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Regulatory Compliance of IFRS-7: A Case Study on the Islamic Banks of Bangladesh

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ABSTRACT

The paper is an earnest effort to inspect the prevailing accounting standard for the Islamic banks and find out the extent of their compliance. Banking industry's nature of operation is totally diverse. Recognizing this aspect, some specific IFRS (International Financial Reporting Standard) have been prescribed for them. One of which is IFRS 7. Institute of Chartered Accountants of Bangladesh prescribed to comply with IFRS-7 from on or after 1st January, 2010. As per requirement, all Islamic banks are required to comply with the standard to uphold the stakeholders' interest. And the result of the study shows that all of the Islamic banks compliance almost 70.71% of the IFRS # 7 requirement. Finally this study recommend on the degree of compliance for the Islamic banks financial reporting.

Keywords: Compliance IFRS, AAOIFI, Islamic banks, profit–loss sharing (PLS).

1. INTRODUCTION

Banking industry is the most dynamic as well as the most contributing sector of our economy. Banking can be termed as one of the primitive business though its institutional look is not aged. Banking sector is the driving force of any country for its sustainable development. It is more than truth for a developing country like ours. At present Bangladesh have 56 scheduled commercial banks, 7 fully Islamic banks, 21 banks having Islamic banking, 6 Islamic banks, 4 nationalized commercial banks, 4 specialized Banks and some NGOs operating for micro credit expansion.

Bangladesh is one of the largest Muslim countries in the world. The people of this country are deeply committed to Islamic way of life. Naturally, it remains a deep cry in their hearts to fashion and design their economic lives in accordance with the precepts of Islam. The establishment of Islamic Banking in Bangladesh is the true reflection of this inner urge of its people, which started function, is

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committed to conduct all banking and investment activities on the basis of interest-free profit-loss sharing system. In doing so, it has unveiled a new horizon and ushered in a new silver lining of hope towards materializing a long cherished dream of the people of Bangladesh for doing their banking transactions in line with what is prescribed by Islam. Above all they are business entities. Therefore compliance of required laws and regulations are compulsory for them. Here lies the major clue for the compliance of accounting standard. Banks and other similar financial institutions are different from other business entities. To disclose the financial performance and financial position of this type of financial institutions, regulatory watchdogs prescribed different techniques. One of such techniques is to comply with the applicable accounting reporting standard such as IFRS 7. Compliance of IFRS aims at faithful representation of financial performance and financial position of an entity. In spite of being flourishing and major sector prior work on compliance with IFRS-7 shows a questionable conclusion as to the degree of compliance. Moreover prior works were done on commercial banks and with other standards also, hence comes the scope of scrutinizing compliance of IFRS-7 by the Islamic banks of Bangladesh. Again since people have more reliance on these banks, so it has deep importance to find out the compliance status of these banks.

2. THEORETICAL BACKGROUND

2.1. Islamic Banking

An Islamic banking and financial system exists to provide a variety of religiously acceptable financial services to the Muslim communities. In addition to this special function, the banking and financial institutions, like all other aspects of Islamic society, are expected to 'contribute richly to the achievement of the major socio-economic goals of Islam'[4]. The most important of these are economic well-being with full employment and a high rate of economic growth, socioeconomic justice and an equitable distribution of income and wealth, stability in the value of money, and the mobilization and investment of savings for economic development in such a way that a just (profit sharing) return is ensured to all parties involved. Perhaps the religious dimension should be presented as a further explicit goal, in the sense that the opportunity to conduct religiously legitimate financial operations has a value far beyond that of the mode of the financial operation itself.

