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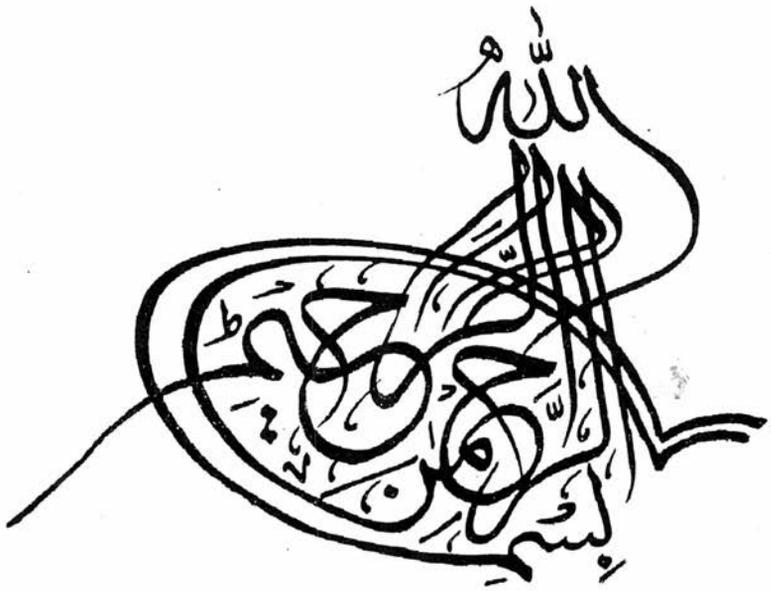
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**Development of an
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Preface

Banking is one of the instruments used for promoting an Islamic economic order. As the economic system is part of an overall social system, it must be viewed in the context of the totality of human existence.

Islam rejects the view that economics is a value-neutral science; rather, it is fully value-oriented and has its own framework and agenda.

I would also like to dispel the impression that a bank becomes Islamic merely by removing the element of *riba* (interest) from its transactions. There are many other aspects of Islamic Banking which must be taken into account. These are based on the principles and precepts of Islam as enshrined in the *Sharia*. The setting up of an Islamic bank, therefore, requires an understanding of the essential ingredients of Islam.

Islamic banking not only prohibits the financing of businesses related to alcohol, drugs, pornography, gambling and other activities viewed by Islam as immoral and anti-social, but it also aims to make a positive contribution to the fulfilment of the socio-economic objectives of the society. Having created a healthy financial climate, Islam points to various alternatives on which Islamic banks may focus their activities.

As Islamic banking is value-oriented, accounts must be properly maintained, and transactions conducted in accordance with the principles of the *Sharia*. Thus Islamic banks must have access to both religious scholars and professional accounting bodies.

The Islamic bank's approach to client's funds is that all financial transactions must be open and above board, with a detailed disclosure of accounts. The basic principle of Islamic banking is that all information should be made available in such a way as to enable the average client to understand the financial position of the organisation.

Preparing the accounts of Islamic banks, in particular how to calculate the profit and loss on transactions, is not simple and requires considerable imagination and innovativeness. There are no easy solutions. Extensive research is needed to solve this vital aspect of accounting.

Islamic banks have been established only in recent years and are still in the process of developing accounting standards. This requires considerable skill. Already useful steps have been taken in this direction.

Taking note of the urgent need to develop an appropriate accounting system for Islamic banks, the Institute of Islamic Banking and Insurance held an international conference in London on "Developing and accounting system for Islamic Banking". The aim of the conference was to focus on the task and discuss various aspects of it. Leading bankers, accountants, economists and scholars from various parts of the world participated in the conference. This book is based on some of the papers presented at the conference and some papers specially commissioned for it.

I wish to express my thanks to DMI and Price Waterhouse for their cooperation in organising the seminar that was basis for this book as well as the learned speakers and writers whose papers have been used in it.

I hope this book will serve as a useful information source, stimulate interest in an accounting system for Islamic banks, and give impetus for its development.

MUZZAM ALI

Chairman

Institute of Islamic Banking and Insurance

Introduction

Omar A. Ali

The Islamic banking system appeared on the international financial horizon only two decades back and is becoming increasingly accepted.

There are today over 100 Islamic financial institutions in the world. These institutions manage billions of dollars and have proved to be capable of acting as financial intermediaries, which is the principal role of a bank or a financial institution.

Islamic banks have to operate under strict religious guidelines, which are based on different principles than those of conventional banks.

These principles are:

1. Prohibition of interest in all forms of transactions.
2. Undertaking business and trade activities on the basis of fair and legitimate (*halal*) profits.
3. Payment of "the poor due" (*zakat*) from their operations.
4. Prohibition of monopoly.
5. Cooperation in the development of society, by investing only in businesses and trades which are not prohibited by Islam.

Although an Islamic bank differs from a conventional bank in the principles on which it operates, its main objective, like that of a conventional bank, is to provide good returns to its depositors and distribute reasonable dividends to its shareholders.

These returns and dividends are based on the results shown in the audited financial reports that are published by banks (whether Islamic or conventional) and which are extracted from the prevailing accounting system maintained by such banks.

Owing to the similarity of their main objectives, the accounting standards and principles applied to Islamic banks do not much differ from those of conventional banks. As a result also, auditing an Islamic bank's accounts should not in principle, differ much from auditing those of a conventional bank.

However, it is becoming increasingly important to standardize, as much as possible, the accounting system that fits into a Islamic banking environment and to harmonise it within the constraints of the Islamic *Sharia* and the restrictions of the different local statutory requirements.

In discussing the development of an accounting system for an Islamic bank, its accounting principles and standards, we should emphasise the fact that although in an Islamic banking relationship, the financial risk of a transaction rests with the investor, such a risk is entrusted by the investor with the Islamic bank on a fiduciary basis, whereby the bank acts as a trust and the investor is the beneficiary.

In return, the Islamic bank participates in the profit and receives some fees.

The whole Islamic banking concept is based on the fact that the trust (in this case, the Islamic bank) shares in the profit or loss of a financial transaction made on behalf of the beneficiary (investor).

Strictly speaking, funds received by an Islamic bank from investors should therefore be treated off-balance sheet. However, Islamic banks operating under different jurisdictions with incompatible local statutory requirements have necessarily differed on the presentation of such funds. Some of them present managed funds as on-balance sheet, while others present them off-balance sheet and again others present some funds under management on-balance sheet with other funds off-balance sheet. In certain jurisdictions, Bahrain for example, a *Mudaraba* fund may be treated as a separate legal entity and may have its own audited financial statements.

On the other hand, conventional banks usually assume the financial risk of a banking transaction. We therefore find that most conventional banks treat their managed funds on-balance sheet. In return, conventional banks make most of their income from the margin they realise on the difference between the cost of their funds and the return they make from their banking transactions.

It is also important to point out that an Islamic bank has to follow high ethical standards and has to comply with the Islamic *Sharia*. This must be carried out within the existing internationally recognised financial system. Therefore, an Islamic bank has to be supervised by a *Sharia* Supervisory Board that will be able to confirm that all the banking activities of such an Islamic bank are *halal* (i.e., are Islamically acceptable).

In this book the following distinguished authorities will give their views on their own specific areas of Islamic banking.

Mr Muhammad Akram Khan, Director General, Audit and Accounts (Training) Pakistan underscores the very basic issues and concepts that are involved in accounting for Islamic Banks.

Dr Trevor Gambling, Professor at the University of Birmingham and author of *Accounting in Islamic Banks*, writes about **accounting for Islamic banks from a Western perspective**.

He raises the fundamental question of whether there is a subject which could be described as "Islamic Accounting for Banks", as opposed to "Accounting for Islamic banks".

Dr Rifaat A. Abdel Karim, Advisor to the Financial Accounting Organisation of Islamic Banks & Financial Institutions, Bahrain, informs us about the most recent **regulations for financial reporting by Islamic Banks**. **Dr Abdel Karim**, brings to light the differences between Islamic banks in accounting for transactions in the same investment instruments owing to the differing interpretations of the various religious boards, and the need to standardise, within the Islamic banking family, the presentation of accounts.

Mr Imtiaz Pervez, General Manager of Faysal Islamic Bank, Bahrain has written an interesting chapter giving an insider's perspective on accounting systems for Islamic banks.

Mr Mustapha Hamat, Financial Director of Bank Islam Malaysia, writes about the information to be disclosed in the financial statements of Islamic banks.

Mr Musa A. Shihadeh, General Manager of the Islamic Bank of Jordan, Amman writes about the many kinds of accounts offered by Islamic banks and how they may be accounted for.

Dr Naim E. Hassan, Department of Accounting and Finance, University of Birmingham, writes about measurement of the financial performance of an Islamic bank *vis-a-vis* a western commercial bank.

Mr Samir Badawi, from SLT Environment, New York, former Partner from Ernst & Young, Paris, writes about methods of allocation of profit generated by an Islamic bank; related party transactions in an Islamic bank; and risk provisions on Islamic invested funds.

Mr Khalid Abdullah Janahi, Partner from Price Waterhouse, Bahrain, writes about the relationship between accounting & Sharia issues and the responsibility of the auditor to an Islamic bank's shareholders and investors.

Mr Ibrahim Sidat FCA explains the accountant's role that he is supposed to perform in an Islamic economy in general and in recording financial statement in interest-free banks, in particular.

Mr. A.A. Abdallah gives a comprehensive account of the role of *Sharia* Supervisory Boards, Department of *Fatwa* and Research and Central Higher *Sharia* Supervisory Board which these units have played in monitoring and guiding the operations of the financial institutions in the Sudan.

Altogether, this book attempts to answer the following fundamental questions:

1. Is there a need for a standardised accounting system for Islamic banks? If so, what are the plans for developing such a system?
2. Can such a standard system be in accordance with the requirements of the regulatory agencies under which Islamic banks operate?

The following chapters go a long way towards answering these questions as well as providing much food for further thought.

Chapter 1

Accounting Issues and Concepts for Islamic Banks

Muhammad Akram Khan

Section I

INTRODUCTION

Accounting and society

Accounting has a close relationship with the social and economic values of a society. Present-day accounting has evolved over centuries, along with the development of capitalist society. Since ancient times, people have been recording the events of business in a manner and style appropriate to their social and cultural needs. But most of this record-keeping has been rudimentary and limited in scope.

With the advent of the Industrial Revolution, the size of business and industry increased. Large-scale business gave birth to new forms of business organizations. The Most significant change was the idea of joint stock companies incorporated as legal entities with limited liability. Similarly, debt capital emerged as a major mode of finance for large-scale business. New forms of ownership and control came into being. The owners of a business separated from the day-to-day management of the business. Professional managers started managing and controlling large-scale business corporations. The interest of shareholders became restricted to dividends, very much like he rentiers of debt capital. The long-term objectives of business became survival and continuity. Professional managers started having a stake in the value of the shares of the business on the stock market.

The anonymity of shareholders created a new scenario. The shareholders could sell their interest in the business without informing anybody, including the business itself. Strangers could take over a business without the knowledge or will of the existing shareholders. Shareholders started realizing that they were at the mercy of managers. They started feeling the need for greater accountability of the managers.

All these developments under capitalism compelled accountants to respond to needs of society. Present-day accounting theory and practice is, in fact, a response to the way capitalist society and its various institutions have evolved over centuries. Although the truth of this is quite obvious, some examples will illustrate the point. Accounting practices regarding issues and sales of shares, mergers and take-overs of companies, liquidation and insolvency, emerged with the joint stock company. Accounting for debt, interest calculations and the issue and redemption of bonds came when loan capital became a normal practice of business. Similarly, accounting for income tax and other indirect taxes, accounting for instalment sales, branch accounting and accounting for holding and subsidiary companies all evolved as business practices as socio-economic developments took place. Accountants started deliberating on various issues relating to these developments. As a result, a body of literature on accounting theory and practice has developed. With some local variations, it is followed all over the capitalist world.

Not only has accounting developed in response to the information needs of society, it also carries the spirit of capitalism. Accountants have been deliberating on various accounting rules within the tacit framework of capitalism. They have been making various implicit assumptions. For example, the assumptions of private property, consumer sovereignty, profit motive, human selfishness, certainty about the future and *lassaiz-faire* have always been present in the backs of the minds of everyone postulating on accounting concepts. Look at the present-day format of financial statement of a business organization. It gives numbers about assets, liabilities, incomes and expenses. This information is needed by the capitalist, the stockholder and the owner of the business. Accountants presume that the ultimate objective of all business organizations is to maximize profit or to ensure survival. They do not perceive that a business firm has any social, economic or cultural objective. Similarly, accountants do not record or report the performance of a business firm with regard to the welfare of the human beings

working in it. They do, of course, disclose the well-being of the owners of whom the business exists. Almost all capitalist societies accept that accounting for tax purposes may be different from accounting for shareholders. The purpose and the users of the information determine the level of income or loss. This is because the society accepts multiplicity of accounts as legitimate. Even the expression "financial statement" speaks of a value judgement. In fact, they should be called "accounting statements". By calling them "financial statements", accounting information on various non-financial but vital areas can be safely excluded. For example, these statements do not disclose quantities produced, purchased or sold. They do not disclose quantities produced, purchased or sold. They do not give the profile of persons employed and the terms and conditions of their employment. They do not disclose the even performance of the firm in keeping contracts. They do not tell the exact nature of the business and its impact on society. For example, if a business is potentially threatening the environment or promoting terrorism or spreading pornography, its accounting statements do not inform the readers about these effects. In fact, such is the powerful effect of present-day accounting practices on business reports that it is not even conceivable that accounting has anything to do with all these non-financial matters. But, if we go deep into the concept of accounting, it must include some sort of accountability of those who are managing the business to the owners, the governments and society at large. If accounting reports do not include this information, then who else is responsible for reporting on these non-financial aspects of a business? In a capitalist society all this is acceptable, since the main objective of accounting is to report the results of a business to its owners, who are mainly interested in maximization of profit on their investment. But once we change the basic social framework, the concepts and procedures of accounting will also undergo a change.

Accounting information needs of an Islamic society

An Islamic society operates under different assumptions. It recognizes private property within the umbrella concept of God's sovereignty and trusteeship of man on this earth. So people have only a limited freedom to earn, spend, save and invest their resources. While operating a business, they have the role of stewardship toward society. They do not have an unregulated licence to operate in any field they choose. They

have a duty toward the society and other fellow citizens. They have the freedom to use the physical resources of the earth, but only within defined moral and social limits. They can cooperate with one another for raising funds and running joint ventures, but should follow the guidelines of the *Sharia*. They have defined duties towards their employees, customers and competitors.

This is a bare outline of the Islamic framework. It leads to different types of business organizations and financial institutions from the capitalist ones. For example, once we recognize that capital cannot be raised through interest-bearing loans, we need to think of alternative arrangements for organizing business, especially when it involves large amounts of capital or the association of large numbers of persons. It also means that the savings of society will have to be channelled to productive routes through some arrangement which is different from the one followed by a capitalist society. Similarly, all individuals having wealth beyond a certain minimum have to pay a specified sum toward *zakah*. This suggests that every individual should keep some account of his or her assets, so that *zakah* may be calculated correctly. The Islamic society obliges its citizens to behave with a sense of justice and benevolence. Of course, not all individuals in all cases will adhere to this norm. But the society has to establish institutions which ensure justice and benevolence. Business firms will also need to follow this general guideline.

From the above it is clear that the information needs of an Islamic society are quite different from those of a capitalist society. More specifically, an Islamic society will expect its individuals and business firms to record and report, besides profitability, liquidity, solvency and efficiency, on such matters as:

- a) Within the Islamic modes of business organization and finance, how is income generated and distributed?
- b) What is the true figure of *zakah* payable? For those departments and agencies managing *zakah*, information on various aspects of collection, distribution and impact of *zakah* will also be needed.
- c) How does a business firm treat its employees? To what extent are considerations of justice and benevolence kept in view?

- d) How far does the business firm keep its promises and fulfill its contracts?
- e) How does the business firm affect the environment?
- f) To what extent does the business firm contribute toward propagation of what is proper and negation of what is improper (*amr bil maruf wa nahi anil munkar*)?
- g) To what extent does the business firm abide by the Islamic code of business ethics while dealing with customers, competitors, and government and various other agencies?
- h) What is the contribution of the business firm toward the socio-economic development of society? What goods and services does it provide and how are they useful?

This is not an exhaustive list of questions. The point of reference is the over-all objective of the *Sharia*. Business firms will need to record and report on the extent to which they promote the objectives of the *Sharia*. Obviously, present-day financial statements will not serve the purpose. Once we change the social paradigm, an entirely new system of accounting will emerge. As in capitalism, when an Islamic society comes into being, it will place its demands on accountants. They will have to respond to these demands. New accounting concepts and procedures will evolve. At present, it seems too utopian to be realistic. It is because we are so much accustomed to living in a capitalist world that it is difficult to imagine a different set of rules and procedures for anything—be it economics or accounting.

Initiative of Islamic banks

But we can see a beginning toward Islamic accountancy in the wake of the Islamic banking movement. During the last two decades, a number of Islamic banks have sprung up. At present there are over 150 such institutions all over the world. They were set up without much home work having been done, so far as accounting was concerned. But soon they started realizing that the conventional accounting concepts and practices needed to be redefined and standardized more precisely to suit their needs. The peculiar modes of collecting deposits and financing operations followed by Islamic banks indicated a need for developing their accounting standards. Therefore, in 1987, seven

ACCOUNTING CONCEPTS FOR ISLAMIC BANKING

Islamic banks, led by the Islamic Development Bank Jeddah, joined hands to set up a Supervisory Committee and prepared a plan to develop accounting standards for Islamic banks. It commissioned several studies from experts in accounting and the *Sharia*. This committee wanted to know the needs of users of financial statements of Islamic banks and financial institutions. It also aimed at studying and analyzing the financial statements of various Islamic banks to specify their shortcomings and the quality of additional data and information which should be disclosed. The experts prepared 57 studies which were compiled in five volumes and deposited in the library of the Islamic Research and Training Institute (IRTI) of the Islamic Development Bank, Jeddah. These studies led to the formation of the Financial Accounting Organization for Islamic Banks and Financial Institutions. The Organization set up a Financial Accounting Standards Board for Islamic Banks and Financial Institutions which started functioning from 26th December 1990. It prepared a three-year plan which provided, inter alia, for the following:

- a). Preparation of the financial accounting objectives for Islamic banks and financial institutions.
- b). Development of financial accounting concepts.
- c). Preparation of three accounting standards.

By December 1992, the Board prepared draft papers on the first two items stated above and a paper on Presentation and Disclosure Standards for Financial Statements of Islamic Banks and Financial Institutions. It organized a seminar in December 1992 at Bahrain to discuss these papers and get feedback from experts in Islamic banking, accounting, auditing and the *Sharia*. In the light of this seminar, the Board revised the Statements in April 1993. It approved the final Statements in October as:

Financial Accounting Statement No. 1: Objectives of Financial Accounting for Islamic Banks and financial Institutions:

Financial Accounting Statement No. 2: Concepts of Financial Accounting for Islamic banks and Financial Institutions: and

Financial accounting Standard No. 1: Presentation and General Disclosure in the Financial Statements of Islamic Banks and Financial Institutions.

In May 1994, the Board was in the process of developing three accounting standards on *Murabaha*, *Musharaka*, and *mudaraba*.

