

THE ADOPTION OF AAOIFI ACCOUNTING STANDARDS DIFFUSION OF INNOVATION

Adel Mohammed Yaslam Sarea

*Faculty of Economic and Muamalat (FEM), Universiti Sains Islam Malaysia,
Malaysia, and*

Hj Mustafa Mohd Hanefah

*Faculty of Economic and Muamalat (FEM), Universiti Sains Islam Malaysia,
Malaysia*

ABSTRACT

Purpose – *The accounting and auditing organization for Islamic financial institutions (AAOIFI) had taken a proper initiative to develop accounting, auditing, governance and ethics standards for Islamic financial institutions. The AAOIFI standards serve as a guideline that may reflect the unique characteristics of Islamic financial institutions. This paper investigates mainly the level of compliance with the AAOIFI accounting standards by Islamic banks Malaysia.*

Design/methodology/approach – *The paper uses a questionnaire in order to explore the level of compliance with the AAOIFI accounting standards. The data was analyzed by using descriptive statistics and multiple regressions were conducted.*

Findings- *the paper indicates that the level of compliance with the AAOIFI accounting standards by Islamic banks of Malaysia have a moderate level of compliance with the AAOIFI accounting standards due to the fact that the AAOIFI accounting standards are as guidelines according to Bank Negara (BNM).*

Originality/value – *This paper contributes to the understanding of the diffusion of the AAOIFI accounting standards and contributes also towards a better understanding and acceptability of the AAOIFI accounting standards.*

Keyword (s): *Islamic accounting, Islamic Financial Institutions, AAOIFI Standards.*

INTRODUCTION

Islamic banks managed assets worth US\$ 112.6 billion making a net profit of US\$ 1.2 billion (Khan, 2001) in addition, there is about 300 Islamic banking and financial institutions across 75 countries, holding a paid-up capital of over US\$13 billion, controlling assets worth US\$300-US\$500 and investments US\$500 billion-US\$800 billion, with an average annual growth of 15 per cent. It has been estimated that

Islamic banking and finance industry will reach to US\$4 trillion by 2010 (Khan & Bhatt, 2008).

Islamic banking acts as an investor, a trader, a financial advisor, a consultant and a financing house (Ariss & Sariaeddine, 2008) However, the development of Islamic financial institutions in the Islamic and non-Islamic countries needs the Islamic accounting standards-AAOIFI accounting standards- due to the unique characteristics of these institutions such as free-interest system.

The trend towards the accounting and auditing organization for Islamic institutions (AAOIFI) standards has become pressing in the Organization Islamic Conference (OIC) countries. Therefore, researchers in financial reporting for Islamic financial institutions have conducted a considerable number of studies in the Islamic banks conformance to accounting standards. Until recently, Islamic banking problems included a lack of standardized accounting and auditing standards (Pomeranz, 1997). Basically, Islamic banks lack some evidence to adopt the AAOIFI accounting standards and analysis of Islamic banking principles under national Sharia'h advisory council, central bank roles, political system and economic structure. Moreover, the problem is the basis of Islamic accounting standards and Islamic disclosure still based on a conventional accounting philosophy (Harahap, 2003). The adoption of international standards by Islamic banks will help enhance their credibility and fuel their growth worldwide (Ariss & Sariaeddine). However, the rapid development of Islamic financial institutions needs clear standards for disclosing information, satisfying not only the general standards of disclosure but also standards relating to Islamic values (Harahap, 2003).

LITERATURE REVIEW

AAOIFI has published 68 standards, 23 accounting standards, 5 auditing standards, 6 governance standards, 2 ethics standards, and 30 *shariah* standards (AAOIFI, 2008). Most of the previous studies focused on the level of understanding and acceptability of AAOIFI accounting standards and the need for Islamic accounting standards, Islamic Sukuk according to AAOIFI FAS 17, comparison between IAS and AAOIFI, the prohibition of interest in Islam and mode of finance. However, in line with that, the research objective is developed and to be tested to evaluate the level of compliance with AAOIFI accounting standards by Islamic banks in Malaysia. A few studies have been conducted in this area. For instance, by Ismail and Latiff (2001), Karim (2001), Shahul, Alrazi and Nazli (2006), Ani Salwani (2006), Farah Nadzri (2009) and Thea Vinnicombe (2010) were found to examine the understanding, acceptability and compliance with the AAOIFI standards.

The first study in this area was conducted by Ismail and Latiff (2001), theoretically examines that to what extent Islamic financial institutions have adhered to the AAOIFI standards and IAS standards, AAOIFI has no legal backing and compliance with its standards is voluntary in some countries e.g. Malaysia. In Malaysia, with regard to AAOIFI's set of standards, BNM has no objection to its adoption to the extent that it is not in contradiction to the national requirements.

