

# THE DISCLOSURE OF ISLAMIC VALUES - ANNUAL REPORT THE ANALYSIS OF BANK MUAMALAT INDONESIA'S ANNUAL REPORT

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## Abstract

*In a capitalist system apt annual report that includes financial statement is assumed to provide sound information concerning a given company. The annual report offers a background to a company, its financial position, operational results, and its performance. According to radical economics, a financial statement serves the interests of capitalists (Belkaoui, 1984). Annual reports are also value free and are not concerned with issues such as justice or ethics. Indeed, current trends in accounting have raised some questions concerning the paradigm of traditional accounting theory and especially its bias concerning capitalist interests. The emergence of Employee Reporting Value Added Accounting, Socio-Economic Accounting, and Environmental Accounting to name just a few, is evidences of the shortcomings of the capitalistic accounting system in establishing both just and fair principles among company stakeholders. This has therefore led to a demand for a new approach towards accounting disclosure including among others things: a clear account of how a company treats its employees, society, the environment and the beliefs of employees. Even though the standard formulated by AAOIFI (1998) based on capitalistic accounting, are still in a theoretical stage of development they can be used as a starting point that may help lead to an improved set of disclosure criteria that can be used by an Islamic bank or organization. This paper will discuss the empirical evidence derived from one such Islamic organization. Bank Muamalat Indonesia, has compiled information using capitalistic accounting standards so as to clarify its financial position and results of operations to stakeholders. It is hypothesized though, that the current disclosures system employed gives no indication of justness or fairness and so is incompatible with Islamic value. The paper argues Muslim researcher should aim to move from utilizing capitalistic practice primarily concerned with the disclosure, of financial indicators and towards a system that also consider justice, fairness, and ethical practices.*

## INTRODUCTION

This paper discusses the issues of disclosure in annual report. Conventional accounting provides some mandatory and voluntary criteria concerning the level of disclosure in an annual report. However, Islamic accounting an emerging model prominently represented by AAOIFI (1998). Includes a somewhat different set of

disclosure requirement for the banking sector. This though is not the sole requirement for Islamic financial institutions and indeed Islamic banks in different countries are generally expected to employ disclosure system based on accepted capitalistic and domestic regulations. Nonetheless, it is widely accepted that to be considered Islamic organizations, Islamic

banks must comply with *syariah* regulations.

Until very recently, the annual report itself has been used by investors as the main source of information. In the USA, Individual investor, institutional investors and financial analysts are routinely use the annual report as the primary influence in aiding decision making. In UK, Institutional Investor used annual reports as the number one source of information, in New Zealand, financial analysts use annual report as a number one source of information for decision making (Chang, Most and Brain, 1983). Anderson and Epstein (1985) maintain that in Australia, the annual report is used by individual investors as the main source of information for decision making. Usually the annual report consists of chairman's letter, the director's report, the financial statements, footnotes, notes relating to financial statement, the auditor's report, and other sets of disclosures (Anderson and Epstein, 1985).

In Indonesia, Susanto (1992) argues that annual report has been used as the primary sources of information for Indonesian investors in making decision relating to security, though they are generally unwilling to reach a decision concerning a company's soundness if they only receive financial and non-financial information. In Indonesia, the listed companies, opened corporations, the companies that have issued promissory note of total assets exceeding Rp. 50 billion in value are required to annually publish a financial statement in accordance with Indonesian Accounting Standard (PSAK). The content of this financial statement are determined by Government Decree (PP) No 24/1998.

In conventional accounting, there are a number of new demands for concerning disclosure and, for example include employee

reporting, human resources accounting, and environmental reporting (Belkaoui, 1986). As a religious based commercial bank though, *Muamalat Bank Indonesia (BMI)* is expected to also present a religious dimension to its disclosures.

Using the Indonesian Islamic Bank, Bank BMI, as an example, this paper will analyze how far Islamic values applied in contents of BMI's annual report. This paper will also discuss the role of annual report and the rapid growth experienced by Islamic finance and banking organizations. The objectives of financial accounting, and accounting and disclosure standards as laid out in the annual report will then be reviewed followed by review of financial disclosure practices in Indonesia. Research methodology will be discussed before an analysis is made. The conclusion will highlight the limitations inherent to the practices put forward, leading on to a set of considerations as to how future research can possibly overcome these.

