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Roles and Impacts of Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in Dealing with the Accounting and Disclosure of Zakah and Interest (Riba)

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Master of Business

2009

Roles and Impacts of Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in Dealing with the Accounting and Disclosure of Zakah and Interest (Riba)

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A thesis submitted to Auckland University of Technology in partial fulfilment of the requirements for the degree of Master of Business (MBus)

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Faculty of Business

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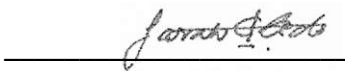
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Attestation of Authorship

I hereby declare that this submission is my own work and that, to the best of my knowledge and belief, it contains no material previously published or written by another person (except where explicitly defined in the acknowledgements), nor material which to a substantial extent has been submitted to the award of any other degree or diploma of a university or other institution of higher learning.



Farah Aida Ahmad Nadzri

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Abstract

The issues of zakah and interest for IFIs have been highlighted for several years and attracted many arguments among Islamic scholars and public. The increasing public interest on the Islamic Banking since 1970s has been driven by the increasing sensitivity among Muslims to the relationship between religion and economic activities. With the emergence of IFIs, Muslims community has demanded for an establishment of an accounting body to develop a set of accounting standards that adhere to the Islamic tenets, hence AAOIFI was established. However, the journey of AAOFI in achieving such objective has not been smooth. This paper intended to study the effectiveness of AAOIFI in dealing with the issues of zakah and riba for IFIs by examining the disclosure practice of 25 IFIs worldwide. Based on the analysis conducted, it is concluded that the extents of disclosure by the IFIs are much lower than the AAOIFI requirements. The study also found that leverage and origin factors might contribute to the level disclosures of zakah and financial products. In addition, the test performed also revealed that the adopters of AAOIFI do provide more disclosure as compared to the non-adopters. However, the mean result is relatively low to suggest full compliance with the AAOIFI standards.

Chapter 1: INTRODUCTION

Thirty to forty years ago, Islamic finance concept was regarded as an "exotic niche" in the financial industry. However, since the introduction of the first private interest-free bank, the Dubai Bank in 1975, the number of Islamic Financial Institutions (hereafter IFI) is growing rapidly especially in the Muslim countries (Abdul Gafoor, 1995). Currently, it is estimated that there are about 300 IFIs in 75 different countries with the holding assets estimated at more than US$300 billion. The amount is primarily in banks in the Middle East, Malaysia and the United Kingdom; although a number of multinational non-muslim banks such as HSBC, Standard Chartered, and Citigroup also offer products based on Islamic finance. The products offered by these institutions are not only limited to commercial banking services but also include insurance services, e-commerce, asset management services, and Islamic brokers or dealers (KPMG, 2006).

The history of Islamic accounting has started since 610 A.D with the revelation of the Holy Quran to the Prophet Muhammad, please be upon him (pbuh). Since then, the Islamic principles and concepts have been widely applied to the financial system. In fact, it is believed that the common concepts used today, for instance *mudaraba*[1] and *murabaha*[2], are based on the concepts applied during the early Islamic period. However, since the fall of Islamic Empire and the increasing European influence during the colonialism period, this system has been ignored and most of the Islamic countries have started to adopt the conventional economic system. But, since 1960s, with the revolution of Islamic knowledge, the Islamic countries have begun to re-examine their economic system and re-introduce the Islamic financial system that adheres to the *shariah*[3] requirements (Mohamed Ibrahim, 2001).

[1] A partnership in profit between capital and work. For example, in a partnership between a bank (provider of fund) and a business owner (worker), at the end of the financial period, the profits (or losses) are shared between the two parties as agreed initially.
[2] Sale of goods at cost (inclusive of the purchase price and any other expenses incurred) plus agreed profit mark up. To illustrate, a bank financing a house for its client, and the client will pay the bank at an agreed mark up price with the payment in installation.
[3] Islamic laws derived from Al-Quran and As-Sunnah

The revolutionary of the modern IFIs started in 1970s with the introduction of Commercial Islamic Banks in the Gulf and Middle East countries. During this period of time, the IFI only offered basic financial Islamic products such as *mudaraba*, *murabaha*, *musharaka*[4], and *ijarah*[5]. Then in 1980s, IFIs started to enter the Asia Pacific market with the establishment of IFIs in Malaysia, Bangladesh, and Indonesia. More products were also offered during the period with the introduction of *takaful*[6] services by The Islamic Insurance Company in Sudan. Moreover, a number of new Islamic investment companies were also introduced during the time (International Organization of Securities Commissions (IOSCO), 2004).

Then, the number of IFIs continued to increase gradually in 1990s. The institutions also expanded with the introduction of asset management companies and Islamic brokers and dealers, offering new products such as mutual funds, unit trust, bonds, and stocks that were all based on Islamic concepts. In the late 90s, the IFIs also began to penetrate the European and American markets and a number of IFIs were established in countries such as the United Kingdom, Sweden, and Denmark. In line with the expansion of the internet transactions worldwide, IFIs also developed their e-commerce system in 2000s (IOSCO, 2004). With an estimated of 1.6 billion Muslims and their fast-growing population, it is projected that the number of IFIs will keep on increasing and the industry would account for at least 40-50% of total savings of Muslims worldwide within the next 6-8 years (IOSCO, 2004; KPMG, 2006).

Despite the phenomenal growing rate of Islamic financial industries recently, there are raising concerns among *shariah* scholars regarding the products and services offered by the IFIs. An Islamic scholar, Zaman (as cited in Abdul Gafoor, 1995), stated:

"*It emerges that practically it is impossible for large banks or the banking system to practice the modes like mark-up, bai' salam, buy back, murabaha, etc. in a way that fulfills the Shariah conditions. But in order to make themselves eligible to a return on their operations, the banks are compelled to play tricks with the letters of the law. They*

[4] A form of partnership whereby each party contributes a portion of the overall fund and participates in work. This is similar with the common partnership agreement.
[5] A transfer of ownership of a service for an agreed upon consideration (similar with lease)
[6] Islamic insurance

actually do not buy, do not posses, do not actually sell and deliver the goods; but the transition is assumed to have taken place. By signing a number of documents of purchase, sale and transfer they might fulfill a legal requirement but it is violating the spirit of prohibition" (p. 11).

Another Islamic scholar, Prof. Kurshid Ahmad also shared the same view regarding the recent products offered by IFIs. As cited in Abdul Gafoor (1995), Ahmad mentioned:

"Murabaha (cost-plus financing) and bai' mu'ajjal (sale with deferred payment) are permitted in the Shariah under certain conditions. Technically, it is not a form of financial mediation but a kind of business participation. The Shariah assumes that financier actually buys the goods and then sells them to the client. Unfortunately, the current practice of "buy-bank on mark-up" is not in keeping with the conditions on which murabaha or bai' mu'ajjal is permitted. What is being done is a fictitious deal which ensures a predetermined profit to the bank without actually dealing in goods or sharing any real risk. This is against the latter and spirit of Shariah injunctions" (p. 11).

Moreover, Khan (2007) addresses his concerns that the clients' doubts on the IFI products and services may pose severe threat to the industry in the long run. As the industry is based on the Islamic law, it is expected that the IFIs would adhere to the *shariah* requirements that focus on the moral and public justice. Zaman and Movassaghi (2002) argue that the value of assets in the Islamic industry appears impressive if one ignored the value of the financial industry worldwide. The researchers added that in reality most of the Islamic Banks are relatively small if compared to the conventional banks and there are even a few that are not making any profit. Furthermore, IFIs most likely fail to attract general Muslims and might be losing their customers in the foreseeable future if the authority fails to provide clear-cut standards on accounting, regulatory, and *Shariah* supervisory that all IFIs worldwide can conform to. Similar concern is expressed by KPMG (2006). One of the crucial factors that could undermine the acceptance of IFIs is the lack of quality and transparency of the financial reporting of the IFIs. Two of the particular thorny accounting issues with respect of IFIs are interest (*riba*) and *zakah*[7]. Besides promoting social issues, IFI is responsible to ensure that their operations are in accordance with the *shariah* requirements. One of the issues that always

[7] Islamic tax

create attention to IFI is the prohibitions of interest which is also known as *riba*. As discussed by Iqbal (2006), there are three different views of *riba* among *shariah* scholars. While the Liberal and the Mainstream view *riba* as usury and both usury and interest respectively, the Conservative believe that *riba* is usury, interest, and activities that result to injustice to the society. In addition, *zakah* is also one of the main interests in this study as it is compulsory for all affordable Muslims to pay *zakah* as it is one of the five 'pillars' of Islam. As the Quran only provides general statements on *zakah*, there are some arguments among scholars on the issues. One of them is if a business is required to pay *zakah* since Quran specifically commands that *zakah* be paid by individuals. Moreover, there are also debates on detailed issues of *zakah* such as the type of assets that is *zakatable* and the rate of *zakah* to be paid (Qaradawi, 1999).

The contentious accounting issues required guidance from a regulatory body and Accounting and Auditing Organization for Islamic Financial Institutions (hereafter AAOIFI) was expected to perform such role. Although conventional accounting research provides evidence that managers voluntarily disclose private information to outside parties (agency theory view), this was not the case with IFIs primarily because the usefulness of such disclosure was not well documented. AAOIFI was established in 1991 with the primary objective of developing accounting and auditing standards for the IFI. AAOIFI has so far promulgated 25 accounting and 5 auditing standards (AAOIFI, 2008). However, AAOIFI has come under severe criticism for its 'capitalist thought' approach in developing standards and for being highly influenced by conventional accounting procedures (Mohamed Ibrahim & Osman, 2003; Napier, 2007). The acceptance of AAOIFI standard has also been questioned as research has revealed that the adoption is limited to certain areas and jurisdictions (Haniffa & Hudaib, 2004; Harahap, 2003). With the guidance provided by AAOIFI on *zakah* and interest accounting, it is expected that the IFIs would adhere to such standards and make the disclosure as required by the AAOIFI standards. However, to date, there has been no known research that carefully examines the actual compliance of IFIs with these two accounting disclosure issues emerges. This study attempts to answer this question by collecting data from 25 members of AAOIFI worldwide. AAOIFI is also faced with the challenge that many IFIs are still

required to follow local General Accepted Accounting Practices (GAAP) or International Financial Reporting Standards (IFRS). Hence, this paper aims to study the roles and impacts of AAOIFI in helping IFIs to deal with *zakah* and interest, two issues that are considered vital to the latter.

Based on the above discussion, the following research questions are developed:

Research Question 1: *To what extent are zakah and riba important to the IFIs; and what are the practical problems that can be associated with the application of these concepts in the current contemporary accounting?*

Research Question 2: *Is AAOFI providing any useful guidance to overcome the problems related to zakah and riba?*

Research Question 3: *As countries globally are moving towards adopting IFRS, what are the roles and contributions of AAOIFI as compared to IFRS standards?*

Research Question 4: *How do IFIs respond to the AAOIFI standards on zakah and riba?*

This thesis is structured as follows**:** Chapter 2 reviews related literature on Islamic accounting concepts while Chapter 3 discusses the relevant standards on *Zakah* and Interest and the quality of such standards. The roles of AAOFI in providing guidance on *zakah* and interest are discussed in Chapter 4 along with a critical evaluation of AAOIFI activities. Chapter 5 uses the content analysis technique to examine the actual compliance of IFIs on the accounting standards related to these two accounting issues. Finally, Chapter 6 concludes the study with the implications of the findings.

Chapter 2: LITERATURE REVIEW

2.1 Introduction

The increasing public interest on the Islamic Banking since 1970s has been driven by the increasing sensitivity among Muslims to the relationship between religion and economic activities. Concepts, applications, and impacts of the Islamic Banking to the rest of the world's economy are some of the major issues being highlighted by the scholars (Abdul Gafoor, 1995). The emergence of IFIs also has increased demands from Islamic community for the formation of a body to develop a set of accounting standards that adhere to Islamic requirements (Islamic Financial Services Board, 2007; Karim, 2001; Mirza & Baydoun, 1999). Hence, in 1991 AAOIFI was established to address this concern.

There exist a number of studies conducted since 1980s by several researchers regarding the issue of Islamic Accounting Standards (hereafter IsAS). Some of the issues discussed in the previous literatures include the history of the Islamic accounting, the Islamic accounting concepts, the importance of having IsAS, and the operations of IFI as an interest-free banking that adheres to the Islamic requirements.

This chapter reviews the key literatures on Islamic accounting based on the research questions developed in Chapter 1. Firstly, the concepts of Islamic economy and accounting concept which are highly related to the concept of *tawheed*[8] will be discussed. This is followed by the problems associated with the applications of Islamic accounting concepts with a particular emphasis on *zakah* and *riba* issues. Then, the literature on AAOFI is reviewed. As mentioned in Chapter 1, AAOIFI was established with the purpose of promulgating accounting standards that adhere to the Islamic principles. However, the journey of AAOFI in achieving such an objective has not been smooth.

[8] Unity or oneness to God

2.2 Islamic Economic System

The lives of Muslims are predominantly based on the concept of *tawheed.* This concept also forms the unique characteristics of Islamic economic system that can be divided into three parts: prohibition to involve in *haram* (unlawful) activities, adherence to specific Islamic requirements, and promotion of equality and social justice. Based on these characteristics, the first private IFI which was the Dubai Islamic Bank was introduced in 1975 to offer a range of products that adhere to the *shariah* requirements (Zaman & Movassaghi, 2002).

Tawheed is the basis of Islamic faith. Mirza and Baydoun (1999, p. 2) define *tawheed* as "unity or oneness to God". It is related to the belief that this universe and its contents are created by God, and human beings as *khalifah* (vice-regent) are responsible to manage the world's resources and the *ummah* (community of believers) properly (Abdul-Rahman & Goddard, 1998; Sulaiman, 2003). Based on this concept, it is obvious that one needs to adhere to the Islamic requirements in every aspect of his or her life including religious, political, social, and economic activities in order to maintain a relationship with God (Mirza & Baydoun, 1999; Mohamed, 2007; Napier, 2007). Muslims believe that they are responsible for their actions and all actions are accountable to God on the Day of Judgment (Napier, 2007). As God created the universe, God is the ultimate owner of everything and human beings are only responsible to steward the God's possessions. Thus, human beings need to manage their property according to the God's way (Mohamed, 2007; Napier, 2007). This main concept constitutes the unique characteristics of the Islamic economic system as opposed to the conventional economy that is discussed in the following subsections.

2.2.1 Prohibition to Involve in Unlawful Activities

One of the key concepts of Islamic economy is the restriction on involving oneself in *haram* or unlawful activities. The majority of Islamic scholars agree that *riba* (interest or usury), *gharar* (uncertainty), gambling, involvement in producing alcoholic, pig, and

tobacco products, price fixing, exploitation, and fraud are *haram* (Hamid, Craig & Clarke, 1993; Lewis, 2001; Mirza & Baydoun, 1999; Mohamed, 2007; Nasir & Zainol, 2007; White, 2004).

Prohibition of *riba* or interests is stated in four verses of the Quran including verse 275 of the second chapter. Allah says:

> *"Those that live in riba shall rise up before God like men whom Satan has demented by his touch; for they claim that riba is like trading but God has permitted trading and forbidden riba."* (p. 62).

It is believed that *riba* is prohibited as it leads to injustice, where one party is guaranteed with a fixed return while another party is uncertain of the revenue (Hamid et al., 1993; Ibrahim, 2001; Sulaiman, 2003). For instance, a customer of a conventional bank is promised with a fixed return of 5% based on his or her savings at the end of a financial period. It can be a disadvantage to the customer if the bank actually earns more than 5% by investing the customer's money. On the other hand, the bank is deprived if it only manages to earn less than 5% from the investment due to several external factors such as an economic crisis. In addition, *riba* is also seen as an exploitation to the poor and the needy since they are required to pay more than the amount they actually borrow, thus, widening the gap between the poor and the rich in the society (Ahmed, 2007; Mohamed, 2007; Sulaiman, 2003).

Venardos (2005) briefly explains the reasons behind the prohibition of *riba*. Besides promoting injustice, it is believed that *riba* discourages innovation especially by small businesses. As small businesses have limited resources if compared to big companies, they are discouraged to invest in new products that require borrowing from financial institutions as this will result in the payment of principal sum plus interest charged irrespective of the outcome of the innovations. Moreover, *riba* also promotes laziness as one does not have to work hard and bear any risk in order to gain profit (Ahmed, 2007; Mohamed, 2007; Sulaiman, 2003).

On the other hand, *gharar* is defined as "to undertake a venture blindly without sufficient knowledge or to undertake an excessively risky transaction" (Lewis, 2001, p. 119). This is also related to high uncertainty, risk, and speculation of a transaction. Islam requires honesty, therefore, any desire to hide the truth from another party involved in a transaction is considered as unlawful. As cited in Mohamed (2007):

> *"Prophet Mohamed (pbuh) prohibited the sale of what is still in the loins of the male; or sale of whatever is in the womb of a she–camel; or sale of birds in the air; or the sale of fish in the water, and any transaction which involves gharar. (i.e. anything that involves deception). He also forbade the sale of fruits before they look healthy and also the sale of crops until the grain hardens. Nevertheless, such advance sales would be acceptable if the element of Gharar does not exist and the quality and the quantity of the goods are pretty well known and predictable"* (p. 89).

It is also believed that the rationale behind the prohibition is to avoid injustice to the buyer and speculation in the future. As the nature of gambling is similar to *gharar*, gambling is strictly prohibited in Islam (Mohamed Ibrahim, 2000).

