



## Formation of Financial Statements at Islamic Financial Institutions

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### Abstract

Conceptually, the key approaches to the formation of financial reporting for an Islamic financial institution (IFI) have much in common with approaches developed for economic entities in the traditional economy. At the same time, the AAOIFI Concept and the Financial Accounting Standard No. (1) provide for Islamic financial institution-specific provisions and reporting forms that reflect the requirements of the Sharia. Disclosure of methods in published accounts is intended to help its users distinguish between changes in the financial position of an Islamic financial institution, the results of its operations, cash flow, limited investment managed by it, the sources and use of Zakat (poor-due) and Kard funds and charitable foundations. Further development of the regulation of the issues on the formation of financial statements seems to us in the making common approaches to its formation closer for companies operating in the traditional economy and Islamic financial institutions.

**Keywords:** AAOIFI; Zakat; Kard; Concept; International accounting standards board; Sharia.



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### 1. Introduction

Since 1996, the Financial Reporting Standard (FRS) No. (1) "General Presentation and Disclosure of Information in the Financial Reporting of Islamic Banks and Financial Organizations" came into force. It was developed by the Accounting and Audit Organization for Islamic Financial Institutions (AAOIFI).

To date, the AAOIFI has published the Conceptual Framework for the Accounting and Audit of Islamic Financial Institutions (hereinafter referred to as the AAOIFI Concept) and the 24th Financial Accounting Standard (Pomeranz, 1997). These standards are for the most part unparalleled among the International Financial Reporting Standards (IFRS). At the same time, the already mentioned financial accounting standard No. (1) was developed to a large extent on the basis of information on financial reporting contained in the International Accounting Standards Board (IASB) Concept. In this connection, the paper presents a comparative description of the requirements of the International Financial Reporting Standards and the Financial Accounting Standard for the preparation of financial statements and outlines the specifics of its compilation for Islamic financial institutions.

Due to the lack of their coverage in Russia, we will consider in this paper the basics of the formation of financial statements in the light of the AAOIFI Concept and Financial Accounting Standard No. (1).

### 2. Methods

Research methods include critical comparative analysis, the synthesis of conceptual approaches to the formation of financial statements developed by the International Accounting Standards Board and the Accounting and Auditing Organization for Islamic Financial Institutions, comprehensive disclosure of the provisions on the financial accounting standard for its compilation for an Islamic financial institution. In the process of research, the following general scientific methods were used: induction and deduction, classification, grouping, a systematic approach to obtaining evidence, which are the basis for the authors' recommendations for further improvement of financial reporting.

### 3. Results and Discussions

The AAOIFI Concept identifies two types of financial reporting: general-purpose financial statements and special financial statements. Financial statements of general purpose, as well as from the Concept of the International Accounting Standards Board, are aimed at meeting common information needs (Mohammed and Mohd, 2013). It includes:

- Prime accounts;

- Accounting policy report;
- Explanations (notes) for reporting;
- Additional reports, if necessary.

The prime accounts include:

- A report reflecting the size of the economic resources of an Islamic financial institution and requirements to it (statement of financial position or balance sheet);

- A report reflecting changes in the value of economic resources due to financial results achieved by the Islamic financial institution (profit and loss account);

- Reports reflecting changes in the amount of economic resources due to other events and transactions: a statement of cash flows; a statement of changes in equity or a statement of retained earnings. They also include those characteristic only for the Islamic financial institution: a report on the sources and use of funds in the Zakat Fund and a charity fund (when the Islamic financial institution is responsible for distributing Zakat funds); a report on the sources and use of funds in the Kard Fund, etc ([Kharisova F. I. and Kurbanova, 2017](#)).

General-purpose financial statements include additional reports and other information. Additional reports may contain additional information about the elements of the statement of financial position and the profit and loss account that are relevant to users. Such a report may also include disclosure of the risks and uncertainties affecting the Islamic financial institution and information about the social responsibility of the Islamic financial institution ([Aribi and Gao, 2011](#)).

