

SOME NOTES ON IFRS CONVERGENCE AND THE ISLAMIC FINANCIAL INDUSTRY

Abstract

IFRS Convergence has been a worldwide phenomenon with most of countries in the world are adopting IFRS instead of their national accounting standards. At the same time, the Islamic finance is gaining its popularity in the present world with the increasing acceptance by international community. In relation to these two phenomena, there have been concerns that the establishment of Islamic financial institutions together with its own unique characteristics will impede the achievement of the global accounting convergence. Furthermore, the promulgation of accounting standards by Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), which is intended to fulfil the unique features of Islamic Financial Industry is viewed as a challenge to the International Financial Reporting Standards (IFRS), which is promoted by the convergence agenda. Numerous complex issues emerge as result of the dilemmatic position of IFIs in retaining its distinct Shari'ah principles, while attempting to be part of the global financial system through adopting the IFRS. This study aims to describe some notes relating to the IFRS convergence and the development of Islamic finance. The objective is to outline the issues, not necessarily to resolve them, and to consider the implications they have for pursuing IFRS convergence in the context of Islamic financial service industry.

INTRODUCTION

The global financial system has witnessed the increasing popularity of Islamic financial industry. Ernst & Young (2012) reports that Islamic banking has been growing 50% faster than the overall banking sector. Song & Oosthuizen (2014) further indicates that the islamic banking industry 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. Nevertheless, such positive growth is challenged with several unresolved issues within the industry such as on the unharmonious regulatory and supervisory framework in different countries. Survey on Islamic banking regulation and supervision by IMF found a wide dispersion of approaches to the legal, regulatory, and supervisory frameworks to accommodate Islamic banking (Song & Oosthuizen, 2014).

One of the unstandardized regulatory aspects within the Islamic banking industry is financial reporting. The initiative to standardize the Islamic banks' (IBs) financial reporting is particularly more challenging in relation to the global efforts to converge the national accounting standards with International Financial Reporting Standards (IFRS) issued by IASB. The Islamic finance has been interestingly seen as a challenge towards the attainment of the International Accounting Harmonization and Convergence (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 perceived 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 Indonesia and 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 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 above background, this study aims to describe several issues concerning the pursuance of IFRS convergence in the context of the Islamic financial industry. Specifically, the objectives of this study are threefold. First, this study aims to discuss the issues of accounting harmonization for the IFIs. Secondly, it attempts to discuss the issues associated with IFRS convergence and Islamic finance; and briefly illustrate the comparison between IFRS and AAOIFI accounting standards by specific reference to accounting for securities. Finally, it attempts to conceptualize possible approaches to the harmonization for the Islamic finance in the response to the IFRS convergence. This paper proceeds as follows. The following section will discuss the relevance of accounting harmonization to the Islamic banks. Next, the issues of IFRS convergence, Islamic finance, and AAOIFI will be reviewed. The discussion on the possible approaches to the harmonization follows in the next section. Conclusion is presented in the last section.

ACCOUNTING HARMONIZATION IN THE ISLAMIC FINANCE

The call for 'harmonization' and 'standardization' has been often voiced out within the Islamic finance not only to refer to the accounting aspects of the industry but of the other various issues which are seen important to be harmonized in the Islamic finance industry. For example Iqbal & Mirakhor (2007) noted that one of the operational challenges for IBs is to standardize the process of introducing new products in the market. The call for harmonization of Islamic banking practices might be partly due to the relative immaturity of the industry within the global financial system.

In particular to the accounting practices, there have been concerns that the current phenomena of accounting practices in the Islamic finance industry pose the challenge of the inability of the industry to achieve the quality and comparability of accounting information. The different ways of reporting and disclosing similar transactions cause the problems of market confidence and competitiveness to become more acute for the IFIs themselves, as well as for the development of Islamic finance in general (ACCA & KPMG, 2010). Such variations have been mainly argued as a result of the different regulatory setting of Islamic banking in different countries in which they are operating. 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 supervisory authorities to regulate Islamic banking tended to

influence the accounting treatment of the investment accounts adopted by those banks in which ultimately render the financial statements of the Islamic banks incomparable.

