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The compliance of disclosure with AAOIFI financial accounting standards: A comparison between Bahrain and Qatar Islamic banks

Jabir Al-Sulaiti, A.A. Ousama, Helmi Hamammi,

The compliance of disclosure with AAOIFI financial accounting standards

A comparison between Bahrain and Qatar Islamic banks

Jabir Al-Sulaiti and A.A. Ousama
Qatar University, Doha, Qatar, and
Helmi Hamammi
ESC Rennes School of Business, Rennes, France

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Abstract

Purpose – This paper aims to examine the compliance of disclosure with the financial accounting standards of the Accounting and Auditing Organisation for Islamic Financial Institutions' (AAOIFI) related to Islamic financing products by Islamic banks in Bahrain and Qatar.

Design/methodology/approach – The study measures compliance using disclosure indexes. The disclosure indexes include the three financial accounting standards of *Murabaha*, *Mudaraba* and *Musharaka*. The data are collected from the annual reports of 24 Islamic banks in Bahrain and Qatar over a period of 2012-2015.

Findings – The paper found that Islamic banks in Bahrain and Qatar comply with AAOIFI financial accounting standards related to *Murabaha*, *Mudaraba* and *Musharaka*. However, there was a level of non-compliance in both countries. In addition, it found that the extent of compliance had increased over the 2012-2015 period. Also, the *Murabaha* standard had the highest mean of compliance. Moreover, the results showed that the Islamic banks in Qatar tend to have more compliance of overall *Murabaha* and *Mudaraba* disclosures compared to the Islamic banks in Bahrain.

Research limitations/implications – The findings are preliminary and highlight that the issue is of high interest to Islamic banks and AAOIFI. Hence, it requires a detailed follow-up to form a complete picture that would assist AAOIFI and regulators gear their policies toward better quality disclosure by Islamic financial institutions. Even though the findings are encouraging, future research is recommended to enforce compliance with the AAOIFI financial accounting standards.

Originality/value – This is a pioneer empirical study that focuses on the level and trend of compliance with AAOIFI financial accounting standards related to the Islamic financing products of *Murabaha*, *Mudaraba* and *Musharaka* standards, especially in Qatar. Additionally, it is the first study comparing between the only two Gulf Cooperation Council (GCC) countries, i.e. Bahrain and Qatar, that mandatory apply the AAOIFI standards.

Keywords Qatar, Islamic banks, Compliance, AAOIFI, Bahrain, Accounting standards

Paper type Research paper

1. Introduction

The Islamic financial system differs from the conventional banking system due to its application of Islamic *Shari'ah* rules (i.e. Islamic law). The teachings of Islam prohibit products that charge *riba* (i.e. interest or usury) which conventional banks apply as a cost of

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advancing credit. In contrast, Islamic finance is based on the idea of profit-risk sharing. Under this model, the Islamic bank undertakes to share profits derived from an investment by a customer as well as potential losses arising from the venture. Islamic banking is continuing its tremendous expansion across the globe with assets reaching up to \$1.3tn. After the establishment of the first Islamic bank in Dubai in 1975, Islamic banking increased rapidly and with more than 300 banks spread across more than 70 countries. A large portion of these Islamic banks is located in countries comprising the Gulf Cooperation Council (GCC). The increased expansion has led to the need to establish a regulatory framework to oversee their operations and handle the task of preparing useful standards. To this end, the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) was established in 1991 to prepare accounting, auditing, governance, ethics and *Shari'ah* standards for Islamic Financial Institutions (IFI). However, little research has investigated the compliance with such standards.

The AAOIFI is an Islamic international autonomous not-for-profit body established based on the Agreement of Association which was signed by Islamic financial institutions on 26 February 1990 in Algiers and was registered on 11 March 1991 in the Kingdom of Bahrain (AAOIFI, 2017). AAOIFI's sole objective is to develop and disseminate accounting and auditing guidelines relevant to IFIs. AAOIFI prepares, promulgates and interprets reviews and amends accounting and auditing standards for IFIs (AAOIFI, 2017). AAOIFI's organisational structures consist of General Secretariat, Board of trustees, Executive Committee, General Assembly, *Shari'ah* Board and Accounting and Auditing Standards Board. The organisation has so far published 96 standards and statements including one Financial Accounting Statement (i.e. Conceptual Framework for Financial Reporting by Islamic Financial Institutions) and 27 financial accounting standards (FAS), five auditing standards, 54 *Shari'ah* standards, seven governance standards and two code of ethics standards (AAOIFI, 2013). The AAOIFI accounting standards are mandatory in Bahrain, Qatar, Oman, Sudan and Syria (AAOIFI, 2017). Moreover, the AAOIFI accounting standards are either used as a basis of national accounting standards in Indonesia and Pakistan or adopted voluntarily in some countries such as Brunei, Egypt, France, Kuwait, Lebanon, Malaysia, Saudi Arabia, South Africa, United Arab Emirates and the UK (AAOIFI, 2017). AAOIFI auditing, governance and ethics standards are adopted by IFIs voluntarily (AAOIFI, 2017). AAOIFI is supported by 202 institutional members from 45 countries (AAOIFI, 2013). This includes central banks, IFIs and other participants from the international Islamic banking and finance industry worldwide. AAOIFI stated in the preface of FAS1 that:

> The emergence of Islamic banks and financial institutions as relatively new organisations and the great challenge they face to successfully serve the societies in which they operate, have led them, to seek the most appropriate means through which accounting standards could be developed and implemented in to present adequate, reliable, and relevant information to users of the financial statements (AAOIFI, 2013).

The Islamic banking in GCC countries (as mentioned earlier) started after the establishment of the Dubai Islamic Bank in 1975. The establishment of the Kuwait Finance House followed in 1977 and Bahrain Islamic Bank in 1979. These remained the only three Islamic banks in the GCC countries in the 1970s. Following the successes of the first two Islamic banks, by the mid and late 1980s, a number of banks were established. There are more than 40 Islamic banks in GCC countries holding more than \$606bn worth of assets as at the end of 2012 (Ernst and Young, 2016). There are estimates that more growth in assets and profits will come in the next three years (Ernst and Young, 2012). Many world financial centres are promoting themselves as a centre for Islamic banking including London, Malaysia and Iran.

