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Critical Review on Financial Reporting Practices by Islamic Banks: (Comparison between AAOIFI and IFRS)

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Abstract: *This paper summarizes the findings of a comparative critical examination of the financial reporting methods of Bank Al-Barakah, BTPN Syariah, and Maybank Islamic Berhad. Due to the discrepancy between theory and practice, several past studies have found that Islamic banks need to alter the implementation of their financing facilities. This fact requires clarification. The research employs the quantitative descriptive method and theoretical with secondary data sources derived from literature research, as well as the IASB Conceptual Framework, AAOIFI Conceptual Framework, Resolution 2 of the Sharia Advisory Committee of Bank Negara Malaysia (SAC BNM), Statement of Islamic Financial Accounting Standards (PSAK Syariah), and other related references. The findings of this study indicate that AAOIFI and IFRS interpret the objectives of financial reporting differently. AAOIFI serves sharia principles as an intrinsic component of financial reporting, whereas IFRS implements neutrality of financial reporting from religion or standard components. Overall, the authors of this article maintain that Islamic banks conform to AAOIFI criteria for all of its components, including financial reporting objectives, key accounting assumptions, and SLM-based revenue estimation.*

Introduction

Accounting serves as a tool for company decision-making for those who require it, including internal parties like managers and external parties like creditors and debtors. Over the decades, the financial reporting system has evolved. Islamic finance evolved in the 1980s and successfully developed accounting standards recognized globally for Islamic Financial Institutions (IFI) – AAOIFI – that differ from conventional financial institutions – IASB. We will discuss these differences further. The AAOIFI accounting standards are helpful as recommendations that can represent the distinctive characteristics of IFIs and as a beneficial instrument for meeting the diverse demands of IFIs. (Mohammed Sarea & Mohd Hanefah, 2013). However, El-Halaby et al. (2021) show in their research that AAOIFI requires more empirical analysis.

Financial Statements involve more than just the reporting of numbers. Reporting depends on several essential premises beyond statements. This premise will dictate the layout of financial statements, which will influence how to report readers perceive the firm's economic impact through reporting. This paper will expound on one of the fundamental accounting principles: substance trumps form and how sharia perceives it. As a result of the fact that financial institutions generate cash flows, varying revenue projections will result in varying profit payments for banks and principal debt payments by consumers. This discrepancy has ramifications for variances in principal and profits collected if the client terminates the contract during the financing term.

Research on the gap between Islamic banking practices and Islamic financial transaction law (*fiqh mu'amalat*) has been widely carried out. The use of *maqasid sharia* shows how the meaning of sharia and its values consolidate into financial reporting demands (Mukhlisin, 2021). Sharia compliance is a critical service point in Islamic banks (Hosen et al., 2021). Due to the discrepancy between theory and practice, a number of perspectives argue that Islamic banks must alter the implementation of their financing facilities. We have found good research examples and concluded that Al-Ijarah Thumma Al-Bay' (AITAB) practice in Malaysian Islamic banks violates the Ijarah principle in classical literature. In terms of asset accountability, Nik Abdul Ghani et al. (2020) conclude that the Ijarah concept conflicts with the Hire-Purchase Act (HPA) and the Contract Act (CA). Since the bank keeps beneficial ownership while the lessee retains legal ownership, the *al-kharaju bi al-dhamman* principle contravenes current HPA and CA legal standards. In addition, they find that the absence of explicit legislative rules about AITAB goods may result in disparities in current product practices, particularly concerning Shariah compliance in asset responsibility problems. This circumstance raises the question of whether Islamic banks' financial reporting must accommodate substance or legal forms.

This fact must be highlighted since, in certain jurisdictions, Islamic banks are required to conform to a legally mandated financial accounting system. Malaysia supports International Financial Reporting Standards (IFRS) and mandates that Islamic banks utilize them in their financial reporting, whereas BTPN Syariah follows IFRS and employs AAOIFI as its primary guideline. This paper is significant because it will help scholars in this field fill in knowledge gaps. Modern Islamic banking transactions are fundamentally based on *fiqh mu'amalat*, accounting regulations, product development, and practice by Islamic banks. Any research that negates the integration of the three disciplines will probably produce insufficient or misleading findings.

Using the 2017 financial reporting of Bank Al-Barakah, Maybank Islamic Berhad, and BTPN Syariah, we compiled this article based on the problems that require critical resolutions: (i) the importance and purpose of reporting and recording, particularly transactional sharia financial statements; (ii) the types of financial reports in the three regimes as practiced by the sample banks; a sharia perspective on key accounting assumptions that substance over form; and (iii) how revenue estimation practiced by the three sample banks is diverse either using Effective Profit Rate Method (EPRM) or Straight Line Method (SLM). This study will analyze the variances in financial reporting and recording among the three sample banks that utilize the Islamic financial reporting standards in effect in their respective countries.

Research Method

McNabb (2020) prescribes that descriptive studies communicate through data, whereas theoretical investigations communicate through data-illustrated notions. This work is both descriptive and theoretical. Descriptive analysis is utilized to characterize the acquired data. As conceptual considerations, we employ the IASB Conceptual Framework. In addition, the AAOIFI Conceptual Framework and 2nd Resolution of Sharia Advisory Council Bank Negara Malaysia (SAC BNM) complement the theoretical base for analysis. Furthermore, the Indonesian customized accounting standard, namely Pernyataan Standar Akuntansi Keuangan Syariah (PSAK Syariah), and other relevant references help develop our findings.

