Introduction

The study of Islamic accounting has grown in recent years with substantive contributions from scholars such as Gambling and Karim, (1986), Lewis and Algaoud, (2001) and Baydoun and Willett (1995 and 1997). It is notable, however, that the emphasis of most of these studies is descriptive or analytical in nature, emphasizing in particular, the implications of Islam for accounting principles and practices, and the theoretical framework from which accounting standards for Islamic entities could potentially be derived (for example, Karim, 1995 and Lewis, 2001). There is little recognition that a practical response to the need for Islamic accounting standards has emerged in the form of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). This body was established in Bahrain in 1991 as the Financial Accounting Organization for Islamic Banks and Financial Institutions (FAOIBFI). The subsequent name change (to the AAOIFI) reflects both its growth and the broadening of its brief to encompass Islamic insurance, as well as auditing, ethical and governance standards for Islamic financial institutions. While the AAOIFI is located in the Persian Gulf State of Bahrain, its purpose is to develop and disseminate accounting and auditing standards for implantation by Islamic financial institutions worldwide (AAOIFI, 2003/1421H[1] p. ix; Lewis and Algaoud, 2001, p. 171).

Despite the evident significance of the AAOIFI's emergence and the accounting standards it has thus far developed and published, there appears to be no empirical research into the implementation of and compliance with these standards by the institutions for which they are intended. There are a number of possible reasons for this.

[1] The second date represent the corresponding year in the Islamic calendar.

Firstly, although the AAOIFI has been in existence for some time, it is typically still referred to in the relevant accounting literature, and hence looked upon, as a relatively new institution (for example, Baydoun and Willett, 1997 and 2000; Karim, 1996 and Maali et. al. 2006). Secondly, the AAOIFI develops and promulgates accounting standards for Islamic financial institutions, but has no powers of enforcement (AAOIFI, 2003-4/1424-5 H, p. 6). Thirdly, and in part this explains the second point, the AAOIFI is developing standards for financial institutions which have in common their commitment to Islam. This single common denominator must, however, be contrasted to the vast range of countries within which Islamic banking takes place, encompassing widely divergent economic, political and regulatory environments, and indeed geographical locations.

A fourth factor which may be significant, is that while accounting standards developed by the International Accounting Standards Board (IASB) and other national bodies, such as the American Financial Accounting Standards Board, are intended to be utilized in the financial reports of a range of entities, to date, the accounting standards issued by the AAOIFI apply only to Islamic financial institutions. It is clear that many of the standards developed by the AAOIFI could be applied to non-financial institutions (Baydoun and Willett, 2000, p. 72). Thus far, however, financial institutions comprise the bulk of explicitly Islamic organizations. Finally, and as already indicated, the focus of much Islamic accounting research to date has a descriptive/analytical rather than empirical orientation.

There is, however, one notable exception to this trend. A study by Maali and others (Maali, et. al. 2006) developed a benchmark set of social disclosures for Islamic banks. This benchmark was used to undertake a comparison with the actual disclosures of a sample of 29 Islamic financial institutions. Approximately 50 per cent of the items included in Maali's benchmark overlap the reporting requirements of the AAOIFI (*Ibid*, p. 281). This current study intends to follow Maali's use of an index to further fill the empirical gap, but with the specific purpose of measuring the compliance of Islamic banks in their financial reporting with the standards issued by the AAOIFI. The annual reports of a sample of banks operating under Islamic banking licenses in Bahrain provide the data from which compliance is tested. Focus on one country avoids potentially complex external factors which are likely to have differing influences on compliance with Islamic accounting standards. Moreover, the Bahrain financial sector provides an ideal environment for an initial study of this nature. The state of Bahrain hosts the AAOIFI and encourages the implementation of its standards through a number of initiatives. These include mandatory financial reporting requirements in accordance with the AAOIFI standards as a basis for the licensing of Islamic banks (BMA, 2004, p. 8).

Deliberately selecting such a positive environment suggests that the hypothesis of the study should be that compliance with the standards will be high, and this is largely verified by the findings. This begs the question as to the relevance of the research. That is, do the requirements of the Bahrain Monetary Authority with respect to Islamic financial institutions render redundant a study into compliance with the standards promulgated by the AAOIFI by Bahraini Islamic Banks? A parallel can be drawn with

studies measuring compliance with the international financial reporting standards (IFRSs) developed by the International Accounting Standards Board (IASB). This research has proven valuable in gauging the real compliance of reporting entities, and hence the progress of the international accounting standards harmonization project (Ali, 2005, p. 31).

While measuring compliance with Western accounting standards, particularly with international accounting standards, has been a focus of research, (for example, Nobes, 1990; Street and Bryant, 2000 and Tower, 2004,) such measures have not crossed over into Islamic accounting studies, where the accounting standards issuing body is itself insufficiently recognized. It is envisaged that further empirical studies, which broaden the geographical region, and encompass exogenous explanatory variables will follow. In the first instance, it is important to develop an understanding of the degree of compliance within a positive environment.

To date, the AAOIFI has published two Financial Accounting Statements, 20 Financial Accounting Standards (FAS 1 – 20), as well as statements relating to auditing and governance, and ethical codes for accountants, employees and auditors of Islamic financial institutions. The index items included in this study do not encompass the full set of standards issued. Instead, they are limited to those standards and statements which relate to issues dominating the theoretical literature on Islamic accounting. Therefore, the literature is used as a guide to identifying benchmark items which reflect issues of primary importance for Islamic reporting entities.

A further questions arises, and that is, why accounting standards specific to Islamic financial institutions have been deemed necessary? In other words, why do Islamic financial institutions require a new and seemingly different accounting treatment to that already existing for traditional Western entities? The answer relates to what has become known as the resurgence of Islam in recent decades (Maurer, 2002; see also Karim, 1990; Haqiqi and Pomeranz, 1987; Algaoud and Lewis, 1991). This resurgence is reflected in the desire of Muslims to apply Islamic principles to all aspects of their lives, including business life. The result has been rapid developments in Islamic economic and financial theory, and a subsequent need for accounting principles and practices that facilitate the reporting of Islamic entities in a manner consistent with Islamic principles.

However, the question remains as to why it became necessary in the mid to late 20th Century to develop economic, financial and accounting principles which accord with a religion that has been in existence for many hundreds of years. The answer lies in the historical development of Islam, of which only a brief overview is necessary in order to understand the salient points for the purpose of this paper. It is generally known that the origins of Islam are found in 7th Century Arabia, where it is believed the Prophet Mohammad (PBUH)[2] received the revelations of God to the Arab world through the agency of the Angel Gabriel (Smith, 1958, p. 228). In a relatively short period of time, these revelations were recorded in what came to be known as the Muslim Holy Book, the Qur'an. This was supplemented by the *sunnah*, the recorded sayings and actions of the

[2] It is customary in the Islamic literature to follow any mention of the Prophet Muhammad's name with the words "peace be upon him". This practice has also been adopted by Westerners writing in the area, irrespective of religious affiliation, as a mark of respect. This paper adopts the convention of using the acronym PBUH.

Prophet (PBUH) during his lifetime, as well as those actions of his followers of which he approved (Hussain, 1999, p. 28f). These two written documents became the primary source of Islamic law, known as the Shari'a and the Shari'a became the mainstay of the Islamic community or *ummah*. It was recognized in the early years of Islam, that the Qur'an and *sunnah* would be insufficient to cover all eventualities, and further, that they would frequently require interpretation in order to be appropriately applied to new situations. Hence, there emerged the study of the Shari'a, known as *fiqh* (jurisprudence), and its practitioners became and are still known as *fuqaha* (jurists) (Lewis, 2001, p. 106).

Islam spread rapidly in the 7th and 8th Centuries, not only throughout the Arab world, but further afield into parts of Asia and Europe (Armstrong, 2001, p. xxix). However, both compliance with and the further development of Shari'a law declined under the subsequent dominance of the Ottoman Empire over the Muslim world (from approximately 1252 – 1914) (Baydoun and Willett, 1997, p. 3; Gambling and Karim, 1991, pp. 42 – 43). This decline continued after the collapse of the Ottoman Empire, when European based secular law was introduced to the Middle East through the French and British Mandates (Baydoun and Willet, 1997, p. 10). More recently, increasing globalization and the concurrent spread of multinational companies, along with other influences, such as global accounting firms and monetary organizations, have all contributed to the international dominance of Western financial and accounting practices (Baydoun and Willet, 1997; Gambling and Karim, 1991). However, much that is involved in Western regulatory and accounting practices is at odds with Shari'a law. In particular, the separation of business and religious life that has been accepted in the West

since the European Enlightenment (Tawney, 1938 [1926]) is not consistent with Islamic precepts.

In recent years, Muslims across the world have expressed a desire to once more harmonize business and religious life (Karim, 1995, p. 287). Islamic banks have been the focal point for achieving this outcome. As with any economy, it is the financial sector which has primary responsibility for the mobilization of funds between depositors and investors. The first modern Islamic bank Nasser's Social Bank, was established in Egypt in 1971, (Pomeranz, 1997, p. 124). Since that time, there has been a rapid growth in the number of Islamic financial institutions, the funds under management and the range of products offered. In 1997 Pomeranz cited estimates of funds under management ranging from 50 to 100 billion US dollars, with an "annual growth rate … between 10 to 15 percent of the asset base (Ibid). Lewis and Algaoud, (2001, p. 7) cite a 1998 estimate of "200 Islamic banks and financial institutions operating in 43 countries of the world, and controlling a financial pool of US$100 billion." Their own subsequent estimates suggest more recent figures are considerably higher, and continuing growth is significant.

While a small number of Muslim nations have Islamized their legal systems (Pakistan, Iran and the Sudan), in most regions, the regulatory and legal systems within which Islamic financial institutions operate is more complex. Typically, Islamic banks exist side by side with traditional Western entities, and do so in a range of regulatory environments. In some cases this has allowed considerable latitude in terms of self-regulation, and in others, Islamic financial institutions have been subject to traditional

Western regulatory regimes. In practice, this means that larger Islamic financial institutions may follow the Shari'a in the financial products they offer, but investors and other stakeholders must have recourse to Western style financial statements when seeking information. Hence, a growing need for Islamic accounting standards has been clear for some time. As noted, there has been a practical response to this need in the form of the AAOIFI, but as yet, there appears to be little empirical investigation into compliance with the accounting standards promulgated by this organization. This paper takes a preliminary step in addressing that gap.

The remainder of the study is organized as follows: the second chapter examines the literature on Islamic accounting and compliance indices. Chapter Three explains the historical development of the AAOIFI. The following chapter identifies appropriate elements to include in the compliance index. The index is developed in Chapter Five, where the sample and findings of the study are also discussed. This final chapter includes concluding remarks and suggestions for further study.

Chapter Two: A Review of the Literature

Baydoun and Willett (2000) identify three categories of literature relevant to Islamic accounting. These are firstly, the relation between religion, culture and accounting; secondly, the elements of Islam relevant to accounting; and thirdly, literature on what can be described as the conceptual framework debate. That is, the debate as to whether or not a conceptual framework is necessary for the development of Islamic accounting standards. This paper will follow a similar approach, but will add an overview of the literature on compliance indices and their potential use in measuring the financial reporting compliance of Islamic banks.

