

The Disclosure Evaluation of Islamic Banking Reports

By Rifqi Muhammad



The Disclosure Evaluation of Islamic Banking Reports: Evidences From Middle East and Other Regions in Asia

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Abstract

Islamic banking is the most attractive sector in Islamic financial system. The institution encourages not only economic aspects but also social aspects in accordance with Shariah principles in operation. Thus, the managements are required to be accountable to their stakeholders at large and not limited only to the shareholders. One of the accountability's forms is the presentation and disclosure in their annual reports. It is the way to disclose financial and non-financial performance of Islamic banks. This paper aims to elaborate the sources of development of Islamic banking reporting based on the AAOIFI standards, the harmonization of Islamic accounting standards with IFRS, the alternative components of Islamic banking reports, and the accounting policies for Islamic banks in some countries. Secondly, this paper attempts to evaluate the existing Islamic banking reporting components in order to scrutinize its development. This paper selects and evaluates 5 Islamic banks in Middle East region and 4 Islamic banks in other regions in Asia, which have significant contribution in the development of Islamic banking and finance. This study found that Islamic banks did not have similarity in the disclosure components. However, these diversities could be complementary to each other toward the ideal Islamic banking reporting.

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Keywords: Islamic bank, Islamic accounting, Islamic corporate report, Islamic accountability

1. Introduction

⁷ Karim (1999) said that Islamic banks were established with the mandate to carry out their transactions in strict compliance with Islamic Shariah. It is generally believed that Islamic banking started to take off in the aftermath of the boom in the oil prices in 1973 – 1974. Islamic banking is the fastest-growing segment of world finance. Currently, there are at least 300 Islamic financial institutions in more than 70 countries. At the beginning of 2007, the assets of Islamic banking, particularly, amounted to around US\$ 300 billion (Shariah Finance Watch, 2008). Karim (1999) noted that in certain countries such as Sudan and Iran, the whole banking system had been transformed to comply with Islamic Shariah. Farook and Lanis (2006) also argued that Islamic banks should ideally operate in accordance with the principles laid down by Shariah. The primary contributing factor that hastened the need for Islamic Banks is the prohibition of usury (riba). What merged with this function is the social role of Islamic banks that entails social justice and accountability, requiring the banks to disclose corporate social responsibility (CSR) information. Usmani asserted that the philosophy behind Islamic banking was “aimed at establishing distributive justice free from all sorts of exploitation” (2002, p. 113). According to Islamic principles, business transactions can never be separated from the moral objectives of society (Usmani, 2002). As such, a number of scholars have developed a normative standard for reporting (Gambling and Karim 1986, 1991; Baydoun and Willett 2000; Lewis 2001) and indeed social reporting for Islamic businesses based on Islamic principles (Haniffa 2001; Maali, Casson and Napier 2003). Governments in Muslim populated countries such as Malaysia and international regulatory institutions such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) have also voiced their support for the development and adoption of such CSR reporting standards encouraged and propagated by Islam (Sharani 2004; Yunus 2004).

¹³ Farook and Lanis (2006) explained that recent ad hoc studies indicated that Islamic banks were not fulfilling their social role completely in accordance with the prescriptions of Islam (Metwally 1992;

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Aggarwal and Youssef 2000; Maali et al. 2003). Maali et al.'s (2003) rudimentary analysis also suggested that Islamic banks' CSR reporting falls short of the benchmark whose operations were founded on Islamic principles. Based on an Islamic perspective, Islamic banks should develop a pragmatic benchmark for social disclosures that the people would expect Islamic banks to provide. Maali et al (2003) found that there was considerable variation in the voluntary social reporting of Islamic banks. For example, some banks reported 35% of expected social disclosure while the others disclosed no social information.

Based on the facts, this paper aims to elaborate the sources of development of Islamic banking reporting based on the AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) standards, the harmonization of Islamic accounting standards with IFRS, alternatives of Islamic corporate reporting, and the accounting policies of Islamic banks in many countries. Secondly, this paper tries to formulate the components that should be reported by Islamic banks in order to increase the degree of accountability. Thirdly, this paper also tries to evaluate the existing Islamic banking reporting components in order to measure the gap between expectations and realities.

2. The Roles of AAOIFI

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The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is an Islamic international autonomous non-for-profit corporate body that prepares accounting, auditing, governance, ethics and Shariah standards for Islamic financial institutions and the industries. AAOIFI was established in accordance with the Agreement of Association, which was signed by Islamic financial institutions on 1 Safar, 1410H corresponding to 26 February, 1990 in Algiers. Then, it was registered on 11 Ramadan 1411 H corresponding to 27 March 1991 in the State of Bahrain.

Until 2014, AAOIFI has issued two financial accounting statements relating to the objectives and concepts of financial accounting for Islamic financial institutions, 26 Accounting Standards, 5 Auditing Standards, 7 Governance Standards, 2 codes of ethics, and 48 Shariah Standards (www.aaofi.com). As an independent international organization, AAOIFI is supported by institutional members (200 members from 45 countries, so far) including central banks, Islamic financial institutions, and other participants from the international Islamic banking and finance industry worldwide.

AAOIFI has gained assuring support for the implementation of its standards, which are now adopted in the Kingdom of Bahrain, Dubai International Financial Centre, Jordan, Lebanon, Qatar, Sudan and Syria. The relevant authorities in Australia, Indonesia, Malaysia, Pakistan, Kingdom of Saudi Arabia, and South Africa have issued guidelines that are based on AAOIFI's standards and pronouncements.

The objectives of AAOIFI are as follows: (a) to develop accounting and auditing thoughts relevant to Islamic financial institutions; (b) to disseminate accounting and auditing thoughts relevant to Islamic financial institutions and its applications through various medias; (c) to prepare, promulgate, and interpret accounting and auditing standards for Islamic financial institutions; and (d) to review and amend accounting and auditing standards for Islamic financial institutions.

The objectives of financial accounting for Islamic banks and financial institutions are as follows: (a) to determine rights and obligations of interested parties; (b) to safeguard entity assets and rights of others; (c) to contribute to enhancement of managerial productive capacities; (d) to provide useful information to make legitimate decisions; (e) to encourage Shariah compliance; (f) to distinguish prohibited earnings and expenditure.

The Statement of Financial Accounting (SFA) No. 1 stated that financial reports for Islamic financial institutions, which are directed mainly to external users, should provide the following types of information as follows:

1. Information about the Islamic bank's compliance with the Shariah precepts
2. Information about the separation of prohibited earnings and expenditures
3. Information about the Islamic bank's economic resources and related obligations
4. Information about the determination of Zakah on Islamic banks' funds and the purpose of the disbursement
5. Information about the estimation of cash flows that might be realized from dealing with Islamic bank, the timing of those flows and the risk associated with their realization. This is related to the

prediction of Islamic bank's ability in generating income in order to distribute profits to equity and investment account holders.

6. Information about the ability of Islamic bank to safeguard the third parties' funds through various investment schemes.
7. Information about the Islamic bank's discharge of its social responsibilities.

Karim (1999) explained that AAOIFI had an extensive due process that governed the production of its accounting and auditing standards. The due process included the vetting of the juristic suitability of the proposed standards by AAOIFI's Shariah Board. It also provided interested parties with the opportunity to express their opinion on the standards before the Board finally approved them. This is made possible by the holding of public hearings to discuss the exposure drafts. It is the practice of AAOIFI to hold a public hearing on the same exposure drafts in two countries.

Karim (1999) argued that AAOIFI did not have the power to force Islamic financial institutions to implement the standards it promulgates. AAOIFI had, therefore, pursued a strategy of having its standards implemented by cooperating with concerned governmental and professional agencies, namely central banks and bodies that are responsible for implementing accounting standards. For instance, the supervisory authorities in Bahrain and Sudan had asked Islamic banks to adhere AAOIFI's standards in preparing their 1998 financial statements. Some Islamic bank in other countries (e.g. Malaysia and Saudi Arabia) had also started voluntarily to use AAOIFI's accounting standards to prepare their financial statements. Furthermore, international rating agencies had also started to take AAOIFI's standards into consideration when rating Islamic banks.

However, Harahap (2003) noted that due to lack of accepted standards for annual report disclosure, Islamic organizations still used accepted disclosure standards for conventional annual reports. Even though AAOIFI had been established, the accounting standards (that includes disclosure) were mostly based on conventional accounting concepts. Therefore, he tried to search the Islamic values inside AAOIFI's accounting standards. Haniffa and Hudaib (2001) argued that the conceptual framework for Islamic accounting should be based on Shariah. According to them, the objectives of Islamic accounting are to assist achieving socio-economic justice (Al-falah) and recognizing the fulfillment of obligation to God, society, and individuals concerned. In addition, it is a form of worship by parties involved in the economic activities such as accountants, auditors, managers, owner, government, etc..

