



**CONVERGENCE OF INTERNATIONAL ACCOUNTING  
STANDARDS ON FINANCIAL INSTRUMENTS FOR  
ISLAMIC BANKS IN MALAYSIA AND BAHRAIN**

**BY**

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## ABSTRACT

Despite the impressive development of the Islamic banking industry, however it still struggles in reaching international consensus on several vital issues including the aspect of financial reporting. The wave of convergence towards International Financial Reporting Standards (IFRS), the obligation to abide to Shariah principles with its differing interpretations as well as to comply with local regulation have resulted in the diversity and inconsistency of the financial reporting in Islamic banks (IBs). Meanwhile the attempt to utilize Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) Standards to serve the specific needs of the IBs' financial reporting has been challenging due to the limited adoption of its accounting standards. Founding on institutional and stakeholder theories and using the case study of the two most recognized Islamic financial hubs, i.e., Malaysia and Bahrain, this study aims to address several issues of IBs' financial reporting in relation to the IFRS convergence. To achieve this objective, this study performed comparative analysis between the IFRS' and AAOIFI's accounting standards on financial instruments, analyzed the adoption of IFRS' and AAOIFI's accounting standards by IBs in both countries for the period of 2007-2009, and also conducted a questionnaire survey to the financial statement preparers of IBs in both countries. This study found and confirmed that IFRS and AAOIFI accounting standards are harmonious in certain aspects particularly on some measurement requirements. However, the areas of divergence are also of clear evidence such as on impairment, recognition and disclosure of gain and loss. While this study indicated that AAOIFI accounting standard is of possible adoption, the adoption level is still very limited even in Bahrain where the standards are mandatory. Meanwhile the survey generally identified positive approval towards IFRS convergence but the respondents also demanded specific accounting standards for IBs that can be incorporated to the existing IFRS framework. It is mainly triggered by the needs to enhance the quality and comparability of Islamic financial reporting as well as to fully adhere to Shariah principles. This study implies that more intense collaboration is needed to provide a complete and internationally accepted framework of accounting and reporting for IBs that is tailored to the requirements of IBs and deem fit for national commitment to IFRS convergence.

## ملخص البحث

على الرغم من التطور الرائع للصناعة المصرفية الإسلامية فإنها لا تزال تحاول التوصل إلى الإجماع على المستوى العالمي في العديد من القضايا الأساسية منها التقارير المالية. ولقد بدأ الاتجاه إلى التقريب من معايير التقارير المالية الدولية (IFRS) وموافقة المبادئ الشرعية على اختلاف المذاهب والفتاوى وكذلك موافقة الأنظمة المحلية الأمر الذي أدى إلى التنوع والتضارب في التقارير المالية في المصارف الإسلامية. وفي الوقت نفسه، فإنّ المحاولة لاستخدام المعايير المحاسبية التابعة لهيئة المحاسبة والمراجعة للمؤسسات المالية الإسلامية (AAOIFI) لتلبية احتياجات المصارف الإسلامية إلى التقارير المالية أصبحت من التحديات وذلك بسبب محدودية تطبيق معايير الهيئة المحاسبية. بناءً على النظريات المؤسسية واستخداماً لنموذج المحلين المعترين في التمويل الإسلامي ماليزيا وبحرين يهدف البحث إلى دراسة العديد من المسائل من التقارير المالية للمصارف الإسلامية فيما يتعلق بمعايير التقارير المالية الدولية. ولتحقيق هذا الهدف قصد البحث إلى التحليل المقارن بين معايير IFRS ومعايير الهيئة AAOIFI وحلّل البحث اعتماد معايير IFRS ومعايير الهيئة في المصارف الإسلامية في كل من ماليزيا وبحرين من خلال 2007 و2009 بالإضافة إلى جمع الاستبانة من قبل معدي القوائم المالية في المصارف الإسلامية في ماليزيا وبحرين. وتوصّلت هذه الدراسة إلى أنّ معايير IFRS ومعايير AAOIFI متقاربتان في جوانب معينة مثل المتطلبات القياسية وبعض المجالات الخلافية بينهما واضحة مثل الضرر، والاعتراف، والإفصاح عن صافي الربح والخسارة. وأشارت هذه الدراسة إلى أن معايير AAOIFI يمكن اعتمادها غير أنّ مستوى الاعتماد محدود جداً حتى في دولة بحرين حيث جعل تطبيقها لازماً. وفي الوقت نفسه أظهرت الدراسة على وجه العموم إمكانية اعتماد معايير IFRS بطريقة المقارنة غير أنه يطلب المستجيبون أن تدمج المعايير المحاسبية الخاصة بالمصارف الإسلامية في هيكل معايير IFRS الموجودة. والسبب الرئيس من هذه الدراسة هو الحاجة إلى تحسين جودة التقارير المالية الإسلامية وقابليتها للمقارنة بالإضافة إلى الالتزام بالمبادئ الشرعية. وتوصّلت هذه الدراسة كذلك إلى المزيد من التعاون لتوفير هيكل المعايير المحاسبية والتقارير المالية التامة للمصارف الإسلامية، والمقبولة على الصعيد العالمي المصممة لتلبية احتياجات المصارف الإسلامية مع موافقتها للشريعة والمستوعبة للالتزام الوطني لمتطلبات معايير IFRS.

