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Statement of Investment Deposits Performance: Improvement of Accountability in the Business Model of Usury-free Banking in Iran, Consistant with IFRS

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Abstract

Statement of investment deposits performance is a separate and supplementary financial statement that is designed with two objectives: 1. Improvement in the level of disclosure and accountability of the banks to the owners of investment deposits as the main providers of the banks' resources, and 2. Implementation of the IFRS standards on banking business in Iran. In this paper, the principles governing the banking business in Iran, and statements of the conceptual framework proposed by the Joint Working Group on IASB and FASB have been combined in order to provide a supporting framework for designing this financial statement. Materiality, comprehensiveness, comparability, maintaining the intrinsic relationship between financial statements, and concordance with the business model are the main features being considered in the design of the supplement. Moreover, the introduction of this financial statement provides some evidence in support of a concept, so called "reasonable flexibility" of universal conceptual framework for financial reporting

Keywords: *Accountability, Usury-free Banking Business Model in Iran, Statement of investment deposits performance, Conceptual framework for international financial reporting, Financial statements*
JEL Classifications*: G14, G21*

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1. Introduction

Over the past several decades, theorists, professional associations, and the accounting standard setters, have been unanimous in one matter: The main objective of financial accounting is to provide information that is useful for decision-making of investors, creditors and other stakeholders of an entity. Nonetheless, much debate has been going on about identifying beneficiaries, their interests, and their information needs. The answers to these questions are important because they determine the mission of accounting in financial reporting.

These answers include from general-purpose financial reporting to specific financial reporting, while the main users, i.e. shareholders and lenders, have received the most consideration. Among the expressed limits of financial reporting, the cost of providing the information and presentation of multiple reports are potential factors that could confuse users. The conceptual framework proposed by the *Joint Working Group on IASB*[1] *and FASB*[2] as the latest document in this regard, not only emphasizes general-purpose financial reporting, but also accepts some kind of reasonable flexibility. Since flexibility is one of the basic requirements for the adoption of a conceptual framework in social sciences, this feature seems greatly essential.

This paper aims to present a financial statement, which is designed for the banking industry of Iran, using the concept of *reasonable flexibility* in financial reporting. Conceptual and legal background of this financial statement, using a consequential method, can be a model for the development of financial reporting. While remaining committed to the conceptual framework accepted; the new financial statement shows the necessity and how to use the flexibility of a theoretical framework in financial reporting.

2. Iran's Usury-free Banking and its Basic Principles[3]

The *Usury-free Banking Law* was passed by the Parliament on Aug 30, 1983. Since then, the Iran banking system has been governed by this law. According to this law, a bank uses investment deposits as well as the funds belonging to investors on the basis of Islamic contracts. The relationship between the bank and its depositors is based on proxy, on behalf of depositors and banks as an

1. International Accounting Statements Board
2. Financial Accounting Standards Board
3. In this paper, the depositors mean the owners of investment deposits.

investor which they engage in a standard contract, which allows the bank to invest and manage the depositors' resources.

The reward from these investment activities is called *mutual income*, which should be divided in proportion to the bank's resources (received deposits) after deducting certain amount of fees from depositors' income prior to the closing of their contract.

This process forms the *core business model of the usury-free banking in Iran*. Among other activities, a bank is allowed to mobilize Qarz-Al-Hasanah resources (interest free), lend Qarz-Al-Hasanah financial facilities, and provide other banking services to its customers. However the revenues coming from these activities belong to the bank and are non-mutual.

According to the definition provided by European Banking Authority in 2013, a business model refers to a set of tools and methods which create profit and growth. These tools and methods are derived from multiple interacting factors that organize the main activities of an organization to achieve its business objectives. Experts have suggested several structures in relation to the business model. One of the most recent ones was suggested by Osterwalder and Pigneur (2010) which considered nine factors that take into account the components of the business model, including customer segments, value propositions, channels, customer relationships, revenue streams, cost structure, key resources, key activities, and key partnerships. With regard to these factors, the basic differences between *conventional banking*[1] and *Usury-Free* banking business models are compared in the following table. This table consists of four out of nine mentioned factors. The main purpose is to show differences affecting financial reporting.

By looking at the table, we can distinguish between usury-free banking and conventional banking business models. Some other differences can be seen between Iran's usury-free banking and Islamic Banking in other countries. Part of these differences is due to the Shia and Sunni's principles, and the other part is related to different rules governing banking business in different countries. It seems that one of the areas that are affected by these differences, is the difference in the structure of financial reporting, particularly in the statements of financial performance. Financial reporting methods for

1.In this paper, the term "*Conventional Banking*" refers to interest-based banking business model, which is common in most countries.

mutual activities and also accountability to depositors, in such a way that the set of financial statements is consistent with International Financial Reporting Standards, are issues to be answered. In other words, we are trying to introduce a financial reporting structure for usury-free banking business in Iran, and yet convergent with International Financial Reporting Standards (IFRS), using a comparative- consequential approach.

