Doctoral Dissertation

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

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Abstract

The globalized accounting world since the adoption of International Financial Reporting Standards (IFRS) has required the elimination of differences between accounting practices among countries. Nonetheless, there are fundamental norms applied in some countries, such as in Muslim majority countries, which need certain attention since they influence how the accounting should work. The International Accounting Standard Board (IASB), as the Board that is responsible for the development of IFRS, shows a lack of concern about how to deal with such matters.

Islamic banks operate on the basis that stems from *sharia* or Islamic law, which is the key difference between Islamic banks and their conventional counterparts. As a result, Profit-Sharing Investment Accounts (PSIAs) are created as a replacement for conventional deposits. PSIAs exist as a result of the elimination of interest which is prohibited according to Islam. They are entitled to profit/loss from the investment, but have no voice on the management of the banks.

This study focuses on an investigation into how PSIAs are classified under current conceptual frameworks and on an examination of the proper classification for PSIAs, as well as other items on the credit side of the balance sheets. It argues using for the equity theory, which consists of different opinions on whose point of view should be adopted for accounting.

The study reveals that Islamic banks, which are subject to various accounting standards, do not indicate a uniform practice for accounting and disclosures for PSIAs when one-size-fits-all accounting standards and a conceptual framework are applied. There is perplexity over classifying PSIAs which causes obscurity in the treatment for PSIAs-related accounts. The fact that there are fewer disclosures pertaining to PSIAs in Islamic banks – which apply accounting standards not specifically tailored to Islamic finance – suggests that Investment Account Holders (IAHs), or the holders of PSIAs, receive less attention under those accounting standards.

It is then argued that among many views in the equity theories, the equity view, which resembles both the proprietary view and the entity view, is the most appropriate view that does not conflict with Islamic teachings. This view sees the entity as separate and independent of its owners and focuses primarily on the information needs of the equity holders. From the Islamic perspective, the adoption of the equity view concludes that the equity holders should not only be limited to shareholders, but also IAHs.

The adoption of the equity view leads to the classification of Islamic banks' balance sheets with a criterion that is critical from the Islamic perspective, which is "risk-sharing". This classification can assist users in assessing the banks' compliance with *sharia*. Nonetheless, the application of full disclosure principle is still crucial, as the IAHs' access to information is limited to what is presented in the financial reports.

This study contributes by presenting an example of how fundamental principles can affect accounting that may not be compatible with the adoption of IFRS. It also defines the problems with the practices of accounting for PSIAs through the survey of Islamic banks' financial reports. Furthermore, this study supports Islamic accounting standard setters' efforts to have conceptual frameworks and financial reporting standards for *shari*a-compliant transactions, and at the same time, have a theoretical basis for accounting.

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List of Abbreviations

AAA : American Accounting Association
AAOIFI : Accounting and Auditing Organization for Islamic Financial Institutions
AAOIFI FAS : AAOIFI Financial Accounting Standards
ACCA : Association of Chartered Certified Accountants
AICPA : American Institute of Certified Public Accounting
AOSSG : Asian-Oceanian Standard-Setters Group
APB : Accounting Principles Board
BNM : *Bank Negara Malaysia* (Central Bank of Malaysia)
CAP : Committee on Accounting Procedure
DCR : Displaced Commercial Risk
DFSA : Dubai Financial Service Authority
DP : Discussion Paper
DSAK-IAI : *Dewan Standar Akuntansi Keuangan-Ikatan Akuntan Indonesia* (Indonesian Financial Accounting Standards Board)
DSAS-IAI : *Dewan Standar Akuntansi Syariah-Ikatan Akuntan Indonesia* (Indonesian *Shari*a Accounting Standards Board)
DSN-MUI : *Dewan Syariah Nasional-Majelis Ulama Indonesia* (National *Sharia* Board of the Indonesia Council of Islamic Scholars)
ED : Exposure Draft
EFRAG : European Financial Reporting Advisory Group
EU : European Union
FAOIBFI : Financial Accounting Organization for Islamic Banks and Financial Institutions
FASB : Financial Accounting Standards Board
IAHs : Investment Account Holders
IAI : Ikatan Akuntan Indonesia (Indonesian Institute of Accountants)
IAS : International Accounting Standards
IASB : International Accounting Standards Board
IASC : International Accounting Standards Committee
ICAEW : Institute of Chartered of Accountants in England and Wales
ICAP : Institute of Chartered Accountants of Pakistan

IDB	: Islamic Development Bank
IFAS	: Islamic Financial Accounting Standards (applicable in Pakistan)
IFIs	: Islamic Financial Institutions
IFRS	: International Financial Reporting Standards
IFSB	: Islamic Financial Services Board
IMF	: International Monetary Fund
IOSCO	: International Organization of Securities Organization
IRR	: Investment Risk Reserve
MASB	: Malaysian Accounting Standards Board
NAS	: National Accounting Standards
NIAS	: National Islamic Accounting Standards
OJK	: *Otoritas Jasa Keuangan* (Financial Service Authority of Indonesia)
PAAinE	: Pro-Active Accounting Activities in Europe
PER	: Profit Equalization Reserve
PSAK	: *Pernyataan Standar Akuntansi Keuangan* (Statement of Financial Accounting Standards applicable in Indonesia)
PSIAs	: Profit-sharing Investment Accounts
SEC	: Securities and Exchange Commission
SECP	: Securities and Exchange Commission of Pakistan
SFA	: (AAOIFI) Statement of Financial Accounting
SFAC	: Statement of Financial Accounting Concepts
SOCPA	: Saudi Organization for Certified Public Accountants
SOP	: (MASB) Statement of Principles
TR	: (MASB) Technical Release
UAE	: United Arab Emirates

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Chapter 1

Introduction

1.1 Background and Problems

Going back almost two decades, the accounting world has undergone drastic changes such as harmonizing accounting standards across borders and the adoption of unified global accounting standards. Those globalized accounting standards refer to the adoption of standards developed by the International Accounting Standards Board (IASB), namely the International Financial Accounting Standards (IFRS).

The IFRS Foundation, which is currently the world's biggest nonprofit accounting standard-setting organization, put the sole responsibility of developing accounting standards on the 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.

The emergence of "Islamic accounting" cannot be separated from the development of IFIs which started its modern history in the 1970s and gained more public interest in the 2000s. Unlike the commonly known financial institutions, hereafter referred to as conventional financial institutions, IFIs claim to operate based on *sharia*[1] or Islamic law. As *sharia* prohibits charging and receiving *riba* or interest, IFIs have to operate by avoiding interest in all their activities.

Thus, the basic difference between IFIs and conventional financial institutions lays on the existence of interest-bearing transactions. Instead of utilizing interest rates, Islamic finance is operated under the profit-sharing principle. As a result, there is no guaranteed return; profit or loss is shared depending on the banks' profitability. This unique feature of Islamic finance is uniformly applied by IFIs around the world.

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 *sharia*. They raise funds through profit-sharing investment accounts (PSIAs)[2] 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

[11]The spelling of "*sharia*" varies because of inconsistent transliteration from the Arabic. It can be found as *sharia*, *shari'a*, *syariah*, *syari'ah*, *syari'a*, or other similar spellings. "*Sharia*" will be the spelling used throughout the dissertation.

[2]Some literature expresses PSIAs in a shorter term, "Investment Accounts".

their share of profits and bear the losses resulting from the investments managed by the banks (Al-Deehani, Karim, & Murinde, 1999; Archer & Karim, 2009).

Parallel with the development of Islamic finance, IFIs started to consider their business to require specific accounting standards (Karim, 1990, p. 302). Accounting for IFIs is expected to reflect their unique practices in order to differentiate IFIs from conventional financial institutions and to ensure the adherence of IFIs' business activities to *sharia*. This then led to the establishment of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), a nonprofit organization that develops accounting, auditing, governance, and ethical standards for IFIs' activities with reference to *sharia*.

Nonetheless, in respect to accounting, there are still diverging opinions on which accounting standards should be adopted for IFIs. Many countries, including countries where IFIs operate, have adopted IFRS. Thus, IFIs in those countries should record and report their transactions using IFRS or IFRS-based accounting standards, either with or without additional adjustments or regulations for Islamic transactions. Others prefer to apply specific accounting standards that have been tailored specifically for IFIs, such as financial accounting standards developed by the AAOIFI (AAOIFI FAS).

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. While the AAOIFI believes that PSIAs should be a distinct element in the credit side of the balance sheet between liabilities and shareholders' equity, IFRS give no option but to report PSIAs as liabilities. The Asian-Oceanian Standard-Setters

Group (AOSSG) (2010) and the joint reports from the Association of Chartered Certified Accountants (ACCA) and KPMG (2010, 2012) consider the perplexity in classifying PSIAs in the balance sheets as one of the main issues in accounting for Islamic financial transactions.

The U.S. Financial Accounting Standards Board (FASB) (1990) points out the importance of the distinction between liabilities and equities, as it will later affect the total liabilities and equity that are essential for calculating financial ratios in order to evaluate the financial health of a company, such as the ratios of assets to equity and debt to equity (FASB, 1990, para. 65). It is also critical in measuring income, as it cannot result from an investment by or a distribution to an owner or from a change in the value of what is considered to be equity (Botosan, et al., 2005, p. 168; FASB, 1990, para 66-67).

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.

In this regard, some questions emerge: How do current conceptual frameworks and standards consider IAHs in comparison to shareholders, as both bear the losses from investments? Whose point of view should Islamic accounting focus on? What should be the basis of classification for the credit side of Islamic banks' balance sheets? Those questions lead the study to examine the appropriate classification for PSIAs in particular and the credit side of the balance sheets in general. This includes the examination of whose accounting point of view should be adopted in Islamic accounting.

1.2 Scope of the Study

Modern accounting literature currently uses the label "Islamic accounting" to refer to accounting for IFIs, although it is actually not limited to this. Napier (2009) notes that the term Islamic accounting, in a religious sense, can be understood as being accounting based on the fundamental accountability as stated in the sources of Islamic doctrine (p. 124). In this regard, Islamic accounting shall be applied to any types of business whose activities are in compliance with *sharia*.

Nonetheless, current Islamic accounting primarily applies only to IFIs. 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. Initiated by the development of Islamic banks, the Islamic financial service industry has now evolved and is comprised of more types of financial institutions such as *takaful* (Islamic insurance), investment companies, and asset management companies (International Organization of Securities Organization (IOSCO), 2004, p. 16).

Nonetheless, this dissertation is focusing only on accounting for Islamic banks, instead of accounting for all types of IFIs, as Islamic banks currently still serve as the biggest and the most important IFIs. Despite the same Islamic values that all IFIs have to follow, each type of institution may have its own nature that is different from the others. In this regard, this study will cover only Islamic banks, instead of all types of IFIs. Subsequent sections and chapters will therefore use the term "Islamic banks" instead of "IFIs", unless the discussions address IFIs in general.

1.3 The Objectives

As Islamic banks operate within the framework of *sharia*, the accounting for Islamic banks is also required to consider the specific environment in which the Islamic banks operate. Thus, in this study, the Islamic perspective is seen *vis-à-vis* the conventional accounting perspective, in order to understand differences between the two.

The objectives of the 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 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 theory 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.

1.4 Research Methods

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.

1.5 Original Contributions

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.

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.

It should be noted that the limited amount of research on PSIAs does not mean that this issue is not academically important. Indeed, what it means is that research into Islamic accounting is still in its infancy stage. Haniffa and Hudaib (2010) argue that, despite the efforts of early Islamic accounting researchers to raise many significant issues, many of them lacked exposure at the international level, resulting in only a few topics getting attention (p.

7). They got hidden among mainstream accounting research, which currently is dominated by the trend of IFRS convergence and adoption.

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.

Moreover, 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.

Thus, 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.

1.6 Organization of the Dissertation

This dissertation is organized into nine chapters. This chapter, or Chapter 1, provides the background of the study, problems, objectives of the study, scope limitation, methods of research, original contributions, and organization of the dissertation.

Chapter 2 is entitled “Profit-Sharing Mechanism and Its Implications for Accounting”, which aims to examine the accounting problems arising from the existence of PSIAs. It starts by briefly explaining the sources of *sharia* that become the guidance of every Muslim’s life. The Quran, as the primary source of *sharia*, mentions the prohibition of interest that influences Islamic finance mechanisms. This chapter then provides an overview of the nature of PSIAs which results from the absence of interest, and how it leads to the accounting dilemma in classifying PSIAs in the balance sheets.

Chapter 3, under the title of “Accounting for Islamic Financial Institutions: The Application of Different Standards”, intends to portray current situation of accounting standards for IFIs. It utilizes the survey conducted by the AOSSG in 2011 to understand the policy of accounting for IFIs in some countries. The survey reveals that in the countries where IFIs exist, most of them apply the same accounting standards for both conventional financial institutions and IFIs. In the case that there is separation of accounting standards for those two financial institutions, AAOIFI FAS is the preference to report Islamic financial transactions. Thus, the comparison between two international accounting standard-setters, which are the IASB and the AAOIFI, is provided from the background of the establishment to current situations, the important support behind the organization, and the organizational transformation. Some parts of this chapter are taken from a paper published in the *Bulletin of Graduate School of Commerce* no. 77, issued in November 2013. The original paper, however, mainly focuses on Islamic accounting in Indonesia.

Chapter 4 is entitled "The Notion of "Profit-Sharing Investment Accounts" in the Islamic Conceptual Frameworks: A Comparison with the IASB Conceptual Framework". This chapter aims to analyze how PSIAs are identified and defined in the Islamic conceptual frameworks in comparison to the IASB conceptual framework that have been widely accepted in conventional accounting. There are only two conceptual frameworks specifically tailored for *sharia*-compliant transactions that have been developed to date: one developed by the AAOIFI and another one developed by the *Sharia* Accounting Standards Board of the Indonesian Institute of Accountants (Indonesian: *Dewan Standar Akuntansi Syariah* or DSAS-IAI). Thus, the discussions of Islamic conceptual frameworks in this chapter refer to those two conceptual frameworks. This chapter has been published as a paper under the same title in the *Bulletin of Graduate School of Commerce* no. 83, issued in November 2016. The content of the paper is presented as Chapter 4 with minor revisions.

Chapter 5, entitled "Classification of Profit-Sharing Investment Accounts in the Balance Sheets: A Survey of Financial Statements of Islamic Banks in Asia", examines the practices of accounting for PSIAs under various accounting standards by surveying 63 financial reports of Islamic banks from 15 Asian countries. It tries to find out whether PSIAs and PSIAs-related accounts are treated similarly in terms of element classification. At the same time, it aims to observe how important Islamic banks consider IAHs to be financial statement users in term of disclosing necessary information pertaining to PSIAs. This chapter has also been previously published as a paper in the *International Journal of Islamic and Middle Eastern Finance and Management*, Volume 10, Issue 3, in 2017. The content of the paper is mostly the same as this chapter, with some revisions to maintain the flow of the dissertation.

Chapter 6, entitled "Discussions on Equity Theories in Islamic Accounting Literature: Is There Any Contributions to Work on Classifications of Elements?", is intended as a start to

find a theoretical argument to solve the classification problem in the credit side of Islamic balance sheets by looking at the discussions on the equity theories in Islamic accounting literature. The exploration of equity theories shows that many accounting books and papers do not always refer, in each view of equity theories, to the same meaning, although they have the same label. The confusion involves two views that dominate the discussions of equity theories, which are the proprietary view and the entity view. Thus, this chapter also provides explanation on various views of equity theories so that the readers can have the same perception of them. A paper with the same title was published in the *Bulletin of Graduate School of Commerce* no. 75, issued in November 2012. However, there are major changes from the original version as the previous content was considered insufficient to encompass important views in equity theories.

Chapter 7, "The Compatibility of Various Equity Theories to Islamic Teachings," attempts to check the compatibility of each view to Islamic teachings. After understanding the various views on equity theories and exploring the discussions in Islamic accounting literature, this chapter provides an analysis whether those views are acceptable to furnish a basis for Islamic accounting. As clarifying the accounting perspective is central to consider how to satisfy the objective of financial reporting (European Financial Reporting Advisory Group (EFRAG), 2010), this chapter also discusses the proposed objective of Islamic financial reporting.

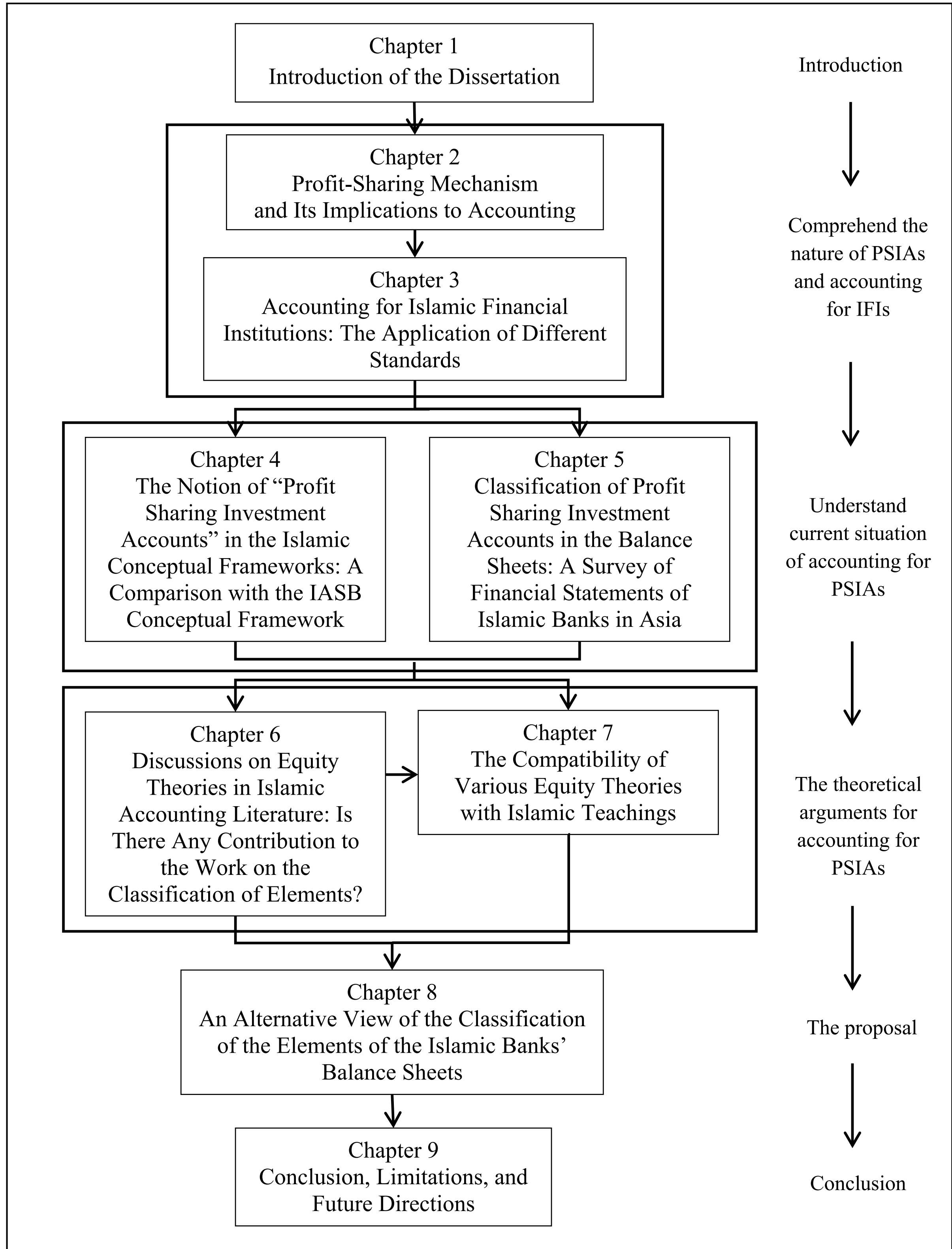
Chapter 8 is entitled "An Alternative View on the Classification of Elements of the Islamic Banks' Balance Sheets". It proposes an alternative view on the classification of elements on the credit side of Islamic banks' balance sheets that is consistent with the proposed objective of Islamic accounting and the point of view adopted. It attempts to choose criteria that can fit all the sources of capital and assist users to ensure the compliance of Islamic banks' activities to *sharia*.

Finally, Chapter 9 seeks to present the conclusions of the dissertation, which are drawn from the previous chapters. This chapter also includes limitations and suggestions for future research.

Figure 1.1 below illustrates the whole structure of the dissertation.

Figure 1.1

Structure of the Dissertation



Chapter 2

Profit-Sharing Mechanism and Its Implication for Accounting

2.1 Introduction

Over the past few decades, financial institutions operating under the banner of IFIs have increased significantly, with their financial assets' growth expanding at a double-digit rate (International Monetary Fund (IMF), 2017), attracting global attention. Numerous books and articles from the point of view of either practitioners or academicians have been published on the topic, which shows that there is growing interest in Islamic finance.

Islamic accounting, on the other hand, remains obscure with less interest shown in it. Although some books in the field of Islamic accounting have been available (Gambling & Karim, 1991; Hayashi, 1989; Napier & Haniffa, 2011), Islamic accounting studies remain immature in comparison to the research into Islamic finance.

As briefly explained in the previous chapter, the prohibition of interest, which is the most polemic matter in Islamic finance, creates some issues with the compatibility of the basic form of financial statements, namely the balance sheets, to present Islamic deposits. This chapter 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.

Before embarking further on the specific topic of accounting for PSIAs, it is helpful to first understand what constitutes the sources of Islamic law or *sharia*, which will be described in Section 2.2. This section will also briefly explain why there are differences in the interpretation of *sharia*. As *sharia* prohibits the consumption of interest, Section 2.3 will provide an explanation of the general ideas of Islamic finance mechanisms. It is then

followed by an overview of PSIAs in Section 2.4. Section 2.5 defines the fundamental part of this chapter, which is the analysis of the problems in applying a generally-accepted form of a balance sheet to account for PSIAs. The last section concludes the discussion in this chapter.

2.2 Islamic Law and Islamic Jurisprudence

Faith in Islam has spread rapidly, which makes Islam one of the largest religions in the world. A demographic study conducted by the Pew Research Center (2009) found that around 23% or 1.57 billion of the world's population are Muslims, with 60% of them living in Asia-Pacific countries and 20% located in the Middle East and North Africa (p. 1). This number is projected to have increase by about 35% by 2030 (Pew Research Center, 2011, p. 13). Consequently, more and more people become familiar with Islamic teachings.

Muslims believe that they are naturally weak and powerless as human beings, but are powerful enough to resist anything with the power of God. They thus have the conviction that they cannot succeed unless they live righteously in accordance with His rules. They have to comply with *sharia* that offers moral and legal guidance for nearly all aspects of life, including how to conduct an ethical business.

2.2.1 The Sources of Islamic Law or **Sharia**

Islam is a religion with the concept of monotheism, also known as *tawhid* or God's unity and supreme sovereignty (Gambling and Karim, 1991, p. 32), which is based on revelations received by the Prophet Muhammad in the 7th century. The concept of *khalifah* or vicegerent is then derived from the concept of *tawhid*, which means that man is a trustee or steward for God on this earth.[3] He has the responsibility to manage the resources, including the environment, for the benefit of the community and is later accountable for his actions to

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

God (Hamid, Craig, & Clarke, 1993, p. 135; Rahman, 2010, p. 55; Sharawy, 2000, p. 160-161; Sulaiman, 2003, p. 152).

The revelations to the Prophet Muhammad were later collected together and recorded in the Quran, the Islamic sacred text that guides Muslims' way of life and is considered by Muslims to be the literal word of God (Powers, 1992, p. 318) and the most important code of conduct or religious law in Islam. The second primary material source complementing the Quran is *sunnah,* which is the behavior or practices taught by the Prophet Muhammad. The Prophet's companions transmitted *sunnah* as a collection of narrative reports known as *hadith*. Those two sources supply extensive information for *sharia*.

In this dynamic and changing society, there are particular situations when neither the Quran nor *hadith* provide direct solutions for new problems and challenges. Under such conditions, it is necessary to provide secondary sources for *sharia*, which are *qiyas* (analogical reasoning) and *ijma* (consensus made by Islamic jurists) (Sharawy, 2000, p. 158). These two secondary sources are the extensions of *sharia* to questions not directly addressed in the either the Quran or *hadith*.

2.2.2 Major Schools of **Sharia**

Islamic jurisprudence, known as *fiqh*, is a process that allows jurists or *ulama* to derive sets of guidelines, rules, and regulations from the rulings laid down in the Quran and *hadith*. Over the centuries, these have been formulated and elaborated upon by successive generations of learned jurists, through interpretation, analogy, consensus, and disciplined research. As *sharia* nowadays will not only be based on the Quran and *hadith*, but also completed by *ijma* and *qiyas* to work out issues peculiar to this modern day and age, there is the possibility of dissimilarities when interpreting *sharia*.

Given the above, Muslims may have different ways of interpreting *sharia*. In fact, Muslims in different regions commonly adopt different Islamic schools of thought or *madhhab.* They usually follow one of four major *Sunni*[4] Islamic schools of thought, which are Hanafi, Maliki, Shafi'i, and Hanbali; all of them were named after jurists that founded the school of thought (Powers, 1992, p. 318). The Hanafi School, which can be considered as the mildest among the other school of thought, is primarily found in Pakistan, Bangladesh, and Central Asian countries. The Shafi'i is popular mainly in Southeast Asian countries, such as Malaysia and Indonesia. The Hanbali School, known as the most conservative, is prominent in Saudi Arabia and the United Arab Emirates, while the Maliki School spread mainly to North Africa, including Egypt, West Africa, and Central Africa (Ahmad, 2010, p. 77-80).

Variations in the interpretation of Islamic law are attributed to the school of thought adopted as the main reference. As a consequence, opinions may also differ over various issues in the area of Islamic finance and accounting.

2.3 Interest-Free Financial System

As the Quran, later augmented by other Islamic law sources, serves as a basis for all Muslims' lives, Man has to obey the rules, including avoiding activities prohibited in Islam. Islam mentions laws regarding prohibited food and drink, such as pork and any alcoholic beverage, and also prohibits activities related to *riba* or interest and *ghahar* or games of chance that are similar to gambling (Lewis, 2001, p. 119).

Those prohibitions should be strictly observed in Muslims' daily lives, thus affecting Muslims' business activities since they are not allowed to engage in any business involving those prohibited activities. Those kinds of activities are considered *haram* or forbidden and

[4]There are two major Islamic schools and branches, which are *Sunni* and *Shia*. The majority of the *Shia* population can be found in Iran. Nonetheless, it often diverges from mainstream Islamic *Sunni*, including the way to perform daily prayers. Therefore, this dissertation does not refer to any specific opinions from *Shia*.

Muslims believe that doing *haram* activities results in punishment and abstaining from them will be rewarded.

However, in this modern era, avoiding these prohibited activities entirely has become a challenge. The elimination of interest can be seen as the most controversial and most discussed issue in Islamic finance, as interest has been the central concept of the practice of modern finance. Since globalization has spread and has great influence all over the world, financial activities dealing with interest are not uncommonly found in countries with Muslims as the majority of the population.

2.3.1 Prohibition of *Riba* or Interest

It is useful to begin examining the Islamic banking system by first defining some basic terms. As the original expressions come from Quranic Arabic words, there can be disagreements over the connotation of the words when they are translated into other languages.

Riba is the Arabic word for the predetermined return on the use of money. Literally, it translates into "excess" or "increase" (Choudhury, 1986, p. 100). In the past, there have been disputes about whether *riba* refers to interest or usury, but there is now consensus among Muslim scholars that the term covers all forms of interest, and not only "excessive" interest. Thus, in the ensuing discussion the terms *riba* and "interest" will be used interchangeably, and an Islamic banking system will be one in which the payment or receipt of interest is forbidden. An interest-based, or conventional, banking system is defined as symmetrical, with interest being paid and charged for the funds.

Riba arises "from the ability of the wealthy to exercise improper pressure, so as to retain the benefits of their wealth, while avoiding the duties and losses attached to its ownership" (Gambling & Karim, 1991, p. 34). It is considered a mistake to consider money

as a commodity since it actually should serve as a medium of transaction. The act of adding a specific interest rate or premium to a loan will trouble the needy while the wealthy do not have to bear any risks or make much effort to gain more money. This unfair system could bring wider social inequalities between the needy and the wealthy in society (Sulaiman, 2003, p. 7), which is called by Mills and Presley (1999) as "the ethical critique of interest" (p. 9).

Controversies on the prohibition of interest are not uncommon. Warde (2000) notices that there is an opinion that argues that "interest" is an economically justified remuneration of capital, which is not synonymous with "usury", since that tends to be more extortionary (p. 55-56). Thus, a normal interest rate is seen, by this view, as not harmful to economic efficiency and is considered permissible (Nagaoka, 2012, p. 116). Moreover, Islamic modernists claim that it would be suicidal for the general interest of *umma* or the Muslim community to avoid bank interest in recent decades, since society has not been constructed on the Islamic pattern (Warde, 2000, p. 56).

However, such opinions are weak and only adopted by a few scholars. Despite the discussions among Muslim scholars on the reasons for the prohibition against interest, the majority of scholars still believe that interest cannot be paid on a loan. Khan (1985) suggests that the protection of the poor is what lies behind the strong condemnation of interest-based transactions (p. 5). Thus, it is undebatable that Islamic banking systems have to eliminate the practice of charging interest from their business operations.

The notion of profit, or deriving benefits from carrying out business by accepting the risk of loss as well, is not the same as taking a fixed or predetermined return on financial transactions. While the latter is considered unlawful in Islam, the former is encouraged in Islam, as long as it does not violate *sharia*. Thus, in order to be consistent with the guidelines of Islam, a banking structure has to evolve in which the returns for the depositors fluctuate according to the actual profits from the investments made by the banks (Khan, 1985, p. 6).

It should be noted that the ultimate objective of *sharia* is success in the world and the hereafter. Hence, social and individual welfare and the quality of life are not merely measured in material terms but in both spiritual and material terms. Muslims are allowed to gain profits, but they have to be legally acquired and used according to *sharia* which restricts the concentration of wealth in the hands of a few. El-Ashker (1987), in his study of Egyptian Islamic business enterprises, shows that the Islamic enterprises are still regarded as profit oriented enterprises. However, instead of using the concept of profit maximization, they prefer to adopt the concept of "sufficient" or "reasonable" profit by taking into account the state of the market.

2.3.2 Islamic Modes of Financing

Islam experienced its golden age in the period between the 6th and 12th centuries. Although Islamic commercial contracts were used to structure many financial products at that period, they gradually disappeared when Islamic civilization declined in the 13th century (Jamaldeen, 2012, p. 46).

In 1963, the history of modern Islamic finance noted the reappearances of Islamic thinking by the establishment of MitGhamar in Egypt, a savings bank with the idea of profit sharing[5] (El-Ashker, 1987; Fisho-Oridedi, 2000, p. 14; IOSCO, 2004, p. 18; Jamaldeen, 2012, p. 49; Sharawy, 2000, p. 167). Unfortunately, it had to end its operations in 1967 for political reasons.

As MitGhamar inspired the development of many other Islamic banks, the development of Islamic finance still went on in the later years. There was a continued increase in the number of Islamic banks in the late 1970s and early 1980s, but the changing political climate in many Muslim countries made some Islamic financial institutions operate without the label

[5]Because of the political situation in Egypt that forbade Islamic political elements in the country, MitGhamar did not explicitly describe its practice as an Islamic bank (El-Ashker, 1987).

of Islam to avoid the negative worldview towards Islam at that time (Sharawy, 2000, p. 168). In the 1980s, IFIs started to enter the Asia Pacific market with the establishment of IFIs in Malaysia, Bangladesh, and Indonesia. In the 1990s, the number of IFIs continued to increase gradually. They began to penetrate the European and American markets and a number of IFIs were established in countries such as Australia, Canada, the United States, and the United Kingdom (IOSCO, 2004, p. 48).

The creation of modern IFIs undoubtedly started with the establishment of Islamic banks, which are the most developed components in the Islamic financial system. The International Organization of Securities Commissions or IOSCO (2004) found that the successful development of Islamic banking stimulated the extension of Islamic practices into other market segments by offering broader Islamic financial products.

The demand for Islamic financing continues to grow and attracts not only Muslims' interest, but also non-Muslims, by showing a staggering growth rate.[6] The stages of the evolution of the Islamic financial service industry can be seen in Table 2.1.

[6]"The Islamic funds in global financial institutions are estimated to be at US$1.3 trillion while the Islamic financial market is estimated to be worth US$400 billion in size, with an annual growth rate of 12-15%. In addition there are over 300 Islamic financial institutions currently operating in about 75 countries worldwide. Out of these IFIs, there is estimated to be more than 100 Islamic equity funds managing assets in excess of US$5billion which is a staggering amount" (Nazeer, 2011, p. 15).

Table 2.1

Stages of Evolution of the Islamic Financial Service Industry

1970s	1980s	1990s	2000s
Institutions: • Commercial Islamic banks	**Institutions:** • Commercial Islamic banks • Takaful • Islamic investment companies	**Institutions:** • Commercial Islamic banks • Takaful • Islamic investment companies • Asset management companies	**Institutions:** • Commercial Islamic banks • Takaful • Islamic investment companies • Islamic investment banks • Asset management companies • E-commerce • Brokers/dealers
Products: • Commercial banking products	**Products:** • Commercial banking products • Takaful	**Products:** • Commercial banking products • Takaful • Mutual funds/Unit trust • Islamic bonds • *Sharia*-compliant stocks • Islamic stockbroking	**Products:** • Commercial banking products • Takaful • Mutual funds/Unit trust • Islamic bonds • *Sharia*-compliant stocks • Islamic stockbroking
Area: • Gulf/Middle East	**Area:** • Gulf/Middle East • Asia Pacific	**Area:** • Gulf/Middle East • Asia Pacific	**Area:** • Gulf/Middle East • Asia Pacific • Europe/America • Global Offshore Market

Source: IOSCO (2004), p. 16

Financial institutions are known as financial intermediaries, which play an important role as the middlemen between the two parties in financial transactions. They basically gain profits by lending money at higher interest rates than the cost of the money they lend. In the absence of interest, financial intermediation is required to follow altered modes of financing.

There are two modes of financing in Islamic finance, which are equity-based modes of financing and debt-based modes of financing. As Islam encourages a greater reliance on equity (Chapra, 2007, p. 326), the equity modes of financing should be considered as the

primary modes.[7] Table 2.2 lists the equity-based financing modes, which consist of *mudaraba* and *musharaka*, and the debt-based financing modes or non-profit-and-loss-sharing modes, which consist of *murabaha*, *salam*, *istisna'*, and *ijara*.

Table 2.2

Islamic Financing Modes

Equity-based Financing Modes	
Mudaraba (passive partnership) A business partnership between fund providers and entrepreneurs with agreed profit sharing while the losses are borne by the fund providers.	Fund provider (silent partner); Fund manager (entrepreneur); capital; expertise; loss; profit; Project; profit
Musharaka (active partnership) An Islamic joint venture agreement in which each party contributes capital (could also include technical expertise) to the project with agreed profit sharing while losses are shared proportionate to the contributed capital.	Fund provider (silent partner); capital/expertise; Fund manager (entrepreneur); profit/loss; Project; profit/loss
Debt-based Financing Modes	
Murabaha (trade with mark up or cost-plus sale) IFIs purchase a commodity requested by the customer, with an agreed mark-up price; both parties should be aware of the original price.	
Salam (advance purchase) A contract to sell or purchase a commodity with immediate payment, but delivery of the commodity is deferred until the future.	
Istisna' (purchase order) Similar to *salam*, a contract is made before the commodity comes into existence, but it involves the manufacturing process whereby the purchaser orders from the manufacturer a specific product. Although it is not a must, payment may be made in advance.	
Ijara (lease financing) It is essentially similar to leasing; IFIs purchase equipment and lease it to the borrower with a fixed fee and specific term.	

Sources: Ahmad (2010); Gambling and Karim (1991); IOSCO (2004); Jamaldeen (2012); Pomeranz (1997)

[7]Nonetheless, the debt-based financing modes, or the non-profit-and-loss-sharing contracts, which are generally used to finance consumer and corporate credit are more common in practice (Hussain, Shahmoradi, & Turk, 2015, p 8).

Despite the critique that the Arabic terminologies can be confusing to non-Arabic speakers, industry practitioners insists on using Arabic names for the contracts. Therefore, the term "*ijara*" is used instead of "lease", or "*murabaha*" instead of the equivalent "cost-plus sale", for the purpose of maintaining credibility (El-Gamal, 2006, p. 11-12).

In order to be able to conduct financing activities, Islamic banks have to collect funds in the form of deposits. Nonetheless, these deposits are not identical with interest-bearing deposits, as are known in conventional banking, since Islamic banks are not allowed to offer a fixed rate of return on their deposits.

Thus, in the Islamic banking system, profits and losses are to be shared between the banks and the fund providers according to certain predefined rules. Khan (1985) notes that in principle the depositors will not be guaranteed a predetermined return on the nominal value of their deposits, but they will be entitled to a share of the profits made by the banks, which makes them similar to the shareholders of the banks (p. 6). If the bank incurs losses, as a consequence, the depositors have to bear these as well, which reduces the amount of their deposits.

Islamic banks commonly maintain two basic types of deposit accounts, which are current accounts and investment accounts. Current accounts are based on the principle of *wadiahyaddhamanah* or safekeeping with a guarantee. Under this arrangement, an Islamic bank is deemed to be the keeper and trustee of the funds but it also has the depositors' permission to utilize the funds for its operations in a *sharia*-complaint manner. Since the funds can be used by the bank in the form of a loan from the depositors, the bank guarantees repayment of the whole amount of the deposits. In this case, the depositors are not entitled to any return or profit on such deposits. It is permissible for the bank to reward the depositors in the form of *hibah* or a gift as a token of appreciation, but such additional rewards should not be a permanent practice.

The investment deposits, or PSIAs, will be the main focus of discussions throughout this dissertation. There are two types of PSIAs, which are unrestricted and restricted PSIAs. PSIAs are commonly governed by a *mudaraba* contract, in which the banks and the IAHs share any profit based on a pre-agreed ratio. The details of these investment funds will be discussed in the next section.

2.4 Profit-Sharing Investment Accounts (PSIAs)

Investment accounts are the main source of funds for Islamic banks, in contrast to conventional banks. This section will specifically discuss PSIAs and the accounts that come up as a consequence of the existence of PSIAs.

2.4.1 The Nature of PSIAs

As explained in the previous section, 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).

2.4.2 Smoothing Profit-Payouts for IAHs: Profit Equalization Reserve (PER) and Investment Risk Reserve (IRR)

Since unrestricted PSIAs are handled in the same way as those of the Islamic banks' own funds, shareholders and unrestricted IAHs share the same risks with the commingled funds. Shareholders gain greater returns, as they are also entitled to a management fee for handling the IAHs' funds. However, the commercial pressure to provide competitive returns such as those provided by conventional banks may induce Islamic banks to forgo some of their share and transfer them to the PSIAs in order to pay a return to the unrestricted IAHs, which is expected to eliminate the potential withdrawal of unrestricted IAHs funds (Archer et al., 2010, p. 11).

According to the Islamic Financial Services Board (IFSB), an international organization that issues standards for the effective supervision and regulation of IFIs, two common techniques are used by Islamic banks to smooth profit-payouts: (1) Forgoing part or all of the *mudarib* share of the profit, and (2) making transfers from shareholders' current or retained profits to unrestricted IAHs out of the current or retained shareholders' profits on the basis of *hibah*[8] (IFSB, 2010, para 19). Some of the unrestricted IAHs asset risks are thus absorbed by the shareholders. This phenomenon is known as "Displaced Commercial Risk" (DCR) (Archer and Karim, 2006, p. 303; IFSB, 2005, para 76).

In order to smooth the profit-payouts and mitigate DCR, Islamic banks employ two kinds of reserve accounts, called the Profit Equalization Reserve (PER) and the Investment Risk Reserve (IRR). PER is taken from profits before those profits are shared between unrestricted IAHs and the Islamic banks, which give PER two components: The shareholders, and unrestricted IAHs aspects. On the other hand, IRR is set aside from the profits available for distribution to the IAHs. The accumulated IRR, which belongs entirely to the unrestricted IAHs, can be used to cover any losses attributable to the unrestricted IAHs that might arise (Archer et al., 2010, p. 15-16).

The next figures will provide a simplified illustration of how the funds are channeled and how the profits are distributed. Islamic banks employ a two-tiered *mudaraba* (Djogosugito, 2008; Vinnicombe, 2012); in the first tier the banks are the fund managers that receive the money from the IAHs as the capital providers, the second tier of *mudaraba* allows the banks to be the capital provider to the borrower or the entrepreneur, who use their expertise to manage the funds in a project.