However, GCC countries are in the lead as far as Islamic finance and banking are concerned. As mentioned earlier, Bahrain, Qatar and Oman are the only three GCC countries that made the AAOIFI's FAS mandatory regulatory requirements in in their jurisdictions. This makes investigating the compliance with the financial accounting standards very important and interesting. The current study focuses only on Bahrain and Qatar as Oman started to have Islamic banks since 2013.

In Bahrain, the first Islamic bank was the Bahrain Islamic bank established in 1979. The country has functioned as a regional financial centre since 1976 keeping its market open to foreign banks. The country has more Islamic financial banks than any other centre within the GCC (Wilson, 2009). According to the Central Bank of Bahrain (CBB):

> The growth of Islamic banking, in particular, has been remarkable, with total assets in this segment jumping from U$1.9 billion in 2000 to US.26.3 billion by June 2009, an increase of over 12 times. The market shares of Islamic banks correspondingly increased from 1.8 per cent of total assets in 2000 to 11.1 per cent in 2009 (CBB, 2012).

The CBB is responsible for regulating and supervising all the activities of Islamic banks in Bahrain. Prior to CBB, the Bahrain Monetary Agency previously acted as the sole regulatory body supervising the activities of Islamic banks. The CBB strictly mandates that all Islamic banks in Bahrain must comply with the requirements of the AAOIFI standards (Vinnicombe, 2012). Additionally, AAOIFI is registered and operates in Bahrain which gives the country an advantage as a lead regulatory body for Islamic accounting standards and a hub of Islamic banking systems.

On the other hand, the Qatari economy continues to post record GDP growth with 11.9 per cent on average over the 2005-2015 period which is considered the highest in the GCC countries (IMF, 2016). In addition, the country has a favourable international credit rating that is supportive of Islamic banking activity (QInvest, 2010). The Qatari Government intends to make the country a hub for Islamic banking (Standard and Poor's, 2013). The Qatari Islamic banking leads as the fastest growing market which has grown by more than 23 per cent during 2012 (Ernst and Young, 2012). The Islamic banks in Qatar have a large portion of the market share in GCC countries. They currently represent more than $25bn worth of Qatar's banking system in assets and could reach more than $100bn by 2017 because of the country's large infrastructure needs and investments, including the 2022 Soccer World Cup (Ernst and Young, 2012; Standard and Poor's, 2013). The government funded infrastructure and investment projects economic growth and by extension the expansion of Islamic banks in Qatar. The Qatar Central Bank (QCB) is responsible for licencing, supervising and monitoring Islamic Banking in the country so as to achieve monetary and financial stability. In addition, QCB is responsible for regulating and reviewing their operations on an ongoing basis (QCB, 2011). According to the QCB, there are four Islamic banks operating in Qatar (QCB, 2011). QCB has directed Islamic banks to adopt AAOIFI standards as guidance for their disclosures. Therefore, there is a need to study compliance of Islamic banks in Qatar with AAOIFI financial accounting standards and compare it with the compliance of Islamic banks in Bahrain as the leading GCC country on Islamic banking systems and setting Islamic accounting standards.

The aim of this paper is to examine the compliance of disclosure with the AAOIFI financial accounting standards requirements, i.e. *Murabaha* and *Murabaha* to the purchase orderer (FAS2), *Mudaraba* financing (FAS3) and *Musharaka* financing (FAS4), the most practised Islamic financing products, by Islamic banks in Bahrain and Qatar. More specifically, it aims to investigate and compare the extent and trend of compliance over the 2012-2015 period. The findings of the study hope to provide empirical evidence on the level and trend of compliance with the AAOIFI financial accounting standards by Islamic banks in Bahrain and Qatar. The comparison between the Islamic banks in Bahrain and Qatar offers an overview of the largest market share of Islamic banking in GCC countries (i.e. Qatar) and the one which is considered to be more advanced in the adoption of AAOIFI standards (i.e. Bahraini). This could lead to greater insights as to the improvements required in the accounting system of Islamic banks in both Bahrain and Qatar to effectively and efficiently adopt and comply with the AAOIFI financial accounting standards. Additionally, the findings are of high interest to AAOIFI to understand the current practices of compliance with its financial accounting standards, especially in countries that have made their application mandatory. It provides suggestions for improvements to overcome the current challenges for more compliance. Moreover, the findings might be useful to investigate the possible reasons for incomplete compliance further.

Overall, the findings of the study are preliminary and highlight that the topic is of high interest and requires detailed follow-up to form a complete picture to assist AAOIFI and regulators in Muslim countries to gear their policies toward better quality disclosure of IFIs. Even though the results are encouraging, a lot of work is still to be done to enforce compliance with AAOIFI accounting standards.

2. Review of the literature

This review of the literature explains the financial accounting standards in greater depth. It highlights the various studies undertaken on the application of standards in the IFIs around the world. There is limited literature on the application of AAOIFI standards worldwide; however, these studies provide an overall view of the extent to which these standards are applied.

Ullah (2013) examined the compliance of AAOIFI guidelines regarding general presentation and disclosure in the financial statements of Islamic banks listed in Bangladesh. The study examined seven Islamic banks listed on the Bangladesh Stock Market and included 203 items of compliance. Ullah (2013) concluded that the level of compliance was relatively low, as only 91 of the 203 items were disclosed. Hence, he recommends that the Islamic banks should increase the level of compliance with the standard and better disclose the financial statements. A limitation of this study was its exclusion of other IFIs that would have expanded the sample to provide more reliable findings.

On another issue, Nadzri (2009) examined the effectiveness of AAOIFI in dealing with the accounting and disclosure of *zakat* and *riba* in IFIs. By using content analysis and including 25 IFIs that are members of AAOIFI, the researcher concluded that the level of disclosure by the sampled IFIs is lower than the AAOIFI requirements. Moreover, the study found that the IFIs following AAOIFI standards offer more disclosure compared to non-followers of AAOIFI standards. However, the research included a small sample of AAOIFI members and examined only limited standards. Nadzri (2009) recommended that further studies can be conducted on a larger sample focusing on more standards. He also recommended the adoption of content analysis through a combined quantitative and qualitative approach for more robust results.

