Chapter 43

Financial Reporting of Islamic Financial Institutions: Comparative Analysis of AAOIFI and IFRS

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ABSTRACT

This chapter elucidates the arguments for and against differential approach pertaining to financial reporting amongst Islamic Financial Institutions (IFIs). The chapter has identified additional objectives which the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) aims to achieve in comparison to International Financial Reporting Standards (IFRS). The chapter has also identified the global adoption status for both AAOIFI Financial Accounting Standards (FAS) and IFRS Standards, as well as the difficulties faced in adopting AAOIFI’s FAS. This chapter offers illustrative examples of AAOIFI’s FAS and IFRS applications to help in providing a much better understanding in terms of similarities and differences in the application of these two sets of standards.

INTRODUCTION

The purpose of financial statements is to provide information, which is useful for making economic decisions. For the financial statements to be useful, it must have certain features, which include reliability, objectivity, understandability, consistency and comparability. For decades, industry practitioners, regulators and academia have discussed and debated appropriate accounting for Islamic finance activities. Several aspects distinguish Islamic finance from its conventional counterparts. First and foremost, charging of interest is prohibited in Islam, and lending is considered as an act of benevolence. Second, excessive uncertainty is prohibited in transactions. Therefore, it is not allowed in Islam to sell something that one does not own, or something that does not exist. Hence, an Islamic financial institution (IFI) is required to own the underlying assets, even if for a very short time. It is required to bear all risks and rewards incidental to ownership, before it can resell or lease the underlying assets. Third, prohibition of non-Halal elements such as pork, alcohol, tobacco, etc in IFI transactions or business dealings. Last,
but not least, difference in philosophy. For example, the activities of an IFI must adhere to the objectives as stated by the Shari‘ah. An IFI must comply with Shari‘ah principles and prescriptions in all aspects of its business.

The differences between the Islamic and conventional finance raises important questions – Shall the financial statements of an IFI must reflect its compliance with the Shari‘ah? In practice, Islamic financial products and services are often structured to provide the same economic effect as the conventional ones. Hence, does it mean that the financial reporting of Islamic financial products and services shall be the same as the conventional ones?

Some argue that there is a need for different accounting treatment for IFIs, as its activities originate from the Islamic worldview and Shari‘ah requirements. The contracts employed by IFIs are different from that of conventional financial institutions. IFIs should also show that they pay Zakat and do not transact in interest. They are socially responsible, and not merely focused on attaining profit. Their disclosures should clearly state their adherence or departure from Shari‘ah.

In terms of disclosure for IFIs, many authors have extended the scope of disclosure to include social accountability disclosures. This has increased the content of financial reporting to include environmental reporting, social reporting, having a specific statement outlining the use of a Qard funds, and Zakat collection, as well as disbursement. Based on this premise, accounting for IFIs can be described as the process, which provides necessary information to stakeholders of an IFI. It will enable them to ensure that the IFI are not only continuously operating within the bounds of the Shari‘ah, but also delivering on its socioeconomic objectives.

Hence, as argued by the proponents of differential financial reporting for IFIs, there is a need for a different set of standards amongst IFIs. They argue that International Financial Reporting Standards (IFRS) are based on transactions that underline the capitalist worldview, whereas IFIs are different. They opine that conventional accounting is based on providing information that is useful in decision-making, while their Islamic counterparts base it on accountability to Allah (Subhanahu wa Taala) and Shari‘ah compliance. This constitutes the difference in the objective of accounting itself.

However, an opposite worldview does not see the need for a differential financial reporting for IFIs. They argue that the IFIs serve the same purpose as the conventional financial institutions, and have the same economic consequences. Furthermore, the accounting method adopted does not have any implication on Shari‘ah compliance. A transaction is valid as long as it fulfils the Shari‘ah requirements.

Nonetheless, two different worldviews have been expressed by two primary alternatives which have been adopted or considered upon by the national standard setters and regulators globally. IFRS Standards are issued by International Accounting Standards Board (IASB) and Financial Accounting Standards (FAS) issued by the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI). FAS are Islamic finance industry-specific standards, whereas, IFRS can be applied in any types of industry.

The important differences between IFRS and the FAS are that IFRS focuses on reporting the economic substance of the transactions undertaken; whereas, FAS’s primary aim is that the IFI’s accounting should demonstrate its compliance with Shari‘ah. IFRS seeks to give attention to the underlying substance and economic reality and not a merely legal form of the transactions; whereas AAOIFI sees accounting and financial reporting as a mean to demonstrate that the IFIs comply with the principles and rules of the Shari‘ah both in form and substance.