Discussion and Results

The Significance and Financial Reporting Objectives

Gilaninia et al. (2013) assert that external users' information requirements and requests motivate financial reporting objectives. Its main purpose is to evaluate the economic impact of events and financial operations on the condition and the business unit performance to assist external organizations or users of financial reporting in making financial decisions on the business unit. Ystrom (2019) suggests that a more comprehensive set of stakeholders are conscious of the companies accountable for their operations in the capital, product, service, and labor markets and environmental acts. Consequently, financial reports have become a control mechanism for shareholders, suppliers, consumers, creditors, employees, agencies of government, and the entire society (Murphy et al., 2013). In this case, we emphasize that Islamic Financial Institutions (IFIs) should adopt this all-encompassing strategy as their financial reporting motivation. Because IFIs are designated to benefit multiple layers of stakeholders in adherence with sharia principles and objectives (*al-maqashid al-shariah*) and their stated purpose, profit, and business entities. Islamic banks are responsible for ensuring Islamic values are implemented in their goal and vision statements and incorporated into their functions and operations within the company's overall strategy (Kamla & Rammal, 2013). Islamic banks can also represent outstanding financial intermediaries that support fair and equitable financial systems for the entire society (Mahyudin & Rosman, 2022).

After noting the significance of financial reporting, particularly for Islamic banks, we compare the financial reporting objectives of IFRS and AAOIFI. In its conceptual framework, IASB (2018) declares that general-purpose financial reporting provides investors, lenders, and other creditors with financial information about the reporting business that is relevant in allocating resources to the entity. These decisions pertain to (a) purchasing, trading, or holding equity and debt instruments; (b) granting loans or other forms of credit clearance; or (c) exercising voting or other influence rights over management's activities that affect the entity's use of its economic resources. This objective statement emphasizes that financial reporting should discharge from cultural, religious, and societal influences.

Alternatively, (AAOIFI, 2010) supports the sharia norms inherent to Islamic bank financial activities. In addition, it distinguishes between financial accounting and financial reporting objectives. First, according to AAOIFI, the purpose of accounting is to determine the rights and obligations of all interested parties, including those resulting from unfinished transactions and other occurrences, in accordance with Sharia's principles and ideals of justice, transparency, and ethical observance. Second, financial accounting must support conformity with the IFI's declared aims and policies, including but not limited to adherence to Sharia's principles and ideals of justice, clarity, and ethical standards. Third, financial accounting provides valuable information for its users in decision-making regarding their connections with the IFIs. By adopting such objectives, Islamic banks are more prudent in pursuing contract documentation. Sharia Non-Compliance Events (SNCE) may occur when the agreement draft does not align with the prevailing fatwa of the country if it is covered. The customer suffers economic impacts or losses and is subject to court or legal litigation due to a shortage in drafting the documentation is another example of SNCE.

In the meantime, financial reporting should provide many information perspectives to reach the purpose. The first is information about the IFI's compliance with Sharia and its objectives. In addition, information regarding the reporting and handling illicit gains and costs. Then, information regarding the IFI's economic resources and obligations (the entity's obligations to transfer economic resources to satisfy its owners' or others' rights) and the impact of transactions, other events, and circumstances on the IFI's economic obligations. This information should estimate the IFI's capital sufficiency to absorb losses and business risks. In addition, it assesses the inherent risk of its investments and analyses the IFI's liquidity position and the required liquidity to meet its obligations and operating demands. Consequently, it is vital to have information to determine the amount of zakah. Information on the IFI's fiduciary and social responsibilities be inevitably disclosed. Furthermore, Hassan & Rabbani (2022) stated that AAOIFI has been instrumental in the development of accounting standards for IFIs and has contributed significantly to the general growth of the Islamic finance sector.

How 3 sample banks treat the concept in their financial reporting

Al-Barakah Bank's accounting policies adhere to the AAIOFI standard, as stated in note 2 of their financial statements. Meanwhile, Maybank Islamic applies Malaysian Financial Reporting Standards (MFRS) and International Financial Reporting Standards (IFRS), as stated in the notes of their financial statements number 2. BTPN Syariah implements PSAK Syariah by adopting IFRS and AAOIFI as guiding principles. The potential use of IFRS that does not adhere to sharia principles or legal maxims raises questions among Islamic finance experts. Siswantoro and Hameed (2013) provide evidence that accounting standards devoid of a solid foundation in Islamic teaching (fiqh) are likely to emerge as a function of their environment, precisely the IFRS convergence tendency. Since Islamic accounting standards are exclusively based on "the convention" of self-proclaimed Islamic experts, this is the case. In addition, as stated by the author, SAC BNM has not yet resolved the motivation upon which the Malaysian Islamic Bank should base its financial reporting. The IFIs are intended to operate under sharia principles and aims. Hence it is anticipated that the presented rules will provide more clarity for Islamic bank consumers in Malaysia. To explain why Islamic banks in Malaysia are now applying IFRS rather than the AAOIFI accounting standard, we anticipate conducting additional studies.

We propose that IFIs are encouraged to embrace the AAOIFI standard because it will operate nearly under the sharia's principles and try to achieve its goals (Maqasid al-Sharia). Suprayogi (2018) discovered that if IFIs adopt non-sharia-based standards, the quality of financial reporting information will decline because of the divergence between accounting reports and the practice of economic consequences.

Types of Financial Statements in AAOIFI and IFRS Standards as Implemented by Sample Banks

Al-Barakah Bank

Al Barakah, the Islamic bank implementing accounting standards developed by AAOIFI, continues to accept IFRS standards in cases where AAOIFI's standards are not dealing with the issue, provided that the IFRS standard does not conflict with the sharia and AAOIFI conceptual framework. The components of the financial statements of the bank consist of (i) a consolidated Statement of Financial Position, (ii) a consolidated Statement of Income, (iii) a consolidated Statement of Cash Flows, (iv) a consolidated Statement of Changes in Owners' Equity, and (v) Consolidated Statement of Changes in Off-Balance Sheet Equity of Investment Accountholders. It shows that AAOIFI standards require additional development.

