AN ASSESSMENT OF FINANCIAL REPORTING PRACTICES OF ECONOMIC SUBSTANCE OF SELECTED ISLAMIC FINANCIAL INSTRUMENTS CONSISTENT WITH SHARIAH REQUIREMENTS

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Abstracts

The introduction of value-based intermediation (VBI) in Malaysian financial industries with reliance on Shariah is to determine its development that creates demands for applied studies to provide empirical evidence on the impact of VBI in achieving Maqasid al-Shariah. With the advanced development of the Islamic banking and finance industry, the actualization of Maqasid (i.e. purposes) and the role of Wasa'il (i.e. means) are to be empirically examined. This is to reduce the gap between Shariah compliance and achieving Maqasid al-Shariah by the industry. For instance, the Ijarah financing contract in the financial statement is under the leasing contract term and has no different from the conventional banks offering vehicle loans. Similar to Murabahah financing, there is no reporting of underlying assets bought by Islamic banks as inventory before the assets are sold to the customers. Hence, the objectives of this research are: (1) to examine the substance in reporting of financial instruments adopted by Islamic banks; and (2) to adopt the Maqasid al-Shariah principles in validating the substance of the financial instruments adopted by Islamic banks. This research analysis was based on focus group discussions with the experts, and thematic analyses were conducted to assess the financial reporting practices that validate the economic substance and legal form of Islamic financial instruments in Islamic banks whether achieve the Maqasid of Shariah or merely compliance with Shariah. The findings include an investigation and discussion on the important themes which are on: (1) definition of object and utilization of assets in Islamic banking activities; (2) interrelation among financial instruments and products of Islamic bank activities that comply with financial reporting requirements and financial representation; (3) issue and concern in the implementation of Shariah compliance on Islamic finance activities. The study suggested a need for accounting standards that focus on the Islamic financial instruments to ensure faithful representation of the financial statements. Moreover, the substance and legal form will align to reflect the financial statement based on policy documents that have been developed and to show the uniqueness of Islamic financial instruments in financial reporting.

Keywords: Maqasid al-Shariah, substance and form, AAOIFI, IFRS, Islamic financial instruments, value-based intermediation.

1.0 Introduction

The contemporary Islamic banking and finance practice has not been without its critics (e.g. El Gamal, 2006; Nomani, 2006). Khan (2010) investigates to what extent actual Islamic banking practices live up to the ideal and to what extent Islamic banking is different from conventional banking. El Hawary et al. (2004) provided the four defining characteristics of Islamic banking and finance as (1) risk-sharing; (2) materiality; (3) no exploitation; and (4) no financing of sinful activities. Then, based on these four characteristics, Khan (2010) analyzes how well contemporary Islamic banking and finance practices are based on the four characteristics. The findings can be summarized as follows:

1. Islamic banking and finance cannot be said to be risk-sharing in any meaningful sense. The argument further stresses that Islamic banking and finance mimic conventional, collateralized debt contracts very closely; and are often being benchmarked by market interest rates.
2. Contemporary Islamic banking and finance often have no meaningful underlying transaction. The argument is on the sale and lease-back of existing physical assets, common in many Sukuk transactions, is fictional materiality in that either no new asset is being financed or that there is no actual title transfer.
3. Islamic banking and finance have failed in this aspect where the arguments include the higher fees associated with Islamic mortgages and investment funds for doing nothing more substantial than mimicking conventional banking and finance products are exploitative.
4. Islamic banking and finance institutions are sometimes guilty of not being Shariah-compliant. The arguments on the commodity placements usually rely on the simple word of the borrowing bank or firm that the funds will not be used for 'sinful' activities and rarely are Shariah audits performed to validate these Shariah non-compliance issues.

Despite the arguments on Islamic banking and finance mimicking conventional banking, instead of the ongoing debates on the issues in practice, the proposed research will examine the different approaches that can support the development of the Maqasid of Shariah framework to explain the substance of Islamic financial instruments adopted by Islamic banks in their operations. The identification of the substance and forms of the Islamic financial transactions are important to justify whether the operation of Islamic banks fulfils the Maqasid al-Shariah or merely complies with the legal form of the contracts. There are few studies (e.g. MIA, 2020; AOSSG, 2018; AAOIFI, 2018; MASB, n.d; BNM, 2022) from the accounting and reporting perspective of Islamic financial transactions. MIA (2020) explains the fundamentals of accounting of Islamic finance by illustrating and explaining the financial statement of Islamic banks and Takaful operators on the reporting of their assets, liabilities, equities, income and expenses. Meanwhile, AOSSG (2018) illustrate the financial reporting issues relating to Islamic banking and finance on the applicability of IFRS 15 – Revenue from contracts with customers and IFRS 9 – Financial Instruments on the reporting of Islamic financial transactions, especially for Islamic sale-based contracts. This examination is very critical to examine the findings from Khan (2010) on whether Islamic banks are mimicking conventional banking or not. Other accounting standards that can be examined include IFRS 16 – Leases.

The approaches taken by IFRS for reporting financial transactions are principally based that required judgements. In terms of the conceptual framework of the reporting for Islamic banks, both AAOIFI (2018) and BNM (2022) have explained the accounting concepts among others such as the application of time value of money, and substance over form. These fundamental concepts are important as the basis to support whether Islamic financial transactions are compliant and also meet the Maqasid al-Shariah. The earlier studies and policy documents have explained the issues on the operation of Islamic banking and finance that can be argued to mimic conventional banking. However, the justification may not be convincing. Hence, this proposed research is among the few that adopt an accounting perspective by explaining through the application of accounting concepts and standards to determine the substance of each main Islamic financial transaction, especially the asset-based transactions such as Tawarruq, Murabahah and Ijarah. From the findings, the Maqasid of Shariah framework in validating the substance of Islamic financial instruments can be proposed. Hence, the validation technique may support whether or not the current Islamic banking operations achieve the Maqasid al-Shariah.