Figure 2.1 illustrates the investment flow of a two-tiered *mudaraba* contract. IAHs invested their money ($400) in the bank, where they enter the first tier of *mudaraba*. The

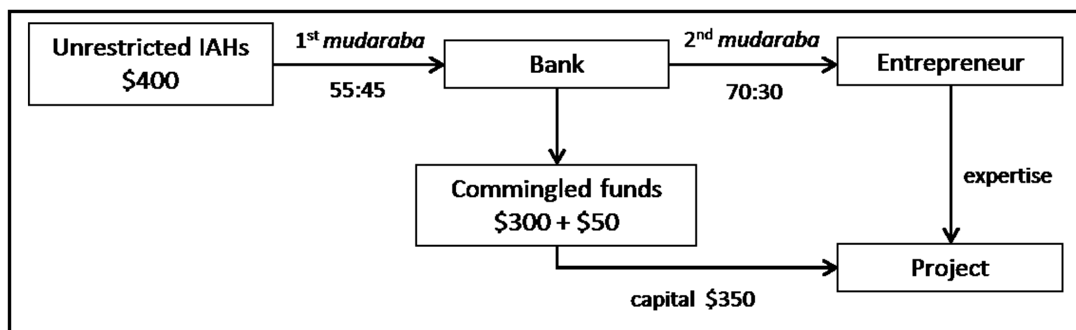
[8]A grant or gift that is not provided in return for something.

profit-sharing ratio between the IAHs and the bank as *mudarib* is agreed as 55:45. As the bank does not commingle restricted PSIAs with other sources of capital, only unrestricted PSIAs that are already mixed in an investment pool, together with the bank's shareholder equity, amounting to $50. When the bank invests $300 of the unrestricted IAHs' funds, the total amount to be invested in the project will be $350.

The bank then channels the money to the second tier of *mudaraba*, where the bank now becomes the *rabb-al-mal* and the entrepreneur is the *mudarib*. Assume that the bank uses all the money in a project and the *mudarib* uses his expertise to work on this project with a profit sharing ratio between the bank and the entrepreneur of 70:30.

Figure 2.1

Investment Flow of a Two-Tiered *Mudaraba* Contract



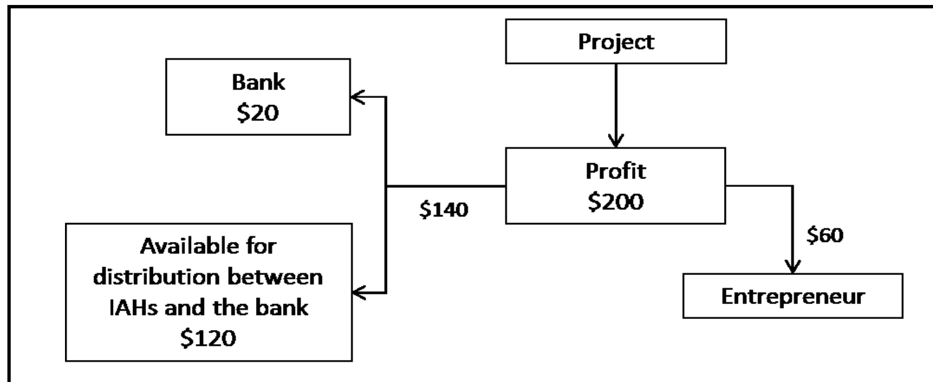
When the project results in profits of $200[9], $140 goes to the bank and $60 is the entrepreneur's share, which is based on the profit-sharing ratio of 70:30. The $140 profit does not belong solely to the bank or the shareholders, as the capital invested comes from the investment pool of both the shareholders' equity and the unrestricted PSIAs. Thus, the $140 profit is divided into two: One part goes directly to the bank ($20) and the rest is available for distribution between the IAHs and the bank ($120). The allocation to both parties is based on

[9]The project generates $550, with $350 being the initial capital, and $200 as the profit.

the ratio of the funds used in the commingled funds for the project, which is 50:300. Figure 2.2 illustrates the first profit distribution.

Figure 2.2

Profit Sharing between the Bank and the Entrepreneur

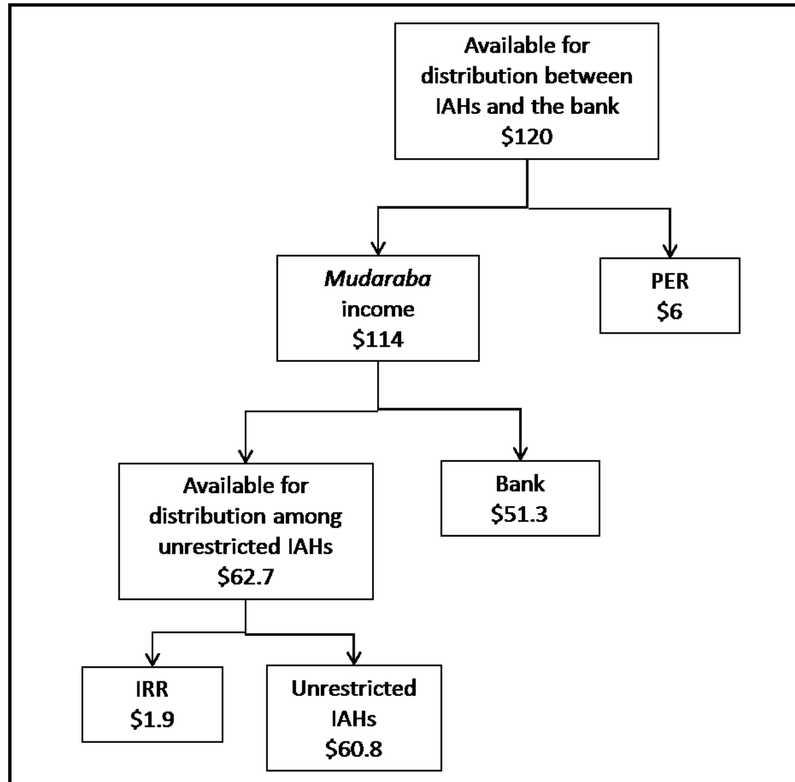


Before distributing the $120 profit to both parties, 5% of the profit, which is $6, is set aside as the PER. After this portion is taken for the PER, the rest of the profit or $114 is the *mudaraba* income. This number is again divided between the bank and the unrestricted IAHs based on the agreed profit sharing ratio, which is 55:45. Therefore, $62.70 goes to the unrestricted IAHs and $51.30 belongs to the bank.

Nonetheless, before the final number is distributed as the return to the unrestricted IAHs, a portion of it is again set aside as a reserve, which is the IRR. If 3% is taken for the IRR, $60.80 of the profit is available for distribution among the unrestricted IAHs. Figure 2.3 illustrates the rest of profit-sharing's distribution.

Figure 2.3

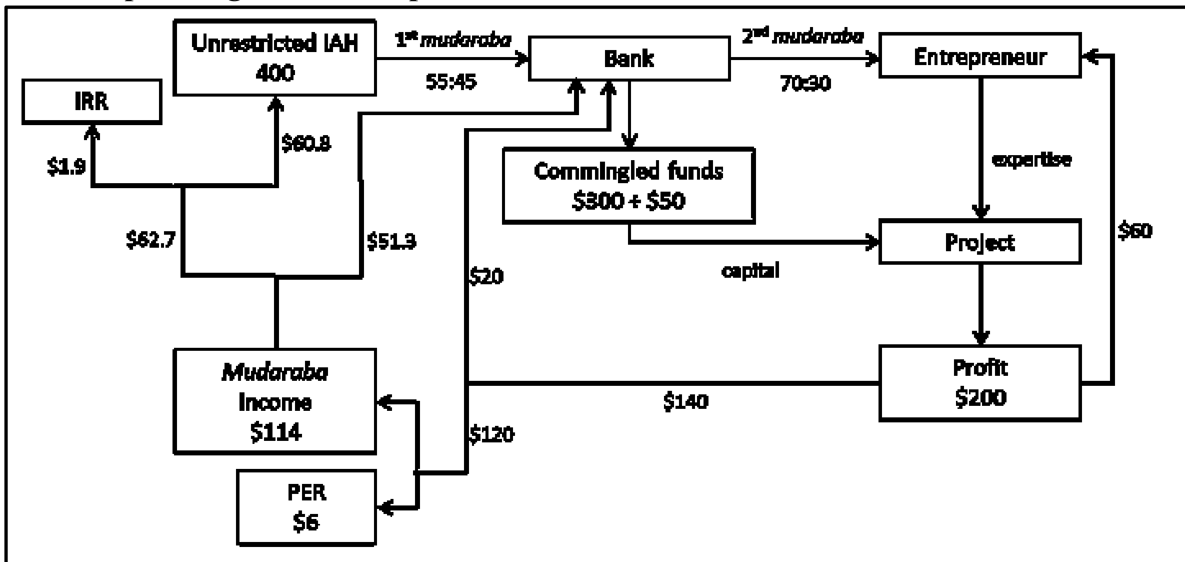
Profit-Sharing between the Bank and the Unrestricted IAHs



The complete figure for the previously discussed two-tiered *mudaraba* can be seen in Figure 2.4 below.

Figure 2.4

A Complete Figure of a Simplified Illustration of a Two-Tiered *Mudaraba* Contract



2.4.3 Profit Distribution

Islamic banks are required to choose from among the alternative methods that have obvious implications for the allocation of profits between the IAHs and shareholders. In allocating the profit between the IAHs and shareholders, Islamic banks normally employ one of the two alternative methods of profit distribution, known as the "pooling method"[10] and "separation method". The differences in the two methods stem from the question of whether the two parties should share all the revenues and expenses incurred in the banks' operations or be strictly limited to only the revenues and expenses pertaining to their investments (Al-Deehani et.al, 1999, p. 272; Archer, Karim, & Al-Deehani, 1998, p. 153; Karim, 1996, p. 35). The *Sharia* Supervisory Board of the Islamic banks commonly decides which method the banks should adopt.

If the bank chooses the pooling method, the IAHs and shareholders share almost all the revenues and expenses. In contrast, when the separation method is employed, the bank clearly draws a line between the revenue and expenses coming from its investment operations and those of its other banking services. As the IAHs strictly enjoy and bear direct investment-related revenues and expenses, the latter technique excludes them from bearing the administrative expenses (Al-Deehani et.al, 1999, p. 272; Karim, 1996, p. 35).

2.5 Accounting for PSIAs: The Islamic Perspective

Following the rapid growth of Islamic finance, the term "Islamic accounting" started to appear in many discussions. The majority of the early research into Islamic accounting in the 1990s focused on developing the objectives of Islamic accounting and reviewing the

[10] Despite the similar name, "pooling method" in this discussion is not the same as "pooling interest method" in a business combination.

accounting concepts from an Islamic point of view (Adnan, 1997; Adnan & Gaffikin, 2011; Gambling & Karim, 1990) to find the ideal Islamic accounting system.

2.5.1 The Notion of Islamic Accounting

Napier (2009) divides Islamic accounting into two categories. The first one refers to Islamic accounting from a religious sense; it seeks to develop accounting theory based on the fundamental concepts implied in the Quran and *sunnah*. The second category addresses the issues of accounting from a temporal and spatial implication, which focuses on "accounting in the parts of the world where Islam is the majority religion, during the periods when Islam was dominant" (Napier, 2009, p. 124). While the second study, which can be considered as the study of Islamic accounting from a historical perspective, is still rarely found, the first study has proliferated after the establishment of the AAOIFI, an international non-profit organization that develops accounting, auditing, and governance standards for IFIs.

According to Napier and Haniffa (2011), Islamic accounting is "accounting ideas and practices that have some fundamental differences from their conventional counterparts, resulting from an adherence to *sharia* principles" (p. xiii). Since accounting from the Islamic point of view should ensure users that the business is in compliance with *sharia*, Shanmugan & Perumal (2005) prefer to describe Islamic accounting as "a tool which enables Muslims to evaluate their own accountabilities to God in relation to their inter-human and environmental relations" (p. 11).

In this dissertation, the term "conventional accounting" is used to differentiate from "Islamic accounting". In this context, "conventional accounting" is not intended to discuss the two groups that dominate financial reporting at the international level, which are the Anglo-Americans or Anglo-Saxons and the European Union (Alexander & Archer, 2000, p.

539). This term simply refers to the accounting system that developed based on acceptable commercial practices and law, with no reference to Islamic principles and ethics.

Hameed (2000) argues that the worldview and values of a society influence its social and economic objectives. In order to reach the objectives, economic norms and laws are formed, which include the regulations to manage transactional behavior. Here, accounting plays a leading role in providing the information required by various stakeholders.

If the accounting system contains mainly extraneous values to those of the host society, the information produced may result in incorrect economic behavior, which also leads to the achievement of incompatible socioeconomic objectives. It consequently changes the economic norms and laws to be compatible with the new objectives (Hameed, 2000, p. 85-86). In other words, it may be difficult for accounting in different economic environments to be satisfied by a "one-size-fits-all" format.

Furthermore, Islam pays special attention to social justice. Muslims have a responsibility to care for others and avoid selfishness and avarice (Kamla, Gallhofer, & Haslam, 2006, p. 253). Besides the prohibition of interest, Islam seeks the distribution of wealth to all members of society by imposing *zakat*, the obligation for every Muslim to set aside a specific portion of their wealth and deliver it to the needy.

Both the issues of interest's prohibition and wealth's distribution have now become the important considerations in developing Islamic accounting, as conventional accounting is not considered to be in conformity with the socioeconomic objectives of Islamic accounting. Therefore, instead of adopting the widely-used international accounting standards, namely IFRS, some Muslim-majority countries or jurisdictions choose to apply AAOIFI FAS.

2.5.2 The Problems of Accounting for PSIAs

In the era of globalization, accounting standards are claimed to be better if there is a set of uniform accounting standards. However, the characteristics of PSIAs, which are not identical with conventional deposits, become a problem when classifying them in the balance sheet. Reporting PSIAs in the balance sheet has become one of the major issues in applying IFRS for IFIs (AOSSG, 2010, para 58-64; ACCA & KPMG, 2010, p. 14-15; ACCA & KPMG, 2012, p. 10).

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.

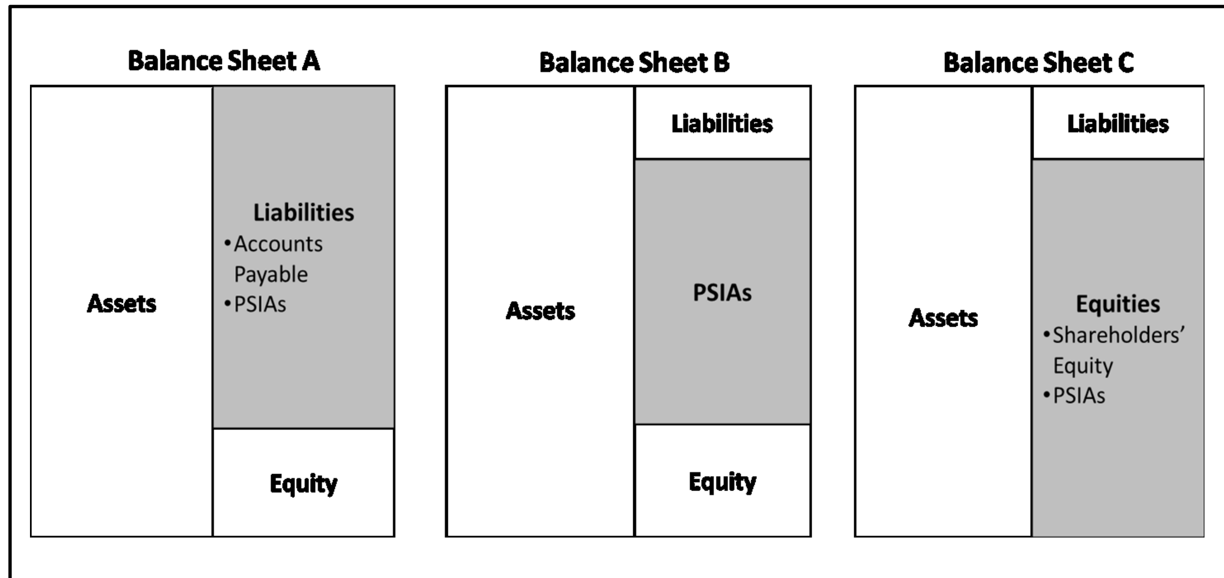
178-181; Shubber & Alzafiri, 2008, p. 18). Under this argument, the AAOIFI introduces unrestricted PSIAs as a mezzanine level between liabilities and equity.

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 2.5 illustrates the three possible classifications of PSIAs in the balance sheets.

Figure 2.5

Possible Classifications of PSIAs in the Balance Sheets



Despite the diverse opinions on how to classify PSIAs in the balance sheets, there is still an inconsiderable amount of research conducted to solve this problem. Most of the research on accounting for PSIAs focuses on the nature of PSIAs, which raises a major

problem of governance and supervision (Archer et al., 2010; Archer & Karim, 2009; Sundararajan, 2013).

The problems of governance and supervision are obvious, since the banks have ultimate control over the funds, instead of the depositors. The IAHs are exposed to the same risks as shareholders, but with no governance rights attached. In other words, there is a lack of protection for IAHs, which leads to more incentives for IAHs to monitor the banks' performance than conventional depositors (Archer & Karim, 2007b, p. 326). Accounting disclosures related to PSIAs are required to be more extensive, as this information should be more important in an Islamic environment (Lewis, 2001, p. 122).

The problem of classifying PSIAs in the balance sheet has created subsequent problems in accounting for PSIAs-related accounts, which are the returns to IAHs and the two reserve accounts, PER and IRR. Whether the returns to IAHs should be classified as expenses or distributions depends on the classification of the PSIAs themselves. Similarly, PER and IRR can also be recorded as part of the liabilities, shareholders' equity, or something in between, which is related to the classification of the PSIAs in the balance sheet.

2.6 Concluding Remarks

The discussion of Islamic finance revolves around the prohibition of interest, which has implications on accounting. In order to eliminate interest, Islamic banks employ Islamic financing modes. *Mudaraba* is the most dominant contract arrangement employed by Islamic banks to mobilize funds, including collecting money in the form of deposits.

Severe complications in accounting for PSIAs, specifically the unrestricted PSIAs that have become the most common type, have emerged. While conventional accounting methods will classify PSIAs as liabilities, the issue became debatable in the area of Islamic accounting.

There is still very limited research that provides ideas/arguments on how to account for PSIAs.

The next chapters will explore more relevant research related to PSIAs. Some research into conventional accounting, such as the discussions on various equity theories that have implications on reporting the credit-side of the balance sheets, will be utilized to help provide solutions to classify PSIAs in the balance sheets of Islamic banks.

Chapter 3

Accounting for Islamic Financial Institutions: The Application of Different Standards

3.1 Introduction

Accounting is a discipline that plays a significant role in the business world. Therefore, a country or jurisdiction carefully selects which institutions it delegates the authority for setting accounting standards to. In the United States, the Securities and Exchange Commission (SEC) appoints the FASB, an independent nonprofit organization, to establish and improve generally-accepted accounting standards in the country. Other countries, such as China, prefer to establish a department under the relevant government ministries to deal specifically with accounting standards.

In this globalized world, uniform financial reporting has become desirable. One of the advantages of applying uniform accounting standards across borders is "eliminating informational externalities arising from a lack of comparability" (Ball, 2006, p. 7), so foreign investors can easily assess the financial performance of a company without additional information acquisition costs. This of course, will not be possible without the existence of international accounting standard-setting bodies.

There is growing acceptance of the accounting standards developed by the IASB. Nonetheless, as explained in the previous chapters, Islamic financial transactions have unique characteristics that are not accommodated by conventional accounting. The nature and activities of Islamic banks are substantially different from those of conventional banks, as they are required to comply with *sharia* in all their transactions. This leads to the

establishment of the AAOIFI, an international nonprofit organization that develops accounting standards for IFIs.

Although the IASB and its standards, IFRS, have been widely known, accounting standards boards that specifically deal with IFIs remain rather inconspicuous in their importance. 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.

This chapter consists of six main sections. Following the introduction, Section 3.2 portrays the application of accounting standards for IFIs around the world by utilizing the Asian-Oceanian Standard-Setters Group (AOSSG) survey conducted and published in 2011. Section 3.3 provides information on two international accounting standard-setting bodies that appear to be the choice for accounting standards for IFIs in certain jurisdictions, which are the IASB and the AAOIFI. As some countries develop their own Islamic accounting standards, Section 3.4 specifically addresses the presence of national Islamic accounting standard setters in those countries. Section 3.5 is the discussion, which is then follwed by some concluding remarks in Section 3.6.

3.2 Accounting for Islamic Financial Transactions: Asian-Oceanian Standard-Setters Group's (AOSSG) Survey 2011

The AAOSG is a group of accounting standard-setters from Asian and Oceania countries that are actively engaged in the development of global accounting standards by discussing various matters related to the adoption of IFRS. Given the extent of the Islamic finance industry in the Asia-Oceania region and the efforts by regional jurisdictions at

converging or adopting IFRS, the AOSSG formed the AOSSG's Islamic Finance Working Group to raise issues and concerns regarding Islamic financial transactions.

In 2011, the AOSSG's Islamic Finance Working Group conducted a survey to understand how IFIs in certain jurisdictions report their transactions and tried to search for any differences in Islamic accounting standards. At the end of the year, the AOSSG published its survey results as a report entitled "Accounting for Islamic Financial Transactions and Entities".

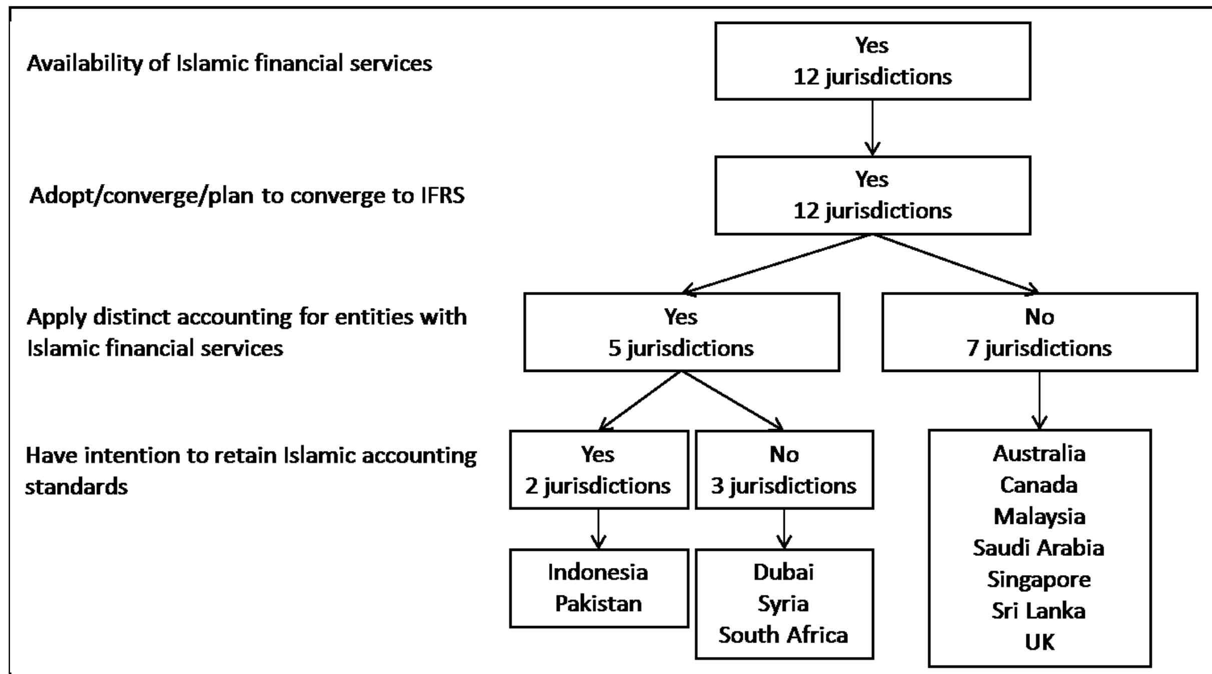
The survey found that the existence of Islamic financial services and accounting standards specific to Islamic financial transactions and entities in each responding jurisdiction varied. Although the AOSSG survey received a reply from 33 jurisdictions, only 24 responses[11] were valid. In order to improve the integrity of the results, the AOSSG included only authoritative responses from the standard setters (AOSSG, 2011, p. 36). Out of the 24 valid respondents, ten standard setters responded that no Islamic finance products were available in their jurisdictions, and another two stated that companies might engage in Islamic finance but only through their foreign subsidiaries in Muslim countries. Thus, they had no concerns on the application of accounting standards for IFIs.

As a result, there were twelve respondents that stated Islamic financial services existed in their jurisdictions. Figure 3.1 shows that all of the twelve jurisdictions that claimed to have Islamic financial services available in their jurisdictions were moving towards the adoption of, or convergence on, IFRS. Hence, it is not surprising that among those twelve respondents, only five jurisdictions, which are Dubai, Indonesia, Pakistan, South Africa, and Syria, applied distinct accounting for their IFIs. Responding to the working group's question on whether applying distinct accounting standards for IFIs was compatible with IFRS convergence or

[11]The 24 respondents are Australia, Belgium, Cambodia, Canada, Denmark, Dubai, Germany, Hong Kong, India, Indonesia, Iraq, Japan, Korea, Malaysia, Mexico, New Zealand, Pakistan, Saudi Arabia, Singapore, South Africa, Sri Lanka, Syria, United Kingdom, and Uruguay.

adoption, Dubai, Indonesia, and Syria did not see this issue as a problem while Pakistan and South Africa thought the opposite, although separate accounting standards are applied for IFIs in their jurisdictions.

Figure 3.1
AOSSG Survey 2011:
Accounting for Islamic Financial Transactions and Entities



Source: data obtained from AOSSG Survey (2011); figure created by author

The survey shows a global move to IFRS, either the countries surveyed are planning to, be in the process of, or have already converged on or adopted IFRS. All of the seven jurisdictions that did not apply distinct accounting standards for entities with Islamic financial services chose IFRS or national accounting standards based on IFRS. Similarly, five jurisdictions that specified another set of accounting standards for Islamic financial transactions had also adopted IFRS or national accounting standards based on IFRS for the entities in general.

Consequently, there is reluctance to retain separate financial reporting standards for Islamic financial transactions. Indonesia and Pakistan are the only two countries that strongly stated their intention to retain Islamic accounting standards. Table 3.1 presents the summary of the survey's results on jurisdictions that choose to apply specific accounting standards for Islamic finance. Their choices of accounting standards were either AAOIFI FAS or nationally developed Islamic accounting standards.

Table 3.1
AOSSG Survey 2011
Accounting for Islamic Financial Transactions and Entities in Jurisdictions with Separate Accounting Standards for IFIs

Country	Converge with, or adopt, IFRS	Accounting standards in general	Accounting reporting standards for entities engaged in Islamic finance	Future policy on Islamic accounting standards
Dubai	Yes	IFRS	AAOIFI FAS	We may need to review some of the requirements of Islamic accounting standards.
Indonesia	Yes	National standards based on IFRS	National Islamic standards *not* based on AAOIFI FAS	We will retain our Islamic accounting standards
Pakistan	Yes	IFRS	National Islamic standards adapted from AAOIFI FAS	We will retain our Islamic accounting standards
South Africa	Yes	IFRS	AAOIFI FAS	We may need to review some of the requirements of Islamic accounting standards.
Syria	Yes	IFRS	AAOIFI FAS	We may need to review some of the requirements of Islamic accounting standards.

Source: AOSSG Survey (2011); summarized by author

3.3 The International Accounting Standard-Setting Bodies

The AOSSG survey indicates that the majority of IFIs around the world are required to apply accounting standards developed by international accounting standard-setting bodies.

Nonetheless, they do not unanimously agree in the choice of which body should be the accounting standard setter for IFIs, as some of them choose the IASB and others prefer the AAOIFI. Henceforth, this section presents information on these two international accounting standard-setting bodies. As the name reveals, the main difference between the two boards is that the AAOIFI's scope of work specifically accommodates the characteristics of IFIs.

3.3.1 The IASB

3.3.1.1 The Background of the Establishment

The IASB was first established as the International Accounting Standards Committee (IASC), with the objective of promoting international accounting standards' harmonization. The initiative to establish the IASC came from Sir Henry Benson, a senior partner in the UK firm of Cooper Brothers & Co and also the president of the Institute of Chartered Accountants in England and Wales (ICAEW) in 1966-1967 (Zeff, 2012, p. 809). It was the rapid growth of international trade and foreign direct investment that motivated Benson to urge the mitigation of differences in accounting practices among countries (Zeff, 2012, p. 808-809).

The establishment of the IASC in 1973 involved national accounting bodies from nine countries, which were Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the United Kingdom and Ireland, and the United States (Zeff, 2012, p. 810). Nonetheless, McGregor (2012) noted that those accounting bodies' willingness to contribute resources to the IASC was not equal to their real interest in adopting the standards in their countries. The countries represented on the board did not amend their accounting standards, so they were closer to the International Accounting Standards (IAS), the standards issued by the IASC.

3.3.1.2 The Important Supports

The current success of the IASB in promoting IFRS cannot be separated from the IOSCO's proposal to the IASC in 1987. The IOSCO would consider endorsing the use of IAS if the IASC were to make significant improvements in its standards, including the elimination of accounting alternatives (McGregor, 2012, p. 226; Zeff, 2012, p. 814). The formal endorsement, however, happened long after the first approach, which was in May 2000, after the IASC decided to restructure itself. At that time, the IAS had undergone many processes of revisions to accommodate the IOSCO's requirements.

Other "support" came from the EU. It was unpalatable that the European Commission's announcement on the adoption of IAS in June 2000 had resulted in the IAS getting more attention from all over the world. The decision was legalized by an IAS regulation, announced on June 7, 2002, that the European Commission would impose the obligation to adopt IAS/IFRS by January 1, 2005 on EU listed companies.

3.3.1.3 The Transformation

The IASC was established as a part-time body with a relatively small staff, which is believed to be the reason for the IOSCO's reluctance to endorse the use of IAS. The IASC leadership finally decided to restructure itself in order to survive and achieve its objective of harmonizing accounting standards around the world.

The restructuration was not easy, since the members were divided into two groups: The independent expert model and the representational model (McGregor, 2012, p. 227). The European countries favored the representational model as it emphasizes the geographical representation of the key constituents and is mostly on a part-time basis. Nonetheless, the final decision chose to accommodate the independent expert model, which was in fact the

SEC's demand to transform the IASC into a body similar to the FASB that accentuates the independence and technical expertise of a small number of mostly full-time board members, assisted by a large research staff (Zeff, 2012, p. 819). Nobes and Parker (2008) noted that the SEC and the IOSCO became the main contributors to the transformation of the IASC into the IASB (p. 89).

The restructuration was approved at the Board's meeting in March 2000. In addition, the IASC would also be overseen by a Board of Trustees with 19 members. In its meeting in April 2001, the IASC officially changed into the IASB, with Sir David Tweedie as the first chairman (Zeff, 2012, p. 819-822).

3.3.1.4 Current Situation

The IFRS Foundation, the oversight body of the IASB, conducted a survey on the use of IFRS around the world. The result reveals that among the 150 jurisdictions that responded to the survey, (1) 84% or 126 jurisdictions required IFRS for all or most domestic publicly accountable entities, (2) 9% or 13 jurisdictions permit or require IFRS for some, while (3) the other 7% or 11 jurisdictions do not allow the application of IFRS for domestic publicly accountable entities in their jurisdictions (IFRS Foundation, 2017).[12][13]

This major shift toward an accounting world under IFRS is condemned as having variations in its implementation, as it may not correspond with "IFRS as issued by the IASB". Aside from "IFRS adopted by the EU", some jurisdictions that claim to have applied IFRS also assert that modifications to IFRS exist.[14] Also two big nations, which are China and the United States, still use their national accounting standards. Nonetheless, the growing number

[12]Including the EU as one jurisdiction.
[13]Information as of March 30, 2017.
[14]Some countries also adopt old version of IFRS. For example, Venezuela and Myanmar subsequently adopted the 2008 and 2010 versions of IFRS and have not updated them. In the survey by the IFRS Foundation, the two countries are included as jurisdictions that have required IFRS for all or most domestic publicly accountable entities.

of countries implementing IFRS still indicates that the IASB is the most successful international accounting standard-setting body to date.

3.3.1.5 The IASB's Concern with Islamic Financial Transactions

In order to answer the problems that may arise when IFRS are applied to *sharia*-compliant transactions, the IASB formed the Islamic Finance Consultative Group, formerly known as Consultative Group on *Sharia*-Compliant Instruments and Transactions.[15] This group held its inaugural meeting in Kuala Lumpur in July 2013.

The group members come from 15 different organizations, which are the IASB itself, the AAOIFI, the Islamic Financial Services Board (IFSB), Islamic Development Bank Group (IDB Group), International *Shari'ah*[16] Research Academy for Islamic Finance, General Council for Islamic Banks and Financial Institutions, Gulf Co-operation Council Accounting and Auditing Organization, the Malaysia Accounting Standards Board (MASB), the Indonesian Institute of Accountants (IAI), the Institute of Chartered Accountants of Pakistan (ICAP), Dubai Financial Service Authority (DFSA), Saudi Organization for Certified Public Accountants (SOCPA), Turkey Public Oversight, Accounting and Auditing Standards Board (POA), PricewaterhouseCoopers Malaysia, and Ernst & Young Saudi Arabia.

Although the AAOIFI is listed as a member, it did not directly respond to the IASB's invitation to join the consultative group. In the meeting in 2014, it was revealed that the AAOIFI had policies that restricted the organization from accepting the invitation (IASB Consultative Group on *Sharia*-compliant Instruments and Transactions, 2015, p. 4). The AAOIFI finally agreed to join the group in 2015 and acted as the host of the meeting in that year.

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[15]For further information on the IASB Islamic Finance Consultative Group, please refer to the IASB website: http://www.ifrs.org/groups/islamic-finance-consultative-group/

[16]*Sharia* and *shari'ah* are two words with identical meaning. See Footnote 1.

Despite many issues that IFIs are facing in applying IFRS, the meeting summaries of the consultative group show that it has not reached notable outcomes on how the problems of applying IFRS to Islamic financial transactions can be minimized. One specific issue, which is the application of IFRS 9 to Islamic finance, recurs in the discussions at the annual meeting. However, there was no meeting held in 2016, which begs the question of the commitment of the IASB in dealing with IFIs and their problems in applying IFRS.

3.3.2 The AAOIFI

3.3.2.1 The Background of the Establishment

Differing from the establishment of the IASB, which is widely known and documented by some notable persons in the accounting world (McGregor, 2012; Zeff, 2012), only a few know about the history of the AAOIFI. It is fortunate that Rifaat Ahmed Abdel Karim, who received his master's degree and PhD subsequently from the University of Birmingham and the University of Bath, UK, has been an active author on the topics of Islamic finance and accounting, and has also had his writings on the AAOIFI's early period published in some academic journals. Later, Karim served as an inaugural Secretary General of the AAOIFI from 1991 to 2002 (Alim, 2014, p. 161-162).

Karim (1990) observed that in the 1980s, 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). Thus, Islamic banks made an effort to apply accounting principles that do not violate *sharia* by setting their own accounting policies, which are different from the accounting policies for

conventional banks. These policies were commonly developed by the *sharia* supervisory boards, together with the external auditor of the bank (Karim, 1990, p. 300).

Considering the fear of Islamic banks and the growth of IFIs, the Islamic Development Bank (IDB) organized an annual meeting, attended by the Islamic banks, and took the initiative to discuss the possibility of creating accounting standards that could accommodate the unique characteristics of Islamic financing. The deliberation resulted in the signing of an agreement to establish the Financial Accounting Organization for Islamic Banks and Financial Institutions (FAOIBFI), the predecessor of the AAOIFI, on February 26, 1990. The FAOIBFI was officially registered as an international, autonomous, nonprofit organization on March 27, 1991 in the Kingdom of Bahrain, which has been the home base of the organization since then (AAOIFI, 2015, p. 13).

It was expected that the existence of an independent body that specifically develops accounting standards for IFIs could lead the regulatory agencies to understand the necessity for Islamic banks to have specific accounting standards, different from those implemented in the conventional financial institutions (Karim, 1990, p. 303). Furthermore, regulating the financial reporting of Islamic financial transactions was expected to encourage the establishment of new Islamic banks as well as increase the IFIs' financial reporting comparability (Pomeranz, 1997).

The initial organizational structure of the FAOIBFI comprised of seventeen members for the Supervisory Committee, the Financial Accounting Standards Board with twenty-one members, an Executive Committee appointed from within the members of the Financial Accounting Standards Board, and four members of the *Sharia* Committee (AAOIFI, 2015, p. 14).

3.3.2.2 The Transformation

Similar to the transformation of the IASC to the IASB, a restructuration also marked the transformation of the FAOIBFI to the AAOIFI in 1995. Nonetheless, this reorganization was performed only four years after the FAOIBFI started its official work. The extension of its scope of responsibilities from being solely for accounting into accounting and auditing became the main reason of the transformation.

The Supervisory Committee decided to form a review committee to look into the statute of the FAOIBFI and its organizational structure. The revised structure consisted of a General Assembly, a Board of Trustees as a replacement for the Supervisory Committee, an Accounting and Auditing Standards Board, an Executive Committee, a *Sharia* Board, and a General Secretariat to be headed by a Secretary General (AAOIFI, 2015, p. 14).

4.3.2.3 The Important Supporters

As the initiator and one of the founding members of the AAOIFI, the IDB, a multilateral financial institution headquartered in Jeddah, Saudi Arabia, has been providing strong support to the organization. During the period of the FAOIBFI, the costs of the organizational activities were paid by contributions from the IDB and the other founding members: Dar Al-Maal Al-Islami Group, Al Rajhi Banking & Investment Corporation, Dallah Al Baraka, and the Kuwait Finance House (AAOIFI, 2015, p. 14). Currently, those institutions are not the only fund providers to the AAOIFI, as every member should pay the stipulated membership fees.

In February 2000, the AAOIFI hosted a conference in Bahrain on the topic of the regulation of IFIs, with the International Monetary Fund (IMF) as the co-sponsor. This conference marked an important achievement by the AAOIFI in gaining global

acknowledgement for Islamic finance. Furthermore, the conference led to negotiations to establish the Islamic Financial Services Board (IFSB) in April 2002, with Rifaat Ahmed Abdel Karim as the Director (Smith, 2005). The IFSB plays its role as an international standards-setting organization that issues standards for the effective supervision and regulation of the Islamic financial services industry.

3.3.2.4 Current Situation

The AAOIFI currently has more than 200 financial organizations from all over the world as its members. This growing membership shows an increase in the global awareness of the AAOIFI standards. Karim (2001) highlights the existence of the AAOIFI, which caters to the unique characteristics of IFIs, as a way to provide comparable and transparent financial statements by the IFIs. This notion of Islamic accounting's harmonization is favored by the Deloitte Islamic finance leader survey in the Middle East (2010) in which 93% of respondents believed that the AAOIFI accounting standards are sufficient to ensure the best practice and transparency of the IFIs' financial reporting.

Yet, the AAOIFI still faces critical challenges. The establishment of the AAOIFI is criticized as being merely in name only; it has no enforcement powers. IFIs can report and disclose similar transactions in different ways, which later poses problems for those institutions themselves, as well as for the development of Islamic finance in general.

Despite the existence of the AAOIFI, Indonesia and Pakistan established their own Islamic accounting standard setting bodies. Thus, the implementation of common Islamic accounting in the various Muslim nations still needs cooperation and the support of accounting scholars, regulatory bodies, and the IFIs in those countries (Karim, 1995; Shanmugan and Perumal, 2005).

4.3.2.5 Standards Issued by the AAOIFI

The AAOIFI has issued a Conceptual Framework for Financial Reporting by the IFIs and 24 AAOIFI FAS (see Table 3.2). As the area of responsibility of the AAOIFI also covers auditing and governance, it has also issued five auditing standards, seven governance standards, and two codes of ethics.

Table 3.2

Conceptual Framework and Financial Accounting Standards Developed by the AAOIFI

Conceptual Framework for Financial Reporting by Islamic Financial Institutions	
FAS 1	General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions
FAS 2	*Murabaha* and *Murabaha* to the Purchase Orderer
FAS 3	*Mudaraba* Financing
FAS 4	*Musharaka* Financing
FAS 7	*Salam* and Parallel *Salam*
FAS 8	*Ijarah* and *Ijarah Muntahia Bittamleek*
FAS 9	*Zakat*
FAS 10	*Istisna* and Parallel *Istisna*
FAS 11	Provisions and Reserves
FAS 12	General Presentation and Disclosure in the Financial Statements of Islamic Insurance Companies
FAS 13	Disclosure of Bases for Determining and Allocating Surplus or Deficit in Islamic Insurance Companies
FAS 14	Investment Funds
FAS 15	Provisions and Reserves in Islamic Insurance Companies
FAS 16	Foreign Currency Transactions and Foreign Operations
FAS 18	Islamic Financial Services offered by Conventional Financial Institutions
FAS 19	Contributions in Islamic Insurance Companies
FAS 20	Deferred Payment Sale
FAS 21	Disclosure on Transfer Assets
FAS 22	Segment Reporting
FAS 23	Consolidation
FAS 24	Investments in Associates
FAS 25	Investments in *Sukuk*, Shares, and Similar Instruments
FAS 26	Investment in Real Estate[17]
FAS 27	Investment Accounts[18]

[17]FAS 17 was superseded by FAS 25 and 26.

