IFRS vs AAOIFI: The Clash of Standards?

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IFRS vs AAOIFI , The clash of standards? (one size doesn't fit all)

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"The Islamic financial industry needs a corresponding alternative set of accounting standards which can at best be harmonized, not standardized due to the different nature and activities of the Islamic banks and financial institutions. These standards already exist, developed by an industry led non profit organization based in Bahrain- the Accounting and Auditing Organization for Islamic Financial Institutions established in 1991. The IASB should reconsider its position and allow alternatives- live and let live, just as there is a need for differential reporting requirements for small and medium businesses."

The Islamic Financial Services Industry now has assets of over $175billion with equity of US$15billion. With more than 300 Islamic banks, finance companies, investment banks, unit trusts and Islamic insurance companies. The growth of this sector has been nothing less than remarkable. In the past 10 years, the industry has grown by 23% a year . It employs around 300,000 people and is spread across 34 countries in all continents except South America. It is projected that this will be a $trillion industry by 2010. Kuala Lumpur and Bahrain are the world's leading Islamic capital markets while Dubai and other players in the Middle-East are fast catching up. In the UK, the first Islamic bank has already opened its doors and Singapore has expressed its interest to be a leading Islamic financial centre, while China and India has expressed interest in Islamic banking.

Islamic banks and finance companies are not just market players in the sense of their presence in capital markets. More importantly, they are a part of the financial intermediation system and are such very important for a country's economy. Further, the nature of banking business which invests public deposits is very much regulated in most countries by their respective central banks' prudential regulations. It is thus very important that a transparent, fair

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and high quality accounting and reporting are adhered regulated by high quality accounting and reporting standards. However, because IFIs have some unique requirements they cannot fully comply with the IFRS in their financial reporting. Instead, they follow a corresponding set of Islamic Accounting standards, which are promulgated by the Accounting and Auditing Organization for Islamic Financial Institutions based in Bahrain. This is an industry led standard setting body which has been in existence since 1991 and has since issued more than 56 Accounting, Auditing, Governance and Shari'a Standards for Islamic Institutions. However, this in many cases have come into conflict with the global International Financial Reporting Standards, which is not in the spirit of global accounting standards convergence.

Since the early sixties, the accounting profession initially and then followed by national and international accounting standards committees and boards developed and enforced accounting and reporting standards in the interests of comparability of financial statements of different business entities. Initially these were in the form of recommendations of best practices which mutated to flexible but mandatory national and international accounting standards which allowed a range of alternative accounting treatments (e.g. bench mark and alternative treatment of the previous IAS's). Research conducted for example by Choi and Muller in the early nineties showed that Financial Statements can vary greatly if they follow different GAAPs, converting $millions in profits to $millions in losses! This leads to difficulties for investors from other countries used to a different GAAP. Hence, the call for harmonisation, and convergence of different accounting standards on a global scale.

The aforementioned series of events have led to more rigid global International Financial Reporting Standards.

Although International Financial Reporting Standards do not have international regulatory clout de jure, the forces of globalization through the action of international association of stock exchanges, security commissions and international organizations such as the EC and the OECD, national accounting member bodies of the international federation of accountants, multinational companies as well as international firms of auditors have made IFRS a de facto compulsory requirement.

The debate on convergence of accounting standards has changed from harmonization to a hegemonic tone of standardization. This is evidenced by the preface to the recent International Financial Reporting Standards which states that financial statements cannot state that they comply with international financial reporting standards unless they comply with all the applicable standards and not some of them. Hence, IFRS permits no exceptions and is Busherian in tone , “either you are with me or are against me!”.

We would do well to remember the accounting developed as a tool for businesses arising from their environmental requirements. Contemporary mainstream accounting practice arose from the requirements of the Industrial revolution in UK and the USA. As business environments change, different type of accounting will be required. This is well demonstrated by the changes made to management accounting techniques from those based on labour intensive to capital intensive to service/knowledge intensive industries.

