The Move Towards Global Accounting Standards For Islamic Financial Institutions: Evidence From AAOIFI[1]

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Abstract

The AAOIFI accounting standards serve as a guideline that may reflect the unique characteristics of Islamic Financial Institutions (IFIs).Islamic financial institutions spread locally and globally with a hundreds of products and services to the market. Many researchers argue that the application of accounting standards or harmonized accounting principles would greatly benefit users of financial statements, especially when the financial data being compared was compiled in a variety of geographical locations. However, AAOIFI through its global network has also persuaded regulatory authorities to adopt its standards, but until now AAOIFI has not been fully successful. It does not have the power to enforce its standards on Islamic financial institutions globally. Accordingly, it is suggested that Muslim countries should give full support to AAOIFI standards by adopting and making them mandatory for all IFIs.

Keywords: AAOIFI, Islamic accounting, Islamic Financial Institutions

1. Introduction

Islam has gained tremendous popularity and currently recognized as the second largest and fastest growing religion in the world. Islam does not only lead to ritualistic religion confined to individuals rather, it also involves an integrated way of life that combines politics, economics, culture, religion and every aspect of human life (Hameed, 2001). Islam is a belief system that unites about 1.2 billion people around the world which approximately constitutes one-quarter of the global population (Masood and Tahir, 2008).Accordingly, it is necessary for Muslims todevelop and embrace a unique economic systemto meet their needs. In this regard, Islamic Financial Institutions have been established to fulfill this need by helping the Muslims community to avoid Ribâ (usury) in their financial engagement and daily financial transactions. Allah Says "Those who eat Ribâ (usury) will not stand (on the Day of Resurrection) except like the standing of a person beaten by Shaitân (Satan) leading him to insanity. That is because they say: "Trading is only like Ribâ (usury)," whereas Allâh has permitted trading and forbidden Ribâ (al-Baqara: 275).

Based on the above quoted verses of the Holy Quran, Allâh has permitted trading and forbidden Ribâ (usury). For that, Allah sent his prophet Mohammed (S.A.W) to teach the Ummah and guide them to the right way.

However, IFIs are increasingly becoming an essential part of the global financial system, since its development in the 1960s, it has continued to help not only the Muslim community but also non-Muslims who want to pursue their economic activities devoid of interest (Dogarawa, 2012). Accordingly, the need of Sharia'h compliance becomes increasingly important to bridge the gap between theory and practice. However, to accommodate these issues, AAOIFI has issued 45 Shari'ah standards as part of the solution to be implemented by Islamic financial institutions globally (AAOIFI, 2010). Moreover, diversity in IFIs practices means that, there are practices that have not been covered by Islamic accounting standards such as the AAOIFI or any accounting standards that are in line with Shari'ah principles. Therefore, developing unique accounting and auditing standards for the dissemination of such information about Islamic Financial Institutions becomes a necessity (Tag El-Din, 2004).However, Islamic banks worldwide prepare their financial statements using variety of accounting standards either international accounting standards or local accounting standards, the problem may exist in the practices and the level of understanding among accountants and the level of compliance of Islamic banks global (Report, KPMG and ACCA, 2010). Thus, the need for Islamic accounting standards may possibly be the right way to resolve these issues. Recently, many Islamic banks have been adopting the accounting standards set by AAOIFI (Maali and Napier, 2010).Therefore, understanding factors affecting the levels of compliance with the Islamic accounting standards (AAOIFI) need to be investigated?

The acceptability and understanding of the role of the Islamic accounting standards (AAOIFI) can be of high significance for policy implications, regulators, and standard setters. Currently, the evolving literatures surrounding the interpretation of the levels of compliance with the accounting standards for IFIs generated a heated debate among the researchers. Thus, this paper aims to provide answers to the current debate. A clear understanding and acceptability have the potential to lead to more compliance with

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Islamic accounting standards such as the AAOIFI. Therefore, it is uncertain to determine whether the Islamic banks would switch to the AAOIFI standards or adopting a combination of both of the AAOIFI and local standards or regulations?

2. Research problem

The dilemma currently experienced in term of the divergence of accounting standards implementations poses a great threat to the sustainability of IFSs. For instance, some of the Islamic banks treat investment accounts that are based on the mudarbah contract as liabilities and report them on balance sheet (e.g. Jordan Islamic Bank, Bahrain Islamic Bank and Qatar Islamic Bank). Other banks treat investment accounts as fiduciary investments. accordingly, report them as off-balance sheet (e.g. Al Rajhi Bank and Shamil Bank of Bahrain) (Ahmed, 2002). In the UK However, Islamic banking practices seem to be far away from its paradigm version (Akbar et al, 2012).