Special reporting is addressed to specific groups of users. There are no generally accepted definitions in the special financial statements. Examples of such statements are a report on assets and liabilities drawn up under a specific contract or agreement, a profit and loss account report for tax purposes, etc.

Off-balance items are also identified according to the AAOIFI Concept. They include, for example, the money that an Islamic financial institution manages based on fiduciary responsibility. For example, the capital of holders of investment accounts, for which an Islamic financial institution does not have the right to make decisions on the use and placement of funds received, is an off-balance item ([Rahman and Rahim, 2010](#)).

A separate element of the financial statements is the return on investment of holders of investment accounts. The return on investment is the share in the net result received for the reporting period attributable to the holders of investment accounts.

The Financial Accounting Standard No. (1) "Presentation and Disclosure of Information in the Financial Statements of Islamic Banks and Financial Organizations" focuses financial reporting on meeting the information needs of users of financial statements and establishes general principles for the presentation of information ([Kharisova F. I. G., 2018](#)).

In accordance with the Financial Reporting Standard No. (1), Islamic financial institutions should publish the following forms of reports included in the full set of financial statements:

- a) Statement of financial position (balance sheet);
- b) Profit and loss account;
- c) Statement of cash flows;
- d) Statement of changes in equity or statement of retained earnings;
- e) Report on changes in limited investments;
- e) Report on the sources and use of funds in the Zakat Fund and a charitable foundation (when an Islamic financial institution is responsible for distributing Zakat funds);
- g) Report on the sources and use of funds in the Kard Fund;
- h) Explanations (Notes) to the financial statements;
- i) Any reporting and other data that assist in providing information to users as specified in the AAOIFI Concept.

According to Financial Reporting Standard No. (1), comparative information should be presented in financial statements, at least for the preceding period. According to the Concept of the International Accounting Standards Board, the forms of financial statements should contain

information for different prior periods. Thus, the Statement of Financial Position includes information for the last three years. In our opinion, such an order of reflection of the indicators for the last three years in the Statement of Financial Position is advisable to provide in the financial accounting standard (1).

The statement of profit or loss and other comprehensive income, the analogue of which in accordance with the financial accounting standard is "Profit and Loss Statement" contains data for the two preceding years.

Unlike the requirements of International Financial Reporting Standards in accordance with the AAOIFI Concept and the Financial Accounting Standard, assets and liabilities must not be classified in the Statement of Financial Position as current and non-current, short-term and long-term ones. In our opinion, such a provision in Financial Reporting Standard No. (1) significantly reduces the analytical capabilities of the balance sheet, and therefore it seems necessary to adopt the provision on grouping the assets and liabilities prescribed in the International Accounting Standards Board's Concept for the financial accounting standard.

Atypical supervisory restrictions imposed on the Islamic financial institution by any legislative body after verification of compliance with any laws that provide for the disclosure of these restrictions are subject to be described in the financial statements.

Supervisory restrictions are recognized as atypical if they limit the ability of a leadership of an Islamic financial institution to make management decisions or prevent it from carrying out its statutory activities. Such restrictions may be imposed, for example, by the Sharia Supervisory Board.

Financial statements should also provide information on the types and amounts of income received by the way prohibited in Sharia (Islamic law). Similar expenses are subject to disclosure. Also, the management's intentions should be disclosed about the disposal of the received assets prohibited by the Sharia.

Information on assets should be disclosed broken down to:

- a) Economic sectors (for example, the agricultural sector, the services sector, the manufacturing sector, the real estate sector, etc.);
- b) Clients, including other Islamic financial institutions without the name of a client;
- c) An internal geographic area with unique economic characteristics;
- d) Foreign countries.

Financial Accounting Standard No. (1) provides for the disclosure of information on amounts for all unlimited investment accounts, their equivalents and other similar accounts in accordance with the maturity dates. Such disclosure should differ from the disclosure of demand accounts.

Also, assets that the Islamic financial institution must pay to other organizations as compensation amounts must be disclosed.

As in the Concept of the International Accounting Standards Board, the financial statements should reflect net assets in accordance with the financial accounting standard under consideration.