[4] M. Umer Chapra. (1985). Towards a Just Monetary System. Leicester: The Islamic Foundation, 1985/1405 A.H., p. 34

Islamic banks have been operating in Bangladesh for about one and half decade alongside with the traditional banks. Like any other traditional commercial banks, they do mobilize deposits and produce loans. But their modes of operation, based on shariah, are different from the other traditional commercial banks. Islamic banks can provide efficient banking services to the nation if they are supported with appropriate banking laws, and regulations. This will help them introducing PLS modes of operations, which are very much conducive to economic development. It would be better if Islamic banks had the opportunity to work as a sole system in an economy. That would provide Islamic banking system to fully utilize its potentials. Studies show that Islamic banks cannot operate with its full efficiency level if it operates under a conventional banking framework, their efficiency goes down in a number of dimensions[5]. The deterioration is not because of Islamic bank's own mechanical deficiencies. Rather it is the efficiency-blunt operations of the conventional banking system that positions obstructions to efficient operation of Islamic banks. This does not mean that the survival of Islamic banks operating within the conventional banking framework is altogether threatened. Evidences from Bangladesh indicate that Islamic banks can survive even within a conventional banking framework by which over from Profit Loss Sharing (PLS) to trade related modes of financing.

2.2. Islamic Banks in Bangladesh

At present there are seven fully Islamic banks in Bangladesh and 21 banks have their Islamic banking services .The list of Islamic banks are

- Shahjalal Islami Bank (SIB)
- Islamic Bank Bangladesh Limited (IBBL)
- First Security Islamic Bank (FSIB)
- ICB Islamic Bank Limited (ICB)
- Export Import Bank of Bangladesh Ltd. (EXIM)
- Al-Arafah Islami Bank Limited (AAI)
- Social Islami Bank Limited (SIBL)

3. OBJECTIVES OF THE STUDY

1. To find out the degree of compliance of the standard by the banks.
2. To find out the deviation from the standard.

[5] Abdul Awwal Sarker. Islamic banking in Bangladesh: Performance, problems & prospects. *International Journal of Islamic Financial Services*, *1*(3), 01.

4. METHODOLOGY OF THE STUDY

Secondary source of information has been analyzed to draw the conclusion on the topic. This includes annual reports, articles on this issue, different relevant acts etc. Content analysis which is widely being used in a social science research which involves reading the annual report and pocking up both qualitative and quantitative information is performed for this empirical study. Weight was assigned to find out the average percentage of compliance, for compliance of each requirement 1, for partial compliance 0.5 and for noncompliance 0.

5. LITERATURE REVIEW

Islamic banking is a new area in the banking world and it is an integral part of current and future financial market. As the history of Islamic banking in the legal format is long the research study on the financial reporting disclosures by the Islamic banking is not so rich. Moreover, it is important to bear in mind that the specific characteristics of Islamic financial institutions (IFIs) which leads to distinctive international accounting standards for Islamic finance[6]. Hossain S, Hossain I and Azad M.H stated the compliance of IAS 30 of the Islamic banks disclosure. Hossain S, and Baser M. A described the compliance of IAS 30 of the specialized banks disclosure. Hossain S, Ahmed K I and Jobair M. stated the compliance of IAS 30 of the private commercial banks disclosure. There is no study about the current study about compliance of IFRS 7 of Islamic Banks of Bangladesh. IAS 30 and IFRS 7 are not similar in functions. In spite of similarity in nature IFRS 7 is different presentation of disclosures which are the updated than that of IAS 30. This study reveals the gap and fill it up. Today most of Islamic banks in different market except Malaysia, Bahrain, Pakistan, Qatar and Saudi Arabia have followed the IFRS to comply the standard of disclosures along with domestic modification of the standard[7].

[6] Dr. Mohamad Nedal Alchaar, Secretary General, AAOIFI, (September 2010). Harmonizing financial reporting of Islamic finance, ACCA, page 14.
[7] Harmonizing Financial Reporting Of Islamic Finance, ACCA September 2010, page 9.