From this basis, Haniffa and Hudaib (2001) divided the accounting into two aspects; technical and human. Technical Islamic accounting needed measurements for zakah purpose thereby understanding how it was distributed. For disclosure aspects, Islamic accounting should clearly state how the institution is fulfilling its duties and obligations according to Shariah e.g. lawful dealings, zakah to beneficiaries, sadaqah (charities/gifts), wages, the achievement objective of business venture and protecting the environment. On the other hand, the human aspects of Islamic accounting should be based on morality, ethics and Divine law and accountability.

Harahap (2003) argued that according to AAOIFI there were some items concerning Islamic value information items needed to be disclosed:

1. Basic information about the Islamic bank.
2. Unusual supervisory restriction
3. Earning of expenditure prohibited by Shariah
4. The method used by the Islamic bank to allocate investment profits (loss)
5. between unrestricted investment account holders or their equivalent and the Islamic
6. Bank as a Mudarib or as an investor with its own funds
7. Statement of changes in restricted investments
8. Statement sources and uses of funds in the Zakah and charity fund
9. Statement of sources and uses of funds in the qard fund

3. Harmonization of Islamic Accounting Standards with IFRS

The globalization of business gives impact to the international accounting standards. The international standards setters have challenges to accommodate the need for a single international accounting standard for all companies around the world in order to simplify the process of financial reporting. Therefore, the

International Accounting Standards Board (IASB), an independent standard-setting board, tried to propose International Financial Reporting Standards (IFRSs) in order to develop and promote a single set of high quality, understandable and international financial reporting standards for general-purpose financial statements. They claimed that 113 countries around the world require and permit IFRS reporting for companies. Moreover, they had implemented IFRS on 1 January 2012 and encouraged all members' countries to adopt the standards gradually.

International Accounting Standard Board (IASB) was established in 2001 by International Accounting Standards Committee (IASC). IASC was created in 1973 between the professional accountancy bodies in 9 countries and from the year 1982 its membership comprised of all the accountancy bodies who were members of the International Federation of Accountants (IFAC). The principle significance of the IASC was to encourage national accounting standard setters around the world to improve and harmonize national accounting standards. The members of the IASC who were Professional Accountancy Bodies of the world delegated the responsibility to the IASC Board. The IASC Board was responsible for all activities including standard setting activity. The Standards adopted by the IASC Board were known as the International Accounting Standards (IAS).

3.1. The International Accounting Standards Board (IASB)

The IASB is responsible for all standard setting activities, including the development and adoption of IFRS. The IASB comprises of 14 members that is to be increased to 16 members. The members of the board are a mix of practical experience in standards setting process, or as a user, or accounting, academia or from the preparer community. The constitution also makes it amply clear that the work of the IASB will not be invalidated by its failure at any time not to have representation in accordance with the geographical allocation laid down in the constitution. Members of the IASB are appointed for a term of up to 5 years, renewable once. At the time the IASC Foundation was constituted first, the IASB adopted all IAS issued by the previous IASC. The existing IAS continues to be operative till the extent it has not been amended or withdrawn by the IASB. New standards issued by the IASB are called the IFRS. Collectively IFRS includes both IAS and IFRS.

3.2. The Roles of IASB

The main aim of IASB is developing a single set of high quality, understandable and enforceable accounting standards to help participants in the world's capital markets and other users make economic decisions. Furthermore, the other objectives of IASB as follows: (a) to formulate and publish accounting standards and to promote their worldwide acceptance; (b) to work on the improvement and standardization of regulations, accounting standards and procedures; (c) the IASB does not appear to believe that the many reasons provided as to why different nations should have different accounting standards (e.g. tied to differences in culture, religion, and so forth) outweigh the benefits of international standardization.

They also have short-term aim is for national accounting standards and IASs to converge. Moreover, the long-term aim of global uniformity is a single set of accounting standards for all listed and economically significant business enterprise. This process is also supported by International Organization of Securities Commission (IOSCO) that is working with IAS/IFRS to achieve widespread acceptance. They together developed a plan such that compliance with IAS/IFRS will allow an organization to have securities listed in all global markets.

3.3. The Challenges for Islamic Accounting Standards

The implementation of IFRS has made the existence of Islamic accounting standards little overlooked because the concepts of IFRS are not directly accommodate the uniqueness of transactions in Islamic financial institutions. IFRS that was derived from conventional accounting worldview took the approach that allowing some concepts that were not relevant to Islamic accounting approach for example: time value of money, substance over form, and conservatism (eltegani, undated). Therefore, some of the accounting standard-setters from several countries that are concerned with efforts to implement IFRS by

making adjustments to the local character as well as the uniqueness of the Islamic financial industry then joined to form The Asian-Oceanian Standard-Setters Group (AOSSG).

The AAOSG has been formed to discuss the issues and share the experiences on the adoption of IFRS and to contribute to the development of a high-quality set of global accounting standards. Some of the objectives of this group are as follow: (a) to promote the adoption of, and convergence with, IFRSs by jurisdiction in the region; (b) to promote consistent application of IFRSs by jurisdictions in the region; (c) to coordinate input from the region to the technical activities of the IASB; and (d) to cooperate with governments and regulators and other regional and international organizations to improve the quality of financial reporting in the region.

One of the important working group that is relevant to the development of Islamic accounting standard is The Working Group on The Financial Reporting relating to Islamic Finance. This group is lead by Malaysia and the working group members are Australia, China, Dubai, Indonesia, Korea, Pakistan, and Saudi Arabia. Unfortunately, the AAOIFI is not joined in this group when this organization has very significant contribution in the development of Islamic accounting standards. The objective of the Islamic Finance Working Group is to facilitate AOSG members providing input and feedback to the IASB on the adequacy and appropriateness of proposed and existing IFRSs to Islamic financial transactions and events. The working group will take into consideration that there may be variation in interpretations and practices of Islamic finance in different jurisdictions.

AAOSG (2010) found that the differing approaches to accounting for Islamic financial transactions can generally be attributed to opposing views on two main points of contention: (a) the acceptability of reflecting a time value of money in reporting an Islamic financial transaction; and (b) the conventional approach of recognising and measuring the economic substance of a transaction, rather than its legal form. Some of the issues in applying IFRS to Islamic financial transactions that have been discussed by the group as follows: (1) recognition of profit in sales contract for murabahah, salam, and istishna; (2) derecognition in sale and buy back agreements (SBBA); (3) the recognition of transaction fees whether all at once or throughout the financing period; (4) the classification of Shirkah-based placements and accounts; (5) Profit Equalisation Reserves (PER) and Investment Risk Reserve (IRR); (6) accounting treatment of Ijarah; (7) Assets transferred to a special purpose entity; (8) Sukuks valuation; (9) Applying IFRS 4 to Takaful; (10) Classification and measurement of Qardh; and (11) Presentation of financial statements of Takaful entities.

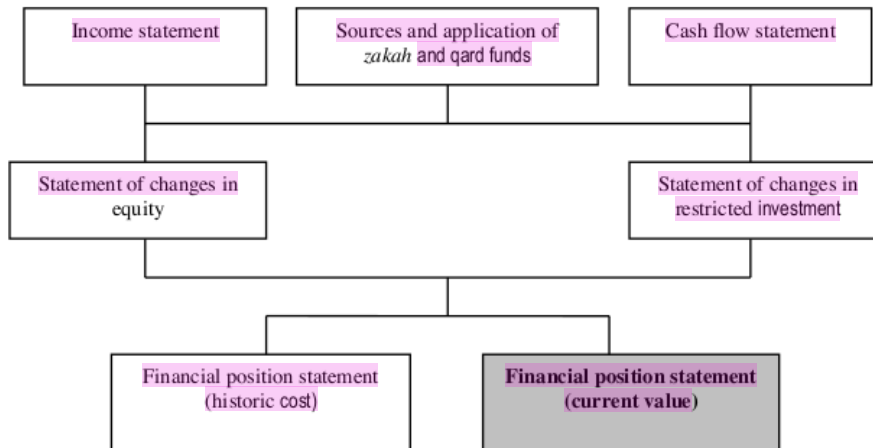
The absent of AAOIFI in the AAOSG Working Group is the weakness for the development of the Islamic accounting standards since they play as the initiator for formulating high-quality standards for Islamic financial institutions. A low level adoption AAOIFI accounting standards should be overcome with the active involvement of AAOIFI by cooperating with countries that develop the Islamic financial industry such as: Indonesia, Malaysia, Pakistan, Dubai, and Saudi Arabia. However, AAOIFI has recognized that some of the approaches in producing Islamic accounting standards were derived from conventional accounting approaches. Thus, many of Financial Accounting Standards (FAS) issued by AAOIFI do not appear conflict with IFRS in that are merely requirements for additional disclosure and presentation.

