countries, which have implemented similar systems (Hasan, 2010). The Malaysian regulatory authority has taken a proactive approach in promoting a steadily increasing Islamic component within a dual banking system that includes conventional and Islamic banking, where both systems are regulated by the Central Bank of Malaysia. The Central Bank of Malaysia places great importance in ensuring that the overall Islamic financial system operates in accordance with Shari'ah principles (BNM, 2010). Accordingly, this is to be achieved through the two-tier Shari'ah governance infrastructure comprising two vital components, which are a centralised Shari'ah advisory body at the Central Bank and an internal Shari'ah Committee formed in each respective Islamic bank. This Shari'ah governance framework has tightened Shari'ah rules for Islamic banks by requiring them to set up Shari'ah review, Shari'ah audit, Shari'ah risk management, and Shari'ah research to reinforce compliance. The framework came into effect in January 2011 to provide a comprehensive Shari'ah governance framework for Islamic financial institutions that include Islamic banks, which are regulated by the Central Bank of Malaysia.

This framework also provides one of the requirements of a Shari'ah committee to disclose sufficient information in the Islamic financial institution's annual financial report on the state of compliance of the Islamic financial institution as per the requirements under the Guidelines on Financial Reporting for Licensed Islamic Banks (GP8-i), which is already repelled. Then, the Central Bank of Malaysia issued new guidelines on Financial Reporting for Islamic Banking Institutions, which was issued on 12 December 2012 (effective for the financial year beginning on or after January 2014); however, Islamic banks may earlier adopt the guidelines. Among the SNCI items that these guidelines should disclose are (i) nature of Shari'ah non-compliant activities; (ii) amount of Shari'ah non-compliant income; (iii) number of non-Shari'ah compliant events occurring during the year; and (iv) rectification process and control measures to avoid recurrence of such Shari'ah non-compliant activities (BNM, 2012 and 2016). It is expected that Islamic banks that disclose all the required information will enable the users of financial statements to appreciate and understand the nature of Shari'ah non-compliant activities that occur in Islamic banks.

2.2. Bahrain

Bahrain is a well-known country and is among the financial hubs of the Islamic banking industry, especially in the Gulf Cooperation Council. The Central Bank of Bahrain is the single regulatory body for Bahrain's financial sector. The Central Bank is responsible for licensing, supervising, and regulating conventional and Islamic financial institutions. The Central Bank requires Islamic banks to comply with the governance requirements and disclosures to provide assurance to stakeholders that they are following Shari'ah principles. Also, a Shari'ah committee has been established at the national level to advise the Central Bank only. At the institutional level, the Central Bank requires appointment of an independent Shari'ah Supervisory Board. Importantly, the rules make specific reference to the AAOIFI Governance Standards for Islamic financial institutions regarding the establishment of Shari'ah Supervisor Boards. By referring to Governance Standard for Islamic Financial Institutions No. 1 on the Shari'ah Supervisory Board: Appointment, Composition and Report (AAOIFI, 2010a), the Shari'ah supervisory board's report should state whether the Islamic bank's contracts and related documentation are in compliance with the Islamic Shari'ah rules and principles. The objective of the standard is to ensure the compliance of Islamic banks in all its dealings and transactions with Islamic Shari'ah rules and principles. This standard has been effective for Islamic banks in Bahrain since 1999. Moreover, the AAOIFI has established the Governance Standard for Islamic Financial Institutions No. 7 on Corporate Social Responsibility Conduct and Disclosure for Islamic Financial Institutions (AAOIFI, 2010b), where there is a mandatory disclosure requirement on the disclosure of earnings and expenditure prohibited by Shari'ah. Accordingly, the disclosure should be made, in the annual report, of the earnings and expenditures prohibited by Shari'ah (impermissible or haram transactions) for the financial year, if any. The disclosure should stipulate the following items in the financial year, which are (i) aggregate descriptions, amounts, account classification (revenue, expenses, liability or asset) and reasons for undertaking the types of transactions; (ii) the Shari'ah Supervisory Board's verdict on the necessity of these transactions; (iii) how the Islamic bank intends to dispose of such amounts; (iv) the Islamic bank's strategy to find viable permissible or halal alternatives, if any, for similar impermissible transactions in the future. Because of this, the Islamic banks in Bahrain are expected to provide this comprehensive disclosure in their annual report.

