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The Needs and Readiness of the Islamic Banks to Adopt the Comprehensive Islamic Accounting Standards: The Malaysian Experience

Muhammad Mukhlis bin Abdul Fatah, *Azlan bin Md. Thani, Anuar bin Muhammad,
Maisarah binti Mohamad Azhan, Nujba binti Mohamad, Nur Iylia Amni binti Ismail
Faculty of Accountancy, Universiti Teknologi MARA, Melaka Branch, Alor Gajah, Melaka, Malaysia
brother_mukhlis@yahoo.com, *annasibn_malik@uitm.edu.my
Corresponding Author: Azlan bin Md. Thani

Abstract: The Islamic finance sector in Malaysia has seen substantial growth over the past few decades, becoming one of the leading markets for Islamic financial products and services. This growth has brought about significant challenges in financial reporting, primarily due to the limitations of conventional International Financial Reporting Standards (IFRS) in addressing the unique characteristics of Islamic financial transactions. The shari'ah transactions are governed by Shariah principles, which prohibit interest (riba) and emphasize on risk-sharing, ethical investments, and social justice. The study aims to provide a comprehensive analysis of the current issues and debates surrounding the need for comprehensive Islamic accounting standards in Malaysia. It will review recent literature, regulatory developments, and the experiences of practitioners in the particular field. Furthermore, the report seeks to highlight the readiness of Bank Negara Malaysia and all Islamic Banks to adopt Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI) standards and explore the feasibility of integrating these standards within the International Financial Reporting Standard (IFRS) framework. Additionally, this report aims to contribute to the ongoing discourse on Islamic accounting by offering critical insights and recommendations for policymakers, regulators, and financial institutions. The ultimate goal is to enhance the transparency, comparability, and reliability of financial reporting in the Islamic finance sector, thereby promoting its sustainable growth and integration into the global financial system.

Keywords: *Islamic Accounting Standards, Islamic Banks, International Financial Reporting Standards (IFRS), Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI).*

1. Introduction

Islamic finance has grown significantly globally, owing to rising demand for Shari'ah-compliant financial goods and services. Malaysia, being a prominent base for Islamic finance, is critical to the industry. Malaysia has built a regulatory framework and supporting government policies that have helped it become a global benchmark for Islamic finance. However, to retain and improve this position, strong Islamic accounting principles are becoming increasingly important. Accounting principles have changed in response to rapid growth in the Islamic finance industry, especially in Islamic financial institutions. According to Sarea and Hanefah (2013), there has been a significant increase in the number of Islamic financial institutions globally, and the Islamic financial industry has attracted large Western institutions such as Citibank, HSBC, and Deutsche Bank to function as Islamic windows within conventional banks. The continued growth rate of Islamic financial institutions in both Islamic and non-Islamic countries necessitate Islamic accounting standards, as existing accounting standards such as IFRS or local GAAP are based on conventional institutions, product structures, or procedures, and may be considered inadequate to account and report Islamic financial transactions (Deloitte, 2023).

Islamic accounting standards are a set of accounting regulations and guidelines based on Shariah principles that are intended to handle the specific accounting issues encountered by Islamic financial organizations. These standards were created by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), an independent, non-profit international Islamic legal entity that develops accounting, auditing, governance, ethics, and Islamic law standards for Islamic financial institutions and businesses (Ismail & Muhamad Sori, 2017). Shariah-compliant transactions that follow the prohibition on imposing interest do not resemble conventional finance and hence have substantial accounting consequences. Islamic accounting standards address a wide variety of issues, covering financial reporting, auditing, governance, and risk management. The creation and implementation of Islamic accounting standards is critical to the growth and development of the Islamic accounting sector (Ahmad et al., 2023; Syahdatul et al., 2022; Delloite, 2023).

