Proceedings of the Second Harvard University Forum on Islamic Finance: Islamic Finance into the 21st Century
Cambridge, Massachusetts. Center for Middle Eastern Studies, Harvard University. 1999. pg.239-241

Accounting and Auditing Standards for Islamic Financial Institutions

Rifaat Ahmed Abdel-Karim*

ABSTRACT

The accounting practices of different Islamic financial institutions today vary greatly, and financial reporting in Islamic financial institutions lacks self-regulation and standardization. It is thus imperative that high and common accounting and auditing standards be developed and implemented across Islamic financial institutions. The Accounting and Auditing Organization for Islamic Financial Institutions, established in and based in Manama, Bahrain, has played a pioneering role in developing and promoting these standards. It has brought together a common *Shari'ah* Board, worked with regulatory as well as financial institutions to implement its standards, and to date made a total of eighteen pronouncements on accounting and auditing standards for Islamic finance.

I. INTRODUCTION

At this stage of their development, Islamic financial institutions are looking forward to being perceived as an industry in the process of becoming mature. This would require the establishment of some basic infrastructure, including greater standardization of products and the development of accounting and auditing standards that enhance the credibility of financial reporting by Islamic financial institutions. This paper focuses on the latter and gives a brief account of some of the differences in the accounting practices of Islamic financial institutions, the efforts that have been exerted to develop the institutional arrangements for self-regulating financial reporting by Islamic financial institutions, and the pronouncements of the body that was established to self-regulate this financial reporting as well as the auditing practices of their external auditors.

II. CHALLENGES

Islamic financial institutions have to abide by the precepts of the *Shari'ah*, which among other things prohibit the payment and receipt of interest in all business transactions.[i] This requires that the financial accounting and reporting done by Islamic financial institutions (or indeed any Islamic business organization) also be developed and practiced in accordance with *Shari'ah* principles. Such a task is likely to open a new dimension of challenges facing accounting academics and practitioners, professionals who are usually conversant only with Western theories and practices. From an auditing perspective, shareholders and investment account holders likewise expect Islamic banks' auditors to deliver a more comprehensive audit that takes *Shari'ah* compliance into account.

At present, the accounting policies adopted by Islamic banks in the preparation of their financial statements are to a large extent unregulated. This seems to have encouraged almost every Islamic financial institution to develop its own accounting policy for the various contracts that govern its work. Such a process is usually based on deliberation between the external auditor and the management, as well as the bank's in-house religious supervisors (*Shari'ah* Supervisory Board, or SSB) in many cases. This process focuses on whether or not the accounting standards adopted by the Islamic financial institution's host country are in agreement with the underlying *Shari'ah* principles of the institution's contracts. Indeed, in some Islamic financial institutions accounting policies are developed by reference to the *Shari'ah* whenever departure from adopted accounting practices is felt necessary.

The present practice of setting their own accounting policies has, however, resulted in a variety of accounting practices across Islamic financial institutions. For example, Islamic financial institutions use at present at least six methods to recognize profit generated from *murabaha* transactions.[ii] I have also been made to understand that some Islamic financial institutions use more than two methods to recognize *murabaha* profits in the same financial period. As another example of variance, there are major differences in how institutions allocate profits between investment account holders and shareholders constitute. The variations also include the use of

* Abdel-Karim is Secretary General of the Accounting and Auditing Organization for Islamic Financial Institutions in Manama, Bahrain.

different measurement attributes for the same transactions, the disclosure of information in different forms and degrees, and the classification of financial statement items in a dissimilar manner.

Such variations seem to be mainly due to the fact that there is no perfect match between the accounting treatments proposed in the international accounting standards on which many Islamic financial institutions tend to rely in preparing their financial statements and the *Shari'ah* characterization of the contracts used in their business transactions. In addition, these variations also tend to arise because of different interpretations of *Shari'ah* rulings.

These differences are bound both to render financial statements of Islamic financial institutions difficult to compare and to weaken their credibility in the eyes of international market players. In addition, such differences offer a legitimate platform on which a case for the regulation of the financial accounting of Islamic financial institutions can be made.

III. AAOIFI

In 1991, the Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was established by Islamic financial institutions and other interested parties to set international accounting and (recently) auditing standards for Islamic financial institutions based on *Shari'ah* precepts. AAOIFI's pronouncements are intended to serve Islamic financial institutions in the various countries in which they operate.

The organizational structure of AAOIFI includes a general assembly. To date, fifty-six institutions from fifteen countries have joined as members of this general assembly. AAOIFI also has a board of trustees and an accounting and auditing standards board each consisting of fifteen part-time members, a *Shari'ah* committee consisting of four part-time members, an executive committee, and a secretary-general who is a full-time executive and heads the general secretariat.

AAOIFI finances its activities from the proceeds of a *waqf* (endowment) and charity fund (developed from the membership fees paid by institutions joining AAOIFI), annual subscription fees, grants, donations, bequests, and others sources.

To date, AAOIFI has issued two financial accounting statements relating to the objectives and concepts of financial accounting for Islamic financial institutions, ten accounting standards, five auditing standards, and a code of ethics for accountants and auditors of Islamic financial institutions (see Part IV of paper). This brings the total number of AAOIFI's pronouncements to eighteen. You may also like to know that we are currently working on three new standards. This is an impressive record of achievement that deserves to be supported and encouraged by all concerned parties.

