<u>**Doctoral Dissertation**</u>

A Study on the Balance Sheets of Islamic Banks: Focusing on the Profit-Sharing Investment Accounts

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Summary

Chapter 1

Introduction

The globalized accounting world under the adoption of the International Financial Accounting Standards (IFRS) has placed the IFRS Foundation as the world's biggest nonprofit accounting standard-setting organization, with the sole responsibility of developing accounting standards on the International Accounting Standards Board (IASB). This Board consists of experts from various practical and academic backgrounds in accounting and reflects wide-ranging geographical diversity (IFRS Foundation, n.d.). The latter is expected to "improve the consistency of IFRS application, reduce criticism of regional over-influence, and promote the legitimacy of the IASB" (Larson & Herz, 2013, p. 99).

Moreover, the broad geographical background can also be assumed to increase the IASB's awareness of the fundamental differences in how businesses are conducted in different countries or communities. Regardless of its current success in promoting the standards, Zeff (2012) notices that the IASB still needs proper understanding on this issue in establishing IFRS and its interpretation, which includes its understanding of how commercial activities in Islamic countries are conducted (p. 834). The Board later decided to establish the Islamic Finance Consultative Group to address the problems arising from the application of IFRS to Islamic finance.

Despite the existence of the Group, there is still lack of concern with respect to the challenges faced by Islamic Financial Institutions (IFIs) in the application of IFRS. The Group has only conducted four meetings since its inaugural meeting in 2013, in which the meeting minutes show that the discussions have not produced significant results on how the IASB will accommodate Islamic edicts on their standards with regard to compliance issues.

As a result, Islamic accounting remains available today as an alternative accounting system for IFIs.

Islamic banks, which currently serve as the most important and developed component in the Islamic financial system, are required to modify their “deposit” system to abide by Islamic law or *sharia*. They raise funds through profit-sharing investment accounts (PSIAs)[1] as a replacement for interest-based deposits in conventional banking. Instead of earning interest on PSIAs, the “depositors” (hereinafter the investment account holders (IAHs)) will receive their share of profits and bear the losses resulting from the investments managed by the banks (Al-Deehani, Karim, & Murinde, 1999; Archer & Karim, 2009).

One of the accounting dilemmas with the application of IFRS to Islamic finance arises from PSIAs, as they partly share the characteristics of liability and partly those of equity. It is widely known that the commonly-accepted accounting, hereinafter referred to as conventional accounting, only explicitly mentions two classifications of elements on the right-hand side of the balance sheet; the claims of creditors or lenders in the company’s assets are shown as liabilities while shareholders’ equity represents the company’s net assets that belong to the shareholders.

This issue of classification of PSIAs draws attention to the definitions or explanations of the whole credit side of the balance sheet, which is not limited to the practice of Islamic banks. It also corresponds to the discussions in conventional accounting, in which accounting researchers (Botosan et al, 2005; Paton, 1922; Scott 1979) have criticized the deficiencies with regard to how existing guidance distinguishes between liabilities and equity, and to the proposed idea of the point of view of accounting in the discussions of the equity theories.

The scope of this dissertation is limited to accounting for Islamic banks, although the term “Islamic accounting” actually refers to a broader meaning than only accounting for IFIs (Napier, 2009). This is because there is the urgency to free financial industries from *haram* or unlawful transactions that make financial industries gain the most attention from Muslims around the world. Moreover, Islamic banks still serve as the biggest and the most important IFIs, which lead this study to limit the scope of study to only Islamic banks.

The objectives of this research can be divided into three main parts. First, the IASB, as the most important accounting standard-setter, faces inevitable challenges due to the existence of regional peculiarities, in which business may be performed in a fundamentally

[1]Some literature expresses PSIAs in a shorter term, “Investment Accounts”.

different manner. The Board is required to deal with them so that they can enhance the global financial statement comparability. Nonetheless, the IASB still shows cognizance deficiency on *sharia*-compliant issues. This study intends to address the accounting problems arising from the uniquely Islamic way of conducting business transactions, which have not been well-accommodated by the IASB.

Second, the discussions of PSIAs have been primarily focused on the governance issue (Archer, Karim, & Al-Deehani, 1998; Archer and Karim, 2009; Magalhães and Al-Saad, 2013). Meanwhile, the problems of classifying PSIAs in the balance sheets have become one of the reasons for the various applications of accounting standards for Islamic banks. Thus, this study aims to explore comprehensively the current situation of accounting for PSIAs that has not been clearly examined in recent Islamic accounting literature.

Third, there is the necessity to provide theoretical defenses for the classification of PSIAs. The search for theoretical defenses will benefit from the discussions of different views on equity theories, because the adoption of equity theory will have direct impact on the classifications of items on the credit side of the balance sheet (Lorig, 1964, p. 564). Therefore, this dissertation also intends to argue the need for theoretical defenses for the classification of PSIAs that can be found in the discussions of equity theory and, subsequently, propose an ideal classification for the balance sheets of Islamic banks that are in agreement with the chosen theoretical defense and that reflect Islamic teachings.

This study is a piece of normative/deductive research which aims to find out not only how things are, but above all how they should be, which will be necessary to answer the questions on the point of view of Islamic accounting and the proper basis for classification of the balance sheet.

In order to answer the question on how PSIAs have been addressed in current conceptual frameworks, this study employs several research methods:

1. Reviewing the literature on the characteristics of PSIAs in order to understand why particular attention should be paid to them in connection to the classification of elements.
2. Examining the conceptual frameworks developed by Islamic accounting standard-setters and conducting a comparative analysis with the IASB conceptual framework.
3. Surveying the financial statements of Islamic banks to determine the problems surrounding the classifications of PSIAs in the balance sheets when certain frameworks

and standards are applied.

Meanwhile, to answer the questions on the ideal classifications of the credit side of Islamic banks' balance sheets, this dissertation uses the following methods:

1. Another extensive literature review is conducted on equity theories in both conventional and Islamic accounting literature.
2. Testing the compatibility of equity theories to Islamic accounting by comparing each assumption on equity theories to Islamic values.
3. Deducing the criteria to classify the credit side of Islamic banks' balance sheets from the general understanding of debt and equity from Islamic perspective.

The original contributions of this study are as follows:

1. In order to achieve financial comparability across borders, the IASB insists on the implementation of a single set of accounting standards. This applies to all countries, with no exception for countries with distinct characteristics in business, such as the unique industrial conglomerates in Japan and Korea, the state-owned dominated businesses in China, and also the Islamic-influenced trade and commerce in Muslim-majority countries. One implication of this dissertation is to call on the IASB to pay thoughtful attention to such issues, in which accounting for PSIAs in Islamic banks, which appear as a requirement for businesses to adhere to *sharia*, are one of the examples.
2. Many pieces of writing on Islamic accounting are not written in English and scattered in not only academic but also non-academic publications, which results in the lack of a considerable amount of research papers discussing the current conditions of Islamic accounting in specific jurisdictions. Although the number of studies on PSIAs has grown in recent years, it is still limited. This research aims to provide comprehensive research on the presentation of PSIAs on the Islamic banks' balance sheets that can be disseminated widely, outside the scope of one country.
3. This dissertation also contributes to the limited literature on accounting for PSIAs by surveying the practices of accounting for PSIAs from financial statements of Islamic banks in Asia. It reveals the diversity of reporting methods for unique transactions in Islamic banks and the insufficiency of current accounting standards to guide them, which creates possible challenges of comparability.
4. The study contributes to the understanding and knowledge of Islamic finance and accounting, with particular attention drawn to the balance sheets of Islamic banks,