There is a number of studies that have been conducted on Bahrain due to the relatively large number of IFIs using AAOIFI standards (Vinnicombe, 2012). Some of these studies used accountants' perceptions as an indicator (Sarea, 2012; Sarea and Hanefah, 2013a, 2013b), while others examined financial statements as an indicator (Vinnicombe, 2012). Sarea (2012) examined the level of compliance of accounting practices with AAOIFI standards. Using 129 questionnaires administered to accountants from various Islamic banks in Bahrain and using descriptive statistics to analyse the results, the study found that there was a high level of compliance with AAOIFI standards. The study suggested that the reason behind the high compliance is due to the consistency of the standards with the regulation imposed by the central bank in Bahrain.

Sarea and Hanefah (2013a, 2013b) then used the diffusion-innovation theory to examine compliance with AAOIFI accounting standards. The study observed that innovation diffusion of ideas precipitates adoption. They found that accountants' perceptions on the level of compliance with AAOIFI influenced their decision to comply with AAOIFI standards. Moreover, the findings showed a positive relationship between relative advantage, compatibility and observability and AAOIFI accounting standards. This means that the relative advantage, compatibility and observability of the AAOIFI accounting standards means the more likely the standards will be adopted. In contrast, the findings showed a negative relationship between trialability, complexity and AAOIFI accounting standards. Having a negative relationship between trialability and AAOIFI standards indicates that *Shari'ah* principles were not being tried, but they need to be fully adopted by all parties. The negative relationship between complexity and AAOIFI standards means that the less complex the accounting standards are, the more likely they were to be adopted.

In another study, Vinnicombe (2012) examined the degree of compliance following the approach adopted by Tower *et al.* (1999) and Taplin *et al.* (2002). The approach involved analysing compliance by developing two separate indexes to understand the degree of compliance and their reliability. Initially, the study developed two indexes but extended the focus borrowing from previous studies that examined the degree of compliance of Islamic banks in Bahrain with AAOIFI standards. The study overcame problems related to subjectivity and limited standards included in the previous study by including the entire Islamic banks licenced by the central bank in Bahrain. Vinnicombe (2012) measured the compliance in relation to a small number of Islamic financing products and issues specific to *Mudaraba*, *Musharka*, *Murabaha*, *zakat* and SSB requirements, restricted investment accounts and unrestricted investment accounts. The study developed the disclosure index based on the use of products due to numerous reasons. First, it offers better insight into the overall compliance by Islamic banks. Second, some contracts are covered by more than one standard, and some standards cover more than one product. The study found a high level of compliance with AAOIFI standards, but there was no increase in compliance over the past four years. The results showed a relatively low level of compliance concerning *zakat*. In contrast, the adoption of SSB requirements showed the highest level of compliance. Compliance with the three products is high especially for the non-violation for nondisclosure. The study recommended the need to mandate the adoption of *zakat* standards. However, there are some limitations in this study such as excluding banks outside Bahrain because Bahrain was the only country where Islamic banks are mandated to comply with the AAOIFI standards at the time of the study.

Al-Abdullatif (2007) examined the application of the AAOIFI standards by the Islamic banking sector in Saudi Arabia. The study explored the effectiveness and importance of Islamic banks' annual reports from the viewpoint of participants. Moreover, the study explored the participants' views regarding the Islamization of conventional banks in Saudi Arabia concluding that many respondents showed acceptance for the application of AAOIFI accounting standards in the country. Notably, participants stated that there is a need to involve the institutions in the standard setting process. Many participants pointed out the need to build a strong AAOIFI database that is accessible to all classes of users and the need to offer more training for executives and accountants to enhance their ability to deal with AAOIFI accounting standards.

Other studies that investigated the AAOIFI standards issues focused on a single standard for in-depth analysis. One of the standards that attracted many studies is the *sukuk* standard (i.e. Islamic bonds). Many of the studies examined and discussed the nature and effects of the new AAOIFI *sukuk* pronouncements issued in 2008 (Ali, 2008; Kamil, 2008; Lahsasna and Idris, 2008; Naim *et al.*, 2013). For example, Naim *et al.* (2013) explored the new standards on *sukuk* that were issued by AAOIFI as a result of Sheikh Taqi's strong criticism that 85 per cent of *sukuk* issuance did not follow the teachings of *Shari'ah*. By examining samples prior and after the pronouncement and concentrating on debateable areas in the pronouncement such as ownership transfer, pricing and guarantee element, the researchers found that there were minor changes on the principle term and condition after the pronouncement. The study implied that the new pronouncement did not have much effect in changing the *Shari'ah* advisers and industry players when making more accurate principles and decisions.

In addition, Salah (2010) in his research examined how the 2008 AAOIFI *sukuk* pronouncement influenced the legal, structural features of (equity-based) *sukuk* structures and discussed recent attempts to issue (equity-based) *sukuk* structures that follow *Shari'ah* teachings. The study found that practitioners must comprehend that (equity-based) *sukuk* is not a static and definite product. The study clarified the various mechanisms related to structure. It also indicated the limitations of the use of purchase undertakings is only allowed at market value and fixing the periodic payments must be subject to actual valuation at maturity. A case study of the Saudi Hollandi Bank illustrated how certain innovative elements could be applied to these transactions: the use of a reserve account and on-account payments subject to actual valuation are *Shari'ah*'s accommodating tools that practitioners can apply. However, certain aspects of the structure of the Saudi Hollandi Bank *sukuk* raised questions that are worth seeing for the further development of the *sukuk* market. Moreover, Ali (2008) highlighted some recent improvements and issues in *sukuk* in the light of the AAOIFI *Shari'ah* pronouncement. The study found that the AAOIFI pronouncement gave rise to a re-examination of market awareness of *sukuk*. *Sukuk* should not and could no longer be observed as a strictly fixed income instrument with capital preservation features. If the pronouncement is stringently adhered to, the equity-based *sukuk* should behave like equity instruments and not to be pulled to fit into the fixed income box.

