TUJISE Turkish Journal of Islamic Economics

# Conformity of Islamic Banks with AAOIFI Standards for General Presentation and Disclosure in Turkey and Bahrain*

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**Abstract:** Islamic (participation) banks in Turkey are required to apply international accounting standards in their accounting and reporting practices, while their counterparts in Bahrain apply the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) standards. The main objective of this paper is to reveal the relation between Islamic and international accounting standards, discussed in previous studies, by comparing the compliance to AAOIFI accounting standards by Islamic** banks in both Turkey and Bahrain. The source of information in this study is secondary data provided in the annual reports of the Islamic banks in Turkey and Bahrain for the year 2017. In order to measure compliance, an unweighted disclosure index was used. The outcomes of this study show that, since AAOIFI accounting standards are compulsory in Bahrain, the level of compliance with AAOIFI standards in relation to general presentation and disclosure in the financial statements of Islamic banks in Turkey is lower than the compliance achieved by their counterparts in Bahrain. Due to the average compliance level achieved by Islamic banks (using the unweighted disclosure index) in Turkey (54.6%), and since all banks in Turkey apply international financial reporting standards and international accounting standards, it is found that there is a relation between AAOIFI and International Accounting Standards Board standards even though they are different. Surprisingly, in the case of Bahrain's Islamic banks, the standard deviation of the total compliance score is 8.66, which indicates an important difference among the Islamic banks in Bahrain in this regard. It is also found that the current practices of participation banks in Turkey do not adequately meet the financial statements and disclosure standards in accordance with the AAOIFI.

**Keywords**: AAOIFI, Islamic Accounting Standards, Islamic Banking, General Presentation and Disclosure

**JEL Classification**: M41, G21

* This paper is prepared based on the master's thesis by Yusuf Avşar.
** Islamic banks in Turkey, as explained in the article, are called "participation banks."

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DOI: 10.26414/A291
TUJISE, 8(3), 2021, xx-xx
tujise.org

Submitted: 18.10.2020
Revised: 09.07.2021
Accepted: 15.07.2021
Online First: 30.09.2021

## Introduction

With the emergence of Islamic financial institutions and the growth witnessed in them, and especially Islamic banks, which have introduced unique products and Sharia-based transactions to the economic system, the need for new standards for the keeping and reporting of those transactions accordingly arose. When the first set of Islamic accounting standards were issued in 2004, new financial statements alongside changes in the balance sheet were made to reflect the essence of the Sharia-based banking products. Although these developments may seem new in comparison with conventional banking and accounting, Islamic accounting has always been present within Islam itself (Trokic, 2015; Vinnicombe, 2012).

Legislations in Islam (Sharia) derive mainly from two sources: the Holy Quran and Sunnah. It is mentioned in the Quran that trade and commercial activities are allowed in Islam as long as they do not involve interest (Quran 2:275). The reason behind the prohibition of usury in Islam is that applying interest leads to a wide gap between the rich and the poor as the rich benefit from the suffering of the poor. Basic banking activities in Muslim societies, such as deposit acceptance, date back to the days of the Prophet Muhammad (PBUH), when Muslims would entrust their money with him or with the first caliph, Abu Bakr Al Siddique, and the Prophet Muhammad (PBUH) encouraged Muslims to turn their savings into investments in order to create jobs and reduce poverty (Ökte, 2010, p. 190; Pomeranz, 1997, p. 124). Unlike traditional businesses, Islamic finance is built on risk sharing, income sharing, and loss sharing (Lawal, 2016, p. 22). Islamic banks apply these rules through various Sharia-compliant finance modes, such as mudarabah and musharakah, which are variable-return products, and other products such as murabaha, salam, istisna, and ijarah with fixed returns (Hassan & Lewis , 2007, p. 85).

Today's Islamic finance products can be offered through three types of banks: i) full-fledged Islamic banks, which have no place for conventional products that do not comply with Sharia; ii) conventional banks with Islamic windows; and iii) Islamic cooperatives in countries where the banking legislation does not allow for the establishment of an Islamic bank (Rammal, 2015, p. 4).

In the 1950s, Pakistan witnessed the establishment of the first local experimental Islamic bank in the world, which did not charge interest on loans (Erol & El-Bdour, 1989, p. 31). The first modern example of a profit and loss sharing principle-based bank was the Myt Gamr Savings Bank in Egypt in the early 1960s (Khan, 1986, p. 7). In Egypt in 1971, the Nasser Social Bank was established with the objectives of granting loans with no interest (or qard of good faith) to people in need, supporting students with scholarships, and backing up small enterprises with micro-credits on a murabaha and mudarabah basis. This bank is also known to be the first Islamic institution including the word 'Bank' in its name (Iqbal & Molyneux, 2005, p. 37). The success of the Nasser Social Bank attracted the attention of many businessmen in other Muslim countries, such as Saudi Arabia and the UAE, and 3 years later the Dubai Islamic Bank was established (Wilson, 1983, p. 80). The number of Islamic banks worldwide had exceeded 500 by the year 2017 (Thomson Reuters, 2018).

