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An appraisal of the financial reporting practices of Islamic banks: the case of *Murabahah* contract

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Abstract

The purpose of this study is to highlight whether there is a need for separate accounting for Islamic banks, focusing on *Murabahah* arrangement. This paper is based on library research, content analysis, and interview, whereby, the recent annual reports for Bank Muamalat Malaysia Berhad (BMMB) and Al Baraka Banking Group (ABG) are evaluated. The paper discourses the concept of International Financial Reporting Standards (IFRS) and Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) standards, worldviews of IFRS principles, and *Shari'ah* issues in adopting IFRS for Islamic financial transactions. This research finds that IFRS tends to deviate what is ought to be the financial reporting practices for *Murabahah* facility as a sale-based trading contract. Hence, the standards set by IFRS for financial institutions cannot accommodate some of the distinctive nature, transactions, and practices of Islamic banks, which *Murabahah* is one. This paper adds to the global response to the need for separate accounting standards for Islamic Financial Institutions. Nevertheless, the paper is only focusing on *Murabahah* contract, thus, hindering the ability to provide the broader scope for the recommendation. This study suggests both exclusivity approach of financial reporting for the long-run, and practically harmonization approach for the mean time should be adopted in addressing the need for separate accounting standards for Islamic banks.

Keywords: Islamic banks, Islamic accounting, Financial reporting, IFRS, AAOIFI, *Murabahah*

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1. Introduction

Islamic Financial Institution (IFI) is a nascent industry yet one of the fastest growing realities within the global financial market. It has been recognised as a feasible and competitive form of financial intermediation, not only in Muslim countries but also beyond the Muslim world, offering a wide range of financial products and services [1]. In fact, financial institutions all over the world, including conventional banks, have launched their own Islamic banking units in trying to keep up with the pace of rising demand for *Shari'ah* compliant products and services such as Citibank, HSBC, Maybank, and others.

As the sector continues to grow, this circumstance forces the policy makers and practitioners to construct standardization for system and management for IFI, particularly for Islamic banks. One major source of assurance is the quality of information issued to the investing public about banks' ability to achieve both financial and *Shar'iah* -related objectives. With this, the need for proper accounting reports entails trust building. Subsequently, the question arises, what is the best way to account IFI and so Islamic bank?

Consistent with [2] prohibition of interest in the financial contract is the main reason why Islamic financial accounting methods and principles have to be carefully distinguished from their conventional counterparts. In fact, it is the primary reason why Islamic financial institutions have existed in the first place. Apparently, Islamic banks experience accounting advantage if continue to record based on Islamic accounting principle particularly on its legal form standard as an Accounting and Auditing Organization for Islamic Financial Institutions' (AAOIFI) recommendation, in terms of gearing ratio, riba cover and earnings per share, as well as tax advantages, from the theoretical basis [3].

In this paper, we will look into detail the accounting treatment of two Islamic bank-Bank Muamalat Malaysia Berhad (BMMB) and Al Baraka Banking Group of Baharain (ABG), specifically on *Murabahah* product. *Murabahah* is a sale-based contract, whereby, the Islamic bank will buy the product then sell it at the markup price. This paper will consider further in recognition and report whether *Murabahah* is treated as trading or financing based facility. The objective of this research is to highlight whether there is a need for separate accounting for Islamic banks, focusing on *Murabahah* arrangement particularly comparing between International Financial Reporting

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Standards (IFRS) and Financial Accounting Standards (FAS) under AAOIFI guidelines in dealing with *Murabahah* contract in their annual financial report.

This paper comprises five major chapters. The first chapter explains about the introduction. The second chapter elaborates the theoretical and empirical literature on *Murabahah* contract from *fiqh* perspective and accounting standard of *Murabahah* contract on IFRS and FAS's AAOIFI requirements. The model and method of estimation that employs in this study is exhibited in chapter three. Chapter four discusses the empirical result from the existence of *Murabahah* accounting treatment on BMMB with IFRS guideline and ABG with AAOIFI standard and the last chapter provides concluding remarks.

