

FINANCIAL REPORTING OF ISLAMIC BANK IN THE LIGHT OF SHARIAH: A CONCEPTUAL FRAMEWORK

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Abstract

This paper intent to examine the function of the financial reporting, in enhancing the Shariah compliance of the Islamic financial transactions and the role of the Shariah committee in the Islamic bank in giving the assurance of Shariah compliance of the financial reporting. These would enhance the integration of the financial reporting of the Islamic bank and Shariah compliance. However, how Shariah compliance is conveyed in financial reporting received scant attentions in academia. This study uses literature as the study method. This is a conceptual paper describing the link between financial reporting on the Islamic financial transactions and Shariah compliance. The conclusion of this study shows that the knowledge in finance and accounting and experience of the Shariah committee enhances the financial reporting to be aligned with the Shariah. Therefore, it could increase the confidence of the stakeholders. As such, this study might be of interest to top management in Islamic banking, industry players, Shariah committee and regulators.

Keyword: Financial reporting, Islamic bank, Shariah compliance, Shariah committee

INTRODUCTION

Islamic finance has steadily progress despite the downturn of the economy, with assets of 2.4 trillion USD and has since grows higher than 2018. Meanwhile, the banks spearhead the Islamic finance industry with 72% of the market share (IFSB, 2020). The Islamic finance industry concentrate in the Middle East, North Africa, South and South East Asia. In the meanwhile Malaysia has been dominating the South East Asia market.

Since the inception of the Islamic finance in Malaysia in 1980s, Shariah compliance and governance have been the utmost priority. Malaysia has make every effort in attaining best practices by incorporating Shariah principles in all aspects of the Islamic system frameworks including operational, reporting, business conduct, risk management and oversight functions (MIFC, 2014). Besides, Shariah compliance is regulated under

Central Bank of Malaysia Act 2009 (CBMA, 2009) and Islamic Financial Service Act 2013 (IFSA 2013).

Accordingly, Islamic bank is required to establish Shariah committee within the institutions. Further, the role of Shariah committee in determining whether the Islamic financial institution's internal policies comply with the requirements of Shariah has become increasingly imperative (MIA, 2020). However, Shariah committee is not being emphasize in determining the Shariah compliance of accounting procedures and policies of the Islamic financial transactions.

The importance of accounting and financial reporting of the Islamic bank to comply with Shariah cannot be ignored. Financial reporting is a platform for sharing the information arising from the Shariah contracts applied in Islamic financial transactions. Rosly (2010) urges the Shariah committee to recognize the role of financial reporting arising from products they have given approval to. Though financial reporting is importance in achieving Shariah compliance in Islamic bank (Rini, 2014), there is hardly any study done on the link between the Shariah compliance and financial reporting practices (Che Azmi & Hanifa, 2015). Therefore, this study is undertaken to fill in the gap.

This paper is seeks to integrate the function of the financial reporting of the Islamic bank in the light of Shariah and the role of Shariah committee in giving the assurance of Shariah compliance of the Islamic bank financial reporting. As a results, the paper primarily provides a framework of Shariah aligned financial reporting.

This paper is organized as follows. First, briefly highlight on the importance and the definition of the Shariah compliance. Second, discussions on the link between Shariah compliance and financial reporting. Third, the role of Shariah committee in giving the assurance of financial reporting in complying with the Shariah. Next, proposes the conceptual framework of the Shariah aligned financial reporting and finally this paper end with the conclusion.

SHARIAH COMPLIANCE

Shariah compliance is the most important aspect of Islamic banking as without it the bank cannot be honoured as Islamic bank (Ullah, 2014). Moreover, the credibility of Islamic bank and confidence of the shareholders and stakeholders could be shown and inspired by its adherence to the Shariah (Hussan & Sulaiman, 2016; Laldin, 2008; Muhamad, 2011; Sheila Aion Yussof, 2013). Therefore, for Islamic bank to survive in this dynamic and competitive industry, a high level of public confidence is essential as the stakeholders expect the operation to be Shariah compliant (Mohammed et al.,

2015). Besides, Shariah compliance gives legitimacy to the practices of Islamic banking.

Shariah compliance definition

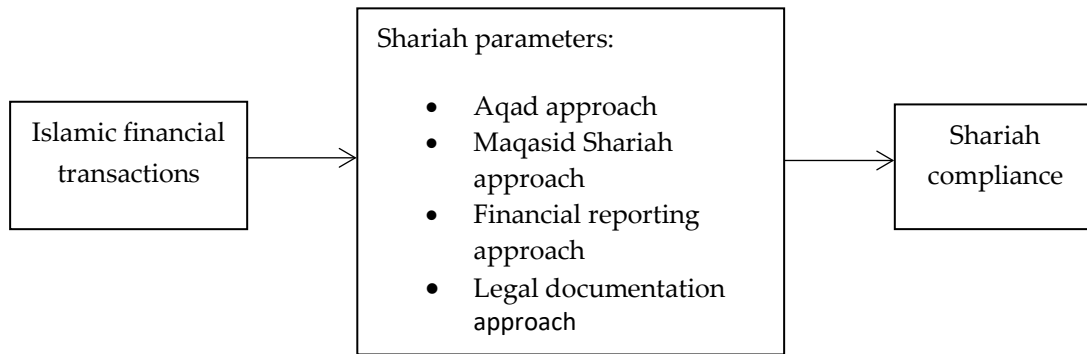
The meaning of compliance with Shariah has been stated in IFSA, section 28(2) as follows:

“A compliance with any ruling of the Shariah Advisory Council in respect of any particular aim and operation, business, affair or activity shall be deemed to be a compliance with Shariah in respect of that aims and operations, business, affair or activity”.