[18]FAS 5 Disclosure of Bases for Profit Allocation between Owners' Equity and Investment Account Holders and FAS 6 Equity of Investment Account Holders and Their Equivalent were superseded by FAS 27.

3.4 Nationally Developed Islamic Accounting Standards

The AOSSG survey in Section 3.2 showed that Indonesia and Pakistan do not adopt accounting standards for their IFIs from any of the international accounting standard-setting bodies. In this section, the accounting standards for *sharia*-compliant transactions in those two jurisdictions are explained.

3.4.1 Indonesia

In Indonesia, the Banking Act No. 7 of 1992 first recognized and allowed the establishment of Islamic banks, although the term used in this act was "profit-sharing bank" instead of Islamic bank. This led to the inauguration of Bank Muamalat Indonesia, the first Islamic bank in Indonesia, which started its operations in the same year (Kasri & Kassim, 2009, p. 183). More acts were passed after the Banking Act No. 7/1992, e.g. Banking Act No. 10/1998, Central Bank Act No. 23/1999, and Islamic Banking Act No. 21/2008, which strengthened the roots of IFIs in Indonesia.

According to the Financial Service Authority of Indonesia (Indonesian: Otoritas Jasa Keuangan or OJK), there are 12 Islamic commercial banks, 22 Islamic business units[19], and 165 Islamic rural banks (OJK, 2016)[20]. As the world's most populous Muslim country, Indonesia is considered to be one of the most important players in the Islamic finance industry, and has created a demand for Islamic financial products.[21]

The accounting standards-setting body in Indonesia is established under the Indonesian Institute of Accountants (IAI), and known as the Indonesian Financial Accounting Standards

[19]Islamic business unit refers to conventional banks that have Islamic windows.
[20]As of June 2016.
[21]However, IFIs in Indonesia still face a huge challenge. From the 88% share of the Muslim population in Indonesia, IFIs serve only 4% of this population (Statistical, Economic and Social Research and Training Center for Islamic Countries (SESRIC), 2012, p. 8). Although this number is predicted to grow, it shows that public awareness of consuming *sharia*-compliant products is still low (Ika & Abdullah, 2011; Widagdo & Ika, 2007).

Board (Indonesian: *Dewan Standar Akuntansi Keuangan* or DSAK-IAI). After the initiation of the first Islamic bank in Indonesia, DSAK-IAI did not directly develop Islamic accounting standards. Thus, Islamic banks in Indonesia used the Statement of Financial Accounting Standards that was applicable in Indonesia at that time (Indonesian: *Pernyataan Standar Akuntansi Keuangan* or PSAK) No. 31 "Accounting for Banking Industry" and some of the AAOIFI standards.

In 1999, the Central Bank of Indonesia, known as Bank Indonesia, initiated the preparation of Islamic accounting standards by issuing the Decree of the Governor of Bank Indonesia No. 1/16/KEP/DGB/1999 which stated that Bank Indonesia, the DSAK-IAI, Bank Muamalat Indonesia, and the Ministry of Finance were the members of the standard-making team of PSAK for Islamic banking (Wiroso, 2010). Ten years after Islamic banks came into being in Indonesia, PSAK 59 "Accounting for Islamic Banking" was issued and came into effect on January 1, 2003, becoming the first milestone of Islamic accounting in Indonesia.

As certain contemporary issues may need additional explanations from an Islamic point of view, *ijma* or consensus, made by religious scholars, is necessary to work out issues peculiar to this modern day and age, including contemporary financial or accounting issues. In Indonesia, the National *Sharia* Board of the Indonesian Council of Islamic Scholars (Indonesia: *Dewan Syariah Nasional-Majelis Ulama Indonesia* or DSN-MUI) is responsible for issuing legal pronouncements on certain Islamic issues that are not directly mentioned in the Quran or *hadith*. Therefore, prior to the issuance of any Islamic accounting standards, it is necessary to get official approval from the DSN-MUI to ensure that the standards are in accordance with Islamic principles.

Due to the increasing activity and numbers of Islamic banks, which have developed into IFIs, the IAI established the Committee of *Sharia* Accounting in 2005 as a part of the DSAK-IAI to specifically prepare accounting standards for IFIs. In 2010, the IAI decided to

transform this committee into the *Sharia* Accounting Standards Board (Indonesian: *Dewan Standar Akuntansi Syariah* or DSAS-IAI) that has equal status with the DSAK-IAI.

Currently, ten Islamic accounting standards, which are PSAK 101-110, have been approved to refine PSAK 59. The DSAS-IAI has also issued a distinct framework for Islamic financial transactions, which is called the "Framework for Preparation and Presentation of Islamic Financial Statements". Table 3.3 lists the framework and standards that have been issued by the DSAS-IAI to account for Islamic financial transactions.

Table 3.3

Conceptual Framework and Financial Accounting Standards for Islamic Financial Transactions in Indonesia

Conceptual Framework for the Preparation and Presentation of Islamic Financial Statements	
PSAK 59	Accounting for Islamic Banking
PSAK101	Islamic Financial Statement Presentation
PSAK 102	Accounting for *Murabaha*
PSAK 103	Accounting for *Salam*
PSAK 104	Accounting for *Istishna*
PSAK 105	Accounting for *Mudaraba*
PSAK 106	Accounting for *Musharaka*
PSAK 107	Accounting for *Ijarah*
PSAK 108	Accounting for Islamic Insurance Transactions
PSAK 109	Accounting for *Zakat* and *Infaq/Sadaqah*[22]
PSAK 110	Accounting for Sukuk

Currently, the AAOIFI has issued more standards for Islamic financial transactions. Thus, in the case that no accounting standards can appropriately account for specific Islamic financial transactions, the DSAS-IAI allows IFIs in Indonesia to use AAOIFI FAS as a reference.

[22]Charity

3.4.2 Pakistan

In Pakistan, the history of Islamic accounting started when the Supreme Court of Pakistan decided that the Institute of Chartered Accountants of Pakistan (ICAP) should address the issues of accounting for Islamic finance. As a result, the Committee on Accounting and Auditing Standards of Interest-Free Modes of Financing and Investment was formed (Rammal & Parker, 2012, p. 14).

The Islamic Finance Department of the Securities and Exchange Commission of Pakistan (SECP) has made a commitment to adopt AAOIFI standards, including AAOIFI FAS (SECP, n.d.). Nonetheless, it seems to be far from a complete adoption of the set accounting standards developed by the AAOIFI. The Committee has so far only adapted, instead of adopted, three AAOIFI FAS into Islamic Financial Accounting Standards (IFAS), which are IFAS-1 "*Murabaha*", IFAS 2 "*Ijarah*", and IFAS-3 "Profit and Loss Sharing on Deposits". As there is no separate conceptual framework for Islamic financial statements, accounting for IFIs is still prepared under the same conceptual framework as for the conventional finance industry.

3.5 Discussion

Accounting standards for *sharia*-compliant transactions are developed to counter any accounting problems arising from the incompatibility of conventional accounting with the specific characteristics of Islamic finance. As conventional accounting standards, namely IFRS or accounting standards based on IFRS, may be perceived to be insufficient to account for IFIs business activities, some jurisdictions decided to apply a distinct set of accounting standards to IFIs. In the AAOSG survey in 2011, five jurisdictions, which are Dubai,

Indonesia, Pakistan, Syria, and South Africa, responded that they separated Islamic and conventional accounting.

However, the majority of the respondents prefer to have only one set of accounting standards for both the Islamic and conventional finance industries. Saudi Arabia and Malaysia, two countries ranked as the second and the third largest countries with *sharia*-compliant assets in 2013 (The Banker, 2013), did not provide distinct accounting standards for Islamic transactions. The Malaysia Accounting Standards Board (MASB) requires its accounting standards to be based on IFRS, and to be applied to Islamic financial transactions, although they still provide additional guidance which should not override the accounting standards.

In October 2011, the Dubai Financial Services Authority (DFSA) followed the MASB by publishing Consultation Paper No. 79 that discussed the possibility of accounting for IFIs to move from AAOIFI standards to IFRS. Currently, the "DFSA Rulebook: Islamic Financial Rules" has stated that IFIs' financial statements should follow the "DFSA Rulebook: General Module No. 8", which mandates the use of IFRS (DFSA, 2013a, p. 63). Despite the mandatory application of IFRS, the DFSA also requires the IFIs' financial statements to contain specific disclosures on Islamic financial transactions (DFSA, 2013b, p. 12).

The conflicts between IFRS and Islamic accounting standards are believed to stem from two fundamental financial reporting concepts, which are the *time value of money* and *substance over form* (AOSSG, 2010, para 15; ACCA & KPMG, 2012, p. 8-9). Time value of money is claimed to be associated with interest, while IFRS includes the use of discounted cash flows with reference to interest rates. Under IAS 39, for example, the use of valuation techniques that involve the calculation of the net present value of future cash flows, discounted at an appropriate rate of interest, is necessary to measure financial assets where an active market does not exist. Thus, the decision to adopt IFRS or accounting standards based

on IFRS for IFIs is difficult to follow by some jurisdictions that consider IFRS unacceptable for Islamic financial transactions.

The notion of substance over form, in which a transaction is measured and reported in accordance with its economic substance, rather than its legal form, is also deemed to be inappropriate from an Islamic perspective. According to *sharia*, it is the Islamic legal form that will ultimately determine the accounting form. *Ijaramuntahiabittamleek*, which is an Islamic form of leasing agreement with the transfer of ownership at the end of the *ijara* term, should be treated as a financing lease under IAS 17. AAOIFI FAS 8, on the other hand, states that the asset remains with the lessor until the legal title is transferred.

The debate over these points is continuing, as there are various schools of thought among *sharia* scholars that may result in different interpretations across jurisdictions. Those who welcome the time value of money concept in reporting Islamic financial transactions believe that it, in terms of showing the financing effect of a transaction, is different from charging interest on a loan. Substance over form, correspondingly, is not contradicted in *sharia* since reporting economic substance is as valuable as reporting its legal form, as long as the information about its legal form is disclosed in the notes of the financial statement (AOSSG, 2010).

Based on these reasons, the MASB delivered their conclusion at a roundtable meeting held by the ACCA and KPMG, "We feel that we can use the IFRS unless someone can show us that there is a clear prohibition in the *sharia*, and then we will amend it accordingly. Until such time, we'll use the IFRS" (ACCA & KPMG, 2012, p. 7). The MASB states that its approved accounting standards shall apply to *sharia* compliant financial transactions and events, unless there is a *sharia* prohibition (MASB Statement of Principles (SOP) *i*-1, 2009, para 6).

Nevertheless, there are jurisdictions that are reluctant to accept IFRS for Islamic financial transactions, since some unique characteristics of Islamic finance are not covered by IFRS. The profit sharing mechanism under *mudaraba*, a most popular form of Islamic transaction, has created PSIAs as a "hybrid" element between equity and liability, which is reported under AAOIFI FAS as unrestricted investment accounts. AAOIFI FAS classifies this item as a mezzanine level between liabilities and shareholders' equity.

As explained in Chapter 2, the no guaranteed return also brings the appearance of profit-sharing reserves, which are intended to stabilize profit sharing in IFIs. When the overall profit levels are low, IFIs forgo their own share of the profits in favor of their customers. In the Profit Equalization Reserve (PER), the reserve is set aside from any profits made, before applying the profit sharing distribution in order to match the current market return. There are different treatments for PER, which are a result of different treatments for the PSIAs.

Table 3.4 presents examples of different treatments for specific accounts under three accounting standards, which are the Malaysian Financial Reporting Standards (MFRS), which is equivalent to IFRS, AAOIFI FAS, and Islamic accounting standards in Indonesia (Indonesia PSAK *Sharia*).

Table 3.4

Different Treatments on Specific Accounts

Standards / **Treatments**	**MFRS**	**AAOIFI FAS**	**Indonesian PSAK *Sharia***
Mezzanine level between liability and equity	No	Yes, called equity of unrestricted IAH	Yes, called temporary *syirkah* funds
PER	Liabilities and equity	Equity of unrestricted IAHs and owners' equity	No PER account (PER is considered *haram* or unlawful)
Ijarahmuntahiabittamleek (*ijara* with purchase option)	Similar to finance lease	Similar to operating lease	Similar to operating lease
Corporate *zakat*	Tr*i*-1 (guidelines)	FAS 9	No accounting standards or guidelines for corporate *zakat*[23]

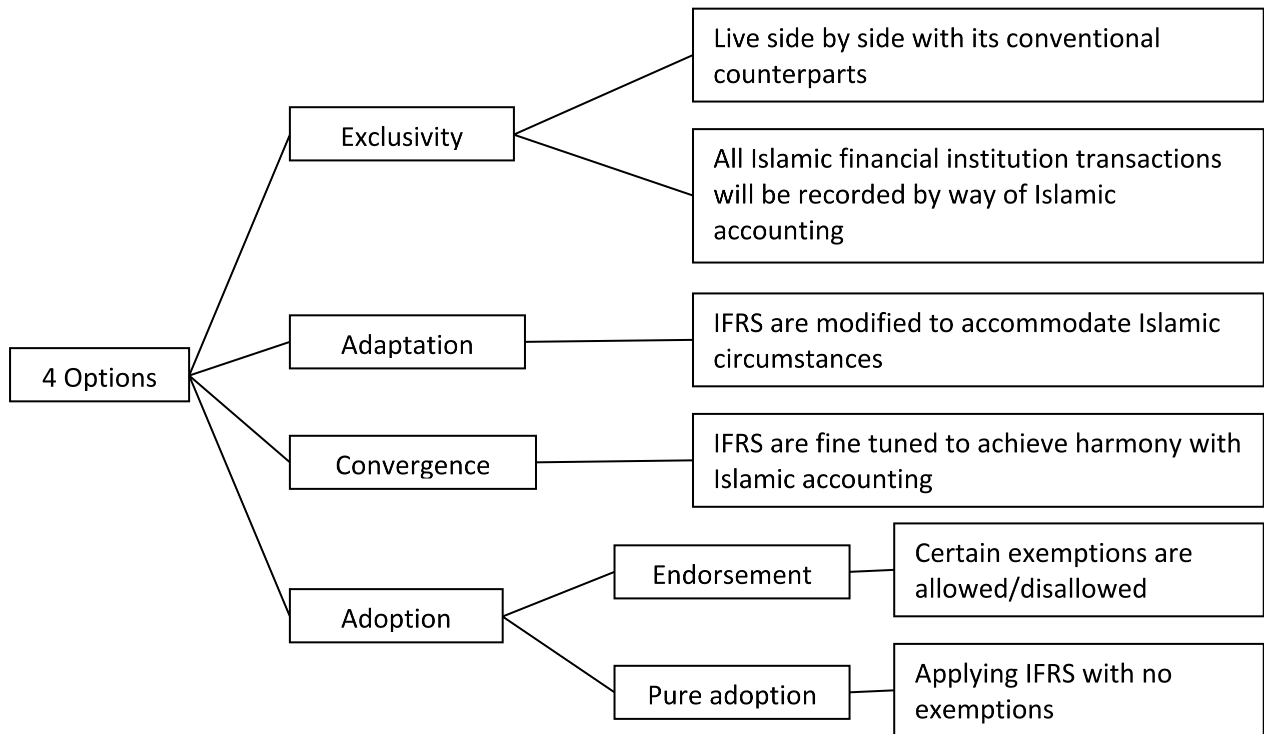
The Islamic financial industry has been facing the challenges of preparing financial statements under various accounting standards. Despite the initiative from the AAOIFI to develop specific accounting standards for IFIs, many IFIs apply IFRS or IFRS-based accounting standards because they are required to by the authorities in their jurisdictions.

There are four possible options for Islamic accounting regarding its position with IFRS (Figure 3.2). The first is exclusivity: Islamic transactions are provided with separate standards and live side by side with their conventional counterparts. Indonesia, Pakistan, and juristictions that currenlty apply AAOIFI FAS prefer this option. The second option is adaptation, where IFRS are modified to accommodate Islamic circumstances. In this option, it is possible that major modifications to IFRS have to be applied. The third one is convergence where IFRS are fine-tuned; both sides work together to achieve harmony. The last option is adoption, which can be divided into endorsement and pure adoption. With the

[23] PSAK 109, "Accounting for *Zakat*, *Infaq*, and *Sadaqah*", are issued specifically for *amil* or *zakat* institutions that collect and distribute *zakat*, mostly from individuals. It is different from FAS 9 that are issued for IFIs on how to calculate and report corporate *zakat*.

endorsement option, certain exemptions are still allowed while pure adoption does not tolerate any exemptions.

Figure 3.2
The Possible Options for Islamic Accounting



Source: modified from Abdullah (2010)

In countries where there are no specific standards for IFIs, thus forcing those institutions to follow IFRS or national standards largely based on IFRS, the condition has had the effect of "a lack of adequate transparency and comparability of financial statements and proper presentation and adequate disclosure to reflect the universal banking nature of Islamic banks" (Archer & Karim, 2007a, p. 304). Mohd Nasir and Zainol (2007) also doubt whether it is feasible to create a common accounting language, since IFRS, which is dominated by Anglo-American accounting thought and practices, is trying to achieve very economically oriented objectives. It is different from Islamic accounting, which attempts to comply with

sharia to achieve socio-economic objectives. On the other hand, it should be noted that adopting IFRS may result in improved comparability and foreign mutual ownership (DeFond, Hu, Hung, & Li, 2011). IFIs may thus have to bear the consequences of using separate standards.

The IASB, with endorsement from the IOSCO, and the adoption of IFRS by the EU, has undoubtedly gained the world's attention. The AAOIFI may have been successful in attracting more interest in Islamic finance, but it does not have enough power to require more countries to adopt AAOIFI FAS. Instead, some jurisdictions, such as Dubai, have shifted the accounting standards for IFIs to IFRS.

Although the results of the AOSSG survey can assist in giving the outlook for the current global Islamic accounting situation, this survey deals with limitations related to the number of respondents; some of the considerable players in Islamic finance such as Iran, Kuwait, and Bahrain are not listed as participating jurisdictions. There is the necessity for more abundant cross-border comparability among the primary players in the Islamic financial industry, to find out whether any positive future intention exists for keeping the development of Islamic accounting on track.

3.6 Concluding Remarks

The rapid growth of the Islamic financial industry has been one of the important factors behind the emergence of Islamic accounting. Conventional accounting, which developed based on the Western worldview, is considered to be insufficient to accommodate the unique characteristics of IFIs. Prior to the establishment of the AAOIFI, almost every IFI set its accounting policy internally (Karim, 1990). Nowadays, based on the accounting standards used, there are five groups of IFIs reporting Islamic financial transactions under: (1) IFRS or local GAAP based on IFRS; (2) IFRS or local GAAP based on IFRS with some additional

guidelines; (3) by adopting AAOIFI FAS; (4) by adapting AAOIFI FAS; and (5) by using national Islamic accounting standards.

As the previously discussed issues have shown, Islamic accounting does not refer to a uniform set of standards. Each jurisdiction has a diverse understanding of Islamic rulings, which results in different accounting treatments for Islamic financial transactions. These different opinions and the varied understanding of *sharia* have become the biggest challenges to a common set of global Islamic accounting standards.

Additionally, the global movement towards IFRS convergence or adoption is likely to influence the choice of accounting standards for IFIs. Dubai, South Africa, and Syria who all implement AAOIFI accounting standards were rethinking the future of Islamic accounting in their jurisdictions, as they moved towards IFRS (AOSSG, 2011). Thus, harmonizing Islamic accounting standards under AAOIFI accounting standards is presumably a long way from being accomplished, as the AAOIFI has no power to enforce the adoption of AAOIFI FAS.

Despite the similar movement towards IFRS in Muslim-majority jurisdictions, there are diverging opinions on how accounting for IFIs should move towards this global accounting phenomenon. In the AOSSG survey, only two out of the five jurisdictions with Islamic accounting standards revealed their intention to retain their Islamic accounting standards.

Chapter 4

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

4.1 Introduction

In the discussions on accounting for Islamic banks, or IFIs in general, the existence of PSIAs has been one of the most controversial issues. The profit-sharing basis, which is the key feature of most "deposits" in Islamic banks, has created a unique consequence in which Islamic banks do not have the obligation of returning the funds to the IAH in the case of a loss, unless it is due to the negligence of the banks.

The fundamental consideration depends on whether PSIAs represent equity, as these funds are not capital certain (Archer & Karim, 2009), or whether they are a liability, since the IAHs possess no ownership rights, unlike shareholders do (Atmeh & Ramadan, 2012; Shubber & Alzafiri, 2008) and there is also a constructive obligation arising out of established practices and regulatory expectations (ACCA & KPMG, 2012, p. 11). As such, the implementation of different accounting standards for Islamic banks has resulted in the dissimilar classification of PSIAs in the balance sheets.

The AAOIFI, an organization that develops accounting, auditing, and governance standards by taking IFIs' unique characteristics into consideration, has required Islamic banks to classify PSIAs as a new element between liabilities and equity. Nonetheless, the great achievement of the IASB in promoting IFRS has also been noticeable in IFIs around the world. Thus, IFRS has become a catalyst for the uniform reporting standards for Islamic banks, including how to account for PSIAs in their balance sheets.

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*-compliance 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 a national accounting standard setter, the *Sharia* Accounting Standards Board of the Indonesian Institute of Accountants or 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.[24]

In performing this 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.

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[24]Pakistan has so far issued only three Islamic accounting standards with no separate conceptual framework for *sharia*-compliant transactions. Thus, it is excluded from the discussion in this chapter.

After the introduction, the next section will provide an outline of each conceptual framework: The IASB conceptual framework, which will be used as a basis of comparison, followed by the two Islamic conceptual frameworks, which are the AAOIFI and the DSAS-IAI conceptual frameworks. The subsequent section, which is the main part of this paper, compares PSIAs in the Islamic conceptual frameworks with the IASB conceptual framework. The last section concludes the analysis and discussions.

4.2 Conceptual Framework for Financial Reporting

4.2.1 The Early Attempts to Develop a Conceptual Framework

Historically, accounting standards were developed without the existence of a conceptual framework. Despite the acknowledgement from Zeff (1999) that sees the works of William A. Paton and John B. Canning in the 1920s as the earliest attempts to develop a conceptual framework (p. 89-90), the first conceptual framework for financial accounting was only issued in 1978, by the FASB. Thus, the notion of a conceptual framework for financial accounting itself can in fact be considered as a relatively new concept.

Marshall S. Armstrong, the first chairman of the FASB, justified at the beginning of the FASB's attempt to develop a conceptual framework that its Board will rely on it for establishing financial accounting and reporting standards, although it may not solve all the accounting problems (Storey and Storey, 1989, p. 67). In other words, a sound conceptual framework should be capable of guiding the development of consistent accounting standards over time.

Nonetheless, Macve (1997) argued that an agreed conceptual framework seemed to be impossible to build, as it could not be separated from the influence of the political process (p. 70), not to mention the early attempts by the US to develop a conceptual framework found it

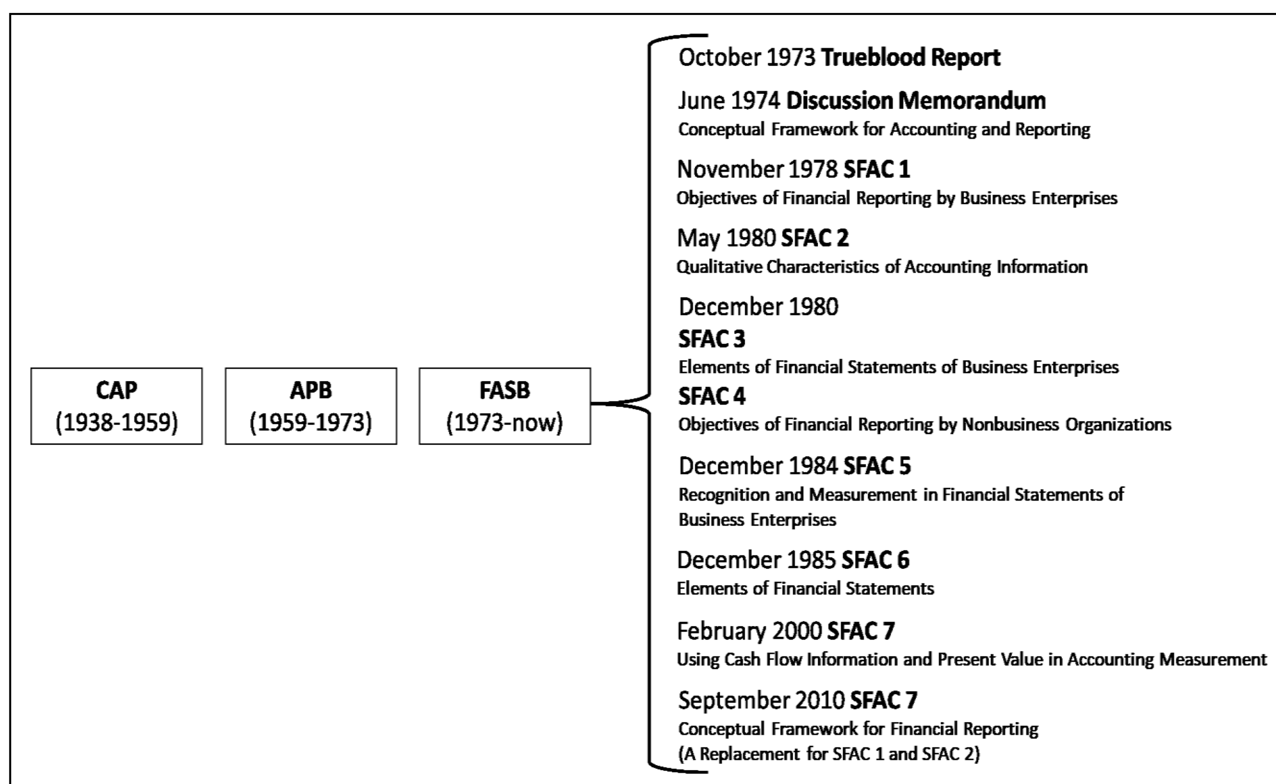
to be a long and winding road. Zeff (1999) marks the American Accounting Association's (AAA) publication in 1936 entitled "Tentative Statement of Accounting Principles Affecting Corporate Reports", published in *The Accounting Review*, as the first institutional endeavor to provide a conceptual framework for financial accounting (p. 90).

The FASB was established due to the failure of its predecessors, the Committee on Accounting Procedure (CAP), and the Accounting Principles Board (APB) to accomplish their tasks. The Trueblood Report on the Objectives of Financial Statements, delivered to the FASB in October 1973, had become one of the most influential reports on the conceptual framework project. It also led to the first use of the term "Conceptual Framework for Accounting and Reporting" by the FASB in its news release on December 20, 1973 (Storey & Storey, 1998, p. 48), followed by the first discussion memorandum, "Conceptual Framework for Accounting and Reporting" in June 1974.

After long endeavor, the FASB finally issued its Statement of Financial Accounting Concepts (SFAC) 1 "Objectives of Financial Reporting by Business Enterprises" in November 1978. The six concept statements were completed in 1985, with some amendments to include not-for-profit organizations. The program to develop a conceptual project continued with the issuance of SFAC 7 in 2000 and the joint venture with the IASB resulted in the replacement of SFAC 1 and 2 with SFAC 8 (further explained in the IASC Conceptual Framework).

Figure 4.1

The Early Conceptual Framework Project in the US



The FASB's successful leap, which took a great deal of time and energy, has embedded the importance of conceptual frameworks to serve as statements for the most basic concepts with which all the accounting standards should conform. The attempts to develop conceptual frameworks were later followed by other countries' accounting standards-setting bodies, including those that develop Islamic accounting standards.

4.2.2 The IASB Conceptual Framework

The IASB, an independent standard-setting body that develops IFRS, was formed in 2001 as the successor to the International Accounting Standards Committee (IASC). It has currently achieved some notable success by gaining more than 100 countries support for the implementation of IFRS.

After the transformation in April 2001, the IASB fully adopted the IASC's conceptual framework. The conceptual framework, entitled "Framework for the Preparation and Presentation of Financial Statements", was originally approved by the IASC in April 1989 for publication in July 1989.

As a result of the Norwalk Agreement in 2002, the IASB and the FASB initiated a joint conceptual framework project. This project, under which the two boards agreed to work jointly on future standards, and to align existing ones, was added to the agendas of the boards in October 2004. It was expected that a common conceptual framework could remove the existing differences between the two frameworks, to fill any gaps in them, and to make improvements where necessary (Whittington, 2008).

However, the IASB and the FASB decided to suspend the joint project to create a conceptual framework as they wanted to concentrate on other projects on their agendas. After issuing the Discussion Paper (DP) and the Exposure Draft (ED), the two parts that had been finished, which are "The Objective of General Purpose Financial Reporting and The Qualitative Characteristics of Useful Financial Information" were issued by the boards, partly replacing the previous conceptual frameworks.

In 2012, the IASB continued its conceptual framework project, with no involvement by the FASB. After more than five years of the project, the final version of the conceptual framework that includes some new chapters was issued in March 2018. Figure 4.2 below displays the documents for a conceptual framework that have been issued by the IASB.

Figure 4.2

Documents Issued on IASB Conceptual Framework Project

	IASC (IASB) Conceptual Framework	IASB/FASB Joint Project		IASB Comprehensive Project		
Objective	1989 (2001)	DP July 2006 ED May 2008	Issued September 2010	DP July 2013	ED May 2015	Issued March 2018
Qualitative Characteristics						
Reporting Entity		ED May 2008 ED March 2010				
Elements	1989 (2001)					
Recognition						
+ Derecognition						
Measurement	1989 (2001)					
Presentation and Disclosure						
Concepts of Capital and Capital Maintenance	1989 (2001)					

[shaded box] : Proposed new chapters of the conceptual framework (Reporting Entity, + Derecognition, Presentation and Disclosure)

Source: modified from the IASB website http://www.ifrs.org/Current-Projects/IASB-Projects/Conceptual-Framework/Documents/May%202015/Snapshot_Conceptual%20Framework_May2015.pdf

4.2.3 Islamic Conceptual Frameworks

As discussed in the previous chapter, IFIs around the world are not of one voice with regard to the accounting standards they apply. While many of them do not consider it necessary for IFIs to have separate financial accounting standards, some of them prefer to apply the AAOIFI conceptual framework and financial accounting standards, which are currently adopted in Bahrain, Sudan, Jordan, Qatar, Syria, Lebanon, and South Africa.

The AAOIFI calls its conceptual framework the “Conceptual Framework for Financial Reporting by IFIs”. Despite the presence of the word “IFIs” in the title, the AAOIFI explains on “Basis for Conclusions” that this conceptual framework can also be applied to entities other than IFIs (AAOIFI, 2015, Conceptual Framework for Financial Reporting by Islamic Financial Institutions (Conceptual Framework), p. 83). Further, it elaborates that the term

"IFIs" shall include all institutions conducting *sharia*-compliant transactions, which reflects the AAOIFI intention to expand its coverage to industries other than the finance industry.

The DSAS-IAI is the only national accounting standard setter that has developed a conceptual framework and some accounting standards. Similar to the AAOIFI, it also claims in its conceptual framework entitled "Conceptual Framework for the Preparation and Presentation of Islamic Financial Statements" that it covers not only IFIs, but also all entities conducting transactions in accordance with *sharia* principles.

The claim of the two boards is in line with the definition of Islamic accounting according to Napier and Haniffa (2011), who define it as "accounting ideas and practices that have some fundamental differences from their conventional counterparts, resulting from the adherence to *sharia* principles" (p. xiii). Despite the present-day focus of Islamic accounting on IFIs, Islamic accounting has been developed based on *fiqh al-mu'amalat* or Islamic commercial jurisprudence, which covers much more than just the financial services industry.

4.2.3.1 The AAOIFI Conceptual Framework

The AAOIFI made its first attempt at developing a conceptual framework in 1992, when it was still under its former name, the FAOIBFI. The attempt was probably driven by the development of previously mentioned conceptual frameworks in the West at that time, namely the FASB conceptual framework (started in 1978), the IASC conceptual framework (1989), and also the ED of "The Objectives of Financial Statements and the Qualitative Characteristics of Financial Information", which is a part of a conceptual framework by the Accounting Standards Board (1991) (Karim, 1995, p. 292).

Karim (1995) notes that the FAOIBFI issued two EDs in September 1992: The objectives of financial accounting and the concepts of financial accounting. After going through a revision process in April 1993, those two drafts were officially approved by the

Financial Accounting Standards Board of the FAOIBFI in October 1993 (p. 289). However, the FAOIBFI did not explicitly label them as conceptual frameworks. Instead, the FAOIBFI named them as Statement of Financial Accounting (SFA) No. 1 “Objective of Financial Accounting for Islamic Banks and Financial Institutions” and SFA No. 2 “Concepts of Financial Accounting for Islamic Banks and Financial Institutions”. Although the FAOIBFI changed its name to the AAOIFI in 1995 due to the extension of its scope of responsibilities from solely accounting into accounting, auditing, ethics, and corporate governance, this transition did not affect the conceptual framework.

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 Gambling and Karim (1991), Adnan and Gaffikin (1997), 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).

In July 22, 2010, the AAOIFI approved the merger of those two statements into the “Conceptual Framework for Financial Reporting by Islamic Financial Institutions”. Although the content does not contain major changes, the AAOIFI amended some parts and shortened some detailed explanations in SFA Nos. 1 and 2. In this new conceptual framework, the AAOIFI altered the explanation of the approach to developing the conceptual framework, which consists of:

1. “The identification of accounting concepts which have been previously developed by the other standard-setting bodies, which are consistent with the Islamic principles and ideals of accuracy and fairness.
2. The identification of aspects that require disclosure and greater transparency to abide by the principles and ideals of the Islamic *sharia.*
3. The identification of concepts which are used by other standard-setting bodies that conflict with *sharia* and the development of new relevant concepts for the purpose of financial reporting by IFIs.
4. The development of concepts to address the unique nature of certain transactions, events or conditions in IFIs. Examples include funds mobilized by IFIs under the *mudaraba* model.
5. The identification of the major users, particularly those that do not have the authority or ability to access information not included for the general purpose of financial reports.
6. The determination of the information needs of the users of financial reports that require to be addressed.”

   (AAOIFI, 2015, Conceptual Framework, para 1/3).

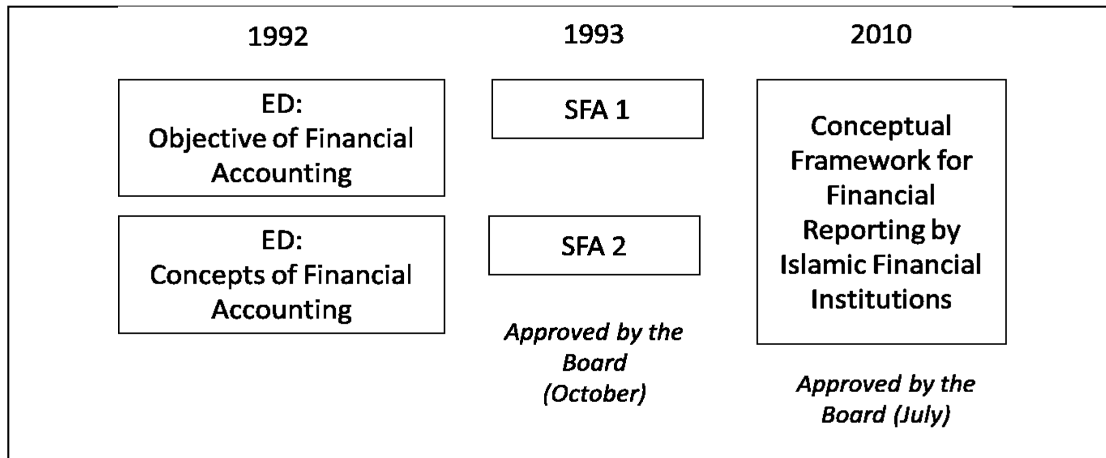
Despite the alteration, it is still apparent that a pragmatic approach dominates the development of the AAOIFI’s conceptual framework.

In addition, the AAOIFI clarifies the rationale behind the development of its conceptual framework, as well as separate accounting standards for IFIs, which are: (1) The obligation to adhere to *sharia* in all of their activities; (2) the prohibition of interest changes the creditor-debtor relationship between IFIs and related parties, particularly “depositors”, into fund providers-fund managers; and (3) the necessity to provide the unique and specific information needs of the common users (AAOIFI, 2015, Conceptual Framework, para 1/1).

Point (2) underlines that PSIAs, as one of the main characteristics of IFIs, should be given careful consideration in the conceptual framework.

Figure 4.3

The Development of AAOIFI Conceptual Framework



4.2.3.2 **Sharia** ***Conceptual Framework in Indonesia***

The accounting standard-setting body in Indonesia, the Indonesian Financial Accounting Standards Board (DSAK-IAI), was established under the Indonesian Institute of Accountants (IAI). Despite the convergence process of Indonesian Financial Accounting Standards (PSAK) with IFRS, IFIs are subject to a separate set of accounting standards.

In January 2003, one accounting standard, PSAK 59 *Accounting for Islamic Banking*, was effective in Indonesia. At that time, DSAK-IAI was responsible for the development of the accounting standards for Islamic banks; there was no specific accounting standard setter for *sharia*-compliant transactions. Thus, IFIs in Indonesia at that time still adopted the same conceptual framework as other industries.

Due to the increasing public interest in IFIs, as well as the growth of this industry, the IAI established a separate committee to develop Islamic accounting standards in 2005, namely the Committee for *Sharia* Accounting, as a part of the DSAK-IAI. This committee

initiated the development of a specific conceptual framework and finally issued the *Conceptual Framework for the Preparation and Presentation of Islamic Financial Statements* in June 2007. In 2010, the IAI decided to transform this committee into the *Sharia* Accounting Standards Board (DSAS-IAI) that has equal status with the DSAK-IAI and this new Board has adopted the conceptual framework with no revisions.

4.3 PSIAs in the Conceptual Frameworks for Financial Reporting

Before further examining PSIAs in each conceptual framework, one important caveat should be carefully paid attention to. According to Pro-Active Accounting Activities in Europe (PAAinE) (2008), the discussions on what elements should constitute the credit side of a balance sheet should take close account of the objectives of financial statements. Meanwhile, these objectives cannot be separated from the identified users of financial statements. Consequently, in order to examine PSIAs in each conceptual framework, this paper will limit its focus to those three topics of conceptual frameworks: The users of financial information, the objectives of financial accounting, and the elements of financial statements. Other topics including the qualitative characteristics of financial information will be overlooked, so as to avoid the discussion expanding to other topics irrelevant to the classifications of PSIAs in the balance sheets.

4.3.1 Users of Financial Information

The 1973 Trueblood Report notes that the objective of financial statements is heavily influenced by the user's need for information. Accordingly, it is essential to identify the primary users of financial statements.

The identification of the users of financial statements in the AAOIFI and the DSAS-IAI conceptual frameworks is not identical. Nonetheless, both recognize the information needs of a wide range of users as shown in Table 4.1 below.

Table 4.1

Users of Financial Information

AAOIFI	DSAS-IAI	IASB
Investors: Equity holders **IAHs** Creditors **Debtors** **Employees** Others who deal with IFIs in any **other manner**	Investors *Qard*[25] fund provider **Temporary *syirkah*[26] fund holders (IAHs)** *Wadiah*[27] fund owner **The payers and receivers of *zakat*[28], *infaq*[29], *sadaqah*[30], and *waqf*[31]** ***Sharia* supervisors** **Employees** **Suppliers and other business partners** **Customers** **Government** **Community**	Primary users: Investors Lenders Other creditors

The bold marks the differences with the IASB conceptual framework.

The AAOIFI considers that those users whose access to information is limited, and therefore rely on the information presented in the company's financial statements, to be the major users of financial reports (AAOIFI, 2015, Conceptual Framework, para 1/3/e). Although government agencies are also external users, they are not considered to be one of

[25]*Qardh* refers to interest-free loan. It may also cover *wadiah*.
[26]Joint partnership.
[27]*Wadiah* refers to a contract between the bank and the customer or depositor on the basis of safekeeping. An example is a current account, in which the bank guarantees full return or refund to the depositors. However, the depositors commonly also give permission for the banks to use the fund for investment. The depositors are not entitled to any profits from the investment.
[28]Obligatory contribution assessed based on certain assets owned by a Muslim that satisfy certain conditions and is to be distributed to specified categories of beneficiaries.
[29]Any benevolent spending approved by *sharia.*
[30]Charity.
[31]Religious endowment.

the major users of financial reports since they have the power and authority to directly obtain the information they need (AAOIFI, 2015, Conceptual Framework, para 1/4).