3. LITERATURE REVIEW

With disclosure requirements in place, Islamic banks would be able to satisfy the interest of users of their financial statements over these banks' involvement in Shari'ah non-compliance activities. Financial users are able to use this information for current and future decision-making. The most relevant study that focuses on SNCI disclosures was made recently by the Islamic Financial Services Board (IFSB), which highlights several issues and challenges in disclosure practices by Islamic banks such as exclusion of detailed information on SNCI and its sources, variation in level of SNCI reporting between the different jurisdictions that are ruled by Shari'ah governance framework, inexistence of standards to gauge the level of Shari'ah governance on a cross-sectorial basis, and negligible instances of extreme SNCR events (Oz, Ali, Khokher and Rosman, 2016). Thus, it is important for Islamic banks to be transparent on the SNCI derived from prohibited activities by Shari'ah, including Shari'ah non-compliance events that did not result in financial loss and are not reflected in the SNCI of Islamic banks.

Other studies (e.g., Haniffa & Hudaib, 2007; Maali et al., 2006, Mallin et al., 2014) also have observed the disclosures of SNCI, but they examined this as part of a list of Islamic values that Islamic banks should disclose. Haniffa and Hudaib (2007) and Mallin et al. (2014) examined the following disclosures related to SNCI: No involvement in non-permissible activities, involvement in non-permissible activities, percentage of profit, reason for involvement in non-permissible activities, handling of non-permissible activities. Maali et al. (2006) examined the following items for SNCI: the nature of unlawful transactions, reasons for undertaking such transactions, the Shari'ah Board's view about the necessity of these transactions, the amount of revenue or expenses from these transactions, and how the bank disposed, or intends to dispose, of such revenues. Although these items were less emphasised in these studies, there are some indications that Islamic banks are found lacking in their SNCI disclosures. Maali et al. (2006:286) found that "[s]ome Islamic banks charge clients who are late in repaying their loans penalties that may take the form of interest, which is strictly prohibited by Islam. None of the banks in our sample disclosed how they deal with insolvent clients." Haniffa and Hudaib (2007:107) highlight that one bank's disclosure failed to be consistent with "its claim of adhering to Islamic principles when clearly there is a combination of conventional and Islamic financing."

Studies such as those of Haniffa and Hudaib (2007), Maali et al. (2006), Mallin et al. (2014), and Harahap (2003) also focused on Islamic values against the requirements of AAOIFI. Only Harahap (2003) discusses the disclosure of Islamic values in Bank Muamalat Indonesia's (BMI) annual report by comparing conventional and AAOIFI accounting disclosure requirements from 1993 to 2000. The paper deliberates on conventional accounting that provides some mandatory and voluntary criteria on disclosure in annual reports and Islamic accounting, represented by AAOIFI, which require a different set of disclosure requirements for the Islamic banking sector. The findings suggest that the more recent annual reports offered a better level of disclosure. It is also revealed that the level and extent of disclosure in the BMI annual report place more emphasis on conventional standards rather than on specific Islamic accounting standards.

Other studies such as those by Wan Abdullah et al. (2013) and Abu Kasim (2012) focus on the quality of Shari'ah governance or Shari'ah Supervisory Board (SSB), Shari'ah compliance and voluntary disclosure, which examines SNCI as only one of the disclosure items. Wan Abdullah et al. (2013) examines the extent of disclosure on the SSB as well as the content of the board's report in the annual reports of Islamic banks in Malaysia and Indonesia for the year 2009. They adopted both disclosure indices and content analysis to measure the extent of disclosure on SSB and zakat. Also, the paper explains the relationship between SSB characteristics and the extent of SSB related and zakat disclosures. The findings indicate that SSB related and zakat disclosure are still limited; also, it is found that the bank reports a low level of disclosure on sensitive matters. Abu Kasim (2012) focuses on the disclosure of Shari'ah compliance reported by the Shari'ah Committee (SC) in the 2008/2009 annual reports of Malaysia's takaful companies. The disclosure of Shari'ah compliance is important in enhancing and protecting the image of takaful operators, as one of the Islamic financial institutions that provides an alternative to a conventional insurance system. The paper discusses whether the advisory role constrains SC members to improve disclosure, which can boost consumers' confidence and companies' accountability, which then would help in promoting Malaysia as an Islamic financial hub. This paper deliberates disclosure-related issues, where SC members are constrained by the advisory role and part-time basis of appointment from fully participating in every stage of product process from its conception to its implementation. The findings suggest the need to enhance disclosure on Shari'ah compliance in the SC reports and to further strengthen the role of the SC members. SNCI reporting is a major component in the SC reports and SC members.