## **APPROVAL PAGE**

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*This work is dedicated to the loves of my life, loyal companions of my PhD journey*

*My husband and our children*

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# CHAPTER 1

## INTRODUCTION

### 1.1 BACKGROUND OF THE STUDY

Islamic banking and finance is aggressively gaining a significant position within the global financial system. It was reported that the growth of Islamic banking is impressively 50% faster than the overall banking sector (Ernst & Young, 2012). It was also projected to continue to grow faster than conventional banking for the foreseeable future given its low base, low level of penetration, substantial market potential, and the strong demand in many Islamic countries for Shariah-compliant products (Song & Oosthuizen, 2014). Despite its strong growth, there is yet no internationally generally accepted legal, regulatory, and supervisory framework dealing with Islamic banking, though various initiatives are in varying stages of development. It is evident in the survey on Islamic banking regulation and supervision by IMF that indicated a wide dispersion of approaches to the legal, regulatory, and supervisory frameworks to accommodate Islamic banking (Song & Oosthuizen, 2014).

Through international and domestic regulatory bodies, there has been effort to standardize regulations in Islamic banking across different countries and financial institutions, although challenges remain. Financial reporting is one of the major regulatory areas in the Islamic banking industry which is yet harmonious in practice. The efforts to harmonize the financial reporting of Islamic banks (IBs) become particularly more challenging in coincidence with the international efforts to converge the national accounting standards with International Financial Reporting Standards (IFRS) issued by IASB. Interestingly to note that historically among the two most

important momentums in the milestone of International Accounting Harmonization and Convergence<sup>1</sup> (IAHC) i.e. the creation of IASC in 1973 and IFAC in 1977 took place at about the same time with the establishment of the first Islamic bank (IB) which was marked by the establishment of Myt Ghamr Saving Bank in Egypt in 1963 and Islamic Development Bank in 1974 (Sultan, 2006). Even though this coincidence does not signal particular reason however the movement of Islamic finance later on has been seen as a challenge towards the attainment of the IAHC objectives (Karim, 2001; Hamid, Craig & Clark, 1993; Vinicombe & Park, 2007). Islam as a religion which drives the development of Islamic financial system was then seen as one of the potential factors to impede the full achievement of IAHC (Hamid et al., 1993; White, 2004).

While IFRS has been widely adopted by many countries including the country with the Islamic banking operation like Malaysia, the questions are still present over its compatibility and adequacy for the unique operation of Islamic banking. Karim (1996) illuminated several reasons of why accounting standards developed for Western business organizations are hardly relevant for IBs. Among others are due to the different nature of operations and financial instruments of IB. On the other hand, within the Islamic banking industry itself there is already a specific accounting standard formulated for the use of Islamic financial institutions worldwide. The accounting standards of Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) were issued due to a vacuum of sufficient international accounting guidelines that help in rendering the financial statements of IBs comparable as the IFRSs do not cater for the specificities of the IBs' financial

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<sup>1</sup>The generic term "International Accounting Harmonization and Convergence (IAHC)" will be employed throughout this study to denote the broad process of harmonization of accounting practices, which has been currently transformed into a convergence initiative. Various terms used in this research theme will be discussed in Chapter 2.

instruments (Archer & Karim, 2007). Nevertheless the AAOIFI are still facing two major challenges mainly on the aspects of adoption and the adequacy of its standards (AAOIFI, 2008).

Given the unharmonious accounting standards and practices of IBs internationally it is vital to identify the best financial reporting framework for IBs, which is in line with Shariah framework. With the unresolved issues of financial reporting for IBs internationally, this study intends to appraise the currently available accounting standards for IBs' practice particularly on the area of financial instrument, examine the extent of adoption of either IFRS or AAOIFI accounting standards by the IBs, and identify the opinions of accounting practitioners in in the industry on the pertinent issues such as on the IFRS convergence and the financial reporting framework for IBs. To embark this study it is considered essential to ask among the following questions of whether there are actually any significant differences between the AAOIFI accounting standards and the IFRSs? What is the entent of adoption of both standards by the IBs? How the stakeholders such as preparers of IBs' financial statements respond to the IFRS convergence and its surrounding issues in the context of Islamic finance? These are among the questions that will basically draft the objectives of this study.

