
COMPARATIVE ANALYSIS OF FINANCIAL REPORTING PRACTICES IN CONVENTIONAL AND ISLAMIC BANKS IN MALAYSIA

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ABSTRACT

The financial position and performance for any company are translated into the financial statements which form part of the Annual Report of the company. Information in the financial statements of Islamic financial institutions (IFIs) is important for stakeholders to make economic and investment decisions as well as to assess the IFIs' extent of compliance with the *Shariah* principles and whether or not they have completed their duty in contributing to socioeconomic justice and stability. This paper aims to examine the differences between the financial statements of Islamic and conventional banks in order to highlight the differences of operations of both types. Although both types of banks are using the same accounting standards, there are issues unique to Islamic banks that require the management to provide different types of information in addition to the standard information found in conventional banks' annual reports. In this study, we have conducted a comparative analysis using qualitative method by the way of content analysis to examine the differences between financial statements of Islamic banks and their conventional counterparts. The study found that the difference of disclosure of financial information in the two types of banks is due to the different nature of Islamic banks' operation as compared to the conventional banks especially in investment management and the use of its Islamic financial contracts. As for the components of annual report,

little differences were found from the content analysis of the banks under analysis. This study recommends some improvements for the Islamic bank's financial reporting so that they would provide more transparency in a fair and equitable manner to the users view of observing Islamic principles and making economic decisions. Detailed future work could be done to study the usefulness of additional information on financial statements of Islamic banks from the perspectives of stakeholders.

Keywords: Financial statements, Islamic banks, conventional banks

INTRODUCTION

Islamic Finance has become an industry that has shown tremendous growth and developed as a competitive form of financial intermediation that has been able to meet the differentiated requirements of the Malaysian economy. This has critically positioned Islamic banks in Malaysia to quickly adopt the most sophisticated financial systems as well as varieties of Islamic financial instruments to cater the growing needs of the people in Islamic Financing facilities.

The increasing demand for Islamic Financial products in recent years has led to the increasing number of Islamic Financial Institutions (IFIs) offering different types of Islamic Financial products. Due to this fact, Islamic Financial Institutions demand for a more thorough and effective financial and *Shariah* reporting framework as well as the disclosures of information which are useful for investors and stakeholders in making economic decisions.

The nature of Islamic banking emphasizes on the importance of lawful and equitable banking business and financial activities, in its transactions and conducts. The IFIs's financial activities as well as its conventional counterparts will be reflected in the financial statements and those financial reporting must comply with certain standards and guidelines outlined by Bank Negara Malaysia (BNM) known as GP8 (Guidelines on Financial Reporting for Banking Institutions) and GP8i (Guidelines on Financial Reporting for Licensed Islamic Banks). In achieving fair and equitable treatment for all stakeholders of the financial institutions, it is very much important for each Islamic and conventional financial institution to abide with the rule of transparency.

LITERATURE REVIEW

Financial statements are equally important for both Islamic and conventional banks. It provides information to the users of the statements which will help them in the decision making process. The only difference is for Islamic banking, beside the need in making economic decisions, is that the users also will view whether the Islamic bank is operating within the context of *Shariah* principles. This is important because Islamic banks have a duty in contributing to socioeconomic justice and stability. This is also part of the accountability that each Muslim holds in front of God on earth since what and how we use wealth is a serious responsibility that needs further attention.

Islamic Accounting serves the big scale of stakeholders which in fact, it serves the society as a whole (Ibrahim, 2009). Thus, communicating information on Islamic banking activities to the stakeholders is important and must be done diligently and truthfully. The duty to disclose the truth is a very important issue in the Islamic context, and this duty applies to businesses as much as to individuals (Maali et. al., 2006).