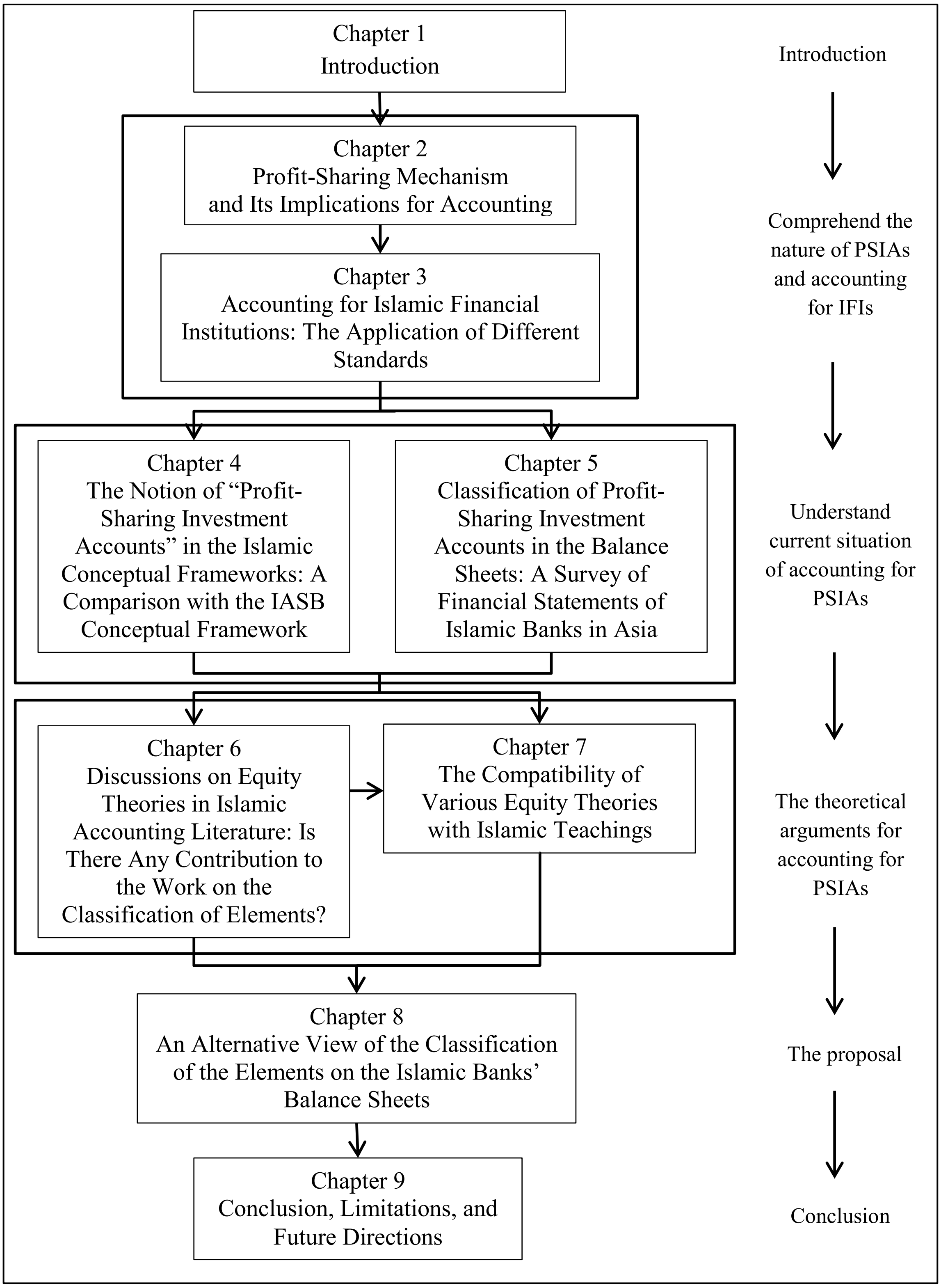
which are related to equity theories. Van Mourik (2010) noted that "equity theories were a popular topic of journal articles from the 1930s to the 1960s … in the 1970s equity theories started collecting dust in accounting theory textbooks and disappeared from most accounting academics and practitioners' frame of reference" (p. 193). In this regard, many accounting scholars, including Islamic accounting scholars, have little understanding of equity theories and their impacts on financial statements.

5. This dissertation also has important significance in the development of Islamic accounting theory, with the focus on the accounting point of view, and sheds new light on the fundamental questions about the classifications of elements on the credit side of the balance sheets. It also intends to support Islamic accounting standard setters' efforts to have a consistent conceptual framework by not only proposing the ideal classification of PSIAs in the balance sheets, but also by providing the theoretical basis.

The full structure of the dissertation can be seen in Figure 1 below.

Figure 1

Structure of the Dissertation



Chapter 2

Profit-Sharing Mechanism and Its Implications for Accounting

Chapter 2 is aimed at examining the accounting problems arising from the existence of PSIAs, which are the deposit accounts resulting from the elimination of interest-bearing deposits in Islamic banks. In this chapter, the explanation of the nature of PSIAs is provided in order to understand why they create accounting problems.

Islamic banks avoid dealing with interest by replacing interest-bearing deposits with PSIAs, which are commonly based on *mudaraba* partnership contracts. Under such contracts, Islamic banks are called *mudarib*, which are the parties that manage the funds, while the IAHs act as the capital providers, also known as the *rabb al mal*. These partners share the profits according to a profit-sharing ratio specified in the agreement, in which the banks' share is considered to be their fee for managing the funds. However, the losses are borne solely by the IAHs, and the banks will not earn any rewards for their efforts. Consequently, PSIAs are not "capital certain" (Archer & Karim, 2009, p. 301; Sundararajan, 2013, p. 50; Zaheer & Farooq, 2014, p. 9-10). This partnership structure allows Islamic banks to conduct business while complying with the Islamic edict.

There are two types of PSIAs: "restricted" and "unrestricted". The *mudaraba* contracts for restricted PSIAs specify certain restrictions, which can limit the Islamic banks' privileges related to utilizing the funds together with other sources of finance. The second type of PSIAs, which are unrestricted PSIAs, is the most common. These accounts allow banks to utilize the funds at their own discretion, without any restrictions on where, how, or for what purpose those funds are invested, as long it does not violate *sharia* (Archer & Karim, 2006, p. 270; Archer, Karim, & Sundararajan, 2010, p. 14; Sundararajan, 2013, p. 50). In this dissertation, the focus will be on unrestricted PSIAs, in which case the term "PSIAs" refers to "unrestricted PSIAs", unless the specific term "restricted PSIAs" is used.

Normally, unrestricted PSIAs are commingled and invested together with shareholders' funds and other sources of funds, such as current accounts, in the same portfolio. In this case, Islamic banks will receive profits and bear any losses proportionately to their share of the total capital in the venture, and also earn entitlement to the agreed *mudarib* share of the profits on the *rabb al mal*'s share of the capital (Archer and Karim, 2009, p. 301; Archer et al., 2010, p. 14; Karim, 2001, p. 180). It is also known as bilateral *mudaraba* or *mudaraba-musharaka* (Archer and Karim, 2009, p. 301).

However, Islamic banks face commercial pressures to provide competitive returns such as those provided by conventional banks, which lead to profit-payout smoothing activities. Islamic banks may forgo some of their shares and transfer them to PSIAs in order to pay a return to unrestricted IAHs, which is expected to eliminate potential withdrawal of unrestricted IAHs funds (Archer et al., 2010). Moreover, Islamic banks employ two kinds of reserve accounts, called profit equalization reserve (PER) and investment risk reserve (IRR). PER is allocated from profits before those profits are shared between unrestricted IAHs and Islamic banks, while IRR is set aside from profits available for distribution to the IAHs.

The accounting dilemma arises from PSIAs, as they partly share the characteristics of liability, and partly those of equity. It is widely known that conventional accounting only explicitly mentions two classifications of elements on the right-hand side of financial statements: the claims of creditors or lenders on the company's assets are shown as liabilities, while the shareholders' equity represents the company's net assets that belong to the shareholders. The application of accounting for PSIAs thus becomes diverse.

As there is no guaranteed amount of interest paid on deposits, Islamic banks are not obliged to return the IAHs' funds in case of loss, and thus PSIAs do not reflect "a present obligation" for the banks. The interest-free system's stress is on partnership, which makes the Islamic financial system essentially an equity-based system rather than a debt-based system (Akacem & Gilliam, 2002, p. 128; Khan, 1986, p. 6). Consequently, PSIAs, arranged under *mudaraba* or a passive partnership contract, are not a debt that should be repaid.

However, the IAHs are not identical to shareholders, as the IAHs do not enjoy the same powers and ownership rights, such as the voting rights held by owners. As a consequence, one thought contends that PSIAs should be distinguished from both liabilities and equity, so the creation of another element of the financial statement would be required (Karim, 2001, p. 177-178; Shubber & Alzafiri, 2008, p. 18).

