The Shariah Committee's Perspective on the Disclosure of Islamic Financial transactions in Malaysian Islamic Banks' Financial Statements

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Abstract

The Compliance of Islamic banking with Shariah is crucial, since Shariah compliant is the fundamental differences between Islamic banking and conventional banking. In regards with the preparing of the financial statement, the Islamic bank is required under Islamic Financial Service Act 2013 to prepare its financial statements in accordance with the Malaysian Financial Reporting Standard (MFRS) which is fully complied with International Financial Reporting Standard (IFRS). However, the suitability of the MFRS is questionable due to the inability of IFRS to cater unique characteristics of the Islamic financial transactions. Thus, this study aims to investigate the perception of Shariah committee on the disclosure of Islamic financial transaction in Malaysian Islamic banks' financial statement. In order to achieve the objective, this study adopt qualitative research method. The content analysis technique was also used to develop themes in this study. The finding reveals three imperative themes concerning the disclosure of the Islamic financial transactions. Firstly, Shariah committee's perspective on accounting practices for Islamic financial transactions in Malaysian Islamic banks. Secondly, Shariah committee's perspective on Islamic financial transactions disclosure in financial statements. Thirdly, Shariah committee role pertaining to financial statement in Islamic banks.

Keywords: Financial statement, Islamic banks, Shariah committee, Shariah compliance, Malaysia.

Introduction

One of the fundamental principles of the Islamic banking is the prohibition of riba (usury/interest). Interest is severely prohibited in Islam as dealing with interest-based transactions entails declaring war against Allah and His Messenger (Muhammad peace be upon him). Allah says in the Al-Quran in verses 278 and 279 of Surah Al-Baqarah:

"O you who believe! Fear Allah and give up what remains of your demand for interest if you are indeed believers. If you do not, take notice of war from Allah and his Messenger: but if you repent, you shall have your capital sum: deal not unjustly, and you shall not be dealt with unjustly".

A number of studies on comparing the business model for Islamic and conventional banking have identified significant difference between Islamic banking and conventional banking. These studies have highlighted the differences in terms of structure and practice (Ryu et al., 2012) which include business orientation (Beck et al., 2013), business organisation, economic roles and law of origin (Wan Ibrahim & Ismail, 2015). In addition, referring to Abdullah Saif Al Nasser & Muhammed (2013), Islamic banking is known as a banking system that is based on the principles of Shariah and guided by Islamic economics.

Following on Islamic principles of Shariah, Islamic banking practices are based on the Shariah contracts, where the core of Islamic financial products is the Shariah compliance (Muda & Jalil, 2007; Dinc, 2020). Malaysian Islamic banks have offered their financial products based on wide range of Shariah contracts for instance, among others include musyarakah (partnership), mudarabah (profit sharing), murabahah (cost plus), ijarah (leasing), wadiah (contract of safekeeping), istisna (contract of manufacturing), wakalah (agency), bai' bithaman ajil (deferred-payment sale), bai inah (sale and buy-back) and tawarruq (Islamic commodity financing).

Malaysia is applying Malaysian Financial Reporting Standards (MFRS) which is IFRS based for Islamic financial products. The argument is that, if the Islamic financial products are Shariah compliance, so the application of accounting and reporting standards by Islamic banks should also in line with Shariah principles, hence, is reflected in the financial statement. However, there are criticisms that IFRS is not suitable for Islamic bank (Karim, 2001;Shahul Hameed & Yaya, 2005; Haniffa & Hudaib, 2011; Hussan & Sulaiman, 2016) . For instance, IFRS cannot always accommodate the distinctive nature of the Islamic financial products (Ahmed et al., 2016; Madah Marzuki et al., 2021).

Given the increased emphasis on Shariah compliance of Islamic banks' financial products, it is vital to consider the underlying nature of the financial products' contractual form and substance. This not only distinguishes Islamic financial products from their conventional counterparts, but also ensures system and financial stability (Sheila Ainon Yussof, 2013).

The assurance of Shariah compliance is under the responsibility of Shariah committee, where the committee has to ensure all operations and business transactions of the Islamic banks comply with Shariah. This is a requirement which is imposed by Bank Negara Malaysia (BNM) for each Islamic bank to appoint the Shariah committee. Thus, this indicates that Shariah committee plays a key role in maintaining and assuring the expected level of Shariah compliance of the Islamic banks. Therefore, it is imperative to study whether the financial reporting practices on the Islamic financial transactions of Islamic banks are comply with Shariah. Hence this study is to investigate the perception of Shariah committee on the disclosure of Islamic financial transaction in Malaysian Islamic banks' financial statement.

