INTERNET FINANCIAL AND ENVIRONMENTAL DISCLOSURES: AN ISLAMIC AND CONVENTIONAL THEORETICAL PERSPECTIVE

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For more than one decade, a new media has been used in business sector and communication; many firms in different countries are using the internet to present their products and also to disclose their information (financial and environmental). The level of using such media too has increased over the last couple of years in the corporate world. Major characteristic of the internet is that information can be accessed almost any time and from anywhere. A number of researchers have identified internet reporting as the most efficient instrument to communicate with the external environment. Within the disclosure literature, several theoretical perspectives have been used to explain this development in financial and environmental disclosure approach through the internet. Although there exist a number of related theories in relation to internet disclosure, but none has discussed from an Islamic perspective. This paper attempts to provide an overview of conventional and Islamic perspectives on financial and environmental disclosures.

Keywords: Financial, Environmental, Islamic Accounting, Theories, Internet Reporting and Disclosures

INTRODUCTION

Since 1990s, many companies in different countries are using the internet in their business not only to sell their products but also to disclose their financial and non-financial information. The level of using such media has increased over the last couple of years in financial markets (Wagenhofer, 2003). Based on the findings of a survey conducted by the members of the National Institute of Investor Relations, investor relations department is under pressure to fulfill the increasing demands of the investors for online information (Sriram and Laksmana, 2006).

The rapid growth of the internet technology has created the ability for firms to disclose all relevant information directly and instantly to world wide users. The most important characteristics of the internet are that information can be accessed almost any time from anywhere. Besides the low costs of dissemination through the internet (Botosan, 1997), and wide reach (Adham and Ahmed, 2005), the information displayed in the internet is group communication, timeliness, and updateable (Joshi and Jawaher, 2003). Internet also allows corporations to provide an account based on the specific needs of various stakeholders without having to gather such information separately for each stakeholder (Lodhia, 2004).

The information disclosed on the internet is also more in quantity and quality compared to other media (AICPA, 1994; Wallman, 1995). Corporations can present their information on the internet in many forms such as dynamic presentations, draws, multimedia, audio, video and others (Ashbaugh *et al, 1999*; Ettredge *et al 2002*). This in turn, leads to enhance the trustiness between stakeholders and their companies as the stakeholder can get all the necessary information that are needed for making their decisions (Sriram and Laksmana, 2006).

Mclvor *et al (2002)* argue that internet technology supports the transparency as it enables corporations to effectively respond to the demand of their rapidly changing operating environment. Leung *et al (2006)* argue that transparency is a good way to help the investors to make better investment decisions and consequently allocate better resource and capital for an optimum return. This in turn leads to an efficient capital market and better economic growth and social welfare (Meek and Thomas, 2003). Besides that, transparency is part of corporate governance mechanism, and thus is essential for the development of emerging economies (Leung *et al 2006*).

Several theories have been linked to internet financial disclosure and internet environmental disclosure such as agency theory, stakeholder theory, legitimacy theory, litigation cost hypothesis, family ownership hypothesis, signal theory, media richness theory, cost and benefit analysis. These theories do not include Islamic accounting theory, which has its own characteristics that are more objective and fulfill the needs of the stakeholders and regulators.

This paper is a first attempt to discuss disclosure practices not only from the conventional theoretical perspective, but also from the Islamic accounting theory perspective (see Hossain *et al., 1994*; Jones *et al 1999*; Craven and Marston; 1999; Andrew, 2003; Lodhia, 2004). The main purpose of this paper is to critically discuss these theories and show that there is no one theory that clearly explains why companies discloses their information on the internet. To clarify this salient point, it will be beneficial to find out the factors that enhance the level of internet reporting and hence the level of transparency.

From the theoretical perceptive of previous studies, these theories can be classified into two categories. Theories that explain the disclosure of financial and environmental information which are agency theory, stakeholder theory, legitimacy theory, litigation cost hypothesis, family ownership hypothesis and Islamic accounting theory, and theories that explain using internet device such as signal theory, media richness theory, and cost and benefit analysis. This section provides an overview of these conventional and Islamic theoretical perspectives. A thorough discussion on these theories is based upon the past literature in this area of research.