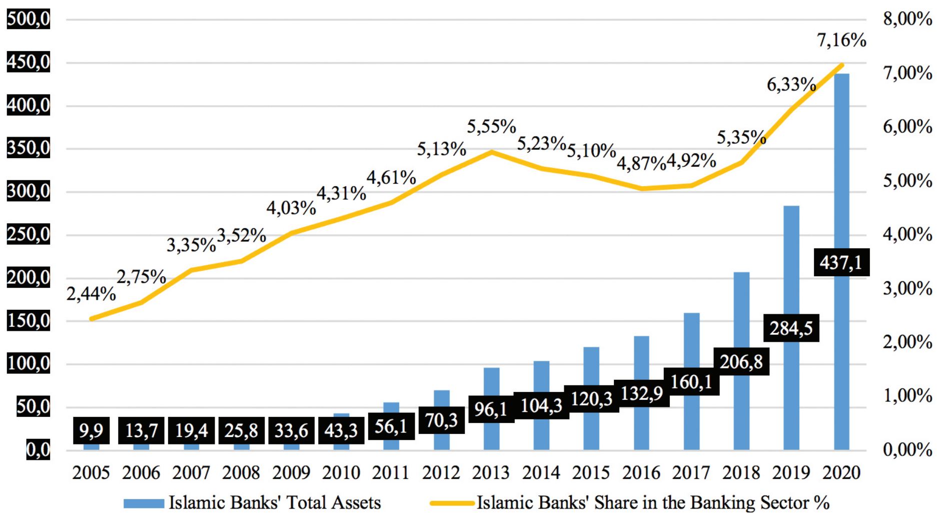
Until the year 2005, the Islamic banks in Turkey, or "special finance houses" as they were called then, were tightly regulated by a secular, and hence skeptical, bureaucracy, and they did not have the same structure and capabilities as their conventional counterparts. For example, the special finance houses (later to be called participation banks) were not included in the Central Bank's insurance scheme (the Deposit Insurance Fund, which was established in 1983) and could not invest in government securities, since they were interest-based, until the Turkish Treasury issued rent certificates (sukuk). Turkish Banking Law No. 5411 ("the Banking Law"), which is the main legislation for banks in Turkey, addressed interest-free banking as a type of banking in Turkey, giving the title of "participation bank," defining the funds collected by participation banks, and founding the Participation Banks Association of Turkey (TKBB), which gave participation banks the same advantages and status that conventional banks had (Kansoy & Karlıoğlu, 2013, p. 134; Ozaltinkol, 2015; TMSF, 2018, p. 9). Participation (Islamic) banks in Turkey prepare their financial statements in accordance with Turkish accounting and reporting standards (TFRSs and TMSs), which are exact translations of the relevant international accounting and reporting standards (IFRSs and IASs) (Avder, 2006). On September 27, 2017, an agreement was signed between Turkey's Public Oversight Accounting and Auditing Standards Authority (KGK) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in order to bring accounting, auditing, ethics, and governance standards related to the Islamic finance sector into legislation in Turkey. These standards were to be put into use by Islamic banks in Turkey starting from January 2020 on a voluntary basis (KGK, 2018).

The first Islamic banks in the Turkish Republic were the Albaraka Participation Bank, established in 1985 as a subsidiary of the Albaraka Banking Group headquartered in Bahrain, and the Faisal Finance Establishment (Sümer & Onan, 2016, p. 4). For four years these banks were the only Islamic banks in Turkey. Four years later (1989), the Kuveyt Türk Evkaf Finans Establishment was founded.

After that, the Turkish Islamic banking sector witnessed the incorporation of other Islamic banks: in 1991, Anadolu Finans; in 1995, İhlas Finans; and in 1996, Asya Finans. In 2001, during the economic crisis in Turkey and due to liquidity problems, İhlas Finance went bankrupt (Selmi, 2018, p. 81; Yanīkkaya & Pabuçcu, 2017, p. 50). The Global Islamic Finance Development Center was established in 2013 in Turkey as a result of mutual collaboration between the Turkish government and the World Bank as a knowledge center for the development of Islamic finance worldwide. For four years, the center took on the duties of leading research, organizing training, and maintaining technical support for World Bank Group client countries interested in developing Islamic financial institutions and markets (Dunya, 2013; Islamic Finance, 2015). By the end of 2020, there were six Islamic banks in Turkey with a total asset volume of 437.1 billion Turkish lira, representing 7.16% of the total banking sector.

**Figure 1**

*Islamic Banks' Assets Development (billion Turkish lira) in Turkey*




Source: (TKBB, 2020)

On the other hand, the Bahrain Islamic Bank was the first Islamic bank to open in Bahrain, established in 1979, and its success led to more development of specialized Islamic products, including leasing, loans, and investment schemes. According to the Central Bank of Bahrain (CBB), the total assets of Bahrain's Islamic banks were $1.9 billion in 2000 (Al-Sulaiti, Ousama, & Hamammi, 2018, p. 3). These banks' total asset volume added up to $26.8 billion at the end of September 2017, in comparison with $26.3 billion at the end of June of the same year, achieving a growth of 9% (BAB, 2018, p. 10). The CBB is the responsible organ for supervising and auditing Islamic banks' operations. Every Islamic bank in Bahrain is also required by the CBB to implement the AAOIFI reporting standards (Vinnicombe , 2012, p. 82). However, the Islamic banks in Bahrain state in their annual reports that they use IFRSs where the AAOIFI standards are silent.

Being a center for Islamic finance, with the support of regional Islamic financial institutions, Bahrain became the home of the AAOIFI, which has set new standards for Islamic institutions. The year 2001 also beheld a significant event in Islamic finance with the development of sukuk (Islamic bonds) by the CBB (OxfordBusinessGroup, 2017). Bahrain is also the host of many institutions that support Islamic finance and particularly Islamic banks, such as the International Islamic Financial Market (IIFM), Islamic International Rating Agency (IIRA), and the General Council for Islamic Banks and Financial Institutions (CIBAFI) (Oushar, 2019).