By referring to Kamali (2020), Malaysia has been seen to focus on important Maqasid-related initiatives in recent years in the areas, particularly in Islamic banking and finance and government policy formulation. For example, in February 2015, the government introduced the Malaysia Shariah index, and in July 2017, Bank Negara Malaysia introduced Value-Based Intermediation. However, the realization of the value-based intermediation concept especially for Islamic banks is still questionable when many reporting made by

Islamic banks on their VBI activities focus on their corporate social responsibilities and the utilization of zakat funds. However, the expectation of VBI is more than that, especially in the realization of Maqasid al-Shariah.

Hence, this research will examine the application of Islamic financial instruments by Islamic banks based on the Shariah contracts. The analysis includes explaining the financial reporting in the financial statement of Islamic banks. The accounting approach of reporting a particular transaction based on its economic substance rather than its legal form will support the development of Maqasid of Shariah framework that validates the substance and forms of financial reporting. Hence, it can conclude whether the objectives of Shariah are met or not in the operation of Islamic banks as VBIs. The framework will support the policymakers and standards setters in validating the application of Islamic financial instruments. This is critical as the ongoing issues on Islamic banks mimicking conventional banks may increase both Shariah non-compliance risks and reputational risk of Islamic banks. Hence, immediate prevention measures and action by the policymakers and standards setters deem necessary.

2.0 Literature Review

2.1 Islamic Financial Institutions as Value-based Intermediaries

Bank Negara Malaysia (BNM) has authoritatively announced Value-Based Intermediation (VBI) as a new initiative for Islamic banking institutions (IBIs) to be more revitalized. The intent of this initiative by the BNM is not only for economic growth but also to allow them to have more involvement in social needs as part of Maqasid al-Shariah which is beyond Shariah compliance in the business activities of IBIs.

Accordingly, the concept of VBI is defined by BNM as "an intermediation function that aims to deliver the intended outcomes of Shariah through practices, conduct, and offerings that generate positive and sustainable impact to the economy, community and environment, consistent with the shareholders' sustainable returns and long-term interests" (BNM, 2017). VBI shares similarities with several established concepts such as Ethical Finance and Sustainable, Responsible, Impact Investing (SRI), Sustainable Development Goal (SDG), and Environmental, Social and Governance (ESG), especially on the objectives that are to promote proactive participation in societal well-being. In fact, it is not completely a new concept.

However, according to BNM, the aspect that makes VBI is difference from the other concepts is because of its raison d'etre (reason of existence). VBI depend on Shariah in determining its underlying priorities, values, and moral compass. The idea of VBI is devised by the industry to revitalize the declining growth rates in IBIs, from inception to the following years recently.

In line with the establishment of VBI, the BNM has also developed an assessment tool to measure the adoption of VBI in IBIs. This assessment was publicly disclosed to allow the stakeholders to compare the performance of IBIs (BNM, 2017). Accordingly, the IBIs also need to ensure their intent, strategy and performance are based on the underpinning thrusts of VBI as a basis for collective action. Four (4) underpinning principles must be manifested by IBIs:

i. Entrepreneurial mindset – Through IBI's holistic offers, which comprise funding and proactive assistance, i.e. advisory services, market infrastructure, and business networks, the goal of this principle is to encourage involvement in the promotion of entrepreneurial activities.
ii. Community empowerment – Its goal is to empower communities by providing financial solutions that have a positive influence on them.
iii. Good self-governance – this thrust instils organizational discipline (self-control) and guarantees meaningful engagement of all stakeholders in the governance framework.
iv. Best conduct - refers to the adoption of methods that help IBIs enhance their offers, procedures, and treatment of their stakeholders (such as customers and employees).

Figure 1: The Underpinning Thrusts of VBI

Source: Bank Negara Malaysia (2018a)

VBI is considered to be an attempt to promote a more holistic perspective of Shariah that goes beyond Shariah compliance in IBIs' commercial operations. One of the elements in Maqasid al-Shariah is the preservation of wealth, which forms the core of the financial transactions of IBIs. However, the approach of VBI on wealth preservation extends beyond its literal meaning by encouraging people to generate, accumulate, and distribute wealth in a just and equitable manner (BNM, 2017). In other words, through VBI's ideas, IBIs has become a great place to contribute to social needs. It also fosters the creation of ethical values for IBIs within the framework of Maqasid al-Shariah.

VBI tries to achieve the following aims in the context of general objectives, all of which are aimed at the public good.

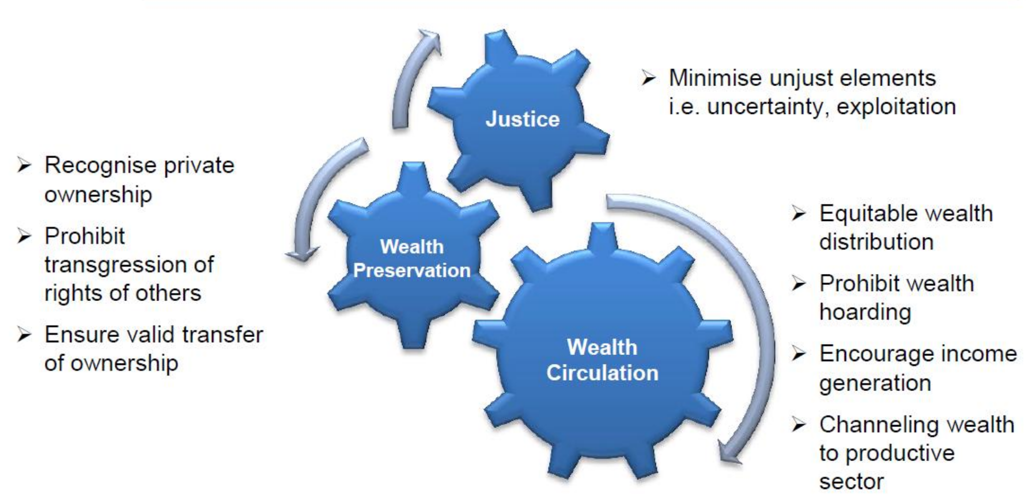

Figure 2: Intended Outcomes of Shariah

Source: Bank Negara Malaysia (2018a)

A brief explanation of the intended outcomes of Shariah is as follows:

1. The pursuit of justice: In IBIs, there are two aspects to achieving justice i.e. macro and micro dimensions. The implementation of a just economic system can be achieved at the macro level through wealth distribution and circulation, resource efficiency, and societal progress (Laldin & Furqani, 2013). In this case, justice is reflected in the framework of VBI through underpinning thrusts such as "Best Conduct" and "Community Empowerment." The aim of "Best Conduct" in the micro-dimension emphasises that stakeholder rights must be preserved through transparent and fair disclosure of all transactions and decisions made by IBIs.