The remainder of the paper is structured as follows: Section 2 reviews the past related studies. Section 3 explains on the research methodology of the study. Section 4 discuss the main findings. Section 5, which the final section provides the study's concluding remarks.

Literature review

Malaysia palys a significant role in the Islamic banking industry (Ishak, 2019). Malaysia continues to be the biggest market in the SEA region worth of USD 210.0 billion and globally, being the third to Iran and Saudi Arabia (IFSB, 2021). In addition to that, Malaysia has spearheaded the initiative to develop a comprehensive legal infrastructure and regulatory framework of which become global benchmarks (Ariff, 2017; Lujja et al., 2016). For instance, the introduction of Shariah Governance Framework (SGF) and Islamic Financial Services Act 2013 (IFSA 2013) which have been in effect from 1st January 2011 and 30th June 2013 respectively, and are globally the notable framework and regulation (MIFC, 2014).

Table 1: List of Islamic banks in Malaysia

No	Name	Ownership	Type of banking structure
1	Affin Islamic Bank Berhad	Local	Full-fledge subsidiary
2	Al Rajhi Banking & Investment Corporation (Malaysia) Berhad	Foreign	Full-fledge
3	Alliance Islamic Bank Berhad	Local	Full-fledge subsidiary
4	AmBank Islamic Berhad	Local	Full-fledge subsidiary
5	Bank Islam Malaysia Berhad	Local	Full-fledge
6	Bank Muamalat Malaysia Berhad	Local	Full-fledge
7	CIMB Islamic Bank Berhad	Local	Full-fledge subsidiary
8	Hong Leong Islamic Bank Berhad	Local	Full-fledge subsidiary
9	HSBC Amanah Malaysia Berhad	Foreign	Full-fledge subsidiary
10	Kuwait Finance House (Malaysia) Berhad	Foreign	Full-fledge
11	Maybank Islamic Berhad	Local	Full-fledge subsidiary
12	MBSB Bank Berhad	Local	Full-fledge
13	OCBC Al-Amin Bank Berhad	Foreign	Full-fledge subsidiary
14	Public Islamic Bank Berhad	Local	Full-fledge subsidiary
15	RHB Islamic Bank Berhad	Local	Full-fledge subsidiary
16	Standard Chartered Saadiq Berhad	Foreign	Full-fledge subsidiary

Source: Bank Negara Malaysia (2024)

To date there are 16 Islamic banks in Malaysia which can be categorized into two types of banking structure, namely, full-fledged Islamic bank and full-fledged Islamic bank subsidiary. There are five full-fledged local and foreign Islamic banks and eleven full-fledged Islamic bank subsidiaries as shown in Table 1 above.

According to Rosman et al. (2016), financial reporting of Islamic financial transactions is still a subject of unsettled debate among the accountants, auditors and industry observers of Islamic financial institutions. In Malaysia, the issues in financial reporting of Islamic financial transactions have been discussed since early 2000 by both academicians and practitioners. Meanwhile, Abdul Rahman (2010) states that the prohibition of interest (*riba'*) and the different forms of financing have led to modified accounting treatments and disclosure requirements for Islamic banking. Besides, Ahmed et al. (2017) conclude in their initial study that Islamic bank policies and practices have diverted from the theory of Islamic banking and Islamic ideology which is welfare of society.

According to Barth (2015), accounting is the means for financial accountability, which leads to a prosperous society. Furthermore, accounting is also regarded as a social institution which should reflect the distinction of its society (Shahul Hameed & Yaya, 2005). Moreover, Voronova & Umarov (2021), highlight that despite providing methods and techniques for planning, organizing, motivating, communicating and monitoring, accounting also defines and describes the organizational goals, procedures and principles. Therefore, from the Islamic bank perspective, the Islamic bank transactions should be reflected by the financial reporting.

Besides, Haniffa and Hudaib (2011) has made an important framework debut for Islamic accounting by developing A Theoretical Framework for the Development of the Islamic Perspective of Accounting (IPA). The IPA shows explicitly the link between accounting and Shariah.

On the other hand, Hassan et al. (2019), review present Islamic financial standards bodies from inception to recent developments such as Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Islamic Financial Services Board (IFSB) and International Islamic Financial Markets standards (IIFM). They emphasize on the establishment of these Islamic financial standard bodies because of the complexity of Islamic financial contracts and rising growth of Islamic finance with the aim of providing standard for Islamic finance that are harmonized with global practices. However, these standards bodies are lacking of sovereign power which weakens their enforcement of guiding regulations.