Accordingly, identifying the main principles of usury-free banking would be the first step to design financial statements that are commensurate with banking business in Iran.

2.1. Basic principles of Iran's Usury-free Banking Business Model

Principle 1

According to the contract between the bank and its depositors, a bank is an assignee for its depositors, and for the use of trust funds belonging to them, and can withdraw its fees from their shares of mutual income. What remains, will belong entirely to the depositors.

Corollary

The contract between a bank and its depositors creates a stewardship relationship between them. This relationship puts the bank in the position of accountability to the second party, namely the depositors. In contrast, in the conventional banking, the relationship between a bank and its lenders (including the depositors) is an ordinary one, in which the accountability of the bank is limited to pay a certain interest, and to return the principal amount of the loan at maturity.

Principle 2

A bank operates under the juridical rule of sharing profits and losses; which says; "Profit belongs to the person who bears the risk". In this spirit, as lenders to a bank, rights of investment depositors differs from both rights of Qarz-Al-Hasanah depositors (current and saving) and conventional banking depositors.

Corollary

Two main groups, namely the owners of investment term deposits, and shareholders of the bank bear the risks related to banking operations. In contrast, in the conventional banking, the rate of return for depositors is determined in advance, in the form of interest rates; so they do not bear the risk of volatility.

The Basic Differences between Conventional and Usury-free Banking Business Models

<table>
<tr><th colspan="4">Key Activities</th><th colspan="2">Key Resources</th></tr>
<tr><td colspan="2">Usury-free Banking</td><td colspan="2">Conventional Banking</td><td>Usury-free Banking</td><td>Conventional Banking</td></tr>
<tr><td colspan="2">- Financial facilities (Based on Islamic Contracts)
- Types of services based on juridical rules
- Types of financial instruments based on juridical rules</td><td colspan="2">-Loan contracts
-Types of investment
-Types of financial services
-Types of financial instruments</td><td>-Shareholders' equity
-Qarz-Al-Hasanah Deposits*
-Investment Deposits**
-Other Islamic Financial Instruments</td><td>-Shareholders' equity
-Debt resources (including types of deposits)</td></tr>
<tr><th colspan="4">Cost Structure</th><th colspan="2">Revenue Stream</th></tr>
<tr><td colspan="2">Usury-free Banking</td><td colspan="2">Conventional Banking</td><td>Usury-free Banking</td><td>Conventional Banking</td></tr>
<tr><td>Non-mutual</td><td>Mutual</td><td rowspan="2">-Interest expenses
-Financial instruments interest
-General and administrative expenses
-Commission
-Financial expenses
-Depreciation
-Provision</td><td>Non-mutual</td><td>Mutual</td><td rowspan="2">-Interest income
-Penalty clause
-Income from investments
-Commission and fee
-Foreign exchange transaction income</td></tr>
<tr><td>- Foreign currency deposits' expenses
- Islamic financial instruments expenses
- General and administrative expenses
- Commission
- Financial expenses
- Depreciation
-Provision</td><td>***</td><td>-Fee
-Income from foreign exchange transaction
-Net income from Qarz-Al-Hasanah</td><td>-Financial facilities income
-Islamic penalty clause
-Income from deposits
-Income from investments</td></tr>
</table>

* The relationship between the bank and the depositors is a borrower and lender relationship, and deposits do not have any interest.

** The relationship between banks and their depositors is based on proxy. Funds belonging to the depositors in a bank are considered as a trust. The depositors share mutual income, but not the bank's expenses.

*** All expenses are non-mutual in the usury-free banking. For the share of investment deposits in the bank's expenses, only a certain amount with a pre-agreed rate as fee is deducted from the depositors' income. All the benefits from investment deposits, after deduction of the fee, are owned by the depositors.

Principle 3

Owners of investment term deposits, as well as small shareholders do not have access to information regarding performance of the bank- in addition, they do not have any role in running the bank, such as the voting right to appoint the managers.

Corollary

This group needs to receive relevant and adequate information, to make economic decisions.

Principle 4

Due to the nature of the banking business in Iran, the resources of Investment depositors, those investors whose rate of return are not determined explicitly, are many times greater than the resources of shareholders.

Corollary

It is imperative that this group of investors receive information regarding the performance of the bank. This is as essential as receiving those information by shareholders, even though the preparation of this information would might be costly.

Principle 5

There is a potential conflict of interests between the depositors and shareholders of a bank, because the earnings of the bank core business are mutual and supposed to be divided between these two groups. This could be potentially controversial. Moreover, bank has full legal authority on how to use the deposits of all depositors. As a result, there is a possibility that a bank employs depositor resources on a high-risk venture at the expense of their depositors and interest of its shareholders.

Corollary

It is important to provide a statement that represents a fair sharing of earnings between the depositors and shareholders of a bank.