Karim (2001) found that Sudan and Bahrain require Islamic financial institutions to comply with the AAOIFI's standards. Efforts to require it are underway in other countries like Malaysia and Qatar. Some Islamic banks, such as Bank Islam Berhad Malaysia, Islamic Development Bank have also started to voluntarily use the AAOIFI accounting standards to prepare their financial statements. The implementation abroad of the AAOIFI standards would require exerting more efforts

with central banks and governments where Islamic banks operate to have the AAOIFI standards recognized.

Shahul, Alrazi and Nazli (2006) argued that how far the Islamic financial institutions have complied with the AAOIFI standards. The calculation is based on the number of the principles which followed AAOIFI to the total accounting principles applied. In this regard, (BIMB) comply with only 15 percent meanwhile (BIB) comply with 61 percent. Thus, the BIMB in Bahrain more comply with the AAOIFI accounting standards than BIB in Malaysia. Also, Ani Salwani (2006) argues that the level of understanding on Islamic bonds and acceptability of AAOIFI FAS 17 investment in Islamic bonds among bank managers in Malaysia. The managers who are involved directly in the investment in Islamic bonds AAOIFI FAS 17 have only moderate level of understanding. It was found that also those who have been well educated in Islamic banking and finance have a better understanding of Islamic bonds. On the other hand, AAOIFI FAS 17 is well accepted by Malaysians bank managers and may be considered applicable in Malaysia even though they have not referred to AAOIFI standards.

Farah Nadzri (2009) concluded that the extents of disclosure by the IFIs are much lower than the AAOIFI requirements. The test performed also revealed that the adopters of AAOIFI do provide more disclosure as compared to the non-adopters. However, the mean result is relatively low to suggest full compliance with the AAOIFI.

Thea Vinnicombe (2010) studied is the extent to which Islamic financial institutions comply with the accounting and governance standards issued by the AAOIFI in their financial reporting. The findings of the study show compliance to be very high with respect to the governance standard relating to the in-house supervisory

boards of Islamic banks, and reporting the Islamic murabaha contract, compliance is also high in the case of murabaha contracts. In contrast, compliance with the AAOIFI's requirements regarding the Zakah religious tax and the mudaraba contract is relatively low.

EMPIRICAL INVESTIGATION AND CONCLUSION

The study population consists of a number of accountants in 17 Islamic banks in Malaysia. The Sampling size in social science refers to the some procedures, in reference to Sekaran (2000) by referred to a rule of thumb, sample sizes between 30 and 500 could be effective depending on the type of sampling design used and the research question investigated. Therefore, *purposive sampling* using in this paper and the total of sampling size is 89 samples. Study of a sample rather than the entire population is also sometimes likely to produce more reliable results and justifiable method which reduces the difficulties such as cost and time Cooper and Schindler (2006). A total of 408 questionnaires were distributed to the accountants of Islamic banks in Malaysia. Only (89) copies were returned to the researchers, approximately 22% which is sufficient for statistics reliability. This section empirically analyzed the level of compliance with AAOIFI accounting standards among the respondents in Islamic banks of Malaysia.

Table 1: Highly compliance with AAOIFI accounting standards:

No	Statement	Mean
1	FAS 1 requires that unrestricted investment accounts be presented on the liabilities and equity in a separate section.	3.85
2	FAS 1 requires that restricted investment accounts be reported off-balance sheet in the statement of the changes in restricted investments.	3.15
3	FAS 5 requires bank to disclose percentages for profit-allocation between investment account holders and the bank.	3.78
4	FAS 6 disclosure should be made, in the notes on significant accounts,	3.89

	of the percentage of the funds of unrestricted investment.	
5	FAS 16 require that disclosures shall be made if the reporting currency is different from the local currency. The reasons for using a different currency shall be provided.	4.02
6	FAS 17 the sukuk held to maturity shall be measured at historical cost.	4.03
7	FAS 20 require that the bank shall disclose in the notes to the financial statements the policy adopted in financing deferred payment sale transactions.	3.88
8	FAS 23 require consolidated financial statements shall be prepared by combining the financial statements of the IFI.	3.66
	Total	3.78

This analysis used mean scores to measure the level of compliance with AAOIFI accounting standards. Table 1 shows that the extent of compliance with AAOIFI accounting standards from accountant's perceptive are moderate level of compliance with AAOIFI requirements the overall 3.25. In reference to Table 1, the researchers found out that 8 accounting standards out of 20 standards have been examined have high level of compliance. Out of these 8 accounting standards 2 standards are relatively were highest adopted, while 6 standards between 3.5 and 4 scores which indicates high level of compliance also. On the other hand, out of 20 standards, 10 standards have moderate level of compliance with AAOIFI accounting standards that means 50 percent of AAOIFI accounting standards have moderate level of compliance based on accountant's perspective. Finally, two items failed to be disclosed at a minimum 50 percent of the AAOIFI requirements regarding AAOIFI FAS 9 Zakah, this results supported by Farah Nadzri (2009) Indicate that the extents of disclosure by the IFIs are much lower than the AAOIFI requirements.

