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A CRITIQUE ON CONSOLIDATION ACCOUNTING FOR ISLAMIC FINANCIAL INSTITUTIONS

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Abstract

Since the establishment of the AAOIFI in 1990, 94 standards in areas of Shariah, accounting, auditing, ethics and governance have been issued, accompanied with a wide acceptance by many countries in which the AAOIFI standards became voluntary or obligatory adopted. Hence, as a newly established Shariah-based accounting standard setting organization, a study that investigates the compatibility of AAOIFI accounting principles with the issued standards, along with examining the usefulness extents of these standards to the different stakeholders is a necessity. To this end, this paper investigates the compatibility of the principle of "form-over-substance" with the AAOIFI FAS 23(Consolidation) as applied by parent IFIs, along with examining the usefulness extent of consolidated reports for IFIs to the different stakeholders. The paper is based on documentary and textual analysis of Islamic accounting theory. The study concluded that consolidation accounting is considered as one of the very first expression of the substance over form principle because it gives priority to the reality of economic relationships over legal form. Meaning that, a large discrepancy between consolidation accounting principles and the framework of principles as set forth by the AAOIFI is existed. Furthermore, the study concluded that stand-alone financial statements for a parent IFI are crucial for stakeholders to evaluate financial performance of the parent IFI accurately.

Keywords: Islamic Accounting; Consolidation Accounting; Islamic Financial Institutions, AAOIFI Standards, Form and Substance.

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1. Introduction

For now, the current figures of Islamic financial services sector are promising. Islamic finance industry has been growing in the value of assets and geographical reach since the establishment of Dubai Islamic Bank as the first modern Islamic bank in the world in 1975. In 2000, the Institute of Islamic Banking and Insurance in London, reported more than 200 IFIs working in 63 Islamic and non-Islamic countries as cited by Maali & Napier (2010) with total assets reaching out to 1.9 SUD by the end of 2016 as stated by the Islamic Financial Services Board (2017). Given this rapid growth and the different nature of IFIs' products and services, IFIs are in need to Islamic accounting standards to increase and enhance the disclosure level in the annual financial reports of IFIs (Sarea & Hanefah, 2013). Some have argued that an Islamic accounting system that commensurate with attitudes, objectives and values of Islamic economic may be more appropriate for IFIs (Abdul Rahman, 2010; Hameed, 2000). Moreover, Uddin (2011) argued that Islamic accounting standards are required for IFIs for many reasons. Firstly, the nature of profit derived from Murabaha is to be recognized equally over the contractual period, while under the IFRS, interest rate is used to recognize the profit. Secondly, the profit equalization reserve used by IFIs is not allowed by IFRS. Thirdly, IFRS requires to discount future cash flow using interest rate. Fourthly, IFRS does not have accounting standard related to corporate zakat. Finally, Takaful companies cannot apply IFRS No.4 on insurance contracts (Uddin, 2011). Another accounting issue relevant to the nature of Unrestricted Investment Account has emerged. IFRS did not recognize the nature of URIA in that it is an element which bear features of both liability and equity- the AAOIFI recognizes unrestricted investment accounts as semi equity (Uddin, 2011).

To this end, the accounting and auditing organization for Islamic financial institutions (AAOIFI) established to develop standards to guide Islamic finance industry around the world. For now, 94 standards in the areas of Shariah, accounting, auditing, ethics and governance are issued. For the purpose of developing accounting standards for IFIs, the Islamization approach was adopted by the AAOIFI so that accounting standards previously developed by other standard setting bodies which are consistent with Shariah are adopted. Moreover, the AAOIFI went further to develop Shariah compliant concepts to replace the concepts which previously developed by other standard setting bodies which conflict with Shariah principles. In this context, the AAOIFI stated clearly that all principles in its conceptual framework are Shariah-compliant and nothing in the conceptual framework should lead to conflict with Shariah principles even in financial reporting matters (AAOIFI Exposure Draft, 2010, p. 4).

Since accounting standards for IFIs issued and developed by the AAOIFI are distinguished by being derived from Shariah principles and rules, thus, AAOIFI financial accounting standards have been designed to ensure that all matters of IFIs are within the Shariah framework. This can obviously be noticed through the objective of the approach adopted by the aaoifi to develop financial accounting standards which is to ensure compliance with the Islamic shariah even in matter related to financial reporting as stated in para (2.1) of the aaoifi exposure draft.

