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Exploring Reflexivity and Resistance of Indonesian Islamic Financial Institutions towards IASB and AAOIFI Financial Reporting Standardization Projects

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Abstract

This thesis critically explores the reflexivity and resistance of Indonesian Islamic Financial Institutions (IIFIs) towards International Accounting Standards Board (IASB) and Accounting and Auditing Organisation of Islamic Financial Institutions (AAOIFI) financial reporting standardization projects. The motivation of this study derived from two conflicting arguments as to whether or not Islamic financial institutions require specific financial reporting standards to accommodate their specific Islamic finance transactions. Most of the financial reporting researches adopt a narrative approach in their attempt to answer the 'Why' question, but neglect further investigation to respond to the 'What is going on here?' question. This thesis fills the gap by answering the latter question and unveiling doubts on the required financial reporting standards for IFIs as well as the IIFIs and suggesting way forward for an enhanced stability of the global financial systems, through harmonization of financial reporting regimes. The data of this study was collected from semi structured interviews with 32 participants who are well versed with the knowledge on financial reporting standardization projects for IFIs/IIFIs, Shariah issues, and public policy. One of the chapters employs secondary data from conceptual framework and financial reporting standards issued by IASB, AAOIFI, and Indonesian standard setter.

The aspect of reflexivity is examined on the extent of IFRS and AAOIFI adoptions by the IIFIs. It begins with the development of IASB and its promoting journey of IFRS that contains political lobbying in the Indonesian institutional arena. Likewise, the aspect of resistance towards AAOIFI is revealed through exploration of the institutional arena that reflects dissimilar finding with that of IFRS. The study involves not only conventional political discourse but also Islamic political interaction that influences the future of Islamic based financial reporting standardization. In other facet, an analysis of the three reporting standards using *Maqāsid ul-Shari'āh* lens supports the early assumption on the need of a specific financial reporting for the IIFIs. As a way forward, International Islamic Financial Architecture (IIFA) institutions are also examined to explore what supports required to have Islamic based financial reporting standards for IFIs in general and for the IIFIs in specific.

The thesis makes four main contributions, both to theories and literatures. Firstly, it shows how the hegemonic political economy of accounting exists within the area of financial reporting standardization, which is not simply by identifying the types of isomorphism that influence the organizations' involvement in the financial reporting standardization. Secondly, in the context of Islamic financial institutions, the different interpretations of Shariah very much dominate in determining the direction of IFIs towards the implementation of Islamic based financial reporting due to the political influence in the respective countries where Islamic finance operates. Hence, the thesis proposes "Islamic Political Economy of Accounting" as a new theoretical framework to analyse similar discourse. Standard setters and regulators of IFIs are required to be tactful when looking into this issue. Thirdly, as the Islamic finance industry is now at continuous growth and maturity while also facing rising challenges, there must be a different approach to regulate the financial reporting standards. The hybrid way may not be appropriate any longer. This is shown in the analysis of the contents of the standards, where low level of *Maqāsid ul-Shari'āh* compliance is apparent. Lastly, this thesis also constructs an assumption about the attitude of dominant political leading countries towards the development of Islamic finance. As there is currently no real leadership in the area of Islamic finance, it would require influences from dominant leaders with congregated visions and a mission in line with Islamic values.

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26 September 2014/2 Thul-Hijjah 1435H

Murniati Mukhlisin @ Mu Kim Ni

Author's Declaration

I declare that, except where explicit reference is made to the contribution of others, this dissertation is the result of my own work and has not been submitted for any other degree at the University of Glasgow or any other institution.

Murniati Mukhlisin

Abbreviations

AAOIFI	Accounting and Auditing Organisation for Islamic Financial Institutions
AFA	ASEAN Federation of Accountants
AITAB	*Al-Ijārah Thumma Al-ba'i*
AOSSG	Asian Oceanic Standard Setters Group
ASAF	Accounting Standards Advisory Forum
ASEAN	Association of Southeast Asian Nations
ASSC	Accounting Standards Steering Committee
CEC	Corruption Eradication Commission *(Komisi Pemberantasan Korupsi/KPK)*
CIPA	Certified Islamic Professional Accountant
CMSA	Capital Market Supervisory Agency
CMSA & FI	Capital Market Supervisory Agency & Financial Institution *(Badan Pengawas Pasar Modal & Lembaga Keuangan/Bapepam-LK)*
CPS	Country Partnership Strategy
CR	Critical Realism
CSAA	Certified Shariah Adviser and Auditor
DAS	Domestic Accounting Standards
DPL	Development Program Loan
EII	Ethical Identity Index
ESQ	Emotional and Spiritual Quotient
EU	European Union
EUP	European Union Parliament
FAOIBFI	Financial Accounting Organization for Islamic Banks and Financial Institutions
FAS	Financial Accounting Standards
FASB	Financial Accounting Standards Board *(Dewan Standar Akuntansi Keuangan/DSAK)*
FASC	Financial Accounting Standard Committee
FGD	Focus Group Discussion
FRS	Financial Reporting Standardization
FSA	Financial Services Authority *(Otoritas Jasa Keuangan/OJK)*
FSAP	Financial Sustainability Assessment Program
FSF	Financial Stability Forum
FSSA	Financial System Stability Assessment
G20	The Group of Twenty Finance Ministers and Central Bank Governors
GAAP	Generally Accepted Accounting Principles
GAS	Government Accounting System
GCC	Gulf Cooperation Council
GCIBFI or CIBAFI	General Council of Islamic Banks and Financial Institutions
GIIBAS	Guidelines of Indonesian Islamic Banking Accounting Standards *(Pedoman Akuntansi Perbankan Syariah Indonesia/PAPSI)*
IAMI	Indonesian Association of Muslim Intellectuals *(Ikatan Cendekiawan Muslim Indonesia/ICMI)*
IAP	Indonesian Accounting Principles
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee

IDB	Islamic Development Bank
IDI	Islamic Disclosure Index
IDX	Indonesian Stock Exchange (*Bursa Efek Indonesia* / BEI)
IFIs	Islamic Financial Institutions *(Lembaga Keuangan Syariah/LKS)*
IFRS	International Financial Reporting Standard
iFSAP	Islamic Financial Sustainability Assessment Program
IFSB	Islamic Financial Services Board
IG	Interview Guide
IIA	Indonesian Institute of Accountants *(Ikatan Akuntan Indonesia/IAI)*
IICRA	International Islamic Centre for Reconciliation and Arbitration
IIFA	International Islamic Financial Architecture
IIFA	International Islamic Fiqh Academy (OIC-IIFA/ Organization of Islamic Cooperation- International Islamic Fiqh Academy)
IIFIs	Indonesian Islamic Financial Institutions
IILM	International Islamic Liquidity Management
IIRA	International Islamic Rating Agency
ILMC	International Liquidity Management Centre
IMF	International Monetary Fund
INCEIF	International Centre for Education in Islamic Finance
IOSCO	International Organization of Securities Commission
IPI	Islamic Performance Index
IRTI-IDB	Islamic Research and Training Institute – Islamic Development Bank
ISFASB	Indonesian Shariah Financial Accounting Standards Board *(Dewan Standar Akuntasi Keuangan Syariah Indonesia/DSAKS Indonesia)*
ISRA	International Shariah Research Academy
ISSFAS	Indonesian Shariah Statement of Financial Accounting Standards *(Pernyataan Standar Akuntansi Keuangan Indonesia/PSAK Indonesia).*
IWB	Indonesian Waqf Board *(Badan Wakaf Indonesia/BWI)*
LAPFF	Local Authority Pension Fund Forum
LMC	Liquidity Management Centre
MASB	Malaysian Accounting Standards Board
MoF	Ministry of Finance
NAM	Non Align Movement
NDPA	National Development Planning Agency *(Badan Perencanaan Pembangunan Nasional/Bappenas)*
NFA	New Financial Architecture
NIS	Neo Institutional Sociology
NSB-ICU	National Shariah Board – Indonesian Council of Ulama *(Dewan Syariah Nasional – Majelis Ulama Indonesia/DSN-MUI)*
NZA	National Zakat Agency *(Badan Amil Zakat Nasional/BAZNAS)*
OIC	Organization of Islamic Cooperation
PBUH	Peace Be Upon Him
PER	Profit Equalisation Reserves
RIA	Restricted Investment Account
ROSCs	Reports on the Observance of Standards and Codes
SAC of BNM	Shariah Advisory Council - Bank Negara Malaysia
SEZ	Special Economic Zone
SFAS	Statement of Financial Accounting Standards *(Pernyataan Standar Akuntansi Keuangan/PSAK)*

SFASB	Shariah Financial Accounting Standards Board *(Dewan Standar Akuntasi Keuangan Syariah/DSAKS)*
SMART	Specific, Measurable, Attainable, Realistic, and Timely
SMEs	Small and Medium-sized Entities
SOP	Standard Operating Procedures
SRA	Sustainability Reporting Assurance
SSB	Shariah Supervisory Board
SSFAS	Shariah Statement of Financial Accounting Standards *(Pernyataan Standar Akuntansi Keuangan Syariah/PSAK Syariah)*
SWOT	Strengths, Weaknesses, Opportunities, and Threats
UAE	United Arab Emirates
UK	United Kingdom
URIA	Unrestricted Investment Account
USA	United States of America
WB	World Bank
WTO	World Trade Organization

Transliteration Guideline

Arabic letters	Pronunciation	Romanization
ا	Alif	omit
ب	Ba	B
ت	Ta	T
ث	Tha	Th
ج	Jim	J
ح	Ha	Ḥ
خ	Kha	Kh
د	Dal	D
ذ	dhal	Dh
ر	Ra	R
ز	Zai	Z
س	Sin	S
ش	Shin	Sh
ص	shad	Ṣ
ض	dhad	Ḍ
ط	Tha	Ṭ
ظ	Zha	Ẓ
ع	‘Ain	‘
غ	Ghain	Gh
ف	Fa	F
ق	Qaf	Q
ك	Kaf	K
ل	Lam	L
م	Mim	M
ن	Nun	N
و	Wau	W
ه	Ha	H
ء	Hamzah	’
ي	Ya	Y

Notes:

- Letter that has long sound such as **a** is written as **ā**, **I** is written as **ī**, and **u** is written as **ū**, each has straight line above **(¯)**. For instance: 1. Fathah + alif written as **ā**; Kasrah + ya’ written as **ī**; and Dammah + wau tamwin written as **ū**.
- Several words have been assimilated into English as loan words, therefore they that do not follow the transliteration format, such as: Islam, Allah, Muhammad, Shariah, Sukuk.[1]

[1] This transliteration format follows Graduation Housing Style Guidelines for Tazkia University College of Islamic Economics 2014 and Housing Style Guidelines for The Islamic Foundation and Kube Publishing Version 2.3, 20th January 2014.

Transcription Notations

Notation	Definition
[word]	Material within brackets represents the transcriber’s clarification of an unclear part, or a change made to preserve anonymity.
[…]	Indicates that material has been omitted from the text.
…	Indicates a short pause, typically no more than one-tenth of a second.
Italics	Italics used to indicate non-English words.
(word)	Material within brackets represents the participant’s emphasis.

Chapter One: Introduction

1.1 Background of the Study

> "Accounting is seen as a set of practices that affects the type of world we live in, the type of social reality we inhabit, the way in which we understand the choices open to business undertakings and individuals, the way in which we manage and organize activities and processes of diverse types, and the way in which we administer the lives of others and ourselves" (Hopwood & Miller, 1994, p. 1).

Hopwood and Miller (1994) argue that accounting is no longer considered a neutral device that merely captures and reports the facts of economic activity. It means accounting is biased because it is influenced by various factors, including political and economic interests of particular groups in society (Cooper, 1980, Lehman and Tinker, 1987, Susela, 1999). In other words, accounting is an important economic tool, reflecting the interests and viewpoints of many interested parties. Several studies, for example Cooper (1980) and Susela (1999), have provided evidence of various interests in different contexts. Accounting, or what this thesis specifically refers it as financial reporting, derives its usefulness from its ability to reflect the social, cultural, and economic aspects of the organisations on which it reports. Each country or society has its own political, economic and cultural values. This requires the economic goals and the information needed to achieve them to be different in different societies. Thus, transferring a type of accounting which reflects the socio-economic and cultural values of developed nations to developing nations has been criticised by many scholars as being unsuitable (Briston, 1978, Samuels and Oliga, 1982, Hove, 1986, Briston, 1990, Wallace, 1990). Such transfers are particularly irrelevant in societies which are bound by specific religious principles in their everyday life, such as Muslim societies.

As a response to the criticism there has been in recent years an increasing interest in developing accounting concepts and standards from the Islamic perspective. One of the aspects that have received substantial focus is Islamic finance through Accounting and Auditing Organisation for Islamic Financial Institution (AAOIFI) project, which aims at harmonizing international accounting standards to comply with Islamic principles (AAOIFI, 2010, p. xvii). The AAOIFI project, however, as any harmonization attempt, has faced a number of challenges, ranging from accepting AAOIFI standards by various accounts preparers across different Islamic countries, to justifying the philosophical and economic foundations of each standard adapted from the International Accounting Standards (IAS). Amidst these doubts two competing discourses are proposed; the first calls for the abandoning of AAOIFI's accounting standards and adopt IFRS issued by IASB instead[2][3] and the second considers reverting to IFRS is fruitless because it does not recognise the political, economic and social constraints that exist in the attempt of developing so called 'Islamic accounting.'[4] It neglects the discussion of the role of accounting from an Islamic perspective at both micro and macro level. Hence, the second approach calls for setting accounting standards solely based upon *Maqāsid ul-Shari'āh* (Haniffa and Hudaib, 2002). In fact, IASB is only interested in presenting financial statements of local companies on the same basis as their foreign competitors, and with fewer detailed rules in order to make comparisons easier. Furthermore, IASB is grounded on the stewardship covenant for shareholders as well as institutional investors and attempting to improve the monitoring role of shareholders and investors for accountability and disciplinary purposes.

Hence, IASB approach has noticeably excluded the high degree of public interest on holding corporate accountable for their actions such as required under the Islamic environment. Thus, any Islamic institution or organization operating under an Islamic worldview may need a different type of accounting i.e. Islamic accounting. Under Islamic worldview, Islamic accounting would be a focus on different users, different objectives, different measurement and valuation, and different disclosure priorities (Ibrahim, 2000).

1.2 Contents of the Thesis

The overall objective of this thesis is to explore reflexivity and resistance of Indonesian Islamic Financial Institutions (IIFIs)[5] towards IASB and AAOIFI financial reporting

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[2] IASB is International Accounting Standards Board that issues International Financial Reporting Standards (IFRS).

[3] A discourse similar to the former has just started by the Indonesian finance ministry in early 2012 following the footsteps of other Islamic countries in the Gulf.

[4] "The term "Islamic accounting" was first introduced by Hayashi (1989), and defined by Ibrahim (2012) as the "accounting process" which provides appropriate information (not necessarily limited to financial data) to stakeholders of an entity which will enable them to ensure that the entity is continuously operating within the bounds of the Islamic Shari'a and delivering on its socioeconomic objectives. Islamic accounting is also a tool, which enables Muslims to evaluate their own accountabilities to God (in respect of inter-human/environmental transactions). The term can also have a temporal and spatial implication. It can be a form of shorthand meaning "accounting in parts of the world where Islam is the majority religion during periods when Islam has been dominant". Geographically, "Islamic accounting" would cover North Africa and a large part of sub-Saharan Africa, the Middle East, the territories of the Ottoman Empire, the Indian sub-continent, much of South-East Asia and Indonesia, as well as large parts of the former Soviet Union." Napier, 2009). However, Islamic accounting is not the focus of this thesis, thus it will not be further analysed.

[5] This chapter refers to IFIs when it means as Islamic financial institutions in the world or IIFIs when it intends to explain Islamic financial institutions in Indonesia.

standardization projects.[6] This thesis adopts a 'manuscript-based' style, with four manuscripts in four separate chapters. Each manuscript contains its own review of the literature, theoretical framework, research methodology, as well as analysis and conclusion sections. However, prior to these four main chapters of the thesis, there are two chapters on the relevant literature for this study. The first chapter discusses accounting standardization effort with the purpose of clarifying the focus of the thesis as delineated in Chapter Two. The chapter also presents conflicting views on International Financial Reporting Standards (IFRS)[7] regarding the standardization effort for the Islamic Financial Institutions (IFIs) in general, and, in specific, for the IIFIs' desires to elucidate the reflexivity and resistance regarding their standards. The second part of the literature analyses AAOIFI standards and revealed AAOIFI's conflict with IASB to explain the reflexivity and resistance of IFIs (see Chapter Three). The gaps in the literatures identified in these two chapters (One and Two) are further discussed in the four manuscripts Chapters: Four, Five, Six and Seven, with their distinctive research methodologies derived mainly from interpretive and critical epistemological approach.

Chapter Four presents various interactions in the social arena after utilizing arguments from the neoliberal perspective, reflexivity towards IFRS adoption was emerged and crystallised but with some varying views derived from the interviews resisting the plan for the adoption imposed upon the IIFIs. However, the Islamic finance industry in Indonesia exerted pressure towards adopting IFRS, in order to legitimate its *sine qua non* purpose of maximizing profit. Although the debate is still ongoing, the Indonesian Institute of Accountants (IIA) seems unwilling to fully adopt IFRS, because this would mean that the IIFIs lose their ability to enforce the specific Islamic characteristics in their financial reporting, hence violating the objective of accounting of 'presenting fairly' the financial statements' of the IIFIs.

Chapter Five utilises Strengths, Weaknesses, Opportunities, and Threats (SWOT) analysis to explore AAOIFI's strategic position. The Chapter suggests that AAOIFI lacks of political enforcement to impose its standards. Although AAOIFI has the capability of issuing international financial reporting standards and pronouncements for IFIs worldwide, it suffers two major weaknesses: financial constraints for issuing and modifying up-to-date standards

[6] An outline of this research has been presented at The Seventh Asia Pacific Interdisciplinary Research in Accounting (APIRA) Emerging Scholars' Colloquium held on 25 July, 2013 in Kobe, Japan.

[7] AAOIFI uses the term 'accounting standards' while IASB refers to them as 'financial reporting standards'. These two terms are used interchangeably except for generalization purposes such as title or topic where both standards are mentioned; in that case this thesis uses financial reporting standards. In short form, this thesis uses the terms 'AAOIFI standards', 'IASB standards' or 'IFRS' in reference to 'accounting and financial reporting standards'.

and limited access to quality manpower. Further empirical findings exemplify how AAOIFI has not taken a consistent strategy by neglecting its member countries' regulators and standard setters, including those in Indonesia. Lack of dealing with its members is a reflexive of AAOIFI's weak political lobbying base at its sponsoring countries such as Saudi Arabian and Bahraini governments. Nonetheless, AAOIFI has the opportunity to set international standards suitable for IFIs, provided that it can be at par with its competing institution, i.e. IASB. Another important aspect is the uniformity in Shariah interpretation among scholars in Muslim countries, which should be resolved regardless of the political and economic varieties among them.

Chapter Six evaluates financial reporting standards issued by IFRS, AAOIFI, and the Indonesian Shariah Statement of Financial Accounting Standards (ISSFAS). The Chapter triangulates the findings in Chapter Four and Five on the requirement of having a set of Islamic based financial reporting standards in order for IFIs fulfilling the objectives of Shariah (*Maqāsid ul-Shari'āh.*).[8] Chapter Six highlights the importance for IFIs to adopt Islamic based financial reporting standards as indicated from the content analysis of ISSFAS, AAOIFI and IASB. The results show a higher score on the *Maqāsid ul-Shari'āh* by ISSFAS than on AAOIFI and IASB standards. However, as none can be claimed to be an Islamic based standards, the results of each reporting standard can be further enhanced by adding more elements of Shariah fitting into the standards. Given the fact that the currently practiced international financial reporting standards are not satisfying the constructed elements in *Maqāsid ul-Shari'āh,* the contesting race among the three standard setters (ISSFAS, AAOIFI and IASB) is open for them to formulate a new set of reporting standards based on *Maqāsid ul-Shari'āh*.

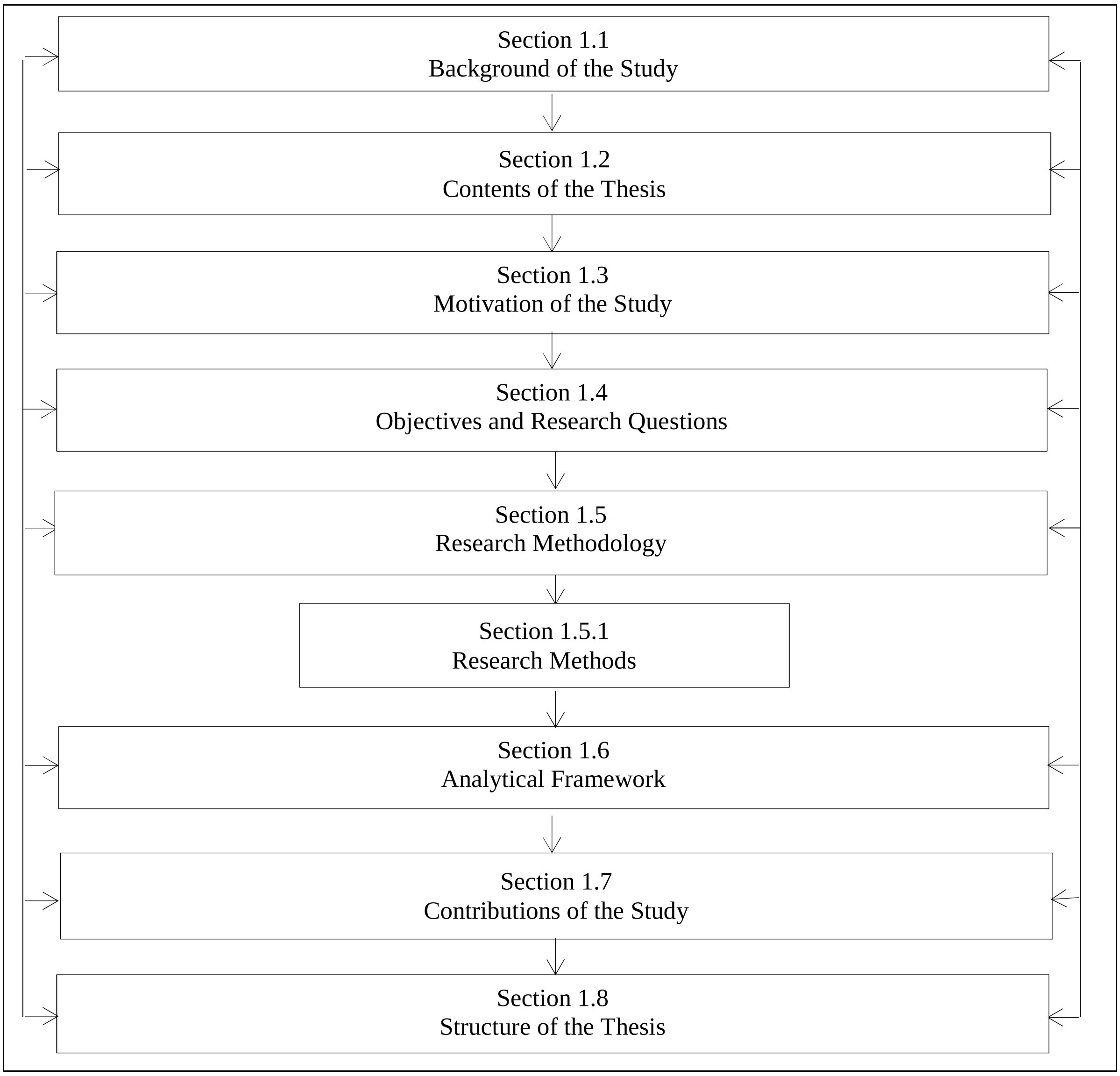
Chapter Seven argues that *Maqāsid ul-Shari'āh* based financial reporting standards would benefit IFIs (including the IIFIs) to achieve their main objective of becoming fully Shariah based institutions with going concern business operations. Supporting institutions for IFIs are definitely required, thus it suggests that the existing institutions under IIFA should be strengthened in order to achieve the main objective of IFIs. Nevertheless, the study indicates that IIFA institutions are not well established as they are weak in building smooth communication and cooperation. In fact, they are more concerned with their own institutions' objectives and reluctant to achieve goal congruence among them. The Islamic Financial Sector Assessment Program (iFSAP), initiated by Islamic Development Bank (IDB), is

[8] *Maqāsid ul-Shari'āh* is defined as the objectives of Islamic law. *Maqāsid* means objectives, a plural form of '*maqsid*'.

expected to offer a solution to the said problems by allowing intervention from International Monetary Fund and World Bank.

The theoretical references which are pertinent to the financial reporting standardization projects adopted in this thesis are DiMaggio and Powell (1983), Tinker and Neimark (1987), Abu Zaharah (1997), Smith et al. (2011), Krippendorff (2012), Modell (2014), and Katz (2006) . How these theoretical references are adopted to respond to the research questions is presented in Section 1.5 with details in each empirical chapter. The following Figure 1.2.1 outlines the structure of this chapter.

Figure 1.2.1: Structure of Chapter One



1.3 Motivation of the Study

Indonesia is a developing country in the South East Asia which obtained its independence in 1945 and according to its records the majority of its population is Muslim. Islamic activists have been seeking for recognition for Islamic practises and acceptance from government and the public, such as the banning of alcohol, closing of brothels**,** and forbidding conventional banking practices. The latter issue was first raised in the 1930s by Muslim scholars from Muslim countries (see Chapter Seven), and the Indonesian Muslim group decided to follow the consensus in 1990s with a proposal to set up an Islamic bank in Indonesia. The government granted the proposal and the first Islamic bank, with the name of Bank Muamalat Indonesia, was established in 1992. For its financial reporting the bank adopted the existing conventional financial reporting standards that followed IAS and modified it with AAOIFI requirements. The industry and the Indonesian accounting standard setter realized that the standard was insufficient to accommodate various transactions of the Islamic banks and took the initiative to issue a separate standard for Islamic banking in 2002 with more references to AAOIFI standards. However, the standard only accommodated banks and excluded non-bank institutions, therefore the accounting standard setter decided to revise it in 2007 in order to serve all Islamic business entities on their reporting requirements. From the phases of development, it shows that Indonesia has combined two methodologies in its reporting standards for the IIFIs i.e. IAS and AAOIFI approaches (see Chapter Six).

To date the standard has been widely adopted by the IIFIs, and Indonesia is the only country that has issued a specific financial reporting standard for IFIs. However, the IIFIs are currently facing complex problems, regarding whether to maintain their current standard and improve its compliance to Shariah requirements, or to follow the IFRS which ignores Shariah necessities in reporting. This occurred when Indonesia, as a G20[9] member country, declared full IFRS adoption starting 2012. In fact, due to the strong influence of IASB in Indonesia, the country started to alter its financial reporting standards towards IFRS in 2008, although some of the standards were revised with ‘carve out’ (a term used by IFRS for local adjustment provided to the standards). The Islamic finance industry is not an exception case not to follow IFRS and the move to follow the standards has been noticeable**,** such as the revision process of the SSFAS 102 on financial reporting standards for *Murābahah* transaction (see Chapters Two and Four). It seems that due to the influence of its international labelling, IFRS has persuaded the IIFIs to adopt and to neglect its institutional characteristics. This is also as a result of AAOIFI’s failure to provide a viable financial reporting standard for IFIs and the IIFIs (see Chapter Three and Five). All these arguments build the motivation to explore why some IFIs show flexibility while others

[9] The Group of Twenty Finance Ministers and Central Bank Governors.

resist to adopt certain reporting standards, and to investigate factors influencing these organizations.

It is well known that the stakeholders in society need reliable and relevant information in order to make economically efficient choices and for optimal risk sharing. It is also understood that the optimal designs of financial reporting standards depend on the institutional characteristics of the political and economic system, and that there are several varieties of capitalism. It is not obvious which of these varieties is best (varieties are, for example, liberal market capitalism, coordinated market capitalism, socialist capitalism). The IASB standards optimized for stock market in liberal economy based capitalism is not necessarily optimal for other forms of capitalism. Since liberal market economy has lost credibility as a way of doing business, the world may be better served by encouraging alternative forms of capitalism, in order to develop financial reporting standards tailored to the various types of capitalism. Hence, Islamic based accounting, based on Islamic market economy, which incorporates social accountability, can be seen as one of these alternatives. In other words, the existence of different varieties of capitalism with different financial reporting standards for groups of countries (the Islamic world or South East Asia) arguably promotes economic progress *vis-à-vis* the imposition of a single set of global accounting standards for all companies. The forced adoption of a single form of financial reporting standard runs the risk and severely restricts different forms of capitalism to develop. It also gives privileges to one particular way of doing business over the alternative forms that currently exist or, more importantly, those that may exist in the future. In effect, the forced adoption of a single form of accounting can be viewed as a form of restrictive practice that prevents alternative and superior ways of doing business from taking shape (Walker, 2010). There are two competing discourses regarding standard setting process for IFIs. The first is a top-to-bottom approach of adopting IFRS with little changes by local accounting standards setters. It is a convergence approach where local setters would work closely with IASB to develop high quality and compatible accounting standards over time. This in turn would make adoption easier and less costly. The second approach is a bottom-to-top approach which views accounting as a socio-economical device that emerges out of the social negotiations and interactions without the intervention of the state. The conflict between these two approaches sheds light on proposing a viable set of financial reporting standards that fulfil objectives of Shariah, incorporated in international tools of financial assessment to regulate.

1.4 Objectives and Research Questions

IASB has been aggressively sponsoring IFRS harmonization, convergence and full adoption on the ground to promote quality of accounting such as comparability and transparency across the world. To date, IASB has sheltered more than 128 jurisdictions (IAS-Plus, 2013d). However, the Islamic finance industry with its unique characteristics is in a dilemma, whether to follow the financial reporting standards issued by AAOIFI, to adopt IFRS completely or to form its own financial reporting standards. In a specific situation faced by IFIs in Indonesia, the institutions have undergone several phases of development in financial reporting standardization. Due to government commitment and a promise of international brand to be more globally competitive, the IIFIs urged the standard setter to follow IFRS standardization project.

Figure 1.4.1: Development of Financial Reporting Standardization for the IIFIs

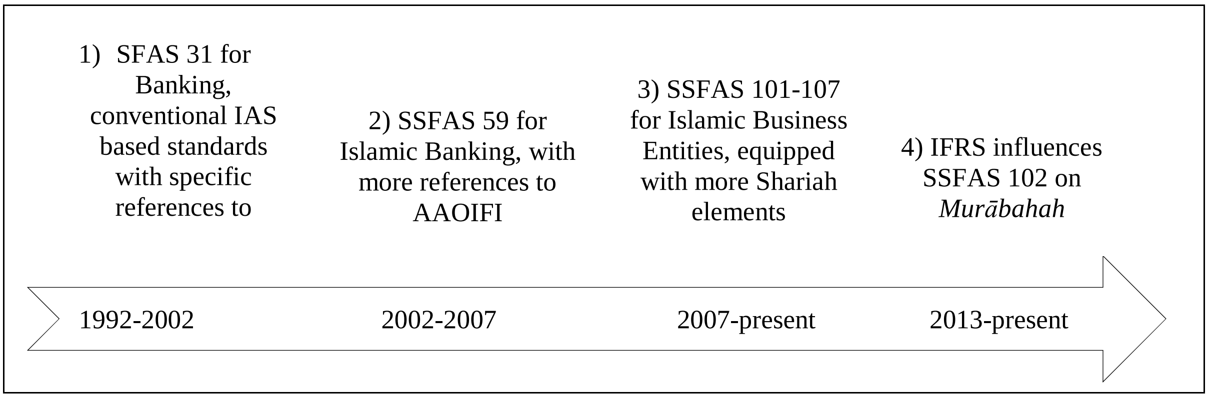


Figure 1.4.1 explains how financial reporting standard developments for the IIFIs are shaped by several factors. The factors are: 1. World Bank and IMF loan arrangements that resulted in IAS influencing the local standard, which was then adopted by the IIFIs from 1992 to 2002 with a reference from AAOIFI for its Islamic content; 2. The industry (particularly Islamic banking) responded to the growth and required a specific financial reporting standard, which resulted in the adoption of SSFAS 59 from 2002 to 2007, with more content from AAOIFI standards; 3. The advancement of Islamic based industry that requires more comprehensive standards that cater not only for Islamic banking. Therefore the SSFAS 101-107 standards for Islamic business entity were released and have been adopted since 2007; and 4. The political economy of accounting permits a powerful standard setting body to reshape the standards for the IIFIs, particularly in the case of SSFAS 102 on *Murābahah*. Therefore, the background and motivation for the study form several objectives for this thesis, all presented in Table 1.4.1 as follows:

Table 1.4.1: Summary of Research Objectives

Theoretical research objective		
The overall objective of this thesis is to explore reflexivity and resistance of Indonesian Islamic Financial Institutions (IIFIs) towards International Accounting Standards Board (IASB) and Accounting and Auditing Organisation for Islamic Financial Institution (AAOIFI) financial reporting standardization projects.		
Specific Research Objectives		**Empirical Chapters**
1	To explore the views on the adoption of IASB standards and whether it is seen as the way forward by IIFIs;	IFRS study on Chapter Four
2	To evaluate AAOIFI's strategy in developing its accounting standards and seeking for acceptance from its member countries including Indonesia;	AAOIFI study on Chapter Five
3	To propose a recommendation on the most appropriate reporting standards for IFIs suitable for international financial reporting requirements as well as compatible with *Maqāsid ul-Shari'āh*;	*Maqāsid ul-Shari'āh* study on Chapter Six
4	To examine institutions responsible for Islamic financial architecture and explore the required supports for the future to impose appropriate financial reporting standards for IFIs.	Islamic architecture study on Chapter Seven

These objectives are interrelated, the first objective starts to analyse why IASB has been successful in promoting IFRS, and begins to find out whether IFIs, including the IIFIs, find the standards compatible for the industry. The literatures on IASB, IFRS, IFIs, and the IIFIs are deliberated in Chapter Two while the empirical analysis is discussed in Chapter Four. The second objective is to evaluate AAOIFI's strategy, which relates to its failure to persuade its member countries – including Indonesia – to adopt its standards. Figure 1.4.1 shows that the IIFIs came up with an initiative to formulate their own standards due to their dismissal to fully adopt AAOIFI standards. The background and literature on AAOIFI are described in Chapter Three while the reasons for the dismissal are presented empirically in Chapter Five. The literature gaps from Chapter Three also lead this chapter to objectives number three and four. The objective number three intends to analyse three reporting standards; IFRS, AAOIFI, and ISSFAS in regard of their degree of compliance to *Maqāsid ul-Shari'āh*. This is debated in Chapter Six. Finally, the objective number four is to propose necessary elements under Islamic finance architecture, in order to support the implementation of a uniformed financial reporting standard for IFIs based on *Maqāsid ul-Shari'āh*. The four research objectives proposed the following five research questions to be separately discussed in the respective analysis chapter:

Question 1: To what extent have Indonesian Islamic Financial Institutions (IIFIs) committed to IFRS?
Question 2a: What is AAOIFI's strategy in developing its standards?
Question 2b: To what extent do IIFIs comply with AAOIFI accounting standards?
Question 3: To what extent do IFRS, AAOIFI, and ISSFAS comply with *Maqāsid ul-Shari'āh*?
Question 4: To what extent does International Islamic Financial Architecture (IIFA) support the role of Islamic based financial reporting standards for IFIs?

These research questions are answered through several methodologies and theoretical frameworks that are explained in the following section.

1.5 Research Methodology

This section discusses the theoretical framework of this study. There are several main key terms that involve discussion of theories such as financial reporting standards and political, economic, social, cultural as well as religious factors. Accounting scholars refer to theories of psychological, economic, or social dynamics providing answers to why questions (Malmi and Granlund, 2009). The theories help the scholars to explain the phenomena in the research problems. The theories are not only adopted in conjunction with the research works or to attend only to serious problems. Everyday theory (Easterby-Smith et al., 2008) is described as “ideas or assumptions carried around in our heads in order to make sense of everyday observation”. Thus, the theories are applied for making sense of even a simple work in life. For instance whether reporting a sale in the market requires some sort of calculation of the inventory, to justify whether all goods have been sold. However, theories that tend to look for higher levels of generalization are divided into middle-range and grand theories as they draw differences in scale and formality. Middle range theories mean they have generalizable proposition that can potentially be tested empirically. Grand theories on the other hand are abstract and contain whole system of belief are not testable (Easterby-Smith et al., 2008). Both types of theories are used to support research and to understand each observation found during the research process and by then, it would strengthen output of the research. Llewelyn (2003) adds that there are five different ways of theorizing in qualitative research such as metaphor, differentiation, conceptualization, context-bound of theorizing of settings, and context-free grand theorizing. This thesis adopts “differentiation” way of theorizing as it explains different type of directions in the studies that are going to be analysed.

Therefore, one purpose to adopt a suitable theory is to make sense of what research to be conducted in order to make it closer to real practices that eventually would contribute to problem solving in practical life. Within a realist philosophy, the real is objectified and seen as discoverable. Social constructs are treated as if they are the issues of this objective reality and measured as such (Chua, 1986). Theories play important role to support real life practices as Lewin,1948 put it neatly “there is nothing so practical as a good theory” (Easterby-Smith et al., 2008). In Islam, the main theories come from Qur’an and Sunnah[10]

[10] Qur’an and Sunnah are two main sources of law in Islam. Qur’an is a holy book while Sunnah is what was transmitted on the authority of Prophet Muhammad (P.B.U.H.), his deeds, sayings, and tacit approval.

(life sample of the Prophet Muhammad) as guidance for Muslims. It is normative in nature as the objectives are set and logical reasoning applied to come up with conclusions. Prophet Muhammad P.B.U.H. reminded Muslims in his last Friday sermon before his death; and he said:

> "I have left two things behind me for you (the *Ummah*). You will never go astray as long as you follow these two things. One of these two things is Allah's Holy Book (Qur'an al-Kareem) and the other is the Sunnah of His Most Beloved Prophet *sallallahu 'alayhi wa sallam* (Muwatta Imam Malik).

These two main references i.e. Qur'anic verses and hadith[11] are mentioned throughout the thesis to support the analysis.

This thesis uses a qualitative methodology using an interpretive exploratory approach. Social exploratory research seeks to find out how people get along in the setting under question, what meanings they give to their actions, and what issues concern them. The goal is to learn 'what is going on here?' and to investigate social phenomena without explicit expectations" (Schutt, 2006, p. 19). Interpretive approach is referred by Lee (1991) as ethnography, hermeneutics, phenomenology, and case studies. This study is concerned on the phenomenology type that relies on the way human makes sense of the world with combination of critical approach that interprets the action of others that may lead to adjustment of the earlier meaning and actions. Social actions in the organization that behave towards several pressures are explained using institutional theory and how it receives impact from political pressure in particular. An exploratory research frequently employs a grounded theory approach in an effort to unearth a theory from the data. Therefore, this thesis in general applies inductive methodology without developing hypotheses based on the existing theory. However, there are several theories that explain the problems in the process setting of financial reporting standards. The topic of the research started from the problem of those who reflect towards the changes in the financial reporting standardization while some other parties resist. The resistance towards the change to a standardization project started with the ideology opposing the Western values that may be inappropriate for the non-Western countries as the Western countries have different culture, belief, and habits. The following methodology describes theoretical framework of the whole study.

[11] that comprises of the Sunnah of the Prophet (his saying, tacit action, and even his silence)

Reflexivity theory and the process of setting accounting standards

The ability to assess the reflexivity of specific discourse is the main interest of Habermasian critical theory known as theory of communicative action (TCA), which is built upon the creative power of language and discourse (Laughlin, 1995). It argues that human justify their approaches and choices based on the nature of discourse and argument presented to them; which is a foundational human characteristic such as sophisticated ability to communicate with one another through the spoken and written word. However, TCA received criticism that it lacks empirical indicators and reference points (Power and Laughlin, 1996). Habermas responded that there is a need to "test empirically the assumption that systemic imperatives force their way into domains of cultural reproduction, social integration and socialization". This testing process needs to address what he calls the "real abstractions" in "the core zones of the life world" (Habermas, 1987a, p. 374 in Power and Lauhglin, 1996). In other words, Habermas tries to reduce complexity into more abstraction so that it can be easily measured. TCA is further strengthened by Edward Arrington and Puxty (1991) with their framework where critical analysis of social and environmental accounting improved through quality of dialogue among the community (Lehman, 2001). Form TCA lens, the mass adoption by numerous countries towards IASB financial reporting standards without quality dialogue among the relevant parties may not be considered as successful attempt. In fact, Wagenhofer (2009) argues that the growth strategies adopted by IASB are risky because their conceptual framework does not sufficiently take into account the diverse objectives of financial reporting; stewardship, prudence, and aggregation can be desirable characteristics of accounting information; and standards that are developed for listed companies need not be well suited for private entities. Therefore, a TCA utility such as way of communication is deemed to assess the discourses employed by all parties involving in standard setting such as AAOIFI and IASB. Also, it can help in exploring the adopted strategies by AAOIFI and IASB in educating their communities about accounting regulation.

Resistance theory and the process of setting financial reporting standards

From cognitive perspective, change in organization is not only sociological or psychological issues only but combination of individuals and of their interactions within the social network and actors who are involved (Macri et al., 2002). From this perspective, resistance arises can be due to clash in the management and the actors who will carry the tasks. Thomas et al. (2011) develop a model that shows how particular communicative practices can lead to generative dialogue, in which resistance to change actually plays a facilitative role, and at the end would result in organizational change based on the transformation of knowledge. Power of managers can facilitate communication process hence lead to a dialogue as Foucault argues that power and resistance are seen as diffuse, co-constitutive, and multidimensional. There “are no relations of power without resistances: the latter are all the more real and effective because they are formed right at the point where relations of power are exercised” (Thomas et al., 2011). Both reflexivity (communication) and resistance (power) are framed in the Arena Concept influenced by New Institutional Sociology theory which is discussed in the following paragraph.

Neo Institutional Sociology Theory (NIS)

Neo Institutional Sociology Theory (NIS) is an extension from Institutional Theory that is assumed as one of the most dominant perspectives in organizational analysis although it is suggested that it is best to integrate it with different theory to provide wider approach (Lounsbury, 2008). NIS is considered as alternative to describe and analyses how external forces influence organizational structure and interactions between institutions (Smith, Haniffa, & Fairbrass, 2011). The uniqueness of this perspective is rooted in its emphasis on the primacy of culture, highlighting how social structures of resources and meanings are created and have important consequences. In this context, NIS is defined it as a way of thinking about formal organizational structures and the nature of historically grounded social process through which these structures develop.[12] If previous theories engage with individual action and organization, this NIS expands its scope to relationship between organizations with another organization. Therefore, more problematic relationship has been developed in this theory. NIS has been adopted in research papers such as in organization (DiMaggio and Powell, 1991a, Greenwood and Hinings, 1996) and public administration (Hansen and Ejersbo, 2002). Different organizations have different expectations thus they respond differently to the institutional process whether they resist or shape to the environment (Dillard et al., 2004). Based on NIS, Smith et al. (2011) devolved the Arena Concept for analysing the interactions among multiple players in one setting (see Section 1.5.1). Combining the understanding of the Arena Concept and NIS, the conceptual framework is developed to organize and compare empirical knowledge about standardization projects in Indonesia. The framework demonstrates how it can support a methodological approach to conduct research on the subject area. In addressing this issue, there is a need to explore how institutional meaning systems are understood and interpreted

[12] Scapens defines institutions as a way of thought or action of some prevalence and permanence, which is embedded in the habits of a group or the custom of a people (Wickramasinghe & Alawattage, 2007, p.429).

within organizations and outside organizations as organizations are viewed as interpretive mechanism that filter, decode and translate the semiotics of broader social systems (Suddaby, 2010).

Political Economy of Accounting

In a free market process, it is possible that political power exercised by a certain group of people for the purpose to gain benefit at the expense of others. This is categorized as political motive in the accounting regulation (Tinker, 1980, Tinker, 1984, Tinker and Neimark, 1987). The political motive is embedded in Arena Concept depicted by each actor both individual and institution, therefore a political theoretical framework is required in this study. As this study stems from the debate on accounting and regulation i.e. financial reporting standardization, therefore a political economy of accounting perspective is proposed which is appropriate to explore more complex situation that deals with IFIs. Tinker and Neimark (1987) asserts that:

> "...the ways used by 'social protagonists' of accounting information and corporate reporting to mediate, suppress, mystify and transform social conflict concerned with the effects on the distribution of income, wealth and power (page 72)."

In this study, social protagonists are referred to anyone who is involved in the arena of financial reporting standardization project for IIFIs. As this study heavily emphasizes on the political motive, therefore there are other complimentary frameworks required to explain the study in a wider spectrum such as hegemony, emergence, and convergence. According to Antonio Gramsci, the concept of hegemony refers to the condition when dominant class utilizes the state to coerce and dominate the civil society (Katz, 2006). Gramsci includes civil society as any form in the society that has no coercive influences, not limited to non-state and non-market structures and activities i.e. trade unions, schools, professionals, education and culture associations, parties, and the churches. The dominant class requires transformation with the end result can be seen in socio-economic changes. The transformation can happen to any organization such as IIFIs, ideology such as Islamic based financial reporting standardization, and action such as decision making process. Spreading neoliberalism in the socio-economic changes is one of the objectives facilitated through convergence of the states and global actors in the globalization era. This can explain the doubt highlighted in the background of the study on why IFIs in major parts of the world follow IFRS.

In the Islamic finance development context, convergence also means as the merging between conventional finance with Islamic finance. To Mirakhor (2007), the convergence between the two is encouraged to ensure financial stability hence contribute welfare for the people through maximization of risk sharing mechanism. However, several pre-conditions should be satisfied including a developed legal system including governance, discipline and trust guarded by Islamic rules and norms. As Islamic rules and norms are considered as public policy where they are not enforceable to all kinds of society, therefore the pre-conditions may not be filled with the rules and norms. The rigorous efforts to converge the Islamic finance to the conventional finance may result to diverge it from the Islamic values (Askari et al., 2010). As Islamic finance is an emerging industry, it is very vulnerable to such emergent pattern of threats.

Critical Realism

Wry (2009) proposes that the Neo Institutional Sociology theory (NIS) is best combined with Critical Realism (CR), in order to study business and society by understanding recurring patterns of action within delimited social context. The combination of the theories offers several benefits: 1. CR and NIS take a multi-level view of reality by recognizing the roots of the problems the institutions are faced with, and providing the tools to analyse them; 2. they consider the importance of social context, and 3. their approach shifts from analysing institutions' responsibility to focusing on their specific practices in the environment.[13] Following several works of Bhaskar and Archer, Modell (2014) argues how human reflexivity is conditioned by evolving social structures as well as how individual and groups of agents strive to produce stability or change by coming together as collective, or corporate agents with the capacity to exercise more powerful influence on social structures. According to Archer (2000; 2003; 2007) ontological interrogation provides the basis for explaining how objective social structures evolve in constant interaction with human agency (Modell, 2014). It helps to unpack the more subjective, actor-centric dimensions of social structures. Modell (2014) explores 'retroduction' and 'retrodiction' approaches to enrich how to unpack social structures proposed in Archer's previous works.[14] Retrodiction is suitable to deal with issues on how institutions support the role of Islamic based financial reporting for IFIs. Wry (2009) argues that the combination of Critical Realism and Neo Institutional Sociology theory evokes a more subtle view, which embeds action in larger social structures. Basically,

[13] CR approach has been very much developed by Bhaskar and Archer who are known as the most influential theorists in the area.

[14] Retroduction denotes to the process of abstracting from empirically observable tendencies by developing theoretical postulates about what individual mechanisms might be responsible for such tendencies. Retrodiction, by contrast, is the process of examining the activation of such causal powers in specific empirical contexts by asking how diverse mechanisms interact to generate particular tendencies.

critical realists put ontological questions (in this area, questions such as: “What are organizations?” and “What does management do?”) before epistemological ones (“How can organizations and management be studied?”) (Edwards, O'Mahoney, & Vincent, 2014, p. 2).

1.5.1 Research Methods

Chapters Four, Five, and Seven of this study adopt the Neo Institutional Sociology theory (NIS) on institutional isomorphism to explain the process of financial reporting standardization with combination of Critical Realism and Political Economy of Accounting perspectives including the concept of hegemony. These chapters employ both primary and secondary data collection strategies through face-to-face interview and focus group discussion. A semi-structured list of questions is constructed using the institutional Arena Concept. The list is designed to capture the requisite information concerning various mechanisms that exist in the institutional arena during the financial reporting standardization process. The results of the interviews and the focus group discussion are analysed manually, using thematic analysis method. Chapter Six acts as triangulation chapter with reference to *Maqāsid ul-Shari'āh*. It analyses documents as secondary data of the study, i.e. conceptual framework and standards of presentation and disclosure, using content analysis method. Secondary data collection is in the form of the study of literature, which mostly cites scholarly journals in accounting and Islamic finance. Employing multiple data collection methods or data sources facilitates triangulation, which increases the validity of the findings (Janesick, 2011, p. 99). As several methods are adopted, the results from the semi-structured interviews and focus group discussion are to be cross-matched with documentary data.

Face to face interviews

This thesis employs a semi-structured interview style, a combination of a structured interview and an unstructured interview, which provides the flexibility to address questions that are not restricted to the prescribed list of questions. The interview style is informal and usually employed in explorative research in order to identify important variables in a particular area, to formulate penetrating questions, and to generate hypotheses for further investigation (Welman et al., 2005). There are two interview phases: the first phase focuses on debriefing the legitimation of standardization projects that covers several areas, such as: 1. the reason of the establishment of the standard setters; 2. focus of standard setters; 3. acceptance of standards by member countries; 4. problems and challenges faced by standard setters; 5. Shariah issues; and, 6. political economy issues. The second phase of interview was specifically designed for Chapter Seven on International Islamic finance architecture and the role of financial reporting. In analysing the interview, a thematic analysis method is applied as a flexible method for identifying, analysing and reporting patterns or themes within data. The interviewees are selected from IASB and AAOIFI officials, managers of Islamic financial institutions, managers of international financial institutions, academicians, managers of Islamic finance supporting institutions, and Shariah scholars who are expert in the issues of financial reporting standards, Shariah law, and government regulation or public policy. 32 participants were involved in the study, and the empirical findings are discussed in Chapter Four, Five, and Seven. The thematic analysis method follow phases suggested by Braun and Clarke (2006) that propose: 1. familiarizing with data; 2. generating codes; 3. searching for themes; 4. reviewing themes; 5. defining and naming themes; and 6. producing the report.

Focus Group Discussion

A Focus Group Discussion (FGD) is a discussion on a particular topic, concept, or product moderated by one person. It includes between 6 to 12 participants (Welman, et al., 2005, p. 202) or has 8 to 10 participants and lasts approximately 2 hours (Sekaran, 2003, p. 220). FGDs are conducted by selecting participants who must be "experts" in the area, and by not selecting hostile respondents. According to Welman et al. (2005), p. 202, the phases of the focus group discussion are as follows: 1. Phase One, introduction of the researcher, the topic of research, research objectives and research questions; 2. Phase Two, the announcement of the rules to benefit as much as possible from the process, and to avoid confusion among the participants; 3. Phase Three, an opening statement from each participant on his understanding about the research problem; 4. Phase Four, the researcher should guide the process so that each person contributes and relates responses to the research questions; 5. Phase Five, the respondent is requested to make his final statement, which may not be challenged. The details of the FGD are analysed in Chapter Five.

Content Analysis

Content analysis is "a research technique for making replicable and valid inferences from texts (or other meaningful matter) to the contexts of their use" (Krippendorff, 2012, p. 18). Through the understanding of the *Maqāsid ul-Shari'āh* theoretical framework, as suggested by Abu Zaharah (1997), the data is analysed using the NVivo 12 software and the results are discussed in Chapter Six. There are three sets of documents included in the study, i.e. IASB, AAOIFI, and IIA conceptual frameworks (IFRS Framework, AAOIFI Conceptual Framework, and ISSFAS Framework), and standards on presentations or disclosures, namely IAS 1, FAS 1, and ISSFAS 101.[15]

Archive documents

As for secondary data, there are several important sources to be used, including government studies, reports and archives, as well as written materials such as textbooks, journals and government publications (Saunders et al., 2011). The secondary data helps to acquire more information about the subject in order to conceptualize a clear idea about the topic. Other advantages of using secondary data are time and money saving.

1.6 Analytical Framework

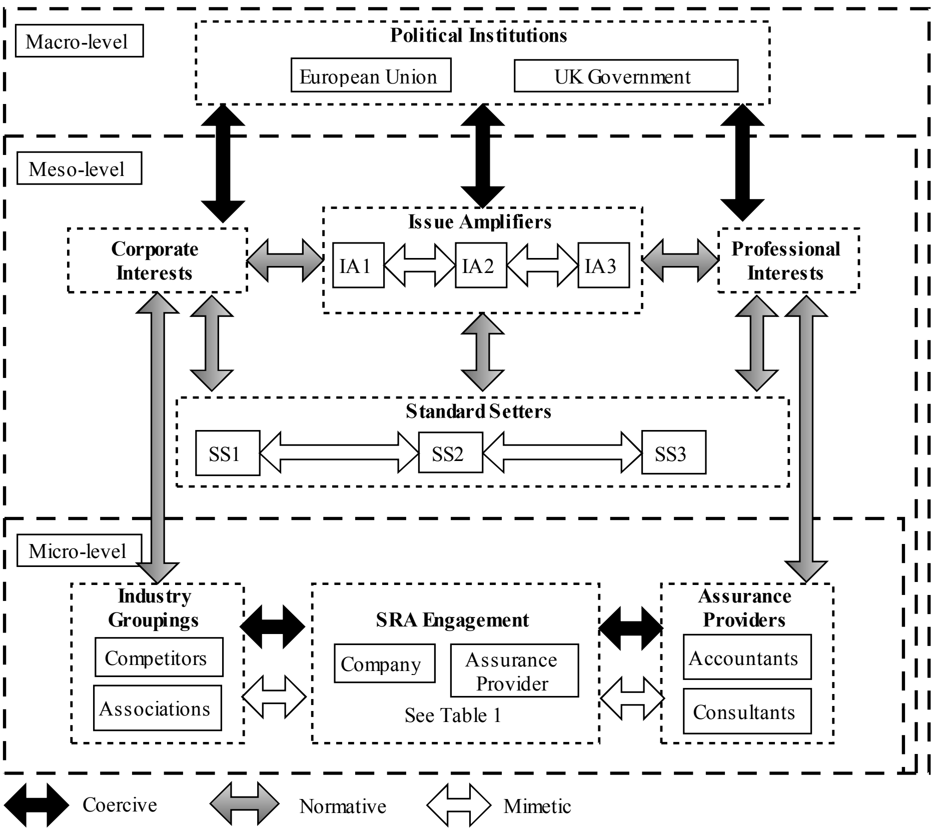
In order to provide answers to the four research questions, this thesis explores reflexivity and resistance towards IASB and AAOIFI standardization projects using a combination of survey instrument and detailed case study of financial reporting standardization experience by the IFIs in Indonesia. The survey was conducted in form of interviews, following a method suggested by Onwuegbuzie et al. (2008) for interpretive researchers. In analysing the interview, a thematic analysis method was adopted, following Braun and Clarke (2006) (see details on interview method on Section 1.5.1). The thesis employs content analysis for comparing the three conceptual frameworks and the financial reporting standards issued by IASB, AAOIFI, and the Indonesian Institute of Accountants (IIA). This step was taken in order to triangulate the findings during the interviews. In addition to the research methods, this thesis adopts several theoretical frameworks and methodologies (see Table 1.5). The Neo Institutional Sociology theory (NIS) is assumed to be one of the most dominant perspectives in organizational analysis, although it has been suggested that it is best to integrate it with a different theory in order to provide a wider approach (Lounsbury, 2008). When Chapters Four and Five seek evidences on reflexivity and resistance of financial reporting standardization projects, the political economy of accounting and Critical Realism perspective are employed.

Political lobbying has a long standing tradition in the arena of financial reporting standardization projects, such as in the body of FASB-US and IASB. They always deal with pressure from those who have vested interest in the direction of the standards (Nobes and Parker, 2012, p. 234). This pressure also occurs in Sustainability Reporting Assurance

[15] International Accounting Standards (IAS), Financial Accounting Standards (FAS), Indonesian Shariah based Statement of Financial Accounting Standards (ISSFAS).

(SRA) setting in the UK, which requires an analysis on 'capture' that takes place during the setting process (Smith et al., 2011). Given this similarity, Chapter Four and Five adopt a specific notion of institutional isomorphism and combined it with the perspective of political economy of accounting in order to guide the analysis on the financial reporting standardization for IIFIs. Therefore, a conceptual framework proposed by Smith et al. (2011) becomes the main reference in Chapter Four and Five (see Figure 1.5.1).

Figure 1.6.1: SRA Policy Formulation as an Institutional Arena



Source: Smith et al. (2011).

Chapter Six adopts the *Maqāsid ul-Shari'āh* perspective from Abu Zaharah (1997). In this perspective, there are three classifications of the *Maqāsid ul-Shari'āh*: *tahzib al-fard* which means educating the individuals, *iqamah al-adl* or establishing justice, and *jalb al-mashalah*, e.g. ensuring the welfare of the society (Abu Zaharah, 1997, p. 364). These three classifications form seven dimensions and construct 42 elements that are used to examine the documents. Similar to Chapter Five, Chapter Seven also adopts Critical Realism perspective besides its reference to institutional isomorphism. This approach is suitable in trying to repair the theoretical concept of design in Chapter Seven that deals with various types of institutions.

1.7 Contributions of the Study

This thesis makes four main contributions, both to theories and literatures. Firstly, it illustrates how political economy of accounting exists in financial reporting standardizations. It goes beyond identification of the types of isomorphism that influence the organizations' involvement in the standardization projects and embarks to different theory of political economy that stems from Islamic political dimension, termed as 'Islamic Political Economy of Accounting' theory. In addition, although the focus of this study is on Indonesia with a long history of colonization, the impact of colonization does not have any influence on the financial reporting standardization for the IIFIs. Thus it rejects previous theoretical base assumptions adopted by conventional financial reporting standardization. This first contribution matches with the literature gap that has been earlier identified i.e. limited study that has been carried out to examine the extent of the IFRS adoption by the IIFIs. The existing studies on IFRS only measure the compliance of the conventional entities with their benefits and challenges. In terms of theoretical contribution, the horizon of political economy of accounting should be enhanced as the Islamic dimension is emerged to examine such unique institutions.

Secondly, formulation of strategy based on internal and external analysis approach offers concrete suggestions for AAOIFI to improve its performance and establish stronger political connection. The strategy is predicted to solve the issue on different interpretation of Shariah that has been immensely influential in determining the direction of Islamic based financial reporting standards for IFIs. The literature gap on the AAOIFI's strategy has been filled by proposing internal and external strategies that AAOIFI should embrace to improve its level of performance in the future.

Thirdly, as the Islamic finance industry is approaching its maturity, this thesis suggests different methodology to regulate financial reporting standardization. This is presented in the analysis of the contents of IFRS, AAOIFI, and ISSFAS where each standard indicates low level of compliance to *Maqāsid ul-Shari'āh.* The current practice of hybrid regulation may no longer be appropriate unless it is accompanied with much stronger emphasis on the fulfilment of *Maqāsid ul-Shari'āh.* The question on which financial reporting standard is the best for IFIs is answered through this analysis where *Maqāsid ul-Shari'āh* should be regarded as the benchmark for financial reporting standard formulation.

Lastly, this thesis proposes an assumption on the significant role of dominant political leading countries towards development of Islamic finance. Where real leadership in the arena of Islamic finance is absent, the influence to develop Islamic based accounting and finance comes only from countries dominating the Muslim world. The literature is now enriched through constructs that enforce the role of financial reporting standard for the sake of IFIs' sustainable development, at least, currently through iFSAP project of IDB. In sum, this thesis calls for intensive effort to promote cooperation among countries in developing mutuality-based concept and orientation to Islamic moral economy. This would eventually encourage IFIs to comply with Islamic based standards and aspire to become important financial institutions of the future.

Table 1.7.1: Research Objectives, Research Questions, and Methodology

Theoretical research objective: to explore reflexivity and resistance of IIFIs towards IASB and AAOIFI financial reporting standardization projects.

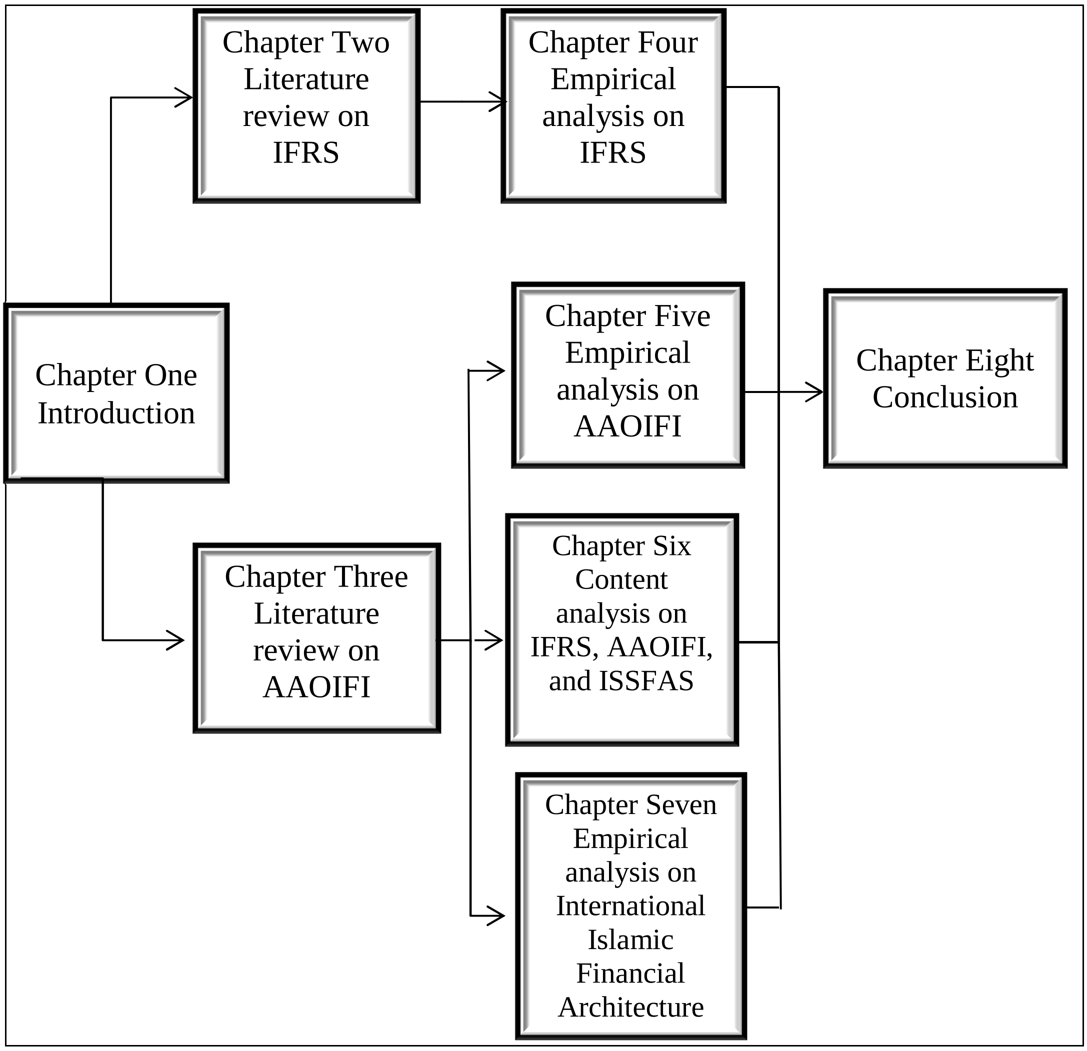
Specific Objectives	Research Questions	Methodology		Literature and Empirical Chapters	Main literatures
		Theory	**Method**		
To explore the views on the adoption of IASB standards and whether it is seen as the way forward by IIFIs;	Q1: To what extent have IIFIs committed to IFRS?	NIS (Institutional Isomorphism) and Arena Concept, and Political Economy of Accounting	Semi-structured interview	Chapter Two and Four	Smith, Haniffa, and Fairbrass (2010) on Arena Concept; DiMaggio and Powell (1983) on Institutional Isomorphism; Tinker and Neimark (1987) on Political Economy of Accounting.
To evaluate AAOIFI's strategy in developing its accounting standards and seeking for acceptance from its member countries including Indonesia;	Q2a: What is AAOIFI strategy in developing its standards?	-	SWOT analysis	Chapter Three and Five	Smith, Haniffa, and Fairbrass (2010) on Arena Concept; DiMaggio and Powell (1983) on Institutional Isomorphism; Tinker and Neimark (1987) on Political Economy of Accounting, and Modell (2014) on Critical Realism.
	Q2b: To what extent do IIFIs comply with AAOIFI accounting standards?	NIS (Institutional Isomorphism) and Arena Concept, and Political Economy of Accounting	Semi-structured interview	Chapter Three and Five	
To propose a recommendation on the most appropriate reporting standards for IFIs suitable for international financial reporting requirements as well as compatible with *Maqāsid ul-Shari'āh*;	Q3: To what extent do IFRS, AAOIFI, and ISSFAS comply with *Maqāsid ul-Shari'āh*?	*Maqāsid ul-Shari'āh*	Content analysis	Chapter Six	Abu Zaharah (1997) on *Maqāsid ul-Shari'āh*; Krippendorff (2012) on content analysis as method; Nobes and Parker (2012) on qualitative characteristics of financial reporting.
To examine institutions responsible for Islamic financial architecture and explore the required supports for the future to impose suitable financial reporting standards for IFIs.	Q4: To what extent does IIFA support the role of Islamic based financial reporting standards for IFIs?	NIS (Institutional Isomorphism) and Critical Realism	Semi-structured interview	Chapter Seven	DiMaggio and Powell (1983) on institutional isomorphism; Ali (2000) on IIFA; Wry (2009) and Modell (2014) on Critical Realism; Muljawan (2011) on iFSAP.

1.8 Structure of the Thesis

A map of the thesis is shown on Figure 1.7.1 and the organization of the thesis is as follows:

- Chapter One (Introduction). This chapter presents the background of the study, contents of the thesis, motivation of the study, objectives and research questions, research methodology, analytical framework, contribution of the study, and structure of the thesis.
- Chapter Two (Literature Review Part I on IFRS). This chapter sets out the dimension and meaning of standardization, IFRS standardization project, and suggests a literature gap.
- Chapter Three (Literature Review Part II on AAOIFI). This chapter reviews the historical development of AAOIFI, critical analysis of AAOIFI accounting standards, studies supporting AAOIFI, different views on Islamic principles applied in IFRS, AAOIFI, and ISSFAS, and recommends three literature gaps.
- Chapter Four (Empirical Analysis on IFRS). This chapter outlines the Neo-Institutional Theory, Arena Concept, and Political Economy of Accounting, standardization and financial reporting, contextual background of Indonesian economy and political landscape, views on IFRS standardization for IFIs, and presents a conclusion and recommendation.
- Chapter Five (Empirical Analysis on AAOIFI). This chapter delineates SWOT Analysis and Arena Concept, AAOIFI development, assessment of AAOIFI, and suggests a conclusion and recommendation.
- Chapter Six (Content Analysis on IFRS, AAOIFI, and ISSFAS). This chapter develops *Maqāsid ul-Shari'āh* as theoretical, conceptual framework and financial reporting standards on disclosures, *Maqāsid ul-Shari'āh* measurement, and proposes a conclusion and recommendation.
- Chapter Seven (Empirical Analysis on Islamic Financial Architecture). This chapter describes institutional isomorphism and Critical Realism, financial architecture, the Shariah objectives and the role of financial reporting, and provides a conclusion and recommendation.
- Chapter Eight (Conclusion). This chapter briefly reviews research aims and objectives, achievements of four objectives, contribution of the study, limitation of the study, recommendation for future research, and highlights self-reflection of the researcher.

Figure 1.8.1: Structure of the Thesis



Chapter Two: International Financial Reporting Standards

2.1 Introduction

This chapter reviews existing literature on international financial reporting standardization, particularly that relates to development of IFRS.[16] In the following chapter, Chapter Three discusses the extant literature on the same subject but relates to development of Accounting and Auditing Organisation of Islamic Financial Institutions (AAOIFI) standardization. This chapter aims at highlighting relevance between literatures and the main concern of the thesis hence this review helps to identify gaps for further research and the research questions to be sought. At first it is imperative to examine the standardization project from its historical development to the debates over its project. It is also important to review studies that reveal why standardization matters and has to be taken into consideration in the development of accounting in the world. In contrary, studies that do not support IFRS standardization are highlighted to show the opposite side of the view. As this study emphasizes on financial institution therefore the chapter includes assessment on the role of IFRS in financial institutions in general and Islamic financial institution in specific. The motive behind IFRS adoption, harmonization and standardization are also reviewed in the presentation of the literatures. The review of the literature has the following purposes. Firstly, to define standardization in financial reporting; to discuss responses towards standardization; to present historical development of standardization and its advantages as well as disadvantages; and to deliberate Indonesian case in standardization of financial reporting. Secondly, to evaluate IFRS standard developments; to identify any resistance and reflexivity of IFRS standardization projects; and to discuss studies that relate to financial institutions and Islamic financial institutions.

By reviewing related literature, several gaps in the existing literature are identified that motivate the researcher to further explore the role of international standardization of financial reporting in Islamic financial institutions. It is discovered from the literature review process that there is a need to conduct study on to explore the views on the adoption of IFRS and whether it is seen as the way forward by the Islamic Financial

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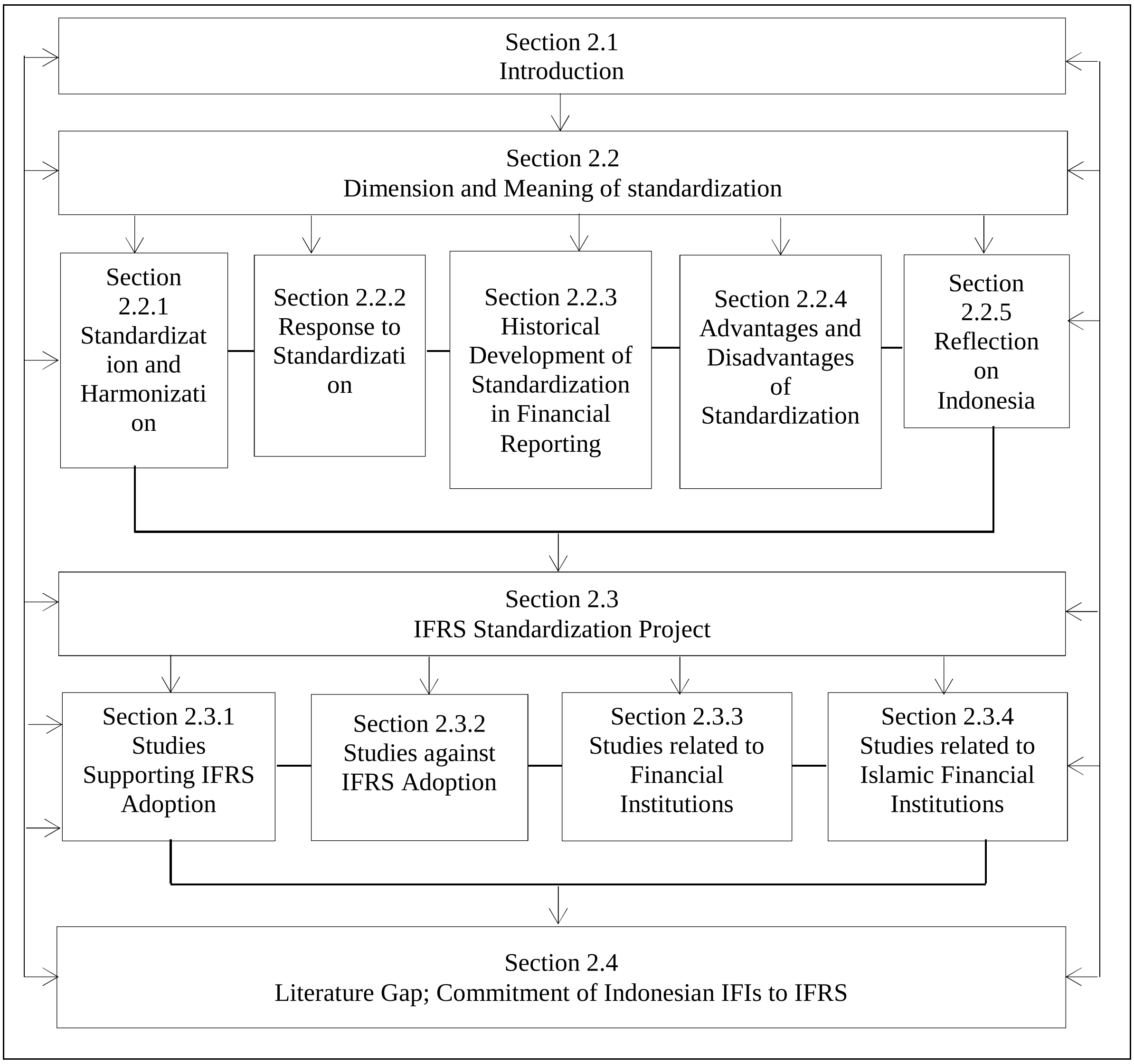
[16] A part of this literature chapter has been presented in the followings: 1) Scottish Area Group - BAFA Annual Conference 2013, 2nd of September 2013 in Glasgow, UK, with the title *"Unveiling IFRS Standardization Project and the position of Islamic Financial Institution."*; 2) The Eleventh Harvard University Forum on Islamic Finance, 25th - 27th of April 2014 in Cambridge, USA, with the title *"Unveiling IFRS Standardization Project and Position of Takaful Industry: a Literature Study";* 3) As a book section in "*Takaful and Alternative Cooperative Finance: Challenges and Opportunities"* by Harvard Law School, Harvard University, with a title *"Accounting for Takaful Industry; between Shariah Compliance and International Requirement."*

Institutions (IFIs). As this thesis focuses on Indonesia, therefore the study emphasizes on Indonesian Islamic Financial Institutions (IIFIs). The following Figure 2.1.1 describes structure of this chapter.

Figure 2.1.1: Structure of Chapter Two



2.2 Dimension and Meaning of Standardization

2.2.1 Standardization and Harmonization

In the literatures there are number of dimensions and meanings of standardization and harmonization. Standardization and harmonization[17] are broadly defined in accounting studies and practical works and within accounting, the words have become technical terms and the differences must not only be seen from both meanings. According to Online Oxford Dictionary (Oxford-Dictionaries, 2013), "harmonization" is from the root word of "harmonize" that is translated as producing a pleasing visual combination and make

[17] To be used interchangeably.

consistent or compatible. In the context of financial reporting, harmonization is required to arrive at one financial reporting standard for one type or more than one type of entities. In other words, harmonization means coordination, a tuning of two or more objects to move away from total diversity of practice (Tay and Parker, 1990, Van der Tas, 1998). Standardization is a process to achieve uniformity (Tay and Parker, 1990) and in Indonesian context, standardization is a process to standardize local accounting with IFRS (Utami et al., 2012). In other definition as spelled out by Online Oxford Dictionary (Oxford-Dictionaries, 2013), "standardization" refers to something used as a measure, norm, or model in comparative evaluations. In accounting however, "standardization" means workings towards a more rigid and narrow set of rules (Nobes & Parker, 2012, p. 81). On the contrary, Perks (1993) earlier suggests that standardization means more than just rigid and narrow rules, in rule-based approach. He argues that the British accountancy profession prefers some flexibility and opposes the idea of a comprehensive code of rigid rules. Perks continued to assert that accounting standards are intended to be more specific but still consider differences in practice, and at the same time, to enhance comparability and support harmonization of the standards. The latter seems to fit the context of this thesis that is discussed in Chapter Four.

Standardization in accounting practices

In accounting practices, the term "standardization" was first adopted in the United Kingdom, when the standardized format of national accounts was first prepared in 1940 by Collin Clark in his publication "National Income" (Suzuki, 2003). In the United States, standardization had become an international strategy in May 1946 when Sapir, Rice and Doblin submitted a report to the Economic and Social Council of the United Nations (Suzuki, 2007). This report with a title "Working paper on the status of national income statistics" was attached with the agenda on international standardization (Rice, Sapir, & Dolin, 1946 cited by Suzuki (2003)). Since 1973, the effort to standardize accounting in the context of modern accounting has come into realization after the establishment of International Accounting Standards Committee with the purpose to produce international accounting standards that can be adopted by various countries. Parallel with this effort, a survey was conducted by Price Waterhouse in 1973 on classification in accounting practices between countries which later followed by several researchers to arrive at more accurate classifications for instance Nair and Frank (1980); Goodrich (1982); Nobes (1983); Berry (1987); Doupnik and Salter (1993). These classifications appear to adopt different methodologies and approaches hence suggest different recommendation. Studies conducted by Nair and Frank (1980) and Goodrich (1982) adopt "scientific" approach to classification, as opposed to the earlier "subjective" studies (Nobes, 1983). While in the later study, Doupnik and Salter (1993) have taken into consideration environmental variables, accounting practices, and empirical approach. Nair and Frank (1980) divide countries into 38 clusters that adopts heavily on the methodology of having similar accounting practices, continued by Nobes (1983) who reviews the clusters into smaller group to 14 developed countries and emphasizes on judgemental approach based on environmental variables, similar accounting practices, and geographical position. Finally Berry (1987) includes more capitalist and communist countries in his classifications that makes up the total to 48 countries.