As of the date of the statement of financial position, the disclosure of unforeseen expenses of an Islamic financial institution that may arise in connection with the opening of a letter of credit, surety and other instruments is required.

Explanations to the statement of financial position should disclose any significant events that could materially affect the results of operations and financial position of the Islamic financial institution.

The increased attention is paid to the accounting policy in the financial accounting standard No. (1) - the principles, rules and methods of accounting, adopted by the leadership of an Islamic financial institution and the disclosure of its changes.

An accounting policy statement that reflects the accounting policies used to prepare the financial statements

allows users to understand the appropriateness of the policy with respect to the operations of the Islamic financial institution, the events and the conditions under which the activity takes place. In addition to traditional ones, these are, for example, the accounting policies adopted by the leadership of an Islamic financial institution, but which do not coincide with the financial accounting concepts for an Islamic financial institution, if any.

The financial accounting standard No. (1) draws attention to the need to disclose transactions with third parties in financial statements. They include, for example: members of the Board of Directors of the Islamic financial institution, its independent auditors, Sharia advisers or members of the Sharia Supervisory Board, the General Director, its deputies, or their peers and other individuals or entities.

In this standard No. (1), general provisions for the compilation of financial reports are defined.

The statement of financial position named in Financial Reporting as Standard No. (1) as well as in International Financial Reporting Standards (in Russia it is the balance sheet) includes assets, liabilities, shares of holders of unlimited investment accounts, and equity.

The consolidated statement of financial position should disclose the minority's interest, which should be reflected in a separate article from unrestricted investment accounts and equity.

The next form of reporting called "Profit and Loss Statement" is intended to reflect information on financial results. In accordance with the International Financial Reporting Standards, the results of the entity's operations are reflected in the form of a report called the "Statement of profit or loss and other comprehensive income".

According to the financial accounting standard

No. (1), this form of reporting should contain the following indicators:

1. Income by type of investment, expenditures,

and profits and losses by type. (The main revenues, expenses, profits and losses by type of activity should be shown.)

2. Gains and losses on the revaluation of assets and liabilities to the value of their cash equivalents, where applicable, including the general principles of an Islamic financial institution for the revaluation of assets and liabilities.

3. Information with a separate disclosure of income from investments, expenses, profits and losses jointly received from Islamic financial institutions holders of unlimited investment accounts and those financed by an Islamic financial institution in an exceptional manner, namely:

a) income and profits from investments;

b) expenses and losses from investments;

c) income (expenses) from investments;

d) share in incomes (expenses) from investment of investment account holders before deducting the share of Islamic financial institution (Mudarib);

e) share in income (expenses) from investments of an Islamic financial institution;

f) share of the Islamic financial institution in the income from Mudarib's unlimited investment accounts;

g) share of the Islamic financial institution in the income from the limited investment accounts of Mudarib;

h) fixed fee for an Islamic financial institution as an investment agent for limited investment;

i) other incomes, expenses, profits and losses;

j) general and administrative expenses;

- k) net profit (loss) before taxes to Zakat;
- m) Zakat and tax collections (to be disclosed separately);
- m) net profit / loss.

The next form, the Cash Flow Statement, provides for the disclosure of information to assess the ability of an Islamic financial institution to generate future cash receipts.

According to Financial Reporting Standard No. (1),  
the following information should be provided in another  
reporting format: "Statement of Changes in Equity or Statement of Retained Earnings":

- a) paid-in capital, mandatory contributions to the reserve fund and discretionary reserves, each separately, retained earnings at the beginning of the period, with a separate disclosure of the amount of profit received from the revaluation of assets and liabilities to the value of their cash equivalents, where applicable;
- b) contributions to the authorized capital for the period;
- c) net profit / loss for the period;
- d) distribution between owners for a period;
- e) increase (decrease) in mandatory contributions to the reserve fund and discretionary reserves for the period;
- e) paid-in capital, mandatory contributions to the reserve fund and discretionary reserves, as well as retained earnings at the end of the period, with a separate disclosure of the amount of profit received from the revaluation of assets and liabilities to the value of their cash equivalents, where applicable.