2.2.2 Specific Requirement by Islam – Payment of *Zakah*

Muslims are obligated to pay *zakah*, one of the five "pillars" of Islam. It is payable on business revenues and assets, gold and silver, and savings at the basic rate of 2.5% (Gambling & Karim, 1986; Hamid et al., 1993; Mohamed, 2007; Mohamed Ibrahim, 2001; Lewis, 2001; White, 2004). Mohamed (2007) claims that Islam requires its following to pay *zakah* so that the money collected can be of help for the poor to have basic requirements in life. Unlike conventional tax, *zakah* is viewed by Muslims as a means of 'purifications' and not an obligation (Gambling & Karim, 1986). Sulaiman (2003) states that *zakah* plays an important role not only in the economy, but also in the moral and social well-being of a society. Morally, *zakah* promotes sharing of wealth and eliminates greediness, whilst socially; it helps to reduce poverty within the community (Gambling & Karim, 1986; Sulaiman, 2003). As a result, wealth is widely distributed to all sections of the society and this, undoubtedly, encourages healthier economic environment. As stated in Nasir and Zainol (2007), the seven categories of people that are eligible to receive *zakah* include "the poor, the needy, the wayfarer, the heavily indebted, freedom of slaves, new converts to Islam, and the cause of Allah." (p. 262). According to

Hamid et al. (1993), Pakistan and Malaysia are the examples of countries that pioneer and have a specific body to collect *zakah.*

2.2.3 Promotion of equality and social justice

Ahmed (2007) points out that the idea of fairness, equality and justice lies under the Islamic economic concept. He argues that by paying *zakah,* wealth and income are fairly distributed and not concentrated only on the hands of few. As brotherhood is perceived as important in Islam, cooperation among society members is encouraged. This will be achieved via payment of *zakah* besides *sadaqah* (voluntary charity) and *waqf* (endowments) by those who can afford. He also states that by having interest, lenders hold too much control over the borrowers. Thus, abolishment of interest is beneficial to the society (Ahmed, 2007).

Ahmed (2007) supports the previous work by Mohamed Ibrahim (2000) who discusses six economic objectives that are deemed to benefit the society as a whole according to Islam. These objectives focus on (i) wide circulation of wealth; (ii) security on people's properties; (iii) authenticity of transactions and contracts; (iv) equity of products and services; (v) dignity of employees; and (vi) reasonable consumption of resources. These objectives are consistent with Islamic tenets that focus more on social benefits instead of individual profit.

Haniffa and Hudaib (2007) agree that Islamic Banking should be more responsible to the society as compared to the conventional banks due to the nature and objectives of the institutions. The group of society according to them can be classified into employees, debtors, and general public. For example, managers are responsible to provide employees with welfare, training and development opportunities and reasonable rewards. Moreover, debtors also have rights in Islam as they are entitled to be given enough information such as debt policy of a company. Even in certain conditions, debtors are entitled to receive *zakah* and debts can be written off as form of charity (*sadaqah*). Finally, companies are also responsible to the general public for the payment of *zakah* or

by providing *sadaqah* (charity) or *qard al-hassan* (benevolent loans). Companies should also be committed, for instance, to serving the public by supporting charity or sponsoring social events (Haniffa and Hudaib, 2007).

2.3 Islamic Accounting

The three unique characteristics of Islamic economic concepts as mentioned in the previous subsection establish the basis for the Islamic accounting principles that are objectively different from the conventional accounting. In conjunction with this Islamic economic doctrines, the Islamic accounting has many objectives to be achieved and, among others, compliance with the Islamic requirements is one of them (Ahmed, 2007). Through the financial reports, it is expected that the external users are fully informed regarding the company's compliance with the Islamic requirements. These include financial reporting on the payment of *zakah* and earnings or expenditures prohibited by Islam (AAOIFI, 2008).

Furthermore, Baydoun and Willett (2000) suggest a full disclosure of financial statements as part of IFI responsibility towards the society. In contrast to conventional banking, IFI should disclose information that is perceived to be important to the general public instead of focusing on the shareholders. It is suggested that, as in conjunction with the Islamic tenet, the Islamic disclosure practice should be based more on a moral sense instead of the expediency of the company. Therefore, to achieve this objective, Baydoun and Willett (2000) suggest the replacement of current Income Statement with the Value Added Statement (VAS). By using VAS, the items in the Income Statement are rearranged and refocused on the share of the groups instead of the shareholders. There are two main parts in the suggested VAS. The first part discloses the sources of the value added based on the revenues received by the companies. In the second part, the statement focuses on the distributions of the value added to the stakeholders such as, (i) beneficiaries through the payment of *zakah*; (ii) government by paying taxes; (iii) employees via payment of salaries; (iv) owners through dividends distributed; and (v) societies by giving charities. They believe that VAS suits both conventional and Islamic

accounting as it provides the current value of the asset in addition to the historical cost. Moreover, according to the researchers, the using of VAS not only meets the requirements of having full disclosure, but also it concentrates on the benefits derived from the activities of the IFI to the society (Baydoun & Willett, 2000).

2.4 Islamic Financial Products

Due to the prohibitions and requirements outlined by *shariah*, various financial instruments have been developed by the IFIs. According to Haniffa and Hudaib (2007), those financial instruments are based on two principles; profit-and-loss sharing (PLS) principles and mark-up principle. PLS is similar to a partnership where both partners (lenders and borrowers) share profits and losses based on the share capital and effort. As opposed to interest-based financing, the rate of return in PLS is not guaranteed (Venardos, 2005). Examples of products that are based on PLS principles are *mudharabah* (venture capital) and *musharakah* (partnership agreement). On the other hand, mark-up principle is a situation where an item is bought by the IFI for a client and the client will buy the item from IFI at an agreed mark up price (Abdul Ghafor, 1995). *Murabahah* (resale with stated profit) and *ijarah* (leasing) are the examples of debt-financing based on the mark-up principle (Haniffa & Hudaib, 2007; Venardos, 2005).

The following table summarizes and defines the common products offered by IFI.

IFI Products	Definitions
Mudharabah	An Islamic Bank, as a limited partner, provides cash to a borrower who uses the funds, usually on a basis not limited in time, to pursue partnership goals. Profit and loss percentages will be established contractually.
Musharaka	An Islamic Bank provides part of the equity plus working capital of a project and shares in profits and/or losses.
Murabaha	An Islamic Bank finances the purchase of goods or commodities in return for a share in the profits realized. Specifications are provided by the purchaser.
Ijara	The Islamic Bank purchases a piece of equipment selected by the entrepreneur and then leases it back to him, he pays a fixed fee.
Ijara wa iktina	The transaction resembles ijara, except that client is committed to purchasing the equipment at the end of the rental period.
Bai al salam	A contract for sale of goods where the price is paid in advance and the goods delivered in the future.
Istisna	A contract to acquire goods on behalf of a third party where the price is paid to the manufacturer in advance but the goods are produced and delivered at a later date.

Table 1: Islamic Investment Vehicles (Pomeranz, 1997, p. 127).

2.5 Problems Associated with the Application of Islamic Accounting Concepts

There are several issues need to be considered by IFI in order to fully apply the Islamic accounting concepts. One of the significant problems is the lack of consistency in interpreting the Islamic requirements, consequently, leading to troubles in applying those concepts. In a broader view, these problems might negatively affect the corporate governance of the industry.

2.5.1 Inconsistency in Interpreting the Islamic Requirements

Mohamed Ibrahim and Osman (2003) emphasize the importance of Al-Quran and *As-Sunnah* (life and practice of Prophet Muhammad pbuh) as the basic guidance for Muslims. For the issues not being explicitly addressed in the Al-Quran or *Al-Sunnah*, *ijma'* (consensus of Islamic scholars) will be used (Hamid et al., 1993; Mohamaed Ibrahim & Osman, 2003). However, unlike Al-Quran and *Al-Sunnah*, *ijma'* can be faulty and is subject to correction or modification in the future.

i) Differences in Schools of Thoughts

There are five major schools of thoughts in Islam, namely The Hanafis, The Malikis, The Shafiis, The Hanbalis, and The Shiite (Ahmed, 2007; Hamid et al., 1993; Lewis, 2001). Each denomination (or *mazhab*) emphasizes different areas. For instance, The Malikis emphasizes Arabic traditions as most of the following are in Medina, Africa and Egypt, whilst The Shafiis stresses the common opinions of qualified Islamic jurists in each era and is viewed as the more moderate in their approach as compared to the other three schools of thoughts (Hamid et al., 1993). Although there are no differences in the principles, there are differences in the detailed explanations and interpretations of *shariah* among the five denominations (Hamid et al., 1993). Venardos (2005) gave an example of difference that exists between the schools of thoughts in relation to *salam* (forward purchasing contracts). Referring to Hanafis, *salam* is not valid if a product is not available at the marketplace during the time of contract although the product is expected to be available on the delivery date. On the other hand, all the other three schools of thoughts agree that *salam* is valid as long as the product is available during the delivery date (Venardos, 2005).

ii) Differences in Methodological Approach

Besides the differences in detailed explanations of *shariah* between five major schools of thoughts, there are also differences in the methodological approach to develop Islamic accounting theory. There is yet to be any consensus among scholars regarding whether Islamic accounting should be developed according to normative or inductive approach. Gambling and Karim (as cited in Napier, 2007) suggest that IsAS should be based on normative deductive approach since Muslims need to follow *shariah* requirements in every aspect of their lives. Under normative deductive approach, all concepts and objectives of accounting should be in accordance to *shariah* principles. Sulaiman (2003) also agrees with the approach, as Islam has its own unique requirements and rules. She further argues that the objectives of Islamic accounting are quite different from that of the conventional accounting, making the latter less relevant to IFIs. However, she also clarifies that Muslims should not reject everything from the West as long as it adheres to the *shariah* (Sulaiman, 2003).

Mohamed Ibrahim and Osman (2003) make a firm statement that the development of IsAS should not be through modification of current conventional accounting. They argue that as the objectives and principles of Islamic accounting and Western accounting are incompatible, adapting the conventional accounting might be harmful to the development of the Islamic accounting in the long run. Baydoun and Willett (2000) believe that the basis for conventional accounting is derived from the values of economic rationalism where success is determined by the amount of profit. In contrast, Islamic accounting concentrates on the Unity of God where the society and environment are the main focus rather than the personal accountability. Due to the differences, it is therefore natural to spot dissimilarities in the criteria of both accounting systems. The major differences between Islamic and Western accounting are summarized in table 2 below.

Characteristics	**Western accounting**	**Islamic accounting**
Philosophical viewpoints	Economic rationalism	Unity of God
Principles	Secular Individualistic Profit maximization Survival of fittest Process	Religious Communal Reasonable profit Equity Environment
Criteria	Based upon modern commercial law – permission rather than ethical; Limited disclosure (provision of information subject to public interest); Personal accountability (focus on individuals who control resources)	Based upon ethical law originating in the Quran (Islamic law – *As-sunnah*); Full disclosure (to satisfy any reasonable demand for information in accordance with the *shariah*); Public accountability (focus on the community who participate in exploiting resources)

Table 2: Comparison between Western and Islamic accounting (Baydoun & Willett, 2000, p. 82).

Another approach used to establish Islamic accounting standards is by testing the current concepts in conventional accounting against *shariah*. Although many scholars prefer the use of normative-deductive approach as discussed above, AAOIFI has decided to adopt the latter approach as it is believed that not all conventional accounting issues violate the *shariah* requirements (Napier, 2007). By using this approach, the AAOIFI is considering the methods being used in the conventional accounting and is deciding whether the concepts are against the Islamic requirements. Only if the concepts are not available in the conventional systems or contradict with the Islamic tenets, then, the AAOFI would develop a new suitable method.

iii) Differences in the Objectives of Accounting and Reporting

As AAOIFI decided to adapt Western accounting to its standards, there are raising concerns regarding the compatibility of conventional accounting framework with the *shariah* requirements. Napier (2007) discusses this issue in detail and the following arguments on the adoptions of conventional accounting concepts in the Islamic accounting can be inferred from his research.

Concepts	**Arguments For**	**Arguments Against**
Separate entitiy	• Mosque were considered as separate during the early Islamic state • Limiting liability is acceptable in *mudharaba* • Islam does not deny the separate entity status of businesses.	• Ethical issue – owner is not responsible for debt during bankruptcy, but still have • rights on residual profits
Going concern	• Annual *Zakah* payment shows that Islam emphasizes on the continuity of business activity • Islam recognizes continuity as the basis of human life	• Only God will live continuously • Islam discourages long term contract • Based on *tandeed*[9] concept, liquidation is required for investments financed by *mudharabah* funds
Periodicity	• *Zakah* is required to be paid yearly	
Stability of purchasing power	• Fair to the lenders	• Adjustment of value is related to *riba*
Historical cost	• Does not violate the *tandeed* principles – no distribution of profit until the amount of capital invested is recovered	• *Zakah* should be calculated based on current value • Can be misleading
Matching	• Relevant to calculate the *zakat* base	• Asset-liability approach to measure the income is more appropriate to Islamic requirements

[9] Liquidation

Accruals	• Provides the true view of wealth	• Subjective judgment involved • Not suitable for *zakat* calculation • Based on The Shafi'i, distribution on *mudharabah* is only on cash profits
Full disclosure	• Islam requires full disclosure of information to the community in general	

Table 3: Arguments for and against of conventional accounting concepts.

iv) Disagreement on the prohibition of interest

In general, it is agreed that *riba* is unlawful in Islam (Hamid et al., 1993; Mohamed Ibrahim, 2001; Sulaiman, 2003). However, as *riba* is commonly deduced as interest, Gambling and Karim (1986) question whether all interests are considered sinful. They are also curious whether the use of interest for the time value of money is unlawful, as based on their understanding, *riba* as stated in the Quran and even in the Bible, refers to the act of taking advantage of the poor and needy. More recently, Zaman and Movassaghi (2002) argue that the prohibition of *riba* in the Quran refers to "*riba-al-Jahiliyya"*, a practice of doubling and redoubling the amount of money borrowed over time during the pre-Islamic period. By referring to the two Arabic books written by Suhail and Tantawi; Zaman and Movassaghi (2002) point out that the current practice of interest is not similar to *"riba-al-Jahiliyya"*. Zaman and Movassaghi (2002) also criticize the interpretations of *riba* or usury by certain Islamic jurists (*fuqaha*). According to them, some *fuqaha* interpreted the word *riba* narrowly by using *riba* and interest interchangeably whilst some Islamic jurists made clear distinction between usury (*riba*) and interest (Zamani and Movassaghi, 2002). Moreover, it was also stated that unlike earlier centuries of Islam, money now should also be considered as a commodity instead of just a medium of exchange. Therefore, not only can money be saved and invested; money should also be traded like other commodities (Zaman & Movassaghi, 2002).

Iqbal (2006) notes the three different views of *riba* among Islamic scholars. Firstly, the more Liberal scholars view *riba* as usury only, and, therefore, it is acceptable to the Islamic accounting as it is to the conventional banking. Secondly, the mainstream view *riba* as usury and bank interest, thus, a major restructuring of the conventional financial system is required. The third view is from the Conservative that believe *riba* is usury, bank interest, and any activities that lead to injustice among society members. Due to the different interpretations among scholars, unsurprisingly, some IFIs may offer products that are considered unacceptable by other IFIs, especially, the ones from different jurisdictions (Olson & Zoubi, 2008).

2.5.2 Applications of Islamic Accounting Concepts

i) Arguments about Financial Products Offered by IFI

The operations of IFI were being criticized by a few scholars for being similar to conventional accounting (Rosly & Abu Bakar, 2003; Zaman & Movassaghi, 2002). Rosly and Abu Bakar (2003) examined the performance of IFIs as compared to the conventional banks in Malaysia. Based on their analysis, they concluded that the operations of IFIs in Malaysia were not as efficient as compared to the conventional banks. They also pointed out that the IFIs were behaving like conventional banks and started to offer interest-like products such as *Al-Bai-bithaman Ajil* (similar to housing loan), *Al-Ijarah Thumma Al-Bay'* (similar to vehicle finance lease) and *Bai al-Dayn* (similar to bill of exchange). They added that this situation indicated that the authority had actually failed to provide proper guidance and direct IFIs away from the conventional banks. Thus, they suggested that the IFIs in Malaysia had yet to fully adhere to the *shariah* requirements.

Furthermore, Zaman and Movassaghi (2002) argue that in reality, the financial products offered by IFIs appear to be different from what is understood in the Islamic literatures. According to Zaman and Movassaghi (2002), the rate of profits offered to long term investors in IFIs is significantly higher than the rate offered to the short term

investors. This is the same approach adopted by the conventional banks and it is suspected that the rates of profits are similar to the pre-determined interest rates. Moreover, it is argued that some practices of IFIs are less Islamic if compared to the conventional banks. Examining the *murabaha* concept, for example, IFIs resell a product to its client at a mark-up price that is usually higher than the interest charged by the conventional banks. And this mark-up price is considered a predetermined profit for the bank. Other examples put forward by Zaman and Movassaghi (2002) are costlier *mudharabah* and *ijarah* transactions. They suggest that there should be a clear guidance for IFIs on the products that should be offered to the clients to avoid exploitation and to promote justice as required by Islam (Zaman & Movassaghi, 2002).

ii) Problems to Communicate the Social Contribution

Social responsibility is one of the major roles that should be performed by the IFIs according to the *shariah.* Gambling, Jones and Abdel Karim (1993) examined the possibilities of producing a true and fair financial report that communicates the social contribution of 'ethically-funded organizations' including IFI and British charities. Based on the analysis, they found that it was quite difficult to prove the social contribution as the output of these organizations. Although the amount of money spent can be shown in the financial report, it is almost impossible to verify that the money has been spent for good reasons. Therefore, they believe that in this situation, *Shariah Supervisory Board*[10] (hereafter, SSB) of an IFI should play their roles to ensure the credibility of the IFI (Gambling et al., 1993).

More recent, Haniffa and Hudaib (2004) examined the disclosure practices of five IFIs in the gulf region. Eight themes including mission statement and corporate objectives, top management, SSB, audit, product, employees, community and Islamic values were studied in detail. Overall, they found that the "current disclosure practices were minimal, lack clarity and consistency, and fell short of their potential to function as

[10] SSB acts as the advisor to the IFI regarding *shariah* related issues. The Board is also responsible to issue a report certifying that the IFI adheres to the Islamic principles.

enabling communication" (Haniffa & Hudaib, 2004, p. 19). Another paper also by Haniffa and Hudaib (2007) concluded that IFI as social and economic institutions, failed to communicate properly particularly in four areas; commitment to the society, IFI vision and mission, management of *zakat*, *qard*, and loan, and information regarding the top management.