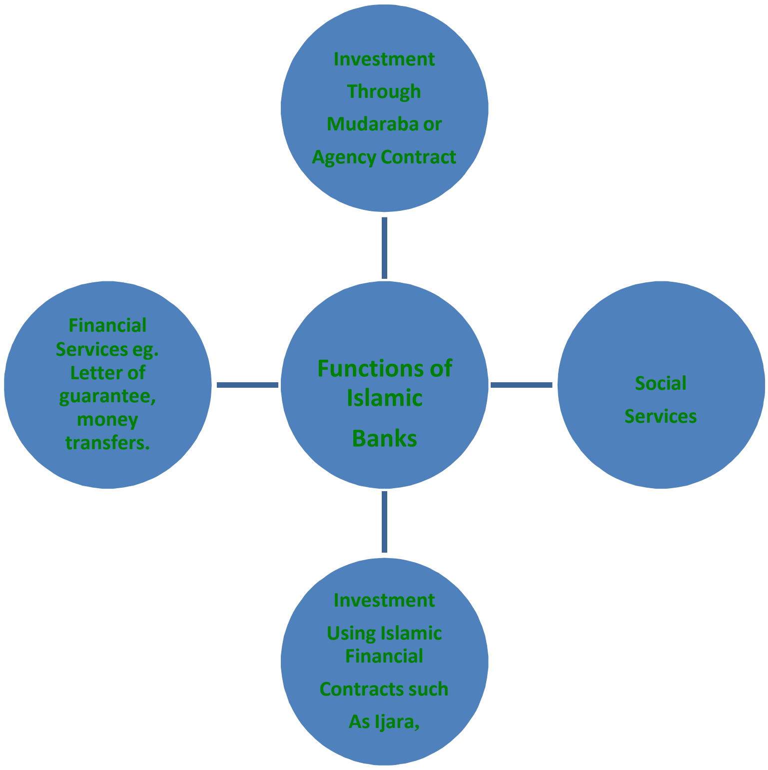
In addition to different and changing business environments, the economic system (capitalist/socialist), culture and the development stage of a country’s economy affect the type of accounting needed, not forgetting the need for accounting for the non profit charity sector, NGOs and Public sector. Critical accounting theorists such Tinker and the late Professor Puxty at Strathclyde called for a more emancipatory Accounting while global warming and other environmental concerns have resulted in calls for Sustainability Reporting resulting in the   The Global Reporting Initiative and the Social and Environmental Accounting .

Back to the question, why do we need a different set of standards for Islamic financial institutions? The higher level answer to this question is that these IFIs are not based on the capitalist worldview which underlies the current International Financial Reporting Standards (IFRS). While conventional accounting is based on a decision usefulness framework, Islamic accounting is based on an accountability cum shari'a compliance framework which seeks to "determine the rights and obligations of all interested parties, including those rights and obligations resulting from incomplete transactions and other events, in accordance with the principles of the Islamic Shari'a and its concepts of fairness, charity and compliance with Islamic business values." (AAOIFI, SFA 1). While, Islamic accounting does not neglect the objective of financial accounting to provide "useful information to users of these reports", these are to "enable them to make "legitimate decisions" in their dealing with Islamic banks, as opposed to buy, sell or hold decisions to increase their wealth.

The second more practical reason for the different set of standards are that the functions of and the contracts used by the Islamic financial institutions are different from conventional banks. We all know that the corner stone of modern banking is the mobilization of deposits and advancement on loans on interest. Islamic banks cannot receive or pay interest in accordance with Islamic law or shari'a and therefore different contracts allowed in Islam are used to earn profits.

The four main functions of Islamic banks are Investment Management, Investment, Financial services and Social Services. Islamic banks may perform Investment Management function based on either a Mudaraba contract or an agency contract. According to the Mudaraba contract, the bank (in its capacity as a Mudarib i.e. the one who undertakes the investment of other parties' funds) receives a percentage of the returns only in case of profit. However, in case of loss the bank receives no reward for its effort and the provider of funds ,(rabb-al-mal) is allocated the losses.

If an agency contract is use, the bank receives either a lump sum or a percentage of the invested amount irrespective of whether or not a profit is realized.