For those reasons, researchers in the area of financial reporting for Islamic financial institutions have conducted a considerable number of studies to investigate the issues of harmonization and compliance with accounting standards and the need for a unique of accounting standards to be adopted by IFIs. For instance, Abdel Magid (1981), Karim (1987), Pomeranz (1997), Hameed et al (2006), Che Pa (2006) and Shadia Rahman (2007) researchers have examined the understanding, acceptability, and need of accounting standards for Islamic financial institutions.

The Afghani of the Islamic bank economist, Abdul Haqiqi, recommends that the establishment of accounting standards for Islamic banks could possibly address the issue of accounting, conformity to Islamic and Arab social and religious objectives, and a coordinated and unified approach to the interpretation of pertinent Islamic law (Pomeranz, 1997). However, the need of investigating the harmonization of accounting practices due to the absence of specific accounting standards for Islamic financial institutions being adopted globally could create some difficulties for users of financial reporting. In the light of the above discussion, review of the relevant studies that propagate the importance of accounting standards for Islamic financial institutions could clarify the research problem.

3. Literature review

Islamic banks operate mainly in developing countries in the Middle East, Africa and South-East Asia are facing some difficulties to adopta unique accounting standards into

their practice due to the absence of a legal framework and inconsistency of financial reporting. For instance, financial institutions in some countries, such as Jordan, the UAE and Qatar, are officially required to comply with the International Accounting Standards (IASs). Meanwhile, in countries such as Saudi Arabia, the authorities require compliance with both IAS and local accounting standards. In Malaysia, there are national accounting standards, which are based on IAS (Ahmed, 2002). In Bahrain, the authorities require compliance with both AAOIFI and IFRS as requested by central bank of Bahrain (CBB).

Researchers in the area of financial reporting for Islamic financial institutions have conducted a considerable number of studies to investigate the Islamic banks' compliance with accounting standards. However, one of the main problems facing Islamic banking includes a lack of standardized accounting and auditing standards (Pomeranz, 1997). Therefore, conventional accounting is inappropriate for Muslim users and Islamic organizations according to Hameed (2001), and it is inappropriate to impose unmodified Western accounting practices on developing countries (Karim, 1987). In addition, International Accounting Standards based on such techniques would create difficulties for Muslims around the world. Therefore, it is imperative for the Muslim accountants to develop accounting standards which are specially adapted to Islamic needs, and for Muslim countries (Shadia Rahman, 2007).

Basically, there is a lack of evidence regarding the adoption of the accounting standards such as the AAOIFI and analysis of Islamic banking principles under national Shari'ah advisory council, central bank roles, political system and economic structure. Moreover, the major problem is the adoption of accounting standards and disclosure in IFIs that is still based on the conventional accounting philosophy (Harahap, 2003). It is argued that the adoption of accounting standards by Islamic banks will help to enhance their credibility and fuel their growth worldwide (Ariss and Sarieddine, 2008). However, the rapid development of Islamic financial institutions needs accounting standards for disclosing information,satisfying not only the general standards of disclosure but also standards relating to Islamic values (Harahap, 2003).

The levels of implementation of the Islamic Accounting Standards such as the AAOIFI requirements among Islamic banks are currently unknown and needs to be investigated. Accordingly, these requirements are voluntary in some countries as well asdue to the absence of authorities to implement Islamic accounting standards; Islamic financial institutions are currently applying different accounting standards in their financial reporting. Thus, diversities exist in terms of their class structure, political systems, legal systems, financial systems, educational systems, and the very nature of

conducting business and business ownership (Choi and Meek, 2005). Furthermore, the problem may be due to lack of representative of the diverse environment factors as a result of adopting or complying with different accounting standards by Islamic banks. These differences among countries would dictate different accounting practices that reflect the environmental factors of each country. A single harmonized standard of accounting practices would be inappropriate and not representative of all the varied environmental factors exhibited in global markets (Lovett, 2002). However, accounting standards are used to generate comparable and reliable accounting information to help users for better decisions. These standards reflect the culture, history, and other characteristics of accounting problems facing those countries (Abonewa, 2005).

Due to the current different regulatory requirements and legislations, the relevance and comparability of financial statements are the foundations upon which accounting standards are predicated. Lovett (2002) documented that, with financial statements prepared under different accounting standards a problem may exist in:

* Comparability of financial statements prepared globally,
* Reliability and creditability.

However, regarding comparability, reliability and creditability of financial reporting globally or locally, Callao, Jarne and La´?nez (2007) pointed out that, local comparability is negatively affected if both the IFRS and local accounting standards are applied in the same country at the same time. In related study, Mutter (1993) stated that, it can be argued that the adoption of international accounting standards would benefit many users of accounting information, who demand comparable and reliable information. However, Haverty (2006) found that, lack of comparability that is caused largely by the revaluations of property, plant and equipment (IAS 16) permitted under IFRS, but not permitted under U.S. GAAP.