Despite the fact the classification is not statistically proven and several debates are presented in these studies such as no underlying theory and accurate methodology in grouping the countries into clusters, but the efforts of these classification have been considered as a reference by international harmonization of accounting practices (d'Arcy, 2001). Following the classification as a part of the effort to harmonize accounting practice, the first international accounting standard referred to as was first issued in 1975 as a result of standardizing the accounting rules.[18] The users of the report that call for standardization come from those who use, regulate, and prepare the financial statements and the pressures come from intergovernmental transnational bodies, multilateral donors such as World Bank and International Monetary Fund (IMF), international accountancy firms, tax authorities throughout the world, and labour unions (Nobes & Parker, 2010, p. 82).[19] In other words, the standard setting arena is considered as a place of struggle between interest groups, both within the profession and outside it (Susela, 1999). If the setting in accounting standardization involves political lobbying, it is then an acceptable practice for example that the international accounting firms protect interest of their major clients; the politico-bureaucrats keep their major clients; government promotes its development plans; or donor institutions ensure transparency of their money invested in the countries. The question is who can deny this political lobbying?

Various political issues discussed in the context of introducing IAS/IFRS particularly in developing countries have been very much arguable (see Rosser (2003); Zeghal and Mhedhbi (2006); Perera and Baydoun (2007)). Rosser in Rosser (2003) p. 267

[18] In the context of present accounting development, the terms "standardization" and "harmonization" are associated with standards referred to International Accounting Standards, International Financial Reporting Standards, and, Auditing, and Governance Standards for Islamic Financial Institutions as far as Islamic institutions are concerned. These standardization mechanisms have been undertaken by IASB and AAOIFI due to higher complexity in the business that requires higher quality of financial report i.e. to improve comparability and enhance quality of financial reporting as required by the users of the report. Therefore, as international organizations, they are responsible to cater this necessity.

[19] These powerful institutions are later referred as hegemonic institutions.

argues that accounting reform (i.e. adopting IAS at that time) occurred in Indonesia was due to the event of financial crisis in 1997-1998 where IMF and the World Bank facilitated foreign aids and investment. In this context, the influence in accounting policy has been shifted from politico-bureaucrats[20] together with their corporate clients and the technocrats within the governments. However, the power of politico-bureaucrats together with their clients and the technocrats remain in existence, at least, to push a partial accounting reforms but not including auditing and judicial reform.[21] This scenario has been classified by Robison (2004) as neoliberal[22] camp and he argues that neoliberal market economies have been under the mission of specific parties in developing countries that have common characteristics such as countries with weak institutions and absence of social capital.

The conflict of political issues such as this is one of the challenges in proposing a uniformity standard in the accounting standardization process. It is inevitable as the initial factors that caused financial reporting different are very complex. Elliot and Elliot (2007) affirm that most writers agree on seven factors (at least some of them) that influence the development of financial reporting namely: the character of the national legal system; the way in which industry is financed; the relationship of the tax and reporting systems; the influence and status of the accounting profession; the extent to which accounting theory is developed; accidents of history, and language. As for Indonesian case, how international financial reporting standards were introduced in Indonesia was mainly through the way in which industry is financed. As a developing country, Indonesia has been very much dependent on the multilateral donors such the World Bank and then later the IMF. The World Bank has provided loan for Indonesia since 1977 and major influence towards the financial reporting standardization reached its initiative in 1984. Section 2.3 presents arguments how the loan administration influenced the international financial reporting standardization process in Indonesia.

2.2.2 Responses to Standardization

Opposite view on standardization is as to whether different accounting practices across

[20] Politico-bureaucrats refer to politicians and state officials who were inclined towards nationalist economic policies (Irmawan et al., 2013).

[21] The accounting reform means the revision on the existing accounting policy and standards during the Accounting Development Project I and II. Auditing and judicial reform were not included in the agreement, except for auditing standards revision. It also refers to auditing policy on the license of foreign audit firm, to date.

[22] Neoliberalism is a continuation of neoclassical liberal prepositions about the efficiency and self-regulating nature of markets adopted in the USA (Reagan), Britain (Thatcher), Australia, and New Zealand with the purpose to centralize regulatory power (Robison, 2004).

countries should be eliminated as harmonization is only beneficial for users who receive similar information from companies in different countries (Nobes and Parker, 2012, p. 83). Therefore it serves only a specific group of users and not the entire stakeholders for instance the stakeholders in specific industry and in specific business. With regard to solution to serve different type of stakeholders, the companies can produce two reports; one for domestic and one for international users, or one report for parent company and one report for consolidation purposes (Nobes and Parker, 2012, p. 83). It is certainly involved high cost if this approach will be taken in terms of number of preparers involved and the setting of accounting technology system. Although the debate on the standardization issue is still taking part, the call for the standardizing financial reporting been receiving broad support from government, business, accounting profession, and academia in terms of campaign, textbook publication, research journals, and professional meetings (Sunder, 2010).

2.2.3 Historical Development of Standardization in Financial Reporting

The first standardized financial reporting standard known as International Accounting Standard (IAS) was published in January 1975 by the International Accounting Standard Committee (IASC). The Board of the IASC promulgated a substantial body of standards, interpretations, conceptual framework, and other guidance that is adopted directly by many companies and that is looked to by many national accounting standard-setters in developing national accounting standards (IAS-Plus, 2012). Since then, the process for setting IAS has undergone substantial evolution, culminating in 2001 by restructuring IASC into the International Accounting Standard Board (IASB). In recognition of the quality of the core set of IAS, in 2000 the International Organization of Securities Commissions (IOSCO) recommended that the world's securities regulators permit foreign issuers to use IAS for cross-border offerings (IAS-Plus, 2012). After that, IASB released accounting standard to complement the existing ones, i.e. IAS using the label of International Financial Reporting Standard (IFRS). As of 2005, almost all publicly listed companies in Europe and many other countries are required to prepare financial statements in accordance with IFRS. The European Union Parliament through Regulation Act EC 1606/2002 mandated the IFRS adoption for all listed companies with the purpose to enhance comparability, consistency, and transparency of their financial statements (Cormier et al., 2009). In addition, the Financial Accounting Standards Board (FASB based in U.S.) has embarked on a comprehensive project aimed at convergence between IFRS and U.S. GAAP (Hail et al., 2010). Today, both standard setters have reached Phase

4 in their joint effort to revise the conceptual framework. Despite its fast progress, Zhang and Andrew (2012) argues that the conceptual framework project has formed an important part of the architecture of neoliberalism (see Chapter Six).

The goal of IASB is to develop a single set of high quality, understandable, enforceable and globally accepted financial reporting standards based on clearly articulated principles. To achieve this goal, IASB in collaboration with worldwide standard-setting community has issued principles-based standards and taken a thorough, open, participatory and transparent due process (IASB, 2012). IASB then formed IFRS Foundation as an independent, not-for-profit private sector organization working in the public interest. IFRS declares its principle objectives, namely; to develop a single set of high quality, understandable, enforceable and globally accepted international financial reporting standards (IFRSs) through its standard-setting body, the IASB; to promote the use and rigorous application of those standards; to take account of the financial reporting needs of emerging economies and Small and Medium-sized Entities (SMEs); and to bring about convergence of national accounting standards and IFRSs to high quality solutions (IASB, 2012). IFRS, which is issued by IASB, is dedicated to “principles-based” rather than “rules-based” accounting standard. Generally, principles-based accounting standards are relatively soft and open room for judgement and justification. Rules-based standards, on the other hand, are very strict and provide only small room for professional judgment. Rules-based provides opportunity for companies to make up the transactions in order to meet a specific requirement (Van der Meulen, Gaeremynck, & Willekens, 2007).

The following Table 2.2.1 is the lists of IFRS standards that have been issued and adopted by number of countries either on mandatory such as EU countries or voluntary basis.

Table 2.2.1: IFRS Standards

No	IFRS	Year	Topic of Standard
1	IFRS 1	2004, 2008*	First-time Adoption of International Financial Standards
2	IFRS 2	2004	Share-based Payment
3	IFRS 3	2004, 2008*	Business Combinations
4	IFRS 4	2004	Insurance Contracts
5	IFRS 5	2004	Non-current Assets Held for Sale and Discontinued Operations
6	IFRS 6	2004	Exploration for and Evaluation of Mineral Assets
7	IFRS 7	2005	Financial Instruments: Disclosures
8	IFRS 8	2006	Operating Segments
9	IFRS 9	2010*	Financial Instruments: Recognition and Measurement
10	IFRS 10	2011	Consolidated Financial Statements
11	IFRS 11	2011	Joint Arrangements
12	IFRS 12	2011	Disclosure of Interests in Other Entities
13	IFRS 13	2011	Fair Value Measurement

Source: IAS-Plus (2013c).
Note: *revised version.

The previous standards referred as International Accounting Standard (IAS) from number IAS No.1 to 41 that were issued as early as in 1976, their names are not converted to IFRS and are still part of IFRS standards (IAS-Plus, 2012). The first IFRS standards were issued in 2004 i.e. IFRS 1 (First-time Adoption of International Financial Standards), IFRS 2 (Share-based Payment), IFRS 3 (Business Combinations), IFRS 4 (Insurance Contracts), IFRS 5 (Non-current Assets Held for Sale and Discontinued Operations), and IFRS 6 (Exploration for and Evaluation of Mineral Assets), but as presented on the above table, IFRS 1 and IFRS 3 have been amended in 2008. IFRS 6 (Exploration for and Evaluation of Mineral Assets) was issued in 2005, and IFRS 8 (Operating Segments) was issued in 2006, while IFRS 9 (Financial Instruments) was issued in 2007 and revised in 2010. As for IFRS 10 (Consolidated Financial Statements), IFRS 11 (Joint Arrangements), IFRS 12 (Disclosure of Interests in Other Entities) and IFRS 13 (Fair Value Measurement) were released in 2011. Besides IFRS, IASB also forms other bodies such as SIC (Standards Interpretation Committee) and IFRIC (International Financial Reporting Interpretation Committee) to issue interpretations on each of the standards. To date, there are 33 SICs, from SIC-1 to SIC-33 and 21 IFRICs, from IFRIC 1 to IFRIC 21. SIC interprets international accounting standards while IFRIC deals with international financial reporting standards.

2.2.4 Advantages and Disadvantages of Standardization

Advantages of standardization

Several advantages of financial reporting standardization are highlighted in the available studies *viz* establishing better capital market discipline (Jeanjean and Stolowy, 2008), improving quality of financial accounting (Ball, 2006, Barth et al., 2008), and enhancing forecast accuracy of financial information (Cheong et al., 2010, Schleicher et al., 2010, Horton et al., 2013). On the contrary, other studies reveal disadvantages from the standardization such as increasing risk (Papadamou and Tzivinikos, 2013), opening room for accounting manipulation (Ball, 2006), and bearing high cost (De George et al., 2013, Kim et al., 2012). Brown (2011) suggests six advantages that can be gained from adopting international accounting standards[23] such as; eliminating barriers to cross-border investing; accounting disclosure quality; an inside influence of standards relative to managers' incentive; comparability; usefulness and value relevance; and market efficiency, liquidity and the cost of equity. Each benefit is discussed in the next section to acquire extensive understanding. On the other hand, Ball (2006) proposes three advantages of having a uniform financial reporting: scale economies where the effort is invented only once and will be used forever; protection to auditors from manipulation of opinion; and gain from comparability of information.

The followings are the combining arguments regarding the benefits of adopting international financial reporting;

1. Quality of accounting information

Barth et al. (2008) interpret accounting quality as quality in accounting income that exhibit less earnings management. They find 21 countries that applied IAS showed higher accounting quality between 1994 and 2003 than the firms that did not apply IAS. The result presents higher variance of change in net income, higher ratio of the variance of the change in net income and change in cash flows, less negative correlation between accruals and cash flows, and lower frequency of small positive net income. This is consistent with Ball (2006) who states that voluntary IFRS adoption would improve quality of financial reporting. He interprets it as high quality financial statements that can provide useful information to investors that offers accurate forecast of the economy, accurate allowance for bad debts, low financial manipulation, timely information, and conservative timeliness

[23] International Accounting Standards (IAS) refers to standards released by the IASC and International Financial Reporting Standards (IFRS) refers to standards released after IASB took over the responsibility from the IASC in 2001. The standard numbering is from IAS No.1 to 41 that were issued since 1976 and even though their names are not converted to IFRS, they are still part of IFRS standards (IAS-Plus, 2012)

between bad and good news. However, method of the study conducted by Barth et al. (2008) that differentiates IAS and non-IAS firms is ambiguous and samples that are taken from various countries which apply different degree of legal enforcement need further evidences. He et al. (2012) argue that performance of companies adopting IFRS in weak legal enforcement turns out to be undesirable (see Risk Relevance). Papadamou and Tzivinikos (2013) comment that the period of the IFRS adoption in research conducted by Barth et al. (2008) was voluntary and may not reach similar conclusion if the adoption was compulsory.[24] Other opposite view is presented by Jeanjean and Stolowy (2008) who find that after the transition period to IFRS adoption, the earning management was pervasively increased in France thus switching to IFRS was not a major vector of improvement in earnings quality. In addition, countries with high enforcement and established institutional structures have shown better reporting quality long before standardization was taken place. Thus, the impact towards the accounting quality is obvious which is in reality they actually experienced only smaller effect.

However, voluntary or compulsory adoption may not be applicable in developing country such as Indonesia. Utami et al. (2012) find only 72% mandatory disclosure[25] made by manufacturing companies that are listed in Indonesian Stock Exchange (IDX) from 100% expected disclosure. This indicates that corporate governance mechanism and law enforcement are still very low. In other study, it is revealed that the implementation of Indonesian Statement of Financial Accounting Standards (SFAS) No. 50 and No. 55[26] shows insignificant impact in reduction of banking earnings management (Diantimala and Baridwan, 2012). This study tests judgement of bank managers in estimating loan loss provisions of 28 commercial banks in Indonesia. In contrast with this view, Wardhani (2010) argues that the degree of IFRS convergence and governance system shows positive effect on accounting conservatism such as earnings quality. Moreover, the study that was conducted in Hong Kong, India, Indonesia, Japan, Korea, Malaysia, Philippines, Singapore, Taiwan, and Thailand documents stronger effect in a weak investor protection environment such as Indonesia. However, the finding of the study is not really clear whether strong governance system or IFRS convergence that contributes to higher degree

[24] IFRS adoption can be divided into two categories i.e. voluntary and mandatory. Voluntary means IFRS is adopted by certain firms without any jurisdiction imposing the adoption while mandatory refers to IFRS that is implemented by firms/countries due to legal enforcement e.g. European Union legislation No. 1606 released in 2002 about mandatory IFRS adoption by all EU countries, G-20 agreement that requires member countries to adopt IFRS.

[25] The IFRS mandatory disclosure is required under Decision Letter from Chairman of Capital Market Supervisory Agency & Financial Institution No. X.K.6 KEP-134/BL/2006 issued on 7th of December 2006.

[26] Statement of Financial Accounting Standards (SFAS) 50 is on Accounting for investment in certain securities and SFAS 55 is on accounting for derivatives and hedging activities.

of earnings quality. Furthermore, conservatism principle is not mentioned as a qualitative characteristics in IASB conceptual framework (Lo, 2012), thus the evidence is not sufficiently strong from which view point the conservatism is being examined. In other study on income smoothing practices, Trisanti (2012) finds that 327 Indonesian listed firms showing lesser income smoothing exercise after the IFRS convergence (2000-2004), as compared to before the IFRS convergence (2005-2009). However, the occurrence is still very high. As far as sample of study is concerned, there is no ample clarification why Trisanti (2012) excludes 58 banks and financial institutions from the sample. The finding shows that occurrence to exercise income smoothing is still considerably high during this voluntary adoption period. This definitely requires further analysis as full implementation of IFRS in Indonesia was declared on 1st of January 2012.

2. Accuracy of forecasting

Companies across countries reported under the same standardized format of financial reporting are most likely to disclose identical financial statements thus allowing forecast analysts to review and predict companies' future financial performance with more accuracy. It is claimed that IFRS adoption can help investors to have better financial information (Ball, 2006). IFRS adopters, especially mandatory adopters, are able to provide more accurate financial forecast and investment cash flow sensitivity during the post adoption period (Cheong et al., 2010, Schleicher et al., 2010, Horton et al., 2013) and it can improve prediction of future profitability (Doukakis, 2010). On the other hand, Atwood et al. (2011) assert that IFRS is not the major factor to improve such accuracy as they find that there are no significant differences for IFRS versus non-U.S. Domestic Accounting Standards (DAS) firms in terms of associations between current profits or losses and future cash flows. The results suggest that, while IFRS and U.S. GAAP are both high quality sets of accounting standards, U.S. GAAP is superior with respect to the prediction of future cash flows. Other caveat from IFRS mentioned in Cheong et al. (2010) that excludes the forecast during economic recession in 2001-2002 as it shows negative performance both in forecast accuracy and quality of information environment during voluntary IFRS adoption. The above studies indicate that by following standardization i.e. adopting IFRS, it contributes some benefits although it is not more superior to the U.S. GAAP. However, in the case of IFRS adoption, it only works in the developed countries with strong law enforcement and it is silent to the financial accuracy performance during an economic downturn.

3. Comparability

One of the main arguments why standardization is sought is the ability to compare companies' financial statements across countries which allows forecast analysts to provide useful information to the investors and other stakeholders who would not need to acquire extra knowledge to understand different reporting standards. Hence standardization of accounting produces a single financial reporting language which would ease comparability of the reports across different countries and increase competition in the international capital market, reduce cost of capital and finally improve market efficiency (Jeanjean and Stolowy, 2008). Comparability is also vital to analyse all firms within the same industry in one country for the purpose of measuring and evaluating their performance. If there are different reporting standards are adopted by the industry, the performance evaluation may not be objective. This is shown by a study conducted by Bedoui and Mansour (2014) for listed companies in Spain. They find that local comparability has worsened when IFRS and local accounting standards are applied in the same country and at the same time. Both studies suggest the importance of having a single reporting standard for the same industry particularly those in the capital market. However, as every industry has its own characteristics such as Islamic finance, will comparability be achieved when analysing this industry with other industry?

4. Value relevance

Proposing standardization is for the sake of promoting qualitative characteristics of accounting and these are the reasons why accounting exists. Value relevance is one measurement that has been exercised to examine the effectiveness of standardization and in this case IFRS adoption.[27] Value relevance is defined as the ability of financial statement information to capture or summarise information that affects share values (Devalle et al., 2010). In addition, value relevance is interpreted as explanatory powers of net income and equity book value for prices, and stock return for earnings (Barth et al., 2008). Companies reported under IAS are shown to provide more value relevance than those reported under German, French and United Kingdom firms (Bartov et al., 2005, Devalle et al., 2010). Nevertheless, as opposed to US GAAP, no study has been reported that the firms are more superior in their value relevance. In studying French firms during transition to IFRS in 2005, Cormier et al. (2009) examine the value relevance of earning and equity rather than value relevance in financial statements per se and they find that the value relevance of

[27] The test on value relevance is related to relevance and reliability of accounting criteria stated by FASB that have several dimensions i.e. feedback value, predictive value, and timeliness, faithfulness, verifiability, and neutrality (Barth et al., 2008)

optional IFRS adoption behaves differently towards capital assets, employee benefits, cumulative translation, financial assets, and business combination. Furthermore, Gjerde et al. (2008) find value-relevance of key accounting figures prepared according to Norwegian GAAP show higher than those reported under IFRS. These mixed evidences show that value relevance is still relative measurement and subject to the quality of country financial reporting standards. In Norwegian case for instance, its financial reporting standard is closed to principal based standards therefore the comparison does not show that IFRS reporting firms are superior. In the case of Indonesia, Lo (2012) documents that the value relevance of earnings and equity book values is higher during the significant IAS/IFRS adoption period in 1994-2000 as opposed to the insignificant IAS/IFRS adoption period in 2001-2009. This study is lacking of evidence as it does not differentiate the impact of IAS and IFRS during the two periods and in the Period I, it cannot be referred as "IAS/IFRS adoption" but only "IAS" adoption as IFRS was first issued in 2002.

5. Market efficiency

Efficiency is commonly associated with easy access, low cost and less time consuming. In the context of having a standardized format of financial reporting, it is expected that the companies are able to provide easy access to financial information without burdening stakeholders for unnecessary time consumption and cost to analyse the reports. Thus more transparent financial information will establish higher investors' confidence which means higher flow of capital hence improve market efficiency. Finally, it will offer more liquidity in the market with lower cost of capital. Schleicher et al. (2010) examine the economic consequences of the mandatory adoption of IFRS in EU countries by showing which types of economies have the largest reduction in investment-cash flow sensitivity post-IFRS. They argue that insider economies (Italy, Greece, Portugal and Spain), or economies with small stock markets, reduced their investment-cash flow sensitivity much higher than those outsider economies (United Kingdom and Norway) which are defined as economies with large stock markets. This result shows that IFRS adoption might have improved the functioning of capital markets although they found several caveats in their study that the finding may be supported by other factors such as EU policy on enforcement for capital market improvement. Ernstberger and Vogler (2008) suggest that voluntary adoption of internationally accepted accounting principles such as IAS/IFRS and U.S. GAAP by German companies resulted in the decrease of their cost of capital as opposed to applying German GAAP. Although in the earlier study, Daske (2006) presents his empirical finding on German firms' financial statement during transition to IFRS adoption that they fail to show lower cost of capital. Even after IFRS has become mandatory, the reduction of cost of capital occurred only in countries with strong legal enforcement (Li, 2010).

6. Trained accountants

When standardization of financial reporting is required across countries, the preparers must be trained with the knowledge on this set of standard or offered special education by the institution that produces the standards. In the context of IFRS, one objective of IASB is to promote the use and rigorous application of IFRS standards (IASB, 2012). Thus, IASB through IFRS foundation has embedded responsibility to provide a learning platform to all standard setters in the world. It can be done through cooperation with the country's standard setter or accounting profession. In reality, this education initiative has been making headway such as through textbook publication for accounting students, research grant for IFRS studies, as well as professional meetings and trainings. According to Sunder (2010) these efforts have been supported by government, business, the accounting profession, and academia. In Indonesia, for instance, IASB has been working parallel with The Institute of Indonesian Accountants (IAI) to promote the IFRS by providing IFRS seminars and trainings for professionals and lecturers.[28] In a study of IFRS implementation in Nigeria, it is argued that adopting a uniform financial reporting standards would train Nigerian accountants to become more professionals so that they can sell their international accounting skills across countries (Ikpefan & Akande, 2012). As Indonesia is one of ASEAN countries, the issue of free flow of skilled labour becomes one major concern to welcome ASEAN single market (ASEAN Free Trade Area) by 2015. From Indonesian perspective, it is believed that ASEAN Economic Community should enhance number of skilled accountants including those who are skilled in IFRS. However, Saito et al. (2012) find that the IFRS implementation in 2012 still had little impact on the curricula and syllabi. Most of the respondents from Udayana University, Warmadewa University, and Mataram University revealed that they do not have any plan to alter the curriculum and syllabi and as government universities, they must wait for the directives from the government (Saito et al., 2012). The study mentioned on the syllabi that are related to accounting for Islamic financial institutions but there was no specific elaboration addressing this issue.

Disadvantages of standardization

Very few studies discuss the opposite or highlight the costs behind the standardization.

[28] 5th IFRS Regional and Policy Forum and IAI Seminar, held in Bali, 23rd – 26th of May 2011, and IAI-AFA International Seminar: "IFRS and Indonesian Accounting Standards 2013 and Beyond" held in Jakarta, 18th of March 2013.

Among these few, Bilka and Skoda (2012) argue that the current fair value accounting have several disadvantages such as pricing deviation, misleading information, manipulation, absence of a market price, limited reliability, volatility, and contribution to the pro-cyclicality of the financial system. This is consistent with Ball (2006) who emphasized if IASB pushed fair value application too much it would create several disadvantages for investors such as; disturbance in market volatility because spread can be too large and cause noise in financial statement; it might stimulate managers to manipulate fair value estimates; the fair value might be sensitive towards financial crisis; it could create bias pricing and estimates when liquid market is absent and even the liquid market exists; and it would give a room for managers to manipulate by using “mark to model” accounting to stimulate market prices. The following arguments on disadvantages of IFRS are described with the fact that IFRS is unable to accommodate the need of all entities:

1. Risk Relevance

Much studies have associated standardization of accounting i.e. through IFRS adoption with several benefits such as value relevance, inter alia: Gjerde et al. (2008) that study IFRS in Norway, and Barth et al. (2008) in their study on IFRS impact in 21 countries. However, the opposite side of this study has not been discussed which may create inevitable risk in the market volatility. Papadamou and Tzivinikos (2013) suggest that there is risk relevance related to IFRS adoption by the Greek financial institution. The finding suggests that there are significant different effects of accounting variables, on systematic and non-systematic risks between pre and post IFRS adoption. The result is shown when total assets variable is included and it is due to fair value measurement on the assets where IFRS is responsible as opposed to Greek Accounting Standards (GAS) that used only historical value. Eventually, there is a cost behind the implementation of this fair value accounting. It undoubtedly would show better result in lowering earning management provided the companies are located in strong institutional environment due to stricter monitoring, supervision, and legal enforcement. Another fair value accounting study in China shows the firms in a weak institutional environment that adopt fair value accounting tend to sell securities to offset the losses resulted from negative fair-value changes in trading securities (He et al., 2012). It means, using “professional judgment” in fair value accounting environment could lead to manipulation of fair value estimates which is consistent with caveat mentioned by Ball (2006) earlier on.

2. Audit Cost

Following standardization of accounting means that the firms are switching from rule-based to principle-based accounting standards and it requires additional training for preparers including auditors. De George et al. (2013) affirm this conjecture through their study on examination of auditor fees during the IFRS adoption transition period. Using Australian stock exchange data from 2002-2006 the empirical test shows that there is an economy wide increase in the mean level of audit costs of 23% during the IFRS transition period and abnormal IFRS-related increase in audit costs in excess of 8%, beyond normal yearly increase. The empirical test also suggests that a fixed component in the cost associated with IFRS adoption being borne by the smallest firms and the small firms bear disproportionate increase in audit costs. This study includes a survey that indicates there are seven accounting policies (i.e. Share-based Payments, Employee Benefits, Income Taxation, Financial Instruments – Disclosure, Financial Instruments – Recognition and Measurement, Impairments, and Intangibles) that have material impact on financial statement preparation hence take part in higher audit cost. This finding is parallel with earlier study conducted by Kim et al. (2012) that examine whether there is an increase in audit fees after IFRS adoption in 11 EU countries. They confirm that the audit fees increased from pre to post adoption period of IFRS for both IFRS adopters and non-adopters. In the transition cost to follow standardization includes training cost by preparers that some of them sit for more than five trainings and examining more complicated report in the IFRS-compliant annual report that is even up to 60% longer than the previous annual reports (De George et al., 2013).

2.2.5 Reflection on Indonesia

The aforementioned studies cast a light on the on-going debates regarding the merits of standardization i.e. the adoption of IAS/IFRS as the format of standardization of accounting rules. Despite the controversial views in looking at the benefits from accounting standardization, the motive behind offering the advantages is eventually to serve certain group of people for instance the politico-bureaucrat and their clients as argued (Rosser (2004), p. 267).[29] Yet, Rosser (2009) argues that when developing countries experienced changes in global and domestic economies, they shift the balance of power between foreign and domestic interest thus it renders the climate conducive to accounting reform for the sake of the reproduction of capital. After the 1997-1998 financial crises that ruined the Indonesian economy, the government decided to accept bailout loan and investment offered through World Bank and IMF and these two institutions took position

[29] There were two camps of politicians and bureaucrats during Soeharto's regime i.e. the technocrats and the politico-business bureaucrats that had conflicting views on how the country's economy should be administered (Irmawan et al., 2013).

in redesigning the economic policy including the accounting policy (Rosser, 2009). Even before the 1997-1998 financial crisis, Indonesian government had received the World Bank loan specifically for Accounting Development Project in 1988[30] amounting to USD 113 million from estimation of USD 130 million and the project was extended to Second Accounting Development in 1994 with total of USD 19.63 million from the approved amount of USD 25 million (WorldBank, 1996).[31] Therefore, for accounting development project itself, the World Bank had provided USD 132.63 million with considerably significant output in accounting development through the projects although only the first project was rated "satisfactory"[32] while the second one was marked "unsatisfactory".[33] The first subcomponent of the second project i.e. Government Accounting System II (GAS II) was considered unsatisfactory due to its failure to address a series of project design. The second subcomponent i.e. enhancing the accounting and auditing standard-setting and enforcement was measured as satisfactory performance. However, the overall evaluation was unsatisfactory. In improving accounting and auditing, the World Bank in this case assisted IIA from 1998-2001[34] to issue ten accounting standards and four auditing standards every year, to design professional examination and continuing education, and to publish accountancy magazine. From the targeted 40 accounting standards and 16 auditing standards, when the project was closed, a total of 25 accounting standards and 17 auditing standards were approved and issued (WorldBank, 2001, p.7-8, p.15). The World Bank reported that Indonesia had achieved a substantial institutional development impact during

[30] The project was to follow on number of projects initiated since 1979 (WorldBank, 1996) such as: Nucleus Estates and Smallholders Project (03) 9/8/1979, Yogyakarta Rural Development Project 12/7/1979, Transmigration Project (02) 29/5/1979, Power Project 29/5/1979, Water Supply Project (02), 29/5/1979, BAPINDO Project (04) 17/5/1979, Highway Project (05) 15/5/1979, Irrigation Project (13) 24/4/1979, Education Project (08) 24/4/1979, Technical Assistance Project 24/4/1979, Urban Development Project (03) 16/1/1979 with total commitment of USD 815 million (WorldBank, 2013).

[31] Following the Country's Assistance Strategy, the World Bank conducted a special project on accounting development (28 July 1988 – 30 June 1995 – one year extension) that had primary objectives such as: (a) to improve accounting practices: (i) in the public sector, by supporting the introduction of modernized government accounting practices, initially in the Borrower's Ministry of Finance and three other agencies, and eventually in all agencies; (ii) in the private sector by supporting the development of technical standards and a code of ethics for the accounting profession; and (b) to support the Government's program to raise the quality of accounting faculty and teaching staff, and to prepare for future expansion of accounting education and training. This project was continued and named as Second Accounting Development (1994-2000) that had objectives namely: (i) to support the Government's strategy to modernize government accounting systems, and (ii), to enhance the credibility and usefulness of financial information for private and public sector enterprises through the implementation of rigorous qualifying examinations for public accountants, a comprehensive set of accounting and auditing standards, and the enforcement of these standards.

[32] Some achievements that were reported i.e. modernized 13 governments accounting system and increased efficiency and effectiveness in audit and provided training for ten thousand government staff, and the failures i.e. students' repayment loan and delay in completion study of PhD scholars.

[33] The output from Government Accounting System I was providing hardware, software and training nationwide; as well as enhancement of accounting and auditing standard-setting and enforcement.

[34] This period was the time when the national accounting standards were more rigorously converged to US GAAP/IAS.

the Accounting Development Project II conducted in Indonesia particularly in the area of accounting standard setting (WorldBank, 2001, p: 9).

The output of the Second Accounting Development Project II (the loan extension from the World Bank) was rated unsatisfactory as it did not achieve the said objectives, particularly on the issuance of accounting standards. The Indonesian accounting standard setter only managed to endorse 25 accounting standards out of 40 targeted standards, while for the auditing standards, there were 17 auditing standards released from 16 targeted standards. Apart from this exercise, other criticism towards the World Bank has been addressed such as by Saravanamuthu (2004) who asserts that the World Bank has failed to promote sustainable economic development in its member countries. However, Annisette (2004) rejects the idea that the World Bank has failed to balance its social and economic objectives in the mission to extend financial help in developing countries and challenge such critical researches to prove it with sufficient evidences. There are several studies that criticize the role of the World Bank and IMF when intervene the economies in the developing countries such as Indonesia i.e. the World Bank and IMF indirectly shaped the Indonesian economy with the ideas of neo liberalism. Thus, the effort of the World Bank to internationalize the accounting standards tied with the loans extended to the member countries was for the purpose to facilitate the liberalization of the economy. Although there was no indication of success in the economy after the recovery projects as there was a political intervention in creating the markets, which according to Robison (2004) the neoliberals have been forced to accommodate.

From the series of events ensued reflection on Indonesian accounting standardization projects, it can be concluded that there are four periods of international financial reporting standardization projects taking place after the issuance of the first international accounting standards in 1975 (see Table 2.2.2) , i.e. Period 1: 1988-1994 Accounting Development Program I; Period 2: 1994-2001 Accounting Development Program II; Period 3: 1997-1998 during the Financial crisis; and Period 4: 2012 Full IFRS Adoption, due to G20 Declaration. It can also be squeezed into three periods i.e. Period 1, Period 2, and Period 4 as the Period 3 occurred during the Period 2, but as the period of financial crisis was one crucial momentum in the Indonesian economic history, therefore, the Period 2 is discussed under separate heading (see Chapter Four).

Table 2.2.2: Summary of Financial Reporting Standardization Development

Conventional		Islamic	
Period 1	Period 1: 1988-1994 Accounting Development Program I	Period 1	1992-2002 SFAS 31 (Existing IAS and AAOIFI influences)
Period 2	Period 2: 1994-2001 Accounting Development Program II	Period 2	2002-2007 SSFAS 59 (Existing IAS and AAOIFI influences)
Period 3	1997-1998 during the Financial crisis	Period 3	2007-present SSFAS 101-107 (with more local content from Shariah perspective)
Period 4	2012 Full IFRS Adoption (G20)		

In between these periods, there is a separate standardization of financial reporting took place in Indonesia namely during the establishment of the first Islamic bank in Indonesia. Although it was not immediately taken into effect, but the process has started with the enforcement of SFAS 31 as standards for Islamic bank effective from 1992. In 2002, IIA took the first initiative to benchmark with the existing international financial reporting standards i.e. Accounting and Auditing Standards for Islamic Financial Institution (AAOIFI) and released the standards with the name of Accounting Standards for Islamic Bank, and after five years, the standards were renewed and introduced as Accounting Standards for Islamic Business Entity and endorsed in 2007. Therefore, for Islamic financial reporting standardization, it can be concluded that there are three periods of standardization took place after the establishment of the first Islamic bank in Indonesia, i.e. Period 1; 1992-2002 SFAS 31; Period 2: 2002-2007 SSFAS 59; and Period 3; 2007-present SSFAS 101-107. It is interesting to compare whether these two different developments of standardization shown in Table 2.2.2 that reflects several events triggered the others. These two groups of events of standardization projects are further discussed in Chapter Four.

2.3 IFRS Standardization Project

IFRS standardization project has been run by a foundation called The IFRS Foundation, which is stated as an independent, not-for-profit private sector organisation working in the public interest (IASB, 2012). According to information presented by IAS-Plus (2013b) the survey made on 174 jurisdictions for domestic listed companies shows 128 jurisdictions as per 19th of June 2013 that permit or require IFRSs.[35] This has been increased post 2007

[35] The survey shows that 25 jurisdictions (14.4%) do not permit IFRSs, 25 jurisdictions (14.4%) permit IFRSs, 11 jurisdictions (6.3%) require some IFRSs, 92 jurisdictions require all IFRSs (52.9%), and there are 21 jurisdiction that do not have stock exchange (12%).

when SEC announced 100 countries had reported the implementation of IFRS (SEC, 2007).

2.3.1 Studies Supporting IFRS Adoption

Results from IFRS adoption have been thoroughly studied and proven through several empirical researches which are mostly conducted in developed countries that have strong enforcement and sufficient infrastructure. Nonetheless, study conducted by Bova and Pereira (2012) shows IFRS adoption in weak standard enforcement country like Kenya also support similar findings on the usefulness of IFRS adoption, provided the firms are given economic incentive to achieve higher level of compliance. However, this study has limitation that it takes samples of firms that are majority foreign owned companies, while the result is not in favour for the firms that are not majority held by foreign ownership. Other than benefits offered by IFRS, several studies support IFRS adoption as it is recognized internationally, facilitates government dealings, and opens international business expansions (Haribhakti, 2008, Wu and Zhang, 2009, Lo, 2012).

2.3.2 Studies against IFRS Adoption

Several studies have shown a promising result after IFRS adoptions; arguing that adoption of the standards results in production of high accounting quality, increase in value relevance information, enhancement of firms' comparability, and hence improvement in the economy. However, other studies counter-claim that the adoption does not work in low enforcement and developing country with low supporting resources and lack of incentives for managers and auditors (Agostino et al., 2011, He et al., 2012, Papadamou and Tzivinikos, 2013). In fact, IFRS is suitable for capital market based companies that are more regulated especially in the developed countries with strong infrastructure such as legal enforcement and strict monitoring and supervision. Most of IFRS studies show positive findings in research on capital market firms (see Section 2.3). In addition, the use of judgment in principal based accounting adopted by IFRS may weaken legitimacy of companies particularly private sectors as it promotes differences in practice and can be missing from the goal of uniformity (Sunder, 2010). As argued by Nobes and Parker (2012) different accounting practices across countries should not be eliminated for the sake of standardization as it only serves insubstantial group of users. Furthermore, the hypothesis that accounting as neutral and unbiased technology has long been rejected by scholars because in practice accounting is influenced by various factors, including political and economic interests of particular groups in society (Cooper, 1980, Lehman and Tinker, 1987, Susela, 1999). Hopwood and Miller (1994) argue that accounting is no longer considered as a neutral device that merely captures and reports the facts of economic activity.

2.3.3 Studies related to Financial Institutions

After the implementation of Regulation 1606/2002, banks and financial institutions in the European countries are significantly affected by IFRS (Agostino et al., 2011). When observing IFRS implementation before and after compulsory adoption in European banks in 15 EU countries, Agostino et al. (2011) share the finding that marginal effect (value relevance of earnings) increased for the entire sample with the largest impact is in German and Italian banks, whereby UK banks experience only little impact. IAS 39 on financial instrument accommodates recognition and presentation of financial institutions and this standard is the most relevant standard with regard to the impact of IFRS to financial institutions. Study related to banks in Greece as a code law country, according to Papadamou and Tzivinikos (2013) took several adjustment as IAS 39 deals with measurement of financial assets that requires valuation of the assets at fair value and financial liabilities at amortized cost whereby GAS practiced in different way; financial assets are valued at the lower value of acquisition cost as well as market and financial liabilities at repayment value. Other than bank, research on IFRS was also conducted on insurance industry. As insurance deals mostly in investment, the most relevant standards are IAS 16 (for real estate held by the insurer not as a financial investment), IAS 27, 28, and 31 (for subsidiaries, associates, and interests in joint ventures), IAS 39 (financial instruments), and IAS 40 (for real estate held as a financial investment). In another study, Post et al. (2007) adopts capital market theory and the concept of information efficiency to evaluate the impact of IFRS in the EU insurance industry. The study suggests that by applying IFRS in insurance firms, there will be impact on financial reporting costs or insurance contract cash flows but cost of capital, asset allocation, and dividend policy are real economic performance that matters to investors (Post et al., 2007). It is obviously understood that the impact towards capital market based companies are positive however IFRS standards for insurance has not been fully implemented thus the study of Post et al. may need to be reconsidered. Moreover, the above studies are all conducted in European countries; the countries that were equally affected by the 1606 regulation that requires them to adopt IFRS in all sectors including financial institutions. Therefore the results are uniform.

The issue of fair value that may impact financial institutions have been controversial. Market price may provide the best estimation for asset value therefore it should be used but on the other hand, during the bad time, the market price may lead to serious distortion or portray excessive and artificial volatility (Allen and Carletti, 2008). Haldane and Cearns (2012) held debates on unrealised gains on banks' fair valued assets which relates to the issue of pro-cyclicality[36] (the fair value will flatter gains and capital during asset upswings and flatten both during downswings) hence create a problem of prudence (eating paper profits before they can be earned). Cearns proposed that derivatives and instruments held for trading should be measured at fair value as historical cost has misled the investors, thus it should reflect the real condition. The case of UK banks recently has shocked the market as a group of major investment funds[37] challenged the legal status of IFRS in the UK. IAS 39 contains substantial legal flaws that results to distortion in the financial statements of banks since its first implementation in 2005 to the current year. UK law states that the dividends must be paid on the correct basis. It is argued that the financial statements of the banks have failed to show true and fair view, hence the dividends paid out by the companies did not reflect the correct figures (Irvine, 2013). Mark to market means allowing unrealised profits, which is in contrast to prudence concept that is to write only realised profits. This on-going case would reveal if the investors are right, the shareholders can urge the current banks' boards to sue the former bank directors and auditors for compensation. The allegation has been expressed similarly in Local Authority Pension Fund Forum (LAPFF) Opinion and Accountancy Age News (LAPFF, 2013, Fuller, 2013).

2.3.4 Studies related to Islamic Financial Institutions

With respect to Islamic financial transactions, it is argued that Islamic Financial Institutions (IFIs) should follow their own accounting standards as the adoption of IFRS raises a number of Shariah compliance issues and it does not fully cover the unique characteristics of Islamic financial transactions (Karim, 2001, White, 2004, Triyuwono, 2004, Ibrahim, 2007, Mulawarman, 2009, ACCA, 2010, Haniffa, 2011). Thus, these

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[36] The way most bank regulation and accounting works which is, in bad times - when asset prices are falling and capital is tight - banks are forced to cut the book values of their assets and seek fresh capital; just the kind of thing that amplifies the ups and downs of business cycles. The more stretched banks become in a recession, the less they can afford to lend to needy companies. The popular theory is to devise a system of countercyclical regulation, forcing banks to build up extra capital in the good years to see them through bad ones and allowing them to set aside provisions before loans turn bad (Tait, 2009).

[37] Universities Superannuation Scheme, Threadneedle Asset Management, UK Shareholders Association and the Local Authority Pension Fund Forum (LAPFF).

unique characteristics of Islamic based transactions seek different accounting treatments. Although other religions such as Judaism, Christianity, or other Eastern religions or philosophies are against social injustice and tyranny (White, 2004, Kamla, 2009) and instead they strongly promote moral principles[38], Islam itself brings more complex message in accounting for instance the calculation and different rates of Zakat (White, 2004). Prior to the introduction to Shariah based financial reporting standards in Indonesia in 2002, Islamic banking practitioners ignored the importance of so called unique characteristics of Islamic banks and neglected the need to have one, instead they claimed that the transactions of Islamic banks require mere technical double entries (Triyuwono, 2004). The unique characteristics are discussed in Chapter Five.

Current conventional accounting is critically evaluated that it is based on the Western thinking and has been successfully considered as the best option merely due to colonization, education, business development and international harmonization (Muhammad, 2003). IFRS relies on certain accounting principles such as substance over form, time value of money, fair value, and probability that have significant impact on Islamic financial transactions (Shafii and Zakaria, 2013). White (2004) has similar argument that the current international accounting standards cannot accommodate Islam as religion as Islam emphasizes obligation of the individual to the society and not the rights of the individual, unlike the Western accounting system that focuses only on the owners of an entity. Moreover, individuals are not only accounted to the society but to God (Haniffa and Hudaib, 2007). Therefore, when it is adopted by IFIs, there are clash of standards as the nature of conventional and Islamic law are different hence products designed by IFIs lay on different foundation. In the case of IFRS and local GAAP where most countries have adopted for their IFIs are insufficient to cater the Islamic transactions (IAS-Plus, 2013a). For instance, conventional banks simply offer credit financing that customers pay back the principal amount plus increment based on interest rate but Islamic banks operate in different type of transactions i.e. trading, partnership and rent whereby the customers pay back using different instrument calculation. In trading, customers purchase an asset with price plus margin determined by the banks and pay it in instalment while in rent and hire purchase, customers pay using rental rate and there is an option to purchase at the end with certain price. As for partnership, the banks and the customers engage in profit loss sharing mechanism on the business that has been performed.

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[38] "I cannot help wondering how many of those who read it will have ever thought that biblical principles could be applied to accounting…The chapter also shows how God's revealed <u>moral principles</u> are so encompassing as to include something that seems, on the surface at least, to be so removed from theology." (White, 2004).

Kamla (2009) asserts that other part of the roles of Islamic banking and finance also to promote social justice, eradication of poverty and free from pressures in any form of subjection, imperialism, and colonialism. Besides having different and unique transactions, the IFIs are also urged to perform social roles in the society by eradicating poverty through payment of Zakat and mobilizing finance programs to enhance the real sector based economy. Therefore, it is clear that the IFIs require different set of financial reporting standards to cater these specific transactions and message in their reporting with the purpose of compelling Islamic accountability. As has been argued by Haniffa and Hudaib (2007) that IFIs are not only financially accountable but also morally accountable for their business behaviour thus, Islamic banks are expected to communicate clearly on number of commitments in their annual reports.

In practice, one different principle is on substance over form and form over substance that is adopted by IFIs. However, IFRS treatment in banks, merely consider substance over form principle[39] by judging economic and behaviour of events and not by considering legal issues and nature of the banking products (Ilahiyah, 2012). In Islamic banks with its *Mudhārabah* contract applies profit loss sharing mechanism although current regulation in Indonesia and Malaysia for instance, requires the banks not to apply loss sharing in case of losses hence management of asset is recorded as off-balance sheet item. Beside substance over form, IFRS covers other accounting principles such as time value of money, fair value and probability and these have significant impact on Islamic financial transactions. In relation to that, Shafii and Zakaria (2013) conduct interview with practitioners in Islamic banks and Islamic insurance (*Takāful*) firms in Malaysia and the interviewees suggest that and agree on; 1. Accounting concepts and entries are not the major determinant of the validity of Shariah compliant financial contract; 2. Shariah Advisory Council - Bank Negara Malaysia (SAC of BNM) approves applicability of substance over form, time value of money, fair value, and probability in IFIs; 3. Time value of money is only for exchange contracts but not debt-based like *Qard*; and 4. The term interest should be replaced with profit. Discussion on the impact of each of these principles is presented on Chapter 3.

As earlier argued by Muhammad (2003) that international harmonization of accounting is a way to justify the current financial reporting standards are the best suited standards by promoting that harmonization carries more advantages (see Section 2.2.4).

[39] IAS 17 Leases requires the preparers of financial statements to consider the substance of lease arrangements when determining the type of lease for accounting purposes. IAS 18 Revenue requires accountants to consider the economic substance of the sale agreements while determining whether a sale has occurred or not.

From conventional point of view, harmonization in accounting practices is defined as reduction of differences in the practices across countries that will result in a set of international norms to be followed globally (Doupnik & Salter, 1993) and the consequences are not much. However, Haniffa (2011) asserts that harmonization of financial reporting for IFIs is far more complex than its conventional counterpart. Harmonization with IFRS could lead to conflicting accounting treatment and may jeopardize the credibility of the information. This view is consistent with that of Hussain et al. (2002) who find some Islamic banks in five Gulf Cooperation Council (GCC) countries, namely Bahrain, Saudi Arabia, Oman, Qatar and the United Arab Emirates, which have adopted IAS and failed to meet the Shariah requirements of financial reporting (have not fulfilled the Islamic banks' accounting standard requirement). For example, although interest is forbidden in the Shariah, IAS does not pay attention to this principle. It answers the question why IFIs are faced with a dilemma such that, on one hand, investors urge them to be comparable with their conventional counterparts at international level by adopting international accounting standards, while on the other hand, they face the issue of inconsistency with the Shariah. Askari et al. (2010) assert that the consequences of globalization in Islamic finance would be convergence or divergence with Islam. In reality, following standardization of financial reporting is a part of globalization that the stakeholders of Islamic finance place the concern although the positive side of globalization has been appreciated. Aksak and Asutay (2011) argue that the globalization has developed the world economy and emerged Islamic finance with substantial impact on both of economies of Muslim geography and global financial markets.

2.4 Literature Gap; Commitment of Indonesian IFIs to IFRS

From the above debates in the literature review, the gap is identified and required further research exploration. First, in terms of area of research; there are several studies conducted in various countries in the world and concluded several consequences from IFRS adoption but there is limited study has been carried out to examine IFRS adoption in Islamic financial institutions. In practice, there are several IFIs have adapted to IFRS such as countries like Malaysia, United Kingdom, including Bahrain where AAOIFI financial reporting standard are issued by AAOIFI office located in Bahrain. Thus, it is necessary to conduct empirical study on to what extent IFIs have committed to IFRS. The research attempts to fill this literature gap by adopting interpretative epistemology that focuses on social action of a group, community or organization with specific study on Indonesia. Following Weber's conceptualization of society, the socio-economic and political context of a society provides the predominant measurement to lead organizational actions which is in this study, may involve bureaucratization when determining financial reporting standard adoption.

Out of three causes of bureaucratization according to Weber, the most important factor is due to competitive marketplace. However, competitive marketplace is no longer the main cause as individual efforts are found to be more aggressive towards creating similarity in the structure, culture, and output, rather, organizational fields are becoming more homogeneous over time or through a process that is called 'isomorphism'. Isomorphism operates through different mechanism such as coercive, normative and mimetic which occur between institutions (Meyer and Rowan, 1977, DiMaggio and Powell, 1983, DiMaggio and Powell, 1991b). In understanding the mechanism of isomorphism, Arena concept is developed by Smith et al. (2011) to facilitate identification of the main arena participations and their roles. This concept as described on Figure 1.5.1 is introduced to describe on what are the factors at macro, meso, and micro levels that influence financial reporting standardization in Indonesia. Arena concept brings Neo Institutional Sociology (NIS) theory to describe interaction among individual actions and institutions that are involved in the politics, the amplifiers, the setters and the industry at all levels. The arena is characterized by both formal and informal rules and allows representations of other organizations and these are the tools to conceptualize capture or possibility that powerful interests become institutionalized (Smith et al., 2011). From the literature, it shows the interaction among institutions and actors in the society that determine the shape of financial reporting standardization. Thus, NIS frames the Arena Concept is appropriate to explain the IFRS financial reporting standardization project that will further discover resistance and reflexivity of the IFIs towards the process of standardization. However, to complement institutional isomorphism, this study refers to Political Economy of Accounting theory suggested by Tinker and Neimark (1987). The shift from a purely economic to a political-economic paradigm was claimed due to the limitations in the former theory (Pure Economic Theory)[40] which emphasises the needs of the shareholders and manager class and the belief that concentration on those needs is sufficient for an understanding of the role of accounting reports in society (Cooper and Sherer, 1984). The main theme of this theory is that it recognizes the interaction of economic activities with politics, society and institution. In other words, it emphasises the specific historical and institutional environment of the society in which it operates. This is a first move in recognising that the nexus of contracts of Islamic financial institutions is

[40] The problems with pure economic theory is its failure to recognise that the economy is dominated by large corporations, often operating in oligopolistic and monopolistic markets (Hannah and Kay, 1977).

not only between management and shareholders but the rest of stakeholders as well. A semi-structured interview is the best method for data collection purposes as to confirm the literatures and theories with opinion from experts. The semi-structured interview is informal and usually employed in explorative research to identify important variables in a particular area, to formulate penetrating questions, and to generate hypotheses for further investigation (Welman et al., 2005). The targeted participants are ranging from accounting standard setters (IFRS, AAOIFI, and IIA), academic researchers, Islamic financial institution managers, Shariah scholars, World Bank and IMF officers, and regulators. This literature gap is discussed in Chapter Four.

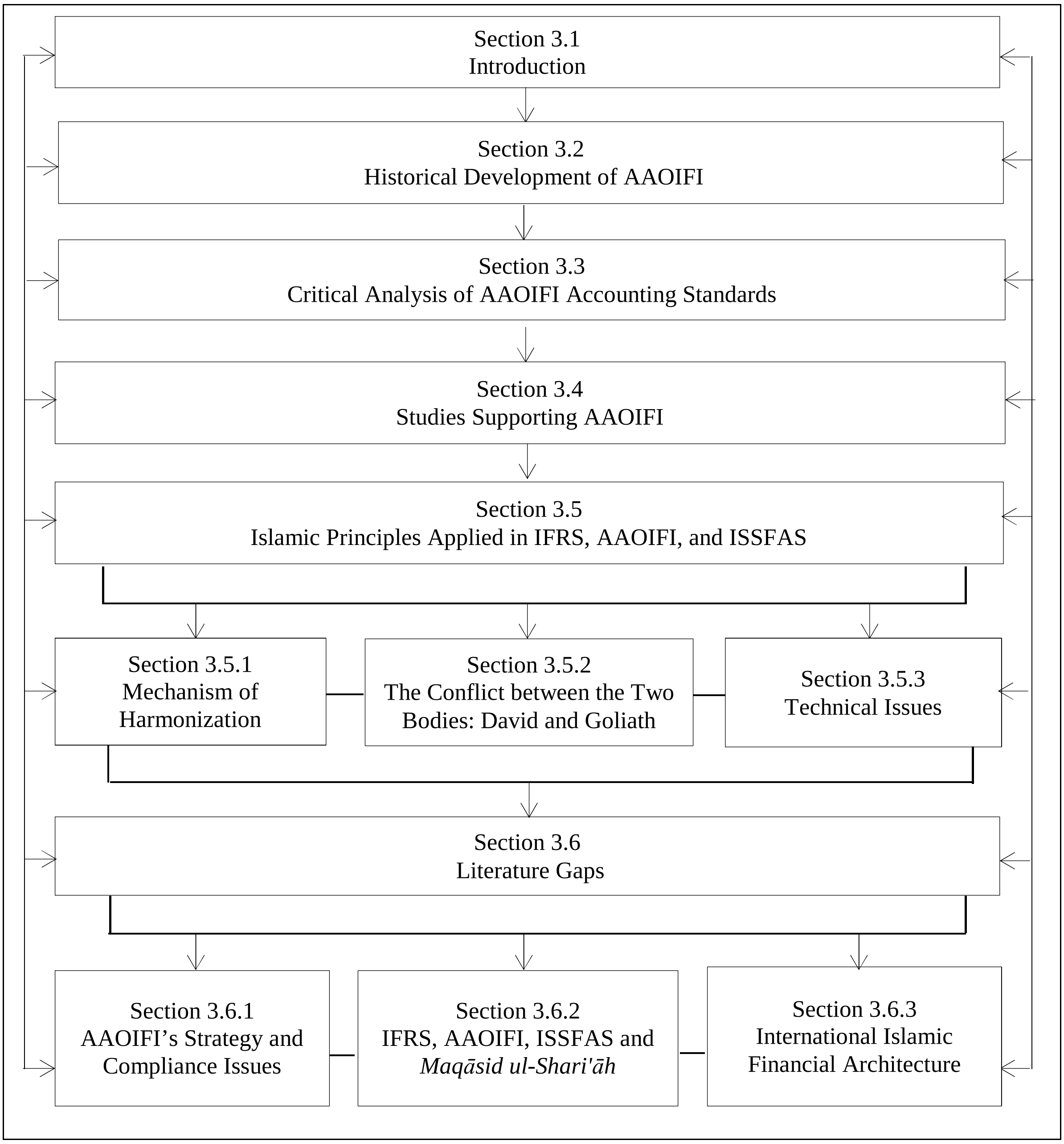
Chapter Three: Accounting and Auditing Organisation for Islamic Financial Institutions

3.1 Introduction

The aim of this chapter is to provide critical analysis on Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) as accounting standard setter for Islamic Financial Institutions (IFIs). The review of the literature has the following purposes. Firstly, to highlight the importance of findings from previous studies on progress of AAOIFI's efforts in standardizing financial reporting for IFIs. Secondly, to evaluate AAOIFI accounting standard developments; to identify any resistance and reflexivity of AAOIFI standardization projects; and to look at the framework for a viable Shariah based financial reporting standards and its required infrastructures. Thirdly, to offer research objectives on what financial reporting standard framework for IFIs ought to be. In general, the literature review helps to identify gaps in the extant literature, to formulate research questions, to make a decision on methodological choice, and to design the overall project.

The chapter starts with historical development of AAOIFI since the preparation of its establishment from 1987 to before 1991, during the establishment in 1991, and its development from 1991 onwards. Critical analysis of AAOIFI accounting standards is discussed to present better view on AAOIFI as organization. The chapter undertakes a selective review of literature from peer-reviewed journals and Islamic studies that discusses the presence of AAOIFI undertaking within the context of financial reporting for IFIs. Similar to IFRS literature review chapter (see Chapter Two), this chapter discusses studies that support AAOIFI standardization project as well as the conflicting views. Using interpretive approach, this literature chapter reveals that several studies required to fill the missing literatures such as: 1. Study that evaluates AAOIFI's strategy in developing its accounting standards and seeking for acceptance from its member countries including Indonesia; 2. Research on the most appropriate reporting standards for IFIs suitable for international financial reporting requirements as well as compatible with *Maqāsid ul-Shari'āh*; and 3. Study that examines institutions responsible for Islamic financial architecture and explore the required supports for the future to impose suitable financial reporting standards for IFIs. These three missing literatures are discussed separately in Chapter Five, Six, and Seven. As this thesis focuses on Indonesia, therefore the study highlights the development of Indonesian Islamic Financial Institutions (IIFIs). The following Figure 3.1.1 outlines the structure of this chapter.

Figure 3.1.1: Structure of Chapter Three



3.2 Historical Development of AAOIFI

The need for Islamic accounting intensified after the accelerated development of Islamic financial institutions and Islamic banks. The first Islamic bank in the world, Mit Ghamr was set up in Egypt in 1963, followed by Islamic Development Bank in Jeddah (1975), Dubai Islamic Bank (1975), Kuwait Finance House (1977), and Faisal Islamic Bank (1978). In this early development, Islamic banks worked with in-house advisers and financial auditors to ensure accounting treatments on their business transactions (Karim, 1990b). The idea for establishment of AAOIFI (or known before as Financial Accounting Organization for Islamic Banks and Financial Institutions/FAOIBFI) was initiated by among others Prof. Dr. Rifaat Ahmed Abdel Karim, a student of Gambling and Tomkins who played an instrumental role in creating the institution, and for which he served as Secretary General from 1996 until 2002. At initial stage, Islamic Development Bank with the support from the Islamic banks agreed to prepare accounting standards for the Islamic banks during the IDB meeting which was held together with the Islamic Banks on 27 Rajab 1407H (27th of March 1987) on the occasion of convening the 11th Annual Meeting for the Governors Council of the Islamic Development Bank in Istanbul. The second follow up from this initiative was through a special workshop to formulate the accounting standards for Islamic Banks that was convened on 7th – 8th of September 1987 at the headquarters of the Islamic Development Bank in Jeddah (Al-Rashed, 1987). In the beginning, Islamic banks opposed the existing international standards as they could not serve the need of the industry as a result each Islamic bank reported its activities using different measurement and recognition methods. This could hinder the development of the Islamic banks as the investors might not be able to interpret the performance of the Islamic banks appropriately. Therefore a setting up of an independent body to formulate the accounting standards for the Islamic Banks was considered urgent.

Karim (1990b) asserts that the establishment of FAOIBFI was due to the fear of the Islamic banks on the regulatory agencies that might influence the Islamic banking accounting practice. The regulators i.e. the central banks and stock exchanges during the year 1987 were not really conversant towards the characteristics of the Islamic finance. Thus, if they interfered the setting of the accounting policy, the regulators tend to govern the direction of the policy setting that might not be parallel with the objectives of the Islamic banks. This can be seen in a case study conducted by Ball (2005) during the setting environmental accounting policy in the local UK government that involved conflicting internal interests referred as political pressures. The conflict was between exploring the implication and the authority’s own agenda. This suggests that a self-regulated standard setting in the case of FAOIBFI was the only option available for such young industry to develop especially when the regulators (proxy by the central banks and the stock exchanges) were seen as threats to their independence.

FAOIBFI was then established on 26th of February, 1990 in Algiers and registered in Bahrain in the following year. It is indubitable that Islamic banks have acted as the main supporters in the setting up of this organization. FAOIBFI at that time consisted of 22 unpaid part-time Board members representing Islamic banks, users of financial reports of these banks, practising accountants, academics, Shariah scholars and regulatory bodies and 17 unpaid part-time members sitting in the Supervisory Committee (Karim, 1995). The formation of this body might not be well represented by all stakeholders of the Islamic banks at that time i.e. independent scholars who possess knowledge on Islamic government and regulators who possess knowledge on political enforcement in which both are required in formulating strategies in promoting international standards. Holthausen (2009) argues effects of law on the financial development of countries and on the effects of accounting standards on financial reporting outcomes and recommends that while enforcement is undoubtedly significant, countries with strong enforcement are likely to have regulations that are more stringent than countries with weak enforcement of financial reporting standards i.e. IFRS. Lacking of the execution strategy in the beginning of the establishment may contribute to the first factor why AAOIFI accounting standards have not become the sole references for the IFIs in the world. Other reason could be due to lacking of focus in developing accounting standards. FAOIBFI has changed its name to AAOIFI in 1995 to indicate a wider scope of responsibility. Since then the AAOIFI has been releasing standards not only accounting and Shariah but also auditing, governance, and ethics.

As recorded in the historical development of AAOIFI, Prof. Dr. Rifaat Ahmed Abdel Karim had taken careful steps before suggesting the idea prior setting up the FAOIBFI by proposing methods and approach he theorized through his seminal academic publications. The first publication was “Standard setting for the financial reporting of religious business organisations: the case of Islamic banks”, published in Accounting and Business Research, in 1990. After the launching of the institution, Karim constantly published his writings both individual and joint efforts to respond to the increasing complications due to the adoption of the standards. For instance, his paper on “The nature and rationale of a conceptual framework for financial reporting by Islamic banks”, published in Accounting and Business Research, in 1994 suggests that the more the FAOIBFI sets accounting standards that incorporate religious ruling, the less it would tend to find its own objectives and concepts useful. He argues that the ambiguities that may arise from different interpretations of the religious rules will require resolutions primarily by reference to religious rather than accounting authority. In his other paper, jointly published with Archer and Al-Deehani “Financial contracting, governance structures and the accounting regulation of Islamic banks: An analysis in terms of Agency Theory and Transaction Cost Economies” in Journal of Management and Governance, in 1998 that recommends three main ways to mitigate deficiencies in investment account holders’ governance such as by reducing Islamic banks’ discretion to manage investment account holders’ return, increase monitoring, and generalisation of hostage posting. He continued publishing his works on accounting up to 2011 when he wrote about “the International accounting harmonization, banking regulation, and Islamic banks” published in the International Journal of Accounting. He argues that the use of IASs as a vehicle to achieving international harmonization of financial reporting must not go unchallenged;

rather, the case of Islamic banks casts light on the need to develop and implement accounting standards that specifically cater for the unique characteristics of the contracts. After he moved to Islamic Financial Services Board (IFSB) in 2002 then to International Islamic Liquidity Management Corporation (IILM) in 2010 (DDCAP, 2013).[41] He changed the topic of his writing to risk management and capital adequacy policy as they are more suitable to his extant profession. Details of Karim's works are listed in the Appendix 3.1.

The studies show the efforts made by AAOIFI to convince the academic scholars on the importance of the standards but similar efforts were not conducted to approach the member countries. Islamic financial institutions and financial regulators in the member countries play very important roles in enforcing the standards therefore intense lobbying to Central Banks, tax regulators, accounting standard setters, and other stakeholders is required. Hence, this relates to the factor on why AAOIFI fails to increase compliance towards its standards. As opposed to the activities that have been organized by IFRS in Indonesia, only few events were held by AAOIFI to socialize its standards and in fact it has been absent for couple of years. Comparing with IFRS, for instance, since 2005, the events organized by IFRS in Indonesia varies from conducting joint-seminar with the Indonesian Institute of Accountants (IIA), facilitating the setting up of IFRS corners in several major universities in Indonesia, to forming working group for several issues arising from the new standards that involve Indonesia as a member. Unlike AAOIFI, the name has been disappeared and in fact, the standards have been discussed less frequently particularly in Indonesia. If any, the programs organized by AAOIFI are mainly held in Mahama, Bahrain which is rarely attended by participants from outside the Middle Eastern countries.

Currently, AAOIFI is known as an international Islamic autonomous non-for-profit corporate body that prepares accounting, auditing, governance, ethics and Shariah standards for IFIs. AAOIFI is supported by institutional members (200 members from 45 countries) including central banks, Islamic financial institutions, and other participants from the international Islamic banking and finance industry (AAOIFI, 2013c). The organisation comprises of experts in Islamic jurisprudence, audit, accounting and law with objectives as follows: 1) to develop accounting and auditing thoughts relevant to IFIs; 2) to disseminate accounting and auditing thoughts relevant to Islamic financial institutions and

[41] Karim is known as Professor Datuk Prof. Dr. Rifaat Ahmed Abdel Karim who was honoured with 'The Award of Excellence for Outstanding Contribution to the Development of the Islamic financial Services Industry' during the 7th London Sukuk Summit Awards for 2013, which was held on 12th June 2013 in London. Professor Rifaat, who is widely known as one of the pioneers of the architecture of the global industry, was the inaugural Secretary General of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) and of the IFSB, where he played a crucial role in introducing accounting standards and prudential and supervisory standards respectively for the Islamic finance industry. He was brought out of semi-retirement to take over the helm at the IILM, whose mandate is to facilitate short-term cross-border liquidity for the global Islamic finance industry (DDCAP, 2013).

its applications through training, seminars, publication of periodical newsletters, carrying out and commissioning of research and other means; 3) to prepare, promulgate and interpret accounting and auditing standards for IFIs; and 4) to review and amend accounting and auditing standards for IFIs (AAOIFI 2010/1432H, Introduction page). In setting these objectives, AAOIFI considered two available options i.e. formulating objectives with reference to Islamic principles and its teachings and considering them with contemporary accounting thought, or borrowing contemporary thought and testing it with Shariah principles then accepting those which are consistent and rejecting those which are not. At the end, majority of accounting academics and practitioners, Shariah scholars, Islamic bankers, and officials in central banks, agreed on the second option. There was no specific argument on why the second approach was opted, nevertheless all scholars unanimously stated that both approaches were acceptable (Karim, 1995). This may be due to two reasons; 1) The businessmen and the officers at the Central Banks at that time were not aware of Islamic accounting or accounting that could be derived from the Shariah, therefore the second approach was considered more effortlessly hence expedited the approval from the Central Banks; and 2) It could be due to the time consuming as building the Islamic based accounting should start from the scratch whereby there were not many experts who could formulate it.

Since the first Islamic bank was inaugurated i.e. Mit Ghamr in 1963, there was no evidence of practising financial reporting standards specifically to cater the transactions of the Islamic banks, thus the period of setting up FAOIBFI in 1990 was considered crucial. Zaher and Hassan (2001) refer this approach as *hybrid way* where Islamic banks adopt in between the paradigm version (Islamic) and conventional version. Due to its simplicity, this approach was then followed by other countries like Malaysia and Indonesia with their accounting for IFIs modified from the accounting conventional standards; see for instance SFAS 59, the first financial reporting standards formulated for Islamic banks in Indonesia in 2002. It was initially stirred by AAOIFI standards with combination of the existing standards that somehow were in tandem with the IAS. As for Malaysia, in the beginning it referred to AAOIFI standards too. Along with its development, it has reached a consensus that accounting standards for IFIs must follow the standards endorsed by Malaysian Accounting Standards Board (MASB) that is equivalent to IFRS (IAS-Plus, 2013a). There are however, specific standard endorsed by the MASB that is termed for instance as MASB i-1; Presentation of Financial Statements of Islamic Financial Institutions. This presentation is a reference for IFIs to prepare their financial reporting. However Siswantoro and Ibrahim (2012) argue that MASB currently has excluded both *Qard* and

Zakat from the required reporting components of the IFIs as an effort to reflect the standards following the IFRS.

In 1993, FAOIBFI/AAOIFI released its first standards for Islamic entities that can be adopted by Islamic bank, Islamic insurance and Islamic capital market. To date, AAOIFI has issued 86 standards for international Islamic finance industry, covering areas of accounting, auditing, ethics, governance, and Shariah. AAOIFI claims that its standards are currently adopted by all leading IFIs across the world and have introduced a progressive degree of harmonisation of international Islamic finance practices. AAOIFI official website reveals that several countries that have adopted the standards i.e. the Kingdom of Bahrain, Dubai International Financial Centre, Jordan, Lebanon, Qatar, Sudan and Syria. It also states that relevant authorities in Australia, Indonesia, Malaysia, Pakistan, Kingdom of Saudi Arabia, and South Africa have issued guidelines that are based on AAOIFI's standards and pronouncements. The following Table 3.2.1 is a list of accounting standards that have been issued by AAOIFI from 1993-2013.

Table 3.2.1: AAOIFI Standards

No	Financial Accounting Standards (FAS)	Year	Topic of Standard
1	FAS 1	1996	Presentation and disclosures (first issuance in 1993)
2	FAS 2, 3 and 4	1993	Modes of financing (*Murābahah*, *Mudhārabah* and *Musyārakah*
3	FAS 5	1993	Disclosures of bases for profit allocation between owners' equity and investment account holders
4	FAS 6	1993	Equity of investment account holders and their equivalent
5	FAS 7 and 8	1993	*Salam* and Parallel *Salam*, *Ijārah* and *Ijārah* Transactions
6	FAS 9	1993	Zakat
7	FAS 10	1993	*Istisnā'*
8	FAS 11	1993	Provision and reserves
9	FAS 12, 13, 15, 19	1993	Insurance companies (in the revision process since 2012)
10	FAS 14 and 17	1993	Investment funds and investment
11	FAS 16	1993	Foreign currency transactions
12	FAS 18	1993	Islamic Financial Services offered by Conventional Financial Institutions
13	FAS 20	1993	Deferred payment sale
14	FAS 21	1993	Transfer of assets
15	FAS 22	1993	Segment reporting
16	FAS 23	1993	Consolidated financial statements
17	FAS 24	1993	Contributions in Islamic Insurance Companies
18	FAS 25	2011	Investment in Sukuk, shares, and similar instruments, amended from Investment in Associates (1993)
19	FAS 26	2013	Investment in Real Estate

Source: (AAOIFI, 2010), AAOIFI (2013c).

There are two new consultation papers on financial accounting standards that solicit views and comments, namely Financial Accounting Standard No. 5 on Disclosure of Bases for Profit Allocation between Owners' Equity and Investment Account Holders; and No. 6 on Equity of Investment Account Holders and Their Equivalent. FAS No. 26 on Investment in real estate has just been released in 2013 (AAOIFI, 2013c). Apart from issuing standards, AAOIFI offers professional programs such as Certified Islamic Professional Accountant (CIPA) and Certified Shariah Adviser and Auditor (CSAA) to enhance skills of human resources capability in Islamic accounting and auditing.

3.3 Critical Analysis of AAOIFI Accounting Standards

Twenty two years after the establishment of AAOIFI, there is no strong evidence on the accomplishment of objectives underlined by the AAOIFI that is to develop accounting and auditing thoughts relevant to Islamic financial institutions. After many years, accounting and auditing thoughts which are already available in the form of standards have only been adopted by several members of this organization. The worse thing is the degree of compliance towards the AAOIFI standards is stagnant or even declining, particularly compliance towards the Islamic required standards. This may be due to lack of professionals developing the standards and lack of strategy in macro setting i.e. approach to member countries' regulators. Vinnicombe (2012) finds that Islamic banks in Bahrain show low level of compliance on Zakat, and unrestricted investment disclosures, while they show high compliance for other issues that happen to be similar to IASB requirements. At present, the IFIs refer to various accounting standards for their financial statement preparation, which cause problems in comparability, reliability, and compliance (Sarea and Hanefah, 2013). This is perhaps, as what Kamla (2009) argues that AAOIFI has not regulated the business organizations for the sake of public interest, equality, sustainability, and social justice, instead it focuses only on technical works. Kamla further urges that Islamic accounting research should take part in changing the role of Islamic banking and accounting by truly incorporating key Islamic teachings, rather than, copying the conventional framework. This fear is highlighted by Zaher and Hassan (2001) that the more current Islamic banking practices diverge from the paradigm version (Islamic), the more Islamic banks lose their distinctive features and tend to resemble conventional banks.

AAOIFI was first established with the objective to follow the Islamic teachings when formulating its accounting standards. The question is whether it is appropriate for AAOIFI to adopt the hybrid approach in order to achieve its objective. Another question is whether IFIs' stakeholders understand the relationship between accounting and Islamic teachings for them to consider the importance of AAOIFI standards. If AAOIFI refers to Islamic teaching in formulating the standards, for instance for the purpose of elevating justice, certainly nobody would disagree with. It could be due to the strategy in communicating the message. Pomeranz (1997) argues that communication between the

West and Islamic countries or Muslim community should be improved as it will facilitate humanity at large to follow ethical and moral conducts of the revealed religions, for instance the protection of the weak is undeniable and commonly instilled by Judaism, Christianity, and Islam. It means noble values promoted by Islam through the Islamic finance eventually can be perceived as positive message rather than a negative campaign. This is very important as Islam rejects Muslims to separate religiosity with that of commercial world. However this must be professionally communicated to the rest of stakeholders of Islamic finance, both Muslims and non-Muslims.

AAOIFI must strictly affirm on the decision of Shariah compliance towards a particular product together with its derivatives. It can be seen from the criticism towards the products launched by Islamic finance that are claimed as not being Shariah compliant. The criticism goes to AAOIFI and some of the accounting standard setters in the world that have been too much accommodating the market needs that end by amending the standards. Sukuk is one example. El-Gamal, as emphasized by Maurer (2010), illustrates how business motive could influence the accounting standards started from potential buyers who are interested in a specific product and approached the accounting standards setters to influence them how to deal with it. Eventually, the accounting standard setters are compelled to accommodate by relaxing its standards or modifying them which unfortunately will be the same with that of conventional accounting standards. The case of 25 Sukuk defaults in Malaysia recently shows the failure of Islamic finance to anticipate moral hazards. However, this would not occur if the players in Islamic finance agree to uphold the original concept of trust in partnership despite the fact that Shariah may act quite leniently towards breach of trust. For instance, the case of bankruptcy will not immediately end to seize of the assets, the case will be first brought to Shariah arbitrageur for further clarification on the default. If the customers are found incapable of paying back the loan, then IFIs will offer chance to restructure the loan by prolonging the term of the contract. In sum, besides the lobbying power that has been absent from the structure of AAOIFI, other criticism towards AAOIFI touch three fundamental areas: 1) AAOIFI fails to provide avenue to disclose sufficient information in their present format of financial reporting standards; 2) The issue of social injustice that has been transformed in the products and services offered by IFIs which are initially claimed as Shariah compliant; and 3) Future solution on the declining trend of AAOIFI standards compliance.

3.4 Studies Supporting AAOIFI

Gambling and Karim (1986) proposes the approach of social accounting which can be reconciled with Islam as they argue:

> "The collective personalities or maze ways of the individual people who comprise a group or society, form their culture, and accounting theory is part of the personality and hence part of the culture. If the individuals are Moslems, their personalities are Islamic and their culture is Islamic. Therefore their accounting theory is Islamic and encompasses the Sharia along with much else."

Gambling and Karim (1986) argue that the above argument as "very British or Western" should not represent the true Islamic message. Islam certainly should be differentiated with that of Muslims who have choices to listen and behave according to the Islamic values or the opposite. Therefore the above statement or so called "Western view" on Islam and Muslims should be revised. Whatever Muslims act in their daily life do not necessarily represents the Islamic teachings. God conveys His message through Qur'an and Sunnah[42] to the individual man and woman, therefore Islam emphasizes rights and obligation to the individual and at the Day of Judgement[43], only individual deeds are accounted for. Application in accounting can be referred to the call for rejecting usury as a form of injustice and paying Zakat as a form of social obligation by the individual and even to the business organization set up by the individuals. Parallel with this statement, White (2004) argues that Islam brings more complex message in accounting such as method of calculation and different rates of Zakat. Gambling and Karim (1986) further argue that accounting and finance are consequences of the society; when the society is changing, the accounting has to adapt to it.

Accounting today, however, is owing to the Western double-entry-based accounting technology that suits only to an orthodox or positivist society and it is not adequate to serve the doctrine from Islam or other belief (Gambling and Karim, 1986). Therefore, considering IFIs are fast growing that require a set of accountability system, therefore it is essential to set up and to adopt AAOIFI accounting standards in order to improve reliability of the financial reporting (Karim, 1990b, Sarea and Hanefah, 2013). Apart from studies promoting the establishment of AAOIFI, some concerns over the existence of AAOIFI have been mentioned for instance by Vinnicombe (2010) who suggests an index to test the compliance of Islamic banks towards the AAOIFI standards to

[42] Qur'an and Sunnah are two main sources of law in Islam. Qur'an is a holy book while Sunnah is what was transmitted on the authority of Prophet Muhammad (P.B.U.H.), his deeds, sayings, and tacit approval.

[43] Muslims believe that there is a life in the hereafter in which all people will be gathered and judged whatever they did in the world.

facilitate the development of these standards in the future. Others such as Pomeranz (1997) asserts that AAOIFI is needed as an agency that would serve as a clearing house for information that may facilitate Shariah committees in making decisions.

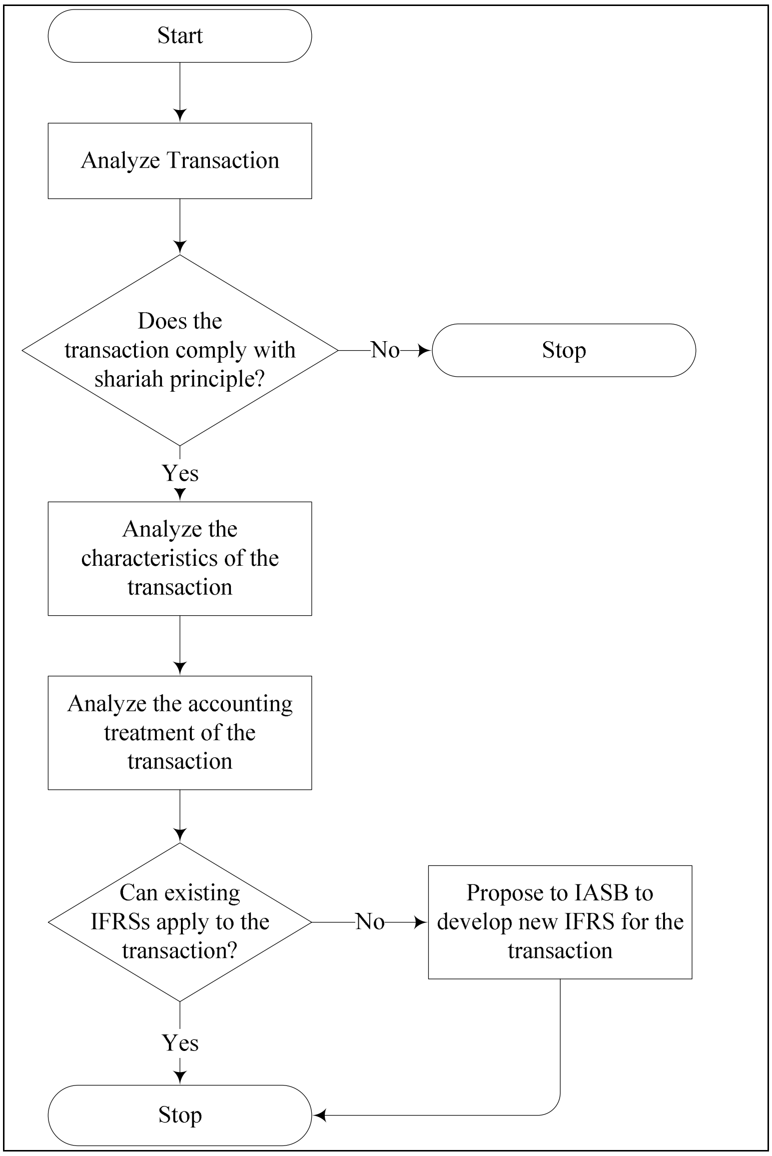
3.5 Islamic Principles applied in IFRS, AAOIFI, and ISSFAS

There is now a conflict in the interpretation of Islamic principles between the two bodies interested in standardising Islamic accounting namely IFRS and AAOIFI. This conflict between the two bodies can be discussed under these subheadings: the mechanism of standard setting, prohibition in the religious values such as *ribā*, *gharar, maysir* and haram and technical matters. Issues around Indonesian financial reporting standards setters are presented to complement the discussion.