Maali, Casson and Napier (2006) also studied the social reporting by Islamic Banks. Using a disclosure index approach, the writers analyzed the actual social disclosures of IFIs as compared to the Islamic requirements. The study focused on several areas such as disclosures of *shariah* opinions, involvement in unlawful activities, payment of *zakah*, environmental reporting, and other aspects of community contributions. Based on the analysis, they found that the social disclosure practices of IFIs were minimal and in reality, social issues were not the main concerns for most IFIs.

2.5.3 Implications for Corporate Governance

Khan (2007) discusses the impacts of diversity in *shariah* opinions to the corporate governance of Islamic Banking. The flexibility and diversity in *shariah* views may lead to dissatisfaction to the end user of IFI products in the long run. This might be due to the possibility that the players in the Islamic Banking industry may take the advantage on such flexibility in order to earn higher profit, at the expense of Islamic spirits. For instance, by offering unrestricted profit-sharing investment products, the IFIs command total controls on the depositors' money which serves the interest of the banks instead of the depositors concerned.

There are two questions raised by Khan (2007) regarding the diversity of *shariah* views.

1. What type of expertise is needed to ensure the IFI is making the right choice in the application of Islamic concept in the industry?

2. What type of standards is needed to ensure that there is transparency among bankers and depositors especially in the matters where there are different views among *shariah* scholars?

Khan (2007) believes that the above questions are crucial to ensure the long existence of IFI. The major concern of IFI clients is whether their money is being managed according to the *shariah* requirements that distinguish the IFI products from the conventional banks products. Khan (2007) conjectures that there is no known arrangement for IFIs to provide a transparent view to the depositors on the management of their funds in accordance with *shariah*. In general, the IFIs only provide an overall *shariah* clearance for the operations of the Islamic Banking and the details of the clearance processes are not being shared with the clients. If the situation persists, it will have a detrimental impact on the confidence level of the customers of the IFI industry, affecting the survival and growth of IFIs in the foreseeable future (Khan, 2007).

2.6 Roles of AAOIFI to Overcome the Listed Problems

AAOIFI was established in 1991 in Bahrain in response to the growing number of IFIs and the increasing awareness of the society regarding the inequality of conventional accounting for Islamic corporation since (Nasir & Zainol, 2007; Pomeranz, 1997). The establishment of AAOIFI was expected to provide a reliable platform to discuss the issues of IFI by hosting conferences and seminars, and focusing on the development of IsAS especially for the Islamic investment vehicles as listed in Table 1 above. Up to this date, AAOIFI has issued 38 standards on accounting, auditing and governance for the IFI, and has about 183 members from more than 30 different countries (AAOIFI, 2008). However, there are a limited number of studies that discuss the roles of AAOIFI in resolving the issues of IFI. Therefore, it is hoped that this thesis will contribute some insights on the roles and contributions of AAOIFI in resolving the Islamic accounting issues mainly on *zakah* and *riba*.

In relation to the issue of differences in the objectives of accounting and reporting from the Islamic perspectives, AAOIFI adopted the objectives derived from the "Statement of Financial Accounting No. 2 (SFA 2): Concepts of Financial Accounting for Islamic Banks and Financial Institutions" (Napier, 2007). The reasons behind AAOIFI choice of the financial concepts are summarized in Table 4 as follows:

Financial Concepts	**Reasons**
Separate Entity	AAOIFI agrees with the arguments that mosque is the proof that separate entity concept has been long accepted in Islamic society and does not violate any Islamic requirements.
Going Concern	On the basis of *mudharabah* contract, even though it is formed for specific period, it is assumed that the contract will continue until the parties involved decided to terminate the contract.
Periodicity	No argument against the use of periodicity concept in Islamic accounting
Stability of Purchasing Power	AAOIFI decided to adopt the concept as it is believed that there are no appropriate "remedial methods" available.
Conservatism	AAOIFI is being silent in this concept and this concept is not mentioned in the AAOIFI standards as well.
Historical Cost	AAOIFI realized the problem of using historical cost but argued that there is not much information available to support the use of current value over historical cost.
Matching	Matching concept adhere to Islamic requirements that assigning the responsibilities of the cost to the beneficiary of the benefits.
Accruals	Believes that in the calculation of *zakat*, current value of the property should be determined, thus accruals should be adopted.
Full Disclosure	Agrees to the Islamic scholars that full disclosure should be applied to ensure the reliability of the IFI financial statements.

Table 4: Accounting Concepts Being Used by AAOIFI.

2.7 Compliance with AAOIFI Regulations

Mohamed Ibrahim and Osman (2003) criticize the AAOIFI approach to developing Islamic accounting standards. Instead of using normative-deductive approach as suggested by majority Islamic scholars, AAOIFI decided to test the conventional accounting standards against *shariah* principles. Following this procedure, AAOIFI developed new standards which are unique to Islamic accounting such as *zakah* or areas perceived to be incompatible with Islamic requirements, for example *ijarah* (Mohamed Ibrahim & Osman, 2003). AAOIFI standards, therefore, are generally perceived as mirroring conventional accounting and highly influenced by 'capitalist thought' (Mohamed Ibrahim & Osman, 2003; Napier, 2007). Islamic rules and values are unique and complete, thus, developing a standard based on conventional thinking is highly unacceptable. Moreover, the establishment of social and environmental accounting by the West suggests that there are defects in the contents of conventional accounting and the Islamic values are already captured in the conventional accounting practices. They also argue that in the long run, AAOIFI standards will become irrelevant since most of the areas covered are within the scope of the conventional accounting standards (Mohamed Ibrahim & Osman, 2003). AAOIFI was also severely criticized for not being competent, lazy and for adopting the conventional accounting concepts although the majority of the Islamic scholars favored the use of normative deductive approach (Mohamed Ibrahim & Osman, 2003).

With respect to the acceptance of AAOIFI standards by IFIs, it seems that the adoption is limited only to certain areas of accounting such as *zakah*. Since the early establishment of AAOIFI, the organization has played an important role in establishing the Islamic accounting standards for *zakah* (Sulaiman, 2003). "Financial Accounting Standards No. 9 (FAS 9): Zakah" was promulgated in 1998 by AAOIFI. FAS 9 takes the position that IFIs are eligible to pay *zakah*, as business is considered a separate entity and the calculation of *zakah* was explained in detail (Sulaiman, 2003). However, the disclosure of *zakah* as required by AAOIFI is viewed as insufficient to the users of financial statement (Haniffa & Hudaib, 2004).

Haniffa and Hudaib (2004) study also indicated that**,** out of five companies researched, only two IFIs had adopted the AAOIFI standards. Interestingly, both IFIs that follow AAOIFI standards were from Bahrain, the country of origin of AAOIFI. Although they claimed that they had strictly followed AAOIFI in preparing their financial statements, there were a number of disclosures required by AAOIFI missing from the financial statements. The lack of acceptability to AAOIFI standards happened probably because Gulf Cooperation Council (GCC)[11] region is still required to comply with Central Bank requirement of following IFRSs. Research on Asian region also revealed the same situation. Harahap (2003) studied the disclosure practices of Bank Muamalat Indonesia (BMI) and found that BMI complied with the requirements of Indonesia Central Bank instead of AAOIFI. Based on the research, the scholar concludes that AAOIFI standards are not binding but being used as a guideline for IFIs instead (Harahap, 2003).

Based on this, it seems that although a number of studies regarding Islamic accounting have been done before, there has been no known study that primarily investigates the compliance of IFIs with the AAOIFI standards. By choosing 25 members of AAOIFI as the samples of the study, this study is intended to fill the gap in the Islamic accounting literatures. However, this study will only focus on *zakah* and *riba* as these two issues often create attention to the Islamic financial industry.

[11] GCC comprises the Persian Gulf states of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates

Chapter 3: ISLAMIC ACCOUNTING ON ZAKAH AND RIBA

3.1 Introduction

In Chapter 2, it was revealed that Islamic economic concepts emphasize the fairness, equality and justice within the society. In order to achieve social justice, Islam requires Muslims to pay *zakah* and prohibits them from being involved in *riba* activities. This leads to major differences between the Islamic and conventional perspectives of economic and accounting. Abdul Rahman (2002) stated that the accounting objectives of Islamic institutions can be derived by its responsibility in the payment of *zakah.* It is believed that once an organization's primary objective is to pay *zakah* as required by Islam, the business tends not to involve in activities viewed as unlawful or haram such as *riba* (usury), fraud, exploitation and gharar (uncertainty) due to the strong believes in the *Tahwheed* concept.

In this chapter, the concept of Islamic accounting on *zakah* and *riba* will be discussed in detail. First part of this chapter will discuss the concepts of *zakah* based on the Quran and Al-Sunnah, followed by the real application of it. This includes the discussion on the nature of assets that is zakatable and the valuation of the assets. Next, the issue of *riba* in the current contemporary accounting will be explored before discussing the relevancy of these two concepts.

3.2 Islamic Accounting on *Zakah*

Generally, Muslims believe that *zakah* is part of their religion whilst Prophet Muhammad (pbuh) declared it as the third of the five pillars of Islam. In the Holy Quran, there is no detailed explanation on the zakatable items and the required percentages of *zakah*. It is left to Prophet Muhammad (pbuh) to enlighten the followers of the general commands in the Quran either explicitly or by providing examples. However, according to Qaradawi (1999), there are a few items or assets mention in the Quran as zakatable such as gold and silver based on the verse 34 of chapter 9, *"And those who hoard up gold and silver, [the money, the Zakah of which has not been paid] and spend them not in the Way of Allah, announce unto them a painful torment"*(p. 353). Additionally, in the second chapter, verse 267, Allah says *"…spend of good things which you have (legally) earned, and of that which We have produced from the earth for you…."* (p. 60). It is believed that the above verse specifically requires the

payment of *zakah* on earnings based on trades or other types of business activities, as well as gains from agricultural and horticultural products. Beside these items, *zakah* is mentioned in general in the Quran such as in the verse "*and in their properties, there was the light of Sa'il (the beggar who asks) and the Mahrum (the poor who does not ask other).*" (p. 708).

Islam specifically requires each individual Muslim to pay *zakah*. This raised an issue amongst Islamic scholars whether a company is responsible for the payment of *zakah*. However, this issue was resolved during the First Conference on *Zakah* in Kuwait in 1984 (AAOIFI, 2008). The conference established that as a company is considered as a separate legal entity, the company is liable for *zakah* either for itself or on behalf of its shareholders, subjected to the following conditions:

i) If a law is passed and it obliges the companies to give *zakah*.
ii) If the main system of the company includes an article which stipulates giving *zakah* on its capital.
iii) If the general assembly of the company issues a decree in this regard.
iv) If the share-holders agree that the company should give *zakah* on their behalf.

(Fatwas Delivered by the First Zakah Conference, 2009).

It is generally agreed that if the company fulfils the *zakah* obligation, the shareholders are not liable to pay it (AAOIFI, 2008).

3.2.1 Wealth Determination

Qaradawi (1999) emphasizes that zakah should be paid on *amwal* (wealth or assets) based on the general texts available in the Quran and Sunnah, such as in verse 103 of the ninth chapter. Allah says:

"*Take sadaqah (alms) from their wealth in order to purify them with it.*" (p. 262).

Qaradawi (1999) further explains that during the revelation of The Quran period, the word *amwal* was originally meant as owned gold and silver, but this was then generalized to include all things that people like to acquire and own, including livestock, agricultural products, and land.

Among the five major schools of thoughts in Islam, there are some differences in the meaning of the word *amwal*. According to The Hanafis, *amwal* is inclusive of everything that a person usually buys and uses. Thus, there are two conditions that need to be considered in order to classify the items as *amwal*; (i) the possibility of earning it, and (ii) the possibility of using it. This further broadens the meaning of *amwal* to include all owned equipments, furniture, and money. Based on The Hanafis definition, even though the items are not actually obtained and used, but there are possibilities of obtaining and using them in the future; such as fish in the sea or usable animals in the forest, these items shall be considered as *amwal* as well. Consequently, based on The Hanafis' definition, services provided such as financial and customer services are not *amwal* as these services are not obtainable (Qaradawi, 1999).

However, according to the other schools of thoughts, namely The Malikis, The Shafiis, and The Hanbalis, an item should be considered as *amwal* once the possibility of obtaining the source of *amwal* is satisfied. Therefore, based on the condition, services provided by a business should be considered as *amwal* according to these three schools of thoughts. This is based on the condition that as a car can be obtained physically, thus, its utility shall be considered as *amwal*. However, Qaradawi (1999) personally prefers the definitions provided by The Hanafis as this appears to be closer to the early definition of *amwal* and more applicable. According to the scholar, it is not appropriate to collect *zakah* from services and distribute them to the deserving people as the services provided are not considered as material assets. For example, if a poor family is allowed to stay in a *zakah* payer's house without any charge incurred, this does not waive his obligation to pay *zakah* as the utility is not a material and cannot be obtained (Qaradawi, 1999).

Nevertheless, it is generally agreed that *zakah* is not paid for all owned *amwal* as there are certain conditions that must first be satisfied. The conditions justify that *zakah* is only imposed on assets belonging to those who can afford to pay it. These conditions are as follows:

i) Ownership

By having an absolute right to ownership of a property, it means that the owner has absolute control over the asset. The owner has the right to extract all the benefits and profits from the

assets and is able to dispose them. Thus, there is no *zakah* on public property or funds held for charitable purposes as the assets have no specific owner. In addition, these types of assets are designated to serve the society in general. Similarly, all not-for-profit organizations are not required to pay *zakah* (AAOIFI, 2008). This requirement also excludes assets gained illicitly as the assets are not actually owned by those who have them. These include items acquired through stealing, cheating, bribery, and *riba*. Scholars in general agree that instead of paying *zakah*, these items should be returned to their true owners or their heirs if known. Otherwise, the items should be given to the poor or needy but not in term of *zakah*, but *sadaqah* (Qaradawi, 1999). However, there are some arguments among scholars whether *zakah* should be paid on debts. Initially, it was agreeable that the right of ownership of both debtors and creditors were incomplete. For the debtors, although they gain benefits from the assets, the assets are actually not owned by them. On the other hand, although the creditors own the assets, they have no absolute control over the assets. Based on the above conditions, it seems acceptable not to impose *zakah* on debts. But more recently, there are suggestions that if a debt is due to be repaid in the future, its creditor is obligated to pay *zakah* on debts as well since the property is under one's control (Qaradawi, 1999).

ii) Growth

The second condition that needs to be considered in determining the liability to pay *zakah* is the ability of the assets to grow either in real terms or by estimation (AAOIFI, 2008; Qaradawi, 1999). Growth by estimation is when the assets have the potential to grow if used properly even if they are not invested (AAOIFI, 2008). This includes assets such as livestock, business assets, agricultural products, and even money. Nonetheless, *zakah* is paid only for growing assets, thus, excluding assets that are being used for personal reasons such as animals that are used as a means of transportations and houses that are occupied by the owners. Similarly, fixed assets of a company that are utilized to produce products are also excluded from the payment of *zakah* as these assets are not growing. On the other hand, Sulaiman (2003) defines "growth" as any realized or unrealized gains on both fixed and current assets. Therefore, it is suggested that an accounting system based on *zakah* should focus more on the significance of the real assets. Thus, for income measurement purposes, the focus should shift from the revenue-expense approach to the asset-liability approach. As a result, it is expected that the statement of financial positions should become the main source of accounting information.

iii) Nisab

Islam does not require the payment of *zakah* for all growing assets as there is a nisab that exempts certain amount of property from *zakah*. Nisab is defined as the minimum amount required in Islam to pay *zakah* (AAOIFI, 2008). Due to the variation of its value, noticeably there are differences in nisab for different types of assets. To illustrate the differences, the nisab for livestock is 5 for camels and 40 for sheep; while the nisab for gold and silver is 85 grams and 595 grams respectively (AAOIFI, 2008; Qaradawi, 1999). It seems that the application of nisab justifies the concept of *zakah*, which is to support the poor and the needy. Thus, it shall only be taken from those who can afford it. This is also consistent with the current practice of tax that exempts certain amount of assets from tax.

iv) Time

The asset is only zakatable once it has been owned for at least a lunar calendar year. Should this be the case, it should then be paid annually at 2.5% (AAOIFI, 2008; Qaradawi, 1999). During the Conference of *Zakah* held in Kuwait in 1984, it was ruled that the rate of *zakah* based on the solar calendar was at 2.5775% instead of 2.5%. However, according to Qaradawi (1999), this condition is only applicable to business assets, livestock, and money but not to agricultural and horticultural products since *zakah* on these products is payable during the harvesting period. This is based on the saying of Allah in verse 141 of the sixth chapter:

> *"And pay the due thereof upon the harvest day"*.

Despite this, there are also differing views among scholars that *zakah* is due on assets even without considering the one year ownership requirement, as long as the nisab is reached (Qaradawi, 1999).

3.2.2 Asset Valuation

After determining the zakatable assets, the valuation of the assets should then be considered. However, according to Sulaiman (2003), there were some arguments among scholars on the accurate method of valuing the assets for *zakah*. On one hand, some scholars suggested the

assets to be re-valued should be based on the current value of the assets during the payment of zakah. They believed that by using the current value, the true wealth of the individuals could be determined. On the other hand, some jurists preferred that the amount of zakah should be determined based on the historical cost of the assets to avoid uncertainties.