2. Literature review

2.1. The Contenders: AAOIFI vs IFRS

Currently, Islamic financial institutions are typically applying either of the two financial report standards apart from local reporting requirements. Firstly, accounting system applying follow IFRS (International Financial Reporting Standards) developed by International Accounting Standard Board (IASB). The rationale of converging to IFRS compliance is to facilitate comparability and increase transparency since international standards are implemented in IFRS. However, IFRS were not considered to be sufficient for all section of business [4], especially for Islamic financial entities dealing distinctive transaction. Secondly, the other accounting system adopting Financial Accounting Standard (FAS) promoted by Auditing Organization for Islamic Financial Institution (AAOIFI). In contrast with IFRS, AAOIFI is deemed to issue standards design for Islamic finance industry and, thus, adhering to the tenets of *Shari'ah* [5]. Nevertheless, the implementation of the AAOIFI standards may create certain bottlenecks in reporting the financial accounting standards on an international arena. It is argued that AAOIFI poses the threat to IASB in their quest to engage countries worldwide in adopting IFRS [6].

2.2. Worldviews on IFRS principles

Questions have been arising among Islamic finance jurisdictions whether IFRS are adequate enough to meet Islamic finance transactions or whether IFIs are so unique that other accounting frameworks are required [7]. In relation to this, three approaches arise. First is exclusivity approach. [8] [9] supports that there is a need for Islamic Financial report to have the different standard. Second is harmonization approach. The Association of Chartered Certified Accountants (ACCA) and KPMG prepare the report on Harmonising Financial Reporting of Islamic Finance [10] support the harmonisation of both AAOIFI's accounting standards and IFRS as they are complementary to one another. In other words, the IFRS standards have to be fine-tuned in order to accommodate *Sharīʿah* principles. Third is convergence approach. According to [11], convergence entails the process of harmonizing accounting standard issued by different regulatory bodies, such as the convergence of International Accounting Standards (IAS) and US Generally Accepted Accounting Principles (GAAP). In Malaysia particularly, most of the policy makers and practitioners follow the approach of full convergence is supported by some practitioners such as Pricewaterhouse Coopers [12], Malaysian Accounting Standards Board [13] and International Accounting Standards Board [14].

2.3. Shari'ah accounting issue

IFRS and FAS's AAOIFI represent principle-based standards in their requirements for transactions and events that satisfy the spirit of a given criteria. Principles are generally harder to be avoided than rules. For the purpose of discussion, the research focuses on the key accounting principles which are substance over form and revenue recognition.

The concept of substance over form asserts disclosures requiring the business to report and recognize the underlying realities of accounting transactions. In order to present a true and fair view of the affairs of the entity, the economic substance of transactions and events must be recorded in the financial statements rather than just their legal form. However, the financial report might result in the same cash flow form as interest bearing loan when adopting substance over form principle, the type of contract used makes the former (*halal*) permissible and the latter (*haram*) impermissible. According to [15], the form over substance approach clearly differentiates Islamic financial products from their conventional counterpart. This is due to the fact that distinguishing feature between the two financial products relies on form and contracts. If reporting only records the end result of transactions, Islamic financial products will appear insignificantly different.

In terms of revenue recognition, most of the Islamic banking products are based on sales and proceeds from such transactions should be accounted for as revenue from the sale of goods. Consequently, in many cases, payment for the sold item is deferred. The issue has been raised on the relevance of conventional standard on revenue recognition for *Murabahah* arrangement. According to IAS 18, there should be distinct recognition of financing charges from the profit margin. The financing charges are recognised on a time proportion basis while the profit margin should be recognised when the risks and rewards of the products are transferred to the customer. Nonetheless, [16] argue that in *Murabahah* contracts, the mark-up is not divisible into trading profits and financing charges, since this would be tantamount to credit loan facility and take mark-up as part of the interest that is evidently unacceptable from the Islamic precepts. Appendix 1 illustrates the divergence in income recognition under AAOIFI and IFRS in the case of *Murabahah* home financing.