4. The Alternative Components for Islamic Banking Reports

There are many studies in the way of Islamic institutions report their financial and non-financial accountability to God and stakeholder. Baydoun and Willet (2000) tried to develop a theory about the form and the content of the financial information that should be included in Islamic financial statement. They proposed Islamic corporate reports (ICRs) as the modification of the form of conventional Western set of financial statement. This model used assumptions that Islamic accounting should encourage social accountability and follow a rule of full disclosure based on the Shariah. ICRs can be referred to criticize the framework for financial reports of Islamic banks released by IFASB (Islamic Financial Accounting Standard Board) in two aspects. Some additional information should be included in financial statements and the form of income statement that still adopted Western financial accounting standards (WFASs) needs to be adjusted. They argued that ICRs should be added by current value balance sheets because zakah was levied based on the current value of assets, surplus to the requirements of the firm, and that

current value information was necessary for the calculation of shares in mudharabah contract. Therefore, the components of ICRs, as amended from IFASB form, would be added by financial position statement using current value basis [see figure 1].

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Figure 1: Form of Islamic Corporate Reports as Amended of IFASB



Moreover, Baydoun and Willet (2000) encouraged the substitution of income statement by using Value Added Statement (VAS). The argument of this proposal was that VAS places more emphasis upon the cooperative nature of economic activity and less on competitive aspects. This was consistent with the religious principle of fair and moderate trading contained in Shariah. Baydoun and Willet (2000: 84) argued that VAS' rearranged the information in the income statement, giving more weight to the shares of groups other than owners in the fruits of the firm's activities [See Figure 2].

Figure 2: Baydoun and Willet's Value Added Statement

Value Added Statement	
Sources of Value Added	
Revenue	XXX
Bought in items	(XXX)
Revaluation	XXX
	XXX
Distributions:	
Employees (wages)	XXX
Beneficiaries (<i>Zakat</i>)	XXX
Government (taxes)	XXX
Owners (dividends)	XXX
Charities (<i>Waqf, infaq</i>)	XXX
Reinvest Funds:	
Profit retained	XXX
Revaluation	XXX
	XXX

Source: Baydoun and Willet (2000: 85)

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Haniffa (2002) asserted that Islamic social disclosure practice should be different from conventional social reporting because the information items that need to be emphasized were different. She suggested the use of the Shariah framework in developing Islamic Social Reports (ISRs) that fulfil both accountability and transparency objectives as it addresses the relationship between man and God, man and man, and also man and nature. Haniffa (2000: 136) suggested two objectives and ethical statements of ISRs that were as follows: (a) to demonstrate accountability to God and community; and (b) to increase

transparency of business activities by providing relevant information in conformance to the spiritual need of Muslims decision makers. She also proposed ethical principles and contents of ISR based on five themes: finance and investment, product, employees, society, and environment [see figure 3].

Figure 3: Summary of Ethical Principles and Contents of Islamic Corporate Report

Theme	Ethics	Content
Finance and Investment	Tawhid Halal v Haram Wajib	Riba activities: Identify activities and % profit contribution Gharar activities: Identify activities and % of profit contribution Zakat: Amount and Beneficiaries
Product	Tawhid Halal v Haram	Nature of Product/Service Identify activities and % of profit contribution
Employees	Tawhid Adil Amanah	Wages Nature of work: Religious provisions; Holiday and leave; Working hours Education and Training Equal opportunities
Society	Tawhid Ummah Amanah	Sadaqah: Amount and Beneficiaries Waqf: Type and Value Qard Hassan: Amount and Beneficiaries
Environment	Tawhid Khilafah Mizan Akhirah I'tidal v Israf	Use of Resources: Description and amount Conservation of Environment: Description and Amount Spent

Source: Haniffa (2002: 136)

Hameed and Yaya (2003) tried to elaborate the development of the practices and discussions of the application of social and environmental accountability in Western countries, which were in line to some extent with Shariah principles. The aim of their study is to develop Islamic corporate reporting for any Muslim business organization and particularly for Islamic banks, which are now still searching for a practical form of Islamic accounting. Their study began to expose the characteristics and the problems of mainstream accounting which were stated by Laughlin and Gray (1988) such as: (1) restricted to accounting entities; (2) accounting only for the economic activities that relate to those entities; (3) only recording those economic events which have already or will generate some cash equivalent; and (4) assumed to be for a particular set of individuals typically investors and others with a purely financial interest and involvement with the accounting entity. Then, they explained the problematic issues in accounting according to Gray (1994) such as (1) the extent and ubiquity of its practice; (2) economic consequences; (3) social and socio-political consequences; and (4) environmental implications.

Hameed and Yaya (2003) searched the alternative accounting practices from the previous researches: potential social responsibility (Bowen, 1953), the lack of the level of social responsibility exercised by American corporations (Drucker, 1965), potential link between social responsibility and accounting (Linowes, 1972), social responsibility accounting adopted by Deutsche Shell Reports (Schreuder, 1979), environmental accountability (Perks, 1993), employee related reporting (Gray, 1996), and value added report (Belkaoui, 1999).

Hameed and Yaya (2003) tried to evaluate the contemporary accounting and reporting for Muslim business organizations. They reviewed four annual reports from Islamic banks in Malaysia and Indonesia especially in the context of Shariah, social, and environmental disclosures. They concluded that Shariah, social, and environmental disclosures were not sufficiently reported by the existing Islamic institutions. The disclosures were only at the stage of explanatory notes. This was only like news reports on the activities without being accompanied with the plan to achieve the better performance in Shariah compliance and social-environmental objectives.

In light of these results, this paper scrutinizes broader perspective of Islamic banking reporting that involved many aspects that are relevant to the development of ideal format for Islamic banking reporting. This idea comes from the assumption that Islamic banks around the world do not have standardization in reporting model, even AAOIFI as the initiator in the development of accounting standards for Islamic financial institutions does not have authority to encourage Islamic banks to implement its standards. Moreover, the attempts of International Accounting Standards Board (IASB) in promoting International

Financial Reporting Standard (IFRS) would affect the AAOIFI's roles since Islamic banks will choose the more appropriate and relevant accounting standards for their future development and the relation with other institution.

Therefore, this paper will cover many disclosure issues in Islamic banks such as the accounting standards that are used by some Islamic banks in Middle East and in other areas in Asian region, the content of annual report both financial and non-financial issues including Shariah, social, and environmental disclosures. Moreover, the discussion regarding harmonization or standardization of accounting standards for Islamic banks is also relevant in order to understand the challenges, faced particularly by AAOIFI.

5. Accounting Policies For Islamic Banks In Some Countries

The AOSSG Islamic Finance Working Group (2015) conducts survey on the financial reporting practices by Islamic financial institutions in 31 countries. They found that there are at least four types of underlying accounting standards which are used to produce financial statements based on the following criterias: Firstly, some of the Islamic financial institutions are fully comply with IFRS for example the Islamic financial institutions in Albania, Australia, Kazakhstan, Malaysia, South Africa, Switzerland, Saudi Arabia and United Arab Emirates (UAE).

Secondly, the Islamic financial institutions adopted IFRS as a specific jurisdiction for example in some financial statements included a statement of compliance with IFRS as adopted the jurisdiction, e.g. "IFRS as adopted by the EU", "IFRS as adopted by the State of Kuwait" or "IFRS which were translated into the Bosnian language".

Thirdly, the Islamic financial institutions use local generally accepted accounting principles (GAAP) – If the financial statements included a statement of compliance with local GAAP; or if it included a statement of compliance with IFRS but with a departure(s) to comply with local law. For example: Bangladesh that they stated that they complied with Bangladesh Financial Reporting Standards (BFRS), central bank directives and AAOIFI FAS. Another example is Pakistan that they comply to the Securities and Exchange Commission of Pakistan (SECP) directives for Islamic financial institutions to comply with Islamic Financial Accounting Standards (IFAS) issued by the Institute of Chartered Accountants of Pakistan (ICAP).

Fourthly, the Islamic financial institutions are fully comply with AAOIFI Financial Accounting standard (FAS) for example some Islamic financial institutions in Bahrain, Jordan, Lebanon, Oman, Qatar, and Sudan.