The study also found that leverage and origin factors might contribute to the level disclosures of zakah and financial products. However, the mean result is relatively low to suggest full compliance with standard of Zakah AAOIFI FAS 9. In addition, AAOIFI FAS 17 Sukuk in Islamic banks of Malaysia the highest mean

scores 4.03 representing the statement in paragraph 8 of the standard. This indicates that Sukuk held to maturity shall be measured at historical cost. The result is expected that the respondents are adopted AAOIFI FAS 17 requirements in their accounting practices.

Furthermore, mean score is 4.02 representing the AAOIFI FAS 16 it is consist of 29 paragraph as well as set out the accounting rules for recognizing, measuring, presenting and disclosing foreign currency transactions and foreign operations that are undertaken by Islamic banks and financial institutions. However, Foreign Currency Transactions and Foreign Operations with high mean score, this indicates that disclosure should be made for using a different currency with the reasons, especially representing the statement in paragraph 21 “Disclosure shall be made if the reporting currency is different from the local currency in the Islamic bank’s country. The reasons for using a different currency shall be provided”.

The AAOIFI FAS 20 “deferred payment sale”. With 3.88 mean scores which indicates that Bai' Bithaman Ajil are the most common financial transactions. this standard aims at setting out the accounting rules for recognizing, measuring, presenting and disclosing assets available for deferred payment sale, and the revenues, expenses, gains and losses relating to these assets as well as receivables that arise from such sale transactions that are conducted by Islamic financial institutions.

Generally, most of AAOIFI accounting standards have similarities mean scores and high compliance with AAOIFI accounting standards due to high awareness and acceptable of the AAOIFI standards. For instance, AAOIFI FAS 5 & FAS 6 also with high mean scores 3.78 and 3.89 respectively.

Finally, FAS 23 with mean scores 3.66 this indicates that Islamic banks should prepare consolidated financial statements in accordance with this standard. This is

indicating that the consolidated financial statements are disclosed to users such; shareholders, investment account holders and general public.

Table 2: Moderate compliance with AAOIFI accounting standards:

No	Statement	Mean
1	FAS 2 Assets available for sale after acquisition on the basis of Murabaha shall be measured at their historical cost.	2.58
2	FAS 3 disclosure should be made in the notes to the financial statements for a financial reporting period if the Islamic bank has made during that period a provision for decline in the value of Mudaraba assets.	3.05
3	FAS 4 disclosure should be made in the notes to the financial statements for a financial reporting period if the Islamic bank has made during that period a provision for a loss of its capital in Musharaka financing transactions.	3.29
4	FAS 7 Parallel Salam transactions shall be recognized when the Islamic bank receives the capital of Salam transactions.	3.07
5	FAS 8 requires leased assets to be booked in an Ijarah Muntahia Bittamleek assets account and measured at book value.	3.44
6	FAS 10 require that the Islamic bank shall disclose in its financial statements revenues and profits of Istisna'a contracts recognized for the financial period.	2.95
7	FAS 11 require that the Islamic bank shall disclose in the notes any deductions, either as a percentage or an amount, from mudaraba income.	2.69
8	FAS 14 In the case of a change in accounting policies, a disclosure to this effect shall be made including the reasons.	3.31
9	FAS 21 require that disclosures shall be made of the accounting policies adopted in the transfer of assets from unrestricted investment accounts to restricted investment accounts.	2.98
10	FAS 22 require disclosure should be made regarding segment revenue and segment expense for each reportable segment.	2.57
	Total	2.99

Table 2 shows the list of accounting treatments of AAOIFI accounting standards. Out of 10 AAOIFI accounting standards being tested, 5 items are 3 mean scores and above. Which indicates that these accounting standards are would be at the moderately high level of compliance. In addition, 10 accounting standards being tested, 5 items are 3 mean scores and less. This indicates that the accounting standards are would be at the moderate level of compliance. These standards are FAS 2 & 3 & 4

Murabaha, Mudaraba Musharkah financing (mode of finance). As well as FAS 21 accounting policies and FAS 22 disclosure of revenue and expenses. With regard to uniform mode of finance standards, the AAOIFI has developed and issued three standards under mode of finance which are: FAS 2 Murabaha financing, FAS 3 Mudaraba financing and FAS 4 Musharkah financing.