Problem Statement

Islamic finance has grown significantly globally, owing to rising demand for Shariah-compliant financial goods and services. Malaysia, being a prominent base for Islamic finance, is critical to the industry. Malaysia has built a regulatory framework and supporting government policies that have helped it become a global benchmark for Islamic finance. However, to retain and improve this position, strong Islamic accounting principles are becoming increasingly important. Accounting principles have changed in response to rapid growth in the Islamic finance industry, especially in Islamic financial institutions. According to Sarea and Hanefah (2013), there has been a significant increase in the number of Islamic financial institutions globally, and the Islamic financial industry has attracted large Western institutions such as Citibank, HSBC, and Deutsche Bank to function as Islamic windows within conventional banks. The continued growth rate of Islamic financial institutions in both Islamic and non-Islamic countries necessitate Islamic accounting standards, as existing accounting standards such as IFRS or local GAAP are based on conventional institutions, product structures, or procedures, and may be considered inadequate to account and report Islamic financial transactions (Delloite, 2023).

As the global Islamic finance industry continues to grow, the need for a robust and Shariah-compliant accounting framework becomes increasingly important. This report explores the current landscape of Islamic finance in Malaysia, the existing accounting standards, and the arguments for and against the adoption of specific Islamic accounting standards developed by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

Research Question

(i) Is it necessary for Islamic Banks to adopt the comprehensive Islamic accounting standards in Malaysia?

(ii) Are Islamic Banks ready to adopt the comprehensive Islamic Accounting standards to be applied by all of the Islamic banks operated within Malaysia?

Objectives of the Research

(i) The objective of this study is to critically examine the necessity of adopting comprehensive Islamic accounting standards in Malaysia.
(i) To explore the readiness of Bank Negara Malaysia and all Islamic banks to adopt the comprehensive Islamic bank standards in Malaysia.

2. Literature Review

Definition of Islamic Accounting Standards (IAS)

Islamic Accounting Standards (IAS) are a set of guidelines designed to ensure that financial practices and reporting within Islamic Financial Institutions (IFIs) are aligned with Shariah principles. These principles include profit-sharing, risk-sharing, and the prohibition of interest (riba). Unlike conventional accounting standards, which primarily focus on financial transactions and profit maximization, IAS emphasizes ethical, social, and religious considerations in financial dealings. The objective of IAS is to ensure that all financial transactions and reporting practices comply with Islamic law, promoting transparency, fairness, and accountability (Harisova et al., 2023).

Comparison between Islamic Accounting Standards and Conventional Accounting Standards

A fundamental distinction lies in the underlying principles guiding each set of standards. AAOIFI standards are firmly rooted in Sharia principles, emphasizing ethical and socially responsible financing practices. This translates to prohibiting interest-based transactions (riba) and promoting profit-sharing arrangements that align with Islamic values. IFRS, on the other hand, focuses on broader accounting principles like fair value, accrual accounting, and a going concern assumption (Hassan & Raza Rabbani, 2022). While these principles aim for transparency and financial health assessment, they don't inherently address the specific ethical considerations of Sharia law.

The way each set of standards treats specific financial instruments is another key difference. AAOIFI provides detailed guidance for Islamic finance instruments like Mudharabah (partnership with profit sharing), Ijarah (leasing agreements), and Sukuk (Islamic bonds). These standards dictate how profits are recognized, risks are shared, and losses are allocated, ensuring adherence to Shariah principles. In contrast, IFRS may not have specific guidance for these instruments (Perwiragama & Fauziyah, 2022). Applying IFRS to such transactions can lead to interpretations that deviate from Sharia compliance. For instance, IFRS might classify a Mudarabah as a loan, which wouldn't reflect the profit-sharing nature of the Islamic partnership.

AAOIFI places a strong emphasis on extensive disclosures related to Shariah compliance processes, profit distribution mechanisms, and the valuation methods used for Islamic financial products. This transparency is crucial for stakeholders to understand both the ethical and financial aspects of an Islamic financial institution's (IFI) operations. Conversely, IFRS disclosures related to Sharia compliance might be limited or even absent (Bibi et al., 2023). This lack of transparency can make it difficult for users to assess the Islamic character and risk profile of an IFI's activities.