Our review of the literature has highlighted two important findings. First, past studies have examined SNCI disclosures but have given it less emphasis; thus, it is difficult to comprehend the overall disclosure practices of SNCI disclosures by Islamic banks. This is particularly important because Islamic banks are now required to report their SNCI as part of the risk management disclosure requirements. Second, with the exception of Harahap (2003), previous literature has focused on examining the AAOIFI regulatory disclosure requirements. There is a need to explore how regulations apart from the AAOIFI are able to regulate Islamic banking disclosure practices on SNCI to provide a better picture of Islamic banks. Our study aims to address these gaps in the literature by examining how Islamic banks in two different regulatory environments, AAOIFI for Bharain Islamic banks and Bank Negara Malaysia (BNM) for Malaysian Islamic banks, are reporting their SNCI.

4. METHODOLOGY

The sample comprises 17 of all Islamic banks in Malaysia and 17 Islamic banks in Bahrain. Annual reports were extracted for the three-year periods, from 2013 to 2015. A disclosure index is a reliable method for corporate disclosure (Marston & Shrives, 1991). The initial step in constructing the SNCI disclosure index is to develop a checklist that would be applicable for Malaysia and Bahrain Islamic banks. This means that we developed the checklist from the BNM and AAOIFI guidelines mentioned in the background section. The final checklist consisted of eight items: (i) nature SNCI; (ii) amount of SNCI; (iii) number of SNC occurrences; (iv) account classification for SNCI; (v) reason for SNCI; (vi) Shari'ah Supervisory Board's verdict on the necessity of SNCI; (vii) disposal of SNCI; and (viii) strategy to control for SNCI.

We scored the disclosures of the annual reports by following a dichotomous scoring, though no penalty is imposed if the item is considered irrelevant (Haniffa & Hudaib, 2007; Al-Shammari 2013). The dichotomous scoring uses either a score of one (disclosure) or zero (nondisclosure). We also read the entire annual report before scoring to understand the nature and complexity of each bank's operations and to form an opinion about whether undisclosed items applied to the company (Cooke, 1989). We assess the scores for SNCI disclosures in the form of an index, which we named the SNCI disclosure index. The approach to scoring is additive and equally weighted. The SNCI index follows the following formula:

$$SNCI\ index_j = \frac{\sum_{i=1}^{n_j} X_{ij}}{n_j},$$

where

$SNCI\ index_j$ is the SNCI disclosures index;
$X_{ij} = 1$ if *i*th item is disclosed, 0 if *i*th item is not disclosed, so that $0 \leq I_j \leq 1$;
n_j the number of applicable constructs or items disclosed by *j*th company,$n_j \leq 8$.

5. RESULTS AND ANALYSIS

Table 1 shows the descriptive statistics for SNCI disclosure index by country. The table also shows that the overall SNCI disclosure index obtained by both countries is quite high and within the range of 0.56 and 0.75. By making a yearly comparison on the SNCI disclosure index by both countries, it is found that Bahrain had a higher score in 2013, while Malaysia had a better score for both 2014 and 2015, where Malaysia obtained the highest score in 2014. Also, the variation of the SNCI index disclosure for all the banks in the sample does not varies much where the highest standard deviation is only 0.28, which is for Bahrain in 2014.