It seems that the adoption of IFRS in the Islamic financial institutions is broader than AAOIFI FAS. This might be happen because might be many standard-setters, regulators and Islamic financial institutions do not share AAOIFI's views on accounting or what constitutes compliance with shariah. Hence, AAOIFI FAS are not universally accepted. On the contrary, IFRS are the more commonly used standards for financial reporting by Islamic financial institutions.

Islamic banks do not have similarity in accountability process especially if we compare one country to another country although AAOIFI has proposed detail standards in recording and reporting financial statements. Indonesia and Malaysia are two countries that have close relationship in the development of Islamic banks. However, both countries have different approaches in developing accounting standard for Islamic bank and financial institutions. In Indonesia, IAI (Indonesian Accountants Association) had launched Shariah Statement of Financial Accounting Standards (PSAK Syariah) in 2007. They tried to separate "Conventional SFAS" and "Shariah SFAS" into two different block numbering. "Conventional SFAS" uses block number 1 – 100, while "Shariah SFAS" uses block number 101 – 200. They also proposed a new conceptual framework of presentation and disclosure of financial statement that based on Shariah principles (KDPPLKS). Up to the beginning of 2014, they have made 10 "Shariah SFASs" as follows:

1. PSAK 101 : The Presentation of Shariah Financial Statement
2. PSAK 102 : Accounting for Murabahah
3. PSAK 103 : Accounting for Salam
4. PSAK 104 : Accounting for Istishna

- | | |
|--------------|---|
| 5. PSAK 105 | : Accounting for <i>Mudharabah</i> |
| 6. PSAK 106 | : Accounting for <i>Musharakah</i> |
| 7. PSAK 107 | : Accounting for <i>Ijarah</i> |
| 8. PSAK 108 | : Accounting for <i>Takaful</i> |
| 9. PSAK 109 | : Accounting for <i>Zakah, Infaq, and Sadaqah</i> |
| 10. PSAK 110 | : Accounting for <i>Sukuk</i> |

Indonesian accounting standards for Islamic banks and financial institutions are almost the same as AAOIFI Standards except Accounting for Zakah, Infaq, and Shadaqah. This happens because the development of public and private amil zakah institutions in Indonesia that need certain accounting standard in recording and reporting the zakah management.

On the other hand, Malaysia stated that they are complying with IFRS. But they also issued specific Islamic accounting standards through Malaysian Accounting Standard Board (MASB) at released FRSi – 1 (2004) on Presentation of Financial Statements of Islamic Financial Institutions. This standard is the first Islamic accounting standard issued by the MASB. The aims of this standard are: (a) to provide guidance for preparers in preparing a complete set of financial statements for users, investors, depositors, and other stakeholders in their decision-making; (b) to harmonize accounting practices especially in areas where Shariah rules allow for different accounting treatments and alternatives; (c) to bridge the gap or areas where the IAS' and AAOIFI's Islamic Accounting Standards have not been able to address; (d) to ensure comparability of operational and financial performance of all IFIs; and (e) to promote healthier growth of the Islamic capital market.

Bahrain has fully complied with the AAOIFI standards. At least, the information of the adoption could be showed in Bahrain Islamic bank annual report particularly in accounting policy. On the other hand, Pakistan did not follow AAOIFI standards and tend to implement IAS and IFRS by several adjustments for transactions such as *Murabahah, Ijarah, Musharakah, Diminishing Musharakah, Istishna* and Export Refinance under Islamic Export Refinance scheme.

Pakistan formally complies with international accounting standards as stated in the section 234 (3)(i) of the Companies Ordinance, 1984:

"...such International Accounting Standards and other standards shall be followed in regard to the accounts and preparation of the balance-sheet and profit and loss account as are notified for the purpose in the official Gazette by the Commission."

In addition, The Securities and Exchange Commission of Pakistan (SECP) requires companies under its purview to comply with Islamic Financial Accounting Standards (IFAS) issued by the Institute of Chartered Accountants of Pakistan (ICAP), namely: IFAS 1, *Murabaha*, through a Notification dated 24 August 2005; and IFAS 2, *Ijarah*, through a Notification dated 22 May 2007.

Furthermore, SBP in its Strategic Plan for Islamic Banking Industry in Pakistan (2014 – 2018) has indicated that it supported the issuance of further Islamic accounting standards:

The existing applicable financial accounting and reporting architecture is based on conventional banking & finance transactions, whereas Islamic banking is substantially different from conventional banking. In order to cater to the peculiarities of Islamic banking & finance, SBP will continue to collaborate and work closely with ICAP in issuing financial accounting and reporting standards for the industry.

8 Bangladesh Bank issued Guidelines for Conducting Islamic Banking in November 2009. Paragraph 3.4 states that:

The reporting institutions are required to comply with the disclosure requirements of the Securities and Exchange Rules 1987, Dhaka and Chittagong Stock Exchange Listing Regulations and other laws and rules applicable in Bangladesh.

Rule 12(2) of the cited Securities and Exchange Rules 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] ...

ICAB has adopted IAS and IFRS as Bangladesh Financial Reporting Standards (BFRS). However, some aspects of IAS 39 have not been adopted.

Despite the requirement to comply with BFRS, there are several Islamic banks in Bangladesh that assert compliance with both BFRS and AAOIFI FAS. AOSSG (2015) found that Al-Arafah Islami Bank Limited and Islami Bank were comply with BFRS and AAOIFI FAS. Al-Arafah Islami Bank Limited stated that BAS/BFRS were applied “to the extent that these do not contradict with the applicable statutory provisions and standards issued by the Accounting and Auditing Organisation for Islamic Financial Institutions”. On the other hand, Islami Bank stated that its consolidated and separate financial statements had been prepared in accordance with Bangladesh Bank circulars, IFRS adopted as BFRS, securities law, exchange regulations and “Standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), as a member of that organization”.

Furthermore, the Central Bank of Kuwait (CBK) issued Instructions to Islamic Banks No. 26, The Bases of Preparing Closing Financial Data of Islamic Banks, which reinforced a resolution by the Ministry of Commerce and Industry to comply with IFRS. Article 1 of the resolution states:

Companies and establishments of all legal constitutions are required to prepare their financial data in accordance with the International Accounting Standards issued by the International Accounting Standards Committee...

All Islamic banks in Kuwait asserted compliance with ‘IFRS as adopted by the State of Kuwait’ complied with IFRS except for the IFRS 39 requirement on collective provisions. This is because CBK requires all licensed financial institutions to provide reserves based on general provisioning.

In Qatar, Qatar Central Bank (QCB), through its Instructions to Banks issued in November 2011, required Islamic banks to apply AAOIFI FAS:

The Islamic banks should implement the accounting standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), as relevant to the accounting policies and treatments, preparing the financial statements and the related disclosures.

Another directive, Circular No. 93/2012, Consolidated Financial Statements for Islamic Banks, provided illustrative AAOIFI-compliant consolidated financial statements that all Islamic banks must comply with for the year ended 31 December 2012.

The Saudi Arabian Monetary Agency (SAMA) requires insurance companies and banks to comply with IFRS. The Board of the Capital Market Authority (CMA) has issued a resolution that exempts listed banks and insurance companies from preparing their interim and annual accounts in accordance with Saudi Organization for Certified Public Accountants (SOCPA) standards as mandated under the listing rules and to use, alternatively, IFRS standards.

Therefore, we can see that some countries where Islamic banks are operated do not have similarity in implementing accounting standards. However, this paper does not intend to uncover the reasons behind the implementation of those accounting standards.

6. The Disclosure Evaluation of Selected Islamic Banks

This section will analyse and evaluate the current reporting format in 5 Islamic banks in Middle East such as Saudi Arabia, Bahrain, United Arab Emirates (UAE), Kuwait, and Qatar, and 4 Islamic Banks in Asia such as Pakistan, Malaysia, Bangladesh and Indonesia. The main source of this evaluation is the annual report of 2008 that can be accessed through their official websites. Gray et al. (1995) argued that the annual report is not only a document produced regularly to comply with regulatory requirements, but also central to the organization’s construction of its own external image. In addition, annual reports are more accessible for research purposes and are used by a number of stakeholders as the sole source of certain information (see also Woodward, 1998).

