Accounting Standards and Islamic Financial Institutions: the Malaysian Experience

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**Abstract**

More than three decades after the establishment of first Islamic bank in Malaysia, there is still debate on the need for Islamic accounting standards. Early studies on this subject demanded a separate set of standards for Islamic Financial Institutions (IFIs) due to notable differences in transactions from their conventional Western counterparts. However, as time passed, one cannot imagine how IFIs have mushroomed and become a very large industry, with Western banks also venturing into the market. Nowadays, many products and services offered by IFIs echo the ones provided by the conventional banks. Along the line, the stance on the need for a set of accounting standards specificities to IFIs has also changed. Many parties including the Malaysian Accounting Standards Board (MASB) agree that International Financial Reporting Standards (IFRS) can be applied to transactions in IFIs. While there are many similarities to conventional banking transactions, a few areas of divergence remain in IFIs. In that case, the likely option to resolve this dilemma is to have guidelines or options for IFIs within the framework of IFRSs. If these guidelines are to be enforced globally, one possible option is for Islamic organisations to work closely with the International Accounting Standards Board (IASB). This paper reviews the subject with respect to accounting standards for IFIs and finds a few areas of research that should be pursued.

**Keywords:** Islamic Accounting Standards, Islamic Financial Institutions, Conventional banking, International Financial Reporting Standards, Malaysia.

1.0 Background

There have been remarkable developments in the Islamic Financial Institutions (IFIs) industry in recent years. These institutions were established for the purpose of fulfilling Shari’ah obligations in serving Muslims who are prohibited from paying and receiving riba (Al-Ajmi, Saleh and Hussain, 2011). Shari’ah which literally means ‘the way to the source of life’ is used as a legal system originating from the code of behavior specified by the Holy Qur’an and the Hadith (the authentic tradition) (Lewis, 2001). Accordingly, the transactions in IFIs are meant to be accountable to God that turn into an act of worship in order to seek reward in this world and in the hereafter (Haniffa and Hudaib, 2010). Therefore, IFIs aim to be different from conventional financial institutions in terms of objectives, operations, principles and practices (Abdul Rasid, Abdul Rahman and Wan Ismail, 2011).

The differences between the conventional banking system and IFIs are summarised in Llias (2008, p. 1): 1. Riba free transactions where any kind of interest is considered usurious and prohibited under Islamic law; 2. Musharaka where every party involved in a financial transaction shares the associated risks and profits; 3. Uncertainty is disallowed unless all of the terms and conditions of the risk are clearly understood by all parties to a financial transaction; 4. Emphasizing ethical investments where any investment in immoral activities such as gambling and liquor production and selling are prohibited; and

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5. There must be tangible, identifiable underlying assets to back-up each financial transaction where money is not considered to be a tangible asset. As a result of differences in IFIs and their ultimate goals, most studies agree that there is a need for a special set of Islamic accounting standards, tailor-made to these IFIs. The way to enforce them is also a major concern for this industry.

In developing Islamic accounting standards, Islamic accounting scholars reveal that the main principle of Islamic accounting is accountability to God (Napier, 2009). According to Napier, with accountability to God, two essential characteristics of Islamic accounting are full disclosure and social accountability, which are antithetical to the ideas of creative accounting, window dressing and reporting legalities over substance. To be accountable to God, it is essential for Islamic financial institutions to gain public trust and confidence by reporting a faithful representation of the economic transactions or events that it purports to represent (Archer and Karim, 2007). The transactions have to be reported in accordance with the substance as well as form of Shari’ah contracts that govern these transactions or events. Additionally, a special agency problem (in reference to worshipping God) has appeared in IFIs that demands for information disclosed should reflect the Islamic transactions environment (Archer and Abid, 1996). Prior literature suggests that the development of this special set of Islamic accounting standards can address problems encountered by IFIs, relating to the lacking of conventional accounting standards such as International Financial Reporting Standards (IFRSs) or local General Accepted Accounting Practice (GAAP) in accounting for IFIs’ transactions.