2. Preservation of wealth through wealth circulation: There are at least two ways to circulate wealth i.e. doing business and facilitating a financial transaction (Lahsasna, 2013). It is envisaged that through implementing VBI, IBIs will be able to achieve their goal of wealth preservation through wealth circulation by engaging in Shariah-

compliant entrepreneurship or company. Furthermore, providing comprehensive offers such as financial and proactive support, and enabling entrepreneurial activity as emphasised in VBI is one of the strategies for wealth circulation in IBIs.

3. Preservation of wealth through wealth distribution: VBI's 'Community Empowerment' thrust emphasis on how the goal of wealth distribution can be achieved by development, finance, and providing solutions to difficulties that communities face, such as the integration of Waqf and Sadaqah into Islamic financial transactions. There are a few indicators that may be used to assess how well this drive is being implemented in IBIs. These indicators include the number of community-based services, goods, and projects, as well as the number of persons who benefited from the activities, as well as the social impact (BNM, 2017).

Finally, VBI serves as a conduit for delivering Shariah's desired objectives. These objectives will be achieved through a variety of tactics and practices. Firm and consistent regulation is essential in this regard. Beyond good practices, BNM must set higher requirements for sustainable finance in the country.

2.2 Maqasid al-Shariah Framework

Maqasid of Shariah is developed to provide a framework for Islamic scholars and institutions including Islamic banks to address the Maslahah of Muslim community and human life. Fisol et al., (2017); Saad & Fisol, (2019) commented that Maslahah, according to Muslim scholars (Fuqaha') including al-Ghazali referred to an effort by seeking of benefits or repelling of harm. The preservation of the objectives of the Shariah including the protection of religion, life, progeny, intellect and wealth constitutes the fundamental meaning of Maslahah. Sharing the same understanding that Maqasid and public interest from the point of view of Al Ghazali. Dusuki & Bouheraoua, (2011) highlighted that al-Shāṭibī defines Maṣlaḥah as addressing the subsistence of human life, the completion of man's livelihood and the acquisition of what his emotional and intellectual qualities required of him.

Scholars of Maqasid for Islamic banking (i.e. Chapra, 2008; Bedoui, 2012) highlighted the main Maqasid frameworks that can be considered for their applicability to Islamic banks developed by Al-Ghazali and Al-Najjar. With Al-Ghazali providing classical text for Maqasid Shariah, Al-Najjar's framework considers the dynamics of Muslim contemporaries with the changing socio-economic spheres of Muslim communities (Ridwan

& Santi, 2019; Ahmad, 2014). Al-Ghazali considers the Protection of Faith (Deen); Human self (Nafs); Intellect (Aql); Posterity (Nasl); and Wealth (Mal) at individual levels as integral elements of Maqasids. Bedoui, (2012) commented that Al-Najjar considers macro elements in his categorization of Maqasid Syariah including safeguarding human rights, society, wealth and environmental ecology.

Drawing from the Islamic moral economy, Asutay, (2008) advocated that the Islamic bank and finance industry should operate within the Maqasid al-Shariah framework to achieve human wellbeing and social justice in financial and economic activities. Submitting to both Maqasid al-Shariah and Shariah laws, Islamic banks demonstrate their moral and religious characteristics by avoiding involvement in Riba, Gharar and Maysir (Tarique et al., 2021). Islamic banking provides an alternative to the conventional financial system and for Muslims to protect themselves from Riba and Shariah-compliant financial transactions as means of maintaining Islamic practices to be observed by Muslims.

Obviously, as economic and financial transactions take a big part of man's activities, the Maqasid space is relevant to be considered in the development and sophistication of Islamic banks as Islamic institutions. Many studies in the literature consider this relevance. For instance, adopting the Maqasid concept of Abu Zahrah, Hosen et al., (2019) highlights three dimensions of public interest (i.e. Maslahah) applicable to Islamic banks' performance including profitability of the banks, redistribution of income and wealth, and investment in the real sector. Lateef et al., (2017) discussed the application of Maqasid with its principles in Islamic banking products is to be clearly outlined and incorporated in the product contracts with the customers.

Interestingly, Bedoui, (2012) further enhanced the Maqasid model for Islamic banking by providing different weights for different dimensions of Maqasid for Islamic banks to focus on in developing and defining the banks' performance measurement system. He does recognize that Islamic banks are more relevant for specific contributions to the development of wealth, and equitable distribution of income in the economy. Specifically, the protection of wealth as part of Maqasid should be given due consideration by Islamic banks in its governance and operations. Dusuki & Abozaid, (2007) highlighted that in order to realise the Maqasid al-Shariah, Islamic banking and finance institutions must ensure that all of their transactions are Shariah compliant not only in its form and legal technicalities but more importantly, the economic substance which is premised on the objectives outlined by the Shariah.

With the importance of financial and economic transactions, Mohd Naim, (2016) explains the relevance of Maqasid al-Shariah to Islamic economics and finance from the perspective of al-Daruriyyah, al-Hajiyyah and al-Tahsiniyyah as categories of Maqasid al-Shariah. With al-Daruriyyah in upholding religious and worldly affairs, Islamic injunctions ensure fair distribution of economic resources, prohibition of riba and gambling, as well as the protection of properties as making its unlawful possessions a crime. With al-Hajiyyat demonstrating the Muamalat transactions through contract details, flexibility in trade is needed to complete the transactions to satisfy all parties in the contracts. Maqasid is also in support of al-Tahsiniyyat which recognises practising Mahasin al-'adat (i.e. good customs) and keeping away from al-Ahwal al-Mudannisat (i.e. vile things). In line with this, in undertaking financial transactions, it is not advisable to pressure others and to charge excess profits at the disadvantage of others even if they are permissible by Islam.