Coming to Islamic accounting principles, one of the most important principle that distinguish Islamic accounting (as adopted by the aaoifi) from its counterpart conventional accounting is the "form over substance" principle. This principle went into a deep discussion by the aaoifi board which finally resolved that: "… the term substance should not be interpreted in the context of conventional standards, for instance

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as the term is being commonly interpreted for Ijarah transactions" (AAOIFI Exposure Draft, 2010, p. 25). By looking at the FAS-8 of AAOIFI (Ijarah and Ijarah Muntahia Bittamleek), all Ijarah leases are classified as operational leases even though they are finance leases in substance. In fact, the effect of adopting the principle of "form over substance" is not limited to leases contract, it further goes to affect broad range of events and financial transactions.

The next section of this paper outlines the relevant literature. The third section elaborate on the research method. The fourth section discuss the findings. The paper ends with conclusion and recommendations.

2. Problem Statement

The need for Islamic accounting standards has emerged with the advent of Islamic financial institutions in the 1970s. Many scholars have advocated the need for Islamic accounting standards that commensurate with the objectives, attitudes and values of Islamic economics (Abdul Rahman, 2010; Hameed, 2000). To this end, Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) established to develop standards in the area of accounting, auditing, Shariah, and governance to guide Islamic finance industry worldwide. In order to develop accounting standards for IFIs, AAOIFI has issued a conceptual framework, which constitute a body of interrelated objectives and fundamentals of the accounting standards, derived from Shariah principles. This has been stated in the AAOIFI Exposure Draft of 2010 that is all principles in its conceptual framework are Shariah-compliant and nothing in it should lead to conflict with Shariah principles even in financial reporting matters.

The principle of "form over substance" was adopted by AAOIFI as one of the key principles that distinguish Islamic accounting from its counterpart conventional accounting. In this regard, the AAOIFI Board went into a deep discussion and resolved that: "… the term substance should not be interpreted in the context of conventional standards, for instance as the term is being commonly interpreted for Ijarah transactions" (AAOIFI Exposure Draft, 2010, p. 25). According to AAOIFI FAS-8 (Ijarah and Ijarah Muntahia Bittamleek), Ijarah transactions are all classified as operational leases, however, they are finance leases in substance. Meaning that the emphasis has been given to the legal form over economic substance for all Ijarah transactions and this should also be applied to all financial transactions of IFIs.

Now, the question is: does consolidated financial statement No 23 that issued by AAOIFI based on the principle of form over substance? In fact, consolidation accounting is considered as one of the very first expression of the substance over form principle because it gives priority to the reality of economic relationships over legal form which means a large discrepancy between consolidation accounting principles and the framework of principles as set forth by the AAOIFI is existed.

Moreover, to what extent are consolidated reports useful to decision makers? Users of financial reports expect to get financial information that enable them to measure; financial performance, financial position, cash flows, analyse receivables, long-lived assets, liabilities and stakeholders' equity in order to take more informed decision toward the targeted entity which are not available in consolidated reports. This is because the parents' separate financial statements are not available for external users.

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3. Research Questions

The article questions are based on the assumptions that: (1) consolidation standards No-23 that issued by aaoifi is contradicting with the principle of form over substance as adopted by the aaoifi, and (2) the consolidated reports of IFIs are useless for the external users to make informed economic decisions. Therefore, the article investigates the following two questions;

1. To what extent does AAOIFI consolidation standard No-23 contradicts with principles and concepts that set forth in the conceptual framework?
2. To what extent are consolidated reports useful to decision makers?

4. Purpose of the Study

The purpose of this article is to investigate the investigates the compatibility of the principle of "form-over-substance" with the AAOIFI FAS 23(Consolidation) as applied by parent IFIs, along with examining the usefulness extent of consolidated reports for IFIs to the different stakeholders.

5. Research Methods

This paper adopts a qualitative research method, specifically a document research and textual analysis. This is because these approaches are the most appropriate to prove the arguments and view point of this article. As this is the first study in this area, empirical study will not be appropriate. The documentary and textual analysis of this article mainly include relevant Islamic accounting literature, history and principle of consolidation accounting literature and law and consolidation accounting literature.