Table 1: Descriptive statistics of SNCI disclosure index of Islamic banks in Malaysia and Bahrain

	2013		2014		2015		2013-2015	
	Mean	**SD**	**Mean**	**SD**	**Mean**	**SD**	**Mean**	**SD**
Bahrain	0.69	0.26	0.70	0.28	0.69	0.26	0.69	0.26
Malaysia	0.56	0.27	0.75	0.19	0.74	0.20	0.68	0.24
Overall	0.62	0.27	0.73	0.24	0.71	0.23	0.69	0.25

Note: SD is the standard deviation.

Table 2 shows that Islamic banks in Bahrain have a higher amount of SNCI compared with those in Malaysia from 2013 to 2015. There is no specific trend in the amount of SNCI over the three years. Table 2 also shows that the three Islamic banks in Malaysia were not disclosing (see ND columns) the amount of SNCI in 2013, while in 2014, one Islamic bank in Bahrain did not disclose any amount of SNCI. In 2015, there are improvements, whereby all banks make disclosures on their SNCI or disclose that they did not have any (see not applicable columns).

Table 2: Amount of SNCI disclosed by Islamic banks in Bahrain and Malaysia.

		2013			2014			2015			Total		
		Mean	**ND**	**NA**	**Mean**	**ND**	**NA**	**Mean**	**ND**	**NA**	**Mean**	**ND**	**NA**
Bahrain	USD BD	1,874,176 91,000	-	8*	533,382 150,000	1	9*	883,840 125,000	-	8*	1,156,475 122,000	1	25
Malaysia	RM	744,663	3	2*	280,165	-	6*	559,713	-	4*	535,946	3	12

Notes: *Includes 1 item disclosed as nonsignificant SNCI: ND=not disclosed; NA=not applicable.

Table 3 shows that the charging of penalties for late repayments for Islamic facilities are high for Islamic banks in Bahrain and Malaysia. Another high occurrence of SNCI for Malaysia is the financing of Shari'ah non-compliant activities, in which four Islamic banks were involved from 2013 to 2015, giving a total of eight occurrences in the three consecutive years. However, only one Islamic bank in Bahrain was involved in the financing of Shari'ah non-compliant activities for these three consecutive years. There is also a high number of Islamic banks that did not make any disclosures on the nature of their SNCI: nine banks from Bahrain and 15 banks from Malaysia.

Table 3: Number of Islamic banks disclosing information on the nature of their SNCI

	Bahrain				**Malaysia**			
	2013	**2014**	**2015**	**Total**	**2013**	**2014**	**2015**	**Total**
Penalties charged on late repayments for Islamic facilities	6	5	5	16	3	3	2	8
Disposal of Shari'ah non-compliant securities	-	-	-	-	-	-	1	1
Financing of Shari'ah non-compliant activities	1	1	1	3	2	3	3	8
Income from use of debit card at certain merchants (mixed of Shari'ah compliant and Shari'ah non-compliant products and services)	-	-	-	-	2	2	2	6
Interest from deposits/projects	2	2	3	7	1	2	2	5
Insurance commission received	-	-	-	-	1	2	2	5
Not fulfilling the conditions of Shari'ah compliant financing	-	-	-	-	1	1	1	3
Not applicable	7	8	7	22	1	5	3	9
Not disclosed	3	3	3	9	8	3	4	15
Total	**19**	**19**	**19**	**57**	**19**	**21**	**20**	**60**

Table 4 shows that many Islamic banks have not disclosed the number of SNC events. For the banks that do make a disclosure on this item, many Islamic banks disclose no SNC events. Malaysian Islamic banks also show that they have more than five SNC events, no Islamic banks in Bahrain have more than five SNC events. Our analysis shows that penalties charged on late repayments for Islamic facilities are not considered as an SNC event.

Table 4: Number SNC events disclosed by Islamic banks

	Years	**Not disclosed**	**0 events**	**1-5 events**	**6-10 events**	**11-15 events**	**Total**
Bahrain (N)	2013	9	7	1	-	-	**17**
	2014	8	9	-	-	-	**17**
	2015	8	8	1	-	-	**17**
Malaysia (N)	2013	11	1	3	0	2	**17**
	2014	8	3	4	2	-	**17**
	2015	7	2	5	2	1	**17**
Overall Total		**51**	**30**	**14**	**4**	**3**	**102**

Table 5 shows that majority of banks in Bahrain and Malaysia classify SNCI into charity accounts. However, we found that many Islamic banks in Malaysia also did not make any disclosure on this item. Islamic banks in Bahrain had better disclosure on this item, as all of its banks made disclosures on this item. However, one particular bank in Bahrain that disclosed charity into a "separate account" did not clarify whether this account is considered a liability.