Nevertheless, this issue was resolved during the Seventh Seminar on Contemporary Issues of Zakah in 1997 in Kuwait (AAOIFI, 2008). The seminar ruled out that the assets should be valued based on the market selling price for the purpose of *zakah*. The decision was made based on the statement of Prophet Muhammad (pbuh):

> *"Evaluate them on the day when zakah is due on the and then pay their due Zakah"*
>
> (Hadith – Jabir bin Zayd)

3.3 Riba and accounting

There are no arguments that *riba* is unacceptable in Islam. As discussed in the previous chapter, Islamic scholars generally agree that practicing *riba* violates an individual right. However, there is yet to be any agreement among scholars regarding whether all interest-related activities should be considered as *riba*. Sulaiman (2003) views that the total abolishment of interest may affect the capital structure of a company and influence the disclosure practices of financial reporting. For companies that follow the views of the Conservative, they are forbidden to involve in any activities associated with *riba*. It is also expected that these companies might not engage in debt financing. This is based on the opinion of some jurists that Islam precludes debts due to the prohibition of interest and the discouragement of Prophet Muhammad (pbuh) against debts (Hamid, et. al, 1993). On the other hand, there is also a view that the prohibition of interest, however, does not lead to the prohibition of debts (Sulaiman, 2003). Therefore, it is expected that the companies following Conservative views are heavily capitalized by the equity as compared to other companies. Sulaiman (2003) added that as interest is strictly forbidden in Islam, the Islamic institutions might be required to provide more disclosure as compared to the conventional companies. This includes the disclosure of any involvements of the institution with the *riba* activities and the reasons these activities occur.

Zaman and Movassaghi (2002) argue for the use of interest rates by the conventional banks. They argue that the interest rate is important to the bank to compensate for the risks and operational costs borne by the institutions. The interest rate charged basically depends on the nature of the loan, the credit history of the customer and the interests charged by other financial institutions. On the other hand, Lewison (1999) points out that the interest not only violates the Islamic tenets, but also it goes against the Judaism's as well. However, he adds that it is almost impossible to totally avoid taking or giving interest in this modern economy especially in the financing industry. Although a loan appears to be interest-free on the surface, it is arguable that there must be some extra charges incurred by the loan provider. Therefore, it is believed that some known extra charges imposed on the clients should be acceptable in Islam as long as they do not involve exploitation.

In conclusion, it is undeniable that payment of *zakah* and prohibitions against involvement in *riba* are important to the institutions that are based on Islamic requirements such as IFIs. This is important as the establishment of IFIs, initially, is to provide services based on *shariah* system as demanded by the Islamic society. Thus, not adhering to the Islamic tenets may cause dissatisfactions to the customers and, in the long run, it may also affect the survival of the industry. The issues of *zakah* have long been discussed by the jurists and some problems have even been resolved. These include issues on the percentage of *zakah* if the Gregorian calendar is used, the requirements of Islamic companies such IFIs to pay *zakah*, the conditions that require the payment of *zakah*, and the basis of assets valuation for the purpose of *zakah*. With the detailed guidelines provided by the scholars on *zakah*, it is expected that the IFIs would not have many problems fulfilling their responsibilities to pay *zakah*.

On the other hand, as some issues on the interest and *riba* are yet to be resolved, the IFIs might need to decide what kind of transactions that involve interests are acceptable. Based on the current development on interest, it is expected that some services provided by an IFI might not be acceptable to other IFIs. However, it is expected that the IFIs would honestly disclose their business activities in the financial reports especially for activities that are considered haram. With the full disclosures made by the management of the IFIs, the clients and the general public may be able to evaluate the performance of the banks and decide whether the money invested is managed according to the *shariah* requirements.

Chapter 4: ACCOUNTING AND AUDITING ORGANISATION FOR ISLAMIC FINANCIAL INSTITUTIONS (AAOIFI)

4.1 Introduction

In this chapter, the differences between AAOIFI and IASB are studied. IASB is chosen as the benchmark for this study because, besides US GAAP, the accounting standards practiced by IASB and IFRS are of high quality accounting standards (Daske & Gebhardt, 2006). On top of that, globally, more countries are moving towards adopting IFRS. This chapter starts with the general backgrounds of both accounting bodies, followed by detailed explanations for the procedures taken by both bodies in developing their accounting standards. Later, the accounting standards related to *zakah* and *riba'* published by AAOIFI will be discussed. Unlike *zakah*, no specific standard on *riba'* is promulgated by the AAOIFI. This might be due to the fact that accounting on *riba'* is not specific to only certain type of transactions provided by the IFIs. For the purpose of this study, standards on *riba'* is based on the standards promulgated by the AAOIFI on mudaraba, murabaha and musharaka.

4.1.1 Background

IASB is an autonomous, private body that is responsible for developing and approving IFRS. The Board was established in 2001 in London to supersede the International Accounting Standards Committee (hereafter, IASC) that was created in 1973 (Deloitte, 2008). The IASC was restructured in 2000 due to several problems encountered by them, including poor relationship with national standard setters globally and limited amount of resources available (Alfredson et al., 2007). Currently, IASB is appointed and supervised by the International Accounting Standards Committee Foundation (hereafter, IASCF) that is mainly responsible for the funding of the Board. Besides, IASB is also supported by Standards Advisory Council (hereafter SAC) and International Financial Reporting Interpretation Committee (hereafter IFRIC).

The structure of the IASB is shown in the chart 1 below:

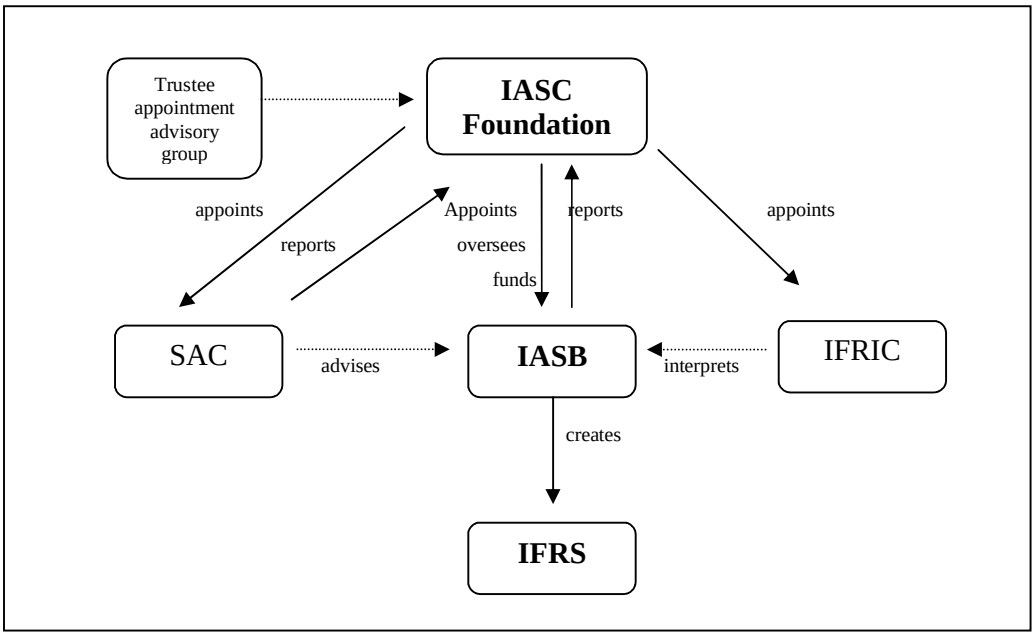


Chart 1: Structure of IASB (Alfredson et al., 2007, p. 16)

As shown in the Chart 1 above, IASB is responsible for reporting to IASCF. At present, IASCF consists of 22 trustees that come from different parts of the world with different professional backgrounds, including auditors, accountants, academics, preparers, and users of financial statements. These trustees are responsible for appointing the members of IASB, SAC, and IFRIC, evaluating the strategy of IASB annually, and approving the funding for IASB. In addition, SAC is responsible for advising IASB in setting the agenda and priority of IASB's work. Similar to IASCF, 40 members of SAC comes from different jurisdictions and professional backgrounds. Finally, IFRIS's responsibilities are to interpret the application of IFRS and provide guidance on the issues faced by the preparers of the accounting standards. They are also accountable for publishing final Interpretations for the public. Presently, there are 14 members of IFRIC appointed by IASCF for the period of 3 years. With strong support from these committees, IASB is expected to create a higher quality of IFRS (Alfredson et al., 2007; Deloitte, 2008).

On the other hand, AAOIFI is an independent, not-for-profit body that prepares accounting, auditing, governance, ethics, and *Shariah* standards specifically for IFI and the related industry. Historically, AAOIFI was established in accordance with the Agreement of

Associations that was signed by a number of IFIs in February 1990 in Algiers. The Body was then registered in March 1991 and based in Bahrain. Currently, the Body is supported by 155 institutional members from 40 different countries mainly from the Gulf region (AAOIFI, 2008).

The AAOIFI structure consists of General Assembly, Board of Trustees, Accounting & Auditing Standards Board, Secretariat General, and *Shariah* Board. The General Assembly consists of all the founding, associate, observing, and supporting members as well as the members representing Regulatory & Supervisory Authorities. The General Assembly is responsible for appointing the 20 part-time members of Board of Trustees who serve for 5 years. The Board of Trustees is composed of representatives from regulatory bodies, SSB, accountants, and users of financial statements. Their authorities include appointing the AAOIFI board's members (Accounting & Auditing Standards Board, Secretariat General, and *Shariah* Board) and arranging the funds for AAOIFI. The twenty members of Accounting & Auditing Standards Board are responsible for preparing and interpreting the accounting and auditing standards besides providing guidelines to IFI. The Secretariat General on the other hand consists of the Secretariat-General, who is also the executive director of AAOIFI as well as the technical and administrative units. As the executive director, he is responsible for coordinating and supervising the daily activities of the AAOIFI and representing the organization at conferences and seminars. Finally, the *Shariah* Board is represented by *fiqh*[10] scholars who represent SSB in the IFI. Their responsibilities include harmonizing the concepts and application between SSB of IFI to avoid any inconsistencies and contradictions in the activities of IFI. They are also responsible for reviewing the AAOIFI standards to ensure the compliance with the Islamic requirements (AAOIFI, 2008). The structure of AAOIFI is summarized in the Chart 2 below:

[10] Islamic jurisprudence

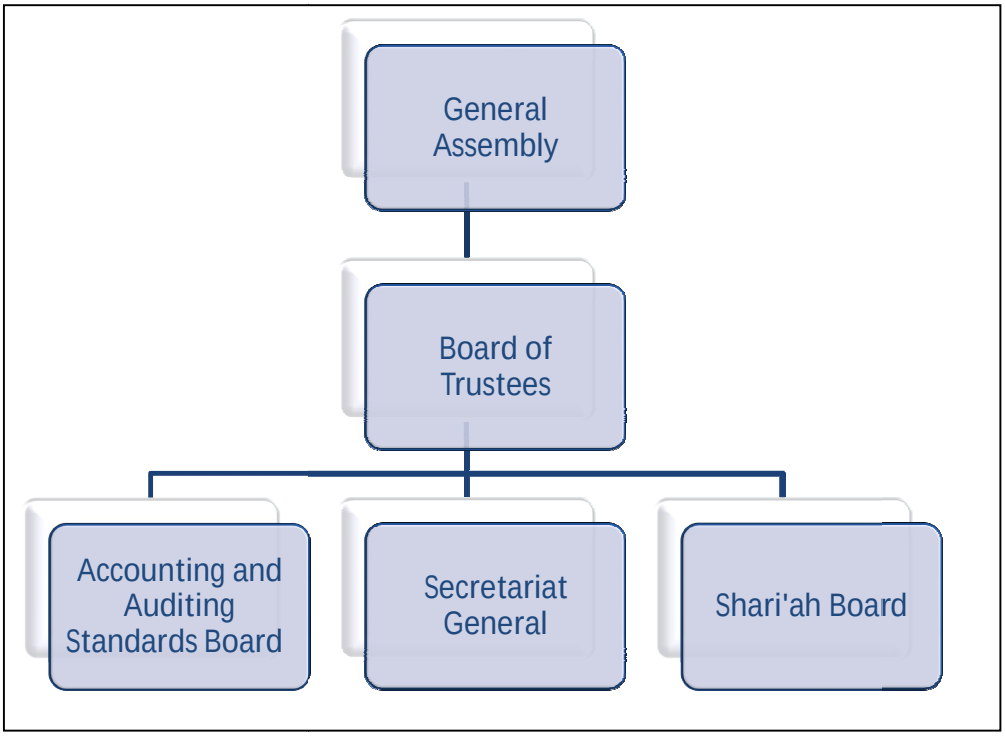


Chart 2: Structure of AAOIFI

4.1.2 Objectives

Both accounting bodies have their own sets of objectives. The main objective of IASB is to develop a single set of high quality accounting standards that is acceptable and enforceable worldwide. In order to achieve this, IASB is aggressive in promoting the use and application of IFRS, harmonizing the national standards with IAS and IFRS, as well as considering the needs of small and medium size entities (Deloitte, 2008; IASCF, 2007). Moreover, in order to achieve high set of accounting standards, IASB have issued principles-based standards that are believed to provide better indications of the company's financial position and performance. IASB has also considered limiting the accounting alternatives, thus minimizing the management's opportunistic discretion in applying the accounting standards (Barth, Landsman & Lang, 2008).

On the other hand, AAOIFI main objectives are to develop Islamic accounting and auditing thoughts as well as standards that are deemed to be relevant to the IFI worldwide. AAOIFI is also active in promoting the concepts and applications of the Islamic accounting and auditing by providing training, seminars, and conducting researches for interested parties.

By providing a high-quality Islamic accounting and auditing standards for IFI that adhere to the *shariah* requirements, it is expected that the assurance level of the users of the financial statements will be increased. Consequently, these may encourage the users to invest and use the services provided by the IFIs (AAOIFI, 2008).

4.1.3 Jurisdictions

According to Deloitte (2008), 113 countries are known to require or permit the use of IFRS. Out of the 113 nations, about 75% or 85 jurisdictions including Australia, Bahrain, Denmark, German, and New Zealand require the use of IFRS for all listed companies. Other 4 jurisdictions namely Azerbaijan, Belarus, Israel, and Russia oblige the use of IFRS only for some listed companies. And the remaining 24 countries such as Turkey and Switzerland permit the use of IFRS. On top of this, in 2006 and 2007, China, Brazil, Canada, Chile, India, Japan, and Korea decided to adopt or use IFRS in the near future (IASCF, 2007).

Although not as widely accepted as IFRS, AAOIFI accounting standards have been adopted in seven countries, namely Bahrain, Dubai, Jordan, Lebanon, Qatar, Sudan, and Syria. The standards have also been used as guidelines for IFI in Australia, Indonesia, Malaysia, Pakistan, Saudi Arabia, and South Africa (AAOIFI, 2008).

4.1.4 Development of the Standards

i) International Financial Reporting Standards

Up to this date, IASB have issued 8 IFRS, 30 IAS, and 24 IFRIC. The 30 IAS are the standards issued by the old IASC while the new standards issued by IASB are called IFRS. However, while waiting for the IASB announcement, the 30 IAS are still enforced until the standards are replaced or amended by the IASB. Nevertheless, the term IFRS is used to refer to the whole standards of IASB including the old IAS (Alfredson et al., 2007). As an established standard-setting body, there are six steps taken by the IASB to develop the accounting standards to ensure the quality and applicability of their standards (IASCF, 2006). These steps are explained below:

a) Setting the agenda

IASB starts developing the accounting standards based on the important issues identified by their staff. Besides, these issues could also be raised by other standard-setters and interested parties. In setting the relevant agenda, IASB considers whether the issues are relevant to the common users, there are resources available, and most importantly, the standards to be developed will be in good quality. In addition, IASB also considers the possibility of conducting the project jointly with other standard-setters. To address these factors, IASB conducts several meetings with the SAC, IFRIC, staff members, and other standard-setters. And these meetings are open to the public for observation to ensure the transparency of the decisions made by the body.

b) Project planning

During the planning stage, usually, a working group that consists of expertise in the relevant industry is set up based on the nominations and applications made. If IASB decides not to establish the group, IASB is required to state their reasons. Similar to the setting agenda stage, meetings of working group members are announced in advance and open to the public (Deloitte, 2008).

c) Development and publication of a discussion paper

IASB usually publish a discussion paper of any major new topic in order to explain the issue to the public, indirectly inviting the public early comments. Normally, a discussion paper consists of a comprehensive summary of the issue, possible methods applied in attending to the issue, preliminary views from IASB, and finally, an invitation to a comment section. Typically, IASB permits 120 days for the public to comment on a topic and these comment letters will then be analyzed and reviewed by the working group. If further clarification on an issue is required, IASB will consider holding a public hearing or conducting a field test in order to receive wider responses from the professionals (Delloite, 2008). A field visit or test is usually conducted after the publication of a discussion paper or an exposure draft, with the aim of tackling a specific practical issue in implementing the proposed standards.

d) Development and publication of an exposure draft

The fourth step is a mandatory and crucial step in developing any new accounting standards. After addressing all the relevant recommendations, comments, and suggestion from various parties in the earlier steps, an exposure draft is outlined and ready for balloting process. For an exposure draft, IASB requires at least nine votes in favor from the IASB members before the exposure drafts can be published for public comments. Similar to a discussion paper, IASB usually allows 120 days for public comments.

e) Development and publication of an IFRS

For a major project, after all the issues during the exposure draft have been resolved, the IASB may consider publishing the second exposure draft for public comments. If the IASB meeting decides that the re-exposure draft is necessary, the fourth stage of the due process will be repeated. If satisfied with the final exposure draft, the IFRS will then be drafted and ready for another voting process. The IFRS draft will also be posted in their limited-access website for the paying subscribers. Finally, after all the outstanding matters have been resolved and the IASB members have voted for the publication of the standards, the IFRS is issued.

f) Procedure after an IFRS is issued

After the IFRS has been issued, several meetings are conducted between IFRS and interested parties to discover any new issues related to the implementation of the accounting standards. After a period of time, IASB may consider carrying studies on the ground so that the new standards can be reviewed. There may also be changes in the accounting regulations and environments and comments on the quality of the standards of the SAC, the IFRIC, other standard-setters, and even constituents. These studies may lead to new issues added to the IASB's agenda.