6. Analysis and Discussion

6.1. History of Islamic Accounting.

Muslims have a general presumption that Islam is not just spiritual rituals for people, it is a comprehensive system of life that covers both; spiritual and material aspects. Some went further to argue that Islamic religion involves teachings relevant to economic, culture and accounting techniques and ethics for accountants (Mohamed Ibrahim, 2001; Zaid, 2000a). General guidelines for accounting practices were found in Quran and Sunnah. In Surah Al Baqarah (199) Allah SWT says: "O you who believe! When you contract a debt for a fixed period, write it down. Let a Scribe write it down in justice between you. … that is more just with Allah; more solid as evidence, and more convenient to prevent doubt among yourselves...". This longest single verse in the Quran revealed how to records a transaction of financial debt for a fixed period of time (Napier, 2009). Napier goes further to argue that the verse does not indicate the subsequent steps when the transactions are mature. However, the verse emphasis clearly on the importance of recording the debt transaction and goes further to show us the way of recording the debt transaction by taking into account the legal form at the time of recording such financial transactions. The emphasis on the testimony and the documentation of the transaction is to ensure that all legal rights of the contracting parties have maintained and recorded properly.

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Islamic accounting dates back to the Islamic state established by prophet Mohammed Peace be upon him (PBUH). According to Zaid (2000b), in early time of the Islamic state, evidence of accounting records was found in Turkey and Egypt. In addition to the survived accounting records after the disintegration of the Ottoman Empire, considerable accounting archival belong to the eleventh and twelfth century was found (Zaid, 2000b). Many scholars such as (Orbay, 2005; Toraman et al., 2006; Yayla, 2007) have examined many accounting reports related to Wakaf which survived after the disintegration of the Ottoman Empire. Some other scholars have indulged into studying estate accounting records belong to some dead people (Napier, 2009). Toraman, Ögreten, & Yilmaz (2006) have studied the Ottoman Empire bookkeeping style. Toraman et al. (2006) examined the accounts of the Eregli Coal Company which is one of the first modern corporation in the Ottoman Empire during the period between November 1842 to November 1845. They found that financial records of the Eregli Coal Company are different from the conventional accounting system by having the same traditional Ottoman accounting system style.

During the early Islamic state, the term accounting and accountant were not used. Instead, the terms Al Kateb, Mubasher and Katebul Mal were commonly used to refer to accountant or bookkeeper. The Kateb and the Mubasher are general terms used interchangeably to refer to those who record transactions which are not limited to financial once, on the other hand, Katebul Mal term is specific to those who are specialized in recognizing, recording and measuring financial transactions. According to Zaid (2000b), the main motives behind the development of Islamic accounting were the imposition of the religious levy which called Zakat and the growing responsibilities of the Islamic state toward people. In the early stage of Islamic state, Zakat constituted the main resource of the state treasury. The significant increase in Zakat revenues during the reign of Caliph Omar Bin Al Khattab necessitate the need for a proper recording of all revenues that calculated from Zakat in order to facilitate the distribution process to the different beneficiaries as stated by the Qur'an (poor, indigent, travellers, bankrupt, zakat collectors, to liberate slaves or oppressed people and "in the way of God"). The idea of establishing records to have control on the incomes and outcomes of the Islamic state has come out by the companion Al-Waleed bin Hisham Al-Mugier (As-Saleh, 1982; Zaid, 2000b). In this context, the Caliph Omar Bin Al khattab established the Baitul Mal and appointed Katib Al-Mal to be responsible to keep records that contain statistical reports for all ins and outs of the Zakat revenues. Hameed (2000), Hameed & Ibrahim (2012), Ather & Ullah (2009), Zaid (2000b); Zaid (2000a) are all agree on the significant role of Zakat in developing the Islamic accounting. In addition to Zakat, trade activities in Muslim countries contributed significantly to the development of Islamic accounting. These activities in Arab peninsula were flourishing before Islam and become more thriving after the founding of the Islamic state. The booming trade in Arab peninsula during that time necessitated traders to maintain accounting logs to facilitate the process of recording, measuring and reporting the results of their financial transactions. In addition to reporting the final result of their transactions, accounting records were also important for trader in order to help them measuring the profit and capital growth for the purpose of proper measuring for Zakat (Zaid, 2000b).

In conclusion, the development of Islamic accounting in the early Islamic state is mainly attributed to Zakat calculation and the transmission of business authority to individual persons who are not the owners of the businesses. The process of delegating business authority to other individual persons through

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Musharakah, Mudarabah and Wakalah contracts have highlighted the need to maintain sufficient accounting records for the purpose of measuring the business results and calculating Zakat accordingly.

