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Adoption of International Financial Reporting Standards and International Accounting Standards in Islamic Financial Institutions from the Practitioners' Viewpoint

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Abstract: Globally, International Financial Reporting Standards (IFRS) are used by more than 100 countries for various types of organizations. The purpose of this paper is to examine the opinion of practitioners in Islamic financial institutions (IFIs) on Shariah issues when adopting IFRS and International Accounting Standards (IAS) to report Islamic financial transactions. Primary data collection involved a group interview with representatives, such as Shariah officers, accountants and academic experts to obtain insights on how the industry practitioners deal with general and specific IFRS issues in applying IFRS and IAS. The result from the group interview revealed that practitioners are highly concern on various Shariah issues, such as the applicability of time value of money, the terminologies used in IFRS and IAS that reflect conventional concepts of banking and *takaful*. This study provides both the conceptual and practical issues faced by practitioners in applying IFRS for reporting Islamic financial transactions. It suggests the need for collaboration between academicians, standard setter and regulator in providing technical guidance applicable for reporting Islamic financial transactions.

Key words: Islamic financial institutions · International Financial Reporting Standards · Accounting principles

INTRODUCTION

International Financial Reporting Standards (IFRS) are used by more than 100 countries worldwide. Other countries such as Korea, Argentina and Canada have converged to IFRS since 2011. United States has set the year 2014, while Japan extended to the year 2016 as their deadline to move from their national Generally Accepted Accounting Principles (GAAP) to full compliance with the IFRS as their financial reporting system. Malaysia's convergence to IFRS has been effective as from January 1, 2012. Among the entities that will be affected by such convergence are Islamic Financial Institutions (IFIs) which include Islamic banks, *takaful* and *re-takaful* operators, development financial institutions and other financial institutions that participate in the Islamic Banking Scheme [1].

IFRS are principles-based standards as they establish broad rules as well as dictate specific accounting treatments. IFRS also represent the framework which has been adopted by the International Accounting Standards Board (IASB). Many of the standards forming part of IFRS are known by the older name of International Accounting Standards (IAS). The IASs were issued between 1973 and 2001 by the Board of the International Accounting Standards Committee (IASC). As from April 1, 2001 the IASB took over the responsibility for setting IAS from the IASC. During its first meeting the IASB adopted existing IAS and Standing Interpretations Committee standards (SICs). The IASB has continued developing accounting standards, henceforth called IFRS. IFRS therefore comprise:

- International Financial Reporting Standards (IFRS)- standards issued after 2001;

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- International Accounting Standards (IAS)- standards issued before 2001;
- Standing Interpretations Committee standards (SICs)- standards issued before 2001; and
- Conceptual Framework for the Preparation and Presentation of Financial Statements 2010.

On 19 November 2011, the Malaysia Accounting Standards Board (MASB) has issued a newly approved accounting framework, the Malaysian Financial Reporting Standards (MFRS) Framework. This issuance, which was made in conjunction with the MASB's plan to converge with IFRS in 2012, has finalised the MASB Exposure Draft 75 *IFRS-compliant Financial Reporting Standards* released in June 2011. The MFRS Framework comprises standards as issued by the IASB which are effective as from 1 January 2012. It also comprises new/revised standards recently issued by the IASB that will be effective after 1 January 2012 such as Standards on financial instruments, consolidation, joint arrangements, fair value measurement and employee benefits, among others.

Smith [2] reported that IFIs are faced with the challenge between adhering to the distinctive characteristics of their operations and expanding business through deeper integration into the global financial markets. While IFIs are eager to truly comply with and conduct their businesses in accordance with Islamic principles, they also have to ascertain that there is international accounting and financial standardisation in order to be part of the global financial markets [3-5]. IFIs are concern about whether being compliant with IFRSs would result in violating any Shariah principles.

Therefore, this paper aims to examine the viewpoints of Islamic financial practitioners in Malaysia on Shariah issues arising from applying IFRS and IAS for reporting Islamic financial transactions.

MATERIALS AND METHODS

International Financial Reporting Standards & International Accounting Standards: IFRS covers a number of accounting principles, including substance over form, time value of money, fair value and probability. These have significant impact on Islamic financial transactions. This section reviews specific IFRS and IAS that are of concern to recording Islamic financial transactions. It is also noted that local standard setters like the MASB and international standard setters such as the IASB and AAOIFI have adopted various approaches relating to accounting and reporting of Islamic financial transactions, as reflected in their respective standards and guidelines.