**Table 1**
*Acronyms*

| | |
|---|---|
| AAOIFI: | Accounting and Auditing Organization for Islamic Financial Institutions |
| BAB: | Bahrain Association of Banks |
| BDDK: | Banking Regulation and Supervision Agency |
| CBB: | Central Bank of Bahrain |
| CIBAFI: | General Council for Islamic Banks and Financial Institutions |
| FAS: | Financial Accounting Standard |
| IAS: | International Accounting Standard |
| IASB: | International Accounting Standards Board |
| IFI: | Islamic Financial Institution |
| IFRS: | International Financial Reporting Standard |
| IFSB: | Islamic Financial Services Board |
| IIFM: | International Islamic Financial Market |
| IIRA: | Islamic International Rating Agency |
| KGK: | Public Oversight Accounting and Auditing Standards Authority |
| TFRS: | Turkish Financial Reporting Standard |
| TMS: | Turkish Accounting Standard |

## Accounting and Auditing Organization For Islamic Financial Institutions (AAOIFI)

The AAOIFI was established in March 1991 through an agreement signed by a number of Islamic financial institutions and registered as an independent and nonprofit global body in Bahrain. Those participating institutions were the Islamic Development Bank, Dallah Al Baraka, Faysal Group (Dar Al Maal Al Islami), Al Rajhi Banking & Investment Corporation, Kuwait Finance House, and Albukhary Foundation (AAOIFI, Faizsiz Finans Standartları, 2015, p. 25). Since then it has been issuing accounting, auditing, ethics, and governance standards for Islamic banks and insurance and investment companies. With a total of 40 regulatory jurisdictions applying the AAOIFI standards either fully or partially, application has expanded to reach Qatar, the Dubai International Financial Centre, Lebanon, Jordan, Syria, and Sudan while the germane jurisdictions in other countries such as Australia, Indonesia, Malaysia, Pakistan, Saudi Arabia, and South Africa have also prepared guidelines based on AAOIFI standards. In its 2020 footprint report, the AAOIFI stated that the total number of regulatory jurisdictions fully adopting the standards was 26, whereby 16 countries adopted the Sharia, 18 the accounting, and 15 the governing standards, while these numbers for the regulatory jurisdictions were 19, 24, and 18 respectively. The number of standards issued by the organization today has reached 117, consisting of 33 accounting, 59 Sharia, and 25 auditing, governance, and ethics standards (AAOIFI Footprint Report, 2020, pp. 24, 28, 53-54; Sakib, 2015, p. 18).

**Table 2**

*Differences between Islamic Accounting and Conventional Accounting*

| | **Islamic accounting (AAOIFI)** | **Conventional accounting** |
|---|---|---|
| **Definition** | An accounting process that enables stakeholders to ensure that their entity is constantly functioning under Islamic or Sharia Law by providing the essential information while accomplishing socioeconomic objectives | Accounting is the science that shows how to make records that will reveal the financial status of the business and also the efficiency of departments and of employees |
| **Contracts** | Contracts are based on profit-loss sharing | Contracts between the borrower and the creditor are based on interest |

| | Islamic accounting (AAOIFI) | Conventional accounting |
|---|---|---|
| **Approach** | Contract-specific approach considers both substance and form alike, taking both contractual rights and obligations into consideration | Principle-based, adopts wide guidelines in addition to thorough procedures, gives consideration to the element of economic cause |
| **Areas covered by the standards** | Particular to the Islamic banking industry and focused on Islamic finance issues that are not covered by conventional accounting | Covers all types of transactions and activities |
| **Issued standards** | Accounting, auditing, ethics, governance, and Sharia standards | Accounting standards |
| **Basis and principles** | Guided by the basic Sharia contractual rights and obligations; Islamic principles | Guided by GAAP, which focuses on comparability; secular and capitalist principles |
| **Operations** | All operations within the limits of Islamic Sharia are permitted | In operations, it allows everything to achieve maximum profit |
| **Reporting** | Reports socioeconomic and religious events and transactions | Reports only economic events and transactions |

Source: (Ahmed, Sabirzyanov, & Ros, 2016, pp. 191-192; Ather & Ullah, 2009, pp. 12-13; Duncan, 1909, p. 84; Hussan & Sulaiman, 2016, p. 113; Nashida, 2015; Trokic, 2015, p. 2)

## Literature Review

Earlier research shows that Nobes (1990), in his work "Compliance by US Corporations with IASC Standards," was the first to consider financial statements of banks to study the level of conformity with accounting standards.

From Table 3 we can conclude that, in general, the measurement of compliance with accounting standards is performed either by survey, like Al-Abdullatif (2007) and Sarea (2012), or by content analysis of annual reports, like Kadri (2016). These works have mainly focused on the host country of the AAOIFI, Bahrain, like those of Hidayat and Abdulrahman (2014), Sarea (2012), and Sarea, Muslih, and Thonse (2017). Other works compared Islamic banks in Bahrain, such as the study of Al-Sulaiti, Ousama, and Hamammi (2018). Papers published in Turkey regarding the AAOIFI standards are limited.

**Table 3**

*A List of Studies on Conformity to Standards in Relation to General Disclosure and Presentation*

| Author, title, and year | Sample, country, and method | Results |
|---|---|---|
| Nobes, "Compliance by US Corporations with IASC Standards," 1990 | An analysis was performed of 200 financial statements of 200 companies listed on the stock exchanges in the USA to measure compliance with IAS No. 3, 4, and 22 | Compliance found to be less than 50% |
| Al-Abdullatif, "The Application of the AAOIFI Accounting Standards by the Islamic Banking Sector in Saudi Arabia," 2007 | The research covered 499 people from universities, auditing firms, Islamic banks, and Islamic windows in conventional banks in Saudi Arabia | The results of the survey showed lower awareness of AAOIFI accounting standards than expected |
| Nadzri, "Roles and Impacts of Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in Dealing with the Accounting and Disclosure of Zakah and Interest (Riba)," 2009 | The sample covered 25 Islamic financial institutions worldwide for the years 2006 and 2007 and FAS No. 2, 3, 4, and 9 | The level of compliance was lower than the AAOIFI requirements; compliance found to be higher in the institutions that adopted AAOIFI standards than institutions that did not |
| Sarea, "The Level of Compliance with AAOIFI Accounting Standards: Evidence from Bahrain," 2012 | A total of 129 questionnaires covering all Islamic accounting standards and consisting of 20 questions were handed out to Islamic bank accountants in Bahrain | 100% compliance |
| Vinnicombe, "A study of Compliance with AAOIFI Accounting Standards by Islamic Banks in Bahrain," 2012 | The author prepared this study as a continuation of her work in 2010; besides the standards covered in her previous work, the author added standards in relation to musharakah and restricted and unrestricted investment accounts; using various index disclosures, a total of 100 items were checked to measure compliance by Islamic banks in Bahrain | The results indicated higher compliance for some Islamic issues than others |