Functions of Islamic Banks

On the Asset side, Islamic banks invest funds (both owners' equity and by account holders) using investment vehicles consistent with the Shari'a. Examples would include Murabaha contracts, leasing, joint ventures, Mudaraba contracts, Salam or Istisna' (manufacturing) contracts, formation of enterprises or the acquisition of controlling or other interests in existing enterprises, trading products, and investment or trading in publicly traded shares or real estate. The returns are divided between the contributors of funds after the bank receives its Mudarib share of profit which must be agreed upon between investment account holders and the bank before implementation of the contract.

Investment accounts may be divided into unrestricted (i.e. unrestricted Mudaraba) , or restricted (i.e. restricted Mudaraba).

In the case of unrestricted murabaha, the investment account holder authorizes the Islamic bank to invest the account holder's funds in a manner which the Islamic bank deems appropriate without laying down any restrictions as to where, how and for what purpose the funds should be invested. Under this arrangement the Islamic bank can commingle the investment account holder's funds with its own funds or with other funds the Islamic bank has the right to use (e.g. current accounts). The investment account holders and the Islamic bank generally participate in the returns on the invested funds.

Under the **Restricted murabaha investment accounts**, on the other hand, the investment account holder imposes certain restrictions as to where, how and for what purpose his funds are to be invested. Further, the Islamic bank may be restricted from commingling its own funds with the restricted investment account funds for purposes of investment. In addition, there may be other restrictions which investment account holders may impose. For example, investment account holders may require the Islamic bank not to invest their funds in installment sales transactions or without guarantor or collateral or require that the Islamic bank itself should carry out the investment rather than through a third party.

Some of the accounting implications of the above are:

(i) unrestricted investment accounts are not liabilities but a special class of equity

(ii) restricted investments accounts are not the assets or liabilities of the bank but are reported off the balance sheet

(iii) Islamic leasing contracts due to sharia requirements cannot be accounted as a financing lease and thus the leased assets are recognized in the books of the bank and not capitalized in the customers books. Consequently, the leased assets are depreciated in the books of the bank. This may contravene IAS 17

(iv) Islamic banks cannot strictly follow IAS 30 due to their different functions and contracts

(v) Islamic insurance companies cannot follows IFRS 4 on Insurance contracts, as premium contributions by policy holders belong to them, not the insurance company, subsequently, it is off the balance sheet of the insurance company but a separate fund accounting of the policy holders fund is undertaken.

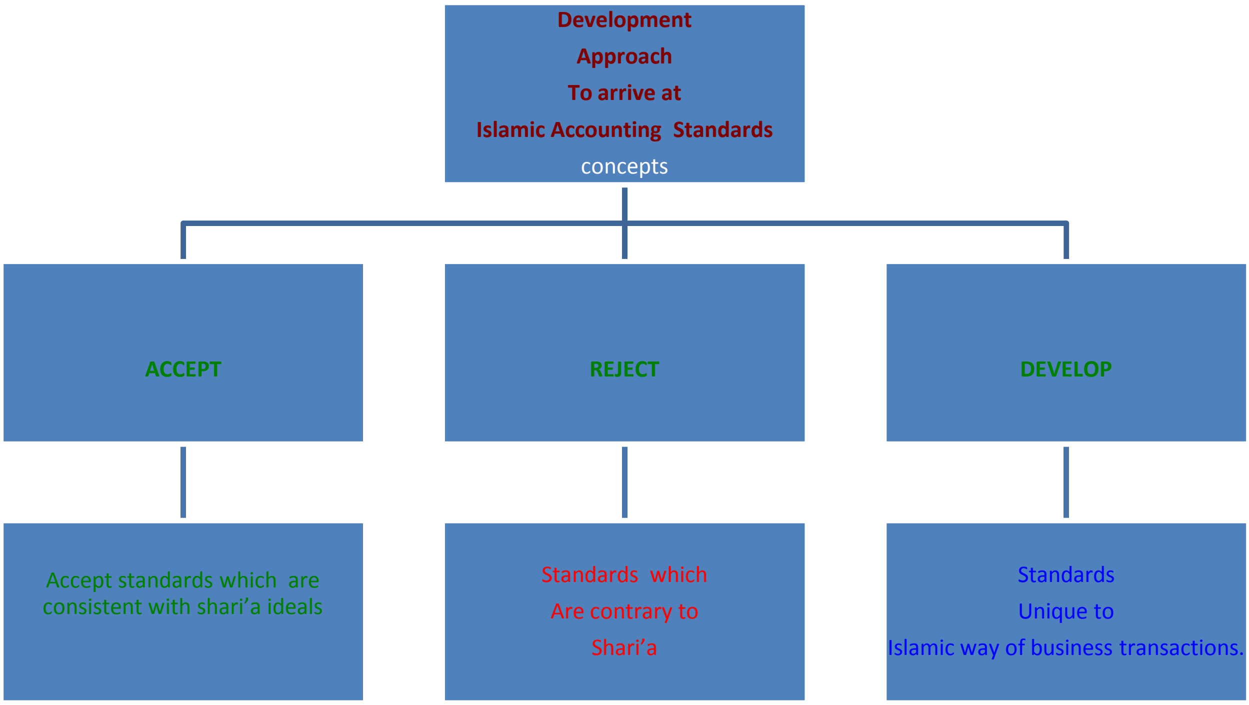
(vi) Certain Islamic contracts and requirements such as leasing with gradual sale and zakah requires inventory to be valued at cash equivalent values (fair values), not lower of historical cost or net realizable value. Hence, IAS 2 cannot be followed in these circumstances.