All of the above procedures must be transparent and accessible, involve extensive amount of consultations and responses, and most importantly they must be responsible (IASCF, 2006). These requirements are crucial for the IASB to ensure that the high quality of the standards is produced, subsequently leading to the high implementation of the IASB

standards. To ensure that the due process is transparent, all the meetings conducted either by the SAC, the IFRIC, or the working group is open to the public for observations. Furthermore, the IASB meetings, commentaries, IASB meetings observer notes, discussion papers and exposure drafts are also available in the IASB websites for public access. Moreover, by making all the discussions, notes, and changes available in the websites, extensive amount of responses from the public can be considered by the IASB. Throughout the due process, IASB involves in a number of discussions with various types of users, academics, preparers and other groups to better understand any concerns shared by the affected parties. All these comments and concerns are considered by the IASB when developing the new accounting standards. Finally, to guarantee the accountability of the due-process, the Trustees review all the processes being implemented to ensure the compliance with the IASB's procedures and mandates. If the IASB decides to skip any non-mandatory steps as outlined in the Constitution, explanations are required to justify their decisions.

ii) AAOIFI standards

As explained before, besides the accounting standards, AAOIFI also issues auditing, governance, ethics, and *Shariah* standards. Until now, AAOIFI has published 25 accounting standards, 5 auditing standards, 6 governance standards, 2 ethics standards, and 30 *shariah* standards. As AAOIFI standards are specifically for IFI and the related industry, the standards are based on the requirements of IFI practices (AAOIFI, 2008). Moreover, for the standards developed by IASB that do not raise any *shariah* compliance issues such as IAS 10 – Events after Balance Sheet Date and IAS 24 – Related Party Disclosure, AAOIFI decides not to issue any new equivalent standards, thus, allowing the application for the IFRS or other local GAAP standards (International Standards for Islamic Finance, 2008). Based on the available AAOIFI accounting standards, the steps taken by the AAOIFI in preparing their accounting standards are discussed below:

a) Identification of issues

AAOIFI started developing their accounting standards based on the areas that were considered important to the IFIs. During the early stages of developing their accounting standards, AAOIFI conducted a number of field studies to identify the objectives of IFI and their current accounting practices. These field studies also determined standards that were

considered vital to the IFI and should be given priority by the AAOIFI. These field studies revealed that the standards relating to the financial instruments should be first developed by the AAOIFI. Later in 1995, a letter was sent to the IFI to seek their opinion on the areas that AAOIFI should focus on next and, based on their responses, six more standards were identified as crucial to the IFI. On the other hand, the latest ten accounting standards were developed based on the meetings conducted by the AAOIFI boards.

b) Preliminary studies

After identifying the areas that should be developed, AAOIFI usually appoints two consultants to conduct a preliminary study on the accounting and juristic aspects of the standards. For major areas such as the financial instrument standards, a set of questionnaires from several countries are sent to the IFIs to seek their opinions on relevant accounting treatments. The preliminary studies are then discussed and reviewed in the Board meetings and both aspects are equally considered to ensure that the accounting standards developed adhere to the *shariah* requirements.

c) Development of the exposure drafts

Based on the preliminary studies and Board meetings conducted, the exposure drafts are then prepared by the consultants. Later, the exposure drafts are discussed and revised in the Accounting Standards Committee meetings. Next, the exposure drafts are referred to the *Shariah* Committee that reviews the juristic aspect of the standards. If necessary and required by the Board meeting, the exposure drafts are sent to the specialists and interested parties in the industry to seek for their opinions and comments. This is generally followed by the discussion in a public hearing. Sometimes, for major areas, AAOIFI may decide to conduct the public hearing twice to gain more responses from the constituents. In general, the public hearings are attended by participants representing the central banks, IFI, accounting firms, *shariah* scholars, academics and other interested parties. All the comments made during the public hearings are considered and discussed in a committee meeting.

d) Development of the accounting standards

After considering all the responses, the Accounting Standards Committee amends the exposure draft and the accounting standards are subsequently prepared by them. Finally, the proposed standards are discussed and approved in the Board meetings after all the outstanding matters have been resolved.

On the surface, it seems that the approach taken by both accounting bodies are almost similar. Both bodies start developing their accounting standards based on the areas that are deemed important to their targeted users. This is followed by several in-depth studies and discussions on the topics including conducting the field studies for crucial areas. Based on the studies, a draft is written and further discussed in several meetings. Finally, after conducting several Board meetings and considering all comments made by the companies, committee members, scholars, and constituents; the accounting standards are issued after being approved by the authority members of both bodies.

However, comparing the steps taken by the AAOIFI and the IASB in-depth, it seems that the approach taken by the AAOIFI is less specific and organized. This might be due to the fact that there is no specific constitution in the AAOIFI that outlines the mandatory steps that should be taken by the institution in order to develop their accounting standards. The AAOIFI approach also appears to be lacking of public responses. Although the field study and surveys are conducted by the AAOIFI in order to identify the areas that need to be developed, these were only conducted until 1995. It seems that all the latest ten AAOIFI standards are developed based on the Board meetings that are conducted yearly by the body. Most of the time, the standards are developed, reviewed and discussed in the closed Board and committee meetings, with the public responses only during the public hearings. Indeed, sometimes the number of participants in the public hearings is relatively low, such as the public hearings for FAS 11 – Provisions and Reserves, with only around 19 participants involved. Even after the public hearings, all the changes made and comments are only discussed among the committee members and the revised drafts are not published for the public to comment. The lukewarm responses from the public occur probably because the AAOIFI websites have not been fully utilized. Unlike IASB that provides some information such as exposure drafts, project updates, meetings schedules, and commentaries freely in their websites, such information is restricted only to the AAOIFI websites. Furthermore, it

appears that not much study is conducted by the AAOIFI after the standards have been adopted. Referring to all the AAOIFI accounting standards, it seems that only FAS 17 is being revised by the body.

4.2 AAOIFI FAS 9 on Zakah

4.2.1 Background of the standards

Based on a letter sent to the IFIs in 1995, AAOIFI identified accounting on *zakah* as one of the areas that needed to be developed by them. As *zakah* is one of the pillars of Islam, developing the standards around the areas is considered vital in order to help the IFI to properly disclose the relevant information relating to *zakah* in their financial reports as well as reduce any differences in the methods applied by those IFI. Thus, it is expected that the standardization in the methods applied would help to provide useful information to the users of the financial reports (AAOIFI, 2008).

The AAOIFI FAS 9 covers the accounting treatments related to the determination of the *zakah* base and disclosure of *zakah* in the IFI financial statements. The standard is one of the earliest standards developed by the AAOIFI and has been made effective since 1 January 1999. Based on the preliminary studies conducted by the appointed consultants, AAOIFI specifies four conditions that require *zakah* to be paid on an asset. These include, unencumbered possession, growth in real terms or by estimation, attainment of the nisab, and finally, the passing of hawl (year). AAOIFI follows the decision ruled by the First Conference on *Zakah* in Kuwait in 1984 that required the rate of *zakah* be increased to 2.5775% from 2.5% for IFIs that used Gregorian calendar instead of the Islamic one.

4.2.2 Recognition of zakah

One of the notable contributions of AAOIFI FAS 9 is the determination of *zakah* base either by using the net asset method or the net invested fund method. Detailed examples provided in the standards prove that if the items are valued constantly, both methods will provide similar value of *zakah* base. Both methods are acceptable by AAOIFI, with the net asset method is based on the method prescribed by the juristic that is generally calculated based on the net current assets. On the other hand, net invested method is based on the method used by some

government organizations in the calculation of *zakah* (AAOIFI, 2008). The items included in the calculation of *zakah* base by using both methods are shown in the excerpts in Table 5 below:

Method	**Zakah Base**
Net assets method	Assets subject to *zakah* – (liabilities that are due to be paid during the year ended on the date of the statement of financial position + equity of unrestricted investment accounts + minority interest + equity owned by government + equity owned by endowment funds + equity owned by charities + equity belonging to not-for-profit organizations excluding those that are owned by individuals) (para 3).
Net invested funds method	Paid up capital + reserves + provisions not deducted from assets + retained earnings + net income + liabilities that are not due to be paid during the year ende on the date of the statement of financial position – (net fixed assets + investments not acquired for trading + accumulated losses). (para 7)

Table 5: The Calculation of *Zakah* base.

AAOIFI FAS 9 also differentiates the accounting treatments between IFIs that are obliged to pay *zakah* and those banks that are required to act as the agent for the shareholders. This is based on the decisions of the First Conference on *Zakah* that obligate IFIs to pay *zakah* if required by the law; or by charter or by-laws; or shareholder's resolutions. For this type of IFIs, paragraph 9 of the standards requires the *zakah* to be treated as non-operating expenses and presented in the income statement. If there is unpaid *zakah* for the accounting period, it shall be recognized as a liability in the statement of financial position. On the other hand, if the banks are required by the shareholders to pay the *zakah* on their behalf, the amount of *zakah* should be deducted from the shareholder's share of distributable profits.

4.2.3 Disclosure Requirements

In general AAOIFI FAS 9 requires a total of 8 items to be disclosed in the financial statements of the IFIs. Among the requirements to be disclosed are the methods and items included in calculating the *zakah* base in the notes accompanying the financial statements. There is also a requirement to disclose the rulings of the Shariah Supervisory Board on the issues not being covered in the standards. Moreover, the IFI need to disclose whether *zakah* is paid on behalf of its subsidiaries, holders of investment accounts and other types of accounts. If the banks decide not to pay *zakah*, they are required to calculate and disclose the amount of *zakah* that is due from each share and investment. Finally, for IFI that pay *zakah*, they are required to provide the "Statement of Sources and Uses of Funds in the *Zakah* and Charity Funds". However, these requirements are varied depending on the practice of the IFIs.

All the above disclosure requirements indicate the need for IFI to be more transparent in disclosing the financial information related to *zakah*. Based on the disclosure of *zakah* in the financial report, the IFI clients may decide whether they are obliged to pay *zakah* on their shares and investments. As mentioned by Qaradawi (1999), if the IFI satisfies the *zakah* obligation, then the shareholders have no obligation to pay it. If the IFIs are not responsible to pay *zakah* on behalf of the shareholders, it is expected that the disclosure requirements would assist the shareholders to determine the amount of *zakah* that needs to be paid. By providing the "Statement of Sources and Uses of Funds in the *Zakah* and Charity Funds", the stakeholders of the IFI may determine the sources of the funds that are being used by the banks to pay *zakah* and where the funds are actually spent to.

4.3 AAOIFI FAS 2 on Murabaha, FAS 3 on Mudaraba, and FAS 4 on Musharaka

4.3.1 Backgrounds of the Standards

The early field studies conducted by a number of consultants in 1991 revealed that these three standards that are related to the financial instruments should be given priority by the AAOIFI. The field studies revealed that Murabaha and Murabaha to the purchase orderer are considered among the financial instrument mostly used by the IFI. On the other hand, although the Mudaraba transactions were not common among IFI during the time, the field study indicated that the standards on Mudaraba is important to ensure the proper applications

of the Mudaraba instruments by the IFI in the near future. Finally, with the average percentage of transactions at 15%, the AAOFI Standards Boards decided that standards on Musharaka should be given priority as well. In addition, the field studies conducted also showed that there were huge differences in the measurements, recognitions as well as presentations of all these financial instruments in the IFIs' financial reports. Therefore, AAOIFI expected that the development of the standards on financial instruments would improve the quality of the IFIs' disclosures and would consequently provide better information to the users of the financial reports (AAOIFI, 2008).

i) AAOIFI FAS 2

FAS 2 shall apply to all assets available for sale by Murabaha and Murabaha to the purchase orderer. This also includes all the revenues, expenses, gains and losses attributable to the assets and receivables. As one of the earliest standards developed by AAOIFI, the standard was made effective for financial statements beginning 1 January 1998. In general, it is agreeable that IFIs should inform the client of the original costs of the assets and the additional mark-up price in the Murabaha transactions. Following the *shariah* requirements, the transactions should also be free of usury or riba'.

ii) AAOIFI FAS 3

On the other hand, FAS 3 shall apply to the Mudaraba financing transactions provided by the IFI and all the related transactions from the commencement period until the time of its completion. However, this standard does not cover accounting treatment of Mudaraba transactions for the IFI's clients; Mudaraba transactions related to unrestricted and restricted investment account funds; and *zakah* on Mudaraba fund. Similar to FAS 2, this standard shall be effective since 1 January 1998.

iii) AAOIFI FAS 4

Finally, FAS 4 shall apply to the Musharaka financing transactions carried out by the IFI either for a constant Musharaka or a diminishing Musharaka. However, the standard neither includes accounting treatment of Musharaka transactions in the client's book nor *zakah* on

Musharaka fund. Similar with FAS 2 and 3, FAS 4 shall also be effective for accounting period beginning 1 January 1998.

4.3.2 Recognition and Measurement

i) AAOIFI FAS 2

Based on the concepts of financial accountings for Islamic Banks published by the AAOIFI, all assets acquired by the IFIs including Murabaha assets should be measured initially at historical cost. Then, at the end of each accounting period, the Murabaha assets are required to be revalued either based on current value or net realizable value**,** depending on the obligation of the purchase orderer. There exist some arguments among *shariah* scholars on whether the final buyers are entitled to benefit from the discount received by the purchaser during the accounting period. Some scholars agree that the buyer should benefit from any discounts received by the purchaser while some view that the buyer should only benefit from the discounts if the purchaser obtained the assets before the Murabaha transactions took place. The AAOIFI accept both views and let the SSB of the IFIs decide on the appropriate approach. The AAOIFI only requires the discount received before the concluding of the Murabaha contracts to be treated as reduction of the cost of the assets. However, if required by the SSB, the IFIs may record the discount as revenue in the income statements.

AAOIFI rules out that for the short term transactions, profits of Murabaha should be recognized at the time of contract for cash transactions. For the long term contracts, AAOIFI provides option to the IFIs to either recognize profit based on proportionate allocations over the period of the credits or when the installments are received. However, the later option should only be used if required by the SSB. In conjunction with the *shariah* requirements that prioritize the benefit of the society, in the case of solvency, AAOIFI does not allow IFIs to impose penalty to the clients.

ii) AAOIFI FAS 3

According to the FAS 3, the Mudaraba financing capital shall be recognized at the time of its payment. As Mudaraba financing capital provided in cash shall be measured by the amount paid to the IFIs, AAOIFI require financing capital based on assets to be measured at the fair

value of the assets. Later, at the end of each accounting period, AAOIFI require the financing capital to be revalued. Any reduction in the value of the financing capital because of a damage or other causes not due to negligence, it shall be treated as a loss to the IFIs. However, if negligence occurs due to the misconduct of the client, the client shall bear the loss incurred. For a short term contract, the profits or loss incurred shall be recognized at the liquidation date, while for a long term contract, profit and loss is recognized at the end of each accounting period based on the proportionate amount.

iii) AAOIFI FAS 4

Generally, the accounting treatment of Musharaka financing is almost similar with the Mudaraba financing. The only difference is, in Musharaka financing, the client is treated as a partner of the IFIs**.** Therefore, any diminishing value of the financing shall be treated by reducing the amount of share transferred in the partnership.

4.3.3 Disclosure

As required by FAS 1, all these 3 types of financial instruments are required to be disclosed separately for the assets jointly financed by the IFIs and those exclusively financed by the bank. For Murabaha transactions, the IFIs are required to disclose whether the contract is made obligatory to the clients. This disclosure is important as there are some differences in the treatments of both transactions. Finally, for Mudaraba and Musharaka financing, the IFI is required to disclose any provisions made by the IFIs that reduce the amount of the financing capital.

In short, both categories of standards are among the earliest published by the AAOIFI. Undeniably, for accounting on *zakah*, AAOIFI manage to provide clear guidelines to the IFIs for the treatment of *zakah.* This include by providing specific example in the appendix of the standard on the calculation of *zakah* base by using both net assets and net invested methods. To improve the quality of disclosures on *zakah,* AAOIFI require the IFIs that involve payment of *zakah* to provide an additional statement in the financial reports, “Statements of Sources and Uses of Funds in the *Zakah* and Charity fund”. However, the statement provided might cause confusion to the users of the financial report as it combines both *zakah* and charity. Although the nature of both transactions is quite similar, it needs to be considered

that *zakah* is compulsory for all Muslims, while charity is voluntary. Thus, it seems that combining both transactions might provide fewer benefits to the users of the financial reports. It is expected that with the adoption of the standard, the methods used by IFI in determining the *zakah* base, and the items included in the *zakah* base is standardized. AAOIFI require an IFI to pay *zakah* only if required by the law; or by charter or by-laws; or shareholder's resolution; rising a question on the obligation of the IFIs in the payment of *zakah*, the third "pillar" of Islam. Although it is arguable that the responsibility is passed to the shareholders of the IFIs, the payment of *zakah* then is only based on the distributed profit. It seems that as a company is considered as a separate legal entity, it might be reasonable to require all IFIs to pay *zakah* on the undistributed profit and provide them an option to choose either to pay *zakah* on behalf of the shareholders or let them to pay *zakah* individually.

On the other hand, AAOIFI standards on financial instruments seem to focus more on the accounting treatments of the financial instruments if compared to the disclosures of the information in the financial reports. It seems that AAOIFI missed a few items deemed important to the users of the financial reports in their disclosure requirements. This includes disclosures on any faults that occur during the financing period that lead to the reduction in the value of the assets or capital. As it is expected that diminishing value of the assets or capital might occur during the transaction period, it might be beneficial if AAOIFI provides some guidelines to the IFIs on the conditions that allow such treatment to arise. However, AAOIFI seems to be successful in limiting the amount of accounting treatments and methods for the financial instruments provided by the banks and in improving the usefulness of the IFIs' financial reports. With a standard method used by the IFIs, stakeholders may compare the efficiency of an IFI with other Islamic banks.