## **1.2 OBJECTIVES OF THE STUDY**

Taking the case of the two most recognized Islamic financial hubs, Bahrain and Malaysia, and based on accounting standards for financial instruments, this study aims to identify the extent of similarities and differences between IFRS and AAOIFI and the extent of adoption of both standards by IBs as well as to examine the perception of financial statement preparers towards various issues in relation to the IFRS

convergence and financial reporting of Islamic banks. Specifically, the followings are the research objectives of this study:

1. To perform comparative analysis between the IFRS and AAOIFI accounting standards on financial instruments.
2. To identify the extent of adoption of IFRS' and AAOIFI's disclosure requirements on financial instruments.
3. To examine whether there is a significant difference in the perception of IBs' accountants concerning the IFRS Convergence and International Accounting Harmonization.
4. To examine whether there is a significant difference in the perception of IBs' accountants with regard to the requirements of IFRS' and AAOIFI's accounting standards on financial instruments.
5. To examine whether there is a significant difference in the perception of IBs' accountants concerning the benefits and challenges of IFRS convergence for Islamic banks.
6. To examine whether there is a significant difference in the perception of accountants on the need to have a specific accounting standards for Islamic banks.

Based on the above research objectives, the following research questions are proposed:

1. What are the similarities and differences of the IFRS and AAOIFI accounting standards on the recognition, measurement, and disclosure of financial instruments (IAS 39, IAS 32 Vs FAS 17)?

2. What is the extent of adoption of IFRS' and AAOIFI's disclosure requirements on financial instruments by Malaysian and Bahrain Islamic banks for the period of 2007-2009?
3. Is there a significant difference in the perception of the IBs' accountants concerning the IFRS Convergence and International Accounting Harmonization?
4. Is there a significant difference in the perception of the IBs' accountants about the requirements of IFRS' and AAOIFI accounting standards on financial instruments?
5. Is there a significant difference in the perception of the IBs' accountants with regard to the benefits and challenges of IFRS convergence for Islamic banks?
6. Is there a significant difference in the perception of the IBs' accountants on the needs to have a specific accounting standard for Islamic banks?

### **1.3 MOTIVATIONS OF THE STUDY**

The need to undertake this study is stemmed from the paramount importance of identifying the most suitable framework of financial reporting for IBs given their unique requirements. Furthermore this study is also moved by the imperative needs of accounting harmonization for Islamic banks added with the impact attributed from the initiative of IFRS convergence, which requires the use of IFRS as a single set of global accounting standards. There have been concerns that IFRSs are not fully compatible with the nature of Islamic banking operation. The use of IFRS in the financial reporting of IBs does not also assure the comparable financial statements is achieved. Karim (2001) for example suggested that even though most of the countries

in which the Islamic banks operate either look directly to IFRSs or develop national standards based primarily on IFRSs however the approach adopted by the authorities to regulate Islamic banking tended to influence the accounting treatment of investment accounts adopted by those banks which ultimately render the financial statements of the Islamic banks incomparable.

Undeniably with the trend of globalization is taking place, the IBs cannot escape from the effects of globalization. Global integration is needed by IBs to help accelerate its growth (Ali, 2008). In the attempt to integrate to the global financial system, accounting harmonization for IBs is viewed as crucially significant to facilitate the development of globally acceptable and tradable Islamic product and services (Yousaf, 2005). Furthermore as Islamic banking products were offered by major global financial players such as Citibank and HSBC, the relevance of accounting standards to enable uniform disclosure of economic activities and a transparent reporting basis that would facilitate rational economic decision making became more credible (Sultan, 2006). Harmonization will also enable the IBs to achieve the quality and comparability of accounting information. At macro level, accounting harmonization will strengthen the economic cooperation among Muslim countries. Therefore, a study to explore the accounting harmonization of IBs and its associated issues is deemed important.

This study is also mainly motivated by the lack of research undertaken in this particular issue. It is admitted that research in IAHC is very well established with very extensive literature has existed since several decades ago. However, the existing literature specifically on the area of IAHC and its impact to the IBs are limited and they are mostly descriptive and conceptual in nature and no comprehensive study has been done to empirically investigate the nature of the accounting harmonization

within IBs and how they are related to the worldwide call for international accounting harmonization.

More importantly it is believed that the IBs' full compliance towards Shariah rulings should be the utmost important objective accomplished by Islamic banks as it is the fundamental identity of the institutions being the "Islamic" banking institutions. Given the tension that has to be faced by the Islamic banks in whether to be part of IAHC and unable to fully comply with the Shariah requirements as these requirements are not specifically addressed by the international accounting standards hence study investigating these issues is believed as highly significant. This significance is particularly more apparent considering the current global IFRS convergence agenda whereby one single standard will be globally and fully adopted by all the countries in the world.