Table 1: Accounting Standards Applicable To Islamic Banks by Country

Country	Accounting standard(s)
Bahrain	AAOIFI and/or IFRS
Indonesia	Indonesian GAAP (inc. specific standards for IFIs)
Kuwait	IFRS and AAOIFI
Malaysia	Malaysian GAAP (inc. specific standards for IFIs)
Pakistan	IFRS, with some local amendments for *all* banks
Qatar	AAOIFI
S Arabia	IFRS (with additional requirements for all banks)
UAE	IFRS (inc specific requirements for IFIs)
UK	IFRS or UK GAAP

Sources: Harmonizing Financial Reporting of Islamic Finance, ACCA September 2010, page 9

During the last decade in the Islamic financial market, there is a strong demand for Islamic accounting standard and the ultimate result we see that like the corporate governance standards issued by the Islamic Financial Services Board (IFSB) as well as the Islamic Accounting and Auditing Standards (IAAS) issued by the AAOIFI. Another compliance by the Islamic banking is Shariah compliance look through by the Shariah Supervisory Board (SSB) which is the most important governance mechanisms for IFIs to ensure compliance with Shariah[8]. Future study is strongly needed to find the degree of compliance by Islamic banks to those standards which are specially designed for the IFIs.

6. FOCUS POINT OF IFRS 7 (FINANCIAL INSTRUMENTS: DISCLOSURES)

6.3.1. Classes of Financial Instrument: Disclose the types of financial Instruments contained in the Balancer Sheet [IFRS 7.6]

6.3.2. Disclosure of Balance Sheet Significance: Disclose the significance of financial instruments for an entity's financial position and performance. [IFRS 7.7]

6.3.3. Balance Sheet Disclosure: This includes disclosures for each of the following categories: [IFRS 7.8]

[8] Mohd Hairul Azrin Haji Besar, Mohd Edil Abd Sukor, Nuraishah Abdul Muthalib and Alwin Yogaswara Gunawa. (January 2009). The Practice of Shariah Review as Undertaken by Islamic Banking Sector in Malaysia. *International Review of Business Research Papers*, *5*(1), 294-306.

- Financial assets measured at fair value
- Held-to-maturity investments
- Loans and receivables
- Assets available-for-sale
- Financial liabilities at fair value
- Financial liabilities measured at amortized cost

6.3.4. Collateral [IFRS 7.14-IFRS 7.15]: Disclose any pledged Asset for Liability.

6.3.5. Income Statement and Equity: Items of income, expense, gains, and losses, with separate disclosure of gains and losses from: [IFRS 7.20(a)]

6.3.6. Accounting Policies for Financial Instruments [IFRS 7.21]

6.3.7 Information about Hedge Accounting [IFRS 7.22]

- Description of each hedge, hedging instrument, and fair values of those instruments, and nature of risks being hedged
- For cash flow hedges, the periods in which the cash flows are expected to occur, when they are expected to enter into the determination of profit or loss, and a description of any forecast transaction for which hedge accounting had previously been used but which is no longer expected to occur
- If a gain or loss on a hedging instrument in a cash flow hedge has been recognised in other comprehensive income, an entity should disclose the following: [IAS 7.23]
- The amount that was so recognized in other comprehensive income during the period
- The amount that was removed from equity and included in profit or loss for the period
- The amount that was removed from equity during the period and included in the initial measurement of the acquisition cost or other carrying amount of a non-financial asset or non- financial liability in a hedged highly probable forecast transaction
- For fair value hedges, information about the fair value changes of the hedging instrument and the hedged item [IFRS 7.24(a)]
- Hedge ineffectiveness recognized in profit and loss (separately for cash flow hedges and hedges of a net investment in a foreign operation) [IFRS 7.24(b-c)]
- Information about the fair values of each class of financial asset and financial liability, along with: [IFRS 7.25-30]

6.3.8. Qualitative Disclosures of Risk [IFRS 7.33]: The qualitative disclosures describe:

- Risk exposures for each type of financial instrument
- Management's objectives, policies, and processes for managing those risks
- Changes from the prior period

6.3.9. Quantitative Disclosures of Risk: The quantitative disclosures provide information about the extent to which the entity is exposed to risk, based on information provided internally to the entity's key management personnel. These disclosures include: [IFRS 7.34]

- Credit Risk
- Liquidity Risk
- Market Risk [IFRS 7.40-42]