Numerous reasons have also been cited to favour the harmonization of IFIs financial reporting and also to have a dedicated accounting standard to guide the accounting practices of IFIs. Iqbal & Mirakhor (2007) highlighted that analysts often have difficulty in collecting useful information regarding IFIs. One of the factors contributing to this problem is the lack of uniform reporting standards followed by the financial institutions. The disclosure practices of IFIs are thus highly dispersed. 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).

The desire for IFIs to regulate their financial reporting is to achieve a high degree of comparability, particularly in those countries where the whole banking system has been 'Islamised' (Karim, 1990). The regulatory process also may result in enhancing the perceived credibility of the financial statements of IFIs. It is also viewed that the harmonization between national and international Islamic accounting standards is very important to facilitate the development of globally acceptable and tradable Islamic product and services (Yousaf, 2005).

While the numerous benefits are expected as a result from the harmonization, an apparent issue is of what level of harmonization of accounting practices is required of the Islamic financial industry and which accounting framework to be adopted. Should it be adequate of accounting harmonization within the Islamic financial industry solely or should it converge with the internationally most-accepted accounting standards "IFRS" for the industry to be accepted as part of global financial system. Certainly harmonization within industry is compulsory however with the strong wave of global convergence of IFRS, the Islamic finance seems impossibly to isolate from the global development. The following section investigates the issues arising from the IFRS convergence to the Islamic finance.

IFRS CONVERGENCE, ISLAMIC FINANCE AND AAOIFI

Development of Accounting Harmonization and Convergence

The term "IFRS convergence" is very popular lately in the business and accounting world. The emergence and the growing use of the term 'IFRS convergence' could probably be traced to the transformation of International Accounting Standards Committee (IASC) to the International Accounting Standards Board (IASB) in 2001 (Peng, Tondkar, Smith, & Harless, 2008). At the heart of the IASB's efforts is the concept of convergence (Tweedie & Seidenstein, 2005). Previously, the effort to achieve the comparability of financial reporting practices around the world was popularly named as 'harmonization'. Studies published prior to 2001 used the term "harmonization" when referring to the comparability and compatibility of accounting standards and published research subsequent to 2001 has frequently used the term "convergence" to describe this process (Peng et al., 2008).

Even though the terms "convergence" and "harmonization" are different in meaning and processes, yet

these two terms are very often used interchangeably in the literature (Chand, Patel & Day, 2008; Larson & Street, 2004). This is perhaps due to the fact that both harmonization and convergence processes are simultaneously taking place in the present time. For instance the IFRS and the GAAP are expected to converge in 2014 but prior to that, the IASB would first attempt to harmonize the two standards (Remo, 2009).

'Convergence' was defined as reducing international differences in accounting standards by selecting the best practice currently available, or, if none is available, by developing new standards in partnership with national standard setters (Whittington, 2005). The process of convergence is accepted as the key factor to implement a single set of accounting standards across the globe (Das, Shil & Pramanik, 2009). The convergence process applies to all national regimes and is intended to lead to the adoption of the best practice currently available. One of the objectives of convergence of accounting standards is to have entities in different capital markets use the same conventions to measure and report their financial position and financial performance (Tokar, 2005). Convergence has also been referred to as a process of narrowing differences between IFRS and the accounting standards of countries that retain their own standards (Ball, 2006).

Today, the world of accounting feels that IFRS should be the single accounting language, as it is the only set of standards that has been prepared through wide international consultations and participations (Das et al., 2009). Although IFRS 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 (Ibrahim, 2008).