Scope of present study

The present study aims at discussing the basic concepts of accounting in relation to Islamic banks. But before going on to the main subject, it is pertinent to discuss a few accounting issues in the Islamic framework. We shall take care of this aspect in Section II of the paper. In Section III we shall highlight the accounting implications of the operations of Islamic banks. This will set the stage for a discussion of accounting concepts for Islamic banks which we shall cover in Section IV of the paper. In this section, the paper will draw upon the work done by the Financial Accounting Standards Board for Islamic Banks and the papers presented to the Bahrain seminar in 1992.

Section II

ACCOUNTING ISSUES IN THE ISLAMIC FRAMEWORK

The Nature of Ownership Equities

1. Proprietary theory

There are two main theories of ownership equities in accounting literature: (a) proprietary theory and (b) entity theory. The Proprietary theory treats the providers of equity as owners of the business. They own its assets and they owe its liabilities. If we accept this theory, the basic accounting equation is:

$$\text{Assets} - \text{Liabilities} = \text{Proprietorship.}$$

The profit is an increase in the value of assets and loss is a decrease in their values. The primary financial statement is the balance sheet, which measures the net worth of the proprietors. The accounting statements determine the wealth of the owners.

The proprietary theory has been in vogue since ancient times and even now, most of the accounting concepts are derived from this theory.²

2. Entity theory

But as capitalist society evolved, the joint stock company came into being for mobilizing large amounts of funds. The early joint stock companies met with several disasters when the companies suffered heavy losses. The shareholders had to meet these losses from their personal assets, although they had never intended to invoke this risk. To overcome this difficulty, the ancient concept of incorporation was applied to the business sector. Incorporation of churches, government, social welfare societies, universities and hospitals had been in existence in all civilized societies since very early days. The innovation made by capitalist societies after the Industrial Revolution was to apply this concept to business firms, albeit a little artificially.

To make the concept work, the business firms were allowed to be registered as companies with legal entities of their own. These entities were accepted as legal persons. They could own assets, incur liabilities, hire employees, sue someone in their own name and could be sued as such. As a result, the liability of the shareholders in respect of the debts of such corporations became limited to the extent of their own capital. In case of difficulty, it was the company which had incurred the debt and it should pay these debts from out of its assets. If the assets of the company were insufficient, the creditors should suffer the loss and not the shareholders. Thus the twin concepts of *incorporation* and limited *liability* were the real spirit behind the entity theory of equity. The necessary legal framework was provided to support the concept.

The accounting implications of this concept are that the providers of funds, whether shareholders or creditors, are equity holders. The basic accounting equation is:

$$\text{Assets} = \text{Equities}$$

The firm is basically interested in maximizing income, which is a surplus of revenue over expenses. The payments to creditors and shareholders arise out of a contract with the business which agrees to pay them interest or dividends. Any surplus after paying interest and

dividends is the property of the firm. Income tax is payable by the firm as an entity. The shareholders and creditors pay income tax as their personal liability. A number of accounting concepts and practices follow the entity theory, although there is no decisive position on the profession in either of these theories.³

3. The Islamic perspective

The Islamic framework supports the Proprietary theory. The entity theory suffers from some incongruities. First, it is not clear who is the ultimate owner of the business. Suppose a company goes into liquidation and its assets are more than its liabilities, who will take the surplus? the obvious and undisputed answer is: the shareholders. Now, let us assume that the assets are not sufficient to pay for its liabilities, who settles the creditors? The reply from entity theorists is that none settles them.

Now, this is an inequitable position. The shareholders have a right to receive all profits whether earned with their money or with borrowed money. But they are not liable to pay off the debts. The Islamic position is that the right to receive a return co-extends with the liability to bear loss.⁴ In this case, the right to profit is unlimited but the liability to loss is limited. We think the concept of limited liability does not go along with the rules of the *Sharia*. According to the *Sharia*, whoever borrows must pay back. This liability remains outstanding even though one dies. In case of his death, the assets of the deceased pay the debt. If a person dies and is in debt, and does not leave any assets, the state picks up his debt. In no case is the creditor told to suffer the loss because he extended a loan.⁵

The concept of limited liability was artificially integrated into the business practices of capitalist society. The capitalist class needed to raise money on a large scale and on interest. It also did not like to expose itself to unnecessary risk. Thus the twin myths of incorporation and limited liability were invented. Accountants merely responded to it and devised practices to suit the capitalist class.

Some people in the Islamic tradition have tried to defend the concepts of limited liability and incorporation on the plea that the institutions of mosque and bayt-al-mal had existed in the Islamic society since the very early days and it would be unfair to make the

liabilities of the trustee of these offices unlimited. Moreover, they argue, in a contract of *mudaraba*, the liability of the investor is limited to the sum invested. Therefore, the concept of limited liability is not alien to Islam. But these arguments miss some essential points. Incorporation, as such, is not against the spirit of the *Sharia*. There is no doubt that institutions have existed in Muslim history which were independent entities. But they were not business institutions. Their trustees were not their owners. They did not derive any profit from these institutions. At best, they were paid employees of these institutions.

It is the application of this concept to a business firm which has changed the entire context. The owners of a business firm derive profit from it. They are beneficiaries of the firm. They benefit from any loans taken by the business. Therefore, they should be the persons who discharge its liabilities. So far as the question of the limited liability of a *mudaraba* is concerned, if the entrepreneur incurs any debt with the explicit permission of the investor, then both of them join in repaying it. However, if the entrepreneur incurs a debt on his own, he is liable to repay it.

Recently, Justice Muhammad Taqi Uthmani, Judge of the Sharia Appellate Bench of the Supreme Court of Pakistan, has argued that in the case of private limited companies, the liability of the shareholders should be unlimited, but in the case of public limited companies, it should be limited. The reason, he thinks, is that in the former case, the shareholders of private limited companies borrow huge sums of money, derive benefits from it and then declare insolvency. To regulate their behavior, it is essential that their liability should be made unlimited. But in the case of public limited companies, it is the small shareholder who is likely to be put to a loss by irresponsible behavior of the directors. He has no say in the affairs of the business. If we make his liability unlimited, it will expose him to unnecessary risk. Therefore, to protect him, the liability of the shareholders of a public limited company should be limited.⁶

There is no doubt that this is the best compromise in the prevailing circumstances. But it does not answer the basic question: who owns the assets of the business firm? Who derives benefits from its profits? Who will receive its proceeds in case of liquidation? If the shareholders are entitled to all this, then why should they not be liable to pay the debts

as well? If we want to protect the remote shareholders from the mismanagement of directors, we should think of other measures such as limitation of their power to borrow, a closer monitoring of their decisions, and better auditing techniques and accountability mechanisms. We should not accept a position in which the creditors are deprived of their funds just because they lent it to a particular firm. In the Islamic framework, it is all the more serious, since the creditors do not even get any interest payments. Why should they suffer for their benevolence and cooperation?

As a matter of fact, the Islamic concept of accountability does not fit squarely into the concept of a legal person. For example, the *Sharia* has levied *zakah* on living persons and not on legal persons. If a legal person does not pay *zakah*, it will not be accountable to God on the Day of Judgement. Therefore, the *zakah* has to be calculated on the property of individuals. This is precisely the position of proprietary theory. There are other reasons why we think proprietary theory is more reasonable. For example, it is not clear why entity theorists add surplus of income after paying dividends, to retained earnings. Who owns the retained earnings? The answer is proprietors. Then why do we not accept the proprietary theory? Similarly, the entity theory cannot explain why interest is treated as an expense. If the concept of entity theory is valid, then it should be a part of the appropriation account, like dividend, as it is a payment to equity holders. There is no answer to this incongruity.

There is a criticism of proprietary theory in that it cannot explain income tax on company income. The shareholders pay income tax on their incomes, but the company has already paid income tax on its income. Thus there is a situation of double taxation of the same income. If we accept proprietary theory, we cannot explain it. The entity theory explains it adequately. Our position is that the concept of levying income tax on company income is also a typical capitalist innovation. In an Islamic economy the income of living persons is subject to income tax but not that of business firms. Therefore, the proprietary theory in the context of Islamic economy does not pose any problem.

In brief, we think the concept of proprietary theory is nearer to the Islamic framework. While defining various accounting concepts in Section four of the paper, we shall derive support from this discussion.

Valuation of assets

The profit of a business organization depends on the value of its assets. In simple words, the assets of a firm have a higher value at the end of a period than at the beginning, without any new introduction of capital or drawings by the owners, it has earned a profit to the extent of the increase in the value of the assets. But the valuation of assets presents several problems except in very simple situations, such as that of a vendor who has a few fixed assets. Calculation of current assets which can be converted into cash in a short period, such as receivables or salable inventory also do not pose much of a problem, as they can be shown at their net realizable value by almost a consensus of accountants. But the valuation of fixed assets, intangible assets or those assets which are likely to be converted into cash over a long period of time present several problems of valuation. Accountants have proposed various methods, but they can be classified into three main categories:

- (a) **Exchange output values**, current output prices, discounted future cash receipts or services potential, current cash equivalents cash and liquidation values;
- (b) **Exchange input values** such as historical costs, current input costs and discounted future costs; and
- (c) **Standard costs** such as the lower of cost or market valuation.

It is beyond the scope of this paper to discuss the merits and demerits of each of these methods. Interested readers can refer to any standard text on accounting theory.⁷ From the Islamic point of view, the valuation methods involving discounted cash flows are important, as they are based on the concept of the time value of money.

1. Valuation of assets using discounted cash flows

The valuation of assets using discounted cash flows is based on the concept that the value of an asset is dependent on its ability to generate future cash flows. But since the future may involve long period of time in which uncertainty and risk increase, it is important to estimate the present value of the future stream of cash flows. This is done by discounting future cash flows to the present. Discounting involves three main assumptions:

- (a) the amount of net cash flows expected to be generated in each of the future years;
- (b) the number of years of the remaining life of the asset; and
- (c) the appropriate discount factor.

The discount factor under conditions of certainty is usually a constant rate of interest assumed equal to the opportunity cost of the capital blocked in the asset. But a variable rate of interest can also be used for each year. Since it is recognized that the future is uncertain, the future expected cash flows are assigned a probability value such that the sum of all probabilities is one. The probabilities assigned are subjective and the best guess of the management. Under conditions of uncertainty, most authors define the appropriate rate as the subjective required rate of equal risk or the target rate of return.⁸

Among Muslim economists, Anas Zarqa has suggested that discounting can be used as a tool of project appraisal by using the expected rate of return, as a discounting factor.⁹

As we shall argue below, that innovation introduced by Anas Zarqa into this concept does not help much to overcome the conceptual and practical difficulties in this method.

2. Time value of money

The discounted cash flow technique is based on the concept of the time value of money. It says that the utility of money in the present is greater than the utility of the same money in the future. This is also one of the most popular justifications of interest on capital lent.

According to this concept, since the utility of the money lent for the lender, greater in the present than the utility of the same money in the future, therefore the borrower should add interest to it, so that the utility of the future money is equal to its present value. Now this is conceptually a faulty assumption. It is true that in some cases the utility of the money in the present can be greater than its utility in the future. In fact, this is so in the case of all poor people. No sooner do they get some money than they consume it in the present, since their need and utility in the present is greater than its value in the future. All consumption signifies that present value of the money (or other resources

being consumed) is higher in the present, otherwise the consumer would have set it aside for the future. But any penny being saved anywhere in the world is an irrefutable testimony to the fact that the saver perceives the value of the money being saved as higher in the future than in the present. Otherwise, he would consume it now and have its higher value in the present. Thus, to the extent of capital saved and invested, the future value of money is higher. There is no rational justification for adding interest to it to make its future value equal to its present value.

It can be argued that there is an undeniable human desire to acquire resource sooner in time than later. Therefore, the asset which generates cash flows earlier in the future should be more valuable than the one which generates cash flows later in time. This commonsense observation is quite valid, but it does not require the discounting of cash flows by a discount factor. One can compare the accounting rates of return of two investment proposals and if the two are equal, then the one which generates higher cash flows in time may be preferred. But if the rates of return are unequal, then generally, a proposal with a higher rate of return will be adopted, except that one hopes that in the case of a lower rate of return, the cash flows received earlier in time will be available for reinvestment and thus its cumulative rate of return will be higher.¹⁰ But again it does not need any discounting.

3. Practical difficulties in applying the concept

The concept as practiced in conventional accounting and economics is replete with subjective value judgements and compound estimations. If we remove the veil of mathematical futures, there remains little justification for pursuing this concept for any rational application. Some of the difficulties in its application are as follow:

- a) For this technique to work in practice, except for the first cash outflow, which carries a negative sign, all subsequent (future) cash inflows must be positive. If this is not so there may be no unique rate that will discount the flows back to the original investment.¹¹

This is obviously an unrealistic assumption since, in real life, cash flows can become positive and negative, depending upon market conditions.

- b) It assumes that the discounting factor must always be positive.¹² This is also obviously an unreal assumption. At times of high inflation, the discount factor (i.e., interest rate) can be negative. Moreover, as discussed above, it is not true to assume that a rupee now is always greater in value than a rupee in the future. It all depends upon the person, his circumstances, possibilities of future use and the risks involved in the future.
- c) It assumes that there is an effective market for future cash flows. It means that whether cash flows will be generated in the future, they will be invested profitably and that there is an assured market for that. Obviously, this is based on mere wishful thinking.
- d) The concept of the time value of money assumes that "the enterprise is capable of infinite expansion in the future without invalidating the model., For example, a beggar selling matches in the street has a wonderful return on capital, but is still miserably poor. Why do not venture capitalists pour investments into these match-sellers? Clearly, many of them simply would not run a larger business, but even those who could are unlikely to be able to sell a large number of matches and still earn their original return!"¹³
- e) There is no objective basis for "converting the expectations about future cash flows into single values or certainty equivalents without knowing the risk preference of the users of the information; the adjustment by including it in the subjective discount rate is conceptually inappropriate."¹⁴
- f) The method emphasizes the time factor and expected cash flows only. All other economic, technological, political and social factors are ignored. It is common knowledge that the profitability of an asset or a business venture depends on a host of complex factors. Therefore, analysis based on these two factors cannot be reliable.
- g) The method is not suitable for the accountability of management. It does not become clear whether the expected income through this method is due to the efforts of the management or due to some other (external) factors.

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- h) While discounting into the future, it is often forgotten that the firm has a past and a present. The past events and present environment are totally ignored, although at times they may be more relevant.
- i) The objective of this method is to estimate the income of the firm, which is the result of past activities. But it does not use past data to estimate that, nor does it allow the user of the information to use his own predictions about the future. Also, it does not give any criteria to evaluate the predictions made by the management.
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- j) In real life, which is uncertain, the expectations reflect the mood of the people making the estimates, which is closely influenced by the prevailing optimism or pessimism. For human beings, it is very difficult to see very far into the future realistically.
- k) The future expected cash flows are adjusted for uncertainty by using probabilities of their realization. But these probabilities are subjective. There is usually no basis for them. Similar is the case of adjustments made in the discount rate for risk preferences. They are perceptions of the management or accountants and are purely subjective.
- l) The productivity of assets often depends on their combinations with other assets or with human beings. In practice, it becomes very difficult to estimate the cash flow arising from any one particular asset. There is hardly any basis for allocating the cash flows to different assets in such a situation. Similarly, it is not possible to add all the cash flows from different assets, even if they are estimated with some success, and get the value of the firm, since this often ignores intangible assets.

These are the practical difficulties in using this method. We understand that the method of discounted cash flows is based on the concept of the time value of money, which is often offered as a rationale for the legitimacy of interest. Even when we do not use the rate of interest as a discounting factor, acceptance of the concept of the time value of money will justify interest as a reasonable and rational concept. We think this concept has rational difficulties. It also violates the *Sharia* prohibition of interest.

4. Current cash equivalent

The question remains: what is the most appropriate method of asset valuation within the Islamic framework? We think the *Sharia* supports a system of valuation which is good for all purposes, whether shareholders, government, future investors or general public. The concept of arriving at a different figure of profit for shareholders and income-tax authorities is accepted in a number of capitalist societies as legitimate under the law. But we believe that accounts in an Islamic society should consist of one set of figures good for everyone. The reason for this is that the business firm in an Islamic society has a social role as well. One set of the main objectives of accounting in an Islamic society is to help an individual to determine his or her liability for *zakah* and pay it promptly. The accounts should be good for the individual as well as for government. Thus, we think, it is fair to accept the same basis of valuation of assets which is good for calculating *zakah*.

Zakah is a tax on wealth, but in certain cases it is also payable on income, for instance, agricultural income or rent income. For calculating *zakah* on assets (or wealth), the agreed basis is *net realizable value*.¹⁶ But this is also a limited view, because in case of those assets which are not meant for sale, the *zakah* law does not give much guidance. But we find a very valuable suggestion in the book by T. Gambling & R.A.A. Karim, *Business and Accounting Ethics in Islam*. They have proposed that the valuation method proposed by R.J. Chambers is most appropriate for evaluating assets in the Islamic framework.¹⁷

This method, known as *Current Cash Equivalent*, says, the assets of a business should be evaluated according to the cash or generalized purchasing power that could be obtained by selling each asset under conditions of orderly liquidation, which may be measured by quoted market prices for goods of a similar kind and condition.¹⁸ It ignores past prices, as they are not relevant for future actions. At the same time it does not accept future cash flows as a valid basis, because they are mere subjective guesses. Instead, the method tries to determine current cash equivalents in the contemporary market. Professor Chambers held the view that it was possible to determine a market value for every type of asset. But if it was not possible to do so, then, in fact, such an

asset was valueless and should not appear in the financial statement. The method has several distinctive features over other methods of valuation.

- a) It depicts the real life situation in accounts. The balance sheet discloses values as they are on the balance sheet date.
- b) It minimizes the subjective element in the valuation of assets. For example, in the historical cost method, fixed and intangible assets are amortized over the expected useful life of the assets. But the rate of amortisation, life of the asset and method of calculating amortisation are all subjective and are guesses of the management or accountants. The same is the case in the method involving discounted cash flows, where the life of the asset, cash flows and discounting factor are all assumed subjectively. But this methods tries to determine the value prevailing in the market. No guesses are involved. It takes care of the controversies surrounding the question of amortisation of intangible assets such as goodwill.
- c) True to the concept of proprietary theory and the Islamic concept of *zakah* calculation, it emphasizes the position of wealth rather than revenue and expenses. It determines the profit by evaluating assets and liabilities and not by matching revenue with expenses, which involves many subjective assumptions about allocation of costs and recognition of revenue.
- d) The most important from the Islamic point of view, it adopts a basis of valuation which is good for the calculation of *zakah* as well. We do not have to prepare another set of accounts for this purpose.
- e) The method dispenses with the need for any inflation accounting, which has created several controversies in the profession. The values assigned to the assets are the market prices, which incorporate the inflationary effect, if any.

But this method has one serious limitation in that it excludes those assets which do not have a market value, intangible assets or non-vendible specialized equipment, although Chambers has suggested a way out of this difficulty by proposing some adjustments.¹⁹ We think some more research is needed to refine this concept in the Islamic

framework. But at the present state of our knowledge, the concept proposed by chambers comes nearest to the objectives of the *Sharia*.

5. Assumption of "Going Concern" and Conservatism

Two most important assumptions of conventional accounting are: "*Going Concern*" and *Conservatism*. The former means that the assets are valued with the assumption that the firm has to continue for an indefinite period; therefore, the values taken are not the values which the assets or liabilities will fetch in the market on the balance sheet date. This assumption makes the life of accountants easier, since otherwise, they will have to enquire into the market price of each asset on the balance sheet date.²⁰ Therefore, as a matter of practical convenience, they have adopted this assumption although, by itself, it may lead to a untrue picture of the firm's financial position'. Once we adopt the Current Cash Equivalent method for valuation of assets, we do not need to make the assumption of Going Concern.