By integrating AAOIFI standards within the IFRS framework, Islamic financial institutions can achieve several advantages. Firstly, it enhances Sharia compliance. AAOIFI standards ensure that Islamic financial transactions are conducted according to Shariah principles, fostering trust and confidence among stakeholders who value ethical conduct. Secondly, it improves comparability. Combining IFRS with AAOIFI standards allows for a more standardized approach to financial reporting within the Islamic finance industry. This facilitates financial analysis and comparison between different IFIs, providing a clearer picture of their performance. Finally, greater transparency is achieved. The additional disclosures mandated by AAOIFI provide a more comprehensive picture of the IFIs' financial health and risk profile, particularly for users unfamiliar with Islamic finance concepts (Elhalaby et al., 2023).

The Needs of Comprehensive Islamic Accounting Standards in Malaysia

The need for comprehensive Islamic accounting standards in Malaysia is driven by several key factors, stemming from the unique requirements of Islamic finance and the overarching principles of Shariah law. Islamic Financial Institutions (IFIs) in Malaysia and elsewhere operate based on principles that differ significantly from conventional financial institutions. These differences necessitate a distinct approach to accounting standards to ensure that financial reporting aligns with the ethical and religious obligations of Shariah.

The core principles of Islamic finance prohibit activities such as paying or receiving interest (riba), engaging in speculative transactions (gharar), and investing in businesses that provide goods or services contrary to Islamic values (haram). Given these principles, the financial transactions and instruments used by IFIs differ markedly from those of conventional banks (Kaya, 2023). For example, Islamic finance employs profit-sharing contracts like mudarabah (profit-sharing) and musharakah (joint venture), sales-based contracts such as murabahah (cost-plus financing), and lease-based contracts like ijarah (leasing). Each of these contracts has specific implications for recognition, measurement, and disclosure in financial statements, which are not adequately addressed by conventional accounting standards.

Moreover, the credibility and authenticity of Sharia-compliant products are paramount for IFIs. To build and maintain public trust, these institutions need to demonstrate compliance with Shariah through transparent and specific financial reporting standards. The use of conventional accounting standards without necessary modifications can undermine stakeholders' confidence in the Shariah compliance of the financial products and services offered by IFIs. Therefore, a separate set of Islamic accounting standards would provide clarity and enhance the reliability of financial statements, ensuring they reflect the true nature of Islamic financial transactions (Nor Farizal et al., 2018).

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has developed a set of accounting standards tailored for IFIs, addressing the unique characteristics of Islamic financial transactions. Despite this, the adoption of AAOIFI standards is not widespread, and many countries, including Malaysia, continue to primarily use IFRS. The collaboration between AAOIFI and the International Accounting Standards Board (IASB) is crucial in bridging the gap and developing comprehensive guidelines that can be integrated into the IFRS framework (Haroun, 2021). This collaboration would facilitate the creation of standards that are globally recognized and accepted, enhancing the comparability and consistency of financial reporting among

IFIs worldwide.

3. Methodology

Description of Methodology: This study emphasizes the need for comprehensive Islamic Accounting Standards to be fully adopted by Islamic Banks throughout Malaysia. Moreover, this study also will focus on the readiness of Bank Negara Malaysia as well as all the Islamic bank operators in Malaysia to adopt the comprehensive Islamic Accounting Standards within Malaysia. Hence, the study focuses on the subsequent factors. i)The definition of Islamic Accounting Standards as per the Islamic banks understanding, ii) Comparison between Islamic Accounting Standards and Conventional Accounting Standards, iii) The Need for Comprehensive Islamic Accounting Standards in Malaysia.

This study will employ data from the combined research method which consists of a qualitative method comprised of interviews and a quantitative method using the questionnaires to be distributed to the Islamic bank practitioners. The qualitative approach will focus on the in-depth interview with the Islamic Banks respondent and the feedback will be recorded, documented and transcribed by applying the procedure of thematic analysis while the quantitative approach will focus solely on using the structured questionnaires to get accurate results.