Further, Lahsasna and Idris (2008) examined the AAOIFI *sukuk* pronouncement in 2008. It found that the AAOIFI announcement is to ensure the *Shari'ah* compliance in *sukuk* issuance and trading. Moreover, the study concluded that it is vital for the *sukuk* industry to meet the requirements of the AAOIFI announcement to ensure the marketability of the product, especially if it is for the global market.

Evident the discussion of the above literature is a paucity of studies that examine the application of AAOIFI financial accounting standards in Qatar despite having mandated these standards for IFIs. Therefore, the study tries to examine the disclosure compliance with specific AAOIFI financial accounting standards related to the most used Islamic financing products of *Murabaha*, *Mudaraba* Financing and *Musharaka*. It compares the compliance of disclosure of Islamic banks in Qatar with Bahrain which is believed to be more advanced in terms of the application of AAOIFI accounting standards. This comparison could also show the deficiencies in the application of AAOIFI financial accounting standards by Islamic banks in both countries.

3. Research methodology

3.1 Sample size and data collection

As previously indicated, the study selected the Islamic banks in Bahrain and Qatar that are licenced by the central banks in both countries. The total number of IFIs registered in

Bahrain is 402 as of November 2013, 99 of which are banks, 75 of which are conventional banks, and 24 are Islamic banks (CBB, 2013). On the other hand, there were 44 IFIs registered in Qatar as of September 2013 (QCB, 2011). Out of them, 19 are from the banking sector. Out of these 19 banks, seven are conventional national banks, seven are conventional foreign banks, four are Islamic banks, and one is a representative office. Therefore, the sample of the study consists of 24 Islamic banks in Bahrain and Qatar (refer to Tables I and II, respectively). The sample from Bahrain consists of 20 out of the 24 Islamic banks operating in the country, which represents 83 per cent of the population in Bahrain. The exclusion of the four banks from the 24 Islamic banks in Bahrain was due to the fact that the annual reports for 2012 could only be found for 20 banks while the reports for the other four could be found neither on the Bahrain stock exchange website nor their official websites. On the other hand, the sample from Qatar is considered 100 per cent of the population due to the small number of Islamic banks in the country. As the study uses a multiple years approach (i.e. four years) for data collocation (as discuses in the next section), the sample is considered sufficient to produce reliable findings for examining the compliance with some of AAIOIFI accounting standards.

The data were gathered from the 2012, 2013, 2014 and 2015 annual reports (English language version) of the selected banks available through the stock exchange markets websites and the official websites of the banks. The 2012-2015 period was selected due to the

No.	Bank name
1	ABC Islamic Bank
2	Al Baraka Islamic Bank
3	Al Baraka Islamic Bank
4	Al-Salam Bank (Bahrain)
5	Bahrain Islamic Bank
6	Capinnova Investment Bank
7	Citi Islamic Investment Bank
8	Elaf Bank
9	First Energy Bank
10	Global Banking Corporation
11	Gulf Finance House
12	International Investment Bank
13	Investors Bank
14	Ithmaar Bank
15	Khaleeji Commercial Bank
16	Kuwait Finance House (Bahrain)
17	Kuwait Finance House (Bahrain)
18	Liquidity Management Centre
19	Seera Investment Bank
20	Venture Capital Bank

Table I. List of Islamic banks in Bahrain

No.	Bank name
1	Barwa Bank
2	Masraf AL Rayan
3	Qatar International Islamic Bank
4	Qatar Islamic Bank

Table II. List of Islamic banks in Qatar availability of the required data. Additionally, a multiple years approach was used to increase the number of annual reports (i.e. cases or observation) to collect the required data. Various researchers have argued that annual reports are a common and popular means of communication with stakeholders (Singh and Ahuja, 1983; Guthrie and Lee, 1990). Annual reports are viewed as a formal public document produced by public companies largely as a response to mandatory and voluntary requirements existing in many countries. They comprise quantitative information, narratives, photographs and graphs (Stanton and Stanton, 2002). Therefore, 96 annual reports were reviewed and analysed to collect the needed data. Moreover, the independent auditor opinion on the annual reports is reviewed to make sure that the banks complied with AAOIFI accounting standards.

3.2 Development of the disclosure indexes

Firstly, to develop the disclosure indexes to measure the compliance with the AAOIFI accounting standards, the study adopted the disclosure indexes of Vinnicombe (2012). The indexes examine the compliance based on Islamic financing products rather than the standards one by one. This approach contrasts with other studies that measured the compliance with International Financial Reporting Standards (IFRS) through a standard-by-standard basis such as Sucher and Jindrichovska (2004). In Islamic banking, it is better to measure compliance by examining products rather than standards basis. This is thought to be a better indication of the level of disclosure in the annual reports of IFIs as more than one standard covers some contracts. Secondly, some modifications are done to the adopted disclosure indexes by including only the *Murabaha*, *Mudaraba* and *Musharaka* standards and the exclusion of the SSP, *zakat* restricted accounts and unrestricted accounts standards. *Musharaka*, *Mudaraba* and *Murabaha* are chosen in this study due to some reasons. These three Islamic financing products are widely used by the Islamic banks. These three financing products are among the most used products (refer to Table III) by Islamic banks (Vinnicombe, 2012). In addition, a field study conducted by AAOIFI consultants in 1991 concluded that the three products are widely used by IFIs and require more attention from accounting standards setting agencies (Nadzri, 2009; Vinnicombe, 2012). Moreover, a number of AAOIFI financial accounting standards related to some Islamic financing products are not currently widely used by the Islamic banks thereby rendering their investigation ineffective.