Al-Barakah Bank emphasizes the significance of zakah, as Islamic Bank likewise plays an essential role in promoting zakah within the Islamic community. In the instance of zakah and good faith qard, the bank included zakah in the owner's equity statement (see Figure 1). Additionally, the zakah computation was disclosed separately before the five consolidated financial statements. This accounting technique demonstrates that zakah is not a burden for the bank. Zakah is a capital-based duty that must surpass the minimal threshold (nisab).

According to the AAOIFI conceptual framework, the predicted future economic advantages received from assets are not included in the definition of an asset. Good faith qard, on the other hand, is recorded under the assets position like other assets. It is appropriate since the AAOIFI conceptual framework defines an asset as a resource owned by an IFI and financed by its owners or investment accountholders (Muhamad Sori, 2017b). It is the manner in which the AAOIFI accounting standard applies *fiqh mu'amalat* to financial reporting. AAOFI would be prosperous and strengthen the overall regulation of the Islamic financial industry if it were more extensively embraced (Vinnicombe, 2012). Maybank's Islamic Financial Statements deviate from those of Islamic banks that have adopted the IFRS accounting standards in areas such as those which will be explained below.

Maybank Islamic Berhad

Maybank Islamic Berhad's financial statements included (i) the Statement of Financial Position, (ii) the Income Statement, (iii) the Statement of Comprehensive Income, (iv) the Statement of Changes in Equity, and (v) the Statement of Cash Flows. From these elements, we can deduce that the AAOIFI standard requires a supplementary financial statement, namely a statement of changes in the Off-Balance Sheet Equity of Investment Accountholders. Figure 2 illustrates that Islamic banks in Malaysia also offer investment account holder products but record them as liabilities.

The difference arises from how AAOIFI and IFRS interpret the term "liability." According to Muhamad Sori (2017b), IFRS (accepted by MASB) defines a liability as a present obligation of the entity originating from past events, the settlement of which is anticipated to result in an outflow of resources representing economic advantages from the entity. Meanwhile, liability is a present economic duty that is enforceable against the IFI, according to AAOIFI. Thus, from an accounting standpoint, Maybank Islamic pays zakah as a liability, but al-Barakah Bank pays zakah as a change in owner's equity. In addition, zakah is accounted for under the provision for taxation and zakah liabilities, as shown in Figure 3.

Maybank Islamic Berhad does not provide qard as a financing option. The Qard contract is solely utilized as the contract underlying the depositor's fund. Only the liability side is affected. Meanwhile, Al-Barakah bank is committed to offering customer finance with qard as the underlying contract. Based on this finding, we infer that Islamic banks following the AAOIFI accounting standard are more socially conscious than those applying IFRS. They are willing to assume the qard risk without a predefined economic benefit from the funding.

Bank Tabungan Pensiunan Nasional (BTPN) Syariah

BTPN Syariah adheres to the PSAK Syariah policy due to the IFRS adoption process and uses AAOIFI as the basis of guidelines. PSAK Syariah differs from the AAOIFI standard, which requires five components of financial statements. It means that for things that are not listed in IFRS and are not under sharia principles, then AAOIFI is the reference in formulating the policy. Accounting policies in Indonesia generally work under the system contributed by the efforts of The IAI as a standard setter, the National Shariah Board as a Shariah expert, and Bank Indonesia (BI) as a regulatory and supervisory authority in Indonesia (Mukhlisin et al., 2015). So that the components in the financial statements following PSAK Syariah reflect commercial activities, which consist of (i) a Statement of Financial Position; (ii) a Statement of Profit or Loss and Other Comprehensive Income; (iii) Statements of Changes in Equity; (iv) Statements of Cash Flows;(v) Statements of Reconciliation of Income and Revenue Sharing, and reflecting social activities consisting of 6) Statements of Sources and Distribution of Zakah Funds;(vii) Statements of Sources and Uses of Qardhul Hasan Funds. Within that, the Consolidated Statement of Changes in Off-Balance Sheet Equity of Investment Accountholders is reported as a temporary *syirkah* funds account in the statement of financial position between liabilities and equity and is not included in liabilities and equity, as shown in Figure 3.

Islamic banking in Indonesia has improved in meeting its social objectives over time, but sometimes at the cost of other objectives relating to the environment and customers (Hamidi & Worthington, 2021). In addition, zakah is reported separately in statements of sources and distribution of zakah funds as mandatory reporting. The separation is carried out to help evaluate the bank's fulfillment of the mandated responsibility in securing funds and a form of emphasis on obligations in fulfilling zakat. It is in line with Maybank, which records zakah on the liability side in its financial statement. However, it is unfortunate that until the end of 2017, BTPN Syariah has not appointed a *zakah* management institution, so the Bank has not managed the receipt of *zakah* funds, both from the Bank and outside parties, see Figure 4. Knowing how BTPN Syariah reports *zakah*, it is clear that there is a difference with the AAOIFI policy implemented by Al-Barakah.

Implementing the *Qardh* contract at BTPN Syariah as the underlying contract in every financing and written in statements of sources and uses of *qardh hasan* funds. The penalty system applies to customers who cannot fulfill their obligations within the specified time unless it is proven that the customer cannot pay. The fine will be used as social funds (*qardhul hasan*), with the number of fines following the initial agreement. So, once again, we assume that the adoption of AAOIFI is more socially oriented with a *qardh* risk insurance policy.