Atmeh and Ramadan (2012) argue that the classification of unrestricted PSIAs as an equity is more appropriate, with additional separation on the asset side to distinguish between assets attributable to shareholders and assets attributable to unrestricted PSIAs. Hence, this will comply with the equity's definition as residual interest (Atmeh & Ramadan, 2012, p. 16).

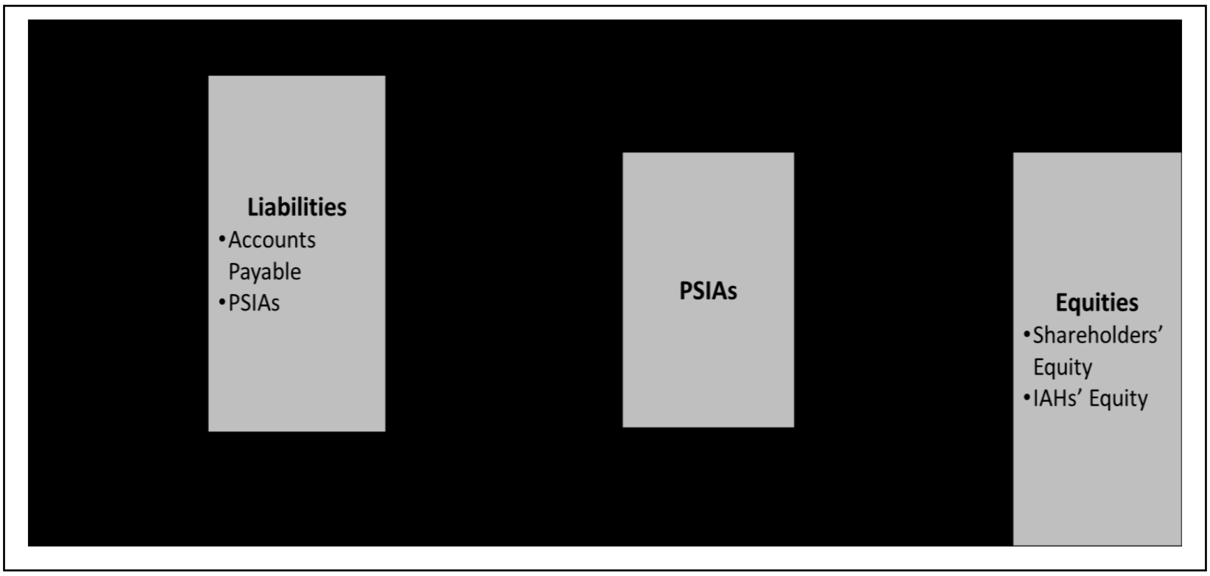
Although there is no contractual guarantee for the return of capital, it is a customary business practice to provide such a return in the desire to maintain good business practices

(ACCA & KPMG, 2012, p. 11). Therefore, there is an argument to use IFRS that classify PSIAs as a liability.

Figure 2 bellow illustrates the three possible classifications of PSIAs in the balance sheets.

Figure 2

Possible Classifications of PSIAs in the Balance Sheets



Chapter 3

Accounting for Islamic Financial Institutions: The Application of Different Standards

The main purpose of this chapter is to provide an overview and analysis of the current situation of the application of accounting standards for IFIs, and to understand the underlying institutions related to the accounting standards applied by IFIs. Furthermore, this chapter also describes some of the competitive problems faced by the Islamic accounting standard setters.

The survey conducted by the Asian-Oceanian Standard-Setters Group (AOSSG) in 2011 found that the existence of Islamic financial services and accounting standards specific to Islamic financial transactions and entities in each responding jurisdiction varied. Most of jurisdictions that apply distinct accounting standards for IFIs chose to use the financial accounting standards develop by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

The Islamic accounting standards do not refer to a uniform set of standards. Based on the accounting standards used, there are five groups of IFIs: those reporting Islamic financial transactions (1) under IFRS or local Generally Accepted Accounting Principles (GAAP) based on IFRS, (2) under IFRS or local GAAP based on IFRS with some additional guidelines, (3) by adopting AAOIFI Financial Accounting Standards (AAOIFI FAS), (4) by adapting AAOIFI FAS, and (5) by using national Islamic accounting standards.

AAOSG survey also shows a global move to IFRS; some jurisdictions that applied distinct accounting for entities with Islamic financial services were considering reviewing their Islamic accounting standards. As IFRS are not developed with *sharia* consideration, IFIs can report and disclose similar transactions in different ways that later poses problems for those institutions themselves as well as for the development of Islamic finance in general.

The AAOIFI was established on the initiative of the Islamic Development Bank in 1980s, because Islamic banks were dismayed that the central bank or other regulatory agencies in their countries might meddle in regulating their accounting practices, since these regulatory agencies still pictured them as a new and deviant part of the financial industry, and the business community in general (Karim, 1990, p. 302). The AAOIFI was later registered as an international autonomous nonprofit organization on March 27, 1991 (AAOIFI, 2015, p. 13). Although the initial establishment was intended to develop accounting standards, it currently has extended its scope of responsibilities into auditing as well.

Despite the existence of the AAOIFI, there is also preference to apply national Islamic accounting standards. It is because each jurisdiction has diverse understanding on Islamic rulings, which results in different accounting treatments for Islamic financial treatments. In Indonesia, IFIs need to follow Islamic accounting standards developed by the *Sharia* Accounting Standards Board (Indonesian: *Dewan Standar Accountansi Syariah* or DSAS-IAI). While in Pakistan, the Institute of Chartered Accountants of Pakistan developed accounting standards by adapting AAOIFI FAS.

Yet, the AAOIFI still faces critical challenges. The establishment of the AAOIFI is criticized as merely a name, which has no enforcement power. The different opinions and the varied understanding of *sharia* have become the biggest challenges to a common set of global Islamic accounting standards.

Chapter 4

The Notion of "Profit-Sharing Investment Accounts" in the Islamic Conceptual Frameworks: A Comparison with the IASB Conceptual Framework

The purpose of this chapter is to analyze how PSIAs are identified in Islamic conceptual frameworks, in comparison with the IASB conceptual framework. A conceptual framework is the foundation that reinforces the development of financial reporting standards and "makes standard setting more efficient by providing a common set of terms and premises for analyzing accounting issues" (Gore & Zimmerman, 2007, p. 30). For that reason, conceptual frameworks need to be examined, as they should provide guidelines on how to account for PSIAs under the broad classes of the groupings of the financial transactions or events, otherwise known as the elements of financial statements.

There are two conceptual frameworks of financial accounting that are tailored for *sharia*-compliant transactions. The first one is developed by the AAOIFI, whose accounting standards have been adopted or used as guidelines by IFIs in some countries. The second one is formed by Indonesian *sharia* accounting standard setter, the DSAS-IAI, which is adopted by the entities conducting *sharia*-compliant transactions in Indonesia. Thus, these two conceptual frameworks will dominate the discussions in this chapter.

In performing the analysis, this chapter relies on the written conceptual frameworks issued by the two boards to access the content of the conceptual frameworks. As the Islamic accounting system is relatively new compared to conventional accounting, the approach used is a comparative one, using the IASB conceptual framework which is a more widely known and accepted conceptual framework, as the basis for the comparison. This paper contributes to the accounting literature by providing a better understanding of PSIAs in the current Islamic conceptual frameworks.

In establishing the objectives and concepts of financial accounting for IFIs, there were debates about whether it should be started by using the Islamic normative approach or with contemporary accounting thoughts and test them against *sharia*; accepting those that are consistent with *sharia* and rejecting those that are not (AAOIFI, 2010, p. 13, Lewis, 2001, p. 112). Islamic accounting scholars, such as Adnan and Gaffikin (1997), Gambling and Karim (1991), and Karim (1995) advocated the first approach which they believed would help minimize the influence of secular contemporary accounting thought on the objectives and concepts of financial accounting. Nonetheless, the latter approach was finally chosen, as it was considered to be more pragmatic and would facilitate a timelier implementation (Lewis, 2001; Vinnicombe, 2010).