In addition, the accounting and auditing practices would administer the implementation of the financial transactions as approved by the Shariah committee at the first stage of the Shariah compliance process as Mohd Zamil (2014) has emphasized and depicted in Table 2. At the same time Mohd Zamil (2014), points out that the involvement of the accounting and auditing practices in the Shariah compliance process would assure the Shariah compliance of the Islamic bank operations and enhance the confidence of the stakeholder in the credibility and legitimacy of the Islamic bank as a whole.

Table 2: Shariah Compliance Process: From Concept to Reporting

Shariah Compliance	Financial Institutions	Accounting Standards	Auditing Standards
Approval of product development and innovation	Implementation of Approved product	Financial accounting and reporting	Auditing
Prudential requirement			
Shariah based prudential requirement			

Source: Mohd Zamil (2014)

Previous research and studies have discussed extensively the linkage between Islamic product and Shariah (Ahmad et al., 2017; Ahmed, 2014; Ali & Hassan, 2020; Asadov et al., 2018; Fa-Yusuf & Ndiaye, 2017; Ismail et al., 2016; Loke & Thaker, 2017). However, little research has been carried out to investigate the links between Shariah and accounting practices and reporting. Meanwhile, research on the linkage between Shariah principles and the financial reporting have been more studied in Islamic non-profit organizations, for instance, waqaf institutions studied by Che Azmi & Hanifa (2015) and mosque by Zakariyah et al. (2017) which rely on sources on zakat, waqf and sadaqah (Ramli et al., 2018).

Meanwhile, Isa & Lee (2020) investigate how the Shariah committee in Islamic banks affects banks' risk-taking behaviour and performance. The panel data from 15 Islamic banks in Malaysia from 2007–2016 was used for this investigation. They found that members with finance/banking qualifications are positively related to risk-taking and performance. Thus, they provide justification that the regulators should take into account the Shariah committee's composition in order to ensure a diversity of expertise pertaining to the banking industry and that the roles and functions of the Shariah committee should be revised to emphasize both Shariah compliance, and the business aspects of the banking operations.

In further study, Isa et al. (2022) evaluate the roles and functions of the Shariah committee of Islamic banks in Malaysia and to recommend a resetting of the scope of responsibilities to enable the Shariah committee to effectively respond to current market needs. Thus, their results conclude that Shariah Committee are not involved in product development, nor responsible for financial performance. Their results also provide evidence that the Shariah committee highlights three ways for further development of their role: improving banking knowledge of the members, more engagement with the board of directors and broadening the functions of Shariah committee.

Despite the abundance of literature revealing the linkage between Islamic financial transactions and Shariah, there are still few comprehensive and rigorous studies on the disclosure of the Islamic financial transaction disclosure in financial statements and Shariah. Hence, this study is an attempt to fill this gap by comprehensively examining the Shariah committee's perspective on the disclosure of Islamic financial transactions in Malaysian Islamic banks' financial statements.

Methodology

In order to achieve the objective, this study adopt qualitative research method. Qualitative research helps to describe the behavior of the people in the research field (Effendi, 2013), allowing the researcher to understand how people interpret their experiences, construct their worlds, and give meaning to their experiences (Merriam, 2009a).

Semi-structured, face-to-face interviews are the primary method of data collection in this study. A comprehensive interview guide was developed by the researcher. According to Merriam (2009) the interview guide would help the researcher to gain the experience and confidence in conducting more open-ended questioning and the guide helped the researcher to conduct the interview process smoothly.

This study uses the purposeful sampling technique in selecting the best-fitted participants for the interview. Creswell (2009) points out that purposefully select participants help the researcher to understand the problem and the research question thoroughly and involve small samples.

A potential list of interviewees is established, drawn from all the 16 Islamic banks in Malaysia as shown in Table 1. The official letters and/or emails requesting an interview session are sent to the Shariah committees of the 16 Islamic banks. Ten Shariah committees from six Islamic banks answered positively as shown in Table 3.

Table 3: List of interviewees and their background

Code name	Designation	Number of people	Experience (years)	Ownership	Type of banking structure
CSC 1	Chairman of Shariah committee	1	8	Local	Full-fledge
CSC 2	Chairman of Shariah committee	1	14	Local	Full-fledge
MSC 1, 2	Member of Shariah committee	2	6, 7	Foreign	Full-fledge
MSC 3, 4, 5	Member of Shariah committee	3	7, 5, 5	Local	Full-fledge subsidiary
MSC 6	Member of Shariah committee	1	9	Foreign	Full-fledge subsidiary
CSC 3, MSC 7	Chairman of Shariah committee, member of Shariah committee	2	1, 3	Foreign	Full-fledge subsidiary
Total		10			6 banks

Source: Developed by the author

All the interviewees had agreed their interview to be recorded. The interview time duration was between 30 minutes to 90 minutes. The interview was conducted in both languages, in Malay and English as most of the interviewees spoke both languages (Malay and English).