### **ISLAMIC BANK GROWTH**

The growth of the Islamic banking Industry from 1990 to 1998 has been tremendous. The weighted average growth of some variables of the 12 Big Islamic Banks are as follows (Iqbal, 2000):

Table 1: Growth of 12 Big Islamic Banks

No	Variables	Weighted Average Growth 1990.1998
1.	Total Equity	8.8
2.	Total Deposit	7.2
3.	Total Investment	9,1
4.	Total Asset	7.8
5.	Total Revenue	7.3

The number of key financial ratios for Islamic financial institutions is more than

satisfactory. It means that in essence, such institution require very demanding evaluations. As such, the rapid development of Islamic financial institutions needs clear standards for disclosing information, satisfying not only the general standards of disclosure but also standards relating to Islamic values.

In Indonesia, aside from BMI several other organizations are practicing Islamic banking including Bank *Syariah* Mandiri, BNI *Syariah*, Bank Bukopin *Syariah*, Bank IFI *Syariah* and the *Syariah* People's Credit Banks. In addition there exist a number of more conventional banks that are currently considering open *Syariah* Windows at their branches. As well as such relatively recent initiatives, Jakarta has been the introduction of an Islamic Capital Market and the Jakarta Islamic Index at the capital stock exchange, which trades Islamic certificates and other securities. This rapid development requires that disclosure standards comply with Islamic values that include the disclosure of how the firm interprets Islamic values in its daily operations.

The problem we face in this situation is that two paradigms existed: capitalist and Islam. The basis of our accounting standards and our disclosure standards is still based on a conventional accounting philosophy. However, at the same time our belief needs a different base, in accordance, to a different philosophy and different paradigm. In this situation there is inconsistency in values between conventional accounting standards and Islamic accounting values (Hameed, 2001). Until now, the development of Islamic accounting is still in an early stage of development in which the discourse is still on following normative approach. This is

highlight when viewing the annual reports of the Islamic banks targeted in this study.

## **ISLAMIC BANKING ACCOUNTING STANDARD**

Due to lack of accepted standards for annual report disclosure, Islamic organization still uses accepted disclosure standards for conventional annual reports. Even though the Accounting, Auditing Organization for Islamic Financial Institution (or AAOIFI) has been established, the accounting standards (that includes disclosure) are mostly based on conventional accounting concepts. This paper will compare the disclosure requirements needed by conventional accounting standards, AAOIFI, and several ideas adapted from Islamic value or Islamic accounting thinking. The disclosure requirements for Islamic banking formulated by AAOIFI can be seen in Appendix B. These standards will be used to evaluate the level of disclosure in accordance to Islamic values of BMI's annual report. AAOIFI has been employed to offer guidance in the preparation of financial statement and annual report for Islamic financial organization, though its recommendations are not binding. So as to rectify this, the Indonesian Institute of Accountants (known as IAI in Indonesia) with the support of the Central Bank, currently plans to formulate accounting standards for Islamic banks. From the lists relating to disclosure standards, we can see that the information specifically relating to Islamic values only number 7 items from a total of 29. In other words, 87,7% of the standards followed are related to conventional accounting. Such items may be classified as conventional aspects, though this is not to say that they do not necessarily comply with Islamic values.

In presenting its annual report, BMI employed accounting standards issued by the Indonesian Institute of Accountants, the Indonesian Supervisory Body for the Stock Exchange, Bank Indonesia, and the BMI *Syariah* Supervisory Board. In Indonesia, there are no binding standards for presenting annual reports by Islamic banks. Thus the disclosure regulations are only based on the conventional Indonesian Financial Accounting Standards or PSAK (*Pernyataan Standar Akuntansi Keuangan*).