The perspective of Sharia on A Key Accounting Assumption (Substance Over Form Issue or SOF)

Proponents for SOF

Friedman and Kass (2018) asserted that substance over form in terms of an organization's long-term viability. Even though their recommendation applies to various organization types in general, the banking institution is innately one of them. According to the authors, managers, accountants, and auditors charged with guaranteeing an entity's long-term viability (going concern) must pay particular attention to this notion of substance over form. Litigation risk, or the fear of being sued for an allegedly inappropriate audit, appears to impact auditor behavior significantly. Litigation risk leads to a more conservative audit, sometimes called auditor conservatism.

Furthermore, the implementation of SOF influences how an organization structures its contractual transactions. Ahmed et al. (2019) maintain that while standards emphasizing substance are flexible enough to accommodate contracts with various formats, the priority placed on legal forms makes it impossible to accept diverse contracts. As such, Islamic banks that adopt the SOF in their accounting standard have some flexibility in developing their financing products.

Opponents of SOF within Islamic Bank's Financial Reporting

The idea of SOF results in Islamic financial reports delivery that confuses information to the users of financial reporting and incompatible transactions with Islamic principles. Suprayogi (2018), in his study's findings, suggest that adhering to the SOF principle in Islamic financial reporting probably depreciates the quality of Islamic financial reporting regarding relevance and trustworthiness. It is because of the economic contents which do not conform to legal forms.

It mandates that Islamic banks employ positive law as the economic basis for musyarakah mutanaqisah contracts, such as cash financing. Islamic banks must concurrently comply with both positive and Islamic law (Can, 2021). However, the two legal systems cannot be reconciled. Therefore, Islamic financial reporting based on the SOF concept will result in different findings than sharia oversight conducted by the Sharia Supervisory Board of Islamic banks. The notion of SOF will prevent Islamic financial reporting from accomplishing its goals. One of the objectives of Islamic financial reporting is to promote compliance with Islamic principles and provide information regarding this compliance. An Islamic banking product is sharia-compliant once it satisfies the prevailing fatwa. The national sharia board could determine the fatwa if the jurisdiction adopts a centralized governance system or the institutional sharia board if a decentralized governance approach prevails.

The substance is Equal to the Form

Hamour et al. (2019) exposed the substantial gap between current and classical Islamic finance contracts. His research deliberates that form is just as important as substance in Islamic financial contracts. If the form differs from the substance, there will be distinctive forms regarding operating and finance leases. An operating lease enables the use of an asset without transferring the ownership of the asset. This contract represents the actual substance of the lease, which does not transfer ownership. The finance lease transfers the ownership at the end of the leasing period. Such a scheme does not manifest the real purpose of the lease, which is intended only to use the asset.

For Muslims, it is essential to specify the contract or contracts underpinning the financing arrangement and to differentiate Sharia-compliant transactions from interest-bearing financing. Consequently, some have proposed that Sharia-compliant transactions be identified and assessed utilizing alternative principles instead of the IFRS.

Bridging Way

Bank Negara Malaysia (2010) concluded that SOF is permissible as it does not contradict the general sharia principles. Moreover, the SOF principle adjoins the legal maxim that "Matters are determinable according to intentions." Ideally, the accounting information should be faithfully trusted to represent the economic events resulting from business activities.

Ebrahim & Abdelfattah (2021) assert that Substance over form is an integral component of the accounting information quality characteristic of faithful representation. Accounting information should accurately reflect the essence of economic events rather than only its legal form to be viable and faithfully represented.

How 3 sample Banks Implement This Concept in Their Financial Reporting

Maybank Islamic documents Ijarah as an asset, but as hire purchase receivables for Al-Ijarah Thumma Al-Bay (AITAB). This financial asset consists of cash and bank balances, financing, advances, and other receivables. In accordance with the bank's accounting principles, financing and receivables are classified as non-derivative financial assets with fixed or determinable payments that are not linked to an active market. These financial assets are initially recognized at fair value, including direct and incremental transaction expenses. They are then assessed at amortized cost using the effective yield technique, less accrued impairment losses (see figure 5).

The recording of *Ijarah* in BTPN Syariah is identified as loans and receivables. Loans and receivables are initially recognized at fair value plus transaction costs and subsequently measured at amortized cost using the effective rate of return method. Loans and receivables are non-derivative financial assets with fixed or determinable payments and do not refer to an active market. See Figure 6 to illustrate how margin income on financial assets categorized as loans and receivables is included in the profit or loss and reported as "Income from sales and purchase."

Nevertheless, Al-Barakah Bank accounts for Ijarah as an asset and considers Ijarah assets its cost. The bank gives more information regarding the Ijarah financing components. According to the accounting regulations, the Ijarah Muntahia Bi Tamlik (IMBT) accounting includes land, buildings, equipment, and other charges. As Islamic contract law requires, these intrinsic components of Ijarah also contain accumulated depreciation (see figure 7). According to Ijarah, apart from Maybank's Islamic principles, assets are not receivables. They allude to a dynamic marketplace.

In summary, Maybank Islamic, BTPN Syariah, and Al-Barakah Bank use the SOF principle because they recorded AITAB or IMBT in a single transaction with different implications of asset accounting. International Accounting Standard 18 Revenue (IAS 18) promotes the SOF principle when calculating the recognized revenue. When two or more transactions are interrelated in such a way that the commercial impacts cannot be understood without reference to the series of transactions, the transactions are handled as a single unit for revenue calculation (Atmeh & Maali, 2017). In the case of those three banks, one treats *Ijarah* assets as receivables, and the others perceive it as cost and depreciation. Hamour et al. (2019) suggest that the concept of form over substance (FOS) could apply to IMBT and AITAB. With the SOF principle, ownership transfer occurs through a sale contract at the end of the lease period. A separate sale and purchase agreement will be declared between the lessor (seller) and the lessee (buyer) within a single document.