3.3 Measurement of compliance

The study applies an unweighted average disclosure index to score the items to measure compliance with the AAOIFI financial accounting standards. In an unweighted disclosure index, a checklist of requirements from the standards is prepared and examined against the data of the sample using unweighted approach meaning giving (1) if it's disclosed, (0) if it is not and (N/A) if it is not applicable to the data. Many researchers have previously used this approach to measuring compliance (Hassan *et al.*, 2006; Aly, 2008; Ousama and Fatima, 2010; Mardini *et al.*, 2012). There are a number of advantages in using unweighted disclosure indices rather than weighted disclosure. First, an unweighted disclosure index is considered unbiased and avoids subjectivity, as it is based on weighting by zero or one,

Table III.
Islamic products use by banks

Islamic product	Use by banks	(%)
Murabaha	65	98
Mudaraba	36	55
Musharaka	18	27

while weighted indices could be biased, as there is space for human intervention. Second, the ability to verify the information is greater in unweighted indices than weighted average disclosure indices (Cooke and Wallace, 1989; Marston and Shrives, 1991). The independent auditor report of the selected Islamic banks was reviewed to ensure that the banks are following the AAOIFI financial accounting standards.

3.4 Murabaha, Mudaraba and Musharaka contracts

Murabaha is an Arabic noun that means gaining profit. It is a product that involves the selling of a commodity for the purchase price and an agreed upon profit margin. This margin can be a percentage of the purchase price or a lump sum (Khoja, 1995). *Murabaha* is primarily divided into ordinary *Murabaha* and *Murabaha* sales connected with a promise (Khoja, 1995). Some scholars specify certain steps that that should be followed for a transaction to be eligible. First, the purchaser determines his need. Then, the purchaser signs on a promise to purchase agreement. After that, the bank notifies the purchaser of its approval of purchasing the commodity. The bank may pay the price immediately or as per the agreement. Finally, the commodity is delivered to the purchaser, and the *Murabaha* sale contract is signed.

Murabaha products date back to the days of the prophet Muhammad (PBUH). The *Murabaha* contract was discussed by the scholars of the four *Fiqh* schools (*Maliki, Shafee, Hanbali and Hanafi*) who all agreed that this kind of transaction is permissible according to verses from the holy Quran that "It is no crime in you, if you seek of the bounty of your Lord" *Al-Baqara* 198, and "Whereas *Allah* [SWT] has permitted trading and forbidden *riba* (usury)" *Al-Baqara* 275. Some researchers believe that this kind of contract can replace home loans and personal loans for cars, and it can also be used for commercial ventures such as the purchase of a consignment of goods for resale (Vinnicombe, 2012).

One kind of *Murabaha* which although mentioned individually is treated in the same standard is the *Murabaha* to the purchase order which is a modern contract that some researchers believe was invented in 1973 following the emergence of Islamic banking. *Murabaha* to the purchase order is different from classical *Murabaha* (Taner, 2011). In classical *Murabaha*, two parties are involved – the buyer and the seller – whereas in modern *Murabaha*, three parties are involved: the seller, the buyer and the bank. The *Murabaha* and *Murabaha* to the purchase orderer standard (FAS2) set out the accounting rules for recognising, measuring and disclosing the transactions of *Murabaha* and *Murabaha* to the purchase order that are carried out by Islamic banks and other IFIs. This includes all the revenues, expenses, gains and losses attributable to the assets and receivables (AAOIFI, 2013).

Mudaraba is a valid form of equity investment and profit-sharing arrangement (Taner, 2011). It contains two parties one who has available capital (*rab-al-mal*) and the other is the agent who has investment expertise. Losses are borne only by the capital provider. The *mudarib* may be liable for a loss in a case of misconduct or negligence (El-Hawary *et al.*, 2007). However, the modern practice of *Mudaraba* by banks is much more complex. The modern-day version of the *Mudaraba* contract is unavoidably more complex and associated in practice with a number of problems not readily foreseeable in the early theory. In the modern *Mudaraba*, funds are deposited with an Islamic bank, the depositor being (*rab-al-mal*), and the bank then acts as the *mudarib* as it mobilises funds for depositors. It can also be done by what is called the two-tier *Mudaraba* model with the second tier being the bank in the role of *(rab-al-mal*) and the borrower the *mudarib* (Vinnicombe, 2012). It is important to mention here that the *Mudaraba* contract is seen by some researchers as a contract that could expose IFIs into larger country party risk (El-Hawary *et al.*, 2007). The *Mudaraba* financing standard (FAS3) aims to set up accounting rules for recognising, measuring and disclosing the transactions of *Mudaraba* financing that are carried out by Islamic banks and other IFIs. It applies to the *Mudaraba* financing transactions carried out by the Islamic bank as a provider of funds and the transactions related to the capital provided by the Islamic bank to be used in a *Mudaraba* (AAOIFI, 2013).

Musharaka is a product similar to *Mudaraba*. In *Musharaka*, the capital owners enter into a partnership by contributing equity with others in return for sharing profits and losses at a predetermined ratio. The parties are more than two, and this distinguishes it from *Mudaraba* where in *Mudaraba* two parties are involved. In *Musharaka*, the partner's contributions need not be equal, and contributions may be in the form of physical or intangible capital such as labour, management, skill and goodwill (El-Hawary *et al.*, 2007). The *Musharaka* financing standard (FAS4) sets the accounting rules for recognising, measuring and disclosing the transactions of *Musharaka* financing that are carried out by Islamic banks and other IFIs (AAOIFI, 2013). The accounting treatment for *Musharaka* is that in *Musharaka* the client is treated as a partner of the IFIs. Therefore, any diminishing value of the financing shall be treated by reducing the amount of share transferred in the partnership (Nadzri, 2009).

4. Findings and discussion

Table IV shows the descriptive statistics results for the compliance of overall disclosure (i.e. combined disclosure of *Murabaha*, *Mudaraba* and *Musharaka*). The results showed that the overall mean disclosures were 73.16, 80.56, 79.81 and 81.79, for the years 2012, 2013, 2014 and 2015, respectively. The minimum percentage of disclosed items was 38.71 and the maximum 100. The results are considered relatively high, which reveals that the Islamic banks in Bahrain and Qatar comply with the AAOIFI financial accounting standards related to *Murabaha*, *Mudaraba* and *Musharaka* financing. This finding is consistent with prior studies (Al-Baluchi, 2006; Vinnicombe, 2012; Sarea, 2012). However, the results showed that Islamic banks still lacked in compliance by a mean of almost 20. This could be due to a degree of ambiguity in the standards and reporting (Vinnicombe, 2012). This is interesting as those standards are mandatory in both countries. This needs to be further investigated by the Islamic banks and AAOIF. For the trend of compliance, the results in Table VIII showed that there was an increase in the mean of compliance over the 2012-2015 period. Nonparametric Wilcoxon signed-rank test was conducted to examine the significant differences between means of compliance over the period 2012-2015. Table IX showed that the increase in the compliance for overall compliance between years 2012-2015 was statistically significant at 0.01 level. The findings indicate that Islamic banks in Bahrain and Qatar improved their overall compliance of disclosure requirements related to *Murabaha*, *Mudaraba* and *Musharaka* standards.