In mentioning investors as one of the users of financial information, the AAOIFI expands the scope of investors by not limiting it just to shareholders, but also IAHs[32] (AAOIFI, 2015, Conceptual Framework, para 1/4). Nonetheless, on "Basis for Conclusion", the AAOIFI (2015) mentions that the information in the financial statements is targeted primarily at "capital providers" (p. 83), in which the term "capital providers" is used as a replacement for "shareholders"[33]; this makes it unclear what the AAOIFI considers to be either "capital" or a "capital provider". There is inconsistency between the explanations in "Basis for Conclusion" and in the main part on how the AAOIFI identify the users of financial statements. Likewise, there is no further explanation of how debtors are included as users of financial information or how they are similar to other financial statement users.

Furthermore, the AAOIFI considers that the wide range of users have common information needs, which are information to: (1) Evaluate IFIs' compliance with *sharia;* (2) assess inherent risk; (3) evaluate IFIs' ability to use and safeguard economic resources, carry out their social responsibilities, provide for the economic needs of those who deal with the IFIs, maintain liquidity; and (4) evaluate employment relationships (AAOIFI, 2015, p. 46, para 1/5). Despite the so-called "common" information needs, "evaluating employment relationships" seems to be specific rather than a common information need of all the users.

Similar to the AAOIFI, the DSAS-IAI agrees that IAHs should be explicitly recognized as one of the users of financial statements. However, there is a dissimilar choice of terms. The DSAS-IAI prefers to label PSIAs as "temporary *syirkah* funds", and temporary *syirkah*

[32]However, the AAOIFI also uses the term "equity and investment account holders", which limits the term "equity holders" to shareholders only (AAOIFI, 2015, Conceptual Framework, para 1/4).
[33]The paragraph states that, "The information presented in the financial statements is, nonetheless, targeted primarily at capital providers. Furthermore, adopting the entity perspective does not preclude the IFIs from including within the financial reports information relevant to other key stakeholders, including IAHs, fund providers, employees or for that matter regulators and government agencies" (AAOIFI, 2015, p. 37).

funds holders as the fund providers or IAHs. Nonetheless, both IAHs and temporary *syirkah* fund holders imply PSIAs holders. In order to simplify, temporary *syirkah* fund holders will also be called IAHs.

The explicit recognition of IAHs as one of the users of financial information is unsurprising, as the interest-free system places stress on partnership, which makes the Islamic financial system become an equity-based system instead of a debt-based one (Akacem & Gilliam, 2002). Furthermore, Al-Deehani et al. (1999) also drew from a sample of 12 Islamic banks, mostly from Middle Eastern countries, and found about 74 % of the total funds were PSIAs, which denotes the importance of IAHs to Islamic banks.

Nonetheless, inconsistency in the use of the term "investors" is found in the DSAS-IAI conceptual framework. The DSAS-IAI uses the expression "investors" to cover only shareholders but excludes IAHs in one place, but refers to temporary *syirkah* fund holders as the owners of temporary *syirkah* investment funds in another sentence (DSAK-IAI, 2007, para 09).

In addition, instead of using the term "creditor", the DSAS-IAI specifically lists "*qard* fund provider" and "*wadiah* fund owner" as users of financial statements. Despite the similarities between "*qard*" and non-interest bearing loans and also the similarities between "*wadiah*" and safekeeping deposits, it seems that DSAS-IAI tried to accentuate the absence of interest in Islamic business activities by choosing neutral terms rather than frequently-used terms such as creditors and depositors.

Although the DSAS-IAI does not use the term "primary" users, it admits that shareholders and IAHs are providers of risk capital or funds to the entity. Therefore, the provision of financial statements that meet their needs will also meet most of the needs of other users. A similar statement can be found in the IASC conceptual framework, which was

later adopted by the IASB (hereinafter, the IASC conceptual framework), in which the Board states that "investors are the providers of risk capital to the entity" (IASB, 2001, para 10).

In comparison to the AAOIFI and the DSAS-IAI which both list a wide range of users, the IASB precisely mentions that investors, both existing and potential investors, lenders and other creditors, are the primary users of financial information (IASB, 2010, OB5). By placing all capital providers as the primary users, the IASB conceptual framework may gain acceptance in countries where banks are institutional investors that provide capital needed for expansion, as well as in countries where equity markets are a major source of financing. Nonetheless, the decision of the IASB to exclude broader users as users of financial information is criticized by Zhang and Andrew (2014) as the symbol of the success of financialization, wherein financial markets became a proxy for the public interest (p. 21).

4.3.2 The Objectives of Financial Reporting

Decision-usefulness has been widely known as the objective of financial reporting. In the Islamic conceptual framework, this is also generally the case, but with a broader context. Table 4.2 shows comparisons between the objectives of financial reporting according to the AAOIFI, the DSAS-IAI, and the IASB.

Table 4.2

The Objectives of Financial Reporting

AAOIFI	DSAS-IAI	IASB
General objectives: To provide information about the IFIs' financial positions, their results from operations and cash flows as well as assets they are responsible for, to **assist users in making decisions with regards to the financial aspects** as well as the *sharia* compliance consideration Objectives of financial accounting • To determine the rights and obligations of all interested parties, in accordance with *sharia* • To contribute to the enhancement of the managerial and productive capabilities of the IFIs and encourage compliance with their goals and *sharia* • To provide useful information to users to enable them to make decisions when dealing with IFIs Objectives of financial reports To provide information on: • Compliance with *sharia* • IFIs' economic resources and related obligations • Determination of *zakat* • Fiduciary responsibilities • Social responsibilities	Main objective To provide information about the financial position, performance, and changes to the financial position of an Islamic entity that is **useful for making economic decisions to a wide range of users** Other objectives: • To enhance the compliance with *sharia* • To provide information on the compliance with *sharia* and non-compliance, if any • To evaluate the responsibility of the entity in safeguarding the funds and investing them at a reasonable profit rate • To provide information on the investment rate of return for shareholders and temporary *syirkah* fund holders, as well as information on the social functions of the entity. Implicit objective: To assess the stewardship or accountability of management	To provide financial information about the reporting entity that is **useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity**

The bold marks the similarity.

The AAOIFI provides the objectives of financial accounting and financial reports for IFIs separately, but there is no clear distinction of what financial accounting and financial reports are, or any explanation about why there should be different objectives for both. The objectives underline that determining the compliance with *sharia* of the IFIs business is paramount, without disregarding the needs of users when they make economic decisions. In

"Basis for conclusion", the AAOIFI summarize these objectives by emphasizing that the main objective of financial accounting is to provide information about the IFIs' financial performance, to assist users in making decisions regarding its financial aspects and *sharia* compliance (AAOIFI, 2015, p. 83). In other words, the AAOIFI still leans towards accounting's usefulness as the objective of financial accounting.

The DSAS-IAI agrees that its usefulness should be the main objective of financial reporting, but refuses that it is the only objective. There are other objectives, which include providing information on compliance with *sharia*. Similar to the IASC conceptual framework, the DSAS-IAI implicitly includes stewardship or the accountability of management as the objectives of financial reporting. In the IASC framework, which is followed by the DSAS-IAI, stewardship and accountability are suggested to be synonymous (Lennard, 2007, p. 57).

Meanwhile, some Islamic accounting scholars have proposed different objectives for financial reporting. Adnan and Gaffikin (1997/2011) strongly argue that the ultimate objective should be directed to the accountability of human beings to God, for the purpose of *zakat* payments, which is a form of religious tax in Islam. Baydoun and Willett (2000) see that the determination of the objectives of financial reporting cannot be separated from the social accountability. Using a specific term, Hameed (2000) suggests that Islamic accountability, which arises through the concept of man as the trustee of God's resources, should be the primary objective that leads to Islamic socioeconomic objectives. The appearance of the term "accountability" as an objective of financial reporting is not a new idea. In the area of conventional accounting, Ijiri (1983) is known as a strong proponent for an accountability-based framework.

Needless to say, the IASB does not present "*sharia*-compliance" as the objective of financial reporting. It emphasizes the usefulness of financial information in assisting users to make investment and credit decisions, regardless of the adherence to *sharia*. Therefore, it will

be difficult for the users of the IFIs' financial statements to evaluate more than the companies' financial or economic related performances.

4.3.3 Elements of Financial Statements

In the FASB Statement of Financial Accounting Statement No. 6, elements are explained as the building blocks that construct financial statements. The term 'elements' refers to broader classes than particular economic things or events, which may meet the definition of elements. Assets are elements while cash, inventories and buildings are more appropriately labeled as *items* rather than elements (FASB, 1985, para 5).

Basic elements identified by the AAOIFI have similarities with those of the DSAS-IAI. On the other hand, the DSAS-IAI's basic elements also have similarities with those of the IASB.

Table 4.3

Elements of Financial Statements

AAOIFI	DSAS-IAI	IASB
Assets	Financial Position	Financial Position
Liabilities	Assets	Assets
Equity of IAHs	Liabilities	Liabilities
Owners' equity	**Temporary *syirkah* funds (PSIAs)**	Equity
Off-balance sheet items		
Income (represents revenues and gains)	Equity	Performance
		Income
Expenses and losses	Performance	Expenses
Return on investment accounts	Income	
	Expenses	
Net income (net loss)		
	Third parties' shares in temporary *syirkah* funds	

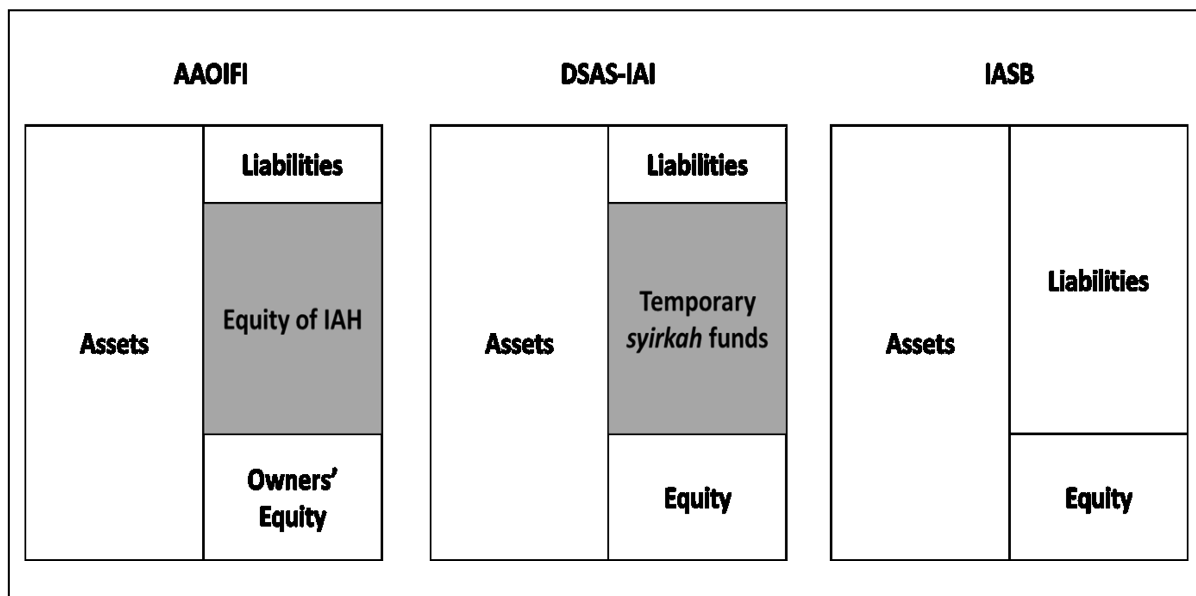
The bold marks the differences.

The AAOIFI identifies nine basic elements, with the equity of IAHs, off-balance sheet items, and return on investment accounts as "new" basic elements. Although it may be easy to notice, the AAOIFI does not specifically divide which elements are related to the

measurement of the financial position in the balance sheets and which elements belong to the measurement of performance in the income statements.

A major difference in the identification of users of Islamic financial statements compared to the IASB is in the acknowledgment of IAHs. In the light of this, the AAOIFI and the DSAS-IAI affirm that PSIAs should be a distinct element in a financial statement. Figure 4 illustrates how each board defines the elements of financial statements in the balance sheets. The AAOIFI and the DSAS-IAI share the same opinion on the inevitability of adding a new element between liabilities and equity.

Figure 4.4
Balance Sheets under the AAOIFI, DSAS-IAI, and IASB Conceptual Framework



As this paper focuses on PSIAs, the elements on the credit side of the balance sheets will be specifically discussed in later parts.

4.3.3.1 Liabilities

The definition of liabilities, according to the DSAS-IAI and the IASB, is similar (see Table 4.4).[34] Although many similarities are also found in the characteristics of liabilities according to the AAOIFI, the AAOIFI prefer to list "enforceable against the entity" rather than "expected to result in an outflow from the entity's economic resources". The AAOIFI, however, is silent whether "enforceable" refers to an obligation arising from a legal factor. In addition, the AAOIFI does not present "expected outflow of economic benefit" as a characteristic of liabilities.

Table 4.4

Liabilities

AAOIFI	DSAS-IAI	IASB
Present economic obligations that is **enforceable against the entity,** resulting from past transactions or events	Present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefit	A present obligation of the entity to transfer an economic resource as a result of past events

The bold marks the difference.

4.3.3.2 PSIAs

The AAOIFI and the DSAS-IAI believe that PSIAs should be accounted for as a distinct element, an element that does not exist in the IASB conceptual framework. Nonetheless, as previously mentioned, there is another disagreement with regard to labeling PSIAs. The AAOIFI name them as the equity of IAHs, which is placed at a mezzanine level between liabilities and equity. Despite the same placement, the DSAS-IAI prefers to name the funds as temporary *syirkah* funds.

[34]The DSAS-IAI's definition of assets was identical to the definition of assets on IASB's conceptual framework before it was modified in 2018.

Aside from the labeling, the two elements are not exactly the same. 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. All funds under *mudarabamutlaqa*,[35] *mudarabamuqayyada*,[36] *musharaka*, and other similar arrangements are considered temporary *syirkah* funds which should be classified in the mezzanine level between liabilities and equity. 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).

The DSAS-IAI explicates similar reasons on why PSIAs are different from either liabilities or equity. Other than what the AAOIFI has mentioned, the DSAS-IAI also

[35] *Mudaraba* with no restrictions from fund providers or IAHs
[36] *Mudaraba* with restrictions from fund providers or IAHs

highlights the presence of a maturity date as one of the lucid differences between PSIAs and equity.

In Table 4.5, the definitions of PSIAs according to the two boards are provided.

Table 4.5

PSIAs

AAOIFI Equity of IAHs	DSAS-IAI Temporary *syirkah* funds
Funds received for the purpose of investment on a profit sharing or participation basis **under *mudaraba* arrangements**	Funds received as an investment **for a certain period of time**, in which the entity has the right to manage and invest the funds with agreeable investment profit sharing

The bold marks the difference.

4.3.3.3 Equity

Although the name does not always make it clear, “equity” is associated with owners’ or shareholders’ equity. Nonetheless, the AAOIFI is the only one that explicitely uses the term “*owners*’ equity”, which accentuates the shareholders as the owners’ of the bank, and thus does not include the IAHs.

The three boards all agree that entity is a residual interest. Table 4.6 presents the definitions of equity according to each board. As the AAOIFI and the DSAS-IAI recognize a middle level on the balance sheet, equity is the excess amount of assets after all liabilities and PSIAs are deducted.

As we can see in Figure 4.4, the IASB only allows two elements on the right-hand side of the balance sheet. In other words, PSIAs are not elements of a financial statement. Rather, they are an *item* that can be classified as either a liability or equity. As PSIAs are not residual interest in the assets of the entity, there is a high possibility that PSIAs are classified as liabilities instead of equity. Therefore, Islamic banks applying IFRS may not classify PSIAs

as liabilities, not because they represent a present obligation, as they are not capital certain (Archer & Karim, 2009), but because PSIAs do not match the definition of equity.

Table 4.6

Equity

AAOIFI Owner's Equity	DSAS-IAI Equity	IASB Equity
Residual interest in the assets of the entity after deducting all its liabilities **and equity of IAHs.**	Residual interest in the assets of the entity after deducting all its liabilities **and temporary *syirkah* funds.**	Residual interest in the assets of the entity after deducting all its liabilities.

The bold marks the difference.

Other than the three elements above, both the AAOIFI and the DSAS-IAI also list the return to IAHs as an element of financial statements. According to the AAOIFI, the return on investment accounts is the share of the net result attributable to the IAHs during the period covered by the financial statements. It is considered an allocation of the investment profits and losses accruing to the IAHs from the investments (AAOIFI, 2015, p. 59, para 6/8). Similarly, the DSAS-IAI also considers that third parties' shares of the profit cannot be associated with expenses (in the case of profit) or revenue (in the case of loss). It is a profit or loss allocation of the mutual investment to the IAHs. A question may appear, as both Islamic conceptual frameworks do not list distributions to owners or shareholders as an element of financial statements, but list returns to IAHs as one.

4.4 Concluding Remarks

From this analysis of PSIAs in the Islamic conceptual frameworks, compared with the existing IASB conceptual framework, it is found that there are some similarities and some fundamental differences between them.

The two Islamic conceptual frameworks were not developed normatively. Instead of deducing from the *sharia* percepts what ought to be the objective and concepts of financial accounting, the AAOIFI chose a pragmatic approach. Similarly, the DSAS-IAI has drawn heavily on the prior work of the IASC with additional Islamic values added into it. Birton et al. (2015) calls this process the *shariahization* of accounting conceptual frameworks (p. 729). Hence, many similarities are found, probably because of a deliberate attempt to make the accounting system not differ too far from the widely accepted accounting practices.

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.

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

5.1 Introduction

IFIs show a promising future as their global assets had reached $1.8 trillion in 2013, an average annual growth of 17% (Ernst & Young, 2013). More countries are engaging with Islamic finance businesses: Switzerland and the UK, two European countries with only 5.5% and 2% Muslim populations, respectively, ranked 13th and 17th out of the 20 countries with the largest total of *sharia*-compliant assets (The Banker, 2013). Countries in Asia, however, still dominate the Islamic finance industry.

Islamic banking, which is currently the most important and developed component of the Islamic financial system, raises funds through PSIAs. PSIAs replace deposits found in conventional banking, as Islamic banks have to comply with *sharia,* which does not allow any activities engaging with *riba*, or interest. Instead of earning interest on PSIAs, the depositors or IAHs receive their share of the profits or bear the losses resulting from the investments managed by the banks (Al-Deehani et al., 1999; Archer et al., 2009).

The accounting dilemma arises from PSIAs partly sharing 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 the financial statements: The claims of creditors or lenders on the company's assets are shown as liabilities, while shareholders' equity represents the company's net assets that belong to the shareholders.

This problem is aggravated since Islamic banks, or IFIs in general, are subject to different accounting standards. Although some Islamic banks prepare their financial statements based on financial accounting standards developed by the AAOIFI or the AAOIFI FAS, many apply IFRS, which have recently become the common global language of business. Unfortunately, IFRS remain silent on the issue of Islamic finance, while Islamic banks tend to subjectively choose the standards in IFRS that are most closely related to Islamic financial transactions (Archer & Karim, 2007, p. 304).

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.

This chapter suggests that there is some inconsistency in the classification of PSIAs under IFRS, and a lack of concern for IAHs when accounting standards do not specifically notice the existence of IAHs. There are currently insufficient accounting standards to guide IFIs, which can preclude the IFIs financial reports from achieving a high degree of comparability. The research calls for the deliberate involvement of related organizations, including the IASB, the AAOIFI, and regional standard setters to work on the harmonization of the accounting standards for IFIs.

5.2 Accounting Standards for PSIAs Developed by International Standard-setting Bodies

As explained in the previous chapter, IFRS represent the most globally accepted business language. More than 130 countries have made public commitments to IFRS as a single set of international accounting standards (IFRS Foundation, 2017).

However, Islamic teachings are considered to have a potential influence on accounting policies and practices (Hamid et al., 1993). The initiative taken by the Islamic Development Bank in the late 1980s resulted in an agreement to regulate financial reporting standards for Islamic banks.

The AAOIFI was then established in the State of Bahrain as an independent organization that developed accounting standards for IFIs. Parallel to the need for harmonization in conventional accounting, regulating the reporting of Islamic financial transactions was expected to increase the IFIs' financial reporting comparability (Pomeranz, 1997), which might encourage the establishment of new Islamic banks.

5.2.1 IFRS

The IASB requires neither specific standards to deal with PSIAs nor certain disclosures on PSIAs and PSIAs-related accounts. Therefore, it is possible that Islamic banks that implement IFRS use their own judgment or interpretation to account for *sharia*-compliant transactions under IFRS, including PSIAs.

PSIAs are most likely to be treated by a bank as a *sharia*-compliant substitute for conventional retail deposit accounts. They occupy a position in Islamic banks' balance sheets similar to that of conventional banks' deposit liabilities, although, unlike deposits, PSIAs are not debt obligations for Islamic banks (Archer and Karim, 2009). Similar to PSIAs, IFRS

require neither specific treatment, nor disclosure on the returns attributable to IAHs and smoothing practices of profit-payouts to IAHs, including PER and IRR.

5.2.2 AAOIFI FAS

According to the AAOIFI, since PSIAs are not mobilized through a debt contract, they cannot be considered to be a liability. Islamic banks guarantee neither the customers' capital nor any return on it. However, PSIAs are not equity either, as IAHs commonly have the option to withdraw their investment at their initiative or at maturity (Al-Deehani et al., 1999, Karim, 2001) with no rights to monitor the management through boards like the shareholders (Al-Deehani et al., 1999; Karim, 2001; Zaheer and Farooq, 2014).

In its conceptual framework, the AAOIFI (2015) lists PSIAs as one of the elements of financial statements, which should be "considered to be on-balance sheet items if the IFIs has the authority over decisions with regards to the use of and deployment of the funds it has received" (para 6/3). This means that restricted PSIAs, which impose limitations on Islamic banks in managing the funds, are considered off-balance sheet items, as the banks do not enjoy authority over decisions on the use and deployment of such funds (AAOIFI, 2015, Conceptual Framework, para 6/5).

Additionally, in AAOIFI FAS No. 1 General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions, the AAOIFI mentions that unrestricted PSIAs should be disclosed and presented in the statement of the financial position as a separate item, which is a mezzanine level between liabilities and owners' equity, namely "equity of unrestricted investment account holders". This new element distinguishes AAOIFI FAS from other accounting standards, as no elements other than liabilities and shareholder equity can be found on the right-hand side of financial statements.

The classification of unrestricted PSIAs as a mezzanine level impacts the accounting for the return to IAHs. The AAOIFI does not consider the return as an expense (in case of profit), but it is provided in the income statement and considered as an allocation of the investment profits and losses accruing to the IAHs from the investment activities. However, the AAOIFI recognized that a variety of profit-sharing methods are used by Islamic banks, such as the pooling method and separation method, which will influence the revenues and expenses distributed between shareholders and IAHs (Al Deehani et al., 1999). Hence, the AAOIFI introduced a requirement for Islamic banks to disclose information related to profit sharing via its AAOIFI FAS 5 Disclosure of Bases for Profit Allocation between Owners' Equity and Investment Account Holders.

PER and IRR are covered in AAOIFI FAS 11 Provisions and Reserves, which defines a reserve as "a component of equity, of either IAHs or shareholders, and is constituted by appropriations made out of income…" (AAOIFI, 2015, FAS 11, para. 15). Since PER are collective profits that belong to IAHs and shareholders, the share of IAHs in the PER should be presented under the equity of unrestricted investment account holders, and the share of the Islamic banks or shareholders in the reserves should be presented as part of the reserve under shareholders' equity in the statement of the financial position. In consideration of IRR which belongs solely to the IAHs, it should be presented under the equity of unrestricted investment account holders in the financial position statement (AAOIFI, 2015, FAS 11, para 22–23).

The AAOIFI also requires Islamic banks to report the principal amount of IAHs' funds, the share of IAHs in PER, and the balance of IRR separately in the statement of the financial position, under the section of equity of unrestricted IAHs in the balance sheet, or in the notes to the financial statement. It is also necessary for Islamic banks to outline—in the notes to their financial statements—the changes that have occurred during the financial period in the PER and IRR, together with information about the basis they have applied to determine the

PER and IRR (AAOIFI, 2015, FAS 11, para. 25–27). Figure 5.1 provides an illustration of a balance sheet under AAOIFI FAS.

Figure 5.1

Reporting Unrestricted PSIAs in the Balance Sheet of Islamic Banks under AAOIFI FAS

Assets

Liabilities

Equity of Unrestricted Investment Account Holders
Beginning amount xxx
PER xxx
IRR xxx
End balance xxx

Shareholders' Equity
Paid-up capital xxx
Reserves:
PER xxx
Retained earnings xxx
Total shareholders' equity xxx

IAHs' shares of PER

Presented either in the statement of financial position or notes to the financial statements

Islamic banks' shares of PER

Atmeh and Ramadan (2012) criticize the accounting for *mudaraba* contracts by the AAOIFI. They claim that unrestricted PSIAs, while they are called "equity" for unrestricted IAHs, they are not properly classified as equity. Unrestricted PSIAs will match the equity definition when followed by a separation of the assets in the financial statement to reflect the assets attributable to shareholders and those attributable to IAHs (Atmeh & Ramadan, 2012, p. 16).

5.3 Prior studies on PSIAs

PSIAs are different from conventional deposits; there is no guarantee of a return from them (Archer and Karim, 2009; Gambling and Karim, 1991; Sundararajan, 2013) and IAHs have no similar rights to those owned by shareholders, such as monitoring or voting rights (Al-Deehani et al., 1999; Karim, 2001; Zaheer and Farooq, 2014). Those studies argue that PSIAs should then be reported differently from debt. Furthermore, Archer and Karim (2007) highlight the subjectivity of Islamic banks in matching *sharia*-compliant contracts with conventional accounting, including how to report PSIAs in the balance sheets. They contend that it results in a lack of transparency and comparability of financial statements, but no further evidence on the various methods of reporting PSIAs in the balance sheet is provided.

Al-Deehani et al. (1999) drew from a sample of 12 Islamic banks and found that PSIAs were one of the main sources of funds (about 74% of the total). This enables Islamic banks to increase their shareholders' rates of return with no additional risk, and also to increase their market value without altering the weighted average cost of capital, which supports a new dimension of the theory of capital structure. Shubber and Alzafiri (2008), who conducted a study on the published accounts of four Middle Eastern banks, concluded that "deposits" in Islamic banks are viewed as profit-sharing instruments instead of liabilities. Nevertheless, Rosman et al. (2013) examined the trend of PSIAs in Malaysian Islamic banks from 2009 to 2013 and noticed that restricted PSIAs had a higher growth than unrestricted PSIAs.

Ahmed (1996) conducted a case study on the Faysal Bank of Sudan and found that shareholders diverted their profits to IAHs for the purpose of encouraging more deposits to Islamic banks, which proved the existence of DCR. Archer and Karim (2006) also analyzed the phenomenon of DCR in Islamic banks, which can be an efficient and value-creating means of sharing risks between IAHs and shareholders. However, in practice, Islamic banks

maintain reserves to minimize the risk of them giving up their share of the profits. Adequate disclosures on this matter are thus required to prevent IAHs from the risk of receiving a lower rate of return (Archer & Karim, 2006, p. 278).

In addition, Taktak, Zouari, and Boudriga (2010), in their empirical studies, examined income smoothing with 66 samples from Islamic banks and found that, unlike conventional banks, Islamic banks did not use loan loss provisions to stabilize net income. They suggest that Islamic banks probably use PER and IRR not only to smooth profit-payouts to IAHs, but also to stabilize income. However, the non-disclosure information of PER and IRR became a limitation to conducting further tests on this assertion.

Sundararajan (2013), in his study of the risk characteristics of Islamic products, includes a survey of the disclosure practices of 15 Islamic banks from 2002 and 2003. The results also cover PSIAs-related disclosures: All the banks disclosed their returns on unrestricted PSIAs, only one bank disclosed its return on restricted PSIAs, and 30% of the banks disclosed their PER. Ameer et al. (2012) conducted a study on PSIAs related-disclosures in five Malaysian Islamic banks by developing a questionnaire using Bank Negara Malaysia (BNM) guidelines. The findings indicate that Islamic banks record most of the items listed on the questionnaire for internal or management purpose, yet only a small fraction of the information is shared with the stakeholders in the annual reports.

Archer et al. (1998) highlight the monitoring issues related to PSIAs, as IAHs fully depend on this monitoring on behalf of the shareholders. Moreover, Magalhães and Al-Saad (2013) argue that current practices in Islamic banks do not show effective protection for unrestricted IAHs as an investor, e.g. investment losses resulting from the negligence of the banks may be smoothed by the PER. Lahrech, Lahrech, and Boulaksil (2014) conducted an empirical study on the financial statement disclosures of 25 Islamic banks and suggested that greater transparency can reduce the possibility of any hiding profit-allocation practices,

which enables IAHs to monitor their funds better. As a solution to this governance problem, Archer and Karim (2009) propose that Islamic banks separate retail banking and the entities that manage PSIAs.

Those studies show that there is still limited research into PSIAs. Overall, the extant studies that exist examine the characteristics of PSIAs and the practice of PSIAs in Islamic banks, including concerns over limited disclosures related to PSIAs in financial statements. This research attempts to contribute to the literature on PSIAs, especially in connection with accounting for PSIAs under the various accounting standards with which Islamic banks comply.

5.4 Research design

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.[37][38] 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.

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[37]When the holding company is listed as the top IFIs, the financial statement of Islamic bank will be surveyed instead.

[38]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.

There were only 63 Islamic banks from 15 countries surveyed (see Table 5.1), 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.

In this paper, the following information was surveyed from the financial statements:

The accounting standards applied

- What accounting standards do the Islamic banks comply with?

PSIAs

- How do Islamic banks present PSIAs in their statements of their financial position?
- Is there any separation between restricted and unrestricted PSIAs?

Returns attributable to IAHs

- How do Islamic banks present returns attributable to IAHs?
- Do Islamic banks provide one or more of the following disclosures about profit allocations between shareholders and IAHs?
    a) The basis applied in profit allocation
    b) Expenses charged to PSIAs
    c) The percentages for the profit's allocation

Smoothing profit-payouts to IAHs

- Is there any observable information on smoothing profit-payouts to IAHs?
    a) If yes, do they disclose the amount or the changes during the period?
    b) If they smooth profit-payouts to IAHs by maintaining specific reserve accounts, how do they present the reserve accounts in the financial statements?

Table 5.1

List of Surveyed Islamic Banks

<table>
<tr><th>Region[39]</th><th>Country</th><th colspan="2">IFIs and Financial Reports Surveyed</th></tr>
<tr><td rowspan="3">Southern Asia</td><td>Bangladesh</td><td>Al Arafah Islami Bank
EXIM Bank
First Security Islami Bank
ICB Islami Bank*</td><td>Islami Bank Bangladesh
Shahjalal Islami Bank
Social Islami Bank</td></tr>
<tr><td>Pakistan</td><td>AlBaraka Bank Pakistan**
Burj Bank
Bank Islami</td><td>Dubai Islamic Bank Pakistan**
Meezan Bank</td></tr>
<tr><td>Sri Lanka</td><td colspan="2">Amana Bank</td></tr>
<tr><td rowspan="4">South-Eastern Asia</td><td>Brunei Darussalam</td><td colspan="2">Bank Islam Brunei Darussalam Berhad</td></tr>
<tr><td>Indonesia</td><td>Bank BJB Syariah*
Bank Syariah Bukopin*
Bank Syariah Mandiri*
Bank Mega Syariah*</td><td>Bank Muamalat Indonesia
BNI Syariah*
BRI Syariah*</td></tr>
<tr><td>Malaysia</td><td>Affin Islamic Bank Berhad*
Bank Islam Malaysia Berhad**
Bank Muamalat Malaysia Berhad*
CIMB Islamic Bank Berhad*
HSBC Amanah*</td><td>Hong Leong Islamic Bank Berhad*
KFH Berhad**
Maybank Islamic Berhad*
Public Islamic Bank Berhad*
RHB Islamic Bank Berhad*</td></tr>
<tr><td>Thailand</td><td colspan="2">Islamic Bank of Thailand</td></tr>
<tr><td rowspan="8">Western Asia</td><td>Bahrain</td><td>Al Baraka Islamic Bank
Al Salam Bank
Bahrain Islamic Bank</td><td>Ithmaar Bank**
Khaleeji Commercial Bank
Kuwait Finance House Bahrain**</td></tr>
<tr><td>Jordan</td><td>Islamic International Arab Bank*
Jordan Dubai Islamic Bank</td><td>Jordan Islamic Bank</td></tr>
<tr><td>Kuwait</td><td>Ahli United Bank Kuwait*
Boubyan Bank*</td><td>Kuwait Finance House
Kuwait International Bank</td></tr>
<tr><td>Oman</td><td colspan="2">Nizwa Bank</td></tr>
<tr><td>Qatar</td><td>Al Rayan Bank
Barwa Bank</td><td>Qatar Islamic Bank
Qatar International Islamic Bank</td></tr>
<tr><td>Saudi Arabia</td><td>Alinma Bank
Al Rajhi Bank</td><td>Bank Albilad
Bank AlJazira</td></tr>
<tr><td>United Arab Emirates</td><td>Abu Dhabi Islamic Bank
ADNIF*
Ajman Bank
Al Hilal Bank</td><td>Dubai Islamic Bank
Emirates Islamic Bank*
Noor Islamic Bank**
Sharjah Islamic Bank</td></tr>
<tr><td>Yemen</td><td colspan="2">Tadhamon International Islamic Bank</td></tr>
</table>

*subsidiary of conventional bank or entity
**subsidiary of Islamic bank or entity

[39]The geographical divisions follow the United Nation's regions based on the continents (https://unstats.un.org/unsd/methodology/m49/).

Unfortunately, the possibility of sample selection bias, due to the nature of the method used for the collection of the data, cannot be completely ruled out. The study is intended to examine the classification of PSIAs under various accounting standards, which takes the sample from the list of top IFIs around the world. In this regard, the availability of Islamic banks' financial statements online is essential to obtain the data. Some of the Islamic banks' websites, particularly those of the small Islamic banks, only contain information limited to their basic services, while some others have no accessible websites at all. As a result, this study is biased towards larger Islamic banks.

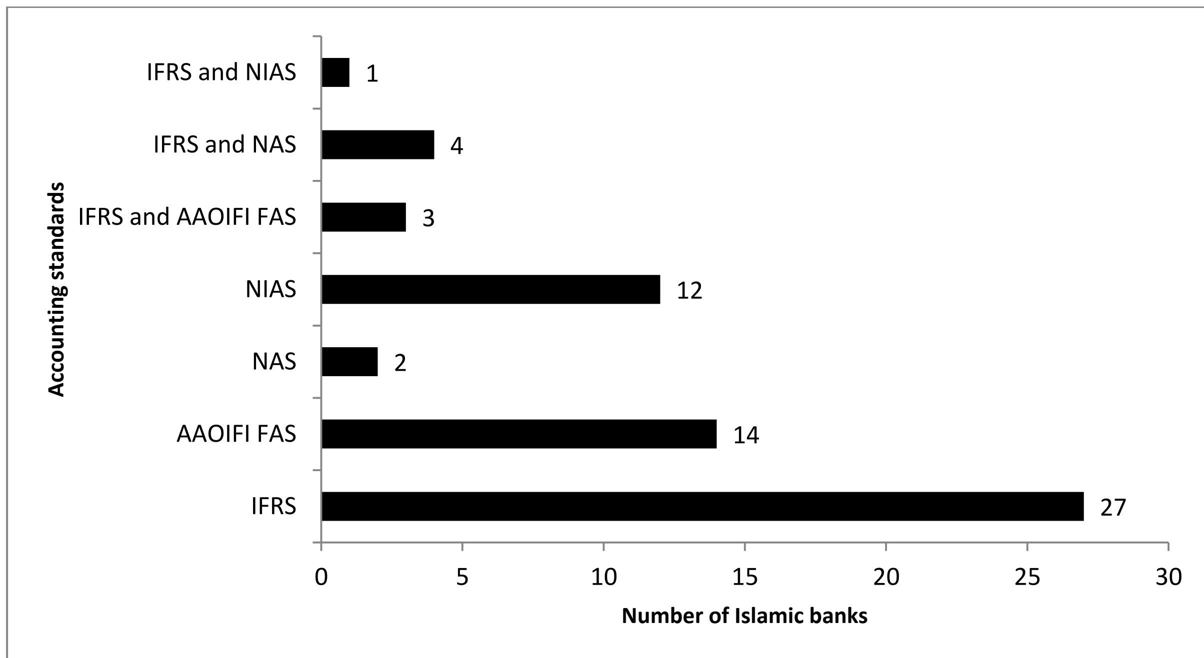
5.5 Findings

IFRS have become the preferred accounting standards of Islamic banks in Asia. Figure 5.2 shows that 55%, or 35 out of 63 of the Islamic banks surveyed, apply IFRS[40] as the foundation of their financial statements. Among those 35 Islamic banks, eight Islamic banks also mention compliance with another set of accounting standards. Fourteen Islamic banks are in compliance with AAOIFI FAS, while the others prefer to implement National Accounting Standards (NAS) or National Islamic Accounting Standards (NIAS).

[40]It also includes accounting standards nearly identical to or based on IFRS. Whether the accounting standards applied based on IFRS is examined from the information available at IFRS Foundation website as of May 2015.

Figure 5.2

Compliance with Accounting Standards



Eight Islamic banks that claim to apply more than one accounting standard come from three different countries[41]:

- Three out of seven Islamic banks from Bangladesh comply with the Bangladesh financial accounting standards or IFRS as adopted by the Institute of Chartered Accountants of Bangladesh, and claim that the standards do not contradict AAOIFI FAS.
- All the Islamic banks from Saudi Arabia comply with accounting standards for financial institutions issued by the Saudi Arabian Monetary Agency and IFRS.
- The only Islamic bank from Yemen complies with IFRS and Accounting Standards for Islamic Financial Institutions, with no further explanation of the Islamic accounting standards they implement.

[41] Although Islamic banks from Malaysia mention compliance with MFRS and IFRS, MFRS is considered identical with IFRS.

Islamic banks from the same countries apply the same accounting standards, possibly due to regulations that require the implementation of certain accounting standards.[42] Table 5.2 groups the countries of origin of Islamic banks based on the accounting standards they apply.

Those that adopt AAOIFI FAS are from Western Asian countries, also known as Middle Eastern countries. Nonetheless, there are disagreements on whether AAOIFI FAS should be the sole accounting standards for Islamic banks, or IFIs, in that region. Islamic banks from Kuwait, Saudi Arabia, the United Arab Emirates (UAE), and Yemen prefer to adopt IFRS.

Instead of implementing IFRS or AAOIFI FAS, Islamic banks in Pakistan[43] and Indonesia apply Islamic accounting standards developed by their national accounting standard setters. All the Islamic banks from two other countries—Brunei Darussalam and Thailand—implement national accounting standards that are also applied to industries other than the Islamic finance industry in those countries.

[42]In Bangladesh, four Islamic banks mention compliance only with IFRS, while the other three banks also mention compliance with AAOIFI FAS.
[43]Pakistan applies national Islamic accounting standards adapted from AAOIFI FAS (AOSSG, 2011).

Table 5.2

Country of Origin of Islamic Banks based on Their Applied Accounting Standards

<table>
<tr><th>IFRS/based on IFRS</th><th>National Accounting Standards (NAS)</th><th>National Islamic Accounting Standards (NIAS)</th><th>AAOIFI FAS</th><th>Dual Compliance*</th></tr>
<tr><td rowspan="6">Bangladesh**
Kuwait
Malaysia
Sri Lanka
UAE</td><td rowspan="6">Brunei Darussalam[44]
Thailand</td><td rowspan="6">Pakistan
Indonesia</td><td rowspan="6">Bahrain
Jordan
Oman
Qatar</td><td>IFRS and AAOIFI</td></tr>
<tr><td>Bangladesh**</td></tr>
<tr><td>IFRS and NAS</td></tr>
<tr><td>Saudi Arabia</td></tr>
<tr><td>IFRS and NIAS</td></tr>
<tr><td>Yemen</td></tr>
</table>

*Financial statements that are in compliance with more than one set of accounting standards.
** Bangladesh appears twice, as three Islamic banks from Bangladesh claim to comply with IFRS and AAOIFI FAS while others only mention compliance with IFRS.

Given the variety of accounting standards implemented in Islamic banks, PSIAs are thus subject to different classifications. As shown in Table 5.3, Islamic banks that comply with IFRS mainly report PSIAs as a component of liability, similar to conventional deposits. The same classification is also adopted by Islamic banks that apply national accounting standards.