3.5.1 Mechanism of Harmonization

It has been argued by various scholars that IFIs should adopt different set of financial reporting standards due to their Islamic characteristics, among others i.e. prohibition of usury and fulfilment of Zakat obligation (Karim, 2001, Ibrahim and Yaya, 2005, Ibrahim, 2007, ACCA, 2010, Haniffa, 2011). The characteristics debated by the scholars from the early development of AAOIFI to the current practices are elaborated in this section. Fifteen key issues highlighted by a research conducted by Asian-Oceanic Standard-Setters Group (AOSSG) in 2010 are discussed. As a group of standard setters, AOSSG has objective to facilitate its members in providing feedback to the IASB on the appropriateness of proposed and existing International Financial Reporting Standards (IFRSs) to Islamic financial transactions. As a part of harmonizing the standards, AOSSG applies the following mechanism described on Figure 3.5.1 to discuss the key issues arised by the members.

Figure 3.5.1: Mechanism of Islamic Finance Working Group, AOSSG



Source: (AOSSG, 2010, p. 70).

Figure 3.5.1 explains that if the transactions that are clearly viewed by AOSSG as against Shariah principles, they will not be discussed by the working group such as sale and buy back contract, profit equalization reserve (PER)[44], effective interest rate, and present value. Other than that, the working group will work to analyze the accounting treatment of the transactions and if the present IFRS do not provide flexibility, the working group will conduct hearing among the members and propose comments and suggestions to the chairman of IASB in writing. This suggests that a conflict of approach among AAOIFI and AOSSG on the effort of harmonization is illustrated in the following Table 3.5.1.

[44] This term is misleading as PER is a reserve, not a provision, should be referred as "pay-out stabilization reserve" as what is stabilized is the profit pay-outs not the profit themselves (Archer et al., 2010). The PER is a reserve formed of appropriations from investment profits before these are allocated between shareholders' component and unrestricted Investment Account Holders (IAH)'s component. This reduces the amount of profit attributable to IAH and may be used for stabilizing the periodic profit pay-outs to IAH, but not for covering any periodic losses.

Table 3.5.1: Approach of AAOIFI and AOSSG

No.	Notions	AAOIFI	AOSSG
1	Practiced & Islamic transactions	y	y
2	Practiced & non-Islamic transactions	n	y
3	Non-practiced & Islamic transactions	y	n
4	Non-practiced & non-Islamic transactions	n	n

Table 3.5.1 described that for practiced and Islamic transactions, both bodies agree to analyse the standards but if the transactions is not Islamic, AAOIFI will not take it into consideration, only AOSSG will see it whether it is compatible with that of IFRS. As for the non-practiced transactions but they are Islamic, AAOIFI will consider to prepare the standards but not for the case of AOSSG. If something is not practiced and it is not Islamic, both groups agree to leave them. For the case of PER, eventhtough it is not inconsistent with Shariah but as it is not permissble under IAS 39/IFRS 9, the subject is not further discussed by the AOSSG. It argues that IAS 39/IFRS 9 only allows aggregation when the financial assets share common credit characteristics.

To date, the members of AOSSG working group are the accounting standard setters from Australia, China, UAE/Dubai, Indonesia, Korea, Pakistan, Saudi Arabia. According to MASB the fundamental difference between IFRS and AAOIFI standards are on the two key concepts in IFRS: substance over form and time value of money (IAS-Plus, 2013a). These two concepts are included as characteristics of the Islamic finance. By understanding the debate on the characteristics that influence the financial reporting standards, therefore this section demonstrates the differences between IFRS, AAOIFI and relevant standards practiced by the IFIs. The followings are the four main differences referred as religious prohibitions between the accounting standard setters when setting financial reporting standards: the prohibition of usury (*ribā*), impermissibility of uncertainty (*gharar*), banning of gambling (*maysir*), illegal goods and services (haram).[45]

Prohibition of usury (Ribā)

Prohibition of usury (*ribā*) is certainly is not an issue with IASB, but AAOIFI sees it as a fundamental. It is described in the Conceptual Framework of AAOIFI (Statement of Financial Accounting (SFA) No. 1) that IFIs are different from their conventional counterparts in which the use of interest is prohibited. The terminology of *ribā* is defined

[45] These prohibitions are mentioned in the AAOIFI Conceptual Framework, Para 1.1.b: "Unlike conventional entities IFIs are prohibited the use of interest *(ribā)* in their investment and financing transactions; from entering into highly speculative transactions *(gharar)* and also prohibited from entering into transactions that are not permissible by Shariah *(i.e. maysir,* haram*)*" (AAOIFI, 2010/1432H).

as usury or interest in the modern terms. The Qur'an has clearly mentioned the prohibition towards *ribā* or usury in Qur'an *Al-Baqarah* (2): 275 with its meaning "*But Allah has permitted trade and has forbidden interest*." The term of trading in this verse is then translated as replacement of taking interest from loan to customers to transaction of selling and buying. However, the application of interest has been widely debated as to whether the term can simply be replaced by "profit loss sharing" or "margin" or "rental" or the term can be hidden in the substance although it disappears on its form. The term "time value of money" in determining present and future value of a transaction that relate to the extension of *ribā* is also inevitably debated. The use of time value of money in Islamic transactions are allowed by several scholars like Anas Zarqa and Rauf Azhar and majority of jurists in the price difference of purchasing commodity at the current and future date as long as it is not used as pre-determined value (Khan, 1996). Pre-determined value for return on investment is prohibited in Shariah because it is involved in uncertainty hence, it is replaced by profit and sharing mechanism whereby the return is only determined in percentage of a profit or loss that is going to be occurred. In this case, time value of money used to predict the return is not allowed. In other case where time value of money acceptable is when it is used in certain contracts like the purchase where payment will be made in instalment (*Bai' Muajjal*) or the purchase of goods that will be delivered in future date but the payment is made at the time of contract (*Bai' Salam*). For these cases, Khan (1996) proposes that it is acceptable to consider time value of money as rental rate towards an asset that is permissible in Islamic contracts. The waiting period is then a proxy of the rental period.

The following case is an illustration of *Bai' Muajjal* or *Murābahah*[46] describes how time value of money or economic value of time is measured. As an illustration, Mr. A signed a contract for purchasing one unit of car from B Islamic Bank, with an agreed price plus margin for five years or 60 months instalment period of USD 15,000, or USD 60/month. Both parties know that the original price is USD 10,000 therefore USD 5,000 is the increment on the basis of payment is made in the future date, or 10% margin per year times five years. In other instance, suppose the same person, Mr. A signed a contract for car credit from C Bank, with a floating interest rate of 10% per year and keeping the rate is more less the same in actual, that the instalment is around USD 60/month. This seems to be similar in the amount of payment but in essence, it is different. In the first contract, B Islamic Bank charged 10% on the asset value and considered the margin as rental rate

[46] *Bai' Muajjal* is a *fiqh* term and *Murābahah* is a specific transaction or contract term frequently used in Indonesian Islamic finance, as stated in the Fatwa Book of National Shariah Board – Indonesian Council of Ulama.

charged to Mr. A for using the car, but in the second contract, C Bank charged 10% on the amount of money borrowed, regardless of the existence of the asset. The issue of asset based contract is one of the fundamental differences in this case.

Since the start, AAOIFI has been standing firmly on the issue of time value of money and regards it as violating the Islamic values. This can be seen from Financial Accounting Standards No. 2 on *Murābahah*, Para 2/4 on *Murābahah* profit that AAOIFI states two methods: 1) Proportionate allocation of profits over the period of the credit whereby each financial period shall carry its portion of profits irrespective of whether or not cash is received, 2) As and when the instalments are received. These two methods do not recognize the concept of time value of money whereby the amount of instalment received in period 1 and period 1+n does not differ. Unlike the issue of *Murābahah* profit practiced in Malaysia that absorbs risk relates to time value of money which is then the profit recognized in the period 1 is bigger than the period 1+n. In Indonesian case too, new Bank Indonesia guideline permits the Islamic banks to measure *Murābahah* profit using annuity method where the approach mimics the conventional bank in calculating its interest income on loan, especially home financing (PAPSI, 2013). This is another controversy that AAOIFI fails to interfere although in AAOIFI Shariah standard No. 13 Article 8/8, it explicitly states that "In measuring receivables, neither time value (interest rate) nor discount on current value for extension of period of payment shall be taken into consideration."

Impermissibility of uncertainty (gharar)

There is no evidence that IASB has a concern towards the uncertainty whereby it is another element that AAOIFI emphasizes on its Conceptual Framework. IFIs are not allowed to enter into transactions that are not clear according to Shariah. As uncertainty should not exist in any transaction of Islamic finance thus the accounting should not also record that type of transactions in any form. In one hadith, Prophet Muhammad (P.B.U.H.)[47] says: *"Rasulullah forbids transaction that contains gharar"* (Hadith narrated by *Al-Baihāqi from Ibn 'Umar*). In other hadith, the Prophet says: *"It is not allowed to sell something until you own it"* (Hadith narrated by Al-Baihaqi from Hukaim bin Hizam) (DSN-MUI, 2012/1433H). These two hadiths do not permit IFIs to transact something that IFIs do not have in their possession. Its implication to accounting is therefore, the standards should make it clear that any transactions that entail this element should be revoked and any income derived from this transaction should be disclosed as non-permissible income or

[47] P.B.U.H. stands for Peace Be Upon Him, which is translated from "*sallallahu 'alayhi wa sallam*", a salutation to Prophet Muhammad.

known as “Non-Halal income” or the IFIs that involve in this type of transactions can be considered as legal flaws. The hadiths, on the other hand explain permissibility of the selling and buying shares in the Islamic capital market because according to Wahba al-Zuhaili *in Al-Fiqh Al-Islāmi wa Adillatuhu* Juz 3/1841 the stockholder is a partner in business based on his own shares (DSN-MUI, 2012/1433H). These two hadiths are considered as source of laws (see Sunnah) that regulate practices in the Islamic finance. Nevertheless, there is no clause that highlights consequences of the law or there is no authority imposed for any breach of the law. This is what lacking in the structure of IFIs, there is no sanction towards negligence of Shariah law by IFIs. For instance, Sukuk transaction involving in uncertainty of ownership of assets, which shows only the Islamic form but not Islamic in substance which according to Maurer (2010) the practitioners have neglected the Islamic values in the pursuit of profit.

Banning of gambling (maysir)

Speculation or the elements that may contain speculation has not been discussed in the IASB standard setting process. AAOIFI on the other hand highlights this matter on its Conceptual Framework that IFIs should be aware of. Gambling or speculation towards goods transacted in IFIs where income is expected to derive from is completely forbidden. The prohibition of this element in the Islamic contract prescribed in Qur’an *Al-Mā’idah* (5): 90: *“O you who have believed, indeed, intoxicants, gambling, [sacrificing on] stone alters [to other than Allah], and divining arrows are but defilement from the work of Satan, so avoid it that you may be successful.”* The relevant transaction in this case is speculation of gold price in the pawn-house transaction (*Rahn*), as practiced by among others Bank Rakyat Indonesia (BRI) Syariah, a major Islamic bank in Indonesia. Bank Indonesia through Bank Indonesia Circular No. 14/7/DPbS sent reminder to all Islamic banks and simply rectified the limit of *Rahn* transaction to Rp.100 million instead of previously Rp.500 million on the basis that Islamic pawn is taken place when there is an emergency (*darūrah*) without placing severe sanction to the bank. The bank certainly recognizes the purpose of *Rahn* as the Shariah Supervisory Board of the bank must put their consent on any product released by the bank. The sanction however was a mere reminder with no substantial penalty to the bank, instead, the bank is now freely offering similar product to customers by following the amended rules set out by Bank Indonesia. Even, in the accounting aspect, there is no correction made by the bank that the income figure where the bank engaged with the product should be altered as it did not meet Shariah principles or it could be classified as Non-Halal income. IFIs perhaps can learn from enforcement of law on Islamic finance practices in the UK, such as stipulated under the UK law as quoted "The UK government and its agencies have no interest in whether an Islamic bank conducts its affairs in accordance with Shariah. However, this is qualified by the point that where a bank has held itself out as being Shariah compliant, the contracts held by its customers may entitle them to redress for failure to adhere to Shariah, or the bank may acquire legal exposures if its marketing were held to be untruthful" (Amin, 2009).

*Illegal goods and services (*haram*)*

Other than the above clear message on the prohibition of elements contain *ribā*, *gharar*, and *maysir,* the AAOIFI states on its SFA No. 1 that any transaction that violates Shariah including the illegality aspect such as haram or halal should be avoided by IFIs. Thus, all transactions must be clearly disclosed to show that they are free from those elements. Unlike IASB, this is not within its jurisdiction to interfere the legality of goods and services that would be disclosed in the financial report of the institutions. In Qur'an *Al-Baqarah* (2): 160: "*O mankind, eat from whatever is on earth [that is] lawful and good and do not follow the footsteps of Satan. Indeed, he is to you a clear enemy*." This verse suggests clearly on the prohibition towards the illegal goods and services thus IFIs should be aware of goods and services that are unlawful. The sample of unlawful goods and services are among others taking pork, alcohol, dead animals,[48] and cigarettes,[49] or getting involved into activities such as pornography, smuggling, or human trafficking. IFIs should avoid to finance or associate themselves in any financial transactions with the parties involved in providing or consuming unlawful goods and services.

By satisfying the above requirement, IFIs have fulfilled basic human right and these are referred as *Maqāsid ul-Shari'āh* (objectives of Shariah). It is the foundation for the Shariah rules and regulations; it provides knowledge, understanding and justification for the principles of Shariah (Abdullah & Furqani, 2012). Therefore, should any of the above illicit activities occur, the accounting of the IFIs should record it in a way that the income derived from such event considered as Non-Halal and ensures IFIs dispose it to charitable institutions or organize it as source of fund for benevolent loan. This is the way recommended by Shariah scholars on how to deal with such type of income as IFIs cannot

[48] Without passing through the Islamic way of slaughtering i.e. not mentioning *Bismillah ar-rahmān ar-rahīm which* means "In the name of God, most Gracious, most Compassionate." This has been expressed in Qur'an *Al-Kawthar* (108) :2 "So pray to your Lord and sacrifice [to Him alone]" and hadith narrated by Muslim No. 1978 that states that Rasulullah said: "….Allah curses those who slaughter not for Him…"

[49] Dealing of which is considered as *mubāzir* (spendthrift). The reminder of this forbidden act has been stated in Qur'an *Al-Isrā'* (17): 27 "Indeed, the wasteful are brothers of the devils, and ever has Satan been to his Lord ungrateful."

record it as their operating income, instead it must be reported in a specific statement. AAOIFI states such injunction in FAS No. 1 on Statement of Sources and Uses of Funds in the *Qard* Fund, paragraph 4/7 (AAOIFI, 2010/1432H, p. 60) on how it is reported and disclosed. However, defining what is lawful and unlawful sometimes provokes controversy such as defining what usury really means, therefore according to Pomeranz (1997), there is a need for a mix of Shariah committee members who have knowledge on Islamic law, faith, and business. AAOIFI stipulates the appointment, composition and report of Shariah Supervisory Board (SSB) in Governance Standard for IFIs No. 1 that underlines the board to have at least three members but there is no specific area of expertise required by the standard. Should there be any need arise; the board may seek expert opinion from the areas of business, economics, law, accounting and/or others. Ensuring what is lawful and unlawful transactions reported by the IFIs may not be acknowledged by the Shariah board, therefore the audit firms must be aware of this matter hence the external auditors should possess knowledge on the legality standard of the products and services. To date, there is no evidence that the audit firm has placed this concern over their audit duty as external auditors of IFIs. Karim (1990a) argues that it is necessary to have a joint forces between Shariah board of IFIs with the external auditors so they will be perceived to be more independent in ensuring the credibility of financial statements.

In Indonesia, according to DSN Directive No. 3 Year 2000 on functions and obligations of SSB, whereby details of SSB such as definition; requirement; roles, rights and obligations; procedures as well number of SSB are stipulated under Bank Indonesia Regulation No. 6/17/PBI/2004 dated 1st of July 2004, No.6/24/PBI/2004 dated 14th of October 2004 renewed to No.7/35/PBI/2005 dated 29th of September 2005, and No.8/3/PBI/2006 dated 30th of January 2006, concerning operations of Islamic banks, Islamic Rural Banks and Conventional Banks with Shariah Operation. In this directive, the SSB should consist of at least 2-5 members for Islamic commercial banks, and at least 2-3 members for Islamic rural banks whereby each member can assume maximum four positions at IFIs. Restriction on number of SSB members is very crucial as a scholar may not be able to share his time properly to discuss important matters regarding the Shariah validity of a product or service of an IFI. Shaikh Yusuf Talal DeLorenzo, a prominent Islamic scholar, argues that unless a financial product or service can be certified as Shariah compliant by a proficient Shariah supervisory board, the Shariah validity of the product is doubtful (IIBI, 2013). Nevertheless, as there is no clear and detail guideline from AAOIFI, the practice in other countries varies. For instance one Islamic scholar may sit in tens of IFIs at the same time. This is not surprising then why legality issue of a product or service of IFIs often invites controversy in the market nowadays.

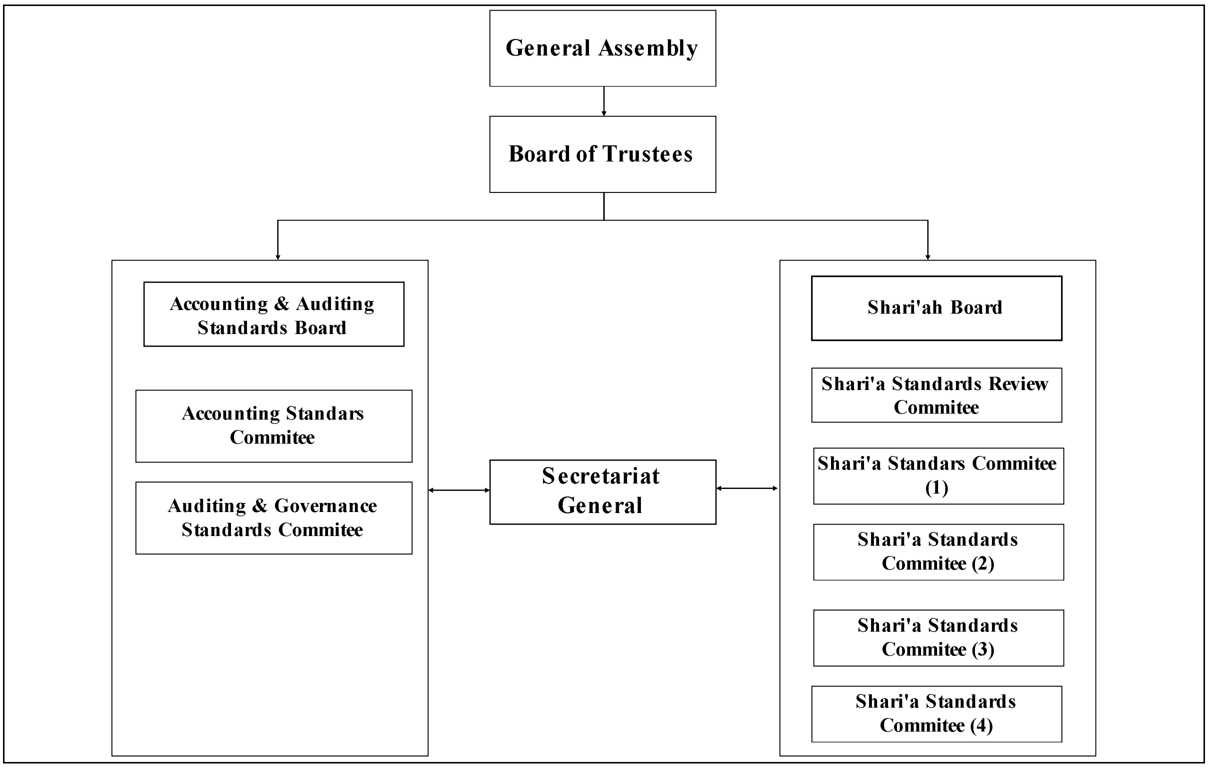
3.5.2 The Conflict between the Two Bodies: David and Goliath

Comparing AAOIFI and IASB appears like comparing David and Goliath. One is a tiny organization and claimed as an international standard setting for IFIs around the world, whereby IASB the Goliath which is an established organization claimed as a successful standard setting body. There are three dimensions at least to compare these two organizations such as organization structure, funding, and the location.

Organization structure

AAOIFI is structured right from General Assembly which composes of all founding, associate, supporting and observing members and regulatory and supervisory authorities. Observer and supporting members have the right to participate in the meetings of the General Assembly but without a right to vote. The General Assembly is the supreme authority and convenes at least once a year. The following Figure 3.5.2 describes General Assembly and lines of organization.

Figure 3.5.2: AAOIFI Organization Structure

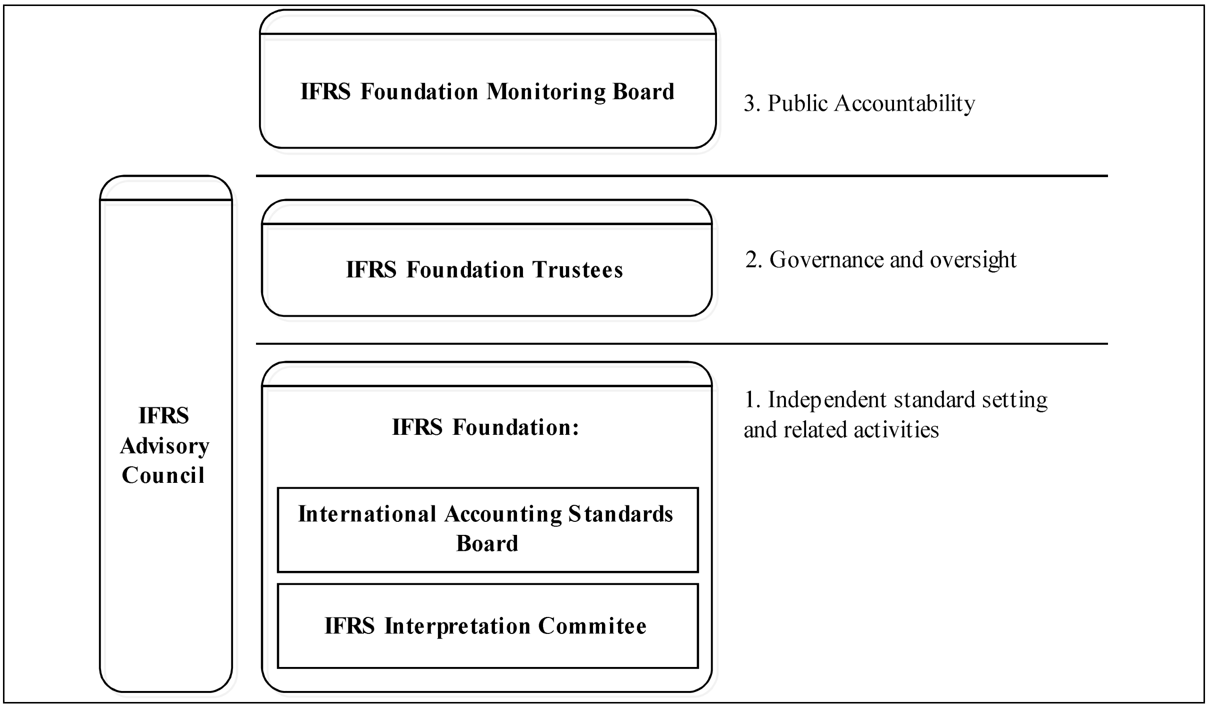


Source: AAOIFI (2013a).

Board of Trustees has 18 persons including a chairman, 16 members, one member/rapporteur; and a secretary general. While Shariah Board that consists of 21 persons including a chairman, a deputy chairman, 18 members, and a member/rapporteur, supervises Shariah Standards Review Committee and four Shariah Standards Committees. The four Shariah standards committees are Shariah Standards Committee 1 (6 persons consist of all members); Shariah Standards Committee 2 (8 persons including Chairman, 6 members, and a rapporteur); Shariah Standards Committee 3 (9 persons including chairman, 7 members, and a rapporteur); and Shariah Standards Committee 4 (13 persons including chairman, 11 members, and a rapporteur). AAOIFI regulates three different standards i.e. accounting, auditing, and governance, therefore the structure goes as follows; Accounting and Auditing Standard Board (comprises of Chairman of Accounting and Auditing Standards Board, Vice Chairman of Accounting and Auditing Standards Board, Chairman or Accounting Standards Committee, Chairman of Auditing and Governance Standards Committee), 12 members, and a rapporteur). Besides, there are 6 persons sitting in the Accounting Standards Committee and 8 persons in the Auditing and Governance Standards Committee. What matters here is not how long the list of the people sitting in the standard body, but who are the full time members who can really dedicate their time, knowledge, and experience for the sake of developing the institution. There is no indication whether all the big names appeared in the structures attend the meeting of AAOIFI, see H.E. Shaikh Ebrahim Bin Khalifa Al Khalifa appointed as Chairman of the Board of Trustees (as Minister of Housing, Kingdom of Bahrain), Sheikh Muhammad Taqi Usmani appointed as Shariah Board (Vice-President Darul-Uloom Karachi, Pakistan and Permanent member of OIC Fiqh Academy), or Sheikh Nizam Yaquby appointed as member of the Shariah Board (Member, Shariah Board, Bahrain Islamic Bank). The most active person in AAOIFI is known with the position as Secretary General who is placed as one of the members in Board of Trustees, or acts as a rapporteur. It is currently hold Dr. Khaled Al-Fakih who replaced Dr. Mohamad Nedal Alchar and Prof. Dr. Rifaat Ahmed Abdel Karim. There is no information on the number of real full time staff running the organization.

While IASB as depicted on Figure 3.5.3 shows complete information on its website on the organization structure that includes advisory bodies, members of the IASB (17 persons including chairman Hans Hoogervorst and vice chairman, and all are full time), members of the IFRS interpretation committee (15 persons, all are full time), the list of the trustees (22 persons), to whom should be addressed to regarding the media (3 persons), up to the rate should be paid for the IASB staff to speak at any conference or seminar on IFRS. The structure shows that IFRS Foundation acts very important role as it is responsible on the standard-setting process. Detail of staff's term is specified to show when a person is appointed and when the term will expire. Regarding the administrative staff, there are 10 personnel stated as senior staff of the IASB.

Figure 3.5.3: IASB Organization Structure



Source: IASB (2013c).

Funding

In terms of funding, the website shows that AAOIFI holds certification program and charge the participants for the courses and examination i.e. Certified Islamic Professional Accountants (CIPA) and Certified Shariah Adviser and Auditor (CSAA). AAOIFI also sells several publications such as books both in Arabic and English that contain accounting, auditing, and governance standards (in one book), and Shariah standards (in one book), and collection of past exam papers/conference papers. As for IASB, its commercial publications are both in printed and electronic forms including amendments to IFRSs, electronic products, IFRS books, discussion papers, exposure drafts, education materials, external IFRS translations, and subscriptions to IFRS updates, most of them are available in various languages. There is no evidence on how much both AAOIFI and IASB charge a country through its accounting standard setters or relevant regulator on membership or adoption to the standards.

Location

Location-wise, AAOIFI is located in Bahrain, a country that is not really strategic, for instance as compared to Dubai. Dubai has emerged as a cosmopolitan metropolis and become a global city and a business and cultural hub of the Middle East and the Persian Gulf region. It is also a major transport hub for passengers and cargo globally. For IASB, London is a strategic place that has been known as a leading global city with strengths among others in commerce, finance, media, professional services, research and development, and transport and it is also one of the world's leading financial centres. The strengths invite people to visit the IASB office, attend IFRS conferences, and live as IASB consultants and experts. The location may not matter much but it is important to note how IASB organizes conferences across the worlds which have been reaching to more people as opposed to AAOIFI that mostly hold their conferences in Mahama, Bahrain.

3.5.3 Technical Issues

Conceptual Framework

According to Nobes and Parker (2012), the main purpose of the conceptual framework is to give useful information to various users particularly investors in making decision. The first Conceptual framework was proposed by Accounting Standards Steering Committee (ASSC) in 1974 and the report was published in 1975. This important report describes the scope and aims of the published financial reports, public accountability, working concepts, users of the reports, and means to measuring and reporting and it is in no way out-dated (Alexander and Britton, 2001). Conceptual Framework seems to be the main parameter to judge the quality of financial reporting standards as it would determine direction of the standards. Because Conceptual Framework is such vital, especially to adjust the scope of standards to the current development, it is quite often to hear that the revision of Conceptual Framework is taken place, for instance, IASB is currently revising the Conceptual Framework of IFRS by establishing a special working group called Accounting Standards Advisory Forum (ASAF) on November 2012 to provide advice and views to the IASB on the matter (IASB, 2013b). A number of Conceptual Framework projects were undertaken in the U.K., U.S.A., Canada, and Australia including FASB’s Conceptual Framework. Hines (1989) criticized the approach on the prevailing reason of the revision only focused on the functional and technical sides but neglected social and cultural parts of it. Karim (1995) adds that review of the Conceptual Framework is concerned only on the information useful in making economic decision but ignores non-market consideration such as social responsibility and illegal acts.

As far as financial reporting standards for IFIs are concerned, a conceptual framework is definitely required. In its early development, Karim (1995) asserts that AAOIFI/FAOIBFI may require objectives and concepts both for legitimating its own role and in mandating accounting standards for those issues which are not affected by Shariah rulings. He was uncertain by stating that this will be subject to the limitations faced by all standard-setting bodies in utilizing their conceptual frameworks. AAOIFI 2010 covers a section titled Conceptual Framework for Financial Reporting by Islamic Financial

Institutions that is also referred to as ‘Statement of Financial Accounting No. 1’,[50] from page 3 to page 40 that discusses the introduction; authoritative status of the framework; objectives of financial accounting and financial reports for IFIs; limitations; financial reports and process; elements of financial statements; financial accounting process, recognition, measurement concepts and accounting assumptions; financial reports and process; preparation and presentation of accounting information providing useful financial reporting information is limited by two pervasive constraints, materiality and cost; and adoption.

As argued by previous scholars that the Conceptual Framework of AAOIFI mainly focuses on the practical side but neglects the principal message and therefore, it does not distinguish the characteristics of IFIs (Haniffa and Hudaib, 2007). They propose Islamic perspective of accounting and how accounting from this perspective can ensure socio-economic justice that would facilitate Muslims to fulfil their obligation to God and at the end to attain rewards both in this life and the hereafter. Therefore they argue that the IFIs should disclose the following: commitments to operate within Shariah principles/ideals; commitments to provide returns within Shariah principles/ideals; commitments to engage in investment and financing activities that comply with Shariah principles; commitments to fulfil contractual relationships with various stakeholders via contract statements; current and future directions in serving the needs of Muslim communities; and statement of appreciation to stakeholders. These several commitments appear to be a significant argument on the accountability concept in IFIs that certainly contrasts from the conventional institutions i.e. IFIs are accountable to God and its society.

3.5.3.1 True and Fair View

IAS 1 Paragraph 15 states that financial statements shall present fairly the financial position, financial performance, and cash flows of an entity. It also emphasises that the financial statements need to faithfully represent the spirit of the definitions and recognition criteria for assets, liabilities, income, and expenses as spelled by the framework. It is important to note that the financial statements must comply with all requirements of IFRS and shall provide an explicit and unreserved statement of such compliance.[51] However, Paragraph 19[52] mentions exceptions whereby the management

[50] This statement was replaced by ‘Statements of Financial Accounting 1 and 2’ in 2011.

[51] Paragraph 16: “An entity whose financial statements comply with IFRSs shall make an explicit and unreserved statement of such compliance in the notes. An entity shall not describe financial statements as complying with IFRSs unless they comply with all the requirements of IFRSs.”

may depart from IFRSs, referred as the true and fair view override. Such overrides may pose problems for the users in understanding the financial statements (XIM, 2013).

For IFIs that record transactions using standards other than IFRS, cannot declare that they are IFRS compliance. As for AAOIFI, it does not impliedly state that the financial statements must comply with all the requirement of AAOIFI to be referred as complied with AAOIFI standards. Besides, AAOIFI has no power to enforce its standards. Islamic Banks in Malaysia and Indonesia, for instance, are not required to comply with the AAOIFI standards (Wan Abdullah et al., 2011). For Indonesia, Islamic Banking Act No. 21 Year 2008 that was released on 16th of July 2008 states a compulsory reference for all Islamic Banks to follow financial reporting standards issued by the IIA.[53] Similarly, in the United Kingdom, the true and fair view financial statement must be produced by the IFIs as stipulated by Companies Act 2006, and by virtue of EC 1606/2002 agreement, all IFIs in the United Kingdom must prepare their financial reports based on the IFRS. In Malaysia, Section 169, The Companies Act 1965 as amended in 2007 (The Companies Amendment Act) requires all companies registered under this act (including the IFIs) to prepare annual financial statements that include a balance sheet, a profit and loss statement, and a directors' report. In accordance with Section 166A of the Act, companies are required to prepare their financial statements based on the approved accounting standards that are issued by MASB under Section 7 of the Financial Reporting Act (1997). As Malaysia has declared full IFRS adoption on 1st of January 2012, therefore, direction of MASB for IFIs in Malaysia seems to follow IFRS (Siswantoro and Ibrahim, 2012).

3.5.3.2 Transaction Fees

Interest on loan is not permissible according to Shariah but fees charged on transactions or products under Islamic finance are allowed. The fees mentioned such as in *Wakālah* transaction that delegates a duty to another party like agency, apply to various Islamic finance products such as *Musyārakah*, *Mudhārabah*, *Murābahah*, *Salam*, *Istisnā* and *Ijārah*. *Wakālah* as defined by AAOIFI as the act of one party delegating the other to act

[52] Paragraph 19: "In the extremely rare circumstances in which management concludes that compliance with a requirement in an IFRS would be so misleading that it would conflict with the objective of financial statements set out in the Framework, the entity shall depart from that requirement in the manner set out in the paragraph 20 if the relevant regulatory framework requires, or otherwise does not prohibit, such a departure."

[53] Clause 5.2 spells out that Islamic bank and Islamic business unit are obligatory to submit to Bank Indonesia a financial report that consists of yearly balance sheet and profit and loss complete with its notes to the accounts which are reported according to 'generally accepted Islamic accounting principle' (as prepared by IIA), as well as other necessary reports, with format and within time frame specifically regulated by Bank Indonesia regulation.

on its behalf in what can be subject matter of delegation. As IFIs act as agents for their customers therefore the fees charged are allowable for IFIs and shall record them as their income. In Indonesian Islamic bank's financial report, it is reported as "Income from banking service fees" under "Other business income."[54] The method of how to record the fees is still debatable as to whether it is wise IFIs to recognize the fees in full at the beginning of the contract or to divide it proportionately according to the period of the contract. In *Murābahah* profit proportional method, the administration fees (including the *Wakālah* fees) is absorbed by IFIs as their income at the beginning. However, under the new Bank Indonesia accounting guideline, the annuity method permits Indonesian Islamic Financial Institutions (IFIs) to recognize it proportionately (PAPSI, 2013). This is in line with IAS 18 para 14 that states that "The recognition of revenues for financial service fees depends on the purposes for which the fees are assessed and the basis of accounting for any associated financial instrument. The description of fees for financial services may not be indicative of the nature and substance of the services provided. Therefore, it is necessary to distinguish between fees that are an integral part of the effective interest rate of a financial instrument, fees that are earned as services are provided, and fees that are earned on the execution of a significant act." In AAOIFI, there is no specific standard for profit or fees recognition similar to IAS 39/IFRS 9.

3.5.3.3 Profit Recognition

Profit recognition in Islamic financial institutions is subject to type of contract as IFIs offer not only credit financing but sale and buy, rental, and services. For sale and buy contract, for instance *Murābahah*, AAOIFI specifies that the *Murābahah* profit is recognized at the time of contracting if the sale is cash. If the sale falls on credit sale, there are two methods to recognize the profit; proportionate allocation of profits over the period of the credit whereby each financial period will carry its portion of profits irrespective of whether or not cash is received (preferred method); or as and when the instalments are received (AAOIFI, 2010/1432H, p. 106).

As IIFIs refer to *Shariah* Statement of Financial Accounting (SSFAS) 102 for *Murābahah*, the IIFIs should recognize their profit in two ways; On the delivery of goods if it is cash or instalment not later than one year (similar to AAOIFI); or the whole period of contract with the conditions to level of risk and effort if the period is longer than one

[54] *PENDAPATAN USAHA LAINNYA*/OTHER BUSINESS INCOME
Pendapatan imbalan jasa perbankan/Income from banking service fees   XXX
(see Financial Report, Bank Syariah Mandiri 2012).

year. Given understanding to level of risk and effort, there are three methods to recognize the *Murābahah* profit i.e. profit shall be recognized on the delivery of *Murābahah* asset - this can be exercised if the risk to collect payment is low and expenses on financing administration is relatively small; the second method states that the profit shall be recognized proportionately - this is exercised if the risk to collect payments and expenses on financing administration[55] is relatively high; and the third method suggests that the profit shall be recognized when the whole profit has been collected and this is the most extreme case, see Technical Bulletin for SSFAS 102 paragraph 23 for more details (IAI, 2013). The technical bulletin does not specifically approve the annuity method raised in this bulletin; rather, it suggests the users to further refer to other relevant standards such as SFAS 55 (Financial Instruments; Recognition and Measurement), SFAS 50 (Financial Instruments; Presentation), and SFAS 60 (Financial Instruments; Disclosure). The issue of annuity method used in the profit recognition is discussed in Chapter Five.

The annuity method that considers time value of money in the profit recognition has been debated; particularly whether this method follows the way conventional bank recognizes its interest income for the sake of recognizing early profit. As far as IAS 18 (Revenue Recognition)[56] Paragraph 14 is concerned, it states that revenue from the sale of goods shall be recognised when all the following conditions have been satisfied: 1) The entity has transferred to the buyer all significant risks and rewards of ownership of the goods; 2) The entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold; 3) The amount of revenue can be measured reliably; 4) It is probable that the economic benefits associated with the transaction will flow to the entity; and 5) The costs incurred or to be incurred in respect of the transaction can be measured reliably.

In relation with profit, there are two types of profit sharing reserves i.e. Profit Equalisation Reserves (PER) and Investment Risk Reserves (IRR). PER is taken from profits before applying the profit-sharing distribution to the customers and IRR is reserved from part of the profits allocated to investors to absorb losses and that these activities are known as part of income smoothing in the earning management term. In *Mudhārabah* contract, should any losses occur will be borne by *Rabbul māl* (the owner of the fund, in this case fund owners/depositors of Islamic banks). Nevertheless, for the sake of ensuring competitiveness, the Islamic banks do not charge the losses to the owner of the fund, instead, they use the PER and IRR (known as displaced commercial risk in IFRS term).

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[55] Such as *Penyisihan Penghapusan Aktiva Produktif* or Allowance for Possible Losses on Earning Assets.

[56] From Shariah point of view, revenue recognition or profit recognition does not constitute any dispute.

However, Indonesian IFIs prohibits PER as it is against Shariah principle (AOSSG, 2010, p. 71). Whereas, IAS 39/IFRS 9[57] does not recognize loss sharing to the customers and the law of the country such as Companies Act in the United Kingdom, as stated by Amin (2009) that "the decisions taken regarding regulation imply a government view that all customers depositing money with UK licensed banks should be entitled to be repaid in full unless the bank becomes insolvent." This statement implies that Islamic banks are not allowed to offer profit and loss sharing investment accounts due to fixed repayment entitled by the customers for any investment activities conducted by the banks. In this case, loss sharing is perceived as an act that is against the rights of the customers. It may be true in the sense that there are no controlling institutions that can observe IFIs which may not act based on faithfulness entrusted due to them. Although, it is clear that in Islam, God underlines the importance of trust in Qur'an *Al-Baqarah* (2): 283: *"…and if one of you entrusts another, then let him who is entrusted discharge his trust [faithfully] and let him fear Allah , his Lord. And do not conceal testimony, for whoever conceals it - his heart is indeed sinful, and Allah is Knowing of what you do.…"*

Ascarya (2010) finds in the case of IIFIs, profit and loss sharing financing is not a preferred mechanism due to several factors. The internal factors are technical IT difficulty, Standard Operating Procedures (SOP) required-revision, and lack of commitment from top management of the Indonesian IFIs whereby the external factors show that lack of government support towards law amendment and inadequate trust from the public to the IIFIs. There are certain requirements to be resolved for the profit and loss sharing mechanism to be practiced such as the role of IFIs' supporting institutions. Learning from the success of Malaysia in promoting its Islamic finance, the role of government is utmost important, at least through the active role of Bank Negara Malaysia that has provided conducive environment and supported the establishment of some important financial infrastructure. For instance, the establishment of such as International Financial Services Board (IFSB) in 2002 and International Islamic Liquidity Management (IILM) in 2010; the set-up of International Centre for Education in Islamic Finance (INCEIF) in 2005 and International Shariah Research Academy (ISRA) in 2008 (see Chapter Seven). This is shared by a model of civilization proposed by Ibn Khaldun on the role of government in civilization which provokes the development can be achieved through the role of Government, G = f(S, N, W, j and g). This explains a civilized society is supposed to be led by the political authority (G) which is influenced concurrently by factors such as the

[57] IFRS 9 on Financial Instruments is going to replace IAS 39/IFRS 9 projected effectively starting from 1 January 2015.

direction of Shariah (S), the role of people (N), the use of wealth (W), the development of a country (g), and the promotion of justice (j) (Chapra, 2008b).

3.5.3.4 Classification of *Mudhārabah*

FAS 3, AAOIFI differentiates two types of *Mudhārabah* investment contracts i.e. Restricted Investment Account (RIA) and Unrestricted Investment Account (URIA) where the difference is on the control imposed by the fund owners on how the fund shall be invested by the *Mudhārib* or the parties who manage the investment (IFIs). FAS 3 disclose RIA as off-balance sheet item as it is neither asset nor liability while URIA is presented as a special class of equity. However, IAS 32 divides the financial instrument into liability and equity and does not recognize such *shirkah* (partnership) concept. Similar to AAOIFI, SSFAS 105 on *Mudhārabah* also separates two types of *Mudhārabah* investment contracts. The motivation of conducting *Mudhārabah* comes from a hadith narrated by Ibn Majah from Shuhaib, "Prophet Muhammad (P.B.U.H.) said: *There are three things that contain a blessing: not buying and selling in cash, Muqaradah (Mudhārabah), and mixing smooth with millet grain (coarse grain) for domestic purposes, not for sale*." This unique classification of *Mudhārabah* is one of the reasons why IFIs should adopt different standards than of IFRS.

3.5.3.5 Classification of *Ijārah*

Under IAS 17, there are two classifications of leases i.e. operating lease and financing lease. The difference is subject to the risks and rewards between lessor and lessee. *Ijārah* refers to an arrangement under which the lessor leases equipment, building or other facility to a client at an agreed rental against a fixed charge, as agreed by both parties. This type of leases can be regarded as operating lease that has no conflict with IAS 17 as it does not transfer all the risks and rewards to the ownership. Besides *Ijārah*, AAOIFI states other form of *Ijārah* that is *Ijārah Muntahia Bittamlīk* (hire purchase agreement) that refers to a leasing contract which includes a promise by the lessor to transfer the ownership either at the end of the term or by stages during the term of the contract (FAS 8, *Ijārah* and *Ijārah Muntahia Bittamlīk*). The latter cannot be considered as financing lease under IAS 17 as it transfers all risks and rewards to ownership. In other words, there is no such thing as transfer of risks and rewards to the asset ownership in Islamic leasing. Other term of Islamic hire purchase is *Ijārah Thumma Al-ba'i* that refers to a leasing which subsequently followed by a sale contract in which upon expiry of the leasing period, the hirer enters into a second contract to purchase the goods from the owner at an agreed price. This *Al-Ijārah*

Thumma Al-ba'i (AITAB) type of contract is popularly practiced in Malaysia, however Abdullah and Dusuki (2012) criticize that the AITAB is carbon copy of the conventional hire purchase and it is not complied with Shariah. As for its accounting treatments that have been implemented by all Malaysian Islamic banks have no difference from conventional hire-purchase in which the Islamic banks do not recognize asset and expenses, thus, the financial statements do not truly and fairly reflect the Shariah rights and obligations of the parties (Shiyuti et al., 2012). Although Malaysia has enjoyed massive development in Islamic finance as compared Indonesia,[58] Shariah element as suggested by Ibn Khaldun must be ensured at all times. This is what lacking and has become the biggest challenge faced by the Muslim nations particularly in the developing countries. They are less consistent to adhere with Islamic practices according to Shariah (Antonio and Mukhlisin, 2013).

3.5.3.6 Sukuk

Sheikh Taqi Usmani, Chairman of Shariah Advisory Board of AAOIFI states that nature of Sukuk transaction practiced in the market that adopts *Mudhārabah* and *Musyārakah* format is not complied with Shariah (Bi, 2008). Nevertheless, AAOIFI has earlier issued a Shariah standard regarding definition of Sukuk that states "Sukuk are certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity" (Paragraph 2 of page 307 of AAOIFI Shariah Standards 2006). AAOIFI also revised FAS 25 from formerly referred as "Investment in Associates" in 1993, then modified as "Investment in Sukuk, shares, and similar instruments" in 2011 (See Table 3.2.1). There is contradiction between Shariah opinion of the Chairman of Shariah Advisory Board of AAOIFI that is supposed to become a basis to issue standards with the action of AAOIFI Shariah Standards Review Committee and Shariah Standards Committee in this case. As a result, this standard caused confusion that can be seen from the following illustration.

In *Mudhārabah* Sukuk, the investment represents the ownership of units of equal value in the equity of the *Mudhārabah*. The Sukuk holders provide capital for the Shariah compliant investment activity that is undertaken by the investment agent. The investment

[58] In terms of Islamic banking and finance industry growth as a whole, the total was recorded at USD 1.357 trillion in 2011; Indonesia recorded USD 5 billion in 2010 increased to USD 9 billion in 2011 while Malaysia documented USD 120 billion in 2010 and improved to USD 131 billion in 2011(GIFR, 2012, p. 45). With regard to Islamic Finance Country Index, Indonesia was on the 4th ranking in 2011 and moved down to 7th ranking in 2012; Malaysia maintains its 2nd ranking in 2011 and 2012 after Iran, out of 42 rankings The index is formulated based on total Muslim population, number of Islamic financial institutions, number of Islamic banks, size of Islamic financial assets, size of Sukuk, regulatory and legal infrastructure, central Shariah Supervisory Board, and education and culture (GIFR 2012, p. 219-222).

agent is paid an agreed fee out of any profits derived from the business activity. While in the *Musyārakah* Sukuk, the investment represents ownership of *Musyārakah* equity and any profits derived from this transaction are distributed between the issuer and the originator at an agreed ratio. Sheikh Muhammad Taqi Usmani firmly argues that both formats breach Shariah principles because they provide the issuer with a purchase undertaking to buy back the underlying assets from the issuer at face value on the expiry date of the Sukuk or in the event of a default (Bi, 2008). In other words, the credit on Sukuk was based on the credit worthiness of the provider of the purchase undertaking and not the assets underlying the Sukuk. This relates to an understanding as to whether assets backed and/or assets based are acceptable in Shariah, which in the case of the above *Mudhārabah* and *Musyārakah* Sukuk the asset backed is selected. It means there should not be any physical asset offered in the agreement. If IFIs follows IFRS for evaluating value of Sukuk , according to IAS 39/IFRS 9, Sukuk or Islamic bonds held for trading and available for sale where an active market no longer exists would have to be measured based on nett present value using interest rate, which is not in accordance with Shariah (Haniffa, 2011). In Indonesia, SSFAS 110 stipulates that Sukuk transactions are allowed to use *Ijārah* and *Mudhārabah* formats, both as issuer or investor. In the case of Sukuk issued by government, the government assets transferred to a special purpose entity.

Maurer (2010) critically sees the development of Islamic finance in Indonesia is haunted by neoliberal reform that relaxes the rule of Shariah such as in the case of Sukuk financing, where Shariah compliance is in form only but not in substance. With regards to neoliberal issues, Lehman et al. (2013) state that neoliberal governments are associated with a discourse of targets, best practices, costs and cost benefits which provides the framework within which individuals, groups and agencies are given freedom and autonomy to act. The issue of relaxing the Shariah law puts AAOIFI in difficult situation on how it can accommodate. AAOIFI is only responsible to release its standard but cannot "penalize" when any IFI is practicing the opposite (whether Sukuk is asset backed or asset based and the recognition of asset ownership during the leasing period). The debates over Sukuk financing and its accounting have not reached any uniformed solution that firmly states standard for Sukuk which is truly accordance with Shariah. AAOIFI standard on Sukuk (FAS 25) that clearly pronounces how Sukuk should be treated seems incompatible to many countries. Perhaps, AAOIFI should follow its Chairman of Shariah Advisory Board that has affirmed if Sukuk using *Mudhārabah* and *Musyārakah* platforms is not permitted under Islamic finance concept. As an international body, AAOIFI fails to clarify the Shariah implications and provide solution towards any controversial accounting practice in the Islamic finance industry, such as the case of Sukuk issuance in Indonesia.

According to Maurer (2010), the case of Sukuk financing in Indonesia was seen as a tool to pressure liberalization of the economy through privatization of state resources where the details of transactions seem to diverge from the true Shariah principles (see Chapter Four for discussion on neoliberalism in Indonesia).

3.5.3.7 *Takāful*

IFRS 4 that was issued in March 2004 with effective date 1st of January 2005 is considered inapplicable for *Takāful* (Islamic insurance) industry (Ibrahim, 2007). Apart from its philosophy and definition, there are several transactions that differentiate the *Takāful* industry with that of insurance companies such as the issues of *Qardul Hasan*, and separation of *Takāful* entity and *Takāful* fund. From definition, traditional insurance is about risk transfer whereas the basic principle of *Takāful* is about risk sharing (solidarity). *Takāful* should also free from *gharar* (uncertainty), which differentiates it with Western insurance foundation. As they are principally different, it is not possible to reconcile them as it is the cornerstone of each system (SOCPA, 2010). Unlike insurance company, *Takāful* is a mutual protection scheme where the underwriting fund does not belong to the *Takāful* company but to the policyholders, therefore there should be two accounting entities (Siswantoro and Ibrahim, 2012). Moreover, the *Takāful* firm must disclose shareholders' funds and policyholders' funds in its financial report (Hidayat, 2010). While under IFRS 4, there is no such recognition of entity in entity concept as the risk is simply transferred to policyholder to the insurer. Insurance related standards are covered under IAS 39/IFRS 9, Financial Instruments that pronounce recognition, measurement, and disclosure of assets and liabilities of the company. With the reference of SSFAS 108 on *Takāful*, Islamic insurance companies in Indonesia apply *Wakālah* (representation) contract while *Takāful* based on *Mudhārabah* contract is prohibited. AAOIFI spells out the standards for Islamic insurance on FAS 12 (general presentation and disclosure), FAS 13 (disclosure of bases for surplus and deficit), FAS 15 (provision and reserves), and FAS 19 (contribution). However, AAOIFI is currently reviewing its accounting standards on *Takāful* that is expected to complete by second half of 2013 (AAOIFI, 2012).

3.5.3.8 Classification and Measurement of Zakat and *Qard*

Zakat or Islamic tax specifically presented on Statement of Sources and Uses of Funds in the Zakat and Charity Funds. The accounting treatment for Zakat is measured under FAS 9 for Zakat of AAOIFI standard that highlights the sources and uses of the fund. Para 2/2 of this standard spells out that the sources of Zakat are from Islamic bank that should treat it as an expense and shall include it in the determination of net income in the income statement of the entity, other than the account holders. Zakat base is calculated at 2.5% for a lunar calendar year or 2.5775% for a solar calendar year, using either one of the two methods i.e. net asset method and net invested funds method.[59] However, the standard lacks of insistence as it provides room for the Islamic banks to comply or not to comply. The standards offer three options as to whether the Islamic banks should satisfy the obligation i.e. in the event of the entity is required by law, by its charter or law, or by shareholders' approval. Therefore it is an option for an entity to apply Zakat accounting. This is related to the *fiqh* understanding about obligation of paying Zakat that is understood as liability of a person not an entity. According to Islam, each individual has an obligation to pay Zakat. The importance of such rule described in the Qur'an, which refers the word Zakat in 82 separate verses, and has associated Zakat immediately after prayer on 32 occasions. Qur'an *Al-Ma'idah* (5): 12: "*I am with you. If you establish prayer and give Zakat…*" In Shariah interpretation, the word "you" refers to individual and not entity, thus Islamic banks are not obligatory to pay zakat.

In the case of Indonesia, the IIFIs pay Zakat from their profit and also collect Zakat from public and their customers. However, acceptance towards Zakat that must be paid by the entity comes from the *fiqh* understanding that Zakat is paid on behalf of the shareholders of the entity. In addition, AAOIFI also states that the Islamic bank is not obliged to pay Zakat if the Islamic bank acts as agent in meeting the Zakat obligation. IFIs in Indonesia also follows similar standard i.e. SSFAS 109 on Zakat, *Infaq* and *Shadaqah* that was released on 6th of April 2010 after four-years debate with relation to another long-debate in the parliament on the enactment of Act No. 38 Year 1999 on Management of Zakat. As for *Qardul Hasan* or "*Qard*" is benevolent loan disbursed by the IFIs for non-commercial transactions, therefore there should not aim for profit but the loan can be undertaken as means to complete other commercial products (DSN-MUI, 2012/1433H, p. 597-598). Thus, in Islamic banks, *Qard* is applied in *Rahn* (pawn), *Hajj* Financing, Shariah Charge Card, *Hawālah*, Shariah Credit Card, and Shariah Factoring. In *Takāful* industry, *Qard* is transacted as a loan made to the *Takāful* fund in order to cover a deficit in that fund after exhausting any contingency reserves (SOCPA, 2010). FAS 1, AAOIFI stipulates

[59] Statement no. 2/1/1 (a) states that using net asset method, the Zakat base equals to Assets subject to Zakat – (liabilities that are due to be paid during the year ended on the date of the statement of financial position + equity of unrestricted investment accounts + minority interest + equity owned by government + equity owned by endowment funds + equity owned by charities + equity belonging to not-for-profit organizations excluding those that are owned by individuals (para 3). Statement no. 2/1/2 (a) presents the net invested funds method as follows = paid-up capital + reserves + provision not deducted from assets + retained earnings + net income + liabilities that are not due to be paid during the year ended on the date of the statement of financial position – (net fixed assets + investments not acquired for trading e.g. real estate for rent + accumulated losses) (para 7) (AAOIFI 2010/1432H, p. 263-264).

presentation of financial report of IFIs to include Statement of Sources and Uses of *Qard* Funds, similar to Indonesian accounting standards for the IFIs i.e. SSFAS 101.

The standard presents that one source of *Qard* fund is derived from Non-halal income. Perhaps, it was due to the wider scope of users of this standard that formulates not only for the interest of the IFIs but also the Zakat institutions. Unlike MASB that excludes both *Qard* and Zakat from the required reporting components of the IFIs that is as argued by Siswantoro and Ibrahim (2012) that MASB is in the effort to reflect the standards following the IFRS. As far as IAS 39/IFRS 9 on Financial Instrument is concerned, the standard does not recognise such loan without commercial profit for the IFIs. If MASB does not recognize *Qard* and Zakat in the standards, therefore there is no so much difference between Islamic banks and conventional banks and then why the Islamic banks should bear the Islamic title. As the IFIs are responsible to achieve social objectives by improving social condition of the societies where they operate, the importance of promoting Zakat and conducting good deeds are essential. Zakat and *Qard* as well as Non-halal transactions are information related to justice, environment, morality and ethics, which are also important elements needed to be disclosed in the financial reports of IFIs to promote the message of accountability to Allah and society (Haniffa and Hudaib, 2011, Ibrahim and Yaya, 2005, Adnan and Furywardhana, 2009). Furthermore Zakat is one of the five binding pillars in Islam, as follows: *Shahadah* (belief or confession of faith), *Ṣalāt* (worship in the form of prayer), *Ṣawm Ramadhān* (fasting during the month of *Ramadhān*), Zakat (alms or charitable giving), *Hajj* (the pilgrimage to Mecca at least once in a lifetime). The true Muslim believers are obliged to fulfil all the binding pillars to ensure their faith is in accordance with Islam.

3.6 Literature Gaps

From the above literature review, there are three main gaps that have been identified and required further research exploration; 1) AAOIFI's strategy in developing its standards and the degree of IIFIs comply with AAOIFI accounting standards; 2) The level of IFRS, AAOIFI, and ISSFAS comply with *Maqāsid ul-Shari'āh*; and 3) The extent of the International Islamic Financial Architecture (IIFA) support the role of Islamic based financial reporting for IFIs.

3.6.1 AAOIFI's Strategy and Compliance Issues

It is evident from the review of the above literature on AAOIFI development and compliance that some elements such as the philosophy and practical sides have explained the need to have a reformed AAOIFI as international accounting standard setter for IFIs by several measures i.e. internal and external settings. Within the internal setting, AAOIFI is examined using Strengths, Weaknesses, Opportunities, and Threats (SWOT) analysis approach introduced by Humphrey and team in 1960s (Humphrey, 2005). SWOT analysis helps mapping the problems why AAOIFI fails to become a successful international accounting standard setter for IFIs. Secondly, the other literature gap measures the extent of IIFIs on its adoption or adaptation to AAOIFI accounting standards. This literature is discussed in Chapter Five that adopts institutional isomorphism with institutional Arena Concept developed by Smith et al. (2011) and Political Economy of Accounting theory discussed by Tinker and Neimark (1987) as well as Critical Realism perspective argued by Modell (2014). The Indonesian institutional arena framework on IFRS proposed in Chapter Four is brought forward to Chapter Five as the analysis tool. Lastly, semi-structured interview is best to describe empirical evidence from experts who are aware with the policy setting in the Islamic finance industry.

3.6.2 IFRS, AAOIFI, ISSFAS and Maqāsid ul-Shari'āh

The Indonesian Institute of Accountants (IIA) in joint effort with National Shariah Board – Indonesian Council of Ulama and Bank Indonesia has been issuing standards for the IIFIs: 1) During the establishment of the first Islamic bank called Bank Muamalat Indonesia (BMI) in 1992 was established; 2) During the period when SFAS 31 on Banking was modified to suit the need of BMI reporting requirement; and 3) During the time when SFAS 31 was replaced by SSFAS 59 known as accounting standards for Islamic Banking in 2002; and 4. After SFAS 59 was replaced by SSFAS 101-107 in 2007 which is known as accounting standards for Islamic Business Entity. However, there is no recognition whether the reporting standards employed by the IFIs in Indonesia i.e. SSFAS 101-107 have been fully complied with Shariah. Likewise, there is no evidence if the financial reporting standards issued by IASB and AAOIFI have been fully complied with Shariah. Therefore, it is timely to conduct a content analysis with reference to *Maqāsid ul-Shari'āh* perspective to evaluate which standard that is highly complied with *Maqāsid ul-Shari'āh* that can be recommended as the future model of financial reporting standards for IFIs. *Maqāsid ul-Shari'āh* is broken into three main components: educating the individual, promoting justice, and catering for public interest (Abu Zaharah, 1997, p. 364). This approach is considered as more systematic way to group the elements of Shariah in the content analysis. This literature gap is discussed within *Maqāsid ul-Shari'āh* concept as informed by Abu Zaharah (1997) in Chapter Six.

3.6.3 International Islamic Financial Architecture

In practice, IFIs rely on several institutions (which is later known as International Islamic Finance Architecture/IIFA) to promote their growth and to keep them sustainable. AAOIFI is one of the institutions that has been setting standards and providing guideline on Shariah, accounting, auditing, governance, and ethics for IFIs. From the literature, AAOIFI has not been influential to ensure the standards are in use particularly its accounting standards. After AAOIFI is evaluated is Chapter Five, there is a need to review roles of other institutions under the IIFA (i.e. Liquidity Management Centre in Bahrain, International Islamic Liquidity Management (IILM), General Council of Islamic Banking and Financial Institutions (GCIBFI), Islamic Financial Services Board (IFSB), International Islamic Rating Agency (IIRA), International Shariah Research Academy for Islamic Finance (ISRA), International Islamic Financial Market (IIFM), Arbitration and Reconciliation Centre for Islamic Financial Institutions (IICRA)) towards the implementation of financial reporting standards. Vice versa, it is important to highlight the role of financial reporting standardization in ensuring sustainability of IFIs. A library study supported by a semi-structured interview with several experts proficient in the field is appropriate methodology to analyse this literature gap. In addition, institutional isomorphism combined with Critical Realism theory is adopted in order to interpret the social actions occur in the emergence of the institutions. Retro diction in Critical Realism perspective explored by as is used to simplify the understanding of the theory that was initially developed by Bhaskar and Archer. This literature gap is delivered in Chapter Seven of this thesis.

Appendix 3.1: List of Karim's Works

Journal/Book	Title	Authors, Year	Citation[60]	Research Recommendation/Summary
Journal of Business Finance & Accounting	Islam and 'social accounting'	Gambling & Karim, 1986	64	The traditional Western double-entry based accounting technology is well-suited to an orthodox, positivist society of any kind, and it is proving inadequate for an integrated Islamic world-views.
The American Journal of Islamic Social Sciences	The Shariah and Its Implications for Islamic Financial Analysis: An Opportunity to Study Interactions Among Society, Organization and Accounting	Tomkins & Karim, 1987	16	The full paper is not found.
Arab Journal of the Social Sciences	Towards an understanding of the use of the financing mechanisms of Islamic banks	Karim & Ali, 1988	6	The full paper is not found.
Journal of Business Finance & Accounting	Determinants of the financial strategy of Islamic banks	Karim & Ali, 1989	24	This paper attempts to shed light on that important aspect of Islamic banks.
Accounting, Auditing & Accountability Journal	The independence of religious and external auditors: the case of Islamic banks	Karim, 1990a	43	It is necessary that through joint forces, SSB and external auditors are perceived to be independent to ensure the credibility of financial statements.
Accounting and Business Research	Standard setting for the financial reporting of religious business organisations: the case of Islamic banks	Karim, 1990b	23	The fear of Islamic banks of possible future intervention by their regulatory agencies in their current accounting practices seems to be the predominant factor that has motivated Islamic banks to establish a standard setting body to regulate their financial accounting and reporting.
Mansell London	Business and accounting ethics in Islam	Gambling & Karim, 1991	102	The full paper is not found.
Financial Accountability & Management	Credible organizations: Self-regulation v. External standard-setting in Islamic banks and British charities	Gambling, Jones, & Karim, 1993	28	The common feature of accounting for charities, Islamic banks, and governments, is the absence of agreement over the inherent moral justification of their financial activities, thus requires assurance.
Advances in International Accounting	The impact of a non-cognitive factor on the performance of accounting students: a third world perspective	Karim & Ibrahim, 1994	1	The full paper is not found.
Journal of Administrative	Accounting aspects of profit	Karim, 1994	3	The full paper is not found.

[60] Number of paper citations as per 09/09/2013.

Appendix 3.1: List of Karim's Works

and Economic Science	allocation methods between shareholders and investment account holders in Islamic banks			
Accounting and business research	The nature and rationale of a conceptual framework for financial reporting by Islamic banks	Karim, 1995	31	The more the FAOIBFI sets accounting standards that incorporate religious ruling, the less it would tend to find its own objectives and concepts useful. The ambiguities that may arise from different interpretations of the religious rules will require resolutions primarily by reference to religious rather than accounting authority.
International Journal of Bank Marketing	The impact of the Basle capital adequacy ratio regulation on the financial and marketing strategies of Islamic banks	Karim, 1996	15	It develops four possible scenarios for the treatment of profit sharing accounts.
Research in Accounting Regulation	Agency theory, corporate governance, and the accounting regulation of Islamic banks	Archer & Karim, 1997	11	The full paper is not found.
Journal of Management and Governance	Financial contracting, governance structures and the accounting regulation of Islamic banks: an analysis in terms of agency theory and transaction cost economics	Archer, Karim, & Al-Deehani, 1998	34	Three main ways to mitigate deficiencies in IAH governance; reduce Islamic Banks' discretion to manage IAH's return; increase monitoring; generalisation of hostage posting.
New Horizon	Islamic finance and standardisation of accounting for Islamic financial institutions	Karim, 1999	N/a	The full paper is not found.
International Journal of Theoretical and Applied Finance	The capital structure of Islamic banks under the contractual obligation of profit sharing	Al-Deehani, Karim, & Murinde, 1999	41	It provides new dimension to the theory of capital structure.
The International Journal of Accounting	International accounting harmonization, banking regulation, and Islamic banks	Karim, 2001	56	The calls to use IASs as a vehicle to achieving international harmonization of financial reporting must not go unchallenged. Rather, the case of Islamic banks casts light on the need to develop and implement accounting

Appendix 3.1: List of Karim's Works

				standards that specifically cater for the unique characteristics of the contracts.
Euromoney Books and AAOIFI	Islamic finance: innovation and growth	Archer & Karim, 2002	31	The full paper is not found.
Islamic Financial Services Board working paper	Capital adequacy for institutions offering Islamic financial services: regulatory rationales and key conceptual issues	Archer & Karim, 2004	7	The full paper is not found.
International Journal of Theoretical and Applied Finance	On capital structure, risk sharing and capital adequacy in Islamic banks	Archer & Karim, 2006	26	The full paper is not found.
The Company Lawyer	Corporate governance, market discipline and regulation of Islamic banks	Archer & Karim, 2006	9	The full paper is not found.
Handbook of Islamic Banking	Accounting standards for Islamic financial institutions	Archer & Karim, 2007	4	The full paper is not found.
Wiley.com	Islamic finance: the regulatory challenge	Archer, Karim (Eds.), 2007	33	The full paper is not found.
Journal of Banking Regulation	Risks in Islamic banks: Evidence from empirical research	Ariffin, Archer, & Karim, 2009	19	The findings show policy implications for the issue of transparency, with particular reference to risk reporting in Islamic banks.
Journal of Banking Regulation	Profit-sharing investment accounts in Islamic banks: regulatory problems and possible solutions	Archer & Karim, 2009	12	It explains problems of and offers solution to profit-sharing investment account holders.
Journal of Islamic Accounting and Business Research	Supervisory, regulatory, and capital adequacy implications of profit-sharing investment accounts in Islamic finance	Archer, Karim, & Sundararajan, 2010	12	The findings show the characteristics of PSIA can vary from being a deposit like product (fixed return, capital certain, all risks borne by shareholders) to an investment product (variable return, bearing the risk of losses in underlying investments), Second, DCR has a major impact on Islamic bank's economic and regulatory capital requirements, asset-liability management, and product pricing.
Journal of Banking Regulation	The structure, regulation and supervision of Islamic banks	Archer & Karim, 2012	1	The full paper is not found.

Chapter Four: Commitment of Indonesian IFIs to IFRS

4.1 Introduction

The objective of this paper is to explore the views on the adoption of IASB standards (known as IFRS) and whether it is seen as the way forward by the IFIs and IIFIs.[61][62] The motivation is to address the emerged gap in the existing literature where the specific socio-political background of these IIFIs influenced their specific operating and commercial characteristics. Bearing the "Islamic logo" as part of IIFIs' brand management suggests that these institutions follow Islamic law from the start of their business activities up to the production of their annual financial reports. Prior to the commitment to adopt IFRS, IIFIs prepare their financial reports partially based on eclectic set of accounting standards carefully borrowed from the International Financial Reporting Standards (IFRS), Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) standards or locally developed financial reporting standards. For the case of Indonesia, this is more suitable for the IIFIs where both financial reporting frameworks i.e. IFRS and AAOIFI did not adequately address in line with Indonesian religious and regulatory requirement. Hence, there is no one IIFI in Indonesia is fully adopting AAOIFI standards or IFRS but this way has worked for them as it gives flexibility to adhere to financial standards suitable for their brand names as well as other national requirements.

The history of the IIFIs adopting the international accounting standards goes back when the Indonesian government signed a loan agreement with the World Bank during the 1980s and 1990s.[63] The momentum to adopt IASs/IFRS re-emerged and strengthened when the President of the Republic of Indonesia agreed at G20 meeting in 2008 to fully adopt IFRS by early 2012 by all commercial institutions including IIFIs. The consequence of this agreement is that when the IIFIs lose their exclusive right for exemption resulting in

[61] A part of this chapter has been presented at Critical Perspective of Accounting Conference 2014 held in Toronto, Canada on 6th July 2014 with title of "*Is there a political economy of accounting in financial reporting standardization for the Islamic financial institutions?*"

[62] Research grant amounting to £2700 has been granted by Adam Smith Business School, University of Glasgow in April 2014 with the purpose to expand and publish the research in accounting journal.

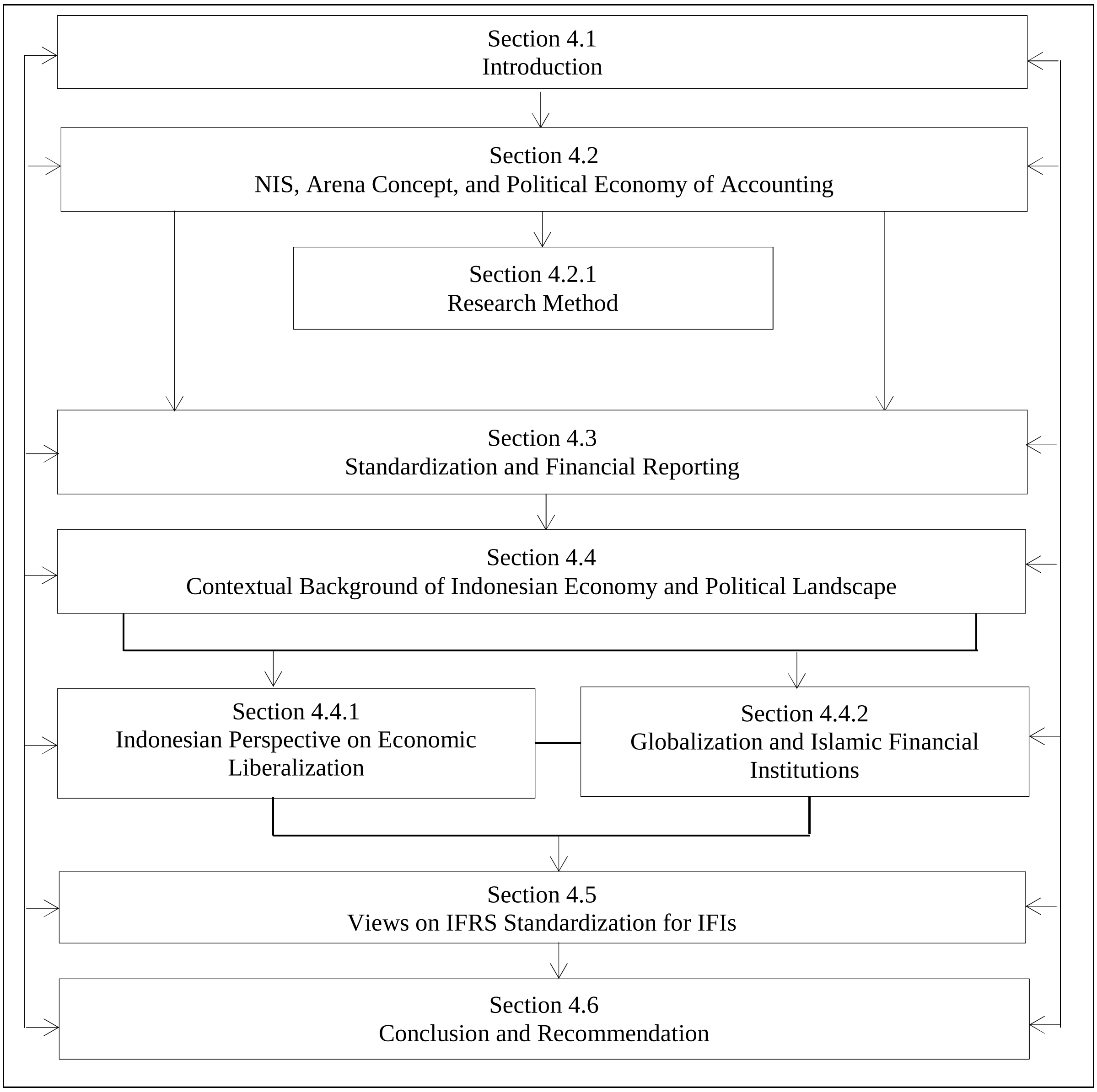
[63] Following the Country Assistance Strategy, the World Bank conducted a special project on accounting development (28th July 1988 – 30th June 1995 – one year extension) that had primary objectives such as: (a) to improve accounting practices: (i) in the public sector, by supporting the introduction of modernized government accounting practices, initially in the Borrower's Ministry of Finance and three other agencies, and eventually in all agencies; (ii) in the private sector by supporting the development of technical standards and a code of ethics for the accounting profession; and (b) to support the Government's program to raise the quality of accounting faculty and teaching staff, and to prepare for future expansion of accounting education and training. This project was continued and named as Second Accounting Development (1994-2000) that had objectives namely: (i) to support the Government's strategy to modernize government accounting systems, and (ii), to enhance the credibility and usefulness of financial information for private and public sector enterprises through the implementation of rigorous qualifying examinations for public accountants, a comprehensive set of accounting and auditing standards, and the enforcement of these standards.

transactions that will not reflect their true economic and religious substances, and the pressure is mounting; they are expected to also respond to this agreement by fully cooperating with what has become part of Indonesian statutory regulation. It must be one financial reporting framework that the IIFIs should abide by as International Accounting Standards Board (IASB) through its IAS 1 has clearly stated that it does not permit exemptions from in terms of presentation and disclosure requirements of any of its IFRSs. Therefore, an appropriate research question of this chapter is: to what extent do Indonesian Islamic financial institutions (IIFIs) have committed to adopt IFRS?

This chapter uses the Indonesian socio-political landscape and Arena Concept together with Political Economy of Accounting theory to analyse the commitment of IIFIs towards the adoption of IFRS. Library study is combined with semi-structured interviews with experts in the area that took places in the UK, Indonesia, and in the USA. The analysis focuses on how the adoption of IFRS has proceeded, who are the main actors involved in supervising the standardization of IIFIs financial reporting, and how the IIFIs position themselves against this ongoing process. From the interactions of the actors associate with the process of standardization, the study suggests that political and economic imperialist motive exists in financial reporting standardization in Indonesia. As the IIFIs are established to demonstrate their accountability for both shareholders and society, therefore, not only their operation must uphold the mutuality concept but also their reporting mechanism. This suggestion shows clear argument that the IIFIs should understand their distinctive characteristics as opposed to the conventional counterparts. There is no doubt that the distinctive characteristics must be treated differently. Since the conventional financial institutions have been in the existence for many hundred years, therefore the conventional system including the political and economic imperialist system is a complex system to adjust to the characteristics of Islamic finance.

The remainder of this paper is organized as follows. Section 4.2 proposes theoretical framework and research methodology, Section 4.3 reviews relevant literature on standardization while Section 4.4 delineates Indonesia as background and content of the study. Finally, Section 4.5 presents analysis on the views on IFRS standardization and Section 4.6 provides conclusion and recommendation. The following Figure 4.1.1 delineates the structure of this chapter.

Figure 4.1.1: Structure of Chapter Four



4.2 NIS, Arena Concept, and Political Economy of Accounting

As this study involves in identifying actions of those who involve in financial reporting standardization in Indonesia who are mainly referred by Smith et al. (2011) as "process of managerial and professional capture", Arena Concept is best to describe the scenario in the process of the standardization. The term "capture" is defined as possibility that powerful interests become institutionalized. The Arena Concept brings NIS to describe interaction among individual actions and institutions that are involved in the politics, and act either as the amplifiers, the setters and the industry at all levels (see Figure 1.51).

From Figure 1.51, it can be seen that the term institutional isomorphism of DiMaggio and Powell (1983) and Moll et al. (2006) that operates through three mechanisms i.e. coercive, normative, and mimetic, and normative has been extended to three levels: macro, meso and micro. Coercive isomorphism describes how external factors such as government policy, regulation or commercial pressures drive organizations to reflexively adopt certain regulations into their organization policies. While mimetic isomorphism calls for organization to follow other organization to select certain regulations, normative isomorphism creates specific response proposed by professional bodies or consultants. As explained in the Analytical Framework in Chapter One, the nature of this chapter is to seek evidences from reflexivity and resistance of IFRS that involve in three level influences in the institutional arena. The literature suggests political lobbying is the main key success factor in disseminating financial reporting standards, therefore, political economy of accounting perspective is employed in this chapter. This is in tandem with the argument from Cooper and Sherer (1984) that an understanding is required on how accounting systems operate in their social, political and economic context in order to design 'better accounting system'. They identify three features of a political economy of accounting such as 'power and conflict' in the society, specific historical and institutional environment of the society, and the adoption of a more emancipated view of human motivation and the role of accounting in society. These characteristics match with the Arena Concept that introduces capture possibility that powerful interests become institutionalized in all three levels of financial reporting standardization may take place, such as indicated by (Tinker and Neimark, 1987). Both characteristics and definition are appropriate to explore a complex situation that deals with IFIs with various forces that may be captured such as elites, classes in the society, government, and other 'social protagonists' interested in wealth and power distribution.