6.3.10. Transfers of Financial Assets [IFRS 7.42A-H]: An entity shall disclose information that enables users of its financial statements:

i. To understand the relationship between transferred financial assets that are not derecognized in their entirety and the associated liabilities; and
ii. To evaluate the nature of, and risks associated with, the entity's continuing involvement in derecognized financial assets. [IFRS 7 42B] (Source: www.ifrs.org)

7. ANALYSIS & FINDINGS

7.1. Compliance of IFRS 7 by the Institutions

The business entities design their accounting system as per the requirements of the Income Tax Law. And above all in order to provide a standardized report all types of banks try to follow the IAS 30 (BAS 30) now named IFRS 7 which is the demand of the modern competitive business world. Here is the investigation whether the Nationalized Commercial banks of Bangladesh follows this underlying standard regarding the preparation of their financial statements. The result can be derived as follows:

Table 2: Schedule of Compliance Status

Requirement/ Disclosures	IBBL	EXIM	AAI	ICB	SIB	SIBL	FSIB
Classes of Financial Instrument [Para 6]	√	√	√	√	√	√	√
Balance Sheet Presentation [Para 7]	√	√	√	√	√	√	√
Balance Sheet Disclosures [Fair value of Assets and Liabilities and Loans] [Para 8]	Partial	Partial	Partial	Partial	Partial	Partial	Partial
Collateral [Para 14-15]	√	×	√	×	×	√	√
Income Statement & Equity (Income, Expense Gains Losses) [Para 20]	√	√	√	√	√	√	√
Accounting Policies [Para 21]	√	√	√	√	√	√	√
Disclosure about Hedge [Para 21-30]	×	×	×	×	×	×	×
Qualitative Risk Disclosure [Para 33]	√	√	√	√	√	√	√
Quantitative Risk Disclosure [Para 34-42]	√	√	√	√	√	√	√
The nature of the transferred assets [Para 42 D]	×	×	×	×	×	×	×

The empirical findings of the study from Table 1 are shown below;

No. of companies	7
No. of requirements as per IFRS-7	10
Maximum number of requirement complied by the company	8
Minimum number of requirement complied by the company	6
Average number of compliance by the companies	7

Table 3: Summary of Compliance by Individual Nationalized Commercial Bank

Complying Banks	Total Compliance Requirement	No. of Requirement Fulfilled	(%) Compliances Fulfilled	Deviation from the Industry Average (%)
IBBL	10	7.5 [Full 7 + Partial 1]	75%	(4.28%)
EXIM	10	6.5 [Full 6 + Partial 1]	65%	5.71%
AAI	10	7.5 [Full 7 + Partial 1]	75%	(4.28%)
ICB	10	6.5 [Full 6 + Partial 1]	65%	5.71%
SIB	10	6.5 [Full 6 + Partial 1]	65%	5.71%
SIBL	10	7.5 [Full 7 + Partial 1]	75%	(4.28%)
FSIB	10	7.5 [Full 7 + Partial 1]	75%	(4.28%)

(%) of compliance = Requirement complied/ Total requirement.

The analysis shows that of the four banks and of the total 10 requirements, IBBL, AAI, SIBL and FSIB Banks complied with 7.5 requirements with full compliances 7 and partial of 1. Then here, total compliance is 7.5 weights (75% compliance), and EXIM, ICB and SIB Banks complied 6.5 requirements fully (65%).

Another important finding is that some requirements were completely ignored where some were partially followed and others were fully complied. Besides 6 requirements were complied with by all the seven companies, 2 requirements are totally not complied by any of them and partial 2.

Table 4: Average Number of Compliance

Status of Compliance	No. of Requirement	Weight	Weighted Score
Fully complied	6	1	6
Partially complied	2	0.5	1
Not complied	2	0	0
Total			7

For full compliance weight = 1
For non-compliance weight = 0
For partially complied weight = 0.5
Weighted score = 7/10 = 70%

It is also worth mentioning that the average compliance of the standard by the companies is 70.71%. Of the seven banks the average deviation from the industry is almost same for all the banks 2.23%.