However, a lack of guidelines on the application of IFRS by Islamic banks has led to different judgments on how to report PSIAs. The Kuwait Finance House classifies only unrestricted PSIAs as liabilities, while restricted PSIAs are reported off-balance sheet. Tadhamon International Islamic Bank in Yemen, while claiming to comply with IFRS, reports all PSIAs as a mezzanine level between liabilities and shareholders' equity. Al Rajhi Bank in Saudi Arabia also presents PSIAs differently, by considering *mudaraba* transactions

[44]Brunei Darussalam started its full IFRS adoption effective January 1, 2014 (Brunei Darussalam Accounting Standards Council, 2014).

as off-balance sheet items.[45] No information on PSIAs was found for two out of the four Islamic banks in Saudi Arabia.

Islamic banks that prepare financial statements based on AAOIFI FAS follow the standards by reporting them differently: Unrestricted PSIAs as a mezzanine level between liabilities and shareholders' equity in the financial position statement, while restricted PSIAs are reported off-balance sheet.[46]

Islamic banks in Indonesia and Pakistan, which apply national Islamic accounting standards, have different opinions on how to report PSIAs. Islamic banks in Pakistan report PSIAs as liabilities; while in Indonesia three different ways of presenting PSIAs are found. Bank Syariah Mandiri presents PSIAs[47], regardless of the restrictions from IAHs, as a middle level between liabilities and shareholders' equity in the financial position statement. Bank Syariah Bukopin report unrestricted PSIAs as liabilities, while restricted PSIAs should be off-balance sheet. No information about restricted PSIAs was available from five other Islamic banks in Indonesia.

Fifty-one percent, or 32 of the banks disclosed the type of PSIAs; whether unrestricted or restricted PSIAs. Islamic banks in Malaysia, Kuwait, and Yemen, which are in compliance with IFRS, separate between unrestricted and restricted PSIAs. Although Islamic banks in Malaysia classify all PSIAs as liabilities, restricted and unrestricted PSIAs are reported under different headings. Similarly, Tadhamon International Islamic Bank in Yemen, and Bank Syariah Mandiri in Indonesia also report unrestricted and restricted PSIAs under different names, but classify both as mezzanine levels between liabilities and shareholder equity.

[45]Islamic banks in Saudi Arabia only disclose the amount of PSIAs in the notes to their financial statements.
[46]In the financial statements of three banks applying AAOIFI FAS, no information about restricted PSIAs.
[47]PSIAs in Indonesia are known as temporary *syirkah* funds. *Syirkah* means joint-partnership.

Table 5.3

Classifications of PSIAs in Islamic Banks under Certain Accounting Standards

Country	Accounting Standards	IFIs and Financial Reports Surveyed		Presentation of PSIAs
Bangladesh	IFRS and AAOIFI FAS	Al Arafah Islami Bank Islami Bank Bangladesh	Shahjalal Islami Bank	PSIAs as liabilities
	IFRS	EXIM Bank First Security Islami Bank	ICB Islami Bank Social Islamic Bank	
Sri Lanka		Amana Bank		
Malaysia		Affin Islamic Bank Berhad* Bank Islam Malaysia Berhad* Bank Muamalat Malaysia Berhad* CIMB Islamic Bank Berhad* HSBC Amanah*	Hong Leong Islamic Bank Berhad* KFH Berhad* Maybank Islamic Berhad* Public Islamic Bank Berhad* RHB Islamic Bank Berhad*	
United Arab Emirates		Abu Dhabi Islamic Bank ADNIF Ajman Bank Al Hilal Bank	Dubai Islamic Bank Emirates Islamic Bank Noor Islamic Bank Sharjah Islamic Bank	
Kuwait		Ahli United Bank Kuwait Boubyan Bank	Kuwait International Bank	
		Kuwait Finance House*		Unrestricted PSIAs: liabilities Restricted PSIAs: off-balance sheet
Brunei Darussalam	NAS	Bank Islam Brunei Darussalam Berhad		PSIAs as liabilities
Thailand		Islamic Bank of Thailand		
Pakistan	NIAS	AlBaraka Bank Pakistan Bank Islami Burj Bank	Dubai Islamic Bank Pakistan Meezan Bank	
Saudi Arabia	IFRS and NAS	Alnima Bank		
		Al Rajhi Bank		All PSIAs: off-balance sheet
		Bank AlJazira	Bank Albilad	No PSIAs
Yemen	IFRS and NIAS	Tadhamon International Islamic Bank		All PSIAs as mezzanine level
Indonesia	NIAS	Bank Syariah Mandiri*		
		Bank Muamalat Indonesia* BRI Syariah* Bank Mega Syariah*	BNI Syariah* Bank BJB Syariah*	Unrestricted PSIAs: mezzanine level No information about restricted PSIAs
		Bank Syariah Bukopin*		Unrestricted PSIAs: liabilities Restricted PSIAs: off-balance sheet
Oman	AAOIFI FAS	Nizwa Bank *		Unrestricted PSIAs: mezzanine level; Restricted PSIAs: off-balance sheet
Qatar		Qatar Islamic Bank * Qatar International Islamic Bank*	Al Rayan Bank * Barwa Bank*	
Jordan		Jordan Islamic Bank *	Islamic International Arab Bank*	
		Jordan Dubai Islamic Bank *		Unrestricted PSIAs: mezzanine level No information about restricted PSIAs
Bahrain		Al Salam Bank *	Bahrain Islamic Bank *	
		Ithmaar Bank* AlBaraka*	Kuwait Finance House Bahrain* Khaleeji Commercial Bank*	Unrestricted PSIAs: mezzanine level; Restricted PSIAs: off-balance sheet

* Islamic banks that separate between restricted and unrestricted PSIAs.

[shaded box] : No information on PSIAs

Differing from conventional banking that uniformly states the returns to depositors as interest expenses, there are a variety of terms referring to returns for IAHs. Different terms are chosen by the banks to present the returns attributable to IAHs in the income statements, which complicate the comparability of information between banks.

Table 5.4 lists how the Islamic banks surveyed present the returns attributable to IAHs in the income statements. Since the AAOIFI does not consider PSIAs as liabilities, AAOIFI FAS do not classify returns to the IAHs as expenses, but as an appropriation of profit (or loss), which is reported in the income statement. All Islamic banks that recognize the mezzanine level in their financial statements, either under AAOIFI FAS or national Islamic accounting standards, agree to the AAOIFI FAS consideration. The method of reporting this in the income statement, however, is similar to reporting the return to IAHs of most of the Islamic banks under IFRS.

Under IFRS, returns attributable to IAHs should be classified as expenses. Nonetheless, the term "expense" is not found in the majority of Islamic banks applying IFRS. In the Islamic Bank of Thailand and Amana Bank in Sri Lanka, returns attributable to IAHs are included in financing expenses, but there is no clear information on the amount of profit sharing on PSIAs themselves. Moreover, some Islamic banks use the term "distribution to depositors" even though they comply with IFRS, which obscures the classification of the returns to IAHs as an expense.

Table 5.4

Terms Referring to Returns Attributable to IAHs in the Income Statements

<table>
<tr><th colspan="2">Financial Reporting Standards</th><th colspan="3">Returns attributable to PSIAs holders</th></tr>
<tr><td rowspan="2">IFRS</td><td>PSIAs as liabilities</td><td>Financing expense</td><td>Income/profit to depositors/IAHs</td><td>Distribution to depositors</td></tr>
<tr><td>Unrestricted PSIAs as liabilities</td><td colspan="3">Distribution to depositors</td></tr>
<tr><td colspan="2">AAOIFI FAS
(unrestricted PSIAs as mezzanine level)</td><td colspan="3">Return to (share of) unrestricted IAHs</td></tr>
<tr><td colspan="2">NAS
(PSIAs as liabilities)</td><td colspan="3">Income attributable to depositors
Financial expenses</td></tr>
<tr><td rowspan="3">NIAS</td><td>PSIAs as mezzanine level</td><td colspan="3" rowspan="2">Third parties’ share of return on investment accounts</td></tr>
<tr><td>Unrestricted PSIAs as liabilities</td></tr>
<tr><td>PSIAs as liabilities</td><td colspan="3">Profit/return expenses</td></tr>
<tr><td>IFRS and AAOIFI FAS</td><td>PSIAs as liabilities</td><td colspan="3">Profit to depositors</td></tr>
<tr><td>IFRS and NAS</td><td>PSIAs as liabilities</td><td colspan="3">Return on time investments</td></tr>
<tr><td>IFRS and NIAS</td><td>PSIAs as mezzanine level</td><td colspan="3">Return on investment accounts</td></tr>
</table>

Since fourteen banks report PSIAs as off-balance sheet items, either only restricted PSIAs or both restricted and unrestricted PSIAs, it is necessary to disclose information on those items in the notes of the financial statement. Islamic banks applying AAOIFI FAS disclose information on PSIAs as off-balance sheet items in a separate financial statement called a Statement of Restricted Investment Accounts, while no Islamic banks applying IFRS, including Islamic banks in dual compliance with IFRS, disclose full information related to PSIAs as off-balance sheet items (Table 5.5). Although the Kuwait Finance House and Bank Bukopin Syariah disclose that they maintain restricted PSIAs separately from unrestricted PSIAs, they do not disclose the amount and profit received from the restricted PSIAs.

Table 5.5

PSIAs as Off-Balance-Sheet Items

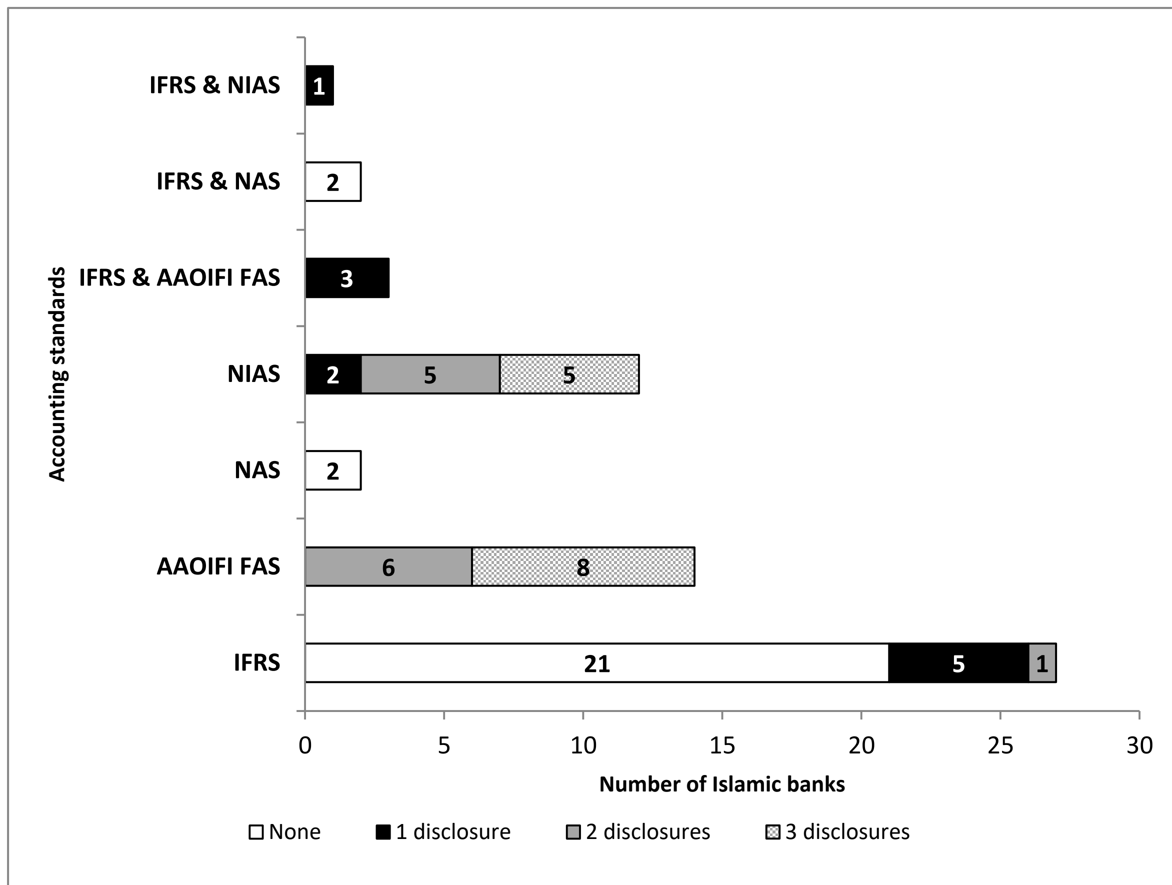
Accounting standards	Country	Islamic banks	PSIAs as off-balance sheet items	Disclosures on amount and profit in PSIAs as off-balance sheet items
IFRS	Kuwait	Kuwait Finance House	Restricted PSIAs	No
AAOIFI FAS	Bahrain	Ithmaar Bank AlBaraka Kuwait Finance House Bahrain Khaleeji Commercial Bank	Restricted PSIAs	Yes
	Jordan	Jordan Islamic Bank Islamic International Arab Bank	Restricted PSIAs	Yes
	Oman	Nizwa Bank	Restricted PSIAs	Yes
	Qatar	Qatar Islamic Bank Qatar International Islamic Bank Al Rayan Bank Barwa Bank	Restricted PSIAs	Yes
NIAS	Indonesia	Bank BukopinSyariah	Restricted PSIAs	No
IFRS and NAS	Saudi Arabia	Al Rajhi Bank	Restricted and unrestricted PSIAs	Only the amount

Note: In the financial statements of Islamic banks that implement NAS and dual accounting standards, no PSIAs are found to be off-balance sheet.

It is possible that the method of profit sharing influences the choice of terms for returns attributable to PSIAs in the income statement: That is, whether they are “expenses”, “profit sharing”, or “distributions”. However, disclosures related to the basis for profit sharing are difficult to find in Islamic banks applying IFRS. Figure 5.3 provides an overview of whether Islamic banks provide disclosures related to profit allocations, which are the basis for profit allocations; expenses charged to PSIAs; and the percentage of the profit allocation between IAHs and shareholders. This figure contains only information on disclosures presented by 61 banks, as two Islamic banks do not provide any information on PSIAs in their financial statements.

Islamic banks that prepare financial statements under IFRS and national accounting standards seem reluctant to provide more information on profit sharing to IAHs. On the other hand, those that apply AAOIFI FAS provide at least two out of the three disclosures surveyed, which may be related to the guidelines provided by the AAOIFI. Islamic banks that apply national Islamic standards disclose at least one of the three disclosures on returns attributable to IAHs.

Figure 5.3
Number of Disclosures Related to Returns Attributable to IAHs Provided by Islamic Banks

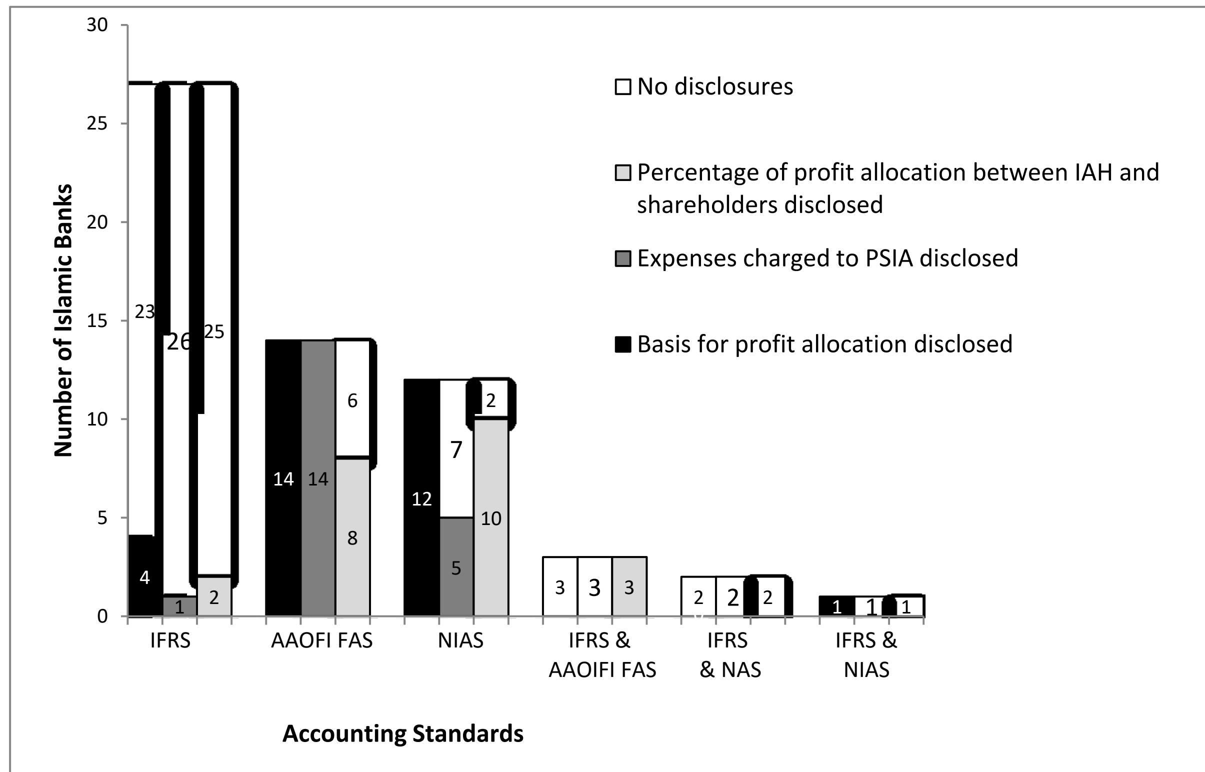


Disclosures on the basis of profit allocations are provided by most of the Islamic banks (Figure 5.4). Islamic banks that apply AAOIFI FAS have fewer concerns about unveiling the percentages of the profit allocated between IAHs and shareholders, rather than the other two

disclosures. It is because some Islamic banks prefer to merely mention that the profit is shared based on a pre-agreed ratio, without clarifying the percentage of the allocation.

Figure 5.4

Disclosures Related to Returns Attributable to IAHs



Note: Similar to Figure 3, this figure eliminates two banks that provide no information on PSIAs.

In this survey, 29 Islamic banks were found to disclose information about smoothing practices; either in the form of reserves or of transfers from shareholders' funds to IAHs (see Table 5.6). The disclosures provided also vary; some Islamic banks only mention that the banks maintain reserve accounts with no further information about them, while others disclose the amount or the changes during the period. No disclosures related to smoothing profit-payouts to IAHs are available from Islamic banks that apply national accounting standards.

Table 5.6

Observable PER, IRR, and Other Profit-Payout Smoothing Practices in the Surveyed Islamic Banks

Country	Name of Islamic Bank	Observable Smoothing Practice		Amount or Changes during the Period	Presentation of Reserve
		Reserve	Others		
IFRS					
Malaysia	Affin Islamic Bank Berhad	PER	-	Undisclosed	
	Bank Islam Malaysia Berhad	-	Forgo bank's profit	Undisclosed	
	Hong Leong Islamic Bank Berhad	PER	-	Disclosed	Liabilities
	HSBC Amanah	PER		Disclosed	Liabilities and Equity
	KFH Berhad		Support from shareholders' fund	Undisclosed	
	Maybank Islamic Berhad	PER	*Hibah*, if necessary	Disclosed	Liabilities and Equity
	Public Islamic Bank Berhad	PER	When no PER: Forgo banks' share or profit or *hibah*	Disclosed	Liabilities and Equity
UAE	Sharjah Islamic Bank	PER	-	Undisclosed	
	Abu Dhabi Islamic Bank	PER	-	Disclosed	Depositors' accounts (liabilities)
	Al Hilal Bank	Depositors' Profit Reserve	-	Undisclosed	Other liabilities
	Dubai Islamic Bank	IRR	-	Disclosed	Customers' deposits (liabilities)
AAOIFI FAS					
Bahrain	Ithmaar Bank	PER	-	Disclosed	Equity of unrestricted IAHs
	AlBaraka	PER and IRR	-	Disclosed	Equity of unrestricted IAHs
	Al Salam bank	PER and IRR	-	Undisclosed	
	Bahrain Islamic Bank	PER and IRR	-	Disclosed	Equity of unrestricted IAHs
	Khaleej Commercial Bank	PER and IRR	-	Disclosed	Equity of unrestricted IAHs
Jordan	Jordan Islamic Bank	Investment Risk Fund	-	Disclosed	Joint investment account holders
	Islamic International Arab Bank	Investment Risk Fund	-	Disclosed	Equity of unrestricted IAHs
	Jordan Dubai Islamic Bank	PER and Investment Risk Fund	-	Disclosed	PER: Equity of unrestricted IAHs and Shareholders' Equity Investment Risk Fund: Equity of unrestricted IAHs
Oman	Nizwa Bank	PER and IRR	-	Disclosed	Equity of unrestricted IAHs
Qatar	Qatar Islamic Bank	-	Shareholders' contributions	Disclosed	
	Qatar International Islamic Bank	-	Support provided by the bank	Disclosed	
	Al Rayan Bank	-	Support provided by the bank	Disclosed	
	Barwa Bank	-	Owner's contribution	Disclosed	
NIAS					
Pakistan	Bank Islami	-	*Hibah*	Disclosed	
	Burj Bank	-	*Hibah*	Disclosed	
	Meezan Bank	-	*Hibah*	Disclosed	
	AlBaraka Bank Pakistan		*Hibah*	Disclosed	
	Dubai Islamic Bank Pakistan		*Hibah*	Disclosed	

The table excludes Islamic banks that do not provide any information on smoothing practices.

The practices of smoothing profit-payouts for IAHs are mainly observable from the financial reports that are prepared under AAOIFI FAS, although there is a discrepancy between the manner of reporting PER according to AAOIFI FAS, and the findings on the financial statements surveyed. Moreover, maintaining reserve accounts is the way Islamic banks prefer to smooth the profit-payouts to IAHs.

Despite the reluctance of Islamic banks that apply IFRS to disclose information related to the returns attributable to IAHs, seven out of ten Islamic banks from Malaysia and four out of eight Islamic banks from the UEA provide information on their practices of smoothing profit-payouts.[48] This is probably due to the available guidelines from the regulatory bodies. In Malaysia, the Central Bank or BNM issued PER guidelines to stipulate the management of DCR[49] while in the UAE, the Dubai Financial Services Authority's rulebook on Islamic Finance Rules includes additional requirements for Islamic banks to disclose the reserves maintained to mitigate DCR.[50]

It should be noted that the practice of using reserves as a method to smooth profit-payouts to IAHs in Islamic banks is not acceptable in Indonesia (AAOSG, 2011), where PER are considered unlawful.

5.6 Discussion

Despite the movement of global accounting standards towards IFRS, Islamic banks are still subject to various accounting standards: IFRS, AAOIFI FAS, national accounting standards, and national Islamic accounting standards.

[48]RHB Islamic Bank discontinued maintaining PER in 2012 and discloses no information on the smoothing practices in 2013.
[49]BNM/RH/GL 008-12, Guidelines on Profit Equalisation Reserve
[50]Islamic Financial Rules IFR/VER7/07-13

The absence of guidelines for applying IFRS to Islamic banks has resulted in different opinions on how to classify PSIAs and related accounts. Although the majority of countries that implement IFRS agree that PSIAs should be liabilities, there is disagreement on how to classify PSIAs in the financial statements. Contradictory terms are also used for the returns attributable to IAHs: while PSIAs are liabilities, the returns attributable to IAHs in some banks are referred to as “distributions”. However, only a few Islamic banks apply IFRS that require the disclosure of information on the bases of profit sharing, which may explain this discrepancy.

The findings are in line with prior studies that suggest limited disclosures on PSIAs and related accounts (Ameer et al., 2012; Sundararajan, 2013; Taktak et al., 2010). This absence of adequate disclosures may be related to the lack of any mandated disclosure requirement, meaning that management has no motivation to disclose the information fully. Meanwhile, the IFSB underscores the importance of disclosing information about smoothing practices, notably in the form of reserves. The lack of information on smoothing practices can result in a fallacy regarding how well Islamic banks actually manage PSIAs (Archer et al., 2010; IFSB, 2010, p. 9), and is likely to result in less transparent financial reporting.

The accounting practices for the PSIAs of Islamic banks that apply national accounting standards are closer to IFRS. They all classify PSIAs as liabilities, and provide limited disclosures related to PSIAs. In the case of the availability of disclosures, Islamic banks in Indonesia and Pakistan, which apply national Islamic accounting standards, disclose more information on the returns attributable to PSIAs. Nonetheless, disclosure on profit-payout smoothing practices is found only in Islamic banks in Pakistan. Similarly, Islamic banks in Malaysia and the UAE show a greater willingness to disclose information on their smoothing profit-payout practices compared to other countries’ Islamic banks that apply IFRS.

The AAOIFI provides standards on how to report PSIAs and related accounts, and requires certain disclosures relating to them. Although there are still gaps between the standards and practices, Islamic banks that apply AAOIFI FAS present a more uniform and transparent manner of accounting practices for PSIAs. Under AAOIFI FAS, it could be said that IAHs correspond to a special class of investors, while under IFRS, IAHs are no different to any other creditors. It is possible that this specific acknowledgement has encouraged Islamic banks to disclose a greater amount of information that is useful to IAHs.

5.7 Concluding Remarks

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 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.

Islamic banks, or IFIs in general, face challenges related to implementing the various accounting standards, which makes direct comparisons difficult. Specific standards or strict guidelines, in the case where no specific Islamic accounting standards are required, will be helpful in refining this condition.

Zeff (2012) also notes that despite the success of the IASB in promoting IFRS, the IASB needs to be aware that some businesses, such as IFIs, are conducted in different ways, so that proper attention must be paid to these nuances in the development of related standards. Thus, this research calls for attention from the related organizations and regulatory bodies, including the IASB, to the importance of harmonizing financial reporting standards for IFIs.

The survey in this chapter is limited by the availability of the Islamic banks' financial statements online. Nonetheless, this survey provides important insights into the possible areas related to PSIAs that need to be improved to increase the comparability and transparency of Islamic banks' financial reporting. It can also be seen as providing essential groundwork for a further critical study on financial reporting standards and practices for PSIAs and related accounts, to determine the appropriateness of, and adherence to, both the Islamic and accounting theoretical perspectives.

Chapter 6

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

6.1 Introduction

Previous chapters have explained the current situation with the level of accounting standards and practices for the accounting of PSIAs, with particular attention to unrestricted PSIAs. There are a few arguments for whether PSIAs should be liabilities (ACCA & KPMG, 2012, p. 11), equity (Atmeh & Ramadan, 2012, p. 16), or neither (Karim, 2001, p. 177-178; Shubber & Alzafiri, 2008, p. 18). Nonetheless, there are no theoretical defenses provided for any particular position.

PSIAs 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.

Those problems 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.

Based on previously mentioned issues, 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.

After the introduction, the second section lists the elements' classification issues discussed in the Islamic accounting literature. The next section, which is Section 6.3, tries to reveal the equity theories in conventional accounting according to some equity theorists while Section 6.4 specifically discusses equity theories in Islamic accounting literature and compares them to those explained in the preceding section. Based on the review in Section 6.4, Section 6.5 attempts to answer the research questions, analyzing whether the equity theory discussions mentioned in the preceding section have addressed the elements' classification issues. The last section or Section 6.6 concludes the study with the implications of the findings.

6.2 Element Classification Issues in Islamic Accounting

6.2.1 PSIAs

The discussions on PSIAs have been elaborated in the previous chapters. Instead of obtaining funds from creditors in the form of conventional loans, Islamic banks commonly cooperate with funds owners who are interested in investing their funds, in which case the banks have the right to manage and invest them in accordance with certain policies and profit sharing agreements. The relationship between Islamic banks and IAHs, as the owners of PSIAs, is considered as that of an investor-fund manager instead of a creditor-debtor relationship.

This contract has created a certain amount of confusion since it creates funds which partly share the characteristics of equity and partly those of liabilities (Karim, 2001; IOSCO, 2004). Two Islamic accounting standard setters, which are the AAOIFI and the Indonesian *Sharia*Accounting Standards Board (or DSAS-IAI), agree that there should be a mezzanine level between liabilities and shareholders' equity to accommodate PSIAs. Thus, in the case of Islamic banks, the widely-known basic accounting equation cannot be used and should be revised into:

Assets = Liabilities + PSIAs + (Shareholders') Equity

Therefore, the balance sheets for Islamic banks will have a new element's classification as illustrated in Figure 6.1.

Nonetheless, what PSIAs actually comprise of is not uniformly agreed. As discussed previously in Chapter 4, the AAOIFI believes that only unrestricted PSIAs, in which the

banks have the authority over the decisions to use and deploy the funds, should be included in the mezzanine level of the balance sheets, while the DSAS-IAI include both restricted and unrestricted PSIAs in the mezzanine level of the balance sheets.

Figure 6.1
The Balance Sheet for Islamic Banks under the Conceptual Frameworks for IFIs

<table>
<tr><td rowspan="3">Assets</td><td>Liabilities</td></tr>
<tr><td>PSIAs</td></tr>
<tr><td>Equity</td></tr>
</table>

The AAOIFI calls the unrestricted PSIAs "equity of unrestricted investment account holders". The board explains its reasons to separate these funds from liabilities and shareholders' equity:

> "The IFIs is not obliged to return the original amount of the funds received in case of loss, unless the loss is due to its negligence and accordingly, the equity of the investment account holders is not considered a liability of the IFIs. Likewise, the equity of unrestricted investment account holders is not considered to be the owners' equity since the holders of these accounts do not enjoy the powers and ownership rights, for example the voting rights, that are held by owners." (AAOIFI, 2015, Conceptual Framework, para 6/3)

This confusion will consequently bring forth another problem, *i.e.* whether the agreed profit sharing will be treated in a similar manner to an expense or a distribution. According to the AAOIFI, the agreed profit sharing is reported in the income statement as the return on investment accounts, which is considered as neither an expense nor a distribution, but an allocation of the investment profits and losses accruing to the IAHs (AAOIFI, 2015, Conceptual Framework, para 6/8). Figure 6.2 illustrates an income statement by an IFIs under the AAOIFI conceptual framework. A similar opinion is voiced by the DSAS-IAI, which agrees on the classification of the returns to IAHs as neither expenses nor distributions.

Figure 6.2
An Example of Income Statement for IFIs

Income		
From sales and purchases		$.........
From rent		…..
From profit sharing		…..
Total income from fund management by bank		…..
Less		
Return on PSIAs before bank's share as *mudarib*	…..	
Bank's share as *mudarib*	(…..)	
Return on PSIAs		(…..)
Other operating income		…..
Operating expenses		(…..)
Operating income (loss)		…..
Non-operating income and expenses		…..
Net income before *zakat* and income tax		…..
Zakat		(…..)
Income before income tax		…..
Income tax		(…..)
Net income		$.........

Source: modified from the AAOIFI (2015) and DSAS-IAI (2017)

6.2.2 Corporate **Zakat**

The five pillars of Islam, which consist of *shahada, salat, zakat, shawm,* and *hajj,* are the foundations of Muslim life. They are practiced consistently by Muslims and therefore affect Muslims' daily lives and behavior.

Shahada, the first pillar, is the creed or testimony of conviction for those who have faith or believe in the Oneness of God and the finality of the prophet-hood of Muhammad, while *salat* is the establishment of the daily prayers. The third is *zakat* or almsgiving, to the needy, at least once in a year, which is followed by the forth pillar, *shawm*or fasting during *Ramadhan.* The last one is *hajj* or the pilgrimage to Mecca for those who are physically and financially able to do so, which is also a symbol of equality and equity for every Muslim.

Among all of these five pillars of Islam, recently *zakat* has been discussed more intensely in the context of business, as it influences the accounting practices of Islamic businesses. Muslims are expected to distribute their wealth in accordance with Islamic rules, irrespective of whether the government takes part in the process of its collection and distribution.

Muslims are obligated to perform *zakat* once their wealth has met the requirements, which are *nisab* and *haul*, since in the wealth they own there are some shares which belong to the needy.[51] *Nisab* is the market value of 85 grams of gold while *haul* is the possession of the wealth for one lunar calendar or 355 days. The rate of *zakat* is not specifically mentioned in the Quran. However, according to *hadits*, it is generally 2.5% of the wealth that has to be levied as *zakat*.[52] This rate could change in the case of specific business activities, such as agriculture or mining. *Zakat* is performed by *muzakki* or *zakat* payer and belongs to the poor and needy. It goes to specific categories consists of eight groups of people called *mustahiq*.

[51]Quran 2:177, 2:267, 2:273

[52]According to AAOIFI in the FAS 9, "…In the case of the solar calendar the rate of *zakat* is increased to 2.5575% instead of 2.5%, as ruled by the Conference of *Zakat*" (FAS 9, p. 350).

Zakat is also the symbol of social justice in the Islamic community by preventing the accumulation of wealth in a few hands and assigning it to be more properly distributed (Sulaiman, 2003). Literally, *zakat* means growth, multiplicity, and purifying. In practice, the act of giving *zakat* means setting aside a specific portion of one's wealth and delivering it to the needy in order to purify it and gain Allah's blessing to make it grow in goodness.

Abdalati (1996) argues that *zakat* is not merely a charity, but it also has far-reaching effects (p. 72). In someone's wealth, there is a share which belongs to the needy. If he surrenders a part which does not belong to him, it will result in a clean society, because *zakat* also purifies someone's heart from selfishness and avarice. Nonetheless, the obligation to pay zakat is not an endorsement to be indolent. Ahmed (1991) quoted the story of Prophet Muhammad who bought a needy man an axe to cut wood instead of just giving him charity to meet his immediate requirements.

The issue related to classifications for *zakat* is highlighted by Adnan and Abu Bakar (2009). They point out that the current Islamic standards and guidelines, AAOIFI FAS No. 9 on *zakat* and the Malaysian Accounting Standards Board (MASB) Technical Release *i*-1 (TR *i*-1) entitled "Accounting for *Zakat* on Business", contain mistreatments, since both organizations classify *zakat* as an expense.

Adnan and Abu Bakar criticize that those current accounting standards and guidelines do not offer a proper treatment for corporate *zakat*. Classifying *zakat* as an expense is against the substance and spirit of *zakat* itself and cannot reflect the true purpose of *zakat*. As Islamic teaching is based on *tawhid,* that states God or Allah is the ultimate owner of everything on earth, they argue that *zakat* should be treated as a distribution, since it is basically "an act of transferring back the temporarily trusted wealth to the real owner" (Adnan & Abu Bakar, 2009, p. 40).

This argument is different from Mohd Nasir and Hassan (2005), who see the *zakat* paid

by corporations as a more complex issue, depending on who performs *zakat* in the company; it could be the company itself or the company on behalf of the shareholders as individuals. Although *zakat* does not contribute to revenue generating activities, it is an expense when it is paid by a corporation, since it satisfies the IASB definition of expenses that reduce the amount of assets and equity (Mohd Nasir and Hassan, 2005, p. 172). However, it should be a distribution when it is performed as an obligation of the shareholders as Muslims, with the assumption that the shareholders are individuals. Their reason is because *zakat* is taken from the shareholders' dividend portion (Mohd Nasir and Hassan, 2005, p. 173).

Whether an entity is liable to pay *zakat* is a long arguable issue. Some Islamic researchers suggest that a business entity is liable for zakat. One of them is Usmani (2002), who argues in his paper using a settled principle of the Shafi'i School, in which a joint-ownership company has made *zakat* payable on the joint-ownership as a whole, although one of the members of the joint-ownership may own assets not exceeding the *nisab*. It is similar to the Islamic *Fiqh* Academy's decision that *zakat* is attached to an enterprise as a corporate entity (AAOIFI, 2015, p. 348).

Different opinions on whether a corporate entity is liable to pay *zakat* result in the AAOIFI providing an explanation for both situations; when zakat is paid by a bank as a corporation, or by the shareholders as individuals. AAOIFI FAS 9 on *zakat* (2015) explains that in the case that Islamic banks are obliged to pay *zakat*, it should be treated as non-operating expenses and included in the calculation of net income (para 9). However, if Islamic banks are not obliged to pay *zakat* and the shareholders ask the banks to pay *zakat* on their behalf, it should be deducted from the shareholders' share of distributable profits (AAOIFI, 2015, FAS 9, para 10). The statement of sources and uses of funds in the zakat and charity funds should be prepared by the banks, and present all the *zakat* and charity funds from various sources (AAOIFI, 2015, FAS 9, para 12).

In Indonesia, the DSAS-IAI has not developed accounting standards for corporate *zakat*. The reason behind this issue is the debate whether an entity, or only an individual, is liable to pay *zakat*. As a result, DSAS-IAI does not mention how *zakat* is presented in the income statements. Thus, some IFIs in Indonesia that pay *zakat* follow AAOIFI standards by presenting *zakat* as an item before income tax, while others do not explicitly present *zakat* but disclose it as an item in non-operating expenses. Nonetheless, both ways of presenting zakat considers *zakat* as an expense.

6.3 Accounting Point of View: Equity Theories in Conventional Accounting

Accounting serves the interest of the party (or parties) it places the focus on. In order to provide useful information for the users, as well as maintain a consistent treatment for the items presented in the financial statement, it is important to decide the accounting point of view. The question is, whose point of view it is?

Before embarking on further discussions of the equity theories, 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.

6.3.1 Various Views on Equity Theories

Principally, there are two widely known views in corporate accounting affecting how businesses are managed, which are the proprietary and entity views.[53] The proprietary view

[53]The two theories are also known by other names. In law, Roberts (1955) denotes that the entity view is similar to the fiction theory while the proprietary theory is known as the association theory, in which both have different opinions regarding the granting of power or the recognition of authority in the corporate enterprise (p. 12). The fiction theory believes that the government giving the power to act to the corporate

(Husband, 1938) and the entity view (Paton, 1922; Anthony, 1984) have gained more attention, compare to the other equity theories, such as the fund view (Vatter, 1947), the enterprise view (Suojanen, 1954), the commander view (Goldberg, 1965), and the residual equity view (Staubus, 1959). The latter views are argued to be improvements to the previous two views (Lorig, 1964, p. 563) and said to be less supported in the practice of business accounting (Van Mourik, 2010, p. 195). The fund view and commander view, however, refrain from setting up priorities among interests and have the tendency to be similar to the other equity theories (Meyer, 1973, p. 125). Thus, they will be excluded from the discussion in this chapter.

The exploration on equity theories shows that many accounting books and papers refer to the same equity theories by different names. Therefore, it is important that this chapter defines each equity theory.

6.3.1.1 Proprietary View

According to this view, a company owned by some persons or groups is the center of interest, which is called the proprietor. Accounting is held to serve the proprietor's interests and the items in the financial statements are treated from the proprietor's, or shareholders', point of view, since the proprietor gets the ultimate benefits of the business, as well as suffering from any failure the most (Rosenfield, 2005).

The notion of proprietorship originally comes from the logic of the exposition of double-entry bookkeeping:

Assets – Liabilities = Shareholders' Equity or Proprietorship

---

enterprise and the association theory states that the rights of the shareholders are transferred from the shareholders to the corporate enterprise (Roberts, 1955, p. 13).

From this basic accounting equation, it can be interpreted as all the assets of the firm belong to the owners or proprietor, and any liabilities are also their obligation. Thus, revenues received by the firm are increases of the proprietorship of the firm and, likewise, the liabilities born by the firm are decreases of the net proprietary interest in the firm (Hendriksen & Breda, 2001). The important stress in accounting is to determine the owners' or proprietor's net income or the changes in their wealth or proprietorship (Lorig, 1964, p. 565). As a consequence, retained earnings are assumed to belong solely to the proprietor. In other words, the firm itself is seen as simply an instrument or a medium that the proprietor or owners use to increase their wealth (Meyer, 1973, p. 116).

Interest, taxes, and other deductions are treated as expenses since they decrease the proprietorships; the only distribution is the dividend paid to the stockholders. Husband (1954), an accounting theorist who favors the proprietary view, finds that this treatment provides logic and consistency in accounting thinking, as stockholders or owners are the ones who bear the ultimate risk. He insists that the proprietary theory "appears to provide a more realistic basis for the development of accounting principles, in spite of the fact that it encounters an obstacle in the situs of legal title" (Husband, 1938, p. 253).

Lorig (1964) criticized the proprietary view as being unclear in defining who are included as the proprietors in a business corporation, although "an overwhelming majority of accountants consider only the shareholders to be the owners" (p. 565). It is because shareholders are the owners who have influence on the management of the company, bear the ultimate risk, and their rights constitute the company's residual equity. With those specific characteristics of shareholders, they have the right to control their managers, including removing them from the company, and thus the managers tend to serve the shareholders' interests above other interests (Lorig, 1964, p. 566).

When this proprietary view is adopted for Islamic banks, the balance sheets will result in the classification of PSIAs as liabilities. It is because there is no equity other than the equity that belongs to the shareholders, who are considered to be the owners with control, and who bear the greatest risk. The balance sheet then becomes similar to the current balance sheets of Islamic banks that apply IFRS.

Figure 6.3
Balance Sheet of Islamic Banks under the Proprietary View

This view is said to be best applied in the case of small businesses or single proprietorship companies where the owners or proprietor can be easily identified. Under this claim, it might become less acceptable to adopt the proprietary view when the businesses are bigger and more complex.