The assumption of conservatism means that if there is a possibility of any loss it must be provided for, whereas if there is a doubt about any income, it must not be included in the profit.²¹ This rule is valid in so far as we are dealing with historical cost figures. Once we adopt the current cash equivalent method of valuation, we cannot take a conservative position by choice. We shall be governed by the market values, whether they lead to a loss or a profit. By implication, we can say that such concepts as last-in-first-out (LIFO), which are supported to evaluate inventories at a lower figure during inflation, or provision for doubtful (but not actually bad) debts, may have to be abandoned.²² The full-scale implications of the change in these assumptions will need more research. Suffice it to say at this place that our preference for the current cash equivalent method will dispense with the need to make these two assumptions of conventional accounting.

Determination of profit

In the Islamic framework, the determination of a true figure of profit is much more important than it is in the capitalist framework. The reason is that in a business venture in an Islamic economy, all parties, financiers, investors, entrepreneurs and government, are interested in a true figure of profit. In a capitalistic framework, those who provide capital as credit do not have much concern for a true profit. They are interested in their principal and interest thereon. The banks fall in to

this major category. The depositors of banks also are not keen to know the true figure of the bank's profit or loss. They are interested in a fixed interest on their savings. In the Islamic framework, since capital joins an enterprise on the basis of profit -and-loss-sharing, an untrue, subjective, or manipulated figure of profit will lead to serious injustice in the society.

If we adopt the current cash equivalent method of valuation of assets, the determination of profit becomes simple and objective. Profit or loss in this framework means any increase or decrease in the current cash equivalent of assets at the end of the accounting period over the beginning of the period. It takes care of any subjectivity in the valuation of assets and liabilities and simplifies the complexities arising out of matching cost with revenue, which at times may be arbitrary.

It also takes care of the controversy in conventional accounting over the meaning of the value of net assets, i.e., whether the increase has to be measured in financial terms or in physical productive capacity. It is obvious from the above discussion that in the Islamic framework, it is the monetary figure of capital which has to be maintained before profit can be determined.

Treatment of *zakah* in accounts

A controversy which is specific to Islamic accounting relates to the treatment of *zakah* in the accounts of a business.²³ One view is that *zakah* is a cost and should be shown in the accounts as an expense. The other view is that *zakah* is part of profit distribution and should appear in the appropriation account. We think that the first view is mistaken and does not fit into the overall scheme of the *Sharia*. If we show *zakah* as an expense of the business enterprise, it will reduce the amount of profit and thus the value of net assets subject to *zakah*. Thus it will injure the right of the *zakah* as an expenses encourages the tendency to pass on the incidence of tax consumers through higher product prices. Business firms would like to recover the *zakah* paid them by building it into the prices as an element of cost. some of these products would be bought by the *zakah* beneficiaries. Thus part of the *zakah* paid will return to the business firms from the *zakah* beneficiaries. This will defeat the very purpose for which the *Shari'a* has levied *zakah* . Therefore, in our opinion, the *zakah* should be disclosed in the

Appropriation Account as distribution of profits and not as a cost.

The question of preference shares

The preference shares of a joint stock company in the contemporary world carry "preferential rights in relation to other shares but often do not carry any voting rights. . . Most preference shares have a right to receive, before any dividend is paid on the ordinary shares, a fixed dividend and also a right to repayment prior to ordinary shares in the event of winding up . . . If they are cumulative, shareholders have the right to claim a missed dividend in subsequent years and before payment of a dividend to the ordinary shareholders."²⁴ There is no difference of opinion among Islamic scholars that preference shares with a fixed rate of return are un-Islamic, since they are very much like interest - bearing loans. Similarly, cumulative preference shares are not covered by the *Sharia*, since the principle of profit-and-loss sharing does not permit that the profit of some shareholders should accrue even though there is a loss. EI-Ashker has mentioned the practice of the Islamic Finance House, which has issued Islamic Preference shares. These shares do not carry any fixed rate of return. In case of loss, they share the loss as well. But they have a prior right to receive profit over ordinary shareholders. In the event of wind-up also, they will have a preferred right to reclaim their share and also a right to participate in any surplus after the ordinary shareholders have been paid up.²⁵

We think that even this type of preference shares is not covered by the *Sharia* since, in a business venture, the right to have preference in the distribution of profit can arise either because a certain category of shareholders undertakes a higher risk or because these shareholders contribute more effort. There can be no other reason for preferential treatment. The preference shareholders are not even voters in the management of the company, not to speak of taking a higher risk or making a higher effort. Therefore, any such term will make the deal very close to *riba*. We think Islamic companies should not engage in such deals.

Premium and discount on Issue of capital

In a capitalist society, joint stock companies issue capital, sometimes on a premium or at a discount. the premium is considered as a capital gain and discount as a capital loss for the company. In the Islamic

framework, the company is not a separate entity from its owners. Therefore, if it issues capital on a premium, it is a situation in which the existing shareholders are earning profit on the capital which has not yet been employed in the business. Similarly, in the case of a discount, they are agreeing to bear a loss from a capital which has not yet been invested. The issue of capital by the company is not a trading activity. It is only an *invitation to trade*. One cannot make a profit or loss just by inviting someone else to participate in a business venture. Profit or loss arises only after a trading activity has taken place.

We find authority from the hadith (sayings) of the Prophet (SAAW) on this question. He forbade the exchange of gold for gold or silver for silver, except in equal quantities. Excess in this case would be tantamount to be *riba*. (See ahadith relating to *baisarf*). We come across the following *hadithy* in *Sahih Muslim*:

“Fudala bin Ubayd reported: I bought on the day of Khaybar a necklace for twelve dinars. It was made of gold studded with gems. I separated the gold (from the gems in it) and found (gold) of more (worth) than twelve dinars. I made a mention of it to Allah’s Apostle, whereupon he said: It should not be sold unless it is separated.” (*Kitab al- muzarah*, H. 111)

This *hadith* clearly states that buying worth more at a discount conflicts with the injunction of the Prophet (SAAW). In case of the shares of a company being issued by the company, the cash being paid by the buyer is not sale price of any asset. The company has yet to buy assets with this cash. The share certificates at this state represent only the cash paid. Therefore, it is a type of *bay as- sarf* at this stage. It is only after this capital has been invested in the business that these certificates will represent some assets. At that stage, the holder of these certificates will be eligible to sell these certificates at more or less value than the par value of the shares. That is what happens on the stock exchange. Trading of shares on the stock exchange represents an activity in which a person who owns some assets in a business offers to sell them and another agrees to buy them in an open market. This deal can be at any price.

The accounting implication of the above argument is that the balance sheet of an Islamic company will not show a premium or a

discount on the issue of shares as legitimate gain or loss, but under illegitimate gain or loss, if it chooses to enter this type of business.

Truth and fairness in accounting statements

There is almost a consensus that the financial statements of a business organization should depict a *true and fair* picture of its financial position. But in practice, business firms hardly ever disclose all the truth. For example, they never disclose *negative information* about themselves, such as bribes and kick-backs paid to win contracts, cheating in income tax calculations, violations of contracts, unfair treatment of employees, environmental pollution caused, incomes from bid-rigging or expenses for creating cartels, etc. It is also not easy to persuade them to do so, because they will be in the grip of the law if they disclose all these matters. The situation will be so in the Islamic framework as well.

But there are certain transactions which are lawful in the capitalist framework but unlawful or undesirable in the Islamic framework. We think such transactions should be adequately disclosed in the financial statements of Islamic business firms to give a true and fair picture of its affairs to the users of the statements. At the same time, business firms in an Islamic society should try to follow the Islamic code of ethics as far as possible.

However, adequate disclosure will involve (a) amounts (b) sources (c) circumstances which forced the firm to engage in such transactions and (d) the method by which such incomes or assets were or will be, disposed of. Some examples of these transactions are as follows:

- a) Interest income from external sources
- b) Interest paid on any account
- c) Penalties or fines paid for violating any rule
- d) Fines paid on late payments of bills of utilities
- e) Contracts not performed, for whatever reason.
- f) Premiums or discounts on issue of capital
- g) Investments on mark-up without taking any risk
- h) Income from financing leases

- i) Loans taken or other liabilities incurred on interest

Financial statements can be true and fair only if they disclose this and similar information.

Section III

The Business of Islamic Banks: An Accountant's Perspective

In this section, we shall give a brief account of Islamic banks' business from the perspective of an accountant.

Prohibition of interest

The genesis of Islamic banking lies in the Quranic prohibition of interest on loans. The Islamic banking movement started in response to Muslims' search for an alternative to interest - based conventional banking. There is now a respectable body of literature on Islamic banking and the curious reader can refer to it.²⁶ We shall not, therefore, discuss the concept and practice of Islamic banking in any detail. Briefly, Islam does not recognize a predetermined fixed return on capital. One of the reasons for this is that the person who receives a fixed return in the form of interest does not undertake any risk, which is an essential component of any business enterprise. It, therefore, enunciates a general principle: whoever wants to earn a return on his capital must be willing to undertake the risk of loss as well. No risk, no return. Islamic banking is based on this general principle.

The principle has an accounting implication. Any income which an Islamic bank may receive, either explicitly as interest, as, for example, a result of dealing with conventional banks, or as a result of transactions which have a disguised element of interest, should be disclosed separately in the financial statements and should not be included in the legitimate income of the bank. This income should also not be distributed among investment depositors or shareholders of the bank. Islamic banks should decide a uniform policy about the disposal of such income.

Resource Mobilization

1. Current deposits

Like conventional banks, Islamic banks accept deposits from household savers and business firms. These can be current or time deposits. Current deposits are for keeping safe custody with the banks. The banks may levy service charges for maintaining these accounts. The banks are responsible for returning the savings in deposits intact on demand from depositors. But the banks treat these deposits as loans. They keep some portion of these deposits in liquid cash to meet the day-to-day needs of the depositors. They can invest the other portion of these deposits through any permissible mode of finance. Any profit or loss on such investments belongs to banks. The depositors' funds are secure.

There are, at least, two accounting implications to this.

1. The current account deposits are current liabilities of the Islamic banks. Any service charge on them is the income of the bank.
2. Any income to the bank from investment of current deposits arises from the willingness of the bank to assume responsibility or *daman* for the safeguard of these funds.

Thus, income from the investment of these funds should be recognized as a special class of income and could be termed as *daman* income. Similarly, any loss from investment of these funds should be termed as *daman* loss. These classes of income and loss are unique to Islamic banks and we do not see them in financial statements of conventional banks.

2. Investment deposits

The investment deposits of Islamic banks may be of two major types:

1. unrestricted investment deposits and
2. restricted investment deposits.

The former are with the bank for investment in any manner the bank deems fit, but within the permissible modes of finance.

Restricted investment deposits may be of several types. The banks may have mutual funds for different purposes, such as leasing, instalment sales, trade financing, equity investment, *musharaka* or *mudaraba*.

The depositors may specify that their funds should be invested through any of the modes of finance in which an Islamic bank is operating. Whatever the nature and type of the investment deposit, it does not carry any fixed return. The bank acts as an intermediary or agent of depositors to place funds on their behalf in various business ventures or investment proposals. The return from the investments is entirely the depositors'. The bank is entitled to a management fee, irrespective of whether the depositors get a profit or suffer a loss. The accounting implication is that in the case of restricted investment accounts, the bank's income is classified as a management fee. After deducting its management fee, the bank passes on the entire income from investment of these funds to the depositors. In the case of loss on these investments, the bank passes on the entire loss to the depositors after adding its management fee.

In the case of unrestricted investment deposits, the bank acts as it deems fit. It takes the additional responsibility of choosing an appropriate mode of finance. In this case, it participates in profit or loss with the depositors. But it depends on the mode of investment. For example, in the case of *musharaka* finance, the bank shares in both profit and loss but in the case of *mudaraba*, it passes on the financial loss to the depositors but itself suffers loss to the extent that it does not get any return for its services as manager of these funds. In the case of trade financing or leasing, the bank gets an agreed percentage of the profit.

The accounting implications of both types of investment accounts is that the funds in them are not the liabilities of the bank. They are in trust with the bank and it receives its share either as a proportion of the profit or as a management fee. This is an innovative feature of the Islamic banking business. In conventional banking, all deposits are shown as liabilities of the bank. This is not so in Islamic banks.

Banks' financing

Islamic banks provide finance through a variety of modes. Besides investment in ordinary shares through the stock exchange or purchase of shares on public offer the banks provide finance on following basis:

1. *Musharaka*

This is a partnership arrangement. The banks provide finance as partners and also join in management and control of the business. This could be through representation on the Board of Directors or by

nominating an officer on a full-time basis to work in the business. The actual arrangement depends on the terms of agreement of both parties. The banks share in the profit or loss according to predetermined ratios.

An innovative feature of *musharaka* financing is that the bank joins the business neither as equity holder nor as creditor, but still shares in profit or loss of the business. The bank's capital is redeemable after a certain period, while the equity holders invest funds on a permanent basis. This is a unique feature of Islamic business law.

An accounting implication is that the banks keep accounts of *musharaka* funds separately. Any income or loss on this account is first distributed among the investment depositors and the bank according to their respective proportions of the capital. The share of the bank appears in its income statement. The bank's own funds, provided on the basis of *musharaka*, appear as an asset of the bank, as usual.

2. *Mudaraba*

In its simplest form, this is an agreement to provide funds to an entrepreneur (or group) to undertake an investment project. The bank provides the funds and the entrepreneur employs his labour. The bank absorbs the financial loss. The entrepreneur loses his labour and does not get anything. In practice, *mudaraba* is being practiced on a large scale in some countries, especially Pakistan. A joint stock company may float a *mudaraba* and collect deposits from the public. It may invite Islamic banks to join it. The *mudaraba* can be in any business. Its profits are shared by the investors in the *mudaraba* and the parent joint stock company responsible for its floatation and management. In case of loss, the investors bear it on a pro rata basis, while the joint stock company does not get any return for its services.

The Islamic banks invest funds in *mudaraba* ventures either on their own account or as agents of their investment depositors. In the former case they may be using their equity funds or some portion of current account deposits. The accounting implication is that any profit on account of their own funds will form part of the banks' income and must be disclosed as such. Any loss from *mudaraba* will also be disclosed as a *mudaraba* loss distinctly. But when they are investing on behalf of unrestricted investment depositors, they will be entitled

to a share in the profit. In the case of loss, the bank will pass on the entire loss to the unrestricted investment depositors. The bank's loss will be that it incurred expenses on the management of these funds throughout the year but did not get anything. The entitlement of the bank to receive profit arises from the bank's willingness to accept the responsibility (*daman*) for managing these funds properly or from the bank's decision to invest them in a *mudaraba* rather than any other mode of investment. Similarly, in case of loss, the bank's expenses in managing these funds proved to be unfruitful. A rigorous accounting treatment will suggest that the income from *mudaraba* should be recognized separately, as perhaps, *daman* income, and in the case of loss a proportion of the expenses allocable to management of the *mudaraba* funds should be disclosed as *daman loss*. However, in the case of restricted investment depositors who themselves had requested the bank to place their funds in a *mudaraba*, the banks would receive a management fee from these depositors irrespective of whether the depositors received a profit or not.

3. Trade finance

The Islamic banks provide short-term trade finance on the basis of mark-up. The operation of this mode is as follows. A business firm which requires finance to purchase merchandise or a durable asset, or import a consignment approaches the bank. The bank offers to supply the required product on the condition that it will charge an agreed amount of mark-up on its cost. The business firm is liable to pay the price of the product along with the mark-up over a specified period. In case of default there is no mark-up on mark-up. The banks can levy some fine, although its permissibility as a percentage of the principal sum, under the *Sharia*, is questionable. The above method of financing is of doubtful validity, since the banks do not take any risk. The product is usually selected and purchased by the business firm. The banks calculate their mark-up and add it to the price of the product. Thus the way this mode is being operated is very much akin to interest.

However, some Islamic banks have adopted methods which justify this mode of finance under the *Sharia*. For example, they procure the product needed by the business firm and give it the option of not

purchasing it, if it so wishes. Thus these banks undertake a business risk. They procure a product in the hope of selling it for a profit, but they may not be able to do so, or they may have to search and wait for another customer. This clause makes the banks' business very risky. The banks may become loaded with unsold inventories. Because of this risk, their return becomes lawful under the *Sharia*.

The accounting implication is that income from mark-up financing should be disclosed separately. The financial statement should also state whether the banks provided this finance on a risk-free basis or after taking a risk as discussed above. In the former case, the income of the bank from this source will not be legitimate and should not be distributed, among either depositors or shareholders.

4. Leasing

Islamic banks also invest funds on the leasing of assets. A lease can be either operating or financing. The operating lease involves providing an asset such as a building, vehicle or machine on a specified rent. After the agreed period, the asset returns to the bank for further leasing or final disposal. There can be vacant periods when these assets are not leased for the want of a lessee. The banks invoke the risk of purchasing such assets which they may not be able to lease. They also undertake the risks of depreciation and obsolescence. In the case of a financing lease, the banks do not undertake any risk. The asset to be leased is usually procured by the lessee and he retains it till it is consumed or purchases it from the bank at the end of the agreed period. The banks provide funds and determine the lease rate after calculating a mark-up on capital. The banks retain the ownership of the asset on behalf of investment depositors during the period of the lease, but that is more or less a collateral against default. The banks do not undertake any risk in the case of a financing lease. Therefore, it is very much like interest-bearing finance.

Some banks also operate on the basis of lease-purchase. It is doubtful if this type of financing is permissible under the *Sharia*. The litmus test is: do the banks take any business risk in this type of financing? If they are not taking any business risk, but provide money and get it back over a period of time with a return added to it, it is nothing but interest and cannot be justified under the *Sharia*.

The accounting implications are as follows:

1. In the case of an operating lease, the banks should clearly determine the proportion of their own funds and those of unrestricted investment depositors being used. The banks own funds include that portion of current deposits which the banks may like to invest at their own risk.
 2. The income from the lease will be divided between the bank and the investment depositors in proportion to their capital. But from the share going to unrestricted investment depositors, the bank will receive a share of the income. And out of the share of the restricted investment depositors, it will charge a management fee.
 3. The ownership of assets during the lease will be in proportion to the capital employed by each party, i.e., bank, unrestricted investment depositors and restricted investment depositors.
 4. Any income from a financing lease, being unlawful under the *Sharia*, should be disclosed separately. This income should not be available for distribution among depositors or shareholders.
- 5. Management of *zakah* funds**

Another unusual feature of Islamic banks is that they manage *zakah* funds on behalf of shareholders and depositors. The banks deduct *zakah* from accounts of depositors and shareholders and keep them in a special *zakah* fund. They spend these funds for the purposes specified in the Qur'an (9:60). An accounting implication is that the banks can charge a management fee from this fund. This is permissible under the *Sharia*. But they should not charge anything beyond what they spend in managing this fund. This implies that the banks will need to allocate their expenses to this fund on a judicious basis.

6. Foreign currency transactions

The question of foreign currency transactions and the basis of translation into the home currency is important in the case of Islamic banks as some of them accept deposits and invest in foreign currencies. The general principle of the *Sharia* is that the currencies can be exchanged at the current market rate. This principle guides us to the accounting treatment of foreign currency transactions of Islamic banks:

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- a) In the case of current deposits in foreign currencies, the banks should keep those accounts in the same currency. All deposits and withdrawals will be in the same currency.
- b) For unrestricted investment accounts, the banks are supposed to invest the depositors' money in investments which the banks think appropriate. Any profit or loss due to foreign exchange fluctuation will be shared by the banks with the depositors. The profit or loss will be determined by translating the currencies at the rate prevailing on the date of the transaction.
- c) In the case of restricted investments, any profit or loss due to foreign exchange fluctuations will flow to the accounts of the depositors. The banks will charge their management fee, in any case. The profit or loss on foreign exchange transactions will be determined by translating the currencies at the rate prevailing on the date of the transactions.
- d) The valuation of foreign currency financial asset balances will be done on the rate of exchange prevailing on the date of the balance sheet. The difference due to fluctuation in the foreign exchange rates will be disclosed in the bank income statement.