One of the important milestones in the development of IFIs is the establishment of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in Bahrain in 1991. This organization produced 60 AAOIFI accounting, auditing, and governance and Shari’ah standards. Despite the full commitment shown by AAOIFI in the development of accounting standards, there appears to be a lack of support from national regulators in many countries. For example in Malaysia, although the IFIs have existed since the 1970s, since then there has been an absence of approved Islamic accounting standards. The implementation of Islamic transactions in IFIs is not without challenges. One of the main challenges is the fact that these institutions are competing with other banks operating within a global financial market dominated by the Western banking industry. This has led many transactions using Islamic contract to echo traditional Western banking transactions (Napier, 2009; Khan, 2010). This occurrence has also influenced the reporting environment in IFIs. This paper aims to review the issue related to the development and enforcement of the accounting standards in IFIs. In the end, this paper hopes to share some light in resolving the dilemma of accounting standards and IFIs. In reviewing the issue, this paper finds that IFIs have grown rapidly worldwide and developed secular goals. This phenomenon contributes to the stagnant development and adoption of a special set of Islamic accounting standards. The paper is organised as follows: Section 2.0 explains the need for Islamic accounting standards; Section 3.0 describes the relevance of AAOIFI standards; Section 4.0 discusses the involvement of Malaysia in the setting up of Islamic accounting standards; Section 5.0 recommends the future options; and finally, this paper ends with concluding remarks in Section 6.0.

2.0 Need for Islamic accounting standards

Islamic institutions play an essential role in promoting economic prosperity as a basis of social stability where people live with good values and religious faith (Vinnicombe, 2010). This prompts the need for the IFIs to deliver high quality financial statements since Muslim society expects them to adhere to the principles of Shari’ah. The resurgence of IFIs which offer a wide range of products that differs from Western financial products demand Islamic accounting standards in a manner that is consistent with Islamic financial products (Vinnicombe, 2010; Kamla, 2009). The development of accounting standards for IFIs will fulfill the desire of Muslims to apply Islamic principles in all aspects of their lives including their banking transactions.

To avoid confusion, it is necessary to mention here that discussions on Islamic accounting standards create two separate issues. The first issue is in regard to IFIs. The literature discusses that preparers need some guidance in preparing their financial statements as their transactions differ from the conventional banking system. The second issue is in respect to Muslim accountants working in various organisations and whether the accounting treatments given in the IFRSs are consistent with the principles of Shariah. As Muslims cannot compartmentalise their daily lives from their business transactions, some may argue that accounting treatments in IFRSs do not adhere to the principles of Shari’ah. In this case, it is necessary for Islamic accounting scholars to examine the conceptual framework for financial reporting and search for one Islamic conceptual framework that Muslim accountants can use.
Given the choice in IFRSs, Islamic conceptual framework can serve as a guideline for Muslims accountants to choose an accounting treatment which adheres to the principles of Shari’ah regardless of the types of companies that they work for. To have a separate set of accounting standards for Muslim accountants is unnecessary as it leads to redundancy of work and implies that Islam is a religion that separates faith from daily normal business. An Islamic conceptual framework can guide the development of accounting standards for IFIs. The discussions in this paper focus on accounting standards for the IFIs.

This special set of Islamic accounting standards is required to address the difference in transactions between the IFIs and the conventional banks. After all, Islamic financial institutions developed with the aim of complying with Shari’ah principles, so the application of the same accounting standards will imply that the products offered by IFIs are just the same as those offered by conventional financial institutions. For IFIs to survive, a high level of public confidence is essential. In order to achieve this public confidence, Islamic banks should disclose information transparently to convince the public that they have the ability and capacity to achieve financial goals and objectives in accordance to Islamic Shari’ah law (Archer and Karim, 2007). Effective supervision and regulation has become the main challenge for these IFIs that operate in a dynamic and competitive industry (El Qarchi, 2005). The question is how to issue a standard accounting methodology to regulate various types of patterns or Islamic banking financing schemes that can be accepted internationally.