6.2. Consolidation Accounting: Objectives and Basis.

The history of consolidation accounting dates back to 1900. It was first used in the US by the United States Steel Company which published consolidated financial statements since its inception in 1901 (NOBES et al., 2010), and concepts like "entity" and "group" have emerged later with the evolution of its theoretical principles (Nistor, 2015). In consolidation accounting, a parent's financial reports are merged with its subsidiaries on line-by-line basis to reflect the existence of only one economic entity. They show the operating results and financial position for the group as if the individual entities were a single economic entity.

Until the moment, the objectives of consolidated financial statements are still mysterious. According to Walker (2006), much of accounting consolidation literature covered the technique of preparing consolidated financial statements and avoided to state to what exactly these statements were intended to show (Walker, 2006). Supporters of consolidated reports claim that consolidated financial statements are important because they reflect the soundness of financial position for the group. The objectives of consolidated financial statements as stated by the different regulatory bodies are almost similar. The 1937 SRC No. 3 (accounting release), 1959 ARB No. 51 (AICPA) and 1978 ASC SSAP 14, all stated that consolidated financial statements were intended to show a single legal entity for a group of entities (a parent company with its subsidiaries). The 1988 IAS E30 and the 1992 FRS 2 claims that consolidated reports are important because they provide financial information about the overall financial status including the changes in financial position of the group. In addition, 1992 FRS 2, 1994 IAS 27, 2013 IFRS 10 and 2015 AAOIFI FAS 23 agree that a group of account must be prepared for entities under the control of a parent. On the other hand, opponents of consolidated reports claim that no one up to date could prove that consolidated financial statements gives economic decision makers useful information on the overall soundness of the financial status of group companies as an economic unit (Frank Clarke, Dean, & Oliver, 2003)". For them, consolidated financial reports do not reflect the reality of the financial status of the group. Frank Clarke et al. (2003) argued that the financial performance and financial positions figures obtained from data in consolidated financial statements are fictitious. They add; the most misleading aggregation of financial data are the consolidated financial reports. This is because the notion of a "group" that is consolidation accounting is based on is just an accounting fiction. The idea of "consolidated" revenues, expenses, assets and liabilities, contradict with the legal transactions' financial outcomes. In this context, the Accounting Standards Review Committee (ASRC) on its comment to the Australian Company Accounting Standards stated that: "to say that a group can have a state of affairs or can earn profit is misleading… no set of consolidated reports can give a true and fair view of anything" (Accounting Standards Review Committee, 1978, pp. 128–9; Chambers, 2014). The logic behind those claims is that the process of injecting data to consolidated reports that often do not appear in financial statements of the separate legal entities, require assumption of "not-at-arm's-length" in order to apply the consolidation standard to the group financial statements which in turn would produce adverse outcomes to those reflected

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in the separate once (Frank Clarke et al., 2003). Furthermore, Clarke& Dean (2010), on their commentary to the proposed amendments of the Australian Corporate Reporting Framework 2010 mentioned that:

"Stockholders in listed companies will not have access to the financials of the parent companies in which they have invested. This is because consolidated reports are prepared in accord with highly questionable accounting practices that generally mask, rather than elaborate, their financial relationships." (Frank & Graeme, 2010, p. 1)

According to the accounting standard No. 10 (Consolidated Financial Statements) that issued by Australian Accounting Standards Board (AASB), a parent may not present their separate financial statements to external users, therefore, consolidated reports are the only available to the different users.

From Islamic accounting perspective, examining the existed concepts in conventional accounting against Shariah and developing concepts which are unique for some Islamic finance transactions is the approach used by the AAOIFI to develop accounting standards for IFIs (Aida, 2009). As mentioned earlier, objective of the approach adopted by the aaoifi to develop financial accounting standards is to ensure compliance with the Islamic shariah even in matter related to financial reporting. Meaning that, accounting standards for IFIs issued and developed by the AAOIFI are designed to make sure that financial and no-financial matters of IFIs are within Shariah framework. To this end, the AAOIFI has adopted the principle of "form-over-substance" as one of the most important principle that distinguish Islamic accounting (as adopted by the aaoifi) from conventional accounting. The aaoifi in its conceptual framework adopted on 22 July 2010 stated clearly that: "for faithful representation … it is important to take into account the substance and economic reality of a financial transaction along with the legal form". In this context, the board members of aaoifi emphasised that the interpretation of "substance" should not be like that of conventional standards, but rather, as the term being generally interpreted for Ijarah transactions. Given the FAS-8 of AAOIFI (Ijarah and Ijarah Muntahia Bittamleek), all Ijarah leases are classified as operational leases even though they are finance leases in substance. Thus, it became clear that the legal form of a transaction has been given a bigger emphasis in aaoifi accounting standards over the economic substance.