Note: Income paid on account[1] to the depositors - as authorized by the Usury-free Banking Law -may lead to a misconception that they have received

1. By on account we mean regular monthly payments with predetermined rates which according to the present law, depositors usually receive from banks. This amount is not final and at the end of each year after the bank finds the final amount, depositors receive the difference.

all their interests during the financial period. However, it is a part of the earning that bank expects to earn with certainty, and the difference between the realized income and the income paid on account should be paid to the depositors at the end of each period. On the other hand, paying more than the realized income to the depositors is a substantive defect, and conflicts with the religious and legal basis of the Usury-free Law. However, in the event of such a case, decision on the excess income paid is on the discretion of shareholders - that is, real and legal shareholders for the private banks, and government for the state-owned banks. In fact, the excess payment means to donate a portion of the shareholders' profit interest to depositors.

3. Conceptual Framework for Financial Reporting

The proposed framework provided by the Joint Working Group on IASB and FASB is the most recent and authoritative statement. In this section, statements related to the fundamental assumptions are extracted from the conceptual framework and the comparative basis needed for the outcome will be provided.

Statement 1. Introduction

> *Strengthens accountability by reducing the information gap between the providers of capital and the people to whom they have entrusted their money. Standards based on the "Conceptual Framework" provide information that is needed to hold management to account*

Corollary

Depositors are the main providers of funds in the banking business in Iran. Therefore, the bank management must provide them with the information needed for decision-making in order to fulfill accountability, and reducing the information gap.

Statement 2. Description and scope of the reporting entity

> *A reporting entity is not necessarily a legal entity. It can comprise a portion of an entity, or two or more entities.*

A reporting entity does not have to be a legal entity. If a reporting entity is not a legal entity, the boundary of the reporting entity needs to be set in such a way that the financial statements:

a. Provide the relevant financial information needed by those existing and potential investors, lenders and other creditors who rely on the financial statements; and

b. Faithfully represent the economic activities of the entity.

Corollary

According to the conceptual framework for IFRS, financial reporting does not necessarily conform to the legal entity, and allows the financial statements to include a part of the activities of a reporting entity. In this case, the financial statements should faithfully reflect the required information, and the economic activity occurring within the entity. Thus, in the banking business in Iran, providing the information needed by the depositors in the form of a separate report would be permitted.

Statement 3. Purpose, usefulness and limitations of general-purpose financial reporting (1)

Many existing and potential investors, lenders and other creditors cannot require reporting entities to provide information directly to them and must rely on general purpose financial reports for much of the financial information they need. Consequently, they are the primary users to whom general purpose financial reports are directed.

Corollary

In the banking business in Iran, shareholders and the depositors are considered as very clear examples of users of general-purpose financial reporting.

Statement 4. Purpose, usefulness and limitations of general-purpose financial reporting (2)

General purpose financial reports do not and cannot provide all of the information that existing and potential investors, lenders and other creditors need.

Corollary

It is necessary to review which group of stakeholders cannot obtain the required information from the common formats of general-purpose financial reporting. In the banking business in Iran, depositors are clear examples of this review.

Statement 5. Purpose, usefulness and limitations of general-purpose financial reporting (3)

> *Individual primary users have different, and possibly conflicting, information needs and desires. The Board IASB, in developing financial reporting standards, will seek to provide the information set that will meet the needs of the maximum number of primary users. However, focusing on common information needs does not prevent the reporting entity from including additional information that is most useful to a particular subset of primary users.*

Corollary

The emphasis of financial reporting is to provide maximum information needed for users. So, if general-purpose financial reporting is unable to meet these needs, it is imperative to provide additional information for some specific groups of users. Therefore, it is necessary to examine in any economy and business:

- Whether sufficient efforts have been made in the general purpose financial reporting, and
- What groups - especially among the main users - still require more information?

It seems that the depositors are still candidates for such review in this case.

Statement 6. Presentation and disclosure as communication tools

Financial statements present, in the statement of financial position and the statement(s) of financial performance, information about recognized assets, liabilities, equity, income and expenses. They also disclose additional *information about those recognized elements and other information that is relevant to users.*

Corollary

Financial performance reporting is not limited to a single financial statement, and several financial statements can be used if needed. Financial performance statements can cover certain activities of a reporting entity. Therefore, the depositors can be target of one of the financial performance statements.

Statement 7. Presentation and disclosure objectives and principles (1)

In setting presentation and disclosure requirements, an appropriate balance is needed between:

- *a.* *Giving entities the flexibility to provide relevant information that faithfully represents the entity's assets and liabilities, and the transactions and other events of the period; and*
- *b.* *Requiring information that is comparable among entities and across reporting periods*

Corollary

Appropriate balance in providing information allows flexibility in the entities' financial reporting, provided there is the possibility of comparison between different reporting entities and different reporting periods. In practice, this requirement may be interpreted as providing specific information in a different economic environment, or in a specific business should not undermine the comparability of financial reporting.

