Financial Statements of
Islamic Banks and Islamic Financial Institutions with
Reference to AAOIFI and Bangladesh Bank Guidelines
**Introduction**

Like conventional banks/financial institutions, Islamic Financial Institutions (IFIs) are engaged in the business of dealing in money (collection of deposits and lending and investing). However, the fact, which distinguishes them, is that their dealings with depositors are based on profit and loss sharing rather than a fixed pre-determined interest. This signifies an IFI's fiduciary role where it is considered to be dealing in trust money. Compared to other financial institutes, Islamic Banks are obliged to disclose certain facts in the annual reports and financial statements. This disclosure practice is a bit more crucial for the Islamic institutions than other non-Islamic ones in the sense of Islamic obligation.

There are fifty-seven scheduled banks in Bangladesh and among these eight banks are operated under Islamic Shariah. Average market share of Islamic Banks is around 20%. Seven of these Islamic banks are listed on stock market.

**Background**

Islami Bank Bangladesh Limited, the first Islamic bank in South and South-east Asia, was established in 1983. At that time, there was no separate guidelines for this type of banks for preparing their financial statements (FSs). In the absence of separate Act, all banks are to prepare their financial statements in accordance with the Banking Companies Ordinance 1962. After enactment of the Banking Companies Act 1991, banking companies were preparing their financial statements in accordance with the formats prescribed under this Act. However, no separate formats were prescribed in the Banking Companies Act 1991 for the Islamic banks. So, it became difficult for the banks under Islamic Shariah to comply with the prescribed format. Finally, in November 2009 Bangladesh Bank issued separate guidelines on the Specimen Reports and Financial Statements for banks under Islamic Shariah.

**Regulatory Requirements of Financial Statements of Islamic Banks**

The banks are primarily registered with Registrar of Joint Stock Companies and Firms (RJSC) under the Companies Act 1994 as a public limited company. The important provisions regarding financial reporting have been laid down under Sections 181 to 185 and 192 of the Companies Act 1994. Section 181 directs to keep proper books of accounts whereas Section 183 requires presenting audited balance sheet and profit and loss account in the annual general meeting. Section 185 prescribes the form and contents of balance sheet and profit and loss account of a company. Moreover, Section 192 states that every company being a limited banking company or an insurance company has to prepare the statements in accordance with Schedule XII, or as near thereto.

To do the banking business in Bangladesh every bank is to take license from Bangladesh Bank under Section 31 of the Banking Companies Act 1991. The important provisions regarding financial statements of banks have been laid down in Section 18, and 36 to 43 of the Banking Companies Act 1991. Besides, Section 2 of this Act states that the banking companies should comply with provisions of the Companies Act 1994. The most important section regarding
preparation and presentation of FSs is Section 38 that prescribes the requirements of balance sheet and profit and loss accounts.

All of the listed companies are to comply with the provisions laid down in the Securities and Exchange Ordinance 1969 which was expedient to provide regulations of capital market and issue for the protection of investors.

In addition to the requirements of these guidelines Islamic banks are to comply with International Financial Reporting Standards (IFRS), the Securities and Exchange Rules 1987, Dhaka and Chittagong Stock Exchanges’ Listing Regulations, AAOIFI\(^1\) Standards, IFSB\(^2\) Standards, and Islamic Shariah and other laws and rules applicable in Bangladesh. So, the Islamic banks are to abide by more rules and regulations than the conventional banks.

Rule 12(2) of the Securities and Exchange Rules 1987 prescribes compliance with International Accounting Standards (IAS):

The financial statements of an issuer of a listed security shall be prepared in accordance with the requirements laid down in the Schedule and the International Accounting Standards as adopted by the Institute of Chartered Accountants of Bangladesh (ICAB). The institute has adopted IAS and IFRS as Bangladesh Financial Reporting Standards (BFRS). However, some aspects of IAS 39 have not been adopted.

**The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)**

AAOIFI was established in accordance with the Agreement of Association which was signed by Islamic financial institutions on 26 February 1990 in Algiers. Then, it was registered on 27 March 1991 in Bahrain. It has members from more than 45 countries, including central banks and Islamic financial institutions. It is an Islamic international autonomous non-profit organization which sets different standards for Islamic financial institutions. IBBL is an associate member of AAOIFI.

