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The influence of AAOIFI Accounting Standards in Reporting Islamic Financial Institutions in Malaysia

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Abstract

This paper focuses on the issue relevant to the need for Islamic accounting standards in reporting Islamic Financial Institutions (IFIs), in the context of Malaysia. With recent rapid growth of IFIs, there is still inconclusive stance regarding the need for specificity accounting standards for IFIs such as the ones issued by Accounting and Auditing for Islamic Financial Institutions (AAOIFI), prompting this paper to examine this issue in more detail. Drawing upon seven in-depth semi-structured interviews conducted with IFIs' leading officers who are highly involved in preparing financial statements in Malaysia, the paper offers evidence on the influence of AAOIFI accounting standards in reporting IFIs. Whilst interviewees admit the feasibility of IFRSs in reporting IFIs, many interviewees placed greater emphasis on the spirit of Islam based on Islamic contract. In that case, the findings show that in order to convince the public that they offer Shariah compliance products approved by Shariah Advisory Council, there is a need for specificity guidelines or standards for IFIs within the IFRS framework. The main concern raised in the paper is that separate Islamic accounting standard is not needed, instead the option need to be within the IFRS framework with the collaboration work of Accounting and Auditing for Islamic Financial Institutions (AAOIFI) and the International Accounting Standard Board (IASB). Without such collaboration, the intended specific guidelines for IFIs will be unlikely to be accepted globally.

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Keywords: Islamic Accounting Standards, Islamic Financial Institutions (IFIs), Accounting and Auditing for Islamic Financial Institutions (AAOIFI), International Financial Reporting Standard (IFRS), Malaysia, Shariah

1. Introduction

Islamic finance has been identified as an important engine to contribute in positioning Malaysia as a hub for

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foreign direct investment. With that, there has been remarkable growth of Islamic Financial Institutions (IFIs) in recent years, not only in Malaysia, but also globally where the western banks have also started to venture into the market. The establishment of IFIs initially is an act of response towards Shariah[*] prohibition of paying and receiving riba (interest). Therefore, transactions in IFIs are meant to be accountable to God that turn into an act of worship in order to seek reward in this world and in the hereafter (Haniffa and Hudaib, 2010). In that case, for these IFIs to survive in this dynamic and competitive industry, a high level of public confidence is essential as the stakeholders expect the operation to be Shariah compliant, bringing the task to report transparently becomes critical (Archer and Karim, 2007).Hence, in regulating and supervising IFIs, the decisive issue to search is a standard accounting methodology to regulate various types of patterns or Islamic banking financing schemes that can be accepted internationally. Although there are AAOIFI accounting standards for IFIs, the current practice in many countries is to apply IFRSs wholeheartedly for IFIs in reporting their practices. Despite the acceptability of such practice, there are those who believe that IFIs transactions ought to be accounted for in a different manner due to the notable differences in objectives and operations (Hanefah and Singh, 2012). Following the debates, the objective of this research is to explore views of financial statements preparers with regard to the practices in reporting IFIs, thereby contributing to answer whether there is indeed a need for a separate set of Islamic accounting standards for IFIs.

During the earlier years of IFIs, prior literature suggests to have a separate set of Islamic accounting standards for IFIs due to significant differences in IFIs' transactions from their conventional Western counterparts. With that, the Accounting and Auditing for Islamic Financial Institutions (AAOIFI) was established as a body to regulate IFIs, which till to date has published twenty three Financial Accounting Standards (FAST 1–23), as well as standards for Islamic insurance companies, auditing standards, governance standards and codes of ethics for accountants, auditors and employees of IFIs. Despite the full commitment shown by the AAOIFI in the development of accounting standards, these standards will not be enforced without the support from the national regulators.

In Malaysia, although IFIs have existed since the 1970s, there has been an absence of approved Islamic accounting standards. Although there had been attempt from the Malaysian Accounting Standard Board (MASB) to develop special standards for IFIs, it seems over the years, the stance on reporting has changed, reflecting the practices of IFIs much echo the conventional banking practice. Prior literature has started to discuss how IFIs are moving away from the initial sacred aim in recent years (Kamla, 2009; Haniffa and Hudaib, 2010), however the issue is beyond the scope of the paper, instead the discussion in this paper focuses on the market needs of reporting the practice of IFIs. The structure of the paper is as follows. The first section provides a literature review on historical background of accounting environment of Islamic Financial Institutions. This is followed by a discussion about the initiatives taken by MASB and AAOIFI with regard to the issue of reporting of IFIs. The next section describes the research method adopted for this research, followed by the findings from seven interviews. Finally, the last section provides discussion on the issue and draws the conclusion reflecting upon the evidence presented.