The comparison between Islamic banks in Bahrain and Qatar in the overall compliance (Table VIII) showed that the banks in Qatar had on average the highest compliance over the 2013-2015 period. For the year 2012, banks in Bahrain had higher compliance compared to

Year	Mean	Median	SD	Minimum	Maximum
2012	74.16	75.83	12.39	38.71	93.55
2013	80.56	82.35	9.81	45.16	100.00
2014	79.81	83.87	10.16	38.71	87.50
2015	81.79	83.87	5.70	64.52	87.50

Table IV. Compliance of disclosure – overall banks in Qatar. Some Islamic banks did not fully disclose their compliance with the AAOIFI accounting standards requirements. This is consistent with the findings of Al-Baluchi (2006). The result could be interesting as the CBB and QCB mandate the compliance with AAOIFI standards. This indicates that authorities and parties in Bahrain and Qatar should work in close cooperation for better enforcement of the AAOIFI financial accounting standards.

Further analyses of the compliance of disclosure at an individual standard for the entire sample (24 Islamic banks in both countries) and a comparison between Bahrain and Qatar for individual standards and years were conducted. The results were presented in Tables V, VI, VII and VIII. The means of compliance of *Murabaha* disclosure standard were 79.68, 81.04, 81.60 and 82.74, for the years 2012, 2013, 2014 and 2015, respectively (Table V). This is considered the highest compliance of disclosure compared to the *Mudaraba* and *Musharaka* standards. This is supported by the fact that *Murabaha* is practised by 98 per cent of the Islamic banks (as shown in Table III). This is consistent with the findings of Vinnicombe (2012) which indicated that the *Murabaha* product is widely used by Islamic banks and thus

Year	Mean	Median	SD	Minimum	Maximum
2012	79.68	83.75	11.08	55.56	100.00
2013	81.04	87.50	14.53	25.00	100.00
2014	81.60	87.50	12.42	37.50	100.00
2015	82.74	87.50	8.18	62.50	100.00

Table V. Compliance of disclosure – *Murabaha* financing

Year	Mean	Median	SD	Minimum	Maximum
2012	68.24	71.43	17.85	33.33	100.00
2013	77.63	77.78	12.47	50.00	91.67
2014	76.99	77.78	14.00	41.67	91.67
2015	78.91	77.78	10.73	58.33	91.67

Table VI. Compliance with disclosure – *Mudaraba* financing

Year	Mean	Median	SD	Minimum	Maximum
2012	73.53	72.73	11.09	58.33	90.91
2013	77.53	80.91	9.28	54.55	90.00
2014	76.23	80.91	12.95	36.36	90.00
2015	79.48	81.82	6.77	63.64	90.00

Table VII. Compliance of disclosure – *Musharaka* financing

	Murabaha		*Mudaraba*		*Musharaka*		Overall	
Year	Bahrain	Qatar	Bahrain	Qatar	Bahrain	Qatar	Bahrain	Qatar
2012	81.11	73.26	67.95	68.75	76.50	63.64	75.49	68.14
2013	80.14	85.07	72.31	89.58	79.67	69.70	80.06	82.69
2014	80.14	88.19	71.39	89.58	78.02	69.70	78.94	83.50
2015	82.22	85.07	74.16	89.58	82.15	69.70	81.58	82.69

Table VIII. Compliance with disclosure – Bahrain and Qatar the level of disclosure was high. In addition, the results revealed that there were increases in the compliance with the disclosure requirements in the *Murabaha* standard over the 2012-2105 period. Nevertheless, the Wilcoxon signed-rank test (Table IX) showed that the increases were statistically significant. This finding indicates that Islamic banks in both countries tried to improve the extent of disclosure for *Murabaha* standard thereby increasing the level of compliance.

On the comparison between Islamic banks in Bahrain and Qatar, the results in Table VIII showed that Islamic banks in Qatar over the period from 2013 to 2015 had, on average, the highest compliance of disclosure requirements of *Murabaha* compared to its counterpart in Bahrain. However, in 2012 the Bahraini Islamic banks achieved a higher mean of compliance (i.e. 81.11) compared to the Qatari Islamic banks (i.e. 73.26). Further analysis showed that *Murabaha* disclosure compliance by Islamic banks in Bahrain was the highest compared to *Mudaraba* and *Musharaka*. More specifically, these two countries used historical cost in measuring assets values at acquisition, disclosed the *Murabaha* receivables in the balance sheet and had profit recognition of long-term *Murabaha* requirements. Nonetheless, the Bahraini Islamic banks provided more disclosure of recording *Murabaha* receivables as cash equivalents. This could suggest that Bahraini Islamic banks are proposing more detailed necessities than Qatari Islamic banks in 2012 due to their familiarity with disclosure requirements compared to the Qatari counterpart. Additionally, a significant number of the Islamic banks in the sample of Qatar are relatively newly established.

Table V shows the means of compliance with *Mudaraba* disclosure were 68.24, 77.63, 76.99 and 78.91 for the years 2012, 2013, 2014 and 2015, respectively. On average, these results indicate that the compliance levels are considered high. However, they are relatively lower compared to the *Murabaha* and *Musharaka*. Table V provided more details about the minimum and maximum of compliance with *Mudaraba* disclosure by the Islamic banks over the period 2012-2015. It showed that the overall minimum was 33.33 per cent while the maximum was 100 per cent in the year 2012. Similar to the *Murabaha* disclosure, the results showed that the compliance of the *Mudaraba* disclosure had increased between the 2012 and 2015 period. This is supported by the results of the Wilcoxon signed-rank test in Table IX which showed that the increase in the means of compliance of *Mudaraba* disclosure between 2012 and 2015 was statistically significant at 0.05 level.

