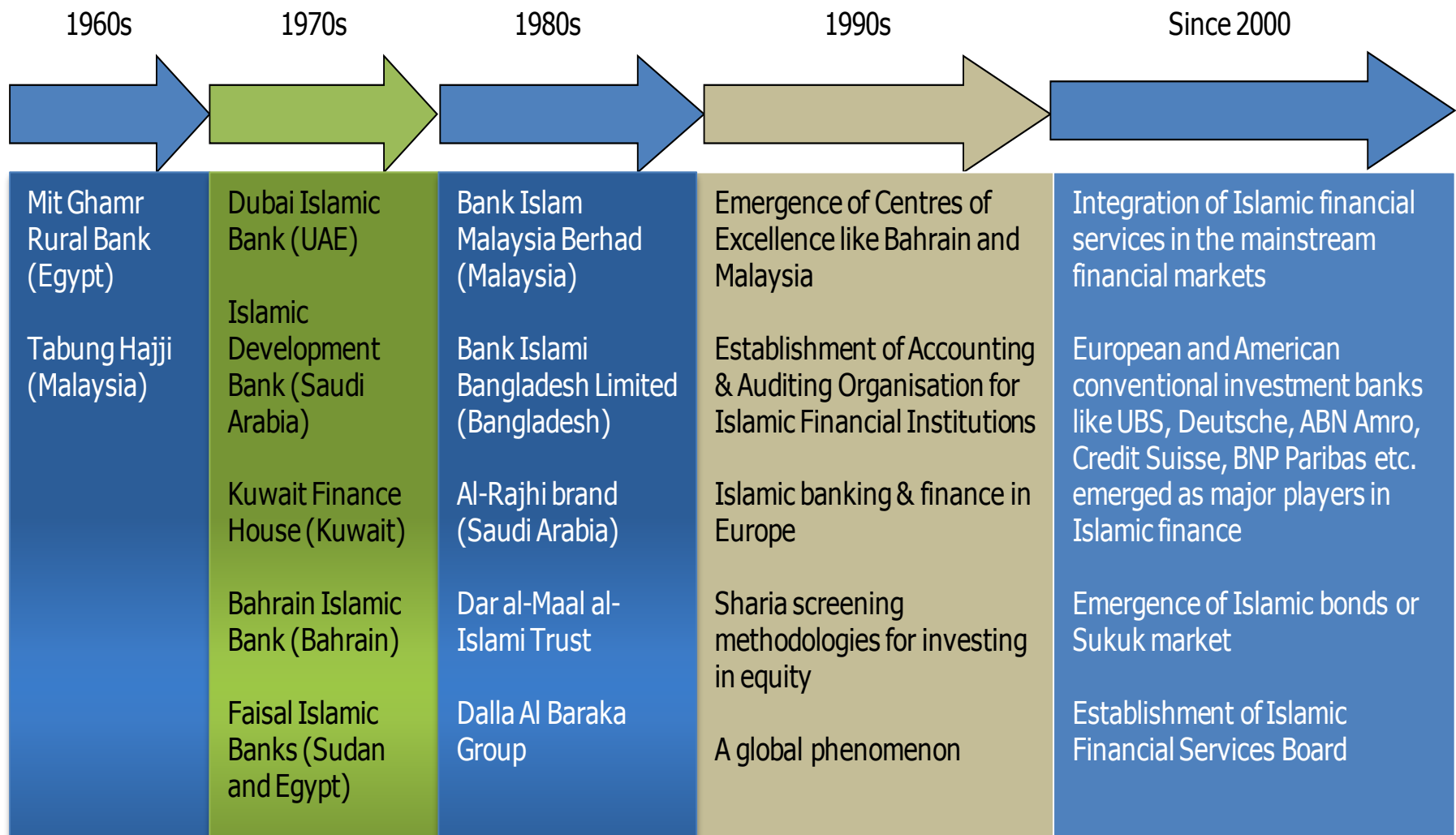


Challenges in Applying Conventional International Accounting Standards for Islamic Finance



Sutan Emir Hidayat
Senior Lecturer, Islamic Finance
University College of Bahrain