Currently, the IFIs have subjectively chosen IFRS standards that in their thinking do match the contracts governing the underlying transactions. This has led the auditor to interpret those standards even though the standards do not cater for the specificities of IFIs transactions where interest and pure money speculation are banned and trades must be underpinned by physical assets. The different interpretations by various national regulators, institutions and scholars leads to different rules and practices which in turn generate confusion among users. The most critical issue of conflict between Islamic finance and conventional accounting rules concerns the ownership of the asset. In order to avoid interest but also ensure that banks can generate some profits, Islamic banks buy an asset on behalf of a customer and lease it out until the customer is able to acquire ownership. The IFRS standards require the accounting treatment for such a transaction as finance lease, where the lease is recorded as an interest-earning loan which is contradictory to Shari’ah law. Applying the IFRS accounting treatment implies that there is no difference between the conventional banking system and Islamic financial institutions. This area of reporting based on substance over forms remains an area requiring further clarification. Although there have been accounting standards developed by the AAOIFI for IFI which complement the IFRSs, these standards seem to be difficult to enforce. The relevance of AAOIFI accounting standards is discussed below.

3.0 AAOIFI accounting standards

While the main aim of IFIs is to adhere to the principle of Shari’ah, IFIs operate in Western-dominated competitive and dynamic industry. IFIs need regulatory supervision much like Western institutions (Islam, 2003). The key to successfully regulating IFIs was the establishment of AAOIFI. AAOIFI developed 60 standards covering accounting, auditing, governance and ethics that IFIs need to apply. AAOIFI works are a lot based on the current reporting system. The approach began with objectives established in contemporary accounting thought, and then testing them against Islamic Shari’ah; in short, accepting those consistent with Shari’ah and rejecting those that are not (Lewis, 2001). This approach avoids redundancy in the current reporting system and is seen as harmonizing the accounting standards so that consistency with globally accepted accounting standards is attained. The Deloitte Islamic Finance Knowledge Center (IFKC) finds that 79% of the industry leaders surveyed support a convergence initiative of the AAIOFI standards with IFRS, while 7% did not support the convergence. An alternative approach is to establish objectives based on the spirit of Islam and its teachings and then consider these established objectives in relation to contemporary thought (Lewis, 2001).

This approach adopted by AAOIFI is acceptable in the short term while in the long term; an Islamic accounting model should focus on developing accounting standards based on Islamic concepts (Archer and Karim, 2007). AAOIFI’s adoption of this second approach resulted in accounting standards that were very much based on IFRSs (Kamla, 2009).

Some Islamic accounting scholars support IFIs to comply the accounting standards promulgated by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) to reflect the unique transactions of IFIs (Archer and Karim, 2007; Vinnicombe, 2010). Employing AAOIFI accounting standards would not only improve the comparable, relevant, reliable, transparency and efficiency of the countries' financial institutions but would also expedite the processes of globalization (Karim, 2001; Hussain, Islam, Gunasekaran, Maskooki, 2002). The adoption of AAOIFI standards is useful as there are areas of differences in reporting IFIs and likewise, the IFIs need to be sustained in this global financial market dominated by conventional banking transactions. Although AAOIFI managed to develop a set of accounting standards for IFIs, this body lacks the power to enforce regulations. AAOIFI accounting standards have not been fully accepted by regulatory regimes and a range of political, economic, and social circumstances due to the lack of appreciation of the benefits of these standards (Karim, 2001; Vinnicombe, 2010). The choice of whether to adopt AAOIFI accounting standards depends on national regulators.