1: The Relation Between Religion, Culture and Accounting

Culture emerged as a major variable in explaining differences in accounting principles, practices and standards between nations only in the 1980s. This followed the adoption by accounting researchers of Gert Hofstede's claim to have identified a number of national cultural values (NCVs), which are stable over time, and deterministic with respect to other variables (such as economic, political and social factors) that had previously been associated with accounting variations (Hofstede, 1980). Gray (1988), followed by Perere (1989) developed frameworks for linking Hofstede's NCVs with what were described as "accounting sub-culture values" (Gray, op. cit.). The appeal to accounting theorists of Hofstede's NCVs lay in the combination of their claimed long-term stability and pervasive influence, which, at least initially, appeared to clarify by simplifying the

identification of determinants of international accounting variation. Subsequent studies suggested that the incorporation of other factors, particularly economic, lead to models with more explanatory power.

The potential influence of religion on culture is strikingly lacking in the research of this period (Baydoun and Willett, 2000; Hamid et. al. 1993). This may in part be explained by Hofstede's identification of religion as deterministic. That is, he claimed NCVs to be prior to religion, maintaining that nations only adopt religions that are compatible with established NCVs. Once adopted however, religion becomes a support for the long-term stability of NCVs (Hofstede, 2001, pp. 113 – 114). Hamid et. al. (1993) use the example of Islam to show religion to be a much more complex factor than had been identified by Hofstede. While Hofstede defined culture as "the collective programming of the mind" (Lewis, 2001), most religious scholars consider faith to be "more than a culturally conditioned response to events" (Baydoun and Willet, 2000, p. 74). In the first instance, many religions both transcend national borders and also differ within single nations. Islam, in particular, provides a comprehensive framework for the entire life of a Muslim, and hence does not comprehend "religious beliefs as a subset of a wider set of cultural beliefs" (Ibid).

2: The Elements of Islam Relevant to Accounting.

Much of the literature that can be categorized under this heading seeks to demonstrate specific aspects of the Islamic faith that impact on or change the needs of users of Islamic Corporate Reports (ICRs). The Corporate reports of Western entities are largely a 20th

Century invention intended to inform various stakeholders of an entity of its financial position and performance, and of its compliance with the regulatory regime in which it operates. Stakeholders therefore range from regulatory bodies to investors and employees.[3] In a traditional Western reporting environment, accounting standards are intended to provide guidance to preparers in the production of financial statements that are relevant for this range of users. Consistent accounting standards facilitate the preparation of financial statements that demonstrate compliance with regulatory requirements and allow other interested parties to assess an entities' economic performance.

It is envisaged that the needs of ICR users will not be identical to those of traditional Western corporate reports. Identifying those elements in the Islamic faith that are pertinent for the construction of ICRs has been a primary focus of much of the Islamic accounting literature to date (for example, Lewis, 2001; Baydoun and Willett, 2000). Baydoun and Willett (2000), claim, however, that all the essential elements that need to be addressed in ICRs can be found in what is regarded as the seminal paper in this area, Gambling and Karim's 1986 paper on Islam and Social Accounting. These elements are as follows: first and foremost, the importance of *Shari'a* compliance; secondly, the ban on *riba* or usury found in the *Shari'a*, thirdly, the lack of distinction between secular and religious life; fourthly, the importance of the religious tax or *zakah*, and finally, the importance of the Islamic community. We will follow Gambling and Karim, and add an additional factor, forbidden business activities.

[3] In the Social Reporting literature, additional factors, such as the impact of an entities operations on the environment, are also considered important (Maali, et. al. 2006).

The Importance of Shari'a Compliance

Islamic banks are defined by their commitment to following the *Shari'a* in all aspects of their organization. We have noted that the two most important sources of *Shari'a* law are the *Quran* and *sunna.* These are regarded as the primary sources of law, which have, over time, been supplemented by the work of learned Islamic scholars. The commentaries, interpretations and new laws to meet changed circumstances produced by jurists are an important part of the *Shari'a*, but are regarded as secondary sources. While five major schools of thought are evident in these sources (encompassing the split between Shia and Sunni Muslims), there is general agreement on matters of primary importance (Hussain, 1999). A final source of *Shari'a* is *ijitihad*, or the reasoning of contemporary scholars on issues not previously addressed. This is perhaps the most contentious source of Islamic law, partly because it is not always clear precisely who is qualified in this respect.

The major point with respect to the combined sources of the Shari'a is the intended flexibility to meet changing circumstances.[4] The Shari'a provides precedents not only with respect to judgments, in a manner similar to Anglo/American case law, but also precedents in the developments of new laws. This is particularly relevant to the production of accounting standards for Islamic financial institutions in the late 20th early 21st Century. However, although the Quran is largely regarded as a source of principles

[4] This view is almost universally expressed in the literature on Islamic accounting standards. While it may be true that there are Muslims, who have found it possible to follow a literal interpretation of the Quran, as is purportedly the case with the Taliban in Afghanistan, such a perspective is not common in the accounting and finance literature.

and guidelines (Hussain, 1999) it also contains "approximately 500 injunctions of a legal nature, 20 of which are on economics" (Lewis and Algaoud, 2001, p. 21). Where the Quran provides such rulings, they are fixed for all time; as the revealed word of God cannot be improved upon by human reasoning. The most important of these injunctions for accounting purposes relate to the points that follow; the ban on *riba*, the payment of *zakah*,the importance of the Islamic community, and specific commercial activities which are forbidden.

Riba

The ban on *riba*, which is now widely understood as a ban on interest bearing financial products, is both the most well known aspect of Islamic banking and finance, and that with the most far reaching implications.[5] Profit from the interest spread between deposits and loans forms the basis of Western finance. Hence, its prohibition requires alternative financial products "both in mobilizing funds for … [Islamic banks] operations and in providing finance for their clients that comply with the principles and rules of *Shari'a*." (Maali et. al., 2006, p. 267). Alternative financial products also require alternative reporting guidelines and hence accounting standards.

The earlier Islamic accounting literature included some debate as to how *riba* should be defined, and to what extent it should be interpreted as a complete ban on interest in a contemporary context (Algaoud and Lewis, 1999; Karim, 1995). Hamid, et. al. (1993), for example, claim the literal meaning of riba to be simply "increase". Gambling and Karim, in their 1986 paper provide a more comprehensive definition of riba as "usury in

[5] Hamid, et. al. 1993 cite three specific versus in the Quran where riba is forbidden; *al-Imran* 3: 130, *al-Rumm* 30:30 and *Baqara* 2:275.

its broadest sense of oppressive or miserly dealings, as well as the more particular issue of charging interest of fixed amounts on loans". A decade later Karim, writing alone (1996, p. 134) explains the strict or literal translation of riba to be usury, but clarifies its interpretation by "modern Islamic scholars as being equivalent to interest". Karim reflects a general consensus that all interest bearing deposits and finance, and even valuation models using interest rates are subject to the prohibition found in the Quran.

As said, for practical purposes, the significance of the ban on riba is the need for Islamic financial institutions to develop alternative financial products, and the subsequent need for new accounting treatments and hence standards. Although interest is primarily banned by virtue of the relevant passages in the Quran, there is also a reasoning behind this which is indicative of the application Shari'a law to all aspects of life for Muslims, summarized as follows:

> (T)he potential for the borrower to invest money and earn a profit introduces an unacceptable speculative element into the business undertaking. To exact a higher amount than the sum lent on that conjectural basis is regarded as being a kind of unjust exploitation…. Injustice is presumed to arise wherever there is a guaranteed and fixed return to one party (in this case the lender), but an uncertain and variable return to the other (the borrower) (Hamid, et. al. 1993, p. 143).

This ban on *riba* is also linked to a dislike of debt attributed to the Prophet (PBUH). Reportedly, the Prophet's (PBUH) concern lay with the potential for debt to cause

humiliation and worry for the indebted, and also provide a cause for people to “tell lies and break promises” (Ibid, p. 144). This concern with the impact of commercial activities on ethical behaviour is explored more fully in the next section.

The Unity of Islam

A recurring theme in the current literature, is the “totality of a Muslim’s being” (Lewis, 2001, p. 103). Essentially this means there is no separation between religious and secular life in Islam, so that Shari’a principles inform business life as much as they inform the manner in which a Muslim should worship God (Tinker, 2004). An ideal Muslim state would therefore be one in which Shari’a law governed. The modern reality is that secular and Shari’a law exist side by side, and until recently, the former prevailed in matters of business. We have already described the historical antecedents of this contemporary reality, and have also indicated the increasing desire of Muslims to abide by the Shari’a in all aspects of their lives, including in business and economic matters.

This concept of *Tawhidi* or unity (Harahap, 2006) is quite foreign to contemporary Western society, where the separation of church and state is the accepted norm. This dichotomy in Christian society dates to the time of the European Enlightenment[6] (Tawney, 1938 [1926]). However, the roots of contemporary Western law can be found in Medieval canon law, where similarities to the Shari’a are evident in the moral and ethical concerns governing business conduct. And, despite the long separation of church and state in the West, ethical concerns are still apparent in the framework and rules of Western financial regulatory regimes (Karim, 1995, p. 285).

[6] Usually dated to the period from 1650 (Tinker, 2004).

In the spirit of this application of the Shari'a to all aspects of life, Islamic banks are expected to play a positive role in the Muslim community or *umma.* According to Lewis and Algaoud (2001, p. 165), the first obligation incumbent upon an Islamic bank is to "serve Allah and develop a distinctive corporate culture". By this they mean the organization must reflect Islamic values in all its activities, from providing Shari'a compliant financial products to the treatment of its staff, and in its dealings with customers. Private property and commerce are encouraged in Islam, as is the circulation of wealth. Economic prosperity is regarded as the basis of a stable society in which Muslims can live a good and faithful life. Islamic financial institutions are seen as playing the same significant role in economic prosperity as they do in Western market economies (Rahman, undated).

This thinking is not entirely removed from the writings, for example, of Adam Smith, who promoted free markets on the grounds of their universal benefits (Smith, 1776). A major difference with respect to Islam is that unconstrained pursuit of wealth is not encouraged. Instead, Islam qualifies the notion of private property through the teaching that all wealth ultimately belongs to God, and is held by humankind in stewardship only for the period of a person's life. Further, the Qur'an includes directives concerning the use of that wealth, for example, that it is not to be used wastefully, and that commercial dealings with others must be honest and fair (Rahman, *op. cit.*). The notion of social justice permeates Islamic teachings (Haqiqi and Pomeranz, 1987). This is exemplified in the levying of *zakah* to which we now turn.