| **Author, title, and year** | **Sample, country, and method** | **Results** |
|---|---|---|
| Ullah, "Compliance of AAOIFI Guidelines in General Presentation and Disclosure in the Financial Statements of Islamic Banks in Bangladesh," 2013a | Financial statements of 7 Islamic banks in Bangladesh for the year 2011 were examined; a comparison was made with 203 items taken from FAS 1 | On average, banks were found to be in compliance at a rate of 44.68%; according to the standard deviation of 3.14, there is very little difference between the banks covered in the study |
| Hidayat & Abdulrahman, "An Analysis on Disclosures in the Annual Reports of Islamic Banks in Bahrain," 2014 | Authors executed analysis of 5 Islamic banks in Bahrain for the year 2010 | Bahrain's Islamic banks achieved high compliance with mandatory disclosures required by AAOIFI accounting standards |
| Hossain & Khatun, "Disclosure Compliance of Islamic Banks in Bangladesh: Local and International Regulatory Perspective," 2014 | In order to measure compliance by full-fledged Bangladeshi Islamic banks, two lists of standards were checked against Bangladeshi banking guidelines and AAOIFI standards | Rates of compliance to local and AAOIFI standards were respectively 94.20% and 64.22% |
| (Kadri , Islamic Financial Reporting: Evidence from Malaysia, 2016) | In Malaysia, 17 Islamic financial institutions' annual reports were compared with the AAOIFI's disclosure requirements | Results found compliance to presentation of the financial position statement, income statement, statement of changes in equity, and cash flow statement to respectively be 70.3%, 45.6%, 95%, and 100% |
| Sarea, Muslih, & Thonse, "Measuring the Level of Compliance with Financial Accounting Standard No. 8: Evidence from Bahrain," 2017 | Using a survey, this study aimed to examine the awareness of Islamic financial institutions' accountants in Bahrain on the level of conformity with FAS 8 | Islamic banks in Bahrain were highly compliant |
| (Ullah, Khanam, & Tasnim, Comparative compliance status of AAOIFI and IFSB standards An empirical evidence from Islami Bank Bangladesh Limited, 2017) | The compliance by IBBL Islamic Bank in Bangladesh, which is a member of both IFSB and AAOIFI, was measured regarding AAOIFI and IFSB standards using annual reports for the period of 2008-2012 | The bank achieved compliance with AAOIFI standards by 46.31% and IFSB standards by 52.5% |

| **Author, title, and year** | **Sample, country, and method** | **Results** |
|---|---|---|
| Al-Sulaiti, Ousama, & Hamammi, "The Compliance of Disclosure with AAOIFI Financial Accounting Standards: A Comparison between Bahrain and Qatar Islamic Banks," 2018 | The authors measured the compliance by 24 Islamic banks in both Qatar and Bahrain with mudarabah, murabaha, and musharakah standards issued by the AAOIFI using annual reports for 2012-2015 | Overall, the findings indicated that the requirements with the highest compliance were musharakah requirements; Islamic banks in Qatar achieved compliance to murabaha and mudarabah disclosure requirements more highly than their counterparts in Bahrain |
| Polat, "Code of Ethics and Participation Banking: A Comparison between AAOIFI Standards and Turkish Ethical Principles of Banking," 2018 | Banking codes of ethics adopted by the Banks Association of Turkey (TBB) and Participation Banks Association of Turkey (TKBB) were compared with ethical standards published by the AAOIFI | Islamic banks in Turkey should make further development in both written ethical rules and the application and supervision of these rules |
| (Kadri & Ibrahim, Compliance Towards AAOIFI Requirements in Financial Reporting: Evidence from Brunei, 2018) | The financial statements of an Islamic financial institution in Brunei were compared with the format of the consolidated financial statements required by AAOIFI standards | Statement of financial position was at 80.00% conformance, statement of profit or loss 80.00% conformance, statement of changes in equity 66.67% conformance, and statement of cash flow 100.00% conformance to the format recommended by the AAOIFI; statement of sources and uses of qard funds and statement of restricted investment were not disclosed |
| Ehsan, Saeed, Shahzad, & Iqbal, "Compliance of Financial Statements of Islamic Banks of Pakistan with AAOIFI Guidelines in General Presentation and Disclosure," 2019 | Four full-fledged Islamic Pakistani banks' financial statements for the years 2009, 2015, 2016, and 2017 were evaluated empirically with 111 items regarding general presentation and disclosure (FAS 1) | The results showed differences with respect to banks and years; however, the compliance degree of the banks to FAS 1 within the scope of the study was over 50% |

# Research Methodology

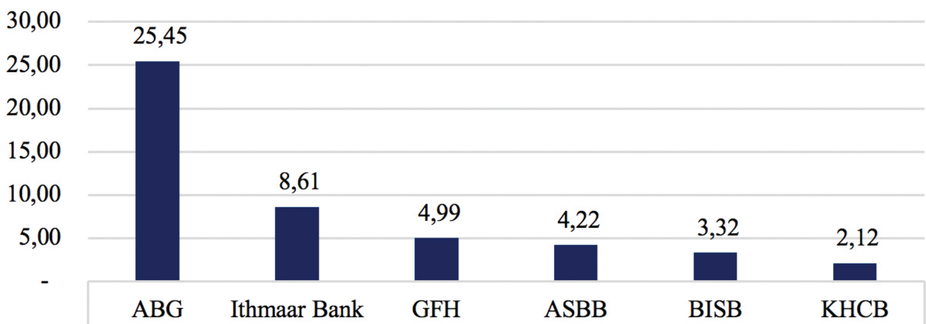
## Sample Size and Data Collection

In order to measure compliance, this study includes five Islamic banks in Turkey; in doing so, the total population of Islamic banks in Turkey at the time of the study is examined.