There are a few factors influencing the decisions to adopt AAOIFI standards. AAOIFI was established in the early 1990s, the era before the move to IFRS. With the whole world moving towards a single set of accounting standards, many regulators are reluctant to have a separate set of accounting standards. Since IFRS is becoming the lingua franca of financial reporting, it is costly for IFIs to prepare two sets of financial statements. Additionally, comparing financial statements will be affected by having two sets of accounting standards. Some scholars argue that there is not much difference between AAOIFI accounting standards and IFRSs. The financial accounting standards issued by AAOIFI are basically compatible with IFRS except in only one or two cases (Archer and Karim, 2007). Since AAOIFI standards have mainly been based on IFRS, this approach has been criticised as embracing the spirit of dominant capital and free market ideology (Kamla, 2009). This approach has endured due to the challenges faced by IFIs that operate in a competitive and risky industry. The growth of Islamic finance has seen many products offered that are copied from the conventional banking industry (Khan, 2010). It is argued that rather than fulfilling religious duties, the real aim of IFI has been seen by some as creating secular goals and not religious ones (Haniffa and Hudaib, 2010). This has led the national regulators including the Malaysian Accounting Standards Board (MASB) to have the view that IFRS adheres to the principle of Shar’i’ah and is applicable to IFIs. The next section discusses the involvement of Malaysia in setting up accounting standards for IFIs.

4.0 Malaysian involvement in the setting up of Islamic accounting standards

In the early 2000s, MASB was actively engaged in the development of Islamic accounting standards in order to streamline the reporting of IFIs. According to MASB the absence of a proper set of accounting standards for IFIs prohibited the comparison of banks’ financial performance or between periods for individual banks. As a consequence, MASB held the view that the lack of dedicated standards will hamper the development of Islamic investment vehicles as well as a robust Islamic capital market. In that case, the MASB has given careful consideration to the substance of AAOIFI standards, which they believe to have a separate set of Islamic financial institutions that will enhance transparency and help nurture the development of these institutions. The early development has seen the issuance of FRSi-1: Presentation of Financial Statements of Islamic Financial Institutions (previously known as MASBi-1) as providing a basis for the presentation and disclosure of financial statements representing Islamic banking activities. However, this standard has been withdrawn lately due to redundancy of the IFRS requirements. The standard has now become known as MASB Exposure Draft ED i-3: Presentation of Financial Statements of Islamic Financial Institutions. In later years MASB issued a few discussion papers on Islamic financial transactions to create a wider understanding of the issues; DP i-1 Takaful, DP i-2 Sukuk, DP i-3 Shariah Compliant Profit-sharing Contracts. Besides the issuance of discussion papers by MASB, Bank Negara (The central bank of Malaysia) issued some guidelines on the reporting of IFIs; Revised Guidelines on Financial Reporting for Licensed Institutions (BNM/ GP8); Guidelines on Financial Reporting for Licensed Islamic Banks (BNM/ GP8-i); TRI-1: Accounting for Zakat[1] on Business; TRI-2: Ijarah[2].

The stance of agreeing to have a separate set of Islamic accounting standards has changed nearly a decade later along with the vast growth of IFIs. The Chairman of MASB, Mohammad Faiz Azmi, was quoted by The Malaysian Reserve in 2009, as agreeing with there being no necessity for Islamic accounting standards (Singh, 2009). According to him, there is no significant divergence between Islamic and the conventional banking system and IFRSs can cater to IFIs’ requirements. Currently, MASB has the view that approved accounting standards adhere to the principles of Shari’ah and therefore, they can be used in reporting financial standards. This paper posits that the vast development in IFIs together with Western banks entering the Islamic financial market has influenced financial reporting behaviour. This approach reveals that many products offered by IFIs echo the products offered by the conventional banking system, implying there are no significant differences between Islamic and Western banking transactions. In that case, the MASB approach to convergence in every aspect of transaction prompts further research that should examine to what extent the products offered by IFIs are Shari’ah compliant and differ from their counterparts in the conventional banks. It is also useful to know whether Islamisation has indeed been used as a label for marketing the bank products, moving away from the original sacred aims.