In reference to table 2 shows that FAS 2+3+4 modes of financing (Murabaha, Mudaraba and Musharaka) are at the same range of compliance with AAOIFI accounting standards.

Table 3: Low compliance with AAOIFI accounting standards:

No	Statement	Mean IBM
4	FAS 9 require that zakah should be treated as expenses of the bank.	2.37
5	FAS 9 require that unpaid zakah should be treated as liabilities.	2.48
	Total	2.43

Based on the analysis conducted, the lowest mean score for Islamic banks of Malaysia is 2.37 and 2.48 representing the AAOIFI FAS 9. This indicates that Zakah should be treated as expenses and unpaid zakah should be treated as liabilities. In other words, perception of accountants in Islamic banks of Malaysia gives relatively low compliance to this standard due to less understanding.

Zakah: Literary, “Zakah means blessing, purification, increase and cultivation of good deeds. It is called Zakah because it blesses the wealth from which it is paid and protects it. In Shari’a, Zakah is an obligation in respect of funds paid for a specified type of purpose and for specified categories. It is a specified amount prescribed by Allah the Almighty for those who are entitled to Zakah as specified in the Qur’an. The word Zakah is also used to indicate the amount paid from the funds that is subject to Zakah” (AAOIFI, 2008).

AAOIFI FAS 9 consist of 21 paragraph that describe measurements, recognition and disclosure requirements as well as this standard aims at setting out accounting rules for the treatments related to the determination of the Zakah base (i.e., the base on Zakah is to be computed), measurement of items included in the Zakah base and disclosure of Zakah in the financial statements of the Islamic banks and financial Institutions (AAOIFI, 2008).

TEST OF HYPOTHESES

The following hypotheses explain the relationship between independent variables and compliance with AAOIFI accounting standards in terms of the relative advantage, compatibility, complexity, trialability, and observability. The outputs of multiple regression are showed in table 4

Table 4: Regression results

Independent Variables		Coefficients
Expected Sign		Malaysia
Constant		-80.757
Relative advantage (+)		.000
Compatibility (+)		.015
Complexity (-)		.078
Trialability (+)		.096
Observability (+)		.000
Adjusted R²		.723
F value		15.473
No. of observations		89

Table 4 presents the results of regression model that examine the relationship between level of compliance and independent variables. The model includes Islamic banks in Malaysia based on Rogers's variables which are five independent variables (e.g. the relative advantage, compatibility, complexity, trialability and observability). The model is significant with R² (adj.) of 0.723. The results reveal that, as predicted, the level of compliance with AAOIFI accounting standards effect by the relative

advantage, compatibility, complexity, trialability and observability. There are significant differences in the level of compliance with AAOIFI accounting standards by Islamic banks in Malaysia.

The results provide support for the research hypotheses that the more relative advantage, compatibility and observability of AAOIFI accounting standards, the more likely AAOIFI accounting standards will be adopted. On the other hand, the more complexity of AAOIFI accounting standards, the less likely AAOIFI accounting standards will be adopted. In addition, the more trialability of AAOIFI accounting standards, the more likely AAOIFI accounting standards will be adopted. The “trialability” variable are not supported due to the fact is AAOIFI accounting standards not for trial propose, AAOIFI accounting standards needs legal back to be adopted.

The result confirms the trend observed in the descriptive analysis, namely that the level of compliance in Malaysia relatively a moderate level of compliance with AAOIFI accounting standards. The researcher is expected that Islamic banks in Malaysia are comply with AAOIFI accounting standards due to prior study conducted by (Hameed, 2006) which confirms that Bank Islam Malaysia Berhad (BIMB) are comply with AAOIFI accounting standards.

SUMMARY INSIGHTS AND CONCLUDING REMARKS

Due to the rapid growth in the Islamic Capital Market (ICM), compliance with the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) standards is a newly emerging area of study in line with greater interest in Islamic finance. Adopting or complying with Islamic accounting standards has become the focus of increasing attention among accountants, academics, practitioners, researchers

and investors. In reference to data analysis, results further show that the level of compliance with AAOIFI accounting standards by Islamic banks in Malaysia is moderate level due to their consistence with their regulation impose by the regulatory bodies in Malaysia such as BNM and MASB. On the other hand, in Malaysia adopted AAOIFI standards are voluntary or as guidelines.