The effect of adopting the principle of "form over substance" is not limited to leases contract, it further goes to affects a broad range of events and financial transactions. According to Meyer (1976), twenty-seven instances classified into four categories are affected by the principle of "substance over form". In category 1, which contain six items in which ownership characteristics are prevailing, there are six items classified under this category in which consolidated financial statements is one of them. Those items are the earnings per share denominator, consolidated reports, method of equity, the pooling of interests method, long-term leases as purchases and long-term leases as sales. Meyer, on his commentary to the effect of "substance over form" on consolidated financial statements said, "the presentation of consolidated financial statements, in lieu of those of the parent and its subsidiary(ies) on an unconsolidated basis, reflects the notion of the economic unity characteristic of a single company" (Meyer, 1976, p. 82). It is undoubtable that conventional consolidation accounting is based on the principle of "substance over form". In other words, consolidated financial statements are based on the acquisition transaction which in turn is determined based on the concept of control. Regardless of the legal form of the acquisition transaction, consolidated financial statements would lead to show the financial position and the results of operations for the group as if the individual entities were a single economic entity.

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Coming to the objectives of financial information, financial reporting is designed in a way that enable people who use this information to make more informed decisions. However, from the Islamic accounting perspective, the type of financial information needed by users of financial statements may differ from those of conventional accounting, but the ultimate purpose of using financial reports is to make informed economic decision. The question posed is "to what extent consolidated reports can provide useful information to the different stakeholders?". In other words, users of financial reports expect to get financial information that enable them to measure; financial position, financial performance, cash flows, analyse receivables, long-lived assets, liabilities and stakeholders' equity in order to take more informed decision toward the targeted entity. Consolidated financial reports have been accused widely of distorting the usefulness of accounting information. Nistor (2015), on his article that touched on some matters relating to theories of consolidated reports concluded that information presented to the stakeholders by using the entity theory are unjustified by the market value relevance of information. He further argues:

"legally, subsidiaries and parents are separate entities, no claims the shareholders of subsidiaries have on the parents, respectively on its profits. As a consequence, financial information regarding the assets, liabilities or income of the individual subsidiaries which are needed by the shareholders and draw upon the data in consolidated financial statements are useless for economic decision making". (Nistor, 2015, p. 434)

Clarke et al., 2003, Walker, 2006 and Frank & Dean, 1993 all agree on the pseudo role of consolidated financial statements. For them, consolidated reports do not reflect the reality of a financial transaction in its legal, economic and social contexts. They accused consolidated financial statements of playing a major role to many Australian corporate failures by failing to provide useful accounting information to assist users to take informed decision regarding the financial health of a corporate group.

6.3. Arguments of Form and Substance.

One of the most important accounting principle is the form and substance. The application of this principle to financial accounting significantly affects the classification, recording and presenting of financial transaction. From a conventional accounting view of point, the concept of Substance over Form is prevailing. Looking at IFRS, economic substance has been given greater emphasis over the legal form. However, this does not mean that legal form is ignored (Shafii, at al. 2013). In this context, the IASB's Conceptual Framework for Financial Reporting Paragraph 2.14 (IFRS Foundation, 2015) stated clearly that: "… a faithful representation provides information about the substance of an economic phenomenon instead of merely providing information about its legal form".

The application of Form and Substance for reporting Shariah-compliant financial transaction differ significantly from its application to conventional accounting. Hameed (2000), argued that new types of financial instruments such as Mudarabah and Muqarada bonds have the characteristics of both debt and equity, therefore, a different accounting treatment is needed. In this regard, Hameed stated:

"… this is not only a matter of different technique but also a matter of change in the fundamental accounting assumption of substance over form, which underlies conventional accounting standards, e.g. IAS 1 (IASC, 1975) which may not be acceptable from an Islamic point of view". (Hameed, 2000, p. 184)

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Standard setting bodies for IFIs have been with considerable disagreement regarding the recognition of whether "Substance over Form, or Form over Substance". For instance, Shariah Advisory Council of Malaysia (SAC) in its 57th meeting dated 30 March 2006 and 71st meeting dated 27 October, has resolved that:

""substance" and "form" are equally important and highly taken into consideration by the Shariah. In this regard, the Shariah emphasises that "substance" and "form" must be consistent and shall not contradict one another. In the event of inconsistency between "substance" and "form" due to certain factors, the Shariah places greater importance on "substance" rather than "form"".