In contrast, if such a transaction is recorded following the FOS concept, the financial statements will reflect two separate transactions: (1) rental throughout the Ijarah (lease); and (2) sale following the aqd (contract) for the transfer of the Ijarah (lease) asset. In this situation, the financial statements will identify a single transaction to account for the ultimate sale, similar to a regular lease–purchase deal in which the lease (rental) and sale (purchase) contracts merge into a single contract. Suppose, however, that the SOF principle prevails.

The discrepancy in the Revenue Estimation Method (EPRM vs. SLM)

First of all, let us illustrate. Someone who purchases a motorcycle worth USD 1000 and disburses the payments in installments at ten months' maturity will regularly pay USD 100 monthly. From the seller's standpoint, the motorcycle's price of USD 1000 contains the USD 900 original price (principal) with a USD 100 profit margin. Even though the purchaser will pay the installment the same amount monthly, the method the seller charges revenue estimation will entail diverse consequences of profit and principal distribution during the debt or financing period.

This example is applicable to Islamic banking practices. Adopters of the AAOIFI accounting standard estimate revenue from financing activities to the customer using the Straight-Line Method (SLM). In contrast, Islamic banks adhering to the IFRS accounting standard adopt the Effective Profit Rate Method (EPRM) for estimating revenue. The EPRM, according to Muhamad Sori (2017a), is a method for estimating the amortized cost of a financial asset or liability and allocating financing revenue or expense over the relevant lifespan. The effective profit rate is the rate at which future cash payments or receipts are discounted to the net carrying value of the financial asset or obligation over the expected life of the financial instruments. The technique inherits the discounting element, equivalent to the interest rate. Meanwhile, The SLM is an equitable distribution of revenues and principal payments over the life of the financing period. In other words, the bank treating financing revenue estimation using the SLM equally distributes the total amount invested in Asset A across financing periods (Ackermann et al., 2016).

Using the same example, a monthly payment of $100 would consist of a USD 10 profit for the bank and a USD 90 motorcycle price during the loan term. This revenue distribution is accounted for during the ten-month financing period using a monthly proportional calculation. In practice, the accounting policies of al-Barakah Bank's financial statements apply the SLM for the depreciation of Ijarah Asset (customer's regular payment) in Ijarah Muntahiyah Bi Tamlik (IMBT), as shown in figure 8. Figure 9 depicts Maybank Islamic's use of the EPRM following its revenue-recognition accounting principles. Per BTPN Syariah, which applies an effective return similar to EPRM by discounting future cash reception estimates, see figure 10.

Maybank Islamic will record monthly profits and principals differently, using the same simplified example of acquiring a motorcycle via an IMBT contract. In the initial months, profits are recorded as greater than the followings, and principals are recorded as fewer. At the time of financing, the tenure advances, earnings decline, and principals rise. Based on the hypothetical calculation depicted in Figures 8 & 9, with the same $100 monthly payment, the customer pays a higher profit of USD 10.83 and a principle of USD 89.17 in the first month, with the numbers changing in the ninth month of payment. He pays the bank only USD 2.81 in interest and USD 97.19 in principal. We shall compare EPRM with SLM, as seen in figures 11 and 12.

This substantial disparity suggests that Islamic banks employing EPRM are not only for the client. The problem will come if the client cancels the financing throughout the term. With SLM, contract termination in the seventh month indicates that the bank has collected USD 630 in principals, whereas with EPRM, the bank has collected USD 644.82 in principals. Therefore, the consumer should pay the bank more earnings and principles using EPRM than SLM. In addition, Muhamad Sori's (2017a) research shows the possibility of risk transfer because the Bank can transfer the risk of customers stopping financing in the initial period by collecting higher income and lower principal payments in customer monthly installments.

This paper states that although Islamic banks can employ EPRM as their revenue estimator for risk management, adopting SLM is more equitable because of the proportionate distribution of customer profits and principals to the bank. Using EPRM is comparable to the usual bank technique of discounting future cash flows at an interest rate. Suppose the Islamic bank continues to use the traditional system under the guise of profit rather than the interest rate. In that case, there will be no other significant differences between conventional and Islamic banks. According to Islamic law, using SLM can be based on Maslahah (public benefit) if it serves the bank and the client justly. The International Accounting Standard (IAS) recognizes the SLM in implementing operating leases. An operating lease occurs when the bank purchases and rents out the customer-required asset for a predetermined rent and term (Gupta, 2015). In the case of an operating lease, rental income should be recorded on a straight-line basis for the lease period unless another systematic approach is indicative.

Conclusion

Compiling the flow of the above debate, we conclude (in section 2.3.1) that AAOIFI and IFRS see the financial reporting objective(s) differently. AAOIFI serves sharia principles as an intrinsic component of financial reporting, whereas IFRS implements neutrality of financial reporting from religion or standard components. Currently, Maybank Islamic Berhad utilizes IFRS, BTPN Syariah adopts IFRS and AAOIFI, and Al-Barakah Bank employs AAOIFI as the fundamental accounting principle. Maybank Islamic and BTPN Syariah employ the Effective Profit Rate Method (EPRM), while Al-Barakah Bank utilizes the Straight-Line Method (SLM). In addition, the accounting system employs various revenue estimation methods, with Ijarah as an example. AAOIFI and IFRS continue to use the same principle of substance over form by recording certain arranged transactions in a single contract. This paper reveals, however, that there were variations in the Ijarah contract's recording.