Agency Theory

The agency theory predicts that as conflicts arising from the separation of ownership and control of a company, shareholders would like to have assurance that their equity is not subject for any misused or expropriations by the management. The management, in order to alleviate this problem, undertakes several actions including voluntary disclosures and establishes monitoring mechanisms (Xiao *et al., 2004*; Marston and Polei, 2004). Jensen and Meckling(1976) extensively defined an agency relationship as follows:

> "A contract under which one or more persons (the principal(s) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent, if both parties to the relationship are utility maximizes there is good reason to believe that the agent will not always act in the best interest of principle. The principal can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent. In addition, in some situations it will pay the agent to expand resources(bonding cists) to guarantee that will not take certain actions which would harm the principal or to ensure that the principal will be compensated if he does take such actions...)" pp. 308.

The existence of information asymmetry also plays an important role in expanding the gap between the stakeholders and the management. Information asymmetry not only affects the relationship between the shareholders and management inside the company but it also affects the market in the long term (Weil, 2002). This is one of the problems that Securities and Exchange Commission (SEC) chairman Arthur Levitt indicates when he states that the SEC is "working with similarly interested parties from around the globe to advance the cause of efficient and transparent markets" (Securities and Exchange Commission, 2001). Frankel and Xu Li (2004) argue that reducing information asymmetry is a regulatory goal in the USA as it is stated in 1934 Securities Act. Benston (1973) notes that:

> "Underlying the disclosure requirements of the '34 Act is the belief that required disclosure of financial data is necessary for the fair and efficient operation of capital markets..... Perhaps even more important is the concept of "fairness," the belief that all investors, big and small, insiders and outsiders, should have equal access to relevant information"(pp. 134).

Therefore, the management has to provide and disclose sufficient information in order to minimize the agency gap and to strengthen the market (Richardson and Welker, 2001; Rahman, 2002). However, although the agency theory theoretically explains the purpose of disclosure by corporations, and it has been referred in most of disclosure studies, but this theory alone is insufficient to explain internet disclosure. This is for the following reasons: firstly the agency theory fails to explain the disclosure in family-controlling firms. Chen *et al. (2007)* find that in some extent, family controlled firms disclose their information although they face lower information asymmetry between owners and managers. Secondly, the theory also fails to explain using the medium for disclosure such as the internet device itself. There are other theories such as signal theory or cost and benefit theory which give more explanation regarding the medium of disclosure and more relevant to agency theory.

Stakeholder Theory

Stakeholder theory states that:

> "The corporation is continued existence requires the support of the stakeholders and their approval must be sought and the activities of the corporation adjusted to gain that approval. The more powerful the stakeholders, the more the company must adapt. In this context, social disclosure is seen as part of the dialogue between the company and its stakeholders (Gray *et al 1995,* pp. 53).

According to the above definition, the corporation, in order to survive and be successful in the long run, has to get support from all its stakeholders. This requires a dialogue between the management of a corporation and its stakeholders. Therefore, the stakeholder theory recognizes the need to be responsive on the demands of the public who will be affected by the actions of the company. This includes environmental disclosure.

Smith *et al (2005)* state that the concept behind the stakeholder theory is that stakeholders have to enlarge managerial responsibilities and roles. This include the interests and claims of non-stakeholders group such as public, employees, the press, authorities, investors and other interest groups. However, the shareholders can affect (directly or indirectly) managerial decision by having a majority share of the company (Deegan, 2000). In this case, the management normally follows the demand of the shareholders (Ullman, 1985) by disclosing the required information regardless whether it is mandatory or voluntary.

Many companies, however, still do not give a serious consideration to environmental disclosure (Solomon and lewis, 2002). This is contributed by two reasons: (1) the cost of environmental reporting and printing is very high

(Debreceny *et al., 2002*); and (2) the management is not aware of the importance of disclosing environmental information as its benefits are intangible in nature (Ramasmy and Ting, 2004).

However, although stakeholder theory concentrates on the stakeholders' preferences and the type of information that management should disclose, but it ignores disclosure medium such as the internet as a multiuse channel.