The analysis consists of the types of statement or notes to disclose and the discussion of each report. The discussions will be divided into three sections. Firstly, Section 1 discusses about accounting standards that are followed by some Islamic banks in Middle East and Asia and the types of conventional financial reports that are disclosed in their annual reports. Secondly, Section 2 discusses the additional financial reports that are recommended by AAOIFI and local accounting standards in some countries regarding the important information for the stakeholders of Islamic banks. Thirdly, Section 3 discusses the additional of non-financial reports such as some information that are related to social responsibilities, human resources development, community development activities, and report of Shariah Supervisory Board (SSB). Fourth, last section discusses the audit firm in charge in Islamic banks that are observed. This could be relevant to examine the possible reasons of Islamic banks in implementing accounting standards. The figure 4 will compare the presentation and disclosure in selected Islamic banks [See Figure 4]:

Figure 4: The Disclosure Evaluation of Selected Annual Reports of Islamic Banks

No.	Types of statement or notes to disclose	Al Rajhi Saudi Arabia	Bahrain Islamic Bank	Dubai Islamic Bank	Kuwait Finance House	Qatar Islamic Bank	Meezan Bank Pakistan	Bank Islam Malaysia	Islamic Bank Bangladesh	Bank Syariah Mandiri (Indonesia)	Additional Information (See discussion)
1	Accounting Standards	IFRS & SAMA	AAOIFI	IFRS	IFRS	AAOIFI	IFRS	IFRS & MASB	IFRS	PSAK (SFAS) Shariah	Section 1
2	Conventional financial reports*	√	√	√	√	√	√	√	√	√	Section 1
3	Statements of Changes in Restricted Fund (<i>Mudharabah Muqyyadah</i>)		√							√	Section 2.1
4	Statements of Reconciliation of Revenue and Profit Sharing									√*	Section 2.2
5	Disclosure on sources & uses of fund in Zakat	√*	√	√*	√*	√*	√*	√*	√*	√	Section 2.3
6	Disclosure on sources & uses of fund in Qard		√							√	Section 2.4
7	Disclosure of profit or loss sharing calculation (<i>mudharabah mutlaqah</i> deposit)		√*		√*	√*					Section 2.5
8	Analytical Financial Reports About Earning or Expenditures Prohibited by the <i>Shariah</i>		√*								Section 2.6
9	Reports Concerning the Islamic Bank's Fulfilment of Its Social Responsibilities	√	√*			√*		√*		√	Section 3.1
10	Reports about the development of Islamic Bank's human resources	√*			√*	√*	√*	√		√	Section 3.2

1 1	Disclosure on community development activities					√*		√			Section 3.3
1 2	Reports of the Shariah Supervisory Board		√			√	√	√		√	Section 3.4
1 3	Auditors in charge	E & Y PWC	E & Y	Local audit firm	E & Y Deloitte	PWC	KPMG	KPMG	Local audit firm	Local audit firm	Section 4

Sources: Al Rahji (Annual Report 2008), Bahrain Islamic Bank (Annual Report 2008), Dubai Islamic Bank (Annual Report, 2008), Qatar Islamic Bank (Annual Report, 2008), Meezan Bank Pakistan (Annual Report, 2008), Bank Islam Malaysia (Annual Report, 2008), Islamic Bank Bangladesh (Annual Report, 2008), and Bank Syariah Mandiri (Annual Report 2008).

√* = not fully disclosed

6.1 Discussions Section 1.

From the figure 11 figure 5, only two Islamic banks particularly in Bahrain and Qatar that clearly followed AAOIFI accounting standards. In addition, Indonesian Islamic banks follow the local accounting standards that are called Shariah SFAS. However, some contents of its standards are very much the same as AAOIFI accounting standards by some adoptions. The others stated that they have produced financial reports based on IFRS although they still use some local accounting standards that are relevant to their operation. These facts show that the IFRS could challenge the roles of AAOIFI since the globalization has forced Islamic financial institutions to follow the IASB agenda based on the reasons of the need for standardization of financial reports (Shahul Hameed, 2007). Therefore, AAOIFI should approach IASB to discuss the possibility of harmonization of international accounting standards for Islamic financial institutions. AAOIFI must have strong position in debating the rationale of international accounting standards. The set of AAOIFI's accounting standards indicates that Islamic financial institutions should treat Islamic mode of transactions differently.

Another fact from the figure shows that all Islamic banks observed use financial information as the main sources of reporting especially the existing conventional financial reports. However, several things are interesting to discuss especially the modification of conventional financial reports in accordance with Shariah principles and product characteristics. Firstly, Bahrain, Qatar and Indonesian Islamic banks are almost the same in the process of preparing financial reports. Both of them try to modify balance sheets by changing the accounting equation based on AAOIFI prescription. The accounting equation would be: [see also figure 5]

Assets = Liabilities + Unrestricted Investment Accounts + Equity

Figure 5: ABC Islamic Banks Balance Sheet 31 December 2008

SETS	(amount)	(sub total)	(total)
Cash and balance with central bank		xx	
And other banks		xx	
Accounts Receivables:		xx	
<i>Murabahah</i> receivables	xx		
<i>Salam</i> receivables	xx		
<i>Istisna</i> receivables	xx		
<i>Ijarah</i> rental receivables	xx		
<i>Mudharabah</i> investment		xx	
<i>Musyarakah</i> investment		xx	

Investments		xx	
Investments in associates		xx	
Investments in <i>Ijarah</i> assets		xx	
<i>Ijarah muntahiya bittamleek</i>		xx	
Other assets		xx	
TOTAL ASSETS			xx
LIABILITIES, SYIRKAH TEMPORARY FUND, AND EQUITY			
LIABILITIES			
Customers' current account		xx	
Other liabilities		xx	
TOTAL LIABILITIES			xx
UNRESTRICTED INVEST. ACCOUNTS			
Customers' Current Account (<i>mudharabah</i>)		xx	
Deposit (<i>mudharabah</i>)		xx	
TOTAL SYIRKAH TEMPORARY FUND			xx
EQUITY			
Share capital		xx	
Share premium		xx	
Retained Earning		xx	
Proposed appropriations		xx	
TOTAL EQUITY			xx
TOTAL LIABILITIES, SYIRKAH TEMPORARY FUND, AND EQUITY			xx

Source: Bahrain Islamic Bank (2008)

Unrestricted investment accounts are the account that accommodates the partnership contracts such as: mudharabah saving and deposit accounts. The mudharabah contract cannot be recognized as liabilities or equity as well. Meanwhile, Ayub (2007: 81) argued that the assumption of business risk was a precondition to any profit over principal. The important Shariah maxim: "Al kharaj bi-al-Daman" or "Al Ghunm bil Ghurm" was the criterion of legality of any return on capital, meaning that one has to bear the risk of loss, if any, if he wants to get any profit over his investment. Baydoun and Willet (2000: 76) asserted that the major conceptual difference between Islamic corporate reports (ICRs) and Western financial accounting statements (WFASs) was in the special treatment of unrestricted mudharabah and other investments as a separately identifiable category of assets and funds accounts, which has partly the characteristics of equity and partly those of liabilities. Moreover, mudharabah saving/deposit accounts holders cannot be classified as shareholders of the companies that have voting rights and the profit realization, both from current and other non-investment accounts. Because of that, the accounts then separate into special accounts in order to make a clear position of mudharabah account holders. On the other hand, Islamic banks in Pakistan and Malaysia still use the existing conventional accounting equation.

Secondly, Islamic banks in Bahrain, Qatar and Indonesia also try to modify the component of income statements especially using return on unrestricted investment accounts [see figure 6].

Figure 6: ABC Islamic Bank Income Statement for the year ended 31 December 2008

INCOME	(amount)	(sub total)	(total)
Income from Islamic finance (bank as a mudarib):			
Revenue from sales financing		xx	

Murabahah margin	xx		
Salam margin	xx		
Istisna margin	xx		
Revenue from leasing financing		xx	
Revenue from Ijarah	xx		
Revenue from investment financing		xx	
Mudharabah profit sharing	xx		
Musyarakah profit sharing	xx		
Other revenue		xx	
Total income from Islamic financial transactions			xx
Return on unrestricted investment accounts before			
bank's share as a mudarib		xx	
Bank's share as a mudarib	(xx)		
Return on unrestricted investment accounts			xx
6			
Bank's share of income from unrestricted investment accounts (as a Mudarib and Rab al-mal)			xx
Income from investment		xx	
Gain on fair value adjustment for investments in properties		xx	
Share of results of associates		xx	
Other income		xx	
TOTAL INCOME			xx
EXPENSES			
Staff costs		(xx)	
Depreciation		(xx)	
Other expenses		(xx)	
TOTAL EXPENSES			(xx)
Net income before provision			xx
Provisions			(xx)
NET INCOME FOR THE YEAR			xx

Source: Bank Syariah Mandiri 2008 (modified)

Mudharabah accounts holders have certain percentage of profit/revenue distribution from their investment. They do not categorize this account as an expense because the return actually is the right of mudharabah accounts holders. This condition is relevant to the definition of expense (FASB, 1975) as follows:

"Expenses are outflows or other using up of assets or incurrence of liabilities (or combination of both) during a period from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's major or central operation."