2. Literature review

Islam is a complete way of life that does not separate beliefs and daily activities including any involvement in economic activities. In fact, Islam highly honor trading and muslims are encouraged to participate in economic activities that do not violate the Shariah. This resulted in the emergence of Islamic Finance Institutions[†] (IFIs). Since then, there have been remarkable developments in the Islamic Financial Institutions (IFIs) industry, particularly in recent years. Following similar trend, the Malaysian government has established Bank Islam Malaysia Berhad in 1993 and Bank Muamalat Berhad in 1999. The years after have seen expansion in the Malaysian industry where foreign Islamic banks such as Kuwait Finance House, Al-Rajhi Banking & Investment

[*] Shari'ah literally means 'the way to the source of life' is used as a legal system originating from the code of behavior specified by the Holy Qur'an and the Hadith (the authentic tradition) (Lewis, 2001).

[†] The IFIs include Farmers' Credit Union in Pakistan (in the late 1950s), Mit Ghamr Savings Bank in 1963 in Egypt and Nasser Social Bank (Maali and Napier, 2010) and the oldest commercial Islamic bank, Dubai Islamic Bank in the UAE, was established in 1975 (Saleh, 1986, as cited by Maali and Napier, 2010).

Corporation and Qatar Islamic Bank, joined the market and domestic banks created Islamic subsidiaries such RHB Islamic bank and Hong Leong Islamic bank. Nowadays, the IFIs are not only operating in competing with conventional banks in Muslims countries but the industry has expanded to Western countries like the USA, UK and Australia (Haron and Wan Azmi, 2008).

These IFIs were meant to fulfill Shari'ah obligations in serving Muslims who are prohibited from paying and receiving riba (Al-Ajmi, Saleh and Hussain, 2011). Based on Shariah, Islam views riba (usury) ie. the flat annual interest rates as evil because it involves accepting fixed gains without sharing the risks entailed in productive enterprise (Shook, Dale and Salah, 1998). With this idea, banking transactions are not supposed to be separate from Islamic faith but to be accountable to God in seeking reward in this world and the hereafter (Haniffa and Hudaib, 2010). Following Shariah, IFIs aim to be different from conventional financial institutions in terms of objectives, operations, principles and practices (Abdul Rasid, Abdul Rahman and Wan Ismail, 2011). Nevertheless, IFIs operate in a Western-dominated competitive and dynamic industry, thereby requiring regulatory supervision much like Western institutions (Islam, 2003). Different approaches adopted by supervisory authorities of IFIs may render non-comparable financial statements of IFIs (Kamla, 2009). Therefore, IFIs industry calls for a sound accounting and reporting system that, first, meet the requirements of syari'ah, and, second, relevant to be practiced (Abdul Rahman, 2003). Report by KPMG and ACCA (2010) presents that there may be problem exist in the practices and the level of understanding among accountants and the level of compliance of Islamic banks globally due to the variety applications of accounting standards either IFRSs or local accounting standards in the preparation of financial statements among the Islamic banks worldwide.

This issue of effective supervision and regulation has become the main challenge for these IFIs that operate in a dynamic and competitive industry (El Qorchi, 2005). Although IFRSs exist as a tool for regulatory supervision, the application of the same accounting standards as conventional banks are doubtful implying that the products offered by IFIs are just the same as those offered by conventional financial institutions. As IFIs are developed with the aim of complying with Shari'ah principles, prior literature suggests the development of Islamic accounting standards is required to address the difference in transactions between IFIs and the conventional banks (Vinnicombe, 2010; Kamla, 2009). The recent remarkable growth of IFIs in the market has created interest in Islamic accounting (Maali and Napier, 2010). The interest in Islamic accounting has led to the discussion of separate set of Islamic accounting standards for IFIs (Sarea and Hanefah, 2013). Prior literature suggests that the development of this special set of Islamic accounting standards can address problems encountered by IFIs, relating to the lacking of conventional accounting standards such as International Financial Reporting Standards (IFRSs) or local General Accepted Accounting Practice (GAAP) in accounting for IFIs' transactions (Archer and Karim, 2007). Further, the development of accounting standards for IFIs will fulfill the desire of Muslims to apply Islamic principles in all aspects of their lives including the accountability to God (Napier, 2009). It is essential for IFIs to gain public trust and confidence by reporting a faithful representation of the economic transactions or events (Archer and Karim, 2007) in accordance with the substance as well as form of Shari'ah contracts (Vinnicome, 2010). High quality financial statement is an important tool for IFIs to survive in the industry where the public are confidence that the products comply with Shariah principles (Archer and Karim, 2007).