4.2.1 Research Method

In order to achieve the objectives of this Chapter, Arena Concept as informed by Smith et al. (2011) is operationalised through the use of a semi-structured interview with 18 relevant respondents from academia, regulatory bodies, accounting standard setters (IASB, AAOIFI, and The Indonesian Institute of Accountants (IIA), practitioners working in Islamic financial institutions and Shariah scholars (Appendix 4.1 for Plain Language Statement and Appendix 4.2 for Interview List with their coded credentials). The interview guide (IG) was prepared and tested through a pilot interview session (see Appendix 4.3 for the IG).[64] Two terms of interview took place in Jakarta, Indonesia in July 2012 and July 2013 as well as in London, United Kingdom in February 2013. During the

[64] The IG consists of several sets of questions to capture all research questions addressed in Chapters Four and Five.

interview, the ethical procedures were carried out with medium language of English, Indonesian, and mixed with Arabic terms, Qur'anic verses and terms with a duration of one hour at average. For language other than English was translated by a professional English translator. A cluster of concepts with specific meanings attached to Indonesian accounting regulation environment with keywords economic liberalization, politics, economy, standard setters, and Islamic financial institutions. In analysing the interview, thematic analysis method is adopted following Braun and Clarke (2006) that refers to three level of factors influencing the standardization suggested by Smith et al. (2011) i.e. macro, meso, and micro levels.

4.3 Standardization and Financial Reporting[65]

Perks (1993) defines financial reporting standardization as one set of rigid and narrow rules for financial reporting practices. The term of standardization in accounting practice was first introduced in the United Kingdom in and then found its way to the United States economic reports in 1946 (Suzuki, 2003, Suzuki, 2007). The effort to standardize and harmonize the accounting practices were first started by Price Waterhouse In 1973, by classifying accounting practices of different countries into different clusters. It was followed by other researchers proposing more accurate classifications (see for example, Nair and Frank (1980); Goodrich (1982); Nobes (1983); Berry (1987); Doupnik and Salter (1993)). According to d'Arcy (2001) these efforts later on became important source of reference by parties interested in the international harmonization of accounting practices. However, the call for accounting standardization also came from various sectors i.e. intergovernmental transnational bodies, international development agencies such as the World Bank, tax authorities throughout the world and labour unions (Nobes & Parker, 2010, p. 82).

The standardization creates a conflict of interests between specific interest groups, both from within and outside the profession (Susela, 1999). Several studies show disagreement over the implementation of a form of standardized reporting, such as in developing countries (see Rosser (2003); Zeghal and Mhedhbi (2006); Perera and Baydoun (2007)). As a developing country, it is argued that the accounting reform in Indonesia took place during the World Bank loan on accounting development project in 1988 and 1994 that ended with the adoption of IAS as stated in the World Bank loan documents (No. Loan 2940-IND and CPL-3801O; SCL-3801A; SCPD-3801S). The reform

[65] Under this section only a summary of literature is presented but for detailed review please refer to Chapter Two.

was then continued through IMF loan prescribed conditions with political intervention during the financial crisis of 1997-1998 (Rosser, 2003, p. 267). The conditional term in the loan agreement specified that IAS must be adopted by Indonesian government agencies and listed firms. Like nation states, World bank and IMF attempt to govern and regulate action in distance (Neu et al., 2006). In addition, Indonesian reaction towards standardization is also examined from other view such as Robison (2004) who ironically describes it as a way to bring the country closer to the neoliberal camp. This issue is further elaborated in Section 4.4.

The literature suggests several advantages for standardizing financial reporting practices such as establishing better capital market discipline (Jeanjean and Stolowy, 2008), improving quality of financial accounting (Ball, 2006, Barth et al., 2008) and enhancing forecast accuracy of financial information (Cheong et al., 2010, Schleicher et al., 2010, Horton et al., 2013). On the contrary, there are also studies that highlight the disadvantages associated with standardizing accounting practices such as increasing risk (Papadamou and Tzivinikos, 2013), opening space for accounting manipulation (Ball, 2006), and bearing high cost (Kim et al., 2012, De George et al., 2013). Studies that argue for IFRS are those related to countries enforcing strong governing, such as the study on Kenya (see (Bova and Pereira, 2012). The study documents the usefulness of adopting IFRS and suggests that Kenyan firms are to be given economic incentives in order to obtain higher level of compliance. Meanwhile others argue that standardizing international financial reporting is not needed, as it benefits only certain users (Nobes and Parker, 2012), and it also neglects the country's social, cultural, and institutional setting, as well as the role of influence by the politic and economic institutions (Cooper, 1980, Lehman and Tinker, 1987, Susela, 1999). In other words, accounting is no longer considered as a neutral device that merely captures and reports the facts of economic activity (Hopwood and Miller, 1994). From these literatures, it is discovered that the standardization process of financial reporting in Indonesia has been influenced by the active role of those steering the direction of the economy, especially those who believe that the neoliberal economic model is the way forward for the country. This becomes evident in the series of events that emerged from further reflection of the Indonesian financial reporting standardization projects.

The Indonesian financial reporting standardization process can be classified into four periods, the first one being accounting development program I in 1988-1994. This period encompasses the issuing of the first international accounting standards in 1975. The second period, accounting development program II, occurred in 1994-2001, during which time the Indonesian Financial crisis (1997-1998, the third period) also took place, and in

2012 when Indonesia declared full adoption of IFRS (the fourth period). However, for Indonesian Islamic financial reporting standardization, there are three periods of standardization that took place subsequent to the establishment of the first Islamic bank in Indonesia: 1) 1992-2002 SFAS 31; 2) 2002-2007 SSFAS 59; and 3) 2007-present SSFAS 101-107.[66] The case of standardization of financial reporting for the IFIs in Indonesia is deliberated in the following section.

4.4 Contextual Background of Indonesian Economy and Political Landscape

Indonesia is a democratic, non-Islamic country by legislation, located in Southeast Asia and Oceania along the archipelago that is consists of 17,504 islands with 34 provinces.[67] In 2010, the total population was 238 million, of which 85% were Muslim (Minister of Religious Affairs, 2010).[68] Indonesia is considered to be the country with the highest Muslim population; every 250 Muslims have access to one mosque or place where they can conduct their religious activity. This is to shows the concern of government and local community for there to be worshipping places for Muslims. Indonesia is a founding member of ASEAN, a political and economic organisation that was established in 1967. Its member countries increased from five to ten in 1998, and it has been a member of the G20 major economies since 1999. Indonesia is endowed with rich natural resources, including crude oil, natural gas, thermal coal, geothermal, cocoa, tin, rubber (of which it is the world’s largest producer) and palm oil (of which it is the world’s largest exporter). Indonesia is renowned for its easy mineral resource extraction compared to South Africa, Australia and Canada, and it is home to a biodiversity that is second only to Brazil (BKPM, 2013).

Thus, Indonesia was many decades ago a target for extraction of natural resources by colonial powers, such as the Dutch, who controlled Indonesia for about 350 years, followed by the Spanish and Portuguese power masters. It was the Japanese occupation at the height of the World War II, and the Japanese’s subsequent defeat by the American forces, that facilitated Indonesian independence in 1945. Giving the Dutch colonial history of systematically absorbing Indonesian wealth, it is not surprising that even with such abundant resources, the acute poverty remains widely spread throughout the country.

[66] Statement of Financial Accounting Standards (SFAS) and Shariah Statement of Financial Accounting Standards (SSFAS).

[67] The newest province that has been officially declared is North Kalimantan, separated from East Kalimantan in 2013.

[68] The population was 179 million in1990 increased to 206 million in 2000.

According to Indonesian Statistics Indonesia, the poverty rate of Indonesia was 12.49% in 2011, which means there are about 30.02 million Indonesians who live with less than one dollar a day (it was 13.33% in 2010).[69] The figures vary somewhat, for instance with the statistics of the World Bank, which reported poverty using headcount ratio of people with income less than two dollars a day. With this ratio, the poverty rate in Indonesia reached 43.3% in 2011, which is slightly reduced from 46.1% in 2010. However, realizing that the total population was also increased by 3% from 2010 to 2011, the reduction in the poverty rate does not seem to make any difference.

The Indonesian economy has in recent times also experienced turbulent and challenging times, such as severe natural disasters and political or bureaucratic malfunction and corruption, which lead to several economic and financial crises. The latest and biggest tragedy of natural disaster was the Indian Ocean tsunami in 2004, which swept away approximately 250 thousand of people, as well as the strong tectonic earth quake in Yogyakarta in 2006 that destroyed thousands of properties. According to the National Development Planning Agency (NDPA) Republic of Indonesia, the tsunami itself caused financial losses of about USD 4.5 billion to Indonesia (Tempo, 2005). With regards to corruption, there are 559 investigation cases related to 1,842 defendants that have been processed by the Corruption Eradication Commission (CEC) since it was established in 2003. The year 2011 is considered to be the highest, with 78 cases. These corruption cases caused the country to lose USD 14.6 billion by 2013 (Tempo, 2013). The problem of corruption in Indonesia must be seen as a structural problem of politics and misuse of public power, rather than a sign of cultural or moral decay.

Clearly Islam, the religion that the majority of Indonesians follow, prohibits deviation from formal rules and democratic deficit in power-sharing, accountability and transparency, as stated in Qur'an *Al-'Araf* (7): 55-56: *"Call upon your Lord in humility and privately; indeed, He does not like transgressors. Do not make mischief on the earth after it has been set in order…"* and continued in separate verse, Qur'an *Al-'Araf* (7): 85*: "…There has come to you clear evidence from your Lord. So fulfil the measure and weight and do not deprive people of their due and cause not corruption upon the earth after its reformation…."* The deduced meaning of corruption from these verses is the annihilation of trustworthiness, the deception of the rules and processes that are ought to be adhered to for the purpose of achieving personal self-interest (Syam, 2013). Islam combats all types of corruption, as highlighted in the following hadith: *"Allah curses the bribery giver, the taker and the person who becomes the middleman*" (Hadith narrated by Ahmad and

[69] The World Bank puts the poverty headcount ratio at two dollars a day with 43.3% of the population on poverty line (reduced from 46.1% in 2010).

Abdullah bin Amr'Rhadiyallahu 'anhuma). Fighting corruption is also considered as religious duty, which must be carried out by Muslim scholars and preachers to call for abolishing corrupted transactions, abuse of trust, collusion and dishonesty among individuals during Islamic gatherings and motivational programs. In 2000, a motivational program called "Emotional and Spiritual Quotient (ESQ) Training" was set up by a group of individuals who care about this phenomenon and it has been well accepted by both Muslims and non-Muslims in Indonesia.[70]

The worst economic crisis to hit Indonesia took place during 1997-1998, where the Rupiah was significantly depreciated to just 80% of its original value as it shrunk from Rp.4,850/USD on 14th of August 1997 to Rp.17,000/USD on 22nd of January 1998 (SEAsite-Indonesia, 1998).

Table 4.4.1: Indonesian Economic Growth 1996-2000

	1996	1997	1998	1999	2000**
			(Percent change)		
Real GDP Growth	8.2	1.9	-14.2	1.5 to 2.5	3 to 4
Consumer prices (period average)	5.7	12.9	64.7	-0.6	5.4
			(Percent of GDP [minus sign signifies a deficit])		
Central government balance	1.2	-1.1	-2.2	-3.3	-4.8
Current account balance	-3.4	-0.9	4.4	3.1	1.9
			(In billions of US dollars)		
External debt	127.4	135.0	149.9	147.6	149.1
			(Percent of GDP)		
External debt	54.5	163.1	129.0	91.0	86.9

Sources: Indonesian authorities and IMF staff estimates (IMF, 2000).
Notes:
*Fiscal year, which runs from April 1st to March 31st.
**Program, budget for April 1st to December 31st.

The crisis seriously attacked many companies that obtained un-hedged and short-term offshore loans in in foreign currencies, mainly US Dollars, and the condition worsened when the companies rushed to buy dollars. As indicated by Table 4.4.1, the economy had shrunk from a positive GDP growth of 8.2% in 1996 to -14.2% in 1998, in addition to a massive increase of the inflation rate to 64.7% per year. The financial institutions suffered huge losses and pleaded for bailouts, and the government decided to seek financial assistance from the IMF, World Bank, ADB and other bilateral institutions.

[70] The founder, Ary Ginanjar Agustian declares the program is designed to achieve the vision of Golden Indonesia 2020. Sugiharto, a newly appointed Minister for State-Owned Enterprises issued a letter in 2004 "recommending" that employees of all state-owned enterprises in Indonesia to complete the ESQ training program (Rudnyckyj, 2009). To date there are nearly 1.3 million alumni of the ESQ. The ESQ program also provides free recharge program for the alumni as they have to maintain the spirit and motivation. However, there is no research on the impact of this training for instance towards elimination of corruption cases or work efficiency.

With a bailout package commitment of USD 49.7 billion[71] to restore the market, Indonesia had to agree to a list of conditions from the creditors, including cutting down government subsidies, raising more taxes, and increasing interest rates that turned the currency crisis into a banking crisis. IMF claims that the bailout contributed to the Indonesian economic recovery signed by the increase in output growth, decline in interest rate, stronger exchange rate and higher reserves from 1999 onwards (IMF, 2000). However, several researchers criticized IMF's attempt saying that it failed to stabilize the crisis, instead inflaming the situation due to inappropriate remedy (Pincus and Ramli, 1998). In addition, Basri (2013) commented that "the IMF 'over-managed' the crisis by demanding extreme fiscal austerity and excessive policy conditionality while also displaying a lack of political sensitivity at key periods." Instead for these conditions to stabilize Indonesian economy, IMF policies had caused the economy to be worse off and experience a downturn trend (Stiglitz, 2007, p. 34). In the financial crisis periods, accounting regulations in Indonesia had been changed to follow the IAS due to the loan commitment and this was further strengthened during the bailout process.

Political Landscape and Instability

In contrast, the political ideology governing Indonesia seemed to be isolated from any required economic reform. For more than three decades, the country had been ruled by Soeharto and his cronies, consisting of a small group of people (family and friends), who had mixed their public and private affairs for personal gains. By the time the financial crisis eventually occurred, they had dragged the country to more widespread socio-political crisis. In March 1998, Soeharto formed a new cabinet dictated by the IMF to gradually reduce government subsidies until October of the same year. However, the economic situation deteriorated, and demonstrations in the streets of Jakarta called for the president to step down and for his cronies to be held accountable for their political abuse and rampant corruption.[72] Due to the increasing pressures, after 33 years in power, Soeharto finally stepped down and handed over the Presidency to Vice President Bacharuddin Jusuf Habibie. During Mr Habibie's time, the fourth agreement for new funding with IMF was signed, despite the wider budget deficit. The rupiah became stronger and the crisis started to ease up, including the inflation rates, stock exchange, and non-oil exports. In the

[71] Only USD 21.9 billion was disbursed as per 30 May 2000 (44%)

[72] The biggest riot occurred in an area called "Glodok" the business centre owned by elite Chinese close to Soeharto's family and who were responsible in distorting the economy in order to create rents that they can siphon off funds marked for country's massive infrastructure and social and economic development.

following year (1999), Indonesia rolling up to the major economy ranking and recruited as G20 member country.

Basri and Rahardja (2010) reckon that economic liberalisation and privatisation of public companies were introduced during the 1998 crisis as part of reforming the old corrupted economic structure. The reform also included getting rid of private monopolies and the elites from Soeharto's cronies, who were profiting from the widespread corruption. In terms of the monetary and fiscal policies, the plan was to float the exchange rate of the local currency and open the country for global trading regime. However, economic liberalisation had significantly contributed to the increase of corruption in the country by facilitating new opportunities for opportunists. Unfortunately, the economic liberalisation and free trade were operating in the country, but without adequate safeguards of accountability and transparency to restrict corruption and power abuse. Nevertheless, in 2008 the government introduced the financial stress test and other stabilizing mechanisms, such as reliable accounting information aimed at supervising the global liberalization trade with Indonesia (Basri, 2013).

4.4.1 Indonesian Perspective on Economic Liberalization

According to Martinez and Garcia (1996), there are five characteristics of neoliberalism, namely the rule of the market, cutting public expenditure for social services, deregulation, privatization, and eliminating the concept of "the public good" or "community". The market exercises its rules to regulate any business including the international business that is free to enter in this globalization era, with a campaign that aims to benefit all people as the effect trickles down. Cutting public expenditure for social services such as education and health care are one of the highest expenditures that the government should bear, and this is one government function that neoliberals believe should be demolished. As the government should lessen its power to regulate the market and rule the people, the neo-liberals must safeguard their interests to ensure that they gain the highest benefits possible by disallowing the government to issue any regulations against them. Therefore, they are very conscious on any government initiative or any new regulation. They are also willing to make an attempt to influence the government into altering the existing regulations if they find them unfavourable. State-owned enterprises and provision of essential goods and services are considered inefficient in the hands of public entities; hence they should be managed in more professional way, for example through privatization. Common targets for this argument are banks, key industries, railroads, toll highways, electricity, schools, hospitals and water. Public goods or public community should be rephrased to individual responsibility, as everyone has an equal right to compete and accept the fact that he may be a winner or a loser. Lastly, the neoliberal group assumes that poverty is not caused by the environment, but caused by the individuals themselves who are not efficient in managing their life. It is concluded that neoliberalism is instrumental discourse that mystifies, justifies, naturalizes and universalizes inequality and elite economic status (Merino et al., 2010).

However, the emerging of such a liberal economic regime was not unprecedented. Ten years after its independence, Indonesia and other developing countries from Asian and African continents initiated a commitment in the Asia Africa Congress in Bandung, Indonesia, to be independent in the economy. They also agreed to form a Non Align Movement (NAM) at the dawn of the US and USSR (Soviet Union) Cold War, to ensure their freedom in developing their respective economies. With the spirit to fight against imperialism and neo-colonialism, these countries were trying to save their economies by means of protecting their resources and building cooperation within the member countries. The movement is in tandem with the spirit spelled out by the United Nations on Universal Declaration of Human Rights as a foundation of freedom, justice, and peace in the world. However, neoliberalism is somehow so obscure that cannot be simply accused for betraying the charter, especially when it offers financial merits as so called tools of development to many of these newly independent and often poor countries. Therefore, Indonesia and the rest of member countries were unable to refuse development aids controlled by the World Bank and International Monetary Fund, which opened the path to globalization and economic liberalization. Furthermore, the impact of export expansion from the US to Indonesia (1950s and 1960s), and the Ford Foundation scholarship for Indonesia in the 1950s have sharpened the existence of neoliberalism model in the Indonesian economy. However, it still creates the question as posted by David Harvey below:

> How and why neoliberalism emerged victorious as the single answer to this question is the crux of the problem we have to solve. In retrospect it may seem as if the answer was both inevitable and obvious, but at the time, I think it is fair to say, no one really knew or understood with any certainty what kind of answer would work and how (Harvey, 2005, p. 13).

The term “neo-liberalization” has been debatable, as some argue that it does not exist and it is likely associated with political tension. Therefore in this Chapter, the term that refers to open or borderless economy, as well as globalization or liberalization is used interchangeably. Many researchers highlight the impact of economic liberalization as somehow unfair to the majority of the people, particularly in developing countries. They seem to argue against economic development that puts priority on liberalization and demand for justice towards the common people, who are severely affected by this regime. For instance, at an intercontinental gathering in 1996 in Chiapas, Southern Mexico, about 3,000 people attended, crying out against economic liberalization. They were mostly activists, representing countries in Western Europe, America, Asia, Oceania, Africa, Japan, Iran, Zaire, and South Africa. Suharto (2004) argues that there are two sides of impact of the globalization, i.e. the good and the bad. The good aspect is that the economy becomes more accessible, and it promises increasing welfare for the people as trades between nations become possible. On the other hand, the invisible hand theory is seen as a myth, as the market is not always self-regulated, but rather dominantly under the control of certain groups of people. These groups are mostly economic powerhouses, multi-national companies and others that benefit most from the neoliberal pressures, as it promotes borderless trade. In the economy, the term ‘one size fits all’ refers to the nature of the liberalization, and this has been considered unacceptable. “Whether it is scholarly, ideological, or policy forms, economic liberalism is narrow because it tends to treat economic issues ahistorically and detached from their political and social contexts” (Klak, 1998, p. 17). Indonesia has been facing liberalization in economy at the global (through WTO), regional (through ASEAN), as well as the bilateral level (such as with individual countries, for instance Australia). The protest towards multi-national companies is emerging in Indonesia and other parts of the world. In Indonesia, the labour union of Carrefour, a giant retailer imported from France, craves for better treatment towards the workers, including converting their status from contract based to permanent employees. Keeping employees on contract base is one method practiced in the liberalized economy to maximize the profit, by eliminating social and economic burdens. Tesco, a British multinational grocery chain is even criticized by small British grocery operators, who are pasting the slogan in their shops “Say No to Tesco, Support Local Stores!”

It is very likely that this free market competition only benefits a handful of people. Cooper et al. (2010) argue that the economic liberalization creates the phenomenon where the rich are becoming richer and the poor are becoming poorer. In addition, Damanhuri (2008) also argues that the positive side of the liberalization of economy is that it is promising and offers wider opportunities for even the poorest to seek their economic blessing. The negative side is that it may abandon a country that is located in the periphery capitalism world. Damanhuri continued to assert that this is due to the control over international infrastructures, such as modern technology that is not owned by all people, for example those living in the peripheral regions. As such, it will only benefit those who have access to the technology. It has been emphasized earlier that “the neoliberal development model has brought about a massive deterioration of living standards, growing income disparities, environmental destruction, an erosion of national sovereignty and the undermining of equity-producing policies" (Nef & Robles, 2000, p. 18).

Actors in the economic liberalization

The global economic regime that controls financial and political elites in the economic liberalization is in the hands of the International Monetary Fund (IMF), the World Bank (WB), and the World Trade Organization (WTO) (Klak, 1998, p. 36). The policy themes of these organizations, particularly IMF and WB, are derived from a well-known consensus referred as the "Washington Consensus", which was initiated by John Williamson in 1989. The consensus includes ten broad sets of policy recommendations: 1) Fiscal policy discipline, with avoidance of large fiscal deficits relative to GDP; 2) Redirection of public spending toward fields offering high economic returns and pro-poor services like primary education, primary health care and infrastructure investment; 3) Tax reform, adopting moderate marginal tax rates and broadening the tax base; 4) Interest rates liberalization; 5) Competitive exchange rates; 6) Trade liberalization; 7) Liberalization of inflows foreign direct investment; 8) Privatization of state enterprises; 9) Deregulation, abolition of regulations that impede market entry or restrict competition; and 10) Security for property rights. These ten policies have been severely criticised by Joseph Stiglitz, through his slogan "one size fits all", and by Dani Rodrik who referred to it as a mantra of "stabilize, privatize, and liberalize". The Washington consensus has waned in countries around the world, where it was used in Africa and Latin America, and the economies in transition have shown its failures (Stiglitz, 2007, p. 44). On the other hand, Williamson counter argues that his recommendations have been misinterpreted by referring them as neoliberal policies applied by Washington-based international financial institutions (WB and IMF), which led the countries to crisis and misery (Williamson, 2002).

World Bank

The World Bank was created after the 1944 Breton Woods Conference that was dominated by representatives from the United States and the United Kingdom. The Bank has evolved from facilitating post-war reconstruction in Europe, and later on development to alleviate worldwide poverty in more than 100 member countries. Indonesia started receiving the World Bank loan in 1968. It supported Indonesian infrastructure programs, such as irrigation, road building, agriculture, education, and water supply after the country's independence. As per 31 May 2012, the total principal loan has reached USD 18.9 trillion with total disbursement close to USD 13 trillion, which includes more varieties of loans designed for poverty alleviation, community empowerment, as well as loans for the financial sector and investment climate to reform tax and accounting systems (WorldBank, 2012).

International Monetary Fund (IMF)

IMF was also set up together with the World Bank in 1994, with the mission to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world. While the World Bank focuses on countries' infrastructure development, IMF concentrates on monetary stability issues. Indonesia has been a member since 21 February 1967, and started its major loan in 1997 (during the financial crisis). In 2006, the governor of Bank Indonesia announced that Indonesia has settled the IMF loan by making the statement "As of today we no longer have any more debts to the IMF, and we expect this will provide more room for Indonesia's economy to grow with more confidence and in a healthier fashion without being burdened by the IMF debt." (Jakarta-Post, 2006). Some years later, during G20 meeting in 2012, Indonesia made a commitment to loan the IMF a sum amounting to USD 1 billion, to support countries in financial trouble, as the IMF required USD 430 billion in total (VOA, 2012). However, it has been questioned why Indonesia extended this commitment, despite the country still suffering from its own foreign loan that floated up to USD 251.2 billion at the end of 2012.

World Trade Organization (WTO)

Initially, WTO was instigated by several developing countries for the purpose to improve their economic conditions through relying on raw materials. After the Asia-Africa Conference in 1955 in Bandung, participants such as India and Algeria proposed to form such a body, called WTO. After the North-South meeting, the developed countries tabled a commitment to open a market for the developing countries, which led to the growth of several countries in Asia. Meanwhile, the United States experienced a deep recession under Reagan's administration, and pursued a solution from the other countries. Then, during the meeting in Morocco, it was agreed to form a borderless trade to achieve universal welfare under the control of WTO. Prior to this commitment, IMF had been assigned to cater the monetary side and the World Bank had been authorized to ensure developmental aid for the developing countries. This would later become known as the trio "Global Super Body" (WTO-IMF-WB), allegedly employed by the developed countries to sustain their economic hegemony through accelerated globalization process. Damanhuri (2008) argues that the globalization way of WTO worsened the problem of unemployment through globalization of the labour force. He added that significant number of unemployment in Indonesia, reaching nearly 40 million people in 2007, was accompanied by the low quality and productivity of the labour force, due to Indonesia's incapability to compete in the free labour market.

Globalization, accounting and the persistence of corruption

It has been argued that the accounting reform through the adoption of IAS at that time occurred due to the Indonesian financial crisis of 1997-1998, when IMF and World Bank promised to attract foreign aids and investments to the country (Rosser, 2003; p. 267). In this context, the power of regulating accounting shifted from the politico-bureaucrats and their corporate and technocrats clients to IMF and World Bank. However, the politico-bureaucrats remained reluctant to relinquish their influence on accounting and pushed for accounting reforms. Therefore, adopting IAS was due to Indonesian's needs for international financial aid, and not a response from the local business environment. This was inevitable, because as a developing country that requires massive development, Indonesia very much relied on the financial donors such World Bank, and later on IMF. Through approving loans for Indonesia, the World Bank became the major source of influence for introducing the international financial reporting standards to Indonesia since 1977, reaching its full initiative in 1984. This IAS imposing effort was continued by IMF during the financial crisis in 1997-1998 and later on by G20 and ASEAN.

Group of Twenty (G20)

The G20 Group, a group of the 20 largest economies, was established in September 1999. It consists of 19 countries, plus the EU, and Indonesia is an active member.[73] The group brings together finance ministers and central bank governors in regular meetings to agree on several economic commitments for the betterment of the member countries. Being a member of the G20, Indonesia has followed the majority of the other countries in announcing public commitment for IFRS adoption in the 2008 summit. The seven notes about this commitment stated by IFRS foundation (IASB, 2013a) are as follows:

i) Unanimous commitment towards supporting a single set of high quality global accounting standards.
ii) Common commitment to regard IFRSs as the single set of global accounting standards.

[73] G20 includes Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, the Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, and the United States of America plus the European Union.

iii) There are 14 members that have declared that their public listed companies have adopted the IFRSs with remaining six that made reservations (India, Japan, USA permit IFRSs on voluntary basis, Saudi Arabia requires IFRS only for banks and insurance companies only, China has substantially converged its national standards to IFRSs, Indonesia has adopted some IASs/IFRSs but has not announced a timetable for full adoption).

iv) 14 G20 jurisdictions that have adopted IFRS; 11 require IFRSs for all, while Mexico and Argentina require IFRSs for all other than financial institutions, and Canada allows US GAAP for some and has deferred IFRSs for some others.

v) The G20 jurisdictions made very few modifications to IFRS and are said to steps in planning for full adoption. The five EU countries that join G20 made an optional "carve-out" from IAS 39.

vi) There are 18 jurisdictions that state conformity with IFRS in their auditors' reports, while China and Indonesia still record it as conformity with national standards.

vii) G20 jurisdictions have either adopted the IFRS for SMEs or are considering it.

ASEAN

The Association of Southeast Asian Nations (ASEAN) was established on the 8th August 1967 in Bangkok, Thailand, and currently has 10 member countries i.e. Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam. According to AccountancyASIA (2009), ASEAN Federation of Accountants (AFA) has encouraged its member bodies to implement IFRS for SMEs as this would render more benefits to the ASEAN member countries where small, medium and non-public interest entities are the backbone of the economies.

The above illustration shows how the Indonesian economy has followed the stream of the globalization of economy through multilateral and bilateral relationships. A country with rich natural resources but still suffers from inadequate infrastructure, corruption and a complex regulatory environment should be a consideration for Indonesia in ensuring its future direction. Adopting full IFRS raises the question, whether or not Indonesia will be able to promote better transparency and reliability, and henceforth combat corruption and shape a more disciplined regulatory environment. Another question is whether or not IFRS will produce a uniform picture of a real Indonesian economy including the IFIs, which will be of advantage only to the well-informed capitalists who extract the full potential of the Indonesian economy (asymmetric information). The next question would be whether by adopting IFRS makes it hard for the Corruption Eradication Commission to create local monitoring mechanisms for companies' activities, since these companies can claim that by adopting IFRS and being audited by an internationally recognised audit firm, their financial statements are free from material misstatements.

Following the issue of globalization in the economy, globalization from an outsider's (foreigner's) perspective refers to the dire and fierce global competition for products and employees of multinational enterprises (Cooper et al., 2010). However, from the local Indonesian perspective, globalization has a number of other meanings, such as the following:

i) It means that multinational companies with numerous marketing and financial transactions buy concessions, preferences, and offer kickbacks to local entrepreneurs that network with the decision makers of the country.
ii) It means accessing Indonesia would not happen without taking the economy towards a liberal market economy.
iii) Liberalised economy relies on a handful of individuals in society who have privileged access to business opportunities and financial resources. It creates a localised social class and supplies it with massive wealth in order to create more businesses and thus contributes to the economic growth.
iv) Under liberalised economy, businesses are managed by a few local entrepreneurs, not by public organisations and institutions. Therefore, economic growth and modernisation under the liberal economic model is considered as more important than democracy and transparency. Consequently, implicit corruption is largely seen as something that could "grease the wheels" of modernisation.
v) Liberalising the economy takes Indonesia to be dependent on, subservient to and exploited by multinational corporations through the local (political) elites. Corruption and underdevelopment would only persist. The solution would be to break with the liberalisation agenda and become a nation of self-generation, with endogenous growth and industrialisation policies.

In this study, the statements above become the central against the role of globalization and its impact on financial reporting, as well as on the Islamic financial institutions in Indonesia. The following section describes globalization and Islamic financial institutions.

4.4.2 Globalization and Islamic Financial Institutions

There are three platforms that relate to the background of this Chapter where Islamic transactions can be performed: in banks, insurance firms, and capital market.

Islamic banking industry

An Islamic bank is defined as an entity that abides by the principles of the Shariah (Islamic law), including the prohibition of interest and speculative behaviour, promotion of risk sharing mechanisms, and promotion of asset-based transactions (Askari et al., 2010). Islamic banking industry has contributed with the most substantial growth in the Islamic finance industry as a whole. Forty-eight developing and emerging market countries, representing almost one-third of IMF member countries, are increasingly involved, with varying intensity, in Islamic banking (Errico and Farahbaksh, 1998). In the Islamic Republic of Iran, Pakistan, and Sudan, all banks and financial institutions have adopted Islamic banking principles since the early 1980's, and other countries, such as Malaysia, Indonesia, Bangladesh, Jordan and Egypt operate Islamic banking alongside conventional banking (Maurer, 2002, GIFR, 2012b). Islamic banking is increasingly expanding beyond the traditional borders of Muslim countries into western economies, most notably into the United Kingdom (Errico and Farahbaksh, 1998). By the end of 2012 Indonesia had 11 Islamic commercial banks, 24 Shariah business units with 2,663 offices and 158 Islamic rural banks. It also recorded a growth of total assets from USD 828 million in 2003 to USD 20.14 billion (Bank-Indonesia, 2013)[74].

Islamic insurance industry

Islamic insurance is widely known as *Takāful*, which literally means mutual guarantee. In the *Takāful* model, participants or policyholders jointly agree to guarantee among themselves against any hazard or loss incurred during the insurance period. Each participant contributes to the pool of funds, which is separate from the company or investment fund, and the fund is used to pay for any loss or other events as agreed. The role of the insurance company is to manage this fund, and in addition to its own capital and part of participants' funds, invest in profitable activities as part of income generation and risk mitigation. The Islamic Insurance Company of Sudan is the first known *Takāful* firm, and was established in 1979. It was then followed by Malaysia, which adopted the ratification of *Takāful* Act in 1984 and launched its first Islamic insurance company, known as Syarikat Takaful Malaysia. In 1985, the Council of Islamic Scholars in Mecca approved *Takāful* as an Islamic alternative to the conventional insurance. This led to the establishment of other *Takāful* companies in Dubai, Bahrain, Saudi Arabia, Iran, Indonesia and Qatar (Swartz and Coetzer, 2010). To date, *Takāful* is a robust industry with a

[74] 1 USD = 9,920 as per 11 March 2012

recorded growth rate of 15-20 per cent per year. The total contribution of the industry was estimated to reach USD12 billion in 2012 from only USD2 billion in 2005 (Ernst&Young, 2011). Today, the *Takāful* industry in Indonesia has expanded to three *Takāful* life insurance firms, two general *Takāful* firms, 17 Shariah units of life insurance firms, 20 Shariah units of general life insurance firms, and three Shariah units of re-insurance companies.

Islamic capital market industry

The Islamic capital market evolved from the needs of customers and domino impact of Islamic banking development which is to manage funds more broadly. It comprises of money market for liquidity management of Islamic banks, as well as Islamic funds and equity markets that facilitate investment in stocks or equities and other instruments, such as Sukuk. The Islamic capital market is the fastest growing sector in the Islamic finance industry. This can be seen from the growth of the respective product and market. Islamic funds recorded a growth rate of 22% between 2000 and 2005: the Islamic capital market grew from only 16 funds in 1996, 150 in 2000, to more than 400 Shariah-compliant funds worth USD300 billion in 2005. Similarly, the Islamic equity fund has also recorded similar growth rate of 20% per year; with the total market capitalization estimated to be over USD300 billion in 2004. The growth of global Sukuk is even more impressive, increasing from USD7 billion in 2004 to over USD27 in 2007 (Ali, 2008). Today, Shariah based capital market trading in Indonesia has been enjoying rapid growth of capitalized asset of Rp. 2,618 trillion. That means 58.4% of total stock exchange capitalized assets (Rp. 4,485 trillion as per 29 October 2013) are traded through two boards of Islamic index prices, i.e. Jakarta Islamic Index and Indonesian Islamic Shares Index (detikfinance, 2013). Khan and Bhatti (2008) argue that the growth of the Islamic banking and finance industry has been facilitated by several factors, such as the increase of oil prices that stimulates the Middle Eastern economies; industry production innovation; encouraging response from conventional regulators; and the role of information technology. This indicates that the performance of Islamic finance so far has been contributed to by globalization as defined by Martin et al. (2006) earlier, referring to it as a global market where Islamic banking and finance has been engaged. Kuwait Finance House has branches in Malaysia; Al-Rajhi Bank invests in some offices in Sudan, Pakistan, and Malaysia; Bank Muamalat Indonesia has a branch in Malaysia and vice versa Maybank Malaysia converted a bank in Indonesia to become an Islamic bank in Indonesia.

It is undeniable that globalization has aided the development of Islamic finance. Prophet Muhammad (P.B.U.H.) also practiced his business across the borders: he had ample information about market demand, and therefore managed to make successful trades across states. These events have been heavily documented in such a way that what the Prophet has practiced in the business is being replicated by the present Islamic finance industry, such as buying and selling (*Murābahah*), owner-employee relationships (*Mudhārabah*), and partnerships (*Musyārakah*). The terms may not be odd in conventional finance, but what differs is these IFIs must strictly obey by Shariah principles when dealing with a business, although they are now in the trail of the globalized stream. One way of looking at the true form of Islamic finance would be through the use of resources for the welfare of the people within the framework of Shariah (Ayub, 2008 p. 31).

Financial reporting standard development in Indonesia

On the 17th of October 1957, a group of Indonesian accountants formed a committee called "Committee for Establishment of Indonesian Association of Accountants." The association was formally established on the 23rd of December 1957, and is now called Ikatan Akuntan Indonesia.[75] The association did not only focus on education and the practices of accountants, but also on the efforts of improving public trust in its role on formulating public policies. In 1974, the Committee for Indonesian Accounting Principles (IAP) was formed. The IAP served its function for 20 years to formulate and develop financial accounting standards in Indonesia.[76] After the 7th Congress of IIA on the 16th of September 1994, it was agreed that the Indonesian accounting standards would be harmonized to the International Accounting Standards (Cahyati, 2011). The decision of this congress was related to the World Bank loans (see Section 4.3). Since then, an issue has arisen due to duplication in name; The IAP was then altered to Financial Accounting Standard Committee (known as FASC). At the 8th IIA Congress held on the 23d and 24th of September 1998, FASC was again changed to Financial Accounting Standard Board-The Indonesian Institute of Accountants (FASB-IIA) and still exists till today (IAI, 2012). The IIA Rules and Regulation Act of 2008 designated FASB-IIA to formulate develop and approve financial accounting standards in Indonesia. The standards cover the basic framework, statements, application guides, interpretation, implementation guides and technical bulletins. The FASB-IIA membership is a representative of every association and compartment under IIA, government bodies, business associations, non-government

75 Ikatan Akuntansi Indonesia (IAI) or in English, Indonesian Institute of Accountants (IIA) (IAI, 2012).

76 "Rapid economic development in Indonesia, especially after the government program of deregulation and de-bureaucratization at the beginning of the 1980's, has resulted in an increased need for investment funds through various financing resources….. As this new development emerges, there is a need for a financial accounting standard to be used as a guide for the recording and reporting" (IAI, 1994).

associations, and non-competent professional members. As per Shariah standard, the board is referred to as Shariah Financial Accounting Standard Board (SFASB).

On the 23[d] of December 2008, IIA announced that the convergence of the local standard to the international accounting standard (IFRS) should be completed by 2012. Even though the decision of IFRS convergence was decided only in 2008, the pressure had been increasing over time, with Indonesia being the only South East Asian country in the G20 Forum. Compliance with IFRS is one of the commitments in G20, with a target for completion in mid-2011, which will be implemented in 2012 (IAI, 2010a, IAI, 2010b). In IFRS Regional Policy Forum 2011, IIA declared 2012 as the year for full adoption IFRS (IAI, 2011). In line with this commitment, FASB-IIA has been issuing new standards that are purely an adoption from the IFRS standards issued by IASB for the conventional sectors, including the conventional financial sectors. The following paragraph elaborates on the development of the financial reporting standards for the Indonesian IFIs.

Financial reporting standards for Indonesian IFIs

In Indonesia, the issuing of the accounting standard is through enactment of a company law. When Bank Muamalat Indonesia was established in 1992, there was no significant change in accounting regulations to cater for its main business and financial reporting differences. The bank was established under the Banking Act of 1992, which was amended in 1988 (Bank-Indonesia, 2012), and as such the accounting standards that should have been applied were those that existed during that time, i.e. the Statement of Accounting Standards (or SFAS 31). This was what all the commercial banking operating in the country was supposed to follow. The development of special financial reporting standards for the IFIs in Indonesia was started with the issuance of SSFAS No. 59 in 2002, which is also known as the Islamic Banking Accounting Standards. The SSFAS 59 was issued on the 1st of July 2002 by the IIA, taking effect starting the 1st of January 2003. It was implemented for only 5 years, up until the accounting year ended on the 31st of December 2007. The method used for creating SSFAS 59 was to take AAOIFI standards, apply some modifications thought to be suitable for the local context, and then adopt it. In 2008, the SSFAS 59 was replaced by SSFASs, the Statement of Accounting Standards for Islamic Business Entity. The new set of standards consists of SSFAS 101, 102, 103, 104, 105, 106 and 107, which were approved by the SFASB, as illustrated in Table 4.4.2 below.

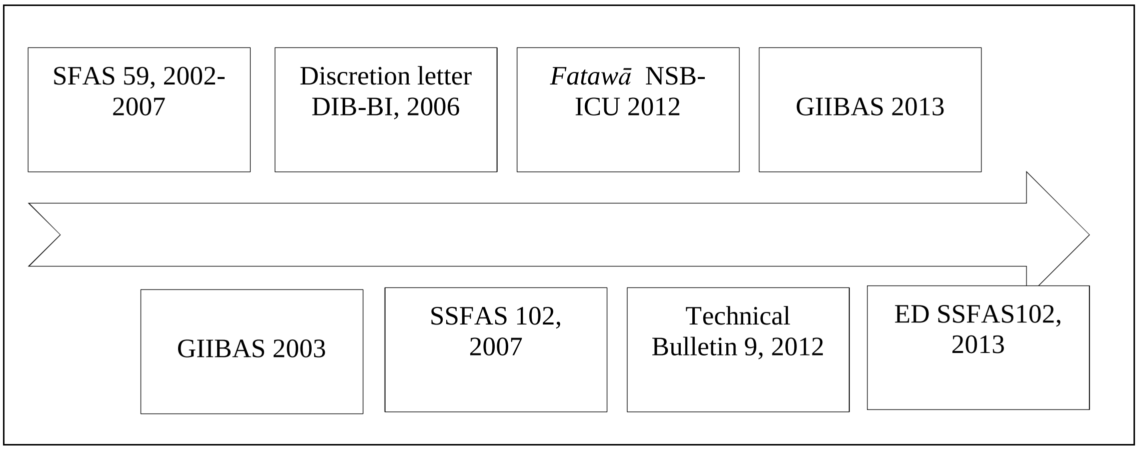
Table 4.4.2: Indonesian SSFAS for Islamic Business Entity

Standard	Description
SSFAS 101	Financial statement presentation
SSFAS 102	Accounting for *Murābahah*
SSFAS 103	Accounting for *Salam*
SSFAS 104	Accounting for *Istisnā*
SSFAS 105	Accounting for *Mudhārabah*
SSFAS 106	Accounting for *Musyārakah*
SSFAS 107	Accounting for *Ijārah*
SSFAS 108	Accounting for Islamic Insurance Transaction
SSFAS 109	Accounting for Zakat and *Infāq/Ṣadāqah*
SSFAS 110	Accounting for Sukuk

Source: (IAI, 2006).

The above standards cover not only the Islamic banking institutions, but also other institutions that offer Shariah compliant financial products and services. The following Figure 4.4.1 shows the chronological order of the events, from the release of SSFAS 59 in 2002 to the revision process of SSFAS 102.

Figure 4.4.1: Chronological order on revision process of SSFAS No. 102



Source: Current Study.

Notes:

SFAS	: Statement of Financial Accounting Standards
SSFAS	: Shariah Statement of Financial Accounting Standards
DPbS-BI	: Directorate of Islamic Banking – Bank Indonesia
GIIBAS	: Guidelines of Indonesian Islamic Banking Accounting Standards
NSB-ICU	: National Shariah Board – Indonesian Council of Ulama
ED	: Exposure Draft

In addition to the accounting standards, the Islamic Banking Directorate of Bank Indonesia issued guidelines in 2003, which functioned as technical interpretations to the adoption of the standards for Islamic banks (GIIBAS). GIIBAS 2003 was revised in 2013 in which one of the revision clauses has been debatable as it approves the *Murābahah* profit calculation mechanism using the annuity method; it means contradictive with the SSFAS 102, which only recognizes proportional based method. The release of GIIBAS 2013 was earlier supported by *fatawā* released by National Shariah Board – Indonesian

Council of Ulama, by approving annuity method as one way for Islamic banks to recognize profit. The issuance of the fatwa was due to the initiative from Islamic banking industry through its association, which voiced out the problem with the proportional method, as spelled out in SSFAS 59, and then later in SSFAS 102 as being the only method of recognizing profit.

Ilahiyah (2012) argues that the two main references of law, i.e. the Qur'an and the Sunnah, are not truly reflected in practices in understanding the epistemology of the Islamic economic concept. Instead, *fiqh,* the understandings of creative rationalization of scholars have become the common references. The products of Islamic finance are said to mimic the conventional non-Islamic products due to their similarities. To certain extent, mimicking the conventional products is acceptable, as long as the characteristics of the transactions do not violate the Islamic law. The products in Islamic finance have varied a great deal, however, and the Islamic theories and underlying Islamic law seem to be matched or modified without critical and systematic analysis concerning the implementation being conducted (Ilahiyah, 2012). Furthermore, El-Gamal (2007) argues that Islamic finance nowadays grows with motive for abnormal profit or rent-seeking, rather than through the mutuality concept that is supposed to be the foundation of Islamic finance. Therefore, financial reporting should restore the effort to re-mutualize the Islamic finance with the growth that will be shared among the stakeholders in the community.

Technically, accounting is a process of identifying, classifying, measuring, recording, summarizing, reporting and interpreting transactions of economic activities by simply following the nature of each transaction. The accountants and the rest of management at the Islamic financial institution are expected to understand whether nature of each transaction has been complied with Shariah. Under the context of Islamic accounting,[77] the process must be able to report and interpret the transactions of Islamic finance according to the corridor of Shariah. It has been a long debate about creating accounting in Islamic countries that centred on two options: whether to adapt conventional accounting and Islamize it or to build accounting based on the foundations of Islam, Qur'an and Sunnah. Due to political and economic non-Islamic policies being adopted by the governments of Islamic countries, the former seems more likely: it seems applicable to accommodate to the current demand of Islamic financial institutions and a financial reporting mechanism.

[77] Islamic accounting can be defined as the "accounting process" which provides appropriate information (not necessarily limited to financial data) to stakeholders of an entity which will enable them to ensure that the entity is continuously operating within the bounds of the Islamic Shariah and delivering on its socioeconomic objectives. Islamic accounting is also a tool, which enables Muslims to evaluate their own accountabilities to God (in respect of inter-human/environmental transactions) (Ibrahim, 2012).

Several scholars have attempted to build accounting based on Islamic foundations. They now criticize the current approach for financial reporting standards in Islamic financial institutions, which have been adapted in Indonesia, i.e. the AAOIFI and its offshoot of SSFAS (Triyuwono, 2004, Mulawarman, 2009, Ilahiyah, 2012). However, the criticism is on a level where it proposes the ideas to be translated from understandings of the Qur'an, without suggesting practical methods on how to make constructive changes in the direction and development of financial reporting standards in Indonesia. For instance, Ilahiyah (2012) presents her criticism that merely on cases highlighted by Asian-Oceanic Standard Setters Group (AOSSG) in its 2010 report on the issues in Islamic finance and how IFRS addresses the differences in transactions according to Shariah, and vice versa. The efforts to propose to base financial reporting on Shariah will be realized after IFIs are restored to the position where they really perform real Shariah based transactions in operation. Currently, the IFIs are criticized as being unable to operate on real Shariah principles. If the claim of El-Gamal (2007) is true on that critique, then the IFIs will never operate Shariah based financial reporting, but rather it will have a similar function to the IFRS, which is mainly to govern the interest of the shareholders and rent-seekers.

Notably, IFRS remains the only international standard that is globally recognized and offers a consistent and comparable accounting framework. It has been accepted in more than 128 jurisdictions as per 19 June 2013 (IAS-Plus, 2013d), see Chapter Two for details. As more and more IFIs in other parts of the world have adopted or plan to adopt IFRS (see study conducted by ACCA)[78], there is a need for Indonesian standard setter to conduct a careful analysis whether it is appropriate for the Indonesian IFIs to follow the action. A prediction following the movement may widen the opportunity for rent-seekers and greedy capitalists hence create more corruption and sharpen the poverty gap. The existence of the IFIs as one economic sector in Indonesia should satisfy the Indonesian Constitution Article 33, which emphasizes on promoting justice and the welfare of the people, particularly when related to management of state wealth.[79] Indonesia can perhaps

[78] ACCA based in the UK conducted a study in 2009 taking several countries with remarkable performance of Islamic banks in the world as proxies such as Bahrain, Indonesia, Kuwait, Malaysia, Pakistan, Qatar, Saudi Arabia, UAE and the UK. The report reveals that countries in this study, which adopt IFRS in their financial reports, are currently facing problems of inconsistencies due to unique transactions in Islamic banking that are not properly treated. ACCA (2010) suggests solutions on how the IFIs should deal with IFRS i.e. adopting IFRS with additional standards specifically to disclose Islamic financial transactions or setting up an Islamic accounting standard based on IFRS but would include specific recognition, measurement, presentation and other disclosure requirements.

[79] Article 33, 1) The economy shall be organized as a common endeavour based upon the principles of the family system; 2) Sectors of production which are important for the country and affect the life of the people shall be under the powers of the State; 3) The land, the waters and the natural resources within shall be under the powers of the State and shall be used to the greatest benefit of the people; 4) The organisation of the national economy shall be conducted on the basis of economic democracy upholding the principles of

learn a lesson by referring to Greece’s recent financial crisis and its attempts to recover. It is suggested that to overcoming Greece’s recent financial crisis was to adopt IFRS 9 on Financial Instruments, as some claimed early adoption would help ease the burden of the EU members' sovereign debt. However, others insisted that changing the accounting rules is not the answer (AccountancyAge, 2011). Therefore, this chapter has addressed an important issue regarding level of commitment of Indonesian IFIs towards IFRS adoption given a case study of Indonesian economy and political climates. In an attempt to answer the research question of this chapter, the following section delineates analysis of the study by incorporating empirical findings extracted from interviews.

4.5 Views on IFRS Standardization for IFIs

As mentioned in the introduction, the objective of this paper is to explore the views on the adoption IFRS and whether it is seen as the way forward by the IFIs and IIFIs. NIS is employed to explain how isomorphism emerge through the interactions of coercive, i.e. how external forces impose rules on IFIs to adopt financial reporting standards, and mimetic, i.e. how IFIs may follow their counterparts in other countries to adopt IFRS, as well as normative interactions, i.e. how IFIs adopt or plan to adopt the standards through influences of dominant professionals/consultants. All these three interactions are examined at three different levels: macro (system perspective), meso (structural perspective), and micro (actors’ perspective). The output of the interviews describes the responses about the consequences of globalization in economy and its impact on Indonesian IFIs, the concerns about IFIs adopting IFRS, and how doing so may be the cause of more miserable economic conditions for Indonesia.

Macro Level

It appears that at macro levels, accounting standardisation has been stimulated by the globalization project, in which global omnipresent competition requires universal standardization in financial reporting standards. This is to facilitate opening new markets, and to have free inflow and outflow of financing activities through common information presented in the financial reports. The views of the pros and cons regarding this issue are mixed. Interviewee I-23 expressed his view regarding the opportunities and threats involved in the globalization of Indonesia:

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togetherness, efficiency with justice, continuity, environmental perspective, self-sufficiency, and keeping a balance in the progress and unity of the national economy; and 5) Further provisions relating to the implementation of this article shall be regulated by law.

> The Indonesian government has created several opportunities for facing the globalization: opening the export market (with various regional cooperation i.e. AFTA in 2015, APEC in 2020, ACFTA in 2010) for hundreds of products and services, right from products requiring high technology (such as planes) and products requiring low technology (snacks) (I-23).

And

> The threat of globalization is that because Indonesia has some limitations, such as quality of human resources, technology capacity, competitiveness, and issues with governance. The readiness of the partner countries is also an issue. Indonesia has, in the end, imported products, services, and experts from the partner countries rather than exported them. In addition, the "rubbish" caused by globalization, such as negative aspect of Western habits, industrial waste, drugs, and trafficking, which is not relevant for the nation can easily sneak in (I-23).

However, Interviewee I-24 responded in a softer way, saying that globalization is an opportunity, not a threat to Indonesia:

> In my opinion, globalization is not a threat, it is actually an opportunity. Through free trade, terms of trade are predicted to increase, and the welfare of the society, too. So far, the government has taken the right steps, but there are a few miscalculations in paradigm. For instance, the Special Economic Zone (SEZ) policy is unnecessary, as Indonesia is already an open country. China has been successful with its SEZ policy because generally China is a closed country; SEZ limits investment to certain places. As a result of SEZ, Shenzhen, which was underdeveloped, is now one of the most important hubs in Asia, even in the world. Thus, government should focus on several variables of gaining from the globalization effectively, i.e. the infrastructure, education, the quality of human resources, macroeconomic conditions, and governance (I-24).

The statements above show that the state plays an important role in laying out the economic policies, and it should be able to anticipate the consequences to protect the national interests, securities, and identity. However globalization is something that one cannot ignore: globalization disregards exclusiveness, including that of IFIs. Interviewee I-09 stated his opinion on the subject:

> We live in a global world, whether we like it or not all transactions, including Islamic banking transactions, must be globalized (I-09).

Being a member of G20 major economies, Indonesia has taken crucial steps towards entering into a global economic world, where Indonesia is involved in formulating international economic policies together with other member countries. G20 created a momentum in changing accounting standards of all member countries, when all of them unanimously declared full IFRS adoption during the first Countries' Leaders Meeting held in Washington in 2008. With special interest as to how declaration was joined by the President of Republic of Indonesia, Susilo Bambang Yudhoyono, Interviewee I-20 described the event:

> There are three levels of meetings in G20: the Countries' Leaders Meeting, the Finance Ministers' and the Central Bank Governors' Meeting, and a Unit Head Meeting. In 2008, the first G20 Leaders' meeting took place in Washington, D.C., when all the leaders voted for full IFRS adoption. […] Usually prior to the meeting, each country would propose an agenda to be discussed. The agenda may come from the central bank, the State Ministry of National Development Planning, or the Indonesian Capital Market Supervisory Agency.[80] If Indonesia has similar concern with other countries, these countries will discuss the matter over e-mail thoroughly before the meeting (I-20).

Joining the declaration for full IFRS adoption in the G20 meeting, or following international accounting standards is not something that has occurred suddenly. In the country's background, stated above, it is documented that Indonesia agreed to standardize its accounting to IAS, back when the World Bank extended two stages of loans for accounting development in 1984 and 1994, and continued the IMF loan agreement in 1998. Interviewee I-13 confirmed the record by saying:

> The declaration in the G20 meeting [about IFRS adoption] is not something new; it is a part of the Post-monitoring program from the IMF loan in 1998, which was then endorsed as a President Decree in 2004 (I-13).

As elaborated in the Section 3, Indonesia has taken major loans from IMF to recover from its economic disaster after the financial crisis. The loan has strict demands that Indonesia must satisfy certain conditions that led Indonesia to adopt mainstream neo-liberal financial policies (Graham and Neu, 2003). However, this financial reform was considered a 'failure', as it attempted to restore the economy through inappropriate remedies (Pincus and Ramli, 1998). However, as Indonesia's economy was considered to have potential in the long run, the country was selected as member of the G20 countries in 1999, in response to the Asian financial crisis as well as the Brazilian and Russian economic crises. Interviewee I-01 stated that the role of Indonesia in G20 in the case of IFRS adoption may not be dominant:

> In the context of the conversion (to IFRS), Indonesia jointly followed the majority in the decision. It is not because Indonesia is ready in 2012, but rather because there is no other option. Sooner or later we have to follow either way, if not, we will be excluded or under the macro context, and then we will not benefit at all. Why we actually joined the G20 is more about political economy than anything else (I-01).

This shows that the influence of super power countries in the G20 has coercively led the decision of Indonesian leaders to follow the interest of the majority, even though it may not be relevant for Indonesia. This includes the commitment expressed by Indonesia to extend USD 1 billion in to IMF in 2012 for securing the countries that are in financial

[80] who are under purview of Ministry of Finance.

difficulties, which was done even though Indonesia was still itself in high foreign debt. The Bank Indonesia Public Relations Director argues that the loan will not shake the foreign exchange reserves in anticipation of the threat of the global economic crisis (Republika, 2012). The balance of the reserves amounted to USD 111,528 billion as per May 2012. This commitment should be exchanged with an economic reform that is in favour of Indonesian economy, rather than a mere commitment mentioned by the Indonesian Finance Minister, Agus Martowardojo, as part of the global community to strengthen world financial institutions. After all, IMF has delayed approval on the reform agenda proposed by emerging economies, which proposed giving developing nations a greater voice in the organization, for example through increasing their voting rights in proportion with the size of their economies. As a result of the delayed reforms, countries under BRICS[81] have been reluctant to commit to more funding for the IMF (Jakarta-Post, 2012).

With regard to the World Bank strategy on loan disbursement, Interviewee I-20 shared her observations:

> I can give basic and general information, but not details on the case like in 1979, 1994 and 2001. But my understanding is that the World Bank has a strategy for each country, right. The loan is derived from the strategy, and the strategy is formulated jointly with related government bodies such as *Bappenas*[82] and Indonesia Ministry of Finance [on] what are the needs of Indonesia for support or development**.** It is called CPS (Country Partnership Strategy) and under CPS, it covers all areas from human development and everything. And I believe this area is supporting financial reporting and accounting standards and my thought [is that] under financial, public financial management. After CPS, there is [another document called] DPL (Development Program Loan). The DPL is used (kind of as a different mechanism) that the government has to meet (I-20).

The statements above provide understanding of certain institutions that are involved in the country loan agreement, which is in this case are the loans from the World Bank on the accounting development project and the IMF loan with conditional terms. Further capture may come from the capital market industry, which is under the supervision of the Capital Market Supervisory Agency (CMSA) Prior to the IFRS declaration, CMSA conducted a cross-country study on IFRS in 2004, funded by Nanyang Technology University, Singapore. It study was done by Etty Retno Wulandari, the Head of Accounting Bureau of Bapepam, who was on study leave in Singapore at that time. Interviewee I-13 commented as follows:

> Mrs Etty (Etty Retno Wulandari), CMSA was the one pushing [the capital market industry] to adopt the IFRS. The CMSA people actually really pushed for it. They

[81] Brazil, Russia, India, China, and South Africa.

[82] State Ministry of National Development Planning *(Bappenas).*

> were also involved in the process of technical assistance extended by the World Bank or IMF (I-13).

The lobbying to offer the IFRS to Indonesia is through certain people, who are by the authorities claimed to be a part of a political lobbying process in the financial reporting standardization project. When Indonesia is ready for globalization, such as through free trading referred to as liberalized economy, there is a market mechanism that must be established. Interviewee I-13 emphasized:

> If we look at our businessmen, they are mostly individual owners, their types of companies are closed and in reality they do not really require financial reporting. They need financial reports if they want to borrow capital from banks. Therefore, it is a market mechanism, if the bank requires a report, or if the investors want to enter the capital market, only then do they require a financial report. However, because of those requirements, the state intervenes. Perhaps, some people are not aware that we must pay £100,000 if we decide to adopt the IFRS. The invoice has been sent to IIA but forwarded to the Vice President Republic Indonesia, Dr. Boediono. It is interesting, why to him? Some people refer him as one member of the Berkeley Mafia. Boediono then directed the invoice to the Ministry of Finance office, but I think it has not been paid (I-13).

The term “Berkeley Mafia” was mentioned by Kwik Kian Gie, an Indonesian economist, who claimed that the candidate for Vice President of Republic of Indonesia 2009-2014, Dr. Boediono, is from the Berkeley Mafia. He claims that Boediono is a follower of the neoliberal group that is responsible for the collapse of the Indonesian economy (Kompas, 2009). Interviewee I-23 explained the impact of the neoliberal or liberalized economy in Indonesia:

> The current neoliberal economy has contributed more hazard to the Indonesian economy, for example more foreign contents controlling the natural resources (mining, food, energy), the financial sector (banking, capital market, insurance), services (airports, seaports, educations), and even development policies, education curriculum, epistemology of knowledge, worldview… (I-23).

The above statement supports Prof. Didin Damanhuri’s statement there are currently 112 government policies (acts) associated with neoliberal and capitalist approaches (SPI, 2012).[83] Damanhuri adds that Indonesia has lost in its food estate programme in Papua and Kalimantan. Apparently, aside from blaming IFRS for being related to the economic liberalization, the IFRS adoption is from a political economic view seen as:

> Accounting system is the same as Language…the Western Hegemony attacks the way of thinking, and a standardized reporting mechanism will facilitate and fortify the Western Hegemony…the purpose is to control peripheral countries so that it will be difficult to uncover the dominated structure therefore it will create a Pyramid of

[83] A professor in Economic and Management Faculty, Bogor Agriculture Institute Indonesia.

the World Wealth Control, where the top of the pyramid is the World Financial Capitalist and on the bottom of the pyramid lays poverty and the peripheral countries that are underdeveloped in all aspects (I-23).

Understanding Gramsci's concept of hegemony, it appears in the financial reporting standardization where the language is used to control the civil society. This argument is earlier shared by Gallhofer and Haslam (2002), p. 3, saying that "accounting at this point is taken to be repressive". They assert:

> Through what it informs about and brings attention to and through what it fails to inform about and displaces from attention, accounting has been understood to have an impact on people's attitudes, ways of thinking and behaviour so as to help sustain and enhance a problematic social order (Gallhofer and Haslam, 2002).

This perspective has been brought attention to by several critical accounting researchers, regarding how accounting has been captured by repressive hegemonic forces." The interviewee continues to assert that in relation with the Western Hegemony, Indonesia would forever remain a marginal country. In the case of the development of IFIs, it will exploit the following:

> Therefore, even with a hundred percent of growth yearly, the IFIs will not contribute a significantly in establishing the economic and social justice, if there is no effort to fundamentally correct the "macro structure", both global and national. In the macro structure banking adopts the centralized "*branch-banking-system"*, which only pulls the liquidity from the peripheral villages and transfers it to the capital city. From there it is then transported it to the word financial centres (New York, London, Tokyo, Paris, Berlin), which further sharpens the income gap within the country as well as between developed and developing countries. Ironically, the Shariah financial system, which fails to adjust to the interest based world economy, would make the structure of existing injustice even stronger (I-23).

The cost of IAS or IFRS adoption is not only paying the membership fees, but other related costs as well, such as accountants' training, the amount of time it consumes, and the dependency. Interviewee I-13 explained:

> There is a concern that information and competence gaps were purposely created to be with us permanently. We cannot create our own standards, because we have to keep following others' competency at this stage. We are not yet content with the IFRS, there are again new things coming up. So, I am not sure if this is something that has been purposely been designed or what, because if we come back to the theory, the development theory, in the country where capitalism is already stagnant, they do not care about real sectors. They only think about profits that are easily created, i.e. from financial sectors, expertise, technology, and accounting, which is regarded as one expertise (I-13).

Rent-seeking, which has been pointed by El-Gamal (2007), is relevant to this development theory. What should not be happening is that the IFIs are feeling comfortable with this motive, rather than promoting a mutuality concept. Interviewee I-10 addressed his perception of IFRS adoption in Indonesia:

> What I see on this standard setting, or whatever it is called, is that it should be on the level of authority. We still rely on the state authority or the Financial Services Authority or whatever it is. They will determine the direction, but who will do the work is something else, while the mandate will come from the authority. If Bank Indonesia would like to standardize, yes, it will be standardized, it will become a mandate. This is somehow a good system because it will lead to a quick process with no controversy. If we ask each industry, it will create a conflict of interest: one may say it is necessary, the other may say it is not. Thus, this IAS standard should have a time frame, (should go through) localized process or whatever it is called, something that adjusts to the local needs. So, it will be adopted as long as it is compatible and comparable. It's called standard, which means minimal (I-10).

The message of comparability is also voiced by Interviewee I-03 who supported the IFRS adoption:

> I think there will be more countries would adopt this standard (IFRS). At least, the effect is on comparability of financial reporting. If there are more (companies) that adopt the same standards, it will certainly ease the process of comparability (I-03).

From the above discussion, it can be concluded that the state intervention in IFRS adoption rests on the capital market and on the central banking authority at the time of declaration. It is now organized under a more independent and integrated authority on financial sectors, referred to as Financial Services Authority (FSA). The FSA was inaugurated under Law No. 21 Year 2011 on the 22nd of November 2011 with function, duties, and authorities in regulation, as well as supervision in the various sectors, namely the capital market, banking, and non-banking financial industry. In addition, the decision to adopt the IFRS was also stimulated through a past binding agreement with the World Bank and IMF (during the Post-monitoring program) as mentioned above. The worries regarding the threats of globalization, a liberalized market economy or extreme neoliberalism is one important aspect to be highlighted, as Indonesia with its abundant resources should first reform its economic conditions for the sake of the welfare of the society. The IFIs too, with their Islamic label, profoundly states that they bear a wider scope of accountability, which is not only to demonstrate their accountability to the society, but more importantly to the Creator of the universe. The existence of the IFIs should be able to support the government and to strengthen the economy in Indonesia with fairness and justice. This is claimed to be the fifth principle in Pancasila as Social justice for all peoples of Indonesia, and is stipulated in the Indonesian constitution Article 33.

Meso Level

At meso level, NIS elaborates how social action accommodates normative influences from professional and corporate interests that can be witnessed in the financial reporting standardization processes. NIS also elaborates on the issues of amplifiers, i.e. actors that work behind the scene of the standardization projects. Normative stimulus also comes from standard setters, in this case from the Institute of Indonesian Accountants and National Shariah Board – National Council of Indonesian Ulama. They have to deal with both IFRS and AAOIFI that competitively offer international advantages of standardization. At the same time, the IFIs with their profit motive coupled with certain restrictions under Islamic ideology have difficult time to resolve. Albu et al. (2011) finds normative influences from professional groups in IFRS implementation in Romania, and see others; Rodrigues and Craig (2007). The Meso level at the Arena Concept explains the process of standard formulation and enforcement in a specific field, i.e. for the IFIs. It also incorporates the actions of the individuals or groups who influence the collective decisions (Renn, 1992, p. 181), and who are clearly framed under the Arena Concept (Smith et al., 2011).

Interviewee I-09 expressed his opinion towards the adoption of IFRS, which according to him is:

> In principle, it is better to adopt everything conventional that can be adopted by Shariah: don't create a new thing, except if something is fundamentally different. For instance, I can see what has been developed in general risk management, or BASEL, so to speak, and it is just the same as that of Shariah. Just eliminate the few parts that are irrelevant, and replace them with relevant Shariah content. … Save effort and energy! According to many scholars: "*Al-Muhāfazah 'ala al-qadīm al-şālih wa al-Akhzu bil al-jadid al-aşlah.*"[84] The Islamic principle is developing a civilization, taking anything that has been developed by mankind, and restoring it. Thus we can take the good work of other people (I-09).

Apparently, the IFIs do not reject conventional systems, procedures, or guidelines, as long as they are not against Islamic values. This general view basically supports the early development of when Islamic banking was first established, when all standard operations used to refer to the conventional banks (the hybrid way). However, Interviewee I-02 had different view on the idea of IFRS adoption:

> In the past five years I have really felt the pressure from various parties not to differentiate between IFRS and the SSFAS (the Indonesian Islamic financial accounting standards*)*. The foundation of conventional business is usury, whereby Shariah business prohibits usury. In reality, in business and accounting practice, they consider these two opposite foundations are the same, except in the contract and the main terms. Thus, where is the beauty of the Shariah business? (I-02).

[84] Maintain that which is old and good, and embrace that which is new and better.

Interviewee 1-02 argued that the IIFIs should differentiate the foundation of their business that is definitely different from the conventional financial institutions hence there is a clear distinction between the two financial reporting standards. However, the pressure from the industry is not only on the issue of financial reporting standards but also on the issuance of *fatawā* . Interviewee I-26 described a process that has once taken place during his presence in the Scholars' meeting on the discussion of *fatawā* for the IIFIs:

> Most of the time, it (the *fatawā* issued) is based on industry needs. I was involved in a Shariah scholars meeting where the company's representative came to the meeting and made a presentation regarding one issue. At that time the company's Shariah scholar who happened to be a consultant for that company also attended the meeting. That situation creates difficulty for the rest of the Shariah scholars to form an independent opinion because the company's Shariah scholar was present in the meeting (I-26).

The interviewee I-26 added that the issuance of *fatawā* is very much related to the interest of the IIFIs:

> In fact, most of the time, the industry forced the Shariah council to endorse opinion in favour of the industry. My worry is the *fatwa* that is issued only to serve the industry's interest and neglect Shariah compliance (I-26).

However, the industry responded that their major concern is to create the business more compatible by welcoming global standardization and the regulators should accommodate this matter including the *fatawā* issuance. The global standardization must be welcomed with careful consideration, as is highlighted in the following transcript from Interviewee I-10:

> Regarding the global standardization, in order for outsiders who are the conventional majority to enter into a new system, it requires a transition, or orientation period, or whatever you call it. We need something that they can understand. So, I believe [we should be] decoupling until we have our own system and everything on our own…The decoupling process, in the same time as the globalization process is like a transition period. Through it, one day, the Islamic banks would be as strong as and have the same competitiveness as conventional banks. So, according to me, international comparability is inevitable. International comparability or compatibility is more suitable than adoption, because just look at BASEL [BASEL Agreement], not to mention the Shariah; not even the conventional banks adopt it fully (I-10).

Although Interviewee I-10 supports global standardization on financial reporting, he thinks that it should be limited to compatibility, rather than full adoption. Therefore, the existing SSFAS that has been issued by IIA has two challenges ahead of it: to consistently comply with Shariah values, and at the same time to be compatible with international requirements for decoupling purposes. Interviewee I-14 supported the above opinion with emphasis on comparing the IFRS and AAOIFI:

IFRS has two points that are relevant to the user. Firstly, comparability with other companies or other institutions; and secondly that AAOIFI is too general, while IFRS is much more detailed…and because AAOIFI is too general, so people may think to use different standards or techniques (I-14).

Both Interviewees I-10 and I-14 argued that comparability as one qualitative characteristic of financial reporting standard is important for the users. However, AAOIFI as another set of financial reporting standards for the IFIs is perceived as not comparable, as it is too general and not adopted by many IFIs. Aside from the internal pressure mentioned above, several external pressures are parallel to different types of mechanisms. The issue amplifier from international firms and their clients (or 'corporate interests') also contributes to the normative influences in formulating IFRS standards. Interviewee I-06 supported that statement:

> Most of the questions they raised would never be raised beyond to this level. They will be dropped to the interpretation committee level, probably by what we call the agenda decision. We would say "No…we don't think this is an issue", or this is what we have been dealing with. But we have to have them as a source, and about 40% of the issues that come to the interpretation committee come from the big firms. And there are seven firms…plus BDO, Grant Thornton, and Mazars (I-06).

Interviewee I-06 confirms that issues brought forward by the big accounting firms (Big 4 plus three other players) are a source for formulating financial reporting standards. The influence of Big 4 in financial reporting standardization has been recognized and there is a need to examine its involvement in forming accounting regulation (Cooper & Robson, 2006). Besides international firms, the corporate interests do play their roles. Interviewee I-11 similarly supported the statement that the source of the regulation comes from the industry. He says:

> In general, for regulation, we offer more priority to the industry; we always invite our colleagues from the industry [Islamic banks] (I-11).

Input from the industry is crucial, as it caters to the demands of the rest of the stakeholders. However, the industry must be able to stand independently, meaning that they must centre their accountability to the community at large. Any proposal to the standard setters or regulators must be genuinely voiced out for the sake of welfare of the society. This means that promoting self-interest, such as rent-seeking, which only serves certain group of people, must be avoided. The academic group is one issue amplifier that supports IFRS adoption in Indonesia, as is expressed by Interviewee I-10:

> I see IFRS as a standard for global communication, which means that those who will benefit from it are people who possess international relations… Secondly, with IFRS, we become aware that there are some basic standards which influence our own standards... IFRS also has qualifications and conditions that are far better than other

> standards, because they provide more consideration and the quality of disclosures are designed in such a way that they release the genuine public accountability (I-16).

The issue amplifier that comes from the academic group is also mentioned by Interviewee I-10, who says:

> We have researchers, academic doctors who initiate an idea from a discussion on what to formulate such as proposal. If the idea is reasonable it can become a decision. When a draft is prepared, all industry players are invited. We will ask them if the proposal will constitute any problems and if it will work towards the betterment of the industry or not (I-10).

At this level, the amplifiers such as corporate interests through international accounting firms, National Shariah Board, academic group, and researchers are identified that influence in normative way to the adoption of the best financial reporting standards for the IIFIs.

Micro Level

Unlike at meso level, at micro level the interactions of social action between standard setter and IIFIs get more complex as the IFiIs are on the playing field, facing demand of the stakeholders and the society at large. Mimetic pressure is indicated by Judge et al. (2010) as the main reason for IFRS adoption in 132 developing, transitional, and developed economies. To date, the IIFIs still refer to their specific Islamic financial reporting standards issued by the IIA, even though more countries are harmonizing their standards to IFRS, as described by Interviewee I-19:

> Some countries think that they can refer to IFRS as the standard for Islamic financial transactions, but it does not happen in Indonesia. We are quite firm in saying say that the Islamic finance context is different when it comes to general accounting standards, not to mention IFRS. Even the general SFAS is not made applicable in the Shariah transactions (I-19).

The IIA staff member's standpoint above may not be persistent, as the pressures to adopt IFRS standards rationalize the conditions either through coercive or normative ways. Deep concern was expressed by the interviewee I-02:

> I really feel the pressure from various parties not to differentiate IFRS with the SSFAS (I-02).

The fear became reality on the 10th of July 2013 when GIIBAS 2013 was released. It contains permissibility for the IFIs to practise annuity method on the revenue recognition, which was previously impermissible due to its conflict with time value of money that implies usury. A debate has surrounded this case since 2006, climaxing when the association of Indonesian Islamic banks approached the Directorate of Islamic Banking, Bank Indonesia about the issue. They claimed that as opposed to proportional method, the annuity method was seen more lucrative to the banks and the investors, as well as the rest of the stakeholders. Interviewee I-09 stated the following:

> I met a colleague from IFBIM[85] Malaysia who asked about the foreign banks with branches in the Middle East etc. Nobody is disputing over the annuity method, why is Indonesia like this? I told him that I have tried my very best to change. So, it is good that he came to Indonesia and I took him to Bank Indonesia to explain [why] foreign banks that have branches in Indonesia cannot workout the proportional method (I-09).

He continues to explain how the annuity method was then allowed to be adopted by all Islamic banks:

> In 2005, the regulator in Bank Indonesia was Harisman who was very rigid regarding the regulation, such as to IIA Shariah standards. After that, the new director arrived (in 2006), Mr. Ramzi, and he wants to listen to the industry. We offered him a talk, I made several presentations, and I wrote a paper. At the end, Mr. Ramzi released a letter, his discretion…Please be aware that accounting regulations should not hinder business development, [should not] involve in risk management, what more risk management in Shariah, on fatwa. The domain fatwa has even allowed it. So what? What [motives] do you have behind this? (I-09).

Indirectly, Interviewee I-02 expressed his view on the interest of the corporation, which is very short-sighted, and he also has the opinion that that *fiqh* as a reference in fatwa formulation is not always appropriate:

> The business players are becoming pragmatic and the competition is getting tougher. Thus they don't want to burden themselves with innovation and the Shariah issues which are unclear, even more so if they must find *Ijtihād* to find substance… The motive is early recognition of profit. It is like applying an interest rate and not through proportional method. In proportional method, they can't recognize profits in a quick way [unlike in annuity method] because there is an implication of time value of money. Actually, the management is short-sighted…The *fiqh* maxim that is currently adopted is a "formalistic" *fiqh*, as long as it satisfies the formal conditions; the contract is regarded as legal (I-02).

Currently, the SFASB has to accommodate the pressure from the industry regarding the case of the annuity method in revenue recognition. As mentioned in Section 4.4.2, on the development on standards for the IFIS, SSFAS 59 was released in 2002 as the first standard for Islamic banks in Indonesia, and was later replaced by SSFAS 101-107. SSFAS 102 on *Murābahah* only distinguished one method to recognize revenue, i.e. the proportional method. As the Islamic banks were not satisfied with the standard, they approached Bank Indonesia and IIA. As a result, Bank Indonesia released a letter to all

[85] Islamic Banking and Finance Institute Malaysia

Islamic banks (No. 9/634/DPbS)[86] through its Islamic banking directorate. The letter is dated the 20th of April 2007 that states the central bank's discretion when referring to generally accepted accounting practice on the annuity method. Eventually, it has similar approach to that of IAS 39/IFRS 9 on Financial Instruments. However, IIA did not alter SSFAS 102 in conjunction with that change, thus the Bank Indonesia letter superseded SSFAS 102 which led to a conflict. Under Indonesian Company Law No. 40 Year 2007 replacing Company Law No. 1 Year 1995, all companies are liable to refer to Part Two on Annual Reports Article 66 (3), which states that *the financial report as set out in paragraph (2) a. must be made in accordance with <u>financial accounting standards</u>*. All IFIs are registered under the Company Law No. 40 Year 2007, but the law does not differentiate between the two different types of financial reporting standards. Therefore, under this law, the IFIs are not obliged to refer to SSFAS 102 for the *Murābahah* transactions.

On July 16th 2008, the House of Representatives Republic of Indonesia released the Islamic Banking Act as the first Islamic banking law. Clause 5.2 spells out that *Islamic banks and Islamic business units are obliged to submit a financial report to Bank Indonesia. It should consist of yearly balance sheets and profit and loss completed with notes to the accounts which are reported according to the <u>generally accepted Islamic accounting principle</u>, as well as other necessary reports, in a specific format and within a time frame specifically regulated by <u>Bank Indonesia regulations</u>.* Under this act, the Islamic banks should abide by the regulation, which explicitly spells out that all Islamic banks must follow SSFAS. The last sentence in the clause, however, relaxes the regulation by stating that Bank Indonesia has authority to regulate the format. After several studies, DSN-MUI then issued a fatwa (No. 84/DSN-MUI/XII/2012) on 21st December 2012, on the Profit Recognition Method of *Al-Tamwil Bi Al- Murābahah* (Murabahah Financing) at the Islamic Financial Institutions that states: "A better profit recognition method in *at-Tamwil bi al- Murābahah* during development period of the Islamic financial institutions is the annuity method."