Overall, the author of this study believes that Islamic banks adhere to the AAOIFI criteria for all of its components, including financial reporting objectives, key accounting assumptions, and SLM-based revenue estimation. These facilitate the incorporation of sharia principles into the financial sector.

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Appendix

Figure 1: Zakah is recorded within changes in owner's equity

Consolidated Statement of Changes in Owners' Equity
For the year ended 31 December 2017

	Attributable to equity holders of the parent and Sukuk holders													
					Reserves		Cumulative changes in fair values							
	Share capital US$ '000	Treasury shares US$ '000	Share premium US$ '000	Perpetual tier 1 capital US$ '000	Statutory reserve US$ '000	Other reserves US$ '000	Investments US$ '000	Property and equipment US$ '000	Foreign currency translations US$ '000	Retained earnings US$ '000	Proposed appro-priations US$ '000	Total US$ '000	Non-controlling interest US$ '000	Total owners' equity US$ '000
Balance at 1 January 2017	1,149,218	(9,588)	18,574	-	139,740	42,231	4,971	36,300	(666,719)	497,374	68,857	1,280,958	727,623	2,008,581
Dividends paid	-	-	-	-	-	-	-	-	-	-	(11,396)	(11,396)	-	(11,396)
Bonus shares issued (note 13)	57,461	-	-	-	-	-	-	-	-	-	(57,461)	-	-	-
Movement in treasury shares	-	38	70		-	-	-	-	-	-	-	108	-	108
Net movement in cumulative change in fair value for investments	-	-	-	-	-	-	(828)	-	-	-	-	(828)	(851)	(1,679)
Net movement in other reserves	-	-	-	-	-	4,408	-	-	-	-	-	4,408	2,533	6,941
Foreign currency translation	-	-	-	-	-	-	-	-	(39,523)	-	-	(39,523)	(16,728)	(56,251)
Net income for the year	-	-	-	-	-	-	-	-	-	129,029	-	129,029	77,890	206,919
Transfer to statutory reserve (note 13)	-	-	-	-	12,903	-	-	-	-	(12,903)	-	-	-	-
Proposed dividends	-	-	-	-	-	-	-	-	-	(24,134)	24,134	-	-	-
Proposed bonus shares	-	-	-	-	-	-	-	-	-	(36,200)	36,200	-	-	-
Dividends of subsidiaries	-	-	-	-	-	-	-	-	-	-	-	-	(31,941)	(31,941)
Zakah paid on behalf of shareholders (note 13)	-	-	-	-	-	-	-	-	-	(4,021)	-	(4,021)	-	(4,021)
Perpetual tier 1 capital (note 14)	-	-	-	400,000	-	-	-	-	-	-	-	400,000	-	400,000
Expenses related to perpetual tier 1 capital	-	-	-	-	-	-	-	-	-	(2,780)	-	(2,780)	-	(2,780)
Profit distributed on perpetual tier 1 capital	-	-	-	-	-	-	-	-	-	(15,750)	-	(15,750)	-	(15,750)
Net movement in non- controlling interest	-	-	-	-	-	-	-	-	-	-	-	-	11,930	11,930
Balance at 31 December 2017	1,206,679	(9,550)	18,644	400,000	152,643	46,639	4,143	36,300	(706,242)	530,615	60,334	1,740,205	770,456	2,510,661

Figure 2: Investment Account Holder as liabilites

Maybank Islamic Berhad
(Incorporated in Malaysia)

Statement of financial position as at 31 December 2017

	Note	2017 RM'000	2016 RM'000
Assets			
Cash and short-term funds	5	17,134,359	15,535,992
Deposits and placements with banks and other financial institutions	6	-	651,558
Financial assets at fair value through profit or loss	7(i)	240,571	252,451
Financial investments available-for-sale	7(ii)	9,882,004	8,719,654
Financial investments held-to-maturity	7(iii)	2,731,560	-
Financing and advances	8	162,072,685	148,523,310
Derivative assets	9	487,989	515,554
Other assets	10	6,690,982	4,506,551
Statutory deposit with Bank Negara Malaysia	11	3,242,000	3,070,000
Deferred tax assets	18	12,903	19,487
Total assets		202,495,053	181,794,557
Liabilities			
Customers' funding:			
- Deposits from customers	12	129,897,440	106,604,492
- Investment accounts of customers[1]	13	24,555,445	31,544,587
Deposits and placements of banks and other financial institutions	14	28,238,141	30,342,006
Bills and acceptances payable		8,854	53,220
Financial liabilities at fair value through profit or loss	15	892,695	902,091
Derivative liabilities	9	650,320	535,161
Other liabilities	16	310,393	91,739

Figure 3: Temporary Syirkah Funds

PT BANK TABUNGAN PENSIUNAN NASIONAL SYARIAH

LAPORAN POSISI KEUANGAN PADA TANGGAL 31 DESEMBER 2017
(Dinyatakan dalam jutaan Rupiah, kecuali dinyatakan lain)

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 2017
(Expressed in millions of Rupiah, unless otherwise stated)