Implementation of financial reporting standard differs between banks and countries due to the differences in how the banks are organized and operated since different bodies will have unique sets of performances. It can be seen from previous literatures that accounting systems across countries and organizations are influenced by many factors including the environment, the speed of business technological innovations, political and economical pressures, and most importantly the level of education (Sulaiman, 2003). Therefore it is natural to expect that Islamic banks would have distinguished accounting systems compared to its conventional counterpart based on the different product development and bounded by the principles of *Shariah*. Furthermore, it can be logically seen that the necessity for Islamic accounting to emerge as being different from the conventional system, stems from the separation of conventional and Islamic banks in the first place (Tag El-Din, 2004).

Since Muslim countries are now aware of the need to “align their economies to accord with the tenets of Islam” (Sulaiman, 2003), it goes hand in hand that the principles of accounting for Islamic societies also

need to change. If not, both theory and practice will not converge and will not represent the real-life activities; therefore the initial purpose of recording the details of transactions would lose ground. However, this does not mean the rejection of conventional practices of accounting and producing financial statements, but to add in more of the Islamic components and taking out those of the prohibited to make the reports Islamic in nature.

In the conventional system, the International Accounting Standard Board (IASB) plays an important role where the International Financial Reporting Standards (IFRS) was being introduced in 2008. The main purpose for this is to encourage a more transparent system in producing financial statements so that the true position of a bank or organization can be seen. The public are then able to use the information to evaluate the financial position of each entity and at the same time, the nature of risks that arise as a result of each transaction. All the information will usually be presented through the balance sheet, income statements, cash flow statements, statement of changes in retained earnings, and finally the notes to the accounts.

With the increasing awareness of Muslims throughout the world to move towards a more Islamic economy, AAOIFI FAS 1 implemented three additional components: statement of changes in restricted investments, statements of sources and uses of funds in Zakat and Charity Fund, and statement of sources and uses of funds in Qard. It can be seen that the differences are not in the general picture of how the transactions are recorded, but it is how funds are actually used. A reason why the knowledge on the uses of funds is important is to minimise the imbalances between the rich and the poor through the distribution of Zakat.

By writing out our responsibilities and events that occur, our sincerity and honesty are both tested on Islamic grounds and good deeds would certainly be rewarded. This is what Islamic accounting is supposed to do through its financial statements. This is further supported by (Maali et. al., 2006) in their view that elements of accountability, social justice, and ownership are the three main cores of Islamic perspective on social relations.

METHODOLOGY

We have adopted a qualitative approach to analyse the financial statements of both Islamic and conventional banks. We analysed the main contents of Islamic banks' financial statements and made the comparisons with the conventional banks. Specific items which represent the differences between Islamic banks and conventional banks are highlighted.

For the purpose of this study, we have chosen CIMB Islamic Bank and Bank Islam Malaysia Berhad (BIMB) to represent Islamic banks. Maybank Berhad (MBB) and CIMB Bank Berhad were examined to represent the conventional banks. All the financial statements are for the year 2009 and are available online on the respective companies' website.

RESULTS AND DISCUSSION

Financial reports provide a general idea of financial position as well as the financial performance of a business entity in a structured manner which is user friendly and easy to understand. It serves as a strategic review to the investors by facilitating comparisons in assessing alternative investment with minimum cost and helps them in making rational decision on what should be considered as a good investment.

In general, banks deal with deposits and financing rather than manufacturing and selling goods, which results to the financial reports for banks to be different from the manufacturing and service companies (Ismail, 2010). The IASB, for instance has developed a specific standard for banks, i.e. IAS 30: Disclosures in the Financial Statements of Banks and Similar Financial Institutions. The Standard was later superseded by IFRS 7 effective in 2007. IFRS 7 deals with disclosures of financial instruments.