### **THE OBJECTIVE OF FINANCIAL STATEMENTS**

Financial statements or annual reports represent a business language that allows management to communicate the financial condition of their organization, the result of operations, and other information to interested parties. Financial Accounting theory has identified the objective of the financial statements is to give information to interested parties for use in decisions making process. APB Statement No 4 (1970: par 21) defined the objective for financial statements as follows:

The basic purpose of financial accounting and financial statements is to provide financial information about individual business enterprises that is useful in making decisions. These objectives are to present reliable financial information about enterprise resources and obligation, economic progress, and other changes in resources and obligation, to present information helpful in estimating earnings potential, and to present other financial information needed by users, particularly owners and creditors. The general objectives determine the appropriate content of financial accounting information.

Trueblood committee (1973) also defines the basic objective of financial accounting as follows:

“The basic objective of financial statements is to provide information useful for making economic decision.” Users of financial statements seek to predict, compare, and evaluate the cash consequences of their economic decisions. (p. 13)

Information should be disclosed in financial statements when it is likely to influence the economic decisions of the user of financial statements. Information that meets this requirement is material. (p. 57)

These objectives are related to capitalist economic and social system in which applies no transcendental view of the world. For the Muslim, however, besides from financial objectives, other information related to the compliance of the organization in applying *Syariah* rules is important. This means that they need the information concerning the transcendental, ethical, moral, and other religious state of the firm to be included in annual report.

### **DISCLOSURE IN ANNUAL REPORT**

There have been a number of studies into which items should be disclosed in an annual report. Susanto (1992) lists the information items as stated in the Appendix A. The disclosure items that should be included in annual report introduced by Botosan (1997) are as follows:

#### **Background information**

- Statement of Carport's goal or objective
- Barriers to entry are discussed
- Competitive environment
- General description of the business
- Principle products
- Principle markets

**Ten or five year's summary of historical results**

- ROA or sufficient information to compute
- Net profit margin or sufficient information to compute
- Asset turn over or sufficient information to compute
- ROE or sufficient information to compute
- Summary of sales and NI for most recent 8 quarter

**Key non-financial statistics:**

- Number of employees
- Average compensation of employee
- Order backlog
- Percentage of sales in products design in the last five years
- Market share
- Unit sold
- Unit selling price
- Growth in unit sold

**Projected information**

- Forecasted market share
- Cash flow forecast
- Capital expenditure and or R&D expenditure forecast
- Profit forecast
- Sales forecast

**Management discussion and analysis**

- Change in sales
- Change in operating income
- Change in cost of goods sold
- Change in gross profit
- Change in selling and administrative expenses
- Change in interest expense and interest income
- Change in net income
- Change in inventory
- Change in account receivable

- Change in capital expenditure or R&D
- Change in market share

Anderson and Epstein (1995) found that investors still demand additional disclosure in annual reports e.g.: pending litigation, unasserted claims, budgeted income statements, current value statements, product line/segment profitability, management auditing, changes of auditor, audit committee reports, peer reviews, social/environment reports and a clear view into the ethical conduct of company officers.

From the point of view of those concerned with applying Islamic Value to the formulation of an annual report, the contents of BIMB (Bank Islam Malaysia Berhad) 1996 annual report (1996) is disappointing. In addition to the application of conventional accounting standard practice it failed to include information concerning the amount of *Zakat* it had disbursed. Other information ignored was asset restrictions, non-halal transactions, the sources of and uses of *Zakat*. The 1998 annual report of Faisal Finance Institution Inc also disclosed limited information on Islamic values and no disclosure was made of the *Syariah* Supervisory Council Report. Indeed, the report only informs readers of the products offered by the firm, including no information concerning *Zakat*, or the *Syariah* supervisory board, required by AAOIFI.

**ACCOUNTING AS A PAIL OF TAUHID PROCESS**

Disclosure in Islamic financial statement should support the idea of compliance to Islamic *Syariah* values. According to Shahatah (2001), Islam is a total system and way of life. Social, political, economic, management and accounting systems should be integrated. The financial statement of an

Islamic organization, as part of such a system, should also be a medium for promoting Islamic values. Financial statements should not therefore only report the general standards of financial statements but also Islamic accounting standards (e.g. justice, *Syariah* compliance, *zakat* requirements).

This fact concludes that a great gap remains in both the complete disclosure and the standardizing of a value added (or Islamic values) concept of accounting in the Islamic banks and financial intermediaries. The Islamic accounting standards should attempt to point out the important role that the institutional shuratic and its discursive process can contribute on developing a complete set of value added (Islamic values) indicators that can be used as the medium for realizing Islamic value, disclosure and standardized practices.