Statement 8. Presentation and disclosure objectives and principles (2)

Efficient and effective communication of information also requires consideration of the following principles:

- *a.* *Entity-specific information is more useful than 'boilerplate' language and is more useful than information that is readily available outside the financial statements; and*
- *b.* *Duplication of information in different parts of the financial statements is usually unnecessary and makes financial statements less understandable*

Corollary

Providing worthless or obvious information or duplicated information in the financial statements undermines the effectiveness and efficiency of financial reporting. So any creative designing of a statement of investment deposits performance should be based on effectiveness and efficiency features.

4. Relationships between Fundamental Principles of Usury-free Banking Business in Iran, and the Statements of IFRS Conceptual Framework

Relationship 1: The relationship between a bank and its depositors is based on a proxy, and the bank acts as a steward. To carry out this task, the bank must be accountable to its depositors.

Conventional income statements (including those belonging to both Iranian banks and the IFRS) are designed primarily for accountability to the shareholders, in such a way that they start from income, and end in earnings per share (of the shareholders). But in current financial statements of Iranian banks, part of information related to the earnings of depositors is disclosed in the income statement, but the important part is in the notes attached to the financial statements. This method of disclosure undermines the integrity and comprehensiveness of financial reporting, and it is in contrast with the first statement of the conceptual framework of a sound financial reporting. According to the second statement of the conceptual framework, reporting entity can be a part of the firm. Therefore, report of investment deposits' performance can be the subject of a separate report.

Furthermore, according to the third statement of the conceptual framework, depositors are among those groups who are unable to oblige the bank to report information directly to them. So depositors (such as small shareholders) are among the addressees of general-purpose financial reporting.

Relationship 2: The Two main providers of the bank's resources, i.e. depositors and shareholders are at risk of the bank core business. In conventional banking, interest rate for lenders is definite and predetermined, and the structure of bank's profit and loss in accordance with IFRS is an appropriate way of reporting financial performance. So basically, it is not necessary to provide a separate performance report for the interests of the lenders (including the depositors). However, in the business model of usury-free banking, the realized income of the depositors is not known in advance, and they are entitled to receive a separate report to be informed of their earnings of the bank's mutual income. The first statement of the conceptual framework emphasizes that accountability can reduce the information gap between lenders and managers. Here, conventional income statement has not been designed for this purpose, and there is always concern about the rights of the depositors. Therefore, the bank report on the performance of investment deposits is necessary.

Relationship 3: The depositors do not have access to the information of the bank performance- nor do its small shareholders. Also, their final return depends on the bank performance. According to the third statement of the conceptual framework, the depositors should also receive a separate report on the implementation of stewardship task of the bank management.

Relationship 4: Considering the importance of the depositors' resources in comparison to the shareholders', it is clear that financial reporting should be in accordance with the needs of this group. This necessity can be deduced from the first, second and fifth statement of the conceptual framework. The final part of the fifth statement clearly supports the provision of certain information to the users when necessary. In the banking system of Iran, the depositors (investors) are clear examples of users who need the relevant information.

Relationship 5: It is clear that there is conflict of interests between the bank depositors and shareholders in Iran. Total mutual incomes are the incomes that should be divided between the depositors and shareholders. In the absence of a clear statement of financial performance, the possibility of intentional or unintentional error increases in sharing these mutual incomes. The fifth statement of the conceptual framework has obviously recognized this conflict of interest. In addition, a separate statement for financial performance can be a subject of comments in the independent audit report. This fact increases the responsibility of auditors, and decreases the potential negative impact of the mentioned conflict of interest.

Note: Income paid on account to investment deposits acts as a double-edged sword. If the income paid on account is less than the real income, there will be a moral hazard risk of under-payment to the depositors. In the opposite case, and due to legal restrictions on returning back the excess paid to the depositors, it will inevitably lead to violation of the shareholders' rights in favor of the depositors. Although the latter should not occur in principle, the experience of recent years shows it has happened in Iran.

5. Deducing Basic Principles of the Proposed Reporting Model for Usury-free Banking System

In order to define an appropriate reporting model for the banking business in Iran, it is necessary to identify the following basic principles based on the relationships between the fundamental assumptions and the statement related to the conceptual framework:

1. It is necessary to design a separate financial statement regarding bank performance, for the investment depositors in addition to the conventional financial statements (Based on Statements 1 to 8 of the IFRS conceptual framework, with emphasis on the statements 2, 3, 4 and 5).
2. The proposed financial statement should be a supplement to the conventional financial statements, and not to replace them. Therefore:
    a. It should not undermine the formation of conventional financial reporting, and the comparability between different reporting entities, and different financial periods; and
    b. Across banking industry in Iran, The statement by itself should be comparable (Based on statement 7 of the IFRS conceptual framework).
3. The proposed financial statement should have the following features:
    a. Reducing the information gap between the depositors – as the main providers of the bank resources - and the resource management authorities of the bank (Based on statement 1 of the IFRS conceptual framework).
    b. Providing the depositors with the necessary financial information, and representing faithfully the economic activity of the reporting

entity on how to use their resources (Based on statement 2 of the IFRS conceptual framework).