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[86] The letter refers to GIIBAS 2003, Section III. F. 1. *Murābahah* Receivables point 3 Explanation letter I:

> *In the event of payment of Murābahah is made on instalment, therefore portion of the principal amount and profit shall be recognized proportionately over the period. If the customers' payment is lower than their total obligation therefore the revenue recognition for business income shall be proportional to the portion of margin in the instalments.*
>
> Modified as:
>
> *In the event of payment of Murābahah is made on instalment therefore portion of the principal amount and profit shall be recognized according to general accounting practice.*

From this fatwa, SFASB-IIA issued a technical bulletin, Technical Bulletin No. 9, dated 16th January 2013, on annuity method implementation in *Murābahah*. According to this technical bulletin, accounting for annuity method should be referred to SFAS 50 and SFAS 55 on Financial Instruments, as SSFAS 102 does not specifically regulate such methods. The industry was still unsatisfied, and insisted on modifying SSFAS 102 to accommodate the annuity method. The technical instruction was then legalized through GIIBAS 2013, which was released on the 10th of July 2013 and effectively implemented on 1st January 2014.[87] The annuity method is adopted with the assumption that if the *Murābahah* transaction falls under the category of financing then it shall refer to SFAS 55 (2011) on Financial Instruments: Recognition and Measurement, SFAS 50 (2010) on Financial Instruments: Presentation, and SFAS 60 (2012) on Financial Instruments: Disclosures. As for the option of adopting the proportional method, the bank shall refer to SSFAS 102 on accounting for *Murābahah*. When GIIBAS 2013 was released, the Islamic banks were stunned as it was more binding, and the consequences of applying SFAS on financial instruments was to allocate impairment costs which were beyond the capability of the majority of Islamic banks. Interviewees I-17 and I-18 expressed their views on the annuity method, as stipulated in GIIBAS 2013:

> We did not expect GIIBAS 2013 to be like this. This put us in a more complicated situation. The illustration shown in the GIIBAS on the annuity method is different from what we have been practising since 2006. Considering the consequences of the SFAS 50, 55, and 60, we think that we are not ready. If we study the method as illustrated in GIIBAS, the annuity method obviously shows interest-based way calculation. In this case, we do not want to be distanced from the Shariah. We still demand SSFAS 102 to be revised (I-17) and (I-18).

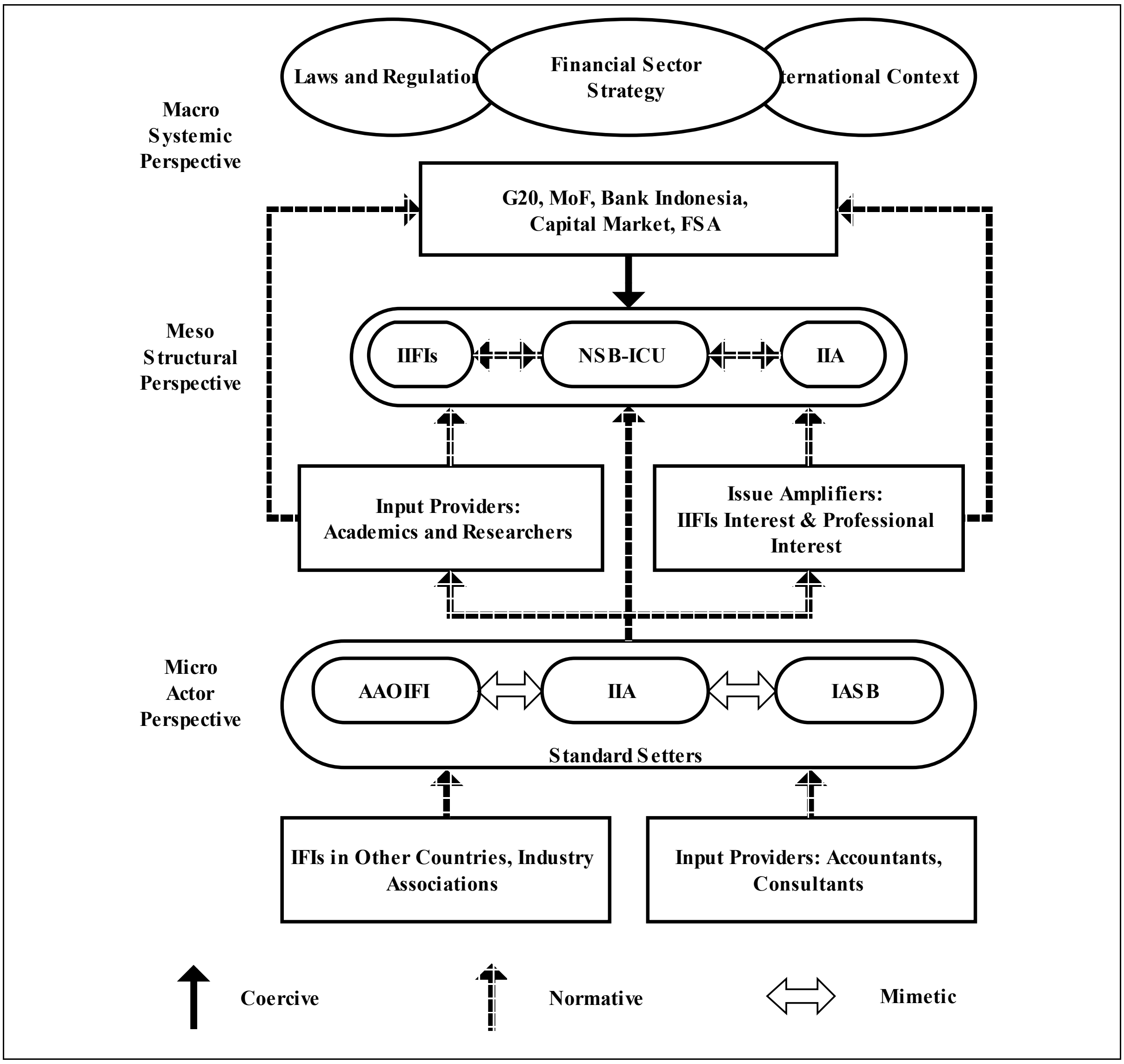
The issuance of GIIBAS 2013 did not successfully offer a solution to the choice between annuity and proportional methods. To encounter this reaction, on the 30th of September 2013, SFASB-IIA called for a hearing to revise SFAS 102. At the time of writing (this text), the final revision of the standard has not been endorsed, and thus the choice between the proportional and the annuity method has not been fully finalized.

4.6 Conclusion and Recommendation

The aim of this research is to explore the alternative views on the adoption of IFRS and whether it is considered as the way forward by the IIFs. Figure 4.6.1 presents the interactions among actors in the financial reporting standardization project in Indonesia.

[87] Chapter IV Sales and Purchase Contract, IV. 1 *Murābahah* C. Explanation No. 09 states that: *In the event of non-cash payment, revenue recognition on Murābahah may refer to annuity method (effective) or proportional method (flat).*

Figure 4.6.1: Institutional Arena on FRS Project for the IIFIs



Source: Adapted from Smith et al. (2011) and current study.

Notes:

G20	: The Group of Twenty (G-20) Finance Ministers and Central Bank Governors
MoF	: Ministry of Finance
FSA	: Financial Services Authority
IIFs	: Indonesian Islamic Financial Institutions
NSB-ICU	: National Shariah Board – Indonesian Council of Ulama
IIA	: The Indonesian Institute of Accountants
AAOIFI	: Accounting and Auditing Organisation for Islamic Financial Institutions
IASB	: International Accounting Standards Board

Figure 4.6.1 represents the interaction of the actors in the arena of Financial Reporting Standardization (FRS) project for IFIs in Indonesia. It indicates that economic liberalization policy at macro level has coercively pressured Indonesia to adopt IFRS without exception for the IIFIs. At meso level, normative influences come from several forces, such as international accounting firms, the National Shariah Board, academic groups, and researchers. While at micro level, the associations of Islamic banks contribute mimetic and normative stimulus to convince the regulators and the standard setters to

formulate similar standards with that of IFRS. From empirical finding on the picture of financial reporting standardization in Indonesia, the analysis gives rise to two main predictions:

(i) Political sectors actors in Indonesia have more powerful influences in IFRS standardization in general; and

(ii) Actors in Islamic financial industry shows stronger lobby to lead direction of financial reporting standardization for the IIFIs with the purpose to maximize profit.

The above predictions can be considered as political and economic imperialist motives. Since the motives cannot be ruled out, this study suggests to scrutinizing the economic and political interests of IASB and international financial institutions i.e. World Bank and IMF that has been heavily influencing the process of financial reporting standardizations in Indonesia. With conflict on *Murābahah* profit recognition method; this study asserts that IFRS indirectly led the IIFIs to focus mainly on the interest of the shareholders and neglect the welfare of the whole stakeholders. This is what referred by Asutay (2012) as social failure. Islamic finance industry has been criticized for its social failure due to the scheme of 'financialisation' which is in this regard mimicking the conventional sector. The concept of convergence to the modern financial system has failed as it has departed from the Islamic values. This is not in tandem with the true objectives of IFIs that they must serve both shareholders and the community and at the same time to uphold the objectives of Shariah. Hence, mutuality concept as suggested by El-Gamal (2007) to abolish rent-seeking motive in the body of IFIs must be promoted, both in operations and financial reporting mechanism of IFIs. The mutuality concept is not something new; rather, it is derived from the basic intention of building Islamic finance industry through the concept of Islamic *ukhuwah* (brotherhood) that was preached by Prophet Muhammad (P.B.U.H) 1435 years ago. This chapter differs from other research papers dealing with institutional theory that it looks at various factors outside the organizations particularly in the area of politics. Previous studies mostly highlight the institutions, their background, performance, and which type of isomorphism influence the organizational experiences. Therefore, this chapter contributes to literature and theoretical advancement on institutional research. However, as this study is tentative with a case study only in one country, an interesting venue for future research would be the comparison between countries and across IFIs in financial reporting standardizations as proxy to investigate the role of each player that constitutes the decision to adopt IFRS and whether similarities apply.

Appendix 4.1: Plain Language Statement

University of Glasgow | College of Social Sciences

Plain Language Statement

Research Title: to explore reflexivity and resistance of IIFIs towards IASB and AAOIFI financial reporting standardization projects.

Detail of researchers:

Researcher	Murniati Mukhlisin (Student No.: 2057808) Accounting & Finance Subject Group, Adam Smith Business School, University of Glasgow, Phone: 0141-3308364, E-mail: m.mukhlisin.1@research.gla.ac.uk
Supervisor	Dr. Mohammad Hudaib, Accounting & Finance Subject Group, Adam Smith Business School, University of Glasgow, Phone: 0141-3304136, E-mail: Mohammad.Hudaib@glasgow.ac.uk

You are being invited to take part in a research study which is regarded as part of fulfilment to my Doctor of Philosophy in Accounting degree. Before you decide it is important for you to understand why the research is being done and what it will involve. Please take time to read the following information carefully and discuss it with others if you wish. Ask us if there is anything that is not clear or if you would like more information. Take time to decide whether or not you wish to take part. This study to explore reflexivity and resistance of Indonesian Islamic Financial Institutions (IIFIs) towards International Accounting Standards Board (IASB) and Accounting and Auditing Organisation for Islamic Financial Institution (AAOIFI) financial reporting standardization projects. In further details, the objectives of this study are as follows; to explore the views on the adoption of IASB standards and whether it is seen as the way forward by IIFIs; to evaluate AAOIFI's strategy in developing its accounting standards and seeking for acceptance from its member countries including Indonesia; to propose a recommendation on the most appropriate reporting standards for IFIs suitable for international financial reporting requirements as well as compatible with *Maqāsid ul-Shari'āh*; and to examine institutions responsible for Islamic financial architecture and explore the required supports for the future to impose appropriate financial reporting standards for IFIs.

The findings from this study can have profound implications to research, practice and policy-making. You have been chosen because you fall into one of four categories that we believe your views on the subjects may be invaluable to our study. The study will involve focus group discussion (FGD) and one face-to-face interview with Islamic scholars, academicians, accounting standard setters, and Islamic finance practitioners who posses the best information and knowledge on the issues related to IFRS and AAOIFI, which should take no longer than two hours for the FGD and one hour for the interview. Participation in the study is completely voluntary and all results are confidential. No one other than the researcher and his supervisor will have access to personal information. Reports will include pseudonym information only; it will not be possible to identify individuals, or individual companies, from any report. All computer files and documents will be coded with subject numbers, not names, and kept in a secure office. All information will be analysed for the purpose of this study and will be stored securely and confidentially for comparison purposes for future studies.

This study has been approved by the ethics committee of the Colleges of Social Sciences at the University of Glasgow. Should you have any queries or require more information about the study, please contact Dr. Mohammad Hudaib, my PhD supervisor, at 0141-3304136. Should you have any concerns regarding the conduct of the research project, please contact the College of Social Sciences Ethics Officer by contacting Professor John McKernan at John.McKernan@glasgow.ac.uk.

Thank you for reading this document.

Murniati Mukhlisin

Appendix 4.2: Interview List

Coding	Duration and Volume	Background				
		Academic	Regulator	Standard Setters	Professional Dir/Manager	Shariah Scholar
I-01	60 minutes, 1 interview			√	√	
I-02	30 minutes-interview and 3 interviews via e-mail			√	√	
I-03	60 minutes, 1 interview	√		√		
I-04	60 minutes, 1 interview	√				
I-05	60 minutes, 1 interview				√	√
I-06	60 minutes, 1 interview			√		
I-07	60 minutes, 1 interview				√	√
I-08	55:49 minutes, 1 interview		√			
I-09	80 minutes, 1 interview				√	
I-10	30 minutes, 1 interview		√			
I-11	60 minutes, 1 interview		√			
I-12	60 minutes, 1 interview			√		
I-13	60 minutes, 1 interview		√			
I-14	60 minutes, 1 interview		√	√		√
I-15	60 minutes, 1 interview		√			
I-16	60 minutes, 1 interview	√		√		
I-17	60 minutes, 1 interview				√	
I-18	60 minutes, 1 interview				√	
I-19	60 minutes, 1 interview			√		
I-20	60 minutes, 1 interview				√	
I-21	30 minutes, 1 interview		√			
I-22	60 minutes-interview and 1 interview via e-mail	√				
I-23	2 interviews via e-mail	√				
I-24	2 interviews via e-mail	√				
I-25	1 interview via e-mail				√	√
I-26	60 minutes, 1 interview	√	√			√

Notes: The interview list consists of 26 interviews; 18 interviewees are analysed in Chapter Four whereby 8 interviewees discussed in Chapter Five.

Appendix 4.3: Interview Guide

Title of Project: Exploring Reflexivity and Resistance towards IASB and AAOIFI Financial Reporting Standardization Projects

Name of Researcher: Murniati Mukhlisin

I. Preliminary

My name is Murniati Mukhlisin. I am first year PhD student at University of Glasgow, conducting research on International Financial Reporting Standards and its applicability to Islamic financial institutions. Thank you for your time that provides me avenue to make an interview today. Everything you say is considered as confidential and the results of this discussion will be reported anonymously. My full research topic is: **Exploring Reflexivity and Resistance towards IASB and AAOIFI Financial Reporting Standardization Projects**, under supervisions of Dr. Mohammad Hudaib and Dr. Kirsten Kininmonth. In your opinion, is IFRS applicable to Islamic financial institutions? To what extent? What about AAOIFI standards? Why do not all IFIs implement AAOIFI standards? Which one is more appropriate for IFIs to adopt? Do you think we need a specific financial reporting standard for IFIs? Why? What are supporting factors for implementation of Shariah based financial reporting standards?

A. IFRS (Interview List for IASB/IFRS Foundation, Academicians, Accountants, Lawyers)

a. Reasons for existence
   a. Can you tell me how IFRS was started?
   b. How does IFRS conduct the process of producing standards?
   c. Which country has more say in IFRS?
   d. Can you share your views on the role of Big-4 in IFRS standards setting?
   e. According to literatures, I have read certain standards are lobbied by certain group/company/government body. What do you say about this?
   f. According to Accounting Regulation Theory, the regulation is to improve public welfare but not to protect private interest. What do you say about this?
   g. Can you elaborate strategies adopted by IASB in promoting the standards?
   h. What are challenges are you facing in general?

b. IFRS focus
   a. From several readings, it is said that IFRS serves mostly capital market-based companies. What do you say about this?
   b. Can you tell me why does IFRS create IFRS for SMEs?
   c. To what extent it is the best way for non-listed companies also to adopt IFRS?

c. Problems when applying IFRS standards
   a. Can you share your view on statement that IFRS cannot be implemented due to differences in institutional settings in each country? I.e. Culture, environment, politics?
   b. How do you deal with countries that are not ready to implement IFRS? What are your strategies?

d. IFRS as a reference for IFIs
   a. To what extent IFRS has become the reference for IFIs? In percentage?
   b. Can you tell me if you know there is any Islamic financial institution that would like to adopt IFRS completely?
   c. What challenges are you facing to convince IFIs about IFRS?
   d. How do you see other financial reporting standards for IFIs? AAOIFI?
   e. According to literatures, we live within different capitalisms therefore one accounting standard will not support all different types of capitalisms. What do you think about this?

e. Asian-Oceanic Standard Setters Group (AOSSG)
   a. Can you tell me who appoints AOSSG?
   b. What are the bases to appoint AASOG member countries that deal with the issues for IFIs?
   c. How efficient the work of this AOSSG-WG?
   d. How do you deal with modification proposed by AOSSG-WG for IFIs?
   e. If the modification cannot be accommodated, do you think there will be clash of standards?
   f. How do you resolve?

B. AAOIFI (Interview List for AAOIFI, Academicians, Accountants, Lawyers)

a. Reasons for existence
   a. Can you tell me how AAOIFI was started?

Appendix 4.3: Interview Guide

- b. How does AAOIFI conduct the process of producing standards?
- c. Which country has more say in AAOIFI?
- d. According to literatures I have read, certain standards are lobbied by certain group/company/government body. What do you say about this?
- e. According to Accounting Regulation Theory, the regulation is to improve public welfare but not to protect private interest per se. What do you say about this?
- f. Can you elaborate strategies adopted by AAOIFI in promoting the standards?
- g. What are challenges are you facing in general?

b. Compliance with AAOIFI standards
- a. Have you conducted any research to evaluate on how many countries that comply with AAOIFI standards?
- b. Does it matter on how many countries that comply with AAOIFI standards?
- c. How true is the research that says number of countries comply with AAOIFI is now decreasing?
- d. What are your efforts to increase number of countries to comply with AAOIFI standards?
- e. Does AAOIFI need to lobby regulators in member country?
- f. What are the factors influencing AAOIFI compliance? Internal? External?

c. AAOIFI standards as a reference or guidance for IFIs
- a. Do you think AAOIFI has served the needs for IFIs for Shariah-based financial reporting standards?
- b. What are the feedback do you receive with regards to the applicability of the standards?
- c. How do you deal with the feedback?
- d. Do you form a special working group to deal with certain emerging issues?
- e. How do you compare AAOIFI standards with others standards (i.e. IFRS)
- f. How do you compare with other Shariah-based local standards?

d. AAOIFI standards to Shariah compliance
- a. How does AAOIFI ensure each standard produced is based on Shariah?
- b. What is the conceptual framework used by AAOIFI to ensure the Shariah values?
- c. Is *Maqāsid ul-Shari'āh* important to look into?
- d. To what extent Shariah Board members in AAOIFI understand the issues in accounting?
- e. How does AAOIFI keep update the Shariah Board members about the issues?
- f. How does AAOIFI deal with the differences in opinion of Shariah Board members? How do they affect the standards?
- g. Is harmonization in Shariah views important for AAOIFI to set the standards that are applicable for all IFIs?

e. Application of SSFAS (**Interview list for Indonesian interview**)
- a. What is the idea to set up own Shariah-based financial reporting standards? Why don't you just adopt AAOIFI?
- b. What are the challenges?
- c. Do you evaluate IFIs whether they comply with the Shariah standards?
- d. What are the challenges and strategies?

C. Shariah issues (Interview list for Shariah scholars)

a. The need for Shariah-based financial reporting standards
- a. Can you tell me your opinion whether IFIs require a specific Shariah based financial reporting standards?
- b. Can you share your view whether the existing financial reporting standards adopted by IFIs have fulfilled Shariah requirements?
- c. What are your critiques towards the existing Shariah-based financial reporting standards that you know?
- d. What are supporting factors to have Shariah based financial reporting standards? Internal? External? How do you rank them?
- e. Do we need Shariah harmonization? Is it possible? Do we need Shariah harmonization in order to have standards that are applicable to all IFIs?
- f. Can you tell me on the role of International *Fiqh* Academy in setting financial reporting standards?
- g. To what extent do we need its active role?
- h. What is your view on IFIs that choose to adopt IFRS or AAOIFI?
- i. What is your view on IFIs that resist to adopt IFRS?

b. The Measurement to Shariah compliance in the existing financial reporting standards

Appendix 4.3: Interview Guide

a. Can you tell me on what is the measurement in the existing financial reporting to ensure IFIs transactions are complied with Shariah?
b. How is the process of measuring compliances to Shariah? What is the possible benchmark?
c. From the literatures, *Maqāsid ul-Shari'āh* seems to be the benchmark to ensure IFIs transactions to follow Shariah rules. What is your opinion about this?

c. Shariah Board

a. Can you tell me about endorsement from Shariah Board on annual report, is it sufficient?
b. How does Shariah Board obtain recognition?
c. Can you tell me how to ensure independence of Shariah Board on Shariah compliance report in the annual report?
d. What are the challenges and solution? Internal? External?

D. Political economy issues (Interview List for World Bank official and Indonesian regulators)

a. What is your opinion on the loans extended by the World Bank for accounting development program in Indonesia?
b. Is loan extended by the World Bank for Indonesia in line with grand plan and architecture of Indonesian economy?
c. Please briefly explain the process of negotiation between World Bank and Indonesian government regarding loan agreement.
d. How does the process of G20 agreement take place?

II. Closing

Final question: is there anything you would like to add which have not been covered in our discussion or any issue you would like to clarify?

Thank you for your participation.

Chapter Five: AAOIFI's Strategy and Indonesian IFIs' Compliance to AAOIFI

5.1 Introduction

This chapter aims at evaluating Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI)'s strategy in developing its accounting standards and seeking for acceptance from its member countries including Indonesia.[88] At the beginning of Islamic finance development in Indonesia, AAOIFI financial reporting standards were regarded as references for preparing financial reporting standards for the first Indonesian Islamic Financial Institutions (IFIs) i.e. Bank Muamalat Indonesia and Syarikat Takaful Indonesia.[89] Although these IFIs considered AAOIFI financial reporting standards as internal guidelines[90], their annual reports did not indicate the compliance to the standards. The IFIs stated their compliance to locally developed standards known as 'SFAS 31' for commercial banks and 'SFAS 28' for insurance companies with additional disclosures specific on Shariah requirements as stipulated in the AAOIFI standards.[91] In the same context, AAOIFI standards were also used during the preparation of SSFAS 59 (accounting standards for Islamic banks) in 2002 to replace SFAS 31. However, starting from 2007 all business entities, including banks, insurance, venture capital and mutual funds, have to comply with newly developed standards known as 'SSFAS 101-107'. In addition to the SSFAS 101-107, there are other specialized standards issued by The Indonesian Institute of Accountants (IIA) such as SSFAS 108 (for Islamic insurance, issued in 2010), SSFAS 109 (for Zakat, 2011), and SSFAS 110 (for Sukuk, 2011) that complement the previous SSFASs.[92]

From the brief history of the financial reporting standards development in Indonesia and the key role played by AAOIFI accounting standards in the development, it is not understood why AAOIFI standards have not been fully recognized by the Indonesian regulators. Equally can be said, why AAOIFI could not achieve its objectives to develop,

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[88] A part of this literature chapter has been presented at International Islamic Finance Conference 2013, 14th-16th of April 2013 in Abu Dhabi, UAE, with title *"A Study on Perception of Islamic Banks' Stakeholders towards Shariah Harmonization in Financial Reporting Standards; the case of Indonesia"*, the paper was awarded as The Best Paper. Currently the paper has been granted for full publication in the International Journal of Islamic and Middle Eastern Finance and Management, Emerald Group Publishing.

[89] Bank Muamalat Indonesia (BMI) (is the first Islamic bank, established in 1992) and Syarikat Takaful Indonesia (STI) (is the first Islamic insurance company, 1994).

[90] AAOIFI standards became later as basis of national accounting standards in jurisdictions (Nizam, 2012).

[91] Statement of Financial Accounting Standards (SFAS), Shariah Statement of Financial Accounting Standards (SSFAS).

[92] Shariah Statement of Financial Accounting Standards (SSFAS).

disseminate and promulgate its standards as practical option available for all IFIs in Indonesia to adopt instead of using locally developed standards. At this point, there is no evidence suggesting that AAOIFI has abandoned this objective to lesser goal of becoming only a reference for IFIs and for other accounting standard setters. Therefore, the research questions for this chapter are: What is AAOIFI's strategy in developing its standards? And to what extent do IIFIs comply with AAOIFI accounting standards? Employing Strengths, Weaknesses, Opportunities, Threats (SWOT) analysis and Arena Concept in New Institutional Sociology theory combined with Critical Realism perspective, this chapter attempts to explore the factors prevented AAOIFI from being fully accepted by countries such as Indonesia and for AAOIFI from positively engaging with national standards setters to coordinate the use of its accounting standards. Indonesia is used as suitable example for the analysis because of its apparent dual political objective where both Islam (the religion of majority Indonesians) that shapes the nature of transactions applicable for the Indonesian Islamic Financial Institutions (IIFIs), and the nationalism that are integrated with local and international actors interested in the development of the financial reporting standards.

The SWOT analysis shows that AAOIFI has strong capability to develop its accounting standards but AAOIFI is lacking of clear strategy in promoting the standards. AAOIFI has an opportunity to remain as international standard setter for IFIs however AAOIFI has to face challenges as IASB offers more pragmatic standards with global approach. The Arena Concept using the proposed framework from Chapter Four shows that Muslim scholars in Indonesia play crucial role in approving which financial reporting standards appropriate for the IIFIs using Shafi'i school of thought as guidance.[93] Most importantly, political lobbying at macro level is dominated by IASB that pushed aside AAOIFI to take part in designing financial reporting for IIFIs. The contribution of this chapter is a recommendation for AAOIFI to consistently update its standards and develop its persuasion strategy in order to reduce disagreement among local Islamic scholars in different parts of Muslim worlds which will eventually increase the adoption of its standards worldwide. The remainder of this paper is organized as follows. Section 5.2 delineates SWOT Analysis and Arena Concept; Section 5.3 reviews AAOIFI development; Section 5.4 presents assessment of AAOIFI; and Section 5.5 summarizes the findings. The following Figure 5.1.1 explains the structure of this chapter.

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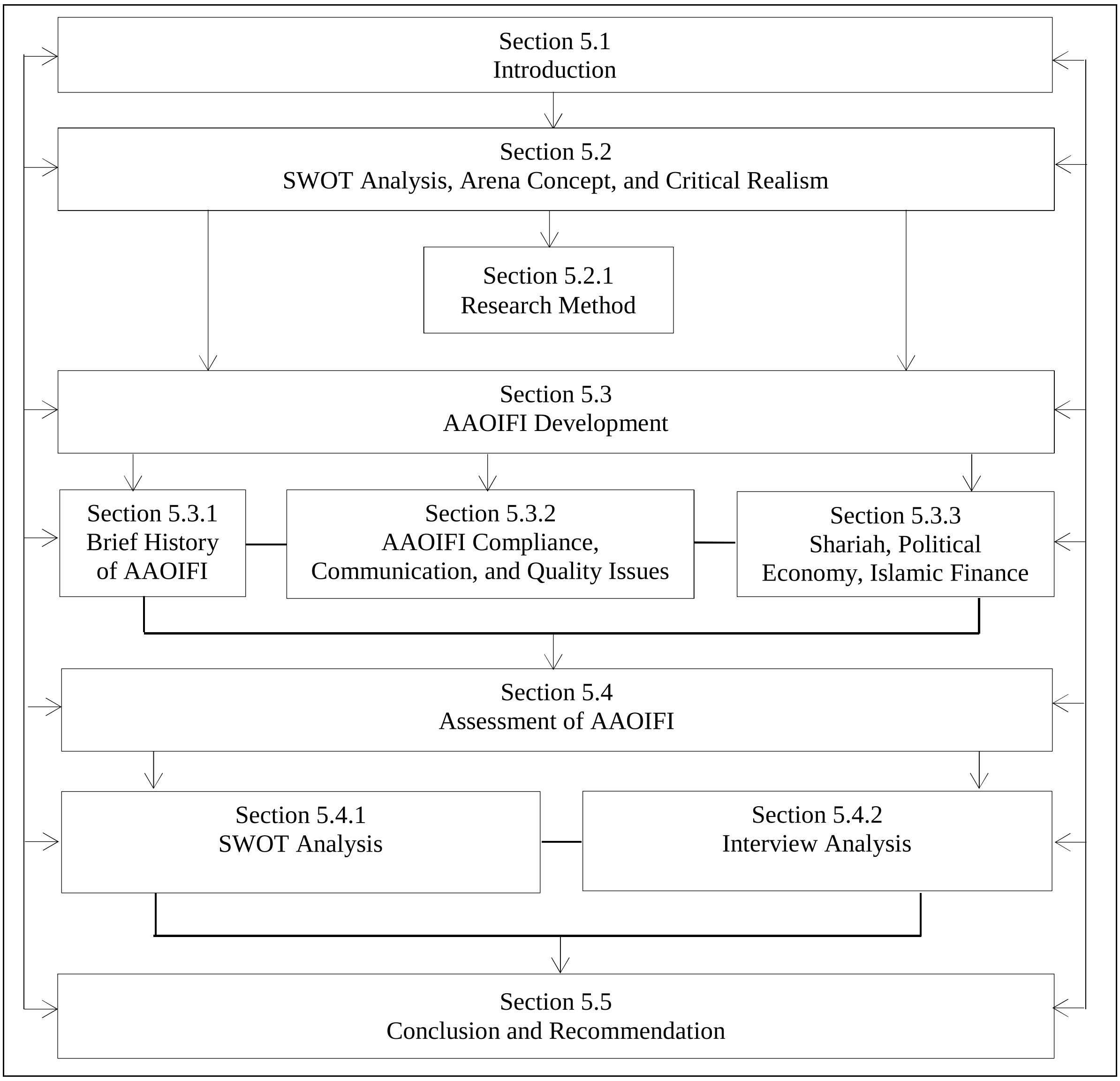
[93] Shafi'i school of thought is one of the four schools of jurisprudence within the Sunni branch of Islam. The Shafi'i school is the dominant school of jurisprudence amongst Muslims in South East Asia including Indonesia.

Figure 5.1.1: Structure of Chapter Five



5.2 SWOT Analysis, Arena Concept, and Critical Realism

In order to answer the first research question of this chapter, SWOT analysis is employed to classify problems and challenges faced by AAOIFI (please see Section 3.6.1). As this paper has an objective to find out what went wrong with the strategies set by AAOIFI in its effort to promote its accounting standards, thus SWOT analysis helps mapping the organization's problems, challenges, and prospects from inside and outside of AAOIFI. One systematic way of conducting SWOT analysis is through a focus group discussion. For this study, the focus group involves several participants who are expert in financial reporting issues for IFIs (see Appendix 5.1). For the second research question, this study adopts institutional isomorphism with institutional Arena Concept developed by Smith et al. (2011) and Political Economy of Accounting framework as informed by Cooper and

Sherer (1984) and Tinker and Neimark (1987). The Indonesian institutional arena framework on IFRS proposed in Chapter Four is carried forward to Chapter Five to guide the analysis (se Figure 4.6.1). Semi-structured interviews are conducted with eight experts (see Appendix 4.1) who are aware with the policy setting in Islamic finance industry.

The institutional arena is applied in this chapter to see whether Indonesia experienced similar approach in the adoption process of AAOIFI. In the case of IFRS, the success of IASB[94] introducing IFRS in Indonesia and convincing it to adopt it was through different mechanisms that worked harmoniously. Coercive mechanism exists at the macro systemic perspective and it is exercised by the state through G20 and Ministry of Finance (MoF), and industry regulators such as Bank Indonesia, capital market regulator, and Financial Services Authority (FSA).[95] At the meso structural perspective; academicians, researchers, and NSB-ICU, through the information received from the AAOIFI, IIA, and IASB play the amplifiers role on the issues related to financial reporting standards based on shared understanding of how important IFRS and the Islamic financial reporting for the IIFIs. At this level, each of these three accounting standard setters also takes part in the exchange of information, specifically information regarding the IIFIs.[96] However, at the micro actor perspective, professional interest persuades the accountants and consultants to carry on with IFRS standards through normative consultancy works. This consultancy work provides professional inputs, for instance from chartered accountants, legal advisors, and investment analysts. Professional actors also act as advisers for enforcement under the pretext of being pragmatic and become a global partner in regulating the IIFIs. In addition, the industry such as association of Islamic banks and other country accounting standard setters influence in the same ways, the actors and their respective roles are embraced for the case of IFRS implementation for the IIFIs in Indonesia. Section 1.5 explains that this chapter also adopts Critical Realism to recognize the problems faced by the institutions, to provide the analysis tools, to consider engagement of the social context, and to focus on the practical contribution.

[94] "IASB has been the most successful, and today, it enjoys unrivalled influence in setting international accounting rules" (Martinez-Diaz, 2005).

[95] At the macro level, super international institutions such as WTO, World Bank, IMF, IOSCO, and IFAC termed as "social protagonists" (Tinker and Neimark, 1987) are not be included in the analysis because of their secondary role in Indonesian arena.

[96] Indonesian Islamic Financial Institutions (IIFIs)

5.2.1 Research Method

A focus group discussion has a purpose to identify strengths, weaknesses, opportunities, and threats of AAOIFI and the discussion took place in June 2012 in Bogor, Indonesia. The discussion was attended by 11 participants from various backgrounds but have similar interest on the issues of financial reporting standardizations for IFIs such as accountant for Islamic bank, Shariah scholar for Islamic insurance company, Islamic finance researcher, lecturers of Islamic accounting study, and students of Islamic accounting study (see Appendix 5.1). The result of focus group discussion is analysed using SWOT framework as guidance. Semi-structured interviews were carried out during February-March 2013 in London, United Kingdom and July 2013 in Jakarta, Indonesia to explore views of the people who are familiar with the issues on AAOIFI accounting standards. Eight respondents are selected from three backgrounds i.e. Islamic scholars, accounting standard setters and practitioners from Indonesia with supporting views from AAOIFI, IASB, and international Islamic scholars in the UK and Malaysia. The reason to include the international scholars from the UK is to see their views on the possibility of Shariah disputes over AAOIFI and IFRS implementation in the UK. In analysing the interview, thematic analysis method is adopted following Braun and Clarke (2006) that refers to three level of factors influencing the standardization suggested by Smith et al. (2011) i.e. macro, meso, and micro levels.

5.3 AAOIFI Development

5.3.1 Brief History of AAOIFI[97]

The emergence of AAOIFI is accredited to the development and the flourish of Islamic banking in the late 1980s following the establishment of Mit Ghamr rural bank in 1963, Islamic Development Bank in 1975, Dubai Islamic Bank in 1975, Kuwait Finance House in 1977, and Faisal Islamic Bank in 1978 (see Chapter Three). The idea to set up an organization that specifically regulate accounting standards emerged from Islamic Development Bank (IDB) Governors Council meeting in 1987, in response to a concern by Islamic banks on the complication of their reporting mechanism because the existing accounting standards are incapable of accommodating their specific requirements. The idea for an independent body to tackle this problem became appropriate, which is

[97] Under this section only a summary of literature is presented but for detailed review please refer to Chapter Three.

according to Karim (1990a), to avoid influences by the regulatory agencies on the Islamic banks' accounting practices. With the help of several unpaid part-time board members representing the Islamic banks, users, accountants, academics, Shariah scholars, and regulators, AAOIFI (or as it was known before as the Financial Accounting for Islamic Banks and Financial Institutions/FAOIBFI) was formed in 26 February, 1990 in Algiers and officially registered in Bahrain in the following year. FAOIBFI changed its name to AAOIFI in 1995 after extending its scope to a wider area of responsibilities such as auditing, ethics, and corporate governance. Rifaat Ahmed Abdel Karim was an eminent scholar behind the scene who initiated and developed the institution for which he served as Secretary General from 1996 until 2002.

He left AAOIFI and helped establishing another body named, the Islamic Financial Services Board (IFSB) in 2002. He then moved again to set up the International Islamic Liquidity Management Corporation (IILM) in 2010 – both are based in Kuala Lumpur, Malaysia. The role and performance of AAOIFI, IFSB, and IILM are discussed in Chapter Seven. Karim published several papers on the nature of the institutions he promoted and how the standards were developed right from their conceptual frameworks, the approaches, and the challenges they faced. He communicated quite well but after he left, AAOIFI was in vacuum as there was no enthusiastic successor replacing him to keep AAOIFI competitive at the international level. From the beginning, AAOIFI adopted a hybrid approach in setting its standards, which according to Zaher and Hassan (2001), is the way where Islamic banks adopt something in between the two paradigms i.e. Islamic and conventional. The hybrid approach borrowed non-Islamic thoughts and verified them with Shariah principles, after which accepted those consistent with Shariah principles and rejected those which are not. In other words, the approach was not to establish financial reporting standards 'based on' Islamic political and social foundations but instead to develop standards that only 'comply' with Islamic principles. AAOIFI issued its first standard in 1993 and to date it has reached the total of 86 standards (after nearly 20 years). AAOIFI reveals that several jurisdictions have adopted their standards including Bahrain, Jordan, Lebanon, Qatar, Sudan, Syria and Dubai International Financial Centre. It also states that relevant authorities in Australia, Indonesia, Malaysia, Pakistan, Saudi Arabia, and South Africa have issued guidelines that are based on AAOIFI's standards and pronouncements. Therefore, there are 11 or 20% from Organization of Islamic Cooperation (OIC) member countries that have made AAOIFI as obligatory and guidelines.

5.3.2 AAOIFI Compliance, Communication, and Quality Issues

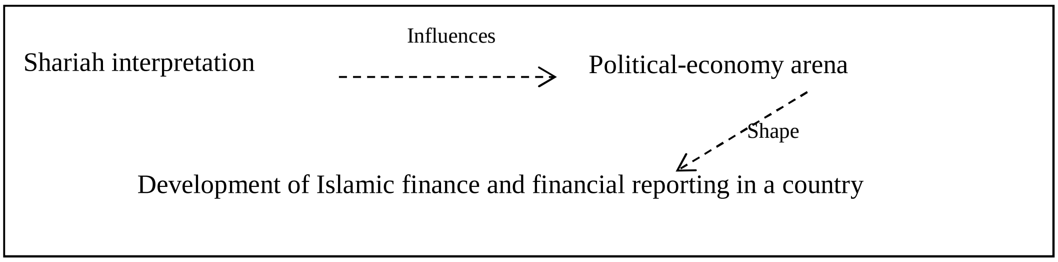
Compliance with AAOIFI standards by IFIs is inconsistent for instance, Vinnicombe (2012) found that Islamic Banks in Bahrain have low level of compliance on Zakat and unrestricted investment disclosures. Despite the fact that Zakat is important for the Islamic banks which is to show their commitment towards Islamic principles and society through the contribution of charity and *Qardul Hasan*[98] (Ibrahim and Yaya, 2005, Haniffa and Hudaib, 2007, Adnan and Furywardhana, 2009). On the other hand, the Islamic banks in Bahrain demonstrated high compliance on issues that are similar to IASB requirements but not Islamic requirement such as Zakat and unrestricted investment account disclosures (Vinnicombe, 2012). Zaher and Hassan (2001) asserts that if the Islamic banks are more inclined to the conventional practices, they might lose some of their Islamic features and identity. However, Haniffa (2011) asserted that AAOIFI has not regulated IFIs for the sake of public interest, equality, sustainability, and social justice, instead it focuses only on their technical aspects. By placing itself as accounting standard setters for IFIs, it is imperative for AAOIFI to clearly communicate its standards to the outside world. However, it appears that AAOIFI has failed to achieve its main objective in an acceptable rate. For instance, there is no evidence that AAOIFI had regular visits to its member countries in recent years in order to identify the issues in adopting its standards. Further, AAOIFI standards have also been criticized for being too flexible and less firm hence providing rooms for business manipulation (Maurer, 2010). Therefore, the business motivation could influence the formulation of its accounting standards that satisfy only certain group of people (referred by El-Gamal (2007) as rent seekers).

5.3.3 Shariah, Political Economy, Islamic Finance

In this section, closer analysis to the structure of these threats is provided. The threats to AAOIFI are in the form of cultural, political, and economic differences and the degree of recognizing Islam as the only ruling base option by AAOIFI member institutions and member countries. Zooming in the analysis helps to understand the conflict in the emerging IFIs particularly in term of its influence on Shariah interpretation. There are several examples where Shariah interpretation has influenced the political-economy arena and in turn played important role in shaping the development of Islamic finance in each country (Warde, 2010, p. 22). This relationship is illustrated in the following Figure 5.3.1.

[98] Is defined as benevolent loans; loan given without margin imposed.

Figure 5.3.1: Shariah Interpretation, Political Economy, and Financial Reporting



Given the understanding from the above figure, the following Table 5.3.1 chronologically lists each country's ranking based on Islamic finance performance measured by assets growth with a reference to GIFR (2013) and the political economy situation that shaped Islamic finance development in the respective country.

Table 5.3.1: Facts on Shariah, Political Economy, Development of Islamic Finance[99]

No.	Country: Political economy arena	Shariah interpretation[100]	Development of Islamic finance
1	Iran: Islamic revolution is embedded in the political parties. Islamic finance is regulated by the government.	Shia: Twelfth sect.	Islamic banks are the product of Islamic revolution in Iran from 1979 onwards. All banks follow Islamic law. Banks are for retailer and industrial development. Islamic finance total asset per 2012: USD 426 billion.
2	Malaysia: secular and weak democracy country. The government provides the infrastructure to avoid conflicting matters hindering the progress of the Islamic finance industry (top-down approach).	Sunni: Shafi'i.	Islamic finance is used to build mega projects and centralize power as the driving force from 1980s onwards. It is used to tap liquidity from the Gulf region by making the country aligned with global Islamic brand (Bassens et al., 2011). Islamic finance total asset per 2012: USD 155 billion.
3	Saudi Arabia: monarchy, non-democratic. The infrastructure is built to legitimise the acquired oil money invested outside the country.	Sunni: Wahhabi.	Islamic finance is a stabiliser annex to the *ribā* based banking industry. It is also used for image and as a tool to identify bright leadership in Islamic world to be placed under the control. It develops the Islamic finance to be closer to the interest based financial institutions. Islamic finance alternatives will be originated from the conventional banks which is considered as Islamic and hence can rely on the interest from its investments (Warde, 2010, p. 22). Islamic finance total asset per 2012: USD 215 billion.
4	United Arab Emirates: same as Saudi regime. However Dubai and Abu Dhabi are very keen to develop Islamic finance as it offers tremendous business	Sunni: Maliki.	UAE objective is to make Dubai a financial hub. The first Islamic bank in 1974 (Dubai Islamic Bank) was set up by a pious businessman with his strong socio-political connections and he steered the bank according

[99] The ranking from 1 to 12 is based on several variables such as: number of Islamic banks, central Shariah supervisory regime, number of institutions involved in Islamic finance industry, size of Islamic financial assets, size of Sukuk, Muslim population, education and culture, regulatory and legal infrastructure (GIFR, 2013).

[100] Sunni and Shia are two major denominations of Islam. Sunni follows Prophet Muhammad (P.B.U.H.)'s tradition, mostly embraced by Muslims in Southeast Asia, China, South Asia, Africa, and some of the Arab world. On the other hand, Shia pays more respect to the Prophet's son-in-law and cousin, Ali bin Abi Thalib, mostly practiced in Iran, Iraq, and Bahrain.

Table 5.3.1: Facts on Shariah, Political Economy, Development of Islamic Finance[99]

	opportunities for the Emirates.		to his own understanding on Islam (Henry & Wilson, 2004, p. 21). Islamic finance total asset per 2012: USD 120 billion.
5	Indonesia: secular, democracy. Islamic finance is developed using bottom-up approach.	Sunni: Shafi'i.	Indonesian Association of Muslim Intellectuals (IAMI) was formerly inaugurated on 7 December 1990 started from activities of several university students who were dissatisfied with condition of the Muslim society at that time and avid for uniting the Islamic community (ICMI, 2013). The leading figure behind IAMI was the Minister of Research and Technology as well as President Seoharto's trusted associate, Prof. B.J. Habibie. Besides Indonesian Council of Ulama, IAMI contributed a substantial influence in the establishment of the first Islamic bank in 1992 and the first Islamic insurance company in 1994. Islamic finance total asset: USD 22 billion.
6	Bahrain: monarchy. Gulf Cooperation Council's hub of banking and finance is developed by the monarch to diversify economic dependence on oil.	Sunni: Shia and Sunni	Among the Middle Eastern countries, Bahrain has more mature regulatory system for Islamic finance where number of multilateral organizations are based in the country (GIFR, 2013) such as AAOIFI that was officially regulated in 1991 and Liquidity Management Centre in 2002. Islamic finance total asset: USD 71 billion.
7	Kuwait: same as Saudi regime but with marginal democratic life	Sunni: Relaxed	Islamic finance flourished in the country with more liberal political climate. But, Kuwait Finance House is closely monitored by the political bureaucrats (Henry & Wilson, 2004, p. 10). Islamic finance total asset per 2012: USD 103 billion.
8	Pakistan: democracy. Political instability prevents Islamic finance attains its potential despite government commitment and support.	Sunni: Hanafi	President Zia ul-Haq was alleged to include neoliberal approach in his economic package in 1977 (Warde, 2010, p. 44) as a result of Pakistan-USA political ties on Afghanistan. At the same time during the Islamization reform, usury was totally banned and followed with the birth of the first Islamic bank in Pakistan in 1979. Islamic finance total asset per 2012: USD 13 billion.
9	Sudan: democracy. Implement full Islamic financial system. Failing to combat poverty and manage inflation prevents significant development of Islamic finance sector.	Sunni: Hambali	The Shariah law was introduced in 1984 which turned the banking industry practice into Islamic. More stringently, the government formed a Sharia High Supervisor Board to oversee the industry compliance to Islamic principles. Neoliberal economy was adopted by Abdul Rahim Hamdi, Minister of Finance (and Islamic banker) during his term in 1992-1993 in which he was inspired by Milton Friedman strategies and claimed that free market was suitable for Islamic economics (Warde. 2010, p. 44). Islamic finance total asset per 2012: USD 14 billion.
10	Bangladesh: democracy. Similar political situation with Pakistan. Secular government has little interest in supporting Islamic finance.	Sunni: Hanafi	Islamic groups introduced Islamic banking in Bangladesh to portray Islam as complete code of life, and with the support from the government they formed the first Islamic bank in earlier 1980s (Sarker, 1999). Islamic finance total asset per 2012: USD 17 billion.

Table 5.3.1: Facts on Shariah, Political Economy, Development of Islamic Finance[99]

11	Qatar: monarchy. Islamic finance involves in the financing of some ambitious infrastructure projects.	Sunni: Maliki	Qatar with Kuwait being the richest GCC states showed the highest portion of banking deposits to GDP per capita in 1998 (Henry & Wilson, 2004, p. 9). Islamic finance total asset per 2012: USD 68 billion.
12	United Kingdom: monarchy. Islamic finance is confident as a business opportunity. City of London is keen to keep status as global financial hub, including as global Islamic finance hub.	Minority Muslim countries. The minority group originally came from India and Pakistan with Sunni: Hanafi understanding.	With only 3 percent population of Muslims, retail Islamic financial activities do not grow significantly since the first Islamic bank was opened in 2005. The corporate Islamic finance however taps the market very well through Sukuk issuances that financed several government projects. In the World Islamic Economic Forum 2013 held in London recently, David Cameron announced that U.K. Treasury is soon to issue £200 million Sukuk (Telegraph, 2013). When U.K. suffers the effect of 2008's financial meltdown, it realises that it is timely to tap the growing pool of Islamic investment. Islamic finance total asset per 2012: USD 37 billion.

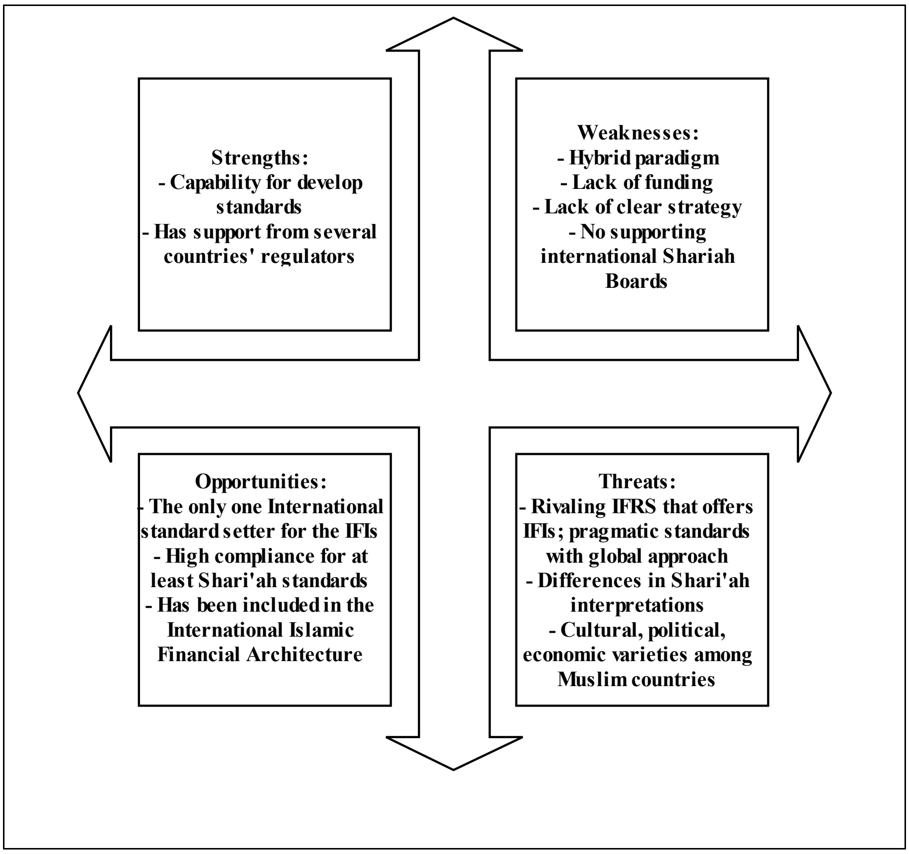
From the above context, one of the important factors i.e. political interests inevitably plays significant role in mobilizing Islamic finance. Impliedly, this is also related to each country's response towards the role of financial reporting standards to support the Islamic finance development. There is no common pattern in all countries shown above to their entry into the world of Islamic finance. Nevertheless, they are notably three models emerged in the development of Islamic finance; 1) Islamic finance is part of economic engine to complement the existing economy (mostly in Middle Eastern countries); 2) Islamic finance is supposed to follow Islamic principles as a way of life for Muslims (mostly in countries with emerging Islamic awareness from the grassroots) i.e. Indonesia; and 3) Islamic finance is a part of political movement to achieve political objectives (mostly in countries with Islam considered as political religion). These three models reflect country above facts describe how these understanding of Islamic finance would then link to the countries' acceptance towards AAOIFI accounting standards. The following section present evaluation on AAOIFI as an organization that issues financial reporting standards for IFIs.

5.4 Assessment of AAOIFI

5.4.1 SWOT Analysis

AAOIFI was established for the following objectives (AAOIFI 2010/1432H, Introduction page): 1. To develop accounting and auditing thoughts relevant to IFIs; 2. To disseminate accounting and auditing thoughts relevant to the IFIs and its applications through training, seminars, publication of periodical newsletters, carrying out and commissioning of research and other means; 3. To prepare, promulgate and interpret accounting and auditing standards for IFIs; and 4. To review and amend accounting and auditing standards for IFIs. In this section these objectives are analysed and discussed using SWOT analysis framework with a purpose of assessing the success rate of AAOIFI in achieving the objectives. The main findings resulted from the focus group discussions are summarised and depicted in SWOT framework shown on Figure 5.4.1 in order to make sense of AAOIFI's problems and prospects.

Figure 5.4.1: AAOIFI SWOT Analysis



Source: Current study.

Strengths

As of March 2014, AAOIFI has issued 88 standards of 48 Shariah standards, 26 accounting standards, 5 auditing standards, 7 governance, and 2 standards on ethics. AAOIFI's approach in producing these standards was first by contemplating how conventional standard may violate Islamic principles and then formulate additional disclosure requirements when necessary in order to present the main characteristics of Islamic practices. For example, closer scrutiny of AAOIFI's first standard, FAS No. 1 (issued in 1993, revised in 1996), aims at dealing with general presentations and disclosure by IFIs reveals similarity of the first four statements with those required by conventional banks: 1. Statement of Financial Position, 2. Income Statement, 3. Statement of Cash Flows; and 4. Statement of Changes in Owners'

Equity (or Statement of Earning). In addition, AAOIFI adds supplementary statements such as Statement of Changes in Restricted Investments, Statements of Sources and Uses of Funds in the Zakat and Charity Fund, and Statement of Sources and Uses of Funds in the *Qard* Fund in order to dress the disclosed information with Islamic outfit. AAOIFI emphasizes that the conceptual framework and accounting standards must be imbued with Islamic values. For instance, the Islamic banks cannot receive any payment with interest component (no Non-halal income); the Islamic banks must provide special reporting on *Mudhārabah's* transaction; the Islamic banks should differentiate between social loan for the poor and small businesses (benevolent loan or *Qardul Hasan*) and should make proper disclosure statements (Tomkins and Karim, 1987, Karim, 1995).[101] AAOIFI has developed its accounting standards over time since the issuance of first standards in 1993 which was once revised in 1996 and subsequently, one-time revision was completed for Financial Accounting Standards (FAS) 12, 13, 15, and 19 standards on Islamic insurance in 2012.[102] Thus, in terms of strength, AAOIFI is the only institution capable of issuing new standards adding to its credit of those readily available standards.

Weaknesses

One of the main weaknesses expressed during the focus group is the hybrid approach adopted to develop Islamic accounting standards. Karim (1995) describes how lengthy was the discussion when the accounting standards setting team decided to adopt the hybrid way in setting AAOIFI standards. He asserted that the process started with objectives established in contemporary accounting thought, test them against Islamic Shariah, accept those that are consistent with Shariah and reject those that are not (see FAOIBFI, 1993, para. 23). Although, the hybrid approach is a temporary solution to the needs of accounting standards for the IFIs, its negative impact on the development of proper Islamic standards became noticeable. The preparers of the financial statements for IFIs tend to borrow conventional concepts as they see it is similar with that of AAOIFI standards. They see that AAOIFI developed accounting standards based on the conventional model and prepared it to be specific accounting standards for IFIs. International accounting firms involved with Islamic financial institutions operation do not fully appreciate the objective of Islamic values for social and economic means. Hence, they tend to emphasis on the superiority of conventional accounting standards as they make sense from meso relationship. Moreover, globalized

[101] The additional disclosures are regulated under FAS 1, FAS 3 (*Mudhārabah*), FAS 5 and 6 (Investment account holders), FAS 9 (Zakat).

[102] The revision in 1996 took place due to the change from FAOIBFI to AAOIFI and revision in 2012 was carried out when Khaled Al-Fakih took position as a new Secretary General of AAOIFI in 2012 (Reuters, 2012)

economy drives businesses into highly competitive markets and this accelerated the process of adopting new conventional standards to facilitate Islamic business transactions. In more than one occasions, the hybrid approach led Islamic scholars to legalize conventional products and services without properly weighting cost and benefit from the Islamic perspective. To them, they have been placed on the conventional platform where the ultimate goal is make IFIs become more competitive and more profitable. For instance, a *fatwa* allowing annuity was issued in Indonesia which led to several problems. The *fatwa* in question is *fatwa* No. 84/DSN-MUI/XII/2012 that has created confusion to the standards setter and many stakeholders who reject the annuity concept in calculating the profit for Islamic banks as it clearly contradicts the Islamic principles. However, despite the violation of Islamic principle the *fatwa* is justified on the bases of making IFIs to be more competitive and profitable. The *fatwa* states that:

> "[…] (4) a better method for profit recognition on *Murābahah* transaction in the phase of IFIs development is annuity method" [translated from Indonesian language].

The method used by National Shariah Board – Indonesian Council of Ulama to issue *fatwa* is by referring to several regulations and standards including AAOIFI Shariah standard which states that:

> The Islamic financial institutions shall not be prohibited to adopt a method accepted by Shariah and local custom in calculating *Murābahah* profit during a specified period of financing, among others profit measurement based on percentage on the total of price/financing in one year, or the whole period of financing *(Ṭarīqah al-hisab allati ta'tamidu 'alā tahdid al-ribh nisbatan 'ala kamil al-mablagh sanawiyan li kamil al-muddah),* or diminishing method *(ṭarīqah al-hisab al-tanazuliyah)*, namely profit calculation based on [remaining] balance of financing that is under responsibility of the customers according to instalment periods. In the two methods, at the time of the contract, selling price must be stated in nominal values. (al-Ma 'ayir al-Syar'iyah li al-Muraja 'ah al-Islamiyah, Mi'yar No. 47, Hai'ah al-Muraja'ah wa al-Muhasabah al-Islamiyah, Bahrain, page 63 [References: Shariah standards for Islamic auditing, Standard No. 47, AAOIFI, Bahrain, p.63]).

Clearly, this Shariah statement contradicts AAOIFI's accounting standard, FAS No. 2 which considered *Murābahah* profit as non-annuity base. FAS 2 states that:

> The profits of a credit sale which is settled in one payment during a future financial period are to be allocated over the financial periods of the sale transaction. (AAOIFI, 2010/1432H, p. 121).

Legitimising time-value calculation of profits meant that the scholars might have taken the side of accounting profession, Islamic bank managers and the investors who urge IFIs to provide risk free profits. The duty of Islamic scholars is to determine the proper economic transactions that are in line with Islamic principles in order to guide practitioners for future transactions. Thus, neutrality of IFIs scholars will be assumed when their *fatawā* are based solely on the principles of Islam rather than based on weighting partially perceived corruptive against the fairly presented benefit of the commercial banks. It is also noticed that the function of issuing *fatawā* has been placed under the responsibility of Shariah Board within AAOIFI jurisdiction in order to achieve harmonization and convergence at both conceptual opinion and accounting practices that can be indorsed by the Shariah supervisory boards of all IFIs. Furthermore, by placing the fatwa under the umbrella of AAOIFI, those scholars can provide the necessary guidance for IFIs in developing new financial products and services; provide Shariah opinion over any dispute with IFIs; and insist that AAOIFI standards (accounting, auditing, code of ethics) are in compliance with Islamic principles at all times (AAOIFI, 2013d). Their opinion often starts firstly by reviewing the position taken by Financial Accounting Standards Board (FASB) based in the USA and International Accounting Standards Board (IASB) based in the UK; secondly, what are the IFIs interests and then how they would consider Islamic view should be. With such power embedded within the position of the Islamic scholars and their advocacy towards AAOIFI's hybrid approach, the issuance of any Shariah standard became meticulously challenging as how each *fatwa* might be interpreted and whether they have taken all the necessary actions to cover any possible differences that might occur as a result of different ways of interpreting their *fatawā* . In other words, AAOIFI hybrid approach made these types of *fatawā* possible despite their violation of Islamic principles. Furthermore, hybrid approach coupled with the emphasis on considering accounting as catering merely for businesses at meso level made those scholars to have not only poor knowledge of the role of accounting in society and but also ignorant about the problematic nature of accounting as biased non-scientific science. Therefore, misinterpreting AAOIFI's accounting standards and pronouncements as well as perceiving them as means for assisting IFIs for survival make *fatawā* that are inconsistent with Islamic based financial reporting standards and the fundamental principles of Islamic Shariah to exist.

Scholars usually adopt a collective *Ijtihād* (reasoning) through regular meetings and maintain famous saying such as "maintain that which is old and good, and embrace that which is new and better" however there are supposed to be clear rules to differentiate between <u>old</u>, <u>good</u>, <u>new</u>, and <u>better</u>. The interpretations and applications of these words vary from one scholar to another scholar; and from one place to the other. It is acceptable to have different interpretations towards one principle as stipulated by other *fiqh* maxim, in which Ibn Qayyim al-Jauziyah is saying that "changes in *fatawā* are acceptable due to dynamic changes in period, place, situation and tradition"; or in other *fiqh* method, it affirms "the law is spinning together with its base to create and to demolish the law" (Ridwan, 2007). But, any changes should not violate Islamic principles. The differences are limited to changes in the *fatawā* on how to apply Islamic law, and only valid for the rulings that are not clearly mentioned in the Qur'an and Sunnah. Yaquby (2013) asserts that the changes are only the *fatawā* but not the original sources. Since the changes depend on period, place, and situation therefore the Islamic scholars must specify and consider these differences in the *fatawā* , which in the AAOIFI standards opinions from the four schools of thought (Hanafi, Maliki, Shafi'i, and Hambali) are quoted in each discussion of the standards. The unique background of the Islamic scholars may warrant different opinions in every case solved in the board. From the list of board members, AAOIFI appoints mostly those who are from the Middle Eastern countries such as Bahrain, Saudi Arabia, Kuwait, Qatar, and UAE while disregards the reality that Islamic finance is also growing immensely in South and Southeast Asia. From 38 Shariah board members, there is only one representative from Malaysia but none from Indonesia (see Chapter Three). Excluding other Islamic scholars is considered as a weakness against AAOIFI's objective of widening the adoption of its standards. Ideally, there should be a truly international and multi-school of thoughts in Shariah board that not only can clarify issues from different perspectives related to *fiqh* matters in Islamic finance and represents countries in majority but also involve in designing the strategy for AAOIFI to move to Islamically based standards and increase countries adopting their standards.

Furthermore, it appears that AAOIFI has the monopoly of issuing *fatawā* of financial and business transactions and no other organisation can challenge this role. For example, a subsidiary of Organization of Islamic Cooperation (OIC), the International Islamic Fiqh Academy (IIFA-OIC) was set up in 1988 (much earlier than AAOIFI) has an objective:

> "to achieve the theoretical and practical unity of the Islamic Ummah[103] by striving to have Man conform his conduct to the principles of the Islamic Sharia at the individual, social as well as international levels; to strengthen the link of the Muslim community with the Islamic faith; and to draw inspiration from the Islamic Sharia, to study contemporary problems from the Sharia point of view and to try to find the solutions in conformity with the Sharia through an authentic interpretation of its content" OIC (2013).

Hence, although all issues on Islamic commerce, banking and finance should be regarded as matter of concerns by the IIFA-OIC, it appears that the ultimate *fiqh* opinions rest within the AAOIFI Shariah Board's jurisdiction too, for instance Shariah guidelines on the ownership of underlying assets in Sukuk. Shikder (2009), the Head of Shariah Advisory and Compliance, Gatehouse Bank London, documents that he refers to both

[103] Islamic Ummah is general term that refers to Muslims in the world.

AAOIFI guidelines and International Islamic Fiqh Academy's Resolutions on Sukuk.[104] As mentioned, there are only few central banks that have expressed their supports on the adoption of AAOIFI standards, which means only few who are willing to pay yearly membership fees to the AAOIFI. Selling AAOIFI red books (collection of standards) and organizing CIPA and CSAA programs as well as organizing some conferences are insufficient to support the AAOIFI operational costs, hence furthering its weaknesses. Since the beginning AAOIFI has been maintained by part-time unpaid board members and only hires consultants occasionally. Thus, it implies that AAOIFI is lacking the efforts to revise its standards to cope with the latest economic and social development and also to ensure its standards comply with the Islamic principles at all times. There are names of several prominent and influential figures sitting in the AAOIFI boards but there is no evidence that they involve in lobbying the country's regulators for adopting AAOIFI's standards (see Chapter Three). AAOIFI received some financial supports from its founder institutions (several Islamic banks) although initially it was considered to be problematic (Karim, 1995). This support was a dilemma for AAOIFI as it wishes to remain independent from either regulatory authorities or other related parties, while at the same time it needs butter and bread for its operation. However, the support from the industry has motivated some central banks to enforce the standards to all IFIs in their respective countries. As a result, AAOIFI standards are stated in the rulebooks of several central banks such as Kingdom of Bahrain[105], Dubai International Financial Centre, Jordan, Lebanon, Qatar, Sudan and Syria (AAOIFI, 2013b).

Opportunities

Besides AAOIFI, there is no other international standard setter that exclusively develops accounting standards for IFIs. This indicates that there is an opportunity for AAOIFI to progress its international position among the rest of global standard setters as the only standard setter for IFIs. However, currently AAOIFI is facing challenges by number of national standard setters that develop their own standards for IFIs with references from AAOIFI's conceptual framework such as Indonesia (see Chapter Six). Therefore, it is

[104] "All [tradable] Sukuk must represent ownership in the underlying real assets (real, usufruct, services) with all rights and obligations) which can be owned and sold in accordance with Shariah and applicable law. Transfer of ownership must be recorded in the seller's books as per Shariah and applicable legal requirements and should not be shown as the assets of seller or manager)."

[105] Central Bank of Bahrain Rule Book, Chapter PD-3 requires all locally incorporated Islamic bank licensees to publish quarterly financial statements, in accordance with Financial Accounting Standards (FAS) issued by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). For products and activities not covered by AAOIFI, International Accounting Standards (IAS) should be followed (CBB, 2011).

challenging AAOIFI's main objectives i.e. developing, amending and disseminating accounting and auditing thoughts standards for IFIs. Given this opportunity, AAOIFI could develop good relationships with those national standard setters in Muslim world for joint effort on this standard setting front. Furthermore, standards that have been developed by AAOIFI should have been adopted by at least 200 member institutions from 40 countries. Therefore, there is good opportunity for AAOIFI to convince the member institutions to adopt its standards otherwise, each regulator body in Muslim countries will continue its effort to develop its own standards or to follow IFRS. Thus, not engaging with national Muslim accounting regulatory bodies can be seen as that AAOIFI has failed to achieve its stated objectives. Member institutions or member countries are said to be in compliance with specific accounting standards if these standards are stated on the published financial reports or in the country's rulebook. Therefore, AAOIFI needs to redefine the meaning of membership and must re-approach the members in order to convince them to comply with its standards and at the same time provide quality standards that suit the needs of IFIs.

AAOIFI Shariah standards at least have become the main reference in many countries including Indonesia regardless whether the standards are used as reference, main sources or as comparison of standards. For instance, Shariah standards issued by Shariah Advisory Council – Bank Negara Malaysia and Securities Commissions are influenced by both Shariah standards issued by the AAOIFI and OIC-IIFA (Hassan and Mahlknecht, 2011, p. 320). This has been affirmed by the Secretary General of AAOIFI:

> "For Shariah standards [AAOIFI] is dominating the market," Khaled Al Fakih, the body's secretary general and chief executive, said on Tuesday. "Everyone is referring to AAOIFI when applying their standards. As for accounting, this is the big problem." (WSJ, 2013).

As the Shariah standards have succeeded to become the main reference for many IFIs, there is a room for the accounting standards too, provided AAOIFI would exercise this opportunity in more strategic ways. Besides, AAOIFI is the only international accounting standard setter that has specific concern on IFIs. AAOIFI has also been regarded by Islamic Development Bank as a major supporting institution for the Islamic finance industry, which would build a more strategic International Islamic Financial Architecture (IIFA). The IIFA provides a development framework for Islamic finance as a whole and a due recognition for the growing systemic importance of IFIs across the Muslim world (Ali, 2000).

Threats

IASB has been promoting its standards to be adopted by IFIs through setting up special taskforce group of accounting standards for the Oceanic region. The main aim is to reduce the gap between the existing IFRS and the needs of the IFIs (see Chapter Three). With this strategy, IASB is trying to offer more pragmatic approach in the pursuit of business expansion in the region through linking up IFIs current practices with the rest of financial institutions that follow their standards. This strategy is quite successful as more IFIs are using IFRS to prepare their annual reports despite the problems associated with adopting IFRS by IFIs and the critiques regarding the applicability of IFRS to IFIs (see Chapter Two). For example, Dr. Khaled Al Fakih, AAOIFI's secretary general and chief executive commented that:

> "When you adopt IFRS or US GAAP, the Islamic spirit in most of the transactions are not there..... Under IFRS or US GAAP, everything is about borrowing and lending (WSJ, 2013).

IASB's success can be seen from: 1. Keeping IFIs away from adopting AAOIFI standards and, 2. Having mutual interest assumed between IASB and IFIs where the former can claim the increased adopters of the standards while the latter gaining the flexibility and credibility associated with IFRS as well as having their financial reports recognised by international market hence making the operation of import and export of cash more credible. Internally, the main reason that made IFRS to be attractive is the weak commitment to apply Islamic fundamental principles by IFIs. This is due to Muslim scholars who tend to be more relax when it comes to money and strict when it comes to social and individual worships. Many differences in Shariah interpretations of Islamic finance practices, which no institution, not even IIFA-OIC or AAOIFI may be able to resolve due to the relaxation strategy with financial affairs (making money and profits as the central gravity for Islamic finance rather than the fulfilment of *Maqāsid ul-Shari'āh*). Hence, it is inevitable that IFIs seek integration with the rest of global financial institutions and are becoming desperate for conventional non-Islamic-based international standardization of practices, under the pretext that Islamic law as the main foundation is interpreted with various perspectives, not only along Sunni–Shia sectarian lines but also within the four main schools of Sunni (Bassens et al., 2011). Bassens et al. (2011) exemplify the relaxing attitudes in the interpretation of financial related Islamic rules such as in Maghreb (e.g. Morocco, Alger & Tunisia) where Maliki followers are the majority; they do not recognize the banning of interest therefore they do not participate in the development of the IFIs, and in Malaysia where Shafi'i school of thought interpretation is more relaxed as opposed to Saudi *Wahhabi* interpretation only on social physical punishments, but when it comes to wealth, the Saudi *Wahabi* become very brilliantly tolerant.

Furthermore, countries where Islamic school of thoughts centralise financial and political affairs (such as the *Wahhabis* and *Shia*)[106], the IFIs are developing very fast towards global integration and hence AAOIFI version of Shariah interpretation that inspire financial reporting standards are perceived incompatible by those IFIs and so claim the need for IFRS to fill the gap. Islamic school of thoughts that centralised personal and economic purification (such as Shafi'i) still considers AAOIFI's standard and when IFRS are used would be just for tactical reason i.e. for international labelling. Hence, this Islamic camp understands the threat against Islamic accounting standards as a temporary phenomenon because Shariah standards are adopted by their member institutions despite the political differences that led to Shariah opinions to take unbalanced approach: relax to moderate on finance and strict on individual spiritual affairs. Another main threat is the lack of financial capability available to AAOIFI compared with IASB. IASB enjoys the status of international accounting standard setter body with strong funding resources and successful record of lobbying regulators in many different countries to enforce the implementation of its standards. These factors, i.e. funding, reputation, and lobbying power pose serious threat to AAOIFI's future viability because AAOIFI has none of them. However, AAOIFI can activate a strategy for achieving them through good reputation that can be built upon its professionalism which can attract good source of funding, especially for AAOIFI's wealthy member countries such as those from the GCC. Only when AAOIFI's members see significant values in its work then AAOIFI can generate adequate funding. Currently, AAOIFI's financial reporting standards that are built upon prudence and financial stability are not seen as important by the wealthier member countries, hence funding AAOIFI for its development hence to issue more standards contradicts its members policy. Thus, AAOIFI professionalism will never been taken into consideration by its wealthy members who are interested in linking Islamic finance to Bloomberg, Dow Jones, LSE and not to the Islamic heritage.

Compared with IASB that has hundreds of consultants, AAOIFI has only limited number of unpaid part-time consultants which begs the question on the contrasted mechanism to ensure quality standards. IASB website is frequently updating its agenda, activities of engagement and promotional trips around the world compared with AAOIFI's scaled down agenda and activities that are mostly held in Manama, Bahrain and using only limited avenues to advertise its programs. As a result AAOIFI fails to attract member countries to participate. In short, depriving AAOIFI from mounting meaningful challenge to IASB is controlled by the block members in the GCC region. The GCC is interested in placing the whole of Islamic finance as a stabiliser annex to the global capitalist model and hence not committed in having

[106] Wahhabi is a religious movement or sect or branch of Islam known very orthodox and ultraconservative embraced by some Muslims in Saudi Arabia.

AAOIFI taking fundamental role in developing the strategic and ideological knowledge that could contribute to the building of Islamic unity among Muslim countries. The above SWOT analysis is confirmed by several interviews below that describes AAOIFI's problems and suggests the way forward.

5.4.2 Interview Analysis

Macro Systemic Perspective

Regulators are the main the party that ensures the enforcement of AAOIFI in a country. According to Interviewee I-12, the supports come from who is in charge on regulating banks or insurance or investment in the respective country.

> It depends on the market. The support I should say it is mainly from the banks, followed by insurance companies, investment management and so on. It depends on who regulate all these in the respective country (I-12).

AAOIFI relies mainly on the regulatory approach which is in the institutional arena known as 'coercive mechanism', a pressure that comes from the regulators in this case they are banks, insurance companies, and investment management. Nevertheless, there is no latest engagement between AAOIFI and any regulatory authorities in Indonesia. This is further expressed by Interviewee I-12 when he was asked about its current engagement with Indonesian regulators:

> We worked quite closely with Bank Indonesia before, (even) till now, to an extent. Hopefully (one day), you know some changes taking place in Indonesia (currently), the regulation and so on. Bank Indonesia used to be part of our board of standards before, during *Bapak* Maulana Ibrahim. […] Currently we are in Bangladesh and Pakistan, I'm sure we will go back to Indonesia soon (I-12)

Interviewee I-12 mentioned Maulana Ibrahim as Governor of Bank Indonesia who served his position from 2002-2007. It means, to the time of interview (2013), AAOIFI has been absent around six to eleven years. For travelling around the world, AAOIFI certainly requires a very strong funding. As non-profit organization, AAOIFI operation largely relies on outside funding; Interviewee I-12 shared his view on this matter:

> Currently we got funding from our members, we also generate the funding through conference, certification programs, and publications. It's the same with source of funding of the IFRS; they get donation *et cetera* (I-12).

Learning from the success of IASB, which has been establishing networks and cooperation with other institutions, is a great opportunity for AAOIFI too as there are now more institutions that have been set up to support the development of Islamic finance. IASB is just like AAOIFI that has no power to impose its standards, but it has intelligently established one to one cooperation with EU in 2005, IOSCO in 2012, and IFAC in 2012, and even has started to approach IFSB in Malaysia through a roundtable discussion. The event that was organized together with SEC Malaysia and IOSCO on 9 September 2012 had a purpose to develop disclosures requirement for Islamic capital market products. Malaysia has been easily approached and at the beginning of 2012 the IFIs in Malaysia have officially stated IFRS compliance in their annual reports. With its promising growth in Islamic finance and location of the international offices (IFSB, ILMC), partnering with Malaysia will lead to bigger coverage for the IFRS users, at least in the Southeast Asian countries. This is consistent to a game-theoretic approach adopted by Mattli and Buthe where the first mover gains an advantage, and the follower is forced to absorb the costs and the ‘institutional complementarities’ determine who moves first and second (Martinez-Diaz, 2005). From the nature of politics in Malaysia where the government aims at global Islamic brand (see Section 5.3.3), the regulators are aggressive to become the first mover in the region including promoting IFRS adoption for IFIs as a whole. What about the current stand of AAOIFI? Interviewee I-14 was concerned on AAOIFI current condition and proposed that Islamic Development Bank (IDB) should play the role:

> AAOIFI should be developed and become a good institution respected by all countries […] now they don’t have so much political influence. IDB is respected by many countries because it has given many contributions so let IDB do that, not Bahrain, not Indonesia, not Malaysia, IDB who (should) organize it. IDB can do many things but not accounting […]. I think is the weaknesses of IDB (I-14).

IDB has an objective to foster the economic development and social progress of member countries and Muslim communities according to Islamic principles through loans, grants, and financial assistance. From the scope of objective, it is relevant when Interviewee I-14 suggested a coercive mechanism that can be exercised by IDB to implement AAOIFI accounting standards for IFIs in the world (see Chapter Seven on IRTI-IDB and Islamic Financial Sustainability Assessment Program). Looking back at the history of AAOIFI establishment, the initiative was emerged during the 11th Annual Meeting for the Governors Council of the Islamic Development Bank in Istanbul (see Chapter Three). Followed up with a workshop, the initiative was developed and the team members decided to set up an independent body which is impliedly it should not be under IDB. AAOIFI has recognized IDB on its website that says “AAOIFI standards are followed […] in jurisdictions that offer Islamic finance across Middle East […] and Islamic Development Bank Group” (AAOIFI, 2013b). Likewise, IDB has been stating its compliance with AAOIFI accounting standards on its annual reports. However, there is no attempt to exercise its authority, for instance to include AAOIFI accounting standards as condition for IDB loan or investment although it is for Islamic finance. IDB is one majority shareholder of Bank Muamalat Indonesia (32.74% size of shares) as per 25 March 2013 (BMI, 2013), IDB did not apply this requirement with the evidence that BMI refers to PSAK 101-107 for its reporting. This shows weak cooperation between IDB and AAOIFI as opposed to how the World Bank incorporates IAS/IFRS in its financing conditions (see Chapter Four). Otherwise, the suggestions would be self-improvement in the body of AAOIFI as Interviewee I-02 conveyed his view on the condition of AAOIFI:

> According to me, the institution such as AAOIFI must be strengthened; AAOIFI must have strong funding; so they can promote its views and uniqueness of Islamic finance (I-02).