On July 2018, the number of Islamic banks licensed by the CBB was 22 (Ahmed , Kelleher, & Rees, 2018, p. 2), while Turkey had only 5 Islamic banks at the time. Due to time constraints, we considered 5 Islamic banks from Turkey and 6 from Bahrain,[1] accounting for the total number of Islamic banks in Turkey and the 6 top-ranked full-fledged Islamic banks in Bahrain regarding asset volume: the Albaraka Banking Group (ABG), Ithmaar Bank, Gulf Finance House (GFH), Al Salam Bank (ASBB), Bahrain Islamic Bank (BISB), and Khaleeji Commercial Bank BSC (KHCB), as shown in Figure 2. The Islamic banks examined in this study are members of the Bahrain Association of Banks and permanent committees of the Islamic Banks Commission. Further information about the banks included in this study is summarized in Table 4.

**Figure 2**

*Ranking of Islamic Banks by Asset Volume in Bahrain, 2017 ($ billion)*




Source: Annual reports of the Islamic banks

The main data for this study were obtained from the annual reports of the banks for the fiscal year of 2017. For Bahrain's Islamic banks, English-language annual reports were obtained from the banks' websites. Turkish-language annual reports were downloaded from the Banking Regulation and Supervision Agency

1 Since the Emlak Participation Bank was established after the study period, it was not included.

(BDDK) website. Since they are significant communication tools for stakeholders and are effortlessly reachable (Nadzri, 2009, p. 52), annual reports were deemed relevant for the present study.

**Table 4**
*Islamic Banks Considered in This Study (2018)*

| Bank name | Year of incorporation | Incorporation country | Total branches | Branches abroad | Listing Status |
|---|---|---|---|---|---|
| **Albaraka Türk** | 1985 | Turkey | 230 | 1 | Borsa İstanbul |
| **Kuveyt Türk** | 1989 | Turkey | 415 | 1 | Borsa İstanbul |
| **Türkiye Finans** | 2005 | Turkey | 306 | - | Borsa İstanbul |
| **Vakif Katılım** | 2015 | Turkey | 91 | - | - |
| **Ziraat Katılım** | 2014 | Turkey | 80 | - | - |
| **Albaraka Banking Group (ABG)** | 1984 | Bahrain | 675 | 667 | Bahrain Bourse and NASDAQ Dubai |
| **Al Salam Bank (ASBB)** | 2006 | Bahrain | 12 | 1 | Bahrain Bourse and Dubai Financial Market (DFM) |
| **Bahrain Islamic Bank (BISB)** | 1979 | Bahrain | 4 | - | Bahrain Bourse |
| **Khaleeji Commercial Bank BSC (KHCB)** | 2004 | Bahrain | 11 | - | Bahrain Bourse and Dubai Financial Market |
| **Gulf Finance House (GFH)** | 1999 | Bahrain | 1 | - | Bahrain Bourse, Boursa Kuwait, and Dubai Financial Market |
| **Ithmaar Bank** | 2016 | Bahrain | 16 | - | Bahrain Bourse, Boursa Kuwait, and Dubai Financial Market |

Source: Annual reports of the Islamic banks

## Measurement of Compliance and Disclosure Index Composition

To evaluate compliance with AAOIFI accounting standards by these banks, previous studies used many forms of disclosure indexes, and then compliance measurement was performed by applying those indexes to the banks' annual reports. Using indexes helps researchers translate annual reports into meaningful and assessable numbers that can be compared with each other.

A disclosure index is defined as a measure by which we compare the level of financial reporting of one company with that of another (Wallace , 1988). Bin Tomy (2013) explained the steps of developing disclosure indexes. Alongside the steps Bin Tomy used, other applicable disclosure indexes were also examined by the researchers and the former was deemed to be the most relevant. Along with the fact that it has been applied at high frequency, this study adopts that method.

An unweighted average disclosure index is used to score the items in order to measure compliance with AAOIFI Financial Accounting Standard No. 1 (General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions). The unweighted index means that all items included in the study have the same level of importance.

We compared the audited annual reports for 2017 for the Turkish and Bahraini Islamic banks with the AAOIFI's general presentation and disclosure requirements. To execute the test, a total of 165 items from FAS 1 were used. For each bank, two scoring categories were adopted: compliance = 1 and non-compliance = 0. In order to measure the compliance by the banks, an index was constituted from the obtained scores. The relation between the disclosed items and the items required to be disclosed was evaluated. In the event that the disclosure of an item depended on the existence of a past event and the bank had not experienced such an event, the bank was given a score of 1 for that item in this study.[2]

### Disclosure index development steps:

i. Depending on specific sources (in this case, FAS 1), a checklist of the information that should be disclosed by the banks was prepared.

ii. After preparing the standard list, the annual reports for the banks were examined and the items included in the list were compared with those reports. In

2 For example, if a bank does not have subsidiaries or branches overseas, it will not be expected to disclose taxation treatment abroad.

this step, a "dichotomous" method was used as in previous studies (e.g., Hidayat & Abdulrahman, 2014; Ullah, 2013a).

The total of the disclosure scores that were actually achieved according to the financial statements of the banks is given by the following equation:

$$D = \sum_{i=1}^{165} a_i$$

Where:

D: The sum of the elements actually disclosed in the bank's annual report.

a = 1, disclosed item

a = 0, undisclosed item

i. In the last step, the disclosure index was calculated by dividing actual scores into maximum standard scores. The following equation was used to calculate the disclosure index:

$$DIND = \frac{ACD}{APD}$$

$(1 \geq DIND \geq 0)$

DIND: Bank index of disclosure.

ACD: Actual number of disclosed items.

APD: Number of items that need to be explained.

The DIND index can yield values between 0% (no items disclosed at all) and 100% (all items disclosed). The higher the value of the DIND index and the closer to 100%, the more presentation and disclosure requirements the bank complies with.

To analyze the results, statistical values such as average, percentage, and standard deviation were calculated using the Excel 2017 program. As shown in Table 3, our list consisted of 13 headings including 165 items regarding general presentation and disclosure in the financial statements of the Islamic banks.