However, Hendriksen and Breda (2001) argue that many of today's accounting practices are still strongly affected by this view and imply that retained earnings are the net wealth of the shareholders. The comprehensive income, which includes all items affecting the net wealth, is one of the accounting practices that reflect the influence of the proprietary view (Hendriksen & Breda, 2001, p. 770).

6.3.1.2 Entity View

Some scholars proposed the entity view, which points out that a company does not belong solely to the shareholders. According to this view, the income of a corporation is not the income of the shareholders. It only becomes the 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 are not intended specifically for the shareholders.

Despite the same idea that accounting is conducted from the viewpoint of the entity itself, there are two different proposals in the entity view, which are proposed by Paton (1922) and Anthony (1984). Nonetheless, there are disputes over whether these two views are other versions of the proprietary or entity view. Meyer (1973) considers Paton's entity view to be another form of proprietary view, which focuses on the equity holders as a group of owners, while Van Mourik (2010) refers to both views as the entity view which has its focus on "self-equity". This section supports the latter opinion, similar to Goldberg (1963) who noted that, perhaps, Paton is the most responsible person to have spread the ideas of the entity view (p. 462).

6.3.1.2.1 Entity View based on Paton's Proposal

In 1922, Paton, a well-known entity theorist wrote in his book that the doctrines of proprietorship have led to serious errors. Paton's work is one of the most valuable contributions to the development of the entity view. He is known for his revision of the accounting equations, which he claimed as the most logical expression, into:

Assets = Equities

Paton's original proposal does not refer to equity that belongs to the entity itself. Nonetheless, Paton (1922) argues that a company, as a legal entity, is "the owner, in about the same sense that the sole-proprietor in an unincorporated business, is the owner" (p. 76) that makes the ownership "reside in the corporate entity itself" (p. 77). Thus, although Paton did not specifically use the term "entity equity", it can be assumed that the equity section will include liabilities, shareholders' equity, and the entity's equity itself. Any surplus is thus included as equity, which is considered to belong to the entity itself. The balance sheet under this view will omit the separation of liabilities and stockholders' equity and is illustrated in Figure 6.4.

Figure 6.4
Balance Sheet under Paton's Entity View

Assets	Equities Liabilities Shareholders' Equity Entity's Equity

The equation carries consequences for the treatment of taxes, interest, and dividends. Under this view, the cost of sales or expenses should exclude any appropriations liable to contractual or residual equities, and be restricted to the demise of purchased structures, commodities and services. Paton's entity view recognizes that distribution belongs not only

to the shareholders, but to all the equity holders. The proposed income statement is exhibited in Figure 6.5.

Figure 6.5

Income Statement under Paton's Entity View (only sections after operating net revenue)

Operating Net Revenue	$.........	
Interest Earned	…..	$.........
Fire Loss		…..
Net Revenue to All Equities, Before Deducting Taxes		$.........
Interest on Mortgage Bonds	$.........	
Interest on Debentures	…..	
Interest on Notes	…..	…..
		$.........
Federal Income and Profit Taxes		…..
		$.........
Preferred Dividends		…..
Net Balance for Common Stock		$.........
Common Dividends		…..
Undivided Profits		$.........
Surplus Balance, Jan 1, 20xx		…..
		$.........
Reserve for Contingencies		…..
Total Unappropriated Surplus, Dec 31, 20xx		$.........

Source: Paton (1922, p. 269-270)

When this view is adopted for Islamic banks, the balance sheets will result in the classification of PSIAs as equities, together with liabilities and shareholders' equity, as they all are equities with different rights. Substituting one form of capital for another does not affect the operations, because this view considers debt and equity providers as fundamentally indistinguishable. The balance sheet is illustrated in Figure 6.6.

Figure 6.6

Balance Sheet of Islamic Banks under Paton's Entity View

Assets	Equities
	Liabilities
	PSIAs
	Shareholders' Equity
	Entity's Equity

6.3.1.2.2 Entity View based on Anthony's Proposal

Another interpretation of the entity view comes from an entity theorist, Anthony (1984), who explains that under the entity view, the entity owns the assets and owes the amounts due to outside parties. Thus, he proposes three sources of funds for entities, which are supplied by creditors, shareholders, and those generated by the entity's own efforts. Funds supplied by creditors are liabilities, while funds supplied by shareholders are the shareholders' equity. Those two fund supplies fill the credit side of the balance sheets, together with the third type of funds called the entity equity. According to Anthony, all constituents other than the entity itself are considered "outsiders" or "third-parties" (Zambon & Zan, 2000, p. 810). In other words, the only equity is the entity equity itself, while other sources of funds are considered liabilities of the entity.

The balance sheet reflects the investment and financing of the entity as a whole, and thus simplifies the basic accounting equation to:

Assets = Sources of Funds

As a result, the balance sheet under Anthony's entity view will look different from the one proposed by Paton, as shown in Figure 6.7.

Figure 6.7
Balance Sheet under Anthony's Entity View

Assets	**Sources of Funds** **External Sources** *Liabilities* *Shareholders' Equity* **Internal Source** *Entity's Equity*

This concept is also trying to answer the question from Husband (1954) which casts doubt on the consistency of the entity view, since the previous entity view does not explicitly provide entity equity or the entity's profit as the bottom line. Anthony's entity view tries to consistently consider all the constituents as third parties and the beneficiary of the accounting process is the firm itself. Therefore, in contrast to Paton's entity theory, it treats all taxes, interest, and dividends as expenses.

When this view is adopted for Islamic banks, the balance sheets will result in the classification of PSIAs as third parties' funds, together with liabilities and shareholders' equity. Although they are labeled as "external sources of funds", all of them are essentially obligations of the entity. The balance sheet is illustrated in Figure 6.8.

Figure 6.8

Balance Sheet of Islamic Banks under Anthony's Entity View

Assets	**Sources of Funds** **External Sources** *Liabilities* *PSIAs* *Shareholders' Equity* **Internal Source** *Entity's Equity*

6.3.1.3 Enterprise View

The new trend for the social concept of firms has played an important role in the formulation of the enterprise view, another equity theory which emphasizes a company's social responsibility. This view focuses on the role of a business enterprise in satisfying the many demands of society, including those of employees, creditors, shareholders, customers, suppliers, and even the community at large (Meyer, 1973, p. 120).

According to this view, a firm is merely a convenient means for achieving goals, in which various participants make contributions to the corporation, particularly a large corporation, in order to gain benefits. Differing from the entity view, it sees that the firm itself owns no assets and enjoys no income.

Suojanen (1954) first formulated the enterprise view as he saw that the development of the social concept of a firm could have implications for the accounting theory and raised the necessity of a supplementary method of income reporting, which he called value-added statements (see Figure 6.9). He believes that large corporations or companies, which legally have their own rights, could have a more significant meaning other than merely being a term;

this has consequences for a company's corporate social responsibilities and it has an equal responsibility, including accountability, to all the parties involved in the company's activities.

Figure 6.9

Value-Added Statement

Sales		$.........
Less: materials, supplies, and service used		…..
Total value added		$.........
Distribution of value added:		
To employees		$.........
To providers of capital		
Dividends	$.........	
Interest	…..	…..
To government		…..
To enterprise for expansion		
Profit retained		…..
Total value added		$.........

Source: Kam (1986, p. 316)

Soujanen (1954) argues the importance of preparing value-added statements, which are intended:

> "…to provide more information to the various participants than they obtain at the present time from either the income statement or the balance sheet, which should still be prepared as they are presently. The value added would be a supplementary report analyzing the value added in production and its source or distribution among the organization's participants" (p. 396).

Therefore, the balance sheets and income statements as currently provided are still considered as the main financial statements. The value-added statements are necessary, following the assumption that a corporation has continuing responsibilities that are not limited to shareholders alone.

Despite the absence of a new equation for the balance sheet in Suojanen's original proposal for the enterprise view, Meyer (1973) and Van Mourik (2010) interpret that as financial reporting being prepared from the perspective of an enterprise as a social institution, the balance sheets under this view will be:

Assets = Investors' input contributions

As a result, "from the point of view of all the participants, all payments (disbursement of assets) to any participant are distributions of revenue" (Meyer, 1973, p. 120). With this point, the similarity between the enterprise view and Paton's entity view can be spotted. Therefore, Van Mourik regards this view as a broader concept of the entity view (p. 204).[54]

The concept of the enterprise view, as interpreted by Meyer (1973) and Van Mourik (2010), is still weakly defined, as there are some points left unexplained. Who are considered as "investors" who input their contributions to the company? Should "direct involvement in the company's business" be a requirement for a party to be regarded as a "participant"? Thus, the concept as proposed by Soujanen is still the common interpretation of the enterprise view.

[54]In his paper, Meyer (1973) refers to the enterprise view as the "social view". He uses the term "enterprise view" to match the idea of accounting as proposed by the American Accounting Association (1957) entitled *Accounting and Reporting Standards for Corporate Financial Statements and Preceding Statements and Supplements*. This section excludes this view as it is not commonly discussed as a new proposal for the equity theories but as a synthesis of various equity theories.

When the enterprise view is adopted by Islamic banks, they are required to prepare the value-added statements, which present the distributions of the value added to the related parties. There is no specific form for a balance sheet under Suojanen's proposal, as his idea focuses on the necessity of value-added statements in comparison to income statements.

6.3.1.4 Residual Equity View

Staubus (1959) is known as a strong proponent of this view, which takes into account the change in the nature of the business entity from a legal viewpoint when a business becomes insolvent (Van Mourik, 2010). His definition of residual equity is "the equitable interest in the organization's 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. 8). He highlights that such unfortunate business conditions might change the position of the residual equity holders from shareholders to creditors (Staubus, 1959, p. 8).

Accordingly, Staubus revised the balance sheet equation into:

$$\text{Assets} - \text{Specific Equities} = \text{Residual Equity}$$

Van Mourik (2010) argues that this view is another form of proprietary view (p. 197). It is because the transactions are analyzed, recorded, and accounted for as to their effect on the business's residual equity holders, usually the common shareholders.

6.3.1.5 Equity View (In between the Proprietary-Entity Views)

Van Mourik (2010) argues that this view corresponds largely with Paton and Littleton's application of the entity theory published in 1940 and refers to this view as "the equity view" (p. 200). It sees the entity as being independent from the owners, which reflects the entity

view, but also resembles the proprietary view because “it sees management as the shareholders’ agents, stresses the residual nature of the shareholders’ interests, and thus it focuses on the information needs of investors, particularly investors in equity capital and considers retained earnings as belonging to the common shareholders rather than to the entity” (Van Mourik, 2010, p. 200).

Furthermore, Van Mourik sees the equation of the balance sheets under this view as:

Assets = Liabilities + Shareholders’ Equity

Nonetheless, Hendrikson and Breda (2001) call this view the “entity view”, in which liabilities on the right hand side are seen as equities with different rights in the enterprise (p. 771). Hence, the rights of shareholders to receive dividends and share in the net assets upon liquidation are the rights of equity holders, rather than owners, of the specific assets. Net income simply represents a residual change in the equity’s position after deducting all the other claims, including the interest on long-term debt and income taxes (Hendriksen & Breda, 2001, p. 772). It is personal income to the shareholders only if the value of the investment has increased or to the extent where a dividend declaration can be made.

Although Hendrikson and Breda (2001) denote this view as the entity view, they also agree that Paton’s entity view is in strict adherence to the entity view. Van Mourik (2010) disagrees and claims that this view should not be called an entity view, as it lies between the proprietary and entity views. He prefers to name it the “equity view”. Furthermore, he believes that this view is the IASB/FASB’s interpretation of the entity perspective (Van Mourik, 2010, p. 200), when the joint project between the two boards published *Preliminary views on an improved conceptual framework for financial reporting: The objective of*

financial reporting and qualitative characteristics of decision –useful financial reporting information in 2006.

However, 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.

Thus, this view has a resemblance to the proprietary view and the entity view, with possible different opinions on what the equities actually comprise of. When there are other equity holders, beside the shareholders, the balance sheet equation will refer to the equity as belonging to all the equity holders, instead of only the shareholders.

6.3.2 Basic Financial Statements under Various Views on Equity Theories

Various views of the equity theories and their effect on the classifications on the credit side of the balance sheet have been elaborated. In this regard, how the income statements will look under these different views may become a question. Thus, this section gives simple illustrations of the basic financial statements of Islamic banks under each view.

In order to simplify this, it is assumed that the banks only provide unrestricted PSIAs. No PSIAs with restrictions, or restricted PSIAs, are offered by them. Each bank also maintains no reserve accounts. Considering the debate on whether a company is liable for *zakat*, as explained in the previous section, the illustration will assume no *zakat* payments are made by the banks.

6.3.2.1 Proprietary View

According to this view, the proprietor or the owners are the center of interest. Thus, accounting is seen from the point of view of the shareholders, as the owners of the company. The emphasis in the accounting is to determine the proprietor's net income or the changes in the proprietorship (Lorig, 1964, p. 565). As a result, interest, taxes, and other deductions are treated as expenses since they decrease the proprietorship; the only distribution is the dividend paid to the shareholders.

Figure 6.10 illustrates the basic financial statements of an Islamic bank under the proprietary view, which results in the net income attributable to the shareholders as the bottom line. Retained earnings are thus assumed to belong solely to the proprietor.

Figure 6.10

Basic Financial Statements of an Islamic Bank under the Proprietary View

Income Statement

For the year 20XX

Income	
Income derived from Investment Pool's funds (shareholders' funds and PSIAs)	
Deferred sales	$ xxx
Investments	xxx
	xxx
Income derived from investment of shareholders' funds	xxx
Total distributable income	xxx
Expenses	
Administrative and general expenditures	(xxx)
Depreciation	(xxx)
Profit-sharing to IAHs	(xxx)
Income before tax	xxx
Income tax	(xxx)
Net income attributable to shareholders	$ xxx

Statement of Retained Earnings

For the Year 20XX

Balance on January 1	$ xxx
Net income	xxx
Dividends	(xxx)
Balance on December 31	$ xxx

Balance Sheets

December 31, 20XX

Assets		**Liabilities and Shareholders' Equity**	
Current assets	$ xxx	**Liabilities**	
Long-term assets	xxx	Current liabilities	$ xxx
Total assets	**$ xxx**	Long-term liabilities	xxx
		PSIAs	xxx
		Total liabilities	xxx
		Shareholders' Equity	
		Common stock	xxx
		Retained earnings	xxx
		Total shareholders' equity	xxx
		Total liabilities and shareholders' equity	**$ xxx**

6.3.2.2 Entity View

The illustration of the financial statements under the entity view will be divided into two. The first one sees the balance sheet equation as the combination of various equities, which is based on the idea proposed by Paton. The second one is the opposite, which considers all the sources of funds, other than those created by the entity itself, as external sources.

6.3.2.2.1 Entity View based on Paton's Proposal

In his proposal, Paton (1922) did not specifically use the term "entity equity" Nonetheless, his idea on ownership that "resides in the corporate entity itself" (Paton, 1922, p. 77) can be interpreted that the company should have the equity that belongs to the entity itself. Thus, it can be assumed that the equity section will include liabilities, shareholders' equity, and the entity's equity itself.

Figure 6.11 illustrates the basic financial statements of an Islamic bank under the entity view based on Paton's proposed model, which results in the net income attributable to all the equity holders as the bottom line. Income tax payments also represent a distribution of income. Retained earnings are thus assumed to belong solely to the entity itself.

Figure 6.11

Basic Financial Statements of an Islamic Bank under Paton's Entity View

Income Statement

For the year 20XX

Income	
Income derived from Investment Pool's funds (shareholders' funds and PSIAs)	
Deferred sales	$ xxx
Investments	xxx
	xxx
Income derived from investment of shareholders' funds	xxx
Total distributable income	xxx
Expenses	
Administrative and general expenditures	(xxx)
Depreciation	(xxx)
Net income to all equity holders	$ xxx

Statement of Retained Earnings

For the year 20XX

	Balance on January 1	Additional	Distributions	Balance on December 31
Equities	xxx	xxx	(xxx)	xxx
Taxes	xxx	xxx	(xxx)	xxx
PSIAs	xxx	xxx	(xxx)	xxx
Shareholders' Equity	xxx	xxx	(xxx)	xxx
Entity's Equity	xxx	xxx	(xxx)	xxx

Balance Sheets

December 31, 20XX

Assets		**Equities**	
Current assets	xxx	Current liabilities	xxx
Long-term assets	xxx	Long-term liabilities	xxx
Total assets	**xxx**	PSIAs	xxx
		Shareholders' equity	xxx
		Entity's equity	xxx
		Total equities	**xxx**

6.3.2.2.2 Entity View based on Anthony's Proposal

Anthony (1984) explains that under the entity view, the entity owns the assets and owes the amounts due to outside parties. Anthony's entity view tries to consistently consider all the

constituents as third parties and the beneficiary of the accounting process is the firm itself. In contrast to Paton's entity theory, it treats all taxes, interest, and dividends as expenses, and results in the net income being the entity's profits.

Figure 6.12

Basic Financial Statements of an Islamic Bank under Anthony's Entity View

Income Statement

For the year 20XX

Income	
Income derived from Investment Pool's funds (shareholders' funds and PSIAs)	
Deferred sales	$ xxx
Investments	xxx
	xxx
Income derived from investment of shareholders' funds	xxx
Total distributable income	xxx
Expenses	
Administrative and general expenditures	(xxx)
Depreciation	(xxx)
Distributions to IAHs	(xxx)
Dividend	(xxx)
Income before tax	xxx
Income tax	xxx
Net income	$ xxx

Statement of Retained Earnings

For the year 20XX

	Balance on January 1	Additional	Distributions	Balance on December 31
Entity's Equity	xxx	xxx	(xxx)	xxx

Balance Sheets

December 31, 20XX

Assets		Sources of Funds	
Current assets	$ xxx	**External Sources of Funds**	
Long-term assets	xxx	Current liabilities	$ xxx
Total assets	**$ xxx**	Long-term liabilities	xxx
		PSIAs	xxx
		Shareholders' equity	xxx
		Internal Sources of Funds	
		Entity's Equity	xxx
		Total sources of funds	**$ xxx**

6.3.2.3 Enterprise View

Soujanen (1954), who is known as a proponent and pioneer of the enterprise view, criticized the rationale for the reported income figures in both the proprietary and the entity views, which revolve around the issues of the existence of, "a natural or artificial person" (p. 391). He highlights that corporations have social responsibilities, since the decisions made by the enterprise have impacts on many parties that either directly or indirectly interact with the enterprise (Suojanen, 1954, p. 392).

The preparation of value added statements is necessary, following the assumption that a corporation has continuing responsibilities that are not limited to its shareholders alone. Nonetheless, the current balance sheet or income statement is still considered to be the main financial statement, which means no new balance sheet or income statement under the enterprise view is presented here.

6.3.2.4 Residual Equity View

The residual equity view takes into account the change in the nature of the business entity from a legal viewpoint when a business becomes insolvent (Van Mourik, 2010). In the normal business condition, it will result in the same income statements and balance sheets as illustrated in Figure 6.10. There are no preferred shares in Islamic banks, since the act of paying fixed dividends is not allowed by *sharia*.

6.3.2.5 Equity View

The balance sheet under this view will depend on the definition of "equity" or "equity holders". It may look similar to that issued under the proprietary view, where the shareholders are regarded as the only equity holders of the company. When there are other

parties considered as equity holders, this affects the income statements in which the bottom line becomes the net income belonging to all the equity holders.

6.4 Accounting Point of View: Equity Theories in Islamic Accounting

Some Islamic accounting scholars have tried to find the link between Islamic accounting and the accounting points of view or equity theories. Similar to the debate on conventional accounting, Islamic accounting scholars also vary in their opinions regarding which equity theory is best implemented in Islamic accounting.

6.4.1 Different Notions of Equity Theories in Islamic Accounting Literature

Gambling and Karim (2001), two leading authors or pioneers in contemporary Islamic accounting, argue their points using the proprietary and equity views. Their book has been considered to be important in Islamic accounting literature, as they tried to develop Islamic accounting theory from the normative approach. They argue:

> "The entity concept is another basic assumption of conventional Western accounting. It views the business organization as an entity separate from its owners. In accounting, a number of theories have attempted to describe the relation between the organization and its owners. According to the proprietary theory, the firm's owners are the focus of the attention. While a firm is considered by law to be an entity separate from its owners, the proprietary theory advocates the view that the firm is an instrument of the owners. The assets of the firm belong to them and its liabilities are their obligations. In this context, accounting plays the role of determining the net worth of the owners. Hence the importance of thebalance sheet as a major source of information. . . the nature of Islamic enterprise would indicate the use of the proprietary theory, as does the need to

account for *zakat* on the value of the stockholders' share of the corporate assets" (Gambling & Karim, 1991, p. 103)

Gambling and Karim propose the proprietary view as the basis for Islamic accounting. Their reason of this preference is based on the consideration that only individuals, and not entities, are liable to pay *zakat*, and therefore the wealth should be calculated from the viewpoint of the owners, to find out the value of the assets and determine the amount of *zakat*. Gambling and Karim, however, do not voice their opinion on the case that shareholders are not individuals.

The discussion of the equity theory in Gambling and Karim's book covers only the proprietary view and has no explicit arguments leading to the entity view. They hesitate to accept the concept of a corporation as an independent legal entity. Nonetheless, it is a debatable issue that has been accepted by the Islamic *Fiqh* (jurisprudence) (AAOIFI, 2010, p. 41), since it has similarities to some Islamic organizations, such as *waqf* (trust foundation), the Mosque, and *dar al-mal* (treasury). It carries the consequence that Islamic financial institutions are considered as accounting units, separate from their owners or other parties who have provided the financial institutions with funds.

Taheri (2005), another proponent of the proprietary theory for Islamic accounting, argues that since individuals, not entities, are personally responsible for their commissions or omissions in life, Islamic accounting is based on the proprietary theory (p. 51). Moreover, he also argues that the entity view is the cornerstone of current British-American accounting and distinguishes the Islamic accounting model from the British-American accounting one; the British-American model uses the entity view, which ignores the social effects, as a theoretical concept while the proprietary concept should be the basis of the Islamic model (Taheri, 2005, p. 51).

On some points, there are flaws in Taheri's arguments. His argument is weakened since the primary goal of accounting, under the proprietary view, is the measurement of profit in a free enterprise society (Husband, 1954, p. 553-554), which is the grand idea of capitalism. In addition, Taheri's argument also conflicts with those of other Islamic scholars, who claim that the overemphasis on the shareholders' interests is the weakness of the proprietary view (Mohamed Ibrahim, 2000; Triyuwono 2001; Harahap, 2008). Furthermore, Taheri also insists that the current conventional accounting is based on the entity view and thus ignores the relationship between the company and society, or the stakeholders in a broader context, and then proposes the idea of value-added statements, which indicates that his idea has shifted from the proprietary to the enterprise view.

A different idea came from Baydoun and Willet in 1994, who first delivered the idea of value-added statements to replace income statements, which then inspired many other researchers to develop similar ideas. Although the first idea was delivered in 1994, their paper was not published until 2000. In this paper, there is no discussion of the accounting point of view, but it reflects the notion of the enterprise view.

> "In contrast to the focus on the owners of the entity in western financial accounting standards, the focus in Islam on the Unity of God, the community and the environment demands a form of social accountability rather than the personal accountability found in Western societies" (p. 81).

Moreover, after arguing the importance of interaction between companies and the society, they propose value-added statements for Islamic financial reporting, which is expected to not only concentrate on dividends, but also to promote the issue of the fair and ethical distribution of a firm's added value. This statement will stress entity performance

from a community's viewpoint, as opposed to focusing on an 'individualistic' entity performance from the viewpoint of the owners, and has more emphasis on the distribution of value-added rather than only dividends.

One of the followers of Baydon and Willet's idea is a leading Indonesian Islamic accounting researcher, Harahap (2008), who wrote a book proposing the value-added statement, similar to Baydoun and Willet's idea.

> "The newest concept is called the enterprise theory, in which the financial accounting information presented is focused on all the stakeholders; owners, investors, creditors, management, employees, and also society. It has inspired the emergence of social economy accounting, value-added accounting, and human resources accounting. This concept is more compatible for Islamic accounting and will become more appropriate if 'God's longing' is added instead of merely human's" (p. 20).[55]

In his book, he mentions that the proprietary, investor, and entity views are three capitalistic accounting views, because those theories focus only on specific groups; owners, investors or creditors, and management, who manage the entity, respectively. Those theories, according to Harahap, represent a capitalistic form of accounting, which clash with Islamic values. On the contrary, the enterprise view sees profit as a whole, including the society's or stakeholders' participation, instead of only from the individual or owner's side (proprietary view) or company's side (entity view). Differing from Taheri (2005), Harahap argues that "a company is a citizen and thus it has to be a good citizen. An unliving entity, as well as a living one, is also a *mukallaf* (one who is competent enough to be responsible for religious

[55]Translated by author.

duties) and has an obligation to Allah"[56] (p. 121). Therefore, a company has to benefit both society and stakeholders.

Furthermore, Harahap (2008) also proposes a correction to the balance sheet equation for Islamic accounting. He argues that certain social rights are in the company's assets, and belong to poor people. In the case of an emergency, for example, a company has to be willing to allow its property to be used for social purposes. Thus, he sugests that:

Assets = Liabilities + *Shirkah* Funds + Equities + Rights of the Needy

Harahap (2008) insists that the "rights of the needy" in this equation should be designated by the government, depending on the socio-economic condition of the country (p. 202). Although he states that his idea uses the concept of the enterprise view, instead of focusing only on the income statement as the conventional enterprise view does, he also revises the accounting equation, which will have a direct influence on the balance sheet.

The idea of replacing income statements with value-added statements is also aggressively followed by another Islamic accounting researcher from Indonesia, Triyuwono (2001, 2003) who tries to develop Islamic accounting theory from a philosophical aspect. He proposes the Islamic enterprise view by adding Islamic values to the conventional enterprise view. In his papers, he proposes the Islamic enterprise view by overruling the entity view, which he claims is a modern idea with capitalistic values (2001), and most of its content is still based on ideological aspects similar to the proprietary view (2003).

> "The entity theory does not express itself as an absolute ownership concept, but it still continues the preceding theory by emphasizing the indefinite accumulation of wealth.

[56]Translated by author.

> Individual absolute ownership, as symbolized by the proprietary theory, is not in use anymore; the rights and obligations of the owners become limited to a company's wealth. As a substitute, a business entity now has the power to utilize its own income and wealth, which surely is for the prosperity of the owners" (Triyuwono, 2003, p. 80-81).[57]

Triyuwono subverts the entity view in favor of the enterprise view as a superior one. He also adds that the entity view has erased the owner's social responsibilities, since absolute ownership is not based on its power to realize its wealth, but on the freedom not to be involved in ethical or social aspects. The transformation of the focus of attention and the wealth's orientation from owners to the business entity is a cover for the normative problem of capitalism in business. Since the owner is the entity itself, the owner does not have to be burdened by ethical questions about its wealth. The ethical and normative legitimization problems of an owner's wealth are not considered a concern in this concept, since owners are external parties or outsiders (Triyuwono, 2003).

Triyuwono's way of proposing the enterprise theory is copied by Mulawarman (2006), who insists that current accounting standards, including Islamic accounting standards by the AAOIFI, have fundamental weaknesses since they are based on the entity view. Neither Triyuwono nor Mulawarman explain clearly which parts of the current accounting standards reflect the practice of the entity view, which is a weakness in their arguments.

6.4.2 The Benefits and Limitations of Equity Theory Discussions in Islamic Accounting

Discussions about equity theories can also be found in Islamic accounting literature. Many Islamic accounting scholars blame the proliferation of capitalism and its ideas for their

[57]Translated by author.

problems, and thus tend to prefer one view over another to try to free Islamic accounting from the influence of capitalism (Gambling & Karim, 1991; Taheri, 2005; Triyuwono, 2001, 2003; Mulawarman, 2006; Harahap, 2008). It is because capitalism is endorsed by the concept of secularism where religious affairs are separate from the state (Abu Sulayman, 1993), which is completely different from the Islamic point of view, where religion governs all affairs. The concept of freedom, which is guaranteed by the state, plays a major role in the capitalist ideology. Therefore, certain accounting scholars insist that the current global accounting standards, which have adopted capitalistic values, cannot be in line with Islamic values.

All the discussions about equity theories in the Islamic accounting literature 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 6. 1). They also try to release Islamic accounting from the influence of capitalism, which has an image of being insensitive to social and ethical issues. Therefore, 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.

Table 6.1

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

Harahap (2008), although he proposes value-added statements, equally tries to look at the enterprise view from both its positive and negative sides, by voicing concerns about the limitations of value-added statements as a replacement for income statements. Some of the limitations he mentions are: (1) Not all involved parties are satisfied, there is a possibility of more incisive conflict; (2) by using value-added statements, management may want to maximize the value-added, which can cause inefficiency; and (3) a wrong interpretation of value-added can result in misunderstandings, such as an increase in the value-added is considered similar to an increase in the profits (Harahap, 2008, p. 230). More incisive conflict

can be caused by different perceptions of how value-added is fairly distributed, while inefficiency may result from wrong decisions by the management to maximize value-added, which can "cost" much bigger value-added distributions to specific groups, such as employees. It is also important to notice that an increase in value-added is not similar to an increased profit, since it does not always mean an increase in the distribution for the owners or investors (Harahap, 2008, p. 230).

The high awareness of the interests of society as a whole is not surprising. Thakur (1996) argues that religion can play a significant role in advancing the cause of social justice, through its emphasis on morality and the spiritual visions necessary for attaining social justice in society. In Islam, social justice can be considered as a core value of Islamic teachings. In view of that, Kamla (2013) notes that Islamic finance and economics literature are dominated by ideas advocating that the role of Islamic finance should constitute much broader social objectives (p. 933).

Human beings are essentially a part of the community; they are not independent from it and have a responsibility to it. Although Islam has concerns about individuals, these concerns also encompasscomprise the community, emphasizing social justice and welfare. Islam prescribes the basic principles of social justice, such as establishing the claim of the poor to the wealth of the rich through *zakat*.

Consequently, Islamic banks, in their business operations, have been described as having a 'social face' (Mashhour, 1996, p. 33). As such, social activities are emphasized in Islamic banks. Iqbal and Mirakhor (2007) state that the prohibition of interest has two dimensions: One is to promote more risk-sharing contracts for commercial activities, and the other is to consider lending as a benevolent act. Therefore, Islamic banks also provide *qardhasan*, which is a loan with repayments over a certain period with no profit accruing to the fund providers. Consequently, Kamla (2009) notes that Islamic accounting should also

place emphasis on the religious as well as the financial, and be accountable to society and the environment as well as fund providers, and report the non-measurable as well as the measurable (p. 924).

Hence, the AAOIFI also mentions that the objectives of financial accounting and financial reports are not only to provide useful financial information to users, but also information about IFIs' compliance with the Islamic principles and Islamic business values. This includes some social aspects as the objectives of financial reporting, which are providing information to assist the concerned party in the determination of *zakat*, and information about the Islamic banks' discharge of their fiduciary and social responsibilities (AAOIFI, Conceptual Framework, 2015, para 3/2).

It should be noted that although IFIs are not merely profit-oriented, they are also institutions that try to make money from their business activities, similar to other corporations. The acquisition of personal wealth and property is allowed in Islam, but taking excessive advantages of ownership is forbidden. In this matter, the Quran specifically mentions that wealth should not be monopolized in the hands of a few individuals, since this will create social imbalance.[58] People are encouraged to earn their living in a fair and profitable way without exploiting others, so that the whole society may benefit, which reflects Islam's emphasis on social responsibility (Lewis, 2001, p. 109). The difference is that Islamic banks have to consistently apply *sharia* in all their activities. There is no prohibition against the accumulation of wealth as long as it is legally acquired, used in God's way, and for the benefit of other people (Rad & Ahsan, 2000).

[58]Quran 59:7.

In fact, Islam encourages trade and business or commerce, as long as it does not cross the prohibited lines.[59] Therefore, information about profitability is no less important than in conventional banking, since stakeholders also have an interest in the banks' future sustainability for different reasons. However, the accentuation of profit is not supposed to be as pronounced as it is in conventional banking, where profits belong to the shareholders and the companies try to achieve higher profitability solely for the sake of them.

On the other hand, the overemphasis on value-added statements can result in misunderstandings about value-added and profit, which can bring erroneous predictions for the future of the IFIs. Profit reflects the residual amount to be distributed to the investors and to be retained for the companies' future activities, while the total value-added measures the amount to be distributed to all the stakeholders. In other words, profit is value-added minus the internal costs of adding the value.

Yaya (2004) also tries to view the value-added statements fairly, in order not to be unaware of the potential problems and questions of whether the existence of the value-added statements could provide significance differences from the income statements. This opinion is consistent with an experiment conducted in Malaysia by Sulaiman (2001) who compared Muslim respondents' opinions regarding value-added and income statements. The result showed that the subjects in the experiment did not favor the value-added statements over the income statements. Although various reasons may be required to explain the thinking behind this situation, alternative ideas for reports may be necessary to accommodate Islamic accounting's necessity for the reporting of social responsibility and accountability issues.

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[59]Quran 2:275, "Those who consume interest cannot stand [on the Day of Resurrection] except as one stands who is being beaten by Satan into insanity. That is because they say, "Trade is [just] like interest." But Allah has permitted trade and has forbidden interest. So whoever has received an admonition from his Lord and desists may have what is past, and his affair rests with Allah. But whoever returns to [dealing in interest or usury] - those are the companions of the Fire; they will abide eternally therein."

Nevertheless, the current Islamic accounting literature related to equity theories has shown that the enterprise view has become the main choice among the other views, by its proposal of the value-added statement for IFIs. It is true that the enterprise view puts greater stress on social concerns, but this view is in fact also "less well-defined in its scope and application" (Hendriksen & Van Breda, 2001, p. 774). The literature highlights the importance of social concern, as mainly discussed in the history of the enterprise view, but the weaknesses or difficulties in the application are unfortunately not widely discussed.

Among all the researchers who propose the enterprise view with value-added statements as a replacement for income statements, none of them has come up with a full or complete plan of how the financial statements will be, except for the highlights of the value-added statement itself. The condition is thus still very similar to conventional accounting; the enterprise view is less well-defined compared to the proprietary and entity views.

6.5 Discussion and Analysis: Is There Any Potential Answer for the Classification of Elements?

This study of the accounting points of view attempts to provide a consistent deductive basis for all accounting transactions and events, which could be useful in the standard-setting process. The proprietary and entity views, which are two well-known equity theories, are widely used, but many accountants do not understand the assumptions in each view and tend to be inconsistent by shifting from one view to another (Lorig, 1964; Moores & Stearman, 1986). Moreover, Roberts (1955) found numerous conflicting ideas in the discussions of both views (p. 208).

The proprietary view provides the most common treatment of items in the financial statements. There are no other distributions but dividends, or the distribution to shareholders,

since a company is seen from the shareholders' point of view. It can easily be noted that current accounting practices, either conventional or Islamic, are influenced by this view.

Differing from the proprietary view, whose proponents have similar opinions regarding element classifications on the balance sheet, the proponents of the entity view favor different interpretations of how to see the company from the entity's perspective, and hence classify the accounts. In Paton's view, all equity suppliers have a right to the profit's distribution; shareholders are not the only beneficiaries of financial statements. On the other hand, Anthony tries to find consistency in the entity view by classifying taxes, interest, and dividends as expenses.

Those two views have inspired the development of other views of the equity theories, such as the residual equity, equity, and enterprise views. Nonetheless, confusion arises from the discussion of equity theories, as accounting researchers do not use a uniform terminology; different names may refer to the same view while a similar label may mean a completely different thing. Thus, Section 3 was provided to harmonize this muddle as summarized in Table 6.2. Each equity theory is dissimilar from the accounting point of view, ranging from the narrow perspective, which is "common shareholders" to the wide perspective, which is "society".

Table 6.2

Different Views on Equity Theories

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

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

In Islam, Allah is the owner of everything.[60] Therefore, there is no absolute ownership since Allah is essentially the ultimate owner (Adnan, 1997; Rad & Ahsan, 2000; Adnan & Abu Bakar, 2009). The Quran explains that mankind is chosen to be God's vicegerents or trustees of what is available on earth. Mankind may utilize God's creations on earth and is encouraged to work and earn wealth for their living. However, this privilege should be followed by responsibility for the trusted wealth, and to spend it in the way of God.[61]

This concept of ownership will lead to the explanation of social responsibility in Islam. Although Muslims are allowed to have wealth, they are obligated to perform *zakat* once their wealth has met the minimum requirements. Lewis (2001) also adds that the Islamic economic system does not allow people to gain wealth by exploiting others. Those who are richer

[60]Quran 3:109, "To Allah belongs all that is in the heavens and on earth: To Him do all questions go back (for decision).

[61]Quran 2:190, 2:195, 9:34

should have a social responsibility towards the community, so that other people might also have the opportunity to live more comfortably. In a broader context, it could be a foundation for a clean society and community welfare.

Hence, responding to the first research question, the discussions of equity theories in Islamic accounting literature are based on the necessity of an accounting theory which can accommodate Islamic accounting's socio-economic objectives. These social and ethical issues are considered as secondary issues in conventional accounting. Since Islamic values are contradicted by capitalistic values, the literature argues that their proposed equity theories are less acceptable to capitalism.

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.

The value-added statement actually has similarities to the idea of an income statement under Paton's entity view, which is proposed in a better way than the enterprise view. Nonetheless, those similarities are not mentioned by any Islamic accounting researchers in the discussions of equity theories. Moreover, in previously discussed value-added statements for IFIs, there remains a question of how consistency will be maintained when the value-added statement is set as one of the main financial statements replacing the income statement. Although this kind of claim can be debatable, proposals which acknowledge only one specific equity theory may in fact intersect with other equity theories.

6.6 Concluding Remarks

Although IFIs are playing a more important role as global finance businesses, Islamic accounting is still in its infancy stage. Thus, there are still imperfections found in the Islamic accounting theory, which keeps evolving nowadays. Islamic accounting scholars are endeavoring to develop an accounting theory which is suitable for Islamic circumstances.

In the discussions of equity theories in Islamic literature, which are expected to provide answers for these problems, there is no argument leading to a definite solution for the inconsistency in Islamic accounting related to the classification of elements, either those related to PSIAs or *zakat*. All of the discussions still focus merely on the topics surrounding the ethical and social issues, which are considered as secondary issues after profit in conventional accounting. Those discussions make an attempt to find a suitable comprehensive theory for Islamic accounting, which covers the ethical and social issues, from the existing theories in conventional accounting theory, which then lead most of the Islamic accounting scholars to state their preferences for the enterprise view. Nonetheless, although they claim to choose one equity theory, their proposed theories show another

inconsistency where they jump from an equity theory to another, at their convenience, which results in no answer for the classification of elements.

The discussions of equity theories in Islamic accounting literature also show the premature understanding of each view of the equity theories. Their understanding about the rejected view is limited to what they think is the currently used basis for conventional accounting and leave the deep understanding of the equity theories unexplored.

The term proprietary or entity views seem to have various interpretations. The identical terminology can in fact refer to an entirely different understanding of the equity theories. The joint project of the IASB and the FASB on a conceptual framework project has shown that discussing equity theories is not a simple task, since it could lead to different perceptions of each view.

Adopting a particular view about equity theories can result in utterly different financial reports. The idea of the enterprise view in Islamic accounting, for example, will remove the existence of "profit" in the financial statements. The possible consequences of each view on the equity theory and the compatibility of each view to Islamic values should be more thoroughly considered.

There are also still a considerable number of ideas about equity theories which remain untouched, and could not only be a possible solution to develop an Islamic accounting theory which underlines the importance of ethical and social matters, but also consistently use an accounting point of view.

Chapter 7

The Compatibility of Various Equity Theories with Islamic Teachings

7.1 Introduction

The debate about which equity theories, or whose point of view, should be adopted as the basis for financial reporting has been going on for decades. The arguments are made primarily to support the two main views of the equity theories, which are the proprietary and the entity views. Either theory or view is considered an acceptable viewpoint from which to conduct accounting, and potentially provides justification for some of the reporting problems in certain circumstances (Ricchiute, 1979, p. 67).

Nonetheless, much of the accounting literature has different definitions for each view of the equity theories. This results in a diverse understanding, as well as confusion, when accounting standard setters bring those terms into the discussions of the conceptual framework. In both the DP and ED of the IASB and FASB joint project for a conceptual framework for financial reporting, published in 2006 and 2008, the appearance of the proprietary and the entity views raised many inquiries about the meaning and significance of each view.

In order to have a uniform understanding, each equity theory 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.

This chapter consists of five sections. After the introduction, the second section carefully examines the basic concept of ownership in Islam. With an understanding of this concept, Section 7.3 outlines the objectives of Islamic accounting, as proposed by Islamic accounting scholars, and determines the most appropriate objectives for Islamic accounting. In Section 7.4, each equity theory is examined to see whether it conforms to Islamic teachings, which is then followed by discussions in Section 7.5. Lastly, the concluding remarks are presented in the sixth section.