At the same time, not only funding, AAOIFI must also be seen as ‘a real independent body’ that represents voices of majority of the members with fast developed Islamic finance, such as Indonesia. Interviewee I-14 emphasized AAOIFI roles and what should be changed:

> First, intensify the lobby, second, make a conference not only in Bahrain, and third, reduce local interest. As you can see the conferences are held in Bahrain with a complicated visa procedure (I-14).

At macro systematic perspective, AAOIFI’s role is very weak: internally it has problems with funding and reputation, externally, AAOIFI is lacking of initiative to collaborate with other institutions to help enforcing its standards (no lobbying power). In terms of actors at this macro level, the institutional arena shows that it differs from the IFRS adoption scenario in Indonesia as described in Chapter Four. In this case, AAOIFI is absent at the top engagement level such as with G20/MoF but it existed in the past, at least with Bank Indonesia. Ironically, IDB which is the founder of AAOIFI did not or fail to exercise its authority to coercively impose AAOIFI standards in loan agreement or financial cooperation with Indonesia, for instance its shareholding in Bank Muamalat Indonesia.

Meso Structural Perspective

All Shariah standards relating to Islamic finance must be endorsed by National Shariah Board – Indonesian Council of Ulama before it is being adapted into any business standards including financial reporting standards. Section 5.3.3 describes that majority of countries with high growth in Islamic finance adopt different school of thoughts. This is said as challenges to form uniformed financial reporting standards for IFIs:

> If the accounting standards are still bound to different types of *mazhab* (school of thoughts), there will not be any single standard. For example, *Bai'-ul-Inah* in

> Malaysia, (although it is rejected in Indonesia, but it is allowed in Malaysia), and as a result the accounting standard setter in Malaysia provides a specific accounting standard for the transaction. It is [therefore] subject to different type of *fiqh* interpretation (I-14).

As discussed in the literature section, not only Shariah interpretation (different school of thoughts) but also political climate shapes the direction of Islamic finance including the issues on financial reporting. This is shown on the development of financial reporting standards in the South East Asia. Indonesia is very tactful in deciding a standard for the IIFIs as the Shariah board is a separate from the regulatory institutions. Unlike Malaysia, the Shariah board sits in Bank Negara Malaysia and Security Exchange Commission and together, they determine direction of Islamic finance. Interviewee I-01 states the following:

> The characteristic of Malaysian regulator is very dominant. It is good in one hand because if the regulator insists to develop the Shariah [Islamic finance], all elements will immediately support, the most important thing is to move forward. Whether it is fully Shariah compliance, it is not urgent now and it could be amended later (I-01).

Converging to the conventional finance practices is seen as the most effective strategy to boast the development of Islamic finance in Malaysia. However, Malaysia has been receiving harsh critiques towards its lenient approach in regulating Islamic finance. It is argued that different *fiqh* interpretation can lead to extreme or relaxed views on one principle and it will be reflected on the financial reporting standard of the respective IFI. Therefore, some scholars do not see adopting AAOIFI standard (as a single standard for all) as urgent since it conflicts with respective country's regulation and approach to develop Islamic finance. The following scholar expresses his view on this issue of what happens in the UK or in the countries where the regulators have not accommodated IFIs as separate entities from the conventional financial institutions.

> I think the scholars are also not interested too much on this […], for example in *Murābahah*. Now if somebody regards that transaction as the loan, the fee is through the *Murābahah*, the profit is through the *Murābahah*, but for tax purposes, it requires to treat that as a loan. I don't think there is an issue. […] Now we have to move forward and try to report it that *Murābahah* is different from *Ijārah*, *Murābahah* is different from *Wakālah* (I-07).

Currently, majority of the IFIs do not produce their own financial reporting according to AAOIFI standards. The Shariah scholars have duty to monitor although they are not reported under AAOIFI standards which means they must fulfil Shariah principles in their reporting. One international Shariah scholar mentioned this matter as follows:

> For the sake of Shariah requirement, they (Islamic banks) maintain separate internal accounting system. […] We have to sign both reports but on the conventional report,

> it just states total receivables, total payables, total profits, total loss, and asset value. So we sign for the sake of shareholders but we say that whatever these figures represent whether it is loss or profit etc. is achieved based on Shariah principles (I-05).

The Interviewee I-05 mentioned dual reporting system which is also suggested by Nobes and Parker (2012) in order to anticipate and satisfy different requirements for the accounting report. However, this method may be costly to certain extents and tedious to implement, however it may be a temporary solution for the current stage of Islamic finance development. To tie this motivation, AAOIFI must be evaluated in terms of its objectives in producing the financial reporting standards. From the objectives of AAOIFI described on the above content, AAOIFI must work towards achieving them with more authoritative strategies. Interviewee I-12 expressed his views that AAOIFI should act such as the following:

> We issue accounting standards for two things where there is an absent in the IFRS for Islamic financial transactions or where IFRS do not address specific standards for Islamic financial transactions. So, there are many IFRSs that can be followed by the Islamic financial institutions. […] If you want to follow IFRS, fine, but do additional disclosure that follows AAOIFI (I-12).

Interviewee I-25 confirms the above statement although the Islamic bank he is attached with follows IFRS but in terms of accounting treatment for Islamic finance contracts, the bank follows AAOIFI standards and provides additional disclosure.

> With regards to Islamic transactions, they are reported in line with AAOIFI guidance and you can see this clearly in the financial report. Each Islamic principle used by the bank is then, explained in the notes and a reference made to its accounting treatment (I-25).

Indeed, there are many IFRS standards that are compatible with Shariah but AAOIFI could modify the existing standards rather than being there in the absent of IFRS (see Chapter Six). AAOIFI objectives must be re-defined as to whether to <u>develop</u> and <u>disseminate</u> accounting and auditing thoughts relevant to the IFIs and to <u>prepare</u>, <u>promulgate</u>, <u>interpret</u>, as well as to <u>review</u> and <u>amend</u> accounting and auditing standards for IFIs or to complement IFRS standards. The objectives could be too ambitious and they may not be so SMART (Specific, Measurable, Attainable, Realistic, and Timely). Besides the objectives, AAOIFI should also renew its scope in its conceptual framework as it is important to be updated with the current changes of IFIs which according to Alexander and Britton (2001) 'it is in no way out-dated.' As opposed to the objectives of IASB (see Chapter Two) i.e. to <u>develop</u> a single set of <u>high quality</u>, <u>understandable</u>, <u>enforceable</u> and <u>globally accepted</u> international financial reporting standards (IFRSs) through its standard-setting body, the IASB; to promote the use and rigorous application of those standards; to take account of the financial reporting needs of emerging economies and small and medium-sized entities (SMEs); and to bring about convergence of national accounting standards and IFRSs to high quality solutions. Comparing these two sets of objectives, an analysis can be drawn that is presented on the following Table 5.4.1. The analysis shows how the respective objectives can be measured, which may portray the success of the institutions. AAOIFI in one hand is not ambitious and SMART while IASB shows its enhancement from its former institutions, International Accounting Standards Committee (IASC) that performed the internationalization of accounting since 1973 to 2001. Previously IASC was examined whether it was a successful project in publishing and promoting accounting standards (called IAS) and found its objectives were not ambitious enough. Its successor records a big success after learning from the failures of IASC i.e. to redefine objectives in setting international standards. To make it more powerful, it is combined with additional 'political pressure' that is lying in the IASB path (Zeff, 2002).

Table 5.4.1: Analysis on AAOIFI objectives

AAOIFI	Indication	IASB	Indication
To develop		To develop	
relevant	Not **S**pecific, not SMART	*high quality*	indicates SMART
To disseminate		*understandable*	
training, seminars, publication, research	**S**pecific, but not rigorous	*enforceable*	
To prepare	Too broad	*globally accepted*	
To promulgate		To promote	
To interpret		*rigorous*	ambitious
To review		To take account	
To amend		*emerging economies*	**S**pecific
	All objectives refer to IFIs without considering type of IFIs (too general)	To bring about	
		high quality solutions	**S**pecific

Source: authors' analysis.

At the meso level, normative pressures seem to be more convincing by rationalizing AAOIFI accounting standards as merely a reference for IFIs, without necessity of its full compliance. If AAOIFI would like threat its accounting standards to be simply as reference or additional disclosures for IFIs, AAOIFI should perform the following: 1. AAOIFI is required to re-define its objectives, 2. IASB will need to consider AAOIFI as complimentary standards to IFRS, and 3. Indonesia with its own standards will determine whether to follow that mechanism or will be consistent with its own SSFAS 101-107. At this stage, there is no empirical evidence that mimetic influence exists on macro, meso, or micro levels. In other words, the IFIs in Indonesia are not attracted to follow its counterparts to comply with AAOIFI accounting standards. It is different in the case of AAOIFI Shariah standard that is still regarded as one of the main references (see Fatwa 84 endorsed by DSN-MUI in 2012). With regard to point number 2 as to whether IASB will need to consider AAOIFI as complimentary standards for IFRS, Interviewee I-06 said the following:

> We are going to form a special team that is in charge of discussing how to consolidate the issues with AAOIFI (I-06).

This indicates that the initiative from IASB may be useful to determine the future of AAOIFI provided AAOIFI has better bargaining power to act as an international accounting standard setter. However, to date, there is no evidence that both international standard setters have conducted a joint-meeting to take serious action on the consolidation.

Micro Actor Perspective

At the micro actor perspective, none of the actors responds to AAOIFI standardization project. From the interviews with practitioners and regulators in Indonesia, they seem unaware of AAOIFI accounting standards as opposed to IFRS. There is no evidence from industry associations or consultants that they put effort to convince the IFIs in Indonesia to implement AAOIFI accounting standards (Unlike the case of IFRS on Chapter Four). Vice versa, the mimetic mechanism is also absent although there are several IFIs are complied with AAOIFI accounting standards such as Bahrain Islamic banks.

5.5 Conclusion and Recommendation

This chapter aims at evaluating the extent of compliance by Indonesian IFIs with AAOIFI. The SWOT analysis shows that AAOIFI has strong capability to develop its accounting standards for IFIs because it is still supported by several regulators, however AAOIFI must deal with some weaknesses, especially its lacking of clear strategy in promoting the standards. On the other hand, AAOIFI has an opportunity to remain as international standard setter for IFIs as it has been included in the structure of Islamic financial architecture design; however the threats that AAOIFI has to face come from IASB with its more pragmatic standards with global approach and strong political lobbying power. In contrast, AAOIFI suffers from funding limitation, reputation, and lobbying power. Overall, the most challenging part derived from SWOT analysis is country’s political setting which is considered as threat to AAOIFI. The political setting determines direction of Islamic finance including its option on which financial reporting standards should be adopted for IFIs.

The Arena Concept shows that Muslim scholars in Indonesia, as one of the main actors, retain the power of interpreting and moderating the understanding of financial transitions in line with Shafi'i school of thought. This factor alone implies a dismissal of AAOIFI accounting standards due to its lack of detailed rules and the negligence of addressing issues related to Indonesian's own need for the standards. Therefore AAOIFI's standards are viable only as a reference for local authorities to consult when preparing national standards for the IIFIs. Political pressures through hegemonic forces at macro level are hitherto unchallenged and this is the weakest part in AAOIFI strategies. The failure of AAOIFI in ensuring the compliance of its standards has been previously experienced by IASC. With the current strategy, its successor plays high level politics that involves 'hegemonic regulators' term introduced by Martinez-Diaz (2005) such as SEC[107], EU, G20, World Bank, ASEAN and it records fast track of success. One interviewee suggests that financial reporting standards should be under jurisdiction of IDB to develop and enforce to its member countries. This suggestion may be at least, to more strongly collaborate with IDB to include the use of AAOIFI accounting standards as conditional term in any IDB project. At the same time, AAOIFI should firmly decide direction of its conceptual framework and limit the scope of its objectives as whether to simply become a reference of IFIs. Otherwise, AAOIFI should be able to consistently update its standards and develop its persuasion strategy by initiating more collaborative projects with IFIs supporting institutions.

This is the first study that uses Islamic perspective on Political Economy of Accounting as the analytical lense to explore AAOIFI standardization project. Hence, in this chapter 'Islamic Political Economy of Accounting' is defined as the critical approach grounded on permissible (*Mubāhāt* - مباحـات) public policy and Shariah rulings aimed at examining the interplay between key stakeholders and the socio-political apparatus involved in developing how accounting is to produce and communicate relevant economic information for decision making. This definition is tentative because it narrows it down to a specific level of the political economy related to accounting; further study is required to develop it in more concrete terms and application which is beyond the focus of this research. Lastly, this study in this chapter suffers from limitation in terms of its research method. A case study research design is more suitable for this type of topic which offers better observation. Exploring deep rooted constraints faced by AAOIFI entails further research.

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[107] Securities and Exchange Commission.

Appendix 5.1: Focus Group Discussion and Resolutions

Focus Group Discussion	
Day, date	2 August 2012
Time	11:00-13:30 (150 minutes with 30 minutes break)
Venue	Tazkia University College meeting room, Bogor, Indonesia
Number of participants	11
Profile of the participants	One Islamic bank's accountant, one Shariah Supervisory Board member, one Islamic banking researcher, four Islamic accounting lecturers, and four Islamic accounting final year students

No	Resolutions: AAOIFI SWOT Analysis
Strengths	
1	Capability for developing standards
2	Has support from several countries' regulators
Weaknesses	
1	Hybrid paradigm
2	Lack of funding
3	Lack of clear strategy
4	No supporting international Shariah board
Opportunities	
1	The only one international standard setter for IFIs
2	High compliance for at least Shariah standards
3	Has been included in the International Islamic Financial Architecture
Threats	
1	Rivalling IFRS that offers IFIs with more pragmatic standards with global approach
2	Differences in Shariah interpretations
3	Cultural, political, economic varieties among Muslim countries

Chapter Six: IFRS, AAOIFI, and Indonesian SSFAS Level of Standards

6.1 Introduction

It is evident from the review of the literatures on Chapter Two and Three as well as the empirical findings on IFRS and AAOIFI adaptation and compliance in Chapter Four and Five that some elements such as the philosophy and practical sides have explained the need to ensure the path of the Islamic Financial Institutions (IFIs) to opt appropriate financial reporting standards. In Chapter Three, the literature gap shows that there is no international recognition as to whether the reporting standards employed by the IFIs in Indonesia have been fully complied with Shariah as well as with the generally accepted financial reporting standards. Likewise, there is no consensus among preparers of IFIs which financial reporting standards are more viable and practical to accommodate the reporting requirements of IFIs in general. Therefore, IFIs in each country do not adopt the same financial reporting standards for instance Saudi Arabia and Malaysia clearly state that they refer to IFRS while Bahrain requires AAOIFI standards for their IFIs. Indonesia has initiated to formulate its own Islamic based financial reporting standards based on IAS and AAOIFI that is referred as Shariah Statements of Financial Accounting Standards (SSFAS).

In accounting literature, financial reporting disclosure is known as the honest revelation of relevant information in the financial statements and in the accompanying notes about business transactions within specific time period. There are two types of disclosures: mandatory and voluntary disclosures. The former are regulated in the standards endorsed by accounting standard setters in the country while the latter are based on discretion of the management of the firm. There are several studies on the extent of financial reporting disclosures where most researchers are more concerned on the voluntary disclosures relating to environmental and social reports and applying disclosures indices to measure the extent of the disclosures. The purpose of calculating the index score is limited to the extent of the disclosures but not necessarily the quality of the disclosures (Marston and Shrives, 1991). In the later study, Belkaoui and Karpik (1989) argue that social information is provided by corporates depending upon their social performance and political stability. In a study on environmental and social accounting disclosure practices in the Asia-Pacific region including Indonesia, Williams (1999) documents that the organizations provide details as a way to protect self-interests in the face of social and political pressures. Williams (1999) employs bourgeois political economy theory suggested by Clark (1991) and social environmental perspective from Gray, et al. (1996) that recognize interactions among actors (individuals or groups) in the pluralistic world who tend to pursue their own goals and self-interests but it is moderated with social environment where they exist. Hence, this has become a provoking question as to whether institution such as IFIs, apply the same behaviour on their disclosures. However, almost all researchers neglect religious influences on financial reporting disclosures standards and practices. This has been acknowledged as a limitation for instance by Williams (1999) as that he did not incorporate the impact of special figureheads and religious doctrines in his study. As IFIs bearing the name of "Islam" therefore their operations must be imbued with Islamic values, including that of reporting mechanism. Asutay (2012) asserts that IFIs carry 'Islamic' in their title therefore they must respond to the responsibility imposed on them by the very title they carry. Currently, various IFIs adopt different reporting standards such as IFRS, AAOIFI, or country specific regulation on financial reporting but without realizing which standards are closer to Shariah requirement. In addition, adopting various accounting standards by IFIs may cause comparability, reliability, and compliance problems (Sarea and Hanefah, 2013).

Given the understanding on the literature gap above, therefore, the objective of this chapter is to propose a recommendation on the most appropriate reporting standards for IFIs suitable for international financial reporting requirements as well as compatible with *Maqāsid ul-Shari'āh*.[108][109] As IFIs must fulfil *Maqāsid ul-Shari'āh* for their undertakings, they must formulate the guidelines to ensure elements of *Maqāsid ul-Shari'āh* are instilled in the three important components of the financial reporting standards: measurement, recognition, and presentation. Shariah can be measured by its branch of objectives known as *Maqāsid ul-Shari'āh* that has three main components: educating the individual, promoting justice, and catering for public interest (Abu Zaharah, 1997, p. 364). From understanding the concept of *Maqāsid ul-Shari'āh* coupled with the concern on which financial reporting standard is the most viable for IFIs, a research question on this chapter is formulated i.e. to what extent do IFRS, AAOIFI, and ISSFAS comply with *Maqāsid ul-Shari'āh*? For this study, the data being analysed are the conceptual framework and standards on presentation and disclosures of IFRS, AAOIFI, and ISSFAS.[110] While this

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[108] A part of this chapter has been presented at the 6th Foundation of Islamic Finance Conference 2014 in Durham University, Durham, 2nd – 3rd April 2014 with title of "*IFRS, AAOIFI, and Indonesian SSFAS Level of Standards; Evaluation from Maqāsid ul-Shari'āh Approach.*"

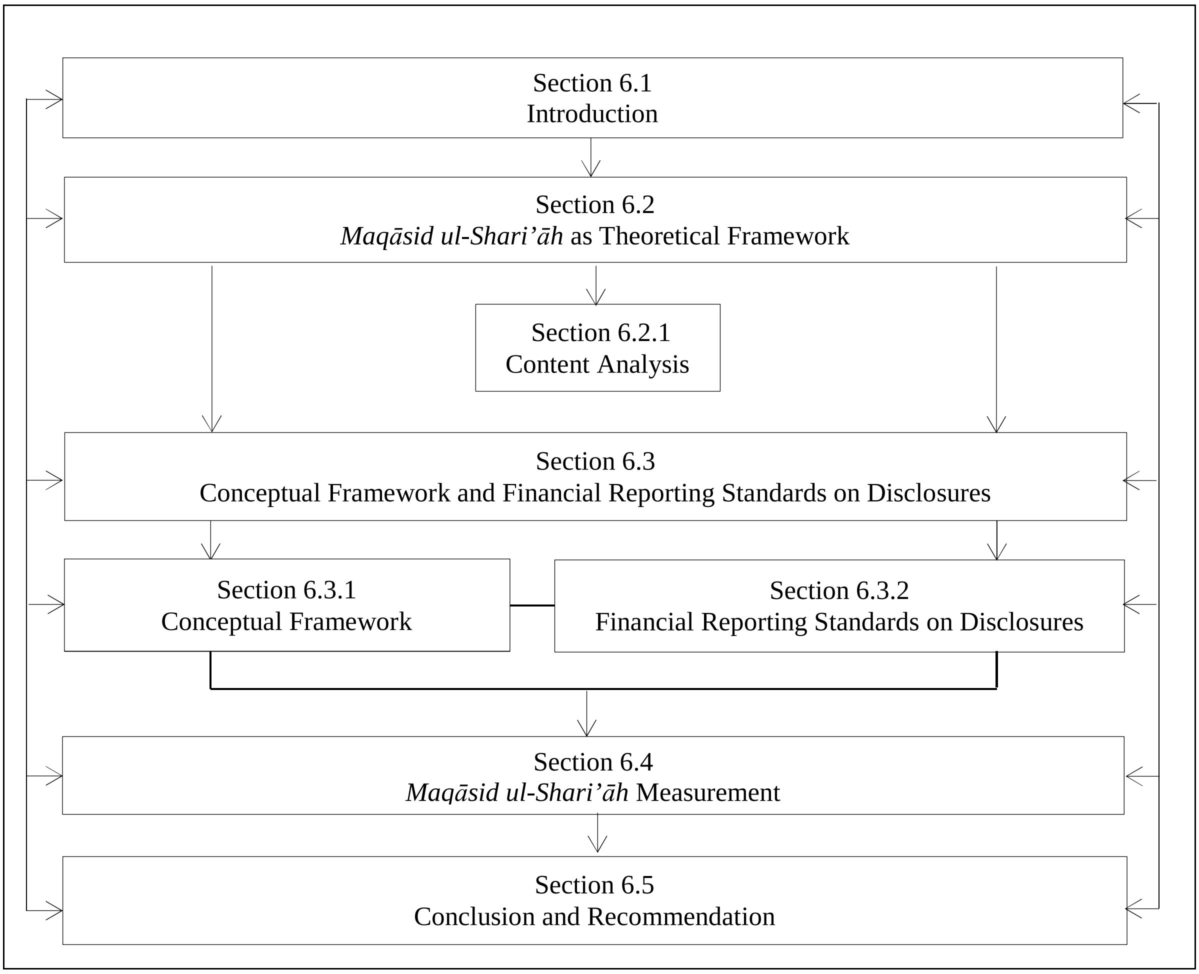
[109] Research grant amounting to £810 has been granted by Adam Smith Business School, University of Glasgow in April 2014 with the purpose to expand and publish the research in accounting journal.

[110] International Financial Reporting Standards (IFRS), Accounting and Auditing Organisation for Islamic Financial institutions (AAOIFI), Indonesian Shariah based Statement of Financial Accounting Standards (ISSFAS).

study is heavily concerned with utilisation of religious values, the content analysis method is adopted to measure the extent of the disclosure requirements towards *Maqāsid ul-Shari'āh*. Our analysis shows that IFRS has the highest scores in educating individual and promoting public interest and has similar score in establishing justice with AAOIFI. However, as opposed to IFRS and AAOIFI, ISSFAS records the highest score in establishing justice and from the three combined categories of *Maqāsid*, it is presented that AAOIFI and IFRS scored 22% and 34% respectively, while ISSFAS scored 44%. It is interesting to learn that ISSFAS obtains the highest score as the standards comprises of international accounting standards and AAOIFI mandates at the same fulfils its own local understanding of *Maqāsid ul-Shari'āh*. It means that ISSFAS has more Shariah messages on the financial reporting standards. High level of disclosing Islamic and non-Islamic information could be attributed to the effort of ISSFAS with its parallel approach in working with Islamists and neo-modernism group who believe that financial reporting should maintain what is old but good, and embrace what is new but better *(Al-Muhāfazah 'ala al-qadīm al-şālih wa al-Akhzu bil al-jadid al-aşlah).* Secondly, when it comes to profit sharing – *a term that is mainly associated with Islamic Mu'āmalāt* – statistical testing indicates significant differences among the three standards. This means that AAOIFI and ISSFAS are frequently using the term 'profit sharing' to differentiate their financial reporting standards from those issued by IASB. The result also indicates that there are more opportunities for improvement where AAOIFI can benefit from the experience by IIA-ISASB on the use of ISSFAS for IFIs. Importantly, IASB must accommodate the fundamental Shariah values that prevent its IFRS standards from being fully adopted by IFIs. Alternatively, IASB should accept the fact that IFRS can only be treated as complimentary standards as a brand of international recognition.

The remainder of this Chapter is organized as follows. Section 6.2 reviews *Maqāsid ul-Shari'āh* as theoretical framework; Section 6.3 delineates conceptual framework and financial reporting standards on disclosures; Section 6.4 discusses *Maqāsid ul-Shari'āh* measurement; and Section 6.5 concludes the study and suggests recommendations for future research. The following Figure 6.1.1 describes structure of this chapter.

Figure 6.1.1: Structure of Chapter Six



6.2 *Maqāsid ul-Shari'āh* as Theoretical Framework

At international level, Shariah ruling is endorsed by a recognized authority such as international agencies known as International Islamic Fiqh Academy (IIFA) and AAOIFI while at the national level, usually the authority falls under an agency called board of Islamic scholars. According to Abdurrachman (2008) mechanism to issue a ruling can be through several ways such as *lil hajāh* (based on needs), *lil maṣlahah* (based on welfare of society), and *lil maqāsid al-shari'ah* (based on objectives of Shariah). Whichever way is chosen, the scholars must refer to the main sources of law i.e. Qur'an and Sunnah. The commonalities have existed among IFIs that they must operate under Islamic ethical business framework drawn by Shariah underpinning (Haniffa and Hudaib, 2007). Thus, they should disclose information in accordance with Shariah standards and Shariah values on their financial reporting standards. To ensure the standards are in line with Shariah, its main references should be Qur'an and authentic Sunnah with additions of *Ijtihād* (derived rule), *ijma'* (consensus) and *qiyas* (deductive analogy). These legal frameworks should be included when measuring Shariah obedience of IFIs such as in reporting their activities.

The objectives of Shariah are principally known as *Maqāsid ul-Shari'āh* pronounced by Al-Ghazali (1058-1111). The discussion on *Maqāsid ul-Shari'āh* was started when scholars like Al-Ghazali, Ibn al-Hajib and al-Shatibi defined primary needs (*dharūriyyah*) as the preservation and safeguarding of five principles such as protection of religion (*dīn*), protection of life (*nafs*), protection of intellect (*'aql*), protection of wealth (*māl*), and protection of lineage (*ansab*) (Chapra, 2008, p. 5-6, Abdullah & Furqani, 2012). These basic principles are important in every human life or institutions to ensure long term sustainability and prosperity of the economic development and welfare of the people. As belief in the hereafter under Islamic teaching is essential, therefore fulfilling human basic needs that covers the protection of these five principles is also for the purpose of preparing the day of judgement that would be held in the hereafter. This is as noted by Al-Ghazali:

> "preventing the loss of these five fundamentals (*usul*) and protecting them can never be neglected in any religious community (*millah*) or legal system (Shariah) that is meant for the good and well-being (*ṣalāh*) of human beings…and this would be a consideration of a *maṣlahah* that we know by necessity was intended by the Shariah, not on the basis of one single proof or one particular rule, but on multiple proofs that are beyond enumeration.

However, the previous scholars (e.g., Al-Ghazali, Al-Shatibi, and Al-Qurtubi) emphasized importantly the five principles which should be considered as supplementary dimensions but they did not suggest any quantitative or qualitative measures to proxy for these necessities (Bedoui and Mansour, 2014). Other view on Maqāsid ul-*Shari'āh* comes from Abu Zaharah which according to him, it has three classifications such as *tahzib al-fard* which means educating the individuals, *iqāmah al-'adl* which means establishing justice, and *jalb al-mashalah* which means ensuring welfare of the society (Abu Zaharah, 1997, p. 364). He argues that the existence of Shariah law is for the benefit of all people in this world as Islam is sent down for all mankind.[111] It means, without restriction, any society can adopt and impose the Shariah law. For the interest of this paper, the above classifications of *Maqāsid ul-Shari'āh* are operationalized into dimensions and elements that are ought to exist in the financial reporting standards for IFIs. Educating individual, establishing justice, and promoting public interest are broken into several elements and dimensions as presented on Table 6.2.1 below.

[111] And We have not sent you, [O Muhammad], except as a mercy to the worlds (Qur'an Al-Anbya' (21): 107).

Table 6.2.1: *Maqāsid ul-Shari'āh* Matrix Category

Concepts (Objectives)	Dimensions	Elements	Sources
1.Educating the individuals	1.1 Creating awareness	1.1.1 Faithful representation	IFRS Framework, IAS 1, AAOIFI Conceptual Framework, AAOIFI FAS 1, ISSFAS Framework, ISSFAS No. 101
		1.1.2 Prudence	
		1.1.3 Completeness	
		1.1.4 Neutrality	
		1.1.5 Free from error	
		1.1.6 Veriability	
		1.1.7 Materiality	
		1.1.8 More disclosures	
	1.2 Advancement of knowledge	1.2.1 Relevance	
		1.2.2 Comparability	
		1.2.3 Consistency	
		1.2.4 Timeliness	
		1.2.5 Understandability	
2. Establishing justice	2.1 Fair recognition	2.1.1 Substance and form	IFRS Framework, IAS 1, AAOIFI Conceptual Framework, AAOIFI FAS 1, ISSFAS Framework, ISSFAS No. 101
		2.1.2 Market price	
	2.2 Elimination of injustice	**2.2.1 Margin**	
		2.2.2 Rental	
		2.2.3 Fee	
		2.2.4 Profit sharing	
		2.2.5 No interest rate, *gharar*, *maysir*, haram	
3. Promoting public interest	3.1 Profitability	3.1.1 Commercial purposes	IFRS Framework, IAS 1, AAOIFI Conceptual Framework, AAOIFI FAS 1, ISSFAS Framework, ISSFAS No. 101
		3.1.2 Going concern	
		3.1.3 Cash basis	
		3.1.4 Accrual basis	
		3.1.5 Dividend	
	3.2 Distribution of income	**3.2.1 Non halal**	
		3.2.2 Zakat	
		3.2.3 *Qard*	
		3.2.4 Charity	
	3.3 Users	3.3.1 Investors	
		3.3.2 Public	
		3.3.3 Zakat institutions	
		3.3.4 *Qard* or Zakat providers	
		3.3.5 Auditors	
		3.3.6 Shariah advisor	
		3.3.7 Regulators	
		3.3.8 Tax agency	
		3.3.9 Employees	
		3.3.10 Customers	
		3.3.11 Creditors	
		3.3.12 Investment account holders	
		3.3.13 Management	

Source: Current study.

Notes: Terms in bold indicate the proposed Shariah elements.

Educating individual

It is a central issue on educating users of financial reporting information although it is necessary to make an assumption that the users should have adequate knowledge before reading the financial reporting standards. Thus, creating awareness and advancing knowledge of the users are highlighted as important elements of educating the individuals. Here, the qualitative characteristics suggested by Nobes and Parker (2012) are best suited to explain the dimensions into several elements i.e. creating awareness that proposes faithful representation, prudence, completeness, neutrality, free from error, variability, materiality, and more disclosures, while advancement of knowledge should cover relevance, comparability, consistency, timeliness, and understandability. Haniffa and Hudaib (2007) argue that Shariah entity upholds its accountability not only to investors, but also to God and society, therefore additional disclosures are required or known here as more disclosures.

Establishing justice

In Ibn Khaldun's concept on Islamic civilization, justice is considered as a core element that he dedicated a special section called "Injustice Triggers the Destruction of Civilization" (Chapra, 2008b, p. 21). Thus, there should be two dimensions to promote justice in the society such as fair recognition and rejection towards injustice. The issue on substance over form or substance and form are still debatable, however in this context, both substance and form should carry equal degree of importance as similarly argued by Karim (2001) that Islamic business transactions should cover both technical and ethical rules. Zakat has been treated as one important disclosure in the Islamic based economy, therefore the elements of fair recognition should cover market price as the basis of valuing assets and Zakat calculation of IFIs. Further, the application of *usury*, *gharar*, *maysir*, haram has been banned as it promotes injustice at the expense of the weak. Alternatively, the rejection is replaced by introducing Shariah based transactions such as contracts on the basis of margin, rental, fee, and profit sharing.

Promoting public interest

Welfare has become illustrious term in the development of both conventional and Islamic finance as more people realized that the gap between the rich and the poor has been very extreme. Worst, as it is argued that the world got into the grip of global finance with a growing demand for reform (Pringle, 2012, p. 5). Thus, any Shariah based institutions such as IFIs should not run their operation in the pursuit of profitability per se but they must also sustain welfare of the society.

Measuring and recognizing profit is another central issue in the current development of financial reporting standards. Generating profit is encouraged to ensure going concern of IFIs provided the profit recognition method is appropriate such as by ensuring the correct basis of calculation i.e. the timing to use accrual and cash accounting. On the other hand, when IFIs distribute its income, they should consider social obligations such as payment of Zakat and Charity, distribute *Qard* fund and disburse Non halal income. The users of financial reporting information are not limited only to common users as described in many accounting text books. In addition, IFIs should also serve Zakat institutions, *Qard* and Zakat providers, Shariah advisors, and Investment account holders.

6.2.1 Content Analysis

Content analysis is "a research technique for making replicable and valid inferences from texts (or other meaningful matter) to the contexts of their use" (Krippendorff, 2012, p. 18). A number of researchers have used content analysis approach for their works particularly on the extent of disclosure of annual reports such as chairman's statement, president's letter, operating and financial review, and other accounting related communication (see Steenkamp & Northcott, 2007). Some of them conducts narrative research on social and environment (see Unerman (2000) and Guthrie and Abeysekera (2006)). However none of them investigates financial reporting standards. In Islamic finance study, there are several researchers who conduct studies on index in examining annual reports of Islamic banks (Ibrahim et al., 2004, Haniffa and Hudaib, 2007). Haniffa and Hudaib (2007) propose Ethical Identity Index (EII) from various components such as personality, behaviour, communication and symbolism while Ibrahim et al. (2004) propose Islamic Disclosure Index (IDI) and Islamic Performance Index (IPI). IDI is derived from Shariah compliance, corporate governance, and social/environment and IPI has seven indicators such as profit-sharing financing, Zakat, directors-employees welfare, Islamic vs non-Islamic investment, Islamic vs non-Islamic income, and AAOIFI index. Further studies show more detail approach such as taking *Maqāsid ul-Shari'āh* perspective in formulating the indices such as the works of Mohamed et al. (2008), Antonio et al. (2012), and (Bedoui and Mansour, 2014).[112] Both groups propose and apply the *Maqāsid* Index (MI) based on their understanding on Abu Zahara's perspective on *Maqāsid ul-Shari'āh* that emphasizes on three components i.e. educating individuals, establishing justice, elevating public interest. These recent studies have not addressed in details the compliance of financial reporting

[112] See Appendix 6.7 for Mohamed et al. (2008)'s work.

standards for IFIs towards *Maqāsid ul-Shari'āh*. Chapter Five suggests that IFIs should fulfil the objectives of Shariah (*Maqāsid ul-Shari'āh*) and not making money and profits as the central gravity for Islamic finance (see more discussion in Chapter Seven). Thus the following two hypotheses are proposed:

H_{01} IFRS has more messages regarding Shariah dimensions than AAOIFI and ISSFAS

H_{02} AAOIFI has more messages regarding Shariah dimensions than ISSFAS

This study tests the hypotheses through content analysis approach that directly operates on the financial reporting standards or called as text or transcripts of human communication (Weber, 1990, p. 10). In this case, the human communication is in the form of written financial reporting standards with the same medium of instructions i.e. English. There are several components in content analysis such as unitizing, sampling, recording/coding, reducing, inferring, and narrating (Krippendorf, 2012, p. 83-85). The first four components are referred as data making where raw or unedited texts are entered into computable data. Unitizing is the systematic distinguishing of segments of text available in financial reporting standards. Method of unitizing is by finding common terms in all financial reporting standards to be observed that are related to three dimensions specified earlier (*Maqāsid ul-Shari'āh* components). Sampling falls on the conceptual framework as pretesting and financial reporting presentation as the representative of the whole financial reporting standards. Recording or coding is formulated based on the *Maqāsid ul-Shari'āh* and sentence messages in the sampling. Step in abductively inferring refers to contextual phenomena and bridge the gap between descriptive texts and their meanings. Abductive inferences (unlike deductive or inductive approach) require warrants backed with evidences and this distinguish content analysis with other mode of inquiry. Lastly, narrating is the analysis part that explains the hypotheses that have been set up.

The empirical analysis was begun with a pilot study on the three conceptual frameworks using sentence-based coding instrument in content analysis approach. The *Maqāsid ul-Shari'āh* concepts are broken down into dimensions and elements as presented in the Table 6.2.1. The steps in the coding exercise are as follows: the starting point to create the coding is from the introduction section of conceptual framework; every word and sentence is thoroughly examined whether it relates to any of the coding rules (see Appendix 6.9). If any of the word or sentence matches, the particular sentence or word is coded in the respective node structured in NVivo 10 software. Data specified for content analysis are conceptual frameworks and standards that deal with presentation of financial reports of IFRS, AAOIFI, and IIA-ISASB. The following Table 6.2.2 describes details of the data:

Table 6.2.2: Data Specification

No.	Standards	Date of issuance/ Effective date	Number of words
1	IFRS Framework	01 September 2010	11,508
	IAS 1 (Presentation of Financial Statements)	01 January 2007	14,384
2	AAOIFI Conceptual Framework	22 July 2010	12,998
	FAS 1 (Presentation and Disclosure)	01 January 1996	6,121
3	ISSFAS Framework	27 June 2007	11,468
	ISSFAS 101 (Presentation)**	01 January 2008	6,184

Source: respective document.
Notes:
-The above word counts include titles, table of contents, page numbers, and footnotes but exclude appendices.
** ISSFAS 101 has been revised in 2011 but has not been translated into English, the only available English publication is the 2008 publication, and thus it is used for this research.

Following the concept of Abu Zaharah (1997), *Maqāsid ul-Shari'āh* is categorized as educating the individuals, establishing justice, and promoting public interest. Each objective is expanded into several dimensions such as advancement of knowledge, creating awareness, fair recognition, elimination of justice, profitability, distribution of income, and users. Each dimension comprises of several elements as describes on Table 6.2.1 above. From the table, the coding rule is set up to explain definition of each element that is formulated as a code and including the sample that has been carried out in the pilot study (see Appendix 6.8). For the purpose of more clear guidance the coding rule also sets up exclusion for sentences that fall under the definition but carry no meaning as a code. For example: Educating the Individual, one element under Creating Awareness is Prudence which is explained that Prudence means Conservatism, although Prudence has been deleted from IFRS framework, but it is still available in AAOIFI and ISSFAS and the coding rule states that the characteristic must be expressed in the conceptual framework and standards on presentations or disclosure. Sample of sentence: The inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty (Indonesian SSFAS Conceptual Framework, p. 18, line 22-24). Other example that appears in the coding rule is More Disclosure; which is argued that more number of elements in the financial report increases more awareness of the users. The coding rule states that the statement which explains about elements in the financial report is highlighted and coded. Sample of sentence: Information to assist in the determination of Zakat (AAOIFI Conceptual Framework, 3.2.3, p. 10). Exclusion: the definitions of an asset and a liability identify their essential features. The coding rules cover all classifications of *Maqāsid ul-Shari'āh* and sub-nodes are created to render specific meaning that can be found in the conceptual framework and financial reporting standards. NVivo 10 helps to code sentences that relate to the elements in the financial reporting standards in node forms. After the pilot study is performed, a reliability check is conducted to ensure the coding rule is correctly applied in the coding exercise. During the reliability process, the volunteer highlighted few issues such as to create special node for investment account holder and to be consistent in the terms used in the nodes. After the revision is taken place, the coding exercise is repeated.

6.3 Conceptual Framework and Financial Reporting Standards on Disclosures

6.3.1 Conceptual Framework

Nobes and Parker (2012) propose that the main purpose of the conceptual framework[113] is to provide useful information to various users particularly investors in making decision. Conceptual framework is regarded as the main parameter to judge the quality of financial reporting standards as it would determine direction of the standards. It must be often updated to cater for the changes in the accounting environment such as country's regulation. Usually, the framework describes the scope and aims of published financial reports, public accountability, working concepts, users of the reports, and means to measuring and reporting and it is in no way out-dated (Alexander and Britton, 2001). The International Accounting Standards Board (IASB) is currently in the midst of updating its framework and there are four chapters: i) objective, ii) reporting entity, iii) qualitative characteristics, and, iv) the framework. Chapter 2 of the framework is due to be completed by IASB following the Exposure Draft ED/2010/2 issued in March 2010. Chapter 4 contains the remaining text of the Framework approved in 1989 and is remained in use until the rest of the chapters are fully revised. In September 2010, IASB revised the first chapter of the Conceptual Framework and decided to replace prudence concept with neutrality principle. This decision invited criticism because prudence (or conservatism) means verification before making a legal claim to a profit. However, as prudence also expresses conservatism worried the IASB because prudence can lead to excessive

[113] Conceptual framework or framework is used interchangeably.

conservatism.[114] If this occurs it creates two problems i.e. during an economic upturn, profits are artificially depressed and investors might miss out on a good investment opportunity; and during the downswing of the economic cycle, where hidden reserves can be used to artificially increase an entity's earnings (Hoogervorst, 2012). However, as neutrality means free from bias. These assumptions (i.e. the effect of economic upturn and downswing) will be neutralized with professional judgements introduced by IFRS. Nevertheless, the European Union Parliament (EUP) expressed its disagreement on the write-off of prudence concept and urged IASB to bring in the concept into the IASB's Conceptual Framework (PwC, 2013). EUP demanded the IASB to take into consideration the voice of EUP members as they are the main sponsor of IASB (contributing €7.1 million or one third of IASB stipend). The UK Financial Reporting Council also urged IASB to reintroduce the prudence concept to ensure all losses and liabilities are reflected promptly and gains are not recognised except where there is adequate evidence (MGI, 2014). For the purpose of this research, prudence and its replacement (neutrality) as well as conservatism are still included in the analysis as both meanings are still relevant. Besides prudence, faithfully represented is re-emphasized in the IFRS and this characteristic covers the old meaning of reliability.

With regards to AAOIFI conceptual framework, it came into effect on 1 January 2011 supersedes the Statement of Financial Accounting No. 1: Objectives of Financial Accounting for Banks and Financial Institutions, and Statement of Financial Accounting No. 2 (amended): Concepts of Financial Accounting for Banks and Financial Institutions. As for the ISSFAS framework for Islamic business entity, the last revision was on 1 January 2008 when it replaced the ISSFAS framework for Islamic banks. Each of IASB, AAOIFI, and IIA-ISASB[115] has unique history when it comes to formulating their conceptual frameworks. For example, the challenges faced by IASB such as the above controversy on prudence concept have not been experienced by the other two standard setters. However, the differences do appear between AAOIFI and ISSFAS standards such as the terms employed. For example Figure 6.3.1 illustrates how AAOIFI and ISSFAS use Zakat, *Qard*, and charity terms:

[114] For example, cookies jar accounting, a term that referred by Hans Hoogervorst, IASB Chairman in many of his speeches on this issue.

[115] The Indonesian Institute of Accountants (IIA), Indonesian Shariah Accounting Standards Board (ISASB).

Figure 6.3.1: AAOIFI and ISSFAS Sample of Differences

AAOIFI	ISSFAS
Statements of sources and uses of funds in the Zakat and charity fund, and	*Statement of sources and uses of Zakat fund*, and
Statements of sources and uses of funds in the qard fund (AAOIFI Conceptual Framework, Section 5.2.1.3, p. 14).	*Statement of sources and uses of charity fund* (ISSFAS Framework, Para 68, line 26-27, p. Framework.21).

Source: AAOIFI Conceptual Framework, Section 5.2.1.3, p. 14 and ISSFAS Framework, Para 68, line 26-27, p. Framework.21).

Figure 6.3.1 demonstrates that AAOIFI is in the opinion that Zakat can be combined with other donations other than Zakat while IIA-ISASB believes that Zakat fund should be treated exclusively as it is solely dedicated to certain recipients as indicated in the ISSFAS No. 101, para 70, p. 101.19-101.20). On the other hand, AAOIFI explicitly mentions the *Qard* fund without mingling with other type of charity fund but IIA-ISASB treats it as charity fund which covers donations other than Zakat together with *Qard* fund.

6.3.2 Financial Reporting Standards on Disclosures

This section elaborates the components spelled out by the three accounting standard setters (IASB, AAIOFI and IIA-ISASB) that should exist in the entity's financial report.

IASB

IAS 1 has been evolved over time since its first publication in March 1974 as Exposure Draft on Disclosure of Accounting Policies which was then officially issued in January 1975. It was subject to further revision from 1975 to 1976 regarding information that needs to be disclosed. Following its progress during 1978-1979 period, the focus was on assets and liabilities disclosures, in 1994-1997 IAS 1, IAS 5, and IAS 13 were structured to become a complete set of Presentation of Financial Statements. After IASB took over, IAS 1 was revised in 2003, 2005, 2006 (twice), 2007, 2008 (twice), 2009, 2010 (twice), 2011, and 2012. In this study we have used the material available online for 2011-version as the complete set of financial statements to be disclosed which consists of:

a) Statement of financial position;
b) A complete set of financial statements comprises:
c) A statement of financial position as at the end of the period;
d) A statement of profit or loss and other comprehensive income for the period;
e) A statement of changes in equity for the period;
f) A statement of cash flows for the period;
g) Notes, comprising a summary of significant accounting policies and other explanatory information; and

h) A statement of financial position as at the beginning of the earliest comparative period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements.

AAOIFI

FAS 1 has been revised in 1996 after its first issuance in 1993. FAS 1, para 2 stipulate that Islamic financial institutions may refer to the following presentation:

a) A statement of financial position (balance sheet);
b) An income statement;
c) A statement of cash flows;
d) A statement of changes in owners' equity or a statement of retained earnings;
e) A statement of changes in restricted investment;
f) A statement of sources and uses of funds in the Zakat and charity fund (when the bank assumes the responsibility for the collection and distribution of Zakat);
g) A statement of sources and uses of funds in the *Qard* fund;
h) Notes to the financial statements; and
i) Any statements, reports and other data which assist in providing information required by users of financial statements as specified in the Statement of Objectives.

IIA-ISASB

ISSFAS No. 101 was revised in 2007 supersedes SFAS No. 59 on Islamic banking that relates to framework on preparation and presentation of financial reporting (para 152-200). SFAS No. 59 was issued by IIA-ISASB in 2002. ISSFAS 101, para 10 states that a complete financial report should cover the following components under Islamic business entity including Islamic financial institutions:

a) Financial position at the end of the period;
b) Comprehensive profit and loss during the period;
c) Statement of changes in equity during the period;
d) Statement of cash flow during the period;
e) Statement of source and uses of Zakat fund during the period;
f) Statement of sources and uses of *Qard* fund during the period;
g) Notes to the financial statements, consist of summary of important accounting policies and other policy explanation; and
h) Comparative financial position statement in the beginning of the period when a *Shariah* entity implements a kind of accounting policy in retrospective or prepares a repeating disclosure on financial report, or when the *Shariah* entity reclassifies posts in its financial reporting.

The above three types of standards clearly indicate that there are different formats for presenting the IFIs' financial operations, that made the ongoing debates to call for the IFIs to adhere to the Islamic based reporting standards instead. Several studies agree that AAOIFI standards is the ideal standards for the IFIs (Sarea and Hanefah, 2013, Ahmad-Nadzri, 2009). With regard to the standards issued by IIA-ISASB, no one yet has recognised the application quality of ISSFAS. Likewise, the IFRS adoption by the IFIs has not been fully examined with regards to the validity of IFRS fair presentation; para 16, IAS 1 states that:

> An entity whose financial statements comply with IFRSs shall make an explicit and unreserved statement of such compliance in the notes. An entity shall not describe financial statements as complying with IFRSs unless they comply with all the requirements of IFRSs (IAS 1, para 16, p. A525).

Arguably, the IFRS adoption stated by IFIs in Saudi Arabia and Malaysia are in question as they still adjust their accounts that supposed to comply with IFRS with the additional presentation required by the respective regulatory agencies of those countries. This question remains as to whether stating IFRS as the standards adopted by the IFIs is for labelling purposes but this is beyond the scope of this paper. Lastly, financial reporting standards for IFIs should govern the characteristics defining Islamic finance transactions where accounting standards have the duty to summarize, analyse, and report these transactions. Therefore, all transactions must be verified as to whether they fulfil Shariah requirement, for any unavoidable transactions that are not in tandem with Shariah, the preparers must be disclosed in a way that is known by Shariah as impermissible transactions (Non-halal transactions) or summarized as Non-halal income if it is due to occur.

6.4 *Maqāsid ul-Shari'āh* Measurement

Table 6.4.1 presents the score for IFRS which shows the highest scores in educating individual and promoting public interest (36% and 46% respectively) and earns the same weight in establishing justice with that of AOAIFI (19%). On the other hand, ISSFAS documents highest score in establishing justice (62%). For all three combined categories, AAOIFI records 66%, while IFRS and ISSFAS demonstrate 101% and 133% respectively. In other words, from the weighted average of the three *Maqāsid ul-Shari'āh* indicators, the amount of disclosures of IFRS and AAOIFI are 22% and 34% respectively whereby ISSFAS shows the highest amount at 44%.

Table 6.4.1: Coding Results of *Maqāsid ul-Shari'āh* Constructs

A	B	C	D	E
Conceptual Framework/Standards	A : Educating individual	%	%	%
1 : AAOIFI FAS 1 Presentation and Disclosure	236	0.016	18%	
2 : AAOIFI Conceptual Framework	124	0.011	12%	30%
3 : IAS 1 Presentation and Disclosure	311	0.024	27%	
4 : IFRS Conceptual Framework	53	0.009	10%	36%
5 : Indonesian SSFAS 101	243	0.021	23%	
6 : Indonesian SSFAS Framework	57	0.009	10%	34%
Total	1024	0.090	100%	100%
Conceptual Framework/Standards	B : Establishing justice	%	%	%
1 : AAOIFI FAS 1 Presentation and Disclosure	6	0.000	4%	
2 : AAOIFI Conceptual Framework	20	0.002	16%	19%
3 : IAS 1 Presentation and Disclosure	8	0.001	6%	
4 : IFRS Conceptual Framework	9	0.001	13%	19%
5 : Indonesian SSFAS 101	11	0.001	9%	
6 : Indonesian SSFAS Framework	37	0.006	54%	62%
Total	91	0.011	100%	100%
Conceptual Framework/Standards	C : Promoting public interest	%	%	%
1 : AAOIFI FAS 1 Presentation and Disclosure	43	0.003	5%	
2 : AAOIFI Conceptual Framework	83	0.007	12%	17%
3 : IAS 1 Presentation and Disclosure	102	0.008	13%	
4 : IFRS Conceptual Framework	122	0.020	33%	46%
5 : Indonesian SSFAS 101	74	0.006	11%	
6 : Indonesian SSFAS Framework	100	0.016	27%	37%
Total	524	0.061	100%	100%

Source: Current study.

Notes:

Column B = number of references to *Maqāsid ul-Shari'āh* constructs coded in each document, Column C = Column B divided by number of words, Column D = weighted average, Column E = total per standard.

IFRS with AAOIFI and ISSFAS

The first hypothesis, H_{01} IFRS has more messages regarding Shariah dimensions than AAOIFI and ISSFAS is further explored through independent samples test with the purpose to find mean of each variable that falls under each category of *Maqāsid ul-Shari'āh* and to examine if the relationship is significant with α is set at 0.05. The collective result is presented in the following Table 6.4.2.

Table 6.4.2: *Maqāsid ul-Shari'āh* Means (IFRS with AAOIFI and ISSFAS)

Dimensions/Elements	Standards	N	Mean	Std. Deviation	Std. Error Mean
1. Educating individual	IFRS	2	.1807	.11973	.08466
	AAOIFI and ISSFAS	4	.1597	.06078	.03039
2. Establishing justice	IFRS	2	.093	.0541	.0382
	AAOIFI and ISSFAS	4	.203	.2263	.1132
3. Promoting public interest	IFRS	2	.229	.1410	.0997
	AAOIFI and ISSFAS	4	.135	.0927	.0464

Source: Current study

Table 6.4.2 describes the three means of the *Maqāsid ul-Shari'āh* categories in which IFRS shows more dominant weight in educating individual and promoting public interest that support the finding in the NVivo 10 on Table 6.4.3. However all three categories do not demonstrate significant differences as shown on the Levene's test results below.

Table 6.4.3: *Maqāsid ul-Shari'āh* Significant Values (IFRS with AAOIFI and ISSFAS)

Maqāsid ul-Shari'āh Categories	t-test for Equality of Means				
	t	df	Sig. (2-tailed)	Mean Difference	Std. Error Difference
1. Educating the individuals	.234	1.267	.847	.02102	.08995
2. Establishing justice	-.922	3.584	.414	-.1101	.1195
3. Promoting public interest	.853	1.456	.511	.0938	.1099

Source: Current study.

There are 16 variables which consist of two dimensions and 13 elements in the Educating the individuals (refer to Appendix 6.1). The element with the highest mean is indicated by 'Faithfully represented' that is at average 30% repeated in both conceptual framework and IAS 1. This is consistent with a clause in IFRS conceptual framework that refers 'faithfully represented' as a fundamental qualitative characteristics of the IFRS besides relevance (IFRS, QC5, p. A33), while both AAOIFI and ISSFAS consider it as assumption under reliability. There are 26 variables under Promoting public interest and the element that shows the highest means as shown on the Appendix 6.3 goes the 'Tax agency' which explains IFRS is more concerned the obligation of the entity to pay tax, as opposed to Zakat and *Qard* as promoted by AAOIFI and ISSFAS.

AAOIFI and ISSFAS

The second hypothesis (H_{02}) testing on AAOIFI whether it has more messages regarding Shariah dimensions than ISSFAS. Table 6.4.4 below shows that AAOIFI has cumulative means that are below from the cumulative means of ISSFAS.

Table 6.4.4: *Maqāsid ul-Shari'āh* Means (AAOIFI and ISSFAS)

Dimensions/Elements	Standards	N	Mean	Std. Deviation	Std. Error Mean
1. Educating individual	AAOIFI	2	.151	.0442	.0312
	ISSFAS	2	.169	.0939	.0664
2. Establishing justice	AAOIFI	2	.096	.0835	.0591
	ISSFAS	2	.310	.3177	.2246
3. Promoting public interest	AAOIFI	2	.084	.0493	.0348
	ISSFAS	2	.187	.1134	.0802

Source: Current study.

This explains that there are more repetitive messages regarding Shariah objectives and dimensions in ISSFAS conceptual framework and ISSFAS No. 101 as opposed to AAOIFI conceptual framework and FAS 1. The result is quite surprising as ISSFAS initially referred to AAOIFI when developed its standards.[116] Nevertheless, all differences are not really significant as shown on the Levene's statistical result on the following Table 6.4.5.

Table 6.4.5: *Maqāsid ul-Shari'āh* Significant Values (AAOIFI and ISSFAS)

***Maqāsid ul-Shari'āh* Categories**	**t-test for Equality of Means**				
	t	**df**	**Sig. (2-tailed)**	**Mean Difference**	**Std. Error Difference**
1. Educating the individuals	-.244	1.422	.838	-.01788	.07336
2. Establishing justice	-.922	1.138	.511	-.2140	.2323
3. Promoting public interest	-1.172	1.365	.406	-.1025	.0874

Source: Current study.

From the 16 variables which consist of two dimensions and 13 elements in Educating the Individuals (refer to Appendix 6.4) is the highest mean is indicated by 'Prudence' concept. It argues that ISSFAS explains more repetitive messages with regards to this concept which also means conservative. The element with the highest mean in Establishing justice (refer to Appendix 6.5) is indicated by 'No interest rate, *maysir*, *gharar*, and haram." This shows that ISSFAS describes more details in its conceptual framework and standard the prohibition of these elements. Lastly, Appendix 6.6 shows that '*Qard* and Zakat providers' has the highest mean and this argues the emphasis in the ISSFAS to include *Qard* and Zakat providers as one of the main users of the financial reporting information. This is in tandem with the discussion presented on Figure 6.3.1 above on the differences in understanding on Zakat and *Qard* reporting between AAOIFI and ISSFAS.

Although the overall significant tests suggest that there is no significant difference but there is one element that highlights differences between IFRS, AAOIFI and ISSFAS namely 'Profit sharing'. This is parallel with the underlying assumption on the most distinguished character between conventional and Islamic finance i.e. profit sharing mechanism. From this result, it tells that IASB does not emphasize the message of 'Profit sharing' (under category of establishing justice) in its standards, unlike AAOIFI and IIA-ISASB.

[116] AAOIFI standards became later as basis of national accounting standards in jurisdictions (Nizam, 2012).

Table 6.4.6: Profit Sharing Significant Values (IFRS with AAOIFI and ISSFAS)

Elements		t-test for Equality of Means				
		t	df	Sig. (2-tailed)	Mean Difference	Std. Error Difference
Profit sharing	Equal variances not assumed	-3.972	3.000	.029	-.2500	.0629

Source: Current study.

The above Table 6.4.6 shows the significant results on the 'Profit sharing' as the most different characteristic between IFRS with that of AAOIFI and ISSFAS.

6.5 Conclusion and Recommendation

The objective of this chapter is to propose a recommendation on the most appropriate reporting standards for IFIs suitable for international financial reporting requirements as well as compatible with *Maqāsid ul-Shari'āh*. This chapter has achieved its objective by proposing a recommendation that alignment between AAOIFI and IFRS is the best financial reporting model for IFIs. The results show that IFRS, AAOIFI, and ISSFAS emphasize different aspects in designing their respective standards. The words 'relevance' and 'faithfully represented' are commonly repeated in IFRS conceptual framework as well as its standards. If IASB accepts the argument proposed by EU that 'prudence concept' must be reintroduced in the standards, it will contribute different emphasis in IFRS Framework although 'neutrality' is considered as a better replacement. AAOIFI is in the midst of revising its conceptual framework in its response to IASB's call for the world review of conceptual framework. This would also shape AAOIFI direction in the future. IIA seems consistent in its route after delivering three phases in designing standards for the IIFIs. However, the forces from the industry to follow the 'generally accepted accounting standards' known as IFRS have become stronger in the recent years (see Chapter Four). As of today, Shariah based capital market trading has been enjoying rapid growth of capitalized asset of Rp. 2,618 trillion or 58.4% from total stock exchange capitalized assets (Rp. 4,485 trillion as per 29th of October 2013) that are traded through two boards of Islamic index prices i.e. Jakarta Islamic Index and Indonesian Islamic Shares Index (detikfinance, 2013). In the pursuit of accelerating the recent development of the industry, the Islamic banks in Indonesia have been permitted to trade in the capital market therefore as traders they should be abide by the regulations to produce their annual report based on IFRS. Soon or later, it will take place that the ISSFAS has to accommodate the forces and eventually it would impact the content of the *Maqāsid ul-Shari'āh* in the ISSFAS.

The result from testing the hypothesis through independent samples tests shows that there is no significant difference among IFRS, AAOIFI, and ISSFAS except for one variable i.e. profit sharing that falls under the category of establishing justice. This clearly specifies that both AAOIFI and ISSFAS use ‘profit sharing' term to differentiate their approaches with that of IFRS. Therefore, among the three categories of *Maqāsid ul-Shari'āh*, establishing justice is clearly differentiated as opposed to the other two indicators. While the second hypothesis that argue there is a significant difference between AAOIFI and ISSFAS is not clearly proven. This indicates that there are much similarities found in both standards. Overall, ISSFAS records the highest *Maqāsid ul-Shari'āh* score (44% as opposed to 22% and 34% for AAOIFI and IFRS respectively) with the fact that the standards are the combination between IAS/IFRS and AAOIFI standards coupled with local adjustment. Does it mean that the alignment between AAOIFI and IFRS is the best model for the IFIs? Several similarities between sentences appeared in the conceptual and disclosure standards of the ISSFAS with that of IFRS are presented in the following Table 6.5.1. This table presents the similarities that are mostly found in the conceptual framework which confirms that ISSFAS is influenced by the IAS/IFRS approach, at the same time, the Islamic values related to financial reporting are also adopted (hybrid way). The result of this study does not acknowledge implied message behind the three conceptual frameworks. In the joint-effort between IASB and FASB on ‘The Framework 2010' Zhang and Andrew (2012) argues that a process of ‘neo-liberalisation' has been going on that includes the practice of accounting which is evidenced by coherence and legitimacy of key ideas reflected by IASB and FASB current project on conceptual framework of IFRS. They discussed several issues from the current conceptual framework i.e. replacement of the term ‘reliability' by faithfully representation, ‘other comprehensive income', and mispricing the risk of financialisation. If this claim is true, therefore, the process of updating AAOIFI and ISSFAS towards better reporting standards should take cautious analysis.

This study eventually requires further research to respond to the question whether combination between IFRS and AAOIFI standards would be the best model for financial reporting standards for the IFIs, but to what extent? Also, how could the accounting standard setters who are in charge of revising the conceptual framework for IFIs financial reporting standards ensure the precaution? Other further study is recommended to combine this meaning-oriented content analysis with discourse analysis in order to increase legitimacy and quality of narrative reporting as suggested by (Merkl-Davies et al., 2014). Following Zhang and Andrew (2012) on their critique on the process of ‘neo-liberalisation' in FASB-IASB conceptual framework project, a critical discourse analysis approach seems appropriate to unveil the hegemony within the vein of neo-liberalisation. This approach concerns on the analysis about who has the power to communicate their own ideology and how that power is achieved and maintained (Merkl-Davies et al., 2014).

Table 6.5.1: Similarities found in IFRS and ISSFAS

Standards	Content
ISSFAS Framework, page Framework.30	Revenue arises in the course ofthe ordinary activities of a Shariah entity and is referred to by a variety of different names including sales, fees, profit distribution, dividends, royalties and rent.
IFRS Framework, page 4.29	Revenue arises in the course of the ordinary activities of an entity and is referred to by a variety of different names including sales, fees, interest, dividends, royalties and rent.
ISSFAS Framework, page Framework.30	For example, the income statement could display gross margin, profit or loss from ordinary activities before taxation, profit or loss from ordinary activities after taxation, and profit or loss.
IFRS Framework, page 4.28	For example, the income statement could display gross margin, profit or loss from ordinary activities before taxation, profit or loss from ordinary activities after taxation, and profit or loss.
ISSFAS Framework, page Framework.29	Commercial, industrial and business activities are often by means of entities such as sole proprietorships, and trusts and various types of government undertakings.
IFRS Framework, page 4.23	Commercial, industrial and business activities are often undertaken by means of entities such as sole proprietorships, partnerships and trusts and various types of government business undertakings.
ISSFAS Framework, page Framework.36	Expenses are recognised in the income statement when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be in an asset or an increase of a liability has arisen that can be measured reliably. This means, in effect, that recognition of expenses occurs simultaneously with the recognition of an increase in liabilities or a decrease in assets (for example, the increase in liabilities or a decrease in assets (for example, the accrual of employee entitlements or the depreciation of equipment).
IFRS Framework, page 4.49	Expenses are recognised in the income statement when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. This means, in effect, that recognition of expenses occurs simultaneously with the recognition of an increase in liabilities or a decrease in assets (for example, the accrual of employee entitlements or the depreciation of equipment). IFRS Framework, 4.49
ISSFAS No. 101, page 101.4	Shariah entities present, outside the financial statements, a financial review by management that describes and explains the main features of the entity's financial performance and financial position and the principal uncertainties it faces. Such a report may include a review of: (a) the main factors and influences determining financial performance, including changes in the environment in which the shariah entity operates, the entity's response to those changes and their effect, and the entity's policy for investment to maintain and enhance financial performance, including its dividend policy;
IAS 1, page A524	Many entities present, outside the financial statements, a financial review by management that describes and explains the main features of the entity’s financial performance and financial position, and the principal uncertainties it faces. Such a report may include a review of: (a) the main factors and influences determining financial performance, including changes in the environment in which the entity operates, the entity’s response to those changes and their effect, and the entity’s policy for investment to maintain and enhance financial performance, including its dividend policy;
ISSFAS Framework, page Framework.28	The amount at which equity is shown in the balancesheet is dependent on the measurement of assets, liabilities, and temporary syirkah fund. Normally, the aggregate amount of equity only by coincidence corresponds with the aggregate market value of the shares of the Shariah entity or the sum that could be raised by disposing of either the net assets on a basis or the Shariah entity as a whole on a going concern basis.
IFRS Framework, page A44	The amount at which equity is shown in the balance sheet is dependent on the measurement of assets and liabilities. Normally, the aggregate amount of equity only by coincidence corresponds with the aggregate market value of the shares of the entity or the sum that could be raised by disposing of either the net assets on a piecemeal basis or the entity as a whole on a going concern basis.
ISSFAS No. 101, page 101.10	The financial statements shall be identified clearly and distinguished from other information in the same published document.
IFRS Framework, page A44	An entity shall clearly identify the financial statements and distinguish them from other information in the same published document.

Source: Current study.

Appendix 6.1: Educating the Individuals (IFRS, AAOIFI, ISSFAS)

Dimensions/Elements	**Standards**	**N**	**Mean**	**Std. Deviation**	**Std. Error Mean**
1. Educating individual	IFRS	2	.1807	.11973	.08466
	AAOIFI and ISSFAS	4	.1597	.06078	.03039
1.1. Creating awareness	IFRS	2	.1734	.15432	.10912
	AAOIFI and ISSFAS	4	.1633	.10904	.05452
1.1.1 Faithful representation	IFRS	2	.2951	.34088	.24104
	AAOIFI and ISSFAS	4	.1024	.09622	.04811
1.1.2 Prudence	IFRS	2	.000	.0000	.0000
	AAOIFI and ISSFAS	4	.250	.3181	.1590
1.1.3 Completeness	IFRS	2	.0000	.00000	.00000
	AAOIFI and ISSFAS	4	.2500	.33140	.16570
1.1.4 Neutrality	IFRS	2	.000	.0000	.0000
	AAOIFI and ISSFAS	4	.250	.1969	.0984
1.1.5 Free from error	IFRS	2	.0752	.10631	.07517
	AAOIFI and ISSFAS	4	.2124	.32142	.16071
1.1.6 Veriability	IFRS	2	.305	.4316	.3052
	AAOIFI and ISSFAS	4	.097	.1948	.0974
1.1.7 Materiality	IFRS	2	.2409	.08820	.06237
	AAOIFI and ISSFAS	4	.1296	.12520	.06260
1.1.8 More disclosures	IFRS	2	.1733	.21963	.15530
	AAOIFI and ISSFAS	4	.1633	.12390	.06195
1.2 Advancement of knowledge	IFRS	2	.2346	.07414	.05242
	AAOIFI and ISSFAS	4	.1327	.10359	.05180
1.2.1 Relevance	IFRS	2	.2660	.24983	.17665
	AAOIFI and ISSFAS	4	.1170	.13702	.06851
1.2.2 Comparability	IFRS	2	.2273	.03645	.02577
	AAOIFI and ISSFAS	4	.1364	.12212	.06106
1.2.3 Consistency	IFRS	2	.2154	.05241	.03706
	AAOIFI and ISSFAS	4	.1423	.14097	.07049
1.2.4 Timeliness	IFRS	2	.2180	.11089	.07841
	AAOIFI and ISSFAS	4	.1410	.09652	.04826
1.2.5 Understandability	IFRS	2	.2371	.09318	.06589
	AAOIFI and ISSFAS	4	.1314	.11929	.05964

Source: Current study.

Appendix 6.2: Establishing Justice (IFRS, AAOIFI, ISSFAS)

Dimensions/Elements	Standards	N	Mean	Std. Deviation	Std. Error Mean
2. Establishing justice	IFRS	2	.093	.0541	.0382
	AAOIFI and ISSFAS	4	.203	.2263	.1132
2.1 Fair recognition	IFRS	2	.158	.0067	.0047
	AAOIFI and ISSFAS	4	.171	.1110	.0555
2.1.1 Substance and form	IFRS	2	.160	.0388	.0274
	AAOIFI and ISSFAS	4	.170	.0810	.0405
2.1.2 Market price	IFRS	2	.224	.1961	.1386
	AAOIFI and ISSFAS	4	.138	.1732	.0866
2.2 Elimination of injustice	IFRS	2	.057	.0806	.0570
	AAOIFI and ISSFAS	4	.221	.3052	.1526
2.2.1 Margin	IFRS	2	.198	.2802	.1981
	AAOIFI and ISSFAS	4	.151	.1893	.0946
2.2.2 Rental	IFRS	2	.334	.4730	.3345
	AAOIFI and ISSFAS	4	.083	.1655	.0828
2.2.3 Fee	IFRS	2	.145	.2054	.1452
	AAOIFI and ISSFAS	4	.177	.1706	.0853
2.2.4 Profit sharing	IFRS	2	.000	.0000	.0000
	AAOIFI and ISSFAS	4	.250	.1259	.0629
2.2.5 No interest rate, gharar, maysir, haram	IFRS	2	.000	.0000	.0000
	AAOIFI and ISSFAS	4	.250	.4305	.2153

Source: Current study.

Appendix 6.3: Promoting Public Interest (IFRS, AAOIFI, ISSFAS)

Dimensions/Elements	Standards	N	Mean	Std. Deviation	Std. Error Mean
3. Promoting public interest	IFRS	2	.229	.1410	.0997
	AAOIFI and ISSFAS	4	.135	.0927	.0464
3.1 Profitability	IFRS	2	.360	.1462	.1033
	AAOIFI and ISSFAS	4	.070	.1092	.0546
3.1.1 Commercial purposes	IFRS	2	.068	.0968	.0684
	AAOIFI and ISSFAS	4	.216	.4316	.2158
3.1.2 Going concern	IFRS	2	.246	.1250	.0884
	AAOIFI and ISSFAS	4	.127	.1441	.0720
3.1.3 Cash basis	IFRS	2	.000	.0000	.0000
	AAOIFI and ISSFAS	4	.250	.1969	.0984
3.1.4 Accrual basis	IFRS	2	.290	.2538	.1795
	AAOIFI and ISSFAS	4	.105	.0991	.0495
3.1.5 Dividend	IFRS	2	.292	.2309	.1633
	AAOIFI and ISSFAS	4	.104	.1305	.0652
3.2 Distribution of income	IFRS	2	.000	.0000	.0000
	AAOIFI and ISSFAS	4	.250	.2249	.1125
3.2.1 Non halal	IFRS	2	.000	.0000	.0000
	AAOIFI and ISSFAS	4	.250	.4134	.2067
3.2.2 Zakat	IFRS	2	.000	.0000	.0000
	AAOIFI and ISSFAS	4	.250	.1887	.0943
3.2.3 *Qard*	IFRS	2	.000	.0000	.0000
	AAOIFI and ISSFAS	4	.250	.2218	.1109
3.2.4 Charity	IFRS	2	.000	.0000	.0000
	AAOIFI and ISSFAS	4	.250	.2556	.1278
3.3 Users	IFRS	2	.207	.1747	.1235
	AAOIFI and ISSFAS	4	.146	.1411	.0706
3.3.1 Investors	IFRS	2	.302	.3044	.2153
	AAOIFI and ISSFAS	4	.099	.1054	.0527
3.3.2 Public	IFRS	2	.071	.0998	.0706
	AAOIFI and ISSFAS	4	.215	.2695	.1347
3.3.3 Zakat Institutions	IFRS	2	.000	.0000	.0000
	AAOIFI and ISSFAS	4	.250	.3724	.1862
3.3.4 *Qard* or Zakat providers	IFRS	2	.000	.0000	.0000
	AAOIFI and ISSFAS	4	.250	.5000	.2500
3.3.5 Auditors	IFRS	2	.293	.4141	.2928
	AAOIFI and ISSFAS	4	.104	.1373	.0687
3.3.6 Shari'ah Advisor	IFRS	2	.000	.0000	.0000
	AAOIFI and ISSFAS	4	.250	.2482	.1241
3.3.7 Regulators	IFRS	2	.081	.1146	.0810
	AAOIFI and ISSFAS	4	.209	.2003	.1002
3.3.8 Tax Agency	IFRS	2	.342	.4838	.3421
	AAOIFI and ISSFAS	4	.079	.0991	.0495
3.3.9 Employees	IFRS	2	.138	.0058	.0041
	AAOIFI and ISSFAS	4	.181	.1861	.0930
3.3.10 Customers	IFRS	2	.174	.1947	.1377
	AAOIFI and ISSFAS	4	.163	.3038	.1519
3.3.11 Creditors	IFRS	2	.448	.6330	.4476
	AAOIFI and ISSFAS	4	.026	.0329	.0164
3.3.12 Investment account holders	IFRS	2	.000	.0000	.0000
	AAOIFI and ISSFAS	4	.250	.1780	.0890
3.3.13 Management	IFRS	2	.207	.0332	.0235
	AAOIFI and ISSFAS	4	.146	.0536	.0268

Source: Current Study.

Appendix 6.4: Educating the Individuals (AAOIFI and ISSFAS)

Dimensions/Elements	Standards	N	Mean	Std. Deviation	Std. Error Mean
1. Educating individual	AAOIFI	2	.151	.0442	.0312
	ISSFAS	2	.169	.0939	.0664
1.1. Creating awareness	AAOIFI	2	.164	.1439	.1018
	ISSFAS	2	.163	.1223	.0865
1.1.1 Faithful representation	AAOIFI	2	.090	.1268	.0896
	ISSFAS	2	.115	.1051	.0743
1.1.2 Prudence	AAOIFI	2	.096	.1354	.0957
	ISSFAS	2	.404	.4359	.3082
1.1.3 Completeness	AAOIFI	2	.150	.2126	.1503
	ISSFAS	2	.350	.4945	.3497
1.1.4 Neutrality	AAOIFI	2	.129	.1830	.1294
	ISSFAS	2	.371	.1569	.1109
1.1.5 Free from error	AAOIFI	2	.340	.4803	.3396
	ISSFAS	2	.085	.1205	.0852
1.1.6 Veriability	AAOIFI	2	.195	.2755	.1948
	ISSFAS	2	.000	.0000	.0000
1.1.7 Materiality	AAOIFI	2	.048	.0684	.0484
	ISSFAS	2	.211	.1264	.0894
1.1.8 More disclosures	AAOIFI	2	.156	.1348	.0953
	ISSFAS	2	.171	.1662	.1176
1.2 Advancement of knowledge	AAOIFI	2	.052	.0460	.0325
	ISSFAS	2	.213	.0657	.0464
1.2.1 Relevance	AAOIFI	2	.027	.0381	.0269
	ISSFAS	2	.207	.1497	.1058
1.2.2 Comparability	AAOIFI	2	.032	.0051	.0036
	ISSFAS	2	.241	.0359	.0254
1.2.3 Consistency	AAOIFI	2	.054	.0760	.0537
	ISSFAS	2	.231	.1499	.1060
1.2.4 Timeliness	AAOIFI	2	.105	.1486	.1051
	ISSFAS	2	.177	.0264	.0187
1.2.5 Understandability	AAOIFI	2	.081	.0684	.0484
	ISSFAS	2	.182	.1663	.1176

Source: Current study.

Appendix 6.5: Establishing Justice (AAOIFI and ISSFAS)

Dimensions/Elements	Standards	N	Mean	Std. Deviation	Std. Error Mean
2. Establishing justice	AAOIFI	2	.096	.0835	.0591
	ISSFAS	2	.310	.3177	.2246
2.1 Fair recognition	AAOIFI	2	.136	.1437	.1016
	ISSFAS	2	.206	.1071	.0757
2.1.1 Substance and form	AAOIFI	2	.152	.1351	.0955
	ISSFAS	2	.187	.0141	.0100
2.1.2 Market price	AAOIFI	2	.096	.1364	.0965
	ISSFAS	2	.179	.2538	.1795
2.2 Elimination of injustice	AAOIFI	2	.074	.0497	.0352
	ISSFAS	2	.369	.4358	.3081
2.2.1 Margin	AAOIFI	2	.000	.0000	.0000
	ISSFAS	2	.302	.1278	.0904
2.2.2 Rental	AAOIFI	2	.000	.0000	.0000
	ISSFAS	2	.166	.2341	.1655
2.2.3 Fee	AAOIFI	2	.100	.0328	.0232
	ISSFAS	2	.254	.2501	.1769
2.2.4 Profit sharing	AAOIFI	2	.174	.0750	.0531
	ISSFAS	2	.326	.1379	.0975
2.2.5 No interest rate, *gharar*, *maysir*, haram	AAOIFI	2	.054	.0770	.0544
	ISSFAS	2	.446	.6301	.4456

Source: Current study.

Appendix 6.6: Promoting Public Interest (AAOIFI and ISSFAS)

Dimensions/Elements	Standards	N	Mean	Std. Deviation	Std. Error Mean
3. Promoting public interest	AAOIFI	2	.084	.0493	.0348
	ISSFAS	2	.187	.1134	.0802
3.1 Profitability	AAOIFI	2	.011	.0153	.0108
	ISSFAS	2	.130	.1465	.1036
3.1.1 Commercial purposes	AAOIFI	2	.000	.0000	.0000
	ISSFAS	2	.432	.6103	.4316
3.1.2 Going concern	AAOIFI	2	.059	.0838	.0592
	ISSFAS	2	.195	.1918	.1356
3.1.3 Cash basis	AAOIFI	2	.129	.1830	.1294
	ISSFAS	2	.371	.1569	.1109
3.1.4 Accrual basis	AAOIFI	2	.062	.0883	.0624
	ISSFAS	2	.148	.1200	.0849
3.1.5 Dividend	AAOIFI	2	.000	.0000	.0000
	ISSFAS	2	.208	.0881	.0623
3.2 Distribution of income	AAOIFI	2	.161	.0527	.0372
	ISSFAS	2	.339	.3429	.2425
3.2.1 Non halal	AAOIFI	2	.069	.0972	.0688
	ISSFAS	2	.431	.6099	.4312
3.2.2 Zakat	AAOIFI	2	.174	.0280	.0198
	ISSFAS	2	.326	.2877	.2035
3.2.3 *Qard*	AAOIFI	2	.177	.1184	.0837
	ISSFAS	2	.323	.3348	.2367
3.2.4 Charity	AAOIFI	2	.146	.0296	.0209
	ISSFAS	2	.354	.3901	.2758
3.3 Users	AAOIFI	2	.110	.0973	.0688
	ISSFAS	2	.183	.2121	.1500
3.3.1 Investors	AAOIFI	2	.106	.1279	.0905
	ISSFAS	2	.091	.1294	.0915
3.3.2 Public	AAOIFI	2	.150	.2123	.1501
	ISSFAS	2	.279	.3950	.2793
3.3.3 Zakat Institutions	AAOIFI	2	.106	.1498	.1059
	ISSFAS	2	.394	.5574	.3941
3.3.4 *Qard* or Zakat providers	AAOIFI	2	.000	.0000	.0000
	ISSFAS	2	.500	.7071	.5000
3.3.5 Auditors	AAOIFI	2	.062	.0881	.0623
	ISSFAS	2	.145	.2049	.1449
3.3.6 Shariah Advisor	AAOIFI	2	.215	.1301	.0920
	ISSFAS	2	.285	.4035	.2853
3.3.7 Regulators	AAOIFI	2	.215	.3046	.2154
	ISSFAS	2	.204	.1656	.1171
3.3.8 Tax Agency	AAOIFI	2	.055	.0781	.0552
	ISSFAS	2	.103	.1453	.1027
3.3.9 Employees	AAOIFI	2	.113	.1603	.1133
	ISSFAS	2	.249	.2446	.1730
3.3.10 Customers	AAOIFI	2	.017	.0235	.0166
	ISSFAS	2	.309	.4369	.3090
3.3.11 Creditors	AAOIFI	2	.018	.0259	.0183
	ISSFAS	2	.034	.0482	.0341
3.3.12 Investment account holders	AAOIFI	2	.310	.0915	.0647
	ISSFAS	2	.190	.2689	.1901
3.3.13 Management	AAOIFI	2	.104	.0368	.0260
	ISSFAS	2	.189	.0101	.0071

Source: Current study.