Legitimacy Theory

This theory can be used to explain how and why companies deal and concern with issues related to the environment. This theory highlights a company's responsibility towards the society and the environment. According to this theory, the existence of any company influences the society in which it works (Gray *et al 1995*).

According to Cormier and Gordon (2001), legitimacy theory lay on the concept that there are embedded contracts between the organizations and a society. By fulfilling these contracts, the organizations and their actions can be legitimated by the society. Thus, in order to become legitimate, the organizations undertake actions that are within the contract. Gray *et al (1995)* propose four strategies that an organization must follow to create legitimacy concern, which include an organization's actions, keeping actions unchanged and attempting to modify how the society see its actions, diverting society attentions away from concerned issues to different issues, and seeking for changing a society's expectations about its environmental performance.

Patten (1991, 1992), Deegan and Rankin (1996), Wilmshurst and Frost (2000) state that legitimacy theory is based on the concept that a company exists among society; it cannot survive in the long run unless it is accepted by the society. The theory predicates that companies are always aiming for common goals with the society in order to get their acceptance (Patten, 1991; Isenmann and lenz, 2001). Gray *et al (1996)* stated that;

> ". . . Organizations can only continue to exist if the societies in which they are based perceive the organization to be operating to a value system which is commensurate with the society's own value system "pg 46.

In other words, given the subjective evidence of an increased societal awareness of the environmental impact of businesses on society in Malaysia and Singapore as an example (Ramasmy and Ting, 2004), legitimacy theory proposes that companies should undertake brave steps in order to obtain a society's acceptance for their activities and performances. It is expected that companies disclose their environmental activities and strategies in the annual reports by using printing media or the internet in order to be accepted by the society.

In sum, it is clear that legitimacy theory like stakeholder theory which refers to the type of information (environmental and social) that company should disclose and take the society into consideration. However, they both fail to give clear explanation why companies disclose their financial and non-financial information on the internet.

Litigation Cost Hypothesis

According to Healy and Palepu (2001), litigation cost hypothesis predicates that the shareholders can influence disclosure decisions and the level of voluntary disclosure in two ways. Firstly, shareholders may take legal actions against managers for insufficient or late disclosures. This in turn motivates companies to increase the level of voluntary disclosure. Secondly, litigation reduces the level of voluntary financial disclosure, in particular forecasting information, because managers believe that they will be penalized if the prediction is incorrect. This is because it is quite difficult to differentiate between unexpected future errors due to chance and deliberate future errors.

However, the absence of litigation can motivate the managers to choose the right time for disclosing good or bad news. In this case, the managers who have bad earnings may opt for information pre-disclosure in order to reduce the litigation cost (Skinner 1994; as reported by Healy and Palepu, 2001). Nevertheless, pre-disclosure cannot totally stop the litigation. Francis *et al (1994)* observe in their empirical study that 62% of the companies in their study are sued due to earnings forecasts or time of disclosure. It is argued that litigation risk is related to both companies with bad news and companies with good news (Miller and Piotroski, 2000; Healy and Palepu, 2001).

Therefore, in order to avoid any trial, the managers prefer to disclose more information in a timely basis to clarify any misunderstanding. Groff and Pitman (2004) state five advantages of the internet reporting which are increased awareness, increased usage, application of analytical tools, avoidance of disclosure redundancy and savings.

In short, it is clear that litigation cost hypothesis links manager's willingness to disclose corporation's information and the probability of getting prosecuted by shareholders. This scenario appears to run counter to the well-known situation of a company that discloses forward-looking disclosures. However, the whole population of voluntary informative disclosures, if measured, seems likely to be far greater than the voluntary forward-looking disclosures that lead to meritless suits.

Family Ownership Hypothesis

Family ownership hypothesis is one of the important propositions that give explanation about the decrease in the level of voluntary disclosure amongst family-owned companies. It is observed that in the family-owned companies, several members of the family have a position in the board. This highlights that there is no separation between those who own and those who manage the capital (Nicholls and Ahmed, 1995). In such a case, the capital owners have more detailed information and direct access to all information than other parties and they do not have to rely heavily on public disclosure and reports to monitor their investments as they hold the majority shares (Adhikari and Tondkar, 1992 as reported by Haniffa and Cook, 2002). Thus, the existence of family member on the board or having family ownership will negatively affect on the level of disclosure (Chen and Jaggi 2000; Haniffa and Cook, 2002; Alarussi 2005).