Studies on the impact of Maqasid on Islamic banking operations tend to focus on Islamic banks achieving social dynamics of Shariah (e.g. Asutay & Harningtyas, 2015); however, fewer studies focus on other dimensions of Maqasid including income distribution and protection of wealth of the Muslims. As highlighted by Lateef et al., (2017) that the primary objective of Maqasid al-Shariah is to establish justice and go away with injustice in society; an Islamic economic system should be devoid of all forms of injustice or exploitation including protection of wealth in undertaking economic activities. This means the contracting parties should preserve justice and avoid injustice in business transactions including the exploitation and abuse in the acquisition of properties of others. Al-Najjar made five indicators to safeguard property which are: (1) by seeking and developing, (2) safeguarding damage, (3) safeguarding property by maintaining ownership rights, (4) safeguarding property by safeguarding value, and (5) safeguarding property by distributing or investment (Ridwan & Santi, 2019). Closely related to the discussion of the study, Ismail, (2010) promoted that Maqasid al-Shariah's protection of wealth is to ensure the community's wealth preservation and growth. With the emphasis on achieving Maqasid, Islamic banks in both products and operations should be designed to contribute to greater wealth creation in line with the Shariah and to ensure its equitable distribution in the community. The concentration of wealth in the hands of a few individuals is not consistent with the spirit of Maqasid.

2.3 Reporting of Islamic Financial Transactions

The reporting standard in Malaysia is based on the MRFS framework that complies with IFRS which enhances the quality, credibility, and transparency of the financial information in the companies and financial institutions in Malaysia. The financial reporting is based on policy documents by Bank Negara Malaysia for the financial institutions and companies to prepare and publish the financial statements that disclose information to the users on the financial performance and position.

From a Malaysian perspective, Figure 3 shows the composition of financing by concepts or Shariah contracts amounting to RM488 billion as of January 2018 (MASB, nd).

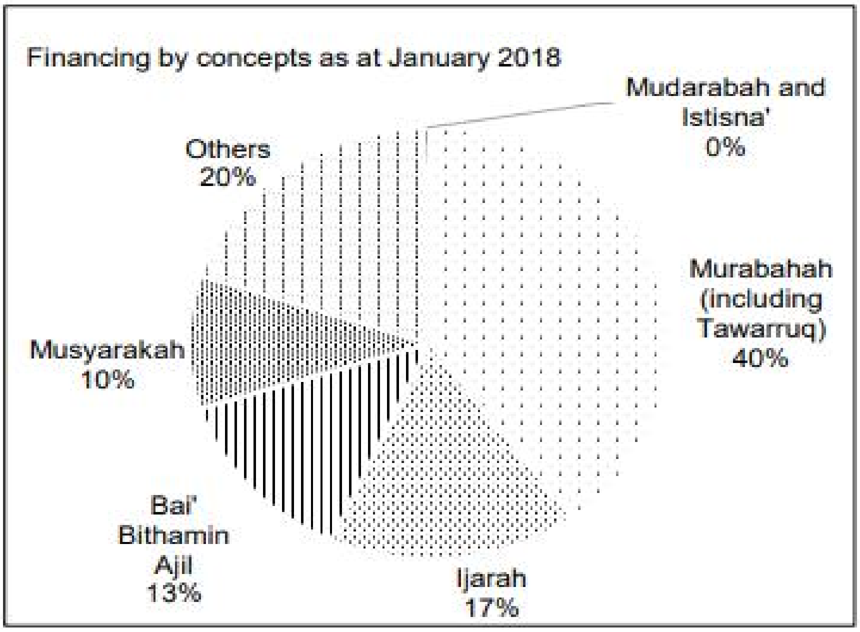

Figure 3: Composition of financing by concepts or Shariah contracts

Source: MASB (nd)

This show that both Murabahah (i.e. including Tawarruq) and Ijarah are the two most used contracts adopted by Islamic banks for their financing. Hence, it is important to examine the substance of both Murabahah and Ijarah financing adopted by Islamic banks and whether or not the instruments applied by Islamic banks achieve the Maqasid of Shariah or merely compliance with Shariah.

In relation to the issues on the reporting of Islamic financial transactions, Asian-Oceanian Standard-Setters Group (AOSSG, 2018) on the reporting of Islamic financial transactions under IFRS, highlighted the update on Financial Reporting Issues relating to Islamic finance. The working group on AOSSG in 2010, had undertaken research in identify issues in applying IFRS to Islamic financial transactions and identified 15 issues including topics on recognition of financing effect, profit sharing contracts, Sukuk, Takaful and Ijarah (AOSSG, 2018). For this research, the following are some summaries of the finding of the working group in **Table 1** specifically on the recognition of the financing effect on the common contracts (i.e. asset-based financing and Ijarah) that have been applied and being classified and recognised in the asset side of the Islamic financial institution's statement of financial positions in the perspective of accounting.

Table 1: Summary of the findings on the selected issues from the working group committee of AOSSG, 2018.