The above meaning of Shariah compliance has been elaborated by Laldin & Furqani (2018) into three elements, namely (1) complying with the rulings of the SAC of BNM and its Shariah standards; (2) ensuring internal policies and procedures are consistent with Shariah requirements; and (3) developing a Shariah audit function. Nevertheless, by focusing on legal aspect which follows the mechanism of Islamic law in ensuring product structure in Islamic finance is insufficient (Laldin & Furqani, 2016). Further, Laldin & Furqani (2016) they define Shariah compliance as “to structure and orient Islamic finance in the Islamic spirit and value system and achieve the ideals and purpose of Islam in the financial sphere”. In short, Shariah compliance is observing strictly to the permissible (halal) and abstaining from the prohibited (haram) as commanded by God (Rosly, 2010).

SHARIAH COMPLIANCE AND FINANCIAL REPORTING

In determining the Shariah compliance of the Islamic financial transactions in Islamic financial institutions, Rosly (2010) has proposed the four parameters namely, aqad approach, maqasid Shariah approach, financial reporting approach and legal documentation approach as shown in figure 1. Rosly (2010) has emphasized that, these parameters should be complementary to one another in ensuring the Shariah compliance of the Islamic financial transactions. In addition, Mohd Zamil (2014) has asserted that financial accounting and reporting is one of the main elements in the process of ensuring Shariah compliance of financial transactions as well as the approval of product development and innovation, implementation of approved product and auditing.



Source: Adapted from Rosly (2010)

Figure 1: Shariah compliance determinants for Islamic financial transactions

Aqad approach has been recognized by Shariah scholars at the supervisory level (Rosly, 2010). Meanwhile, maqasid Shariah has been discussed thoroughly as a financial product framework in structuring and innovating the Islamic financial contracts (Ahmed, 2011; Asadov, Muhamad Sori, Mohamad Ramadilli, Anwer, & Shamsudheen, 2018; Haniffa & Hudaib, 2010; Laldin & Furqani, 2013; Soualhi, 2015). For instance, the aspects of incorporating the Shariah principles into the financial reporting have been studied in Islamic non profit organizations such as waqf institutions (Che Azmi & Hanifa, 2015) and mosque (Zakariyah, Mohd Noor, & Mhd Sarif, 2017) which rely on sources on zakat, waqf and sadaqah (Ramli, Ali, & Muhammed, 2018).

The consideration to financial reporting is explicitly highlighted in the Quran such as the following:

“O ye who believe! When ye deal with each other in transactions involving future obligations in a fixed period of time, reduce them to writing; let a scribe write down faithfully as between the parties; let not the scribe refuse to write; as Allah has taught him, so let him write. Let him who incurs the liability dictate, but let him fear his Lord Allah, and not diminish aught of what he owes. If the party liable is mentally deficient, or weak or unable himself to dictate, let his guardian dictate faithfully. And get two witnesses...” (Al-Baqarah:282)

The above verse provides a guideline for recording and reporting any transaction in business affairs with an emphasis on faithful presentation and the presence of witnesses. It is also implied that a full disclosure of accounting information to the accounting information users. However, the primary objective of accounting information must be to fulfill the ultimate accountability to Allah SWT (Abdul Rahman, 2003). Thus, financial reporting can provide the details of the Islamic financial transactions in a more consistent and transparent way (Hussan & Sulaiman, 2016). Also, Rini (2014)

revealed that the most important dimension in financial reporting quality at Islamic banking was representation faithfulness.

The reporting practices' standards of Islamic banks in Malaysia are shared with the conventional banking, where, Islamic bank financial statements are to be prepared under Malaysian Financial Reporting Standards (MFRS) which fully complies to International Financial Reporting Standard (IFRS). Whereby the IFRS is not primarily meant for the accounting needs of Islamic banks (Ahmed, Tajul Ariffin, Karbhari, & Shafii, 2019). However, the Malaysian Accounting Standards Board (MASB) found that there is no Shariah restrictions in applying the conventional standard (MASB, 2012).

Therefore, the role of accounting and financial reporting of Islamic bank in communicating the information on the banking activities to the users of the financial statements has become crucial. Besides, it is also a medium to communicate whether the establishment of Islamic banks is consistent with Shariah principles and towards achieving the objectives of Shariah (Mohd Zamil, 2014). Meanwhile, Hussan & Sulaiman (2016) are in view that financial statements are equally relevant for the purpose of educating people on Islamic finance.