However, accepting the view that more information disclosure enhance the reputation of the company (Merrick and Crookshanks, 2001; ACCA., 2005) might encourage family-owned companies to disclose more information through different mediums in order to enhance their reputation. Family members, unlike the managers who are not extremely concerned about the reputation of the company that they manage due to the probability of leaving it under any circumstances, have many things to lose in the case of unfavorable reputation. Therefore, the responsibility to enhance the reputation of a company is more significant in family-owned companies.

Signaling Theory

Signaling theory was developed by Spence (1973) to explain behavior in the labor markets (Watts and Zimmerman, 1986). It is also utilized in explaining voluntary disclosures (Watson *et al, 2002*). Signaling theory argues that the companies would like to distinguish themselves from other companies in terms of quality and performance (Morris, 1987; Watts and Zimmerman, 1986; Skinner, 1994). Since the extent of voluntary disclosure is considered as one of the possible way to achieve this difference, the companies are motivated to increase the level of voluntary disclosure with a hope to increase their share price (Healy and Palepu, 2001).

Based on signaling theory, the management will find the internet as the best alternative to improve the quality of the company. This is because, the internet is a high technology tool and its adoption provides the evidence that the company is concerned with the latest approach in information disclosure (Marston and Leow, 1998). In addition, the internet is a wide coverage medium whereby a large number of people can get access to the company's information and eventually the share of the company (Healy and Palepu, 2001; Sriram and Laksmana, 2006).

The internet is not merely a media for communication and disclosure like any other media. It is also a global tool that can be used for different purpose due to its sophisticated features and characteristics. Therefore using the internet for information disclosure is a wise decision and can give good return to the company. Although signaling theory give theoretical explanation about using the Internet as a device to disseminate company's information, it fails to explain the reason beyond this, and even why small, medium and big companies disclose their financial and non-financial information on the internet.

Media Richness Theory

According to Daft and Lengel (1986), media richness theory referred to characteristics that media should have to improve human understanding by reducing uncertainty and ambiguity. Four key factors have been determined to measure the level of media richness, that are immediacy or feedback (refers to the ability of media to provide timely feedback); multiple cues (refer to the ability to express messages through differing signals such as body, language, voice, and tones); language variety (refers to the use of different words to increase understanding); and personal source (refers to the ability to transmit feelings and emotions) (Daft and Lengel, 1986).

Sproull (1991) and Valacich *et al* (1993) add additional decisive factors for media richness which are multiple addressability (the ability to communicate information simultaneously to numerous users); externally recordable (means a record of the communication); computer processable memory (which indicates to the organization and manageability of communication electronically such that searches can be undertaken on them); and concurrency (it allows interactivity simultaneously to several users).

The information users or investors, either potential investors or new investors, need a full disclosure of information in order to make decision (Tan *et al,* 1990). To attract them, the companies have to disclose more details and information to the investors. Adham and Ahmed (2005) suggest for companies that do not have websites to find a way to have website and take advantages of the characteristics provided by the internet technology. This is because such technology is beneficial for companies, investors and customers. The internet offers a good opportunity for companies to disclose more information in a wide coverage area in order to attract more funds at a low cost. The investors will get all needed information that can assist them in making decision. This practice also, on one hand, alleviates the problem between management and stakeholder (agency problem) and on the other hand attracts new investors to invest in the company (Lodhia, 2004; Adham and Ahmed, 2005).

Overall, the purpose of this theory is to clarify the best media that can help human in understanding the nature and in turns help in decision making process. Lodhia (2004) examines whether the internet, as a tool of communication and disclosure, has the characteristics to be a rich medium for disclosure. He uncovers that the benefits of internet reporting prove that it is a rich medium regardless of social and political factors but organizations may face obstacles in the form of new laws and regulations. Therefore, this theory also fails to explain the purpose of disclosing companies' information on the internet.