Stokes (2010), has clarified the basis for adopting the principle of "Substance over Form" by the SAC. In this context, Stokes argued that some Islamic finance contracts ('uqud mustajiddah) include similar elements of traditional contracts ('uqud musamma) and they are binding on one another in a certain aspect, so that, independent reporting of a group of transactions included in this contract would give rise to a kind of uncertainty in the transactions as a whole. Accordingly, recording the group of transactions that are included in the new contract as one transaction only is needed. This process is consistent with the application of "substance over form" principle. Stokes has based his argument on the fiqh maxims which say, "Matters are determined according to intentions", and "In contracts, effect is given to intention and meaning and neither words nor forms". (Shafii et al., 2013) added; the majority of scholars from Hanafis, Malikis and Hanbalis adopted the principle of "Substance over Form", therefore, the SAC of BNM has followed the majority view of scholars to recognise both the substance and form; and in case of conflict raised between the two, the principle of substance over the form is preferred.

In contrast, the second approach which adopted by Hanafi and Shafi'i scholars suggest the opposite. According to this approach, scholars emphasis that the criteria of judging any matter including contracts must depend on their form and structure alone, aside from contractors' intentions and objectives (Abozaid, 2010). The argument of this is based on the Hadith in which the prophet PBUH says "I am a human, so I give judgments based on what I hear; however, if I happen to make a wrong judgment, my judgment then would not legalise the prohibited ... and it is up to him to take or leave". To this group of scholars, judging a contract validity is based on the compliance of its form and structure to Shariah. Coming back to adopting "form and substance" principle by standard setting bodies, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has adopted the principle of "form over substance" to report financial transactions for IFIs. In its conceptual framework (2010), AAOIFI stated clearly that the interpretation of the term "substance" should not be in the context of conventional standards, but rather as the term was interpreted for Ijarah transactions. AAOIFI FAS No. 8 (Ijarah and Ijarah Muntahia Bittamleek) has given preference to the legal form over the economic substance for reporting IMBT transactions. Dr Mohamad Akram Laldin, a Shariah adviser at HSBC Amanah and an Assoc. Prof at INCEIF, gave an answer to "Why does AAOIFI treat all leases as operating lease? Akram says; the underlying contract used in IMBT is Ijarah. Looking at the Fiqh discussion of Ijarah, all the way has confined it to operating lease. He further added:

"IMBT contract is actually two contracts. And when we have two contracts they must be separated because the prophet PBUH prohibited two sales in one, which means selling one item with the condition of

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the other party agreeing in the second deal. That's why AAOIFI has preserved the original of Ijarah as discussed in the classical literature of Fiqh" he elaborated.

The adoption of whether "Substance over Form or Form over substance" by an accounting standard setting body would make significant effects to the classification, recording and presentation of financial transactions. Many literatures discussed the implications of adopting "form over substance, or substance over form" on lease contracts. However, the principle of Form and Substance underlies all accounting principles related to consolidation scope, definition of assets and liabilities, definition of equity… etc. (Muller-lagarde, 2015).

6.4. Form and Substance and Consolidation Scope.

The principle of "substance over form" has constituted a contentious issue between accountants as advocates of substance and the lawyers who always push toward preserving the integrity of legal form. Thus, accountants claim that adopting the legal form over the economic substance may constrict the presentation of useful accounting information and the freedom to require new approaches may be constrain by the legal rules. From the other side, lawyers argue that the interpretation of accountants to the term of "substance" could be very subjective and idiosyncratic, and in any case, conflict with 'the law" should not be permitted (Freedman & Power, 1991a).

Consolidated financial statements as defined by AAOIFI are: Financial statements for a group of entities prepared and presented as those for a single economic entity. Accounting Principle Board (APB) which later was replaced by FASB -in its definition for consolidated financial statements- highlighted the effect of adopting the principle of "Substance over Form" to consolidation accounting. APB statement 4 explained;

"financial position and operating results of a parent company and its subsidiaries are essentially presented in consolidated reports as if the group were a single enterprise comprised of branches or divisions. The resulting accounting entity is an economic rather than a legal unit, and its financial statements are considered to reflect the substance of the combined economic relationships to an extent not possible by merely providing the separate financial statements of the corporate entities comprising the group."