No.	Issues	Explanation
1.0	Recognising a financing effect	When a contract is within the scope of IFRS 15, and that contract contains a significant financing component, IFRS 15 requires an entity to adjust its transaction price for the effects of the time value of money and account for a receivable arising from the contract in accordance with IFRS 9.
		Consequently, if the seller's sale contract meets the definition and scope of a contract with a customer under IFRS 15, the seller will recognise two types of revenue. One is the revenue for transferring promised goods to the customer, and the other is for deferring the consideration. The seller would recognise a financial asset in accordance with IFRS 9 if such a contract is not a contract within IFRS 15.
		The applicability of IFRS 15 to an Islamic sale-based contract that is used to facilitate a financing transaction with a customer involves judgment. Among others, things that have been discussed is whether such a financing contract is "a contract with a customer" within the scope of IFRS 15.
2.0	Ijarah	It is noted that the accounting for Ijarah-based contracts remains controversial between "Islamic accounting standards" and IFRS. This stems from the Shariah requirement that a "lessor" must own the Ijarah asset throughout the Ijarah period regardless of the circumstances accompanying the ijarah arrangement. It must be noted that "ownership" under Shariah does not necessarily result in an asset being recognised for accounting purposes. For

		example, a lessor in an Ijarah contract who has the legal title of the asset would need to derecognise the asset if it is a finance lease under IFRS 16 Leases. In addition, paragraph B45 of IFRS 16 Leases states "…Obtaining legal title does not in itself determine how to account for the transaction."
		Despite the differences, additional disclosures may help to reduce the gap. For example, when an Ijarah is reported as a finance lease under IFRS 16, from a lessor's perspective, the standard requires the lessor to derecognise the Ijarah asset. This has led to the contentious point that such a treatment is not acceptable from Shariah precepts. In this case, additional disclosure could be included, for example in accounting policies or notes to the financial statements to cater to Shariah-conscious users about the "ownership" of the Ijarah asset.
		Additional disclosure is in line with paragraph 17 of IAS 1 Presentation of Financial Statements which states that a fair presentation also requires an entity "…to provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and performance."

The issues in recognizing the financing effects are due to the asset-based contract especially the Murabaha contract is in the category of the sale contract. In this case, a trust sells contracts. Besides, this issue also has been addressed in the Review of Bank Negara Malaysia (BNM) Shariah Policy Documents from a Financial Reporting Perspective issued by MASB. Accordingly, in general, financial reporting considerations can be summarised as follows (MASB, nd):

a. Identification of the applicable MFRS. Amongst others, include the following considerations:
    i. Faithful representation of economic substance versus legal form; and
    ii. Elements of control and nature of returns associated with the contracts.

b. Measurement of the contracts. The review noted that it is critical for an Islamic financial institution to assess the components of cash flows to determine the appropriate classification and measurement of the contracts.

In relation to this research, two types of asset-based financing are explained which are: (1) Murabahah financing; and (2) Ijarah financing, in order to examine the financial transactions in relation to the substance over form concept. Based on MASB, (n.d), Murabahah's structure in relation to the Murabahah policy document can be explained in Figure 4. The structure clearly explains the Murabahah financing adopted by Islamic banks. In particular, it shows both the flows of money and assets, hence, evidencing that the financing is not merely the provision of a loan (i.e. conventional bank), but the involvement of sale contracts. This can be seen as follows:

1. Transfer of ownership of the assets to the Islamic bank from the vendor;
2. Payment of purchase price on the spot by the Islamic bank to the vendor;
3. Transfer of ownership of the asset from the Islamic bank to the customer; and
4. Payment of deferred basis at a "cost plus markup" by the customer to the Islamic bank.

In terms of structure, it is clear that Islamic banks should buy the asset first before the asset is transferred (i.e. sell) to the customer. In particular, to the application of the Murabahah contract by Islamic banks, for sale-based contracts, the Islamic bank needs to consider whether the contracts fall within the scope of MFRS 15. MFRS 15 applies to 'a contract with a customer' whereby a customer is defined as a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities. However, due to the fact that an Islamic bank is an Islamic financial intermediary that provides financing for their ordinary activities, currently, the contracts have been recorded as financial assets within the scope of MFRS 9 i.e. financial instruments.

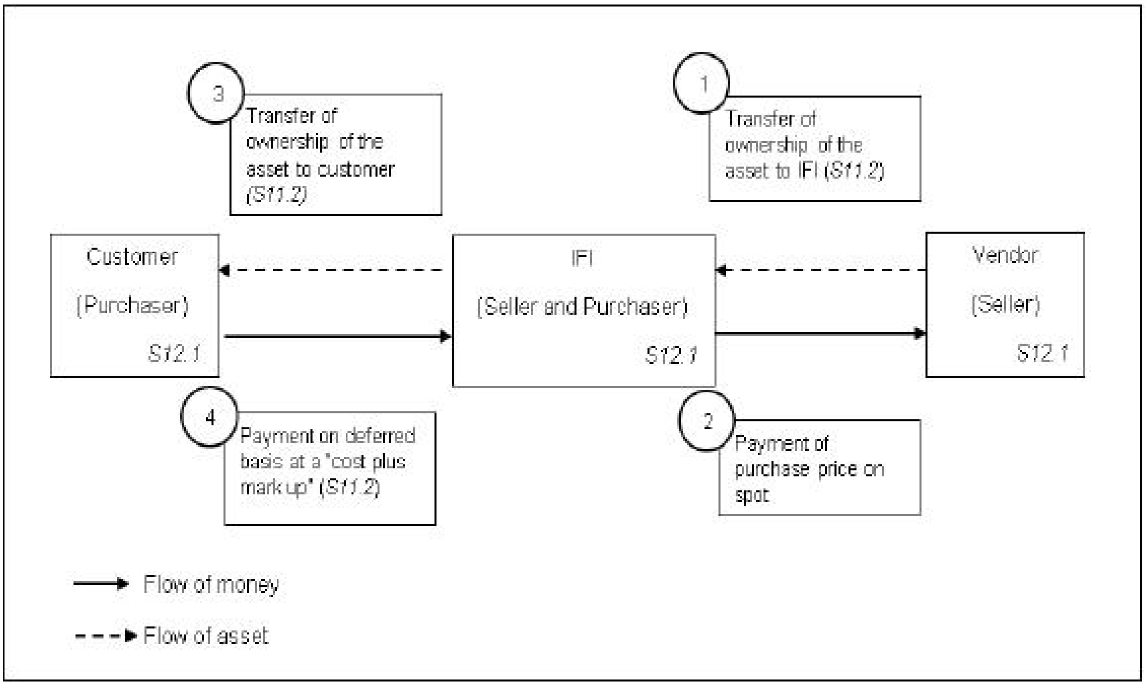

Figure 4: Illustration of Murabahah Structure

Source: MASB (n.d)