c. Assuring the depositors about the fairness of shared earnings (mutual income), and the consequences of potential conflicts of interest (Based on statement 5 of the IFRS conceptual framework).

d. Assisting the depositors in anticipation of the future cash flows (Based on statement 6 of the IFRS conceptual framework).

e. Does not include trivial information, or those that are duplicated or available from other sources. (Based on statement 8 of the IFRS conceptual framework)

6. A Proposed Supplementary Financial Statement for Banking Business in Iran

Based on reporting model which we have concluded in previous section, the proposed supplementary financial statement is a performance related financial statement entitled "Statement of investment deposits performance", which should be presented together with the conventional financial statements on the basis of IFRS. In fact, this financial statement is prepared for the depositors, but it contains information that is potentially useful for other stakeholders such as shareholders.

The financial statement begins with the mutual income, and leads to difference payable to the depositors (that is the remaining claims of the depositors of the mutual income, in addition to the previously income paid on their account). The basis of this financial statement is easily comparable with the income statement, whose main users are shareholders. That Income Statement begins with bank income (as an independent reporting entity), and leads to net profit belonging to shareholders.

As the income statement is based on profit and not loss, statement of investment deposits performance will be based on the difference payable to the depositors, i.e. realized income in excess of the income paid on account. But under certain circumstances, the difference payable to the depositors might be negative, which is called “excess income paid to the depositors”.

7. Description of the Items Comprising Statement of Investment Deposits Performance

According to the Usury-free Banking Law, and its regulations and guidelines, statement of investment deposits performance is comprised of the following items:

A. The mutual income, including:

1. Income from financial facilities[1],
2. Income from deposits,
3. Net income (loss) from investment,

B. The distribution of mutual income, including:

4. Share of the bank's resources from mutual income,
5. Share of the depositors from mutual income, before deduction of the bank's fee,
6. The bank's fee,
7. Share of the depositors from mutual income,

C. Other items, including:

8. Income from Required Reserve Deposits,
9. Compensation for unused depositor's resources,
10. Realized income of the investment deposits,
11. Income paid on account to the investment deposits,
12. The difference of the realized income (extra paid income) to the depositors.

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1. The term "*financial facilities"* in Iran's usury-free banking is equivalent to "*loans*" in conventional banking. Consequently, the expression "*income from financial facilities*" means, "*interest from loans*".

8. Statement of Investment Deposits Performance Structure

Statement of Investment Deposits Performance

		for the year ended 31 December	
	Note	20X2	20X1
Mutual incomes			
Income from financial facilities	*9-1*	xx	xx
Income from deposits	*9-2*	xx	xx
Net income (loss) from investment	*9-3*	xx	xx
Sum of mutual income		**xx**	**xx**
Share of bank's resources from mutual income	*9-4*	(xx)	(xx)
Share of depositors from mutual income before deduction of the bank's fee	*9-5*	xx	xx
The bank's fee	*9-6*	(xx)	(xx)
Share of depositors from mutual income	*9-7*	**xx**	**xx**
Income from required reserve deposits	*9-8*	xx	xx
Compensation for unused depositor's resources	*9-9*	xx	xx
Realized income from investment deposits	*9-10*	**xx**	**xx**
Income paid on account to investment deposits	*9-11*	(xx)	(xx)
The difference of realized income(extra paid income) to the depositors	*9-12*	**xx**	**(xx)**

9. Description of the Nature of Items Comprising Statement of Investment Deposits Performance

9.1. Income from financial facilities

This is the sum of incomes from financial facilities based on Islamic contracts, including Installment Sale, Joaalah, Hire Purchase, Mudarabah, Civil Partnership, Forward, Debt Discounting, Murabaha, Istisna, and any related penalty clause, which should be disclosed separately in the notes attached. Income from foreign currency financial facilities is non-mutual.

9.2. Income from deposits

This is the sum of incomes from deposits, including income from term deposits deposited in other banks, Islamic bonds, Sukuk and Certificates of deposits, which must be disclosed separately in the notes attached.

Income from required reserve deposits is a non-mutual income, and reported under the item 9-8. Also, income from foreign exchange items is non-mutual, and does not belong to the depositors.

9.3. Net income (loss) from investment

This is the sum of incomes from the bank investments, including gains from stock trading and dividends, and increase (decrease) in value of the bank investments, which must be disclosed separately in the notes attached. Since the amount reported is the sum of positive and negative items, it is called the net income (loss) from investment. Also, the income (loss) from foreign currency investments is non-mutual, and does not belong to the depositors.

9.4. Share of bank resources from mutual income

This item includes share of the bank resources from mutual income, which is calculated in accordance with the related relevant instructions, based on a 52-week average of resources. This item and its components and the detailed calculations must be disclosed separately in the notes attached. According to the instructions, if the bank's allocation of mutual resources (i.e. financial facilities, investments, etc.) is less than free resources from investment deposits, the bank's share in the mutual income will be zero. Free resources from investment deposits are equal to the average balance of investment deposits minus Required Reserves. According to the instruction, allocation of these resources is a priority.