Cost and Benefit Analysis

Gray and Roberts (1989) discuss the costs and benefits of voluntary disclosure and investigate its perspective empirically. In their theoretical discussion, they argue that the evaluation of the costs and benefits is critical before determining the choice of disclosure medium. It is argued that the most important cost factors that restrict voluntary information disclosure are:

- Cost of competitive disadvantage, and
- Cost of data collection and processing.

According to Craven and Marston (1999), companies voluntarily disclose their information in order to increase their capital at a minimum cost. This practice in turn increases transparency and decreases misunderstanding between the management and the stakeholders or participants in the market.

The increase in disclosures assist listed companies in attracting new shareholders and thus sustaining companies' shares price in the market (Wong, 2002). Weil (2002) states that there is an interaction between companies and information users, once disclosure systems have been established. Using the internet to distribute financial information might be beneficial because it is everywhere nowadays.

According to the survey undertaken by Department of Trade and Industry in the USA in 1996 about the development of information sources, there is some evidence of internet growth potential in the USA. In 1999, America Online had 15 million members and revenues are expected to grow by 50% to $3.8 billion. Weil (2002) examines the benefits and costs of the information supply from the disclosers and information user perspectives. The results show that comparative benefits and costs affect both the initial architecture of disclosure systems and the interaction between disclosers and users.

According to Epstein and Freedman (1994), 82% of participating individual investors consider annual report as the source to know about environmental activities. However, the environmental information that is disclosed in the annual report is very costly. Besides that the costs for preparing environmental information is also high (Ahmed *et al,* 2003). The traditional printing media is even more costly as it includes costs of printing, collecting and distributing (Debreceny *et al,* 2002).

To recapitulate, it is suggested that voluntary disclosure is determined by managerial assessments of costs and benefits (Gray *et al,* 1990). This means that voluntary disclosure will be undertaken if the perceived benefits outweigh the perceived costs (such as the costs of data collection, production and auditing and indirect costs of potential competitive disadvantages). However, in real situation, managers are under pressure to disclose companies' information on different media regardless the cost of this dissemination. In other words, there are factors other than cost and benefit factor that encourage managers to disclose companies' information such as market situation, investors needs, competitor and company's condition.

Islamic Accounting Theory

From the Islamic perspective, most of the previous theories and hypotheses, if not all, ignore the important element that presents ethical and behavioral principles and objectives in Islam, therefore, most of these theories may not be appropriate to apply on the Muslim society and businesses, which in Islam is known as to one's success *(falah)* (Gambling and Karim, 1991; Adnan & Gaffikin, 1998). Based on this perspective, Islamic accounting can be defined as the "accounting process" which provides appropriate information (not necessarily limited to financial data) to stakeholders in order to ensure that the entity is continuously operating within the bounds of the Islamic Shari'ah and achieving its socioeconomic objectives. In other wards, Islamic accounting is also a tool, which enables Muslims to evaluate their own accountabilities to stakeholders, government and ultimately to God (in respect of inter-human/ environmental transactions).

Therefore, from the Islamic point of view, since the objective of Muslims and the Islamic economic system is to achieve *falah*, Islamic businesses and Muslim businessmen should also conduct their business activity to achieve this *falah*, as business activity is part of human activity and cannot be separated from other daily activities (Beekun, 1997). Hence, the principles of profit and wealth maximization and the incessant concern with shareholder value, on which capitalist businesses are based, are not the main considerations from an Islamic perspective. This is especially so, since Islam has comprehensive ethical principles for business. Accounting and disclosure practices by corporations should support this activity by providing information to achieve *falah*.

This process is the core pillar to Islamic accountability. According to Shahul Hameed (2000):

> Accountability is the duty of an entity to use (and prevent the misuse of) the resources entrusted it in an effective, efficient and economical manner, within the boundaries of the moral and legal framework of the society, and to provide an account of its actions to others who are not only the persons who provided it with its financial resources but to groups within society and to society at large.