Global accounting standards are perceived by a segment of the financial community as the solution to this problem, while other members of the community adhere to the philosophy of maintaining individual, national accounting standards (Lovett, 2002). In the adoption process of the accounting standards, influences that affect the rate of adoption are identified. These influences cause changes in the attitudes of participants in a social system towards the adoption of accounting standards. The influences and their effect on the rate of adoption are what need to be studied in order to interpret the association of the variables influencing the adoption of accounting standards (Lovett, 2002).

The Accounting Standards Steering Committee (ASSC) was a self-regulatory privet sector body; ASSC became the Accounting Standards Committee in 1975 in the UK (Whittington, 1989). Similarly, the AAOIFI Committee is self-regulatory privet body. Both ASSC and AAOIFI brought in to leading accountancy body to prepare and develop accounting standards relating to recognition, measurements and disclosure. Furthermore, ASSC and AAOIFI as professional body sponsored by charted institutions and non-for-profit corporate and independent organization. The AAOIFI is supported by institutional members (200 members from 45 countries) including central banks, Islamic financial institutions, and other participants from the international Islamic banking and finance industry, worldwide (AAOIF, 2010). ASSC also an independent body sponsored by some chartered institutes (the Irish and Scottish institutes) (Whittington, 1989).

Accordingly, by using approach of Solomons Reports 1989 to address this issue, the AAOIFI's current problem is lack of authority. Similarly, the main problem to impose accounting standards in the UK is lack of authority as well as ASSC failed to act or has seemed to be very anxious to avoid controversy by accommodating the needs of pressure groups (Whittington, 1989). Similar problem experienced by AAOIFI Accounting Standard that lost its authority to impose accounting standards globally due to a numbers of Accounting standards bodies over the world either internationally or locally.

4. Accounting standards for Mode of Islamic finance

With regard to uniform modes of Islamic finance, the AAOIFI has developed and issued Financial Accounting Standards (FAS). For instance, FAS 2 Murabahahfinancing (sale by cost mark-up plus), FAS 3 Mudarabafinancing (silent partnership) and FAS 4 Musharakahfinancing (joint venture partnership). Those standards, set by AAOIFI are addressing the recognitions, measurements and disclosure issues.

AAOIFI had tended to start with objectives established in contemporary accounting thought, test these objectives against Islamic shari'ah, and accept those that are consistent with shari'ah and reject those objectives that are not consistent with shari'ah(Maurer, 2010).

4.1 Murabahah Financing: FAS 2

"This standard shall apply to the assets available for sale by Murabahah and Murabahah to the purchase orderer, the revenues, expenses, gains and losses attributable to such an asset as well as Murabahah receivables (para 1, AAOIFI FAS 2).

4.1.1 Background of the Standard

A typical murabahah transaction exists between three major players: the financier or the Islamic bank; the dealer (seller), who is the primary owner of the goods (merchandise) from whom the first purchase occurs, and finally, the bank's client (costmer) as the person seeking to acquire the goods, through the facilitation of the bank (Ahmed, 2002).

Moreover, Murabahah sale warant the Islamic banks to purchase the commodities that is requested by the client. Murabahah mode of investment indicate the consent of the Islamic bank to purchase the specified commodity for a client .The bank then resell it to the client at cost price plus margin as agreed upon by the contract. bassiclly, Murabahah contract is based on deffered payment.

4.1.2 Recognition and Measurement

"Murabahah assets should be measured initially at historical cost. Meanwhile, at the end of period time, the Murabahah assets are required to be revalued. Assets available for sale after acquisition on the basis of Murabahah to the purchase orderer who is obliged to fulfill his promise shall be measured at their historical cost. In cases where the asset value declines below cost whether due to damage, destruction or from other unfavorable circumstances, such decline shall be reflected in the valuation of the asset at the end of each financial period" (para 3, AAOIFI FAS 2).

"The AAOIFI rules out that, regarding the short term transactions, profits of Murabahah or Murabahah to the purchase order are recognized at the time of contract if the sale is for cash or on credit not exceeding the current financial period"(para 7, AAOIFI FAS 2).

For the long term contracts, profit based on profits of a credit sale which will be paid for either by means of lump sum after the current financial period or by installments over several future financial periods shall be recognized by using one of the following two methods (para 8, AAOIFI FAS 2):

(a) Proportionate allocation of profits over the period of the credit whereby each financial period shall carry its portion of profits irrespective of whether or not cash is received.
(b) As and when the installments are received. This method shall be used based on a decision by the Shari'ah Supervisory Board (SSB) of the Islamic bank or, if it is required, by the Supervisory Authorities such as the Central Banks.