Table 5: Disclosure of account classification for SNCI

	Bahrain (N)				**Malaysia (N)**				**Overall**
	2013	**2014**	**2015**	**Total**	**2013**	**2014**	**2015**	**Total**	**Total (N)**
Charity account	14	14	14	42	5	7	6	18	**60**
Gharamah	-	-	-	-	1	1	1	3	**3**
Other creditors & accruals	-	-	-	-	2	2	2	6	**6**
Purification by Shari'ah	-	-	-	-	1	1	1	3	**3**
Separate Account	1	1	1	3	1	1	1	3	**6**
Not applicable	2	2	2	6	-	2	1	3	**9**
Not disclosed	-	-	-	-	7	3	5	15	**15**
Total	**17**	**17**	**17**	**51**	**17**	**17**	**17**	**51**	**102**

Table 6 shows that a majority of the banks in Bahrain and Malaysia (8–10 banks per year) refer to provide a general statement on necessity of SNCI. An example of this statement is as follows: "All earnings that have been realised from sources or by means prohibited by the Shari'ah principles have been considered for disposal to charitable causes."

Table 6: Islamic banks' disclosures on Shari'ah Supervisory Board's verification on necessity of SNCI

	Bahrain (N)				**Malaysia (N)**				**Overall**
	2013	**2014**	**2015**	**Total**	**2013**	**2014**	**2015**	**Total**	**Total (N)**
Amount SNCI disclosed	1	-	-	1	6	6	6	18	**19**
No SNCI	2	2	2	6	1	3	2	6	**12**
SNC event disclosed	1	1	1	3	-	-	-	-	**3**
General statement	9	10	10	29	8	8	8	24	**53**
Not applicable	3	3	3	9	1	-	-	1	**10**
Not disclosed	1	1	1	3	1	-	1	2	**5**
Total	**17**	**17**	**17**	**51**	**17**	**17**	**17**	**51**	**102**

Table 7: Islamic banks' disclosures on reason for SNCI

	Bahrain				**Malaysia**				**Overall**
	2013	**2014**	**2015**	**Total**	**2013**	**2014**	**2015**	**Total**	**Total**
Specific statement	-	-	-	-		1	3	4	**4**
General statement	-	-	-	-	2	2	2	6	**6**
Not applicable	7	8	7	22	1	5	3	9	**31**
Not disclosed	10	9	10	29	14	9	9	32	**61**
Total	**17**	**17**	**17**	**51**	**17**	**17**	**17**	**51**	**102**

Table 7 shows that more than half of banks in Bahrain and Malaysia prefer not to disclose the reason for having SNCI in each of the three years. For banks that make general disclosures, an example of such statement is "non-adherence to procedures/guidelines and improper execution of contracts according to the Shari'ah requirements." Only Malaysian Islamic banks are making specific statements related to this item of disclosures.

Table 8 shows that the number of disclosures made on the description of disposal is good. Table 8 also shows the number of disclosures made on strategy of control for SNCI. These banks usually disclose general statements such as "[t]he Bank has taken the necessary steps to rectify the breaches."

Table 8: Description of disposal for SNCI and strategy to control for SNCI

Descriptions	Disclosure type	Bahrain				Malaysia				Overall
		2013	2014	2015	Total	2013	2014	2015	Total	Total
Description of disposal for SNCI	Disclosed	16	16	16	48	15	17	16	48	**96**
	Not applicable	1	1	1	3	-	-	1	1	**4**
	Not disclosed	-	-	-		2	-	-	2	**2**
	Total	17	17	17	51	17	17	17	51	**102**
Strategy to control for SNCI	Disclosed	-	-	-	-	3	4	6	13	**13**
	Not applicable	7	8	7	22	1	5	3	9	**31**
	Not disclosed	10	9	10	29	13	8	8	29	**58**
	Total	**17**	**17**	**17**	**51**	**17**	**17**	**17**	**51**	**102**