According to Choudhury (2000; 1995) in the eye of the Islamic worldview, which is adequately reflected in the field of Islamic Political Economy but not in Islamic Economics, the substantive meaning of *syariah* is borne out by the comprehensive linkages of accounting and disclosure methods with the general socioeconomic system as means of generating computational results of the background generalized relationships that Islamic banks according to *syariah* rules should identify and promote.

The generalized system of relationships are those that realize the substantive interactions by shuratic discourse followed by consensus and dynamic process of evolution of the rules towards realizing a unified system of inter relationships between finance, money and the real economy *vis a vis* the resulting profitability and social wellbeing that such relationships and the financial instruments bring about. The disclosure method is then a mechanism

that makes the shuratic experience a learning and evolutionary process from and towards unity. In the absence of understanding and applying such a shuratic process there can exist no other discursive process in Islamic financial firms for developing a unified and harmonized system of accounting standards that need to be disclosed in the annual reports, data banks, special reports, public presentations and other means.

Nothing would be gained by Islamic banks and financial institutions in transforming the ummah otherwise (Choudhury, 2000, 1995). This indeed is the subject that needs to be addressed by the theme of Islamic Political Economy. The issues of disclosure, accounting practices and the notion of Islamic values cannot be left independently to banks, which in your case is the Bank *Muamalat* Indonesia. Contrarily, of the shuratic process of standardization and disclosure when adopted within the banking practice would serve as the powerful institutional medium for viewing, analysing and disseminating deeply unifying linkages. Such a generalized unification perspective forms the core of *syariah* in the perspective of the tawhidi episteme. Decisions cannot to be left independently to bank or to central bank policies alone (Choudhury, 2000; 1995).

## **FINANCIAL DISCLOSURE IN INDONESIA**

Even though Indonesia still assumed to be an emerging capital market, the Indonesian Supervisory Body for stock Exchange also requires that all listed companies to disclose a standard set of information is included in their annual reports. Being an important source of information about an organization, a number of studies have been conducted regarding the disclosure issue. In Indonesia, according to Susanto (1992) the extent of voluntary corporate disclosure in annual reports is greater for foreign-based companies listed in W than for domestic companies as measured by the index of voluntary disclosure. It was concluded in the study that the larger the firm, the more likely it was to disclose an extensive array of informational items.

Bandi and Hananto (2000) found that there was a lack of timeliness in company financial reporting (1993-1997) in Indonesia. The lateness of financial reporting between big and small companies (in term of market value) was different, and the lateness does not affect the stock prices.

Yuniati (2000), argued that the level of disclosure was most likely to be associated with the liquidity, solvability, log size, and industrial market segment of the organization. The better the liquidity, solvability, leverages, and log size of a company, the greater the level of disclosure in its annual report. The disclosure items measured in the study were company background, summary of financial reports for the past 5-10 years, non-financial information, information on the future of the company, management analysis and a summary discussion. Besides this information though, some companies also choose to disclose the following items, debt,

change in total assets, change in equity, social activities, the safeness and healthiness of the working environment, the identify and experience of senior managers, general information concerning economic conditions and their impact on the company.

Utomo, Muhammad M. (2000), argues that Indonesian companies have disclosed some social information on their annual report. The bulk of information is related to social, product and consumers themes, as well as labour relationship. He concludes that high profile companies have more disclosure than low profile companies.

## **RESEARCH METHODOLOGY**

This study is the result of qualitative research using comparative and analytical methods. The comparative research was conducted in two ways: comparison between conventional accounting disclosure requirement and AAOIFI requirements. Then annual report of BMI is analysed and compared with those two standards. The Islamic values are defined as information presented by companies that are specifically relevant to the Islamic organizations.