In addition, based on the above definition, the accountability concept is not restricted to spiritual aspects but extends also to social, business and contractual dealings. The Qur'an states that "And Fulfill contract, Verily (fulfillment of) contracts will be questioned (on the day of reckoning)" (Al-Qur'an, 17:34). Hence, any accounting events including disclosure financial and non financial information fall under Islamic accountability. Baydoun and Willet (1998) state that unlike conventional accounting, in Islam the center of attention is on God and the community rather than the individual interests, a social accountability perspective rather than the personal accountability that is considered on the western countries.

Therefore, a principle of full disclosure of accounting information is needed, not based on the outcome of a political process or agency problem but upon what ought to be disclosed in order to serve the objectives of social accountability. They conclude therefore, that the differences in the objectives and the specific prescriptions of certain transactions lead to differences in the type of information that should be disclosed by Islamic accounting. It is imperative to achieve full accountability in Islam, full disclosure of financial and non-financial information is important. This theory of accountability and falah to all will ensure that full disclosure will be achieved. Environmental information which is only considered voluntary according to the conventional theories is a must according to Islamic accounting theory.

SUMMARY

Based on the above discussion, it can be concluded that although signaling theory and cost and benefit analysis explains the benefit of disclosure using the Internet, they, however, fail to give full explanation why firms disclose their financial and environmental reporting through Internet. This limitation is because not all firms disclose their reporting on the Internet to differentiate themselves from others or because of its low cost. In other words, there is no one specific theory that explains internet reporting in totality. A number of theories discussed in this paper are relevant for research in this area, but since there is no one single theory to explain this phenomenon, it indicates the existence of a theoretical gap. This theoretical gap might be explained by the fact that internet reporting is motivated by many factors, one of which may be due to competition amongst companies.

Internet unites different markets into one big market. This forces companies to do the best to survive and compete amongst other companies. Companies have to disclose their financial and environmental performances. It is important for companies to respond to the external users' needs. Fekrat *et al* (1996) assume that "in a competitive environment, firms would tend to compete with each other to disclose information to avoid suffering the consequences associated with withholding unfavorable information,"(pp.177-78).

Market competition is the driving force that leads the level of environmental disclosure to be in the highest level (KPMG, 1999). Companies that understand the advantages of being perceived as concerned about the nature will present a good image of themselves to the public and gain moral support from secondary stakeholders (Clarkson, 1995; Gray, *et al, 1995*).

However, as the purpose of environmental disclosure goes as self-interest of management of company, the number of separate environmental reports has dropped mainly due to an increased focus on ethical and social considerations. Companies shift to produce social reports rather than environmental reports because that is what the regulator and the public are concerned with. Thus, in the US., companies producing environmental reports in 1999 showed an excessive drop from 45% to 30% as compared to 1996 (KPMG, 1999).

In summary, the disclosure on the Internet is a weapon used by companies to compete globally to attract funds and investors confidence. The limitation of knowing the determinants of Internet reporting adds another dimension to figure out the purpose of internet disclosure.

CONCLUSION

Many previous studies, attempts to discuss the theories related to internet reporting and disclosures, but none had specifically identified the relevant theories that could explain the use of Internet by companies for such purpose. In this paper, theories related to disclosures and reporting are discussed such as agency theory, stakeholder theory, legitimacy theory and Islamic accounting theory, or Internet as a device for disclosure such as media richness theory, cost and benefit analysis.

Although signaling theory and cost and benefit analysis give better explanation about using Internet device, but they fail to explain why firms need to disclose their financial and environmental reporting through Internet. As discussed above theoretical gap exists in this area of research. Nevertheless, from an Islamic perspective, obligations and accountabilities of the directors are the utmost factors that must be considered in financial reporting and disclosures. It is highly recommended that Islamic accounting theory, which is more comprehensive compared to others be adopted to ensure full accountability of the public listed companies' directors for reporting in the Internet. Even though environmental disclosure is voluntary but since Islam requires full disclosure of information, directors will comply even if it is not mandatory. It is highly recommended that Islamic principles are adopted by regulators and policy makers to ensure that stakeholders are provided with all the necessary and important information for them to make decisions.

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