The development and various issues surrounding the international accounting harmonization and convergence have attracted significant attention from business world as well as the academia. Studies undertaken on this particular field are indeed very extensive. Among the major themes studied within accounting harmonization revolve around the needs and difficulties of accounting harmonization (Wilkinson, 1969; AlHashim & Garner, 1973; Saudagaran & Diga, 1998; Nobes & Parker, 2006), measurement of accounting harmony (Van der Tas, 1988; Archer, Delvaile & Mcleay, 1995; Taplin, 2003, 2004, 2006), causes for accounting harmony and diversity (Carlson, 1997; Jaggi & Low, 2000; Garrido, Leon & Zorio, 2002; Hassanbelnaby, Epps & Said, 2003; Bradshaw & Miller, 2008) and other issues pertaining to accounting harmonization such as on accounting harmonization in the government sector (Brusca & Condor, 2002; Wallace, 2004). In the latest development, the issue of US GAAP and IFRS convergence is perhaps the hottest issue and many studies are looking into this subject matter (For e.g. Fosbre, Kraft & Fosbre, 2009; Bohusova & Nerudova, 2009; James, 2009; Kennedy & Olinsky, 2010). The IASB and FASB are still in the convergence projects which are expected to end by 2011, where the SEC will decide whether to incorporate IFRS into the US financial reporting system and if so, when and how.

Despite extensive research undertaken in the field of accounting harmonization and convergence, very limited studies have looked at the issues of accounting harmonization and linking it to the establishment of Islamic financial industry. Neither the literature on accounting harmonization nor that on the development

of Islamic accounting sufficiently pay necessary attention to the potential of accounting standards for Islamic financial institutions (i.e. AAOIFI) to hinder and indeed question the harmonization progress (Vinnicombe & Park, 2007). While Islamic accounting appears to be developing as an accounting sub-discipline, the implications for international accounting harmonization are not markedly apparent in the growing body of literature.

Although the concept of harmonization has been discussed in the Islamic accounting literature however the emphasis has been on the importance of consistency and comparability of financial reporting between IFIs. On the other hand, the accounting harmonization debates in the international arena has also proceeded without due regard for the accounting consequences of the possibility of Islamic finance to obstruct the harmonization or convergence process. Apart from the limited available studies, they are also very conceptual and general in nature. It is worthy here to highlight several studies which directly discuss this subject.

Hamid et al (1993) was among the premiers to examine the potential of Islamic religion in particular to impede the harmonization process. White (2004) extends the discussion of Hamid et al. (1993) by identifying several key differences that exist between Western financial accounting systems and those of Islamic systems as suggested by Baydoun & Willet (2000). By supporting the argument of Hamid et. al. (1993) that religion appears as a significant cultural variable that exerts considerable influence both on how financial information is formed and how it is utilized, she further proposed methods to deal with the problem.

Karim (2001) and Smith (2004) specifically discuss the issues of accounting harmonization and Islam in the context of Islamic banking and finance. Accounting for investment accounts was of particular concern for Karim (2001) in analyzing the challenge of international accounting harmonization within the Islamic banking environment. Smith (2004) who view these issues from political perspective even opined that the growing Islamic Financial Institutions (IFIs) might be mobilized economically and politically to promote a regional market for capital mobilization and investment fostered by Islamic solidarity. Likewise in the previous studies, they also agree that the unique attributes of Islamic banking might hinder the harmonization and convergence process. Vinnicombe & Park (2007) who examined the implication of Islamic jurisprudence for the accounting harmonization by comparing the Financial Accounting Standards (FAS) of AAOIFI and IFRS specifically on the recognition, measurement and disclosure of provisions and contingent liabilities. They found that the two standards reveal some clear differences. While such limited coverage of analysis might be insufficient to firmly conclude regarding the implications of Islamic accounting for the accounting harmonization, however they do provide preliminary evidence for further investigation.