Table 9 summarises the location for disclosures on SNCI amounts, accounts, nature, reasons, strategies, disposal, and events by Islamic banks in Malaysia and Bahrain for three years, i.e., from 2013 to 2015. There are five locations of disclosures on relevant SNCI information, i.e., Shari'ah Supervisory Board Report (SSBR), Corporate Governance disclosures (CG), Basel/Risk Management disclosures (BR), Statement of Sources (SS), and Notes to the Financial Statements (NFS). The most popular location of disclosures is in the SSBR (87 out of 102 observations or 85%), which is similar for Malaysia (48 out of 51 observations or 94%) and Bahrain (39 out of 51 observations or 76%). Another popular location of disclosures is in the NFS (77 out of 102 observations or 75%). The same relevant SNCI information may be disclosed at two or more different locations for the same observation. For instance, SNCI amount is disclosed in the SSBR, BR, and NFS for the same observation.

Notably, the Shari'ah Supervisory Committee (SSC) is responsible for providing advisory and conformity on Shari'ah compliance toward the business and financial affairs of Islamic banks. Further research revealed that, on 15 observations (Bahrain – 12, Malaysia – 3), there was no verification or disclosure either on SNCI or SNC events. On 42 observations (Bahrain – 21, Malaysia – 21), the SSBR only provide general verification such as disposal of SNCI (if any) for charity. While on 29 observations (Bahrain – 18, Malaysia – 11), the SSBR provide verification or disclosure on limited SNCI information such as (i) amount only, or (ii) SNC events only, or (iii) amount and disposal only, or (iv) account and disposal only, or (v) amount, disposal and SNC events only. These outcomes show that improvement should be made to the SSBR, as it represents verification by the SSC on Shari'ah compliance activities of Islamic banks. SSBR should provide verification on all relevant SNCI information, i.e., amount, account, nature, reason, strategy, disposal, and SNC events, as they are the most important and qualified persons to provide opinion on the status of Shari'ah non-compliance matters.

Table 9: Location of disclosures in annual reports by Islamic banks in Malaysia and Bahrain

	Bahrain				Malaysia				Overall Total	
	2013	**2014**	**2015**	**Total N (%)**	**2013**	**2014**	**2015**	**Total N (%)**	**N**	**%**
Shari'ah Supervisory Board Report	13	13	13	39 (76)	15	17	16	48 (94)	**87**	**85**
Corporate Governance Disclosures	5	4	4	13 (25)	0	1	1	2 (4)	**15**	**15**
Basel / Risk Management Disclosures	8	8	8	24 (47)	3	4	6	13 (25)	**37**	**36**
Statement of Sources	4	6	5	15 (29)	-	-	-	-	**15**	**15**
Notes to the Financial Statements	13	15	14	**42 (82)**	10	13	12	**35 (69)**	**77**	**75**

The descriptive analysis earlier has demonstrated the nature of SNCI reporting for Islamic banks in Bahrain and Malaysia. Both countries have reported the nature of SNCI and obtained quite high scores on the SNCI disclosure index. Further analysis examines whether or not there are significant difference in their SNCI disclosure index between Islamic banks in Bahrain and Malaysia. The *t*-test result, as shown in Table 10, explains that there is no significant difference on the mean of the SNCI disclosure index for both countries. Similarly, both Mann–Whitney U test and Kolmogorov–Smirnov (K-S) test found no evidence on the differences of the SNCI disclosure index between both countries. Hence, this clearly explains that both Bahrain and Malaysia have a prudent disclosure of the SNCI and have reported at least a minimal explanation in their disclosure. However, there are still many aspects of reporting that need to be improved by Islamic banks in these two countries regarding the nature of the SNCI as proposed by IFSB-4, where Islamic banks need to disclose the inflows and outflows of Shari'ah non-compliant earnings and expenditures, including an explanation of how they are disposed of by suggesting the disclosure of the nature, size, and number of violations of Shari'ah compliance during the year.