6.2 Discussions Section 2.

The discussions on section two is based on the figure above that is related to the additional statement or notes to disclosure which exclude the existing conventional financial reports. Bahraini and Indonesian Islamic banks seem to encourage their management to close the Shariah principles especially in producing financial reports related to several Islamic contracts and business transactions. We can find interesting findings in modifying financial reports as follows:

6.2.1. Statements of Changes in Restricted Fund (Mudharabah Muqayyadah)

Figure 7:
ABC Islamic Bank Statement of Changes in Restricted Investments
for the Year Ended 31 December 2008

Investment at beginning of year		xx
Additional restricted investment fund	xx	
Profit from investment activities	xx	
Profit portion and fees for Islamic bank	(xx)	
Withdrawal of restricted investment fund (by owner)	(xx)	
Investment at the end of year		xx

Source: Bank Syariah Mandiri (2008) (modified)

This report represents the changes of restricted fund based on mudharabah muqayyadah contract, which is managed by Islamic bank as an investment agent [see Figure 7]. Islamic bank will receive fee from the operation as other operational incomes. From the figure above, only Bahraini and Indonesian Islamic banks have produced this report. This policy is also along the lines with AAOIFI standard particularly statement of changes in restricted investments (FAS 1 Paragraph 61 – 64). The AAOIFI standard explained that:

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 portfolio by type (par. 62)

6.2.2. Statements of Reconciliation of Revenue and Profit Sharing

Figure 8:
Statements of Reconciliation of Revenue and Profit Sharing ABC Islamic Bank
In the period of January 2010

The number in the figure below only the assumption.

	(amount)	(amount)
Revenue from main operations (Accrual Basis)		2.000.000
Deduction:		
<i>Revenue in this period, which the cash is not already received:</i>		
<i>Revenue from Murabahah margin</i>	(300.000)	
<i>Revenue from Istisna margin</i>	(200.000)	
The rights of profit share:		
<i>Mudharabah investment</i>	(275.000)	
<i>Musyarakah investment</i>	(225.000)	
<i>Rental revenues</i>	(500.000)	
Total Deduction		(1.500.000)
Addition:		
Revenue from the previous period, which the cash is received in this period:		
Revenue from account receivables payment:		

Murabahah margin	(100.000)	
Istisna margin	(300.000)	
Rental revenues	(200.000)	
Revenue from investment activities:		
Mudharabah investment	(150.000)	
Musyarakah investment	(250.000)	
Total Addition		1.000.000
Revenue available to be distributed*		1.500.000

*The assumption is using Revenue Sharing concept based on fatwa of Indonesian Ulama Council (MUI) No. 15/DSN – MUI/IX/2000. Source: Indonesian Shariah SFASs (2007)

The terminology of this statement comes from the Indonesian financial accounting standard issued by IAI (Shariah SFAS No. 101) about Presentation of Shariah Financial Statements. This statement is based on the basic assumption of accrual basis in transactions recognition. Therefore, when Islamic banks want to share their revenue or profit to the mudharabah saving/deposit accounts holders, the calculation should be converted into cash basis calculation. This conversion occurs because the banks cannot distribute the revenue/profit that has not been really received. On the other hand, they cannot share revenue/profit based on “accrual basis calculation”. This statement tries to eliminate the income that is based on accrual basis calculation and recognize the income that has received in the period of financial statement.

From the observation of Islamic banks reports, all of them do not disclose the statement of reconciliation revenue and profit sharing, even Bank Syariah Mandiri. The possible reason is that the disclosure of profit distribution calculation has shown that they have calculated the cash basis revenue. However, the disclosure is not enough because the customers, especially mudharabah saving/deposit accounts holders would want to make sure that their share is calculated properly.

6. 2.3. Disclosure on sources and uses of fund in Zakah

Ideally, zakah accountability should be separated from other sources and distributions. Surah At Taubah: 60 states there are eight categories (mustahiq) that have rights to receive zakah funds [see figure 9].

Figure 9: ABC Islamic Bank The Report of Sources and uses of Zakat Fund For the year ended 31 December 2008

Sources of Zakat Fund	(amount)	(sub total)	(total)
Zakah from the internal of Islamic bank	xx		
Zakah from the external of Islamic bank	xx		
Total sources of fund		xx	
Uses of Zakat fund			
Fakir	(xx)		
Miskin	(xx)		
Amil	(xx)		
Muallaf	(xx)		
Ghorimin	(xx)		
Riqob	(xx)		
Fii sabilillah	(xx)		
Ibnu Sabil	(xx)		
Total uses of fund		(xx)	
Total – uses of Zakah fund (x)			xx
Beginning Balance, 1 January 2008			xx

Ending Balance, 31 December 2008			xx
----------------------------------	--	--	----

Source: Indonesian Shariah SFASs (2007)

From the brief evaluation, all of Islamic banks disclose the sources of zakah funds with some differences level of disclosures. The Islamic banks from Saudi Arabia and Bangladesh stated that the payment of zakah is on behalf of their shareholders and depositors. However, both banks are only reported the amount of the source of zakah fund without proper explanation about the disbursement. On the other hand, Kuwait Finance House (KFH) shows zakah payment in income statement based on the local regulation regarding Zakah Law Number 46 Year 2006. Dubai Islamic Bank has reported the Zakah computation based on following basis such as: (a) Zakah on shareholders' equity is deducted from their dividends; (b) Zakah on profit equalization provision is charged to this provision after it has been calculated; (c) Zakah is disbursed by a committee appointed by Board of Directors; and (d) Zakah on the paid in capital is not included in Zakah computation and is payable by the shareholders themselves.

In addition, Meezan Bank Pakistan also explains the zakah payment. However, the number and the distributions are not clearly disclosed. The statement of zakah payment has shown in the auditors' report as stated:

In our opinion Zakah deductible at source under the Zakah and Ushr Ordinance, 1980 (XVIII of 1980), was deducted by the Bank and deposited in the Central Zakah Fund established under section 7 of that Ordinance.

Bahrain Islamic Bank and Bank Syariah Mandiri disclose separately zakah and qard funds sources and distributions. The difference is that Bahrain Islamic Bank tries to distribute zakah fund by itself, whereas Bank Syariah Mandiri develop a new amil zakah institution, named LAZ BSM Ummat, to distribute zakah. There is questionable component in Bahrain Islamic Bank Zakah report because some non-Islamic income sources were found in the report. However, there is no explanation about the status of the fund.

Bank Islam Malaysia reports the zakah payment in income statement after profit (loss) before zakah and tax payment. However, there is no specific report that explains the sources and distributions of zakah funds. However, they present several news related to activities in distributing zakah through the Selangor Zakah Centre and Majelis Agama Islam.

Bahrain Islamic Bank has changed the treatment of Zakah from the year 2005 [see figure 10]. Instead of charging it to the statement of income as an expense, it is now treated as a payment on behalf of shareholders and therefore as an appropriation from the retained earnings (Adnan & Bakar, 2008). This statement is also inline with the practices of some Islamic banks like Al Rahji and Islami Bank Bangladesh.

This report is interesting since zakah is one of the important Islamic teachings. Islamic banks should also promote the professional management of zakah fund in order to encourage Muslim shareholders and depositors to pay zakah as the obligation for every qualified Muslim individual. However, most of Islamic banks observed are not aware regarding this issue. Some practitioners argued that it was not required by accounting standards or local regulations. Islamic banks seem only follow mandatory requirements rather than considering some important issues that are accordance with Shariah principles.

Figure 10: ABC Islamic Bank Statement in Changes in Equity for the year Ended 31 December 2008

	(amount)	(sub total)	(total)
Balance at 1 January 20xx			xx
Right shares issued		xx	
Bonus shares issued	(xx)		
Dividends paid	(xx)		
Directors' remuneration paid	(xx)		
Zakah paid	(xx)		
Net income for the year			xx
Transfer to statutory reserve	(xx)		
Unrealized gain on investments in properties			

Realized gain on investments in properties			
Net movement in cumulative changes in fair values			xx
Appropriations			
Balance at 31 December 2007			xx

Source: Bahrain Islamic Bank 2008 (modified)

20

6.2.4. Disclosure on sources and uses of fund in Qard.

AAOIFI – Statement of Financial Accounting No. 2 – Concepts of Financial Accounting for Islamic Banks and Financial Institutions – paragraph 61

“The fiqh definition of Qard is a non-interest bearing loan intended to allow the borrower to use the loaned funds for a period of time with the understanding that the same amount of the loaned funds would be repaid at the end of the period. An Islamic bank may organize a fund for Qard as a means of achieving social objectives”.