7.2 The Concept of Ownership in Islam

In Islam, there is no dichotomy between religion and other matters in life. As a consequence, the concept of secularism as being distinct from religion is not acceptable. Every Muslim is mandated to worship God and thus be conversant with Islamic teachings in all of their activities, including business transactions.

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.[62] Ownership of property is therefore a trust (*amanah*) to be enjoyed conditionally, so long as man follows *sharia* and remains worthy of the trust.

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

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).

Still, legal ownership by the individual is recognized in Islam. A person becomes an owner by the legal acquisition of a thing, which subsequently becomes his property, and he enjoys this ownership in exclusivity. Thus, it prevents others from using or dealing with the property without his permissions or legal authorization (Dolgun, 2016, p. 100).

However, a person may use or deal in the property in any way whatsoever that he/she wishes or desires, with restrictions attached to this freedom. Acquiring a property and later gaining and enjoying wealth from it using the knowledge and skills possessed is allowed in Islam, as long as it does not infringe *sharia* during the whole process of earning or consuming it. Nonetheless, the rights attached with ownership have corresponding obligations, which implies that there is no absolute usage of property (Dolgun, 2016, p. 99).

Human beings should set aside the selfish and unfair tendencies that often result from a mistaken notion of absolute ownership, by undertaking what *sharia* obliges them to do, and refraining from any practices forbidden by *sharia*. Lewis (2011) suggests that the aim of the Islamic economic system is to allow people to earn their living in a fair, but still profitable, way without taking advantage of others for selfish purposes or exploiting them, so that the whole society can benefit (p. 45). Similarly, Chaudhry (1999) notes that one must be neither greedy nor wasteful or extravagant in using one's possessions, rather one must be moderate and the use of the possession must not be damaging other people or the environment. Human beings must always remember that ownership in Islam is a 'beneficiary' ownership, where there is a transfer of right from the first owner, which is God, to human beings (Dolgun, 2016, p. 98).

Islam has limited the means of acquiring wealth, to prevent the excessive accumulation of wealth by only a small part of the society, so that the society may not be filled with two classes with steep social gaps: The overstuffed and the starving (Dolgun, 2016; Mirakhor, 2009). As an example, the owner of property beyond a certain limit is obliged to pay *zakat*. It is subject to the moral obligation that in all wealth, certain groups in society have the right to share. Besides *zakat*, the Islamic law of inheritance also requires the distribution of wealth among the heirs to avoid any concentration of wealth.[63]

Although individuals are expected to feel socially responsible for others in the community, Islam requires every individual to work and produce, instead of waiting and expecting to receive charity. Trade and commerce, which should be honest or truthful and legitimate, are profoundly encouraged in Islam,[64] so that people earn a living, support their families, and at the same time, give charity to the less fortunate (Lewis & Algaoud, 2001, p. 27).

Moreover, Islam does not promote the equal distribution of wealth, in the sense that all individuals should either have an identical level of prosperity or the same way of earning a living. Nonetheless, it guarantees a reasonable process of distribution where all the participants in the marketplace are rewarded for being exposed to different risks and liabilities. Land, labor, and capital jointly can create value and the capital's owners are entitled to share the profit as well as the loss (Choudhury, 2016, p. 93).

7.3 The Objective of Islamic Accounting

The objective of financial reporting should be to meet the information needs of users. In this regard, before jumping to a conclusion about what should be the objectives of financial

[63]Quran 4:176
[64]Many stories describe that Prophet Muhammad was a trustworthy and truthful trader, especially in his early youth.

reporting, it is necessary to identify the primary users of the accounting information and consequently their information needs. Velayutham (2014) claims that Islamic financial reporting frameworks still need to clearly determine the users and the type of decisions they make (p. 132).

7.3.1 Users of Islamic Bank's Financial Information and Their Common Information Needs

Chapter 4 described two Islamic conceptual frameworks developed by the AAOIFI and the standard setter for Islamic accounting in Indonesia, the DSAS-IAI. Similar to conventional accounting, the users of the Islamic banks' financial reports are the external users, whose access to companies' information is limited. Thus, they must rely on the information presented in the financial reports.

Both boards mention a wide range of users as the users of financial information. The boards identify users by using previously developed frameworks, developed by other standard-setting bodies that they consider do not contradict Islamic principles. The AAOIFI concludes that "capital providers" are the primary users of the financial reports, but do not clearly define what or who constitutes the "capital providers" of Islamic financial institutions (AAOIFI, 2015, p. 83). On the other hand, the DSAS-IAI believes that shareholders and IAHs are the two main users, whose information needs should be prioritized (DSAS-IAI, Conceptual Framework, 2007, para 10).

As pointed out in the earlier section, property and resources are held in trust from God and human beings, as the trustees of God, must ultimately account to God as to how they have been employed. Muslims believe that they will eventually have to account for what they have done, including how they spent the resources entrust to them, in the hereafter. Therefore, all parties that have an interest in allocating their resources to IFIs can be considered as the

users of financial reporting. Those external users include a wide range of users, such as shareholders, IAHs, creditors, employees, and other parties dealing with Islamic banks in other ways.

Nonetheless, it is difficult to provide all the information needed by all the categories of users due to the costs involved. Thus, it is important to serve the common needs of the users of financial reports, who do not have the authority, or ability, to obtain additional information from the IFIs. Common information needs should include the need for information that can assist in evaluating the entity's ability to use its economic resources and fulfill its obligations.

Before allocating their resources to IFIs, all the users demand the information to evaluate IFIs' compliance with *sharia*. This aspect differentiates the common information needs of users of Islamic banks' financial reporting from their conventional counterparts. They all have rights to the information that ensures that the entity produces *halal* or permissible products and services, including the whole business process of delivering the products and services to the customers.

However, those that bear the risk of loss may have the need for more precise or detailed financial information. As a consequence, IAHs and shareholders should be recognized as the primary users of the financial reports. This opinion has been adopted by the DSAS-IAI[65].

Adding and specifying IAHs as one of the primary users is different from only acknowledging the shareholders and potential shareholders as the primary users of financial information. It is because IAHs consist of not only those with excessive wealth, as is normally the case with shareholders, but IAHs are also the customers of Islamic banks, which occupy various levels of social status, similar to the depositors of conventional banks.

[65]Again, the AAOIFI, however, does not use the word "capital providers" in a consistent manner. It is unclear whether the term "capital providers" refers to both IAHs and shareholders or shareholders only.

Creditors are also fund providers for Islamic banks. Correspondingly, they need the information on whether the bank can pay their money when it is due. Nonetheless, in Islamic banks, creditors do not reap any profits or bear any risk of loss from their funds. This is different from creditors in the non-Islamic perspective, who can receive a return in the form of interest. Their interests in the financial information about the banks are, therefore, less than IAHs and shareholders.

Depositors or fund owners that put their money in the bank for the purpose of keeping it safe are also creditors of the Islamic banks. The bank guarantees a full return or refund to the depositors, but the depositors also give permission for the banks to use the funds for investment with no profits being entitled to the depositors. It is because in Islam profit is justified on the basis of taking responsibility for the possibility of loss and its consequences (Mirakhor, 2009).

7.3.2 The Proposed Objectives of Islamic Financial Reporting by Islamic Accounting Researchers

Hisab or *muhasabah* is said to be the root of the Arabic word for 'accounting', which means 'to compute' or 'to measure' and includes the meaning 'the calculation of one's act on it' (Hayashi, 1989, p. 49-50). In its generic sense, *hisab* is connected to one's obligation to be responsible to God on all matters of life for which every Muslim is later 'accountable' (Lewis, 2001, p. 113). The importance of the word *hisab* or *mahasabah* can be seen by the frequent appearance of those words and their derivations in the Quran, which is 48 times (Atiya, 1984 as cited in Hayashi, 1989, p. 49).

As pointed out earlier, all resources are made available to individuals in the form of a trust. Individuals are merely trustees for what they have been given by God, and they must use what is being entrusted to them without violating *sharia*. Although they may not be able

to get the outcomes they want right away, Muslims believe that their success in the hereafter depends upon their accomplishments in this world. Lewis (2001) concludes that this dimension distinguishes between the concept of accounting in Islam and those already embodied in conventional accounting, which stems from the believe that every Muslim has an ‘account’ with God and God will reveal those accounts to all the people on their judgment day (p. 113)

Pertaining to this concept, the majority of Islamic accounting scholars agree that the primary objective of Islamic accounting should be the fulfillment of accountability to God (Adnan, 1997, p. 53; Lewis, 2001, p. 114; Mohamed Ibrahim, 2000, p. 482; Rahman, 2010, p. 14; Shanmugan & Perumal, 2005, p. 11). Nonetheless, the connection between human beings and God is not based on a legal contract, in which the implementation can be evaluated immediately. Accordingly, there are different opinions on how the accountability to God should be manifested as the objective of financial reporting.

Adnan (1997) believes that the provision of accounting information should help human beings properly calculate *zakat*, which is the annual obligation for every Muslim to set aside a specific portion of his/her wealth for the needy (p. 53). He argues that by placing zakat as the primary objective of Islamic accounting, it can avoid unlawful actions, such as cheating, because he or she believes that God always watches him or her. Furthermore, he also argues that it can, at the same time, fulfill the entities’ social responsibilities. Placing zakat as the main objective will also stop certain parties putting their interests above those of others (Adnan, 1997, p. 54).

Similarly, Lewis (2001) argues that accountability to God means accountability to the community (*umma*) or society at large. Many of the conventional accounting practices which are most applicable to the concept of private accountability do not seem to be relevant to the type of accountability under *shari*a.

Thus, Lewis (2001) reasons that one of the objectives of Islamic accounting is to provide information which discharges those involved with firms from their accountability to society (p. 113), in which the society has the right to know about the effects of the operations of the organization on its well-being, and to be advised within the requirements of s*haria* as to how this has been achieved. This can be achieved through the responsibility to pay *zakat*, as the obligation to help the poor in society, which needs the calculation and disclosure of the value of the total net assets and liabilities, which should be available on the financial statements (Lewis, 2001, p. 114).

Mohamed Ibrahim (2000) uses the term "Islamic accountability" as the objective of financial accounting. He defines Islamic accountability as "undertaking actions (and refraining from some) and giving an account of the actions taken (and not taken) by an organization or person (the accountor) in discharging its *sharia* obligations, both contractual and social, as an aid to self-correction and inducing the behavior of the stakeholders to be more *falah*[66]" (Mohamed Ibrahim, 2000, p. 254).

This Islamic accountability consists of two accountability roles: Primary accountability to God in the form of social accountability to society and stakeholders, and secondary accountability to the contracted accountee (p. 482). The primary accountability is transcendent, but is visible through the Quran and *hadits* as the sources of Islamic teachings (Mohamed Ibrahim & Yaya, 2005, p. 86). Secondary accountability is established by a written contract between an owner and a manager, which should be discharged by identifying, measuring, and reporting the socio-economic activities pertaining to the Islamic, social, economic, environmental, and other issues to the owner (Mohamed Ibrahim & Yaya, 2005, p. 86). The reporting or the account should make the organization transparent as well as

[66]The success in the world and in the hereafter.

providing feedback for the accountee to enable him to control the accountor and the organization (Mohamed Ibrahim, 2000, p. 246).

Further, Mohamed Ibrahim (2001) also proposes subsidiary objectives for Islamic accounting, which are: (1) The provision of information on *sharia* compliance; (2) the proper assessment and distribution of zakat; (3) the equitable and fair distribution of wealth generated by the organization among its employees and other stakeholders; and (4) the creation of a co-operative environment and solidarity. He stresses that stakeholders are as important as shareholders, as users of Islamic accounting information and that large corporations are also accountable to the community (Mohamed Ibrahim, 2001, p. 482).

Rahman (2010) also argues in a similar fashion to Mohamed Ibrahim about the dual accountability in Islam (p. 21). Furthermore, he believes that the objective of Islamic accounting should be directed at "ensuring fair and just financial transactions between human beings" (p. 13-14), as a requirement of accountability to society and to God. He uses two verses of the Quran[67] that specifically address the issues of business transactions as the basis of his argument.

Differing from other Islamic accounting scholars, Velayutham (2014) argues that decision-usefulness should be retained as the objective of Islamic accounting. His argument is that resource allocations and making economic decisions is just as critical in Islamic societies as in non-Islamic societies (p. 136). Both Islamic and non-Islamic investors would be interested in risk and return, but Islamic investors would be concerned about the nature of the business transactions, i.e. whether the transactions are *halal* or permissible by *sharia* (Velayutham, 2014, p. 33). The difference lies in the criteria they use to evaluate the alternative choices, which can be different between Islamic investors and creditors and those

[67]Quran 2:282 and Quran 21:4.

of non-Islamic investors and creditors. Therefore, additional or new information would need to be disclosed, to assist their decision-making process (Velayutham, 2014, p. 136).

Velayutham bases his arguments on Sulaiman's test of the models of Islamic corporate financial reports proposed by Baydoun and Willet (2000) using a survey (1998) and experimental research (2001). Sulaiman found that there were no differences in the perceptions of their usefulness by Muslim and non-Muslim subjects, which became the challenge to create a separate set of Islamic financial reports.

7.3.3 Determining the Appropriate Objective of Islamic Accounting

The provision of information to calculate *zakat* is favored by some Islamic scholars as the objective of Islamic financial reports (Adnan, 1997; Gambling &Karim, 1991; Lewis, 2001). The arguments, however, are criticized by Mohamed Ibrahim and Yaya (2005), who argue that paying *zakat* will not necessarily adhere to other commandments and will not lead to less creative accounting (p. 84-85). The author agrees with this criticism; setting *zakat* as the main objective of accounting is too narrow, as zakat is only one obligation among many other mandatory matters in Islam. Calculating *zakat* properly does not fully represent accountability to God.

Mohammed Ibrahim's extensive research on determining the objective of Islamic accounting is remarkable. Nonetheless, his proposal on dual accountability in Islam still contains some flaws. First, Islamic accountability is about reporting the *sharia* obligations of the accountor, with primary accountability to God. However, the provision of information on *sharia* compliance is listed as one of the subsidiary objectives of Islamic accounting. It is not clear how those two things are different. Second, he seems to be reluctant to accept the fact that in IFIs, there are categories of stakeholders who, to some extent, rely on the financial

information more than other stakeholders do, and they should be acknowledged as the primary users of financial reports.

Moreover, Mohamed Ibrahim has not come to a conclusion about how Islamic financial reporting should be structured. He disagrees with the view of Baydoun and Willet (2000), who propose value-added statements as the main form of Islamic corporate reports; whose distributional characteristics they consider more appropriate for driving people to become less highly profit oriented. The significant difference of such statements is questionable, other than to influence a better payment for the employees (Mohamed Ibrahim & Yaya, 2005, p. 88).

It cannot be denied that people in both the Islamic and non-Islamic communities should make economic decisions in their daily lives, and they need to evaluate the available alternatives to make the best possible decisions, as suggested by Velayutham (2014, p. 136). Muslim investors are no different to non-Muslim investors who need to evaluate the profitability of the company.

However, there should be explicit emphasis on the importance of the *sharia*-compliant assessment over the merely financial figures, as the objective of Islamic accounting. Otherwise, Muslim investors may get lost in the heaps of information that give no clues on how the business is conducted from the perspective of Islam. Although the interest of Muslim investors is to gain more wealth they are required first and foremost, whatever their situation, to follow God's will. As a consequence, before making economic decisions, the users of financial reports have to be sure about the compliance of the entity with *sharia*.

Accountability as the objective of financial reporting is not a novel idea. Ijiri (1983) proposed an accountability-based conceptual framework which focused on the relationship between the supplier of the accounting information, or the accountor, and the users of accounting information or the accountee (p.75). In this type of framework, accounting

provides a fair system of information flow between those two parties (Ijiri, 1983, p. 75). Gray, Owen, and Adams (1996) also call for an accountability-based framework as a basis for corporate, social, and environmental reporting. They define accountability as the duty to provide an account or reckoning of those actions for which one is held responsible (Gray, et al., 1996, p. 38).

In this regard, the accountability-based framework is related to the principal-agent conflict. There are two problems that arise in the agency relationship, which are: (1) The desires or goals of the principal and the agent conflict; and (2) it is difficult or expensive for the principal to verify what the agent is actually doing, thus the principal cannot verify whether the agent has behaved properly (Eisenhardt, 1989, p. 58).

However, accountability to God is different from accountability between human beings. The relationship between God and man is not based on a contract that needs to be evaluated right away. Above all, God does not have any difficulty monitoring his trustees.[68] Making responsible economic decisions is also a path to accountability to God.

When the information about compliance with *sharia* is provided, accountability to God and economic decision making becomes two intertwined objectives. Thus, 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.

The objective of financial reporting thus becomes similar to the AAOIFI general objective of financial reporting, with an additional emphasis on the accountability to God.

[68]Quran 29:52.

Although the word accountability is not used in the AAOIFI's objectives for financial accounting, Mohamed Ibrahim (2000) suggests that those objectives implicitly reflect accountability, as the board states that financial accounting should put the concern about obeying and satisfying Allah into their financial and other dealings (AAOIFI, 1996, p. 22 as cited in Mohamed Ibrahim, 2000, p. 256).

7.4 The Applicability of Equity Theories to Islamic Accounting

In Chapter 6, five views of the equity theories were defined. The proprietary view is considered the narrowest among all of them, as it uses only the viewpoint of the common shareholders to conduct the accounting. On the other hand, the enterprise view is regarded as the widest, with its emphasis on society as the focus of financial reporting.

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 analyze 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.

Gambling and Karim (1991) suggest the proprietary view as the basis for Islamic accounting. Their reason for this preference is based on the consideration that only individuals, and not entities, are liable to pay *zakat*, and therefore the wealth should be calculated from the viewpoint of the shareholders, as the owners, to find out the value of the assets and determine the amount of *zakat*. However, Islamic jurists have dissenting opinions on this issue. Moreover, shareholders may not be individuals, but also companies or

institutions that own the stock. In addition, as explained in the previous section, *zakat* is only one mandatory affair in Islam, which cannot be used as the only tool to evaluate *sharia* compliance. Thus, it is difficult to use the payment of *zakat* as the reason behind the adoption of the proprietary view for Islamic accounting.

The entity view, on the other hand, sees a corporation as an independent entity from its owner. For that reason, Gambling and Karim (1991) and Taheri (2005) reject the entity view and put their preference in the adoption of the proprietary view. They argue that Islamic teaching does not recognize such concepts, and that individuals should be liable for their actions, instead of the entity itself.

Nonetheless, the view of a corporation as being separate and distinct has been accepted by the Islamic *Fiqh* (jurisprudence) (AAOIFI, 2010, p. 41), since it has similarities to some Islamic organizations, such as *waqf* (trust foundation), the mosque, and *dar al-mal* (treasury). It carries the consequence that Islamic financial institutions are considered as accounting units separate from their owner, or other parties, who have provided the financial institutions with funds. Moreover, some Islamic jurists agree to treat a company as a separate legal entity, with the analogy of the liability of the owners of *mudaraba* investments, which is limited to the amount they have invested (Al-Kafeef, 1962; Al Kayyat, 1983 as cited in Gambling & Karim, 1991, p. 36).[69]

However, conducting accounting from the extreme or pure perspective of the entity itself can be considered improper. 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. Moreover, the entity view suggests that as both the creditors and the shareholders provide the capital, they therefore should be treated in the

[69]Gambling and Karim, however, consider this view as a minority.

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 creditor relationship between the accounting entity and the owners was unrealistic (Bird, 1981). It is reflected in the criticism of the entity view below:

> "A corporation is not person but merely a device, created to benefit the originators. It is, in a sense, a machine. As viewed under the entity concept, it may be linked to a machine that has become personified and has declared a form of independence from its creator and owner, denying any closer relation or greater responsibility to him than to one who loaned money used in building it …" (Lorig, 1964, p. 568)

Similarly, Islam does not consider the entity itself to be accountable to God. Instead, human beings should be responsible for their decisions pertaining to the entity.

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. 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.

7.5 Discussions

In conventional accounting, general purpose financial reports provide information about the financial position of a reporting entity and also information about the effects of transactions and other events that change a reporting entity's financial position. Both types of information provide useful inputs for decisions about providing resources to an entity. However, in the Islamic environment, the financial information is also required to confirm *sharia* compliance.

In the previous section, it is concluded that the equity view may serve as the most appropriate view for Islamic accounting. This is because the strict adoption of either the proprietary or the entity view is difficult to accept from an Islamic perspective. The proprietary view sees the company and the owner as identical, while the entity view sees the firm and the owner as separate beings, with the independent firm having its own rights.

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.

The discussions of equity theories in Islamic accounting, as found in Chapter 6, show the necessity for Islamic accounting to cover the issues of social and ethical responsibility. However, the emphasis on value added, as proposed by some Islamic accounting researchers (Baydoun & Willet, 1994; Harahap, 2008; Taheri, 2005; Triyuwono, 2001, 2003), may be harmful for the sustainability of the business. Profits from trade and productive investments are very much encouraged under Islam, which makes the calculation of profit by a company important, although not paramount. The main objection in Islam is not against the payment of profit but against a fixed predetermined payment (Akacem & Gilliam, 2002, p. 127-128). Thus, when necessary, providing value-added statements for the social accountability of a profit-seeking entity can also be added as a supplement to the main financial statements[70], which can also be regarded as the application of full disclosure in Islamic accounting.

The objective of Islamic accounting is derived from the concept of man, as the trustee of God, being responsible for what is available on earth. Muslims believe that they will be required to account for whatever they have done in this world. Napier (2009) points out that "while this primary accountability to God does not preclude more secular accountabilities to the community, investors, employers, and others, these would need to be assessed in terms of their ability to achieve the primary accountability to God" (p. 123). The objective of Islamic accounting that embodies the accountability to God will be difficult to achieve without adherence to the full disclosure principle.

Full disclosure is deemed to be important in Islamic banks so that users can access the *sharia* compliance of the entity. Full disclosure means providing all the information that should be rightfully given to the users, in accordance with the principles of *sharia* (Baydoun & Willet, 2000, p. 81). Haniffa and Hudaib (2007) propose that Islamic enterprises should also disclose their social responsibilities, which include charities, wages to employees, and

[70]Islamic banks in Bangladesh have included value-added statements in their financial reporting.

environmental protection, in addition to information on any prohibited transactions they made and the *zaka*t obligation they have to pay, and have already paid. Thus, instead of imposing a specific statement as a replacement for the income statement, full disclosure of the information, such as the value added, in other parts of the financial reports is perhaps more reasonable.

Moreover, the social responsibility and accountability can be provided by disclosing the information about the recipients of the bank's investments, instead of just disclosing the charity they perform. Chapra (2007) argues the necessity of an equitable distribution of credit, by spreading the benefit of resources that become available to the banks from a wide spectrum of depositors, to a similarly large spectrum of society rather than to just a few rich individuals (p. 326-327). Islamic finance will not be able to create justice if the financing does not become available for the poor and the middle-class entrepreneurs. The availability of finance for them would not only allow them to advance themselves economically but also to make a positive contribution to their economy.

Islamic banks commonly provide reports from their *sharia* supervisory boards that state the boards' opinions of the banks' compliance with Islamic principles. Such assurance may reduce the necessity for the very detailed disclosure of many issues (Maali, Casson, & Napier, 2006, p. 269). However, Islamic banks in some countries do not supply such reports.[71] Moreover, a bank's *sharia* supervisory board may only state its general opinion on all matters, while users may want to ensure the bank's adherence to *sharia* on a specific matter. For example, the *sharia* supervisory board's report commonly does not provide details about

[71]Maali et al. (2006) conducted a survey on the disclosures of Islamic banks and found that Iran and Pakistan do not provide *sharia* supervisory board reports (p. 285). Similarly, in conducting a survey of financial statements in Chapter 5, the author had to exclude Islamic banks from two countries, which are Iran and Turkey, because there was no information on the existence of a *sharia* supervisory board. Islamic banks from Pakistan, however, appoint such a board and also provide *sharia* compliance reports from the board.

earnings prohibited by *sharia* that were received by the bank, and how the bank dealt with them. Thus, such information should be provided by the banks.

7.6 Concluding Remarks

The concept of ownership in Islam stems from the belief that God is the real owner and that human beings are merely the trustees of what is available on earth. Thus, they have to do the right thing by following His rules, since what they do in this world will affect their lives in the hereafter.

Islamic accounting researchers have made attempts, although only a few, to define the objective of accounting. They debate about whether accountability to God or decision usefulness, as stated in conventional accounting, should be the objective of Islamic financial reporting.

In this chapter, it is suggested that those two objectives are intertwined. Both Islamic and non-Islamic investors are interested in knowing the companies' risks and returns, but Islamic investors place greater concern on the nature of the business transactions. It is difficult for them to make a decision about whether to invest in a firm without knowing that the business is free from any *haram* or forbidden activities in the Islamic context. In other words, the *sharia* concerns should be fulfilled before dealing with the financial figures.

Thus, the objective of financial reporting should be directed to the provision of information to assist users in making economic decisions with regards to the *sharia* compliance consideration, as well as the financial aspects, as a way to fulfill their accountability to God. Financial reports should facilitate mankind to account for its actions in allocating the resources entrusted to it.

Adopting the pure proprietary view or entity view can conflict with Islamic teachings in some matters. The equity view, which is in between the two views, is the most applicable

among the other equity theories to Islamic accounting. It sees the entity as independent from the owners, but it also focuses primarily on the information needs of investors. The focus on investors or equity holders is important, as they do not only bear the risk from the investment, but also have the prevalent responsibility of allocating their wealth among other users.

Nonetheless, investors in Islamic banks are not limited to shareholders. They include IAHs, who are entitled to both profit and loss from the investment, but have no governance rights. The next chapter will specifically discuss the definition of equity from the Islamic perspective and how each fund provided by each capital provider, including IAHs, should be defined in the balance sheets under the equity view.

Furthermore, the principle of full disclosure is necessary to satisfy the need for information on the banks' compliance with *sharia*. It also includes disclosing information on the entity's contribution to society. Current financial reports, as formulated by Islamic accounting standard setters, have more disclosure pertaining to the specific requirements of *sharia*, such as reporting the payment of *zakat*, but are still not sufficient. Adequate disclosure requires that a financial statement should contain all the material information necessary to make it useful to its users, whether it is included in the financial statement, the notes accompanying it, or in additional presentations.

Chapter 8

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

8.1 Introduction

The adoption of one view over the other equity theories will have an effect on the classifications of the credit side of the balance sheets (Lorig, 1964, p. 564). Equity, as well as liabilities, can be defined narrowly, or widely, depending on the view implemented.

The previous chapter has emphasized the importance of *sharia* considerations, for the fulfillment of accountability to God, as the main objective of Islamic accounting. It also proposes the adoption of the equity view, which resembles both the entity view and the proprietary view. This view uses the perspective of equity holders as the perspective underlying the financial reporting

In this regard, 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.

This chapter is structured as follows: Following the introduction, Section 8.2 tries to see the position of Islamic standard setters on certain views of the equity theories and associate it with the classification of elements, particularly on the credit side of the balance sheet. In Section 8.3, the common understanding of equity from an Islamic perspective is discussed.

Then, Section 8.4 raises the importance of defining the elements using criterion that is in line with the objective of Islamic accounting. In Section 8.5, an illustration of the proposed basic financial statements is provided. Lastly, Section 8.6 concludes the chapter.

8.2 Islamic Accounting Standard Setters' Position on the Perspective Underlying Financial Reporting

Atmeh and Ramadan (2012) note that the idea of unrestricted PSIAs is similar to that of non-controlling interest (p. 10). They both represent the ownership interest in a company's assets but they have no significant and direct influence over the decision-making process. The clear difference is, PSIAs are not a separate legal entity and they can only rely on the financial statements of the Islamic banks to obtain the necessary information (Atmeh and Ramadan, 2012, p. 10). Atmeh and Ramadan, however, do not mention any equity theories as a theoretical reference to discuss PSIAs and non-controlling interest.

In conventional accounting, non-controlling interest, or as it used to be known, minority interest, has been referred to as a liability, an equity, or neither. The question of the fundamental nature of minority interest has been linked to the question of whether the appropriate basis of accounting should rely upon the entity concept, also known as the economic unit or the single economic entity concept, or the parent company concept.

These two prominent equity theories of consolidation typically appear as the basis of support for discussions pertaining to non-controlling interest, which are the economic unit theory and the parent company theory. Clark (1993) explains that under the economic unit theory, corporate assets are independent of the capital structure, and both majority and minority shareholders provide different sources of corporate resources, while under the parent company theory, parent company investors are seen as the primary supporters of the consolidated group and minority shareholders as an outside interest (p. 60). Although the

concept of non-controlling interest has gained acceptance since the beginning of the 1900s, no theoretical defenses were offered for any particular position (Clark, 1993, p. 61).

Currently, IFRS 10 *Consolidated Financial Statements*, which replaced some parts of IAS 27 in May 2010, states that non-controlling interests in subsidiaries must be presented in the consolidated statement of the financial position within equity, but separate from the equity of the owners of the parent (para 22). It reflects the adoption of the economic unit concept.

Moreover, Clark (1993) argues that non-controlling interest has not received a great deal of attention in the accounting literature, since he found no conclusions about the issue of the nature of non-controlling interest at the beginning of the 1990s. This argument is apparently true, including for the case of accounting standards for Islamic banks. To the best of my knowledge, there is no Islamic accounting literature that specifically addresses the issue of non-controlling interest's classification in the balance sheet.

According to the AAOIFI (2015), "Non-controlling interests in the statement of the financial position (the balance sheet) shall be identified and reported as a part of the total equity" (FAS 23 Consolidation, para 14). This treatment is similar to the IASB's.

The AAOIFI's treatment on non-controlling interest, however, is not consistent with other standards. FAS 1 General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions states that "A consolidated statement of the financial position should disclose the minority interest, and that interest should be shown on the statement as a separate item between unrestricted investment accounts and owners' equity" (para. 43).[72]

[72] It is possible that difference is due to a careless revision process. The board has amended FAS 23 on Consolidation but left FAS 1 unrevised.

In the conceptual framework, the AAOIFI concludes that they adopt the entity perspective. Under the title of "Entity Perspective", the board elaborates that "The conceptual framework is built on the principle that financial accounting and periodic reports are from the perspective of the IFIs preparing the financial statements, rather than from the perspective of the owners …" (AAOIFI, 2015, p. 83). The DSAS-IAI, however, mentions no stand on such a perspective.

It should be noted that the discussions of equity theories underlying the financial reporting are not at all times identical with the equity theories of consolidation. The certain similarity is they both pay attention to how the entity should be defined. As Meyer (1973) states, the debates on the equity theories relate to "the identity of the matter or activity for which accounting is to occur and the relationship assumed to exist between the entity and the external parties" (p. 116). The common understanding is that the adoption of the equity theories underlying the financial reporting should also have implications for the consolidated financial statements.

It is not clear, however, what the AAOIFI considers as the 'entity perspective' and whether they consistently and carefully take this viewpoint into consideration when developing the conceptual frameworks and financial accounting standards. The AAOIFI's statement clearly does not refer to the pure entity view, since there is no recognition of equity that belongs to the entity itself.[73] The credit side of the balance sheet remains similar to the conventional balance sheet, with the additional mezzanine element in between liability and shareholders' equity. There is a possibility that the board only refers to the entity theory of consolidation, which is the economic unit or single economic entity concept, as the basis for

[73]Since there is a varied understanding of the entity view, there is the possibility that the AAOIFI's use of the term "entity perspective" may refer to other views. However, it does not refer to the pure entity view as discussed in Chapter 6.

the consolidated financial statements[74], while being silent on which view of the equity theories should be adopted as the viewpoint underlying the financial statements.

8.3 Equity from the Islamic Perspective

The previous chapter proposed that the equity view should be adopted, with the equity holders' viewpoint as the perspective underlying Islamic financial reporting. Thus, it is important to identify the equity holders of the Islamic banks.

In Islamic banks, there are three capital providers with different rights on the entity, which are the creditors, the IAHs, and the shareholders. The shareholders, in comparison to the other capital providers, are known for their supreme rights, with which they have the ability to interfere in how the company is run.

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".[75] 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".[76] 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.

[74]The explanation about the entity perspective, however, was already available in the first version of the AAOIFI Conceptual Framework which requires minority interest to be presented as a middle level entry between liabilities and shareholders' equity (The AAOIFI, 2010).
[75]https://www.oxfordlearnersdictionaries.com/definition/english/equity_1
[76]https://dictionary.cambridge.org/dictionary/english/equity

In Islam, no return or interest should be provided for a loan, which makes only the principal amount certain. As a consequence, and differing from the conventional system which is commonly based on debt, the Islamic financial system attempts to encourage partnership. Islamic scholars argue that the Islamic financial system is equity-based, which refers to a financial system with no interest on loans or no certain rate of return (Akacem & Gilliam, 2002, p. 124; Chapra, 2007, p. 327; Hakim, 2007, p. 162; Mirakhor & Zaidi, 2007, p. 51, Zarqa, 1983, p. 181).

Akacem and Gilliam (2002) state that in Islam, money is seen as potential capital instead of the capital itself (p. 125). It cannot be considered as a commodity, but it should be consumed by exchanging it for other things, or it requires the efforts of a businessman to put it to productive use. In the case that people lend their money to a borrower, they have nothing to do with this conversion of money into capital or with using it productively. Money must be put to productive use, and a risk must be undertaken to justify a return (Akacem & Gilliam, 2002, p. 125). Thus, the returns can fluctuate depending on the profits in that period.

Furthermore, Akacem and Gilliam (2002) note that Islamic banks adopt this system, which can be considered as equity financing, since the system puts the emphasis on partnership, as depositors are no longer guaranteed the face value of their deposits. They essentially gain or lose depending on the profits and/or losses from investments made by the bank, which makes them similar to shareholders (Akacem & Gilliam, 2002, p. 128).

Similarly, Zarqa (1983) argues that the strict prohibition of interest on loans constitutes one of the fundamental features of an Islamic economy and implies that all business financing must be equity-based in contrast to a debt-based or loan-based economy (p. 181). This equity-based financing system can consist of various forms of equity (Zarqa, 1983, p. 181), which can be interpreted as the equity of a company can be supplied by different types of capital providers.

Chapra (2007) also notes the importance of equity-based financing, as justice is reflected in how the profit as well as loss is shared by both the financier and the entrepreneur (p. 325). It is against the principles of justice that, in the event of a loss, the entrepreneur bears the entire loss in spite of his hard work and entrepreneurship, while the financier gets a positive rate of return without doing anything.

Similarly, Khan (1986) also notes that the Islamic financial system can be considered as an equity-based one, as opposed to a loan-based system, because the depositor would not be guaranteed a predetermined return on the nominal value of his deposit, and thus be entitled to a share of the profits made by the bank (p. 6). If the bank incurs losses, the depositor would share these as well. The banks need to make a choice between equity-based or debt-based financing, which is to take a partner or borrow money without interest (Khan, 2010, p. 807).

Based on the review on the discussions of debt-equity above, all of the Islamic scholars believe that equity financing is at the heart of Islamic finance. The Islamic banking model relies on equity rather than debt, because it tries to fairly share profits only with those who are willing to bear losses as well. 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.

8.4 Defining the Credit Side of the Balance Sheets of Islamic Banks

8.4.1 The Category of the Credit Side of the Balance Sheet

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.

Moreover, it can solve Atmeh and Ramadan's (2012) criticism by classifying the assets side of the balance sheet into two subcategories, which are assets attributable to shareholders

and assets attributable to unrestricted IAHs (p. 16). This is difficult to do, as their funds are commingled for the purpose of investments. Their demand on this division reflects that they see the credit side of the balance sheet as claims as well. This confusion can be eliminated if the credit side of balance sheets is seen as the sources of capital, instead of claims.

8.4.2 Choosing the Criteria

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. Thus, under this view, equity is defined independently as the capital supplied by the legal owners of the company. As a result, liabilities become the residual of what is excluded as equity.

Levine and Fitzsimons (1991) state that there are some alternatives to distinguish between liabilities and equity, which are: (1) Define equity as a residual concept, as a result of defining the liabilities independently; (2) define equity more independently, with liabilities being the residual element; or (3) change the fundamental structure of the basic elements either by adding another element or by eliminating the present distinction between liabilities and equity (p. 417). It is also possible to combine (1) or (2) with (3).

The IASB uses approach (1) in defining the elements in the balance sheets. The Board 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 alternative (3) by adding PSIAs as the new element.

From an Islamic perspective, this approach is not satisfying. In Section 8.3, the elaboration on the definition of equity in Islam has shown that 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.

Another approach is by choosing the criteria to distinguish what comprises the credit side of balance sheets. It should be noted that choosing one or more characteristics to classify the credit side should also be able to meet the objective of financial reporting (PAAinE, 2008, ES.4). This approach can be considered more consistent, since no items on the credit side of the balance sheets will be left unclassified.

Similarly, Scott (1979) argues that a good classification system should use a 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.

Thus, it is important to know the key features of the debt and shareholders' equity, as well as PSIAs, in order to be able to choose what unites and what distinguishes them. Table 8.1 presents the common key features of debt and equity in both the conventional banks and Islamic banks. It can be seen that in the Islamic banks, PSIAs and shareholders' equity share

the same features, which is participation in risk-sharing, which leads to unguaranteed principal of their invested funds.

Table 8.1

Key Features of Debt and Equity

Classification / Features	Conventional Banks		Islamic Banks		
	Debt	**Shareholders' Equity**	**Debt**	**PSIAs**	**Shareholders' Equity**
Risk-sharing (Unguaranteed principal)		●		●	●
Fixed maturity	●			●	
Known maturity value	●				
Management control		●			
Residual/Subordination		●			●

Source: The part of conventional banks is modified from Hendriksen and Breda (2001, p. 768) and PAAinE (2008, p. 13)

Similar to Scott, PAAinE (2008) notices the problems only if capital that meets more than one criterion, e.g. the criteria A, B, and C, is classified as equity. If the capital instruments fail to meet at least one of these criteria, and so are classified as liabilities, it will result in heterogeneous liabilities. Liabilities will not only encompass those with none of the three criteria but also those that do not meet either A, B, or C, or two criteria among the three (PAAinE, 2008, para 1.34). Thus, liabilities will include those that do not meet all the criteria, or pure debt, those that do not meet either criteria, or debts that have a similarity to equity,

and those that fail to meet only one criterion, or are very similar to equity (PAAinE, 2008, para 1.34).

Table 8.2 lists the key features reflected in the conceptual frameworks that have been discussed in Chapter 4. Usually, capital provided by the legal owners has the characteristics of subordination: The capital is usually subordinated to all other sources of capital (PAAinE, para 1.24). PAAinE prefers the term subordination, which means that one claim may only be satisfied after other claims have been provided for, instead of the traditional term of "residual interest" (PAAinE, para 1.39).

Table 8.2

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

Classification / Features	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 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. 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.

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. As we see in Table 8.2, 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.

This "residual" or "subordination" is found in the definition of equity in all current conceptual frameworks. 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'. Despite the claim that the IASB define liabilities, together with assets, as the primary elements, using the criteria of residual or subordination reflects the proprietary view.

The criteria chosen by each accounting standard setter to define the elements on the right hand side of the balance sheets do not reflect the good classification system. 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. Chapter 7 concludes that the objective of financial reporting should be directed to the provision of information to assist users in making economic decisions with regards to the *sharia* compliance consideration, as well as the financial aspects, as a way to fulfill their accountability to God. Moreover, it does not represent the equity holders from an Islamic perspective, which includes the IAHs.

The equity view can also still be adopted by eliminating the sharp distinction between liabilities and equities, and listing all capital in accordance with the priority of the claims to the assets of the company. However, the sharp distinction between the two cannot be overruled, as the obligation to record debt is emphasized in the Quran.[77]

In Section 8.3, 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 (see Table 8.3). Adopting this criterion is not uncommon from the conventional accounting perspective as well, because an enterprise's ability to pay its creditors depends on the enterprise's success or failure, but the creditor's right to payment is independent of the enterprise's ability to generate a profit, and an owner's right is not (FASB, 1990, para 194).

[77] Quran 2:272

Table 8.3

Key Feature of Each Source of Capital to Determine Compliance to *Sharia*

Features \ Classification	Liabilities	Equities	
		PSIAs	**Shareholders' Equity**
Risk-sharing (Unguaranteed principal)		●	●

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* mentions the importance of paying wages immediately.[78]

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

[78]"Give the worker his wages before his sweat dries." (Ibn Majah, n.d.)

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, is 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 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.

Someone who is the owner of a company, in contrast to a creditor, would generally be expected to have some degree of control over decisions about the company's operations, or at least can have an input on how the company runs (FASB, 1990, para 193). Although IAHs are not the owners of Islamic banks, when they share in the risk to get a return, they will be motivated to take more interest in the affairs of their banks and demand greater transparency and more effective management (Chapra, 2007, p. 325). They do not have the rights of management control, but IAHs equally have need of the information in the financial statements, just as the shareholders do.