Furthermore, the researcher will use systematic sampling which will focus on the respondents from Bank Negara Malaysia as well as all the related Islamic Banks that operate in Malaysia regardless of the local and international Islamic Banks. The data will be analyzed using Structural Equation Modelling (SEM) and Atlas.ti (Tanggamani, Rahim, Bani and Alias, 2024).

4. Contribution of The Study

The contribution of the study is to address the comparability issue with IFRS and AAOIFI Standards. Therefore, it is recommended that Islamic banks in Malaysia adopt a dual reporting framework that incorporates both AAOIFI and IFRS standards. This approach would allow Islamic financial institutions (IFIs) to prepare supplementary financial statements by AAOIFI standards alongside their IFRS-compliant reports. This dual reporting could enhance transparency and comparability for stakeholders who are familiar with IFRS while ensuring that the unique aspects of Islamic finance are adequately captured. For example, IFIs could prepare IFRS-based financial statements for international investors and regulatory bodies, while also providing AAOIFI-compliant reports for local stakeholders and Shariah scholars, thus meeting diverse needs without compromising on compliance (Perwiragama & Fauziyah, 2022).

As for the limitation of regulatory reluctance, the Malaysian Accounting Standards Board (MASB) must engage in dialogue with industry stakeholders, including IFIs, Shariah scholars, and international accounting bodies. By fostering collaboration, MASB can work towards integrating certain AAOIFI standards into the existing IFRS framework in a way that addresses the specific needs of Islamic finance while maintaining global comparability (Muhamad Sori, 2017). Additionally, conducting pilot projects that implement AAOIFI standards on a trial basis could demonstrate their feasibility and benefits. For instance, MASB could pilot AAOIFI standards in select IFIs and assess the outcomes, using the findings to make informed decisions about broader adoption and modifications to the regulatory framework.

Last but not least, to mitigate the challenges posed by economic dependency on Western financial systems, Malaysia should promote the internationalization of AAOIFI standards. This can be achieved by advocating for broader acceptance and understanding of these standards among global investors and financial institutions. Malaysia could also seek alliances with other countries with significant Islamic finance sectors to create a bloc that collectively endorses and uses AAOIFI standards. For example, Malaysia could collaborate with countries in the Gulf Cooperation Council (GCC) to standardize and promote AAOIFI standards, thereby creating a more robust and unified Islamic finance framework that is attractive to global investors. This collective effort could reduce reliance on IFRS and increase the legitimacy and acceptance of AAOIFI standards internationally (Elhalaby et al., 2023).

5. Conclusion

The adoption of comprehensive Islamic Accounting Standards in Malaysia for Islamic banks is essential for ensuring that financial reporting in the Islamic finance sector aligns with Shariah principles. The current use of conventional International Financial Reporting Standards (IFRS) presents significant challenges, as these standards do not adequately address the unique characteristics of Islamic financial transactions. The integration of Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) standards would enhance transparency, comparability, and reliability of financial statements, fostering greater stakeholder confidence and promoting the growth of the Islamic finance industry both locally and globally.

However, the transition to Islamic Accounting Standards is fraught with implementation challenges, including the need for extensive training, updates to accounting systems, and compliance with regulatory requirements. The costs associated with these changes can be substantial, particularly for smaller financial institutions. Moreover, harmonizing Islamic accounting standards with global frameworks like IFRS presents another layer of complexity, as it requires balancing Shariah compliance with international financial reporting norms.

Despite these challenges, the benefits of adopting Islamic accounting standards in Malaysia outweigh the drawbacks. Enhanced transparency and stakeholder confidence, better alignment with Shariah principles, and the potential for Malaysia to position itself as a global hub for Islamic finance are compelling reasons to pursue this transition. Future research should focus on comparative studies with other countries that have implemented AAOIFI standards to identify best practices and address common challenges. Such efforts will be crucial in achieving a more robust and unified Islamic finance framework that can thrive in the global financial landscape.

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