9.5. Share of depositors from mutual income before deduction of the bank fee

This item represents the amount after deducting the share of bank resources from mutual income (9-4) but before deduction of bank fee (9-6).

9.6. The bank fee

This item shows the bank fee, which is for the management of depositors' funds. Calculations of this item must be presented in the separate notes attached.

In this regard, the following points should be considered:

a. The bank fee should be announced at the beginning of the financial period. The central bank determines only the ceiling. But within the limit, the bank board has the responsibility of determining the rate.

b. Total amount of fee is obtained by multiplying the fee rate by the average of the depositors’ free resources. But if the average allocation of mutual resources is less than the average of the depositors’ free resources (i.e. the bank has not allocated all the free resources), the fee rate is multiplied by the average allocation of mutual resources.

c. Based on an incorrect but common practice in the recent years, some banks offset their fee by the excess income paid to the depositors, so that in some cases the total amount of fees equals zero. This offset is against the law and contrary to the principle of full disclosure and accounting standards.

9.7. Share of Depositors from Mutual Income

This item shows the share of depositors from mutual income (9-5) after deducting the bank fee (9-6)

9.8. Income from required reserve deposits

This item shows the income paid to the average required reserve deposits by the central bank according to the resources of investment deposits, which is about one percent at present time. It is non-mutual and wholly belongs to the investment deposits. The detail of its calculation should be disclosed in the attached notes to the financial statements. Of course, the income paid to reserve requirement of the bank resources will be non-mutual and wholly belong to the bank.

9.9. Compensation for unused depositor’s resources

This item represents the cost of not allocating the resources of the depositors. If the resources were used properly, the proceeds would be recorded in one of the items related to the mutual income. Therefore, implicit cost imposed on them and the bank should compensate the losses caused by the failure of its management. According to the instructions, the amount of this cost is derived from multiplying surplus of the investment deposits by return of the average allocation of mutual resources (i.e. mutual income divided by the average allocation of mutual resources). The calculation of this amount should be disclosed in the notes attached to the financial statements.

9.10. Realized income from investment deposits

This item shows the income allocated to the investment deposits, which is the sum of the depositors' share of mutual income (9-7), income from required reserve deposits (9-8), and compensation for unused depositor's resources (9-9).

9.11. Income paid on account to investment deposits

This item represents the sum of income paid on account to the investment deposits, has been paid to the depositors during the financial period in accordance with the bank rates. Components of this item including the variety of investment deposits, the announced interest rate, and the amount paid to the depositors must be disclosed separately in the notes attached to the financial statements.

9.12. The difference of realized income (extra paid income) to depositors

This item shows the difference between realized income of the investment deposits (9-10) and income paid on account to investment deposits (9-11). Normally, the difference is a positive amount, and shows an amount- in addition to the income paid on account- that should be paid to the depositors at the end of the financial period. But a negative amount of the difference indicates that the bank is even unable to earn as much income as paid on account to the depositors. Due to legal restrictions, the excess income paid cannot be claimed back from the depositors, and it must necessarily be considered as a donation to them. Since the share of shareholders will be reduced, it would be outside the scope of financial reporting and it might lead to a legal dispute. However, full disclosure of the positive or negative amount- without any offsetting operation with other items in the statement- is necessary in accordance with accounting practices.

10. Consistancy with International Financial Reporting Standards (IFRS)

One of the basic principles of designing financial statements is to maintain the intrinsic relationship between them. The relationship between statement of investment deposits performance and the income statement will be through a common note in the notes attached to the financial statements. In the IFRS income statement, expense of deposit income includes two components: 1) Expense of income on domestic currency investment deposits (mutual), and 2) Expense of income on foreign currency investment deposits (non-mutual). Expense of income on domestic currency investment deposits is the amount at the end of common note which equals to the sum of income paid to the investment deposits (9-10), and- if any - income payable to the depositors (9-12). So, structure and content of income statement consistent with banks' conventional format and in accordance with IFRS would be provided by preparing statement of investment deposit performance and joining it to income statement (mentioned note and income statement have been presented in attachment). So, as noted earlier, implementation of IFRS in Iran banking business is provided by creating connective channels.

11. Functions of Statement of Investment Deposits Performance

11.1. Full disclosure

Full disclosure has long been one of the most important principles of financial reporting. Comparison of statement of investment deposits performance with the current financial statements of banking business in Iran reveals fundamental differences in the level of disclosure and transparency in these financial statements. A closer look at the income statement of the Iranian banks, and its attached notes, shows the lack of respect for the principle of full disclosure in reporting mutual income. In recent years, offsetting the excess income paid to the depositors has become an incorrect practice in the bank financial reporting. Reporting adjusted rates of fee, zero difference between the realized income and the income paid on account, and even fees equal to zero are examples of this incorrect practice.