The question is how to issue a standard accounting methodology to regulate various types of patterns or Islamic banking financing schemes that can be accepted internationally. AAOIFI has in fact attempted to develop the so called 'Islamic accounting standards' in trying to resolve the differences between IFIs' products and conventional banking products. Prior literature suggests that AAOIFI standards can be used as a starting point that may help lead to an improved IFIs system of reporting (Harahap, 2003). So far 60 AAOIFI accounting, auditing, governance and Shari'ah standards have been produced. However, the application of AAOIFI standards is not mandatory[‡].

[‡] Only Islamic banks in Islamic countries such as Kingdom of Bahrain, Dubai International Financial Centre, Jordan, Lebanon, Qatar, Sudan and Syria have been following the accounting standards set by the AAOIFI (Maali and Napier, 2010).

Based on the above discussion, it is puzzled as to why Malaysia does not adopt a separate Islamic accounting standards ie. the AAOIFI accounting standards in preparing the financial statements for the IFIs. In that case, the objective of this research is to explore views from the preparer with regards to the application of AAOIFI accounting standards by the IFIs. Therefore contributing to answer issues puzzling many people, that is, whether there is a need for a separate set of Islamic accounting standards.

3. Research Method

This paper discusses the views of 7 interviewees gathered from 7 semi-structured interviews conducted during the period of three months from October 2012 to December 2012. The seven interviewees who participated in this research comprised of officers of management team in finance department of IFIs in Malaysia. All of the above interviewees are actively involved in preparing IFIs financial statements. The semi-structured questionnaire was envisioned to capture the essential evidence concerning the research objective raised in the first section. Semi-structured interviews were held within a fairly open context thereby, the questions asked were not necessarily prepared in advance. Five interviews were carried out face to face, lasting one to two hours each, while two interviewees answered in writing by email. All of the interviews were conducted in English with a bit mixture of Malay language. They were tape recorded and then, all were transcribed. They were then coded manually by the researchers. The interviewees are coded as P1, P2, P3, P4, P5, P6 and P7 to represent the opinion from the interviewees. These interviewees were asked on the role of AAOIFI in the preparation of the financial statement by IFIs. The following section reports the findings from the interviews.

4. Findings

a. Views on the role of AAOIFI

In relation to the application of AAOIFI in addition to IFRS in preparing the financial statement, most of the interviewees agree that AAOIFI accounting standards are meant to complement and not competing with IFRSs. They are not meant to be a separate set of accounting standards. The complementary task of AAOIFI accounting standards is agreed by P1 that mentions:

> "Dr. Mohammad Nedal Alchaar, the Secretary-General of AAOIFI always say that AAOIFI standard is never meant to compete with IFRS. It is to complement IFRS" (P1).

The view is in line with the approach of AAOIFI in developing accounting standards for Islamic entities by adapting from the conventional Western standards (Lewis, 2001). The AAOIFI chose this approach believing the efficiencies gained from the previous work will facilitate a timely implementation of their own standards without compromising *Shari'a* law (Vinnicombe, 2010). Due to AAOIFI accounting standards are a lot based on standards issued by the West, international accounting bodies especially the IASB (International Accounting Standards Board), IFRSs take precedence in reporting IFIs products and they refer to AAOIFI accounting standards just for the reference in preparing the financial statements in Malaysia as remarked by **P6**. The difference between AAOIFI accounting standards and IFRs is not apparent. The financial accounting standards issued by AAOIFI are basically compatible with IFRS except in only one or two cases (Archer and Karim, 2007).