Chapter 5: ANALYSIS

5.1 Introduction

To examine the actual disclosure practices of IFIs, a content analysis method is adopted in this study. Content analysis is a method of analyzing "documents and texts that seeks to quantify content in terms of predetermined categories and in a systematic and replicable manner" (Bryman & Bell, 2003, p. 195). The similar method is used in the previous literatures on disclosures of Islamic Banks (Haniffa & Hudaib, 2007; Harahap, 2003; Maali, Casson & Napier, 2006). Since this study is trying to investigate the compliance with AAOIFI standards, the predetermined categories are based on the disclosure requirements by AAOIFI in FAS 9 (*zakah*) as well as FAS 2, 3 and 4 (interest).

Based on AAOIFI FAS 9, there are five items that need to be disclosed by IFIs that fall under category 1 (obliged to pay *zakah*) and 2 (not obliged to pay *zakah* but required to act as an agent). These includes (i) method used for determining *zakah* base; (ii) items included in the *zakah* base; (iii) whether the IFIs pays its share of *zakah* in its subsidiaries; (iv) whether the bank collects and pay *zakah* on behalf of holder of investment accounts and other accounts; and (v) statement of sources and uses of funds in the *zakah* and charity funds as required by FAS 1. In addition, the IFIs are required to disclose (vi) any ruling of SSB on issues related to *zakah* that is not included in the standards; and (vii) any restrictions imposed by SSB in determining the *zakah* base if applicable. On the other hand, if the IFIs are not required to pay *zakah* and act as the agent (category 3), four items need to be disclosed in the notes of the financial statements. These are (i) method used for determining *zakah* base; (ii) items included in the *zakah* base; (iii) amount of *zakah* for each share; and (iv) amount of *zakah* that is due from the equity of investment account holders. Similar with Categories 1 and 2, if applicable the IFIs are also required to disclose (v) any ruling of SSB that is not available in FAS 9; and (vi) any restrictions imposed by SSB in determining the *zakah* base.

As mentioned in the previous chapter, one of the major characteristics of IFIs is its non involvement in the transactions related with usury or *riba*. Therefore, IFIs have introduced and developed various Islamic financial products and services that are *riba*-free such as Salam, Ijarah, Mudaraba, Murabaha, and Istisna'. As there are no specific standards on usury, standards on the Islamic financing products should be relevant under the scope of the usury topic. However, for the purpose of this study, I will focus only on FAS 2, FAS 3, and FAS 4 that are all categorized as IFI main financial instruments. This is based on the field studies initially conducted by the AAOIFI during their early establishment period that identify these three standards as the most vital to the IFIs. According to the FAS 2, IFIs that offer Murabaha services have to disclose two items. These are (i) whether the Murabaha contract is made as obligatory; and (ii) requirement to separately disclose the assets jointly financed by the IFI and those exclusively financed by the bank. The later disclosure requirement is also necessary for Mudaraba and Musharaka financing. Additionally, if there is any provision made reducing the value of Mudaraba assets and Musharaka financing, this should be communicated in the notes of the financial statements as well.

5.2 Sample and Data

The initial population for this study consists of the associate members of AAOIFI which is publicly available in the organization websites and in the accounting, auditing and governance standards for IFI book published by them. This is based on the fact that AAOIFI, as a main body for developing accounting, auditing and governance standards for IFIs, should have some influence on the presentations of financial statements of their members. The associate members of AAOIFI are (i) IFI that comply with *shariah* requirements in all their transactions; (ii) regulatory and supervisory authorities that supervise IFI such as central banks and monetary agencies; and (iii) Islamic fiqh academies and authorities that have a corporate entity, such as BMB Islamic UK Limited (AAOIFI, 2008). However, this paper focuses only on the first category of the AAOIFI associate members, the IFI. Thus, based on the updated list of AAOIFI's members as

attached in the latest publication of "Accounting, Auditing and Governance Standards for IFI", the total population of this study is 117.

Based on the population, 25 IFIs were randomly selected and the English version of annual reports for the year 2006 and 2007 were downloaded from the Internet. As the data collection took place at the end 2008, financial statements for the year 2007 were the latest available. The choice of the two latest financial periods is to examine the consistency of the disclosure behaviour of the IFIs. As the date of each IFI joining the AAOIFI is not publicly available, the selection of the two periods is viewed as sufficient for this study. If the IFI's financial statements are not accessible on the Internet, such as Bank Islam Brunei Darussalam, or the financial statements published are not available in English, for example Tadoman Islamic Bank, another IFI will be randomly selected. Although IFI may use other types of communication, annual report is considered as relevant for this study as it is viewed as the main communication tool to the stakeholders and easily accessible (Haniffa & Hudaib, 2007; Gray, Kouhy & Lavers, 1995). Moreover, annual reports should also be documented regularly and need to comply with regulatory requirements. The sample size of 21% for this study is also consistent with the previous study by Haniffa and Hudaib (2004). Table 6 lists the 25 IFIs examined in this study.

As shown in the table, the 25 IFIs studied are from 12 different countries, with 10 out of the 25 IFIs explicitly stated in the financial reports adopting AAOIFI. These IFIs are those from Bahrain, Sudan, Palestine, Bangladesh and Qatar. The differences in the actual items disclosed by the adopters and non-adopters of AAOIFI standards regarding *riba* and *zakah* are further discussed at the end of this chapter. Based on the disclosure requirements for *zakah* and interest accounting as outlined at the beginning of this chapter, a disclosure index was constructed. Following the method used by Maali et al. (2006), each item in the disclosure index is given the same weight. For the items disclosed in the financial report, a score of 1 is given, while items not disclosed were given 0. As there are some items not applicable to some IFIs, the particular items are ignored for the particular IFIs. For instance, the requirement of providing Statement of

Sources and Uses of Funds in the *Zakah* and Charity Funds is not applicable to those decided not to pay *zakah* and not required to act as the agent of the shareholders.

	Bank	Country	Stated Adopted AAOIFI
1	Al Salam Bank	Bahrain	Yes
2	AlBaraka Banking Group	Bahrain	Yes
3	Bahrain Islamic Bank	Bahrain	Yes
4	Gulf Finance House	Bahrain	Yes
5	Khaleeji Commercial Bank	Bahrain	Yes
6	Shamil Bank	Bahrain	Yes
7	Faisal Islamic Bank	Sudan	Yes
8	Arab Islamic Bank	Palestine	Yes
9	Islami Bank Bangladesh Ltd	Bangladesh	Yes
10	Qatar Islamic Bank	Qatar	Yes
11	AlBaraka Bank Limited	South Africa	No
12	Abu Dhabi Islamic Bank	UAE	No
13	Emirates Islamic Bank	UAE	No
14	Mashreq Bank	UAE	No
15	Sharjah Islamic Bank	UAE	No
16	Dubai Islamic Bank	UAE	No
17	Bank Al Jazira	Saudi	No
18	The National Commercial Bank	Saudi	No
19	Bank Islam Malaysia Berhad	Malaysia	No
20	Bank Muamalat Malaysia	Malaysia	No
21	Hong Leong Islamic Bank	Malaysia	No
22	Takaful Malaysia	Malaysia	No
23	European Islamic Investment Bank	UK	No
24	Islamic International Arab Bank	Jordan	No
25	Kuwait Finance House	Kuwait	No

Table 6: Lists of IFIs examined.

5.3 Results

5.3.1 Zakah

The practice of each IFI on the payment of *zakah* is studied and these IFIs are grouped into 3 categories as outlined in the FAS 9, (i) obliged to pay *zakah*; (ii) not obliged to pay *zakah* but required to act as the agent; and (iii) not required to either pay *zakah* or act as the agent. Although the disclosure requirements of Category 1 and 2 are similar to FAS 9, there are differences in the accounting treatments of both categories. Under Category 1,

the IFIs are required to treat the payment of *zakah* as non-operating expenses and shall be included in the income statement while for the second category, the amount of *zakah* is deducted from the shareholders' share of distribution profits. However, examining the actual practices of the IFIs, it is possible for an IFI to fall into a few categories. For example, Gulf Finance House decided that it was their obligation to pay *zakah* on the undistributed profit (Category 1) and to act as an agent by paying *zakah* on behalf of the shareholders' share of distribution profits (Category 2). In addition, for the investments and other types of accounts, the Gulf Finance House's SSB decided that the payment of *zakah* was the full responsibility of the accounts holder (Category 3). Thus, in this study, the Gulf Finance House disclosure practices are examined based on all 3 categories. The information of the IFIs' obligation on the payment of *zakah* is usually available in the notes of the annual report or SSB reports. By studying the annual reports of each IFI, in 2006, 8 IFIs are categorized as C1; another 8 banks are grouped under C2; and a number of 18 IFIs fall under C3. A year later, only Al Salam Bank decided to change their *zakah* policy and act as the agent for the shareholders. Therefore, in 2007, there were no changes in the number of IFIs under C1, but the number of IFIs under C2 increased to 9, while IFIs categorized as C3 was reduced to 17. The disclosure ratios of both years are summarized in Table 7 below.

Table 7 clearly shows that the extents of disclosure by the IFIs are much lower than the FAS 9 requirements. In 2006, only 5 out of 25 samples managed to disclose at least half (50%) of the *zakah* disclosure requirements. These IFIs are Bahrain Islamic Bank, Gulf Finance House, Abu Dhabi Islamic Bank, Sharjah Islamic Bank, and European Islamic Investment Bank. Out of these 5 banks, 2 claimed that AAOIFI standards were fully adopted, while European Islamic Investment Bank stated the use of AAOIFI FAS 9 in the preparation of the financial reports. Other IFIs failed to disclose at a minimum of 50% of the requirements and even 8 IFIs scored a 0% disclosure of *zakah*. Among these 8 IFIs, 4 (or 50%) did not communicate anything about *zakah* in their annual reports. These are AlBaraka Bank Limited, Qatar Islamic Bank, Mashreq Bank, and Islamic International Arab Bank. Another 2 banks; Al Salam Bank and

Table 7: Level of Disclosure Analysis (*Zakah*)

	Bank	Country	Stated Adopting AAOIFI	Level of Disclosure							
				2006				2007			
				C1	C2	C3	Total	C1	C2	C3	Total
1	Al Salam Bank	Bahrain	Yes			0.00%	**0.00%**		40.00%		**40.00%**
2	AlBaraka Banking Group	Bahrain	Yes			0.00%	**0.00%**			100.00%	**100.00%**
3	Bahrain Islamic Bank	Bahrain	Yes		66.67%	50.00%	**60.00%**		66.67%	50.00%	**60.00%**
4	Gulf Finance House	Bahrain	Yes	60.00%	60.00%	50.00%	**57.14%**	60.00%	60.00%	50.00%	**57.14%**
5	Khaleeji Commercial Bank	Bahrain	Yes			25.00%	**25.00%**			25.00%	**25.00%**
6	Shamil Bank	Bahrain	Yes			25.00%	**25.00%**			0.00%	**0.00%**
7	Faisal Islamic Bank	Sudan	Yes	0.00%			**0.00%**	0.00%			**0.00%**
8	Arab Islamic Bank	Palestine	Yes	40.00%			**40.00%**	40.00%			**40.00%**
9	Islami Bank Bangladesh Ltd	Bangladesh	Yes	60.00%		0.00%	**33.33%**	60.00%		0.00%	**33.33%**
10	Qatar Islamic Bank*	Qatar	Yes			0.00%	**0.00%**			0.00%	**0.00%**
11	AlBaraka Bank Limited*	South Africa	No			0.00%	**0.00%**			0.00%	**0.00%**
12	Abu Dhabi Islamic Bank	UAE	No			50.00%	**50.00%**			25.00%	**25.00%**
13	Emirates Islamic Bank	UAE	No		50.00%	33.33%	**41.67%**		50.00%	33.33%	**41.67%**
14	Mashreq Bank*	UAE	No			0.00%	**0.00%**			0.00%	**0.00%**
15	Sharjah Islamic Bank	UAE	No		66.67%	50.00%	**60.00%**		66.67%	50.00%	**60.00%**
16	Dubai Islamic Bank	UAE	No		50.00%	0.00%	**30.00%**		50.00%	0.00%	**30.00%**
17	Bank Al Jazira	Saudi	No		16.67%	0.00%	**10.00%**		16.67%	0.00%	**10.00%**
18	The National Commercial Bank	Saudi	No		20.00%		**20.00%**		20.00%		**20.00%**
19	Bank Islam Malaysia Berhad	Malaysia	No	16.67%			**16.67%**	16.67%			**16.67%**
20	Bank Muamalat Malaysia	Malaysia	No	60.00%		0.00%	**33.33%**	60.00%		0.00%	**33.33%**
21	Hong Leong Islamic Bank	Malaysia	No	20.00%			**20.00%**	20.00%			**20.00%**
22	Takaful Malaysia	Malaysia	No	0.00%			**0.00%**	0.00%			**0.00%**
23	European Islamic Investment Bank	UK	No [#]			50.00%	**50.00%**			50.00%	**50.00%**
24	Islamic International Arab Bank*	Jordan	No			0.00%	**0.00%**			0.00%	**0.00%**
25	Kuwait Finance House	Kuwait	No		20.00%		**20.00%**		33.33%		**33.33%**

[#] Eventhough not adopting the AAOIFI standards, EIIB did mention that the AAOIFI rules on *zakah* is followed in the preparation of the financial statements

* *Zakah* is not disclosed in the annual report

AlBaraka Banking Group, only provided statements in the SSB report that the banks are not responsible for paying *zakah*. Meanwhile, Faisal Islamic Bank and Syarikat Takaful Malaysia recorded only the amount of *zakah* payment for the financial period in the income statement and no further information was provided in the notes of the financial statements. Comparing between categories, IFI under C2, provided the highest average of disclosure ration at 40% followed by C1 at 32.08%. Meanwhile, IFIs under C3 provided the lowest average ratio at only 18.52%.

In 2007, the disclosure ratios were not much different to 2006. Only 3 IFIs, namely Al Salam Bank; AlBaraka Banking Group; and Kuwait Finance House showed an improvement in the disclosure practices as compared to the year before. On the other hand, the disclosure ratios of Shamil Bank and Abu Dhabi Islamic Bank appeared to be decreased in 2007 by 25% for each bank. During the financial period, AlBaraka Banking Group managed to follow all the disclosure requirements of FAS 9. The group even provided detailed calculation of *zakah* as additional guidance to the users of the financial statements. Besides AlBaraka Banking Group, 4 other IFIs including Bahrain Islamic Bank, Gulf Finance House, Sharjah Islamic Bank, and European Islamic Investment Bank managed to disclose at least 50% of the FAS 9 requirements. However, there were still 7 IFIs that scored 0% disclosure of *zakah.* This includes the 4 IFIs that did not mention about *zakah* in their financial statements in 2006. 3 other banks were Shamil Bank, Faisal Islamic Bank and Syarikat Takaful Malaysia. Evaluating the results between categories, C2 demonstrated a minor increase to 41.48% as compared to 2006, while C3 revealed an increase of 4% to 22.55%. However, there are no differences in the average ratio of C1 between the two studied periods. Table 8 below further analyzes the disclosure ratio of both years based on the disclosure requirements of each category.

As shown in Table 8, the data is further analyzed based on the requirements of each category. For Categories 1 and 2, about 60% of the IFIs (or 5 out of 8) disclosed the methods used by the banks in determining the *zakah* base. Most of these banks follow the guidelines in para. 2 of FAS 9 that require the determination of the *zakah* base by either

using Net Asset or Net Invested Funds method at 2.5% for a lunar calendar or 2.5775% for a solar calendar. However, under Category 1, only Islamic Bank Bangladesh

Table 8: Disclosure Requirements by Category

Category 1 (Obliged to Pay Zakat)	**2006**	**2007**
Disclosure Requirement		
- Method used for determinining the *zakah* base (para 13)	62.50%	62.50%
- Items included in the *zakah* base (para 13)	12.50%	12.50%
- Whether the Bank pays its share of *zakah* in its subsidiaries (para 15)	25.00%	25.00%
- Whether the Bank collects and pay *zakah* on behalf of holders of investment accounts & other accounts (para 18)	37.50%	37.50%
- Ruling of Shariah Supervisory Board on issues related to *zakah* not included in the standard if applicable(para 14)	12.50%	12.50%
- Any restrictions imposed by the Shariah Supervisory Board in determining the *zakah* base (para 19)	-	-
- Statement of Sources & Uses of Funds in the *Zakah* & Charity Funds as Required in FAS 1 (para 20)	25.00%	25.00%
Category 2 (Not Obliged to Pay Zakat but Required to Act As Agent)		
Disclosure Requirement		
- Method used for determinining the *zakah* base (para 13)	62.50%	55.56%
- Items included in the *zakah* base (para 13)	25.00%	33.33%
- Whether the Bank pays its share of *zakah* in its subsidiaries (para 15)	12.50%	11.11%
- Whether the Bank collects and pay *zakah* on behalf of holders of investment accounts & other accounts (para 18)	75.00%	77.78%
- Ruling of Shariah Supervisory Board on issues related to *zakah* not included in the standard if applicable(para 14)	12.50%	22.22%
- Any restrictions imposed by the Shariah Supervisory Board in determining the *zakah* base (para 19)	25.00%	22.22%
- Statement of Sources & Uses of Funds in the *Zakah* & Charity Funds as Required in FAS 1 (para 20)	25.00%	22.22%
Category 3 (Not Obliged to Pay Zakat and Not Required to Act As Agent)		
Disclosure Requirement		
- Method used for determinining the *zakah* base (para 13)	35.71%	46.15%
- Items included in the *zakah* base (para 13)	7.14%	15.38%
- The amount of *zakah* that is due from each shares (para 16)	42.86%	38.46%
- The amount of *zakah* that is due from the equity of investment account holders (para 17)	7.14%	15.38%
- Ruling of Shariah Supervisory Board on issues related to *zakah* not included in the standard if applicable(para 14)	-	-
- Any restrictions imposed by the Shariah Supervisory Board in determining the *zakah* base (para 19)	7.14%	7.69%

provided further information on the items included in the calculation of the *zakah* base as required by paragraph 13 of the standard. As stated under Notes 3.5 of the Bank's 2007 Annual Report, the Bank clearly stated that the payment of *zakah* was based "on the closing balances of Share Premium, Statutory Reserve, General Reserve, Investment Loss Offsetting Reserve, Exchange Equalisation and Dividend Equalisation accounts". Similar result could also be found under Category 2, with only Sharjah Islamic Bank and Dubai Islamic Bank (plus Kuwait Finance House in 2007) disclosed the items included in the *zakah* base in the notes of the financial reports.