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2.4. Murabahah Contract: Principles and Financial Reporting Framework

Murabahah is one of the sale-based contracts which is extensively discussed in literature among the Islamic financial instruments. And, it is also is one of the most common methods of Islamic financing that is principally used in trade financing arrangement [17]. In fact, there are quite a number of financing techniques that have been developed to comply with *Shari'ah* principles such as *Sukuk Murabahah*, *Murabahah* deposits, among other. The *Qur'an* declares sales and purchase of mal (asset) for a profit to be lawful. In the Islamic financial services industry, *Murabahah* is adopted in a transaction known as *Murabahah* to the Purchase Order (MPO) whereby three parties are involved, namely the IFI, the supplier and the purchase orderer. The *Murabahah* credit sale of a specified asset by an IFI to the purchase orderer is at a disclosed mark-up price based on the IFI's cost of financing the purchase [18].

2.4.1. Financial Reporting for Murabahah Financing AAOIFI Standards

AAOIFI FAS 2 adopted the recognition of assets available for sale at the time of contracting based on the shari'ah rule that ownership of the purchased asset is transferred to the buyer at the time of contracting. Thus, accounting journal entries to recognise the asset (financing) and income (profit) are as follows:

At the time of contracting: Dr. Murabahah/BBA Financing account (Cost +Profit) Cr. Cash or Payable account Cr. Unearned Financing Income account

(Recognition of BBA Financing asset) When the instalment is due but not yet received: Dr. Receivable account Cr. Murabahah /BBA Financing account

(Instalment Due) When income is due to recognise (account basis): Dr. Unearned Financing Income account Cr. Profit and Loss account (Recognition of Murabahah / BBA Income)

Fig 1. Accounting journal entries of AAOIFI Standards

In terms of asset measurement, AAOIFI FAS 2 prefers to measure those assets at their acquisition cost, which is the purchase price plus and direct expenses associated with the acquisition process. Besides that, related to valuation of assets available for deferred payment sale at the end of the financial period, AAOIFI prefers to value the assets at their fair value.

Consequently, AAOIFI provides the accounting principles for the treatment of unrealised gains losses and considers two alternatives, and AAOIFI prefers to record the unrealised gains and losses resulting from the valuation of assets available for deferred payment sale in a reserve account, and present this account in the statement of financial position at end of the financial period, taking into account the split between the portion related to unrestricted investment account holders and owners' equity.

2.4.2. Financial Reporting for Murabahah: IFRS Application

Applying IFRS-based reporting standards, if *Murabahah* is treated as the sale-based trading facility, Islamic banks necessitate the adoption of relevant standards such as IAS 2 Inventories, IAS 18 Revenue Recognition, and IFRS 9 Financial Instruments. In this case, the financial statements of IFIs seem to be consistent with the financial statements of commercial companies rather than with that of its conventional counterpart, whereby, account titles such as inventories, the cost of sales, and sales revenue exist. On the contrary, if *Murabahah* operates as financing arrangements, IFIs will only focus on using IFRS 9 and need not to employ IAS 2 and IAS 18 [7]. Therefore, divergence in conceptual journal entries for *Murabahah* contract are as follows.

Financing arrangement: Recognition of *Murābaḥah* financing Dr. *Murābaḥah* financing Cr. Cash

Purchase-and-sale based arrangement: At the point of purchase of the commodities Dr. Inventories Cr. Cash At the point of sale of the commodities: Dr. Murābaḥah receivables Cr. Sales revenue Dr. Cost of sales Cr. Inventories

Fig 2. Conceptual journal entries of IFRS Application

3. Research methodology

This paper is based on both primary and secondary data utilizing the approach for library research, content analysis, and interview. Library research was employed to determine the salient arguments on the need for separate accounting standards for Islamic banks, particularly, relating to *Murabahah* arrangement. The same approach applied in assessing the *Murabahah* principles and financial reporting framework. Furthermore, this study also used content analysis to explore whether the use of different standards (IFRS and AAOIFI) would still portray what is ought to be the financial reporting (as reflected in their annual report) practices for *Murabahah* facility of BMMB and ABG. In

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the same vein, this method helps to evaluate the extent of disclosures of items in the annual report as required by the standards for reporting. For primary data collection, on the spot interview was carried out during the talk of Sir David Tweedie entitled "Reflecting on the Journey of IFRS Standard-Setter" at Bank Negara Malaysia last 31 November 2015.

