

THE UNIVERSITY OF NEW ENGLAND
NEW ENGLAND BUSINESS SCHOOL

AAOIFI REPORTING STANDARDS: MEASURING COMPLIANCE

NEBS 592 Masters Major Dissertation by Thea Vinnicombe.


Submitted in Compliance with the requirements of the Masters in Economics degree at
the New England Business School, University of New England.

September 2007

DECLARATION

This major dissertation is submitted to the University of New England in fulfillment of the requirements of the Masters in Economics degree.

This submission represents my own work, and to the best of my knowledge and belief, contains no work previously published or written by another person, nor material which to a substantial extent has been accepted for the award of any other degree or diploma at this or any other university or institute of higher learning, except where due acknowledgement has been made in the text.

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ABSTRACT

Islamic banking and finance has grown rapidly in recent decades. Islamic banks offer a range of products that comply with Shari'a law, many of which differ from traditional Western financial products. In addition modern Islamic banks are large entities listed on stock exchanges around the world, and as such are required to provide annual financial statements which accord not only with the relevant regulatory authorities, but also demonstrate the entities' compliance with Islamic principles. In consequence, the development of Islamic accounting standards to guide Islamic financial reporting has become an important issue. A practical response exists in the form of the Accounting and Auditing Organization for Islamic Financial Organizations (AAOIFI), established in Bahrain in 1991. To date, the AAOIFI has published a substantial body of accounting and governance standards, but little empirical research has thus far been conducted into compliance with these standards by Islamic reporting entities. This study provides an initial step in addressing the empirical gap.

An index approach following that used to study compliance and disclosure of Western reporting entities is used to test compliance with the accounting and governance standards published by the AAOIFI. A benchmark index comprised of items identified in the literature as most significant for Islamic accounting is identified through a study of the literature. The English language Annual Reports from a sample of Islamic banks licensed and domiciled in Bahrain provide the data to measure compliance over a three year period.

Items in the index were selected are selected from four categories of particular importance to financial reporting in an Islamic context. The findings of the study show compliance to be very high with respect to two of these areas, the governance standard relating to the Shari'a Supervisory Board of individual banks, and reporting the Islamic *murabaha* contract. In contrast, compliance with the AAOIFI's requirements regarding the *zakah* religious tax and the *mudaraba* contract is relatively low. The latter is a complex product unique to Islam and while some initial reporting problems are not unexpected, it is important that these can be identified. Empirical research can assist in doing this. The findings with respect to the high levels of compliance respecting the Shari'a Supervisory Boards are also important, as these internal bodies form an integral component of the overall regulatory framework within which Islamic banks operate.

Some caution is urged with respect to the interpretation of these findings. The Bahrain Monetary Authority (BMA) has provided a particularly conducive environment for the adoption of the AAOIFI's standards by Islamic financial reporting entities. Such a positive environment is not feasible in many regions where Islamic banks must comply with quite different regulatory frameworks. In addition, some methodological shortcomings, such as the sample size and choice of index items are noted. It is hoped, however, that this study will lead to further empirical research across different regions and with wider sample groups.

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