The research uses Annual reports of PT Bank *Muamalat* Indonesia from 1993 - 2000. After analysing the annual reports 1992, 1993, 1994, 1995, 1996, 1997, 1998 and 1999, it became clear that the more recent the annual reports offered a greater degree of information disclosure. The 1999 annual report offered more disclosure than that of 1998 of example. Thus, the study focused primarily on BMI's 1999 annual report. The information items in the annual report are identified and listed. The BMI's 1999 annual report also contained independent accountant reports, the analysis of which also covers the information disclosed through audit reports presented by

independent auditor as part of an annual report. It should be noted though that a number of informational items overlap and a list of information in the annual report can be seen in Appendix C.

The other banking and finance institutions are used as part of a comparative study. Two BIMB annual reports, 1995 and 1996 and the 1998 Faisal Finance Institution Inc annual report are analysed.

The contents of 1999 Annual report of Bank *Muamalat* are quite similar to annual report 1998 and 1997. The information disclosed in the 1996, 1995, 1994, 1993, and 1992 annual reports is quite similar and items disclosed in 1996 is more comprehensive than the information disclosed in the annual report for the previous year. The Contents of information of the 1999 BMI annual report can be seen in Appendix C.

It seems that the contents of the BMI annual report mostly complies with the items disclosed in the Susanto list (1992) rather than the recommendations offered by the AAOIFI. This though is perhaps understandable as BMI must comply with the regulations of the Indonesian Central Bank and the financial report must be audited by an independent auditor compliant with the Indonesian Accounting Standard or PSAK 38 for banking.

## **DISCUSSION AND ANALYSIS**

As Islamic accounting is an emerging model, no Islamic banks are required to comply with any specific Islamic disclosure standards as in the case of BMI. As such, it is perhaps not surprising that the level and extent of disclosure in the BMI annual report place more emphasis on general standards and regulatory standards rather than specific Islamic accounting standards.

The AAOIFI standards have been proposed as a first step towards formulating specific Islamic banking standards though its conceptual framework of Islamic accounting is not considered by many to be well prepared (Haniffa and Hudaib, 2001). Indeed, the BMI annual report mostly employs generally accepted accounting standards (AAOIFI, 97,3% and BMI 83,6%, the percentage of specific Islamic informational items over total informational items). Using Haniffa and Hudaib's argument, disclosure relating to Justice, the environment, morality and ethics has not been made by either the AAOIFI or BMI in its annual report.

The debate as to how Islamic accounting can satisfy Islamic requirements concerning disclosure has been raised by Baydoun and Willet (2000) who recommend the use of Values Added Reporting. Conversely, Triyuwono (2001) argues that Islamic accounting has a different theoretical background to conventional accounting and that a fresh approach needs to be considered. Consensus concerning how an Islamic financial institution should be expected to formulate an accepted annual report, comprehensively detailing its compliance to *Syariah*, appears to, therefore, be some way off.

## **Blending Between General and Specific Values**

The disclosure of information required by conventional accounting does not necessary contradictory to Islamic values, even though the level or extent of disclosure may vary among the information items. Information required in conventional accounting puts significant emphasis on the interests of investors who use the information to choose between alternative investments.

### **Islamic Values**

As investors, Moslem not only need information related to financial indicators but also whether their action comply or not with *Syariah* regulation. Haniffa and Hudaib (2001) argued that the conceptual framework for Islamic accounting based on *Syariah*. The objectives of Islamic accounting are:

*“To assists in achieving socioeconomic justice (al-falah) and recognize the fulfillment of obligation to God, society and individuals concerned, by parties involved in the economic activities viz. accountants auditors, managers, owner, government, etc as a form of worship.”*

From this basis Haniffa and Hudaib (2001) divided the accounting in two aspects; technical and human. Technical Islamic accounting needs measurements for *Zakat* purpose thereby understanding how profit is distributed. For disclosure aspects, Islamic accounting should clearly state how the institution is fulfilling its duties and obligations according to *Syariah* e.g. lawful dealings, *Zakat* to beneficiaries, *saddaqa* (charities/gifts), wages, the achievement objective of business venture and protecting the environment. On the other hand, the human aspects of Islamic accounting should be based on morality, ethics and Divine law e.g.: piety, righteousness and accountability. According to AAOIFI there are some item concerning Islamic value information items need to be disclosed:

- Basic information about the Islamic bank.
- Unusual supervisory restriction
- Earning of expenditure prohibited by *Shariah*
- The method used by the Islamic bank to allocate investment profits (loss) between unrestricted investment account holders or their equivalent and the Islamic bank

as a *Mudarib* or as an investor with its own funds

- Statement of changes in restricted investments
- Statement sources and uses of funds in the *Zakah* and charity fund
- Statement of sources and uses of funds in the *qard* fund

In the BMI annual report 1999, some specific Islamic values has been disclosed as follows:

- The *Shariah* Supervisory Board Opinion and Message
- The Condition of Bank Muamalat for current year
- Funding and Financial Products
- Deposits: *wadiah* demand/time deposit, *mudharabah*
- Margin Income and Profit Sharing, Bonus and Distribution
- Fee and Commission Income
- Financing Facilities and portfolio (*Mudharabah*, *Ba't*; *Bitsaman Ajil*, *Murabahah Musyarakah*, *Al qardhul hasan*, *AI Hiwalah*, etc)
- Sources and Uses of *Zakah* Funds

Some issues between BMI and AAOIFI disclosures that may be noted:

- The AAOIFI does not require the disclosure of the supervisory opinion and message of the Supervisory Board regarding the bank's operation.
- The AAOIFI is very concerned with restriction on transactions, assets and investments based on *Shariah*
- The AAOIFI requires the disclosure of earnings and expenditure prohibited by *Shariah*
- BMI is very concerned about the disclosure of products and services offered by the bank

- BMI and the AAOIFI require information concerning of Zakah and al Qardul Hasan be stated.

Both BMI and the AAOIFI have recognized the importance of disclosing information relating to Islamic issues on the financial statements. However, just what types of information, that should be disclosed, is still open to debate. The extent and level of disclosure is still based on conventional requirements and not on Islamic accounting requirements e.g. the disclosure of lawful dealings, wages, the achievement business venture objectives and protecting the environment (Haniffa and Hudaib, 2001). The content of information disclosed relating to Islamic values in annual reports of BM is more through than that of BIMB and the Faisal Finance Institution though. Islamic disclosure requirements as well as the objective of Islamic accounting are still debatable, so to identify the extent and level of disclosure in Islamic Accounting an agreed formula is clearly needed.

The role of accounting as a part of a shuratic process in a political economy in maintaining the Islamic social value in a society in general and in an Islamic organization in particular, as it has been mentioned by Choudhury (1997) need to be raised. Islam as an integrated way of life (Qur'an: 2: 208) demands that all its subsystems should contribute and support the enforcing of Islamic values in all individual and social activities. Hence. Islamic accounting standard as a part of political economy should be set up to provide indicators to evaluate the performance of Islamic institution in implementing *Syariah* or Islamic values. This is important future agenda.

#### **Local Regulation:**

Form the list of annual report stated in the AAOIFI, Botosan (1997) and Susanto (1992), we can conclude that BMI is more compliant with the list stated in the Susanto study (1992) than to Standard issued by AAOIFI. The standard issued by AAOIFI are not binding but can be used as a guideline to be followed by Islamic financial institutions when preparing their financial statements. It is also argued that the BMI annual report places primary emphasis on local regulations and in particular, those decreed by Indonesia's central bank, Bank Indonesia.

#### **FUTURE RESEARCH**

Because this study is only limited to Bank *Muamalat* Indonesia, its' result are limited. It would follow that for a more in-depth analysis of the annual reports of Islamic banks, the survey would require a global outlook with Islamic financial institutions being studied throughout the world. It would certainly seem to be a good idea to undertakes studies related to the formulation of minimum information disclosure requirements by Islamic bank based on Islamic accounting paradigms. Issues could include what items should be disclosed by Islamic organizations or institutions so that they satisfy general requirements as well as requirements highlighting the value of Islam in their business operations. This is not to say that the area of research has been so far neglected by academics and indeed, some efforts have been made to define the financial report from an Islamic accounting perspective. Baydoun and Willet (2000) for example, argue that Value Added Reporting is compliant with Islamic accounting. We may therefore choose to analyse this more closely in further studies by investigating whether

the items disclosed in Value Added Reporting satisfactorily present Islamic values or whether we need further disclosure more focused on accountability, justice and dedication to God.

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