The Obligation to Pay Zakah

One of the most important considerations for Islamic accounting has been identified as the requirement incumbent upon all Muslims to pay the religious tax or *zakah*. Along with prayer, fasting, alms giving and the pilgrimage to Mecca (for those with the means and health), *zakah* is on of the five pillars of Islam (Tayob, 1999, p. 98). *Zakah* is typically defined as a religious levy or almsgiving (see for example, Lewis and Algaoud, 2001, p. xii). Rahman, (undated, p. 2) explains the literal translation to be "purification". In being levied on unutilized wealth it helps purify Muslims "from the sin of avarice" (Haqiqi and Pomeranz, 1987, p. 157).

Zakah is levied on wealth rather than income, and specifically on what is considered "surplus wealth" (Rahman, undated, p. 3). In consequence, the amount levied "differs according to the type of business. For example, in trade (which includes Islamic banks) it is levied at the rate of 2.5%, while in industry the rate is 10%" (Karim, 1990, p. 43). Wealth obtained through little risk or effort can be levied at the highest rate of 20% (Rahman, op. cit. p. 7). Both the types of wealth subject to *zakah* and the eligible recipients are specipied in the Qur'an (Gambling and Karim, 1991, p. 20). Once collected, *zakah* can be distributed to the less well off in the community, thus providing a means of income redistribution. In fully Islamisized nations, *zakah* provides an integral role in this respect (Ibrahim (b), p. 19).

In this way the levying of *zakah* facilitates the "creation of a society based on mutual assistance" (Haqiqi and Pomeranz, op. cit. p. 57). *Zakah* is however, to be understood as a religious obligation, not as a tax in the traditional Western sense. In particular, it is intended to have a positive effect on the giver (purification), rather than to be regarded negatively, as is typically the case with Western tax systems. Nor is it necessarily the case that the religious tax should replace a more comprehensive tax system. At the same time, it is not to be seen as a substitute for charity. While charity is encouraged in Islam, this is in addition to *zakah*, which is an obligation to *Allah* or God, not an act to help others.

The Importance of the Umma.

The meaning of Islam is to submit oneself to God, and those who do so form the *umma*, the community of Muslims (Lewis, 2000, p. 104). A Muslim, is therefore, automatically part of the Islamic community, and is also obliged to promote the well being of that community. The reasoning behind the prohibition on *riba* and the requirement to pay *zakah* are both examples of the sense of social responsibility incumbent upon Muslims. The significance for accounting standards is that this obligation extends also to business and economic practices. Commerce is encouraged to promote mutual economic well being, but business organizations must be accountable to the community (Lewis, 2001, p. 113). The importance of Shari'a compliant financial reports and the accounting standards necessary to produce these is therefore clear.

Haram Business Activities

The final consideration from Islam for accounting standards is that of forbidden business activities. These include transactions involving alcohol, pornography, the slaughter and sale of pork, and speculative contracts or business transactions where uncertainty is a significant issue (Lewis, 2000, p. 119). Uncertain contracts are forbidden because they may lead to future conflict if circumstances should change between the time the contract is determined and the transaction actually takes place (Ibrahim (a), pp. 20 – 21). The ban on speculative commercial transactions derives from the prohibition in the Qur'an against games of chance. Speculative activities are forbidden as it is perceived that the speculators intention is to gain without effort (Lewis, op. cit.).

The Conceptual Framework Debate

Two schools of thought with respect to the development of Islamic accounting standards have been identified in the literature (Maurer, 2002, pp. 651 – 652). The first is that Islamic accounting standards can be developed most efficiently by examining existing "best practices", and from these, adopting those standards which are Shari'a compliant. Some existing non compliant standards that are nevertheless pertinent, can also potentially be adapted for compliance, and others must be rejected on the basis of non-compliance. The most prominent example of this school of thought is the AAOIFI itself (for example AAOIFI, 2003/1424H, pp. xxiv-xxv). This approach is rejected by other Islamic accounting scholars who emphasize the relevance of Shari'a to all aspects of life, meaning that accounting theory and practice must be derived from, rather than simply

compliant with, Islamic jurisprudence.[7] Their position regarding Western accounting practices is that, implicitly or explicitly, these reflect Western values, including, most importantly, the secularization of the West, and subsequent separation of business from personal, including religious life (Ibrahim, (c), p. 4). In particular, the second school of thought is conscious of the different objectives of enterprises operating in Western market economies compared to those required for Islamic firms. The former being profit maximization or some approximation thereof, while for the latter, Shari'a compliance is primary.

The pragmatic approach taken by the AAOIFI is predicated on its efficiency, in that work already undertaken by bodies such as the IASB can be utilized, thereby minimizing both the time and costs associated with the development of Shari'a compliant accounting standards. Such an approach clearly has much to recommend it. For the purpose of this research, the approach of the AAOIFI is accepted as the study seeks to test compliance with the standards thus far published by developing a relevant compliance index.

Measuring Compliance

Two areas of empirical research relating to accounting practices are pertinent to this study. These are the literature on compliance with accounting standards and that on voluntary disclosure indexes. While there appear to be no previous studies on compliance with Islamic accounting standards, it is possible to draw on the Western literature. Tower et. al. (1998) define compliance with international accounting standards

[7] See Lewis (2001, p. 113) for a summary of the literature relating to the second school of thought.

as being the degree to which entities comply with a multitude of issues in the international accounting standards (IASs)/international financial reporting standards (IFRSs) issued by the International Accounting Standards Board (IASB). In a similar vein, compliance for the purpose of this study can be defined as the degree to which Islamic financial institutions comply with the multitude of issues in the financial accounting standards (FASs) issued by the AAOIFI. Compliance with accounting standards is therefore viewed as essentially value neutral, so that the nature of resulting information is not at issue.

The Western literature is in fact particularly useful to the study of Islamic reporting compliance because it largely pertains to compliance with the accounting standards issued by the IASB and its predecessor body, the International Accounting Standards Commission (IASC). In purely practical terms, the AAOIFI can be viewed as following a similar pattern to the IASB, although the underlying goals of financial reporting for the two bodies differ significantly (that is, capital markets versus Shari'a compliance). Like the AAOIFI, the IASC was established (in 1973) to standardize financial reporting across entities. Also similar are the problems faced by an accounting body with limited powers of enforcement.

The IASB's project is typically described as the harmonization of financial reporting across nations. A necessary component of achieving harmonization is compliance with the IASBs reporting standards. Likewise, to harmonize the financial reporting of Islamic banks, it is necessary to achieve compliance with the FASs developed under the auspices'

of the AAOIFI. Compliance and harmonization though associated, are nevertheless distinct, although this is sometimes unclear in the literature. Van der Tass, 1992, defined harmonization very specifically in terms of what is at issue. Nobes (1994) defines compliance as "the process of increasing the consistency and comparability of accounts". The main point is that harmonization has the potential to differ from compliance. For example, entities may achieve a high degree of harmony in their reporting, through the use of similar accounting practices, but still fail to comply with specific accounting standards (van der Tass, 1992). This study specifically seeks to measure compliance.

Despite the distinction between harmonization and compliance, there is a degree of overlap in the methodologies used to measure both. Of relevance to this study is the development of indexes which are used as benchmarks against which compliance is measured. Typically data for these studies is derived from the annual financial statements of relevant reporting entities. For example, Tower et. al. 1998 studied compliance with IASs in six Asia Pacific nations using the annual reports of ten companies in each of the six countries. The benchmark used for the Tower study was based on 26 IASs applicable to the 1997 fiscal year, from which 512 data points or compliance items were identified.

The pioneering study in this area is that of Nobes, 1990, which measured the compliance of a sample of listed US companies with IASs. This was the first study in which data from annual reports were measured against a benchmark set of accounting rules.

Subsequent studies using a similar methodology include Purvis et. al. 1991 and Street et. al. 1999.

Typically, these studies calculate compliance as a ratio of complying items to the total number of items included in the benchmark. Research conducted in the 1990s often found compliance to be rather low. For instance, Nobes' 1990 study found non compliance to be higher than 50 per cent for most of the standards included in his benchmark. Purvis et. al. however conducted a broader study across 54 countries, and found the average level of compliance to be around 76 per cent.

Interest in measuring compliance increased towards the end of the 1990s and into the 21st Century as reporting in accordance with IASs/IFRSs entered a new stage. From 2005 all listed entities domiciled in the European Union are required to prepare their financial statements in accordance with the IASBs accounting standards. Individual nations, such as Australia and Russia have also introduced legislation mandating compliance with the IASBs standards (Baker and Barber, 2007). More recent studies show a corresponding increase in compliance (Ali, 2005, p. 37).

The benchmarks used in these compliance studies are derived directly from the IASs/IFRSs. The study by Maali, et. al. (2006) which measures reporting on the part of Islamic banks uses a voluntary disclosure index with benchmark items selected on the basis of their perceived importance in an Islamic societal context. The use of disclosure indices to measure information contained in annual financial reports is extensive (Maali,

et. al., 2006, p. 280; Inchausti, 1997, p. 47). While considerable variation in the nature of the indices is evident, most share the common goal of identifying or measuring the quantity and/or usefulness of information disclosed. Studies differ, for example, "in the number of items of information included in the index from 17 (Barrett, 1976) to 224 (Cooke, 1989)" (Inchausti, 1997, p. 48). Some studies attempt to measure aspects of reporting over time and others between countries. Many attempt to relate the level of disclosure to explanatory variables, such as firm size, profitability and the regulatory environment.

An issue of significance in the literature is the viability of using a "decision usefulness" approach to the items included in the index. That is, whether or not the items in the index should be weighted according to their perceived usefulness to users of a firm's financial statements. There is general agreement that this is a reasonable approach, however, practical difficulties have been observed in assigning weights, and the arbitrary nature by which this is done (for example, Barrett, 1976). Moreover, a study conducted by Dhaliwal (1980), compared the results of unweighted and weighted indices and found similar results, suggesting therefore that weighting adds little value to the outcomes. In consequence, many studies use unweighted indices.[8] Typically such studies use a dichotomous scoring method, where unambiguously disclosed items score 1 and undisclosed items score 0. Often an "ambiguously disclosed" category is also included. (for example, Depoers (2000); Maali et. al. (2006). These items receive a score 0.5

[8] For more information, see for example Inchausti (1997).

There is considerable similarity between the indices developed to measure compliance as opposed to voluntary disclosure. The latter are pertinent to this study because they provide an alternative guide to determining the variables to include in the benchmark items against which actual compliance of Islamic financial institutions can be measured. Rather than randomly selecting a subset of financial accounting standards (FARs) published by the AAOIFI, this study follows Maali, et. al. in choosing issues likely to be important to Islamic uses for inclusion in the index. These are identified through a review of the relevant literature. This study also follows Maali et. al. in using an unweighted index with dichotomous scoring.

Chapter Three: The AAOIFI

The AAOIFI has been in operation for well over a decade. During that time it has developed and promulgated an increasingly comprehensive set of accounting standards for Islamic financial institutions. In addition, the AAOIFI has developed guidelines and standards for the auditing of Islamic financial institutions, for their governance through individual Shari'a Supervisory Boards, and ethical codes for accountants, auditors and employees.