Evolution of Islamic Banking and Finance



HIGHLIGHTS FROM THE EVOLUTION

- Modern Shariah-compliant products have come to cover the full spectrum of banking, capital markets, asset management and, insurance (*takaful*) business.
- As Islamic finance moves into the mainstream, a key challenge is identifying a suitably relevant and intelligible accounting framework that is comparable with conventional finance without tainting compliance with Shariah (PWC, 2010).
- This challenge is even more for global financial services groups that include Islamic finance among their diverse services.
- Therefore, in order to align the accounting practice, there is an idea to apply IAS for Islamic Financial Institutions (IFIs)

BENEFITS OF APPLYING IAS/IFRS FOR IFIS

- Using a common framework to account for Islamic and conventional products and transactions would **enhance the transparency and international comparability** of financial reporting for Islamic finance and hence provide an important boost for further investment in, and the development of, the sector (PWC, 2010).
- Applying IAS/IFRS will give the benefit of **international recognition and usage**, making it the most suitable framework for global institutions with Islamic and non-Islamic products and multinational stakeholders (PWC, 2010).
- IAS/IFRS focuses on the economic substance of a product or transaction rather than the legal form. Therefore, IAS/IFRS principles rather than the Islamic legal form will ultimately determine the accounting treatment (PWC, 2010).

Major Issues in Applying Conventional Accounting Standards for Islamic Financial Institutions (IFIs)

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graph TD; A[Major Issues in Applying Conventional Accounting Standards for Islamic Financial Institutions (IFIs)] --> B[Differences in Objectives of the users of Accounting Information (Hameed, 2009)]; A --> C[Differences in Contractual Relationship between The financial Institutions and Their stakeholders (BIBF, 2008)];
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DIFFERENCES IN THE OBJECTIVES OF THE USERS OF ACCOUNTING INFORMATION

(Due to the differences in worldview*)

IFIs

- In the case of IFIs, Shareholders, investors and other users have a primary objective entailing compliance with the precepts of Shariah law in conducting their financial activities and achieving the objectives of the organisations (BIBF, 2008; Hameed, 2009)

Conventional FIs

- The ultimate purpose of financial accounting users is to efficiently allocate scarce resources available to their most efficient and profitable uses based on informed decision (FASB, 1978)

CONSEQUENCES OF THE DIFFERENCES IN OBJECTIVES

- **Differences in the types of information identified.** Conventional accounting concentrates on identifying economic events and transactions (financial information). The users of IFIs are not only interested in financial information, but also interested in **non financial information such as shariah compliance, specific religious requirements and discharge of social responsibilities** (Hameed, 2009)
- **How assets, liabilities and equities are measured, valued, recorded and communicated?** Conventional Accounting mainly uses historic cost (or lower) to measure and value assets and liabilities. Although the idea of introducing fair value measurements is there, its implementation is quite difficult due to its complexity and presumed lack of verifiability. **On the other hand, from Islamic point of view at least for the computation of zakah, current valuation is obligatory** (Hameed, 2009)

DIFFERENCES IN CONTRACTUAL RELATIONSHIP

- IFIs have different contractual relationships with their investors, depositors and customers compared to the relationships which exist between conventional financial institutions and their investors, customers and depositors.
- For example IFIs use the profit sharing contract (Mudaraba) in the case of deposits mobilization and other instruments such as Murabaha, Ijarah, Istisna', Salam, Musharaka in the case of customer financing (BIBF, 2008).

Identified Possible Accounting Issues When IAS is applied for IFIs

ISSUES	IAS	ISLAMIC FINANCE PRINCIPLES
Deposit contract	<p>Conventional banks generally rely on a contractual liability plus interest for their deposit contract. Therefore, all deposits are treated as liability under IAS.</p> <p>Contractual obligations to pay depositors will clearly be liabilities of the institution.</p>	<p>Islamic banks use Mudaraba (profit sharing) and wakala contracts (agency contract) for structuring their deposits.</p> <p>FAS-1 (AAOIFI) requires unrestricted investment accounts' funds (Mudaraba deposit) to be presented in the right hand side of the Statement of Financial Position in a separate section in between liability and equity.</p>
Financial Lease Vs Ijarah Muntahia Bittamleek	<p>The inherent risks and rewards associated with the asset have been transferred to the lessee, who in substance is deemed to be the owner.</p> <p>Finance lease is reported as receivables/loans on the bank's book and an ownership interest being recorded by the lessee</p>	<p>Asset should be reported in the lessor's (bank) books. Maintenance costs are borne by the lessor.</p> <p>The presentation of the lease as a loan/receivable on the bank's book and an ownership interest being recorded by the lessee contradict the principles of Shariah. Shariah stresses that asset ownership rests with lessor throughout the lease term.</p>