**Objectives of AAOIFI**

Within the Islamic Shariah rules and principles, AAOIFI has the following objectives:

- To develop accounting, auditing, governance and ethical thought relating to the activities of Islamic financial institutions taking into consideration the international standards and practices which comply with Islamic Shari’ah rules;
- To disseminate the accounting, auditing, governance and ethical thought relating to the activities of Islamic financial institutions and its application through training seminars,

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\(^1\) Accounting and Auditing Organization for Islamic Financial Institutions

\(^2\) Islamic Financial Services Board is an international body that sets standards and offers guidance for Islamic banking and finance regulatory and supervisory agencies. It is based in Kuala Lumpur, Malaysia, and began operations in early 2003.
publication of periodical newsletters, preparation of reports, research and through other means;

- To harmonize the accounting policies and procedures adopted by Islamic financial institutions through the preparation and issuance of accounting standards and the interpretations of the same to the said institutions;
- To promote good ethical practices relating to Islamic financial institutions through the preparation and issuance of codes of ethics to these institutions;
- To approach the concerned regulatory bodies, Islamic financial institutions, other financial institutions that offer Islamic financial services, and accounting and auditing firms in order to implement the standards, as well as the statements and guidelines that are published by AAOIFI;
- To offer educational and training programs, including professional development programs on accounting, auditing, ethics, governance, Shari’ah, and other related areas, so as to promote knowledge on, and to encourage greater professionalism in, Islamic banking and finance. Training, examination and certification shall be carried out by AAOIFI itself and/or in coordination with other institutions;
- To carry out other activities, including certification of compliance of AAOIFI’s standards, so as to gain wider awareness and acceptance of AAOIFI’s standards on accounting, auditing, ethics, governance, and Shariah.

AAOIFI Standards

As a standard-setting body for the international Islamic finance industry, AAOIFI has already issued a total of 94 standards – consisting of 54 Sharia standards, 26 accounting standards, 5 auditing standards, 2 codes of ethics and 7 governance standards. The standards are published in 2 standards publications, namely Shari’a Standards publications which contain all 54 Shari’a standards, and Accounting, Auditing and Governance Standards publications which contain all the other 40 standards on accounting, auditing, ethics and governance.

The latter contains 26 accounting standards, 5 auditing standards, 2 codes of ethics and 7 governance standards that AAOIFI has issued for the international Islamic finance industry. These standards give guidance on, amongst others, presentation of financial statements for Islamic financial institutions (IFIs), accounting treatment for specific Islamic finance products and mechanisms, external auditing of IFIs, and Shari’a compliance and supervision processes and framework for IFIs. Currently, the standards are followed as part of mandatory regulatory requirement or Islamic financial institutions’ internal guidelines in jurisdictions across the world that offer Islamic finance. Consequently, the standards have introduced greater harmonization of Islamic finance practices in all major Islamic finance markets throughout the world.

AAOIFI FAS No. 1 (Effective from 1 January 1996)

Among the Accounting Standards, FAS No. 1 (General presentation and disclosure in the financial statements of Islamic Financial Institutions) is more important for preparation of
financial statements of banks under Islamic Shariah. According to this standard the complete set of financial statements that should be published by Islamic banks should consist of the following (2 General Provision):

a) A statement of financial position (balance sheet)
b) An income statement
c) A statement of cash flows
d) A statement of changes in owners’ equity or a statement of retained earnings
e) A statement of changes in restricted investment
f) A statement of sources and uses of funds in the Zakah and charity fund (when the bank assumes the responsibility for the collection and distribution of Zakah)
g) A statement of sources and uses of funds in the Qard fund
h) Notes to the financial statements
i) Any statements, reports and other data which assist in providing information required by users of financial statements as specified in the Statement of Objectives³ (para 2)

2/2 Comparative financial statements

An Islamic bank should publish comparative financial statements which should include, as a minimum, the financial statements of the comparable prior period. (para 3)

3/1 Adequate disclosure of material information

The financial statements should disclose all material information that is necessary to make those financial statements adequate, relevant and reliable for their users. (para 8)

4/5 Statement of Changes in Restricted Investments

The statement should segregate restricted investments by source of financing (e.g., those financed by restricted investment accounts, investment units in restricted investment portfolios.) In addition, the statement should segregate investment portfolios by type. (para 62)