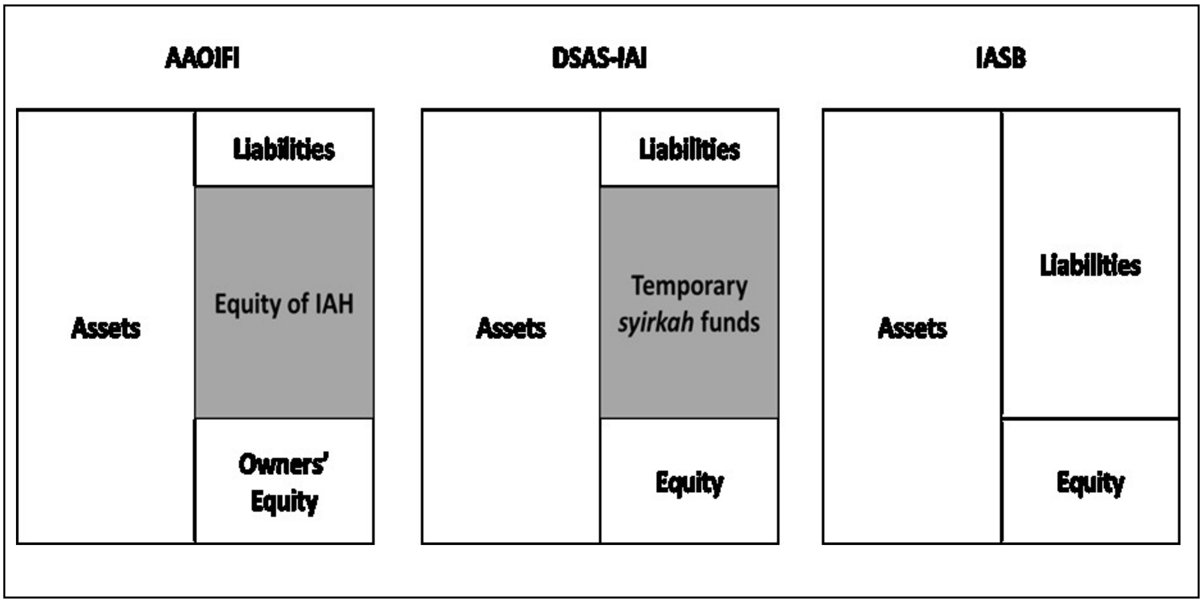
The DSAS-IAI also chose the same approach by adapting the IASC conceptual framework. Hence, many similarities are found probably because of a deliberate attempt to make the accounting system not far different from the widely accepted accounting.

In all three areas, which are the identification of the users of financial accounting, the objectives of financial accounting, and the elements of financial statements, important differences can be spotted. Despite the agreement that making economic decisions should be addressed as the objective of financial accounting, both the AAOIFI and the DSAS-IAI believe that it should also cover compliance with *sharia*, although this objective is still considered to be secondary compared to the decision-usefulness. Furthermore, the boards have also not taken into consideration the proposed objectives of financial reporting by Islamic scholars. Of primary importance is the existence of PSIAs as an element of financial statements, which is related to the specific acknowledgment of IAHs as a user of financial information. It leads to the existence of a mezzanine level between liabilities and equity.

Figure below illustrates the difference on the credit side of the balance sheets of Islamic banks under the three conceptual frameworks.

Figure 3

Balance Sheets under the AAOIFI, DSAS-IAI, and IASB Conceptual Framework



Nonetheless, the new elements placed on the mezzanine level developed by the two Islamic standard setters are not identical. The AAOIFI narrows the definition of the equity of IAHs into only funds received under a *mudaraba* agreement. The equity of IAHs is only entered on the balance sheet when IFIs have full authority for how to use the funds, which indicates unrestricted PSIAs. When IAHs apply some limitations on the deployment of the funds, the equity of IAHs should be classified as off-balance sheet items and be presented in a separate statement called a "Statement of Restricted Investment Accounts". This is different from the DSAS-IAI's opinion, which considers all PSIAs to be temporary *syirkah* funds, regardless of any restrictions from the IAHs. In addition, the DSAS-IAI considers it important to emphasize in the definition of PSIAs that investments using these funds are only for a certain period of time, which is reflected in the fund's name: "Temporary".

According to the AAOIFI, PSIAs should be a separate element from liabilities as the IFIs have no obligation to return the funds in the case of losses. Likewise, IAHs do not enjoy the same power and ownership rights that shareholders do and, accordingly, PSIAs cannot be considered as owners' equity. The name "equity of IAHs" actually indicates that the AAOIFI considers PSIAs to be closer to equity rather than liabilities or a "special class of equity". Nonetheless, despite the label of "equity" in the equity of IAHs, the AAOIFI still uses the term equity holders, by limiting it to shareholders only (AAOIFI, 2015, p. 46, para 1/4).

There was pressure for the Islamic accounting standards boards, especially the AAOIFI, to develop a set of conceptual frameworks and accounting standards that can be widely accepted by IFIs, if not all entities, around the world. While the process of developing the first conceptual framework for financial reporting in the Western world went through a long process, the Islamic conceptual framework was finalized in a relatively short period. As such, there is plenty of room for improvement in a conceptual framework that is derived from Islamic percepts and can lead to a better understanding of Islamic finance's unique characteristics, including PSIAs.

Chapter 5

Classification of Profit-Sharing Investment Accounts in the Balance Sheets: A Survey of Financial Statements of Islamic Banks in Asia

This chapter examines the practices of accounting for PSIAs under diverse accounting standards and, simultaneously, attempts to find out whether—under the same standards—

PSIAs and PSIAs-related accounts are treated similarly in terms of their element classification. It also aims to find out if Islamic banks consider IAHs to be important financial statement users, in terms of disclosing the necessary information pertaining to PSIAs. The financial statements of Islamic banks in Asia are compared with respect to information related to PSIAs, which consists of the accounting classification of PSIAs, and PSIAs-related accounts and disclosures associated with those accounts.

The sample selection was drawn from The Banker's Top Islamic Financial Institutions 2013, in which 26 Asian countries are listed as the locations of the top IFIs. This study selected fully-fledged Islamic commercial banks, which can also be subsidiaries of conventional banks, listed on The Bankers' list in each Asian country.[2,3] The author chose Islamic banks that provide English versions of their financial statements for 2013 on their websites as the samples for the survey. In addition, Islamic banks that do not have an in-house *sharia* supervisory committee are eliminated, to minimize the non-*sharia*-compliant risk of PSIAs, as the presence of such a committee is intended to ensure that the banks' products and services abide by *sharia* (Hamza, 2013). The information on whether a *sharia* committee existed was obtained from either the banks' websites or the annual reports.

There were only 63 Islamic banks from 15 countries surveyed, due to reasons such as: (1) Financial statements available only in the local language; (2) only partial financial statements available; (3) no accessible financial statements on the Islamic banks' websites; or (4) no *sharia* committee that supervises the bank's operations.

The survey reveals the divergence of accounting practices for PSIAs and related accounts. Islamic banks are subject to various accounting standards, which classify PSIAs differently. Islamic banks that apply IFRS—which equates to the majority of Islamic banks surveyed—do not indicate a uniform accounting practice for PSIAs and related accounts. On the other hand, the application of AAOIFI FAS results in more comparable—as well as more consistent and transparent—practices of accounting for PSIAs and related accounts.

Fewer disclosures pertaining to PSIAs, particularly the returns to IAHs, were found for Islamic banks that do not cater to the uniqueness of Islamic finance, which suggests that

[2]When the holding company is listed as the top IFIs, the financial statement of Islamic bank will be surveyed instead.
[3]The number of Islamic banks in each country varies. In some countries, such as Thailand, Yemen, and Brunei Darussalam, there is only one Islamic bank. In this case, only one financial report can be surveyed. On the other hand, when there are a large number of Islamic banks, the number of financial reports surveyed is limited to 10.

IAHs receive less attention when one-size-fits-all accounting standards are applied. Despite the similarity of IAHs and shareholders, the limited information on PSIAs and related accounts in the financial statements shows that IAHs are regarded as less important compared to shareholders. It is a disadvantage for IAHs, as they do not have voice on how the business is run.

Chapter 6

Discussions on Equity Theories in Islamic Accounting Literature: Is There Any Contribution to the Work on the Classification of Elements?