Table 5: (%) Compliance of the Individual Requirement

S.N	Requirement/Disclosures	No. of Complied Companies	(%) of Compliance
1	Classes of Financial Instrument [Para 6]	7	100%
2	Balance Sheet Significance [Para 7]	7	100%
3	Balance Sheet Disclosures [Para 8-19]	7 partial = 3.5	50%
4	Collateral [Para 14-15]	4	57.15%
5	Income Statement & Equity (Income, Expense Gains Losses) [Para 20]	7	100%
6	Accounting Polices [Para 21]	7	100%
7	Disclosure of Hedge Accounting [Para22-30]	0	---
8	Qualitative Disclosure [Para 33]	7	100%
9	Quantitative Disclosure [Para 34-42]	7	100%
10	The nature of the Transferred Assets [Para 42 D]	0	--
	Total		707.15
	Average		70.71%

Apart from above numeric analysis the detailed version of compliance findings are described as follows:

1. Classes of Financial Instrument

All the seven banks fully comply with this requirement by showing classes of financial instrument. So compliance status for this requirement is 100%.

2. Balance Sheet Significant Disclosure

All the seven banks fully comply with this requirement by showing classes of Assets, Liabilities and Equity in Balance sheet. The compliance status for this requirement is 100%.

3. Balance Sheet Disclosure

Disclosures are presented by all four Banks partially showing Loans and Advances and others asset disclosures. But these banks are failed to assess fair value of Assets and liabilities as there is a rule BPRD of Bangladesh Banks. Therefore the compliance is 50%.

4. Collateral

Only four Banks have complied this requirement. They showed the Collateral in the disclosure. Other bank did not do that. The compliance is 57.15%.

5. Income Statement & Equity (Income, Expense Gains Losses)

All the banks show this just after the balance sheet. It has been presented classifying Income expenses Gains and Losses. This requirement is complied by 100%.

6. Accounting Policies [Para21]

All the banks show Accounting policies such as valuation of Assets and their own depreciation policy. Apart from this the impairment of Assets has been also shown in the Reports. It is complied by 100%.

7. Disclosures of Hedge Accounting

No one did disclose about Hedging. So compliance is 0.

8. Qualitative Disclosure [Para 33]

All banks, here, disclosed the quantitative disclosures of Risk. So the compliance is 100%.

9. Quantitative Disclosure [Para 34-42] [Credit Risk, Liquidity Risk, Market Risk]

All banks, here, disclosed the quantitative disclosures of Risk. So the compliance is 100%.

<u>10. The nature of the transferred assets [Para 42 D]</u>
Nothing is mentioned in the long annual reports of six specialized banks as to the nature of the transferred assets. So the compliance is 0.

8. SCOPE OF THE STUDY

8.1. Limitation

1. The analysis of the topic has been done on sample basis on the annual reports of the seven Islamic banks.
2. The analysis is limited to whether the financial statements have been prepared according to the IFRS 730. Any other standard has not been scrutinized.
3. The entities whose financial statements have analyzed are basically guided by different philosophy than that of traditional commercial bank. So there is a risk of matching disclosure of certain important items regarding IFRS 7.

8.2. Future Area of Study

This study is performed through the IFRS 7 compliance which is not sufficient to measure the overall financial reporting disclosures by Islamic banks, so further study is mostly needed to meet up the whole thing together. As Islamic banks is operated on the different philosophy, so to meet up the interest of the users of financial report, special study should gone through to find out what standards are needed to serve this purpose.

9. EFFECT

9.1 Effect of Compliance

The objective of IFRS 7 is to prescribe appropriate presentation and disclosure standards for banks and similar financial institutions which supplement the requirement of other standards. The intention is to provide users with appropriate information to assist them in evaluating the financial position and performance of banks and to enable them to obtain a better understanding of the special characteristics of the operations of banks. The compliance with the standard will face the following scenario:

- Obviously, the major objective of any IFRS is to provide true and fair view of the entity to the stakeholders. Consequently, the compliance of IFRS will enhance the credibility of the information provided.