Obviously, reporting a zero difference is concealment of facts, and even theoretically would be impossible. As a matter of fact, under no disciplined, intelligent, and powerful management the difference between realized income and income paid on account could be zero. It is clear that such an outcome can only be obtained by offsetting procedure, manipulation, and incomplete disclosure. The reason for this behavior is also clear; banks have not even been able to earn as much income as income paid to the depositors. However, regardless of the factors responsible for the current situation, there is no reason to refrain from disclosing actual results. What happened in the past needs to find its own cure, but what comes next and is discussed in this paper is that the newly introduced financial statement can be considered as an effective step in the creation of financial discipline and transparency in financial reporting of banking business in Iran.

11.2. A twofold role for the financial statement in relation to conflict of interests

At first glance it may seem that the statement of investment deposits performance only aims to protect the rights of the depositors. But a closer look at the bottom line (9-12) shows that the difference of the income payable with a positive or negative amount has a twofold role: To disclose this difference in the financial statement both supports and protects depositors and shareholders, as main stakeholders of the bank. If the difference is positive, the depositors can more or less be sure that the audited financial statements have recognized their earnings in the mutual income. But a negative difference indicates that excess income paid to the depositors is paid at the expense of shareholders. Although this amount is not refundable to the shareholders, disclosure of the difference enhances the accountability of managers to shareholders, and is expected to correct their behavior when announcing the income paid on account in the future. All in all, the introduction of this financial statement aims at transparency in accountability and protection of rights of both depositors and stockholders, and would be effective in reducing conflict of interests between these two groups.

11.3. Other consequences of introducing the statement of investment deposits performance

From a retrospective view, financial reporting has a function to clarify and fully disclose what has happened. The theory of accounting has been supporting this concept over the years. The statement of investment deposits performance mostly focuses on sharing the mutual income between the two main groups of depositors and shareholders. However, the task of accounting or financial reporting ends at this point. Of course some legal and juridical debates can arise from this point, which is not the subject of this paper.

On the other hand, from a prospective view, disclosure of the difference is expected to have an effective impact on the future behavior of managers.

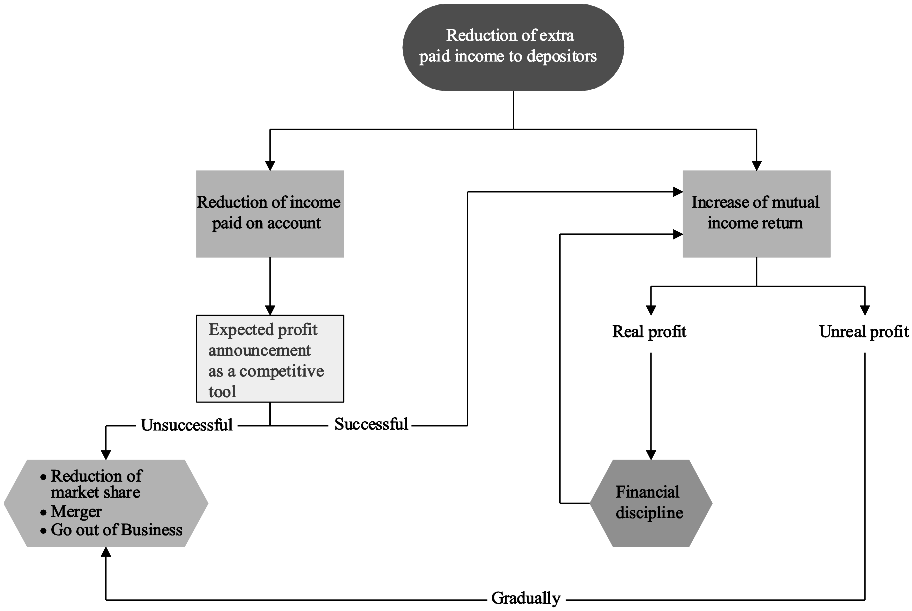
As a result of this change in behavior, income payable on account can become more reasonable. In other words, management of the bank, based on its stewardship responsibility, should estimate a reasonable expected income for the investment deposits. Then relying on this estimation, the income payable on account will be determined in a certain range. This requires a detailed plan and financial discipline, and impacts on key elements of bank activities, such as the quality and rates of lending and deposits.

12. More Disclosure Requirements with IFRS Implementation

One of the major concerns of the depositors can be potentially risky decisions made by the bank management, which could endanger their resources. The Usury-free Banking Law states: "Banks are obliged to repay the principal of the (saving and current) deposits, and they can commit themselves to repay the principal of term investment deposits, or insure them." It is clear that the banks in the financial crisis or in a state of bankruptcy would be subject to the relevant rules and regulations of the country. Since the bank is a public corporation, the responsibility of its shareholders is limited to their capital, and the bank guarantee has no effect on depositors. Deposit insurance, or the deposit guarantee fund, which is still in the early stages of formation and does not have sufficient resources- as is common in other countries- has a ceiling for the guarantee, and there is no insurance coverage above the designated limit.