4/6 Statement of Sources and Uses of Funds in the Zakah and Charity Fund

Disclosure should be made of the Islamic bank’s responsibility for the payment of Zakah and whether the bank collects and pays Zakah on behalf of owners of unrestricted investment account holders. (para 66)

7 Treatment of a correction of an error in prior period financial statements

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³ Refer to the role of the Islamic bank in fulfilling its responsibility towards society.
An error in prior financial statements should be corrected retroactively by restating the financial statements for all prior periods presented which have been affected by the error. Disclosure should be made as to whether such an error affects the rights and obligations of the Islamic bank towards others. (para 83)

**Guidelines on the Specimen Reports and Financial Statements for Banks under Islamic Shariah**

Bangladesh Bank has issued guidelines on November 09, 2009 for Shariah based Islamic Banking in pursuance of Section 45 of Banking Companies Act 1991. It had become necessary to introduce separate guidelines because there are some basic differences in Shariah based Islamic banking and interest based banking. These guidelines should be treated as supplementary, not substitute, to the existing banking laws, rules and regulations.

**Objectives of Guidelines on the Specimen Reports**

- To enable the Islamic banks to prepare their financial statements as per provisions of Banking Companies Act 1991, International Financial Reporting Standards, the Companies Act 1994, Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and Islamic Shariah.
- To maintain the uniformity of financial statements among the Islamic banks.
- To ensure the disclosure of relevant statements for the user of the financial statements so that they can make their investment decision properly.
- To provide relevant details of the items included in the financial statements so that if can give a clear understanding of the users of financial statements.
- To ensure the consistency and compatibility of these statements among the Islamic banks.

**Required Financial Statements**

The minimum component of the specimen reports and financial statements for the Islamic banks are as follows:

1. Balance sheet
2. Profit and Loss Account
3. Cash flow statement
4. Statement of Changes in Equity
5. Liquidity Statement
6. Notes to the financial statements

**Salient Features of the Guidelines**

The prescribed format is applicable to full-fledged Islamic banks and Islamic branches of traditional commercial banks licensed under Banking companies act.
It provides the minimum disclosure requirements of the banks under Islamic Shariah. These banks are to comply with the disclosure requirements of the Securities and Exchange Rules 1987, Stock Exchanges’ Listing Regulations, and other rules and laws applicable in Bangladesh. These guidelines don’t address the necessary adjustments of financial transaction required to comply with the International Financial Reporting Standards (IFRS). So, Islami banks are required to adjust their Financial Statements as per their requirements.

These guidelines don’t address all the aspects of Islamic Shariah. So, Islamic banks are required to follow the shariah rules set by their respective Shariah Supervisory Committee, if any, as well as AAOIFI.

**Some other requirements of FS**

Current year and previous year data will be presented in comparative way. Banks should prepare a classified BS in accordance with prescribed format. Banks are to disclose off balance sheet items; contingent liabilities and commitments. CFS should be prepared under direct method. According to the prescribed form of SCE, equity consist of paid-up capital, share premium, statutory reserve, general/other reserve, asset revaluation reserve and retained earnings. To measure liquidity gap a LS should be prepared. In this statement bank should disclose an analysis of assets and liabilities in maturity groupings based on the remaining period at the balance sheet date to the contractual maturity date. A bank should prepare a fixed assets schedule. Banks should provide detailed information in the notes to the financial statements regarding status of the bank, significant accounting policies, subsequent events, related party transactions, audit committee and classification of assets, liabilities, revenues and expenses.

**Departures from BFRS**

It is observed from the notes to the financial statements that the IFIs departed from BFRS requirements where they differed from Bangladesh Bank requirements. Islami Bank Bangladesh Limited stated:

In case the requirement of guidelines and circulars issued by Bangladesh Bank differ with those of other regulatory authorities and financial reporting standards, the guidelines and circulars issued by Bangladesh Bank prevails.

**Conclusion**

The heart of the banking business is the trust and confidence of the customer. So, it should be the prime concern of banks to maintain customer loyalty. Besides, most of the customers of Islamic banks are religious by nature and want to comply with Shariah. For this reason, it is important for Shariah based banks obey the laws, regulations and guidelines as meticulously as possible. It is also important to ensure the transparency by making proper disclosures.
References