The above review implies that while the attention to the development of international accounting harmonization and lately IFRS convergence is enormous, alightly limited interest has been paid to the implications the convergence has to the Islamic financial industry. It is seen important that significant attention is devoted to understand the position of Islamic financial industry within the global movement towards IFRS convergence. For it is not only to benefit the Islamic financial industry to gain more recognition at the international stage but also to give a way for the IASB to move further with the convergence initiative by considering the unique industry such Islamic banking one. The lack of attention being given to the Islamic banking has however gradually changed in the recent development as this issue has for example become

one of the work programs of Asian-Oceanic Standards-Setters Group (AOSSG). AOSSG for instance which comprise of representatives from Malaysia, China, Japan, South Korea, Singapore, New Zealand, Australia, Hong Kong, Macau, Brunei and Indonesia, emphasized the importance of the accounting needs of IFIs in its representations to the IASB (ACCA & KPMG, 2010). The group has undertaken survey and published its report for the consideration of IASB. Cooperative works by KPMG and ACCA have also advanced the resolutions on the issue. There has also research effort by International Shariah Research Academy for Islamic Finance (ISRA) on issues of the application of IFRS in the Islamic financial transactions from the Shariah perspective.

IFRS vs AAOIFI Accounting standards: Compatibility and Adequacy

Several questions emerge as the process of IFRS convergence is gaining momentum, which also involve the Islamic financial industry operating in the countries, who are committed to converge with IFRS. Can Islamic finance converge to IFRS? Is IFRS compatible and adequate for Islamic finance? What are the issues emerging as consequence of converging with the IFRS when at the same time the specific set accounting standards for IFIs has been promulgated by dedicated body AAOIFI? With regard to AAOIFI, since AAOIFI is specifically dedicated for the Islamic finance and its standards setting is backed by the juristic rules hence the question of compatibility shall not probably be an issue. However, is AAOIFI also adequate?

The fact that the IFIs are found to adopt the IASs/IFRSs in preparing their financial reporting is another interesting point to ponder upon and to be studied. It has been argued that the Islamic financial industry needs a corresponding alternative set of accounting standards which can be best harmonized but not standardized due to the different nature and also the activities of the IFIs (Ibrahim, 2008). In fact such alternative already exist namely the accounting standards which are developed by the AAOIFI. The IFRS' standards and AAOIFI's standard have been proved to be somehow different in several issues (see for example on the treatment of contingent liabilities, Vinnicombe & Park, 2007) and more importantly IFRS' accounting standards do not cover certain specific Islamic banking and finance practices such as on the Zakah, Mudarabah, Salam and Istisna (White, 2004; Ibrahim, 2008).

To understand better the different nature of IFRS and AAOIFI, comparative analysis is undertaken on both accounting standards for investments/securities, i.e. IAS 39 & 32 versus FAS 17. The analysis revealed that there are divergence between IFRS and AAOIFI but they are also in agreement in several areas. However the more obvious finding is that many elements are actually insufficiently covered by both standards, which means that the standards are actually complimenting each other for some aspects. While the IFRS does not cover the uniqueness of Islamic finance for example on the separation of portions relating to owners' equity and unrestricted investment account holders, the AAOIFI standard has also been insufficient in some aspects such as or the reclassification of the securities, fair value and its valuation techniques.

From the comparison, several contradictory principles between IFRS and AAOIFI are apparent. For example, IFRS clearly uphold the principle of substance over form, e.g. the classification of the instruments shall be in accordance with the substance of the contractual arrangement and the stipulated definitions (IAS 32, para.15). Whereas AAOIFI's approach to the classification of investment is based on the well-known Shari'a

classification of trade commodities for the purpose of Zakah. Part of the measurement method is also different as for example AAOIFI requires the use of historical cost or fair value in case of impairment, whereby IFRS requires the use of amortized cost using the effective interest method. For initial recognition, AAOIFI requires all investments to be measured at cost, which is the value of acquiring investment or the fair value (FV) of any consideration in kind, as well as any other transaction cost. Meanwhile IFRS requires held-to-maturity (HTM) and available for sales (AFS) to be measured at FV plus transaction cost but financial asset at FV through profit or loss (which include Held for Trading investments) shall be initially measured at FV only.