Appendix 6.7: Operationalizing the Objectives of Islamic Banking

Concepts (Objectives)	Dimensions	Elements	Performance Ratios	Sources of Data
1. Educating Individual	D1.Advancement Of Knowledge	E1.Education grant	R1. Education grant/total income	Annual Report
		E2.Research	R 2. Research expense/total expense	Annual Report
	D2. Instilling new skills and improvements	E3.training	R 3. Training Expense/total expense	Annual Report
	D3. Creating Awareness of Islamic banking	E4.Publicity	R 4. Publicity expense/total expense	Annual Report
2. Establishing Justice	D4. Fair dealings	E5. Fair Returns	R 5. profit/ total income	Annual Report
	D5.Affordable products and services	E6. Affordable price	R 6. Bad debt/ total investment	Annual Report
	D6. Elimination of injustices	E7. Interest free product	R 7. Interest free income/ total income	Annual Report
3. Public Interest	D7. Profitability	E8. Profit ratios	R 8.Net profit/ total asset	Annual Report
	D8. Redistribution of income & wealth	E9. personal income	R 9. Zakah/ Net Income	Annual Report
	D9. Investment in vital real sector	E10. Investment ratios in real sector	R 10. Investment deposit/total deposit	Annual Report

Source: Mohamed et al. (2008).

Appendix 6.8: Coding Rules

No.	Elements	Definition	Coding Rules	Examples (extracted from pilot study)
			1. Educating individuals	
1.1 Creating awareness				
1	Verifiability	Different observers should be able to come to approximately the same view about whether a faithful representation is being given by the information. So, information must be able to be checked in various ways (Nobes and Parker, 2012, p. 135).	This characteristic must be expressed in the conceptual framework and standards on presentations or disclosures. Exclusion: Excluding information about those phenomena from financial reports might make the information in those financial reports easier to understand. ---After this sentence --- However, those reports would be incomplete and therefore potentially misleading.	Classifying, characterising and presenting information clearly and concisely makes it understandable (IFRS Framework, QC30, p. A36)
2	Prudence	Prudence means conservatism, although it has been deleted from IFRS framework, but it is still available in AAOIFI and ISSFAS (Nobes and Parker, 2012, p. 135).	This characteristic must be expressed in the conceptual framework and standards on presentations or disclosures, both the word and its explanation.	The inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty (Indonesian SSFAS Conceptual Framework, p. 18, line 22-24).
3	Neutrality	The information must be free from bias (Nobes and Parker, 2012, p. 135).	This characteristic must be expressed in the conceptual framework and standards on presentations or disclosures, both the word and its explanation.	Statements must be neutral, that is, free from bias (Indonesian SSFAS Conceptual Framework, p. 18, line 7).
4	Materiality	Information is material if its omission or misstatement could reasonably be expected to influence the economic decisions (Nobes and Parker, 2012, p. 515).	This characteristic must be expressed in the conceptual framework and standards on presentations or disclosures, both the word and its explanation. Exclusion: materiality is an entity-specific aspect of relevance based on the nature or magnitude	Information is material if omitting it or misstating (IFRS Framework, QC11, A34)
5	Faithful representation/reliability	This concept is replaced by IASB to reliability. The readers must not be misled by the contents of the statements (Nobes and Parker, 2012, p. 134).	This characteristic must be expressed in the conceptual framework and standards on presentations or disclosures, both the word and its explanation.	…it must also faithfully represent the phenomena that it purports to represent (IFRS Framework, QC12, A34) Users of financial accounting information prefer that such

			Exclusion: If there is no alternative representation that is more faithful, that estimate may provide the best available information (IFRS Framework, QC16)	information has a high degree of reliability (AAOIFI Conceptual Framework, 8.3, p. 31)
6	Completeness	The information needs to be complete within the constraints of materiality (Nobes and Parker, 2012, p. 135).	This characteristic must be expressed in the conceptual framework and standards on presentations or disclosures, both the word and its explanation.	To be reliable, the information in the financial reports must be complete within the bounds of materiality and cost (AAOIFI Conceptual Framework, 8.3.4, p. 32).
7	Free from error	To enhance the characteristics, the information must not contain any mistake.	Disclaimer for free from error or mistakes should guide the preparers therefore it must be written.	It would be complete, neutral and free from error (IFRS Framework, QC12, p. A34)
8	More disclosures	More number of elements in the financial report increases more awareness of the users (Haniffa and Hudaib, 2007).	The statement that explains about elements in the financial report is highlighted and coded. This also includes motivation to disclose. Exclusion: The definitions of an asset and a liability identify their essential features (IFRS Framework, 4.5, p. A41).	Information to assist in the determination of Zakat (AAOIFI Conceptual Framework, 3.2.3, p. 10)
1.2 Advancement of knowledge				
1	Relevance	Information must be related to its purpose so it will be useful for decision making (Nobes and Parker, 2012, p. 134).	This characteristic must be expressed in the conceptual framework and standards on presentations or disclosures, both the word and its explanation. Exclusion: Decision making Example: The decision making objective of presenting financial statements leads to the overriding criterion (Conceptual Framework, AAOIFI, 2010, p. 26).	Relevance refers to the existence of a close relationship between the financial accounting information (AAOIFI Conceptual Framework, 2010, p. 27). Financial information is capable of making a difference in decisions if it has predictive value, confirmatory value or both (IFRS Framework, QC7, p. A33).
2	Comparability	Information can be compared across periods and companies (Nobes and Parker, 2012, p. 135).	This characteristic must be expressed in the conceptual framework and standards on presentations or disclosures, both the word and its explanation.	However, designation of counterparties (Counterparty A, Counterparty B, Counterparty C, etc.) shall remain consistent from year to year for the years presented to maintain comparability (IFRS 7, B52, p. A281).

3	Consistency	Information is prepared based on consistent method and should be reported if the method is changed (Nobes and Parker, 2012, p. 135).	This characteristic must be expressed in the conceptual framework and standards on presentations or disclosures, both the word and its explanation.	Consistency refers to the use of the same methods for the same items, either from period to period within a reporting entity or in a single period across entities (IFRS CF, QC22, p. A.36).
4	Timeliness	The disclosure of information must meet time limits set by the regulators (Nobes and Parker, 2012, p. 135).	This characteristic must be expressed in the conceptual framework and standards on presentations or disclosures, both the word and its explanation.	This means that if information is not available when it is needed or becomes available only so long after the reported events then it becomes of little use in making decisions (AAOIFI Conceptual Framework, 8.1.2 c, p. 26).
5	Understandability	Information must be prepared to be understood by all educated users (Nobes and Parker, 2012, p. 135).	This characteristic must be expressed in the conceptual framework and standards on presentations or disclosures, both the word and its explanation.	Classifying, characterising and presenting information clearly and concisely makes it understandable (IFRS Framework, QC30, p. A37).
			2. Establishing justice	
2.1 Fair recognition				
1	Substance and form	Economic substance if important (Nobes and Parker, 2012, p. 134) but legality must also be considered from Shariah point of view.	This characteristic must be expressed in the conceptual framework and standards on presentations or disclosures, both the word and its explanation.	If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with its substance and economic reality as well as the legal form (AAOIFI Conceptual Framework, 8.3.3, p. 31).
2	Market price	Current or market value that is used for evaluation of assets (Abdul Rahman, 2013)	Market price is coded when explain a method of calculation.	Information about a reporting entity's financial performance during a period may also indicate the extent to which events such as changes in market prices… (IFRS Framework, OB19, p. A30)
2.2 Elimination of injustice				
1	Margin	A contract of sale between the bank and its client for the sale of goods at a price plus an agreed profit margin for the bank (IIBF, 2014).	Other form of income is margin and must be coded.	… the nature of the financing instrument, including information about *nisbah* profit sharing/margin/fee and the name of fund provider (Indonesian SSFAS No. 101, 87 9(a), p. 101.25

2	Rental	It is an arrangement under which an Islamic bank leases equipment, a building or other facility to a client against an agreed rental (IIBF, 2014).	Other form of income is rental and must be coded.	Net income from *Ijārah* (Indonesian SSFAS No. 101, Income Statement, 3(ii)(1), line 26, p.101.30)
3	Fee	It is derived from *Wakālah* transaction that a bank may charge fees or providing certain services to its customers (IIBF, 2014).	Other form of income is fee and must be coded.	…usually cash, to the IFI for investment purposes with the expectation of receiving attributable profits after paying the IFI a share of the profit and a fee where relevant (AAOIFI Conceptual Framework, 6.3, p. 15).
4	Profit sharing	Profit-and-Loss-Sharing. The term used to describe a mode of financing modes based on the principle of interest-free lending and featuring the use of *Mudhārabah* and *Musyārakah* (IIBF, 2014).	Other form of income is profit sharing and must be coded.	…including sales, fees, <u>profit distribution</u> (Conceptual Framework, Indonesian SSFAS, p. 30, line 7).
5	No interest rate, *gharar*, *maysir*, haram	No interest rate should be applied in the standards for Islamic financial institutions as it constitutes *ribā* that is strictly prohibited (Qur'an *Al-Baqarah* (2): 275); *Gharar*/Speculation (Hadith), *Maysir*/Uncertainty/Gambling (Qur'an *Al-Baqarah* (2): : 219), Haram/impermissible (Qur'an *Al-Baqarah* (2):168).	All income must be free from interest rate, will be coded if stated. <u>Exclusion:</u> …interest income on impaired financial assets accrued in accordance with paragraph AG93 of IAS 39 (IFRS 7, 20(d), p. A254)	Equity of investment accountholders refers to funds received for the purpose of investment on a profit sharing or participation basis under *Mudhārabah* arrangements (AAOIFI Conceptual Framework, 6.3, p. 15).
			3. Promoting public interest	
3.1 Profitability				
1	Commercial purposes	One purpose to disclose financial reporting is to meet profit oriented objectives.	One main purpose of entity is commercial purpose and coded if stated.	..activity that is commercial in nature…(Indonesian Framework, 28, line 4, p. Framework.10)
2	Going concern	An assumption that the business will continue for the foreseeable future (Nobes and Parker, 2012, p. 136).	An entity must assume the status of going concern or the word/s that explain similar meaning.	…it is assumed that the entity has neither the intention nor the need to liquidate (IFRS Framework, 4.1, p. A40)
3	Cash basis	In Shariah, cash basis should also be recognized in revenue/profit calculation.	Cash is stated as a basis of recognizing an item in the financial statement.	Profit measurement for profit distribution purpose is prepared on the cash basis (Indonesian Framework, 42, line 12-13, p. Framework.14)

4	Accrual basis	Transactions should be recognized when they occur, not by reference to the date of the receipt or payment of cash (Nobes and Parker, 2012, p. 133).	Accrual is stated as a basis of recognizing an item in the financial statement.	Accrual accounting depicts the effects of transactions and other events (IFRS Framework, OB17, p. A30)
5	Dividend	A sum of money paid regularly (typically annually) by a company to its shareholders out of its profits (or reserves)	Dividend or earning per share is coded as dividend.	the rights, preferences and restrictions attaching to that class including restrictions on the distribution of dividends and the repayment of capital (Indonesian SSFAS No. 101, 58 (v), line 18-20, p. 101.16)
3.2 Distribution of income				
1	Non halal income	Income that is derived from *ribā* transactions must be disclosed and should not be earned as revenue.	Disclosure must be made for any transaction that is against Shariah.	Non halal revenue (Indonesian SSFAS No. 101, 75 (c) line 4, p. 101.31)
2	Zakat	Another purpose to disclose financial reporting is to meet social objectives such as fulfilling obligation of Zakat.	Zakat must be stated either the entity discloses in separate statement or declare otherwise. It includes method and basis of calculation.	With respect to proper aggregation of accounting data, the financial statements should provide sufficient details to meet the users' need for information about sources and uses of funds in the Zakat fund (AAOIFI Conceptual Framework, p. 27).
3	*Qard*	Another purpose to disclose financial reporting is to meet social objectives such as reporting activities relates to *Qardul hasan* transactions.	*Qardul hasan* or benevolent loan is stated.	The balances of *Qard* outstanding and funds available in the fund at the end of the period should be disclosed (AAOIFI Conceptual Framework, 4/7, para 73, p. 60).
4	Charity	Another purpose to disclose financial reporting is to meet social objectives such as payment of charity.	Other term other than Zakat that an entity may disclose is coded such as charity.	Other sources of funds in the Zakat and charity fund should be disclosed (AAOIFI Conceptual Framework, 4/6, para 67, p. 60)
3.3 Users				
1	Investors	One main group of users of financial information is investors.	Investors must be mentioned as one of the users of financial reporting information. Exclusion: Many existing and potential investors, lenders and other creditors cannot require reporting entities (IFRS Framework, OB5, p. A28))	…they provide information to help existing and potential investors, lenders and other creditors (IFRS Framework, OB7, p. A28).

2	Public	One external group of users of financial information is public.	Public must be mentioned as one of the users of financial reporting information.	other uses for public interest Standard (Indonesian SSFAS No. 101, 75 (3), line 8, p. 101.21)
3	Zakat institution	One external group of users of financial information is Zakat institutions.	Zakat institutions must be mentioned as one of the users of financial reporting information.	Zakat and *Infāq* donators and recipients (Indonesian Framework, 9, line 19, p. Framework.3)
4	*Qard* or Zakat providers	Providers are both internal and external such as shareholders, investors, customers, or specific payee.	*Qard* or Zakat provider must be mentioned as one of the users of financial reporting information.	Zakat and *Infāq* donators … (Indonesian Framework, 9, line 19, p. Framework.3)
5	Auditors	Auditors are both internal and external users of the financial reports.	Auditor must be mentioned as one of the users of financial reporting information.	to assist auditors in forming an opinion on whether financial statements comply with IFRSs (IFRS Framework, Introduction, Purposes and Status (e), p. A25)
6	Shariah advisors	One internal group of users of financial information is Shariah advisors.	Shariah advisors must be mentioned as one of the users of financial reporting information.	Sharia controllers (Indonesian Framework, 9(f), line 8, p. Framework.4)
7	Regulators	One external group of users of financial information is regulators.	Regulators must be mentioned as one of the users of financial reporting information.	…government and other sharia entities seeking to apply this Standard (Indonesian SSFAS No. 101, 6, line 17, p. 101.2)
8	Tax Agency	One external user of financial information is tax agency reporting information.	Tax agency and any statement related to tax purposes is coded.	to determine taxation policies (IFRS Framework, Introduction (e), p. A24).
9	Employees	One internal group of users of financial information is employees.	Employees must be mentioned as one of the users of financial reporting information. <u>Exclusion:</u> to assess the ability of the entity to pay and provide other benefits to its employees (IFRS Framework, Introduction, c. p. A24).	to assess the ability of the entity to pay and provide other benefits to its employees (IFRS Framework, Introduction (c), p. A24).
10	Customers	Customers are external that include loyalty or normal customers.	Customers must be mentioned as one group of users of financial reporting information.	Customers have an interest in information about the continuance of a sharia entity (Indonesian Framework, 9(i), line 24, p. Framework.4)
11	Creditors	One external group of users of financial information is creditors or lenders.	Creditors must be mentioned as one of the users of financial reporting information.	Other parties, such as regulators and members of the public other than investors, lenders and other creditors, may also find general purpose

			Exclusion: general purpose financial reports do not and cannot provide all of the information that existing and potential investors, lenders and other creditors need (IFRS Framework, OB6, p. A28)	financial reports useful (IFRS Framework, OB10, p. A28).
12	Investment account holders	Similar to investors but it does not have voting rights.	Investment account holders must be mentioned as one of the users of financial reporting information.	Return on investment accounts is the share of net result attributable to investment accountholders during the period covered by the financial statements (AAOIFI Conceptual Framework, 6.8, page 17).
13	Management	One internal user of financial information is management.	Management must be mentioned as one of the users of financial reporting information. Exclusion: Information about management's discharge of its responsibilities.	to assess the stewardship or accountability of management (IFRS Framework, Introduction (b), p. A24).
		Ambiguous words		
1	Qualitative characteristics	It refers to relevance, faithful representation, substance and form, neutrality, completeness. Enhancing characteristics include comparability including consistency, variability, timeliness, understandability,	These words are not included in the coding.	Exclude if sounds general: Applying the enhancing qualitative characteristics is an iterative process that does not follow a prescribed order.
2	Topic and sub topic	Topic and sub topic may indicate the keywords as specified in the elements.	These words do not constitute meaning, therefore they are excluded.	Exclude if sounds general: Financial assets measured at fair value through other comprehensive income (IFRS 7, p. A250).
3	Examples	The standard emphasizes the point by giving example.	The sentences that explain the purpose of giving example are excluded.	Exclude if sounds general: …for example, the amounts of inventories held in each of the main categories that are appropriate to the business (Indonesian Framework, 49 line 14-15, p. 16).
4	Footnotes	The standard explains matter in the body text in the footnote.	Any footnote is excluded from the coding.	Exclude every footnote [1] *Mudhārabah* arrangements involve two parties, one providing the funds and other the "effort" in exchange (AAOIFI Conceptual Framework, Introduction 1.b, p. 5)

5	Exclusion	Often the standards make exclusion to the narration.	Any exclusion is excluded although it uses the coding terms.	Exclusion This does not mean, however, that financial reports which are focused on the common information needs of users (AAOIFI Conceptual Framework, 3. Objectives, p. 9)
6	Repetition	Explanation of one issue may be repetitive.	Second sentence onwards are not coded if they express similar concern.	Exclude if it constitute repetition: Example 1 Accordingly, such expenses should be recognized when incurred (AAOIFI Conceptual Framework, 7.1.1.3.a, p. 19). Example 2 To the extent applicable, the following information should be disclosed in the income statement with separate disclosures of investment revenues, expenses, gains and losses jointly financed by the Islamic bank and unrestricted investment account holders and those exclusively financed by the Islamic bank: (a) Revenues and gains from investments. (b) Expenses and losses from (AAOIFI, FAS 1, 4/2, Para 50, p. 57)

Source: Current study.

Notes:

- The rule to code sentences includes counting number of words in a sentence, if one sentence has more than 20 words, then it will be coded twice.
- Exclusion is only stated in the coding rule if necessary to support the clarity.
- Zakah or Zakat, *Qardul* or *Qard*, Non halal income or Non halal revenue, Regulators or Government, Shariah Advisor or Shariah Controller, Accrual basis or Accrual accounting constitute similar meanings. In Indonesian SSFAS, *Qardul* or *Qard* is referred as charity.
- Either or both the word or/and its explanation is/are cited.

Chapter Seven: International Islamic Financial Architecture

7.1 Introduction

Previous chapters discussed how ensuring the sustainability of Islamic finance development was achieved through standardized financial reporting for Islamic financial institutions (IFIs). This chapter discusses the role of Islamic financial architecture in enhancing the importance of financial reporting standardization.[117][118] There are several financial agencies that have been established to support the development of Islamic finance. Islamic Development Bank (IDB) was established in 1973, to act as an international financial body, supporting Organisation of Islamic Cooperation (OIC) countries' development projects for educational facilities, roads, and other infrastructure projects. It also provides direct investment in the area of Islamic finance, for instance in the form of equity ownership of Bank Muamalat Indonesia (BMI). Ensuring liquidity management is part of the Islamic finance's concern, and so far there are two international bodies that deal with this sector: International Islamic Liquidity Management (IILM), based in Malaysia and established in 2010, and Liquidity Management Centre in Bahrain, established in 2002. The standard-setting bodies are known as Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), and General Council of Islamic Banking and Financial Institutions (GCIBFI). Both were established in Bahrain, in 1991 and 2001 respectively, followed by the inauguration of Islamic Financial Services Board (IFSB) in Malaysia in 2002 in the pursuit of governing the operations of Islamic financial institutions. In 2005, International Islamic Rating Agency (IIRA) was set up in Bahrain to rate the Islamic finance products. Malaysia has taken the lead in operating International Shariah Research Academy for Islamic Finance (ISRA) for research and education in 2006, under the support of the Malaysian central bank.

However, with this significant development of institutions, there is no analytical evidence assessing the joint effort among these institutions to identify their strengths, weaknesses, opportunities, and the threats against them. On the non-Islamic front, IMF and World Bank worked on Financial Sector Assessment Program (FSAP) in May 1999 to

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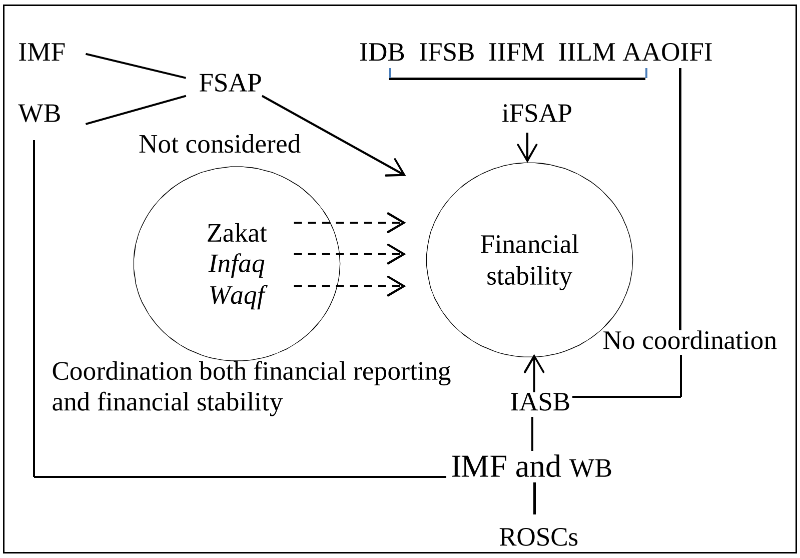
[117] An outline of this chapter has been presented at The Emerging Scholar's Colloquium, Critical Perspective of Accounting 2014 held in Toronto, Canada on 6th July 2014.

[118] A research paper from this chapter has been presented at the 6th IRTI-IDB International Conference on Islamic Banking and Finance: Risk Management, Regulation and Supervision, held in Istanbul, 16th – 17th September 2014 with title of "*The Past, Present, and Future of Islamic Financial Architecture and The Role of Financial Reporting Standards.*"

identify strengths, risks, and vulnerabilities in national financial systems, and to assess the levels of development and the technical assistance that might be needed (IMF, 2013). Since its inception the exercise has been carried out in 142 countries, including Indonesia, which has IFIs operating in the country. The involvement of the FSAP in assessing the needs of IFIs creates the possibility of FSAP potentially not being able to accommodate the needs of IFIs and offer technical assistance to them, as IFIs require specific Shariah consideration while FSAP analyses countries using a similar tool of assessment everywhere. Therefore a non-Islamic FSAP recommendation might not be compatible in an Islamic society. No study has so far been conducted to identify the strengths, risks, and vulnerabilities of a national economy with IFIs in the country. This raises the question, whether or not the FSAP assessments meet the stability objectives of IFIs, as they are dissimilar to their conventional non-Islamic counterparts. In addition to the initiative by IMF and World Bank on FSAP, IDB also engaged in the similar effort to assess the IFIs stability in 2012. The program is known as the Islamic Financial Sector Assessment Program (iFSAP). The Figure 7.1.1 below shows why IDB followed the initiative of FSAP for IFIs.

Figure 7.1.1: Background of iFSAP Initiative



Source: Current Study.
Notes:
FSAP : Financial Sector Assessment Program
iFSAP : Islamic Financial Sector Assessment Program
ROSCs : Reports on Observance of Standards and Codes

IMF first initiated FSAP with support from World Bank with the purpose to ensure financial stability of its member countries. Through coordination with IASB, financial reporting is considered as important element in the assessment which has been included in the Reports on the Observance of Standards and Codes (ROSCs) strategy. However, the strategy ignores characteristics of IFIs including role of Zakat, *Infāq*, and *Waqf*.[119] Thus, the strategy motivated IRTI-IDB to initiate iFSAP by first identifying the roles of the supporting institutions under International Islamic Financial Architecture (IIFA), and then concentrated their efforts on sustainability. The IFSB, IIFM, and IILM are part of the iFSAP framework, and AAOIFI has also been included in the project, to ensure that the accounting standards achieve a higher level compatibility with the Islamic financial operation ((Muljawan, 2011). However between these two programmes, i.e. FSAP and iFSAP, the existing conflict between the accounting standards issued by AAOIFI and IASB for IFIs were not adequately considered. This conflict raises serious issues in standardization of financial reporting for IFIs. This chapter discusses this point in more detail in the following sections. Specific attention is given to the missing component: the coordination among the institutions to implement appropriate financial reporting standards suitable for IFIs.

From the accounting front the direction towards implementing IFRS has been strongly driven by World Bank in its joint effort with IMF on ROSCs and FSAP. This indicates that a similar approach could be implemented in completing the initiative phases of development of iFSAP. The importance of identifying which financial reporting standards should be adopted is an urgent and crucial matter, as it will reflect a guideline that all institutions should comply with. Other institutions that have been highlighted to strengthen the architecture of Islamic finance are the Zakat, *Infāq*, *Waqf* institutions. These modes of charity are known to be successful in combating poverty (Mohammad and Anwar, 1991, Shirazi, 2006, Kahf, 2006, Hassan and Khan, 2007, Ahmed, 2008). For IFIs, they are partners in implementing IFIs' social contribution to the society. As discussed in Chapter Six, it is imperative to note that IFRS may never accommodate such welfare issues, as its main objective is only to serve a commercial based objective (see Chapter Six for the discussion on the important elements of *Maqāsid ul-Shari'āh* in financial reporting standards).

This chapter aims to examine the institutions responsible for Islamic financial architecture, and explore the required support for the future to impose suitable financial reporting standards for IFIs and IIFIs. Therefore the research question of this chapter is to what extent does International Islamic Financial Architecture (IIFA) support the role of Islamic based financial reporting for IFIs? The chapter's contribution is threefold. First of

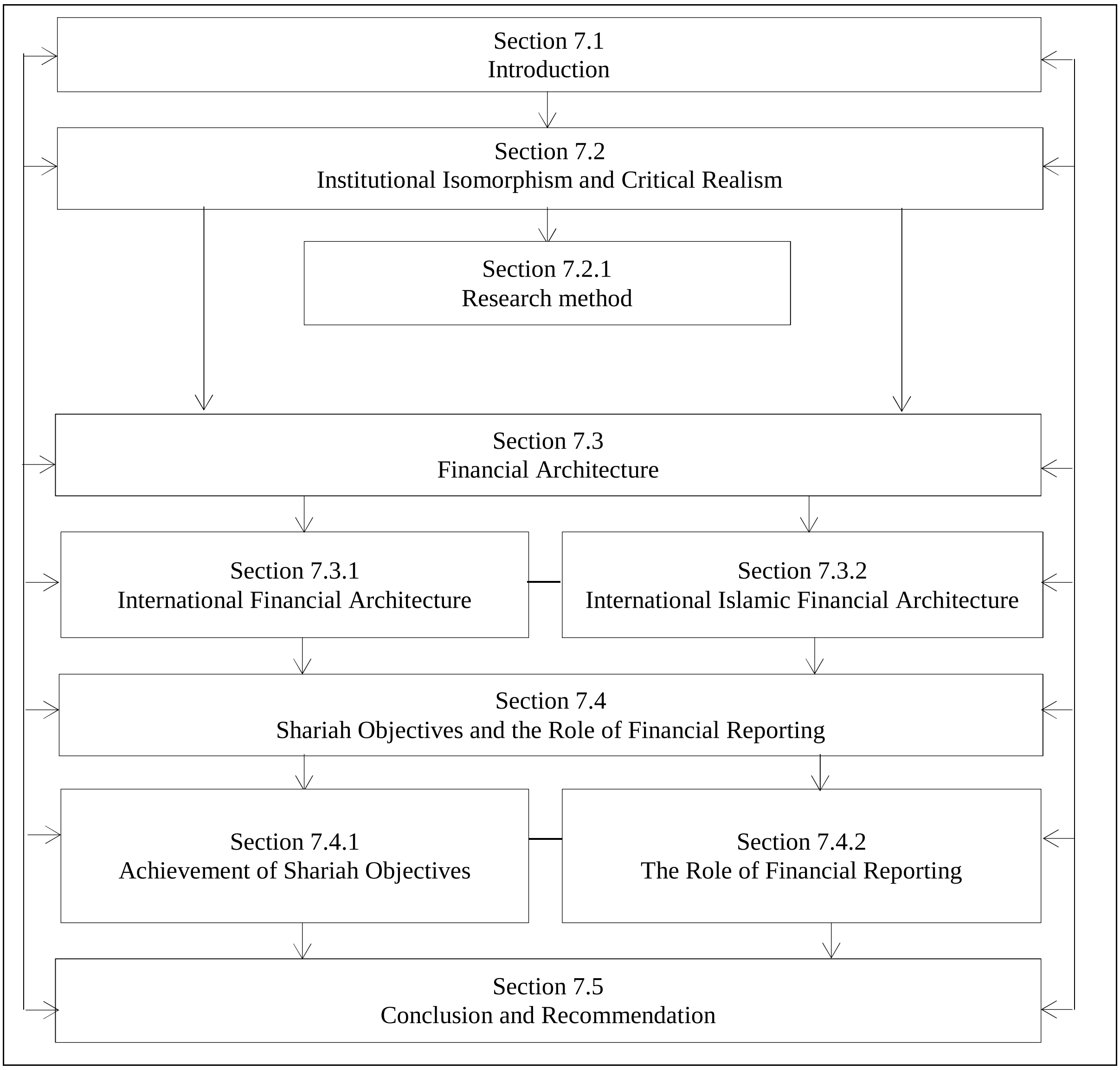
[119] While Zakat is an obligation for all Muslims, *Infāq* and *Ṣadāqah* are forms of charitable donation that are optional in nature but all these forms are normally collected by Zakat institution. During disbursement, Zakat is treated separately as it has its own dedicated recipients (see Section 7.2) while *Infāq* and *Ṣadāqah* can be distributed to any needy persons.

all, the chapter emphasizes the importance of the financial reporting standard for IFIs, an issue which has been ignored by FSAP and iFSAP frameworks, particularly in the international financial architecture studies of IFIs. It is argued that Islamic accounting researchers should be aware about the role of these institutions, as they are the individual key players, and asses the type of involvement they have in the financial reporting standardization for IFIs within the IIFA institutions. Secondly, the chapter explains the performance of various institutions involved in the financial reporting standardization. Thirdly, it analyses the particular interactions of institutions, such as AAOIFI, IFSB, IIFM, IILM, etc., with international financial institutions, i.e. World Bank and IMF, and how the intervention occurred and reflected on the financial reporting standardization of IFIs. It also includes the interaction between the AAOIFI and IASB. The AAOIFI has been considered in iFSAP to be a financial front, but not an accounting front, and therefore this chapter also analyses the gap between AAOIFI and IASB.

This chapter adopts institutional isomorphism perspective and retrodiction approach in Critical Realism as the research theoretical framework. Semi-structured interviews were conducted with participants from IIFA institutions and analysed using thematic analysis. The results show lack of cooperation among the institutions, lack of communication among them, and local versus international centric exist within the institutions. These factors impact the development of IFIs in achieving their objectives, i.e. for them to be complied with Shariah and at the same time sustainable in their business operation. IMF and World Bank's combined actions are regarded to be a power linkage instead of an intervention. An interest of a specific group may be generated in the process of iFSAP due to the emergence of IFIs, but it is believed that 'placing the right person in the right place' becomes a mantra to stabilize the interest. It means that the persons responsible for the process of setting up and operating the iFSAP should be qualified and trustworthy.

The remainder of this paper is organized as follows: Section 7.2 delineates institutional isomorphism and Critical Realism, Section 7.3 reviews financial architecture, and Section 7.4 presents the Shariah objectives and the role of financial reporting. Finally, Section 7.5 summarizes the findings and gives recommendations for future research. Figure 7.1.2 below describes the structure of this chapter.

Figure 7.1.2: Structure of Chapter Seven



7.2 Institutional Isomorphism and Critical Realism

In Chapter Four and Five, the institutional perspective describes the competing efforts for standardizing IFIs financial reporting by IASB and AAOIFI. Supported by interviews and Arena Concept, Chapter Four and Five reveal the nature of interactions in terms of the normative, mimetic, and coercive pressures that are taking place in Indonesian standardization of financial reporting milieu. To extend the research, Chapter Six reports on the closeness of the two competing international financial reporting standards (AAOIFI and IFRS) to *Maqāsid ul-Shari'āh.* Furthermore, this Chapter brings forward the discussion of proposing a solution to the central issue of having an international Islamic financial architecture capable of providing sufficient support to produce Islamic-based financial reporting standards for IFIs. As this Chapter deals with institutions involved in the development of IFIs, institutional isomorphism becomes useful to understand the political forces that legitimize the existence of such institutions. According to DiMaggio and Powell (1983), "organizations compete not just for resources and customers, but for political power and institutional legitimacy, for social as well as economic fitness" (page 150). As this thesis argues in various places, IFIs are not only established for profit maximization purposes. Therefore, to ensure their sustainability, they must fulfil the ultimate objective, which is Shariah-based compliance. Section 1.5 explains that this chapter adopts New Institutional Theory and Critical Realism to recognize the problems faced by the institutions, to provide the analysis tools, to consider engagement of the social context, and to focus on the practical contribution. Through semi structured interviews, NIS and Critical Realism are employed to analyse the problems faced by the institutions and suggest possible solution.

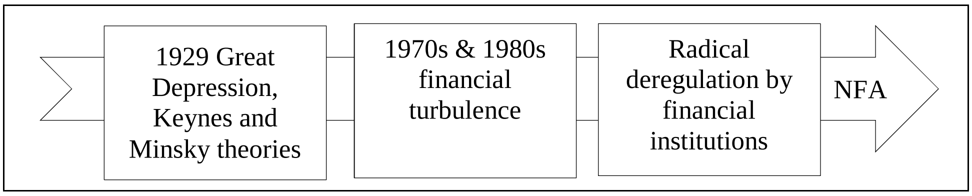
7.2.1 Research method

Semi-structured interviews were conducted in order to achieve the objective of this chapter. The interviewees are representatives from IRTI-IDB, who initiated the iFSAP; participants from the supporting institutions, i.e. the ISRA and AAOIFI; an observer from IMF; political economy experts from an academic institution, as well as a representative from Bank Indonesia (see Appendix 7.8, 7.9 and 7.10). The interviews were carried out in Durham, United Kingdom in the beginning of April 2014 and Cambridge, United States of America at the end of April 2014. Five interviewees from the samples refused to participate, due to public opinion restriction of their respective institutions. During the interview, ethical procedures were carried such as confirming the participation to the research and reading non-disclosure identity of the interviewees. The interviews used medium language of English and Indonesian mixed with Arabic terms with duration of 90 minutes in average. The interview touched upon a cluster of concepts with specific meanings attached to Islamic financial architecture, with keywords such as Islamic finance, financial reporting, architecture, Shariah compliance, sustainability, FSAP, and iFSAP.

7.3 Financial Architecture

According to IMF, financial architecture consists of institutions, markets, and practices that governments, businesses, and individuals use when they carry out economic and financial activities (Khan, 2009). This chapter limits definition of financial architecture as a set of institutions that are concerned with financial reporting standardization project for IFIs. Financial institutions have been facing a repetitive crisis in the recent decade, starting from the financial collapse due to the Great Depression[120] in 1929, which was then revived through the Keynes and Minsky economic policy intervention (Crotty, 2009). However, the Keynes and Minsky theories were later replaced with more efficient financial market hypotheses. After the world faced the economic and financial turbulence of the 1970s and early 1980s, a new classical macro-economic theory arose, signifying a serious crisis of capital accumulation Harvey (2005). The tight financial regulations were justified by an efficient financial market theory, which then embarked on new globally-integrated deregulated neoliberal capitalism (Crotty, 2009). Crotty continued his argument by attributing the cause of the financial crisis essentially to flaws of the current financial regime, referred to as the New Financial Architecture (NFA).[121] Figure 7.3.1 describes the forces of financial architecture formation to become new financial architecture. The financial formation began after the Great Depression in 1929 with Keynes and Minsky theories for economic recovery. The formation was stopped due to financial turbulence in 1970s and 1980s, which, through weakening the government supervisory mechanism, led to radical deregulation programs of financial institutions.

Figure 7.3.1: Building Process of Financial Architecture



Source: Summarized from Crotty (2009).

Without an effective government supervisory mechanism, the financial institutions could operate freely in the market. These financial institutions were then blamed for the last two consecutive crises in 1997 and 2008. With incentive to accumulate profit, the financial institutions, particularly banks, were depicted like a financial bubble. A financial crisis first hit Thailand's currency *(baht)*, which was heavily tied to the speculative property market in 1997. The crisis then spread to Indonesia, Malaysia and the Philippines, and later reached countries such as Hong Kong, Taiwan, Singapore and South Korea (Harvey, 2005, p. 96).[122]

In 2008, a second financial crisis started due to the US sub-prime mortgage industry, which shook financial institutions in almost the entire world. The global banks exaggerated their balance sheet-asset from US$10 trillion in 2000 to US$23 trillion in 2006

[120] It was not just America but spread to Great Britain (known as Great Slum).

[121] NFA refers to the integration of modern day financial markets with the era's light government regulation (Crotty, 2009)

[122] Chapter Four discusses Indonesian history during 1997 and 2008 financial crisis.

due to the bank holdings of MBSs and CDOs.[123] In 2009 IMF estimated potential losses banking practices on US-originated credit assets for US$2.7 trillion between 2007-2010 (Crotty, 2009). It means the financial bubble had burst: there were no liquid assets in the balance sheet; it was merely creation of debts on top of debts. This raises the question why accountants did not inform the users so that they could make the right decisions. The government was unable to exercise its authority, to examine the performance of the financial institutions, due to the deregulation regime. Two conclusions can be derived from the crisis. First of all, it is clear that accounting failed to demonstrate its authority and be persistently objective. In addition, they overlooked the fact that a crisis could diminish the welfare of the entire society, through last resorts methods such as government bailout (as was the case in Indonesia in 1997-1998 and Greece in 2007-2008). Secondly, similarly to United Kingdom in (2007-2008), government regulation was not strong enough, and thus the activities of the financial institutions in the country were not properly supervised.[124] It is deeply worrying that United Kingdom, with its hundreds of years of experience in the financial industry, was not being able to foresee the crisis. It can be argued that perhaps people became a bit negligent because they are so used to living in a welfare state. The story of Prophet Yusuf, who advised the King of Egypt about anticipating vulnerable conditions after a period of plentiful prosperity,[125] may be relevant to this scenario (Qur'an *Yūsuf* (12), verse 43-49).

From the information above we can conclude that most governments are not sufficiently prepared to exercise their powers in order to regulate financial institutions. As

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[123] Mortgage Backed Securities (MBSs), Collateralised Debt Obligations (CDSs).

[124] The Queen Elizabeth even raised her disbelief in 2008 to the academics at the London School of Economics which was answered four years later by Sujid Kapadia, an economist and one of the Bank of England's top financial policy experts (Guardian, 2012):

The Queen	"Why did nobody notice the "awful" financial crisis earlier?"
Sujid Kapadia	"The global economy boomed in the pre-crisis years, The City had got "complacent" and many thought regulation wasn't necessary"
The Queen	"People got a bit lax … perhaps it is difficult to foresee [a financial crisis]."
Sujid Kapadia	"The financial crises were a bit like earthquakes and flu pandemics in being rare and difficult to predict" (then he reassured her that the staff at the Bank were there to help prevent another one)
The Queen	"Is there another one coming?"… "Don't do it again."

[125] "And [subsequently] the king said, "Indeed, I have seen [in a dream] seven fat cows being eaten by seven [that were] lean, and seven green spikes [of grain] and others [that were] dry. O eminent ones, explain to me my vision, if you should interpret visions." They said, "[It is but] a mixture of false dreams, and we are not learned in the interpretation of dreams." But the one who was freed and remembered after a time said, "I will inform you of its interpretation, so send me forth." [He said], "Joseph, O man of truth, explain to us about seven fat cows eaten by seven [that were] lean, and seven green spikes [of grain] and others [that were] dry - that I may return to the people; perhaps they will know [about you]." [Joseph] said, "You will plant for seven years consecutively; and what you harvest leave in its spikes, except a little from which you will eat. Then will come after that seven difficult [years] which will consume what you saved for them, except a little from which you will store. Then will come after that a year in which the people will be given rain and in which they will press [olives and grapes]." (Qur'an *Yūsuf* (12), verse 43-49).

previously argued, the foundation of the current global financial structure is very weak: it is driven by a fundamentally flawed policy-design for banking systems and international assistance programs, and the nature of financial systems are inherently flawed (Colomiris, 2003, p. 261). The flawed system can be attributed to the liberalization of the economy concept discussed in Chapter Four where suggests neoliberal controls the government in regulating the market in order to save the interest of the neoliberal group (Martinez and Garcia, 1996). In terms of ensuring the stability of the financial institutions, Harvey adds that:

> …in the event of conflict, neoliberal states typically favour the integrity of the financial system and the solvency of financial institutions over the well-being of the population or environmental quality (Harvey, 2005, p. 70-71).

The following section discusses the issues of international financial architectures, both the existing financial architecture as well as the Islamic one that is currently under review.

7.3.1 International Financial Architecture

Because of the financial crises described in the previous section and the demonstrated weaknesses in the international financial system, in 1999 the IMF took the initiative to study the world financial system known as Financial Sector Assessment Program (FSAP). The initiative was based on a discussion that was started in the mid-1990s, regarding how to avoid a financial disorder similar to the devaluation of the peso in Mexico in 1994 (Humphrey et al., 2009). The FSAPs that were designed for developing and emerging market countries were conducted through a joint effort between IMF and World Bank. Reports from the Observance of Standards and Codes (ROSCs) were also involved in the debate as early as March 1999. The FSAP assessments include two components: financial stability, which is the responsibility of IMF, and financial development, which is the responsibility of World Bank. Additionally, the ROSCs[126] monitors the extent to which each country observes the internationally recognized standards and codes.

Through the FSAP, the international community is expected to strengthen the "architecture of the international financial system" in order to reduce the risk of crises

[126] The IMF has recognized 12 areas and associated standards as useful for the operational work of the IMF and the World Bank: accounting; auditing; anti-money laundering and countering the financing of terrorism (AML/CFT); banking supervision; corporate governance; data dissemination; fiscal transparency; insolvency and creditor rights; insurance supervision; monetary and financial policy transparency; payments systems; and securities regulation.

(IMF, 2001). The urgency of this program is reflected in the statement of Horst Köhler, the Managing Director of IMF:

> The IMF must gain a better understanding of the dynamics of international capital markets and the operations of private financial institutions, to fulfill more effectively its mandate to oversee the functioning of the international monetary system and promote international financial stability. Equally important, our member countries have a responsibility to do their part, by participating in these architecture initiatives and implementing structural reforms to increase the flexibility of their economies and eliminate sources of vulnerability (Köhler, 2001).

In other occasion, through its First Deputy Managing Director, IMF Anne Krueger, describes why reassessment of International Financial Architecture is required and she said:

> Architecture first. The growth of private international capital flows has delivered important benefits for borrowers and providers of capital alike. Foreign direct investment has risen steadily in importance, but as portfolio flows have become larger and more volatile, a price has been paid in more frequent and more severe financial crises (Krueger, 2001).

These urging statements support the commitment spelled out in Article IV[127] in which the FSAP is regarded as an input for the yearly consultation on development. The

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[127] Article IV: Obligations Regarding Exchange Arrangements

Section 1. General obligations of members

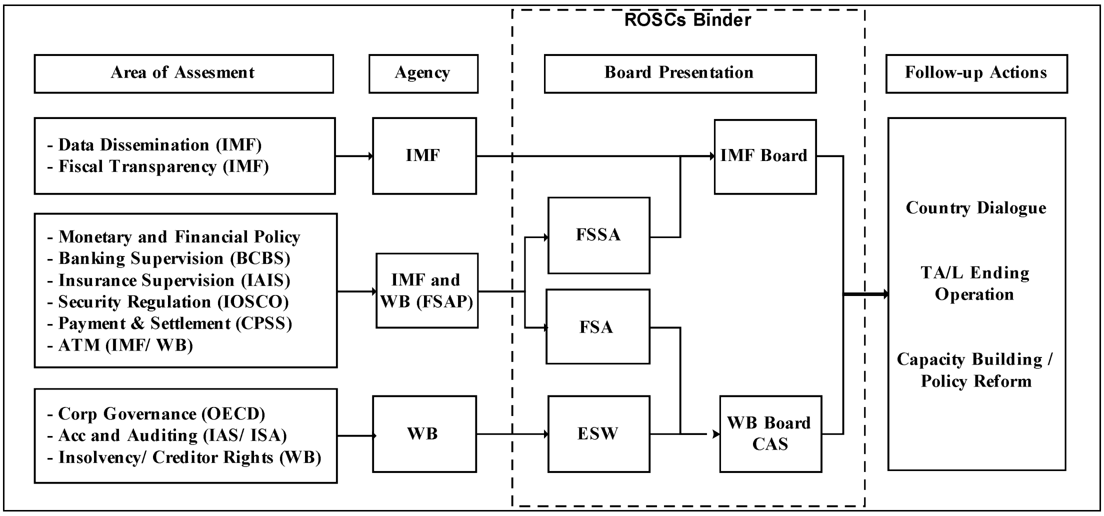
> Recognizing that the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services, and capital among countries, and that sustains sound economic growth, and that a principal objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates. In particular, each member shall:
>
> (i) endeavour to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances;
>
> (ii) seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions;
>
> (iii) avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members; and
>
> (iv) follow exchange policies compatible with the undertakings under this Section.

Section 2. General exchange arrangements

> (a) Each member shall notify the Fund, within thirty days after the date of the second amendment of this Agreement, of the exchange arrangements it intends to apply in fulfilment of its obligations under Section 1 of this Article, and shall notify the Fund promptly of any changes in its exchange arrangements.
>
> (b) Under an international monetary system of the kind prevailing on January 1, 1976, exchange arrangements may include (i) the maintenance by a member of a value for its currency in terms of the special drawing right or another denominator, other than gold, selected by the member, or (ii) cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members, or (iii) other exchange arrangements of a member's choice.
>
> (c) To accord with the development of the international monetary system, the Fund, by an eighty-five percent majority of the total voting power, may make provision for general exchange

consultation is conducted through a visit of IMF economists to the member country, in order to hold discussions with the government and central bank officials. Discussions are also often conducted with private investors and labor representatives, members of parliament, and civil society organizations (IMF, 2014). The FSAP, being a mandatory part of the Article IV, is prepared every five years. It may also include a report on Financial System Stability Assessment (FSSA). Figure 7.3.2 below describes the FSAP and other reports on financial sustainability assurance process. The FSAP is a collaborative work between IMF and World Bank. It assesses several policies set by the IMF, BCBS, IASIS, IOSCO, CPSS, and World Bank. Muljawan (2011) asserts that the next step of the above assessment process can be to integrate the Islamic financial system into the global financial system. However, this integration must comply not only with international prudential measures, but also with the Shariah principles.

Figure 7.3.2: Financial Sustainability Assessment Program



Source: Muljawan (2011).

Notes

ROSCs : Reports on the Observance of Standards and Codes
FSSA : Financial Sector Stability Assessment
FSA : Financial Sector Assessment
ESW : Economic and Sector Work
CAS : Country Assistance Strategy

A research conducted by The South East Asian Central Banks (SEACEN) Research and Training Centre, Zamorski and Lim (2013) highlighted that 22 countries' FSAPs (including Indonesia's FSAP) have three shortcomings:

i) Inadequate resourcing for bank supervision. It can be suggested that there should be a bigger budget for training bank supervisors, so that they may achieve the necessary degree of proficiency and be provided with soft skills.

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arrangements without limiting the right of members to have exchange arrangements of their choice consistent with the purposes of the Fund and the obligations under Section 1 of this Article.

ii) The lack of legal protection for bank supervision. A possible way to overcome this issue would be to protect the bank supervisors from any political pressure and threat of lawsuits for actions that should be enacted in law.

iii) The inability to legally exchange confidential supervisory information with domestic and foreign financial sector supervisors. Due to the supervisors' lack of authority to assess prudential risks they are unable to fulfil their responsibilities.

The points above indicate multiple weaknesses in the international financial architecture which aimed at strengthening the financial sectors. Several attempts have been carried out before the creation of FSAP such as the initiative of G7 member countries on FSF (Financial Stability Forum)[128] in 1999**.** The FSF had the purpose to coordinate the key actors' involvement in the emerging 'international standards regime', but by 2008, the FSF was considered to be a failed project (Helleiner, 2010).[129] Upon close examination of the shortcomings above, it appears that they are caused by difficulties that require both internal and external mechanisms. Shortcoming i) and iii) can be solved through internal discretion, while shortcoming ii) may not be as straight forward, as it involves the interests of many parties. What can Islamic financial institutions learn from this development? Is there a financial reporting standardization issue impliedly contained within the shortcomings explained by Zamorski and Lim (2013)? The following section describes the development of financial architecture that has been established alongside the growth of Islamic finance.

7.3.2 International Islamic Financial Architecture

Figure 7.3.3 describes the evolving of the International Islamic Financial Architecture (IIFA) in order to support the current development of Islamic finance.[130]

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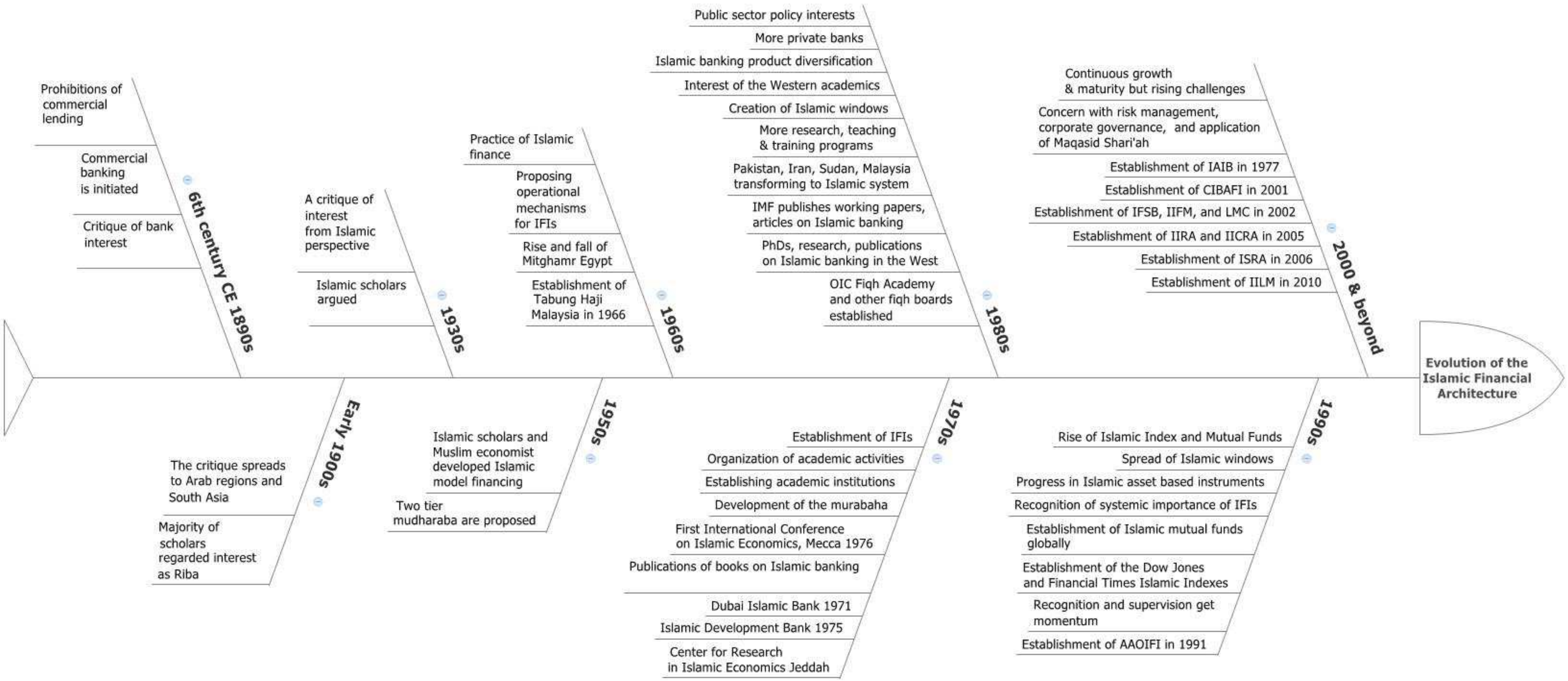
[128] FSF's members include representatives from: the finance ministry, central bank and supervisory authority of each G7 country; a number of relevant international organizations (International Monetary Fund (IMF), World Bank, Bank for International Settlements, OECD, and the European Central Bank); and the international standard setting bodies and other groupings (the BCBS, IAIS, IOSCO, IASB, CPSS, and the Committee on the Global Financial System) (Helleiner, 2010). BCBS = Basel Committee on Banking Supervision (BCBS), IAIS = International Association of Insurance Supervisors, OECD = Organization for Economic Cooperation and Development (OECD), IOSCO = International Organization of Securities Commissions, IASB = International Accounting Standards Board, CPSS = Committee on Payment and Settlement Systems.

[129] In the words of Howard Davies and David Green (2008, p. 116), the FSF failed 'to carve out a distinctive position, integrating the various perspectives of the diverse membership, as was originally hoped' (Helleiner, 2010)

[130] The term Islamic financial architecture was used by President of IDB in 2000 when he delivered his speech at The Fifth Harvard University Forum in Islamic Finance (Ali, 2000)

Figure 7.3.3: Evolution of the International Islamic Financial Architecture



Source: Ali (2000) and current study.

Figure 7.3.3 illustrates the historical development, from the initial idea of establishing an Islamic finance based on the prohibition of usury in the 6th century (during the prophet-hood of Muhammad P.B.U.H), to the introduction of commercial banks in the Muslim world in the 1890s. The critiques passed on by Muslim scholars remarked in the early 1900s up to the 1930s when the commercial banks introduced the practice of usury. After realizing this predicament, the idea of conceptualizing the Islamic economics model in the 1950s was developed, followed by establishing Islamic modern financial institutions in the 1960s. In the following decades, i.e. the 1970s and 1980s, numerous Islamic financial institutions and academic institutions were established, in order to provide a platform for further research and development.

The figure also depicts that AAOIFI accounting standard was first issued in the 1990s. This period was also considered a starting point for the building of several supporting institutions, continued to 2000 and beyond. Asutay (2012) argues although Islamic finance has shown its rapid growth in its second stage of development (from 1997 onwards) but the industry has not contributed to the development of society. As consequences of the growth, issues regarding risk management, corporate governance, and the application of *Maqāsid ul-Shari'āh* arose and require a more resilient Islamic financial architecture (IIFA). In this context, the architecture must fulfil the objectives such as to establish universally acceptable guiding principles for the Islamic financial services industry, and to establish best practices for Islamic financial services; to narrow the *fiqh* interpretations and set up a common regulatory and supervisory regime; and to promote standard compliance using the most relevant regulations (Khan, 2009). The regulations for Islamic financial services include the Shariah and corporate governance, corporate ethics and social responsibility, transparency and disclosures, risk management, capital adequacy, and accounting and auditing.

Due to the high impact of the financial crisis, the issue of financial stability was also deliberated on the level of Islamic financial industry. Ali (2000) argues that the inherent features of the Islamic financial industry could contribute to the strengthening the global financial architecture. However, because of the higher complexity of the Islamic finance products and services that deals with uneven fluctuations of the interest rate, the Islamic financial institutions are currently fragile to the crisis. The 2008-2009 financial crises that included Islamic finance tells us that there is a dire need to have uniformity of Shariah regulation to supervise the market (Ghoul, 2012). This issue is discussed in Chapter Three and Five, due to the fact that there is currently no single Shariah authority that can affirm a decision on the *dos* and the *don'ts* in Islamic finance. Shariah interpretation in form of *fatawā,* that are endorsed by the International Islamic *Fiqh* Academy (OIC-IIFA) and AAOIFI, are not compatible in all countries where IFIs operate. Therefore, there are growing institutions of Shariah scholars in each country, who produce their own *fatawā* to guide IFIs in running their operations. For instance, Malaysian central bank formed the highest Shariah authority in Islamic finance referred as Shariah Advisory Council (SAC) in 1997. In addition, the central bank enacted the Islamic Financial Services Act (IFSA) 2013, in order to strengthen the authority of the SAC. Generally, the purpose of IFSA 2013 is to provide regulation and supervision of IFIs, payment systems, and oversee the Islamic money market, Islamic foreign exchange market and their compliance with Shariah (IFSA, 2013). Similarly, Indonesia formed its National Shariah Council in 1999, under the legal entity of the Indonesian Council of *Ulama,* to issue Shariah guidelines such as *fatawā*. The *fatawā*[131], as stipulated by Islamic Banking Act No. 21 Year 2008, Article 26 (2) p. 15, is regarded to be a compulsory guideline for all Islamic banks in Indonesia. Malaysia is one step ahead of Indonesia in formulating legal system for Islamic finance industry: its first legal forms were the Islamic Banking Act in 1983 and *Takāful* Act in 1984, and they are now repealed by the issuance of IFSA 2013.

Shariah compliance has become a central issue in Islamic finance, as it must be the first objective to be satisfied, ahead of profit maximization. This objective is the 'inherent feature' as alluded by Ali (2000), which has made IFIs resilient to face the financial crises. This inherent feature must be imbued in IFIs financial reporting to ensure their degree of compliance at the time of reporting. This section highlights the importance of disclosing the list of bodies that have been regarded in the IIFA, with particular mind paid to the financial reporting standardizations. Table 7.3.1 lists the institutions that have been established to support IIFA extracted from their respective websites. The table shows the year in which each institution was established, the country of establishment, and the vision and mission of each institution. Three out of twelve institutions do not have vision statements, and five out of twelve institutions do not display their mission statements on their websites. A mission statement is a pervasive feature of a legal binding institution and a valuable tool in corporate communication, management, and strategic planning (Blair-Loy et al., 2011). This issue is discussed in the analysis section below. The following part describes the prospects and challenges each institution faces when it comes to strengthening Islamic financial architecture.

[131] Singular form of *fatawā.*

Table 7.3.1: List of Islamic Finance Supporting Institutions

No.	Name of institutions	Year	Office	Vision	Mission
1	Islamic Development Bank (IDB) http://www.isdb.org/	1973	Saudi Arabia	To be the leader in fostering socio-economic development in member countries and Muslim communities in non-member countries in conformity with Shariah.	The IDB Group is committed to alleviating poverty; promoting human development; science and technology; Islamic economics; banking and finance; and enhancing cooperation amongst member countries, in collaboration with our development partners.
2	International Association of Islamic Banks (IAIB)	1977	Saudi Arabia	N/a	N/a
3	Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) www.aaoifi.com	1991	Bahrain	To guide IF's markets operation and financial reporting on Shariah principle and rules and to provide IF markets with a standards that can support growth of the industry	Standardization and harmonization of international Islamic finance practices and financial reporting in accordance to Shariah
4	General Council of Islamic Banks and Financial Institutions (GCIBFI) http://www.cibafi.org	2001	Bahrain	To participate efficiently and effectively in supporting a universal Islamic economic system	To represent the Islamic finance industry globally; To participate in defending and protecting its role; and to offer support for its expansion
5	Islamic Financial Services Board (IFSB) www.ifsb.org	2002	Malaysia	N/a	Ensuring the soundness and stability of the Islamic financial services industry, which is defined broadly to include banking, capital market and insurance
6	International Islamic Financial Market (IIFM) www.iifm.net	2002	Bahrain	Active and well regulated trading and capital flows across the full spectrum of Shariah compliant and financial instruments internationally	Catalyzing both national and international trading infrastructure, product innovation and information flow within strong, transparent and well regulated standards and guidelines and promoting acceptance and integration with mainstream markets
7	Liquidity Management Centre (LMC) www.lmcbahrain.com	2002	Bahrain	To enable Islamic financial institutions to manage their liquidity mismatch through short and medium term liquid investments structured in accordance with the Shariah	N/a

Table 7.3.1: List of Islamic Finance Supporting Institutions

No.	Name of institutions	Year	Office	Vision	Mission
				principles.	
8	International Islamic Rating Agency (IIRA) www.iirating.com	2005	Bahrain	To foster growth in Islamic capital markets, as a rating agency that stands for trust, transparency, fairness and independence	N/a
9	International Islamic Centre for Reconciliation and Arbitration (IICRA) http://www.iicra.com/en	2005	Dubai	Modern Shariah vision for setting disputes of Islamic finance industry	N/a
10	International Shariah Research Academy for Islamic Finance (ISRA) www.isra.org	2006	Malaysia	To be the premier Shariah research centre in Islamic finance	Integration of Shari`ah experts and industry practitioners; Synergizing total human capital development in Islamic Finance; Relevant to the market needs; Authoritative in research findings
11	International Islamic Liquidity Management (IILM) www.iilm.com	2010	Malaysia	N/a	N/a
12	National Zakat Agency *(Badan Amil Zakat Nasional/BAZNAS)* http://pusat.baznas.go.id/	2001	Indonesia	To become Zakat[132] institution that is trusted, transparent, and professional	To increase society awareness to pay Zakat through Zakat institution; to increase Zakat collection and disbursement based on Shariah principles and modern management principles; to enhance development of being Zakat institution that is trusted, transparent, and integrated; to create centralized database of national Zakat; to maximize role of Zakat in combating poverty in Indonesia through synergy and coordination with related institutions.
13	Indonesian *Waqf* Institution *(Badan Wakaf Indonesia/BWI)* http://bwi.or.id/	2004	Indonesia	Towards a trusted independent institution, with high capacity and integrity to develop national and international *Waqf*[133] assets"	To enhance the Indonesian *Waqf* Board to be a professional institution that is capable for realizing the potency and economic benefits of *Waqf* assets for the sake of religious interests and people empowerment.

[132] Islamic/religious tax.

[133] There is no exact English translation for this, but 'Islamic/religious endowment' is commonly used.

1. Islamic Development Bank (IDB)

The IDB is a multilateral-institution that operates at an international level with the purpose of improving its member countries' economic growth and well-being. The Islamic Research and Training Institute – Islamic Development Bank (IRTI-IDB) is a subsidiary of the IDB, which focuses on developing research in the areas of Islamic economics and finance. Prominent figures in Islamic economics have or have had various positions in IRTI-IDB office for example Umer Chapra, Nejatullah Siddiqui, Tariqullah Khan and Anas Zarqa. The IDB has been extending loans to its member countries, though unlike IMF, which normally imposes certain conditions to its members, the IDB seems to have lenient loan conditions. For instance, it never requires its member countries to adopt certain standards, like AAOIFI accounting standards, as part of a loan agreement (see Chapter Five).

2. International Association of Islamic Banks (IAIB)

This institution may not be in existence anymore, as there is neither website nor any news that update its current status. It is not even on the website of Organisation of Islamic Cooperation (OIC) as its umbrella organization. In spite of this, its works, such as the Directory of Islamic Banks and Financial Institutions (1994, 1997) and the Aggregate Balance Sheet of the International Association of Islamic Banks (1988), were cited by several researchers, for example Aggarwal and Yousef (2000), Sundararajan and Errico (2002), and Choudhury and Hussain (2005) respectively. As the General Council of Islamic Banks and Financial Institutions (GCIBFI or CIBAFI) was established in 2001, the existence of IAIB became redundant.

3. Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI)

As of March 2014, AAOIFI has issued 88 standards. Of these 88 standards 48 are Shariah standards, 26 accounting standards, five auditing standards, seven governance standards, and two are standards on ethics, including one on guidance notes (see Appendix 7.1 and 7.2 for details on standards). The majority of the board members are from Middle Eastern countries. Only one member is from South East Asia: Mohammad Akram Laldin from Malaysia, who serves as a member of Shariah Standards Committee 4. The prospects and challenges of AAOIFI have previously been discussed in Chapter 5. In summary, AAOIFI approach in regulating its standards should be reformed in order to receive a more solid recognition from other member countries. AAOIFI recent engagement with World Bank, through their annual joint conference on Islamic banking and finance, may appropriately empower the institution. However, there is no evidence that AAOIFI communicates with more appropriate agency namely International Accounting Standards Board (IASB), or member country accounting standard setters, such as the Indonesian Institute of Accountants (IIA). This is crucial as AAOIFI has been absent in the forum of financial reporting standardization projects.

4. General Council of Islamic Banks and Financial Institutions (GCIBFI or CIBAFI)

The CIBAFI declares itself to be one of the largest international Islamic architecture institutions, with 106 members around the world (CIBAFI, 2014). The CIBAFI recognizes AAOIFI, IFSB, and IIFM as part of Islamic architecture as well. Several chairmen of Islamic banks in the Middle Eastern countries run the CIBAFI. One chairman is from Bangladesh, but no one is from South East Asia. The CIBAFI's main activities are to organize trainings and seminars on Islamic banking and finance, such as the recent 2nd International Forum for Islamic Banks and Financial Institutions held in Luxembourg on the 3d and 4th of April 2014. In 2012 and 2013 several seminars and forums were organized in Sudan, Mauritius, Jordan, Tunisia, and Azerbaijan but none was held in South East Asia. There are no specific guidelines issued for its members by the CIBAFI. Instead, the website displays the AAOIFI, IFSB, and IIFM standards, as well as country specific regulations. However, there seems to be no effort to update the status of standard development of each respective institution. For instance, AAOIFI's two standards on ethics are not mentioned; the website displays the Blueprint of Islamic Banking 2002 as the banking regulation of Indonesia, instead of the Islamic Banking Act No. 21 Year 2008. Additionally, the Malaysian Islamic Banking Act 2005 (Amendment) has not been updated to the Islamic Financial Services Act (IFSA) 2013.

5. Islamic Financial Services Board (IFSB)

The IFSB website does not specifically state the organization's vision and mission, but it spells out the objective of the institution: to promote the development of a prudent and transparent Islamic financial services industry through introducing new international standards consistent with Shariah principles, or adapting existing standards, and recommending them for adoption (IFSB, 2014). As of April 2014, the IFSB has 184 members, out of which 59 are regulatory and supervisory authorities, eight are international inter-governmental organizations, 111 are financial institutions and professional firms, and six are self-regulatory organizations operating in 45 jurisdictions. The council, as the senior executive and policymaking body, has representative members from countries with full membership, covering Asia and South East Asia, as well as the Middle East, including Iran. The IFSB has issued 15 guiding principles on risk management: capital adequacy, corporate governance, market discipline, and supervisory review process, conduct of business, solvency, liquidity, and stress testing (see Appendix 7.3 for full lists). It has also released five general notes on capital adequacy, risk management, profit pay-out, and rating, in order to support the implementation of the guiding principles that have been issued. There is one technical note on liquidity management that provides details on the procedures. The website shows the IFSB and downloadable files. It is very user-friendly, even to people accessing it from outside Malaysia. However, the IFSB has been facing problems for lacking of authority in endorsing the IFSB standards as obligatory standards for its member countries.

6. International Islamic Financial Market (IIFM)

The IIFM focuses on Islamic capital market and money market, and has its primary focus on the standardization of Islamic financial products, documentation, and related processes. The IIFM Board of Directors comprises of three senior executives from Malaysia, Brunei Darussalam, and Indonesia. Although the majority of the members of its Shariah Advisory Panel are from Middle Eastern countries, two are South East Asian scholars: Mohammad Akram Laldin from Malaysia and Adiwarman Azwar Karim from Indonesia. Since its establishment the panel has produced six standards: treasury, profit rate swap, adaptation of procedures and policies, hedging, interbank investment, and repo alternative and collateralization (see Appendix 7.4). Its market research reports several studies, namely Sukuk, interbank investment, profit swap, and repo alternative and collateralization.

7. Liquidity Management Centre (LMC)

The organization states its vision, but instead of a mission it highlights that its main role is to facilitate the investment of the surplus funds of Islamic banks and financial institutions into quality short- and medium term financial instruments structured in accordance with the Shariah principles. The LMC shareholders consist of several Islamic banks owned by governments of IDB, Bahrain, UAE, and Kuwait. Its total assets, as stated in the audited financial report of 2013, amount to USD 221 million, increased from USD 105 million in 2005. The financial information is updated up until 2013, although its Sukuk market particulars, the Global Sukuk Table, Executed Trades, and Payment Details, have last been updated in 2007 and 2008 (see Appendix 7.5).

8. International Islamic Rating Agency (IIRA)

The IIRA pronounces its vision but without mission statement. Nevertheless, it declares its core values to be to promote the core Islamic values of transparency, integrity, quality and independence. In a conference proceeding published by IRTI-IDB (2005), the IIRA's vision and mission were mentioned as follows: to become the reference for credit rating in accordance with Shariah principles, and introducing standards for greater disclosure and appropriate governance in Islamic banking, and helping clients in understanding and managing various risk in compliance with the Shariah principles. The institution was established to provide its capital market and the banking sector with a rating assessment on capital instruments and specialty Islamic financial products. Its shareholders consists of the IDB, rating agencies from Cyprus, Pakistan, and Malaysia, and several banks and insurance companies from Middle Eastern countries like Turkey, Bosnia, Yemen, Pakistan, as well as from Malaysia. The IIRA released several reports on rating that can be found on Appendix 7.6.

9. International Shariah Research Academy for Islamic Finance (ISRA)

The ISRA has a clear vision and mission, and its activities are regularly updated and accessible to the public. Its range of research activities are well documented in its publication of books and journals, as well as on an online repository called the Islamic Finance Knowledge Repository (I-FIKR). The organization which is funded mainly by the Central Bank of Malaysia offers scholarships and research funding in order to develop Islamic finance areas, particularly in Islamic legal matters. The ISRA Council of Scholars consists of international scholars from the Middle East, accompanied by local scholars. Its research areas cover Islamic banking, the capital market, and Islamic insurance *(Takāful)*, with its focus on the engagement of *fatawā* issuance. One challenging factor of the ISRA is how to measure its success in conducting research that is claimed to be relevant for market needs. The ISRA must be able to measure the benefits of its research to the practitioners of Islamic finance.

10. International Islamic Liquidity Management (IILM)

The IILM states neither a vision nor mission on its website. However, the website discloses its objectives such are to enhance cross-border investment flows, international linkages and financial stability. It is different from other institutions but similarly to the LMC structure, as it has shareholders comprising central banks and monetary agencies from various countries in South East Asia, the Middle East and Europe, as well as the multilateral institution IDB. It has facilitated several Sukuk issuances to support market liquidity (Appendix 7.7 provides details of the Sukuk issuances). In vision, mission, and objectives there is a similarities between the LMC and IILM, as both organizations offer liquidity management solution to Islamic financial institutions. The former is based in Bahrain, while the latter has its main office in the capital city of Malaysia.

11. International Islamic Centre for Reconciliation and Arbitration (IICRA)

The IICRA states its vision to be the centre for settling disputes of the Islamic finance industry. Instead of providing a mission statement, the IICRA mentions its objectives: to supply the industry with its expertise in settling disputes according to Islamic Shariah principles, and to provide consultation on diversity of products and contracts of Islamic financial services. The establishment of the IICRA was supported by the governments of UAE, IDB, and CIBAFI. Its office is located in Dubai. There is no evidence for its work on conducting arbitration and reconciliation on Islamic finance legal cases since its establishment in 2005. However, its role is supposed to be essential, due to the fact that many Islamic finance transactions are governed by English law or the law of another country, instead of Shariah law (GIFR, 2012a). With three other arbitration centres in Dubai, i.e. the DIAC, DIFC-LCIA, and ADCCI,[134] IICRA is operating in agreement with United Nations Commission on International Trade Law (UNCITRAL) and the New York Convention. However, there is no clear segregation with the other three institutions regarding how Islamic finance matters are addressed.

12. National Zakat Agency *(Badan Amil Zakat Nasional*/BAZNAS)

The BAZNAS has been increasing its performance on collections of Zakat and other charity funds from USD 1.4 million in 2011 to USD 1.9 million in 2012 and to USD 5.1 million in 2013 (BAZNAS, 2014). However, its highest achievement in 2013 is only 0.02% of Zakat potential target in 2012, which was USD 22.41 billion. Aside from BAZNAS there are other Zakat institutions established in Indonesia that are operating at national scale, such as Dompet Dhuafa, Rumah Zakat Indonesia, and Pos Keadilan Peduli Umat (PKPU). As far as the Islamic financial institutions are concerned, they have also set up their own Zakat institutions, in which their collections are derived from their respective customers, employees, and networks, such as Baitulmaal Muamalat (BMM) owned by Bank Muamalat Indonesia, Lembaga Amil Zakat Nasional Bangun Sejahtera Mitra Umat

[134] Dubai International Arbitration Centre (DIAC), Dubai International Financial Centre - London Chamber of International Arbitration (DIFC-LCIA), Abu Dhabi Chamber of Commerce & Industry (ADCCI).

(LAZNAS BSM) set up by Bank Syariah Mandiri, and Lembaga Amil Zakat Yayasan *Amānah Takāful* (LAZ *Takāful*) established by Asuransi *Takāful* Indonesia. Zakat institutions are set up not only by IFIs, but by conventional banks like Bank Negara Indonesia and Bank Rakyat Indonesia as well. IFIs that do not have their own Zakat institutions have their Zakat collection distributed through national Zakat institutions, such as the BAZNAS. The most challenging issue is how the total of 20 different Zakat institutions can operate in efficient and effective ways while supporting the IIFA.

13. Indonesian Endowment Body *(Badan Wakaf Indonesia*/BWI)

Contributions to both Zakat and *Waqf* are considered to be gifts or donations as part of charitable giving, but both have strict differences in implementation and recipients. Zakat is mandatory while *Waqf* is voluntary. Zakat recipients are clearly determined in Qur'an *At-Tawbah* (9):60: the *Masākeen* (the destitute), the *Fuqarā* (the needy or poor), *Amil'* Zakat (the alms collectors), *Fissabillah* (people who work on the path of God), *Gharimun* (people burdened with debt), *Ibnussabil* (the wayfarers), *Riqab* (people in bondage or slavery, and *Mu'Allaf* (those who are inclined towards Islam). However, anyone can be a *Waqf* recipient. Therefore, *Waqf* is more flexible, as long as the property or cash (cash *Waqf*) are not blocked or passed to a third party. Due to these characteristics *Waqf* has the potential to improve the economy of Indonesia. Since 2004, the IFIs in Indonesia have been licensed to receive cash *Waqf* from *Waqif* (donors), and after certain duration of time the money is trusted to the *Nadhir* (*Waqf* administrator) to be utilized to improve the welfare of society. If a *Waqf* institution is included in the iFSAP, the most challenging part is how to formulate the implementation strategy of this endowment fund to support Indonesian economic development.

In the above literatures there are several gaps that require enhancement in the structures of Islamic finance supporting systems. Some institutions do not have clear vision and mission statement. There is also no coherent mechanism among the institutions that supports uniformity of viable financial reporting standards for the IFI. There is also the question of who should regulate and supervise the institutions under IIFA as listed on the Table 7.3.1 above, in order to create better cooperation and support the sustainability of Islamic finance development. The FSAP assesses three key components of financial stability in all countries: the soundness of banks and other major financial institutions, including implementing thorough stress tests; the quality of supervision of the financial sectors (banking, securities, and insurance); and the ability of supervisors, policymakers, and financial safety nets to withstand crises and respond to them effectively (IMF, 2013).

The latter which focuses on the ability of supervisors, policymakers, and financial safety nets, is relevant with this study, as it analyses the role of each supporting institution as described on Table 7.3.1 above. As the iFSAP also examines this factor, it is essential to relate the role of each institution to its support in order to standardize the financial reporting for the banks and major financial institutions under the purview of the Islamic finance industry.

7.4 Shariah Objectives and the Role of Financial Reporting

7.4.1 Achievement of Shariah Objectives

Using a thematic code of analysis, several points are derived from the interview: 1) lack of communication, 2) lack of cooperation, and 3) local versus international. Each of these issues is discussed in the following section.

Lack of communication

From the existing vision, mission, and objectives of establishing institutions within the Islamic finance industry, the common aim of all Islamic financial architecture institutions is to achieve the objectives of Shariah. For instance, AAOIFI's vision is to guide Islamic finance market operations and financial reporting on the principles and rules of Shariah, and to provide IF markets with standards that can support the growth of the industry. Its mission is to establish standardization and harmonization of international Islamic finance practices and financial reporting in accordance with Shariah. This ties up with the three higher objectives of Shariah *(Maqāsid ul-Shari'āh)*, as described by Abu Zaharah (1997): educating the individual, promoting justice, and catering for public interest. Eventually, these three objectives will become the fundamental differences between institutions under the International Islamic Financial Architecture (IIFA) and institutions under the International Financial Architecture (IFA). Hence, a clear and publicly stated vision and mission is required to define an institution's purpose and primary objectives. Communicative vision and mission statements also encourage the management and employees of the institutions to work towards its main objectives. Blair-Loy et al. (2011) argues that there is a close relationship between a mission statement and the organization's commitment to providing high-quality work life practices. Having high-quality work practice enables an institution under the IIFA to enhance its performance, and so achieve the Shariah objectives.