This statement shows clearly how consolidated financial statements reflect the economic entity rather than the legal unit (McKee, Bradley, & Rouse, 2006). Many authors consider consolidation as one of the very first expression of the substance over form principle because it gives priority to the reality of economic relationships over legal form (Muller-Lagarde, 2015).

The effects of adopting the principle of "form over substance" by AAOIFI were supposed to be reflected on other accounting standards where appropriate. Thus, according to the application of "form over substance" principle, consolidation accounting is required to be applied if (and only if) merger between businesses occurred. This is because the difference between the legal definition of Merger and Acquisition is considerably vast. Merger as defined by Auerbach (1987) is an amalgamation of two or more entities in which the acquirer firm absorbs the assets and liabilities of the acquiree firm(s). As a result, the acquirer company may retain its original legal entity. In other words, the merger process requires an emergence of identity of one of the two existing entities into another existing entity. Merger can also occur by the

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dissolution of all existing companies and forming a new company by merging their identities into the new emerged company (Auerbach, 1987). On the other hand, Acquisition is based on controlling the financial and operating policies of the subsidiaries with maintaining the independent legal status for both acquirer and acquiree entities. Thus, in contrast to the principle of "form over substance", consolidation accounting practices were allowed by the AAOIFI to account for acquisition transactions.

6.5. Law and Consolidation.

The relationship between accounting and law, in the broad sense of both words, is currently constituting an issue in the world of professional practice. Early accounting studies, such as Napier & Noke (1992) show how the accounting profession in UK is considered as a secondary product of the law and its processes. In this regard, Freedman & Power (1991) went so far to say:

"The substance of law and accountancy ... are becoming increasingly interrelated largely … for certain kinds of transaction, it has become impossible to reflect upon UK business law and accounting in isolation from one another" (Freedman & Power, 1991b, p. 2).

Accounting practices are currently part of the law. The development of accounting practices shows that mercantile practices, regulated by the legislature, the courts and regulatory bodies, are greatly influenced by the language of accounting. Freedman & Power (1991) said that the convergence between law and accounting which reflect the transformations in the marketplace for financial services, might suggest that interdisciplinarity, both intellectually and in terms of professional organisation, should be a natural result. They also go further to elaborate:

"This proximity is evident not merely at the level of substantive developments in company law, concepts of legal liability and the regulation of financial reporting. It also has much to do with a shifting institutional territory, the changing nature of the legal and accounting professions and their claims to expertise on behalf of clients, regulators and a wider public." (Freedman & Power, 1991b, p. 2)

Clarke & Dean (1993), on their article that touched on the validity of claims related to the functions of, and mechanisms for preparing, consolidated accounts under the legislative prescription of the provisions of Australian Law, among many other things, discussed in detail the mandatory financial disclosure of Australian holding companies. In 1991, Australian Securities Commission (ASC) has sanctioned and extended the scope of the Class Order Deed of cross guarantee which was previously sanctioned by the National Companies and Securities Committee (NCSC), whereby all "closed group" companies are required to carry out a deed of cross guarantee. As a result, each "closed group" company would be liable to claims of the creditors of every other company within the group in case of deficiency in the wind-up of a "closed-group". As stated by the ASC, the rationale behind the cross-claim guarantee was to make sure that the effect of going through a Deed of Cross Guarantee for a totally-owned subsidiary was to effectively combine its assets and its liabilities with the holding company once (Clarke, frank Dean, 1993).

What constitute a significant issue in the relationship between consolidation accounting and the law is embodied in the creditors' rights in group liquidations. Cross-claim guarantee is no longer existed in current companies' legislation. The relieving of holding companies from preparing separate subsidiaries accounts aside with cross-claim guarantee relief, would result in loss of creditors' rights. Moreover, the

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current status of consolidated accounts has lost its rationale that was available in consolidation accounting procedures which sanctioned in old company's legislation.