7. Return on incomplete projects

Islamic banks may invest in real-sector projects which spread over more than one year. Sometimes, it is not possible to realize any return from them as the operations have not yet started. Another example might be where the Islamic bank agrees to supply merchandise or machinery over an extended period. They may be receiving some of their investment back gradually. But it is not clear how the bank should treat this money. Should the bank recognize some profit or loss on such investments? In both the above situations, the Islamic banks can estimate the return on investment with reference to the stage of completion of the projected contract, market trends, terms of the contract, etc. and recognise the expected income or loss from the investment, even though they have not yet realized it. They can adjust these figures later on in the light of actual results.

Section IV

ACCOUNTING CONCEPTS FOR ISLAMIC BANKS

Objectives of accounting information

The objectives of accounting information of Islamic banks are different from those of conventional banks for two main reasons:

- a) Islamic banks deal within a *Sharia* framework. As a result, the nature of their transactions is different from that of conventional banks.
- b) The users of the information generated by Islamic banks have different needs from the users of the information published by conventional banks. We shall illustrate this point below.

1. Users of accounting information

The main users of accounting information produced by Islamic banks are:

- a) Shareholders
- b) Current account depositors
- c) Unrestricted investment account holders
- d) Restricted investment account holders
- e) Entrepreneurs, firms or agencies dealing with the banks
- f) *Sharia* regulatory bodies
- g) Government agencies, central bank, ministry of finance, *zakah* administration, planning commission, etc.
- h) General public
- i) Non-Muslim observers
- j) Researchers

- k) Employees of the bank

2. Information needs of users

Users of the information in the reports of Islamic banks are diverse. Some of their needs might be as follows:

- a) Information which assists in evaluating the bank's compliance with the *sharia* rules in letter and spirit.
- b) Information that helps in evaluating the bank's ability to safeguard its assets, maintain liquidity and deploy its resources in a profitable manner.
- c) Information on the bank's initiative in discharging its responsibilities towards employees, customers, society and the environment.
- d) Information which helps in the accountability of the management.

3. Focus of accounting reports of Islamic banks

Looking to the information needs of users, the following should be the focus of the various accounting reports produced by Islamic banks:

- a) The accounting reports should disclose the nature of the bank's operation in a manner which helps users to understand the nature of the bank's business and the extent to which the *Sharia* rules have been followed by the bank. This means that the reports should clearly disclose any prohibited income or expense or any other violation of the *Sharia*, such as violation of contracts, interest earnings, etc.
- b) The accounting reports should disclose information on the liquidity, profitability, solvency and risks taken by the bank.
- c) The accounting reports should help the shareholders, depositors, investors and employees to determine their liability to *zakah*.
- d) The accounting reports should disclose the bank's initiative in fulfilling its social responsibilities, such as protection of the environment, contribution toward various charitable activities, development of employees, cooperation with Muslim countries, contribution toward the economic development of the country, efforts to alleviate poverty and efforts to reduce income inequalities.

Of course, Islamic banks will have to develop standards for these reports so that information is prepared on a consistent and comparable basis.

Accounting statements of Islamic banks

Islamic banks should issue the following accounting reports to meet the needs of users:

- a) Balance sheet showing financial position of the bank
- b) Income statement
- c) Statement of sources and uses of funds
- d) Statement of *al-Qard al-Hasan* fund
- e) Statement of sources and uses of *zakah funds*
- f) Statement of prohibited transactions
- g) Statement of investment for safeguarding the environment
- h) Statement of investment for propagation of Islamic values
- i) Statement of compliance with contracts

Statement of commitments and contingencies

Some of these reports can be merged. Some can be dispensed with by proper disclosure in other statements. For example, a statement on *zakah* can be accommodated in the balance sheet. In the final analysis, until general presentation and disclosure standards for accounting statements are finalized, the types of reports and their style will remain undecided. The above list only points the general direction which emerges from the needs of information users.

Accounting definitions for Islamic banks

The following definitions set out a general conceptual framework for the accounting statements of Islamic banks. These definitions can be used by other business firms with suitable modifications.

1. Assets

An asset is anything that is capable of generating positive cash flows or other economic benefits, either itself or in combination with

other assets. However, to be recognized as an asset in the balance sheet, it should have the following additional characteristics:

- (a) It should be recognized as valid from the *Sharia* point of view. It means such "assets" as interest receivable in the conventional banks' balance sheet will not be treated as an asset in the balance sheet of Islamic banks. It will be shown in the Statement of Prohibited Transactions.
- (b) It should be capable of financial measurement with a reasonable degree of reliability.
- (c) The bank must be able to obtain benefit from it and control the access of others to it.
- (d) It should not be associated with a non-measurable obligation or a right to another party.

2. Liabilities

A liability is an obligation arising from a transaction or other event that has already occurred and that involves the Islamic bank in a probable future transfer of cash, goods or services, or the forgoing of a future cash receipt, the date of which and the settlement of which are measurable with reasonable accuracy.

Generally, a liability should be enforceable under the *Sharia* rules. But if an Islamic bank incurs an obligation which is not valid under the *Sharia* it will still have to be recognized as a liability, although disclosed distinctly as such. Such liabilities will also appear in the Statement of Prohibited Transactions. The liabilities of an Islamic bank are normally met from its assets, but in case the assets are not sufficient to discharge the liabilities, the shareholders are liable to repay them out of their personal resources.

3. Equity of unrestricted account holders

The equity of unrestricted account holders refers to funds received by the Islamic bank from depositors on the basis that the bank will have the right to use those funds without restrictions to finance the bank's investments within the *Sharia* framework. The value of the equity of unrestricted account holders in the balance sheet is equal to the amounts deposited plus any profit or minus any loss or withdrawals.

The equity holders of unrestricted investment accounts are not the owners of the bank. Therefore, they are not liable to pay any liabilities of the bank, nor do they have any voting rights.

4. Ownership equity

Ownership equity refers to the amount remaining on the balance sheet date from the bank's assets after deducting the bank's liabilities, the equity of unrestricted investment account holders and any prohibited earnings.

5. Revenues

Revenues are gross increases in assets or decreases in liabilities during the period covered by the income statement, which result from legitimate investment, trading and other profit-oriented activities of the Islamic bank, including delivery of services. The gross increase in assets and decrease in liabilities should have the following characteristics:

- a) It should not be the result of investment by owners, distribution to owners, deposits or withdrawals by unrestricted investment account holders, deposits or withdrawals by current account holders or the acquisition of assets.
- b) The gross increase in assets or decrease in liabilities should belong to the period covered by the income statement.

6. Expenses

Expenses are gross decreases in assets or increases in liabilities during the period covered by the income statement, which result from legitimate investment, trading and other activities of the bank, including delivery of services. The gross decrease in assets or increase in liabilities should have the following additional characteristics:

- a) It should not be the result of distribution of dividend among owners, deposits or withdrawals by current account holders, withdrawals by owners or unrestricted investment account holders or acquisition of assets.
- b) The gross decrease in assets or increase in liabilities should belong to the period covered by the income statement.

7. Gains and losses

A gain is a net increase in net assets (i. e. total assets minus liabilities) which results from holding assets that appreciate in value during the period covered by the income statement or from legitimate reciprocal (e . g . exchange of gifts) and nonreciprocal transfers with owners or holders or unrestricted investment accounts.

8. Return on unrestricted investment accounts

The return on unrestricted accounts is the share of those account holders in investment profits and losses which they participated in financing with the bank during the period covered by the income statement. The return on unrestricted investment accounts is not an expense (in the case of profit) or revenue (in the case of loss) of the bank. It is an allocation of the bank's income or loss.

9. Net profit

The net profit is the difference between the current cash equivalent value of the assets of the bank at the end of the period and at the beginning of the period. It is explained in the income statement in terms of revenues, gains, expenses and losses.

10. Investment by owners

The investment by owners is the amount of increase in owners' equity resulting from the nonreciprocal transfer by owners to the Islamic bank of assets or services, the assumption or payment by owners of an obligation of the bank for the purpose of increasing their equity in the bank or accrual of any profit to owners from the bank's operations.

11. Distribution to owners

The distribution to owners is the amount of decrease in owners' equity resulting from loss to the bank from its operations or from nonreciprocal transfer by the bank to the owners of assets or services or the assumption or payment by the bank of an obligation of the owners for the purposes of reducing their equity in the bank.

12. Cash and cash equivalent

The cash and cash equivalent include local and foreign currency and demand deposits at other institutions.

13. Restricted investments

Restricted investment are assets acquired by funds provided by holders of restricted investment accounts. The Islamic bank does not own these assets. The bank only manages them either for a fixed fee or, in a *mudaraba* contract, for profit. In the former case, the bank gets the fee anyway, but in the case of *mudaraba*, it receives a share if there is a profit. In the case of loss, the bank does not get anything. Its services are included in the income statement as an expense.

14. Zakah fund

Zakah is an obligatory payment on certain types of wealth and income. It has been prescribed in the Quran and Sunna of the Prophet (SAAW). The Islamic banks have a dual role with regard to this obligation. They collect *zakah* from the owners, account holders, employees and any body else who wishes to pay it through the Islamic banks. The banks can charge a fee for managing this fund. The fee will be the bank's income. The second role of the bank is to calculate the *zakah* liability of the owners and pay it into a *zakah* fund. The *zakah* of the owners is payable @ 2.5% on current cash equivalents of the assets of the banks except on fixed assets such as land or building or the equipment of the bank. Any property of the bank not used for its own operations will also be assessed for *zakah*. But assets which have been leased out will pay *zakah* @ 10% on the lease income after deducting any direct expenses or direct taxes.

15. Al-Qard al-hasan fund

The *al-Qard al-hasana* fund consists of revolving funds for extending interest-free loans for a period of time. In some cases, the loans may be forgiven. Sources of this fund could be a part of current account deposits, contributions by the owners for this purpose, or any prohibited earnings or the bank (until they are properly disposed of).

Accounting recognition concepts

In conventional accounting, accounting recognition concepts are discussed with reference to revenue, expense, gain and loss. The relevance of this discussion is that some incomes or expenses have an effect of periods subsequent to the period covered by income statement, for example, monies received in the present for services to be provided in the future. the question is at what point of time the income should be recognized. such question crop up in expenses, gains and losses. But the debate is relevant if we value the assets and liabilities at historical costs. Once we adopt the current cash equivalent method of valuation for assets and liabilities, the question of whether to recognize income or expense at a particular point of time becomes irrelevant. The values placed on assets and liabilities determine the net profit figure which can be explained by the incomes, expenses, gains and losses as realized. The subjective v valuation of depreciation, doubtful debts and goodwill, etc. lose all importance.

Accounting valuation concept

We have already discussed this question in Section two of this paper. Briefly, the valuation of the assets, liabilities and restricted investments of Islamic banks depends on their current cash equivalents. To make this valuation comparable and reliable, the banks should adhere to the following principles:

- a) To the extent possible, realizable values in the current market should be ascertained. The market should be one in which a particular asset is normally sold or purchased by the bank.
- b) All relevant information, whether positive or negative, should be utilized.
- c) To the extent possible, experts in valuation should be utilized.

As discused earlier, Islam does not recognize the time value of money. Therefore, methods using discounted cash flows for valuation will not be used. This includes any mark-up where the bank does not undertake any commercial risk. Thus, any difference between cash and credit sale prices will also not be recognized as legitimate, unless the bank gives an option to the buyer to purchase an item or leave it.

Qualitative characteristics of accounting information

Conventional accounting theory discusses the qualities of *relevance, reliability, neutrality, comparability and understandability* essential for accounting information. we think these characteristics are quite general and are applicable to Islamic accounting framework as well. The interested reader can look up any standard text of accounting theory.

Concluding remarks

This chapter has tried to delineate differences between accounting concepts in a capitalist society and in an Islamic society. these differences follow from the basic framework of the two societies. The Islamic society does not recognize certain types of business transactions or business organizations. at the same time, it suggests alternative arrangements. The needs of the users of information in the two societies are also different. The Islamic banks are the foremost practitioners of Islamic business principles. Therefore, the question of applying a different accounting paradigm to them has emerged. The discussion in this chapter is quite tentative. The Islamic banks are already engaged in developing accounting standards for themselves. It is hoped that the ideas presented in this chapter may help in clarifying some of the finer issues.

Notes

1. The contemporary debate about social responsibility reporting is of recent origin and it, too, has not been generally adopted by the accounting profession. It is still seen as a fancy idea of some accountants.
2. Kam, Vernon, *Accounting Theory*, John Wiley & Sons, New York: 1986. pp. 304.
3. For an overview of the controversy, see, Lorig, A.N., "some Basic concepts of Accounting and Their Implications," *The Accounting Review*, The American Accounting Association, July 1964, Pp. 563-593; Bird, F.A., Lewis P. Davidson, & C.H. Smith, "Perceptions of External Accounting Transfers Under Proprietary Theory," *Ibid.*, April 1974, Pp. 233-244.
4. This is based on the famous tradition of the Prophet (SAAW): "*al-kharaju bil daman*". See Al - Tirmidhi, *al - Jamial - Sahih*, *Kitab al hadith* No. 1285, Egypt: 1968, Vol. III, p. 573. Also see Al-Lubnani, Salim Rustam Baz, *Sharh al -Majallah*, Beirut: Dar Ihya' al-Turath al-Arabi, 1305 A.H., Art. 85, p. 57.
5. Al-Muslim, *Al-Jamial-Sahih*, *Kitab al-janaiz*, *hadith* 16, 18.
6. *New Horizon*, London, September, 1992, p. 21.
7. For example, Hendriksen, Eldon S., *Accounting Theory*, Homewood, Illinois: Richard D. Irwin, 1990, Pp. 250-272.
8. Hendriksen, *Ibid.*, p. 146.
9. Zarqa, M. Anas "An Islamic Perspective in the Economics of Discounting in Project Evaluation" in Sheikh Abod, *et.el.*, *An Introduction to Islamic Finance*, Kualalumpur: Quill Publishers, 1992, Pp. 94-126.

10. For a more comprehensive treatment, see present writer's "Time Value of Money," in Sheikh Abod, S. Ghazali, *et. el.* (eds.), *An Introduction to Islamic Finance*, Kualalumpur: Quill Publishers, 1992, Pp. 127-143.
11. Gambling, T. & R. A. A. Karim, *Business and Accounting Ethics in Islam*, London: Mansell, 1991, Pp. 96.
12. Gambling, T. & Karim, *Ibid.*, p. 96.
13. *Ibid.* p. 96.
14. Hendriksen, *op. cit.* p. 148.
15. Henderiksen, *Ibid.* p. 149.
16. Al-Qardawi, Y. *Fiqh al-Zakah*, (Urdu Translation by Shams Pirzadah), Lahore: al-Faisal Publishing House, n.d. p. 191.
17. Cambers, R.J., *Accounting, Evaluation and Economic Behavior*, Englewood Cliffs. N. J. : Prentice-Hall, 1966.
18. Henderiksen, *op. cit.* p. 262.
19. Hendriksen, *Ibid.* p. 263.
20. Bhattacharya, K., *Accountancy's Faulty Sums*, London: Macmillan Press, 1992, p. 27.
21. Bhattacharya, *Ibid.* p. 10.
22. El-Ashker is positive that provision for bad debts will not be made in calculating *zakah*. See El-Askher, *The Islamic Business Enterprise*, London: Croom Helm, 1987, p. 50.
23. Hayashi, T., *On Islamic Accounting: Its future Impact on Western Accounting*, Niigata-ken, Japan: IMES, University of Japan, 1989, p. 72ff.
24. Parker, R.H., *Macmillan Dictionary of Accounting*, London: Macmillan Press, 1984, p. 137.
25. For a similar view on the permissibility of preference shares, see Kotby, H. E. , *Financial Engineering for Islamic banks, Niigataken*, Japan: IMES, University of Japan, 1990, p. 90.
26. See, e.g., the present writer's two volume *Islamic Economics: Annotated Sources in English and Urdu*, Leicester: The Islamic foundation, 1983, 1990.

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Chapter 2

Accounting for Islamic Banking

Trevor Gambling

You might wonder why a Christian should have anything to say about Islamic banks or their accounts. One reason is that they are there; if substantial finance houses are conducting their affairs in accordance with the *Sharia*, rather than principles of secular economics, non-Muslims need to know how they go about it. However, a more compelling reason, for me, is the very fact that the *Sharia* rules for the conduct of business are not very different from what the Christian Canon Law and the Law of Moses say about business morality. About 700 years ago, Christian ecclesiastical courts regularly punished business people for the sin of “usury” which was exactly the same as *riba*.

The only difference is that the rise of capitalism in Europe created so much pressure to do things otherwise that the Church eventually gave up trying to regulate business. It became accepted that business was conducted in accordance with secular principles (which eventually developed into economic theory) and that religion was confined to personal morality and belief. Islam does not accept this, and claims to be able to control large-scale modern finance. A Christian must be interested to see how Muslims go about this, especially since people in general are beginning to doubt whether the policy of “business is business” can really deliver the sort of world which most of us want.

Islamic banking is a major response to this general desire for more ethical business methods. Presumably highly ethical businesses ought to prepare highly ethical accounts, but one must wonder whether this requires them to account differently from their secular counterparts. Is there a subject which could be described as “Islamic Accounting for

Banks” as opposed to “Accounting for Islamic Banks”? The question is not an idle one, because Islam is supposed to permeate everything a Muslim does: is accounting something which he or she should do differently?

Prima facie, one might suppose that Islamic accounting can only exist in the way that, say, an Islamic motor car might exist. An Islamic motor car could be a Ford, or a Jaguar or a Nissan, registered in the name of a Muslim. Nevertheless, one might hope that an “Islamic car” would be different from a secular car in some physical respects. The trouble with many cars is that they are poorly maintained, carelessly-driven and the drivers are all too often under the influence of alcohol or drugs. Since Islam enjoins the pursuit of perfection in every aspect of life, “Islamic cars” as such would be presumably all well-maintained and driven by careful, sober drivers.

When Rifaat and I attempted to set down our ideas about “business and accounting ethics in Islam” our initial conclusions were along the same lines. Islamic accounts should be “better” accounts, in the sense that an Islamic accountant should face fewer problems than a non-Muslim counterpart. But that is because most “accounting problems” arise when the underlying business wants to do something which is less than morally straightforward.

For example, how should one account for “convertible debentures”? These are loans made to a company, which holders can demand to have replaced by equity shares when it suits them to do so. Even if the loans were of a profit-and-loss-sharing type (which they are not likely to be), a Muslim might feel that the basic arrangement was not satisfactory. Everyone is God’s regent for his earthly possessions, and so responsible for what is done with his or her capital. Nevertheless, one can see that the responsibility of a loan-creditor is less extensive than that of a shareholder of the whole company. A Muslim might feel that one ought to decide whether one was one or the other at the outset, and not claim to be able to change in mid-stream.