Despite the compatibility function with IFRS, most of the interviewees agreed that comparison issue is the factor inhibiting the adoption of AAOIFI in Malaysia. According to them, the comparability of financial statements will be affected if we were to have two sets of accounting standards. The situation further implicates that IFIs' financial statements are prepared in accordance to IFRSs. With the whole world moving towards a single set of accounting standards i.e IFRSs, many regulators are reluctant to have a separate set of accounting standards.

P1 also commented that the two sets of accounting standards give difficulties to consolidate the financial statements of IFIs with existing branches all over the world. He notes that in order for IFIs to expand and grow, they are unable to use AAOIFI accounting standards resulting in the incomparability of financial statements and qualification issue. This is further supported by P2 that states:

> "Unless everyone agrees to adopt AAOIFI accounting standards worldwide, IFIs can never adopt AAOIFI. IFIs will be in the position where they cannot compare themselves with their counterparts in conventional banking system because

> it is totally different standard and basis" (P2).

In a similar vein P3 also added that:

> "Embracing AAOIFI for IFIs which do not compete internationally seems logical since if global acceptance is not so important, there is no need to comply with international standards" (P3).

Since IFRS is becoming the *lingua franca* of financial reporting, it is difficult for a country like Malaysia that has the western heritage to adopt AAOIFI accounting standards despite the resurgence of Muslims need in Malaysia. As indicated by Altarawneh and Lucas (2012), their findings show that the most significant factor influencing accounting regulators in their mandating of IFRS was economic dependency on the west. IFIs are therefore operating in the industry dominated by the western, comparability is another issue prohibiting IFIs to adopt AAOIFI accounting standards in preparing financial statements as the industry is economically depending so much on the west.

The objective of AAOIFI is to establish contemporary accounting thought that test these objectives against Islamic Shari'ah, thereby embracing those that are consistent with Shari'ah and disallow those objectives that are against Shari'ah (Maurer, 2010). However there are a few Islamic schools of thoughts (mazhabs) that contribute to the differences in the theoretical concept underlies its development. This is another reason why AAOIFI is not adopted in Malaysia. Differences in mazhabs or Islamic school of thought have been applied in Malaysian Islamic banking environment. In that case, in Malaysia, AAOIFI accounting standards usage is restricted only as guidelines and complementary. As it was emphasized by many of the interviewees (P1, P2 and P3) that AAOIFI accounting standards are Bahrain based while Malaysia has its own Sharia' advisory council (SAC) in its each as well as in the Bank Negara. Most of the interviewees mentioned that the Shariah in middle Eastern countries differ from the ones in Malaysia. Further noted by the interviewees, unlike in Middle Eastern countries, it was reported that the Shariah Advisory Council in Malaysia are very liberal under the principle of maqassid al-Shariah, thereby allowing many conventional banks products to be offered by IFIs. The interviewees also reported that there are many differences between the Shariah in Bahrain and Malaysia, due to the different mazhabs observed by the countries. The SAC in Malaysia looks at all the four well-known Mazhabs and not only at Shafi'i Mazhab, which is practised in Malaysia. Due to the fact that AAOIFI accounting standards is promulgated in Bahrain which practises Maliki Mazhab, many products in Malaysia are not within the discussion of AAOIFI that makes IFIs have to refer to IFRS as noted by P3. The interviewees' views above are consistent with Haniffa and Hudaib (2010) that claimed there is divergence in the interpretations of the Shari'ah, which results in the so-called Arab and Malaysian models[§].

The above approach results in significant growth of Islamic finance that offers many IFIs products to be copied from the conventional banking industry (Khan, 2010). It is argued that rather than fulfilling religious duties, the real aim of IFI has been seen by some as creating secular goals similar to the capitalist approach, and not religious ones, moving away from the initial sacred aim (Haniffa and Hudaib, 2010). This has led the national regulators including the Malaysian Accounting Standards Board (MASB) to have the view that IFRS adheres to the principle of Shari'ah and is applicable to IFIs. Currently, the MASB is in the view that there is no necessity to have separate Islamic accounting standards as no significant different in functioning between the IFIs products and the conventional banking products.