The sources of this fund can be received from the allocation of bank’s capital or owner’s policy. Banks can also use the collections of loans during the period or funds deposited in the fund by individuals on a temporary or permanent basis.

From the analysis of the annual reports of Islamic banks observed, only Bahrain Islamic Bank and Bank Syariah Mandiri disclose this clearly. Bank Syariah Mandiri discloses the sources of the qard funds which come from penalty charges imposed to undisciplined customers and interest from conventional banks when they involve in unintentional transactions. Then, they transfer the qard fund into an Islamic social organization to help poor people or the development of public infrastructures (especially from prohibited funds). On the other hand, Bahrain Islamic Bank discloses the sources of the qard funds, which come from donation and contribution by bank. The funds are used for helping marriage, refurbishment, and medical treatment.

6.2.5. Disclosure of profit distribution calculation (mudharabah mutlaqah deposit)

FAS No. 1 AAOIFI explains the disclosure of the distribution of unrestricted investment accounts and their equivalent and other accounts in accordance with their respective periods to maturity. Paragraph 18 of this standard describes that:

“Disclosure should be made in the financial statements of the distribution of unrestricted investment accounts and their equivalent and other accounts, by type, in accordance with their respective periods to maturity, from the date of Statement of Financial Position. The Islamic bank’s disclosure should differentiate between demand accounts and other accounts. With respect to non-demand accounts, the bank should use for the purpose of this disclosure, maturity periods designed to disclose liquidity requirements during the next period and liquidity requirements during the following periods. Maturity periods should be consistently used and changes in the maturity periods used by the bank should be disclosed.”

20

Additionally, paragraph 27 explains the disclosure of the method used by the Islamic bank to allocate investment profits (losses) between unrestricted investment account holders or their equivalent and the Islamic bank as a Mudarib or as an investment manager whether or not participating in the investments with its own funds. The complete explanation is as follows:

“Disclosure should be made in the financial statements of the method(s) used by the Islamic bank to determine the share of unrestricted investments in the profit (losses) of the period. Disclosure should also be made of the returns of each type of investment accounts and their rate of return”

20 Based on both paragraph, it indicates that Islamic banks should disclose the detail calculation of the distribution of unrestricted investment accounts and the method to calculate rate of return of each investment. Bahrain Islamic bank shows the most complete disclosure in this report [see figure 11].

Figure 11: Calculation of Profit Distribution ABC Islamic Bank in the period of July 2008

(Assumption: Wadiah fund is included in calculation)

Deposit Fund	Daily Average Balance	Revenue	Portion for Depositor (return equivalent per year)			Portion for Bank (return equivalent per year)		
			Nisbah	Revenue	Return	Nisbah	Revenue	Return
	A	B	C	D (B x C)	%	E	F (B x E)	%
<i>Wadiah</i>	70.000.000	525.000	Bonus			100	525.000	
Current Account	30.000.000	225.000	45	101.250	4,10625	55	123.750	5,01875
Mudharabah Deposits Account:								
1 Month	20.000.000	150.000	65	97.500	5,93125	35	52.500	3,19375
3 Months	10.000.000	75.000	66	49.500	6,02250	34	25.500	3,10250
9 Months	15.000.000	112.500	66	74.250	6,02250	34	38.250	3,10250
12 Months	5.000.000	37.500	63	23.625	5,74875	37	13.875	3,37625
Total	150.000.000	1.125.000		346.125			778.875	

Source: Indonesian Islamic bank (unpublished)

Its annual report describes the accounting policy for all unrestricted investment account holders and the calculation of rate of return for each type of investment. The calculation is also comparing the condition in the previous year in order to know the growth of rate of return year to year. On the other hand, Bank Syariah Mandiri only disclosed the result of profit distribution for unrestricted investment account holders without detail calculation of the rate of return for each type of investment. Bank Syariah Mandiri explained the method in distributing the share that based on revenue sharing. It means that they distribute the revenue before deducting the operational expenses. In addition, Kuwait Finance House, Qatar Islamic Bank, and Bahrain Islamic Bank do the same thing. However, they added the information with the policy of profit distribution for unrestricted investment account holders and the result of percentages of each type of account.

Actually, this information is not sufficient because one of the main characteristics of Islamic banks is equity sharing based on real productivity (Ahmad, 2000). However, there are facts that most of the Islamic banks observed have not disclosed this information properly.

6.2.6. Analytical Financial Reports About Earning or Expenditures Prohibited by the Shariah

Hameed and Yaya (2003) explain that this information used to communicate income earned by Islamic financial institutions from prohibited transactions or sources and expenditures prohibited by the Shariah and how those earnings were disposed. In this case, users of financial statement may be interested in detailed financial reports. Such reports may include information about the reasons for such earnings, their source, how they were disposed of and procedures established to prevent entering into transactions prohibited by the Shariah.

From the analysis of the annual reports of Islamic banks, only Bahrain Islamic Bank and Bank Syariah Mandiri disclose the information about the earning from prohibited by Shariah. However, both of them do not make special statement of earnings or expenditures prohibited by the Shariah. Bank Syariah Mandiri shows those earning in the sources and uses of fund in Qard. This bank explained that the non-halal income is received from the unintentional transaction with conventional bank because of special case. Thus, it cannot be recognized as the revenue of Islamic bank since it comes from haram source (interest). On the other hand, Bahrain Islamic Bank only explains the policy of recognition of non-Islamic source as follows:

“Accordingly, all non-Islamic income is credited to a qard fund account where the Group uses these funds for various social welfare activities. The movements in these funds are shown in statement of

sources and uses of good faith qard fund. The non-Islamic income includes the penalties charged on late repayments for Islamic facilities.”

6.3. Discussions Section 3.

The discussions in section three covers the issues of corporate social responsibilities, the development of human resources and welfare, community development activities, and reports of the Shariah Supervisory Board. The discussions are as follows:

6.3.1. Reports Concerning the Islamic Bank’s Fulfilment of Its Social Responsibilities

Most of the Islamic banks observed reported their social activities in the annual reports although they provide different level of disclosure. However, there is no Islamic bank that reports completely regarding this issue that involves financial and non-financial reports of social responsibilities. This might be because there is no benchmark for social responsibilities evaluation from outside or independent parties. Currently, Dinar Standard, Dar Al Istithmar, which is supported by AAOIFI, have tried to organize the Social Responsibility Survey of Islamic Financial Institutions. The survey seeks to benchmark the initiatives of Islamic Financial Institutions contributing to building a truly Islamic conception of business that seeks to balance profit motives with societal development. However, this survey is based on voluntary self-assessment surveys, which still have some weaknesses in its implementation. At least, this attempt should be highly appreciated as the effort for encouraging the awareness of Islamic financial institutions regarding the social responsibilities issues.

From the annual reports observed, Bahrain Islamic bank clearly explains the policy in allocating a certain percentage of its annual profits to social causes since its inception in 1979. The bank plays a significant role in the development and improvement of Bahraini society at all level today and will continue to do so to the best of its ability. However, they do not give detail information about the number and the distribution of profit through social responsibility activities. The bank implicitly explained that any income from non-Islamic source and zakah could be claimed as the sources for funding social responsibility activities.

Conversely, Bank Islam Malaysia did different thing. They tried to show social responsibility activities by describing several activities such as supporting education at all level, and building mosque and religious schools. This bank also claimed that zakah as the sources for funding social responsibility activities because the bank was appointed as agent for zakah collection for all states in Malaysia.

Al Rajhi Bank manages many permanent social activities such as: (a) Creation of an Anti-Smoking Clinic; (b) Providing residence and medical equipment for needy patients; (c) Patient Evacuation Scheme; (d) Mobile Diabetic Blindness Combat Campaign Scheme; and (e) Orientation program for children covered by Social Security. All the projects were reported with total amounts of each program.

Qatar Islamic Bank, Kuwait Finance House, Meezan Bank Pakistan, and Bank Syariah Mandiri did not report social responsibility activities clearly. However, from the information above, we can conclude that the understanding of social responsibility report is different between Islamic banks. Bahrain Islamic bank and Bank Islam Malaysia describe zakah as a part of social responsibility although zakah actually is the obligation of every qualified Muslim individually.