3.1. Data collection

All 2014 annual reports released by BMMB and ABG were obtained and downloaded from their respective website. From these, we extract the financial information relevant to the study.

With regards to interview, it was conducted with an academic expert, former conventional bank practitioner but currently in the field of academe and on her process to study Islamic accounting, and accounting practitioners representing the standard setters. The interview raised the question should there be separate accounting standards for Islamic banks? Appendix 2 summarizes the results of the interview.

4. Findings

4.1. Murabahah Arrangement: Bank Muamalat Malaysia Berhad (BMMB)

4.1.1. IFRS

The financial statements of BMMB and its subsidiaries have been prepared in accordance with the Malaysian Financial Reporting Standards ("MFRS"), International Financial Reporting Standards ("IFRS"), and the requirements of the Companies Act, 1965 in Malaysia [19].

With regards to *Murabahah*, it is reported in the financial statement as part of the financial assets, particularly, financing and receivable or financing of customers (Fig 3). Initially, it is recognised at fair value, including direct and incremental transaction costs, and subsequently measured at amortised cost using the effective profit method [19].

Nevertheless, *Murabahah* will be classified as impaired after going into the process of individual assessment, collective assessment, and written off accounts when [19].

1. Principal or profit or both are past due for three (3) months or more;
2. Where financing in arrears for less than three (3) months exhibit indications of credit weaknesses, whether or not impairment loss has been provided for;
3. Where an impaired financing has been rescheduled or restructured, the financing will continue to be classified as impaired until payments based on the revised and/or restructured terms have been observed continuously for a period of six (6) months.

Financing of customers (cont'd.)

(ii) By contract

	Group 2014 RM'000	2013 RM'000
Bai' Bithaman Ajil (deferred payment sale)	3,843,080	4,237,413
Ijarah (lease)	220,758	147,550
Ijarah Thumma Al-Bai (lease ended with purchase)	1,115,632	1,001,324
Inah (sale and buyback)	746,141	238,175
Tawarruq (commodity murabahah)	4,044,360	2,961,096
Bai Al Dayn (purchase of debt)	678,021	753,857
Murabahah (cost-plus)	1,175,415	922,188
Istisna' (sale order)	248,038	295,890
Qard (loan)	2,059	5,537
Shirkah Mutanaqisah (diminishing partnership)/ Musharakah (profit sharing)	55,933	236
Rahnu (Trustee)	40,697	60,656
	12,170,134	10,623,922

Fig 3. BMMB- Financing of Customers by *Shari'ah* Contract

In terms of income recognition, *Murabahah* as a financial instrument is recorded using the effective profit rate including any fees or incremental costs that are directly attributable to the instrument and are an integral part of the effective profit rate, but not future credit losses [19]. Fig 4 and Fig 5 are assumed where income from *Murabahah* and *Bai' Bithaman Ajil* are incorporated.

(i) Income derived from investment of general investment deposits

	Group and Bank 2014 RM'000	2013 RM'000
Finance income and hibah:		
Income from financing	397,055	444,879
Financial investment held-for-trading	13	13
Financial investment held-to-maturity	-	860
Financial investment available-for-sale	133,091	144,458
Money at call and deposit with financial institutions	24,024	37,683
	554,183	627,893
(Amortisation of premium)/accretion of discounts, net	(2,520)	811
Total finance income and hibah	551,663	628,704

Fig 4: BMMB- Income Derived from Investment of General Investment Deposits

(ii) Income derived from investment of other deposits

	Group and Bank 2014 RM'000	2013 RM'000
Finance income and hibah		
Income from financing	232,013	171,585
Financial investment held-for-trading	7	5
Financial investment held-to-maturity	-	332
Financial investment available-for-sale	77,769	55,716
Money at call and deposit with financial institutions	14,038	14,534
	323,827	242,172
(Amortisation of premium)/accretion of discounts, net	(1,473)	313
Total finance income and hibah	322,354	242,485

Fig 5. BMMB- Income Derived from Investment of Other Deposits

Excerpts from its recent annual report that the bank doesn't incorporate any standards on IFRS 2 Inventory (should there be any at the end of reporting period) nor IAS 15 Revenue recognition that is relevant for *Murabahah* to be classified as the sale-based trading facility. Rather, it simply based on standards for financial instruments (IFRS

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9, or MFRS 9 replacing MFRS 139). Therefore, we can conclude that BMMB treated *Murabahah* as financing facility and not as a trading arrangement.