Lastly this kind of study is needed to clarify the areas of incompatibility between Islamic accounting standards of the AAOIFI and the conventional accounting standards (i.e. IFRS). There have been many claims in the Islamic accounting literature that many areas of conventional accounting is incompatible with the Islamic objectives (see for e.g. Hossain, 2003), however there has been limited scholarly works which empirically prove the incompatible areas.

#### **1.4 SIGNIFICANCE AND CONTRIBUTION OF THE STUDY**

This study is significant in various ways. Knowledge and literature wise, it will significantly fill the existing gap whereby limited prior studies has comprehensively and empirically attempted to undertake the issues of IAHC in relation to the Islamic banking industry. Past literature specifically discussing this issue were quite limited and were mostly theoretical. Additionally, many studies on harmonization to date

tend to exclude financial institutions in their sample, hence the availability of this study is also considered important in this respect.

Most importantly this study will supply evidence of to what extent is the IBs' financial reporting has harmonized either to the IFRS framework or AAOIFI framework. Even though the adoption analysis performed in this study was only based on selected standards on financial instruments, it however provides the overall degree of compliance by the IBs in Malaysia and Bahrain towards IFRS' and AAOIFI's accounting standards. The degree of compliance towards both standards also in some way indicate the degree of acceptance to the standards by the industry.

This study is also important in providing the information on the attitude of one of key stakeholders within the financial reporting chain of IBs' (i.e. accountants) in both surveyed countries towards the convergence initiative. Having to know the perception of financial statement preparers in two major Islamic financial hubs (i.e. Malaysia and Bahrain) will supply important information on how the Islamic financial industry generally responds to the call of worldwide IFRS convergence.

In addition to illuminating attitudes to the adoption of IFRS in Islamic banking industry in Bahrain and Malaysia, our results can also assist concerned parties to better assess some of financial reporting impacts of IFRS framework to the Islamic financial practice. Furthermore, the results are perhaps relevant to other reporting jurisdictions in which the operation of Islamic banking is in place and the IFRS is made mandatory or being considered for adoption.

The findings can also add to a growing body of international published works, which can assist regulators and policy-makers to better assess how well IFRS are being received by the Islamic finance communities of countries that promote IFRS adoption as well as pointing to particular issues and controversies facing the

implementation of IFRS around the world especially in the countries with Islamic financial operation. Last but not least, the present study is hoped to shed the light for future research to be undertaken in this field.

## **1.5 SUMMARY OF THE CHAPTER AND ORGANIZATION OF THE THESIS**

This chapter has provided a background of this study and discussed the motivations and the objectives of this study. More importantly, the contribution and significance of this study was accordingly explained. The thesis will be structured into nine chapters. Briefly the remaining eight chapters will be presented as follow:

### **Chapter 2: International Accounting Harmonization and Convergence of Accounting Standards**

This chapter aims to briefly discuss the international accounting research, what cause the differences in accounting practices and how far the literature in the area of international accounting harmonization has progressed hence the researcher could identify the gap in the existing literature. To identify the existing gap in the literature, this chapter will also highlight perception studies undertaken on various IAH issues and other contemporary directions in IAH research.

### **Chapter 3: Harmonization and Convergence of Accounting Standards in the Context of Islamic Banking**

In this chapter, the issues of IAHC and the financial reporting of Islamic banks will be specifically explored. The chapter will discuss the possible factors which influence the accounting practices of IBs, the relevance of accounting harmonization for IBs, the

IBs' positions in responding the IAHC's effort and particularly the role of AAOIFI in the IAHC's agenda. Most importantly the gap of the literature will be examined in the end of the chapter.

#### **Chapter 4: Conceptual Framework and Hypotheses Development**

This chapter will provide the conceptual framework for the hypotheses development. The institutional theory and stakeholder theory are utilized for the purpose of formulating the hypotheses. Both theories are seen relevant in providing a conceptual approach for achieving the research objectives of this study.

#### **Chapter 5: Research Method**

Chapter five will elaborate the research design and method of this study. The discussion in this chapter will cover research objective, research questions, method of data collection, and sample selection. Pilot testing and methods of data analysis will also be highlighted accordingly.

#### **Chapter 6: Comparative Analysis of Accounting Standards for Financial Instruments**

This chapter will compare the International Financial Reporting Standards (IFRS) on financial instruments with its comparable Financial Accounting Standards (FAS) of Accounting and Auditing of Islamic Financial Institutions (AAOIFI) on Investment in shares and securities. Despite the slightly different scope of the two standards, the discussion in this chapter is hoped to be useful in identifying the incompatible areas between the IFRS and AAOIFI's accounting standards especially on the selected issue.