The problems in classifying the credit side of the balance sheets are possibly related to the perplexity of the questions of from whose point of view the company should be seen, or for whom the focus of financial statements should be placed on. In the history of accounting theory, the discussion of the accounting's point of view, which is referred to as the equity theories, addressed some of the connections to this problem. It is because the adoption of equity theory will have a direct impact on the items which appear on the credit side of the balance sheet (Lorig, 1964, p. 564). In those theories, consideration is commonly given to the two major types of equities, outside and inside, or creditors and proprietors or owners, and the possibility of a third type, the equity of the accounting entity itself.

In this chapter, the following research questions have been developed: First, to what extent has Islamic accounting literature provided discussions about equity theories? Secondly, is there any useful direction or argumentation to find a solution for element classification issues?

This chapter aims at searching for a possible solution to the classification of PSIAs from the discussions about the equity theories, which are closely related to the question of whose point of view should be taken in the accounting process (Kam, 1990, p. 302). Further, it is a way to develop a stronger basis to formulate a comprehensive Islamic accounting theory, including a more consistent use of the accounting's point of view, in order to construct Islamic accounting frameworks and standards and to be more competent to encounter conventional financial institutions in the global financial market.

PSIAs, however, are not the only element that is considered questionable. Another issue of an element's classification is a less discussed issue, which can be found in the discussions about *zakat*, which is the obligation for every Muslim to put aside a specific portion of their wealth and deliver it to the needy. It influences business practices, as corporations are also required to perform *zakat* when they have met the requirements. Adnan and Abu Bakar (2009) argue that the current treatment of corporate *zakat,* which classifies *zakat* as an expense, does not reflect either the true purpose of satisfying *zakat* or the nature of zakat itself.

The exploration on equity theories shows that many accounting books and papers refer to the same equity theories in different names. Therefore, this chapter also defines each equity theory. It should be noted that various equity “theories” are referred to by different terminologies: School of thought, viewpoints, conventions, approaches, methods of viewing, and doctrines (Lorig, 1964, p. 563). In this chapter, the term “view” will be chosen to refer to each equity theory in order to underline the diverse points of view as the main differences.

According to the proprietary view, accounting is held to serve the proprietors’ interests and the items in the financial statements are treated from the proprietors’, or shareholders’, point of view, since proprietors get the ultimate benefits of the business, as well as suffer from the failure the most (Rosenfield, 2005). The importance stress of accounting is to determine the owners’ or proprietors’ net income or the changes in their wealth or proprietorship (Lorig, 1964, p. 565).

The entity view, on the contrary to the proprietary view, sees the income of a corporation is not income of the shareholders. It only becomes shareholders’ income once the dividends are declared. In other words, retained earnings are assumed to belong to the entity itself instead of to the shareholders’ (Lorig, 1964, p. 567, Van Mourik, 2010, p. 201). The accounting and financial reporting are conducted for the point of view of the entity itself, and not intended specifically for the shareholders.

There are two entity views that are proposed in different way. According to Paton (1922), liabilities and shareholders’ equities are equities with different rights. Thus, he argues that all the items on the credit side of the balance sheets are equities and recognizes distributions as belong to all of the equity holders, instead of only to shareholders. On the other hand, Anthony (1984) sees other constituents other than the entity itself as the outsiders. In other words, the only equity is the entity equity itself and other sources of funds are considered liabilities of the entity.

The idea of the enterprise view is formulated as a result of the new trend of the social concept of a firm, which emphasizes the company’s social responsibility. This view focuses on the role of a business enterprise in satisfying the many demands of the society including those of employees, creditors, shareholders, customers, suppliers, and even the community at large (Meyer, 1973, p. 120). Suojanen (1954) first formulated the enterprise view as he saw that the development of the social concept of a firm could have implications for accounting theory and raised the necessity of value-added statements.

Residual equity view, which was proposed by Staubus (1959), takes into account the change in the nature of the business entity from a legal view when a business becomes insolvent. His definition of residual equity is "the equitable interest in organization assets which will absorb the effect upon those assets which will absorb the effect upon those assets of any economic event that no interested party has specifically agreed to absorb" (Staubus, 1959, p. 9). He highlights that the unfortunate business conditions might change the position of residual equity holders from shareholders to creditors (Staubus, 1959, p. 8). This view is argued as another form of proprietary view (Van Mourik, 2010, p. 197).

Van Mourik (2010) argues that there is another view, called the equity view, which is in between the idea of both the entity view and the proprietary view. It sees the entity as independent from the owners, which reflects the entity view, but also resembles the proprietary view because it also sees management as the shareholders' agents, stresses the residual nature of shareholders' interests, and thus focuses on the information needs of investors.

However, different from Van Mourik, Meyer (1973) considers Paton's proposal to be the equity view, which resembles the idea of the proprietary view (p. 118). Each equity group represents a distinctive type of control, is subject to a distinctive type of risk, and has a distinctive type of control (Meyer, 1973, p. 118). Perhaps, Meyer sees this proposal as variations of the proprietary view because it does not mention explicitly the equity that belongs to the entity itself. Net income, as a result, is considered to be shareholders' income.

Table 1 below summarizes the different views on equity theories and how they create differences on the balance sheet equation.

Table 1

Different Views on Equity Theories

<table>
<tr><th>Equity Theory</th><th>Point of View</th><th>Proposed Balance Sheet Equation</th></tr>
<tr><td>Proprietary View</td><td>Shareholders</td><td>Assets - liabilities = owner's equity</td></tr>
<tr><td>Residual Equity View</td><td>Common Shareholders</td><td>Assets - specified equities = residual equities</td></tr>
<tr><td>Equity View</td><td>Equity holders</td><td>Assets = liabilities + (equity holders') equity</td></tr>
<tr><td rowspan="2">Entity View</td><td>The Entity</td><td>Assets = equities</td></tr>
<tr><td>The Entity</td><td>Assets = sources of funds
or
Assets = external sources of funds + internal source of funds</td></tr>
<tr><td>Enterprise View</td><td>Society</td><td>None
or
Assets = investors' input contributions</td></tr>
</table>

Source: modified from Meyer (1973) and Van Mourik (2010)

In the area of Islamic accounting, all the discussions about equity theories are basically aimed at one thing: Drawing attention to companies' responsibilities to society, either in the form of *zakat* or through other social concerns (see Table 2). They also try to release Islamic accounting from the influence of capitalism, which has an image of being insensitive to social and ethical issues.

Table 2

Islamic Accounting Scholars Preferences on Equity Theories

Scholars	Preference	Reasons	Proposal
Gambling and Karim (1991)	Proprietary View	It is necessary to calculate *zakat* on the value of shareholders' share.	-
Baydounand Willet (2000)	(Not explicitly) Enterprise View	More focus should be placed on social accountability rather than personal accountability.	Value-added statement
Taheri (2005)	Proprietary View (Enterprise View)	The entity view is the cornerstone of western accounting.	Value-added statement
Triyuwono (2001, 2003)	Enterprise View	The entity view moves the absolute ownership from individuals to a business entity and makes the owners free from ethical and normative legitimation while the entity itself will work to maximize the prosperity of the owners.	Value-added statement
Harahap (2008)	Enterprise View	Other views on equity theories are capitalistic accounting theories; they focus on specific groups only.	• Value-added statement • Assets = Liabilities + *Shirkah* Funds + Equity + Rights of the Needy

Taheri (2005), Triyuwono (2001), and Harahap (2008) insist that it is not possible to use the entity theory as a basis for Islamic accounting. Unfortunately, they are unsuccessful in explaining clearly about their preferred view, which they claim to be the product of capitalism. In comparison to what has been explained in the previous sections about the different views on the equity theories, their understanding about either the proprietary or entity view is limited to what they think is currently used as the basis for conventional accounting, and they leave many interpretations unexplored.

Although the proprietary and the entity views dominate the discussion on equity theories among other views, the term proprietary or entity views still have various interpretations. The identical terminology can in fact refer to entirely different understanding of equity theories. Nonetheless, the discussions of equity theories in Islamic accounting literature also show the premature understanding on each equity theory itself. Their understanding about the rejected view is limited to what they think as currently used basis for conventional accounting and leave the deep understanding of equity theories unexplored.

It is suggested that Islamic accounting scholars were attempting to find an existing accounting theory that could be used to develop an Islamic accounting theory with more emphasis on business ethics and social responsibility, as well as accountability. The majority of them came to a similar opinion that adopting the enterprise view, and inserting Islamic values into it, will result in a new Islamic accounting theory that is more independent from capitalist influences.