IAHs may not be the legal owners of Islamic banks, but they are also equity holders that need to know how their funds are managed. When IAHs are acknowledged as equity holders, the main users of Islamic banks, it is expected that the disclosure of information about the PSIAs-related accounts, such as the methods of calculating the profit and the reserves the banks manage, taken from the profit available for distribution to IAHs, are disclosed more fairly. The survey of financial statements in Chapter 5 reveals the problems of minimum information on such disclosures for financial statements prepared under IFRS.

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.

8.5 Illustrations of Basic Financial Statements of Islamic Banks

The previous sections have argued about how to classify the credit side of the balance sheets under the equity view, which requires PSIAs to be included as one type of equity. This section gives simple illustrations of the proposed basic financial statements, which include not only balance sheets but also income statements. Nonetheless, basic financial statements according to the AAOIFI will be provided beforehand, as a comparison to the proposed financial statements.

In order to simplify this, the illustrations in this section will assume that the bank only provides unrestricted PSIAs that can be commingled with other sources of capital, there are no reserve accounts maintained by the bank, and no payment of *zakat*.

8.5.1 Illustrations of Basic Financial Statements under the AAOIFI FAS

The AAOIFI FAS 1, General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions, provides an example of an Income Statement for Islamic banks or other types of financial institutions. Figure 8.1 is an example of the Income Statement under AAOIFI FAS 1, with eliminations of some unnecessary items.

Figure 8.1

Income Statement for Islamic Banks under AAOIFI FAS

For the year 20XX

Income		
Deferred sales		$ 1,500
Investments		7,900
		9,400
Less		
Return on PSIAs before bank's share as *mudarib*	5,500	
Bank's share as *mudarib*	(700)	
Return on PSIAs		(4,800)
Bank's share in income from investment (as *mudarib* and as fund owner)		4,600
Bank's income from its own investment		5,000
Total bank's revenue		9,600
Administrative and general expenditures		(2,600)
Depreciation		(1,800)
Net income before tax		5,200
Income tax		1,100
Net income		$ 4,100

Although the AAOIFI considers the return on PSIAs to IAHs as neither an expense nor a distribution, the example provided by the AAOIFI still reflects the influence of the proprietary view that acknowledges payment to shareholders as the only distribution. It considers shareholders as a part of the bank, while IAHs are the outside parties. Retained earnings, as a consequence, belong only to the shareholders.

In Figure 8.2, the statement of retained earnings shows the distribution of net income to the shareholders in the form of a dividend payment. It should be noted that the AAOIFI does not provide an example of the statement of retained earnings. It requires information of the retained earnings to be provided as a part of the Statement of the Changes in Owners' Equity.

Figure 8.2

Statement of Retained Earnings for Islamic Banks under the AAOIFI FAS

For the Year 20XX

Balance on January 1	10,200
Net income	4,100
Dividends	(1,000)
Balance on December 31	13,300

Figure 8.3 illustrates a balance sheet for an Islamic bank under the AAOIFI FAS. The AAOIFI requires PSIA to be presented as the mezzanine level between liabilities and the shareholders' equity, because of its dissimilarities with both elements. The credit side of the balance sheet thus consists of liabilities, the equity of IAHs, and the shareholders' equities.

Figure 8.3

Balance Sheet for Islamic Banks under the AAOIFI FAS

December 31, 20XX

Assets		**Liabilities, Equity of IAHs, and Shareholders' Equities**	
Current assets	$ 74,100	**Liabilities**	
Long-term assets	93,750	Current liabilities	$ 11,750
Total assets	**$ 167,850**	Long-term liabilities	23,100
		Equity of IAHs	
		PSIAs	65,300
		Shareholders' equity	
		Common stock	54,400
		Retained earnings	13,300
		Total liabilities, equity of IAHs, and shareholders' equities	**$ 167,850**

8.5.2 Illustrations of Alternative Basic Financial Statements

The alternative view, as proposed in Chapter 7, uses the point of view of equity holders, which are not limited to only being shareholders, but also IAHs. In Figure 8-4, the income statement under the AAOIFI FAS excludes the return to IAHs from the calculation of net income. Thus, IAHs have no rights on the net income. On the contrary, under the proposed view, the income statement as shown in Figure 8.4 will not exclude the allocation of profit to IAHs from the calculation of net income.

Figure 8.4
The Income Statement
For the year 20XX

Income	
Income derived from Investment Pool's funds (shareholders' funds and PSIAs)	
Deferred sales	$ 1,500
Investments	7,900
	9,400
Income derived from investment of shareholders' funds	5,000
Total bank's revenue	14,400
Administrative and general expenditures	(2,600)
Depreciation	(1,800)
Net income (loss) before tax	10,000
Income tax	(1,100)
Net Income	$ 8,900

As the proposed view sees IAHs as one of the beneficiaries of the net income, the statement of retained earnings will show the allocation of retained earnings to both shareholders and IAHs (see Figure 8.5). As all profits to IAHs are directly distributed at the end of the period, the beginning and end balance will be zero.

Figure 8.5

Statement of Retained Earnings

For the year 20XX

	Beginning Balance	Additional	Distributions	End Balance
Equities	10,200	8,900	(5,800)	13,300
PSIAs	0	4,800	(4,800)	0
Shareholders' Equity	10,200	4,100	(1,000)	13,300

Figure 8.6 shows the alternative balance sheet with PSIAs as a form of equity. PSIAs occupy the equity section, along with the shareholders equity.

Figure 8.6

Balance Sheet

December 31, 20XX

Assets		**Liabilities and Equities**	
Current assets	74,100	**Liabilities**	
Long-term assets	93,750	Current liabilities	11,750
Total assets	**167,850**	Long-term liabilities	23,100
		Total liabilities	34,850
		Equities	
		PSIAs	65,300
		Shareholders' equity	
		Common stock	54,400
		Retained earnings	13,300
		Total equities	133,000
		Total liabilities and equities	**167,850**

The illustrations above are the simplified versions of the proposed financial statements. The Statement of the Changes in Equities does not appear here. Nonetheless, such statements

are necessary to show the changes in the amount of each equity that also includes the reserve accounts, including PER and Investment Risk Reserve (IRR) for PSIAs.

8.6 Concluding Remarks

Islamic scholars argue that the Islamic financial system is equity-based, instead of debt-based. This equity-based financial system refers to the absence of interest, which leads to partnership-based business agreements. In Islamic banks, the "depositors" are investors who are willing to share the risks from their investment, which consequently leads to no guarantee of a principal amount of their invested funds. The degree of risk shared can be different, depending on the agreement of the investment.

Thus, equity from an Islamic perspective does not merely refer to the residual, but to all the sources of capital that absorb profit/loss. When the equity holders' perspective is used, it cannot ignore the existence of IAHs, which are also equity holders of Islamic banks, although they do not hold the same rights as the shareholders.

Classifying the credit side of the balance sheets should not leave any sources of capital incapable of finding their match in terms of classification. The classification should also not simply say that A is the one that possess one criterion without further examination of whether the criterion is of central importance in distinguishing the items. This situation will create two classifications that are A and non-A. Instead, it should clearly define the criterion chosen that can be essential to both A and B, so that A and B are two classifications that subsequently have and do not have a certain criterion.

Current conceptual frameworks, both conventional and Islamic, use 'residual interest' as the criterion for defining the equity. Thus, all sources of capital that do not meet the 'residual' criterion cannot be classified as equity.

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

However, PSIAs are based on a *mudaraba* agreement, in which return to IAHs should follow the pre-agreed profit sharing ratio. Regarding this point, the application of the full disclosure principle is critical. The IAHs, who can have access to 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.

Chapter 9

Conclusion, Limitations, and Future Directions

9.1 Conclusion

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 prohibition of interest, which is the core reason for the emergence of Islamic banks, has created new accounts called the Profit-Sharing Investment Accounts (PSIAs). The Investment Account Holders (IAHs), or the holders of PSIAs, commonly enter into a business agreement with a bank on the basis of a *mudaraba* contract. Under such a contract, Islamic banks are called the *mudarib* or the fund manager, while the IAHs act as the capital providers, called *rabb al mal*. The two parties share the profits according to a pre-agreed profit-sharing ratio, but the losses are borne solely by the IAHs (Al Deehani, et al., 1999; Archer & Karim, 2009, Karim, 2001).

PSIAs, in contrast to conventional deposits, are not guaranteed to return the face value of the investment (Archer & Karim, 2009; Karim, 2001; Sundararajan, 2013). They are, however, also different from shareholders as they do not have any influence over how the banks are run. Thus, it creates a debate in the Islamic accounting literature on the compatibility of the basic form of a balance sheet to present PSIAs.

The main objective of this dissertation is to address the accounting problems arising from the distinctive way Islamic business transactions are conducted, which has not been well-accommodated by the IASB. Subsequently, it also attempts to investigate how the current conceptual frameworks classify PSIAs and to examine the appropriate classification for PSIAs in particular, and the credit side of the balance sheets of Islamic banks in general. The latter corresponds to the discussions about the various equity theories, which argue about whose point of view should be adopted as the point of view underlying financial reporting.

As Islamic banks have recently emerged and are spreading rapidly (IOSCO, 2004), both in the countries where Muslims form the majority of the population, and in countries where Muslims are only a minority, conducting such research becomes interesting. Nonetheless, it is also challenging, since the accounting issues for Islamic financial institutions have received less attention than the development of *sharia*-compliant financial products have.

Muslims believe in One God. They also believe that they will obtain success and happiness in this world and in the hereafter only if they follow *sharia* or Islamic law. The primary sources of sharia are the Quran and *hadith*, completed by *qiyas* (analogical reasoning) and *ijma* (consensus made by Islamic jurists) to tackle issues in modern society that are not directly addressed by the main sources. These secondary sources, as a consequence, can create different opinions among Muslims, including in the area of Islamic finance and accounting.

Since each jurisdiction has diverse understandings of Islamic rulings, it results in different accounting treatments for Islamic financial transactions. Currently, Islamic accounting does not refer to a uniform set of standards. These different opinions and understandings of *sharia* have become the biggest challenges to producing a common set of

global Islamic accounting standards. Accordingly, Islamic banks are currently implementing different financial reporting standards.

IDB noticed the effort made by Islamic banks to apply accounting principles that do not violate *sharia,* by setting their own accounting policies (Karim, 1990). It then took the initiative to establish the AAOIFI, which was formally registered as an international autonomous nonprofit organization in 1991 (AAOIFI, 2015; Karim, 1990)

In addition to the AAOIFI, Indonesia and Pakistan also developed their own Islamic accounting standards. While Pakistan adapted the AAOIFI FAS and still uses the same conceptual framework for both its conventional financial institutions and Islamic Financial Institutions (IFIs), the *Sharia* Accounting Standards Board of the Indonesian Institute of Accountants (DSAS-IAI) requires IFIs in Indonesia to follow separate conceptual frameworks and financial reporting standards.

Thus, based on the accounting standards used, Islamic banks nowadays are divided into five groups. They are the Islamic banks that report Islamic financial transactions: (1) Under IFRS or local GAAP based on IFRS; (2) under IFRS or local GAAP based on IFRS with some additional guidelines; (3) by adopting AAOIFI FAS; (4) by adapting AAOIFI FAS; and (5) by using national Islamic accounting standards. In the global movement towards IFRS convergence or adoption, Islamic banks in the first group are likely to dominate the population.

There are similarities and fundamental differences found between the two Islamic conceptual frameworks, which are developed by the AAOIFI and the DSAS-IAI, and the existing IASB conceptual framework. 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. Of primary importance

is the existence of PSIAs as an element of the 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 shareholders' equity.

The AAOIFI and the DSAS-IAI classify PSIAs as a new element on the credit side of the balance sheet, because they partly share the characteristics of liability, and partly those of equity. Islamic banks are not obliged to return the IAHs' funds in case of loss, and thus do not reflect "a present obligation" for the banks. However, IAHs is not identical with shareholders, as the IAHs do not enjoy the same powers and ownership rights, such as the voting rights held by owners (Karim, 2001). As a consequence, one thought contends that PSIAs should be distinguished from either liabilities or equity; hence the creation of another element of the financial statement would be required. Under these arguments, the AAOIFI and the DSAS-IAI introduced PSIAs as a mezzanine level between liabilities and equity.

There are two types of PSIAs, which are restricted and unrestricted. Restricted PSIAs limit Islamic banks' flexibility to invest the funds, as there are certain restrictions applied to the funds for investment. As a consequence, the banks cannot comingle these funds with other sources of funding. The unrestricted PSIAs, on the other hand, allow banks to utilize the funds at their own discretion (Archer & Karim, 2006; Archer, et al., 2010; Sundararajan, 2013). The latter type of PSIAs is the more common type, which becomes the main topic in this dissertation. While DSAS-IAI agrees that PSIAs, regardless of the restriction from the IAHs, should be classified as a mezzanine level between liabilities and equity, the AAOIFI require restricted PSIAs to be presented off-balance sheet. In addition, it is necessary to prepare a "Statement of Restricted Investment Accounts" to report the amount and use of restricted PSIAs.

The characteristics of PSIAs, which are not identical with those of conventional deposits, become a problem when classifying PSIAs in the balance sheets. While

conventional accounting will be forced to classify PSIAs as liabilities, the issue is 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.

In the survey in Chapter 5, a divergence of the accounting practices for PSIAs is found. 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 demonstrate uniform accounting practices for the accounting and disclosure of PSIAs and PSIAs-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.

Fewer disclosures pertaining to PSIAs, particularly of their returns to IAHs, were found for Islamic banks that do not cater to the uniqueness of Islamic finance, which suggests that IAHs receive less attention when a one-size-fits-all accounting standard is applied. It is a disadvantage for the IAHs, as IAHs fully depend on monitoring on behalf of the shareholders (Archer et al, 1998). 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.

In the discussions of the equity theories in Islamic literature, which are expected to provide answers to the element classification problem, there is no argument leading to a definite solution for the inconsistency in Islamic accounting related to the classification of elements. Those discussions make an attempt to find a suitable comprehensive theory for Islamic accounting, which will cover the ethical and social issues of the existing theories in the conventional accounting theory, which then lead most of the Islamic accounting scholars to state their preferences for the enterprise view.

The discussions of equity theories in the Islamic accounting literature also show the premature understanding about each equity theory itself. Their understanding about the rejected view is limited to what they think is the currently used basis for conventional accounting, and leaves the deep understanding of equity theories unexplored. The terms proprietary or entity views seem to have various interpretations. The identical terminology can in fact refer to an entirely different understanding of the equity theories. Adopting a particular entity theory can result in utterly different financial reports.

As clarifying the accounting perspective is central to considering how to satisfy the objective of financial reporting (EFRAG, 2010), before deciding on the viewpoints to be adopted, it is necessary to discuss the proposed objective of Islamic financial reporting. It has been decided that the objective of financial reporting should be directed at the provision of information to assist users in making economic decisions with regards to the *sharia* compliance's consideration, as well as the financial aspects, as a way to fulfill their accountability to God. Financial reports facilitate people to account for their actions in allocating the resources entrusted to them. It is related to the concept of ownership in Islam, in which human beings are merely the trustees of God in managing what is available on earth.

Adopting the pure proprietary view, the pure entity view, or the enterprise view can conflict with Islamic teachings in some matters. The pure proprietary view, which puts too much emphasis on the shareholders as the owners of the company, may ignore other stakeholders which also rely on the information in the financial reports to obtain necessary information regarding the company's activities. On the other hand, adopting the pure entity view means personifying the entity, as if it were a human being that is accountable to God. Despite the support from some notable Islamic accounting scholars, the enterprise view neglects the importance of profit that is related to the continuity of the company's business.

In Islam, the acquisition of profit is allowed and encouraged as long as it does not violate *sharia*.

The equity view, which is in between the pure proprietary view and the pure entity view, is the equity theory that is most applicable to Islamic accounting. It sees the entity as independent from the owners, but it also focuses primarily on the information needs of investors. The focus on investors or equity holders is important, as they do not only bear the risk from the investment, but also have the prevalent responsibility of allocating their wealth among other users.

Nonetheless, equity from an Islamic perspective does not merely refer to the residual, but to all the sources of capital that share the risks and accept unguaranteed amount from their initial investment. When the 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.

From the Islamic perspective, it is necessary to draw the line between debt and equity. However, it is also necessary to follow certain principles of categorization in order to provide a good classification and definition of the elements. Categorizing and classifying the credit side of the balance sheet should not leave any capital unclassified. It is also unadvisable to classify X as A when it does not meet criteria B, which is possessed only by Y.

The current conceptual frameworks, both conventional and Islamic, use various criteria to classify the credit side of the balance sheet. However, the AAOIFI and the DSAS-IAI follow the main criteria for equity as adopted by the IASB, which is 'residual'. Despite the claim that the IASB defines liabilities independently, which makes equity the remaining element, it reflects the 'residual interest' as the criterion of an item to be classified as equity.

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 participation 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 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, as well as serve the proposed objective of financial reporting in regards to *sharia*-compliance considerations.

The availability of the *sharia* supervisory board report as a part of the financial report is intended to ensure that the banks do not violate *sharia* in all aspects of their business. However, the board members are mainly chosen based on their knowledge of *sharia* or those recognized as Islamic scholars. They may lack of specific expertise in other fields, including finance and accounting, resulting in skepticism that *sharia* supervisory board can make a comprehensive assurance of the banks' compliance to *sharia*. 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 terms of the return they received.

Furthermore, the principle of full disclosure is necessary to satisfy the need for information about the banks' compliance with *sharia*. It also includes disclosing information on the entity's contribution to society. The current financial reports required by Islamic accounting standard setters have more disclosures pertaining to the specific requirements of *sharia*, such as reporting the payment of *zakat*, but are still not sufficient. Adequate disclosure requires that a financial statement should contain all the material information

necessary to make it useful to its users, whether it is included in the financial statements, the notes accompanying them, or in additional presentations.

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.

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 the 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 of time. It is hoped that Islamic accounting standards boards can make continuous efforts to further develop the conceptual framework for Islamic financial transactions that reflects Islamic teachings and at the same time, uses a consistent point of view.

9.2 Limitations

In this dissertation, there are some limitations which 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 theory. 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.

9.3 Future Directions

As stated in the limitations, this study has not covered all the elements of financial statements. It is important to revisit other elements and ensure that they are consistent with the proposed objectives and the viewpoint adopted. Some 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.

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Appendix A

The Importance of Full Disclosures

1. The Necessity of Full Disclosures for Islamic Banks

In the main part of the dissertation, it has been explained that the principle of full disclosure is necessary to satisfy the need for information for the banks' compliance with *sharia*, regardless of the point of view adopted to conduct accounting for Islamic banks. Adequate disclosure requires that a financial statement should contain all material information necessary to make it useful to its users, whether it is included in the financial statements, the notes accompanying them, or in additional presentations.

Full disclosure is deemed to be important in Islamic banks so that users can access the *sharia* compliance of the entity. Full disclosure means providing the disclosures of any information that should be rightfully given to users in accordance with the principles of *sharia* (Baydoun & Willet, 2000, p. 81). Haniffa and Hudaib (2007) propose that Islamic enterprises should also disclose social responsibility, which includes charities, wages to employees, and environmental protection, in addition to information on any prohibited transactions they made and *zaka*t obligations they have to pay and have already paid.

In the previous section, it was shown that all Islamic banks that report under the AAOIFI disclose the information on the method of allocating profits between the IAHs and shareholders. Nonetheless, those that report under IFRS are not motivated to do so (please see Chapter 5 for details of the findings from the survey). It becomes a disadvantage for the IAHs that, similar to shareholders, rely on the financial statements as an important source of information.

Islamic banks commonly provide a report from the *sharia* supervisory board that states the board's opinion on the bank's compliance with Islamic principles. Such assurance may reduce the necessity for very detailed disclosures of many issues (Maali, Casson, & Napier, 2006, p. 269). However, Islamic banks in some countries do not supply such reports. Moreover, a *sharia* supervisory board may only state the general opinion on all matters, while users may want to ensure the banks' adherence to *sharia* on a specific matter. A *sharia* supervisory board's report commonly does not give details about earnings prohibited by *sharia* received by the banks and how the banks deal with them. Thus, such information should be provided by the banks.

Considering the disadvantages of IAHs as the parties that may bear the losses from the investment, but without any governing rights, the AAOIFI (2015) requires detailed disclosures related to PSIAs. Those disclosures include the bases applied by the banks to allocate profits between shareholders and IAHs, the revenues shared and the expenses charged to PSIAs, the percentage of profit allocation between shareholders and IAHs, and the percentage of the PSIAs that IAHs have agreed to invest (AAOIFI FAS 27 Investment Accounts, para 22-35).

As social issues are central in Islam, the AAOIFI (2015) also requires disclosures on whether the bank has discharged its social reponsibilities, both in terms of a nominal amount and the type of activities (AAOIFI FAS 1, Appendix (E), para 45). This is also elaborated in the AAOIFI Governance Standards No. 7 Corporate Social Responsibility, Conduct, and Disclosure for Islamic Financial Institutions.

Another important disclosure is related to the activities carried out by Islamic banks, which may not be acceptable with regard to *sharia*. Such earnings and expenditures prohibited by *sharia* should also be disclosed (AAOIFI, 2015, AAOIFI FAS 1, Appendix (E), para 38). The disclosure should include the amount related to *sharia*-prohibitied activities, the

reasons for undertaking such transactions, the *sharia* supervisory boards' argument on the necessity of the transactions, how these prohibited amounts will be disposed, and how permissible transactions can be found as alternatives in the future (AAOIFI, 2015, Governance Standards No. 7, para 16).

Although the AAOIFI has required more detailed *sharia*-related disclosures in comparison to IFRS, there are still criticisms that they are not sufficient. Social responsibility and accountability will also be provided by disclosing the information on the recipients of bank's investments, instead of just disclosing the charitable activities they carry out. Chapra (2007) argues the necessity of equitable distribution of credit, by spreading the benefit of resources that become available to banks from a wide spectrum of depositors to a similarly large spectrum of the society rather than to just a few rich individuals (p. 326-327). Islamic finance will not be able to create justice if the financing does not become available to the poor and the middle class entrepreneurs. Availability of finance to them would not only to advance themselves economically but also to make a positive contribution to their economy.

2. Value-Added Statements

As mentioned in the main part of the dissertation, the value-added statement may be prepared as an additional statement alongside current financial statements, instead of replacing income statements with value-added statements. This can avoid the wrong interpretation that profit is equal to value-added.

An illustration of a value-added statement for Islamic banks under the enterprise view is presented in Figure A-1.

Figure A-1

Value-Added Statement for Islamic Banks

For the Year 20XX

Income from banking	$ xxx
Less: cost of services	xxx
Total value added	xxx
Distributions of value added:	
To employees (salaries and wages)	xxx
To shareholders (dividends)	xxx
To IAHs (profit sharing)	xxx
To government (income tax)	xxx
Depreciation	xxx
Profit retained	xxx
Total value added	$ xxx

Value-added statements gained interest in the United Kingdom in the 1970s, which led to the provision of such statements by the UK companies (Burchell, Clubb, & Hopwood, 1985, p. 386). Perhaps, the deep historic ties between the United Kingdom and Bangladesh have had an impact on the preparation of value-added statements. Most of Islamic banks in Bangladesh that are surveyed in Chapter 5 provide value-added statements in their annual reports. Table A-1 shows that five out of seven Bangladeshi Islamic banks prepare value-added statements.

Table A-1

Availability of Value-Added Statements in Annual Reports of Islamic Banks in Bangladesh

Name of Islamic Bank	Availability of Value-Added Statement
Al Arafah Islami Bank	√
EXIM Bank	-
First Security Islami Bank	√
ICB Islamic Bank	-
Islami Bank Bangladesh	√
Shahjalal Islami Bank	√
Social Islami Bank	√

3. Profit Allocation Methods

The practices across the Islamic financial services industry are not identical. What are considered acceptable or allowed by Islamic jurists in one jurisdiction may not be practiced or may even be considered unlawful by Islamic jurists in other jurisdictions. An example is the maintenance of reserve accounts, which is called Profit Equalization Reserve (PER), to smooth profit-payout to IAHs. Although this practice is common in Islamic banks in many jurisdictions, Islamic jurists in Indonesia still doubt that this practice can be accepted, since the reserve may go to different IAHs from those from whom the profit is initially taken.

The methods in allocating profits between IAHs and shareholders are not uniform either, which have been briefly explained in chapter 2. Two alternative methods that are commonly employed by Islamic banks are known as the "pooling method" and the "separation method". The differences between the two methods stem from the question of whether the two parties should share all revenues and expenses incurred for the banks' operations or strictly limit them the revenues and expenses pertaining to their investments

(Al-Deehani et.al, 1999, p. 272; Archer, Karim, & Al-Deehani, 1998, p. 153; Karim, 1996, p. 35).

If the bank chooses the pooling method, IAHs and shareholders share almost all revenues and expenses. In contrast, when the separation method is employed, the bank clearly draws a line between revenue and expense coming from investment operations and those of the other banking services. As the IAHs strictly enjoy and bear direct investment-related revenues and expenses, the latter technique excludes IAHs from bearing the administrative expenses (Al-Deehani et.al, 1999, p. 272; Karim, 1996, p. 35).

The bank usually cannot decide the method of profit allocation at its convenience, without any *sharia* consideration. When an in-house *sharia* supervisory board presents, the choice of profit allocation method is normally decided by the board in each bank. Nonetheless, it is also possible that the national *sharia* board has required one of the two methods to calculate the profit allocated to IAHs. In the latter case, the method employed by all Islamic banks in one jurisdiction will be uniform.

The disclosures on the profit allocation method are necessary, so that the users, particularly IAHs, can make decisions regarding their investment in the banks. In the survey of financial statements of Islamic banks, which are included as Chapter 5 of this dissertation, all of the Islamic banks that comply with AAOIFI FAS disclosed the expenses charged to PSIAs. Although the terms "pooling method" or "separation method" are not used, the descriptions of what expenses are charged or excluded from PSIAs imply one of those two methods.

Table A-2 lists the choice of method in allocating profits between IAHs and shareholders, which are revealed by Islamic banks applying AAOIFI FAS. Seven banks prefer to use the separation method, while six others adopt the pooling method to allocate

profit sharing between two parties. All Islamic banks in Jordan choose the separation method, while all Islamic banks in Qatar apply the pooling method.

Table A-2

Choice of Method in Allocating Profits between IAHs and Shareholders

Country	**Name of Islamic Bank**	**Method of Allocating Profits between IAHs and Shareholders**	
		Pooling Method	Separation Method
Bahrain	Al Baraka	√	
	Al Salam		√
	Bahrain Islamic Bank		√
	Khaleeji Commercial bank		√
	Kuwait Finance House Bahrain	√	
Jordan	Islamic International Arab Bank		√
	Jordan Dubai Islamic Bank		√
	Jordan Islamic Bank		√
Oman	Nizwa Bank		√
Qatar	Al Rayan Bank	√	
	Barwa Bank	√	
	Qatar Islamic Bank	√	
	Qatar International Islamic Bank	√	

It is also possible that there are additional requirements imposed by either accounting standard-setters or the government related to profit-sharing allocation other than the above-mentioned methods of profit allocation. In Indonesia, the Islamic accounting standards demand an additional statement called "Statements of Reconciliation of Revenue and Profit-Sharing". It is because DSAS-IAI, the Islamic accounting standard-setter in Indonesia, requires revenue distributed to the IAHs on the basis of cash that has been received by the bank or cash basis (IAI, 2016, PSAK 101, para A06).

Appendix B

Surveyed Islamic Banks

No	Name of Islamic Bank	Financial Year	Compliance to Accounting Standards	Presentation of PSIAs in the Balance Sheet	Separation between Restricted and Unrestricted PSIAs	Terms Referring to Return to IAHs	Observable Smoothing Profit-payout to IAHs
Southern Asia							
Bangladesh							
1.	Al Arafah Islamic Bank	2013	Bangladesh Financial Reporting Standards or IFRS as adopted by the Institute of Chartered Accountants of Bangladesh (and do not contradict with AAOIFI FAS)	Liabilities (*Mudaraba* Deposits)	No	Profit paid on deposits	No
2.	Islami Bank Bangladesh	2013		Liabilities (*Mudaraba* Deposits)	No	Profit paid on deposits	No
3.	Shahjalal Islami Bank	2013		Liabilities (*Mudaraba* Deposits)	No	Profit paid on deposits	No
4.	EXIM Bank	2013	Bangladesh Financial Reporting Standards or IFRS as adopted by the Institute of Chartered Accountants of Bangladesh	Liabilities (*Mudaraba* Deposits)	No	Profit paid on deposits	No
5.	First Security Islami Bank	2013		Liabilities (*Mudaraba* Deposits)	No	Profit paid on deposits	No
6.	ICB Islami Bank	2013		Liabilities (*Mudaraba* Deposits)	No	Profit paid on deposits	No

7.	Social Islami Bank	2013		Liabilities (*Mudaraba* Deposits)	No	Profit paid on deposits	No
Pakistan							
8.	AlBaraka Bank Pakistan	2013	Approved accounting standards in Pakistan (including Islamic Financial Accounting Standards by the Institute Chartered Accountants of Pakistan)	Liabilities (Customers' Deposits)	No	Return on deposits	*Hibah*
9.	Burj Bank	2013		Liabilities (Customers' Deposits)	No	Profit/return expensed	*Hibah*
10.	Bank Islami	2013		Liabilities (Customers' Deposits)	No	Profit/return expensed	*Hibah*
11.	Dubai Islamic Bank Pakistan	2013		Liabilities (Customers' Deposits)	No	Profit/return expensed	*Hibah*
12.	Meezan Bank			Liabilities (Customers' Deposits)	No	Return on deposits	*Hibah*
Sri Lanka							
13.	Amana Bank	2013	Sri Lanka Accounting Standards (IFRS Foundation Survey: IFRS with some modifications)	Liabilities (Deposits)	No	Financing Expenses	No
South-Eastern Asia							
Brunei Darussalam							
14.	Bank Islam Brunei Darussalam Berhad	2013	Generally Accepted Accounting Standards in Brunei Darussalam	Liabilities (Deposits)	No	Income attributable to depositors	No
Indonesia							
15.	Bank BJB Syariah	2013	Indonesian Financial Accounting Standards (including Islamic Accounting Standards)	Mezzanine (Temporary *Syirkah* Funds)	Yes (But no information on Restricted	Third parties' share on return of temporary *syirkah* funds	No

					PSIAs)s		
16.	Bank Syariah Bukopin	2013	Indonesian Financial Accounting Standards (including Islamic Accounting Standards)	Liabilities (Mudaraba Deposits)	Yes (Restricted PSIAs: off-balance sheet items)	Third parties' share on unrestricted investment revenue sharing	No
17.	Bank Syariah Mandiri	2013	Indonesian Financial Accounting Standards (including Islamic Accounting Standards)	Mezzanine (Temporary *Syirkah* Funds)	Yes (Both are messanine: Temporary Syirkah Funds)	Third parties' share on return of temporary *syirkah* funds	No
18.	Bank Mega Syariah	2013	Indonesian Financial Accounting Standards (including Islamic Accounting Standards)	Mezzanine (Temporary *Syirkah* Funds)	Yes (But no information on Restricted PSIAs)s	Third parties' share on return of temporary *syirkah* funds	No
19.	Bank Muamalat Indonesia	2013	Indonesian Financial Accounting Standards (including Islamic Accounting Standards)	Mezzanine (Temporary *Syirkah* Funds)	Yes (But no information on Restricted PSIAs)s	Third parties' share on return of temporary *syirkah* funds	No
20.	BNI Syariah	2013	Indonesian Financial Accounting Standards (including Islamic Accounting Standards)	Mezzanine (Temporary *Syirkah* Funds)	Yes (But no information on Restricted PSIAs)s	Third parties' share on return of temporary *syirkah* funds	No
21.	BRI Syariah	2013	Indonesian Financial Accounting Standards (including Islamic Accounting Standards)	Mezzanine (Temporary *Syirkah* Funds)	Yes (But no information on Restricted PSIAs)s	Third parties' share on return of temporary *syirkah* funds	No
Malaysia							
22.	Affin Islamic Bank Berhad	2013	Malaysian Financial Reporting Standards/IFRS	Liabilities (Deposits from	Yes (Both are	Income attributable to	PER (amount undisclosed)

				Customers)	liabilities)	depositors	
23.	Bank Islam Malaysia Berhad	2013	Malaysian Financial Reporting Standards/IFRS	Liabilities (Deposits from Customers)	Yes (Both are liabilities)	Income attributable to depositors	Forgo banks' profit (amount undisclosed)
24.	Bank Muamalat Malaysia Berhad	2013	Malaysian Financial Reporting Standards/IFRS	Liabilities (Deposits from Customers)	Yes (Both are liabilities)	Income attributable to depositors	No
25.	CIMB Islamic Bank Berhad	2013	Malaysian Financial Reporting Standards/IFRS	Liabilities (Deposits from Customers)	Yes (Both are liabilities)	Income attributable to depositors	No
26.	HSBC Amanah	2013	Malaysian Financial Reporting Standards/IFRS	Liabilities (Deposits from Customers)	Yes (Both are liabilities)	Income attributable to depositors	PER (amount disclosed: liabilities and equity)
27.	Hong Leong Islamic Bank Berhad	2013	Malaysian Financial Reporting Standards/IFRS	Liabilities (Deposits from Customers)	Yes (Both are liabilities)	Income attributable to depositors	PER (amount disclosed: liabilities)
28.	KFH Berhad	2013	Malaysian Financial Reporting Standards/IFRS	Liabilities (Deposits from Customers)	Yes (Both are liabilities)	Income attributable to depositors	Support from shareholders' fund (amount undisclosed)
29.	Maybank Islamic Berhad	2013	Malaysian Financial Reporting Standards/IFRS	Liabilities (Deposits from Customers)	Yes (Both are liabilities)	Income attributable to depositors	*Hibah* (if necessary)
30.	Public Islamic Bank Berhad	2013	Malaysian Financial Reporting Standards/IFRS	Liabilities (Deposits from Customers)	Yes (Both are liabilities)	Income attributable to depositors	PER (amount disclosed: liabilities and equity); When no PER: h*ibah*
31.	RHB Islamic Bank Berhad	2013	Malaysian Financial Reporting Standards/IFRS	Liabilities (Deposits from Customers)	Yes (Both are liabilities)	Income attributable to depositors	No
Thailand							
32.	Islamic Bank of Thailand	2013	Thai Financial Reporting Standards	Liabilities (Deposits)	No	Financial Expenses	No
Western Asia							
Bahrain							
33.	Al Baraka Islamic Bank	2013	AAOIFI FAS	Mezzanine (Equity of IAHs)	Yes (Restricted	Return on Equity of Unrestricted	PER and IRR (amount disclosed: Equity of

					PSIAs: off-balance sheets items)	IAHs	Unrestricted IAHss)
34.	Al Salam Bank	2013	AAOIFI FAS	Mezzanine (Equity of IAHs)	Yes (Restricted PSIAs: off-balance sheets items)	Return on Equity of Unrestricted IAHs	PER and IRR (amount undisclosed)
35.	Bahrain Islamic Bank	2013	AAOIFI FAS	Mezzanine (Equity of IAHs)	Yes (But no information on Restricted PSIAs)	Return on Equity of Unrestricted IAHs	PER and IRR (amount disclosed: Equity of Unrestricted IAHs)
36.	Ithmaar Bank	2013	AAOIFI FAS	Mezzanine (Equity of IAHs)	Yes (Restricted PSIAs: off-balance sheets items)	Return on Equity of Unrestricted IAHs	PER (amount disclosed: Equity of Unrestricted IAHs)
37.	Khaleeji Commercial Bank	2013	AAOIFI FAS	Mezzanine (Equity of IAHs)	Yes (Restricted PSIAs: off-balance sheets items)	Return on Equity of Unrestricted IAHs	PER and IRR (amount disclosed: Equity of Unrestricted IAHs)
38.	Kuwait Finance House Bahrain	2013	AAOIFI FAS	Mezzanine (Equity of IAHs)	Yes (Restricted PSIAs: off-balance sheets items)	Return on Equity of Unrestricted IAHs	No
Jordan							
39.	Islamic International Arab Bank	2013	AAOIFI FAS	Mezzanine (Unrestricted IAHs' Equity)	Yes (Restricted PSIAs: off-balance sheets items)	Unrestricted IAHs' share	Investment Risk Fund (amount disclosed: Equity of Unrestricted IAHs)
40.	Jordan Dubai Islamic Bank	2013	AAOIFI FAS	Mezzanine (Unrestricted	Yes (Restricted	Unrestricted IAHs' share	PER and Investment Risk Fund (amount disclosed:

				IAHs' Equity)	PSIAs: off-balance sheets items)		PER under Equity of Unrestricted IAHs and Shareholders' Equity; Investment Risk Fund under Equity of Unrestricted IAHs)
41.	Jordan Islamic Bank	2013	AAOIFI FAS	Mezzanine (Unrestricted IAHs' Equity)	Yes (Restricted PSIAs: off-balance sheets items)	Unrestricted IAHs' share	Investment Risk Fund (amount disclosed: Joint IAHs)
Kuwait							
42.	Ahli United Bank Kuwait	2013	IFRS as adopted by the State of Kuwait	Liabilities (Deposits from Customers)	No	Distribution to Depositors	No
43.	Boubyan Bank	2013	IFRS as adopted by the State of Kuwait	Liabilities (Deposits from Customers)	No	Distribution to Depositors	No
44.	Kuwait Finance House	2013	IFRS as adopted by the State of Kuwait	Liabilities (Depositors' Accounts)	Yes (Restricted PSIAs: off-balance sheets items)	Distribution to Depositors	No
45.	Kuwait International Bank	2013	IFRS as adopted by the State of Kuwait	Liabilities (Depositors' Accounts)	Yes (Restricted PSIAs: off-balance sheets items)	Distribution to Depositors	No
Oman							
46.	Nizwa Bank	2013	AAOIFI FAS	Mezzanine (Equity of Unrestricted IAHs)	Yes (Restricted PSIAs: off-balance sheets items)	Return on Unrestricted IAHs	PER and IRR (amount disclosed: Equity of Unrestricted IAHs)
Qatar							

47.	Qatar Islamic Bank	2013	AAOIFI FAS	Mezzanine (Equity of Unrestricted IAHs)	Yes (Restricted PSIAs: off-balance sheets items)	Return on Unrestricted IAHs	Shareholders' contribution (amount disclosed)
48.	Qatar International Islamic Bank	2013	AAOIFI FAS	Mezzanine (Equity of Unrestricted IAHs)	Yes (Restricted PSIAs: off-balance sheets items)	Return on Unrestricted IAHs	Support provided by the bank (amount disclosed)
49.	Al Rayan	2013	AAOIFI FAS	Mezzanine (Equity of Unrestricted IAHs)	Yes (Restricted PSIAs: off-balance sheets items)	Return on Unrestricted IAHs	Support provided by the bank (amount disclosed)
50.	Barwa Bank	2013	AAOIFI FAS	Mezzanine (Equity of Unrestricted IAHs)	Yes (Restricted PSIAs: off-balance sheets items)	Return on Unrestricted IAHs	Owner's contribution (amount disclosed)
Saudi Arabia							
51.	Alinma Bank	2013	Accounting Standards by Saudi Arabian Monetary Agency and IFRS	Liabilities (Customers' Time Investments)	No	Return on Time Investments	No
52.	AlRajhi Bank	2013		All PSIAs are off-balance sheets items	No	--	No
53.	Bank Albilad	2013		No information on PSIAs			No
54.	Bank AlJazira	2013		No information on PSIAs			No
United Arab Emirates							
55.	Abu Dhabi Isamic	2013	IFRS	Liabilities (Depositors'	No	Distribution to depositors	PER (amount disclosed: Depositors' Accounts/

				Accounts)			liabilities)
56.	ADNIF	2013	IFRS	Liabilities (Customers' Deposits)	No	Depositors' share of profit	No
57.	Ajman Bank	2013	IFRS	Liabilities (Customers' Deposits)	No	Depositors' share of profit	No
58.	Al Hilal Bank	2013	IFRS	Liabilities (Customers' Accounts)	No	Depositors' share of profit	Depositors' Profit Reserve (amount undisclosed: other liabilities)
59.	Dubai Islamic Bank	2013	IFRS	Liabilities (Customers' Deposits)	No	Depositors' share of profit	IRR (amount disclosed: Customers' Deposits/liabilities)
60.	Emirates Islamic Bank	2013	IFRS	Liabilities (Customers' Accounts)	No	Customers' share of profit	No
61.	Noor Islamic Bank	2013	IFRS	Liabilities (Depositors' Accounts)	No	Depositors' share of profit	No
62.	Sharjah Islamic Bank	2013	IFRS	Liabilities (Customers' Deposits)	No	Distribution to depositors	PER (amount undisclosed)
Yemen							
63.	Tadhamon International Islamic Bank	2013	IFRS and Islamic Accounting Standards for IFIs	Mezzanine (IAHs' Equity)	Yes (Both are mezzanine)	Return on investments	No