There were also minimum disclosures on the ruling of SSB on the related issues not addressed in the FAS 9 (para. 14) and restrictions imposed by SSB in determining the amount of *zakah* base (para. 19). As both requirements should only be disclosed if applicable to the IFIs, there are two situations that might lead to this low percentage. Firstly, there were no new issues or restrictions addressed by the SSB of the IFIs, or secondly, although these issues exist, they were not disclosed clearly in the notes. As the former situation is acceptable, there are concerns on the second situation as it violates the Islamic accounting concepts that require full disclosure of relevant information to the society. The above table also reveals the low percentage of Islamic Banks that provide the "Statement of Sources and Uses of Funds in the *Zakah* and Charity Funds". This statements are the additional requirements by AAOIFI for the IFIs that fall under Category 1 or/and 2. The statements play an important role in meeting the third objective of the financial reports for IFI, which is to provide "information to assist the concerned party in the determination of *Zakah* on the Islamic bank's funds and the purpose for which it will be disbursed" (para. 39 of SFA 1). With this statement, it is expected that the depositors and shareholders will be well informed on the resources used by the banks in the payment of *zakah* and the distribution of the *zakah* on behalf of them. Despite the importance of this statement, only Gulf Finance House (Category 1 and 2); Arab Islamic Bank (Category 1) and Bahrain Islamic Bank (Category 2) provided such statements in their financial reports.

There was less disclosure requirements for IFIs under Category 3 as, unlike other IFIs, these institutions are not involved in paying *zakah* on behalf of their clients. However, they are still required to disclose the amount of *zakah* that needs to be paid by each share and how the amount is deduced. This information is important to the shareholders and act as the guidance for them to fulfill their obligations in the payment of *zakah*. Table 8 shows that, overall, banks under Category 3 scored the lowest in each disclosure requirements as compared to the IFIs that directly involved in the *zakah* payment. They scored the highest at only around 35% to 47% for both years for the method used in determining the *zakah* base (para. 13) and the amount of *zakah* due from each shares (para. 16). As illustrated in Table 8, the scores for other requirements are much lower with a maximum number of 2 IFIs disclosing in each category. The poor overall scores for Category 3, firstly, could be attributed to the belief held by a number of banks that they were not responsible to pay *zakah* on behalf of all or some of their clients (such as holders of investments and other accounts) and, secondly, to their refusal to provide further explanations for it. Under notes 29 of 2007 Annual Reports, Shamil Bank stated that "*zakah* is directly borne by the owners and investors in restricted and unrestricted investment accounts. The Bank does not collect or pay *Zakah* on behalf of its owners and its investment account holders". Besides this excerpt, no other information on *zakah* could be found in the Bank's financial statements. Moreover, for eight IFIs that fall under Category 1 or 2, and Category 3, there is a tendency by the banks to disclose less information under Category 3. Extracted from the Notes 4 in the Dubai Islamic Bank Annual Report 2007, it is stated that,

> *"Zakat is computed as per the Articles and Memorandum of Association of the Bank and its subsidiaries and is approved by the Fatwa and Sharia'a Supervisory Boards of the respective entities on the following basis:*
>
> *i) Zakat on shareholders' equity is deducted from their dividends and is computed on their zakat pool (shareholders' equity less paid up capital, donated land reserve and cumulative changes in fair value) plus employees' end of service benefits.*
>
> *ii) Zakat on profit equalisation provision is charged to this provision after it has been calculated.*
>
> *iii) Zakat is disbursed by a committee appointed by the Board of Directors and operating as per the by-law set by the Board.*

iv) Zakat on the paid up capital is not included in the zakat computations and is payable directly by the shareholders themselves" (pg 21).

Although Dubai Islamic Bank provides some information on the calculation and amount of *zakah* for shareholders' equity in the above excerpt of financial statements, the only information available for the holders of investment accounts is point iv) in the extract above. Without sufficient information, the holders of the investment accounts in Dubai Islamic Bank might be unaware of the amount of *zakah* borne by them for the financial period.

Table 9: T-test for Differences in the Percentage of *Zakah* Disclosure (2007)

Item	Sample Size	Level of *Zakah* Disclosure		t-test (p-value, two-tail)
		Mean	Median	
IFI adopting AAOIFI standards	11	0.3686	0.4000	1.6476
IFI not adopting AAOIFI standards	14	0.2071	0.2000	(0.1130)
IFI compulsory adopting AAOIFI	8	0.4111	0.3250	0.2688
IFI voluntarily adopting AAOIFI	3	0.3527	0.4000	(0.7942)
IFI with total assets > sample median	13	0.2965	0.3333	0.3720
IFI with total assets < sample median	12	0.2583	0.2250	(0.7133)
IFI with leverage > 2	16	0.2021	0.4000	2.1643
IFI with leverage < 2	9	0.4135	0.2000	(0.0411)
IFI originates from Bahrain	6	0.4702	0.4857	2.3331
IFI originates from other countries	19	0.2176	0.2250	(0.0288)

As mentioned above, the sample of this study is selected from the latest available lists of AAOIFI's members. However, based on the analysis of the IFI's financial reports, it seems that not all members of AAOFI have adopted the standards. Generally, 10 IFIs mentioned clearly in the notes of their financial reports that they were adopting AAOIFI standards besides the local GAAP or IFRS. In addition to the 10 IFIs, European Islamic Investment Bank did disclose that the bank was following the AAOIFI standards on *zakah* in the preparation of its financial reports. Initially, it is expected that banks following the AAOIFI standards would provide higher level of disclosure on *zakah* if compared to the non adopters. Referring to Table 9, the mean percentages of *zakah* disclosures of these banks was at 36.86% as compared to 20.71% for the banks not adopting the AAOFI standards. However, using the t-test for the difference of means, the mean difference is not statistically significant at the 0.05 level. Based on the analysis, it

seems that quite a number of IFIs that claim to adopt AAOIFI standards in fact failed to follow the disclosure requirements of the AAOIFI FAS 9 standard. This includes the failure of two IFIs that claimed using AAOIFI standards, Faisal Islamic Bank and Islami Bank Bangladesh Limited to provide the "Statement of Sources and Funds in the *Zakah* and Charity Funds" as required in FAS 1. The t-test result further supports the analysis in Table 7 above that shows the low level of overall *zakah* disclosure of the adopters of AAOIFI such as 0% disclosure of Shamil Bank, Faisal Islamic Bank, and Qatar Islamic Bank.

It was also presumed that IFIs adopting the AAOIFI voluntarily would provide lower level of disclosure as compared to the compulsory adopters. This assumption is based on a study conducted before found that there were improvements in the level of disclosure for firms that used to follow the IFRS voluntarily during the mandatory transition period to IFRS (Horton, Serafeim & Serafeim, 2008). In this study, compulsory adopters are those IFIs originate from Bahrain, Sudan, and Qatar that require the adoption of AAOIFI for all IFIs. On the other hands, Arab Islamic Bank, Islami Bank Bangladesh Limited, and European Islamic Investment Bank are the 3 IFIs in this study that follow the AAOIFI standards voluntarily. Although the means of disclosure level of voluntary adopters are higher at 41.11% as compared to 35.27%, the p-score of 0.7942 as shown in Table 9 above indicates that the difference is insignificant.

Later, the similar univariate test was also conducted to investigate the relationship between the levels of disclosure with the size of the IFIs based on the amount of the total assets. It is expected that IFIs with bigger amount of assets would disclose more as compared to the IFIs with smaller assets. For this analysis, the IFIs were rearranged based on the amount of the total assets in the US currency, and the median of the total assets were determined. IFIs with total assets similar or more than the median were categorized as 'big' IFIs, whereas those IFIs with assets smaller than the median were considered as 'small' IFIs. The average disclosure of the 'big' IFIs is slightly better at 29.65% than the 'small' IFIs at 25.83%. However, the difference is still statistically insignificant at 0.05 level.

According to Renders and Gaeremynck (2007), low levered companies are more likely to disclose more information as opposed to high levered firms. This is because low levered firms are more dependent on equity financing, thus high disclosure is expected to meet the information demands of the capital provider. The leverage of each IFIs is computed using the debt to equity ratio. Following the general guidelines, IFIs with leverage ratio more than 2 were considered as high leverage banks, while those banks with leverage ratio less than 2 are noted as low leverage IFIs. The mean disclosure of the low leverage banks is 41.35% and 20.21% for the high leverage banks. And based on the t-test conducted, the difference is statistically significant at 95% confidence level with p-value at 0.04.

Finally, the study also looks at the mean difference between those banks from Bahrain, the origin country of AAOFI, and other IFIs. Banks from Bahrain score a mean of 47.02%, while other IFIs gain an average disclosure of 21.75%. The p-level of 0.02 indicates that the mean difference is statistically significant at 95% confidence level. This suggests that IFIs from Bahrain tend to provide more information on *zakah* as compared to other IFIs.

5.3.2 Interest

Similar approach has been conducted to study disclosure practice of the samples IFIs relating to interest. The disclosure ratios of the content analysis on interest are set out in Table 10. According to the AAOIFI standards, there are two disclosure requirements for each mode of financial instruments. IFIs that provide Murabaha and Murabaha to the purchase order services are required to disclose whether the Murabaha contracts between the banks and the clients are made obligatory (para 16 of FAS 2). If the contract is with obligations, the purchaser is binding to purchase the assets at the agreeable time period. In contrast, contract without obligations can only be considered as a willingness of the purchaser to buy the assets in the future (AAOIFI, 2008). On the other hand, banks that offer Mudaraba Financing are required to inform any provisions made for reductions in the value of the Mudaraba assets (para 19). Similar to the disclosure requirements in FAS

3 – Mudaraba Financing, the Islamic Banks that provide Musharaka Financing are also required to disclose any provision made for a loss incurred on its capital in the Musharaka financing transactions (para 17). In addition to the above requirements, all IFIs that provide any of the above financial products are obliged to the requirements in the FAS 1, which is "to separately disclosed the assets jointly financed by the bank and unrestricted investments and restricted investments" (para 37 of FAS 1).

In this study, 22 out of 25 samples offer Murabaha and Murabaha to the purchase orderer transactions (FAS 2); 21 banks provides Mudaraba financing (FAS 3); and 15 banks offer Musharaka financing (FAS 4) to their customers. These modes of financing offered are consistent between the two sample years. Among the 25 samples, only Islamic International Arab Bank disclosures could not be further analyzed in this study as none of these financial instruments activities were disclosed in the Bank's annual report. Interestingly, under the Performance of the Group's entities, the IFI claimed that the increase in Murabaha rates in 2006 is one of the main factors of their growth profits.

As there were no changes in the financing activities regarding Murabaha, Mudaraba, and Musharaka transactions among the banks in both years, there were also no changes in the ratio analysis. Table 10 clearly shows that the extent of disclosures for the interest related transactions are falls for short of the AAOIFI requirements in FAS 2-4. Only 3 banks out of 24 samples (or 12.5%) managed to disclose at least half of the disclosure requirements of the AAOIFI. Those banks were AlBaraka Banking Group, Shamil Bank, and Qatar Islamic Bank. On the other hand, 50% of the IFIs (12 / 24 banks) failed to disclose anything from the AAOIFI requirements. This includes Bank Al-Jazira, Kuwait Finance House, Bank Islam Malaysia Berhad, Emirates Islamic Bank and Islami Bank Bangladesh Limited. Most of these banks only recorded the amount of the transactions in the financial statements without disclosing further information as required by the AAOIFI. On average, banks that offer Musharaka financing score 33.33%, while those provides Mudaraba financing score the average of 21.43%. IFIs that offer

Table 10: Level of Disclosure Analysis (Interest)

	Bank	Country	Stated Adopting AAOIFI	Level of Disclosure							
				2006				2007			
				FAS 2	FAS 3	FAS 4	Total	FAS 2	FAS 3	FAS 4	Total
1	Al Salam Bank	Bahrain	Yes	50.00%	50.00%	0.00%	**40.00%**	50.00%	50.00%	0.00%	**40.00%**
2	AlBaraka Banking Group	Bahrain	Yes	100.00%	100.00%	100.00%	**100.00%**	100.00%	100.00%	100.00%	**100.00%**
3	Bahrain Islamic Bank	Bahrain	Yes	50.00%	0.00%	50.00%	**40.00%**	50.00%	0.00%	50.00%	**40.00%**
4	Gulf Finance House	Bahrain	Yes	0.00%	50.00%	-	**25.00%**	0.00%	50.00%	-	**25.00%**
5	Khaleeji Commercial Bank	Bahrain	Yes	0.00%	50.00%	50.00%	**33.33%**	0.00%	50.00%	50.00%	**33.33%**
6	Shamil Bank	Bahrain	Yes	50.00%	50.00%	50.00%	**50.00%**	50.00%	50.00%	50.00%	**50.00%**
7	Faisal Islamic Bank	Sudan	Yes	-	0.00%	50.00%	**25.00%**	-	0.00%	50.00%	**25.00%**
8	AlBaraka Bank Limited	South Africa	Yes	0.00%	0.00%	0.00%	**0.00%**	0.00%	0.00%	0.00%	**0.00%**
9	Arab Islamic Bank	Palestine	Yes	50.00%	0.00%	-	**33.33%**	50.00%	0.00%	-	**33.33%**
10	Islami Bank Bangladesh Ltd	Bangladesh	Yes	0.00%	0.00%	0.00%	**0.00%**	0.00%	0.00%	0.00%	**0.00%**
11	Qatar Islamic Bank	Qatar	Yes	50.00%	50.00%	50.00%	**50.00%**	50.00%	50.00%	50.00%	**50.00%**
12	Abu Dhabi Islamic Bank	UAE	No	0.00%	50.00%	50.00%	**33.33%**	0.00%	50.00%	50.00%	**33.33%**
13	Emirates Islamic Bank	UAE	No	0.00%	0.00%	-	**0.00%**	0.00%	0.00%	-	**0.00%**
14	Mashreq Bank	UAE	No	0.00%	0.00%	0.00%	**0.00%**	0.00%	0.00%	0.00%	**0.00%**
15	Sharjah Islamic Bank	UAE	No	0.00%	0.00%	-	**0.00%**	0.00%	0.00%	-	**0.00%**
16	Bank Al Jazira	Saudi	No	0.00%	-	-	**0.00%**	0.00%	-	-	**0.00%**
17	The National Commercial Bank	Saudi	No	0.00%	-	50.00%	**25.00%**	0.00%	-	50.00%	**25.00%**
18	Bank Islam Malaysia Berhad	Malaysia	No	0.00%	0.00%	0.00%	**0.00%**	0.00%	0.00%	0.00%	**0.00%**
19	Bank Muamalat Malaysia	Malaysia	No	0.00%	0.00%	0.00%	**0.00%**	0.00%	0.00%	0.00%	**0.00%**
20	Hong Leong Islamic Bank	Malaysia	No	0.00%	0.00%	-	**0.00%**	0.00%	0.00%	-	**0.00%**
21	Takaful Malaysia	Malaysia	No	-	0.00%	-	**0.00%**	-	0.00%	-	**0.00%**
22	Dubai Islamic Bank	Dubai	No	0.00%	50.00%	50.00%	**33.33%**	0.00%	50.00%	50.00%	**33.33%**
23	European Islamic Investment Bank	UK	No	0.00%	0.00%	-	**0.00%**	0.00%	0.00%	-	**0.00%**
24	Islamic International Arab Bank[(1)]	Jordan	No	-	-	-	**-**	-	-	-	**-**
25	Kuwait Finance House	Kuwait	No	0.00%	-	-	**0.00%**	0.00%	-	-	**0.00%**

[(1)] Murabaha accounts were not presented in both years even though Murabaha was mentioned as Bank's activity in Notes

Murabaha and Murabaha purchase orderer on the other hand, only score 15.91%. Comparing between the 11 IFIs that claim to adopt AAOIFI with the other 13 banks, those banks that follow AAOIFI standards show a higher average score of 36.06% as compared to an average score of 7.05% of IFIs that not adopting the AAOIFI standards.

Table 11: Disclosure Requirements by Standards

FAS 2 (Murabaha and Murabaha to the Purchase Order)	**2006**	**2007**
Disclosure Requirements		
- Whether the Murabaha contract is made as obligatory (para 16)	13.64%	13.64%
- Separately disclosed the assets jointly financed by the IFI and those exclusively financed by the bank (para 17)	18.18%	18.18%
FAS 3 (Mudaraba Financing)		
Disclosure Requirement		
-Any provision made for decline in the value of Mudaraba assets (para 19)	38.10%	38.10%
-Separately disclosed the assets jointly financed by the IFI and those exclusively financed by the bank (para 20)	4.76%	4.76%
FAS 4 (Musharaka Financing)		
Disclosure Requirements		
-Any provision made for a loss of its capital in Musharaka financing transactions (para 17)	60.00%	60.00%
-Separately disclosed the assets jointly financed by the IFI and those exclusively financed by the bank (para 18)	6.67%	6.67%

Table 11 further examined the disclosure requirements based on each accounting standards. Under the FAS 2 – Murabaha and Murabaha to the purchase order, only 3 IFIs (or 13.64%), namely Qatar Islamic Bank, AlBaraka Banking Group, and Bahrain Islamic Bank stated in their notes whether or not the Murabaha contract is made obligatory to the client. Moreover, following the requirement in paragraph 17 of the standards, only 4 out of 22 Islamic Banks separately disclosed the Murabaha assets that are jointly financed and exclusively financed. These banks are Shamil Bank, Al Salam Bank, AlBaraka Banking Group and Arab Islamic Bank. On the other hand, there are 8 from 21 IFIs (38.10%) that offer Mudaraba financing, provide provision for declining in the value of Mudaraba assets. All of these banks stated their Mudaraba assets at the cost less provisions for impairments in the Statement of Financial Position as at the year end. To illustrate, Shamil Banks stated in their Notes of Financial Statements that "Mudaraba investments are initially recorded at cost and subsequently re-measured at fair value".