Much the same applies to so-called “capital leases”, whereby one can irrevocably “hire” pieces of equipment for effectively the whole of their working lives. The secular accountant has to worry about the fact that there is a firm liability to pay the balance of the “rent” of such

equipment for the rest of its life, which is all payable instantly if the company becomes insolvent. A Muslim doesn't have to worry at all, because the arrangement itself is undesirable. Somebody is responsible to God for the equipment, so the question of who really owns it is important — and this is very unclear in the case of a capital lease.

However, there may be aspects of accounting for entirely moral transactions which can produce moral problems. Are there any *Sharia* rules about the treatment of profit and losses? How do we “recognise” a profit or loss - which is to say, how do we define “income” and “expenditure”? The traditional approach is known as “accruals-based historical cost accounting”, and involves the calculation of depreciation-charges for fixed assets, based upon their original cost. It is rather well-known that price-levels change over time, so this accounting policy can actually overstate (and occasionally understate) the true profit, in the sense that what is retained in the business may not be the correct amount needed for it to continue trading.

Should the true *Islamic* profit take account of changing price-levels? At the outset, we may suppose that it should always take account of them, or never take account of them. This is because Islam takes the view that the same rules of life apply everywhere: it does not seem to recognise “situational ethics”, whereby some might claim that it was *sometimes* right to commit a crime to achieve some better end. Now the *Sharia* does lay down how assets are to be valued for some purposes, namely the calculation of the *zakah*. This requires market values to be used. This led Rifaat and me to wonder whether a scheme of income recognition known as “Continuously Contemporary Accounting” might be best suited to Islamic enterprises of all kinds. This was a system which was proposed by a highly-respected Australian accounting theorist, R.J. Chambers, but which never achieved any degree of recognition in practice. It was Professor Chambers' view that a credible resale value could be found for almost every type of assets and that if one could not be found, it was probable that the asset in question had no real value at the time. He placed no value on possible future income arising from the asset, except to the extent that it was reflected in its current resale value. “Goodwill” only exists, in Chambers' view, to the extent that it is reflected in the resale value of the assets.

The philosophy has much to commend it, to those who consider themselves open to obedience to the Word of God. This demands total flexibility. One might feel oneself moved by the spirit to extend or contract one's present activity, or perhaps to do something quite different. The current realisable value of the assets is all that would matter in such a case, and the measure of the "true" profit or loss of the enterprise is the change which has occurred in that value over time.

I should emphasise that this method of arriving at profit or loss is just an idea, and not a statement of what any Islamic bank or other business ought to do. It is a contribution by Dr. Rifaat Ahmed Abdel Karim and myself towards some future debate as to what sort of accounting method might apply in an Islamic state. Current accounting practice is mostly secular, even in Muslim countries. Islamic banks have to conform to the laws of the countries in which they operate.

However, Islam might be expected to affect accounting in another respect, which is not likely to conflict with any secular requirements. Accounting profit or loss will be a less significant measure of the effectiveness of any Islamic business (or of a non-Muslim activity which is ethically managed) than of a secular one. You will recollect that the disclosure standard of the Financial Accounting Organisation for Islamic Banks and financial Institutions lays great emphasis on the need for "Notes to the Accounts" and the need to point out that these notes are an integral part of the financial statements. The recommended practice for British charity accounts has the same emphasis, for the same reason, and also requires a very detailed narrative report from the trustees.

All that matters in a secular business is whether items of income and expenditure are properly ordered, properly delivered and properly paid for. An ethical activity will also want to show that its terms of trade and the price charged are "fair"; in addition, it will want to be sure that it undertakes all the transactions which it ought to make and not just those that it is easiest or most profitable to do. This cannot be discovered from the accounts themselves and this is why the "Notes" and management reports are so important.

Narrative reports are of little value unless the business is sufficiently well-controlled for one to be sure that it always does follow

its own rules of conduct. This might be reflected in the standards of book-keeping and record-keeping of such a concern: it would be important to be able to cross-reference every transaction to its relevant contract, price-calculation and the various consultations which authorised it.

In general, an Islamic bank will have a *Sharia* Supervisory Board, and this body, together with any secular internal audit or compliance function, will be the principal guarantor that the moral dimension of the bank's activities is being maintained.

In conclusion, I would repeat that the practices of Islamic banking, and the sort of accounts and reports which such banks ought to produce, are not very different from those which ought to be followed by any organisation which claims to be ruled by ethical standards. The fact that so many organisations which behave very differently also claim to act in an ethical way is a measure of the difficulty of reforming the moral standards of business and administration. In a secular society, it is easy to suppose that morality is reflected in personal integrity; most people do not even suspect that the machinery and institutions of modern commerce may be such as to make personal morality of little consequence in the outcome.

The following books and articles may provide more information on some of these ideas:

R.J. Chambers, *Accounting, Evaluation and Economic Behaviour*.
(Prentice Hall, 1966).

T.E. Gambling and R.A.A. Karim, *Business and Accounting Ethics in Islam*.

(Mansell Publishing, 1991).

T.E. Gambling, R.H. Jones and R.A.A. Karim, "Credible Organisations; Self-Regulation v. External Standard-Setting in Islamic Banks and British Charities", *Financial Accountability and Management*.

Vol. 9 (3), August 1993, pp. 195-207.

R.C. Tawney, *Religion and the Rise of Capitalism: An Historical Study*.

(Murray, 1926)

Regulation of Financial Reporting by Islamic Banks

Rifaat Ahmed Abdel Karim

Islam does not recognise any separation between economic and spiritual affairs and considers trade and industry to be a matter of morality and subject to revealed doctrines. Hence, the cardinal objective of an Islamic bank is to conduct its business transactions in accordance with *Sharia* principles, which are the foundation of Islamic Law. This is similar to 'ethically-funded organisations' in the West which do not invest in companies that fail to meet their social criteria or disinvest from companies whose activities become unacceptable.

To assure consumers of their services that they actually adhere to the revealed doctrines which govern their business and accounting transactions, almost every Islamic bank employs in-house religious advisers, commonly known as *Sharia* Supervisory Board (SSB). The Islamic credentials of the members of the SSB are considered to be impeccable and they are usually appointed by a decision of a general meeting of the shareholders of the bank to strengthen their independence.

The functions and duties of an SSB have no true equivalent in the West. While some may compare an SSB to Western non-executive directors or to an investment committee of a US mutual fund, an SSB has more powers and rights. In general, an SSB carries out the following:

- a) design and improve the bank's contracts for its basic activities;
- b) participate with the external auditor and the management of the bank in setting the bank's accounting policy on issues which are not covered by the accounting standards enforced in the country or those whose treatment violates the *Sharia*;

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- c) vet the doctrinal suitability of the bank's business transactions; and
- d) issue a report at the end of the financial year to assure consumers of the bank's services that it had access to all the documents and records that it deemed necessary in carrying out its duties and that the bank's financial dealings are in compliance with *Sharia* precepts.

The involvement of the SSB in the setting of the accounting policies of Islamic banks reflects the moral dimension which this process must accommodate if it is to be perceived as credible by users of the financial statements of Islamic banks. Furthermore, the vetting of the doctrinal suitability of the bank's transactions by the SSB means that the management and external auditor of the Islamic bank are not free to choose the accounting procedures which they prefer in preparing the financial statement of the bank. This implies that the role played by the SSB seems to impose a form of internal self-regulation on the financial reporting of Islamic banks.

However, although this role of the SSB may have established credibility for Islamic banks, it has resulted in a variety of accounting practices for the same transaction within Islamic banks, as I explain below. This has rendered the financial statements of Islamic banks non-comparable and has offered a legitimate platform for the external regulation of financial reporting of these banks.

The *Sharia* categorically prohibits, among other things, the earning or payment of *riba* (translated strictly as usury but interpreted universally as interest) in all financial transactions. One of the main financial instruments which is used by Islamic banks as an alternative to interest in the mobilisation and application of funds is *mudaraba* which is based on the concept of profit-sharing. Other financial instruments commonly used by Islamic banks in their use of funds include *musharaka* (joint venture based on profit-and-loss-sharing), *murabaha* (instalment sale of goods based on cost-plus negotiated mark-up), *salam* (forward delivery contracts), *istisna* (manufacturing contract), *ijara* (lease financing), *ijara-wa-iqtina* (lease financing with an option of transfer of ownership to the customer).

The measurement and reporting of business transactions which are carried out through these financial instruments tend to differ

within Islamic banks and between them and what is prescribed by Western and international accounting standard-setting bodies. For example, Islamic banks use four different accounting methods to recognise income arising from the popular *murabaha* transactions. These include both cash accounting and accounting and accrual accounting. On the other hand, unlike Western generally accepted accounting principles, Islamic banks do not report long-term *mura-baha* receivables at their present value.¹

The differences in accounting treatment within Islamic banks are mainly due to two reasons, namely,

- 1) the SSB interpretation of the *Sharia* principle relating to the transaction; and
- 2) the accounting method mandated by the regulatory bodies (e.g. central banks) may differ from one country to another.

The differences between generally accepted Western accounting principles and the accounting policies adopted by Islamic banks are basically due to the fact that the former “do not deal with the morality of the objectives of commercial accounting entities, or even of the methods by which they are pursued” (Gambling et.al. 1993:196).

Despite the present internal self-regulations of their accounting policies, Islamic banks (and other interested parties) have recently appreciated the need to externally self-regulate their financial reporting. In effect, this would replace the second duty performed by the SSB, namely, the setting of the accounting policies of the bank in consultation with the external auditor and the management. However, it is argued that,

“The regulation of the financial reporting by Islamic banks cannot be seen as a replacement for the present mechanism for moral control by their SSB’s. The accounts may conform to the appropriate standards, and properly disclose the financial effects of the bank’s transactions, but they cannot show whether or not the transactions themselves violate the *Sharia*. Thus the ‘bottom line’ of the income statement of an Islamic

1 This does not mean that Islam rejects the concept of the time value of money. Rather, the concept is considered not to violate the *Sharia* precepts only if it is used in relation to real transactions.

bank may not always give a valid picture of its Islamic contribution to society” (Gambling *et.al. op. cit* ; 201).

In 1991, several parties (including practising accountants and central banks) helped set up the Financial Accounting Organisation for Islamic Banks and Financial Institutions (FAOIBFI) - a private sector standard-setting body - in Bahrain with the aim of producing international accounting standards based on *Sharia* precepts for Islamic banks and financial institutions.

The Financial Accounting Standards Board (the Board), responsible within the FAOIBFI for setting accounting standards, consists of twenty-two unpaid, part-time members representing Islamic banks, users of financial statements of these banks, practising accountants, academics, *Sharia* scholars and regulatory bodies. The Board is assisted by a *Sharia* committee which reviews proposed pronouncements and advises the Board on their compliance with Islamic precepts; and an Executive Committee for Planning and Follow-up which recommends priorities to the Board and draws up its agenda. The members of the latter committee are drawn from the same categories of the Board.

The appointment of members of the Board and the raising of funds for the FAOIBFI are the two main duties of the Supervisory Committee, the highest authority in the FAOIBFI. The Supervisory Committee consists of seventeen unpaid, part-time members representing the same categories of the Board and are appointed by representatives of Islamic banks. Members of the Supervisory Committee and the Board serve for a term of 3 and 4 years respectively and can be reappointed for one more term only. It is worth noting that the main reason behind having a two tier structure is to separate the unit responsible for fund, raising from the unit in charge of producing the standards in order to minimise the influence of the former on the latter.

The participation of *Sharia* scholars in the various committees and in the membership of the Board and the Supervisory Committee reflects the importance which the FAOIBFI gives to the moral aspect that must be catered for in setting accounting standards for Islamic banks.

The FAOIBFI has an extensive due process of eight phases which governs the production of its accounting standards. The due process

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includes the vetting of the doctrinal suitability of proposed standards by the *Sharia* Committee and also provides interested parties with the opportunity to express their opinion on the standards before they are finally approved by the Board.

Hence, unlike the present process of setting the accounting policies of Islamic banks, which is confined to the SSB, the external auditor and the management of the bank, the due process of the FAOIBFI enables a wider range of categories from different countries to communicate their views on the proposed accounting standards for Islamic banks. Apparently, this is meant not only to tap the expertise on interested parties but also to enhance the credibility of the standard-setting process.

Following a similar approach to that of FASB in the USA, the FAOIBFI has decided to start its work by developing objectives and concepts of financial accounting for Islamic banks. In September 1992, the FAOIBFI issued two Exposure Drafts, one on the objectives of financial accounting and the other on the concepts of financial accounting. These were revised in April 1993. The final statements were approved by the Board in October 1993 as Financial Accounting Statement No. 1: Objectives of Financial Accounting for Islamic Banks and Financial Institutions and Financial Accounting Statement No. 2: Concepts of Financial Accounting for Islamic Banks and Financial Institutions, and, Financial Accounting Standard No. 1: Presentation and General disclosure in the Financial Statements of Islamic Banks and Financial Institutions.

The FAOIBFI is now preparing three accounting standards on *murabaha*, *musharaka* and *mudaraba*.

At present, the FAOIBFI has neither the consent of regulatory bodies (e.g. central banks) nor the power to force Islamic banks to implement its proposed standards. Hence, in order to ensure compliance with its standards, the FAOIBFI might have no choice but to try and secure the support of the concerned regulatory bodies and to obtain the co-operation of at least the major Islamic banks and their auditors. However, the co-operation of the latter alone would be sufficient to enforce the FAOIBFI's standards. This is because banks are subject to the jurisdiction of the central bank which has the power to decide which standards are considered acceptable and, therefore, should be implemented.

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Furthermore, given that Islamic banks are set up in many parts of the world and are, therefore, subject to different requirements of regulatory bodies and various legislation, adherence to the FAOIBFI's standards might not be an easy task to achieve. For example, some Islamic banks were established by special laws which included accounting policies that have to be implemented by the banks. Changes in these laws would require the approval of the legislative bodies in these countries.

On the other hand, many of the larger Western banks (e.g. Chemical Bank, Citibank, Kleinwort Benson, ANZ Grindlays and Goldman Sachs) have recently opened an Islamic window through which they conduct major financial transactions that accord with the *Sharia*. It is not yet clear whether these standards promulgated by the FAOIBFI would apply to these Western banks particularly those that conduct their Islamic transaction through their branches in the Middle East.

The lack of power to force its standards may suggest that the FAOIBFI's accounting standards would be produced by what is, in essence, a bargaining process. This is highly likely to be the case when the FAOIBFI has to decide on issues which have significant economic consequences, for example, the profit recognition of *murabaha* sale transaction on which Islamic banks are currently divided. However, even if that were to be the case, the accounting practices emanating from such a process would still be within the boundaries of what is permissible by *Shariah* precepts.

A comparison of the current internal self regulation of accounting policies with the FAOIBFI's external standard-setting reveals the following:

Differences Between Internal and External Standard-Setting

Internal self regulation

Islamic banks currently set their own accounting policies, particularly on issues which are not covered by the accounting standards enforced in the country in which they operate or those which violate the *Sharia* precepts. This process is carried out by the management of the bank, the external auditor and the SSB.

- If the SSB believes that the accounting policies adopted by the bank do not comply with the *Sharia* precepts, it may qualify the report which it issues to the public. Hence, the SSB puts pressure on the bank to adopt accounting policies that do not violate *Sharia* precepts.
- Differences in the interpretation of the *Sharia* principles may lead to a variety of accounting practices by Islamic banks which may render their financial statements non-comparable.

External standard-setting

- Accounting standards are issued after a lengthy due process which avails interested parties of the opportunity to express their views as to what should be the accounting treatment of the issue under consideration.
- Given that the promulgated standards should comply with the *Sharia* precepts, it is unlikely that the SSB would play a role in vetting the mandated accounting policy.
- Lack of power to enforce accounting standards. Hence, to secure the compliance of Islamic banks, the promulgated accounting standards may be the result of a bargaining process.
- Adherence to promulgated standards may not be an easy task because of different requirements of regulatory bodies and various legislation in the countries in which Islamic banks operate.
- A high degree of comparability can be achieved if Islamic banks adhere to the promulgated standards.

References

Gambling. T.Jones, R, and Karim, R.A.A., "Credible Organizations: Self-Regulation v. External Standard-Setting in Islamic Banks and British Charities," *Financial Accountability and Management*, Vol. 9, No. 3 (August 1993), pp. 195-207.



Accounting Standards for Islamic Banks

Mustapha Hamat

Introduction

The objective of this chapter is to highlight the existing accounting standards (for example the International Accounting Standard (IAS), the Statement of Standard Accounting Practice (SSAP) and Financial Accounting Standard Board (FASB) that are relevant to the operation of Islamic banks and to assess their applicability in reporting results of the Islamic banks' operations. This paper, therefore, discusses the changes and modifications which are considered necessary to reflect application and compliance of banking practices with *Sharia* principles and at the same time maintain the true and fair view characteristic of financial reporting.

For the purposes of this chapter, however, I confine my discussions to the following standards:

- Disclosure of accounting policies;
- Information to be disclosed in the financial statement;
- Accounting for *mudaraba* and *musharaka* financing;
- Accounting for leasing;
- Accounting for foreign currency transactions; and
- Accounting for provision for bad and doubtful financing.

Disclosure of accounting policies (IASI):

Disclosure of Significant Accounting Policies is very important as treatment of certain accounting issues varies widely from one bank to another. Islamic bank's adoption of a particular accounting policy for a particular accounting issue reflects not only variations in the treatment of the accounting issue but also the variations in the application of *Sharia* principles. Therefore, standards for disclosure of accounting policies usually vary in the following areas:

- Consolidation policies;
- Conversion or translation of foreign currencies, including disposition of exchange gain or losses;
- Overall valuation policy (such as historical cost, replacement cost etc.);
- Subsequent events;
- Leasing, hire purchase, instalment transactions and related interest or profit;
- Receivables;
- Investment, subsidiary companies, associated companies and other investments;
- Commitment and contingencies;
- Gains and losses on disposal of property;
- Accounting for reserve, statutory or otherwise, including direct charges and credit to surplus accounts.

The survey conducted by Mr Samir T. Badawi on 10 Islamic institutions revealed that there were no specific accounting standards laid down by the accounting bodies in most countries where these Islamic financial institutions were operating. Therefore, the focus of financial reporting has been left to the discretion of management with no pressure from the users, and emphasis given to the disclosure is very minimal¹. The findings may not be true for BIMB or any other Islamic

1. Butterworth, *Islamic Banking and Finance*, 1986, p.90

financial institutions operating in Malaysia and some other countries. In reporting the results of the bank's operation and presentation of its financial position, the bank has first to observe, after taking care of *Sharia* requirements, the detailed disclosure requirements outlined in the Ninth Schedule of the Companies Act 1965 and the Malaysian Association of Certified Public Accountants (MACPA)/Malaysian Institute of Accountants (MIA) disclosure standards.

For example, Para 1(a) of the schedule requires the operating revenues be disclosed in the profit-and-loss account. The same paragraph also requires that the basis on which the income is determined is stated. In this particular case, the MACPA has adopted International Accounting Standard Statement No. 1 (IASI) to be the standard with regard to the disclosure of significant accounting policies. Para 16 of the IASI states that going concern, consistency and accrual are the fundamental assumptions in preparing accounting reports. Therefore, it is not necessary to disclose them in the financial statements. However, should there be any departure or modification to the standards, the fact must be properly disclosed and may be in the form of a Note to the accounts.

BIMB is required to observe this standard. As it operates on a modified cash basis, where the income is recognised only when it falls due and cash is actually received, the fact is disclosed in a note to the account under the caption of "Significant Account Policies". The same standards are also practised in the UK and the USA. They are covered by the SSAP2 and Opinion 22 of the APB (1972)² respectively.