Lack of cooperation

In addition to communication, proper cooperation among the members of the institutions must be established. Coordination between institutions under the IIFA is considered poor, and urgent efforts have been made to strengthen the cooperation through restructuring the management of the institutions, implementing the rules, regulations and guiding principles, and providing consultation among members. Only through well managed cooperation can institutions of the IIFA achieve their vision, mission, and objectives, including the Shariah objectives. Interviewee I-101 claims that the objectives of Shariah must be promoted by all institutions under the IIFA, and not only be a burden of IFIs. He asserts that:

> Islamic finance is only one component within the whole framework. We have Zakat institution, *Waqf* institution, *Ṣadāqah* institution, and other social institutions. The problem is they are all segregated; we are not working under one framework. Each and every institution has been compartmentalized. If we were able to pull all these different institutions then we will create one theme (I-01).

Zakat and *Waqf* institutions are now included in the iFSAP framework proposed by IRTI-IDB. Hence they are under the same framework of the IIFA. Zakat-*Infāq*-*Ṣadāqah* and *Waqf* (ZISW) may be able to provide enough low cost funds and infrastructure so that the entire system can serve the low income society more effectively (Muljawan, 2011). As described in the Section 7.3.2 above, Zakat-*Infāq*-*Ṣadāqah* is organized by a dedicated institution called the Zakat institution, while *Waqf* is administered by a specific institution called the *Waqf* institution. If these two are included in the IIFA framework, they are expected to capture the important objective of enhancing the welfare of the society by working together with the IFIs. Additionally, smooth communication among the members under the IIFA framework is required. As indicated in Section 7.3.2, the roles of all institutions are central in promoting the IFIs. It is also crucial that they strengthen their own contribution to the society, thus supporting the role of the IIFA as a whole. In addition, the role of country's regulators is crucial to support IFIs in their country by allowing IFIs to adopt the standards issued by IIFA institutions. For instance, AAOIFI accounting standards will be most likely implemented under the discretion of the regulators in the various industries. According to Interviewee I-02, the supports should come from who is in charge on the regulation in the country:

> The required support must come from the regulators of the banks, followed by insurance companies, investment management and so on. It depends on who regulate all these (industries) in the respective country (I-12).

Therefore, lacking of cooperation among IIFA must be first resolved to show that they are resilient institutions with reliable services hence the country's regulators are willing to cooperate with IIFA institutions to achieve favourable growth of IFIs.

Local versus international-centric institutions

A solid cooperation among IIFA institutions is the utmost important, in order to ensure the sustainability of Islamic finance as a whole or within each country. As mentioned by the IMF (2012), the communication between banks and supervisors, and between supervisory agencies within a country, is one of the conducive environments in which to test the vulnerability of a portfolio, an institution, or an entire financial system. The objective of sustainability of the IMF eventually also falls under the Shariah objective framework: to establish justice and educate individuals. Therefore it also requires more serious communication, for example in creating goal congruence among the separate institutions in order to achieve sustainability of Islamic finance. Goal congruence is a voluntary integration of institutions that share certain norms and values (Vázquez, 2006). In reality, there is an existing gap in communication among these institutions. The gap is described by Interviewee I-04:

> Communication among these institutions seems imperfect and very much rivalry rather than communicating and coordinating the activities (I-04).

This problem is also inherent to supervisory organisations, such as the Liquidity Management Centre (LMC) and the International Islamic Liquidity Management (IILM). The establishing of the LMC in Mahama Bahrain in 2005 overlapped with the existence of the IILM in Kuala Lumpur in 2010. According to Interviewee I-01, the initiative to set up a similar institution to the LMC was due to the inactive role of the LMC:

> Actually the ILMC, International Liquidity Management Corporation in Malaysia is an entity to provide liquidity to the banks, you see. In Bahrain they have, long time ago, but it does not work. There was no any product that was issued, so it has died, a 'natural death' (I-01).

Interviewee I-01 may be right on the 'natural death' of the LMC. Its website (see Section 7.3.2 and Appendix 7.5) releases details of the Sukuk market between 2007 and 2008, but no more updated data from 2008 onwards. As compared to IILM, the institution has been well performing as indicated from IILM issuance of Sukuk (see Appendix 7.7). Other issues regarding local versus international-centric institutions are also addressed by Interviewee I-04, who has perceived the IFSB and AAOIFI as local agents:

IFSB would be seen as agent of Malaysian model and therefore it has not been taken up by number of countries, AAOIFI the same thing, is perceived in similar way (I-04).

This statement is supported by Interviewee I-01:

When it comes to standard, we have to understand that different jurisdictions have different peculiarities, okay. Take for the example of AAOIFI, AAOIFI Shariah Standard is very much Middle Eastern centric, you see (I-01).

For Malaysia, the solution to overcome the Middle Eastern-centric way of thinking is by issuing more 'international' standards, such as the current Shariah standards. Malaysia recently released the Islamic Financial Services Act 2013, in which one of the requirements of the IFSA is for the IFIs to follow Shariah standards issued by Bank Negara Malaysia. Interviewee I-01 comments on whether a set of these Shariah standards overlaps on the Shariah standards issued by AAOIFI, and whether this set of standards would be used by the international community:

Well, in the future, possible, yes, because how we come up with the standard is that we did not only cater for the local, because you have to understand in Malaysia we have local banks, we have international banks. Okay, we have Ar-Rajhi Bank, Kuwait Finance House; we have to cater to all of them. So the standard is not only applicable for the Malaysian banks that are operating in Malaysia, but also for the international banks that are operating in Malaysia because it is mandatory even for the international banks, to follow the Shariah Standards. You see, so we try to make it as broad as possible so that it will cater a wider horizon, okay. So that is the reason why we come up with the standard, and it is not necessarily a repetition of AAOIFI Standard, it as an enhancement. We do take into account AAOIFI Standard and *Majma Fiqh Islami*[135] as well as some other *fatawā* being given across the globe (I-01).

Instead of rivalry in 'institutional legitimacy and social fitness', the existing institutions are expected to contribute to a strong IIFA. They are to do so by first ensuring goal congruence among the institutions, the mutual goal being to achieve the sustainability of the institutions and thus attain the objectives of Shariah. Table 7.4.1 below shows how these institutions may complement each other in support of sustainability of the whole IFIs.

[135] *Majma Fiqh Islami* (Islamic Fiqh Academy) is an academy under Organization of Islamic Conference (OIC) that issues Islamic *Fiqh* Resolution that has become one of references for Islamic Finance operation.

Table 7.4.1: IIFA Institutions and Their Contributions to IFIs

No.	Institution	Expected contribution to the IFIs
1	Islamic Development Bank (IDB), 1973	Equity shares in IFIs, coordination with IMF and World Bank, research contribution to the IFIs, training on Islamic economics, management, and finance for the public, academics, scholars through research funding, conferences, scholarship, consultation.
2	Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), 1991	Setting standards on Shariah, accounting, auditing, governance, ethics and education on the subjects through certification programs
3	General Council of Islamic Banks and Financial Institutions (GCIBFI or CIBAFI), 2001	Research and training programs on Islamic banking and finance
4	Islamic Financial Services Board (IFSB), 2002	Guiding principles for IFIs
5	International Islamic Financial Market (IIFM), 2002	Product development training on capital market
6	Liquidity Management Centre (LMC), 2002	Liquidity management solution through issuance of Sukuk
7	International Islamic Rating Agency (IIRA), 2005	Rating services
8	International Islamic Centre for Reconciliation and Arbitration (IICRA), 2005	Arbitrage services
9	International Shariah Research Academy for Islamic Finance (ISRA), 2006	Research, training, conferences, discussion on Islamic finance
10	International Islamic Liquidity Management (IILM), 2010	Liquidity management solution through issuance of Sukuk
11	National Zakat Agency *(Badan Amil Zakat Nasional/BAZNAS)* , 2001	Zakat services in Indonesia
12	Indonesian *Waqf* Institution *(Badan Wakaf Indonesia/BWI)*, 2004	*Waqf* services in Indonesia

Source: Current study

The institutions under the IIFA exist to strengthen the position of the IFIs. The IFIs currently have enormous growth but are also experiencing challenges. In terms of size and asset growth in the Islamic banking and finance industry, it has increased significantly within the last decade: from USD 639 billion in 2007 to USD 1,631 billion in 2012 (GIFR, 2013, p. 35). In ensuring its sustainability and competitiveness at the same time as complying with Shariah, the IFIs have been working with related institutions under the IIFA. This collaboration included the issue of financial reporting, though in that case the collaboration was with the AAOIFI and not the IASB). In the case of Indonesia, the regulation and supervision is ensured by Bank Indonesia, the Financial Services Authority, Capital Market Supervision Agency, and the Ministry of Finance. The financial reporting regulation falls under the Indonesian Institute of Accountants (IIA)[136] and appropriate agencies for approval.

[136] Shariah Accounting Standards Board (SASB).

The analysis as to whether these institutions are working as well as they should be would be conducted during the iFSAP exercise**.** Previously, the FSAP has examined the sustainability of the financial infrastructures of many countries where IFIs operate. IMF set of tools was used without considering different landscapes of Islamic finance and the nature of IIFA institutions**.** As a result, the findings and recommendations for these countries are not strategic to the development of the institutions and the countries. Interviewee I-06 provides an example of this issue:

> Indonesia has just completed its FSAP assessment in 2010 that were conducted by IMF and World Bank. We were surprised with one recommendation related to Islamic banking that they asked the central bank to set the same capital requirement for both conventional and Islamic banks, [and we can't fulfil this]. Our capital requirement to set up an Islamic bank is to provide capital of Rp. 1 trillion unlike conventional bank, which is currently Rp. 3 trillion (I-06).

The uniqueness of Islamic banks and the differences in their objectives have not been addressed by IMF and World Bank in their FSAP tools. Therefore, the iFSAP becomes urgent. The financial sustainability of a country that has Islamic finance can be fairly assessed by iFSAP tools, and so a recommendation for their future development would be properly addressed. This statement is confirmed by Interviewee I-03:

> One is the objective, and the second one is the uniqueness of the Islamic Finance. So these two items are very important when you want to create the financial stability programme [in a country where it has Islamic finance]. That's why the Financial Sustainability Assessment Programme should be different from the conventional programme because of these two issues (I-03).

Furthermore, the FSAP does not recognize the roles of IIFA institutions and IIFA's impact on IFIs in their assessment. Due to this issue, the initiative to introduce iFSAP, addressed by the IRTI-IDB became a central agenda. A major challenge is the status of the institutions under the IIFA framework which operate without any single authority to impose their policies, standards, and regulations to IFIs. The issue is as commented on by Interviewee I-04:

> Of course the major issue that we have is none of these institutions is mandatory, IFSB or AAOIFI and that makes terribly difficult for them to have an incentive to cooperate, to communicate, and establish strategies together (I-04).

This is a major problem of all the institutions under the IIFA, including AAOIFI (see Chapter 5). Is it possible to make the institutions implement the policies? Interviewee I-04 asserts that:

> We cannot in any way force them (IFIs) to adopt a particular public policy because Islamic banks act as private agents. Why private agents should comply with some

> public policies? Of course in a very, very much within the socialist construct you'd expect that to happening because these institutions (IFSB, AAOIFI) aim to put them in a particular order so that the outcome can be in a particular line, accepting to the compliance in terms of accounting standards and et cetera, but compared to conventional finance, Islamic finance is very free, very liberal. […]. They have defined themselves in a neo liberal ways; banks, commercial banks, therefore they are not complying with these institutions or they don't think that they should not be bothered with it at all. […]. None of government could impose that except few such as Bahrain because AAOIFI is there or Malaysia because IFSB is there. […]. Second thing is very much related to the emergence of Islamic Finance where Islamic Finance is very pragmatist (I-04).

The situation is in a deadlock for the IIFA institutions to work as they should be and for the iFSAP to be able to assess the sustainability of the Islamic finance. Interviewee I-03 argues that a possible solution may involve a political intervention, in order for the iFSAP to be implemented. For that purpose, the IRTI-IDB invites the IMF and World Bank to sit on iFSAP board.

> We don't have the power for the particular country to use that programme or that test (iFSAP), okay. So what we are trying to do now is to work with IMF and also World Bank as the issue is intervention. Okay, the intervention if let's say, that a country has to stabilize first its banking institutions before IMF/World Bank can intervene, so now the country has to come up with a programme to stabilize its banking system before they can intervene. What we're trying to do is to link with IMF, let's say if IMF/World Bank wants to intervene in a particular country, under one particular condition is the Islamic financial institution is stable, but then the intervention must be based on Islamic perspective (I-03).

The 'intervention' that involves IMF and World Bank may not work effectively in all countries, as the IMF does not exist in the Middle Eastern countries. Interviewee I-04 explains:

> There are actually issues there. One, IMF is not present in the Gulf [countries]; no one is bothering with IMF anyway so the politics examine the way it works. And on top of that we have the normal regulations that Islamic banks also are facing in each country, they have normal regulations and whether they're Islamic or not and therefore they have to comply with conventional regulations, and then the second layer of regulations (Islamic) because they are Islamic. So they would consider that there will be transaction cost for them, through layers of regulations. But for us it is a moral responsibility that they should do but for them, because they define themselves as commercial entities, regardless of the 'Islamic' at the beginning as the suffix, it's nothing it's a commercial institution. So therefore, the difficulty is one, the place of IMF in the Muslim world in particular in GCC and two, the response of Islamic banks because you cannot make it mandatory for them (I-04).

This is an exercise for regulatory agencies on how to regulate Islamic finance in the superpowers, such as the Gulf countries (the rich Middle Eastern countries) mentioned by Interviewee I-04, as Islamic finance there has different setting and force. The IMF and

World Bank's interventions in the financial institutions in the member countries have drawn the attention of several researchers, who wonder whether or not these international bodies that have hegemonic control to exercise their voting powers for their own interest. These two organizations are extra sensitive to political forces, both from inside and outside the organizations, and are therefore less 'economically neutral' (Swedberg, 1986). Interviewee I-01 responds to this concern:

> You must have the right person (from country who liaisons the task) who is doing the right thing. Of course when you talk about finance, the interest is always there, you see. Everyone whether they are Muslims, they are Non-Muslims, Muslim Country, Non-Muslim Country, they see the opportunity to make money, they will grab it. I mean that is the nature and that is something that we have to understand and also when we talk about Islamic Finance, provided that we preserve the fundamental of Shariah, we preserve our integrity. Because, in the end of the day as we know that Shariah is revealed by Allah *Subhānahu Wata'āla* as *Rahmatan lil Ālamīn* (I-04).

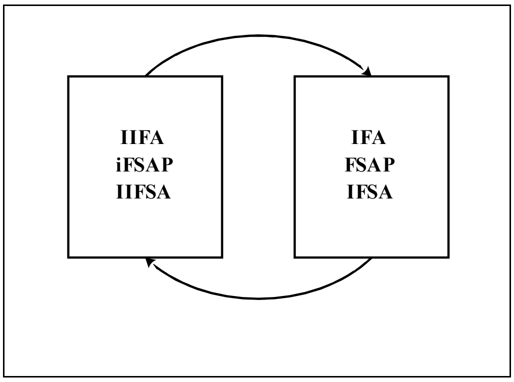
The development of the IFIs that Interviewee I-01 refers to is for *Rahmatan lil Ālamīn*, which means 'blessing for the whole world'. *Rahmatan lil Ālamīn* does not differentiate between who relishes the profits generated from Islamic finance; anyone in the world can benefit from it. Therefore all countries, independently or under the umbrella of IMF and World Bank, should be interested in Islamic finance, as they themselves are also part of the beneficiaries. This point has become a sensitive issue, as Indonesia has had a difficult time due to the IMF policies that were implemented during the country's past financial crisis recovery program (see Chapter 4). Stiglitz (2007) argues that the policies caused the Indonesian economy to be worse off than it was before, experiencing a downturn trend (p. 4). Interviewee I-05 agrees, saying:

> Yes, true, IMF made mistakes in the past, including what happened in the 1997-1998 in Indonesia. However, the Fund has made some improvement. It exercises more careful analysis on each country before making policy recommendation. For instance, cutting expenditure; whether this policy will make other vulnerable people suffered (I-05).

On the other hand, for countries such as Indonesia, the idea of an 'intervention' may solve the problem of the IIFA institutions that are lacking of power. The intervention requires IFIs in every country to comply with the rules, regulations, and guiding principles under the iFSAP, and thus as a part of the FSAP process as a whole. In fact, an intervention within the IIFA may be required as well, provided that Indonesia places 'the right man in the right place' to preserve the organization's integrity and uphold the foundation of Shariah.

However, because Indonesia has a dual-financial system and the system's specific socioeconomic needs, some think that there is a need for Indonesia to have its own Islamic financial architecture. Bank Indonesia has initiated a framework for the Indonesian Islamic Financial System Architecture (IIFSA) in 2008, which will complement the existing Indonesian Financial System Architecture (IFSA). With its Islamic financial architecture, Indonesia can reflect on its own specific needs, and be in tandem with what has been done by the IRTI-IDB when designing the iFSAP. The IIFA should be seen as complimentary mechanism to the IFA, the iFSAP as complimentary to the FSAP, and the IIFSA as complimentary to the IFSA. Figure 7.4.1 depicts these three relationships.

Figure 7.4.1: Relationship on Conventional and Islamic Complimentary Mechanism



Source: Current Study.

Notes:

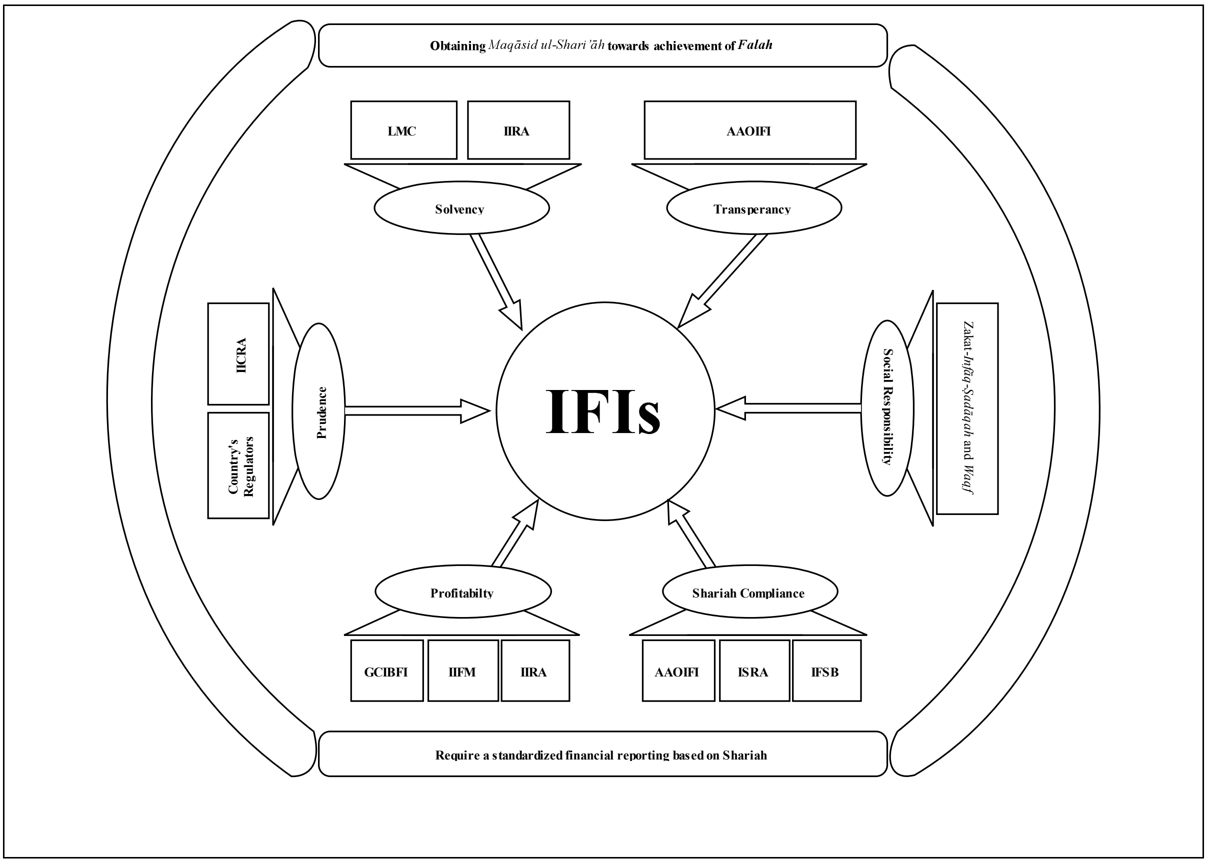
IIFA	: International Islamic Financial Architecture
IFA	: International Financial Architecture
iFSAP	: Islamic Financial Sustainability Assessment Program
FSAP	: Financial Sustainability Assessment Program Work
IIFSA	: Indonesian Islamic Financial System Architecture
IFSA	: Indonesian Financial System Architecture

The IIFSA is still in the pipelines of the Directorate of Islamic Banking at Bank Indonesia, and has not yet been approved. This is because the Indonesian financial regulatory system formed a new authoritarian body, the Financial Services Authority, on December 31st 2012. During the current consolidation period, the IIFSA has not been fully explored.

7.4.2 The Role of Financial Reporting

The third research problem addressed in this chapter is the role of financial reporting for the IIFA. Figure 7.4.2 below shows how the IFIs operate within the regulatory and supervisory agencies, as well as in the various institutions under the IIFA.

Figure 7.4.2: Achievement of *Maqāsid ul-Shari'āh* through IIFA

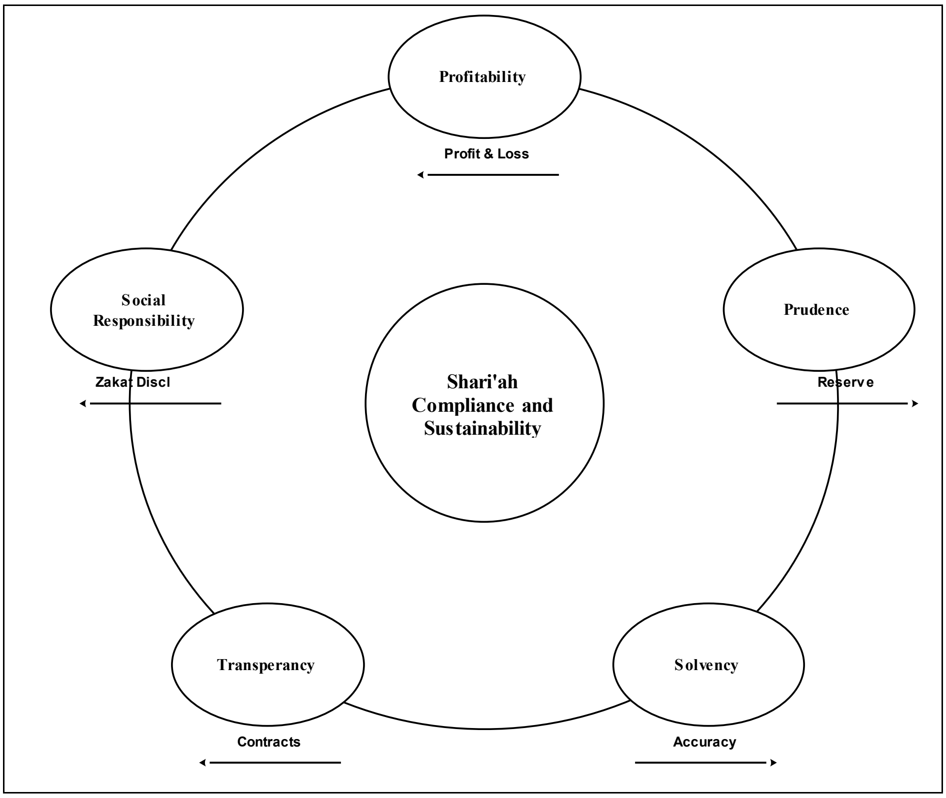


Source: Current study.

Each IIFA institution has its own vital role that contributes to the reshaping of the IFIs. All these institutions operate within the spirit of achieving *Maqāsid ul-Shari'āh*. Achieving the stage of being profitable, prudence, and solvent, at the same time being Shariah compliant, is important to ensure justice to the investors, employees, customers, and the rest of the stakeholders. Being transparent in transactions is also a part of the effort to educate the customer, and the entire society, in what is halal (permissible) and *tayyib* (good) for them. Another part is being responsible towards the society in meeting the third objective of Shariah; promoting public interest. The efforts to be Shariah compliant, profitable, prudence, and solvent in Islamic finance can be achieved via identifying, measuring, and reporting the transactions of IFIs' economic activities. A central issue for accounting is to be seen not only as a reporting mechanism, but rather a supporting device for IFIs in achieving sustainability and the stage of *Maqāsid ul-Shari'āh*. In conferences of Islamic finance, for instance, issues of financial reporting for IFIs are rarely discussed, compared to their conventional counterpart. On the conventional platform, financial reporting issues are thoroughly debated even in detailed subjects such as political economy of accounting, history of accounting, and the impact of accounting on financial institutions.

It is vital to assess how accounting measurement, recognition, and disclosure accommodate the issues of profitability, prudence, solvency, transparency, and social responsibility based on Shariah. Figure 7.4.3 below presents the relationships of these issues, and ways to achieve a level of sustainability.

Figure 7.4.3: The Role of Financial Reporting in Achieving Sustainability



Source: Current study.

Shariah based financial reporting standards help IFIs to properly disclose their transactions in order to fulfil their accountability (see Chapter Three). The above figure shows how the IFIs manage their income activity through clear contracts and engagement, tax and Zakat obligation, and reserve and liquidity. For the IFIs to be comparable among themselves and their counterparts, one common financial reporting standard is required. It can be problematic to adopt various different financial reporting standards, such as IFRS, AAOIFI, or local standards, as they have different degrees of measurement and reporting (see Chapter Six). Interviewee I-03 asserts that the IFRS should be included as a reporting mechanism for all countries to follow.

> The IFIs to adopt IFRS because it is international standards; it is comparable and useful to measure sustainability. How can iFSAP measure sustainability if they are not comparable? If there is something contradict in the IFRS for the IFIs, revisit and harmonize it (I-03).

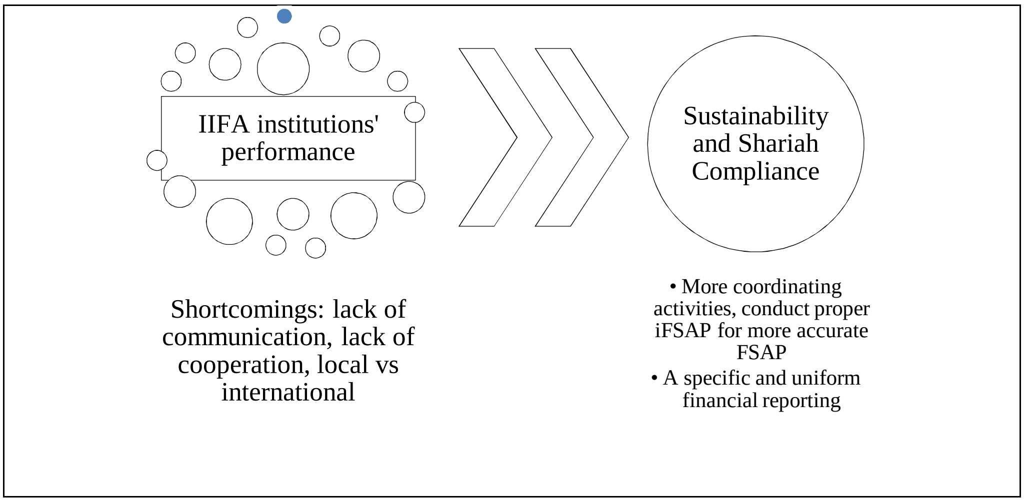
The response from Interviewee I-03 supports the finding in Chapter Three, which suggest that a combination of IFRS and AAOIFI standards has been proven to be the best financial reporting standard. The study shows that the Indonesian SSFAS achieved the highest score in fulfilling the objectives of Shariah *(Maqāsid ul-Shari'āh).* Its approach is to develop its standards over time, so that they follow emerging issues in accounting (which AAOIFI is lacking), at the same time to ensure its *fiqh* references in accounting (which the IFRS is lacking). However, the convergence towards the practices of conventional finance is a threat for IFIs to comply with the Islamic *fiqh* including in their financial reporting regulation, thus another manoeuvre is required.

7.5 Conclusion and Recommendation

This Chapter has an objective to examine institutions responsible for Islamic financial architecture and explore the required supports for the future to impose suitable financial reporting standards for IFIs. To achieve the objective, the examination is started from analysing vision and mission of the IIFA institutions including their activities and future direction to implement appropriate financial reporting standards for IFIs. Institutional isomorphism framed with retrodiction in Critical Realism approach is employed as a research methodology that led the debate regarding the IIFA institutions, their political power, institutional legitimacy, and economic supremacy. The empirical findings describe the roles of each institution under the IIFA and explain how sustainability of the IFIs can be achieved. The result shows that IIFA institutions suffer from shortage of communication, lack of cooperation, and endless rivalry between local vs international-centric way of thinking. All these problems hinder IFIs from achieving their objectives i.e. being compliant to Shariah and at the same time sustainable in the business operations. The cooperation of IMF and World Bank is regarded as a power linkage, rather than an intervention given the fact that they represent so called the Western hegemony (see Chapter Four). A specific group under neoliberal control may have been interested in the process of the iFSAP at the time when the IFIs emerged. However, 'placing the right person in the right place' becomes a mantra for stabilizing the interest of the group. Nevertheless, the threat from the hegemony of power to regulate Islamic finance industry including the financial reporting regulation will never stop which becomes the remaining balance of agenda for the Muslims to solve.

The role of financial reporting is crucial - although it requires more substantial effort to convince all IFIs - and it is necessary to find a specific financial reporting standard to be adopted by all IFIs in order to promote comparability and sustainability. Implementing a proper iFSAP that will present a more accurate picture of a country's financial performance during the FSAP procedure is indispensable. This however excludes some Middle Eastern countries, which are not IMF or World Bank member countries and in which the iFSAP has become optional. Figure 7.5.1 below shows the process of examining the IIFA institutions and their relation to financial reporting for IFIs.

Figure 7.5.1: IIFA, Shortcomings, Way Forward for Financial Reporting



Source: Current study

As this study is tentative, its analysis gives rise to two main predictions:

(iii) A country's political power plays a significant role in promoting the IIFA institutions. Without proper coordination, the efforts of the IIFA are meaningless. The iFSAP and FSAP exercises can offer solution to the problem regarding lack of authority in IIFA institutions, with the exception of several Middle East countries that rule their economies under their own legitimacies.

(iv) Through the iFSAP, a mandatory rule to follow financial reporting that is international and uniform, yet specific for the IFIs, will be the way forward. It will improve the role of financial reporting in attaining the sustainability of the IFIs with continuous status of Shariah compliance. Therefore, the action of AAOIFI consolidating with IFRS will be a major task.

This study has a limitation in the use of Critical Realism framework because combining it with institutional theory is still a new avenue in the accounting research. In addition, the study suffers from lacking of empirical data due to poor support from the targeted interviewees. Therefore, a more critical study is recommended for future research with additional library exposure to support.

Appendix 7.1: AAOIFI Accounting and Auditing Standards

No	FAS	Year of Adoption	Topic of Standard
Accounting			
1	FAS 1	1993-revised in 1996	Presentation and disclosures
2	FAS 2	1993	Modes of financing (Murabahah, Mudaraba and Musharaka
3	FAS 3		Mudaraba Financing
4	FAS 4		Musharaka Financing
5	FAS 5	1993	Disclosures of bases for profit allocation between owners' equity and investment account holders
6	FAS 6	1993	Equity of investment account holders and their equivalent
7	FAS 7	1993	Sālam and Parallel Sālam, Ijārah and Ijārah Transactions
8	FAS 8		Ijārah and Ijārah Muntahia Bittamleek
9	FAS 9	1993	Zakat
10	FAS 10	1993	Istisnā'
11	FAS 11	1993	Provision and reserves
12	FAS 12	1993 – revised in 2012	Insurance companies
13	FAS 13	1993 – revised in 2012	Disclosure of Bases for Determining and Allocating Surplus or Deficit in Islamic Insurance Companies
14	FAS 14	1993	Investment Funds
15	FAS 15	1993 – revised in 2012	Provisions and Reserves in Islamic Insurance Companies
16	FAS 16	1993	Foreign currency transactions
17	FAS 17		Investments
18	FAS 18	1993	Islamic Financial Services offered by Conventional Financial Institutions
19	FAS 19	1993 – revised in 2012	Contributions in Islamic Insurance Companies
20	FAS 20	1993	Deferred payment sale
21	FAS 21	1993	Transfer of assets
22	FAS 22	1993	Segment reporting
23	FAS 23	1993	Consolidated financial statements
24	FAS 24	1993	Contributions in Islamic Insurance Companies
25	FAS 25	2011	Investment in Sukuk, shares, and similar instruments, amended from Investment in Associates
26	FAS 26	2013	Investment in Real Estate
Auditing			
1	ASIFI 1	1996	Objective and Principles of Auditing
2	ASIFI 1	1996	The Auditor's Report
3	ASIFI 3	1997	Terms of Audit Engagement
4	ASIFI 4	2000	Testing for Compliance with Shari's Rules and Principles by an External Auditor
5	ASIFI 5	2003	The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements

Source: AAOIFI (2010), AAOIFI (2013c).

Appendix 7.2: AAOIFI Governance and Ethics Standards and Guidance Notes

No	Standards	Year of Adoption	Topic of Standard
Governance			
1	GSIFI 1	1997	Sharia Supervisory Board: Appointment, Composition, Report
2	GSIFI 2	1998	Shari'a Review
3	GSIFI 3	1999	Internal Shari'a Review
4	GSIFI 4	2001	Audit & Governance Committee for Islamic Financial Institutions
5	GSIFI 5	2005	Independence of Shari'a Supervisory Board
6	GSIFI 6	2005	Statement on Governance Principles and Disclosure for Islamic Financial Institutions
7	GSIFI 7	2009	Corporate Social Responsibility Conduct and Disclosure for Islamic Financial Institutions
Ethics			
1	CEAAIFI	1998	Code of Ethics for Accountants of Islamic Financial Institutions
2	CEEIFI	2002	Code of Ethics for the Employees of Islamic Financial Institutions
Guidance Notes			
1	AGN	2011	Guidance Note on First time Adoption of AAOIFI Accounting Standards by an Islamic Financial Institution

Source: AAOIFI (2010), AAOIFI (2013c).

Appendix 7.3: Guiding Principles Issued by IFSB

No	Number	Year	Topic of Principles
Guiding Principles			
1	*IFSB-1*	2005	Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) offering only Islamic Financial Services (IIFS)
2	*IFSB-2*	2005	Capital Adequacy Standard for Institutions (other than Insurance Institutions) offering only Islamic Financial Services (IIFS)
3	*IFSB-3*	2006	Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial Services (Excluding Islamic Insurance (*Takâful*) Institutions and Islamic Mutual Funds
4	*IFSB-4*	*2007*	Disclosures to Promote Transparency and Market Discipline for Institutions offering Islamic Financial Services (excluding Islamic Insurance (*Takâful*) Institutions and Islamic Mutual Funds)
5	*IFSB-5*	*2007*	Guidance on Key Elements in the Supervisory Review Process of Institutions offering Islamic Financial Services (excluding Islamic Insurance (*Takâful*) Institutions and Islamic Mutual Funds)
6	**IFSB-6**	**2008**	Guiding Principles on Governance for Islamic Collective Investment Schemes
7	**IFSB-7**	**2009**	Capital Adequacy Requirements for *Sukûk*, Securitisations and Real Estate investment
8	**IFSB-8**	**2009**	Guiding Principles on Governance for *Takâful* (Islamic Insurance) Undertakings
9	**IFSB-9**	**2009**	Guiding Principles on Conduct of Business for Institutions offering Islamic Financial Services
10	**IFSB-10**	**2009**	Guiding Principles on *Sharîah* Governance Systems for Institutions offering Islamic Financial
11	**IFSB-11**	**2010**	Standard on Solvency Requirements for *Takâful* (Islamic Insurance) Undertakings
12	**IFSB-12**	**2012**	Guiding Principles on Liquidity Risk Management for Institutions offering Islamic Financial Services
13	**IFSB-13**	**2012**	Guiding Principles on Stress Testing for Institutions offering Islamic Financial Services
14	**IFSB-14**	**2013**	Standard On Risk Management for *Takāful* (Islamic Insurance) Undertaking
15	**IFSB-15**	**2013**	Revised Capital Adequacy Standard for Institutions Offering Islamic Financial Services [Excluding Islamic Insurance (*Takāful*) Institutions and Islamic Collective Investment Schemes]
Guidance Notes			
1	**GN-1**	**2008**	Guidance Note in Connection with the Capital Adequacy Standard: Recognition of Ratings by External Credit Assessment Institutions (ECAIs) on *Shariah*-Compliant Financial Instruments
2	**GN-2**	**2010**	Guidance Note in Connection with the Risk Management and Capital Adequacy Standards: Commodity *Murâbahah* Transactions
3	**GN-3**	**2010**	Guidance Note on the Practice of Smoothing the Profits Payout to Investment Account Holders
4	**GN-4**	**2011**	Guidance Note in Connection with the IFSB Capital Adequacy Standard: The Determination of Alpha in the Capital Adequacy Ratio for Institutions (other than Insurance Institutions) offering only Islamic Financial Services
5	**GN-5**	**2011**	Guidance Note on the Recognition of Ratings by external Credit Assessment Institutions (ECAIS) on *Takâful* and Re*Takâful* Undertakings
Technical Notes			
	TN-1	**2008**	Technical Note on Issues in Strengthening Liquidity Management of Institutions Offering Islamic Financial Services: The Development of Islamic Money Markets

Appendix 7.4: Standards and Market Research by IIFM

No	Standards	Year	Topic of Standard
Published standards			
1	MATP	2008	Master Agreement for Treasury Placement (MATP)
2	TMA	2010	ISDA/IIFM *Tahawwut* (Hedging) Master Agreement (TMA)
3	MA	2012	ISDA/IIFM *Mubadalatul Arba'ah* (MA) (Profit Rate Swap)
4			IIFM Standard on Interbank Unrestricted Master Investment *Wakālah* Agreement
5			IIFM Standard Agreements Adaptation Procedures & Policies for Institutions
6			IIFM Reference Paper on *I'aadat Al Shira*'a (Repo Alternative) and Collateralization
Market research			
1			IIFM Sukuk Report (3rd Edition) A Comprehensive study of the Global Sukuk Market
2		2007	Islamic Finance news - Bahrain Report 2007
3			Inter – Bank Unrestricted On-Balance Sheet Master Wakālah Agreement (Concept Paper)
4			Concept Paper on *Mubadalatul Arba'ah* (Profit rate swap)
5			IIFM Reference Paper on *I'aadat Al Shira'a* (Repo Alternative) & Collateralization Possibilities
6			IIFM Sukuk Report (2nd Edition) A Comprehensive Study of the Global Sukuk Market
7			IIFM Sukuk Report (1st Edition)
8		2009	IIFM Sukuk Analysis (as of December 2009)
9			IIFM Study on Indonesian Sukuk Market & Global Sukuk Issuances

Source: IIFM (2014).

Appendix 7.5: Sukuk Issuance Arranged/Advised by LMC (2001-2007)

Issuer	Issue Date	Country	Arranger/Advisor	Issue Size (Source currency MM)	Issue Size (US$'MM equivalent)	Margin/ Tenor	Rating/ Listing	Remarks
Short Term Sukuk Centre (Corporate) *	Monthly	Kingdom of Bahrain	LMC	USD 261.25	261.25	1m LIBOR + Variable Spread / Monthly	-	-
Thani Investment Sukuk (Corporate)	September 2007	United Arab Emirates	LMC / Emirates Islamic bank	USD 100	100	6m LIBOR + 2.25% / 5 Years		
Lagoon City Sukuk (Corporate)	December 2006	Kuwait	LMC	USD 200	200	6m LIBOR + 2.25% / 5 Years	-	-
Bukhatir Investments Sukuk (Corporate)	May 2006	United Arab Emirates	LMC , EIB / Bukhatir Investments Limited	USD 50	50	6m LIBOR + 1.75% / 5 Years	-	-
Al Marfa'a Al Mali Sukuk (Corporate)	July 2005	Kingdom of Bahrain	LMC	USD 134	134	3m LIBOR + 2.50%/ 5 Years	-	-
Durrat Al Bahrain Sukuk (Corporate)	January 2005	Kingdom of Bahrain	LMC / KFH	USD 152.5	152.5	3m LIBOR + 1.25%/ 5 Years	-	-
The Commercial Real Estate Sukuk (Corporate)	May 2005	Kuwait	LMC, KFH, Markaz / The Commercial Real Estate Company	USD 100	100	6m LIBOR + 1.25%/ 5 Years	CI: A-	-
First Islamic Investment	October 2004	Kingdom of	LMC / FIIB	EURO 76	91.5	6m EURIBOR+1.25% /2 Years	-	Fully Redeemed

Appendix 7.5: Sukuk Issuance Arranged/Advised by LMC (2001-2007)

Issuer	Issue Date	Country	Arranger/Advisor	Issue Size (Source currency MM)	Issue Size (US$'MM equivalent)	Margin/ Tenor	Rating/ Listing	Remarks
Bank (Corporate)		Bahrain						
Emaar (Corporate)	July 2004	United Arab Emirates	LMC / EBI & Others	USD 65	65	6m LIBOR + 0.7% / 5 Years	-	-
Govt. of Bahrain – BMA (Issue#7)	May 2003	Kingdom of Bahrain	LMC / BMA	USD 250	250	6m LIBOR + 0.60%/ 5 Years	S&P: A- / Bahrain	-
NICBM Sukuk (Corporate)	September 2006	Kuwait	Kuwait Finance House / Standard Bank / Gulf International Bank / Liquidity Management Centre	USD 100	100	LIBOR + 1% / 5 Years	-	-
Bahrain Monetary Agency	May 2003	Kingdom of Bahrain	LMC / Central Bank of Bahrain	USD 250	250	6m LIBOR + 0.60% / 5 Years	S&P: A-	-

Source: LMC (2014).

Appendix 7.6: Rating and Research Reports by IIRA

No	Title of Report	Year	Country	Rating	Fiduciary
1	Sovereign Rating Report Republic of Turkey	2013	Turkey	AAA(tr) A-1+(tr)	
2	Fiduciary Rating Report of Asya Katilim Bankasi A.S	2013	Turkey	A(tr)/A-2(tr)	
3	AppendixFiduciary Rating Report of Kuveyt Turk Katilim Bankasi	2013	Turkey	AA-(tr)/A-1+	
4	Fiduciary Rating Report of ABC Islamic Bank	2013	Bahrain	A+(bh)/A-1(bh)	76 – 80
5	Fiduciary Rating Report of Bank AlJazira	2013	Saudi	A+(sa)/A-1(sa)	71 – 75
6	Fiduciary Rating Report of Burj Bank Limited	2013	Pakistan	A-(pk)/A-2(pk)	66 – 70
7	Fiduciary Rating Report of Qatar International Islamic Bank	2013	Qatar	A+(qr)/A-1(qr)	71 – 75
8	Corporate Governance Rating Report of Banque Islamique du Guinee	2013	Guinea	CGR-4	
9	Corporate Governance Rating Report of Banque Islamique Du Niger	2013	Niger	CGR-4	
10	Credit Rating Report of Jordan Islamic Bank	2012	Jordan	A+(jo)/A-1	
11	Fiduciary Rating Report of Bank of Khartoum	2013	Sudan	A+(jo)/A-1	71 – 75
12	Sovereign Rating Report Republic of Turkey	2012	Turkey	AAA(tr) A-1+(tr)	
13	Shari’a Quality Rating Report Of Jordan Islamic Bank	2012	Jordan	AA (SQR)	
14	Rating Report of Kuveyt Turk Katilim Bankasi	2012	Turkey	A+(tr)/A-1	
15	Fiduciary Rating Report of Bahrain Islamic Bank B.S.C	2012	Bahrain		66- 70
16	Rating Report of Bank Asya Katilim Bankasi A.S.	2012	Turkey	A(tr)/A-2(tr) CGR-7	
17	Fiduciary Rating Report of ABC Islamic Bank (E.C)	2012	Bahrain	A+(bh)/A-1(bh)	75 - 80
18	Sovereign Rating Report on Kingdom of Bahrain	2012	Bahrain	AAA(bh)	
19	Corporate Governance Rating Report of Banque Islamique Du Senegal	2012	Senegal	CGR-4	
20	Developing Regional Sukuk Hubs				
21	Jordan Islamic Bank	2012	Jordan		
22	Establishment of the Republic of Kazakhstan as a Regional Sukuk Hub				
23	Kuveyt Turk Katilim Bankasi A.S.	2012	Turkey	A(tr) A2(tr)	
24	Sovereign Rating Report on Republic of Turkey	2012	Turkey	AAA (tr)/ A1+(tr)	
25	Fiduciary Rating Report of Burj Bank Limited (Pakistan)	2011	Pakistan	A/A-2 (Pk)	70%
26	Sovereign Rating Report Republic of Turkey	2013	Turkey	AAA(tr) A-1+(tr)	
27	Fiduciary Rating Report of Asya Katilim Bankasi A.S	2013	Turkey	A(tr)/A-2(tr)	
28	Fiduciary Rating Report of Kuveyt Turk Katilim Bankasi	2013	Turkey	AA-(tr)/A-1+	
29	Fiduciary Rating Report of ABC Islamic Bank	2013	Bahrain	A+(bh)/A-1(bh)	76 – 80
30	Fiduciary Rating Report of Bank AlJazira	2013	Saudi	A+(sa)/A-1(sa)	71 – 75
31	Fiduciary Rating Report of Burj Bank Limited	2013	Pakistan	A-(pk)/A-2(pk)	66 – 70
32	Fiduciary Rating Report of Qatar International Islamic Bank	2013	Qatar	A+(qr)/A-1(qr)	71 – 75

Appendix 7.7: Sukuk Issuance by IILM (2013-2014)

Issuers	Issue Date	Country	Arranger/ Advisor	Issue Size (Source currency)	Issue Size	Margin/ Tenor	Rating/ Listing	Remarks
1. Abu Dhabi Islamic Bank; 2. Al Baraka Turk; 3. CIMB Bank Berhad; 4. KBL Private Bankers; 5. Kuwait Finance House; 6. Malayan Banking Berhad; 7. National Bank of Abu Dhabi; 8. Qatar National Bank; and 9. Standard Chartered Bank	26 November 2013	Malaysia	IILM	-	USD490 million	3m+0.5571%	A-1 S&P	Fully Subscribed
1. Abu Dhabi Islamic Bank; 2. Al Baraka Turk; 3. CIMB Islamic Bank Berhad; 4. KBL Private Bankers; 5. Kuwait Finance House; 6. Maybank Islamic Berhad; 7. National Bank of Abu Dhabi; 8. Qatar National Bank; and 9. Standard Chartered Bank	20 January 2014	Malaysia	IILM	-	USD860 million	3m+0.55635%	A-1 S&P	Fully Subscribed
1. Abu Dhabi Islamic Bank; 2. Al Baraka Turk; 3. CIMB Islamic Bank Berhad; 4. KBL Private Bankers; 5. Kuwait Finance House; 6. Maybank Islamic Berhad; 7. National Bank of Abu Dhabi; 8. Qatar National Bank; and 9. Standard Chartered Bank	25 February 2014	Malaysia	IILM	-	USD490 million	3m+0.55485%	A-1 S&P	Fully Subscribed
1. Abu Dhabi Islamic Bank; 2. Al Baraka Turk; 3. CIMB Islamic Bank Berhad; 4. KBL Private Bankers; 5. Kuwait Finance House; 6. Maybank Islamic Berhad; 7. National Bank of Abu Dhabi; 8. Qatar National Bank; and 9. Standard Chartered Bank	17 April 2014	Malaysia	IILM	-	USD860 million	3m+0.52635%	A-1 S&P	Fully Subscribed

Source: Summarised from IILM (2014).

Appendix 7.8: Targeted and Successful Interviewees

No	Name of institutions	Contacted	Office	Status
1	International Association of Islamic Banks (IAIB)	No	Saudi Arabia	Not in existence
2	Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) www.aaoifi.com	Yes	Bahrain	Interviewed in London
3	General Council of Islamic Banks and Financial Institutions (GCIBFI) http://www.cibafi.org/	No	Bahrain	Not picked up as sample
4	Islamic Financial Services Board (IFSB) www.ifsb.org	Yes	Malaysia	Public opinion restriction
5	International Islamic Financial Market (IIFM) www.iifm.net	No	Bahrain	Public opinion restriction
6	Liquidity Management Centre (LMC) www.lmcbahrain.com	No	Bahrain	Not picked up as sample
7	International Islamic Rating Agency (IIRA) www.iirating.com	No	Bahrain	Not picked up as sample
8	International Shariah Research Academy for Islamic Finance (ISRA) www.isra.org	Yes	Malaysia	Interviewed in Durham
9	International Islamic Liquidity Management (IILM) www.iilm.com	Yes	Malaysia	Public opinion restriction
10	International Islamic Centre for Reconciliation and Arbitration (IICRA)	No	Dubai	Not picked up as sample
11	Islamic Research and Training Institute – Islamic Development Bank (IRTI-IDB)	Yes	Jeddah	Interviewed in Durham
12	World Bank (WB)	Yes	Washington DC	Public opinion restriction
13	International Monetary Fund (IMF)	Yes	Washington DC	Public opinion restriction, replaced with IMF observer (interviewed)
14	Durham Centre for Islamic Economics and Finance, Durham University, Durham, United Kingdom	Yes	Durham, UK	Interviewed in Cambridge, USA
15	Directorate of Islamic Banking, Bank Indonesia/Financial Services Authority, Indonesia	Yes	Jakarta, Indonesia	Interviewed in Jakarta, Indonesia

Appendix 7.9: List of Interviewees and Their Credentials

Coding	Institution	Duration and Volume (Average)
I-01	International Shariah Research Academy for Islamic Finance (ISRA), Kuala Lumpur, Malaysia	60 minutes, 1 interview
I-02	Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), Mahama, Bahrain	60 minutes, 1 interview
I-03	Islamic Research and Training Institute – Islamic Development Bank (IRTI-IDB), Jeddah, Saudi Arabia	60 minutes, 1 interview with two breaks
I-04	Durham Centre for Islamic Economics and Finance, Durham University, Durham, United Kingdom	45 minutes, 1 interview
I-05	IMF Observer, Washington DC, United States of America	45 minutes, 1 interview
I-06	Directorate of Islamic Banking, Bank Indonesia/Financial Services Authority, Jakarta, Indonesia	60 minutes, 1 interview

Appendix 7.10: Interview Guide

I. Preliminary

My name is Murniati Mukhlisin. I am third year PhD student at University of Glasgow, conducting research on Islamic financial architecture and the role of financial reporting standards for the IFIs. Thank you for your time that provides me avenue to make an interview today. Everything you say is considered as confidential and the results of this discussion will be reported anonymously and if you wish, your name will not be appeared in any report of the interview. My full research topic is: **Past, Present, and Future of Islamic Financial Architecture and The Role of Financial Reporting Standards**, under project supervisions of Dr. Mohammad Hudaib and Dr. Kirsten Kininmonth.

A. List of questions for supporting institutions i.e. IFSB, ISRA, IILM etc.

a. What is your opinion on the initiative launched by IRTI-IDB on evaluating Islamic financial architecture?
b. To what extent does architecture support development of IFIs?
c. What is the role of your institution towards this initiative?
d. How do supporting institutions contribute to the development?
e. How important does the issue of financial reporting standardization under this architecture?
f. How strong political economy plays role on the development of Islamic financial architecture?
g. To what extent does the role of the World Bank and IMF intervene the development of Islamic finance including the initiative of this architecture?

B. List of questions for World Bank and IMF

a. What is your opinion on the prospect and challenges of Islamic finance in Indonesia?
b. Is there any threat from economic liberalization towards development of Islamic finance in Indonesia?
c. If any, how to anticipate the threat derived from the economic liberalization?
d. To what extent do the threats of economic liberalization impact people life, religion, and culture?

C. List of questions for political economy experts

a. What is your opinion about New Financial Architecture defined by Crotty (2009) and Islamic Financial Architecture defined by Ali (2000)?
b. To what extent do supporting institutions of Islamic finance under NFA and IFA establish communication and cooperation among them? Are they are in good harmony? Do they hold the same objective to achieve sustainability?
c. What is your recommendation to establish good coordination among the supporting institutions?
d. What is your opinion on iFSAP framework that basically follows initiative from IMF and World Bank on FSAP?
e. What kind of environment in the architecture will help Islamic finance achieve its sustainability at the same time comply with Shariah law?

II. Closing

Final question: is there anything you would like to add which have not been covered in our discussion or any issue you would like to clarify?

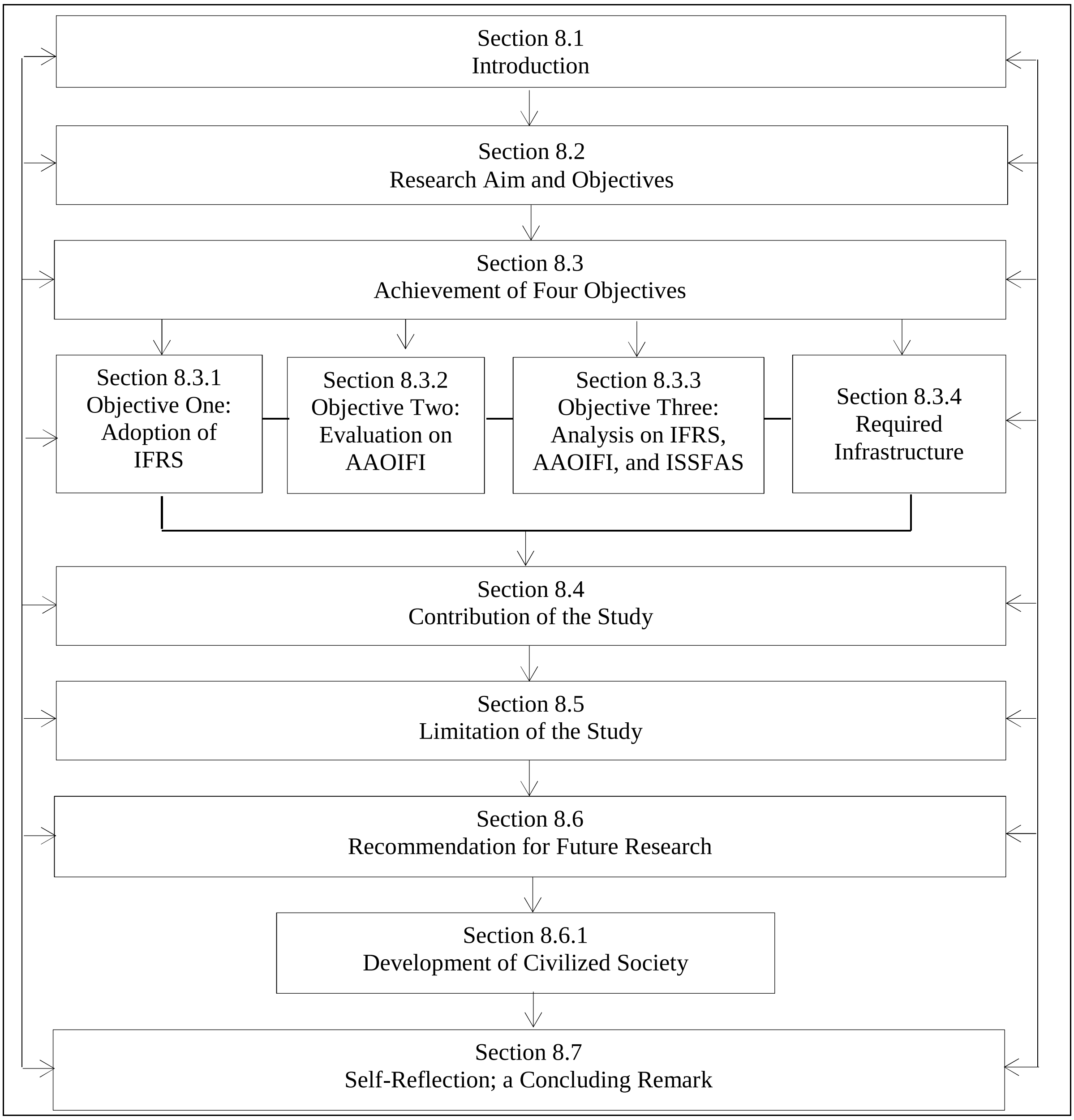
Thank you for your participation.

Chapter Eight: Conclusion

8.1 Introduction

This chapter concludes the thesis. There are six sections in this chapter including the introduction. Section 8.2 reiterates the overall aim of this thesis and the four research objectives. Section 8.3 describes briefly the achievement of the four research objectives. Section 8.4 discusses the contributions of the thesis. Section 8.5 explains the limitations of the study. Section 8.6 concludes the chapter by stating the contribution for future research and Section 8.7 presents self-reflection of the author. The following Figure 8.1.1 explains the structure of this chapter.

Figure 8.1.1: Structure of Chapter Eight



8.2 Research Aim and Objectives

The main objective of this research is to explore the reflexivity and resistance of IIFIs towards IASB and AAOIFI financial reporting standardization projects with main focus at the Indonesian arena. Section 8.3 describes the achievement of individual objective of Chapter Four, Five, Six, and Seven. Three research objectives generated four research questions with specific methodology assigned to each of them when conducting the analysis. The following section present achievement of the four objectives.

8.3 Achievement of Four Objectives

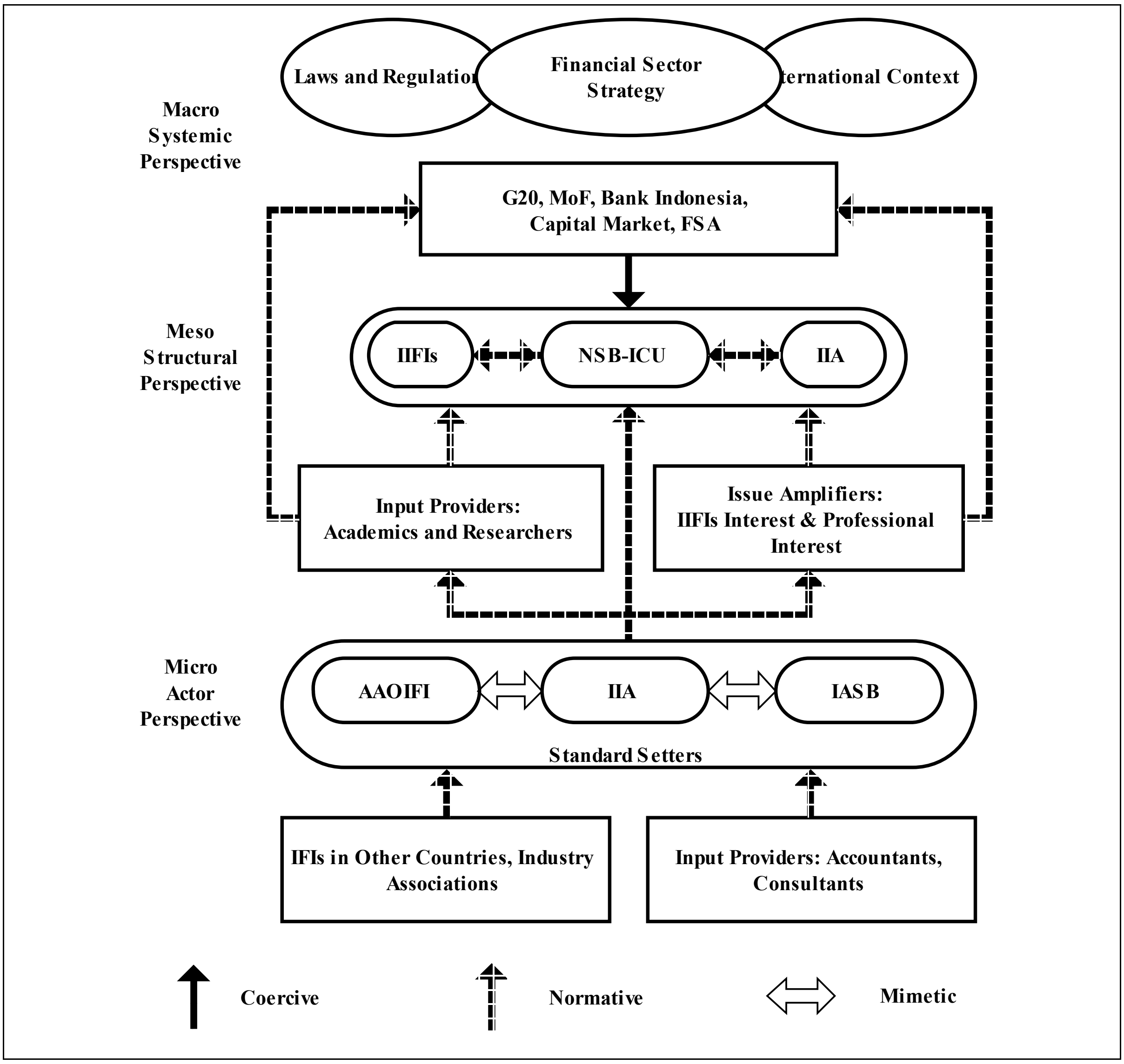
This section presents findings of each individual objective and how it has been achieved. There are four individual research objectives as has been described in the following sub-sections.

8.3.1 Objective One: Adoption of IFRS

The first objective is to explore the views on the adoption of IASB standards and whether it is seen as the way forward by IIFIs. This was addressed by Research Question No. 1: *To what extent have Islamic financial institutions committed to adapt to IFRS?*

The finding indicates that global economic liberalization policy at the macro level has coercively pressured Indonesia to adopt IFRS without any exception for the specification of IIFIs. For example financial instruments and revenue recognition in Islamic banks should have its specific treatment but because of coercive, mimetic, and normative pressures, the IIFIs should follow IFRS. A closer observation on the financial reporting standardization in Indonesia also exposed that in order to fully understand the implication of great power coercion to shift policy direction, other important elements such as financial crisis in 1997-1998 needed to be taken into account. The empirical debate shows that during that period of time, the neoliberal institutions played the role as authoritative international institutions. However, they have been losing their power as a result of current improvement in the Indonesian economy. Indonesia has been gaining better bargaining position as indicated by the commitment to extend USD 1 billion loan to help IMF strengthen its capital base. At the same time, Indonesia is also allowing other social actors to seize the momentum, for instance the industry that has pushed the implementation of IFRS standards to the IIFIs on the revenue recognition. Although the neoliberal institutions did bark in the beginning, but it was not so loud, at the end, that other form of neoliberalism such as industry players acting in the financial reporting standardization arena prevails. Figure 8.3.1 describes Arena Concept of whom and how the actors play their roles at each level. After the analysis, Chapter Four proposed the new framework based on the interactions of actors in Indonesian arena. The Financial Reporting Standards (FRS) framework as shown on Figure 8.3.1 depicts different types of pressures exist in each level of arena.

Figure 8.3.1: Institutional Arena on FRS Project for the IIFIs



Source: Adapted from Smith et al. (2011) and current study.

Notes:

G20	: The Group of Twenty (G-20) Finance Ministers and Central Bank Governors
MoF	: Ministry of Finance
FSA	: Financial Services Authority
IIFs	: Indonesian Islamic Financial Institutions
NSB-ICU	: National Shariah Board – Indonesian Council of Ulama
IIA	: The Indonesian Institute of Accountants
AAOIFI	: Accounting and Auditing Organisation for Islamic Financial Institutions
IASB	: International Accounting Standards Board

The framework presents the evidence that the pressures are vary subject to political environment and motivation of Islamic finance industry in a country. For Indonesia, Islamic finance is developed using bottom-up approach that started with 'grass-roots movement' and gradually a shift from the conventional finance to Islamic based finance. However, 'financialisation motive' has influenced the industry to be more pragmatic in profit generation hence this chapter suggests a new paradigm shift to 'return to basic' intention of building Islamic finance industry by upholding the concept of mutuality and Islamic moral economy aspiration (see El-Gamal (2007) and Asutay (2012)).

8.3.2 Objective Two: Evaluation on AAOIFI

The second objective of this research is to evaluate AAOIFI's strategy in developing its accounting standards and seeking for acceptance from its member countries including Indonesia, focusing on Research Question No. 2: *What is AAOIFI's strategy in developing its standards and to what extent do IIFIs comply with AAOIFI accounting standards?*

From the first part of the empirical analysis, the study concludes that political lobbying power gained by IASB is currently unchallenged and this is the missing component in AAOIFI strategies. Furthermore, the political setting and different Shariah interpretation determine direction of Islamic finance including the option on which financial reporting standards should be adopted by IFIs. It discovers that the failure of AAOIFI in ensuring the compliance of its standards resembles the experience of IASC. The failure of the IASC became a lesson learnt by IASB through modification of its strategy to play more seriously in high level politics that involves 'hegemonic regulators' term introduced by Martinez-Diaz (2005) such as SEC, EU, G20, World Bank, ASEAN and it recorded fast track of success. The second part of the analysis shows that AAOIFI accounting standards merely serves as unofficial guidelines for the IIFIs since the beginning of the development of Islamic finance industry in the country. However, due to its weak political lobbying with the Indonesian regulators, AAOIFI's popularity has shrunk in the financial reporting standardization arena in Indonesia. In addition, its inflexible and outdated standards are not making them favorable to the IIFIs either.

This chapter proposes that AAOIFI should collaborate with 'hegemonic regulators' in Islamic finance such as IDB and the rest of IIFA supporting institutions to promote the function of AAOIFI through their internal and external regulatory power. At the same time, AAOIFI should amend the quality of conceptual framework and standards to be at par with that of generally accepted financial reporting standards in the world.

8.3.3 Objective Three: Analysis on IFRS, AAOIFI, and ISSFAS

The third objective of this research is to propose a recommendation on the most appropriate reporting standards for IFIs suitable for international financial reporting requirements as well as compatible with *Maqāsid ul-Shari'āh*, focusing on the Research Question No. 3: *To what extent do IFRS, AAOIFI, and ISSFAS comply with Maqāsid ul-Shari'āh?*

The results show that IFRS, AAOIFI, and ISSFAS emphasize different areas in designing their standards hence show different level of *Maqāsid ul-Shari'āh* compliance. However, from testing the hypothesis, the three reporting standards offer no significant difference as IAS has influenced the three standards significantly with differences laid upon the Shariah elements in AAOIFI and ISSFAS. ISSFAS on the other hand shows that it achieved the highest score on the three elements measured under *Maqāsid ul-Shari'āh* but the score is not promising enough. Furthermore, there is only one Shariah element i.e. profit sharing that demonstrates significant difference compared to the rest of the elements. As unique characteristic of Islamic finance, the profit sharing identifies the spirit of AAOIFI and ISSFAS to accommodate mutuality concept in IFIs transactions. Therefore, the differences between AAOIFI and ISSFAS with that of IFRS could have been more obvious provided more Shariah characteristics are emerged in the standards. Although this chapter recommends that alignment between AAOIFI and IFRS is the best financial reporting model for IFIs but instilling more Shariah values in the standards will make them much closer to the compliance to *Maqāsid ul-Shari'āh*.

8.3.4 Objective Four: Required infrastructure

The last objective of this research is to examine institutions responsible for Islamic financial architecture and explore the required supports for the future to impose appropriate financial reporting standards for IFIs, focusing on Research Question No. 4: *To what extent does International Islamic Financial Architecture (IIFA) support the role of Islamic based financial reporting standards for IFIs?*

The research finding shows that IIFA institutions do support the role of Islamic based financial reporting standards for IFIs, however there is no convincing result as the institutions suffer from lacking of communication, lacking of cooperation, and the endless rivalry between local vs international-centric debates. Obviously, all these problems impact their contribution in achieving the main objectives of IFIs i.e. compliant to Shariah and at the same time commercially sustainable. From empirical analysis, it is revealed that iFSAP has been progressing through cooperation with IMF and World Bank. Surprisingly, the cooperation however is regarded as a power linkage, rather than an intervention which promises the iFSAP to gain considerable influence. It differs from the finding from Chapter Four that criticized IMF and World Bank for having used their power in shaping the direction of financial reporting in Indonesia, eventually it also influenced the approach of financial reporting for the IIFIs. Therefore, this chapter suggests building a proper coordination among IIFA institutions to support the implementation of Islamic based financial reporting standards for IFIs thus to achieve IFIs' sustainability at the same time compliance to Shariah.

8.4 Contribution of the Study

This thesis makes four main contributions, both to theories and literatures. Firstly, it shows how the political economy of accounting exists within the area of financial reporting standardization, which is not simply by identifying the types of isomorphism that influence the organizations' involvement in the financial reporting standardization. Secondly, formulation of strategy for AAOIFI and suggestion for the political engagement may improve the future of AAOIFI in regulating Islamic based financial reporting standards for IFIs. Thirdly, as the Islamic finance industry is now at continuous growth path and maturity while also facing rising challenges, there must be a different approach to formulate the financial reporting standards for IFIs. The hybrid way may not be appropriate any longer. This is shown in the analysis of the contents of IFRS, AAOIFI, and ISSFAS, where they demonstrate low level of *Maqāsid ul-Shari'āh* compliance. The approach suggests instilling more Shariah values in the standards that persuade it to the higher level of *Maqāsid ul-Shari'āh.* Lastly, this thesis also constructs an assumption about the attitude of dominant political leading countries towards the development of Islamic finance. As there is currently no real leadership in the area of Islamic finance, it would require influential dominant leaders with congregated visions and a mission in line with Islamic values.

8.5 Limitation of the Study

This research implies four limitations that are concluded from each analysis chapter such as:

i) Refer to research objective on Section 8.3.1: this study does not present government documents and files as primary evidence of coercive mechanism towards IFRS adoption in Indonesia due to time constraint and limited access.

ii) Refer to research objective on Section 8.3.2: two dominant figures from macro level institution refused to be interviewed due to public opinion restriction that results to limited exposure on AAOIFI development.

iii) Refer to research objective on Section 8.3.3: this study only analyses the contents of conceptual frameworks and standards on disclosure/presentation of the three standard setters. It is appropriate to include more standards that may contribute to solid measurement towards *Maqāsid ul-Shari'āh*.

iv) Refer to research objective on Section 8.3.4: This study has a limitation in the use of Critical Realism framework because combining it with institutional theory is still a new avenue in the accounting research. In addition, the study suffers from lacking of empirical data due to poor support from the targeted interviewees.

8.6 Recommendation for Future Research

There are four recommendations for future research emerged from this study such as the following:

i) Refer to research objective on Section 8.3.1: Other critical perspective of accounting theory such as Islamic Political Economy of Accounting combined with the concept of mutuality can be adapted to conduct research on similar standardization projects both in the Muslim and non-Muslim countries.

ii) Refer to research objective on Section 8.3.2: A case study approach is more suitable for this type of study which offers better perspective to explore the hidden constraint faced by AAOIFI.

iii) Refer to research objective on Section 8.3.3: It is appropriate to include more standards that can contribute to more solid measurement towards *Maqāsid ul-Shari'āh* such as standards on asset and liabilities recognition, equity, and income recognition. It is also interesting to explore whether combination between IFRS and AAOIFI standards would be the best model for financial reporting standards for IFIs in other country given the different understanding of Shariah that it may have towards elements of *Maqāsid ul-Shari'āh* in the financial reporting standards.

iv) Refer to research objective on Section 8.3.4: A more critical study is recommended for future research with additional library references to support such as by using different type of political framework. Therefore, it is commendable to see how a model of civilized society development captures the role of Islamic finance including its financial reporting mechanism, refer to Section 8.6.1.

8.6.1 *Development of Civilized Society*

Ibn Khaldun model offers a comprehensive explanation on development of a country towards a civilized society and conveniently suitable with the context of international accounting development as the model could explain not only environment but also the function of each variable. Furthermore, Alatas (2006) argues from epistemological point of view that Western thinkers have different attitude and worldview compared to non-Western social thinkers. This model refers to the work of Ibn Khaldun (1332-1406 CE) in *Muqaddimah* in which he introduced a theory of society development and decline; although published more than 600 years ago but his ideas endure (Alatas, 2006, Chapra, 2008b). Chapra (2008b) condensed Ibn Khaldun's model on civilization as follows:

i) The strength of the sovereign does not materialize except through the implementation of the Shariah;
ii) The Shariah cannot be implemented except by the sovereign;
iii) The sovereign cannot gain strength except through the people;
iv) The people cannot be sustained except by the wealth;
v) Wealth cannot be acquired except through development;
vi) Development cannot be attained except through justice;
vii) Justice is the creation by which God will evaluate mankind;
viii) The sovereign is charged with the responsibility of actualizing justice.

Chapra (2008b) also attempts to elaborate these eight wise principles by introducing socio economic and political variables, including the sovereign/political authority such as government (G), the beliefs and rules of behaviour/Shariah (S), the people/nation (N), the wealth (W), the development (g), and the justice (j) that influence one another. In the form of a functional relationship, Chapra suggests the relationship to be stated as $G = f(S, N, W, j \text{ and } g)$. This model may be appropriate to conduct future research on how Islamic based financial reporting can be implemented with the spirit to uphold mutual concept and fulfil the aspiration of Islamic moral economy in the society. Combined with Islamic Political Economy of Accounting perspective, this model of development will be able to critically examine the future of Islamic finance not only in the financial reporting area but in other emerging studies such as governance and risk management.

8.7 Self-Reflection; a Concluding Remark

Taplin et al. (2002) argue that regulation is based on mainly on public and private interest arguments. In this view, regulation is perceived as a method to improve public social welfare in contrast with private interest theory that is concerned only on wealth maximization of certain individual or group. In the same vein, financial reporting standardization needs to be regulated in such way that it would serve the purpose of promoting social welfare of the users or public in general. In Islam, the issue of promoting public interest is considered as an important issue. The idea on public interest has been discussed by various well-known Islamic jurists right from Imam Malik bin Anas (d.179/795) with his term *maslahah*, al-Basri (d.478/1085) then al-Ghazali (d.505/1111) with their term called *istislah* or *masalih mursalah*, then continued by al-Razi (d.639/1149), and al-Shatibi. Al-Ghazali divides public interest into three criterions such as it must be necessary (*dharūriyyah*), general (*kulli*) and definite (*qat'i*) (Laludin et al., 2012). In Addition, the financial reporting is governed in the Qur'an that is used as a media on recording transactions between one party to another (see Qur'an *Al-Baqarah*: 282). This becomes a guidance to create harmony in society by changing the condition of the people from bad to good, from good to great (change by themselves, see Qur'an *Ar-Ra'd*:11). Standardization is inevitable to arrive at the harmony in which the thesis heavily argues.

God requires all people to make continuous changes in their life that is to make changes by adopting what has God wants people to do, i.e. follow the Islamic rules. God promises for those who make changes in their life by means of by having better status in society to have better life. This change behaviour is applicable to any single individual, society, country and even the whole world where God encourages human to make changes to have better life in the future. The above verse can relate to the role of accountant that is required to play his role in professional way possible and make changes for the betterment of the society. Why this motivation is important in one's life? In Islam, one pillar of beliefs is a belief in hereafter or life after death where everyone will be judged on his accountability during his lifetime. Death is not the end of the world, in fact, human should walk through his life with good deeds as savings for his life in the hereafter that is more eternal. Therefore, human should inculcate values in favour of God in every single thing he does in his life including his duty to create a better society. Mahmood (1987) explains how the world was created and would be destroyed from scientific point of view with several sources from Qur'an and hadith. Mahmood states relationship between human soul and accountability from beginning of human's life to the death, "great trial" in the graves, doomsday, day of judgement and the choice between paradise and the hellfire. A professional accountant plays his role to ensure his work to prepare financial reporting as a piece of accountability and justice that he submits it not only to stakeholders or society but also to ultimately God as the Lord of the universe (Haniffa and Hudaib, 2007). God will judge him as to whether he has fulfilled his duties accordingly and should there be any error he should bear which will be judged in the Day of Judgment. That would then determine which place he will spend his life in the hereafter, either in paradise where he will enjoy his eternal life with bounty of joys or in hellfire with severe punishment.

Therefore, making changes should never stop in regulating financial reporting for IFIs in general and the IIFIs in particular for the purpose to serve God and society (vertical and horizontal obligations). The threat for IFIs through hegemony of power that continuously shapes their future development should be anticipated through concerted efforts of the Muslim leaders with one ultimate goal to achieve the highest welfare of the people hence seek the God's blessing. The call to exercise Islamic Political Economy of Accounting is becoming crucial as the strategy to govern the originality of IFIs and to prevent from being only Islamic on their label. Bottom-up approach in Indonesian financial Islamic institution development shows stronger willingness to be attached to Islamic rulings while in Malaysia case, for instance, the top-bottom approach may document failure to comply with the rulings in between the struggle to weigh the interest of the social protagonists. Although an interpretive study only conducts observation but the critical recommendation is powerful to leave the ambiguity on the issues of what constitutes Islamic based financial reporting standards.

Lastly, as part of the theoretical development, critiques are embodied that shows continuity of the development. A theory may be seen perfect at a particular time frame but it shows defects after going through the process. The later generations fix the defects to ensure the message of the theory is still relevant to respond to the phenomenon of social science and its concern on sociology study of the people. After Neo Institutional Sociology theory, Political Economy of Accounting theory, and Critical Realism theory, the journey has not ended, it is paving through the more complex history of human to arrive at causal explanation. Changes have been witnessed since Weber's time, most importantly they exist to render understand on the trends to which he called attention has never been more immediate (DiMaggio & Powell, 1983).

With this in mind, it is expected that this thesis grants a new understanding in dealing with financial reporting standardization issues. The existence of political power, individual, institutions, hegemony, Islamic finance, and their compliance to *Maqāsid ul-Shari'āh* are embedded and provide a valuable insight for accounting researchers, accounting standard setters, policy makers, and practitioners in Indonesia as well as in other country where Islamic finance operates.

Appendices

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