Banking business is a potential source of a triangular conflict of interests. Bank managers, depositors, and shareholders are the three vertices of the triangle. Getting into risky activities could have potential earnings to the shareholders at the expense of the depositors. Managers appointed by the shareholders, in particular under the influence of major shareholders – who are potentially susceptible to this type of risk-oriented activities. They are able to put at risk the resources of both shareholders and the depositors, for instance, by increasing the size of the bank (as their territory), in order to maximize their own interests, such as bonuses, salaries and earnings. Depositors and shareholders are at greatest risk because they have no role in the appointment of the bank managers.

Behavior of banks to reduction of extra paid income to depositors



Risk disclosure requirements in the notes attached to the financial statements, especially in the statement of investment deposits performance, can play an important role in preventing banks from going into risky areas, and also promotion of professional management for running the banks. A range of risk disclosure requirements will be achieved by the use of International Financial Reporting Standards (IFRS) in the banking business in Iran. Due to this fact, it is necessary to implement these standards as soon as possible.

13. Conclusion

Following widespread dissatisfaction with the performance of Accounting Principles Board (APB), Financial Accounting Standards Board (FASB) was established in 1973, and for the first time "accounting principle" was officially replaced by "accounting standard"(Hendriksen & Van Breda, 1992). In response to concerns arising from lack of accounting principles, the conceptual framework for financial reporting was formed (like the constitutional law compared with general law). Then, this approach was used in other countries. The latest effort in this regard, has been the conceptual framework proposed by Joint Working Group on IASB and FASB. This conceptual framework which is supposed to be universal should be large enough to cover all countries with different regulatory and economic structures. Accepting this fact, one of its features should be its flexibility. Yet, it is essential that such flexibility would be consistent with business model and has a reasonable, clear and systematic framework. In this way it could prevent disorder and personal judgment – which can potentially undermine the comparability of financial statements.

This paper provides evidence in support of what we name “reasonable flexibility” by introducing a supplementary financial statement for financial reporting in Iran banking business.

The usury-free banking principles, governing the entire Iranian banking business with a set of rules and regulations, impose requirements on financial reporting of banks. On the other hand, academicians, professional associations and the regulatory bodies are interested in implementing IFRS standards that in some cases its requirements are in conflict with usury-free banking principles. Potential flexibility of the conceptual framework is a way to exit this dilemma. Based on this approach, in order to implement the IFRS, this paper introduces a supplementary financial statement entitled “Statement of investment deposits performance” for financial reporting in banking business of Iran provides some evidence in support of what is called "reasonable flexibility”. It was shown that this financial statement improves financial reporting in terms of accountability and disclosure. At the same time, it maintains the integrity and comparability of financial statements and intrinsic relationship between them. Finally, it seems that in absence of this supplementary financial statements, financial reporting for banking business of Iran in accordance with IFRS, would be contrary to its conceptual framework. Also IFRS is concerned that financial reporting should reduce the information gap between the agents (managers) and owners of the bank resources, and provide information for economic decision-making by the bank main stakeholders. Without this supplementary statement this feature of IFRS is not maintained.

Finally, in order to prevent disorders arising from personal judgments, there should be an operational definition of reasonable flexibility. Here, some features such as materiality, comprehensiveness, comparability, maintaining intrinsic relationship between financial statements, and adaptability with business model should be considered.

Profit and Loss Statement

	Note	for the year ended 31 December	
		20X2	20X1
Income from financial facilities and deposits		xx	xx
Expense of deposit income	***A***	(xx)	(xx)
Net income from financial facilities and deposits		xx	xx
Fee and commission income		xx	xx
Fee and commission expense		(xx)	(xx)
Net fee and commission income		xx	xx
Qarz-Al-Hasane net income		xx	xx
Net Income (Loss) from Investment		xx	xx
Net Income (Loss) from trading and foreign exchange transaction		xx	xx
Other operating income		xx	xx
Total operating income		**xx**	**xx**
Other income		xx	xx
Net impairment loss on financial assets		(xx)	(xx)
General and administrative expenses		(xx)	(xx)
Financial facilities provision		(xx)	(xx)
Financial Expenses		(xx)	(xx)
Depreciation and amortisation		(xx)	(xx)
Other expenses		(xx)	(xx)
Profit before tax		xx	xx
Income tax expense		(xx)	(xx)
Profit		**xx**	**xx**

A- Expense of deposit income

	Note	for the year ended 31 December 20X2	20X1
Expense of investment deposits income (on domestic currency)	*A-1*	xx	xx
Expense of investment deposits income (on foreign currency)		xx	xx
Total Expense of deposit income		xx	xx

A-1	for the year ended 31 December 20X2	20X1
Income paid on account to investment deposits	xx	xx
Plus (minus) The difference of realized income(extra paid income) to depositors (cited from statement of investment deposits performance)	xx/(xx)	xx/(xx)
Realized income from investment deposits	xx	xx
Plus income donated to depositors (equivalent extra paid income to depositors)	xx	xx
Expense of investment deposits income (on domestic currency)	xx	xx

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