On the other hand, Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has also highlighted on the importance of financial reporting for Islamic banks as stated in Financial Accounting Statement No. 1 (FAS No. 1) and FAS No. 2 which emphasized on the importance of contractual rights and obligations and adherence to the *Shariah* principles as well as addressing the issue

of prohibited earnings and expenditures while ensuring reasonable rates of returns to the depositors. Among the objectives of financial reporting for Islamic banks are summarized as follows:

- The operations of Islamic banks must be *Shariah* compliant in terms of its principles, rules and opinions
- Must clearly distinguish and disclose any prohibited earnings and expenditure
- Present entity's economic resources and obligations and related risks pertaining to its assets and liabilities
- *Zakat* obligations must be determined for both depositors and shareholders
- Estimation of cash flows and related risk of bank's financing assets
- Ensuring reasonable rates of returns to investors
- Disclosure of Islamic bank's discharge of social responsibilities

The difference of disclosure of financial information in the two types of banks owes to the different nature of Islamic banks' operation as compared to the conventional banks especially in investment management and investment using Islamic financial contracts. As for the components of annual report, little differences were found from our content analysis on the banks under analysis. The results of our content analysis are highlighted in two sub-sections namely differences in operations and differences in annual reports.

Differences in Operations

There are similarities and differences in the functions of Islamic banks and conventional banks.

The main functions of an Islamic bank can be classified into;

- Investment Management,
- Investment using Islamic financial contracts,
- Financial services and
- Social services.

When comparing an Islamic bank to a conventional bank, more differences can be seen in the first two areas while the majority is similar for the later two functions.

Investment managements

In general, the basic mechanism for both Islamic and conventional bank is to accept deposits and offer financing facilities to the customers. Deposits are recorded under the liability section while financing facilities disbursed to customers are recorded under the assets section (Tag El-Din, 2004).

What makes investment management in Islamic banks to be different than how it is done in conventional banks is that Islamic banks have to make sure that all their operations are in the conformity of *Shariah* principles. Table 1 summarises the differences in operations of an Islamic and a conventional bank.

Table 1 : Differences in Operations between Islamic and Conventional Banks

CONTENTS	CONVENTIONAL BANKS	ISLAMIC BANKS
Standard and Guidelines	IASB (IFRS), FASB (GAAP), Local regulatory body – MASB in Malaysia	AAOIFI (FAS and SS), IFSB, Local regulatory body
Sources of Income	Interest and commission	Share of profit/loss and fees
<u>Granting of loans:</u> Interest based Interest free (Qard Hasan)	Yes (Main field) No	No Yes
<u>Investment:</u> Trading in commodities & leasing Participation in clients' businesses (Profit Sharing)	No No	Yes Yes

Source: Authors' analysis from various annual reports

Based on the analysis of the deposits structure of the selected Islamic banks, we found the deposits are reported in two different manners. For CIMB Islamic, the deposit has been reported in two ways: *Mudharabah* and non-*Mudharabah* (*Wadiah* or *Qard Hasan*). Meanwhile for BIMB, it classified deposits into types of accounts (current and investment accounts) without further explanation on the contracts. In practice, Islamic banks provide guarantee only for deposits placed by customers in *Wadiah* or *Qard Hasan* savings and current accounts and these deposits are treated as liabilities in Islamic bank (Ismail, 2010).

Meanwhile for *Mudharabah* investment account, banks do not guarantee the capital and at the same time depositors do not have the right to monitor the management of business transaction. *Mudharabah* is considered unrestricted if the depositors do not put any restrictions on the uses of funds, and if they put any restrictions in *Mudharabah*, the investments are considered restricted. The Islamic banks can co-mingle the unrestricted account's funds with their shareholders' funds and invest both funds under the bank's management in the same investment portfolio. Bank will report these investments in the bank's balance sheet and income statement.

On the other hand, restricted investment accounts are not considered an element of bank's balance sheet because the Islamic bank does not have the right to use or dispose these funds and therefore it is an off balance sheet items.

In conventional banks, they receive deposits from customers and they report this transaction in a liability section because bank guarantees the deposits and also promises for the return (interest). That is why there is interest expense in Income statement of the financial report.

Investment using Islamic financial contracts

The functions of Islamic banks are different from the conventional banks in investments as Islamic banks uses financial contracts which could be done in several ways. Such examples are Musyarakah Investment, Murabahah, Ijarah and Sukuk investment.