**Table 5**

*Checklist Details*

| **FAS 1** | |
|---|---|
| **Category** | **Number of items** |
| General provisions | 14 |
| General disclosures in the financial statements | 47 |
| Statement of financial position | 38 |
| Income statement | 20 |
| Statement of cash flows | 5 |
| Statement of changes in owners' equity | 6 |
| Statement of changes in restricted investments | 12 |
| Statement of sources and uses of funds in the zakah fund | 4 |
| Statement of sources and uses of funds in the qard fund | 5 |
| Format of financial statements | 7 |
| Treatment of changes in accounting policies | 4 |
| Treatment of changes in nonroutine accounting estimates | 2 |
| Treatment of a correction of an error in prior periods' financial statements | 1 |
| **Total** | **165** |

## Analysis and Findings

### Islamic banks in Turkey

By meeting 90 out of the 165 requirements mentioned in FAS 1, Albaraka Türk and the first state-owned Islamic bank in Turkey, Ziraat Katılım, complied with the highest percentage (54.55%) of required items. Türkiye Finans and Vakıf Katılım ranked second with one fewer complied item in total. The Islamic bank with the lowest compliance level was Kuveyt Türk with 53.33% total disclosure.

**Table 6**

*Level of Compliance with AAOIFI Standards of Disclosure and General Presentation by Islamic Banks in Turkey*

| Category | Disclosure % | | | | | Overall average of disclosure | SD |
|---|---|---|---|---|---|---|---|
| | Albaraka Türk | Kuveyt Türk | Türkiye Finans | Vakıf Katılım | Ziraat Katılım | | |
| General provisions | 71.43 | 71.43 | 71.43 | 71.43 | 71.43 | 71.43 | 0.00 |
| General disclosures | 78.72 | 74.47 | 78.72 | 74.47 | 80.85 | 77.45 | 1.34 |
| Statement of financial position | 52.63 | 52.63 | 52.63 | 55.26 | 52.63 | 53.16 | 0.45 |
| Income statement | 40.00 | 40.00 | 40.00 | 40.00 | 40.00 | 40.00 | 0.00 |
| Cash flows statement | 80.00 | 80.00 | 60.00 | 80.00 | 60.00 | 72.00 | 0.55 |
| Statement of changes in owners' equity | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 0.00 |
| Statement of changes in restricted investments | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Statement of sources and uses of funds in the zakah fund | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Statement of sources and uses of funds in the qard fund | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Financial statements format | 14.29 | 14.29 | 14.29 | 14.29 | 14.29 | 14.29 | 0.00 |

| Category | Disclosure % | | | | | Overall average of disclosure | SD |
|---|---|---|---|---|---|---|---|
| | Albaraka Türk | Kuveyt Türk | Türkiye Finans | Vakıf Katılım | Ziraat Katılım | | |
| Treatment of hanges in accounting policies | 50.00 | 50.00 | 50.00 | 50.00 | 50.00 | 50.00 | 0.00 |
| Treatment of changes in nonroutine accounting estimates | 50.00 | 50.00 | 50.00 | 50.00 | 50.00 | 50.00 | 0.00 |
| Treatment of a correction of an error in prior periods' financial statements | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 0.00 |
| **Total** | 54.55 | 53.33 | 53.94 | 53.94 | 54.55 | 54.06 | 0.84 |

For general provisions, Islamic banks in Turkey achieved 71.43% compliance. None of these banks prepared statements of changes in restricted investments, statements of sources and uses of funds in the zakah fund, or statements of sources and uses of funds in the qard fund since they were not required by IFRSs, and the KGK did not make the adoption compulsory in the related period.

None of the Islamic banks in Turkey complied with the following points regarding general disclosure in financial statements: i) the role of the Sharia adviser or the Sharia board in supervising the bank's activities; ii) the bank's responsibility towards zakah; iii) the use of historical cost as a basis of determining equity of owners of unrestricted investment accounts and their equivalent; iv) disclosure of unusual supervisory restrictions; v) disclosure of earnings or expenditures prohibited by Sharia; vi) the magnitude of balances of all unrestricted investment accounts and their equivalent and other accounts by type in foreign countries; vii) disclosure of the distribution of unrestricted investment accounts and their equivalent and other accounts in accordance with their respective periods to maturity; viii) disclosure of the method used by the Islamic bank to allocate investment profits (losses) between unrestricted investment account holders or their equivalent and the Islamic bank as a mudarib or as an investment manager; and ix) any natural person or entity that directly or indirectly owns a percentage of the bank's voting ownership units and relatives of the natural person to the second degree.

A total of 17 out of 38 disclosure items were not disclosed in the balance sheets of all the Islamic banks in Turkey as follows: i) disclosure of the net realizable value of an asset if such value is less than the asset's recorded amount; ii) disclosure of the unrestricted accounts; iii) categorization of the current accounts, saving accounts, and other accounts; iv) murabaha receivables; v) salam receivables; vi) istisna receivables; vii) mudarabah financing; viii) musharakah financing; ix) investments in other entities; x) inventories; xi) salam payables; xii) istisna payables; xiii) separation between unrestricted investment accounts and the owner's equity; xiv) receivables collected during the period that were previously written-off; xv) disclosure of minority interest as a separate item between unrestricted investment accounts and the owner's equity; xvi) zakah payable; and xvii) rights, conditions, and obligations of each type of unrestricted investment account.

Salam, murabaha, mudarabah, musharakah, etc. are unique banking products introduced by Islamic finance and are not included in international accounting standards. Since Turkey's accounting standards are based on IFRSs, it is not odd that Islamic banks in Turkey did not comply with a large part of the information required to be disclosed in the balance sheet. Murabaha, which is the most commonly used transaction of Islamic banks, shows a different application method in terms of disclosure in the financial statements when applying the IFRSs; AAOIFI FAS 2 considers murabaha as a trading contract that is conducted upon the customer's desire to purchase an asset and views murabaha receivables as assets in the balance sheet. Since the IASB considers murabaha as a financing contract, the applicable IFRS standard for murabaha is IFRS 9, which requires the Islamic bank to view the murabaha receivables as a financial asset in the balance sheet (Rosman, Abdul Hamid, Amin, & Ahmed, 2016, p. 5). Turkish participation banks did not refer to murabaha receivables in their financial statements in financial assets notes.