Unfortunately, it leads to the answer to the second research question, in which the discussions of the equity theories in Islamic accounting literature have provided almost no useful arguments to solve the element classification issues in Islamic accounting, which is also one of the major differences between Islamic accounting and IFRS.

Although equity theory discussions about the classification of elements have been one of the most debatable issues in conventional accounting, and may benefit similar discussions in Islamic accounting, Islamic accounting researchers have not considered using equity theories to solve this issue. It may be considered to be less urgent compared to the necessity of finding a more socially responsible and ethical accounting theory for IFIs, which then lead most of the Islamic accounting scholars to state their preferences for the enterprise view.

Chapter 7

The Compatibility of Various Equity Theories to Islamic Teachings

In order to have a uniform understanding, each different view of equity theories has been defined in Chapter 6. Each equity theory has a different viewpoint from which accounting should be conducted. Five equity theories were specifically discussed, which are the proprietary view, the residual equity view, the equity view, the entity view, and the enterprise view. Each view has assumptions which bring consequences for how the credit side of the balance sheet will look.

This chapter examines the compatibility of each view of the equity theories with Islamic teachings. It provides an analysis of whether those views are acceptable to act as a basis for Islamic accounting. As clarifying the accounting perspective is central to considering how to satisfy the objective of financial reporting (EFRAG, 2010), this chapter also discusses the proposed objectives of Islamic financial reporting.

Muslims are bound by the concept of ownership rights in Islam, which originate from the concept of *khilafah* or vicegerent. It is derived from the concept of *tawhid* or the absolute Oneness of God; it is the most fundamental stricture of monotheism. As a *khilafah* of God, the absolute and eternal owner of everything on earth and in the heavens, man acts as a trustee or steward for God on this earth.[4] Ownership of property is therefore a trust (*amanah*) to be enjoyed conditionally, so long as man follows *sharia* and remains worthy of the trust. He has the responsibility to manage the resources for the benefit of the community and is later accountable for his actions to God (Gambling & Karim, 1991, p. 33; Hamid, Craig, & Clarke, 1993, p. 135; Lewis, 2001, p. 100; Rahman, 2010, p. 55; Sharawy, 2000, p. 160-161; Sulaiman, 2003, p. 152).

Based on the basic concept of ownership in Islam, the objective of financial reporting should be directed at providing information to assist users in making decisions with regards to the *sharia* compliance consideration, as well as the financial aspects, as a way to fulfill their accountability to God. It should be noted that the *sharia* consideration should come before any financial aspect. When users are convinced of the *sharia* compliance of an entity, they will require more specific financial information for making resource allocation decisions.

It is found that conducting accounting from the extreme or pure perspective of the proprietor or the entity itself can be considered improper. The proprietary view assumes that all the assets of the firm belong to the proprietor and any liabilities are also their obligation. Van Mourik (2010) argues that the proprietary view leads to financial statements which only measure and analyzes the owners', or shareholders', net worth (p. 195). Managers, as the stewards, are considered to be responsible only to the owners, which neglects the important accountability to God. This is different from Islamic teaching, which does not oppose any material pursuit, but is against the accumulation of excessive wealth. Adopting the proprietary view is therefore deemed to be erroneous, as it puts too much emphasis on the owners.

On the other hand, adopting the pure entity view will also be problematic. It is because the entity becomes the thing that is considered responsible for itself, while Islamic teachings clearly defines that individuals should be the ones' that are responsible in the hereafter.

[4] Quran 2:30; 6:165; 51:56; 35:39

Moreover, the entity view suggests that as both the creditors and the shareholders provide the capital, they therefore should be treated in the same way (Clarke, 1993). Nonetheless, Islam has put a sharp distinction on debt and equity, such that debt should not be paid with additional returns.

The residual equity view is basically similar to the proprietary view, with the focus on the nature of the business entity from a legal view when the business becomes insolvent. Meyer (1973) notices that the appearance of residual equity views is the assumption that various shareholders are antagonistic to each other; lower ranking shareholders always want to minimize the profits attributable to the higher ranking shareholders (p. 117). This is different from Islamic teachings, which require people to being moderate; they should set aside the selfish and unfair tendencies that often result from a mistaken notion of absolute ownership.

The enterprise view, which emphasizes a company's social responsibilities, is claimed by some Islamic accounting scholars (Baydoun & Willet, 2000; Triyuwono, 2003; Harahap, 2008), as the most appropriate basis for Islamic accounting. The distributional characteristics of value-added statements are considered more appropriate, as they will drive people to become less highly profit oriented.

However, it does not fully or accurately reflect Islamic teachings. First, profit seems to be seen as destructive, while in fact, it is not always seen in a negative sense (Mohamed Ibrahim, 2000, p. 273). Making a profit is allowed and even encouraged in Islam, as long as it is obtained in a fair way and does not violate *sharia*. When value-added statements replace income statements, it becomes difficult to evaluate the company's profitability because value added does not equal profit. Profit, instead of value added, is crucial for a company's survival and it may be forfeited when the emphasis is shifted to value added. Second, the enterprise view is seen from the point of view of the society, which can be considered ambiguous. Shareholders may consider the distribution of value added reasonable, but the employees may disagree. This is because there is no standard of what is considered as "fair" in distributing value added.

The possible alternative is to implement the equity view, which resembles both the proprietary and the entity view (Van Mourik, 2010, p. 200). The equity view approves the concept of an entity as a separate unit from its owners. However, it also exhibits the perspective of the proprietor because it focuses primarily on the information needs of investors and considers retained earnings as belonging to them rather than to the entity (Van Mourik, 2010, p. 200).

This view can be adapted to Islamic accounting, for a number of reasons. First, it recognizes an entity as a separate unit from the owners, which is acceptable from the Islamic view, since it has similarities to some Islamic organizations, such as *waqf* (trust foundation), the mosque, and *dar al-mal* (treasury) (AAOIFI, 2010, p. 41). In the Islamic perspective, the concept of an entity as an independent unit from its owners is not intended to let the owners escape from responsibility for their actions towards the corporation, but to allow the organization to collect funds for its own use, instead of that of individuals. While it forms a means to share risks, and to some extent profits, Ahmed (1994) also argues that it reduces the possibility of the concentration of wealth in only a few hands. Second, it can satisfy the proposed objective of Islamic accounting, which is primarily targeted at investors, as the parties that bear the risks from investing their funds. Although all parties in the company are accountable to God for their involvement in the business, those that reap the profits are morally more responsible for their investment decisions.

Nonetheless, more investigations should be undertaken. In Islamic banks, shareholders are not the only parties who bear the investment risks. *Mudaraba* contracts allow IAHs, as the fund providers, to give Islamic banks, as the managers, the discretion to invest the funds with an agreed profit-sharing, while the losses are borne solely by the fund providers. They are, in some ways, similar to shareholders. Thus, the definition of equity in Islamic banks should be clearly defined, in order to decide who the equity holders are.

Chapter 8

An Alternative View of the Classification of the Elements on the Islamic Banks' Balance Sheets

Taking into consideration that equity view is the most applicable one for Islamic accounting, two main questions are raised in this chapter. First, what is equity from the perspective of Islam and, as a consequence, who are considered to be equity holders? Second, what should be the criteria, or criterion, for classifying the credit side of the balance sheets of Islamic banks that are in line with the proposed viewpoint?

This chapter is aimed at proposing an alternative view of the classification of elements on the credit side of Islamic banks' balance sheets. It takes into consideration the proposed objective of Islamic accounting and the equity view.

From the accounting perspective, there are many definitions of equity. The simplest definition may be obtained from the dictionary, which is intended to give a picture of equity to common people. The Oxford Dictionary defines equity as "the value of a company's shares; the value of a property after all charges and debts have been paid" and "shares in a company which do not pay a fixed amount of interest".[5] On the other hand, the Cambridge Dictionary defines equity as "the value of a company, divided into many equal parts owned by the shareholders, or one of the equal parts into which the value of a company is divided".[6] While the Oxford Dictionary refers to equity as being "residual" and "an uncertain amount of return" with no reference on the parties owning it, the Cambridge Dictionary specifically denotes equity as being what the shareholders own.