6.3.2. Reports about the development of Islamic Bank’s human resources

Almost all Islamic banks observed only report the development of Islamic banks human resources in the form of news report. There is no detail information including budget allocation for improving human resources welfare and education. However, Meezan Bank Pakistan is the most comprehensive in reporting the employee’s welfare. It disclosed statement of value added and distributed that consist of value added sources (profit, fee, commission, dividend income, and other incomes) and value added allocation (to depositors/financial institutions, to employees, to shareholders, to government and to expansion). This report seems to Baydoun and Willet (2000) suggestion for including Value Added Report as one of the element of Islamic Corporate Report.

6.3.3. Disclosure on community development activities

The report consists of information of the activities in society surrounding company in order to increase the welfare of society. The activities can be organized by empowering society in several real economic activities such as farming, fishing, gardening and handcrafting.

Interestingly, Qatar Islamic Bank provides special page in annual report about strategic partnership with the society. However, the information is still minimal since it only shares the general information regarding the policies of social empowerment without detail program and budget. In addition, the source of the program of social empowerment is partly from zakah. On the other hand, the most comprehensive report regarding this issue has shown by Bank Islam Malaysia. It provides several pages in its annual report in order to explain various activities in empowering community. This bank promotes three main programs such as: (a) Promoting Islamic Banking and Supporting Educational Development; (b) Elevating Well-Being of the Society; and (c) Enhancing Relations with Stakeholders.

These efforts showed that the awareness of the important roles of Islamic banking in the society has developed. However, there are some opinions stating that these efforts should have been undertaken many years ago. It is because the society knows that the initial idea of Islamic banks have brought economic and social functions simultaneously.

6.3.4. Reports of the Shariah Supervisory Board (SSB)

Hameed (2008) defined Shariah auditing as a systematic process of objectively obtaining and evaluating evidence regarding assertions about socio-economics, religious and environmental actions and events in order to ascertain the degree of correspondence between those assertions and Shariah, and communicating to users.

Hameed (2008) explained that Mulyani (2007) made a survey of accounting academics, audit practitioners and Shariah scholar in Malaysia. She found that the respondents agreed strongly to the creation of a new Shariah audit discipline with a separate regulatory framework. A new group of professionals termed Shariah Auditor should conduct this Shariah audit. Hameed (2008) also summarized that Shariah audit should report not only the methodology of gathering audit evidence but also the findings on a number of issues covering the scope of the Shariah report. Mulyani's research indicated that the Shariah audit report should contain: (a) the objective of the Shariah audit; (b) process and procedure taken in performing the Shariah audit; (c) opinion on the extent of Shariah compliance; (d) findings (e.g. detailed breach and violation of Shariah principles by Islamic Financial Institutions); (e) implications; and (f) recommendations for improvements.

A good example of Shariah advisor's report is shown by Meezan Bank Pakistan. It disclosed important information that should be known by stakeholders, such as the review of the development of the bank, scope of investigation, findings, recommendations, and conclusion including final opinion of Shariah advisors. However, some Islamic banks observed disclosed Shariah advisor's report in different type and composition. It seem that there is no standard followed by them, so this condition should be addressed because Shariah Supervisory Board (SSB) have obligations to direct, supervise, and review the activities of the Islamic financial institution to ensure Shariah compliance in all its activities (Hameed, 2008).

However, three Islamic banks observed did not disclose their SSB reports without any reasons although they have written the names of SSB members in annual reports. The others disclose SSB report but still minimum in explanation. Most of the reports only stated the final opinion of SSB regarding the operation, products issued, and other shariah aspects. These facts are contradicted with the reality that SSB has a big responsibility in order to ensure that Islamic banks have operated in accordance with the shariah principles.

6.4. Discussions Section 4.

The last discussion is about the auditor in charge in each Islamic bank. This issue is raised since the current issue of standardization of financial reporting that is also promoted by “big four” audit firms such as Price Waterhouse Cooper, Deloitte, Ernest & Young, and KPMG. From the evaluation regarding this issue, 6 out of 9 Islamic banks observed have audited by “big four” audit firms. Only Dubai Islamic Bank, Islami Bank Bangladesh, and Bank Syariah Mandiri Indonesia have been audited by local audit firms. These facts could be the challenges for Islamic banks since “big four” are the main supporter of promoting a single set financial reporting standard through IFRS project. This project seems to ignore the development of Islamic accounting standards that were initiated by AAOIFI. The unexpected situation would be if the “big four” try to force their ideology in implementing IFRS without any consideration of the uniqueness of Islamic contracts. They could expect Islamic banks to change the accounting standards by using globalization and competition reasons.

Yin Xu and Wang (2008) explained that there was dramatic increase in management consulting and other non-audit services for the last 30 years. They supported their argument with data of audit and non-audit services fees for 30 companies in Dow Jones Industrial Average (DJIA) in 2001. It was shown that 26 of 30 blue-chip companies paid their accounting firms more for consulting and other services in 2001 than for the company's audit service. This fact strengthens the presumption that there is a tendency of accounting firms in supporting huge amounts of fund to IASC foundation. At least, accounting firms will get benefit from several sources as follows: (a) non-audit services especially consultation since most of the companies will convert their accounting reports to IFRS based on the requirement of securities commissions; (b) audit services will increase as the efficiency of interpretation of accounting standards. Multinational companies will adjust all branches' financial statements. Thus, accounting firms will easier to analyse since they do not have to make any adjustments or revaluations. Consequently, these treatments will reduce the costs and increase the profit of them.

Some Islamic accounting proponents argued that the issue is not only accounting standard, but also the qualification of audit firm in examining Islamic banking transactions since the “big four” were still used conventional framework. However, it is understandable that AAOIFI as the initiator of Islamic accounting standards does not have any intention in developing Islamic audit firms since AAOIFI should be independent as the standards setter. Therefore, the practitioners of Islamic financial system should initiate the audit framework for Islamic financial institutions in order to serve the needs for this kind of audit.

7. Conclusions and Suggestions

Based on the discussion above, it can be concluded that Islamic banks did not have similarity in disclosing financial and non-financial activities. Islamic banks in Bahrain, Qatar and Indonesia seem to follow AAOIFI standards, while Indonesia creates their own financial accounting standards called Shariah SFAS. Furthermore, Bahrain as the home base of AAOIFI tried to show the comprehensive report especially for financial reports. However, they do not show comprehensive disclosure on corporate social responsibility and Shariah report.

On the other hand, other Islamic banks observed did not follow AAOIFI accounting standards especially in disclosing the components of financial statements based on IFRS or adopted IFRS as a specific jurisdiction. However, Pakistan Islamic bank shows a comprehensive report of Shariah supervisory board. This report can become “a gold standard” (Hameed, 2008) of Shariah supervisory board reporting. Moreover, Malaysia Islamic bank shows a better disclosure in reporting social activities although without detail financial information. Nevertheless, lesson from alternative western accounting reports should be considered as the vehicles in developing Islamic corporate reporting (Hameed & Yaya, 2003). Thus, the accounting standard setting for Islamic bank and financial institutions e.g. AAOIFI, MASB and IAI should motivate the implementation of existing accounting standards to increase the credibility of Islamic banks to the society and their environment and Shariah compliance.

Furthermore, AAOIFI and other Islamic financial system supporters should consider developing the idea of an accounting and audit firm that can serve Islamic financial institutions based on its standards and precepts. Currently, most of Islamic financial institutions have been auditing by conventional accounting firms that do not have enough capacity and capability in shariah knowledge. Although some conventional

accounting firms have hired shariah scholars to help them in examining Islamic financial institutions accounting reports, this is still not sufficient to have a good quality of audit system for Islamic financial institutions.

AAOIFI should also approach IASB to discuss the possibility of harmonization of international accounting standards for Islamic financial institutions. AAOIFI must have strength position in debating the rational of international accounting standards. The set of AAOIFI's accounting standards is the best facts that Islamic financial institutions should treat Islamic mode of transactions differently.

Moreover, the national accounting associations that committed to promote Islamic financial systems should unite in supporting AAOIFI by following fully or only accommodate some standards of AAOIFI efforts in order to strengthen the position of AAOIFI in global competition. At least the members of Organization of Islamic Conference (OIC) should promote the AAOIFI's accounting standards and other pronouncements.

Although Islamic banks have different model in disclosing financial and non-financial report, this diversity model can be complementary to one another towards ideal Islamic banking reporting. Further research should consider the understanding of Islamic banks about Corporate Social Responsibility because most Islamic banks observed have claimed that zakah as part of "CSR". Secondly, further research can study the statement of corporate governance as a possible part of Islamic corporate reports. Finally, the components of Islamic reports should not merely become accessories of Islamic banks to attract customers and investors. The most important in Islamic reporting is the form of accountability and responsibility to Allah SWT and society.

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