Accounting standards are developed based on the Generally Accepted Accounting Principles (GAAP) which basically covers the fundamental accounting concepts. The GAAP include concepts such as: historical cost, conservatism, accrual and matching, substance over form, going concern, monetary measurement, time value of money, fair value, probability, materiality and consistency [6]. It also includes concepts that relate to the aspect of recognition and measurement of accounting transactions. These principles form the basic construction of the conceptual framework and accounting standards developed by the IASB. The IASB stresses the importance of having a conceptual framework that will assist in the harmonization of regulations, accounting standards and procedures that relate to the preparation and presentation of financial statements. As at date, the IASB has issued nine IFRS and twenty nine IAS published on the website of the IFRS Foundation.

Shariah Issues in Specific IFRS and IAS: One of the prominent researches on the applicability of IFRS to Islamic financial transactions is done by the Asian-Oceanian Standard-Setters Group (AOSSG). This is a grouping of accounting standard-setters in the Asian-Oceanian region discusses issues and shares experiences on the adoption of IFRS. The objective of the Working Group is to facilitate the consideration and application of IFRS by AOSSG members by providing input and feedback to the IASB on the adequacy and appropriateness of proposed and existing IFRS to Islamic financial transactions and events.

AOSSG [7] discusses accounting issues related to Islamic financial transactions within the IFRS framework. Within the perspective of addressing the important issue of financial reporting harmonisation, the AOSSG's study sampled the opinions of working group members- consisting of accountants from the Islamic financial industry in various jurisdictions including Indonesia, Pakistan, Saudi Arabia and Malaysia- on issues relating to financial reporting in Islamic finance. According to the AOSSG [7], two main approaches could be adopted when accounting for Islamic financial transactions: (i) through a separate set of Islamic accounting standards; or (ii) by adapting IFRS with some modifications to accommodate for Shariah principles.

Table 1: Shariah Concerns in IFRS and IAS relating to Islamic Financial Transactions

IFRS	Paragraphs of Concern	Explanation
IFRS 4: Insurance Contracts [10]	The definition of insurance in Appendix A: *"A contract under which one party (the insurer) accepts significant insurance risk from another party (the participant) by agreeing to compensate the participant if a specified uncertain future event (the insured event) adversely affects the participant."*	The definition of an insurance contract may exclude *Takaful* because of the different way the risks are shared in their operations [11]. However, PricewaterhouseCoopers [11] opines that while the *Takaful* operational models may differ from their conventional counterparts, the economic substance of risk sharing - which is the basis of IFRS 4 - is still relevant to the *Takaful* business.
IFRS 7: Financial Instruments: Disclosures [12]	Paragraph IN5: The IFRS requires the disclosure of: (a) The significance of financial instruments for an entity's financial position and performance. These disclosures incorporate many of the requirements previously included in IAS 32 [13]. (b) Qualitative and quantitative information about exposure to risks arising from financial instruments, including specified minimum disclosures about credit risk, liquidity risk and market risk. The qualitative disclosures describe management's objectives, policies and processes for managing those risks. The quantitative disclosures provide information about the extent to which the entity is exposed to risk, based on information provided internally to the entity's key management personnel. Together, these disclosures provide an overview of the entity's use of financial instruments and the exposures to risks they create.	The information to be disclosed on exposure to risks is usually based on the usage of sensitivity analysis. This analysis is for each type of market risks to which the entity is exposed at the end of the reporting period. Disclosure is required for the sensitivity analysis performed, the methods and assumptions used and any changes in methods and assumptions used. The issue that arises is that some entities may not disclose the interest rate sensitivity of their Islamic finance operations on the premise that Islamic financial transactions do not charge or incur interest [7].
IFRS 9: Financial Instruments [14]	Paragraph 1.1, IFRS 9: Establishes the principles for the financial reporting of *financial assets* and *financial liabilities* that will present relevant and useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of an entity's future cash flows. *Chapter 4 Classification* 4.1.4 A financial asset shall be measured at fair value unless it is measured at amortised cost in accordance with paragraph 4.1.2. *Appendix B Application Guidance* *Measurement* B5.1 …the fair value of a long-term loan or receivable that carries no interest can be estimated as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument …	Measurement of fair value may require the use of discount rates (i.e. one type of valuation technique) in cases where the market for a financial instrument is not active. Examples of applying discount rates are the use of net present value of future cash flows discounted at an appropriate rate of interest and using effective interest rate. As a result, the use of interest rates as a discount rate may not be allowed in some jurisdictions.
IAS 17: Leases [15]	Paragraph 8, IAS 17: Classifies leases as finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.	The issue that arises is whether to record *Ijarah* ending in the transfer of ownership (*Ijarah wa Iqtina*) as two separate transactions of operating lease and sale or to treat it as one transaction as in the case of a finance lease.