In relation to Ijarah, The BNM Ijarah policy document distinguishes between primary Ijarah and Ijarah financing as indicated in Figures 5a and 5b. General application of primary Ijarah is limited, and Ijarah financing is broadly used for hire purchase financing. By examining the structure of Ijarah financing, where this type of financing is accounted for in accordance with MFRS 16 if the Ijarah meets the definition of a lease and the Islamic bank is exposed to not only credit risk but also residual asset risk. This may be true for the reporting of Ijarah as in Figure 5a. However, it is found that the reporting of Ijarah financing namely al-Ijarah Thumma al-Bai (AITAB) widely used for vehicle financing reported as financing (i.e. assets side of the balance sheet). Similarly, the Islamic bank as a financial intermediary is merely a financier, the contract is likely to be accounted for under MFRS 9 financial instruments.

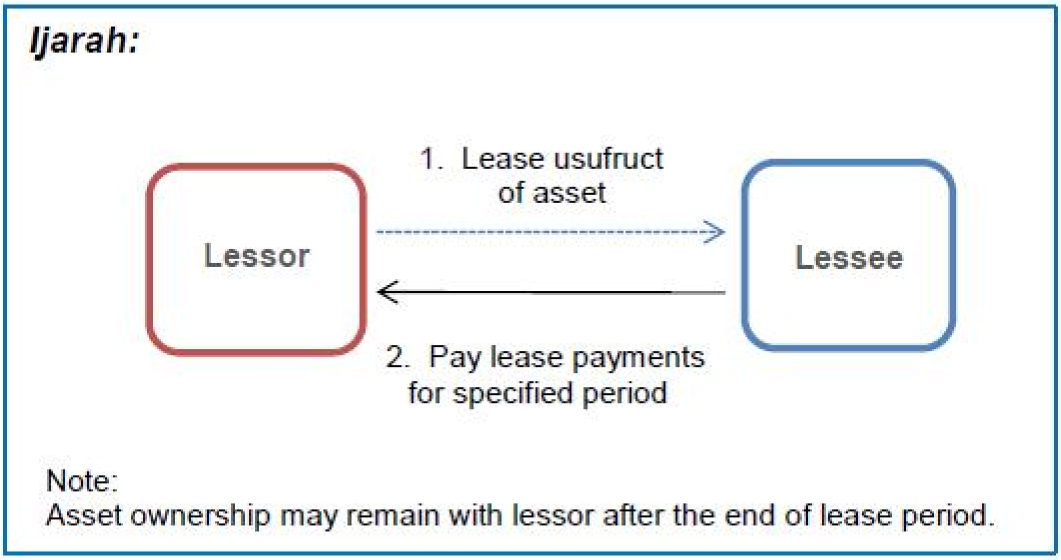

Figure 5a: Illustration of Ijarah Structure

Source: Bank Negara Malaysia (2018b)

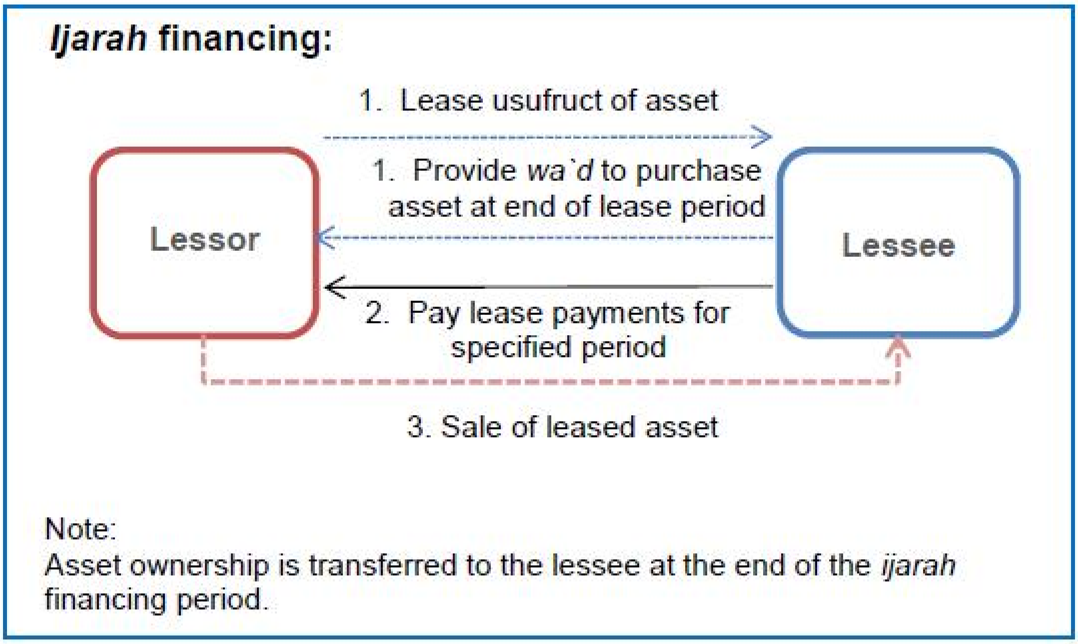

Figure 5b: Illustration of Ijarah Financing Structure

Source: Bank Negara Malaysia (2018b)

3.0 Methodology

The research adopts qualitative methods and techniques. The quantitative analysis summary findings on the issues of economic substance and legal form of the Islamic financial instruments are presented to the expert in accounting and Islamic banking in a focus group discussion as in Figure 6 that briefly explain the conceptual framework in relation to the research. There are four experts participate in the focus group discussion who are exposed to accounting and Islamic banking.