Although established in 1991, the Islamic accounting literature throughout the 1990s almost universally referred to the AAOIFI as a new organization, and little attention was given to its actual progress and the implementation of its standards by the organizations for whom they were intended. There are exceptions. For example, albeit in a 1997 paper, Pomeranz heralded the establishment of the AAOIFI as an "important regulatory debut" (Pomeranz, 1997). For the most part, however, the literature continues to emphasize those aspects of Islam which give rise to the need for differing financial products and hence accounting treatment. In other words, although an Islamic accounting standard setting body is "up and running" potential and actual contributions made by this body have received little acknowledgement.

Some change is evident in the literature on the debate as to the need for a conceptual framework from within which to develop Islamic accounting standards. Research published in Western finance and accounting journals, while commending steps taken by

the AAOIFI, have been critical of its pragmatic approach to accounting standard development (for example, Lewis, 2001).

This chapter explains the need for an Islamic accounting standard setting body, the development of the AAOIFI, its approach to developing accounting standards, and the problems and challenges it faces. The need for Islamic accounting standards coincides with the development of Islamic financial products. It is clear that new and substantially different financial products require commensurate accounting treatments, especially where institutions are required to produce annual financial statements. However, many early Islamic financial institutions were small community based organizations, and hence their need for accounting standards was not pressing. In addition, the rapid growth of Islamic financial institutions, both small and large, and small to large (Pomeranz, 1997, p. 124), meant their growth outstripped the ability of accounting standard development to keep pace.

Moreover, the emphasis in the Islamization of economic activities focused on developing financial institutions and financial products, rather than developing regulatory bodies. This may reflect the idealism which impelled the resurgence of Islam. Many believed that Shari'a compliance would reduce the need for regulatory bodies in an Islamic context.

Prior to the establishment of the AAOIFI, individual Islamic institutions instituted (and continue to maintain) Shari'a Supervisory Boards (SSBs). Typically these take the form

of in-house advisory boards, but small organizations may choose to hire individual consultants on a less permanent basis. While there is no overruling legal requirement for Islamic banks to employ SSBs, in some countries they must do so in order to be licensed. In addition, it is generally perceived that the "moral expectations" of customers are better served through the presence of an SSB (Karim, 1995, p. 288).

Individual SSBs have expended considerable effort in examining, modifying and advising on appropriate accounting treatments (Ibid, p. 292). This process has necessitated much duplication of work, as similar issues are confronted by most Islamic financial institutions in their search for appropriate accounting treatments. The differing schools of thought within Islam, and the variation in the nature of individual SSBs, have led to differences in findings regarding such treatments. In addition, prior to the standards for SSBs introduced by the AAOIFI, there were no guidelines for individual SSBs to follow, and no guidelines for financial institutions in establishing their SSBs. These factors contributed to there being considerable variation in accounting practices between institutions, and even within the same institution over time. Pomeranz, (1997), for example, quotes O'Sullivan, (1996) as finding five differing but accepted accounting treatments for one Islamic financial product.

Variations in accounting treatments used by Islamic banks became increasingly problematic during the 1980s. As a result, these institutions faced increasing pressure to conform to uniform accounting standards (Rahman, undated, p. 6; Pomeranz, 1997, p. 127). There was a growing belief that one overriding standard setting body could provide

consistency through developing single acceptable accounting treatments for a range of issues. Where variations in belief between SSBs made a single treatment impossible, a limited range of differing treatments could be specified (Maurer, 2002, p. 651).

The AAOIFI developed not only as a response to this perceived need for uniform accounting standards, but also out of a concern on the part of Islamic financial institutions that regulations would be imposed upon them by individual regulatory bodies in the various jurisdictions where they operated (Karim, 1995, p. 288). The AAOIFI is therefore somewhat unusual in the Middle East, as it came about through the initiative of the private sector in a specific industry. Individuals and organizations involved in its inception, however, included representatives of government bodies in largely Islamic nations, as well as financial institutions, practicing accountants, Islamic scholars and the Islamic Development Bank.

The AAOIFI commenced operations in Bahrain in March 1991 (11 Ramadam 1411H)[9] "in accordance with the "Agreement of Association which was signed by Islamic financial institutions on February 26th 1990 [1 Safar 1410H] … in Algiers (AAOIFI, 2003/1424H, p. ix). This agreement was the result of "intensive efforts" on the part of a range of interested parties, as described above. The AAOIFI cites a working paper presented by the Islamic Development Bank to its Board of Governors in 1987 as the first step in the process (Ibid). Initially known as the Financial Accounting Organization for Islamic Banks and Financial Institutions (FAOIBFI), the name change to AAOIFI

[9] The dates which follow in brackets represent the Islamic calendar which the AAOIFI follows.

occurred in 1995. This change reflected a broadening of the brief for the organization to include auditing standards in response to demands from the Islamic financial community.

The initial structure of the AAOIFI was two tiered, consisting of a Supervisory Committee and a Financial Accounting Standards Board (FASB). The role of the former was twofold; firstly to raise funds to support the organization as a whole and secondly, to appoint members to the FASB. This structure mirrored that of many Western accounting standards bodies (for example the American Financial Accounting Standards Board), in separating financing the accounting standard setting organization from the actual accounting standard setting. This type of set-up is commonly implemented in the hope that it will isolate accounting standard setters from potential financial pressure by interested parties.

In 1995 [1415H], a review committee was formed to reassess both the organizational structure and the aims of the then FAOIBFI. A General Assembly consisting of "all founding, associate and observer members" was introduced to replace the Supervisory Committee as the organizations most authoritative body. It is incumbent upon this body to convene at least once per year (AAOIFI/1424H, 2003, p. xiii). An accounting and auditing standard board (AASB) replaced the former FASB, reflecting broader areas of standard setting. A General Secretariat and Executive Committee were also established, and perhaps, most importantly, a *Shari'a* Board specific to the AAOIFI was formed.

The nature of the AAOIFI's funding also changed significantly. Rather than relying on member contributions a *waqf* (endowment) and charity fund financed from membership fees, annual subscriptions, grants, donations and bequests was established. This step further distances financing from standard setting.

The aims of the AAOIFI were first formulated in 1991, updated in 1995 and again in 1998. Briefly, they cover they cover the preparation and promulgation of accounting, auditing and governance standards for Islamic financial institutions with the goal of achieving harmonization in the "accounting adopted by [Islamic financial institutions] in the preparation of their financial statements" (Ibid). Likewise, the AAOIFI seeks to achieve harmonization in the auditing and governance practices of Islamic financial institutions. In addition, the aims include providing guidelines for Islamic financial institutions in a number of areas where they have or potentially will experience difficulties in finding appropriate accounting treatments or interpretations. This includes, for example, issues relating to Islamic insurance and new financial products. Finally, it is the goal of the AAOIFI to promote the adoption of its standards by Islamic financial institutions through the support of the relevant regulatory authorities in countries where these institutions operate. To this end they work to include such bodies as AAOIFI members, and also work with international bodies, particularly the International Accounting Standards Board (IASB).

In 1993, the then FAOIBFI issued Financial Accounting Statements 1 and 2 (FAS1 and FAS2) (Karim, 1996, p. 119). These two statements represented finalization of the

FAOIBFI's initial task to develop objectives and concepts of financial accounting for Islamic banks. FAS1 outlined the objectives, and FAS2 the concepts (Karim, 1995, p. 289). Taken together, the two statements are often described as providing a framework for the further development of Islamic accounting standards (Karim, 1996, p. 119). The two statements were followed by Financial Accounting Standard Number 1 (FAST1), which detailed requirements for the general presentation and disclosure for financial statements of Islamic banks.

The AAOIFI has now published twenty Financial Accounting Standards (FAST 1- 20), including standards for Islamic insurance companies, five auditing standards, four governance standards and codes of ethics for accountants, auditors and employees of Islamic financial institutions. This constitutes a substantial body of work in a relatively short period of time. The AAOIFI follows a similar procedure to Western accounting setting bodies in the development of its standards. It has "an extensive due process" which "provides interested parties with the opportunity to express their opinion" on the standards being developed (Karim, 1995, p. 288). Of particular importance in an Islamic context is that the due process includes input and approval from the organizations SSB, as well as that of the SSBs of interested parties.

In common with all accounting standard setting bodies, the AAOIFI faces a number of challenges. Its task is perhaps comparable to that of the International Accounting Standards Board (IASB) in that, unlike national accounting bodies, it must set standards for banks located in vastly different parts of the world. The standards therefore need to

be acceptable to a variety of regulatory regimes and a range of political, economic and social circumstances. Islamic banks operate in developing countries with high poverty levels (for example the Sudan), in nations where conflict is rampart (for example, Palestine and Iraq), across diverse nations in the Far East (Malaysia, India and Indonesia), as well as within the more homogenous and prosperous conditions of Middle East Gulf nations, such as Bahrain. The AAOIF has no power of enforcement, and must therefore proceed by gaining the support of national regulatory bodies and the major Islamic banks (Karim, 1995, p. 289). Such support is best exemplified in Bahrain as will be further clarified in Chapter Five.

Challenges also exist in the form of pre-existing Islamic accounting practices. For instance, some of the earlier Islamic banks were created through specific laws, which included the accounting standards to be followed (Ibid). A complicating factor is the need for the AAOIFI to acknowledge and incorporate the work already accomplished by the SSBs of individual banks. As already indicated, many of these small bodies have worked hard to develop accounting principles and practices for their institutions. In order to gain the cooperation of these banks it is likely that the AAOIFI must acknowledge this work. (Ibid, p. 292). Clearly, the advice and opinions of the SSBs will vary. The AAOIFI therefore faces the problem that in showing it does not discredit work already done, it may need to make compromises with respect to standards in order to reach agreement. Similar compromises in Western accounting standard setting have been problematic in that the result is typically too many accepted treatments, too little guidance for financial statement preparers and too little information for users.

Despite these problems, the AAOIFI has experienced considerable success in terms of its output, growing membership and what appears to be increasing acceptance by the regulatory authorities in many largely Islamic countries. It seems timely therefore to test the extent to which the standards promulgated by the AAOIFI are implemented by Islamic banks.

Chapter Four: Determinants of the Compliance Index

The compliance index constructed for this study follows the methodology developed by Maali et. al. (2006) in their study of social reporting by Islamic banks. Maali et. al. sought to measure actual disclosures of Islamic banks relative to a benchmark set of social disclosures based on Islamic principles. Similarly, this study will develop a benchmark set of compliance items derived from the standards issued by the AAOIFI. In order to measure compliance with the accounting standards promulgated by the AAOIFI, the potential set of benchmark items would include all standards and guidelines issued to date by the Accounting and Auditing Standards Board (AASB) of the AAOIFI. It is considered that such a comprehensive index would be better suited to further studies. A smaller set of items is more likely to yield insight into the nature of current disclosure, which can then provide the basis for future research. This study therefore restricts the index to those items included in standards and guidelines published by the AAOIFI that are considered most important for users of Islamic financial statements. The emphasis therefore lies with items which assist users determine the extent to which reporting bank complies with the Shari'a in its operations. These items were identified through a survey of the literature and include the following: *zakah*, accounting for the most common specifically Islamic financial products, *mudaraba* and *musharaka* financing and finally, the Shari'a compliance report of individual SSBs.