In relation to Islamic financial transactions, the key challenge has been to find a relevant accounting framework that will allow for comparability with conventional finance as well as international comparability without affecting the Shariah compliance of Islamic financial transactions. However, if IFRS are to be implemented by IFIs, there are a number of reporting issues that may arise. Generally, it is questioned as to whether the existing accounting standards or IFRS could adequately address the reporting of Islamic financial transactions, or whether the transactions are so unique that some other form of accounting framework would be required [8].

Various studies have looked at the need and difficulties of accounting harmonization but not specifically linking it to the Islamic financial industry [9]. Therefore the current study tries to fill in this gap by looking at possible Shariah issues when IFIs apply IFRS to record their financial transactions.

Among the issued IFRS and IAS standards, the standards which have a significant impact on Islamic financial transactions are: IFRS 4 Insurance Contracts; IFRS 7 Financial Instruments: Disclosures; IFRS 9 Financial Instruments; and IAS 17 Leases. Table 1 depicts some of the Shariah-related issues that may arise when these IFRS and IAS are applied to Islamic financial transactions. Broadly, the issues pertain to: the definition of *Takaful* under IFRS 4; the disclosure of interest rate risk in Islamic financial operations under IFRS 7; fair value measurement and the relevant discount rate applicable under IFRS 9; and the accounting treatment for *Ijarah wa Iqtina* (lease) under IAS 17.

Methodology

Sampling Frame: Both secondary and primary data were collected for the purpose of this study. Library search was used to examine the specific Shariah issues arising from the application of IFRS and IAS for Islamic financial transactions. Primary data collection, on the other hand, involved a group interview with representatives from some IFIs. The group interview was conducted with Shariah officers and accountants from the respective IFIs as well as academic experts in the area of accounting for Islamic financial transactions. In Malaysia, there are 16 Islamic banks and 12 *Takaful* operators as per listed in the Bank Negara Malaysia's (BNM) website. However, the group interview was attended by representatives from only 10 IFIs comprising of six Islamic banks and four *Takaful* operators. In addition, representatives from MASB, Malaysian *Takaful* Association (MTA) and a professional firm that provides Shariah advisory services attended the meeting.

Data Collection: The interview raised the question on how the industry practitioners currently deal with the general IFRS issues notably time value of money, substance over form, probability and fair value. In addition, they were requested to identify the transactions that they perceive as being unique to the operations of their respective IFIs as well as provide information on how their institutions deal with the reporting of these Islamic financial transactions. The industry practitioners were also requested to provide their feedback and comments on the specific transactions relating to the IFRS standards identified in AOSSG's findings [8]. The main issues discussed during the interview were grouped under a number of themes. A thematic analysis was conducted on the themes and patterns of the interviewees' responses.

RESULTS AND DISCUSSION

In this study, the academic and practical contribution will be on how Islamic banks and *takaful* institutions considered and dealt with the Shariah issues when they cater for the accounting of the transactions.

Responses and feedbacks were sought from Shariah officers and accountants from Islamic banks and *Takaful* operators and academicians in a group interview session. The discussions revolved around the general concepts or underlying assumptions (i.e. substance over form, time value of money, probability and fair value). In the interview, the interviewees identified unique and specific issues in terms of technically applying the IFRS when recording for specific Islamic financial transactions such as *Ijarah*, presentation of financial statements for *Takaful* Operators, profit sharing contracts and the like.