Another issue that relates to the disclosure of accounting policies is depreciation. Para 1(f) of the same schedule requires the profit-and-loss account to show the amount charged for depreciation, amortisation or diminution in value on:

- fixed assets;
- goodwill and other intangible assets;
- investments;

But it does not require that the method or basis of provision be stated. In this case, the MACPA, by way of adopting IAS4, para 18, requires that the following be disclosed in financial statements:

2. APB Opinion No. 22, Notes

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- depreciation method;
- useful life or depreciation rates used;
- the gross amount of depreciable assets and the related accumulated depreciation.

In the UK, this standard is covered by SSAP12, and in the USA, it is covered in ARB No. 33 and 34.

There is no direct *Sharia* implication with regard to depreciation. Therefore, for the purpose of conservatism and prudent banking practices, BIMB adopted this standard in its financial reporting. However, the implication may occur when the customer deposit is accepted on the basis of *mudaraba* principle and the Islamic banks adopted the view that operational cost can be deducted from the *mudaraba* revenue. It will be charged to the pre-distribution profit. The effect is that the distributable profit will be reduced by the amount of depreciation. In this case, disclosure with regard to which account is charged, need not be disclosed as the disclosure of the *Sharia* principle underlying the acceptance of the deposit will be sufficient for readers to understand the treatment of depreciation.

Goodwill arising from Islamic banks acquiring existing businesses may pose a unique accounting problem. Para 1(f) of the Ninth Schedule requires that amortisation of goodwill be reflected in the profit-and-loss accounts. The issue is still being debated though it was covered by IAS22 and SSAP22. MACPA and MIA have decided that the subject should be dealt with in separate accounting standards. The controversy centred around the question whether goodwill should be written off immediately, amortised over a period or given no amortisation at all. Recently, MACPA and MIA have issued a joint discussion paper on this issue.

From the point of view of Islamic banks, the issue came into the picture in two stages, the decision whether to amortise or not and secondly, if it is to be written off, to which income should it be charged, to depositors' profit or to banks' profit?

Goodwill is created when the purchase price exceeds the value of the company acquired. As far as *the Sharia* is concerned, the case is straightforward. Whatever the banks paid, that is the amount recorded in the book. Whatever dividend or profit is derived from this investment

will be distributed between the banks and the depositors. The issue is therefore a pure accounting problem (prudent conservatism). As goodwill is not represented by any tangible assets, it will be prudent and more conservative if it is amortised. Para 41 of IAS22 requires that any goodwill, positive or negative, be written off, if it seems it does not support any future income. As this is purely an accounting issue, Islamic banks can easily adopt IAS22 or any other suitable standard.

Information to be disclosed in financial statement:

The basic principle is that all information that helps to make the financial statement understandable should be disclosed. In Malaysia, the relevant standards to be observed are given in IAS5. In the case of specialised industries such as banking and insurance, the layout and grouping are allowed to vary according to the requirements of the industries. Islamic banks are allowed to vary the grouping of the assets, liabilities and profit-and-loss items according to *Sharia* principles, Companies and Islamic Banking Acts.

Generally, the classification and grouping of information for the purpose of disclosure requirements are as follows:

- general items such as the method of allocating provision for pension and retirement plans, contingent assets and liabilities etc.
- long-term assets
- current assets
- long term liabilities
- current liabilities
- other liabilities and provisions
- shareholders' fund
- sales and other operating revenue
- depreciation
- income/profit
- income from investment etc.

As far as disclosure of information is concerned, the existing standards do not conflict with the *Sharia*. In fact, Islam actively encourages disclosure of information so as not to mislead stakeholders.

Accounting standards relating to *Al-Mudaraba* and *Al-Musharaka* financing:

Mudaraba and *musharaka* financing are quite similar to joint ventures that are usually undertaken by investment and industrial banks. Traditionally, conventional commercial banks in Malaysia are not allowed to finance customers through joint venture unless approved by Bank Negara Malaysia (Central Bank of Malaysia)³. The profit from this type of financing is not fixed. It depends on the actual profit after the accounts have been closed or the project has been completed.

Neither the Malaysian Companies Act 1965 nor the Islamic Banking Act 1983 gives specific direction on the presentation of these assets. However, the accounting convention of accrual, matching, periodicity and conservatism are expected to be observed, and any departure from these conventions should be properly disclosed. Recording these financings on the basis of the expected profit to be received at the end of the period violates the accounting conventions mentioned above. In the case of BIMB, the issue does not arise as it recognises income on a cash basis. The amount taken up into the book and reflected in the financial statement will be the amount the bank actually disbursed, net of any provision for doubtful and bad financing. This is in accordance with the requirements of IASI.

Accounting standards relating to short-term and long-term *Murabaha* or *Bai-Bithaman-Ajil* financing:

For income tax purposes⁴, the profit portion charged by the BIMB in its financing and investment activities is taken to be equivalent to

3. It appears that the scope of conventional banks' operation is limited by section 2 of the Banking and Financial Institution Act 1989, where it defines "banking business" to mean "the business of receiving money in any currency on current or deposit accounts, paying and collecting cheques drawn by or paid in by customers, and making advances to customers, and includes such other business as Central bank, with the approval of the Minister, may prescribe for the purposes of the Act".
4. The Income Tax Act 1967, Subsection 7 of Section 2, states that any reference to "interest" in the Act shall apply, *mutatis mutandis*, to gain or profit received and expenses incurred in lieu of interest, in transactions conducted in accordance with *Sharia*"

the interest charged by other banks. If we accept this interpretation, the method of revenue recognition is covered by the IASI 8, where Para 25 states that revenue must be recognised on the basis of time proportion, taking into account the cost and profit margin applied. Therefore, if the contract is going to be over within the same financial year, no accounting problem arises. But if the contract is going to go through the period of more than one year, they will have to be apportioned according to the financial year.

The recognition of the profit portion will depend on the method used. There are a few acceptable methods adopted by financial institutions and banks. The common ones are the sum of digit, constant rate of return and straight-line methods. Applying any of these methods will enable the banks to segregate the cost and profit from monthly, quarterly and semi-annually repayments. This standard practice has been accepted by the revenue law in some countries and does not violate the requirements of the *Sharia*. As far as presentation is concerned, the standard relates to the accounting conventions which apply. Therefore, the amount to be reflected in the financial statement is the total receivable balance, less the profit portion which is not due. This is in accordance with the requirement of IASI7 and IASI8.

Accounting standards relating to lease financing

Lease is defined in ISAI7 to be an agreement whereby the lessor conveys to the lessee, in return for rent, the right to use an asset for an agreed period of time. This definition includes contracts for the hire of an asset which contain a provision giving the hirer an option to acquire the title to the asset upon the fulfilment of agreed conditions. these contracts are described as hire-purchase contracts in some countries. In some countries, different names are used for agreements which have the characteristics of a lease (i.e. bare-boat charters). There are two types of lease arrangement; finance leases and operating leases.

Para 49, IASI7, requires that recognition of income under a finance lease be based on a pattern reflecting a consistent periodic rate of return on lessors' net investment outstanding and the method should be applied consistently. In the case of the operational lease, Para 52, rental income should be recognised on a straight-line basis over the lease term, unless another systematic basis is more representative of the time pattern of the earning process in the lease.

There is no *Sharia* complication as far as the straight forward leasing arrangement is concerned. However, in a case where the profit margin is tied up to the interest rate, such as LIBOR, BLR etc., the arrangement is not permitted by *the Sharia* as it creates *Gharar* (uncertainties). The lessees' total rental payable or the banks' total rental income now vary according to changes in the interest rate. With regard to the method of income recognition, it is an administrative matter; no *Sharia* complication arises here. It is up to the management which method to adopt, so long as it is just and fair to both parties, but the method used must be systematic one and reflective of a constant periodic rate of return as required by IAS17.

As far as presentation is concerned, the *Sharia* does not impose any condition. As such, what BIMB does is to observe the requirements of the existing accounting standards, such as IAS17, the FASB13-29, and APB 5,7,27 and 31 or the SSAP21. According to these standards, the leased asset will not be recorded as a fixed asset in the balance sheet, but as lease receivable less the profit margin which is not received. In the case of an operating lease, the leased assets should be recorded as fixed assets in the balance sheet of the lessor. As such, depreciation for these assets is provided periodically.

Accounting for foreign currency transactions:

Reporting transactions conducted, or assets and liabilities stated, in currencies other than reporting currency varies greatly. These variations arise mainly from the methods adopted for translation, and the treatment of differences arising from application of these methods. BIMB translates its foreign currency transactions into Malaysian Ringgit at the rate of exchange ruling at the dates of realisation of the transactions, whereas the assets and liabilities on the balance sheet date are stated at the rate of exchange ruling on the dates of transactions. Gains or losses resulting from this translation are only recognised when realised, in accordance with the cash basis of accounting. Kuwait Finance House (KFH), Bahrain Islamic Bank (BIB) and al-Barakah Islamic Investment Bank (BIIB) adopt the same method for the translating of transactions conducted in foreign currencies. The gains or losses are transferred to the profit-and-loss account. Some Islamic banks, such as Faisal Islamic Bank, Egypt do not disclose their method at all.

Conceptually, the *Sharia* principles adopted in accepting deposits, and giving out financing should determine the methods of translation used by Islamic banks. Therefore, questions such as whether the transactions or assets and liabilities belong to the shareholders' fund or customers' deposits and if they belong to the customers' deposits, whether they arise from *murabaha* or *musharaka* or any other forms of financing, should be asked. If the transactions or assets and liabilities belong to the shareholders' fund, there will be no *Sharia* complications. But if they belong to customers' deposits (assuming the deposit is accepted on the *mudaraba* principle), the method chosen for translating foreign currencies must reflect the terms and conditions of the *murdaraba* contract and the contract which the Islamic banks used in investing their funds. For example, using the exchange rates prevailing on the date of realisation for *murabaha* transactions, utilising *mudaraba* funds is more reflective of the terms and conditions of the contract with depositors.

Gains from foreign currency translation can be distributed to the depositors, as they derive from completed and realised transactions. According to Shafii School of thought, interim distributions made by a *mudarib* to the owner of capital while the capital fund is still tied to receivable or other forms of working capital cannot be conclusively treated as profit. In the case where receivable or debtors accounts become uncollectable and the business suffers losses, it becomes a refund of capital. The portion received by the entrepreneurs will have to be refunded to the owner of the capital as part of his capital⁵. Therefore, based on this view, only realised foreign exchange gains can be distributed. As such, the method adopted by BIMB is closer to the requirements of this view. This does not mean that other methods cannot be used. KFH, BIB and BIIB must have some acceptable *Sharia* arguments for adopting methods which differ from those of BIIB.

The main issue in this case is not the debate on whether the method adopted is in accordance with the *Sharia* or not. What is important here is flexibility in adopting methods for translating foreign exchange transactions allowed by the *Sharia*. This requires adequate disclosure. In this particular case, it is felt that the existing standards found in IAS21, SSAP20 and FASB#52 may not be adequate, as they do not cover the *Sharia* aspect of the issue. The proposed standard must outline the

5. al-Jaziri, Abd-al- Rahman, *Al-Fiqh ala Madhahib Arbaa*, undated, p. 61.

disclosure requirement with regard to foreign exchange translation, the underlying *Sharia* principles and the method of translation.

Accounting for provisions for bad and doubtful financing:

As mentioned in the earlier part of this chapter, prudent banking practices require that provisions for doubtful and bad debts be created and maintained at a certain level in order to reflect the realistic and collectable balance of financing and investment. Such prudent and conservative management of the bank's assets and liabilities is not contrary to the requirements of the *Sharia*, so long as the Islamic banks try to be fair and just in dealing with depositors. The Maliki and Hanafi schools of thought have allowed the charging of such provisions to the predistribution profit.

In the case of bad accounts, they may have to be re-valued to determine the extent of the loss to be specifically provided for.

In line with the "real" nature of loss as dictated by the *Sharia* principle of *mudaraba* and in order to maintain fairness to the banks' present and future depositors, the valuation is based on the gross realisable value for the account; that is, the actual amount of what remains from the outstanding cost of financing plus the expected profit that may be further generated from this amount⁶. The procedure of realising income from monthly or quarterly instalments of the subsequent financing arrangement should be abandoned. Instead, all payment received will be treated in full as recovery for the outstanding cost of finance plus all incidental expenses thereto until this amount is fully recovered. Subsequently, all this income will be credited in full to the earned profit account.

There is no accounting standard existing at the moment which deals, directly with this issue, other than the standards mentioned in IASI, SSAP2 and OPB opinion #22 and a little bit in FASB#15.

As the issue is directly related to the terms and conditions of *mudaraba* contract, it is felt that the existing accounting standards are inadequate to deal with the matter. A new standard, encompassing the *Sharia* as well as accounting aspects should be formulated in order for Islamic banks' financial statements to be more informative and meaningful.

6, *Ibid*, p.62.

Conclusion:

The flexibility allowed by the accounting convention and the *Sharia* in adopting different accounting methods for the treatment of certain accounting issues leads to different results being presented in the financial reporting. Therefore, unless proper disclosure with regard to the issues, the underlying *Sharia* principles and the accounting methods adopted is made, the information contained in financial statements will not be useful for comparison of the performances of different Islamic banks. Insufficient disclosure of the underlying *Sharia* principles will subject the Islamic banks, activities to a lot of questions with regard to their adherence to Islamic principles.

However, this does not mean that Islamic banks must come up with complete sets of new accounting standards. The existing standards continue to be applicable, so long as they do not go against the requirements of the *Sharia*. As mentioned earlier, most of the accounting issues found in the operation of Islamic banks fall within the scope of existing accounting standards. Therefore, in these cases, there is no need for new standards to be formulated.

Modifications are necessary to existing accounting standards to take into account the unique characteristics of Islamic banking, specifically those relating to additional disclosures. In certain cases, however, such as provision for doubtful and bad debts and foreign exchange translation, a new set of accounting standards needs to be formulated, as the existing standards do not cover this issue, or, where they do, the coverage is inadequate.

Accounting Systems for Islamic Banking An Insider's Perspective-I

Musa A. Shihadeh

Introduction

Banks play an active and essential role in the development of modern economies. Accordingly, some Islamic countries have taken steps towards the comprehensive application of the principles of the *Sharia* in banking. Muslims started to look for an Islamic form of banking which would operate on a non-usurious basis.

Muslims firmly believe that the principles of Islamic economy were revealed by God, and that the ultimate purpose of Islamic economy is to maintain the welfare and happiness of human societies.

Islam, like all other divine religions, prohibits usury because of the negative effect that usury has on the social and economic behaviour of individuals and groups. The use of funds in Islam cannot be separated from worship as Islam is not merely a religion of prayer and fasting, but encompasses all the aspects and activities of human society.

Therefore, the mission of Islamic banks is multifold. They must perform their activities on a non-usurious basis and at the same time prove that a proper combination between capital and labour can achieve remarkable success in the progress of their respective national economies.

Activities of Islamic Banks

I shall try to give an idea of the activities of the Jordan Islamic Bank, which in essence correspond to most of the activities of other Islamic banks.

Objectives:

The bank aims at meeting economic and social needs in the field of banking services, financing and investment operations on a non-usurious basis. These objectives include:

1. Expanding the extent of the banking sector by offering non-usurious banking services with special emphasis on introducing services designed to revive various forms of collective social responsibility on a basis of mutual benefit.
2. Developing means to attract funds and savings, and channeling them into non-usurious investment.
3. Providing the necessary financing to meet the requirements of the various sectors of the economy, particularly those which are not likely to benefit from usurious banking facilities.

Functions:

In order to realise its objectives, the Bank carries out, on a non-usurious basis, such operations in the following fields of banking services as will enable it to attain such objectives.

1. Accepting deposits:

Such deposits include the following:

a) Trust deposits

Deposits received by the Bank where the Bank is authorised to use the deposits at its own risk and responsibility in respect of profit or loss, and which are not subject to any conditions for drawing or depositing.

b) Joint investment accounts

These include deposits received by the Bank from persons desiring to participate in multilateral and continuous investment and financing operations, whereby such deposits will receive a certain percentage of the annual net profits realised in accordance with the conditions of the account under which they are entered.

c) **Specified investment accounts**

Deposits received by the Bank from persons desiring to appoint the Bank as agent for investment of these deposits in a specific project or in a specific manner, on the basis that the bank will receive a part of the net profits realised, but without liability for any loss which is not attributable to any violation or fault by the bank.

d) ***Muqarada* bonds**

These are documents having a uniform value, issued by the Bank in the names of the persons who subscribe therein by paying their face value, on the basis of participation by the holders of these bonds in the annual profits realised in accordance with the terms of each separate issue of such bonds.

2. **Finance and investment activities:**

The Bank performs all sorts of finance and investment activities organised on a non-usurious basis. These include:

a) ***Mudaraba***

Advances by the Bank of the necessary funds, fully or partially, for financing a specific operation administered by another person on the basis of participation in the profit or loss arising from such operation.

b) **Participation, which can be sub-divided into:**

(i) **Decreasing participation**

Participation by the Bank as a financing partner, fully or partially in a profitable project, on the basis of agreement by the other partner that the Bank will receive a certain part of the net profit actually realised, and is entitled to retain the remaining part, or any part thereof, as may be agreed upon, to be off-set against the funds advanced by the Bank for financing the project.

(ii) **Continued participation**

Where the Bank holds a share in the equity of a project.

that is expected to gain a return, it continues to be a partner.

c) **Purchasing for others on a pre-agreed profit basis**

Implementation by the Bank of an agreement where by the Bank purchases on behalf of the other contracting party goods requested by the said party, and pays the purchase price in full or in part, on the basis of an undertaking by the contracting party to re-purchase the same goods at a profit agreed upon in advance.

3. Other non-usurious banking operations:

The Bank carries out, whether for its own account or for the account of others, such traditional or modern banking activities as it is able to undertake within the limits of its commitment, including:

- a) Accepting deposits and opening current and other accounts of various types, as mentioned earlier. payment and clearance of checks. Collection of bills of exchange, transfer of funds, opening of documentary credits, issue of bank guarantees, and other banking services.
- b) Dealing in the purchase and sale of foreign currencies on the basis of spot rates only. It is permissible, in this regard, to undertake mutual lending in various currencies without interest as may be required.
- c) Giving fixed term loans as a mere service without interest.
- d) Management of properties and other assets which can be managed by the bank on the basis of an agency fee.
- e) Acting as a trustee
- f) Carrying out feasibility studies and giving information and consultancy services on various economic matters.

4. Social services:

The Bank acts as a trustee in organising social services designed to strengthen the ties of solidarity and co-operation among various groups and individuals, through the following activities:

DEVELOPMENT OF AN ACCOUNTING SYSTEM FOR ISLAMIC BANKING

- a) Giving beneficial loans for productive purposes in various fields to enable the beneficiaries to start independent lives or to raise their incomes and standard of living.
- b) Establishment and administration of special funds for various social purposes.
- c) Any other activities within the scope of these general objectives.

In short, Islamic banking is interest-free banking, elaborating the possible ways of reorganising banking without the institution of interest. Islamic Banks offer to those who want to avoid interest the mechanism needed through which savings are channelled from savers to investors on the basis of a profit-sharing system. They function as financial intermediaries between savers and the ultimate users of funds, where the savers share the risk of low return or even loss.

Accounting Systems of Islamic Banks:

In regard to the accounting system of the Jordan Islamic Bank, it is worth pointing out that the articles which govern this system, as stated in the Bank's Law, are explained and / or detailed by the Bank's Board and management, and that these explanations are subject to the approval of the Bank's Sharia Consultant, who must, in turn, elaborate the *Sharia* standpoint on these explanations.