	Catatan/ *Notes*	2017	2016	
LIABILITAS, DANA *SYIRKAH* TEMPORER DAN EKUITAS				***LIABILITIES, TEMPORARY SYIRKAH FUNDS AND SHAREHOLDERS'EQUITY***
LIABILITAS				***LIABILITIES***
Liabilitas segera	2p,14	20,406	79,655	*Liabilities due immediately*
Bagi hasil yang belum dibagikan	15	13,747	12,320	*Undistributed revenue sharing*
Simpanan nasabah - pihak ketiga	2q,16			*Deposits from customers - third parties*
- Giro *wadiah*		95,169	13,400	*Wadiah demand deposits -*
- Tabungan *wadiah*		1,202,662	979,450	*Wadiah saving deposits -*
		1,297,831	992,850	
Utang pajak	17a			*Tax payable*
- Pajak penghasilan		85,696	66,403	*Income taxes -*
- Pajak lain-lain		10,033	7,793	*Other taxes -*
		95,729	74,196	
Liabilitas lain-lain	18	28,484	56,831	*Other liabilities*
Akrual	19	64,720	27,103	*Accruals*
Liabilitas imbalan kerja karyawan	2v,36	132,911	92,962	*Employee benefit liabilities*
JUMLAH LIABILITAS		1,653,828	1,335,917	***TOTAL LIABILITIES***
DANA *SYIRKAH* TEMPORER				***TEMPORARY SYIRKAH FUNDS***
Bukan bank				***Non-bank***
Tabungan *mudharabah*	2r,20			*Mudharabah saving deposits*
- Pihak ketiga		92,925	63,641	*Third parties -*
- Pihak berelasi	2d, 37	763	361	*Related parties -*
		93,688	64,002	
Deposito *mudharabah*	2r,21			*Mudharabah time deposits*
- Pihak ketiga		5,147,649	4,324,203	*Third parties -*
- Pihak berelasi	2d, 37	6,711	6,509	*Related parties -*
		5,154,360	4,330,712	
JUMLAH DANA *SYIRKAH* TEMPORER		5,248,048	4,394,714	***TOTAL TEMPORARY SYIRKAH FUNDS***

Figure 4: Statements of Sources and Distribution of Zakat Funds

PT BANK TABUNGAN PENSIUNAN NASIONAL SYARIAH

LAPORAN SUMBER DAN PENYALURAN DANA ZAKAT UNTUK TAHUN YANG BERAKHIR PADA 31 DESEMBER 2017
(Dinyatakan dalam jutaan Rupiah, kecuali dinyatakan lain)

STATEMENT OF SOURCES AND DISTRIBUTION OF ZAKAT FUNDS FOR THE YEAR ENDED 31 DECEMBER 2017
(Expressed in millions of Rupiah, unless otherwise stated)

	Catatan/ *Notes*	2017	2016	
Saldo awal dana zakat		-	-	***Beginning balance of zakat funds***
Sumber dana zakat				***Sources of zakat funds***
Zakat dari Bank		-	-	*Zakat from Banks*
Zakat dari pihak luar bank		-	-	*Zakat from non-bank parties*
		-	-	
Penyaluran dana zakat	2y	-	-	***Distribution of zakat funds***
Kenaikan dana zakat		-	-	*Increase in zakat funds*
Saldo akhir dana zakat		-	-	***Ending balance of zakat funds***

Figure 5: Receivables accounting treatment Maybank Islamic Berhad

Maybank Islamic Berhad
(Incorporated in Malaysia)

2. Accounting policies (cont'd.)

2.2 Summary of significant accounting policies (cont'd.)

(i) Financial assets (cont'd.)

(b) Initial recognition and subsequent measurement (cont'd.)

(1) Financial assets at fair value through profit or loss ("FVTPL") (cont'd.)

Included in financial assets designated at FVTPL are derivatives (including separated embedded derivatives), debt securities and equities.

Subsequent to initial recognition, financial assets held-for-trading and financial assets designated at FVTPL are recorded in the statement of financial position at fair value. Changes in fair value are recognised in the income statement under the caption of 'other operating income'.

(2) Financing and receivables

Financing and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Financial assets classified in this category include cash and bank balances and financing and advances and other receivables. These financial assets are initially recognised at fair value, including direct and incremental transaction costs, and subsequently measured at amortised cost using the effective yield method, less accumulated impairment losses.

Figure 6: Receivables accounting treatment BTPN Syariah

2. ACCOUNTING POLICIES *(continued)*

c. Financial instruments *(continued)*

Financial assets *(continued)*

(a) Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments which are not quoted in an active market, except:

- *those for which the Bank intends to sell immediately or in the short term, which are classified as held for trading, and those that the Bank upon initial recognition designates as at fair value through profit or loss;*
- *those for which the Bank upon initial recognition designates as available-for-sale; or*
- *those for which the holder may not recover substantially all of its initial investment, other than because of non-performing loans and receivables.*

Loans and receivables are initially recognised at fair value plus transaction costs and subsequently measured at amortised cost using the effective rate of return method. Margin income on financial assets classified as loans and receivables is included in the profit or loss and is reported as "Income from sales and purchase".

In the case of impairment, the impairment loss is reported as a deduction from the carrying value of the financial assets classified as loan and receivables recognised in the profit or loss as "Allowance for impairment losses".

Figure 7: IMBT accounting treatment as asset

Notes to the Consolidated Financial Statements

At 31 December 2017

7. IJARAH MUNTAHIA BITTAMLEEK

	2017			*2016*		
	Self financed US$ '000	**Jointly financed US$ '000**	**Total US$ '000**	Self financed US$ '000	Jointly financed US$ '000	Total US$ '000
Land and building						
Cost	142,061	1,786,674	1,928,735	179,444	1,730,599	1,910,043
Accumulated depreciation	(26,822)	(365,554)	(392,376)	(27,795)	(472,851)	(500,646)
Net book value	115,239	1,421,120	1,536,359	151,649	1,257,748	1,409,397
Equipment						
Cost	134,129	296,447	430,576	130,730	368,355	499,085
Accumulated depreciation	(38,696)	(93,756)	(132,452)	(22,326)	(90,333)	(112,659)
Net book value	95,433	202,691	298,124	108,404	278,022	386,426
Others						
Cost	-	34,677	34,677	-	56,469	56,469
Accumulated depreciation	-	(13,142)	(13,142)	-	(21,953)	(21,953)
Net book value	-	21,535	21,535	-	34,516	34,516
TOTAL						
Cost	276,190	2,117,798	2,393,988	310,174	2,155,423	2,465,597
Accumulated depreciation	(65,518)	(472,452)	(537,970)	(50,121)	(5,85,137)	(635,258)
Net book value	210,672	1,645,346	1,856,018	260,053	1,570,286	1,830,339