Although the mandating accounting standards for IFIs is IFRSs, a few interviewees stated that AAOIFI accounting standard was well received and being referred by the practitioners due to the Islamic spirit for the transactions. However the amount of additional disclosures is something that IFIs concerned about. Some banks are willing to consider AAOIFI accounting standards as mentioned by P2:

> "Many things need to be in place especially in the terms of the system, infrastructure and education before AAOIFI accounting standards can be implemented, so that will take some time and resources" (P2).

[§] Additionally, Malaysia has been accused as being too liberal in their interpretations of Islamic Shari'ah principles regarding banking and financial affairs resulting in the offer of many products that echo conventional banking products (Khan and Bhatti, 2008).

In terms of latest development, P2 stated that some IFIs are determined to embrace AAOIFI accounting standards starting from the year 2014 "where elements of AAOIFI will be incorporated in terms of accounting policy for mudarabah, ijarah and murabahah. There will be additional disclosures as far as AAOIFI is concerned".
The amount of disclosure required by AAOIFI on top of the existing IFRS in Malaysia is perhaps the factor inhibiting the adoption of AAOIFI accounting standards as remarked by P3. The reason is too much disclosure requirement for the preparers to produce including the write-back of provision against the mudarabah fund manage, will consume a lot of time, effort and other resources of the IFIs resulting in the implementation of AAOIFI in Malaysia questionable. The findings are consistent with Nadzri (2009) that reveal the extents of disclosure by the IFIs are much lower than the AAOIFI requirements, explaining the unwillingness of IFIs to disclose as much as per requirements of AAOIFI.

5. Discussion and Conclusion

The paper has considered the development of IFIs over the years and found that the stance on reporting has also evolved consistently with the growth of IFIs around the world. Interestingly, the evidence indicates that the interviewees placed greater importance on the practicality of reporting in this competitive industry while balancing the need to serve the Muslim society. The findings reveal that the IFIs are aware of the existing AAOIFI accounting standards, where the standards are being used as a reference in preparing financial statements. The prominent reason of concern that prohibits the use of AAOIFI accounting standards in reporting IFIs is the issue of comparability. Since many countries around the world have accepted IFRSs globally, it is difficult for AAOIFI accounting standards to penetrate into the IFI market, which the industry is dominated by the western industry.
In addition, it was found that another challenging factor in applying the AAOIFI accounting standards is the different of Islamic schools of thought in understanding the Islamic principles. Malaysia has been said to be very liberal since all the four mazhabs have been referred in formulating the IFIs' products. In that case, the IFIs products vary among the Muslim countries depending on the approval of SAC in that particular country, resulting in the launching of many IFIs' products in Malaysia.
The evidence from the interview clearly implies how the evolvement in IFIs reporting reflects the practice of IFIs which reveal how the initial sacred aims of IFIs evolve similarly into the capitalist practice of conventional banking system. Since the IFIs' products are similar in functioning to conventional banking products and the difference lies only in terms of contract, the IFRSs are therefore able to report the IFIs' products in similar way of conventional banking products. This paper brings more evidence to suggest that IFIs emphasize more on technical instrumental of products resulting in the initial aim of IFIs is far to reach. However, the discussion on how can IFIs achieve the true aims of Islamic teaching through their service is beyond the scope of this paper. Further research on how to offer the Shariah compliance products aiming to achieve sacred objective and the respective accounting treatment to follow is worth to explore.

The above interview evidence suggests that separate Islamic accounting standards is not crucially needed to regulate the IFIs environment, instead, they need urgently the standards on disclosure to explain the Islamic contracts and to convince the Muslim society that they are actually offering Shariah compliance products, approved by the SAC. Despite, there are respondents who prefer the accounting treatment by AAOIFI in order to reflect the product contracts according to Islamic principles. However, the guidelines for IFIs will not be applied globally if they are separate accounting standards. The resulting extensive with the issue of harmonisation and convergence to IFRSs where most of the interviewees would like to see the accounting treatment or disclosures for IFIs to be placed under the IFRS framework in order for the standards to be successfully applied globally. Including options or guidelines to IFIs under the IFRS framework will be a great effort in Islamic reporting development. Although some will argue that this effort will still be based on capitalist nature and help to legitimise the IFIs products, this will be a good development in reporting the IFIs products. In future, it is hope to see the effort for IFIs to offer the Shariah compliance products in substance and form and to be reporting based on Islamic reporting conceptual framework. This development will help to fulfill the desire of Muslims to apply Islamic principles in all aspects of their lives.

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