Below are some contracts from the Bank's law:

Article four: Profits realised from investments

SECTION 18 Profits and losses relating to financing and joint investment activities shall be separated in the accounts from the other income and expenditure relating to other activities and services offered by the Bank. The same applies to the income and expenditure of investments for specific purposes, in respect of which a separate account must be kept for each particular project.

SECTION 19 In accounting for the profit income connected with its financing and investment activities, the Bank may not adopt a method of accounting which takes into account estimated or expected profits, but it must confine itself

to the profits realised in accordance with the nature of the operations which the bank finances, and in accordance with the following rules:

- a) In the case of individual *mudaraba*, the profits shall be realised on the basis of a final settlement of accounts carried out between the Bank and the party utilising the funds. Such settlement should be based on actual receipt of the cash and realisation of the income and should be duly approved and accepted. The profits of each year shall be entered in the accounts of the year in which such settlement is carried out, whether in respect of the complete project or a part of it.
- b) In the case of decreasing participation, the profit or income shall be realised on the basis of the net income derived from the project concerned until the end of the financial year, even if such income is not in fact received in cash, as in such event, the income realised shall be treated as money due but not received.
- c) In the case of purchasing for others on a pre-agreed profit basis, the profit shall be realised upon the conclusion of the subsequent contract and on the basis of the difference between the actual cost and the price agreed upon with the party who ordered the purchase.
- d) The various financing operations shall be charged with all the direct expenses and costs arising there from, and should not be charged with any part of the general overhead expenses of the Bank.

The apportionment of joint investment

SECTION 20 a) In order to replenish the special account for meeting investment risks, the Bank shall deduct annually an amount equal to ten per cent of the net profits realised from various investment operations during that year.

- b) The amounts so deducted annually shall be kept in a special account to meet any losses exceeding the total profits derived from investment in that year.

- c) The deduction of such percentage should be stopped as soon as the accumulative balance of this account reaches twice the paid-up capital of the Bank.

SECTION 21 Distribution of Profits between the Bank and the investors:

- a) the Board shall announce by public notice the general percentage of profit to be allocated to the general funds participating in joint investments, such announcement to be made at the beginning of the same financial year and not later than the end of the first month of every year.
- b) the Bank as joint venturer shall be entitled to the remaining percentage after the deduction of the amount allocated to the investors. The Bank shall also be entitled to participate in the profits of joint investments in proportion to the amount of its own funds or the funds which it is authorised to risk in joint investments.
- (c) In determining the funds participating in joint investment, priority shall be given to joint investment deposits and to the holders of joint *Muqarada* bonds. The Bank may not consider itself as a participant in financing from its own funds save to the extent of the excess of the amounts utilised in financing over the total balances of the investors.

SECTION 22 a) The Bank, as a joint venturer, shall bear any losses resulting from any cause for which it is legally liable, including any cases where authority is exceeded or insufficient care or caution is exercised by the members of the Board of Directors, or the managers or employees or workers of the Bank. Insufficient exercise of care for which the Bank is answerable shall include any cases of fraud, abuse of trust, collusion, and similar forms of misconduct which fall short of the standards of honesty expected in the management of joint venture operations by the Bank.

- b) Losses incurred which are not attributable to misconduct involving the exceeding of authority or failure to exercise

care or caution, shall be deducted from the total profits realised for the year in which such losses are incurred. Any excess of losses over the profits which were actually realised during that year shall be deducted from the reserve account opened for covering the risks of investment.

- c) If the total profits realised in the year, together with the reserves accumulated from the previous year are not sufficient to cover the losses incurred, the Bank must carry out a comprehensive assessment of expected profits and losses, based on market rates, from operations which are financed by venture funds and which have not reached the stage of final settlement by the end of the financial year.
- d) If the result of such assessment indicates that the estimated profits are sufficient to cover the excess loss, the Bank must carry forward the excess loss so that it may be covered from the proceeds of the expected profits as and when they are realised from the operations included in the comprehensive assessment.
- e) If, on the other hand, the estimated profits are less than the excess loss, the Bank may treat it as a loss carried forward, provided that the amounts withdrawn from the joint investment deposits and the joint *muqarada* bonds shall be charged with a pro-rata part of the excess loss in proportion to the percentage of participation of the amount withdrawn in the investment operations, and depending on the type of the account in each case.

SECTION 23 The Islamic legal consultant who is appointed in accordance with the provisions of this law shall ascertain the existence of a legal doctrinal (*fiqhi*) basis to support the charging of any loss resulting from joint investment operations to the Bank.

SECTION 24 In case of liquidation of the Bank, the depositors' rights shall be dealt with as follows:

- a) The rights of depositors in trust deposit accounts, and other deposited funds which are not intended for investment

- and participation in investment profits, shall be settled first.
- b) Next, the rights of depositors in joint investment accounts shall be settled in accordance with the special conditions applicable to such accounts, as well as shall the rights of the holders of joint *muqarada* bonds, who shall receive the same percentage as the depositors in joint investment accounts.
 - c) The rights of depositors in specific investment accounts, and of the holders of specific *muqarada* bonds, shall be linked to the projects specified for each investment, and they shall bear the risk of such specific investment.
 - d) The rights of shareholders shall be settled on the basis of a distribution among them of the remaining fund, in proportion to the shares held by each of them.
 - e) The balance of the reserve account for covering investment risks shall be transferred, upon the liquidation of the Bank, to the account of the charity (*zakah*) fund to be spent for the purposes prescribed under the special law of the aforesaid fund.

Final Accounts, Balance Sheet, and profit and loss accounts

SECTION 29 The accounts of the Bank are maintained in accordance with banking accountancy methods. The final accounts shall be closed annually on the thirty- first day of December of every year.

SECTION 30 The annual balance sheet and profit-and-loss Accounts are audited annually, prior to their presentation to the general meeting, by the auditors who are elected in accordance with the provisions of the Articles of Association.

SECTION 31 The investment profits are distributed to investment depositors and holders of *muqarada* bonds from the special accounts relating there to during the month of January of the following financial year.

SECTION 32 The net profits accruing to the Bank which are realised until the end of the financing year shall be apportioned as follows:

- a) 10 per cent to the compulsory reserve account, until the balance accumulated in this account becomes equal to the capital of the Bank.
- b) 5 per cent to the remuneration of the members of the Board of Directors accounts, to be distributed among them in proportion to the number of meetings within the limit prescribed in the Companies' Law.
- d) Any percentage the Board may deem necessary to provide a suitable reserve to meet the various liabilities, within a maximum limit of twenty per cent of the net profits of that year.
- e) The balance of the profits is distributed to the shareholders in proportion to the number of shares which each of them holds.

General notes

As previously indicated in Section 29, the Jordan Islamic Bank's accounts are kept according to banking accounting standards. Yet, when we compare these standards with the applications used in the Jordan Islamic Bank, we notice that some of the Jordan Islamic Bank's practices coincide with international standards while others do not.

Some of these differences are explained hereunder.

1. Revenues versus interest

In traditional banks, interest rates and commissions are calculated according to value date, taking into consideration suspended interest deducted from doubtful, overdrawn accounts.

In comparison, Islamic banks do not deal in interest. If we look at investment revenues in Islamic banks and the way these revenues are treated, we will notice that they are recorded, as previously mentioned, according to accounting rules which are different from those maintained by traditional banks.

Our bank's special law, however, sets the rules for how to record these revenues, how to verify them and how to distribute them among depositors, shareholders and investment risk provision.

2. **Securities**

According to International Accounting Standard No. (30), securities for trading purposes and securities for long-term investments are kept in separate accounts. And the difference between cost and market prices is taken as a provision against the decline of the prices of securities.

Investments in securities in the books of the Jordan Islamic Bank appear in Financing and Investment Accounts under other Investments. No special provision is made for these investments, as they are treated like all the other investments of the bank. As previously mentioned, a fixed percentage of 10% is taken on all investments as investment risk provision.

According to the Bank's law, revenues or losses realized from securities are recorded after the sale thereof has been actually completed, and dividends are effected when such profits have been actually collected (on a cash basis).

3. **Real estate**

Entries of real estate are determined according to the sources of the funds used for purchasing them. The purchase decision must indicate whether the funds used are from investment funds or from shareholders' funds, in order to decide where rents, revenues or losses must be entered.

Real estate constructed from shareholders' funds is depreciated annually according to traditional standards, while investments in real estate of investment deposits are not depreciated.

4. Revenues from banking services are separated from investment revenues, as the former belongs to the shareholders.
5. Investment risk provision, as previously explained, belongs neither to shareholders nor to depositors, as this provision is used to extinguish loss incurring from investments, in any financial year, if these losses exceed the profits realized in that same year.

6. Below, I give an example of Investment Revenues Distribution, Profit-and-Loss Accounts and Profits Distribution which illustrates how these operations are carried out at the Jordan Islamic Bank, and I conclude by giving profit-and-loss accounts of shareholders and its distribution and by giving a sample of the auditors' showing comments on our accounting policies from their statement on our accounts.

Investment profits

Investment profits realized in 1993 amounted to JD 27,855,553 against JD 22,532,374 in 1992. These profits were distributed according to the Bank's law and the decisions of the Board of Directors as follows:

	1993 <u>JD</u>	1992 <u>JD</u>
Provision for Investment Risks	2,785,555	2,253,237
Joint Investment Accounts' portion	14,237,810	13,154,710
The Bank's portion	<u>10,832,188</u>	<u>7,124,427</u>
Total	<u><u>27,855,553</u></u>	<u><u>22,532,374</u></u>

Profit-and-Loss Account

In 1993, the Bank realized a net profit of JD 4,310,274. The Board of Directors recommends the distribution of these profits as follow:

(1) Profits Total	<u>JD</u>
— Net profit before tax	4,310,274
— Income Tax provision	(1,966,085)
— Retained profit brought forward	<u>267,290</u>
Total of distributable profits	<u><u>2,611,479</u></u>
(2) Distribution of profits.	
— Statutory reserve (10% of net profits before tax).	431,027
— Staff Merit Rewards 2.5% of net profits as per the Bank's Law.	107,757

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— Voluntary Reserve	400,000
— Other Reserves	41,568
— Universities' Levies	43,103
— Provisions for scientific research and vocational training.	43,103
— Board members remunerations	31,667
— Profits proposed for distribution to shareholders 12%	864,000
— Retained profits	649,254
Total	<u>2,611,479</u>

Main Accounting Policies

- a) In all of its transactions, the Bank adheres to the accounting principles of its special law, which conforms to the provisions of the Islamic *Sharia*.
- b) Shares and real estate investments are recorded at cost. Profits and losses thereof are recorded in accordance with the provisions of the law of the Bank whenever they actually occur.
- c) Assets and liabilities in foreign currencies are evaluated, for balance sheet purposes, at the middle rate of buying and selling thereof, as issued by the Central Bank at balance sheet date. The difference is entered to the profit-and-loss account.
- d) Fixed assets are recorded at cost, but are annually depreciated according to the fixed ratios specified by the Income Tax Department.
- e) Forms provided by the Central Bank are used for classifying and illustrating the financial statements.

Conclusion:

As we have seen, the accounting system of the Jordan Islamic Bank and, to my knowledge, the accounting systems of other Islamic banks correspond with the conventional accounting system in some general aspects, but differ in certain applications which are particular to Islamic banks.

This speciality of the Islamic accounting system has forced Islamic bankers to seek a model accounting system which accommodates the requirements of banking and at the same time complies with the provisions of the *Sharia*. To pursue this purpose, a committee was formed in 1987

Accounting Problems of Islamic Banks An Insider's Perspective II

Imtiaz A. Pervez

Introduction

In today's world, enterprises are becoming larger and more complex. That makes their management at internal and external levels impossible unless accurate and consistent information about them is available. Such information is provided by accounting an academic discipline which has been given quite a few definitions in the available literature.

According to the Committee of the American Accounting Association (AAA) accounting is "the process of identifying, measuring and communicating economic information to permit informed judgment and decision by users of the information". The American Financial Accounting Standards Board (FASB) defines financial reporting as activities intended to serve the informational needs of external users who lack the authority to prescribe the financial information that they want from an enterprise, so that they are obliged to use the information which the management communicates to them.

Accounting is a vital process through which information about an enterprise is provided to:

1. Managers for *ex poste* monitoring of performance, controlling of organisational operations and *ex ante* decision-making processes.

2. Legislators and regulatory bodies to appraise the organisation for supervision and to make decisions as to its future,
3. Lenders, owners, investors and employees to decide how much resources and time to provide to the organisation.
4. Business-contact groups, customers, suppliers, competitors and business rivals, for dealing, evaluation, mergers, amalgamations and takeovers.
5. Economists, advisors and analysts for research and analysis.
6. Tax/rate-payers, consumers, political parties, etc., for general information.
7. Government for national income accounting and resource management purposes.

In the case of the enterprise itself, the financial manager needs to understand accounting as it provides the information he uses, and the accountant needs to understand finance in order that he may design his information in a manner that will be most useful for the user.

Any theory aimed at realistically predicting the outcome of a decision needs to take into account all the related information. As a major provider of information, accounting helps to test economic theories as well as to resolve uncertainty and avoid distortions. It also plays an important role in assisting capital markets with free and accurate information presenting the true financial state of an enterprise and thereby eliminating such indiscretions as inside trading.

All these objectives, however, are achievable only if accounting concepts and measurement principles take full and complete account of every underlying factor relevant to the enterprise and the industry, including, but not confined to, principles, bases, conventions, rules, procedures, etc., and provided that these are consistently adopted by the industry. In the traditional environment, this process is ensured by many accounting standards, boards and committees across the world, such as the Generally Accepted Accounting Principles (GAAP), the Financial Accounting Standards Board (FASB), the Board for International Accounting Standards Committee (IASC), and others.

The concepts and measurement principles are subject to continuous study and review, as a result of which new accounting standards are

adopted on an on-going basis as the old ones are revised and developed. The purpose of this exercise is the identification of accounting issues arising from various economic activities.

Accounting and economics are essentially complementary, being both professional activities and academic disciplines, since both deal with economic activity. But they differ in approach. Accountants provide information relating to business activities by accurately recording economic events, while economists observe, measure and analyse economic activity and identify new ground. Economics, therefore, has an *ex poste* and an *ex ante* relationship with accounting.

Economic Considerations

Further discussion on economic aspects is essential, since economic activity is what accounting describes. On certain economic principles, Islam has its own views, which are different from the traditional ones. The moral and ethical elements, as well as rationality, are an integral part of all Islamic economic theories, since socio-economic justice is the main objective of the economic system advocated by Islam.

In a traditional sense, economics and the social sciences are considered to have separated from moral and political philosophy in the second half of the 18th century. The economic system prevalent at that time could be termed "commercial capitalism". The production and distribution of all goods and services were entrusted to market forces and not to arbitrary stipulations of law as in the previous century. The wage level was determined by supply and demand of labour and profits were exposed to competition rather than subjected to government protection.

Physiocratic thought and Smith's *Wealth of Nations* reflect this extraordinary discovery that scientific laws thought to be found only in nature could also be found in society. There was a desire to discover the natural laws of economic life and to formulate the natural precepts which rule human conduct. The classical economists upheld the notion that natural laws were embedded in the economic process as beneficial laws and a belief in the existence of rules of nature that were capable of being discovered.

Economic theories continue to be established which either offer new ground or are criticisms of the older theories. Despite the accumulation

of a vast number of economic theories, the economic problems of the world are in no way near a resolution and economic equilibrium is a myth which still appears to be far beyond the horizon.

In the meantime, several writers have issued warnings and argued that economics has come to be dominated to an unhealthy degree by ideas from the 20th century philosophy of physical science. It may be added that while the fine old family of the moral science remained a powerful and vigorous connection, an economist could be deeply influenced by ideas from the sphere of natural philosophy (as Adam Smith was by those of Newton).

It is also argued that, in this century, the moral sciences have undergone a crisis of confidence, the influence of the philosophy of the physical sciences has been almost entirely one way and that particular philosophical concepts which were imported into economics in the present century were such as to be uniquely destructive of the whole enterprise of the moral sciences.

Today, commercial capitalism is over-awed by financial capitalism, whereby economic volatility continues to rage across the globe. Nations are still suffering from inflation, recession, unemployment and vast anomalies in national living standards between nations. According to Helmut Schmidt, "the world economy has entered a phase of extraordinary instability and ... its future course is absolutely uncertain,".

The Islamic View

Over time, modern economics has become more or less a value-free empirical science akin to applied mathematics, without much relevance or regard to the needs of the individual the moral and ethical part of this process has become secondary and the individual is exposed to the risks of market movement and volatility not of his doing.

"Disorder has appeared everywhere because of what people have done".

(Quran 30:41)

"We are betrayed by what is false within". (Meredith, *Love's Grade*).

The Islamic economic system, on the other hand, is strongly inimical to self interest and undue profiteering. It is non-discriminatory

to human society, being aimed at building a relationship between the individual and society through cooperation, integration and duty, providing satisfaction for human beings by enabling them to perform their obligations to God and society.

In this context and the consideration that accounting and economics are complementary, it is essential to highlight the need for the Islamic principles to be taken into account for the purpose of establishing concepts and measurement principles upon which accounting standards may be further developed.

Interest-based Instruments

Islam considers money as sterile. It is a unit of value and means of exchange, not a store of value or a commodity. It must be sunk in exchange. The arbitrary fixation of a nominal rate at the front end (interest) on financial operations has no economic and scientific justification. Purely financial instruments create new capital (or demand) without an increase in the corresponding supply of goods and services, thereby creating an economic anomaly. New capital must be generated from actual commercial, not financial, activity, since it is not possible to preempt such capital generation until after the economic activity has taken place.

In the Islamic economic system, non-commercial borrowing will not be possible, since, in this case real generation of capital will never occur and the lender will have no incentive for parting with his money. The merits of this concept are justified by the following facts:

1. Consumer demand being unleveraged will be more real and hence sustainable since it will not be leveraged. Take the classic case of the United States. In previous decades, individuals and small firms raised substantial amounts of loans for personal consumption purposes. This led to high consumption demand, more jobs, high profits and expansion in industrial production, thereby bringing in an artificial boom.

Subsequently, debt servicing eliminated whatever real consumption demand the sector had in itself. As a result, a protracted spell of recession gripped the country in which a vast number of people have had to suffer substantial losses (Savings & Loans and the property market collapse wiping out the individual's equity).

2. Public sector borrowing will be limited to the acquisition of assets and not used for current expenditure, whereby it will be impossible for governments to raise debts payable by future generations, which is both unwise and unethical. Since borrowing will be related to assets, any debt so raised will be possible for future generations to pay off by the disposal of the underlying asset. This has a double-edged effect: a) that public sector borrowing will not require an arbitrary percentage stipulation by the IMF as it will be governed by market forces; and b) unnecessary expansion of monetary assets without their corresponding physical assets will not be possible to obtain, thereby controlling inflation.

In consideration of the foregoing, accounting standards for capital instruments (detailed under FRS4) as "all instruments that are issued by reporting entities as a means of raising finance, including shares, debentures, loans and debt instruments, options and warrants that give the holder the right to subscribe for or obtain capital instruments", will require revision and the incorporation of such Islamic instruments as *musharaka* and *mudaraba*.

Balance Sheet Presentation

"Behold, ... I will create a vicegerent on earth".

(Quran 2;30)

As Creator, God is The Owner of the universe. Man is His vicegerent and must perform his duties as prescribed by the Creator. Wealth is a trust from the Owner and is to be used in a manner that will lead to the welfare of humanity in accordance with the rules laid down for the purpose.