5.0 Future options

This recent substantial growth in IFIs with many Western banks has also entered the market, contributes to a great challenge for the development of Islamic accounting standards. It is seen to be almost impossible to have Islamic accounting standards living in its exclusivity. Islamic finance has expanded very much as a form of finance and one major reason for this is that there is not much area of differences between the products offered by IFIs and the conventional banks. In fact, the differences can be reconciled with the help of professional judgment. The possible practical option to regulate the reporting of IFIs is to harmonize accounting treatment for IFIs and accounting for conventional banks. It is viable for IASB to have options under IFRSs to serve the differences in IFIs. These options ensure a uniform application across the whole industry while blending with the IASB’s standards for conventional accounting. It has been reported by Reuters (2012) that the Asian-Oceanian Standard Setters Group (AOSSG), a regional organization which creates accounting guidelines, is suggesting the IASB should draft the guidelines for Islamic finance standards. Based on their survey, more than three quarters of 24 financial standards-setting bodies agreed to not have separate Islamic accounting standards outside the IFRS framework because they were inconsistent with the global trend of converging with IFRS.

Despite the existence of AAOIFI standards, unlike the IASB, AAOIFI cannot force the regulators to adopt their standards. Another challenge is IFRS has responded accordingly to the issue of fair value such as IAS39 (Financial Instruments: Recognition and Measurement) and IFRS7 (Financial Instruments: Disclosures). However, the slow response by AAOIFI in respect to the issue makes it difficult for IFIs to adopt AAOIFI standards. Therefore, it is believed that the job of producing guidelines for Islamic finance is likely to be that of the IASB. With the whole world moving towards a single high-quality financial reporting system, it is almost impossible for IFIs break free of the momentum for harmonization. Harmonization is a better option to accommodate Islamic issues into IFRSs. This is another area of research in Islamic accounting to be explored. Although the approach now is still very much based on IFRSs, an Islamic organization such the AOSSG and the AAOIFI should also move towards developing an Islamic conceptual framework that respects Shari’ah law. MASB can play a rigorous role in the search for this conceptual framework, thereby engaging in developing guidelines within IFRSs for IFIs as Malaysia is a dynamic market for Islamic finance Future research may aim to develop Islamic conceptual framework focusing each concept in great detail. MASB needs to revise its stance on the applicability of IFRSs to IFIs’ transactions. This is because Malaysia has been accused as being too liberal in their interpretations of Islamic Shari’ah principles regarding banking and financial affairs (Khan and Bhatti, 2008).

6.0 Concluding remarks

The early literature demanded a separate set of Islamic accounting standards for IFIs. The AAOIFI has played the key role in developing the standards for IFIs.

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However, it has been stated that these standards are merely based on IFRSs. One future area of research that is critical to Islamic accounting is the need for a Islamic conceptual framework so that standards for IFIs can be developed. It should emphasize issues like social accountability, full disclosure, periodicity, materiality, and reliability (Lewis, 2001). Although there is not much divergence between the accounting treatment in IFRSs and AAOIFI standards, there are still areas of difference in transactions of IFIs that need further investigations, for example the issue of substance over form which open room for future research. AAOIFI has attempted to deal with this issue; however, national regulators are reluctant to adopt the AAOIFI’s standards. This is because AAOIFI does not carry much weight since the IASB enforces the implementation of accounting standards. Currently, with the lack of consensus of accounting in Islamic finance, many institutions have applied the IFRSs according to their interpretations of IFIs. This may contributes to the incomparability of financial statements and thus confuses many users of financial statements. This approach has also implied that products and services offered by IFIs are merely similar to the ones offered by their Western counterparts.

It is vital to convince the public and customers that the products offered are indeed in accordance with the principles of Shari‘ah, and are not merely labeled as Islamic products. However, the Islamic finance industry has become so large and criticized for moving away from Islamic beliefs and expectations. It is now impossible to have Islamic accounting standards that exist in their own right. The main reason for this is that there are very few issues of divergence which can be catered for by including IFI guidelines under IFRS. Indeed, IFRS under the authority of the IASB has the ability to impose such guidelines. With the AAOIFI’s lack of power to enforce standards, harmonization of Islamic guidelines to IFRSs is the likely approach to resolving accounting controversies. This move may encourage the further development of Islamic financial products.

References