Table VIII showed the results of comparison of *Mudaraba* compliance between Islamic banks in Bahrain and Qatar. For *Murabaha* compliance, Islamic banks in Qatar had the highest compliance mean of *Mudaraba* disclosure than Islamic banks in Bahrain over the 2012-2105 period. The results indicate that, on average, there is around 20 per cent none compliance for both countries. This possibly owes to the complexity of the *Mudaraba* standard practice among Islamic banks (Vinnicombe, 2012). This could affect those who prepare financial statements in the Islamic banks and cause complexities in preparing the necessities related to *Mudaraba* products. Some prior studies showed a negative relationship between complexity and adoption of AAOIFI financial accounting standards

Table IX.
Mean differences in the trend of compliance in the period 2012-2015

Test	*Murabaha*	*Mudaraba*	*Musharaka*	Overall
Z	−1.388b	−2.318b	−1.434b	−2.777b
Asymp. sig. (two-tailed)	0.165	*0.020*	0.151	*0.005*

Note: Wilcoxon signed ranks test

which means that the more complex the standards, the less likely they will be adopted (Sarea and Hanefah, 2013a, 2013b). Moreover, the results show high instability in the disclosure of *Mudaraba* in Bahraini Islamic banks. This would support the previous line of thought and may imply that some planners in Islamic banks in Bahrain lack sufficient knowledge of how to deal with *Mudaraba* products. More specifically, the analysis showed how Islamic banks highlight a low compliance of *Mudaraba* with the requirement of recognising the long-term losses due to misconduct. In fact, none of the Islamic banks in Qatar for the year 2012 complied with this requirement which requires that the *mudarib* shall bear the losses incurred due to misconduct or negligence on his part. The overall none compliance with this requirement suggests that many banks are acting as the *mudarib* and resist disclosing such requirement, as they could consider such disclosure a risk.

Another interesting finding is that all the Islamic banks for the year 2012 complied with presenting the *Mudaraba* in financial statements and the reporting of non-monetary assets. The Islamic banks in Bahrain better comply with the measurement of capital in cash and the requirement of measuring the capital paid (in kind) at fair value with no Islamic banks in Qatar complying with these two requirements. This could be possible in the case of Qatar because of the lack of understanding of the importance of disclosing such items which suggest that there is a lack of adequate knowledge in dealing with AAOIFI financial accounting standards.

Table VII showed the means of compliance for *Musharaka* disclosure were 73.53, 77.53, 76.23 and 79.48 for the years 2012, 2013, 2014 and 2015, respectively. The results indicate a relatively moderate result compared to the other two standards. Vinnicombe (2012) found that *Musharaka* products are the least used by Islamic banks with 38 per cent. This could indicate that the products that are used less often by Islamic banks cause fewer pressures on banks to comply with the standards. Also, Table VII presents the trend analysis of the compliance of *Musharaka* of the disclosure. The results showed that they increased in the years 2012-2015. Nonetheless, the results of the Wilcoxon signed-rank test (Table IX) showed that the increase in compliance of the *Musharaka* disclosure was not statistically significant.

Furthermore, the results of the comparison showed that the compliance of *Musharaka* disclosure by Islamic banks in Bahrain was higher than Islamic banks in Qatar. Interestingly, the analysis showed that that none of the Islamic banks in both countries complied with the requirement of recognising the losses due to partner's negligence or misconduct. This part of FAS4 states that if the partner's misconduct or negligence results in having losses incurred in a *Musharaka*, the partner shall bear the Islamic banks share of such losses and shall be recognised as receivable due from the partner. This confirms the resistant status of Islamic banks in applying certain requirements that require more force by regulatory bodies. However, the Islamic banks in Bahrain and Qatar scored the highest compliance in disclosing the requirement of recording provision for the *Musharaka* receivables account and the requirement of recording *Musharaka* finance contracts on the balance sheet. Moreover, the Islamic banks showed relatively high compliance in measuring the banks share in the constant and diminishing capital in historical cost and the recognition of long-term diminishing/constant contracts profits and losses. Nevertheless, none of the Islamic bank in Qatari complied with measuring capital share that is paid in cash/kind. This may indicate that there could be a lack of expertise in applying AAOIFI financial accounting standards by the Islamic banks in Qatar.

Finally, the standard deviation for the *Murabaha*, *Mudaraba* and *Musharaka* varied with the highest for *Mudaraba*. This result indicates that there was variation in the way Islamic banks deal with *Mudaraba* standard. This could support the previous findings that *Mudaraba* products and its standard are much more complex. Nevertheless, the relatively low standard deviation of *Murabaha* and *Musharaka* indicates that Islamic banks are less unstable in complying with their standards. This could suggest that in respect of *Murabaha*, the more this product is used, the less unstable it is in complying with Islamic banks.

5. Conclusion

Islamic banking recently showed a rapid increase all over the world, especially and in the GCC countries. The AAOIFI standards came into being to fill the gap by providing accounting standards that evaluate the main needs of the IFIs. The current study aimed to examine the extent and trend of compliance of disclosure with the AAOIFI financial accounting standards requirements of *Murabaha* (FAS2), *Mudaraba* (FAS3) and *Musharaka* (FAS4) by Islamic banks in Bahrain and Qatar over the 2012-2015 period. The study found the compliance of disclosure of the AAOIFI *Murabaha*, *Mudaraba* and *Musharaka* financial accounting standards by Islamic banks in Bahrain and Qatar was relatively high over the period 2012-2015. However, the Islamic banks in both countries were not fully complied with almost a mean of 20. This finding indicates that there is a gap in the compliance with some particular requirements which need to be further assessed by the Islamic banks and central banks in both countries on the one side and AAOIFI in the other. In addition, the study found that the trend of compliance of disclosure for the three standards was increased over the 2012-2015 period. Moreover, the study found that the compliance of disclosure of *Murabaha* financing financial standard was the highest compared to the *Mudaraba* and *Musharaka* financing financial standards. The *Musharaka* standards showed the moderate-to-high level of compliance of disclosure whereas the *Mudaraba* standards showed a relatively low level. The relatively low level of compliance of disclosure indicated that the *Mudaraba* contracts are complex and contain problems related to its requirements. The findings suggest that the Islamic banks in Bahrain and Qatar need to work on raising awareness and expertise about the AAOIFI financial accounting standards. Finally, the study found that Islamic banks in Qatar had the highest compliance of disclosure for overall, *Murabaha* and *Mudaraba* standards compared to the Islamic banks in Bahrain. However, Islamic banks in Bahrain had the highest compliance of disclosure for *Musharaka* standard compared to its counterpart in Qatar.