Other IFIs either did not provide any provision in the value of Mudaraba assets, or this provision was not declared in the notes of the financial report. Furthermore, only AlBaraka Banking Group separately disclosed the assets as required in paragraph 20 of FAS 3. Finally, about 9 out of 15 IFIs (60.00%) that offer Musharaka services did provide the provision for a loss of its Musharaka capital in both accounting period. Similar to the provision in the Mudaraba assets, the Musharaka capitals of these banks were also impaired at the end of each accounting period. Consistent with the above findings on separate disclosure, AlBaraka Banking Group was also the only IFI offering Musharaka financing that disclose the Musharaka capital separately between jointly and exclusively financed by the bank.

Table 12: T-test for Differences in the Percentage of Interest Disclosure (2007)

Item	Sample Size	Level of Interest Disclosure		t-test (p-value, two tail)
		Mean	Median	
IFI adopting AAOIFI standards	10	0.3967	0.3667	4.1471
IFI not adopting AAOIFI standards	14	0.0655	0.0000	(0.0004)
IFI compulsory adopting AAOIFI	8	0.4542	0.4000	1.5141
IFI voluntarily adopting AAOIFI	2	0.1667	0.1667	(0.1685)
IFI with total assets > sample median	12	0.2056	0.2500	0.0396
IFI with total assets < sample median	12	0.2014	0.0000	(0.9687)
IFI with leverage > 2	15	0.0778	0.0000	3.6180
IFI with leverage < 2	9	0.4130	0.4000	(0.0015)
IFI originates from Bahrain	6	0.4806	0.4000	4.0001
IFI originates from other countries	18	0.1111	0.0000	(0.0006)

T-test for the difference of means was also conducted to deduce the relationship between these independent factors with the level of interest disclosure. Based on the results in Table 12, the average of the 10 IFIs that adopting AAOIFI standards is 39.67%, while the non-adopters score only 6.55%. The result is highly significant at 95% of confidence level. Based on this, it seems that on average, the adopters of AAOIFI do provide more disclosure on the financial instruments as compared to the non-adopters. However, the average of only 39.67% does not justify that these adopters do comply with the disclosure requirements of AAOIFI on financial instruments.

However, comparing the results between compulsory and voluntary adopters, the difference on the average is insignificant although the compulsory adopters score higher at 45.42% as compared to the voluntary adopters at only 16.67%. The data was further processed to study the relationship between the amounts of total assets with the disclosure of interest. Similar with the results of *zakah* disclosure, the difference of means between 'big' IFIs and 'small' IFIs is not significant to suggest that 'big' IFIs provide higher level of disclosure. However, looking at the leverage of these IFIs, the analysis shows there are huge mean difference between high and low leverage IFIs. The high leverage IFIs only score the average of 7.78% as compared to 41.30%. The p-score calculated support that this difference is statistically significant at $\alpha = 0.05$. Finally, comparing the mean of disclosure of the IFIs originating from Bahrain at 48.06% and those banks not from Bahrain at only 11.11%, the difference is again statistically significant at 95% confidence level. In summary, for accounting standards on financial instruments, there are a few factors that influence the disclosure level of the IFIs such as the adoption of the AAOIFI standards and the level of leverage. Similar to the result on *zakah*, it seems that IFIs from Bahrain tend to follow the disclosure requirements of AAOIFI as compared to the IFIs from other jurisdictions. This raises question on the acceptance of AAOIFI standards by IFIs from other countries.

Chapter 6: IMPLICATIONS AND CONCLUSIONS

This thesis aims to study the roles and effectiveness of AAOIFI in providing guidelines to the IFIs in dealing with the issues of zakah and riba. To achieve the main objective of this study, four research questions were developed in Chapter 1. This chapter response to the research questions based on the previous literatures and current findings. This is followed with the limitations, suggestions for further research, and conclusions of this study.

6.1 Response to Research Questions

i) To what extent are zakah and riba important to the IFIs; and what are the practical problems that can be associated with the application of these concepts in the current contemporary accounting?

Based on the previous literatures and further analysis provided, this study suggests that the issues of zakah and riba are significant in the current contemporary accounting especially for IFIs. One of the main reasons that cannot exclude IFIs from these issues is both are the requirements of Islam. As mentioned in Chapter 2, prohibition to involve in riba activities is clearly stated in four verses of the Holy Quran. Previous literatures revealed that riba is prohibited in Islam as it contradicts with the religion's tenets that value the importance of equality and social justice. Riba is also viewed as unfair as one party is guaranteed with a fixed return, while another party is left uncertain with the revenue. Therefore, for institutions that are established based on Islamic beliefs such as IFIs, it is crucial for them to not involve in riba as required. Moreover, as discussed in Chapter 4, based on the field studies conducted during the early establishment of the AAOIFI, IFIs suggested that accounting standards for Islamic financial instruments namely murabaha, mudaraba, and musharaka should be given priority by the standard setting body. These financial instruments are introduced and developed by the IFIs as the alternative to the usury related products offered by the conventional banks.

On the other hand, zakah is declared as the third of five "pillars" of Islam, and it is payable on the assets such as gold, livestock, agricultural products, and funds. Similar to the prohibition of riba, the requirement to pay zakah is also closely related with the idea of equality and justice that lies under the Islamic principles. The main purpose of zakah is to support the less fortunate group in the society such as the poor, the needy, the wayfarer, or

the heavily indebted with the hope that this group of people will at least have the basic requirements in life. Several Islamic scholars believe that zakah plays an important role in term of economy, moral and social well-being of a society. With a revival of zakah ordinance in most of the Islamic countries, IFIs are responsible to meet the demands of the stakeholders regarding the issue of zakah. The survey conducted by the AAOIFI in 1995 showed that the IFIs were demanding a set of accounting standard on zakah to help them in identifying the items to be disclosed in the financial statements and to reduce the methods applied by those IFIs.

Despite the importance of both areas, there are a few problems related with the application of these two Islamic concepts. Although both items are mentioned in the Holy Quran, there is limited detailed explanation on how these should be performed. Therefore, there exist some inconsistencies among the Islamic jurists in interpreting the detailed Islamic requirements. For the riba issues for instance, there is yet to be any consensus among scholars regarding whether all interest related activities should be considered as riba. Previous literature showed that there are three different views of riba among Islamic scholars. The Liberal view riba as usury only, while the Mainstream consider riba as usury and interest, and finally the Conservative believe that riba is usury, interest and any activities that result to injustice to the society. In order to avoid riba, IFIs offer various Islamic financial products that are based on profit-and-loss sharing and mark-up principles. However, as there is yet no agreement among scholars on what is riba, there are arguments that some products offered by the IFIs might not adhere to the shariah requirements. Moreover, for products commonly offer by IFIs such as murabaha, mudaraba, and musharaka, there were differences in accounting treatments and disclosure of those items in the financial report. For the zakah application, there are few questions on whether a company is responsible for the payment of zakah, and if so, how zakah for business should be calculated. These became an issue as in early 90s; research conducted revealed that there were differences among IFIs on the treatment and disclosures of zakah in the financial statements.

ii) Is AAOIFI providing any useful guidance to overcome the problems related to zakah and riba?

AAOIFI was established in 1991 in Bahrain with the primary objective of developing accounting and auditing standards for the IFIs. After the establishment of the accounting body, based on the field studies and surveys conducted, AAOIFI decided to give priority to

nine standards which were considered as crucial to the IFIs. This includes standards on financial instruments; FAS 2- Murabaha and Murabaha to the purchase orderer, FAS 3- Musharaka financing, and FAS 4- Mudaraba financing, which were all shall be effective for accounting period beginning 1 January 1998. This is followed by the promulgation of FAS 9 – Zakah, exactly a year later.

In Chapter 4, the accounting measurements and the disclosure requirements for the financial instruments and zakah have been presented. It is pointed out in the standards for financial instruments that IFIs should measure the murabaha assets, as well as mudaraba and musharaka financing, initially at historical cost. Later, at the end of accounting period, the assets and financing capital are required to be re-valued. It is viewed that the requirements manage to reduce the differences among IFIs on the treatment of the financial instruments assets and financing capital. However, in some areas such as the measurement of the murabaha discount, AAOIFI provide options to the SSB of the IFIs to decide on the appropriate approach. Moreover, consistent with the requirement of full disclosures, AAOIFI requires these items to be disclosed separately for the assets jointly financed by the IFIs and those exclusively financed by the bank. Although the standards manage to provide some guidelines on the accounting treatments and disclosures of the financial instruments, it seems that the questions of whether these financial instruments follow the Islamic requirements and are usury-free are still left unanswered.

For zakah accounting, AAOIFI promulgated FAS 9 with the aim to standardize the methods used by IFIs in determining the amount of zakah and disclosure of the items. FAS 9 provides detailed explanation on the calculation of zakah by allowing two methods to be used; Net asset method and Net invested funds method. It is suggested that either method used will provide similar amount of zakah base, as illustrated in the Appendix A and B of the standard. Following the decision made during the First Conference on Zakah in Kuwait in 1984, AAOIFI requires an IFI to pay zakah at either 2.5% (based on lunar calendar) or 2.5775% (based on solar calendar), if required either by the law; or by charter or by-laws; or shareholder's resolutions. Based on this, there are high possibilities that some IFIs do not pay zakah on their business such as 9 IFIs in this study that fall only under Category 3 (Table 7). This raised a question on the obligation of the IFIs as the Islamic based organization in the payment of zakah. Although, one might argue that the responsibility is passed to the shareholders of the IFIs, the zakah is then only paid on the distribution profits. Therefore, it is

suggested that the IFIs should be obligated in paying the zakah for the undistributed profits. The AAOIFI also requires the IFIs to prepare the "Statement of Sources and Uses of Funds in the Zakah and Charity Funds". However, it is argued that the statement might be more beneficial if the amount of zakah and charity is separated.

iii) As countries globally are moving towards adopting IFRS, what are the roles and contributions of AAOIFI as compared to IFRS standards?

Chapter 4 of this research discussed the differences between AAOIFI and IASB in term of the backgrounds and objectives of both accounting bodies; and the steps taken in promulgating the set of accounting standards. One of the notable differences between AAOIFI and IFRS is AAOIFI standards are specifically for IFI and the related industry. AAOIFI only develop standards on issues not being addressed by the IASB such as Islamic financial instruments, zakah, and ijarah; or IFRS standards that are perceived to be incompatible with Islamic requirements such as accounting standards for investments and foreign currency transactions. Thus, it is expected that AAOIFI will not develop for instance, standards on related party disclosure or events after balance sheet date, as both areas do not raised shariah compliance issues. For the areas not covered by AAOIFI, the IFIs are allowed to follow IFRS or other local GAAP standards deemed to be appropriate. Several scholars such as Mohamed Ibrahim and Osman (2003) and Napier (2007) condemning this approach by stating that IsAS should not be developed based on the conventional accounting. It is pointed out that in the long run, the AAOIFI standards might become irrelevant since most of the areas covered are within the scope of conventional accounting standards.

However, considering the impacts of harmonisation of accounting standards, the AAOIFI approach might be considered as reasonable for IFIs. Unlike IASB, AAOIFI main objective is to develop Islamic accounting and auditing standards that are deemed to be relevant to the IFI worldwide, and not to replace the whole conventional accounting system. Contemplating the fact that not all aspects of conventional accounting violate the Islamic requirements, it is reasonable for AAOIFI to develop new standards that are considered as unique to the IFIs such as zakah and allowing the IFIs to follow the IFRS or local GAAP for other accounting issues. As zakah, ijarah, istisna'a, murabaha and mudaraba for instance are specifically for IFIs, it may not be possible for IASB to develop such standards, hence, the AAOIFI standards may still be relevant for IFIs in the future. Nevertheless, to ensure the

relevance of AAOIFI standards, responds of IFIs to the AAOIFI regulations specifically on zakah and riba are presented next.

iv) How do IFIs respond to the AAOIFI regulations on zakah and riba?

Using the content analysis technique, the actual compliance of IFIs on the accounting standards related to zakah and riba is examined and discussed in Chapter 5. The content analysis covered 25 IFIs that were randomly selected among the members of the AAOIFI. The 2006 and 2007 annual statements of those IFIs were downloaded and then, the actual disclosures of zakah and financial instruments were compared with the requirements of AAOIFI. In general, comparing the two financial periods, it is reasonable to suggest that the disclosures of the IFIs were relatively consistent.

The analysis conducted revealed that the extents of disclosure by the IFIs are much lower than the AAOIFI requirements for both areas. In both years, only 5 out of 25 IFIs managed to disclose at least 50% of the disclosure requirements in FAS 9 – Zakah. Surprisingly, the number is lower than 7 IFIs in 2007 that score 0% disclosure of zakah. Analysing the items disclosed by the IFIs, it seems that the disclosure of the method used in determining the zakah base score among the highest in all three categories. However, the requirement of AAOIFI to provide "Statement of Sources and Uses of Funds in the Zakah and Charity Funds" for IFIs that are categorized under C1 or/and C2 seems to be ignored with only 3 IFIs provided such statements. Other disclosure requirements such as items included in the zakah base, ruling of SSB on issues not covered in the standards, and whether zakah is paid on behalf of the subsidiaries, investors and other type of account holders also scored much lower than expected. The study also found that banks with low leverage tend to provide more disclosure on zakah than the high levered banks. This is consistent with a theory that low levered companies are likely to disclose more to meet the information demands of the capital provider. Similarly, the t-test conducted showed that IFIs from Bahrain tend to follow the AAOIFI zakah disclosure requirements as compared to banks not originating from Bahrain. This is not surprising as AAOIFI itself originates from Bahrain.

Similar scenario could also be seen in the disclosures of the financial instruments. As shown in Table 10, on average, IFIs that offer musharaka financing score 33.33%, while those provides mudaraba financing score the average of 21.43%. On the other hand, banks

that provide murabaha and murabaha purchase orderer services only score 15.91%. These figures clearly suggest that the disclosures of free-interest related transactions are falls for short of the AAOIFI requirements in FAS 2-4. It is pointed out that majority of the IFIs failed to separately disclose the assets that are jointly and exclusively financed by the bank as required. The t-test conducted suggests that consistent with the finding of zakah, IFIs with low leverage, and IFIs from Bahrain, provide more disclosure on financial instruments as compared to the other banks. In addition, it is also statistically significant to suggest that in term of disclosures of financial instruments, IFIs that adopt AAOIFI provided higher disclosure than the non-adopters.

The findings imply that leverage and origins of the IFIs may influence the disclosures of zakah and interest in the banks' financial reports. It is also suggested that IFIs that claim to adopt AAOIFI standards do disclose more on financial instruments as opposed to the non-adopters. However, the average of only 39.67% does not justify that these adopters do comply with the disclosure requirements of AAOIFI on financial instruments. As leverage factor is expected to influence the disclosure practice, the origin factors may evoke questions on the acceptance of AAOIFI standards by IFIs not from Bahrain. The findings are also contradicted with the AAOIFI objective to develop accounting standards that are deemed to be relevant to the IFI worldwide. Based on the findings, it may be reasonable to state that the AAOIFI standards are not actually binding, but being used as a guideline for IFI instead.

6.2 Conclusion

The issues of zakah and interest for IFIs have been highlighted for several years and attracted many arguments among Islamic scholars and public. There is increasing public interest on the IFIs since 1970s driven by the sensitivity of Muslims regarding the relationship between religion and economic activities. With the emergence of IFIs, Islamic community demand for an establishment of an accounting body to develop a set of accounting standards that adhere to the Islamic tenets, hence AAOIFI was established. Since then, a number of studies conducted by the Islamic scholars regarding the issue of IsAS. However, no known research yet exist that carefully examines the actual compliance of IFIs with the AAOIFI standards on zakah and riba. This thesis was intended to answer this question by collecting data from 25 global members of AAOIFI.

Since this study is trying to investigate the compliance with AAOIFI standards, the actual disclosures of zakah and financial instruments are compared with the disclosure requirements by AAOIFI in FAS 9 (Zakah) as well as FAS 2 (Murabaha and Murabaha to the Purchase Orderer), FAS 3 (Mudaraba Financing) and FAS 4 (Musharaka Financing). Based on the analysis conducted, it is concluded that the extents of disclosure by the IFIs are much lower than the AAOIFI requirements. The study also found that leverage and origin factors might contribute to the level disclosures of zakah and financial products. In addition, the test performed also revealed that the adopters of AAOIFI do provide more disclosure as compared to the non-adopters. However, the mean result is relatively low to suggest full compliance with the AAOIFI standards.

This paper also contributes to the current literatures by examining the process of developing the AAOIFI standards. In general, there are four stages of standards development for AAOIFI. These include (i) identification of issues; (ii) conducting preliminary studies; (iii) development of the exposure drafts; and (iv) development of the accounting standards. Researching the process in-depth, it seems that the approach taken by the AAOIFI is lacking of public responses. This might be one of the reasons why the compliance of the AAOIFI standards are reasonably low as found in the analysis part of this study.

However, as the study focus on the accounting for zakah and riba based on only 25 samples, the findings therefore cannot be generalized. For that reason, further studies using a larger sample and other standards might further contribute to the issue. Moreover, as this paper using content analysis method, the findings are limited to the comparison between actual disclosures of the IFIs with the requirements of AAOIFI standards, without addressing the actual reasons behind the non-compliance. Therefore, future research may consider in combining both content analysis and interview method to enhance the understanding of the disclosure issues of Islamic institutions.

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