7. Findings

7.1. Consolidation and conflict with form over substance principle

The conflict between accounting and law professions has been an issue for a long time. As discussed above, the issue under dispute between layers and accountants is the application of form and substance principle. The application of this principle to financial accounting significantly affects the classification, recording and presenting of financial transaction (Meyer, 1976). From a conventional accounting view of point, the concept of Substance over Form is prevailing where conflict between the two exists. On the other hand, the application of Form and Substance for reporting Shariah-compliant financial transaction is different from its application to conventional accounting. The longest verse in Surah Al Baqarah (199) Allah SWT emphasis on the importance of contractual recording of the debt transaction and goes further to show us the way of recording the debt transaction by taking into account the legal form when recording the debt transactions. The emphasis on the testimony and the documentation of the transaction in this verse is to ensure that the legal rights of the contracting parties have maintained and recorded properly. Accounting researchers such as Hameed (2000) and Abdul Rahman (2010) argue that due to the different worldview of Islamic economy, then developing Islamic accounting system that consist with the values of Islamic economy would be more appropriate. Islamic accounting does not differ from conventional accounting in technique only, but also goes further to differ in the essential accounting principle of substance over form, that underlies the conventional accounting, which may not be acceptable from Islamic perspective (Hameed, 2000). Coming to the AAOIFI conceptual framework (2010) which constitute a body of interrelated objectives and fundamentals of the accounting standards, para (8.3.3) states that a transaction and other events to be represented faithfully, it is necessary to be represented in accordance with its substance as well as the legal form. In circumstances where substance and form are inconsistent, it has been mentioned in the "basis of conclusions" which are accompanied with the AAOIFI conceptual framework that the term substance should be interpreted in the context of Ijarah standard, but not as the term being commonly interpreted for conventional lease transactions. The AAOIFI treats of all Ijarah contracts as operating leases. However, Ijarah Muntahia Bittamleek and Ijarah Thumma al-bai (lease follow by sale) are sale in substance, so that following the principle of substance over form will result in assets to be booked in the client's books while the bank will treat the finance as receivables in the balance sheet. In contrast, following the form over substance principle to record the lease transaction, Ijarah expenses will be recorded in the books of the client, and leased asset will be presented in the bank's financial position. Thus, the adoption of form over substance for Ijarah transactions gives a proof that AAOIFI follows this principle as a fundamental for all financial accounting standards. As discussed above that consolidation is considered as one of the very first expression of the substance over form principle because it gives priority to the reality of economic relationships over legal form, thus, consolidation standard No. (23) issued by the AAOIFI constitute a major discrepancy between consolidation accounting principles and the framework of principles as set forth by the AAOIFI.

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7.2. Usefulness of consolidation accounting

Under the AAOIFI FAS No.23 para (4/1 and 4/2), an IFI is required to prepare and present consolidated financial statements and on its own volition may present its own separate financial statements with those of its subsidiaries. The underlying arguments regarding the extent of usefulness of consolidated financial statements has arisen as a natural result of the non-availability of the parent's separate financial reports. As discussed above, consolidated financial statements have been criticised severely in conventional literature such as those of F Clarke & Dean (1993), Clarke et al. (2003), Walker (2006) and Clarke & Dean (2010). They all agree on the fictitious and misleading figures of financial performance and financial positions that extracted from the data in consolidated financial reports. The logic behind their claims is that "consolidated" assets, liabilities, revenues and expenses, contradict with the legal financial outcomes of the transaction. They also claim that users of financial reports expect to get financial information that enable them to measure; financial performance, financial position, cash flows, analyse receivables, long-lived assets, liabilities and stakeholders' equity in order to take more informed decision toward the targeted entity which are not available in consolidated reports. In other words, as Nistor (2015) claims;

> *"... because subsidiaries are separate from their parents, the stockholders of the subsidiary have no claim on the parent, respectively on its profits. As a result, stockholders interested on obtaining information regarding the assets, liabilities or income of the individual subsidiaries do not benefit from the consolidated financial statements*" (Nistor, 2015, p. 434).

Thus, so long as consolidation accounting standard that issued by AAOIFI is just a similar version to IFRS 10 -consolidated financial statements- that issued by IASB, all criticism that highlighted in the literature review above are applicable to it.

8. Conclusion

In an effort to explore the adoption of the form over substance principle by the AAOIFI financial accounting standards, an exhaustive review to AAOIFI's conceptual framework, relevant accounting standards and literatures was undertaken. The research inquiry yielded a major discrepancy between consolidation accounting standard and the form over substance principle that adopted by the AAOIFI. In reference to the extent of usefulness of consolidated accounts, the results further show a critical need for separate financial statements for the parent IFI and its subsidiaries. The AAOIFI could have avoided falling in these mistakes if it made consolidation as an additional requirement by enforcing the parent IFI to present its separate financial statements. In case a parent IFI was obliged to present its separate financial statements, the principle of form over substance will not be violated any more. This is because the financial reality in its legal form for the group will be available through the separate financial statements.

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