Table 10: Parametric tests

Individual Tests	***t*-test**
Hypotheses	There is a significant difference between SNCI disclosure index between Bahrain and Malaysia
Test statistics	t (Prob > t)
SNCI disclosure index	0.198 (0.843)

Note: Number in parentheses is the *p*-value associated with the *t*-test

6. DISCUSSIONS AND CONCLUSION

Our review of the literature shows that SNCI is examined as part of an overall framework of Islamic reporting. The previous literature (e.g., Haniffa & Hudaib, 2007; Maali et al., 2006, Mallin et al., 2014) have not emphasised the extent that SCNI is being reported by

Islamic banks. By understanding the disclosure of SNCI, the stakeholders, in particular the investment account holders, the shareholders, and all the users of financial statements are able to understand the extent to which Islamic banks are managing the riskiness of incurring Shari'ah non-compliant activities. This study examines the nature of SNCI and analyses the extent of financial reporting and disclosure of Shari'ah non-compliance income in the annual reports of 17 Islamic banks in Malaysia and 17 Islamic banks in Bahrain from 2013 to 2015. Islamic banks in Bahrain and Malaysia on average obtained quite a high SNCI disclosure index within the range of 0.56 – 0.75 during the study periods. Islamic banks in Bahrain and Malaysia demonstrate transparency and consistency when disclosing the nature of SNCI, where the parametric and non-parametric tests showed no significant difference in both countries' SNCI disclosure index. Also, it is found that Malaysia obtained a higher score in 2014 and 2015, while Bahrain obtained a higher score in 2013.

The descriptive analysis found that Islamic banks in both countries are willing to disclose the amount of SNCI but are less inclined to disclose the nature of these SNCI. The majority of Islamic banks in both countries only provide general statements on the nature of SNCI; they also prefer not to disclose the reasons of having SNCI. This is a worrying factor, as stakeholders may require more transparent disclosures of amounts along with the specific nature of the SNCI. The study also found from those Islamic banks that disclose the nature of SNCI, where most of the SNCI result from charging penalties for late payments on Islamic financing facilities, a finding similar to that of Maali et al. (2006). This may be due to charging penalties by Islamic banks as a deterrent mechanism for customers who intentionally make delayed payments. However, cautions need to be taken before charging penalties, as Islamic banks must ensure that their customers are not having difficulties in making prompt payments. However, it is also found that financing of Shari'ah non-compliance activities is among the nature of SNCI, which is consistent with the findings of Haniffa and Hudaib (2007). This can cause a reputational risk, as Islamic banks should not be involved in any financing activities that are contradictory to Shari'ah. Finally, it is also revealed that, in spite of there being many locations on where the SNCI disclosure should be reported, the majority of Islamic banks disclose the SNCI in the Shari'ah Supervisory Board's report. This will enhance the importance of the duties and responsibilities of Shari'ah boards or Shari'ah committees of each Islamic bank in providing opinions of Shari'ah non-compliance activities. Both countries, Malaysia and Bahrain, are known to be hubs of the Islamic banking industry in Asia and have highly regulated Islamic banking systems. The SNCI disclosure practices of Islamic banks in these two countries could be attributed to their good regulatory framework. The SNCI practices of these banks could serve as benchmarks for Islamic banks in other countries.

It is expected that Islamic banks need to improve the quality of their SNCI disclosure requirements, especially to the users of financial information, including the investment account holders, shareholders, and public at large. Future studies could examine reasons behind the lack of disclosures on SNCI and also the specific reasons on SNC events that occurred in Islamic banks. Understanding the nature and extent of SNCI disclosure will help policymakers to improve the regulations of the Islamic banking industry, particularly in mitigating Shari'ah non-compliance risk for the sustainability and reputation of Islamic banks. The sustainability of Islamic banks is important for achieving the socioeconomic goals in Muslim countries. Various socioeconomic instruments in Islamic banks such as *zakat*, *waqf*, *qard al-hassan*, and other types of financial instruments provide financial assistance to micro-businesses and small to medium enterprises (Ali et al., 2013; Khan, 2017). These instruments, if properly implemented, can play major roles toward unemployment and poverty eradication and eventually transform the socioeconomic environments of Muslim communities.

ACKNOWLEDGMENT

This research was supported by the Islamic University of Malaysia Research Grant.