In the case of income statements, all Islamic banks in Turkey complied at a rate of 40%. None complied with the following: i) revenues and gains from investments; ii) expenses and losses from investments; iii) income (loss) from investments; iv) share of unrestricted investment account holders in income (loss) from investments before the bank's share as a mudarib; v) the Islamic bank's share in income (loss) from investments; vi) the Islamic bank's share in unrestricted investment income as a mudarib; vii) the Islamic bank's share in restricted investment profits as a mudarib; viii) the Islamic bank's fixed fee as an investment agent for restricted investments; ix) net income (loss) before zakah; x) zakah base; and xii) disclosure of the minority interest in net income (loss) before net income (loss).

In the statement of cash flows, the considered banks did not reveal transactions or other transfers that did not require the payment of or did not result in the receipt of cash.[3] Ziraat Katılım and Türkiye Finans did not disclose their policies with respect to the components of cash and its equivalents.

For the statement of changes in owner's equity, all the Islamic banks in Turkey complied 100% with the requirements mentioned in the AAOIFI's first financial accounting standard.

None of these banks prepared the following statements: statement of changes in restricted investments, statement of sources and uses of funds in the zakah fund, and statement of sources and uses of funds in the qard fund. Nevertheless, the Islamic banks in Turkey showed restricted investment accounts in the balance sheet.

All Islamic banks in Turkey complied with the format for changes in owners' equity statements, while other statements were not in the format given in FAS 1.

With regard to the treatment of changes in accounting policies, the considered banks did not apply the new policies by restating the financial statements for the last period presented. Their annual reports did not include the disclosure of the effect of the change in an accounting policy on unrestricted investment accounts owners' share in income (loss) from investments. Islamic banks in Turkey also did not make disclosures about the effect of the change in a nonroutine accounting estimate on unrestricted investment account holders' share in income (loss) from investments. All considered banks disclosed their treatment of a correction of an error in prior periods' financial statements.

Islamic banks in Turkey disclosed on average 89.2 items in their 2017 annual reports, which is a rate of 54.06%. Both Table 6 and the value of standard deviation (0.84) show that there is no important difference between the disclosure compliance level achieved by these banks. The KGK is the responsible organ for setting and publishing standards related to accounting and auditing in Turkey. Since the banks in Turkey are required by the Banking Law to apply Turkish accounting and financial reporting standards,[4] it is expected that the considered banks in Turkey should comply at the same level.

3 For example, acquisition of assets by borrowing or leasing, or acquisition of an enterprise by issuing shares and conversion of debts into equity. According to TMS 7, such transactions shall not be explained in the cash flow statement.

4 Turkish Banking Law, article 37.

This result also suggests that there is a low level of difference in compliance with IAS No. 1 among the Islamic banks in Turkey. However, this is beyond the scope of this study and could be measured in other research. Moreover, the ijarah transaction accounting practices of these banks are far beyond compliance with Sharia requirements. In conventional accounting for finance leases, assets acquired through leasing transactions should be recognized in the balance sheet of the lessee and are subject to amortization throughout the lease term. In Islamic banking or the AAOIFI, the leased asset remains on the lessor's (the bank's) balance sheet as an operating lease and lease installments are recognized by the lessor as revenue and by the lessee as expenses for the duration of the lease term even when the ijarah is ending with the transfer of the asset to the lessee (ijarah muntahia bittamleek) (Gupta, 2015, p. 376).

## Islamic Banks in Bahrain

Table 7 reveals that the Albaraka Banking Group (ABG) has the highest index disclosure value (142 items) regarding AAOIFI presentation and disclosure requirements among the Bahrain-based Islamic banks included in this study. The results for Ithmaar Bank, Al Salam Bank, Gulf Finance House, Bahrain Islamic Bank, and Khaleeji Commercial Bank for disclosure index as measured in their annual reports from 2017 are respectively 129, 116, 129, 123, and 131.

**Table 7**

*Level of Compliance with AAOIFI Standards of Disclosure and General Presentation by Islamic Banks in Bahrain*

| **Category** | **Disclosure %** | | | | | | **Overall average of disclosure** | **SD** |
|---|---|---|---|---|---|---|---|---|
| | **ABG** | **Ithmaar** | **ASBB** | **GFH** | **BISB** | **KHCB** | | |
| General provisions | 92.86 | 92.86 | 85.71 | 92.86 | 92.86 | 92.86 | 91.67 | 0.41 |
| General disclosures | 85.11 | 78.72 | 72.34 | 78.72 | 76.60 | 80.85 | 78.72 | 2.00 |
| Statement of financial position | 97.37 | 81.58 | 84.21 | 89.47 | 78.95 | 89.47 | 86.84 | 2.37 |

| **Category** | **Disclosure %** | | | | | | **Overall average of disclosure** | **SD** |
|---|---|---|---|---|---|---|---|---|
| | **ABG** | **Ithmaar** | **ASBB** | **GFH** | **BISB** | **KHCB** | | |
| Income statement | 90.00 | 90.00 | 75.00 | 75.00 | 75.00 | 75.00 | 80.00 | 1.26 |
| Cash flows statement | 100.00 | 100.00 | 100.00 | 80.00 | 100.00 | 80.00 | 93.33 | 0.49 |
| Statement of changes in owners' equity | 100.00 | 83.33 | 100.00 | 100.00 | 100.00 | 100.00 | 97.22 | 0.17 |
| Statement of changes in restricted investments | 83.33 | 58.33 | 0.00 | 58.33 | 0.00 | 75.00 | 45.83 | 4.36 |
| Statement of sources and uses of funds in the zakah fund | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 0.00 |
| Statement of sources and uses of funds in the qard fund | 0.00 | 0.00 | 0.00 | 0.00 | 100.00 | 0.00 | 16.67 | 2.01 |
| Financial statements format | 85.71 | 85.71 | 71.43 | 85.71 | 85.71 | 71.43 | 80.95 | 0.49 |
| Treatment of changes in accounting policies | 50.00 | 50.00 | 50.00 | 50.00 | 50.00 | 50.00 | 50.00 | 0.00 |
| Treatment of changes in nonroutine accounting estimates | 50.00 | 50.00 | 50.00 | 50.00 | 50.00 | 50.00 | 50.00 | 0.00 |