Zakah

We begin with the obligation to pay *zakah*, which is primary in being one of the five pillars of Islam (Gambling and Karim, 1986, p. 40). We have seen z*akah* is typically

defined as being a religious levy or almsgiving (Lewis and Algaoud, 2001, p. xii). And also, as indicated, the Qur'an specifies both who should pay the religious tax and who is eligible to receive it (Gambling and Karim, 1986, p. 40). *Zakah* is levied on

> ….money, investments (for income generation), animals, agriculture, trade and business. All money that is put aside and not used for a whole lunar year, has a *Zakah* of 2.5 percent levied on it. Similarly, 10 percent is levied on income from investments and 2.5 percent from personal income (Salaries and Wages). With respect to trade, *Zakah* is levied on both the net worth, which is capital plus reserves – fixed assets, and on the net profit at the rate of 2.5 percent; or on the net working capital and net profit. These include Islamic banks, companies and traders … (Ibid, p. 43)

Because the Qur'anic injunction to pay *zakah* predates large corporations in its inception, the varying tax levels specified in the *Shari'a* apply largely to individuals. In consequence, there has been a certain amount of debate in the literature as to whether *zakah* applies to business organizations (Maali, et. al. 2006, p. 275).[10] Some Islamic banks, however, are required to pay *zakah*, either to comply with their regulatory environment, or in accordance with the principles of their establishment. Lewis, (2001, p. 118) argues that where *zakah* is not required, it becomes the duty of an Islamic bank to establish a *zakah* fund and ensure the proceeds are distributed to the poor. In addition, Islamic banks

[10] Maali et. al. refer also to Gambling and Karim, (1991) and Ghihaadeh, (1987) regarding this issue.

sometimes either pay *zakah* on behalf of their shareholders and/or disclose the amount payable by shareholders in their annual reports (Karim, 1990). It is generally accepted in the literature that Islamic financial institutions must at least calculate the *zakah* payable by shareholders.

The calculation of *zakah* in a contemporary economic environment, and in accordance with the guidelines provided by the *Shari'a* is complex. The most pertinent issue is appropriate asset valuation in order that wealth subject to *zakah* can be accurately calculated. Calculating the *zakah* base requires asset valuation, which is a problematic issue in financial reporting generally (Baydoun and Willett, 1997, p. 7). In the Islamic accounting literature there appears to be agreement that, for *zakah* purposes, assets should be divided into current and non-current, and only the latter should be subject to the religious levy (for example, Gambling and Karim, 1986; Baydoun and Willett, 1997). It is argued that fixed capital or non current assets are utilized capital, and therefore not subject to the tax. Islamic scholars also argue that current cost accounting (rather than historical cost) should be used for accurate valuations. Gambling and Karim (1991) also point to the need to use the lunar or Islamic calendar for valuations to be precise. The overriding issue is that differing views between Islamic financial institutions with respect to asset valuation, including what should be included and what accounting treatments should be used, have led to a variety of accounting treatments, and the consequent need for guidance to achieve harmonization.

The AASB of the AAOIFI addresses this issue in Financial Accounting Standard Nine (FAST 9), adopted in June 1998 [Saffar, 1419H]. Paragraph one refers to the scope of the standard as follows:

> This standard shall apply to the accounting treatments related to the determination of the Zakah base, measurement of items included in the Zakah base and disclosure of Zakah in the financial statements of the Islamic bank (AAOIFI, 2003, p. 276).

Two accounting treatments are permitted for calculating the *zakah* base, however, paragraph two of the standard states that both methods should provide equivalent valuations if properly calculated (Ibid). The standard specifies the assets to be included, and states that where no current value is clear, cash equivalent valuation should be used. Guidance for valuing *zakah* according to both the lunar (Islamic) and solar (Western) calendars are provided. Accounting treatments and disclosure requirements are specified differently for banks required by law to pay *zakah*, and those not required to do so.

The Shari'a Supervisory Board

The role played by SSBs in ensuring *Shari'a* compliance for individual banks has already been discussed, as has the problem with variations in rulings between the SSBs. The internal governance role of the SSBs, however, has not been sufficiently clarified. That is, at the same time as the AAOIFI has been

developing accounting standards in order to improve the external regulatory regime in which Islamic banks operate, individual SSBs have continued to grow and develop and are increasingly the source of internal regulation. Their position is primary to the success of Islamic banking as "those who deal with an Islamic bank require assurance that it is transacting in accordance with *Shari'a* law" (Algaoud and Lewis, 1999). SSBs intend to provide confidence in this respect. Users of information provided by SSBs include individual shareholders of the banks, account holders and customers of the range of a banks financing facilities (Lewis and Algaoud, 2001, p. 36).

The usual duties of SSBs can be summarized as follows:

1. Design and approve the bank's contracts for its basic activities and issue religious rulings in response to requests by the staff.
2. Participate with the external auditor and the management of the bank in setting the bank's accounting policy on issues which are either not covered by the accounting principles enforced in the country or are in violation of the *Shari'a*.
3. Ensure the bank complies with the spirit as well as the letter of Islamic law and
4. Prepare a report of the SSB to be published with the bank's financial statements, and which attests to the banks Shari's compliance in all its activities. (Karim, 1995, p. 288)

The policies developed by individual SSBs are based on their interpretation of the Shari'a, leaving scope for differing interpretations, and hence variations in accounting treatment. Given the existence of differing schools of thought in Islam it is not surprising that differences of opinion arise between the SSBs of different banks and even within the SSBs of an individual bank. Examples of variations between SSBs include the number of members, the range of issues on which the SSB advises, as well as diversity in accounting standards and treatments which are recommended and permitted (Pomeranz, 1997, p. 10).

The standards and guidelines published by the AAOIFI are viewed not as a replacement for the individual SSBs, but as providing a means to harmonize differences (Karim, 1995, p. 298). Maintaining and formalizing the internal regulatory role of SSBs is vital. SSBs are best placed to assist their individual organizations in achieving Shari'a compliance, and thus play an important role in the overall regulatory environment. The individual SSBs can, for example, most closely monitor the transactions of their banks, for instance, through random sampling to check the compliance of old contracts, regular daily perusal of new contracts, regular meetings to discuss *Shari'a* compliance issues, and finally, the conduct of an annual review, which forms the basis of an annual report (Algaoud and Lewis, 1999, p. 81). This annual report should "verify … (that) the bank's activities as reflected in the financial statements, (are) in accordance with the *Shari'a*" (Karim, 1990, p. 39). Karim (Ibid) considers the annual report of the SSB to be potentially more extensive and hence more important than that of the

external audit, as an SSB is more able to review all the transactions of an organization, rather than a sampling.

The AAOIFI has published a set of governance standards for Islamic banks which address the issues relating to internal SSBs. Of relevance for reporting purposes is Governance Standard for Islamic Financial Institutions Number 1 (GSIFI 1), which specifies the composition of the board, and the basic elements of its annual report. GSIFI 1 makes it mandatory for all Islamic financial institutions to appoint an SSB. The qualifications of the board and its duties are also outlined. Board members must be specialists in Islamic jurisprudence, however, it is possible for the board to include one or more members with expertise "in the field of Islamic financial institutions" and only "knowledge" of Islamic jurisprudence (AAOIFI, 2003/1424H, Governance Standards, p. 5). Each board must be comprised of at least three members. The board must produce an annual report, which must be published with the bank's financial statements. Basic elements to be included in the report are specified as follows;

a) title;
b) addressee;
c) opening or introductory statement
d) scope paragraph describing the nature of the work performed;
e) opinion paragraph containing an expression of opinion on the compliance of the Islamic financial institution with Islamic Shari'a Rules and Principles;
f) date of report; and
g) signature of the members of Shari'a supervisory board. (Ibid, p. 6).

The existence of the SSB, its composition and a summary of the specifications above are included in the compliance index.

Mudaraba Financing

The ban on interest or *riba* has been identified as perhaps the most significant aspect of Islamic finance and accounting. This is because it leads to the need for alternative financial products to mobilize Islamic funds. Contemporary Islamic scholars have turned to the past to guide their development of appropriate financial products and reporting thereof. In theory, profit and loss (PLS) sharing products are favoured as they promote the spirit of brotherhood and community which Islamic finance intends to facilitate (Algaoud and Lewis, 1999, p. 63). The PLS product which receives the most attention in the literature is *mudaraba* financing.

The *mudaraba* contractual form predates Islam having thus far been traced to the time of the Babylonians, (Karim, 1996, p. 120). In early Islamic times a *mudaraba* was typically contracted between two parties, one providing the capital and the other labour or expertise for a commercial venture. Once the venture was concluded, any profits would be divided between the provider of capital (the *rab al-mal*) and the investor (the *mudarib*) according to a pre-determined and agreed upon ratio. The liability of the *rab al-mal* was limited to the amount of his/her investment, and of the *mudarib* to his/her time and or labour (Maali, 2006, p. 268). Maurer, (2002, p. 653) describes the modern *mudaraba* as essentially a "scaled up" version of the classic form.

The modern product is, however, considerably more complex, and as such, presents challenges for accounting and financial reporting. In the first instance, the *mudaraba* governs the relationship between an Islamic bank and holders of Islamic investment accounts. The bank is the *mudarib*, or manager of the funds, and investment account holders are *rab al-mal* (Karim, 1996, p. 120). These contracts can be restricted or unrestricted and uni-lateral or bi-lateral (Ibid). In the case of the former, the Islamic bank is able to use the investment account funds in a way that is unrestricted with respect to "the kind of activity, duration and location of the enterprise" (Algaoud and Lewis, 1999, p. 66). The one important stricture is that all ventures funded by the bank must comply with the *Shari'a*. Investors can, however, restrict the use of their funds. Restrictions may relate, for example, to the financial products used and the area/s of investment activity.

Unrestricted investment accounts tend to be more common in both number and quantity. The funds in these accounts are typically pooled by the bank and referred to as pooled *mudaraba*. Pooled funds can be either bilateral or unilateral. In a unilateral fund, investments are made entirely through the use of investment deposits, with no use of bank equity. Bilateral funds are more commonly used by most Islamic banks. In these, the investment funds can be commingled with the bank's equity and/or other available funds, for example, those in short-term deposit accounts (Karim, 1996, p. 6). The range of potential investments to which bilateral unrestricted funds can be directed is very wide, including not only

domestic ventures, but also foreign and interdenominational investments (so long as the Shari'a is not violated) (Hamid, et. al. 1993, p. 141). Recording such investments has the potential to become very complicated. The bank acts as *mudarab* to the depositor investors, but at the same time, becomes *rab al-mal* in relation to a range of business ventures. As with the traditional *mudaraba* account, profit is allocated at a predetermined rate, both between the users of investment funds and the bank, and the bank and investment fund holders.