From the interview session, the interviewees agreed unanimously on the following issues:

- Accounting concepts and entries are not the major determinant of the validity of Shariah compliant financial contracts.
- The interviewees complied fully with the resolutions made by the Shariah Advisory Council (SAC) of BNM on the Shariah permissibility of the general concepts/underlying assumptions which are the applicability of substance over form, time value of money and fair value and probability in recording Islamic financial transactions.
- Shariah does allow the application of time value of money principle only for exchange contracts that involve deferred payment. However, it is strictly prohibited in debt-based transactions (i.e. *qard*).
- Terminology used in the IFRS should be 'Islamised' such as the term interest, which is equivalent to *riba* whereas in practice the term profit is used to replace interest.
- There is a need for departure from the application of IFRS on certain Islamic financial transactions. However, the interviewees did not provide the discussion on the specific financial transactions that required departure. Nonetheless, the interviewees agreed that the rule for departure should be dictated by the regulators and standard setting body.
- There are two Islamic banking models that exist in the Islamic banking industry - that is, the financing and trading model. Whatever model that is used by respective Islamic banks should be reflected in how their business activities are accounted for in their financial reporting system.

The results from the analysis on how practitioners perceive the Shariah issues in IFRS and IAS adoption do not imply that their opinion could be used as a Shariah input for other institutions to follow. The objective of this exercise is to study what are the Shariah issues identified at their respective IFI's level and how the IFIs manage the issues.

To further analyze the responses from the interviewees, the participants/interviewees in the session is given a number. This number is used throughout the analysis. It can be identified from Table 2 that the same interviewees responded more often than others. From the analysis conducted, interviewees from an international bank and a

Table 2: Common Themes Analysis on Shariah issues in IFRS/IAS Adoptions

No.	Shariah Issues in IFRS/IAS Adoptions	Response from	Common Themes
1.	Accounting entries does not determine Shariah compliancy of a contract	*Interviewee* 1 Representative from an Islamic bank	Accounting does not reflect Shariah Compliancy of Islamic financial transactions
2.	How to establish departure mechanisms	*Interviewee* 2 Representative from an Islamic bank	Departure mechanisms
3.	Technical issues containing Shariah concerns but not addressed by regulators	*Interviewee* 3 Representative from a *takaful* operator	Role of regulators in reporting Shariah-related issues
4.	Possibility for departure in IFRS 4	*Interviewer* Chairperson	Departure mechanisms
5.	Stand to follow SAC of BNM on the concept of time value of money, substance over form and probability	*Interviewee* 5 Representative from a *takaful* operator	Role of regulators in reporting Shariah- related issues
6.	SAC of BNM on the concept of time value of money, substance over form and probability	Chairperson	Role of regulators in reporting Shariah-related issues
7.	What are the practitioners' concerns on Shariah issues when adopting IFRS	*Interviewee* 6 Representative from a regulatory body	Role of industry to identify Shariah issues
8.	An Islamic bank's approach to Time Value of Money, PER, IFRS 7, IAS2, *Ijarah*, Fair Value, Investment in Subsidiaries and Intangibles	*Interviewee* 7 Representative from an Islamic bank	IFIs' identification of Shariah issues
9.	Shariah Committee's role to review compliancy of documents	*Interviewee* 8 Representative from a *takaful* operator	Role of Shariah Committee to review Shariah issues
10.	No Discussion held with internal Shariah Committee on Time Value of Money, Probability and Fair Value	*Interviewee* 9 Representative from a *takaful* operator	Role of Shariah Committee to review Shariah issues
11.	No issue in following IFRS Standards	*Interviewee* 10 Representative from an Islamic bank	No issue in IFRS adoption
12.	Accounting does not determine the status of Shariah contract	*Interviewee* 11 Representative from an Islamic bank	Accounting does not reflect Shariah Compliancy of Islamic financial transactions
13	The Shariah issues yet to be discussed in Shariah Committee's meeting	*Interviewee* 12 Representative from an Islamic bank	Role of Shariah Committee to review Shariah issues
14.	Shariah consultants look for the principles of the contracts, little on accounting	*Interviewee* 13 Representative from an external auditor's firm	Role of Shariah Consultants
15.	The need to report the financing effect from Islamic banking operations, not the Shariah substance.	*Interviewee* 1 Representative from an Islamic bank	Financing Model versus Trading Model
16.	Islamic banks in Malaysia are not trading banks, thus need to report financing effects	*Interviewee* 2 Representative from an Islamic bank	Financing Model versus Trading Model
17.	Accounting has to reflect the true and fair view based on the adopted Islamic banking model	*Interviewee* 6 Representative from a regulatory body	Financing Model versus Trading Model
18.	An Islamic Bank using financing model	*Interviewee* 2 Representative from an Islamic bank	Financing Model versus Trading Model
19.	SAC of BNM's Shariah Perimeter	*Interviewee* 14 ISRA representative 1	Role of regulators in reporting Shariah-related issues
20.	An Islamic Bank reporting the underlying contract	*Interviewee* 1 Representative from an Islamic bank	Financing Model versus Trading Model
21.	An Islamic Bank reporting based on financing model	*Interviewee* 6 Representative from a regulatory body	Financing Model versus Trading Model