4.2. Murabahah Arrangement: Al Baraka Banking Group

4.2.1. AAOIFI

Even though Al Baraka Group follows FAS as issued by AAOIFI, for matters for which no AAOIFI standard exists, the Group uses the relevant International Financial Reporting Standards ('the IFRS') as issued by the International Accounting Standards Board (the 'IASB'), given it does not contradict with Shari'a Rules and Principles and the conceptual framework of AAOIFI [20].

In terms of asset recognition, Murabahah is reported as sales receivables that consist mainly of murabahah and international commodities stated net of deferred profits and provision for a doubtful amount as illustrated in below. Presenting Murabahah as "sales receivable" depicts trading arrangement than using "financing receivable" that portray a loan facility. For asset measurement, Murabahah is recognized at fair value as determined at the Bank or subsidiary level at the end of the financial period at their cash equivalent value [20].

4.1 Sales (Murabaha) receivables

	2014			2013		
	Self financed US$ '000	Jointly financed US$ '000	Total US$ '000	Self financed US$ '000	Jointly financed US$ '000	Total US$ '000
International Commodity Murabaha	66,642	324,653	391,295	60,406	327,012	387,418
Other Murabaha	2,103,908	10,945,418	13,049,326	1,711,299	10,019,224	11,730,523
Gross Sales (Murabaha) receivables	2,170,550	11,270,071	13,440,621	1,771,705	10,346,236	12,117,941
Deferred profits	(219,278)	(1,055,947)	(1,275,225)	(177,273)	(915,326)	(1,092,599)
	1,951,272	10,214,124	12,165,396	1,594,432	9,430,910	11,025,342
Provisions (note 20)	(58,008)	(345,480)	(403,488)	(57,795)	(335,261)	(393,056)
Net sales (Murabaha) receivables	1,893,264	9,868,644	11,761,908	1,536,637	9,095,649	10,632,286

Fig. 6 ABG- Sales (*Murabahah*) Receivables

With regards to income recognition, sales (*Murabahah*) receivables are recognized when the income is both contractually determinable and quantifiable at the commencement of the transaction. Such income is recognized on time-apportioned basis over the period of the transaction. Where the income from a contract is not contractually determinable or quantifiable, it is recognized when the realization is reasonably certain or when actually realized. Moreover, income related to accounts that are 90 days overdue is excluded from the consolidated statement of income [20].

5. Conclusion

The emergence of IFI is motivated by the increasing demand from Muslims communities worldwide for *Shari'ah* compliant Islamic financial products and services. With this, compliance with the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) standards becomes subject to scrutiny. However, these guidelines have not been enforced and penetrated in wider scale among IFIs across the globe in spite of AAOIFI's persuasion of its application in the global network. In relation to this, addressing the argument of should we separate the accounting standards for Islamic banking, this paper compares the divergence in accounting standards of AAOIFI as applied by Al Baraka Group (ABG) and IFRS as the basis of Bank Muamalat Malaysia Berhad (BMMB) through highlighting *Murabahah* facility.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
At 31 December 2014

14 NET INCOME FROM JOINTLY AND SELF FINANCED CONTRACTS AND INVESTMENTS (continued)

14.1 Receivables

	2014 US$ '000	2013 US$ '000
Sales (Murabaha) receivables	1,019,486	925,471
Salam receivables	11,590	9,011
Istisna'a receivables	3,954	3,280
	1,035,030	937,762