To summarize, AAOIFI formulates industry specific standards while IFRS are not industry specific except IAS 30 and IAS 41. Even IAS30 cannot be followed in full because of shari'a compliance issues. In essence, AAOIFI develops alternative Islamic standards when:

i)when the equivalent IFRS cannot be adopted in whole by the IFIs., e.g Ijarah standard vs IAS 17.

ii) when the IASB has no IFRS to cover the specific Islamic banking and finance practices e.g. Mudarabah, Musharaka, Salam and Istisna.

And when certain IFRS can be adopted, then either AAOIFI does not develop a standard or it develops and adapts IFRS.



According to Khairul Nizam, the director of technical development at AAOIFI, "it is clear that gaps and differences exist and will continue to exist between the two set of standards. These gaps and differences are a natural result of the differing structural objectives of the IASB and AAOIFI. AAOIFI's mandate is to develop standards where IFRS's do not cater for the specificities of Islamic Banking or leads to Shari'a compliance issues. As long as there are economic, legal and social differences between Islamic and conventional banking and finance practices, there will also be differences in the standards issued." The question is will the IASB tolerate genuine difference or force "the other" to conform to "us"?

The objective of true and fair reporting, holds true for Islamic as well as conventional accounting. However the concept of truth and fairness has to be in line with the concepts of the shari'a for IFIs.. While the original objective of accounting standards was comparability and consistency and hence to improve usefulness to users, the accounting standards especially the IFRS seem to have evolved into a dominating monopoly on "truth" and "fairness" and insists that only by following ***all*** the IFRS can this be attained. I have always thought truth is based on evidence, logic and even inspiration and revelation, not by committee or public hearing. This perhaps echos the Christian tradition of having "councils" to determine theological dogmas as opposed to preserving and interpreting revealed texts. The thesis that the IFRS in the only possible route to truth and the whole world must follow it reifies the Quranic dictum "Never will the Jews and Christians approve until you follow their way". This is unreasonable as Al-Qaeda's stand that the "crusaders" will have to accept Islam before they will negotiate.

It is interesting to note here that one of the cardinal principles of auditing/accounting judgement, the true and fair override, where an management/auditor if in his judgement concludes that by following a financial reporting standard would result in untrue or unfair view can do so, has now somehow been constrained by the warning that " the circumstances requiring a departure are expected to be extremely rare and the need for departure will be a matter for considerable debate and subjective judgement.." and the "IASC will monitor instances of non-compliance". The auditor and the professional accountant is under threat by his professional body's ethical code and will usually result in disciplinary action, if the accountants are not prepared and presented in accordance with IFRS. This state of affairs is made worse by countries that promote Islamic finance but insist that Islamic banks must follow IFRS in line with other listed companies. I have yet to see an audit report by a firm of professional accountants who have the moral courage to give a true and fair override. In jurisdictions such as Bahrain where the local regulator require Islamic financial institutions to follow AAOIFI standards and this could not be done, their auditors (who are usually the big 4) qualifies the departure instead of emphasizing matter.