Clearly, agency problems are heightened in such circumstances. The bank can choose from a range of investment alternatives of differing risk and return, and can potentially use different funding combinations for different investments. Typically the bank also has wide discretion in the use of commingled unrestricted investment funds. It is therefore conceivable that a bank could use uni-lateral funds for high risk investments, and bi-lateral funds, or even its own equity alone for safer ventures. In addition, because profits are shared at pre-determined rates, the users of the bank's funds have an incentive to overstate costs and understate profits in order to increase their actual returns. The bank has the same incentive with respect to investment fund holders. Accounting standards for reporting purposes therefore becomes extremely important.

There are other more positive aspects of PLS financing. For instance, because the bank shares the risk with investors, there is more inventive for careful selection. And as with the traditional *mudaraba*, the liability of investors is limited to the

sum total of their investment, as is that of the bank. Perhaps, most important, is the ideological underpinning, whereby a financial institution shares with investors both the profits and losses of any venture.

Although the modern *mudaraba* is considerably more complex than its historical predecessor, the contemporary Islamic accounting literature suggests the relevant accounting principles should be developed to mirror those which governed the early *mudarabas*. The most problematic issues for contemporary accounting are the number of investors, and the spread of pooled funds across multiple investments. Traditional *mudaraba* contracts usually involved only two parties, the lender and borrower, and were made in order to carry out a single business venture. The contracts were dissolved at the completion of that venture. In contrast modern *mudaraba* contracts tend to be "numerous, continuous in nature and are usually not liquidated simultaneously at the end of the financial year Karim" (1996, p. 125).

In addition, there is often an expectation of periodic profit allocation regardless of the timing of the equity ventures and fund liquidations. Financial reporting is therefore further complicated in two ways: firstly, the timing of deposits into investment funds is not restricted to the start of a venture. Secondly, the timing of maturity of the investment accounts of different account holders and of different investment ventures varies. The fund, however, does not normally liquidate at the maturity of one investment. Most importantly, and underlying all the above is the issue of multiple fund holders and

multiple ventures. While early PLS funds generally involved only two participants, modern funds involve three *categories* of participants, account holders who are the providers of funds, banks acting in their dual role as *mudarib* to depositors and *rab al-mal* to borrowers, and finally the recipients of the assets (Karim, 1996, p. 125).

A further difficulty with respect to developing accounting standards for *mudaraba* contracts is the calculation of income for the purpose of allocating profit. Calculating income first requires asset valuation. Maurer, (2002, p. 656) cites researchers such as Ibrahim (1999) who argued that, for the purpose of income calculation, current cash equivalent (CCE) should be the method employed to determine asset value. The reason for this is associated with the commingled funds. The problem perceived by contemporary scholars in using historical cost valuation is that some investors would potentially be deprived of unrealized gains, or may not be liable for unrealized losses "that result from appreciation or depreciation in the value of jointly financed assets (Karim, 1996, p. 10). This suggests interim profit distributions based on CCE could be appropriate. However, investors are also liable for losses up to the sum of their investment. Problems would arise if there is a partial distribution of profit during the term of the *mudaraba* and losses follow. The parties who received the profit distribution would, in theory, be liable to return a sum equal to their proportionate share of the losses. In practice, it is difficult to imagine how this could be implemented (Hamid, 1993, p. 141).

A final problem respecting the calculation and distribution of profit for both restricted and unrestricted *mudaraba* contracts relates to what costs are deducted by the bank. While some banks deduct only expenses directly related to specific investments, and a management fee, others also deduct proportionate indirect expenses (Lewis, 2001, p. 122). Guidance is needed not only with respect to costs and expenses, but also in determining the proportion of profit and loss to be divided between the parties. Should this, for example, be a competitive process between banks, or should there be some guidance perhaps related to risk and return, that helps guide and protect all parties?

Mudaraba contracts are addressed by the AAOIFI in FAS2 and in FAST2, FAST3 and FAST5 (AAOIFI, 2003/1424H). FAS2 paragraph 25 distinguishes between the treatment of unrestricted and restricted investment accounts. The former are "considered as one of the elements of the financial position of the bank". Restricted accounts are to be treated as off-balance sheet items and reported in a separate statement (Ibid, FAS2, paragraph 25). Unrestricted accounts are to be disclosed in the Statement of Financial Position on the basis that a bank is able to use these funds as they wish, including commingling with their own equity. They do not have the same liberty with restricted accounts. However, these cannot be treated as a liability, as a bank is not obliged to return any losses associated with their use. Hence, they are to be disclosed in the notes to the financial statements. The separate disclosure is potentially significant in that returns on commingled as opposed to restricted funds can be compared in terms of performance. This may go some way to addressing the agency problems outlined above (Karim, 1996, p. 122).

FAS2 also deals with asset valuation for both restricted and unrestricted investment accounts (Paragraphs 93 – 95). It is recognized that asset valuation at historical cost may lead to inequities in the distribution of profit, where account holders "provide or withdraw funds at different points of time during the life of the investment" (AAOIFI, 2003, FAS2, paragraph 93). Nevertheless the Accounting and Auditing Standards Board (AASB) of the AAOIFI believes that no "adequate means" of revaluation to current value equivalent are yet available. In consequence, it has chosen not to adopt this concept for the time being. Instead, historical cost for valuing assets and liabilities is indicated (Ibid, paragraph 98).

FAST3 addresses the recognition, measurement and disclosure requirements between the bank as *rab al-mal* and the *mudarib*. FAST5 is intended to "establish rules that regulate the disclosure of such profit allocation in order to standardize the bases of disclosure of this information among Islamic banks and financial institutions" (Ibid, p. 191).

The issues outlined above are included in the included in the *mudaraba* category of the compliance index.

Murabaha Financing

Islamic banks have been successful in obtaining funds (deposits) on a PLS basis, but "the same degree of transformation to PLS *financing*" has not yet developed (Algaoud and Lewis, 1999, p. 78, emphasis added). It is considered permissible,

by most contemporary Islamic scholars, for financial institutions to enter into cost plus mark-up forms of financing.[11] The most common form of credit plus mark-up finance is the *murabaha* contract. Although often associated with replacing personal or mortgage loans to individuals, these contracts can also be used to finance various business activities. Under this form of financing, the bank purchases a single good, or perhaps a consignment of products, on behalf of a customer, who repays the cost plus a mark-up. Repayments are usually made according to a pre-arranged schedule, which includes the mark-up. As said, this form of finance can replace personal loans for items such as automobiles, and also home mortgages. Likewise, a business can enter a *murabaha* contract to purchase new capital or for other purposes. For example, the *murabaha* can be used to finance importing and exporting or other forms of commerce. The bank may pay for a consignment of imported goods on behalf of a client, who then sells the goods and settles the financing arrangement.

Although the *murabaha* is a relatively straight forward form of financing, a number of accounting issues have arisen. In particular, profit recognition for reporting purposes varies significantly between banks. Karim (1995) observed a number of different forms of profit recognition across Islamic financial institutions. Profit can be recognized when the contract is completed or over the

[11] Many Islamic scholars have in fact been critical of what they see as an overuse of markup financial products and a corresponding failure to sufficiently promote PLS financing. Algaoud and Lewis, (1991, p. 78) refer, for example, to Qadir (1994), Ahmad (1994) and Zamar (1994), who describe "the *mudarabaha* mark-up and buy back schemes as effectively interest based lending under another name". The banks, in contrast, point to higher risks associated with PLS contracts, and the often long wait times for returns.

life of the *murabaha.* If the latter, it can be recognized according to the predetermined scheduled repayments, or when the payments are actually received. Specification of accepted practice/s is therefore necessary. In addition, many banks require guidelines as to the allocation of costs in order to better standardize this practice. While it is recognized that a financial institution will incur costs in purchasing a product/s and transferring the same between parties, calculating other costs, such as the mark-up and the costs of establishing the *murabaha* contract are not so straight forward.

This issue of failure to meet scheduled repayments on the part of the client must also be addressed by Islamic banks. The Qur'an encourages lenders of capital to be lenient in this respect. "If the debtor is in a difficulty, grant him time till it is easy for him to repay. But if ye remit it by the way of charity, that is best for you if ye only knew" (Qur'an, 2:280, quoted in Maali, et. al. 2006, p. 276). In any case, Islamic banks are not permitted to request or accept guarantees for *murabaha* contracts. However, it is possible for a bank to request an initial deposit, from which overdue installments can be deducted. Where a client fails to meet scheduled repayments because he or she is insolvent, Islamic law and the nature of the *murabaha* contract prevent the financial institution taking legal action. Where a client is solvent, but fails to make scheduled payments, the bank must determine appropriate action. This is an issue which requires guidance from the AAOIFI.

It has been noted that not all Islamic scholars accept the validity of *murabaha* contracts. Critics in the main lie with the perceived resemblance between the mark-up and interest. Banks point out the significant difference in terms of ownership. Under the terms of the *murabaha* contract, the bank retains ownership of the product/s until the contract is finalized, and thus must bear or take steps to avoid any losses associated with damage or other causes of a decline in value. Other criticisms relate to a reliance on *murabaha* financing, which remains evident in many Islamic banks (Maali, et. al., p. 268). Some critics see this as a failure to embrace the ideology of Islam, which they believe is better reflected in PLS arrangements, such as *mudaraba* financing. In these financing arrangements, both profits and losses are clearly shared between borrower and lender, or bank and client. Typically also, these ventures involve more economic activity, and hence, have a better potential to promote the economic health and development of the *ummah*.

Murabaha contracts are addressed by the AAOIFI in FAST2, "Murabaha and Murabaha to the Purchase Orderer". This standard covers the measurement of the value of assets covered by the contract both at the time of and over the longer term by the Islamic bank. Accounting for a decline in value of such assets is also covered. In addition, FAST2 provides guidelines for profit recognition and disclosure, for the purchaser, meaning the bank. Finally, procedures for failure to meet payments, and insolvency are given (AAOIFI, 2003, FAST2).

The AAOIFI's treatment of *murabaha* and *mudaraba* financing, as well as FAST9, Zakah, and GSIFI1 on the SSBs of individual banks provide the basis for constructing the compliance index for this study. The required disclosures based on the AAOIFI's treatment of the issues above are summarized in Appendix 1. The issues addressed by the AAOIFI in the relevant statements and considered by the author to be most significant in terms of the literature review are delineated as the benchmark compliance requirements. The items are divided into four categories as determined in the discussion above.

Chapter Five: The Empirical Investigation and Conclusions

The discussion in the previous chapter identified those issues in the current Islamic accounting literature which are considered most significant for Islamic reporting. These were then matched with the accounting standards currently issued by the AAOIFI to derive a benchmark set of required disclosures. The annual reports of a sample of Islamic banks were used to compare actual disclosures with those identified in the benchmark in order to measure compliance with the accounting standards developed and promulgated by the AAOIFI.