Financial services

The financial services of conventional banks and Islamic banks are almost similar besides traces of interest involved in the former. Fees and commission are analogous to the functions and also Letters of Credit where the bank guarantees the import of an item using its own funds for a client, on the basis of sharing the profit from the sale of this item or on a mark-up basis. The services are provided on a commission or charges basis.

For credit cards facility, there is slight difference between the two types of banks. For Islamic banks credit cards, the contract is based on sales and purchase agreement and the late payment charges (*ta'widh*) is not compounded in the total principal amount where as in Conventional banks credit cards, the contract is based on loan agreement and the late payment charges is compounded on the principal amount.

Other differences in terms of operations of both Islamic and conventional banks can clearly be explained based on the services being offered: financing, deposits, and remittances. Remittances services provided by Islamic banks are similar to conventional banks where the bank's own money is not involved.

Other service charges in conventional banks are due from no interest loans, but levied with service charge to cover the bank's expenses. This charge may be subject to a maximum set by the authorities. No-cost loans are also provided to needy parties such as small farmers, entrepreneurs and producers. Overdrafts are also available, subject to a certain rate of interest.

Social services

Both types of banks engage in social services. Islamic banks are not only obliged to report the information regarding the economic performance of the banks but also the information about the banks' achievements in fulfilling their financial reporting on *Shariah* compliance and social and environmental to their stakeholders.

Differences in the Presentation of Annual Reports

From the sample banks we found that the general components of the annual reports are almost similar (Chairman's message, corporate profile, statement of corporate governances, audit committee report, etc) for all banks. One difference is that some banks do not have a few components which others have. For instance, MBB and BIMB explicitly show their shareholding structure, while both CIMB Berhad and CIMB Islamic do not.

Another difference is the *Shariah* Advisory Report which is provided by the two Islamic banks and not MBB and CIMB Berhad. However, we find that the report from BIMB is much more detailed compared to CIMB Islamic's report. BIMB provides a more specific description of what the committee has considered, reviewed, and approved during the financial year through meetings. This is important to see whether the product development of the bank is actually adhering to the *Shariah* law or not.

In addition, although all our sample banks provide the statement of internal control, we think there is a need to improve on these statements since most of these only portray the descriptive scenario of responsibilities on internal control, not going into the details of its weaknesses and further improvements to be done in the future. It is understood that no company or organization would feel at ease in displaying the many events but for these banks to promote the welfare of society and bringing about the truth and sincerity in handling the public money, it would not be harmful to just be more transparent.

As for the financial statements, the differences are due from the fact that the operations differ as discussed earlier in this report. Although the description of transaction may have almost similar titles, the actual source or events are actually different. Table 2 and 3, shows the differences in title for the transactions in balance sheets and income statements.

Table 2: Differences of Components in Balance Sheet of Islamic and Conventional Banks

	CONVENTIONAL BANK	ISLAMIC BANK
ASSETS	Cash and short-term funds Deposits and placements Loan & Advances Statutory Deposits Fixed Assets Other Assets	Cash and short term funds Deposits and placements Financing & Advances Statutory Reserve Fixed Assets Other Assets
LIABILITIES	Deposits Bill & Acceptances Derivative Liabilities Provision of tax and zakat	Deposits Bill & Acceptances Islamic derivative financial instruments Provision of tax and zakat
EQUITY	Owners' Equity	Owners' Equity

Source: Authors' analysis from various annual reports

For a conventional bank, the assets differ from Islamic banks through the loan and advances versus the financing attribute in Islamic banks. For example, MBB's Loan and Advances largely comes from overdrafts and term loans which BIMB does not have. In CIMB Islamic however, although said to be an Islamic bank, there are still loans given, but in a small amount which still needs to be disclosed in the report as stated in its notes to financial statements. Generally, Islamic and conventional banks do have cash and liquid assets. But in Islamic banks, these are mainly cash assets and not instruments like treasury bills as in the conventional banks (Al-Omar & Abdel-Haq, 1996).

In the liabilities section, the derivatives are replaced with Islamic derivatives for Islamic banks, also shown in Table 3. However, BIMB does not deal with any sort of derivatives according to its balance sheet.