Nonetheless, from the Islamic perspective, Islamic scholars believe that equity financing is the heart of Islamic finance. In Islam, no return or interest should be provided for loan, which makes only the principal amount is certain. As a consequence, different from conventional system which commonly based on debt, Islamic financial system attempts to encourage partnership. Islamic scholars argue that Islamic financial system is equity-based, which refers to financial system with no interest on loan or no certain rate of risk (Akacem & Gilliam, 2002, p. 124; Chapra, 2007, p. 327; Hakim, 2007, p. 162; Mirakhor & Zaidi, 2007, p. 51, Zarqa, 1983, p. 181). Equity from an Islamic perspective thus corresponds to the willingness to share the risks from the investment, and consequently accept no guarantee on the face value of their invested funds.

In Islamic banks, sources of capital are not only from creditors and shareholders, but also from the IAHs. As the contract between the IAHs and the bank is commonly based on a *mudaraba* agreement, the IAHs will not only receive return when their investment is profitable, but also bear any loss from their investment. Thus, based on the previous understanding of equity from an Islamic perspective, it is concluded that capital that has the commitment of risk-sharing are the equities, which include the PSIAs as equity. Equity holders are, as a consequence, both the shareholders and also the IAHs. The adoption of

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[5]https://www.oxfordlearnersdictionaries.com/definition/english/equity_1
[6]https://dictionary.cambridge.org/dictionary/english/equity

equity view for Islamic accounting, as a result, refers to accounting from the point of view of both equity holders: the shareholders and the IAHs.

PAAinE (2008) argues that the credit side of balance sheets comprises of the 'claims' of capital providers to the assets of the reporting entity (para 1.1). This view is also adopted by accounting standard setters, such as the IASB, and is taken for granted by accounting researchers when discussing the credit side of balance sheets (such as in Schmidt, 2013, p. 201; López-Espinosa, Maddocks, & Polo-Garrido, 2012). Thus, the balance sheet is seen as the representation of assets, or resources, with offsetting claims against those resources, either from creditors or investors.

The credit side, as the "claim side", is criticized by Scott (1979). Claims are defined as a demand under law (Kohler, 1963, as cited in Scott, 1979, p. 755). If the right hand side of the balance sheets consist of claims or rights to assets, and shareholders' equity is equivalent to the rights or claims of shareholders, then those rights should not only be subject to quantification but they should also be linked with assets, both in the amount and through logical association (Scott, 1979, p. 755). He then proposes that the category of the credit side of the balance sheet be the "sources of capital", which he defines as "a category that portrays the entity's acquisition of capital in past transactions, which is now invested or held in various asset forms, and the magnitude thereof" (Scott, 1979, p. 759)

In Islam, the emphasis is on the efforts to transform land, labor, and money into productive processes (Akacem & Gilliam, 2002; Choudhury, 2016). Thus, it will be more appropriate to consider the credit side of balance sheets as displaying the sources of capital, instead of merely claims.

The easiest approach to define equity is by identifying the "owners" of the entity and classifying only the capital provided by them as equity. The shareholders are the legal owners of the enterprise, which makes their capital, according to this approach, the only equity in the company, and capital provided by other sources is considered as liabilities (PAAinE, 2008, para 1.39). It is similar to the common practices, in which capital provided by the "owners" or shareholders is referred to as equity, whereas capital provided by external contributors other than the owners is referred to as debt. Such an approach is consistent with the proprietary view.

Current conceptual frameworks define equity as "residual". When shareholders' equity is defined as residual interest, equity is the difference between the company's assets and its liabilities as the equation says 'assets – liabilities = shareholders' equity'. Based on the discussion in chapter 6, using the criteria of residual or subordination also reflects proprietary view

The IASB starts by defining the assets and liabilities, while the equity is the remaining element. In other words, the Board adopts the asset-liability approach, also known as the balance sheet approach, with assets and liabilities as the primary elements. The DSAS-IAI and the AAOIFI choose to follow this approach, but also add PSIAs as the new element.

From an Islamic perspective, this approach is not satisfying, as equity-based capital is preferred over debt-based capital. Equity financing is the heart of Islamic finance since it reflects the principle of justice in which no one has the right to harvest the yields without sharing the risks (Chapra, 2007). As a consequence, describing the equity as a residual element after defining liabilities can be perplexing.

Scott (1979) argues that a good classification system should use the single characteristic of an object that is of central importance to the classification system's primary users, to unite similar objects and distinguish them from fundamentally different objects. Each object ought to be classified in only one category, instead of more than one, and none of them should be incapable of being classified (Scott, 1979, p. 752). In other words, choosing one criterion, instead of more than one, will result in a more consistent classification of the credit side of the balance sheets

The criteria chosen by each accounting standard-setter to define the elements in the right-side of the balance sheets do not clearly reflect the key features of the elements (see Table 3). The definition of equity of IAHs and temporary *syirkah* funds by the two Islamic Boards mention that PSIAs are received for the purpose of investment and are entitled to profit sharing, which reflects the risk-sharing feature. While shareholders' equity is also received for the purpose of investment, both the AAOIFI and the DSAS-IAI follow the IASB by defining shareholders' equity as residual interest.

Table 3

Key Features of Each Source of Capital Reflected in the Conceptual Frameworks

Features \ Classification	IASB		AAOIFI			DSAS-IAI		
	L	**E**	**L**	**EIAH**	**SHE**	**L**	**TSF**	**SHE**
Risk-sharing (Unguaranteed principal)				●			●	
Fixed maturity							●	
Residual/ Subordination		●			●			●

L: liabilities
EIAH: Equity of IAHs
SHE: Shareholders' Equity
TSF: Temporary *Syirkah* Funds

The IASB claims to define liabilities independently, which results in the definition of equity as the residual concept. However, this definition does not represent a good classification system as Scott (1979) points out, as it does not use an object that is of central importance to uniting similar objects and distinguishing them from fundamentally different objects. The definition of liabilities does not represent any key features of liabilities as one of the sources of capital that can distinguish it from equity. On the contrary, the key feature is reflected on the definition of equity, which is "residual". Consequently, in the case of reporting PSIAs under IFRS, they become liabilities because they do not represent the residual interests of the entity. Despite the claim that IASB defines the liabilities independently, "residual" becomes the key feature that draws the line between liabilities and equity.

According to Scott (1979), a lack of permanence in the sources of capital can serve as the basis for dividing a balance sheet's credit side into two mutually exclusive categories (p. 761). He further divided the sources of capital into two: Transitory sources of capital and standing sources of capital. However, Scott's proposal does not serve the objective of Islamic accounting, which includes the assessment of *sharia* compliance.

It was explained that equity from the Islamic perspective is attached to the key feature of risk-sharing, with different degrees of risk shared between parties, depending on the agreement to invest the funds. When someone decides to invest his funds with the expectation to receive return, he is not allowed to avoid losing his money as a result of an unprofitable investment. Thus, this criterion should be adopted as the distinguishing item between liabilities and equity, which makes both PSIAs and shareholders' equity fall under the classification of equities.

Nonetheless, one may argue that PSIAs and shareholders' equity are not identical and thus should not be put in one classification. It is because PSIAs are based on a *mudaraba* contract, in which there is the requirement that the profit sharing should be decided at the beginning. When the maturity date is reached, the profit, if any, should be calculated and distributed based on the pre-agreed profit-sharing ratio.

An equity-based financing system can obtain funds from different types of equity holders. However, the critical line to define them from the Islamic perspective is the same: they share risks from the investments that makes no guarantee on their initial amount of funds. It is similar to liabilities, which belong to different types of creditors. All of the creditors are guaranteed that they will receive the full amount that the entity owes. Nonetheless, employees can be considered as the preferential creditors, as a *hadith*[7] mentions the importance of paying wages immediately.[8]

PSIAs, although not identical to shareholders' equity, are a form of equity in Islamic banks which share the risk of their invested funds. The degree of risk shared is different, as PSIAs do not bear the same risks as the shareholders; shareholders' funds are also used in other investments that are not commingled with PSIAs. It also has another feature that is important from the Islamic perspective, which is the presence of a pre-agreed profit-sharing ratio.