Table 2: Continue

No.	Shariah Issues in IFRS/IAS Adoptions	Response from	Common Themes
22.	Shariah issues are present when reporting *Ijarah* transaction if using IFRS	*Interviewee* 15 ISRA representative 2	Shariah issues in specific IFRS
23.	An Islamic Bank using trading model	*Interviewee* 11 Representative from an Islamic bank	Financing Model versus Trading Model
24.	Departure needed in takaful	*Interviewee* 5 Representative from an Islamic bank	Departure mechanisms
25.	Reporting issue is crucial in *takaful* operations, i.e. to reflect takaful operation	*Interviewee* 3 Representative from a *takaful* operator	Reporting should reflect the operation
26.	Applicability of Time Value of Money	*Interviewee* 1 Representative from an Islamic bank	Shariah issues in specific IFRS
27.	Issue in FRS 101 in *takaful* operations	*Interviewee* 3 Representative from a *takaful* operator	Shariah issues in specific IFRS
28.	Issue of separation of ownership of *takaful* operators and *takaful* funds	*Interviewee* 6 Representative from a regulatory body	Shariah issues in specific IFRS
29.	Profit Equalisation Reserve in *takaful* operations	*Interviewee* 3 Representative from a *takaful* operator	Shariah issues in specific IFRS
30.	Input for departure mechanisms are from the industry	Chairperson Departure mechanisms	
31.	Conventional terminology as in IFRS should not be allowed in IFIs reporting	*Interviewee* 1 Representative from an Islamic bank	Shariah issues in specific IFRS
32.	Conventional terminology as in IFRS should not be allowed in IFIs reporting	*Interviewee* 3 Representative from a *takaful* operator	Shariah issues in specific IFRS
33.	A takaful operator response on the needs for feedback from regulators on the issues discussed	*Interviewee* 17 Representative from *takaful* association	Role of regulators in reporting Shariah-related issues
34.	An Islamic bank response on the needs for feedback from regulators on the issues discussed	*Interviewee* 7 Representative from an Islamic bank	Role of regulators in reporting Shariah-related issues
35.	The Shariah issues yet to be discussed in Shariah Committee's meeting	*Interviewee* 18 Representative from a *takaful* association	Role of Shariah Committee to review Shariah issues
36.	Availability of Shariah research in TVM	*Interviewee* 14 ISRA representative	Role of regulators in reporting Shariah-related issues
37.	Takaful operators having difficulties to apply IFRS due to the existence of various types of funds in takaful operations	*Interviewee* 19 Representative from a *takaful* association	Shariah issues in specific IFRS

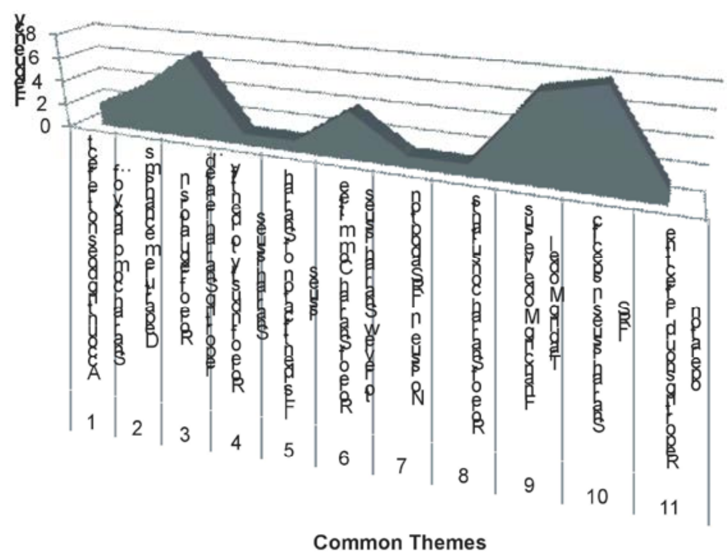

Fig. 1: The Common Themes Discussed at the Interview Session

full-fledged Islamic bank as well as an interviewee from a *takaful* operator contributed more than the rest of the interviewees.