The Islamic derivative financial instruments of CIMB Islamic is shown to come from various instruments including direct credit substitutes, irrevocable commitments to extend credit, and foreign exchange related contracts as compared to MBB derivatives: currency forwards and swaps, options, and interest rate swaps.

Table 3: Differences of Components in Income Statement of Islamic and Conventional Banks

CONVENTIONAL BANK	ISLAMIC BANK
Interest income (Interest expense)	Income from depositors and shareholders' funds
Net Interest Income +Non interest income	(Allowances for losses on financing) (Impairment losses) (Profit Equalization Reserve)
Net income (Non interest expense) (Allowances for losses on loans and advances)	Total Distributable Income (Income distributable to depositors)
Operating profit (Impairment losses)	Total net income (Overheads and Expenses)
Profit before taxation and zakat (Taxation and zakat)	Profit before zakat and tax (zakat and tax)
Profit (Loss)	Net Profit (Loss)

Source: Authors' analysis from various annual reports

The differences in the income statements are the results from the different schemes of operations for both Islamic and conventional banks. Since conventional banks operate from the interest based scheme, the source of income or revenue will directly come from these features as shown in Table 2 for MBB and CIMB Berhad. While for BIMB and CIMB Islamic, the income comes only from depositors' and shareholders' funds as a result of the profit sharing scheme in Mudharabah or *Musharakah* financing.

CONCLUSION

From the content analysis of the financial statements of both Islamic and conventional banks, we offer some recommendations to improve the content of financial statements of Islamic banks.

Firstly, Islamic banks may provide explanations to the Islamic financial transactions reported by providing the information on the Shariah permissibility of the transactions with indications of sources of the rulings.

Since the remuneration of the Shariah supervisory council members is quite significant, the stakeholders has a right to demand more explanation to justify the figure. BIMB has included a more detailed Shariah supervisory council report listing down the functions carried out by the Shariah committee throughout the year. It has also tracked the amount from non-halal income sources which needs to be disposed off to charity. We would recommend CIMB Islamic to follow a similar approach rather than only stating the opinion of conformity with the Shariah. In addition, the banks should try to include a Shariah compliance audit by an external independent Shariah committee and giving ratings on the Islamic financial products of the bank.

Islamic financial report should use the Hijrah or Islamic calendar for the period covered in the financial report to give the impression of being more Islamic. This helps the *Zakat* payments as *Zakat* are paid on lunar year. At the moment all Islamic financial reports operate on Gregorian calendar which can mislead the payment of *Zakat* which is an important act of ibadah. Muslims are supposed to pay 2.5% of their wealth every lunar year; which on the contrary of using Gregorian calendar, the calculations was adjusted to 2.557%.

To make the financial report more Islamic it needs to help the *Ummah* as Hamid et al. (2009) argued that the concept of disclosure is related to the concept of accountability: The *Ummah* has the right to know how organizations that are part of the *Ummah* affect its well-being.

Harmonization of Islamic financial report will reduce ambiguous elements and eliminate confusion. From the two Islamic banks' financial report observed they have different displays and very difficult to follow up especially for non connoisseurs. Those who prepare financial reports may take advantage to conceal the truth of the content in the financial report which is against Islamic teachings. Truth is an important aspect in Islamic teaching as Hamid et al. (2009) added that "the duty to disclose the truth is a very important issue in the Islamic context, and this duty applies to businesses as much as to individuals".

The financial report can be more Islamic if it describes more on the welfare of the Islamic *Ummah*, for example most Islamic banks only spend minute amount on Qard Hassan. The financial report could be more Islamic if the income statement section could show more on expenses on the welfare of the disadvantage *Ummah*.

Finally, for the financial report to be more Islamic, it needs to involve employees and other general welfare. As discussed by Gray, et.al (1987), the disclosure in the annual report is expected to include the entity's contribution to employee well-being, product quality, public health and safety, environment protection, and related social aspects. It is a fact that many banks already include employees' benefits in its financial report; however, it is short of the public health and safety etc.

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