The current study has some limitations. First, it is limited to Bahrain and Qatar, which can hinder a broader understanding of the compliance of disclosure requirements of AAOIFI accounting standards. Future research might include more countries from the GCC and Middle East countries in addition to other Islamic countries. Second, the study is inclusive of three financial accounting standards (i.e. *Murabaha*, *Mudaraba* and *Musharaka* financing). Future research might include more standards especially standards related to other products that are used widely by Islamic banks. Finally, the preliminary findings of the study are mainly descriptive. Future research can investigate additional analyses such as causality relationships.

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Appendix 1

Standard	Paragraph	Brief description	Scoring possibilities
FAS2	2/1	Use of historical in measuring asset value at acquisition	Yes, No, NA
FAS2	2/2/1	Valuation after acquisition: case 1	Yes, No, NA
FAS2	2/2/2	Valuation after acquisition: case 2	Yes, No, NA
FAS2	2/2/3	Treatment of discount after acquisition	Yes, No, NA
FAS2	2/3	*Murabaha* receivables recorded at cash equivalent	Yes, No, NA
FAS2	2/3	*Murabaha* receivables shown in the balance sheet	Yes, No, NA
FAS2	2/4/1	Profit recognition: short-term *Murabaha*	Yes, No, NA
FAS2	2/4/2	Profit recognition: long-term *Murabaha*	Yes, No, NA
FAS2	2/5	Deferred profits	Yes, No, NA
FAS2	2/6/1	Early settlement, deduction of part profit possibility 1	Yes, No, NA
FAS2	2/6/2	Early settlement, deduction of part profit possibility 2	Yes, No, NA
FAS2	2/8	Failure to fulfil promise	Yes, No, NA
FAS2	2/8/1	Failure to fulfil promise when the promise is binding	Yes, No, NA
FAS2	2/8/2	Treatment when the promise is non-binding	Yes, No, NA
FAS2	2/9	Disclosure as to whether the promise is binding	Yes, No, NA
FAS2	2/9/2	Presentation	Yes, No, NA

Note: Number of items in this category: 16
Source: Adopted from Vinnicombe (2012) with modifications

Table AI. Disclosure index of *Murabaha* and *Murabaha* to the purchase orderer financing

Appendix 2

Standard	Paragraph	Brief description	Scoring possibilities
FAS3	2/1/4	Presentation in the financial statements	Yes, No, NA
FAS3	2/1/4	Non-monetary assets should be reported as such	Yes, No, NA
FAS3	2/2/1	Measurement of capital paid in cash	Yes, No, NA
FAS3	2/2/2	Measurement of capital paid in kind (fair value)	Yes, No, NA
FAS3	2/2/3	Expenses generally not to be recognised as part of capital	Yes, No, NA
FAS3	2/3/1	Capital should be stated net of repayments	Yes, No, NA
FAS3	2/3/2	Treatment of partial loss of capital	Yes, No, NA
FAS3	2/3/3	Treatment of full loss of capital without negligence	Yes, No, NA
FAS3	2/3/4	Treatment of non-received capital on termination of contract	Yes, No, NA
FAS3	2/4/1	Recognition: short-term contracts profits or losses	Yes, No, NA
FAS3	2/4/2	Recognition: long-term profits – as distributed	Yes, No, NA
FAS3	2/4/3	Recognition: long-term losses – as deducted	Yes, No, NA
FAS3	2/4/4	Recognition: long-term losses – at liquidation	Yes, No, NA
FAS3	2/4/5	Recognition: long-term losses due to misconduct	Yes, No, NA
FAS3	2/5	Disclosure requirements	Yes, No, NA

Note: Number of items in this category: 15
Source: Adopted from Vinnicombe (2012) with modifications

Table AII. Disclosure index of *Mudaraba* financing

Appendix 3

Standard	Paragraph	Brief description	Scoring possibilities
FAS4	2/1	Recognition of Islamic bank's share in the *Musharaka* capital	Yes, No, NA
FAS4	2/2/1	Measurement of the bank's capital share when paid in cash	Yes, No, NA
FAS4	2/2/2	Measurement of the bank's capital share when paid in kind	Yes, No, NA
FAS4	2/2/3	Expenses generally not to be recognised as part of capital	Yes, No, NA
FAS4	2/3/1	Historical to measure the banks share in constant capital	Yes, No, NA
FAS4	2/3/2	Historical cost to measure the banks share in diminishing capital	Yes, No, NA
FAS4	2/3/3	Treatment where liquidation occurs before complete transfer	Yes, No, NA
FAS4	2/3/4	Treatment where liquidation occurs and the banks share is unpaid	Yes, No, NA
FAS4	2/4/1	Recognition: short-term contracts profits or losses at liquidation	Yes, No, NA
FAS4	2/4/2	Recognition: long-term diminishing contracts profits and losses	Yes, No, NA
FAS4	2/4/3	Recognition: long-term constant contracts profits and losses	Yes, No, NA
FAS4	2/4/5	Recognition of losses due to partner's negligence or misconduct	Yes, No, NA
FAS4	2/4/6	Provision should be made for doubtful receivables	Yes, No, NA
FAS4 and FAS4	2/5/1 and 1/18	*Musharaka* Finance contracts should be recorded in the balance sheet	Yes, No, NA

Note: Number of items in this category: 14
Source: Adopted from Vinnicombe (2012) with modifications

Table AIII.
Disclosure index of *Musharaka* financing

Corresponding author
A.A. Ousama can be contacted at: osamaanam@gmail.com