A common theme analysis as reported in Table 2 is presented to identify the main issues discussed during the sessions with the interviewees.

Further analyses were performed to highlight the number of frequency of a common theme being discussed in the interview session. From Figure 1 below, it is noted that high numbers of responses were channeled into Common Themes No. 10, 3, 9, 6 and 2 with Common Themes No. 10 giving the highest number of frequency.

Common Theme No. 10-Shariah Issues in Specific IFRS: Interviewees generally agreed Shariah issues do exist when IFIs apply specific IFRS, such as certain terminology (i.e. interest, insurance, etc) used in the accounting standards that literally reflect conventional banking terms to be applied for Islamic banking and *takaful* operations [7]. Furthermore, practitioners also pointed out technical problems in applying specific IFRS such as IFRS 4 on Insurance Contracts to be applied for recording *takaful* transactions. Some of the interviewees' concerns related to the application of insurance definition on *takaful* operations, the concept of leases being applied for *Ijarah* and the application of time value of money for recording financial instruments.

Common Theme No. 3-Role of Regulators in Reporting Shariah Related Issues: The interviewees highlighted that regulators, such as the BNM play a significant role in providing reports or guidelines with regard to Shariah issues when recording and reporting Islamic financial transactions. As IFI are very much regulated in Malaysia, it is expected that reporting decisions made by IFIs are usually based on the disclosure requirements issued by BNM as well as MASB.

Common Theme No. 9-Financing Model vs Trading Model: The interviewees believed that Islamic banking can be based on a financing or trading model. In the financing model, Islamic banks purely provide financing based on Shariah. Whereas, a trading model occurs when Islamic banks incur risk when purchasing cars or house before reselling or leasing it to consumers. An international Islamic bank highlighted that there is no need for a warehouse to store cars, motorbikes and the like in order for a bank to operate based on trading model but the important factor is the sequence of the product offering or contract conditions whereby the Islamic banks must own the assets first before reselling or leasing to consumers.

Common Theme No. 6-Role of Shariah Committee to Review Shariah Issues: Generally, the duties of Shariah Committees members revolves around issuing decisions, views and opinions relation to the overall business of the IFIs by focusing the compliance of financial products to Shariah principles [16]. The interviewees responded that the Shariah Committee members have not discussed any Shariah issues in applying IFRS for recording and reporting purpose. A respondent from a local IFI highlighted that accounting entries is not one of the contract condition that determine Shariah compliancy of a contract. However, other respondents would like some discussion of this matter at the committee level.

Common Theme No. 2-Departure mechanisms: Departure mechanisms are exemptions for reporting entities in applying certain paragraphs or specific IFRS to cater for Shariah considerations. This is stipulated in the IAS in paragraph 19 of IAS 1 [17], which states:

> *"In the extremely rare circumstances in which management concludes that compliance with a requirement in an IFRS would be so misleading that it would conflict with the objective of financial statements set out in the Framework, the entity shall depart from that requirement in the manner set out in paragraph 20 if the relevant regulatory framework requires, or otherwise does not prohibit, such a departure."* (Para. 19, IAS 1)

The interviewees were concerned on the possibilities of IFIs not applying IFRS for specific Islamic financial transactions such as *Takaful* accounting or should there be a separate accounting framework for recording Islamic financial transactions. As IFIs are highly regulated, the interviewees opine that it is best for them to wait for guidelines and standards from BNM and MASB.

In general, the practitioners of IFI believed that there would be Shariah issues when applying IFRS in recording Islamic financial transactions. However, since these findings only represent limited number of IFIs, future research should attempt to obtain responses and feedback from all IFIs in the industry including Shariah consultants/advisers, accountants, auditors, BNM and MASB.

CONCLUSION

This study implied that there are *Shariah* issues when practitioners apply the IFRS and IAS in recording Islamic financial transactions. Therefore, there is an urgent need that the technical aspects unique to Islamic financial transactions should be addressed by regulators and standard setters. This would greatly contribute in ensuring IFI's compliance to Shariah and at the same time attempting to minimise divergent practices, which may hinder current harmonization effort made by MASB and IASB. There should be further collaboration between academicians, standard setter and regulator in providing technical guidance applicable for reporting Islamic financial transactions that supports IFRS as well as within Shariah precepts.

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