REFERENCES

AAOIFI (2010a). *Governance Standard for Islamic Financial Institutions No. 1, Shari'a Supervisory Board: Appointment, Composition and Report*. Bahrain: AAOIFI.

AAOIFI (2010b). *Governance Standard for Islamic Financial Institutions no. 7, Corporate Social Responsibility Conduct and Disclosure for Islamic Financial Institutions.* Bahrain: AAOIFI.

Abu Kasim, N. A. (2012). Disclosure of Shari'ah compliance by Malaysian takaful companies. *Journal of Islamic Accounting and Business Research*, *3*(1), 20 – 38.

Ali, S. S., Shirazi, N. S., & Sami Nabi, M. (2013). The role of Islamic finance in the development of the IDB member countries: a case study of the Kyrgyz Republic and Tajikistan. *Islamic Economic Studies*, *21*(2), 2121–130.

Al-Shammari, B. (2013). An investigation of voluntary disclosure by Kuwaiti Shari'ah-compliant companies. *Journal of Economic and Administrative Sciences*, *29*(1), 21 – 41.

Ariss, R. T. (2010). Competitive conditions in Islamic and conventional banking: a global perspective. *Review of Financial Economics*, *19*(2010), 101 – 108.

BNM. (2010). *Shari'ah Governance Framework for Islamic Financial Institutions.* Malaysia: Bank Negara Malaysia.

BNM. (2012). *Guidelines on Financial Reporting for Islamic Banking Institutions* (GP8-i). Malaysia: Bank Negara Malaysia.

BNM. (2016). *Financial Reporting for Islamic Banking Institutions*. Malaysia: Bank Negara Malaysia.

Cooke, T. E. (1989). Voluntary disclosure by Swedish companies. *Journal of International Financial Management and Accounting*, *1*(2), 171 - 195.

Haniffa, R., & Hudaib, M. (2007). Exploring the ethical identity of Islamic banks via communication in annual reports. *Journal of Business Ethics*, *76*(1), 97 – 116.

Harahap, S. S. (2003). The disclosure of Islamic values – annual report: The analysis of Bank Muamalat Indonesia's annual report. *Managerial Finance*, *29*(7), 70 – 89.

Hasan, Z. (2010). Regulatory framework of Shari'ah governance system in Malaysia, GCC countries and the UK. *Kyoto Bulletin of Islamic Area Studies*, *3-2*(March), 82 – 115.

Khan, M. M., & Bhatti, M. I. (2008). Islamic banking and finance: on its way to globalization. *Managerial Finance*, *34*(10), 708 – 725.

Khan, N. (2017). The role of Islamic finance in economic development. *Lingnan Journal of Banking, Finance and Economics, 6*. Retrieved February 12, 2017, from http://commons.ln.edu.hk/ljbfe/vol6/iss1/

Maali, B., Casson, P., & Napier, C. (2006). Social reporting by Islamic banks. *Abacus*, *42*(2), 266-289.

Malaysia International Islamic Financial Centre (MIFC) (2015). *Islamic finance supports socio-economic development*. Malaysia: Bank Negara Malaysia.

Malaysia International Islamic Financial Centre (MIFC) (2016), *Malaysia's Islamic Finance marketplace is open to the world*. Retrieved March 12, 2017, from www.mifc.com.

Mallin, C., Farag, H., & Ow-Yong, K. (2014). Corporate social responsibility and financial performance in Islamic banks. *Journal of Economic Behavior & Organization*, *103*(Supplement), S21 – S38.

Marston, C. L., & Shrives, P. J. (1991). The use of disclosure indices in accounting research: a review article. *British Accounting Review*, *23*(23), 195 – 210.

Oz, E., Ali, M. M., Khokher, Z. R., & Rosman, R. (2016). *Shari'ah non-compliance risk in the banking sector: impact on capital adequacy framework of Islamic banks.* IFSB Working Paper Series No WP-05/03/2016.

Wan Abdullah, W. A., Percy, M., & Stewart, J. (2013). Shari'ah disclosures in Malaysian and Indonesian Islamic banks. *Journal of Islamic Accounting and Business Research*, *4*(2), 100–131.