Sample

Maali et.al.'s 2006 study identified the potential population from which their sample could be drawn as consisting of all fully flagged Islamic banks. Fully flagged Islamic banks were defined as those banks claiming to be fully Islamized as opposed to those offering only an "Islamic window." The population for the 2006 study was identified through the International Directory of Islamic Banks and Institutions (IDIBI), issued by the Institute of Islamic Banking and Insurance in London. Other fully flagged Islamic banks, known to the authors, but not listed in the directory, were also included, bringing their total population of fully flagged Islamic banks to 88. A sample was then drawn from this population, consisting of those banks which provided the authors with a copy of their annual financial statements for the year 2000. These requests yielded a sample of 29 banks.

Because the current study examines compliance with the accounting and governance standards published by the AAOIFI, it was considered more appropriate to define the population through membership of this body. AAOIFI members are categorized into founding, associate and observer members. Founding members include large organizations such as the Islamic Development Bank. Observer members have typically not yet made a firm commitment to adopt the AAOIFI standards. This may be due to circumstances such as their national regulatory requirement, or their not being "fully flagged" Islamic banks. Only associate members have made a commitment to implementing the AAOIFI standards. Hence, only those banks in this category were deemed suitable for the study. In 2007 there are 167 such member banks.

Of this total population, the country of origin of associate member banks ranges from relatively stable and largely Islamic nations such as Bahrain and the United Arab Emirates, to vastly diverse areas, including Russia, Pakistan and South Africa. Clearly, exogenous political, economic, social and geographic factors will impact the degree of AAOIFI compliance amongst the member banks of different nations. Due to this lack of homogeneity, it was decided to confine the study to member banks in one nation only, Bahrain. Bahrain is the most obvious choice for an initial study of AAOIFI compliance. Not only is it the host nation for the AAOIFI, but, perhaps more importantly, it is a requirement of the Bahrain Monetary Authority (BMA) that all Islamic financial institutions licensed in Bahrain must comply with the standards issued by the AAOIFI (BMA, 2007). In addition, the BMA, and the Bahrain government more broadly, promote the nation as "the leading centre for Islamic finance in the Middle East" (Ibid).

They cite the growth in the number and size of Islamic financial institutions operating in Bahrain since the 1970s as evidence of their success in this initiative. Currently there are 25 Islamic banks licensed and domiciled in Bahrain, including 6 full commercial banks and19 investment banks (Ibid).

In addition, Bahrain has been identified by a number of researchers in Islamic accounting and finance as the most suitable current locale to study Islamic banking. For example, Algaoud and Lewis use three banks in Bahrain for their 1999 study of corporate governance in Islamic banking. Their choice was based on Bahrain having "established itself … as a leading regional and international centre for conventional banking and financial activities" as well as for Islamic banking operations. In pursuant of the latter, Bahrain at that time was host to "over 30 Islamic financial institutions, dealing in diversified activities including commercial banking, offshore banking, funds management, and Islamic insurance". In addition "it (had) ambitions to be recognized as the main global centre for Islamic banking and finance" (Algaoud and Lewis, 1999, p. 71).

In summary, Bahrain provides a stable and conducive environment for the progressive development of Islamic banking and finance. Accordingly, in light of this study, it was anticipated that a significant proportion of Islamic banks in Bahrain would have modern websites in English as well as Arabic, including annual financial reports freely available for downloading in both languages. The sample for this study was therefore delineated as those fully flagged Islamic banks licensed in Bahrain, that are listed on the AAOIFI

website as current associate members of that organization, and from which English language annual financial reports are publicly available on the bank's website. The BMAs list of licensed Islamic Banks was used to supplement the AAOIFI member list (BMA, 2007). A total of eleven banks were found which conformed to this criterion. All banks identified claimed in their annual reports to be Islamic financial institutions. Being licensed in Bahrain and therefore subject to the regulatory environment of the BMA, this means that all eleven banks in the sample are required to comply with the accounting and governance standards issued by the AAOIFI. In addition, the independent auditor's reports accompanying the financial statements were examined to ensure that:

1) the audit was conducted in accordance with the auditing standards published by the AAOIFI.
2) the opinion statement confirmed that the financial statements had been prepared in accordance with the accounting standards published by the AAOIFI.

It should be noted that the audit report is considered to provide a only a preliminary indication of compliance. Previous studies have shown that even in cases of clean audit reports, an entity may not score highly on compliance measurements (for example, Nobes, 1990).

Data

The previous chapter discussed the disclosure items identified for this study, grouped into four categories. These are shown in Appendix 1. Table 1 below shows the items in each

category by number and as a percentage of the total. The scoring in this study follows the approach used by Buzby and Falk, (1979), Inchaashi, (1997) and Maali, et. al. (2006) (among others) in allocating clearly disclosed items a score of 1, "ambiguously" disclosed items a score of 0.5 and undisclosed items a score of 0. The individual items are therefore unweighted. Table 1, however, indicates that in deriving items matched to categories, more importance is unavoidably attributed to some categories as opposed to others, and to the categories selected for the study as opposed to those not selected. While the four categories included were derived from a survey of the literature, the number of items in each category tends to reflect the detail required in the AAOIFI's standards with respect to identifying compliance, rather than the relative importance of each category. The latter is not clear from the literature, as authors writing in this area have identified issues they have found to be of particular importance and interest thus far. Maurer, for example, has highlighted the complexity of *mudaraba* contracts and the difficulty of developing appropriate standards to clarify these contracts for Islamic financial statement users (Maurer, 2002). Algaoud and Lewis (1991) and Karim (1990) have shown the importance of individual Shari'a Supervisory Boards in the corporate governance of Islamic banks. Clearly *zakah* as one of the five pillars of Islam is also highly significant.

As Islamic accounting is an emerging area of research, and as Islamic banking, Islamic financial products and Islamic accounting, auditing and governance standards are in the process of development, it is likely that other issues of perceived interest and importance will become known. In short, the categories and items identified should not be seen as

exhaustive, and caution should be exercised in associating the relative number of items in each category with the relative importance of the categories.

Nevertheless it should be noted that the number of items in the *mudaraba* category (23) exceeds the sum of the number of items in the three other categories (ten, five and four). The *mudaraba* contract is a product unique to Islamic finance and with some quite complex characteristics. It presents challenges for accounting standard setters and financial report preparers. These are not limited to reporting compliance. Islamic corporate reporting should ensure users are adequately informed as to the Shari'a compliance of this product. The number of items in this category therefore reflects the more complicated aspects of this product, such as the degree to which *mudaraba* investment funds are commingled with other funds, the basis of profit and loss sharing, and the bank's fee structure with respect to these funds.

Table 1: Compliance items by category

Category	**Number of Items**	**Weight**
Shari'a	10	23.8
***Mudaraba* Finance**	23	54.8
***Murabaha* Finance**	5	11.9
Zakah	4	9.5
	42	100

Because the sample is quite small, and the standards relatively new, compliance was tested over a three year period from 2004 to 2006. The standards used were published in 2003/1424H, limiting the relevant period to 2004 onwards. Not all banks in the sample had complete English language annual reports for all three years. For example, some had reports available for 2003 and 2004, but not 2006, while others had reports for 2005 and 2006, but not 2004. One bank, Al-Salam Bank, was incorporated in 2006, so only had

financial reports available for that year. The year 2005 yielded the most comprehensive sample.

While the sample is relatively small, it is not considered too small to yield insights into the nature of Islamic financial reporting. There are precedents for similar sized samples. For example, Tower et. al., 1998 examined the annual reports of only ten entities in each of six countries. Moreover, the small sample size facilitated familiarity with the annual reports and websites of the sample banks, thereby providing additional information which supplemented that available in the financial reports and accompanying notes.

Results:

Table 2 shows compliance by category for each bank over the three year period by number and as a percentage of actual items relative to the maximum possible items for the bank in each period. Table 4 shows the mean, median, minimum and maximum values for each bank for each of the three years.

The total number of items identified for the compliance index is 43 (see Appendix 1). These are decomposed into categories as indicated in Table 1. Not all items in the benchmark index are applicable to all the banks in the survey. Column 1 in Table 2 shows the total number of applicable items for each bank over each of the three years. For example, in 2004, the maximum number of applicable items for both Arcapita and Unicorn Banks was only 19, while for Shamal Bank it was 43. Compliance was measured by calculating the ratio of items actually reported (in the second column) to the

number of items in Column 1. This ratio is then shown in Column 3. Table 3 shows the mean, maximum and minimum number of items in the three sampling periods.

Table 2: Level of Compliance by Bank and Year.

2004		Level of Compliance	
	Column 1	Column 2	Column 3
Bank	**Max items per bank**	**Compliance**	**Compliance as a ratio**
Arcapita Bank	19	13.5	71.1
Bahrain Islamic Bank	37	30.5	82.4
Gulf Finance House	37	13.5	36.5
Investors Bank	22	9.5	43.2
Kuwait Finance House	38	25.5	67.1
Shamil Bank	39	30.5	78.2
Unicorn Investment Bank	19	12.5	65.8

2005		Level of Compliance	
	Column 1	Column 2	Column 3
Bank	**Max no**	**Actual no**	**Percentage**
Al-Amin Bank	39	31	79.5
Al Baraka Bank	38	31	81.6
Arcapita Bank	37	28.5	77.0
Bahrain Islamic Bank	39	32.5	83.3
GFH Commercial Bank*	39	24	61.5
Gulf Finance House	40	27.5	68.8
Investors Bank	39	16	41.0
Kuwait Finance House	40	27.5	68.8
Shamil Bank	40	34	85.0
Unicorn Investment Bank	41	16.5	40.2

2006		Level of Compliance	
	Column 1	Column 2	Column 3
Bank	**Max no**	**Actual no**	**Percentage**
Al-Amin Bank	39	30.5	78.2
Al Baraka Bank	38	32.5	85.5
Al Salam Bank	37	26	70.3
Gulf Finance House	39	26.5	67.9
Investors Bank	39	18	46.2
Khaleeji Commercial Bank*	39	27	69.2
Shamil Bank	36	31.5	87.5
Unicorn Investment Bank	18	13.5	75.0

*Previously GFH Commercial Bank

Table 3: Descriptive Statistics by item

	2004	2005	2006
Mean	30.14	39.20	35.63
Median	37.00	39.00	38.50
Minimum	19.00	37.00	18.00
Maximum	39.00	41.00	39.00
Sum	211.00	392.00	285.00
Count	7.00	10.00	8.00

Table 4: Descriptive Statistics - by disclosure

	2004	2005	2006
Mean	63.46	68.38	72.48
Median	67.11	72.89	72.64
Minimum	36.49	40.24	46.15
Maximum	82.43	85	87.5

There is some evidence in the data of an increase in compliance over the period. The sample mean for 2006 is 72.48 compared to 68.38 in 2005 and 63.46 in 2004 (See Table 4 above). The median also increases from 67.11 in 2004 to 72.64 in 2006. However, there was little change in the medians between 2005 and 2006. It is reasonable to suppose that as standards are in place over a longer period of time, they are better understood and hence compliance increases. Aisbitt (2001) used the Wilcoxon rank sum test to evaluate the statistical significance of differences in the medians in her study of harmonization in Nordic countries. While harmonization and compliance are not identical, this test could prove similarly useful in testing changes in compliance over time. However, the limitations of this sample in terms of the different banks in the periods where the medians differ (2004 and 2006), make the test inappropriate in this instance.

