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International accounting harmonization, banking regulation, and Islamic banks☆

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Abstract

Islamic banks perform both commercial and investment banking services but do not establish firewalls to separate these two services legally, financially, and managerially. Unlike conventional commercial banks, Islamic banks are prohibited from charging or paying of interest. Instead, Islamic banks offer profit-sharing investment accounts, such that investors' return depends on the return on the assets financed by the investors' funds. Supervisory authorities in countries in which Islamic banks operate have taken various approaches to regulate Islamic banking. Such variations appear to have resulted in Islamic banks adopting different accounting treatments for investment accounts, although most of the countries in which Islamic banks operate either look directly to international accounting standards as their national standards or develop national standards based primarily on international accounting standards. This rendered the financial statements of Islamic banks noncomparable. It also implies that the calls for worldwide adherence to international accounting standards to achieve harmonization in financial reporting, regardless of cultural differences that affect the way in which business transactions are carried out (in substance as well as in form), should not go unchallenged. The paper also casts light on the need to implement the accounting standards promulgated by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), because these standards specifically cater for the unique characteristics of the contracts that govern the operations of Islamic banks. © 2001 University of Illinois. All rights reserved.

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1. Introduction

Over the last 15 years there has been increasing interest in enhancing the harmonization of accounting and financial reporting by banks. For example, as part of its harmonization program, the European Union issued in 1986 the Council Directive which contains regulations on the layout of bank balance sheets and profit and loss accounts.[1] The International Accounting Standards Committee (IASC) also issued International Accounting Standard (IAS) No. 30: *Disclosures in the Financial Statements of Banks and Similar Financial Institutions* (1990) and IAS No. 32: *Financial Instruments: Disclosure and Presentation* (1995). And more recently, the Basle Committee (1998a, 1998b) and the United Nations (1996b) issued studies that attempt to enhance transparency and comparability in banks.

It is argued that the need for international accounting harmonization should be met by an international accounting organization (Carsberg, 1998). Transnational institutions (e.g., World Bank, United Nations, European Union, Organization of Economic Cooperation and Development, and the Basle Committee) support the IASC as the only plausible world harmonizer of accounting (Nobes, 1996). Furthermore, the IASC is working with the International Organization of Securities Commissions (IOSCO) to bring about the possibility that companies with stock market listings in many countries can satisfy all the regulatory requirements with one set of accounting standards, IASC standards. The IASC is also working with the Basle Committee on an exposure draft that deals with accounting for financial assets and financial liabilities. This covers, among other things, important matters relating to banks, e.g., how to deal with impaired loans, how to report borrowings, and how to account for the effect of transactions undertaken to hedge risks.

The recent global economic crisis also seems to have renewed support to the need for a *lingua franca* of financial reporting, thereby giving further endorsement to the work of the IASC as a vehicle for achieving international harmonization of financial reporting. For example, it is reported that the Group of Seven leading industrial nations (G7) "will expect nations to work towards a common accounting practice, which is obviously likely to work towards companies adopting a common accounting standards."[2] Furthermore, the World Bank and the International Monetary Fund (IMF) could probably put more pressure on regulators by tying their loans to use of IASs. It is also reported that the World Bank and IMF agreed with the Big Five accounting firms that IASs and International Standards on Auditing "are the standards that should be used by financial institutions in those countries to accomplish the World Bank and IMF objectives of fostering economic stability."[3] The World Bank would also like to see the Big Five accounting firms stop putting their names to accounts drawn up under local standards that do not meet international reporting standards.[4]

[1] For more details see Arthur Andersen & Co. (1987).
[2] Accounting and Business (1998, p. 2).
[3] IFAC Quarterly (1998, p. 7).
[4] Accountancy International (1998, p. 6).