Each of the interviews was transcribed verbatim and coded, providing textual material for analysis. The transcription process was done before the next interview was conducted. In order to protect the confidentiality and anonymity of the respondents, pseudonyms were used. The interview in Malay was translated into English by a translator.

In this study, content analysis was used, which involved reading the transcriptions thoroughly and repeatedly and highlighting words or phrases that represented information connected to the Islamic financial transaction disclosure for example. During this process, the emerging themes become the data's initial codes.

Findings and discussions

Shariah committee's perspective on accounting

Most of the the interviewees agreed that the accounting is a tool or system that could ease the disclosure of the Islamic financial transactions that could only capture the quantitative information. Furthermore, they also of the opinion the accounting will not affect the Shariah compliance. Below are some of the answers that support the above opinion:

Accounting is a practice that ensures everything is in place as it should be [MCS1].

Accounting only captures quantitative information. So, the qualitative items it can't capture. So, it's a tool that captures certain information, and then depending on the institution, it may only report material information [MCS3].

An accounting is like a system, as long as there is no contradiction with the Shariah, no frauds, we can say it is Shariah compliance [MSC1].

On the other hand, some Shariah committees acknowledge that accounting has an impact on Shariah compliance and highlighted embedding of the spirit and the beauty of Islam in the financial statements. The statement of the interviewees are as follows:

An accounting is the proof that the transaction is Shariah compliance. Because we have a contract, whereby, in this Shariah, what is really matter is the contract. This agreement is binding with the accounting report. So, if we have any dispute later on, then we have to refer to the accounting report [MSC5].

If accounting principles are not implemented in accordance with Shariah principles in financial reporting, then, the Shariah system in the bank will be violated [MSC2].

Shariah committee's perspective on Islamic financial transactions disclosure

The majority of the Shariah committee recommended for more disclosure on Islamic financial transactions in the financial statements, as the current standards do not capture the essence of the transactions.

Financial transactions (Islamic) are unique in nature, and of course the conventional standard cannot capture that uniqueness of the transactions [MSC7].

There should be more disclosure in the financial statement. Currently IFRS does not restrict in terms of disclosure in the financial statement. Therefore, I think the management should be generous enough to provide more and more disclosure in order to educate, to make the stakeholder understands better how the Islamic financial institution's financial statement rather than they compare both (the conventional and the Islamic) looks the same [MCS6].

We need to look things in integrated manner, not only product disclosure, it should encompass financial disclosure, management, all kinds of thing. I think that's the whole idea. We want to show the beauty of Islam [MCS6].

Shariah committee role pertaining to financial statement in Islamic banks

The financial report is being presented to the Shariah committee prior to being presented and published. Subsequently, the Shariah committee will look at it in general and focus on specific items. The statement of the interviewee is as follows:

Financial report or the annual report was indeed presented to the Shariah committee before being approved [CSC2].

Certain items that we are focused on, for example, zakat. The discussion on how it was distributed or the calculation of zakat, were reviewed in separate meetings. Time was spent specifically to calculate zakat. That is the duty of the Shariah committee to approve it. The other items are related to, for example, sources of income that are not Shariah complaint [CSC2].

To summarize, it can be said that a majority of Shariah committees supported the current accounting practices do not affect the Shariah compliance. However, the Shariah committee is concerned with incorporating the spirit and the beauty of Islam into the financial statement. Nevertheless, the shariah committees are inclined to have more disclosure of the Islamic financial transaction and they believe that it is not compulsory, and it is not a priority for them to focus on the disclosure of the Islamic financial transactions in the financial statements.

Conclusion

This study gathered the views of Shariah committee regarding the disclosure of Islamic financial transaction in Malaysian Islamic banks' financial statements via semi-structured interviews. The finding reveals three imperative themes concerning the disclosure of the Islamic financial transactions. Firstly, Shariah committee's perspective on accounting practices for Islamic financial transactions in Malaysian Islamic banks. Secondly, Shariah committee's perspective on Islamic financial transactions disclosure in financial statements. Thirdly, Shariah committee role pertaining to financial statement in Islamic banks.

The IFRS has become widely used around the world and the number of nations adopting it has increased in recent years. These findings can give some insight to the practitioners as well as to the policymakers and regulators. Furthermore, this study also has significant contributions to the body of knowledge.

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