| Category | Disclosure % | | | | | | Overall average of disclosure | SD |
|---|---|---|---|---|---|---|---|---|
| | ABG | Ithmaar | ASBB | GFH | BISB | KHCB | | |
| Treatment of a correction of an error in prior periods' financial statements | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| **Total** | 86.06 | 78.18 | 70.03 | 78.18 | 74.55 | 79.39 | 77.78 | 8.66 |

On average, the six Bahrain-based Islamic banks conformed with the disclosure and presentation requirements of the AAOIFI standards at a level of 77.78% (128.33 items). The highly varied disclosure index values for these banks mainly derive from the high value of the standard deviation regarding the requirements of disclosure for restricted investment accounts (4.36), which ASBB and BISB did not prepare in their annual reports for the year of 2017 (see Table 7).

Regarding general provisions, all Islamic banks in Bahrain complied at a rate of 92.86% except for ASBB, which complied at 85.71%. Only four banks prepared statements of changes in restricted investment accounts: Albaraka Group (ABG), Ithmaar Bank, Gulf Finance House (GFH), and Khaleeji Commercial Bank BSC (KHCB). A statement of qard fund was prepared only by BISB.

In the case of general disclosure, among other items, none of these banks disclosed the names of the bank's subsidiaries whose financial statements were not consolidated with those of the bank's, nor did they disclose the reasons for excluding their financial statements from the consolidated financial statements of the bank.

In the statement of financial position, these Islamic banks in Bahrain complied at an average rate of 86.84%. The only bank that disclosed previously written-off collected receivables was KHCB. Only ABG included disclosure about salam receivables in annual reports.

All considered banks complied at a rate of 75% for income statements, except for ABG and Ithmaar Bank, which complied at rates of 90%. These banks did not disclose fixed fees as an investment agent for restricted investments and did not show the minority interest before net income. Regarding income statements, the items disclosed only by ABG and Ithmaar were the share of the Islamic bank in restricted investments as the mudarib, net profit before zakah and tax, and disclosure of tax and zakah separately.

All Islamic banks in Bahrain except KHCB disclosed transactions and other transfers that did not require payment or receipt of cash. GFH did not disclose its policy regarding the components of cash and its equivalents. Only four banks in Bahrain prepared a statement of changes in restricted investments. All of them prepared a statement of sources and uses of funds in the zakah fund with full compliance. Only Bahrain Islamic Bank prepared a statement of sources and uses of funds in the qard fund.

At an average rate of 80.95%, ABG, Ithmaar, ASBB, GFH, BISB, and KHCB complied with financial statement formats with the following respective individual compliance rates: 85.71%, 85.71%, 71.43%, 85.71%, 85.71%, and 71.43%.

In terms of disclosing the treatment of changes in accounting policies and nonroutine accounting estimates, the Islamic banks in Bahrain complied with the same requirements that the Islamic banks in Turkey complied with. All considered banks in Bahrain did not disclose their treatment of correction of an error in prior periods' financial statements.

## Conclusion

The preparation of Islamic accounting standards is basically based on the format of international accounting standards. Standards that do not contradict with the principles of Islamic law (Sharia) are applied; otherwise, alternative standards are published. The Islamic accounting standards published by the AAOIFI are not compulsory for all Islamic financial institutions in the world. There are fundamental differences between AAOIFI accounting standards and the standards issued by the International Accounting Standards Board (IASB), and since financial practices of Islamic banks differ from the practices of their counterparts, these differences should continue to exist.

Currently, all financial institutions in Turkey, including Islamic banks, apply TFRSs, which are translations of international accounting and reporting standards. Islamic banks in Turkey achieved high compliance to FAS 1 regarding general provisions and general disclosures. Because these banks apply IFRSs, it can be concluded that the AAOIFI brought differences in general disclosure and general provisions.

Islamic banks in Turkey make murabaha, musharakah, mudarabah, and other contracts that are exclusive to Islamic finance, but, at the same time, using the international accounting standards does not provide efficient accounting treatments for these contracts. This case does not encourage foreign investors, who may otherwise avoid making contracts with conventional banks to invest in the former. Compared to other Islamic countries, Islamic banks in Turkey still have a small share in the overall banking sector. In this study, alongside Bahraini Islamic banks, the compliance achieved by Islamic banks in Turkey to AAOIFI standards was measured even though the latter are not obligated to follow AAOIFI accounting standards. In order to attract Islamic foreign investors' attention and direct their funds toward the Islamic banking industry, these Islamic banks have to publish high-quality, transparent financial statements that are deemed reliable by Muslim users and, most importantly, financial statements need to be published by trusted organizations related to the sector. Nevertheless, one of the most concerning issues for Muslim investors is whether the bank is doing its business in compliance with Sharia law or not. Fortunately, the end of 2020 brought the application of AAOIFI standards by the Islamic banks in Turkey to help bridge the gap in the accounting practices conducted by these banks.

This work has been prepared with the hope of contributing to the knowledge and increasing the awareness of the importance of the application of Islamic standards. Forces of globalization have made IFRSs a de facto obligatory requirement around the world, and, on that account, business and trade are facilitated more than ever before. The same result could be achieved in the Islamic economy if there were a unified standardization in relation to accounting practices in those economies. This paper indicates that there are common points between the Islamic and conventional accounting standards, but the latter are insufficient in relation to disclosure in Islamic banks' financial statements.

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