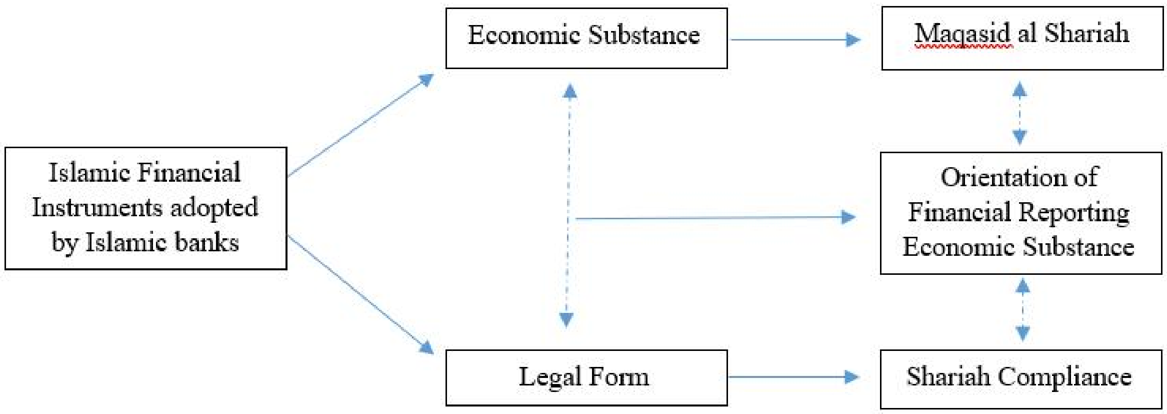

Figure 6: Conceptual Framework

The focus group discussion held for about two hours via online platform and the questions have been given before the discussion. During the focus group discussion, the reporting issues will be elicited from the views of the expert based on Islamic bank mimicking conventional banks, and whether the current practices achieve the Maqasid al-Shariah will be debated and documented.

The main questions for focus group discussion include the following:

1. Are Islamic banking activities expected to differ from the conventional bank in terms of their object and utilization (real economic benefits) of the assets as represented by the contractual relationships?
2. Should the financial products and instruments of Islamic banks comply with similar conventional bank regulatory and prudential requirements to safeguard and meet the needs of the Islamic finance community (such as financial reporting standards and requirements)?

3. Should the financial representation (reality) of Islamic bank activities be presented as similar or comparable to the conventional bank?
4. With only specific provisions on Shariah Compliance in IFSA (2013) do we expect the Islamic finance activities to be part (subset) of the single financial system?
5. To what extent do Shariah control functions in the BNM Shariah Governance Policy (2019) document distinguish the object and utilization of Islamic financial instruments to be consistent with Maqasid al-Shariah?

The principles can then be applied to analyzing the reporting practices of Islamic bank's financing and investment activities as in the conceptual framework. The principles can be a basis to assess whether or not the Islamic banking operations are consistent with Maqasid al-Shariah and to explain to what extent its operations and reporting mimic conventional banking practices.

The next section explains the main findings from the data analysis of the focus group discussion. The qualitative analysis addresses the issues found and groups them to several themes accordingly which identify the relevant Maqasid al-Shariah principles for validating the substance of Islamic financial instruments. The principles can then be applied to analyzing the reporting practices of Islamic bank's financing and investment activities as in the conceptual framework. The principles can be a basis to assess whether or not the Islamic banking operations are consistent with Maqasid al-Shariah and to explain to what extent its operations and reporting imitated conventional banking practices.

4.0 Findings and Discussion

This section summarises the findings based on the questions that were asked and discussed during the focus group discussion. The findings have been categorised into the three (3) important themes as follows:

1. Definition of object and utilization of asset in Islamic banking activities.
2. Interrelation among financial instruments and products of Islamic bank activities that comply with financial reporting requirements and financial representation.
3. Issue and concern in the implementation of Shariah compliance on Islamic finance activities.

Theme 1: Definition of object and utilization of asset in Islamic banking activities.

In general, the idea was to ascertain the expert view on the object and utilization of asset in Islamic banking activities. Indeed, all respondents posited that Islamic banking activities is differ from conventional bank in terms of its object and utilization (real economic benefits) of the asset by the contractual relationships. One of the respondents remarked the following:

> *"...about how important of the contractual nature of Islamic banking products. Because the contractual nature will make it difference from conventional. To me, the contracts is very important. When look into the issue of accounting, we really need to take consideration of the nature of the legal contracts, as it will make a bigger difference between Islamic products and conventional products." (Respondent 4)*

It is important to note that there are a few of Islamic financial instruments in particular the Murabahah financing and Ijarah financing that by its legal form should be the transaction of trading of an assets and leasing of an assets respectively. These are the arguments on economic substance versus legal form. One of respondents pointed out that:

> *"…object is referring to the financing that recorded as a financial instrument using MFRS 9 however it is not tally with policy document which in Islamic banking required trade and ownership on the asset before sell or rent using MFRS 15 on the revenue recognition." (Respondent 1)*

However, the fact that the contractual relationship has shown the similarity between Islamic banking and conventional banking even though there is a development in a product characteristic to adapt with the object and utilization. One of respondents remarked as follows:

> *"In the contractual itself, it is quite blurred to me with the recent development. Some of the arguments coming, they would like to have the Murabahah hakiki again, but now the Islamic bank come out with new contract which is similar to "Murabahah Hakiki" but the product itself is specific and designed to tell the customer that it is real and own by the bank. The bank buys piece of land and sell it to customer…" (Respondent 3)*

In summary, all respondents have attempted to shed light on the various concepts of object and utilization of Islamic banking activities. Islamic banking is supposed to be differed from conventional banking to remain competitive in the market; however, contractual relationship needs to be aligned with policy document and reporting requirement in the financial instruments.

Theme 2: Interrelation among financial instruments and products of Islamic bank activities that comply with financial reporting requirements and financial representation.