Figure 8: Ijarah Financing Revenue Recognition based on SLM

2. ACCOUNTING POLICIES (Continued)

Significant accounting policies (Continued)

s. Treasury shares

Own equity instruments which are reacquired (treasury shares) are deducted from equity of the parent and accounted for at weighted average cost. Consideration paid or received on the purchase, sale, issue or cancellation of the Group's own equity instruments is recognised directly in equity of the parent. No gain or loss is recognised in consolidated statement of income on the purchase, sale, issue or cancellation of own equity instruments.

t. Revenue recognition

Sales (Murabaha) receivables

Profit from Sales (Murabaha) receivables is recognised when the income is both contractually determinable and quantifiable at the commencement of the transaction. Such income is recognised on time-apportioned basis over the period of the transaction. Where the income from a contract is not contractually determinable or quantifiable, it is recognised when the realisation is reasonably certain or when actually realised. Income related to accounts that are 90 days overdue is excluded from the consolidated statement of income.

Salam and Istisna'a receivables

Income on Salam and Istisna'a is recognised on time-apportioned basis when the income from a contract is contractually determinable or quantifiable.

Mudaraba and Musharaka financing

Income on Mudaraba and Musharaka financing is recognised when the right to receive payment is established or on distribution by the Mudarib. Income related to accounts that are 90 days overdue is excluded from the consolidated statement of income.

Ijarah Muntahia Bittamleek

Income net of depreciation is recognised on a time-apportioned basis over the lease term.

Fee and commission income

Fee and commission income is recognised when earned.

Figure 9: Income recognition based on EPRM in Maybank Islamic

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Maybank Islamic Berhad
(Incorporated in Malaysia)

2. Accounting policies (cont'd.)

2.2 Summary of significant accounting policies (cont'd.)

(xiv) Income recognition

For all financial instruments measured at amortised cost and profit-bearing financial investments classified as held-for-trading and available-for-sale, profit income for all profit-bearing financial instruments are recognised within finance income in the income statement using the effective yield method.

The effective yield method is a method of calculating the amortised cost of a financial asset or a financial liability and of allocating the finance income over the relevant period. The effective yield rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instruments or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective yield/profit rate, the Bank takes into account all contractual terms of the financial instrument and includes any fees or incremental costs that are directly attributable to the instrument and are an integral part of the effective profit rate, but does not consider future credit losses.

Figure 10: Income recognition based on EPRM in BTPN Syariah

***2. ACCOUNTING POLICIES** (continued)*

s. Income from fund management by the Bank as mudharib

Income from fund management by Bank as mudharib consist of income from sales and purchases of murabahah transactions and income from other main operating activities.

The Bank prescribes the risk rate policies based on the internal regulation. The Bank terminates the amortisation of deferred income at the time its financing is classified as non-performing. The Bank's income from business transactions, which are classified as non-performing, is recorded as revenue to be received in the statement of commitments and contingencies.

The revenue recognition of murabahah receivables, which do not have significant risk in relation with the ownership of inventory, are recognised in the statements of profit or loss using the effective rate of return method.

Effective rate of return is an allocation method of revenue recognition and the rate which exactly discounts the estimated future cash receipts through the expected life of the murabahah receivable to obtain the carrying amount of a murabahah receivable. When calculating the effective rate of return, the Bank estimates cash flows in the future by considering all contractual terms of the murabahah receivable, but does not consider the loss of receivables in the future. This calculation includes all commissions, fees and other forms received by the parties in a contract which are an integral part of the effective rate of return, transaction costs and all other premiums or discounts.

Figure 11: EPRM hypothetical calculation

Months	Initial Balance	Installment	Payment of Profit	Payment of Principal	Ending Balance	Column1
1	1,000.00	100.00	10.83	89.17	910.83	
2	910.83	100.00	9.87	90.13	820.70	
3	820.70	100.00	8.89	91.11	729.59	
4	729.59	100.00	7.90	92.10	637.50	
5	637.50	100.00	6.91	93.09	544.40	
6	544.40	100.00	5.90	94.10	450.30	
7	450.30	100.00	4.88	95.12	355.18	644.82
8	355.18	100.00	3.85	96.15	259.03	
9	259.03	100.00	2.81	97.19	161.83	
10	161.83	100.00	1.75	98.25	63.58	

Figure 12: Payment schedule based on SLM

Months	Initial Balance	Installment	Payment of Profit	Payment of Principal	Ending Balance	Colum
1	1,000.00	100.00	10.00	90.00	910.00	
2	910.00	100.00	10.00	90.00	820.00	
3	820.00	100.00	10.00	90.00	730.00	
4	730.00	100.00	10.00	90.00	640.00	
5	640.00	100.00	10.00	90.00	550.00	
6	550.00	100.00	10.00	90.00	460.00	
7	460.00	100.00	10.00	90.00	370.00	630.00
8	370.00	100.00	10.00	90.00	280.00	
9	280.00	100.00	10.00	90.00	190.00	
10	190.00	100.00	10.00	90.00	100.00	