Table 5 provides more information on disclosure by category. The two areas where compliance is very high are the SSB report and *murabaha* financing. In nearly all instances banks complied with the requirement to include an annual report from the SSB with the financial statements. The SSBs' reports were also mostly prepared in accordance with the requirements of the relevant governance standard (GSIFI 1). Only one bank was consistent across the three periods in failing to meet this requirement. The high level of compliance in this category is an important outcome given the significance of individual SSBs in ensuring Shari'a compliance on the part of Islamic financial institutions. Moreover it should be noted that the SSBs report attests to the Shari'a compliance of all the banks activities, not specifically or solely compliance with the FASs of the AAOIFI.

Compliance is also high in the case of *murabaha* contracts. However, there are only five items in this category, and all are relatively straight forward. They include, for example, the presentation of *murabaha* contracts in the financial statements. The *murabaha* contract is in itself quite simple, mainly involving the purchase of a single item through scheduled repayments over a designated period.

Reporting by Category – percentage of items reported out of a possible 100% for each category

2004 **BANK**

CATEGORY	**Al-Amin Bank**	**Al-Baraka Bank**	**Al-Salam Bank**	**Arcapita Bank**	**Bahrain Islamic Bank**	**GFH Comm Bank**	**Gulf Finance House**	**Investors Bank**	**Kuwait Finance House**	**Shamil Bank**	**Unicorn Investment Bank**
Shari'a	*2004*	*2004*	*2004*	95	95	*2004*	15	10	85	95	80
***Mudaraba* Finance**	*figures*	*figures*	*Figures*	N/A	72.2	*figures*	27.8	100	63.2	67.5	N/A
***Murabaha* Finance**	*not*	*not*	*Not*	60	100.0	*not*	90	100	100	100	80
Zakah	*available*	*available*	*available*	25	75.0	*available*	62.5	12.5	0	62.5	12.5

2005 **BANK**

CATEGORY	**Al-Amin Bank**	**Al-Baraka Bank**	**Al-Salam Bank**	**Arcapita Bank**	**Bahrain Islamic Bank**	**GFH Comm Bank**	**Gulf Finance House**	**Investors Bank**	**Kuwait Finance House**	**Shamil Bank**	**Unicorn Investment Bank**
Shari'a	80	90	*2005*	80	90	90	85	15	80	70	90
***Mudaraba* Finance**	73.6	82.5	*Figures*	77.7	71.0	45.0	41.3	52.5	64	88	16
***Murabaha* Finance**	100	90	*Not*	100	100.0	100.0	90	30	100	100	40
Zakah	100	33.4	*available*	37.5	100.0	25.0	100	63	25	87.5	50

2006 **BANK**

CATEGORY	**Al-Amin Bank**	**Al-Baraka Bank**	**Al-Salam Bank**	**Arcapita Bank**	**Bahrain Islamic Bank**	***GFH Comm Bank**	**Gulf Finance House**	**Investors Bank**	**Kuwait Finance House**	**Shamil Bank**	**Unicorn Investment Bank**
Shari'a	80	80	90	incomplete	*2006*	90	90	15	*2006*	95	90
***Mudaraba* Finance**	67.5	86.8	58.3	22.3	*figures*	60.0	50	50	*figures*	91.2	N/A
***Murabaha* Finance**	100	100	100	60	*not*	100.0	100	100	*not*	100	75
Zakah	100	25	37.5	25	*available*	25.0	62.5	50	*available*	37.5	37.5

Gulf Finance House (GFH) Commercial Bank renaned Khaleeji Commercial Bank

In contrast, the second category showing the level of compliance in regard to *mudaraba* contracts is much more problematic. This is not unexpected as *mudaraba* financing is quite complex (Maurer, 2002), and potentially an area about which Islamic financial report users require detailed information. Accordingly, the AAOIFI standards require Islamic banks to disclose relatively detailed information respecting these contracts. This includes information relating to the bank's fees as *mudarib*, the degree of commingling of *mudaraba* funds with funds from other non-bank sources as well as more usual requirement relating to valuation and recognition. There is an almost uniform failure on the part of the sample banks to comply with the more detailed requirements regarding fees, commingling of funds, and the means for determining the distribution of profit from *mudaraba* ventures between the various parties to the contract.

This raises a particularly problematic issue in the measurement of compliance through compliance indexes. There are generally many issues covered by accounting standards on which reporting entities are silent. The researcher must therefore determine if absence of information constitutes non-compliance or is simply an indication that the issue does not apply to the entity. There are different approaches to dealing with this problem. For instance, Tower et. al. (1998) developed two ratios for their sample. The first applied an easy rule to account for absence of information, assessing all instances of non-disclosure as meaning the item was not applicable. These items were then deducted from the total number of possible items, and the compliance ratio was calculated as the number of disclosures over the total number of relevant items. The median ratio resulting from this easy rule was very high at 0.9068. When a more stringent rule was applied, that is, no information is interpreted

as non-compliance, the median ratio dropped to 0.4220. In a subsequent study using the same data Taplin et. al. (2002) developed a "discernibility" index to increase the certainty with which a lack of information is categorized as non-compliance as opposed to not relevant.

In this current study, where information was not readily available in the financial statements, the full Annual Reports and the banks' websites were used as additional sources of information. In some cases, for example, the qualifications of the SSB members, the required information was, for the most part, readily available from these additional sources. Because this information was typically available, where it was not, this was treated as non-compliance.

The *mudaraba* contracts proved more challenging. In some instances items were easily identified as non-applicable to particular banks, and could therefore be deducted from the total number of items. For example, some banks clearly had no restricted *mudaraba* investment deposits, meaning items relating to these contracts could be deducted from the total. In other instances, judgments were more subjective. For instance, failure to supply any information regarding the banks fees as a *mudarib* was treated as non-compliance, even though some banks had stated they did not charge such fees, raising the possibility that this was similarly the case for others. This judgment was based on the author's perception of the importance of such fees, and hence their disclosure, by way of reference to the relevant literature. In contrast, if no information was provided as to commingling of *mudaraba* funds with non-bank funds, this was treated as not applicable.

The final category in the study concerns reporting requirements relating to the banks *zakah* obligations. Compliance in this category was surprisingly low, with most banks choosing to declare only that they were not obliged to pay *zakah* on the part of their shareholders. The AAOIFI standards clearly require more detail. In some instances, the wording of the relevant note accompanying the financial statement implied that more information was available elsewhere. However there were no cases where this information could be found on the website or elsewhere in the Annual Report.

Further Problems With the Methodology.

The main methodological problems have been identified. These are, first and foremost, the problems relating to non-disclosure, and secondly the lack of consistency in the sample banks over the sampling period. A further problem previously alluded to is the means by which items are chosen for inclusion in the compliance benchmark. These are intended to encompass the issues most relevant to Islamic reporting through reference to a review of the literature. Inevitably the standards chosen to reflect these issues and the rules within the standards selected are somewhat subjective and this may influence the findings with respect to the degree of compliance.

The problem is not unique to this study. For instance, Aisbilt (2001) constructed a benchmark index comprised of twenty items which she believed reflected “the

essence of financial reporting". Although having recourse to the literature in determining these items, she nevertheless recognized the process as being subjective.

Concluding Comments

This study has made a preliminary step in measuring the extent to which Islamic financial institutions comply with the accounting and governance standards issued by the AAOIFI in their financial reporting. Because Islamic banks operate under vastly different regulatory regimes and political and economic conditions across the globe the sample banks were selected from the Gulf state of Bahrain. To date, the AAOIFI has issued a substantial number of reporting and governance standards. Rather than test compliance against all, or even a specific number of standards, a compliance benchmark was developed based on those items considered most important for users of Islamic corporate reports. These items were derived through a survey of the relevant literature. The results showed high levels of compliance in some areas, and some evidence of increasing compliance over time. Compliance was shown to be lower in other areas, most specifically with respect to *mudaraba* financing and reporting *zakah*.

Limitations with the methodology, particularly relating to the treatment of non-disclosure were discussed. This issue is especially relevant to *mudaraba* contracts, so caution should be exercised in interpreting this section of the data. Nevertheless, some problems in reporting this complicated financial product are not unexpected.

This study goes some way to addressing the gap in the empirical analysis of compliance with the reporting standards thus far issued by the AAOIFI. Future research could compare compliance in Bahrain initially with other banks in the region, and then across regions. Testing whether or not there is a relationship between compliance and performance would also be of considerable interest both in the Islamic and non-Islamic world.

Appendix 1: Compliance Items

Category	Item and Corresponding AAOIFI Standard/Statement
1. Shari'a Supervisory Board	
1	Appointmment of the SSB GSIFI 1
2	Composition of the SSB
3	SSB Report published with the financial statements
	The following items are specified for incusion in the SSB Report
4	Title GSIFI 1.10
5	Adressee GSIFI 1.11
6	Opening paragraph GSIFI 1.12
7	Scope paragraph GSIFI 13 – 19
8	Opinion paragraph GSIFI 1.20
9	Date GSIFI 1.22 - 23
10	Signature GSIFI 1.24
10	**Total Number of Items in Category 1**
2. *Mudaraba* Financing	
	(i) Presentation
11	a) Restricted
12	b) Unrestricted
	(ii) Recognition
13	Changes to profit (loss)
14	Note on the accounting policy adopted by the bank in recognizing profit (loss)
	(iii) Disclosure
15	*The following items should be disclosed in the Income Statement (FAST 1.5)*
16	Revenues & gains from investments
17	Expenses & losses from investments
18	Income (loss) from investments
19	Account holders share before the bank's share as *mudarib*
20	Bank's share in income (loss) from investments
21	Bank's share as *mudarib*
22	Bank's fees as *mudarib*
	The following items relate to measurement & disclosure of mudaraba contracts
23	Method used to allocate profit between the bank & *mudarib* holders
24	Basis of charging expenses to unrestricted *mudarib*
25	Disclosure of total administrative expenses
26	Proportionate allocation of profit between equity & investment account holders (where applicable)
27	Disclosure of increases in the bank's share of profit as *mudarib* (where applicable)
28	Disclosure of comingling of *mudarib* funds with non-bank funds (where applicable)
29	Basis of revenue sharing between unrestricted and other accounts

	31	Basis of charging provisions against *mudarib*
	32	Source of *mudarib* funds
	33	Distribution of *mudarib* investments
	34	Valuation technique
	23	**Total number of items in category 2**
3. *Murabaha* financing		
	35	(i) Presentation
		(ii) Profit recognition
	36	a) short-term
	37	b) long-term
		(iii) Asset valuation
	38	a) at acquisition
	39	b) after acquisition
	5	**Total number of items in category 3**
4. Zakah		
	40	Method used to determine the *zakah* base
	41	Disclosure as to whehter the bank pays *zakah* on behalf of investors/shareholders
	42	Calculation of *zakah* required from shareholders
	43	Disclosure in accordance with FAST 1
	4	**Total number of items in category 4**
	43	**Maximum total number of items**

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