This is why full disclosures in Islamic banks, with particular attention to PSIAs, are critical. The pre-agreed profit-sharing ratio is critical from the *sharia* perspective, as the banks should not infringe the contract. The IAHs, who can have access on banks' financial information which is limited to the information presented in the financial reports, should be able to obtain such information from those reports. Thus, strict rules on providing information on PSIAs are deemed to be vital, so that IAHs can monitor their investment. Another reason is related to the availability of information about the use of the reserve accounts. When the accumulated amount of IRR is not used for the intended purpose of

[7]A source for religious law ranks second to that of the Qur'an.
[8]"Give the worker his wages before his sweat dries." (Ibn Majah, n.d.)

covering any possible loss, the amount should be donated to charitable causes (AAOIFI, 2015, p. 421). The full disclosures on PSIA-related accounts can help IAHs monitor the sharia-compliance of their investment.

The existence of the *sharia* supervisory board is intended to ensure that the banks do not violate *sharia* in all aspects of their business. They prepare a *sharia*-compliant report that emphasizes that the banks have been fully *sharia*-compliant, as well as disclose any non-*sharia*-compliant activities, if any. Thus, the ideal condition is that *sharia*-compliant report should be sufficient to ensure the adherence to *sharia*.

However, the *sharia* supervisory board is overwhelmed by multifarious functions (Jabbar, 2010, p. 289). The board members are mainly specialized in religious matters, and they may not speak the same 'language' as the bank directors who are more fluent in the 'language' of finance and accounting (Ghayad, 2008, p. 215). Thus, there is skepticism that a *sharia* supervisory board can make such assurances due to "the lack of time, energy and resources of the board, lack of knowledge and expertise, and lack of regulatory or governance control over the board" (Jabbar, 2010, p. 290). The "risk-sharing" as a criterion to classify the credit side of the balance sheets can help current and potential investors, as well as other stakeholders, to monitor whether the sources capital have been *sharia*-compliant in term of the return they received.

In Chapter 6, it was also mentioned that there is another classification issue related to corporate *zakat*. The adoption of the equity view eliminates the use of the term "owner", which may be confusing as "owner' can be interpreted differently. Instead, the term "equity holders" is suggested to reflect their equity invested in the entity. Thus, distributions belong to equity holders, or those that are entitled to receive return from their investments, as well as bear any loss that may occur. Although *zakat* is basically distribution required by the real Owner of all wealth, it is not a distribution to parties that share risks of their invested funds. Thus, when Islamic bank as an entity is required to pay *zakat*, the payment of zakat should be included as an expense instead of a distribution.

Chapter 9

Conclusion, Limitations, and Future Directions

The globalized accounting world under the IFRS necessitates the elimination of any differences in accounting practices among countries. Nonetheless, there are fundamental norms applied in some countries, such as in the Muslim majority countries, which need a certain amount of attention since they influence how the accounting should work. The IASB, as the Board that is responsible for the development of IFRS, still shows a lack of concern about how to deal with such matters.

The characteristics of PSIAs that are not identical with conventional deposits become a problem in classifying PSIAs in the balance sheets. While the conventional accounting will force to classify PSIAs as liabilities, the issue became debatable in the area of Islamic accounting. As the world is moving towards IFRS, Islamic banks that apply IFRS for their transactions are forced to use their own judgment when unique Islamic financial transactions are not accommodated by IFRS. The survey of financial statements of Islamic banks in this study shows no uniform practice for accounting and disclosures for PSIAs when IFRS are applied.

In order to provide a theoretical basis for Islamic accounting, the discussions on equity theories are explored. The discussions of equity theories in Islamic accounting literature show the premature understanding on each equity theory itself. They merely focus on finding suitable equity theory that covers ethical and social issues. Their understanding about the rejected view is limited to what they think as currently used basis for conventional accounting and leave the deep understanding of equity theories unexplored.

Based on the review of equity theories, this study concludes that the equity view, which focuses on the equity holders, can be adopted for Islamic accounting. Nonetheless, equity from Islamic perspective does not merely refer to residual, but to all sources of capital that share risk from the investments. When equity holders' perspective is used, it cannot ignore the existence of IAHs, which are also the equity holders of Islamic banks, although they do not hold the same rights as the shareholders.

The refinement should reflect the objective of Islamic financial reporting, which is intended to ensure compliance with *sharia*, as well as the equity holders viewpoint. Thus, the proposed criterion used for the credit side of the balance sheet is the commitment in risk-sharing, which leads to the classification of PSIAs as equity.

The existence of PSIAs draws attention to the importance of full disclosure in Islamic banks. PSIAs are based on a *mudaraba* agreement, which requires the profit sharing ratio to be stated at the beginning of the agreement. The IAHs, who can have access on banks' financial information that is limited to the information presented in the financial reports, should be able to obtain such information from those reports. Thus, strict rules on providing information on PSIAs are deemed to be vital, so that IAHs can monitor their investment, as well as serve the proposed objective of financial reporting in regards to *sharia*-compliance considerations.

The IASB shows a lack of attention to PSIAs, despite their central importance in Islamic finance. The Board gives no option for the classification of PSIAs except as liabilities, despite the failure of PSIAs to meet the IASB's definition of liabilities. With the current acceptance of IASB's conceptual framework by most countries around the world, it seems impossible for the Board to specifically consider the issue of PSIAs as one of discussion topics for its conceptual framework.

Moreover, Islamic accounting should be able to advertise the importance of equity-based financing, instead of debt-based financing, which is pivotal in Islam. Based on this consideration, the adoption of equity view requires the definition of equity to take precedence over the liabilities. The IASB, on the other hand, does not share the same principle. Noticing this key difference, it seems difficult to adopt the set of conceptual framework and financial reporting standards developed by the IASB.

In this dissertation, there are some limitations, which are needed to be acknowledged:

1. In Chapter 5, a survey of financial statements was conducted to find out how PSIAs and related accounts are classified under various accounting standards, which took the sample from the list of top IFIs around the world. The possibility of sample selection bias due to the nature of the data's collection cannot be completely ruled out. The availability of Islamic banks' financial statements online was essential to obtain the data. Some of the Islamic banks' websites, particularly the smaller Islamic banks, contain only information limited to their basic services, while some others do not have accessible websites at all. As a result, this study is biased towards larger Islamic banks.
2. Chapter 6 provides explanations on each view of the equity theory, based on the review of the literature on the equity theory conducted by the author. As there are various interpretations of each equity theory, the author needed to adopt a certain understanding in order to lead the readers to a uniform understanding of each view of the equity theories. In other words, the stand adopted by the author may be different from other authors.

3. Islamic accounting research is mainly conducted by researchers from Muslim majority countries. Consequently, much of their output is written in languages other than English. This dissertation, however, use only references written in English and Indonesian, and does not specifically refer to books or papers written in Arabic, Urdu, Turkish, or any other languages in which Islamic accounting research related to PSIAs may also have been conducted.
4. PSIAs included in the equity section of the balance sheets should be those without restrictions, which allow them to be commingled with other sources of funds. In the case that such restrictions exist, they should be reported off-balance sheet with a separate statement on the use of these funds. This is because the restrictions limit the control of the banks over the funds and require them to be handled with more prudence. Nonetheless, this type of PSIAs is not as common as the unrestricted PSIAs and thus is not part of the central discussions in this dissertation.
5. What has been done in the study is merely limited to an evaluation of the current classification of the credit side of the balance sheet, with particular attention to PSIAs. No comprehensive definition for each element on the credit side of the balance sheet, let alone all the elements of financial statements are offered. Thus, the proposal of this dissertation is not intended for immediate or direct use. Rather, it contributes as an idea for Islamic financial transactions to have their own accounting theory. It is necessary to elaborate them in a more pragmatic fashion, and to further examine them before real implementation can be carried out.

Therefore, future directions are thus directed to the accomplishment of the proposal that comprises all elements of financial statements to ensure that they are consistent with the proposed objectives and the viewpoint adopted. Islamic-related matters that are common to Islamic banks, such as *zakat* and some types of charity, require more attention in the discussions.

This research is indeed merely a starting point for creating an Islamic conceptual framework and a set of financial reporting standards that reflect Islamic teachings and at the same time provide a sound theoretical background. Thus, the entire Islamic conceptual framework, as well as the standards, still needs to be critically evaluated. As enormous time and effort will be necessary to achieve this, good collaboration between Islamic researchers and Islamic accounting standards setters in this endeavor is undeniably essential.