AAOIFI has also taken on board another important issue for the Islamic banking industry. Early this year it published a discussion memorandum on the calculation of the capital adequacy ratio for Islamic banks. We are very encouraged by the responses we received in this regard. As a result, the Committee in charge has issued an exposure draft statement on this issue.

AAOIFI has an extensive due process that governs the production of its accounting and auditing standards. The due process includes the vetting of the juristic suitability of the proposed standards by AAOIFI's *Shari'ah* Committee. It also provides interested parties with the opportunity to express their opinion on the standards before the Board finally approves them. This is made possible by the holding of public hearings to discuss the exposure drafts. In 1997, we held two public hearings, one in Bahrain and the other in Malaysia. This year we again held two public hearings, one in Bahrain and the other in Pakistan.

The public hearing is also meant to increase awareness of AAOIFI's standards amongst the financial community. Furthermore, it is intended to enhance confidence in the financial statements of Islamic financial institutions on the part of the users of these statements. AAOIFI is very much encouraged by the number of central banks, Islamic financial institutions, and professional accountants who attended the public hearings. Members of the accounting and auditing committees in our organization who are responsible for drafting the standards have benefited tremendously from the useful discussions that took place in these public hearings. It is hoped that through such a process AAOIFI will issue standards that help in providing relevant and reliable information and hence play an instrumental role in developing and enhancing Islamic capital market activities.

AAOIFI is endeavoring to produce high quality standards and to keep them up-to-date to meet the needs of the users of the financial statements of Islamic financial institutions. However, such efforts can only bear fruit if the standards are implemented.

The implementation of AAOIFI's standards is indeed very important and I would even say imperative for the Islamic banking industry. Knowing these standards does represent an important factor in the implementation process. AAOIFI endeavors to fulfil this by organizing conferences and seminars in order to inform the industry about the standards it has issued. However, this is not enough. We ask the people in the industry to take part in debates and discussions through every possible media to highlight the positive benefits that will flow from the implementation of these standards.

At present, AAOIFI does not have the power to force Islamic financial institutions to implement the standards it promulgates. AAOIFI has therefore pursued a strategy of having its standards implemented by cooperating with the concerned governmental and professional agencies—namely, the central banks and bodies responsible for implementing accounting standards. We are very pleased that some countries (e.g., Bahrain and Sudan) have made it mandatory for Islamic banks to adhere to AAOIFI's standards, while others (e.g., Malaysia, Pakistan, and Qatar) have taken practical steps to enforce our standards. Additional efforts are being exerted to increase the number of Islamic financial institutions that adhere to AAOIFI's standards. These include working closely with the securities exchange commission in countries in which Islamic financial institutions operate so that all listed institutions engaged in Islamic banking be required to adhere to AAOIFI's standards.

Despite AAOIFI's lack of power in enforcing its standards, other players in the market, (e.g., international rating agencies) are gradually recognizing its standards. Although we are very delighted and encouraged by these developments, we are aware that the growing acceptance and implementation of these standards, will require a high degree of cooperation between us as standard-setters and national regulatory bodies.

AAOIFI also seeks the acceptance of its accounting and auditing standards around the world by cooperating with the International Accounting Standards Committee and the International Federation of Accountants.

Let me close by briefing you on a major development we have been able to participate in: the formation of a *Shari'ah* board which comprised of fifteen *fiqh* scholars from among the members of the SSBs in Islamic financial institutions. The formation of this board is in response to varying and sometimes inauthentic *fatawa* issued by different SSBs. Such variations did import some of the standards issued by AAOIFI—e.g., the *murabaha* standard.

IV. AAOIFI'S PRONOUNCEMENTS

A. Financial Accounting Statements

1. Objective of Financial Accounting of Islamic Banks and Financial Institutions
2. Concepts of Financial Accounting for Islamic Banks and Financial Institutions

B. Financial Accounting Standards

1. General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions
2. *Murabaha* and *Murabaha* to the Purchase Orderer
3. *Mudaraba* Financing
4. *Musharaka* Financing
5. Disclosure of Bases for Profit Allocation Between Owners' Equity and Investment Account Holders
6. Equity of Investment Account Holders and Their Equivalent
7. *Salam* and Parallel *Salam*
8. *Ijara* and *Ijara Muntahia Bittamleek*
9. *Zakat*
10. *Istisna'* and Parallel *Istisna'*

C. Auditing Standards

1. Objective and Principles of Auditing
2. The Auditor's Report
3. Terms of Audit Engagement
4. *Shari'ah* Supervisory Board: Appointment, Composition, and Report
5. *Shari'ah* Review

D. Ethics

1. Code of Ethics for Accountants and Auditors of Islamic Financial Institutions

[i] The *Shari'ah* is the sacred law of Islam. It is derived from the Qur'an (The Muslim holy book), the *Sunna* (the sayings and deeds of Prophet Muhammad), *ijma'* (consensus), *qiyas* (reasoning by analogy), and *maslaha* (consideration of the public good or common need).

[ii] *Murabaha* is broadly defined as credit sale at cost plus an agreed upon margin of profit.