Identified Possible Accounting Issues When IAS is applied for IFIs

ISSUES	IAS	ISLAMIC FINANCE PRINCIPLES
<p>Recognizing a sale of good with deferred payment (AOSSG, 2010)</p>	<p>Reporting all Islamic financial transactions as financing transactions</p> <p>IAS 18 requires the difference between the fair value and the nominal amount of consideration in a sale of goods is recognized as interest revenue (AOSSG, 2010).</p>	<p>The staff of Indonesian Accountant institute indicates that: “According to sharia fatwa in Indonesia, murabahah cannot be accounted for as financing transaction. This kind of transaction should be treated as sales transactions. Treating it as financing will eliminate the essence of shariah principle . (AOSSG, 2010)</p> <p>The staff of Institute of Chartered Accountants of Pakistan (ICAP) mentions that: “Deferment of profit is allowed by scholars, but it should be separately recorded as a deferred profit and not as interest. (AOSSG, 2010)</p>

Identified Possible Accounting Issues When IAS is applied for IFIs

ISSUES	IAS	ISLAMIC FINANCE PRINCIPLES
Takaful concept	The premium received is part of the insurance company's revenues.	<p>Takaful is not insurance, it is a mutual protection scheme where the underwriting fund does not belong to the takaful company but to the policyholders. Hence we actually have two accounting entities (Siswantoro and Hameed, 2011).</p> <p>Therefore, the Takaful company must segregate between shareholders' funds and policyholders' funds in its financial report (Hidayat, 2010).</p>
Conceptual Aspects	Substance over form principle. This principle recommends recording a transaction according to its reality (what is) not to its legal form (what ought to be) (SII, 2006).	<p>From an Islamic point of view, although reality (what is) should be taken into account in deciding strategies, it cannot be a substitute for what ought to be (Hameed, 2009).</p> <p>The reality may reflect a deviation from normative precepts of Islam. In fact, Islam has already eternal ethical and behavioural principles and objectives (Hameed, 2009).</p>

Additional Accounting Issues that an IFI needs to disclose which IASs do not address

- Income incidentally generated from transactions or relationships, which contradict Shariah. (e.g: late Penalty)
- Funds paid out as Zakat and /or charity.
- Restricted Investment Accounts: Islamic banks raise deposits through restricted Mudaraba-profit sharing contract- and/or Wakala-agency contract for a fee.
- The socially responsible financing (i.e. Qard Hasan) is not catered for by conventional accounting standards.

Conclusion

- Despite the benefits that International accounting standards offer, applying their standards to IFIs towards some extent will eliminate the essence of shariah principle. In other words, shariah compliance cannot be adequately reflected by financial statements and notes. **While, In fact, compliancy to Shariah is the main reason for IFIs' existence.**
- The full application of IAS also will hold back/hinder our steps in developing accounting standards that adequately cater for shariah compliant transactions thus ignoring the significant contributions made by AAOIFI.
- IAS-IFRS were written with conventional products and operations in mind. When they are applied to Islamic products, typically they will treat the products, in economic substance, as equivalent to their conventional counterparts.
- Therefore, obviously, there are huge impediments on fully applying IAS for IFIs. But, a broad harmonization can be reached by the application of the relevant aspects of IAS. This is the wisdom that AAOFI does.

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وبالله التوفيق



UNIVERSITY
COLLEGE
BAHRAIN

SUTAN EMIR HIDAYAT

**SENIOR LECTURER AND ACADEMIC ADVISOR
FOR ISLAMIC FINANCE
P.O. BOX 55040, MANAMA
KINGDOM OF BAHRAIN
+973-39361625**

sutan@ucb.edu.bh