In general, most respondents agree that Islamic banks should not have complied with conventional bank reporting. The adoption of the MFRS and IFRS were a significantly to the capital market that is applicable for companies to prepare financial statements. However, there are characteristic of IFRS that is not transparent under Shariah reporting. Besides, the Islamic banks should look towards the real economic benefits by actively addressing the social issue besides profit orientation. One of the respondents pointed out that:

> *"Regulators need to have additional guideline issue even though not a full solution, at least provide the customer to understand the uniqueness of Islamic banking and Shariah contract requirement." (Respondent 1)*

Moreover, one of the respondents suggested that to comply with conventional banks' standard, as long as it reflects the economic reality of the transactions. The contracts need to be clear and legality in terms of Shariah requirements. One of respondents remarked as follows:

> *"Not totally reject but its more beneficial, look into more flexibility in adoption of financial standard where need additional guideline and additional rules and regulation which more accurate on the activity in Islamic banking because of uniqueness compared to conventional banking." (Respondent 3)*

The most important is the substance, the content that can show the difference between Islamic and conventional banks which apply the Shariah principle in the financial statement. The item under the financial statement is different as compared to conventional banks such as financing, finance income and so on. Islamic banks in Bahrain, for instance, that adopted the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) have more items to show the uniqueness of Islamic banking transactions in the financial statement and the presentation items in the financial statement should be reflecting the contract. Therefore the Shariah contract use needs to be reflected and useful information to the users. Auditors and users can compare between Islamic bank and conventional bank that comply with a financial standard because of their legal requirement. One of respondents pointed out that:

> "…*Good to have a presentation on what Bahrain and AAOIFI has done in the financial statement…. The presentation is the key part in financial statement that should be reflected in that financial statement. Of course, the note just be the detail to be referred later. So, I would say that it shouldn't be an issue that will reflect the liability, asset and equity, only the auditors will not want to be reflected there, as my experience dealing with external auditors when come on the presentation wise, where they want to follow exactly like commercial bank...*" *(Respondent 1)*

In summary, the financial product and instruments of Islamic banks can comply with conventional banks regulation and requirements if there are flexibility and additional guideline that are more suitable for the Islamic banking activities that can solve the issues in the Islamic banks such as Zakat, Waqf dan other Islamic banking products. Moreover, convergence can be applied besides the standardisation concept to comply and meet the requirements for Islamic bank as well as conventional banks.

Theme 3: Issue and concern in implementation of Shariah compliance on Islamic finance activities.

In general, most of the respondents agree that the specific provision on Shariah compliance in IFSA 2013 because there is an act on Islamic bank and takaful on the dual legislation in Islamic finance. According to one of the respondents, there is a different on implementing the Shariah compliance in financial system based on the Shariah law and constitutions of the country. However, the Islamic banking need to clear and independent based on Shariah principal to implement in the accounting standard. One of the respondents remarked that:

"Acheh has managed with qanun number 11-2013. Before end of 2022, have optic of all nearly 90 percent of Islamic financial institutions from Acheh. Its trigger the movement in other places as well, but again, there are very weak in term of undang-undang (law) unlike Acheh as autonomy to regulate based on Shariah. So, if you would like to look at how Malaysian would be, look at Acheh, and to me is amazing. Bring peace and clear understanding of the people that how the Islamic banking look like. Because everything is Islamic." (Respondent 2)

Moreover, the Shariah committees need to have the evidence when conducting the task in Islamic finance activities based on policy documents by Bank Negara Malaysia which can be referred as a guideline and ensure it is placed properly. Besides, one of the respondents recommended suggesting a unique and different reference from the existing references. Shariah committees need to ensure the control functions will be based on the Shariah committee report to look into the object and utilization to do the task. One of the respondents pointed out that:

"When come to Shariah audit and Shariah review, the references can either from Shariah committee ruling, Shariah Advisory Council (SAC) ruling and all policy document of Bank Negara Malaysia, all the policy document and parameter issued by Bank Negara Malaysia, I think whatever will be there will be use by control financial to perform their specific rule in audit or review." (Respondent 1)

Furthermore, there is an issue of the limitation on accounting. One of the respondents suggest to development Shariah accounting ruling independently and having more collaboration or discussion with another Islamic countries to effectively reflect the accounting standard on Shariah and more appropriate for Islamic banking. One of the respondents pointed out that:

"When it's come to accounting, it does not really full blood. For example, in Malaysia, whether we try to use IFRS framework for both, so I don't have negative regards to use IFRS, but off course, we need to understand when we take one accounting framework to support side of institutions; conventional and Islamic banking, there were some limitations, how accurate for example like IFRS can really represent the uniqueness of Islamic banking operation." (Respondent 3)

In summary, Masaqid of Shariah framework in Islamic banks needs to be compliant with Shariah control function based on the Bank Negara Malaysia policy documents. The adoption of reporting in financial instruments for Islamic banks needs a further discussion in order to develop the Shariah accounting ruling that can reflect the accuracy and manage the issue in Islamic banking. There are a lot of issues pertaining development of Islamic products, especially on the nature of the products themselves. Not only that but there are also no specific policy documents for Waqf and Zakat for Islamic banks. Hence, despite the current issues on reporting the Islamic financial instruments by Islamic banks, the further complication may arise when the Islamic banks report the Islamic social finance instruments (e.g. Zakat and Waqf) adopted by Islamic banks.

5.0 Conclusion

The validating of substance and forms on the reporting in Maqasid of Shariah framework for the financial instruments can be applied by Islamic banks to ensure compliance. There is a need for accounting standards that focus on the Islamic financial instruments to ensure faithful representation of the financial statements. For instance, under the Ijarah financing contract, the bank has to buy and own the asset (i.e. lessor), and then customers (i.e. lessee) will pay the rental to the bank. Finally, the bank will transfer the ownership to the user during the settlement period. However, in the financial statement, Ijarah financing does not reflect the leasing contract term and has no different from the conventional banks proving vehicle loans. Similar to Murabahah financing, there is no reporting of underlying assets bought by Islamic banks as inventory before the assets are sold to the customers. The substance and legal form should be aligned to reflect the financial statement based on policy documents that have been developed and to show the uniqueness of Islamic financial instruments in financial reporting. The debate is still ongoing due to the reporting of Islamic financial transactions in Malaysia is currently are based on MFRS. Hence, it is hoped that more research can address the issues.

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