The study found that relative advantage, compatibility, and observability show the positive influence and significant over the compliance with AAOIFI accounting standards which indicates that the more the relative advantage, compatibility, trialability and observability of AAOIFI accounting standards, the more likely AAOIFI would be adopted. On the other hand, the complexity shows negative influence on the compliance with AAOIFI accounting standards which indicate that the more complexity the less likely AAOIFI would be adopted. In addition, the complexity, trialability was insignificants due to The AAOIFI standards serve as a guideline that may reflect the unique characteristics of Islamic financial institutions and then follow Shar'ah principles.

REFERENCES

- AAOIFI. (2008), "Accounting and Auditing Organization for Islamic Financial Institutions", *Accounting and Auditing Organization for Islamic Financial Institutions*. Manama, Bahrain.
- Archer, S & Karim, A. (2002). "Islamic finance. Innovation and Growth". *Euro money books and AAOIFI*. Nestor House. London.
- Ani Salwani Che Pa. (2006), "An exploratory study on the understanding and accounting for Islamic bonds: perspective of Malaysian bank managers". (Master thesis). International Islamic University Malaysia.
- Ariss, R & Sariaeddine, Y . (2007), "Challenges in implementing capital adequacy guidelines to Islamic banks". *Journal of Banking Regulation*. Vol. 9, 1 46–59 & Palgrave Macmillan Ltd, 1745-6452 \$30.00

- Chapra, U. M. & Khan, T. (2000), "Regulation and Supervision of Islamic Banks: Islamic Development Bank". *Islamic Research and Training Institute*. Occasional Paper 3. Jeddah-Saudi Arabia.
- Cooper, D.R & Schindler, P.S. (2006). "Business Research methods". (International edition). *Mcgraw-Hill*. Singapore.
- Hameed, S. M. I, Wirman, A. Alrazi, B. Nazli, M. & Pramono, N (2006), "Alternative Disclosure and Performance Measures for Islamic Banks". *International Islamic University Malaysia* from <http://www.iiu.edu.my/iaw/Students>
- Hameed, S. M . (2009), "IFRS vs AAOIFI: The Clash of Standards?". *International Centre for Education in Islamic Finance*. MPRA Paper No. 12539.
- Harahap, S. S. (2003), "The Disclosure of Islamic Values-Annual Report the Analysis of Bank Muamalat Indonesia's Annual Report". *Managerial Finance*. Vol. 29. ABI/INFORM Global pp. 70-89.
- Ismail, H & Abdul Latiff, R. (2001), "Survey and Analysis of financial reporting of Islamic banks worldwide". *Arab-Malaysian Banking Group*. Kuala Lumpur.
- Karim, R. A. A. (2001), "International Accounting Harmonization, Banking Regulation, and Islamic Banks". *The International Journal of Accounting*. Vol. 36. pp. 169–193.
- Khan, T. (2001). "Risk Management an Analysis of Issues in Islamic Financial Industry". *Islamic Development Bank Islamic Research and Training Institute*, Occasional Paper No. 5 Jeddah - Saudi Arabia.
- Khan, M & Bhatti, M. (2008), "Islamic banking and finance: on its way to globalization. *Managerial Finance*". *Emerald Group Publishing Limited*. Vol. 34 No. 10, pp. 708-725.
- Kendall, J.D, Tung, L.L, Chua, K.H, Hong, C, Dennis Ng & Tan, S.M. (2001). "Receptivity of Singapore's SMEs to electronic commerce adoption". *Journal of Strategic information managements*. Vol.10. pp. 223-242.
- Lovett , R. (2002). "The adoption of international accounting standards: A diffusion of an innovation". (*PhD thesis*). *Nova Southeastern University*.
- Rafidah Noor. (2006). "A study on the factors that influence the adoption of e-commerce among Malaysian small and medium enterprises". (*Master thesis*). *International Islamic University Malaysia*.
- Pomeranz, F. (1997), "The Accounting and Auditing Organization for Islamic Financial Institutions: An Important Regulatory Debut". *Journal of International Accounting, Auditing & Taxation*. Vol.6. No. 1. pp. 123-130.
- Rogers, E. M. (2003). "Diffusion of Innovations". (3rd Ed.). New York: The Free Press

Sekran Uma. (2000), “Research Methods for Business: A Skill-Building Approach”.
3rd Edition, John Wiley & Sons, Inc. New York.

Vinnicombe, T. (2010), “AAOIFI reporting standards: Measuring compliance”.
Advances in Accounting, incorporating Advances in International Accounting.
Vol. 26 .pp 55–65