In this light, of the Shariah encourages for faithful presentation and full disclosure. Thus affirms the importance of financial reporting in achieving Shariah compliance. Moreover, Shariah aligned financial reporting will give stakeholders increased confidence (Hussan & Sulaiman, 2016). Therefore, it is vital to have the Shariah committee to give the assurance of the Shariah compliance of the financial reporting.

SHARIAH COMMITTEE ASSURANCE AND FINANCIAL REPORTING

Manifestly, Shariah committee constitutes of the only party responsible in determining Shariah compliance status of the Islamic bank. Besides, Shariah committee is the gatekeeper of the Shariah compliance that acts as an oversight body to monitor the operations and business affairs of the Islamic bank. Their main role is to issue opinions on the Shariah conformity of the Islamic bank operations as a whole.

However, there is a claim that the level of disclosure of Shariah committee is under expectation of the stakeholder (Aribi, Arun, & Gao, 2019). This also supported by Masruki, Hanefah, & Dhar (2020) in which the Shariah committee report focused more on disclosing Shariah committee attributes. They further urged that the report should consider other Shariah governance factors namely; Shariah risk management, Shariah review, Shariah audit and transparency and disclosure.

According to Hassan & Haridan (2019) their study reported that the deficiency of the Shariah committee members in performing the Shariah audit compliance task is due to their lack of accounting related knowledge.

However, since most of the Shariah Committee members have a Shariah background, whilst on the other hand the Shariah auditors with accounting background, it has been a challenge for Shariah Committee members to understand the issues highlighted by the Shariah auditor (Shafii, Abidin, Salleh, Jusoff, & Kasim, 2013). The finance and accounting knowledge and experience of Shariah committee complements the Shariah scholars' understanding of financial statements and issues related to risk assessment and management (Basiruddin & Ahmed, 2019). The presence of accounting and finance knowledge in shariah scholars enhances the shariah compliance, leading to high credit rating (Mansoor et al., 2020).

Therefore, the Shariah committee should be re-skilled and further equipped with the necessary knowledge such as accounting and finance, in order for the internal control system to be synonym with business-related fields. Meanwhile, Ajili & Bouri (2018) great support to stakeholders and policy makers to give more pressures on Islamic banks to improve the quality of their Shariah committee structure. Shariah committee quality on the relationship between the financial performance and the accounting disclosure. Hence, to have the Shariah committee with accounting background is crucial, in order to have a holistic Shariah compliance. Thus, knowledge clusters concerning the Shariah, economics, finance and accountancy, and law should be reflected on Shariah committee members in order to support their viewpoints in the Shariah committee report (Rosly, 2010). Inherent deficiencies of Shariah committee members in performing their task which is attributed to their lack of banking and financial knowledge (Haridan, Hassan, & Karbhari, 2018). Having discuss the link between Shariah compliance and financial reporting and significance of the Shariah committee accounting and finance knowledge in enhancing their report disclosure, the author suggest Shariah aligned financial reporting framework as shown in figure 2.

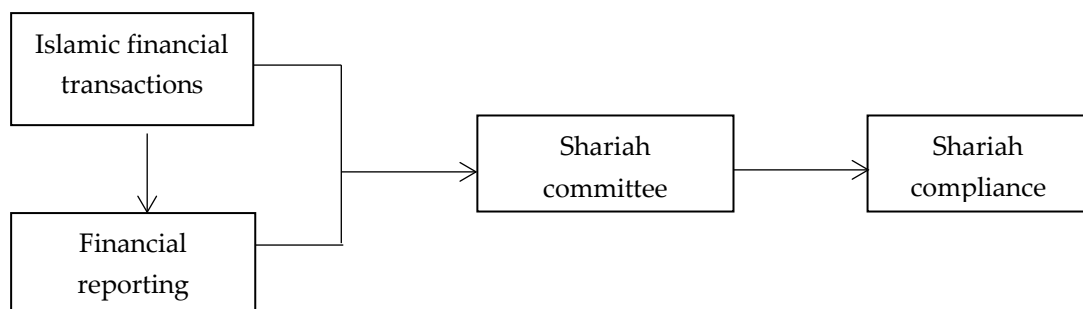


Figure 2: Framework for the Shariah aligned financial reporting

DISCUSSION AND CONCLUSION

The existence of the Shariah committee in Islamic bank is one of the features that distinguish the conventional bank and Islamic bank system. In the light of the Shariah parameter in achieving Shariah compliance, financial reporting is one of the main parameter that should be taken care of by the Shariah committee. The finance and accounting knowledge and experience of the Shariah committee enhance the financial reporting to be aligned with Shariah. Nevertheless it is not being exclusively implemented by the Shariah committee of the Islamic bank. This is relevant as the society is being skeptical to the Islamic financial transactions and Shariah aligned financial reporting could be able to promote confidence of the society and stakeholders as to the credibility of Islamic bank.

Thus, it can be concluded that this study has the potential to help Islamic bank and regulators make informed decisions about selection and requirement pertinent to Shariah committee members.

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Penafian

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