There are also unique aspects which are not covered by IFRS, especially in the disclosure requirements. On the other hand, AAOIFI has also not provided sufficient guidelines on certain aspects that are necessary for the measurement and disclosure especially in terms of derecognition, reclassification and impairment of investments.

This brief comparison is meant to highlight the inadequacy and compatibility issues of IFRS to be fully adopted by IFIs. However, through the analysis, it is also discovered that AAOIFI standards, at least for the securities, are also inadequate in some matters. Since it is not the purpose of this study to specifically elaborate the issues of accounting for securities, further discussion on this topic is considered unnecessary.

POSSIBLE APPROACHES TO HARMONIZATION

Several issues which were discussed in the previous sections necessitate for formulation of solutions. With regard to the position of IFIs in the context of global accounting harmonization, Smith (2004) forwarded few strategic options for IFIs approaching the challenges of preserving their uniqueness in spite of the international financial standardization. First is to avoid the extra costs of regulation (or rejection to the international regulation) and retreat into the informal sector. In this option it is suggested that IFIs (especially the smaller ones) which normally have special status with their national regulatory might be able to negotiate their compliance with their national banking laws. They are also considered to have resources for self-regulation derived from the engagement with the internal Shariah supervisory boards to carry many informal business arrangements. However such option might not be workable with larger and the more globally integrated Islamic banks hence Smith (2004) illuminated that a second option might be just to follow the direction of International regulation such as by IASB or Basel Committee of the Bank for International Settlements (BIS). Again, this alternative still pose the IFIs into the dilemma of not being able to reflect its distinctiveness as the framework used by conventional banking regulators is not specifically tailored to the needs of IFIs.

The shortcomings inherent in the previous two options have triggered the largest, most globally present IFIs to pursue an attempt of Islamic integration into global markets. This involves a vigorous defense of the need for distinctive standards while conceding the need for harmonization and improved governance and transparency within the Islamic banking industry. In this case AAOIFI is regarded as key institution leading the charge (Smith, 2004). Beyond the direct standardization of Islamic standards, a key element of AAOIFI's work has been to achieve integration with global financial network (Thomas, 2005). Nevertheless, AAOIFI has to face various challenges to exercise such role.

Specifically to the financial reporting mechanism, it is suggested that the success of international accounting harmonization can be achieved provided that the IASB allow the nations to report their financial information in two formats (White, 2004). The first format would be to fully comply with IAS and in addition prescribe a specific accounting treatment for each area reported. The second format is to allow companies to publish financial statements prepared according to national priorities and customs but on top of that the companies need to prepare reconciliation schedules with the international standards. With this arrangement national standard setting bodies would still have a significant and visible role in the accounting standard setting process. Ultimately she believed that this approach would address the need for comparability of financial information while at the same time acknowledging that accounting information does not come in a "one-size-fits-all" format.

However, the present agenda of IFRS convergence does not seem to allow room for the above recommendation. The IASB are aggressively taking various initiatives to materialize the convergence agenda, which also cover the Islamic finance industry. In the very recent development, the proponents of IFRS have indicated their willingness to be in talk with Islamic finance authorities and they are ready to modify the existing system to accommodate the Islamic finance standards (Remo, 2009). IASB will also increase the number of their board members to better accommodate the diverse background as in the case of Islamic finance.

With this present development, it seems clear that the future outlook for Islamic finance is also to be part of the global agenda of accounting convergence with the condition that IFRS is able to accommodate the Islamic finance features. However, it is then unclear with regard to the position of AAOIFI together with its standards if such movement is taking place, whether the AAOIFI and its standards should be dissolved or could its standards be allowed to be adopted in selected jurisdictions. As for Malaysia, there has been clear position to fully converge to IFRS by January 2012 (Singh, 2009). Indeed the Malaysian Accounting Standard Board (MASB) has indicated to issue a statement of principle stating that it does not think there is a need to have Islamic accounting standards (Singh, 2009). It was argued that the IFSB concept and operational model demonstrates the ability of Shariah compliant structure to co-exist with conventional framework (Yusoff (2009). While the effort of AAOIFI so far is commendable, it should consider working with and compliments IASB in ensuring the convergence incorporates Islamic finance agenda, as this would also support the effort in promoting Islamic finance in to the main stream.