Fig 7: ABG- Income from *Murabahah*

This study asserts that the use of IFRS tends to deviate what is ought to be the financial reporting practices for *Murabahah* facility, a sale-based trading contract. This is mainly because financial institutions such as banks in conventional parlance do not envisage trading transactions but merely financing deals. In other words, the standards set by IFRS for financial institutions are not designed to accommodate some of the distinctive nature of Islamic banks such as in the case *Murabahah* arrangement. More so, the use of effective profit rate that is seen as tantamount to the effective interest rate in the conventional bank will pose the threat on potential investors to on capitalizing their funds. *Shari'ah* compliance is the hallmark and the key success factor of Islamic banks. If this will be stain with reservation in the global market, especially by Muslim investors, the promising growth of Islamic finance may turn into depression.

Further, this paper adds to the global response on the need for separate accounting standards for Islamic Financial Institutions. Nevertheless, the paper is only focusing on Murabahah contract, thus, hindering the ability to provide the broader scope for the recommendation. Finally, our conclusion whether Islamic banks necessitate separate accounting standards, we contend ideally, exclusivity approach or separation for the long-run is the best, and practically harmonization approach for the mean time. We recognized the nascent stage of Islamic finance in the global market. Time is of the essence to prove to the world that Islamic accounting standards are worth to be applied not only for Islamic financial institutions but may also cater conventional financial institutions.

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Appendix

Appendix 1: Divergence in income recognition under AAOIFI and IFRS: Case of Murabahah Home Financing

	Under AAOIFI standards		Under IFRS
Year	FAS 2, paragraph 2/4/2 (a)	FAS 2, paragraph 2/4/2 (b)	IAS 18, paragraphs 11, 29, 30 IAS 39, paragraphs 9, AG5-AG8
	Proportionate allocation of profits over the period of credit	Profits recognised as and when instalments are received	Difference between fair value and the nominal amount of consideration recognised as interest revenue … in accordance with IAS 39
	RM	RM	RM
2001	19,665	19,665	33,866
2002	19,665	19,665	31,278
2003	19,665	18,026	28,503
2004	19,665	21,304	25,527
2005	19,665	19,665	22,337
2006	19,665	19,665	18,915
2007	19,665	19,665	15,247
2008	19,665	19,665	11,313
2009	19,665	19,665	7,094
2010	19,665	19,665	2,571
Total profit / interest income	196,650	196,650	196,650

Source: Malaysian Accounting Standard Board (MASB)

Appendix 2: Summary of Interview

Below is the summary of the on the stop interview administered during the talk of Sir David Tweedie last 6 November 2015 at Bank Negara Malaysia entitled “Reflections on a Journey of an IFRS Standards Setter”. The event was participated by various academic experts, practitioners, and students.

Question 1: Should there be a separate accounting standard for Islamic banks?

Respondent 1: Yes, Islamic banks should have its own accounting standards that envisage its culture and values. Accounting in itself is not merely a tool but rather a reflection of belief. For instance, let's take the issue of substance over form. If one person claims to own a car that can be substantiated by him enjoying the benefit of its usage, but in a legal form he steals it. Then, how can we justify it by merely considering the substance of the situation?

Respondent 2: Islamic banks need to compete globally to become more competitive in the market, harmonizing with IFRS will be better. Islamic finance is still an emerging market. It needs to complement with the existing acceptable standards such as IFRS. So long as such practices do not depart from Shari'ah principles, then there will be no dilemma.

Question 2: Are IFRS guidelines sufficient enough to meet the needs of Islamic Financial Institutions, particularly for Islamic banks?

Respondent 3: We recognize that there are some transactions that are unique for IFIs. So far, IFRS are not build to accommodate all business model as much as we want to. Hence, we will be needing the participation of experts in Islamic finance such as those in the Middle East to facilitate the application of IFRS to IFIs

Respondent 4: IFRS does not deviate with most Shari’ah principles, IFRS can be adopted for Islamic banks. In fact, even those practitioners in Saudi Arabia and other parts of Arabian Peninsula apply IFRS. With this, initiatives have been started to craft a book that tackles the application of IFRS in Islamic banks.

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