4.1.3 Disclosure requirements

"The bank should disclose in the notes accompanying the financial statements whether it considers the promise made in the Murabahah to purchase order as obligatory or not" (para 16, AAOIFI FAS 2).

4.2 Mudarabah Financing: FAS 3

Mudarabah has the potential to be adapted as Islamic finance system. Mudarabah is where the capital provider (rabbul Mal) and the small entrepreneur (mudarib) become a partner. The profits from the project are shared between capital provider and entrepreneur. Furthermore, Mudarabah structure may also be based on two-tier structure or re-mudarabah where three parties i.e. capital provider (public, government, zakat, waqf, etc.), intermediate mudarib (microfinance institution), and final mudarib (microentrepreneur) are involved (Abdul Rahman, 2010).

The Mudarabah transaction is a financing process, whereby one party, the capital owner, parts with control over a defined amount of his money, and allows another person, the mudarib, to invest the money in proftable investment, subject to share of returns (Ahmed, 2002).

4.2.1 Background of the Standard

"This standard shall be applied to Mudarabah financing transactions carried out by the Islamic bank as a provider of funds and the transactions related to the capital provided by the Islamic bank to be used in a Mudarabah, from the time of its beginning to the time of its completion. And shall apply whether the Islamic bank finances the Mudarabah capital exclusively from its own funds, from the pool of commingled funds comprising the Islamic bank's own funds and unrestricted investment accounts or from restricted investment accounts. shall also apply to the transactions pertaining to the Islamic bank's share in Mudarabah profits or losses" (para 1, AAOIFI FAS). In Mudarabah agreement, the bank provides capital and the entrepreneur contributes his effort and exercises complete control over his business venture. In case of a loss, the bank earns no return or a negative return on its investment and the entrepreneur receives no compensation for his effort, in case of a gain, returns are split according to a negotiated equity percentage and the contract between the parties (Hassan ,1999).

4.2.2 Recognition and Measurement

"Mudaraba financing capital (cash or kind) shall be recognized when it is paid to the mudarib or placed under his disposition" (para 3, AAOIFI FAS 3).

4.2.3 Disclosure requirements

"Disclosure should be made in the notes to the financial statements for a financial reporting period if the Islamic bank has made during that period a provision for decline in the value of Mudarabah assets" (para 19, AAOIFI FAS 3).

4.3 Musharakah Financing: FAS 4

"The Islamic bank's share in Musharaka capital (cash or kind) shall be recognized when it is paid to the partner or made available to him on account of the Musharaka. This share shall be presented in the Islamic bank's books under a Musharaka financing account with (name of client) and it shall be included in the financial statements under the heading "Musharaka financing"(para 3).

4.3.1 Background of the standard

"This standard shall be applied to Musharaka financing transactions carried out by Islamic banks whether by means of a constant Musharaka (short- or long-term) or a diminishing Musharaka (one which ends in transferring ownership to one party). This shall apply whether the Islamic bank finances its share in Musharaka capital exclusively from its own funds, from the pool of commingled funds comprising the Islamic bank's own funds and unrestricted investment accounts or from restricted investment accounts" (para 1, AAOIFI FAS 4).

4.3.2 Recognition and Measurement

"Profits or losses in respect of the Islamic bank's share in Musharaka financing transactions that commence and end during a financial period shall be recognized in the Islamic bank's accounts at the time of liquidation" (para 11, AAOIFI FAS 4). And "The Islamic bank's share in the Musharaka capital provided in cash shall be measured by the amount paid or made available to the partner on account of the Musharaka"(para 4).

4.3.3 Disclosure requirements

"Disclosure should be made in the notes to the financial statements for a financial reporting period if the Islamic bank has made during that period a provision for a loss of its capital in Musharaka financing transactions" (para 17, AAOIFI FAS 4).

5. Conclusions

The objectives of the AAOIFI are to prepare and develop accounting, auditing, governance, ethical and Shari'ah standards relating to the activities of Islamic financial institutions. This paper has discussed the move and the need ofAAOIFI accounting standards to be implemented locally and globally as well as discuss a number of modes of Islamic finance such as (Murabahah financing (sale by cost mark-up plus), Mudaraba financing (silent partnership) and Musharakah financing (joint venture partnership) according to the AAOIFI accounting standards to provide additional evidence to ensuring the need of accounting standards for IFIs.Therefore, the AAOIFI accounting standards may be the best technical for increasing foreign investments and investor's confidence.Thus, this paper concludes with some recommendations to ensuring the move towards global accounting standards for IFIs.

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