Above all, the more harmonized financial reporting will be important for both Islamic finance and the institutions offering it to reach their full potential (ACCA & KPMG, 2010). In reaching the optimal solution, it will be encouraging to see for the IASB and AAOIFI to have convergence initiatives like what has been pursued between IASB and FASB in the US. This can probably be achieved by establishing working group representing all-important elements and interest in Islamic finance and also representatives from IASB to identify and resolve the issues. The opinions from experts in Islamic jurisprudence must also be incorporated to ensure that the accounting dimension of Islamic finance is also compliant with Shari'ah. In this study, a comparison was made to one of the accounting standards between the IFRS and AAOIFI's. Further comprehensive investigation of the actual needs and accounting requirements of Islamic finance by reference to AAOIFI and IFRS or even

improving on the currently available standards is considered vital.

CONCLUDING REMARKS

The world has witnessed the emergence of an alternative financial system, i.e. Islamic finance, which demands specific accounting approach for its operation. However, as industry grows at phenomenal rate and appears to be increasingly accepted at the international scene, it is also affected by the global initiative taken in converging accounting standards, the process which is popularly known as IFRS convergence. While this study does not provide sufficient evidence to conclude on the impact of IFRS convergence to the Islamic banks, it has however outlined several issues and implications that need to be considered by relevant bodies involving both in international accounting standards setting and Islamic financial industry.

Several issues were highlighted. Even though it is commonly urged to harmonize the IFIs' accounting practices, however consensus need to be reached of what form of harmonization is necessary. If the IFIs would to be part of global IFRS convergence by fully adopting the IFRS it has then to face the question of compatibility and adequacy of IFRS to suit their operation. Apart from the inadequacy, several principles inherent in IFRS especially the reporting elements are seem to be in conflict with the principles promoted by the Islamic finance. On the surface, it might seem valid to argue that financial reporting is merely a recording function that would neither sanctify nor nullify the Shariah validity of a transaction, nevertheless it is through financial reporting that the Islamic banking uniqueness is reflected and made known to the respective stakeholders thus the confidence of stakeholders can be uphold and the IFIs' accountability can be better exercised. For example, a random analysis on the IFIs' practices on the accounting for securities by utilizing 2009 annual reports, it has been somehow surprising to discover one of the IFIs' statements as "The amortization of premium and accretion of discount on HFT securities is recognised as interest income using the effective interest rate method". It is unclear of whether such reporting is merely an unintentional error or it is considered acceptable to report in such a way provided that the actual transaction is free from the prohibited elements in Shari'a. Nevertheless this kind of reporting element might mislead the stakeholders and tarnish the confidence in the Shari'ah compliance commitments by IFIs.

On comparison made between IFRS and AAOIFI standards on financial instruments especially the investments/securities, it is found that AAOIFI is also inadequate in some elements. This triggers the IFIs for example in Bahrain to refer to IFRS in relevant uncovered details by AAOIFI despite they are obliged to fully adopt AAOIFI. In this respect, if even the IFIs decide to accomplish within-industry accounting harmony based on the available accounting standards for IFIs, they might still face the problem of inadequacy.

Possible solutions were also highlighted. Given the fact that the Islamic financial industry cannot escape from the IFRS convergence movement, the positive outcome from further discussions and initiatives between relevant parties are deemed crucial. The results of this discussion is hoped to fully accommodate the unique requirements of Islamic financial industry, while at the same time align with the international convergence initiative.

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