- The compliance will also important for the compliance of requirements by the regulatory watchdogs
- The legal framework of the state also requires the full compliance of IFRS.
- The third pillar of BASEL-2 deals with market discipline through effective disclosure to encourage safe and sound banking practices. This disclosure pillar is closely related to what the International Financial Reporting Standard (IFRS) does with regard to The International Accounting Standard (IAS) 30.
- This compliance will be helpful for credit rating purpose and can collect investment from outsider also.
- The compliance will make the management more accountable and thus go a long a way to fulfill the intended objectives of specialization.
- These banks can meet up their fund problem by issuing shares in the capital market, but before that compliance with required standard is must.
- All the Islamic banks are in a very new and challenging position to comply with the IFRS 7 due to different culture. Compliance can help them to get customer confidence in Islamic banking.

9.2. Effect of Non-compliance

IFRSs are the guidelines to present a true and fair view of the financial performance and financial position of an entity to its users. Obviously if not complied with the standards it poses to some negative results. So it is very clear that the noncompliance will act as a hindrance in fulfilling the core objective of financial reporting. The non-compliance will fetch the following problem.

- Noncompliance will enhance the scope of corruption by the management.
- It will not be justifiable to be list in the capital market without perfectly comply the accounting standard.
- Simply speaking noncompliance of IFRS is the violation of laws as according to the Companies Act 1994 and is subject to punishment according to section# 211-218 of the said act.
- Principally it reduces the degree and scope of usefulness of financial information.
- Consolidation with other entity becomes difficult due to improper valuation.
- Earnings management happens continuously and it has severe impact on our resource mobilization.
- Corporate governance requires compliance with all rules and regulation to uphold the interest of the stakeholders. This is also a part of the

corporate social responsibility. So this cannot be maintained without full compliance of the required standard.
- Policy formulation by the government will be in a fix due to lack of real picture of the Islamic banks.

10. RECOMMENDATIONS

After a careful scrutiny of the annual reports of 7 Islamic banks it has been found that the companies are presenting their information on the financial statements in line with the IFRS-7. Although the degree of compliance of the banks is very high, following recommendation should considered by all the parties concerned;

- To have a fair picture of the organization as the banks play a significant role in the development of our country, they should comply with all the requirements guided by the nationally and internationally recognized standards.
- The policies, regulatory and governmental should be reviewed considering the requirements of the IFRS-7.
- Due to different nature, a regulatory authority can also be formed to monitor consists of expert from traditional as well as Islamic scholar and to ensure the full version application of the accounting standards.
- The accounting personnel of the concerned entities should be trained as to the update of the new accounting pronouncement.

11. CONCLUSION

Presentation of financial statements complying IFRSs is of immense importance to the users of those because it enhances the degree and scope of usefulness of accounting information. It is now becoming increasingly evident that existence of properly functioning banking system facilitates the development process in many important ways. Proper accounting and reporting contribute positively on proper functioning of banks. That's why the International Financial Reporting Standards (IFRS) 7 is developed to give standardized reporting aspects for banking sector. It is evident from the above analysis that Islamic banks are good at complying with the required compliance by the standard prescribed for them. It is hoped that due to the globalization, private banking can easily capture the essence of the international requirements, which make them competitive in providing the services. Based on the analysis, it has been found that there is no significant difference in terms of compliance of IFRS 7, among the seven Islamic banks. That means all of the sample banks try to follow similar items needed to comply with the international standard in order to provide accountability and transparency in financial reporting, which ensure maximum disclosure of the relevant, reliable and useful information to the interested user groups. In fine it can be culminated that preparation of financial statements of the companies in line with the IFRS-7 is satisfactory but still subject to solve the differentiations between traditional rule and Islamic principles. So to eliminate the deviation due to different philosophy of Islamic banking it is demanding that all the relevant bodies should work together to develop a unique standards for the financial reporting standard of Islamic Banking .

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