The statement of retained earnings should disclose:

- a) retained earnings at the beginning of the period, with a separate disclosure of the amount of undistributed profit received from the revaluation of assets and liabilities to the value of their cash equivalents, where applicable;
- b) net profit / loss for the period;
- c) transfers to the fund of mandatory and discretionary reserves for the period;
- d) distribution between owners for a period;
- e) retained earnings at the end of the period, with a separate disclosure of the amount of retained earnings received from the revaluation of assets and liabilities to the value of their cash equivalents, where applicable.

The equity of an Islamic financial institution represents a residual interest in the assets of that organization after deducting all the liabilities and capital of the holders of investment accounts. This form is compiled by analogy with the "Report on Changes in

Equity for the Period", developed by the International Accounting Standards Board.

"Report on changes in limited investment", as provided in Financial Reporting Standard No. (1), has no analogue in International Financial Reporting Standards. It should represent sources of funding in a grouped form, including financing through the limited investment accounts or shares in the portfolio of limited investments, etc.

The Report on Changes in Limited Investments shall disclose:

- a) the balance of limited investments at the beginning of the period, with a separate disclosure of the remainder of the limited investment revaluation up to the value of their monetary equivalent, where applicable;
- b) the number of shares in each investment portfolio and their cost per unit at the beginning of the period;
- c) received deposits or shares issued by an Islamic financial institution for the period;
- d) withdrawal from the account or reverse purchase of shares for the period;
- e) the share of the Islamic financial institution in the investment profit in the capacity of a Mudarib or its fixed fee as an investment agent;
- e) the distributed overhead costs of an Islamic financial institution, if any, for limited investment accounts or a portfolio.
- g) profit (loss) for limited investments for the period with a separate disclosure of the part of the remainder from revaluation of limited investments up to the value of their cash equivalents, where applicable;
- h) the balance of limited investments at the end of the period, with a separate disclosure of the remainder of the limited investment revaluation up to the value of their cash equivalents, where applicable;
- i) the number of shares in each investment portfolio and their cost per unit.

Characteristic only for an Islamic financial institution is the "Report on the sources and use of funds in the Zakat Fund and a charitable foundation". This report provides users with information about the responsibilities

of an Islamic financial institution for the payment of Zakat on behalf of all holders of unlimited investment accounts. It should also describe all sources of funding for the Zakat

Foundation and the charitable foundation are subject to disclosure ([Magalhaes and Al-Saad, 2013](#)).

Also specific only for an Islamic financial institution is the "Report on the sources and use of funds in the Kard Fund" ([Maali et al., 2006](#)). This report should disclose:

- the balance of the funds available in the fund at the beginning of the period by their types;
- the amount and sources of funds contributed to the fund for the period according to their types;
- the balance in the Kard fund and the funds available in it at the end of the period by their types ([Khasheva et al., 2017](#)).

## 4. Summary

In our opinion, summarizing the above we can conclude that the conceptually key approaches to the formation of financial statements for an Islamic financial institution have much in common with the requirements developed for economic entities in the traditional economy. However, for an Islamic financial institution, the AAOIFI concept and the financial accounting standard provide for:

- requirements that allow users of general purpose accounts to understand that an Islamic financial institution functions in accordance with the norms of Sharia (Islamic law);

- disclosure of specific information and therefore explaining the specific essential characteristics of the economic relations of an Islamic financial institution.

## 5. Conclusions

The AAOIFI concept and the financial accounting standard No. (1) provide for reporting the forms which are specific to an Islamic financial institution and also reflect the requirements of the Sharia. These include, for example, a report on the sources and use of funds in the Zakat Fund, a report on the sources and use of funds in the Kard Fund, a report on changes in limited investment.

Further development of the topic considered in the paper seems to us in making closer the common approaches to the formation of financial statements for companies operating in the traditional economy and for an Islamic financial institution. So, in our opinion, it is advisable to include in the Concept of the International Accounting Standards Board a separate section on the AAOIFI Concept, what will facilitate their harmonization.

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