Under the Islamic *Sharia*, a bank is not an entrepreneur. A bank is basically a financial intermediary as it provides services to its clients in the management of their surplus capital on a fiduciary basis. The services a bank offers include management and investment expertise, provision of technological facilities, bringing together clients, institutions and markets, carrying out transactions, etc.

The traditional definition under which the bank borrows money from its clients which it lends onwards to borrowers cannot be true for the reason that even after generous upward revisions, the regulatory

authorities still allow banks to leverage around 12-13 times their capital.

This is highly dangerous considering that in terms of the bank's own internal policy, leveraging of 1:2 is too high and that too in respect of an enterprise which is closely managed and monitored by its owners who have full control over the operations of the enterprise. In the case of banks, 1:12 leveraging is more dangerous because the bank lends onwards to clients in a situation where it has no control over the operations of the borrower, who may or may not use the borrowed funds for commercially productive purposes.

The other implication of treating the bank an entrepreneur is that losses equal to 8% of its deposits render it bankrupt, whereby the bank assets are realised through a forced sale process which may not net the real value of the assets. Not only that but the shareholders will have lost all their investment capital and the depositors will also lose to the extent that the full value of the assets is not realised.

In the case of Islamic banks, there is no danger of this. As a trustee, the Islamic bank invests funds only in enterprises and activities which have been previously approved by the depositors. Any profit realised is for the benefit of the depositors (less the bank's management fee). The same may be said of losses, in which case the bank loses its management fee, since the management fee is a percentage of the profits obtained. The Islamic bank, therefore, has good reason to ensure the profitability of its operations.

In addition, the Islamic bank is more closely related to its depositors and users of funds, since it must ensure that the use of funds is properly directed and that the enterprise benefits therefrom. In the event of any difficulties, the Islamic bank does not withdraw from the enterprise; rather it evaluates the technical, managerial and financial needs of the enterprise and makes all possible efforts to put it back on its feet.

The financial standards for balance sheet presentation as applicable to Islamic banks, therefore, need to be redeveloped or revised. This will give rise to the relevant considerations regarding capital adequacy, liquidity management and other regulatory requirements. These issues are to be addressed in the context of the fundamentals of Islamic economic and not by merely symptomatic treatment in a conventional

sense. These fundamentals require that the regulatory authorities should, instead of stipulating capital adequacy and other ratios and ceilings, emphasise the ability of the banks to function as providers of the services referred to above. No matter how much capital a bank may provide in relevance to its deposit liabilities, indiscretions due to inefficient or imprudent investment decisions will always lead to unsustainable losses both for the shareholders and the depositors. It is surprising to note that by stipulating capital adequacy ratios, the regulatory authorities ignore the interests of the shareholders, who are also members of the public.

The question of the presentation of on-and off-balance sheet items, therefore, needs to be addressed in the context of the principles and procedures laid down for banks by Islam.

“We sent Our messenger with the Book and the Balance, so that mankind may establish justice”.

(Quran 57:25).

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Auditing of Islamic Banks A Practitioner's Perspective I

Samir T Badawi

Introduction

In theory, the audit of an Islamic bank should be no different in many aspects from the audit of other banks. However, experience shows that to perform the audit of an Islamic bank requires a certain understanding and knowledge of the Islamic *Sharia*, of how Islamic banks develop and put together the various investment vehicles and of the accounting policies to be adopted in preparation for the published financial statements.

The financial Accounting Organisation for Islamic and Financial Institution has been very active in the promotion and development of relevant accounting standards. Although these efforts should be recognised, there still remains a need for the development of a supplement for audit standards. This should cover three areas.

1. The need for the auditor to express a separate opinion on the method of allocation of the profit generated by the Islamic bank between various investors, including its own shareholders.
2. The audit of related party transactions and the extent of disclosure to be made.
3. The risk provisions related to invested funds and to whom such provisions should be reimbursed in case the risks disappear.

While the first and third issues are not common when auditing other banks, the second issue has received great attention by all

accounting bodies in the United States of America and the western world and by the International Accounting Standards. Let us take these three issues in turn.

1. There is a need for an independent opinion to be expressed by the auditor on the method used by the Islamic bank and financial institution to allocate the profit between the shareholders and the investors.

Until now the auditors of the Islamic banks and financial institutions have been required to give their opinion on the fair presentation of their financial statements. This opinion principally serves the shareholders, the regulars and other financial institutions with whom the bank has transactions. It also serves the general public to confirm that the institution in question has a solid base to accept funds and to be credible in managing these funds on behalf of private investors.

Until recently, Islamic banks and financial institutions were not required to publish their financial results except once, at the end of their financial year. However, this practice seems to take a different turn in certain jurisdictions. In Bahrain, where International Accounting Standards have been adopted since 1992, banks and financial institutions with shares publicly traded are now requested to publish their results on a quarterly basis. This rule applies to all banks and financial institutions. Along with this new requirement, it is fair to expect to have an update on the return realised by the bank or the financial institution on the funds left to invest by their customers. To comply with such a request, Islamic banks and financial institutions have a long way to go in developing more sophisticated accounting and management information systems.

An investor with an Islamic bank or financial institution signs a contract whereby he accepts to give them his funds and to share any profit or loss. A contract between an investor and an Islamic bank or financial institution may cover a *murabaha* or a *mudaraba* transaction. The investor will normally place his funds either for a specific project or for the bank or financial institution to use with their own funds at their discretion. The contract clearly defines a number of agreed terms (i.e. the type of investment to be used, the period during which the investor is willing to leave his funds with the *mudarib*, the percentage of profit to be granted to the *mudarib* for managing his funds, the forfeiture of

profit in case of early withdrawal, etc.). At the maturity date or at the end of the financial year, the management of the bank or the financial institution review their overall results. Funds invested in a specific project will be allocated the profit or the loss when the project is completed. The profit accrued to the investor is normally reduced by the fee due to the *mudarib* for managing the fund. Investments left with the *mudarib* may also include liquid funds to be withdrawn without prior notice. These funds, along with other unrestricted investments, are normally mingled with the bank's or financial institution's funds. And, the profit realised on such funds is not shared with such investors. The philosophy is that these funds, are guaranteed by the bank's or financial institution's shareholders and any profit or loss generated from their used should not be shared but revert only to the shareholders. As auditor, I will not comment on the logical merits of such an attitude, since many *Sharia* scholars have voiced their opinion on the fairness of this attitude.

Islamic banks and financial institutions allocate their profit or loss by various methods. In determining the formula for profit or loss sharing, the Islamic bank or financial institution and its management are not governed by any rules or guide-lines. The Mudaraba contract may or may not be very clear on the method to be followed. Even with a method being expressly defined in the contract, experience shows that the final details are left in the hand of the Islamic bank or financial institution with no proper disclosures being made to highlight the methodology adopted in the allocation of the profit or loss of the *mudaraba* or *musharaka* transaction.

The various elements which affect the allocation of the profit or loss between the shareholders and the investors are listed below:

- (a) Not all invested funds are put into transactions. Normally a percentage of these funds will remain liquid to meet future potential requests for liquidation. The percentage of the liquid fund will be determined by the bank management on the basis of prior experience and the period that the investor has accepted to invest his funds with the bank or financial institution. In certain countries, the regulators may dictate the percentage of funds to be left on deposit with the central bank.

- (b) The average funds available from the various groups of investors and the timing of these funds should be made available to each investor.
- (c) The percentage of profit to be granted to the bank or financial institution as a fund manager and to the actual investors should be agreed.
- (d) The method followed by the bank or financial institution to allocate its overhead costs between the various investment vehicles should be disclosed.
- (e) The accounting policies adopted by the bank or financial institution in recognising their revenues and their philosophy of providing for general risk will also affect the allocation of profit or loss.

In my experience, the above elements are not formally and fully discussed or disclosed to the investors. Changes to the treatment of these elements may be unilaterally made by the shareholders and the management of the bank or financial institution without consultation with the other parties who have a direct interest in the amount of profit or loss to be distributed. The bank or financial institution auditor is presently nominated by the shareholders and has no legal responsibility *vis-a-vis* the other investors. The present audit guidelines do not assist him to argue any case of conflict of interest.

Furthermore, it is noted that in practice the individual investors are unable to verify the correctness of the allocation made to them by the bank or financial institution of the profit or the loss generated by their funds.

To verify the profit to be distributed by the bank or financial institution to the participant investors, it is common practice that the auditor of an Islamic bank or financial institution review the methodology and the formula adopted by the management. This verification is done for the purpose of expressing an opinion that the financial statements are fairly stated and that the bank or financial institution's liabilities are not understated. The auditor's opinion is not itself a certification that the profit or the loss have been allocated in accordance with the contractual agreement signed by the bank or financial institution and

the investors. Until such opinion is mandatory, it is very difficult for the investors to accept or argue that their profit-and loss-sharing has been subjected to an independent review by the external auditor of the bank or financial institution.

The recent draft of the accounting standard dealing with the presentation of Islamic banks, and financial institutions' financial statements requires the insertion of a separate accounting policy explaining the method used by the bank in calculating the profit on the invested funds left in their trust. The draft standard does not cover the need for a separate opinion to confirm the accuracy of the allocation of the profit and the loss between the providers of the funds (i.e. the shareholders and the investors). Therefore, it is imperative that guidelines be developed whereby the auditor becomes more responsive to the needs of the participating investors and expresses a separate opinion on the profit and loss allocated to their investments.

2. There is a need to determine what information needs to be disclosed for the related party transactions and to issue clear guidelines for the auditor to adopt in reviewing such transactions.

In the US, the main accounting standard dealing with the issue of related party transactions is the Statement of Financial Accounting Standards No. 57v, which was issued in March 1982 as a codification of the AICPA Statement of Auditing Standards No. 6, Related party transactions (SAS 6) and its interpretations. The SAS provides the guidance on how to review and identify related party transactions. A number of other pronouncements, including SFAS 68 - Research and Development Arrangements and SFAS 13 - Accounting for Leases and various Staff Accounting Bulletins issued by the SEC establish the disclosure requirements.

In the UK, the only proposed standard for the disclosure of related party transactions is ED 46. For many years, the financial reporting of related party transactions has been significantly affected by the Department of Trade and the Companies Act requirements.

International Accounting Standards (IAS 24) requires disclosure of all material transactions with related parties. Here we will focus more on the International Accounting Standards and will try to view the problems which are faced by the auditors of Islamic banks and

financial institutions.

Related party relationships are a normal feature of commerce and business. The definitions offered by IAS 24 are summarised in the following paragraphs.

- Related parties are considered related if one party has the ability to control the other or exercise significant influence over the other party in making financial and operating decisions.
- Related party transaction means a transfer of resources or obligations between related parties, regardless of whether a price is charged.
- Control ownership, directly, or indirectly through subsidiaries, means control of more than one half of the voting power of an enterprise, or a substantial interest in voting power and the power to direct, by statute or agreement, the financial and operating policies of the management of the enterprise.

Significant influence means participation in the final and operating policy decisions of an enterprise, but no control of those policies. Significant influence may be exercised in several ways, usually by representation on the board of directors, but also by, for example, participation in the policy-making process, material inter-company transactions, interchange of managerial personnel or dependence on technical information. Significant influence may be gained by share ownership, statute or agreement.

Most Islamic banks and financial institutions are related through ownership and management. Excess funds and many investment vehicles and opportunities are presently shared by more than one Islamic bank and financial institution.

For an auditor of an Islamic bank and financial institution, the burden is larger in reviewing related party transactions. First, an Islamic bank and financial institution should have an accounting system which identifies such transactions. Secondly, the bank or financial institution required to design and to implement a strong

internal control system whereby any related party transaction is carefully scrutinised and approved by the proper level of authority. In many countries, the regulators have made it mandatory to disclose, and to seek approval of, certain categories of related party transactions. These transactions involve their shareholders and their families, the directors and their remuneration, the existing banking facilities and their terms, inter-company transactions and investments and balances with group and associated companies.

The draft standard on disclosures to be made by Islamic banks recently circulated by the Financial Accounting Organisation for Islamic Banks and Financial Institutions seems to cover this area adequately. However, guide-lines to the auditors on how to perform his assignment when auditing an Islamic bank or financial institution need to be developed to meet the present cross-relationships existing between these banks. Through a recent review of the audited financial statements, I discovered an interesting note to the financial statements of an Islamic institution, where the management decided that it was not practical to disclose the details of the related party transactions. The note vaguely indicated that because of the small size of the Islamic banks and financial institutions the intermingling of the shareholders and the major groups controlling them and the complexity of the transactions involved, it was difficult for the bank or financial institution to disclose the related party transactions.

3. We now come to the risk provisions covering the managed funds and to whom they should revert in case of the risk disappearing.

The provisions recorded by Islamic banks or financial institutions in determining their profit or loss for the year may be classified in the following manner:

- a) Provisions for doubtful accounts
- b) Provisions for a permanent decline in the value of an investment (i.e. real estate, long term investment in a company, or a drop in the value of a marketable security).
- c) Provision for any contingent liabilities due to outstanding litigation.

As these charges are judgmentally developed and not definitive in nature, a question is raised by the auditor as to how conservative the

management should be at the end of the year in setting aside these provisions and who will be the beneficiary of these provisions if they are released in the future, keeping in mind that an Islamic bank or financial institution has two types of investors, those who are long-term (the shareholders) and those who are short-term only.

It may be argued that the experience of the Islamic bank or financial institution is short in history and that we should enhance this new experiment by trying to keep their progress slow but steady. A very important question that needs to be addressed is how we should disclose the provisions made at the end of the year and who is entitled to receive the benefits in case the provisions are reversed. A close look at what the management of an Islamic bank or financial institution is doing at the present time will get us back to the old days when normal banks used to have what is well known as an "inner reserve". By overproviding today and later reversing these provisions, the management of an Islamic bank or financial institution is trying to smooth future years earnings, an issue which intimately concerns the auditor of the bank, the shareholders, the regulators and the short-term investors.

A review of the financial statements of a bank or financial institution which has an overprovision will not detect it. For the auditor, the presentation of an asset after deducting the overstated provision will not be fair and may put a question mark on the "true and fair view" opinion he is expressing. For the shareholders, the equity shown in the financial statements does not indicate the strength of a bank which is carrying an overstated provision for risks which are judgmental in nature. The same argument goes for the regulators. As for the short-term investor, his profit will be understated because of the excess provision made by the bank or financial institution to meet certain contingencies which are difficult to identify.

All these problems require a detailed review by the profession in order to codify the alternatives to be followed by auditors when performing their work on Islamic banks and financial institutions.

Auditing of Islamic Banks A Practitioner's Perspective-II

Khalid Abdulla Janahi

On-and off-balance sheet issues

In the context of Islamic banking, there are currently no established criteria for the accounting treatment of customer deposits in respect of which the associated risks and rewards are borne by the investor.

Accordingly, the dilemma surrounding the treatment of such deposits or investment accounts, i.e., whether these should be included within the Islamic bank's balance sheet or reflected off-balance sheet has, for some time, been the focus of attention of eminent Islamic scholars, jurists and professionals. However, the debate continues and no consensus has as yet been reached on the uniform treatment of investment accounts.

Additionally, formal accounting standards have not as yet been developed specifically for Islamic banks and financial institutions and therefore there are no formal rules and regulations governing the accounting treatment of investment accounts. The resolution of this matter is not an easy one, since, as discussed below, there are a number of tenuous issues arising from both methods of treatment.

Certain Islamic banks include investment accounts within their balance sheet, whilst others reflect such accounts as funds under management off-balance sheet. The classification of investment accounts, either on-or off-balance sheet is, at times, also determined by the

regulatory environment in which the Islamic bank operates. The differing treatment adopted by Islamic banks in respect of their investment thus renders compatibility and comparability of financial statements of individual Islamic banks difficult, if not meaningless. The issue becomes further compounded in the case of multinational Islamic financial institutions, where, for example, the holding company, which does not have regulatory constraints, classifies investment accounts off-balance sheet, whereas its subsidiaries or branches operate in countries which require investment accounts to be included within the balance sheet.

Islamic banks which distinguish between on-and off-balance sheet investment accounts apply the risk and recourse criteria in classifying such accounts as either on-or off-balance sheet. Funds managed by Islamic banks without risk and recourse to the bank are reflected off-balance sheet and not co-mingled with the bank's own assets and liabilities.

On the other hand, if investors place funds with the Islamic bank without recourse to the customer, these funds and their ultimate investment are co-mingled with the bank's own assets and liabilities.

Islamic banks which include all investment accounts, irrespective of the risk and recourse criteria, within their balance sheet, co-mingle such investment accounts with their own assets and liabilities. However, certain banks, which have assets with maturities in excess of five years, tend to designate such assets as their own assets, financed by shareholders' funds and not by investment accounts.

Such banks, however, exclude from their balance sheets investor funds, which are managed on a non-discretionary or "restricted" basis. These funds are accordingly reflected off-balance sheet.

Issues associated with classification of investment accounts on-balance sheet

Following are some of the issues which may arise if discretionary investment accounts are reflected within an Islamic bank's balance sheet irrespective of the risk and recourse criteria:

- a) The inclusion of all investment accounts within the balance sheet of an Islamic bank may have the effect of considerably

inflating its balance sheet and may consequently give rise to capital adequacy issues. As a result, Islamic banks may be required to increase their capital base in order to comply with internationally stipulated capital adequacy ratios.

- b) Certain countries have regulatory requirements which restrict banks from extending credit facilities to non-licensed deposit-takers in excess of a stipulated percentage of the bank's capital and reserves..

Inclusion of investment accounts on the balance sheet may result in Islamic banks, encountering difficulties in complying with these regulatory requirements, since it is not unusual for customer funds to be invested in individually significant financing transactions. Islamic banks may therefore have to reduce the size of individual credit exposures and/or increase their capital base to an appropriate level in order to comply with regulatory requirements.

- c) Since the assets and liabilities of the bank's managed funds are to be co-mingled with those of the bank, elaborate internal accounting records, systems and procedures may need to be developed and maintained in order adequately to segregate the bank's own assets and liabilities from those of its managed funds. Care may also need to be exercised in circumstances where the bank is investing in certain transactions jointly with its customers.

Issues associated with classification of investment accounts off-balance sheet

a) Issues associated with borrowing from, and lending to, managed funds

Islamic banks which classify investment accounts managed on a "without risk and recourse basis", off-balance sheet, designate such accounts as "managed funds" or "funds under management". These banks may at times borrow from and lend to their managed funds, such transactions occasionally reaching significant proportions.

Before expanding upon the issues associated with borrowing from and lending to managed funds, it would be useful to understand the circumstances under which Islamic banks may borrow from and lend funds to their managed funds.

Borrowing from the bank's managed funds may be undertaken under the following circumstances:

- (i) Islamic banks are constrained from raising funds in the conventional money market and therefore, at times, may resort to borrowing available funds from their managed funds.
- (ii) in certain situations, an Islamic bank invests in assets which are denominated in currencies in which the bank may not have available financing resources. In order not to expose itself to foreign currency, the bank may borrow the required currency from its managed funds.
- (iii) Under certain other circumstances, the Islamic bank may be faced with a situation in which it has under taken a relatively high-risk, off-balance sheet investment for which it may not have available investor funds for that particular type of transaction.

The Islamic bank may therefore borrow funds at its own risk from off-balance sheet investors who wish to invest in comparatively low-risk, liquid instruments and invest these funds in the off-balance sheet, high-risk transaction.

The Islamic bank may lend to its managed funds under the following circumstances:

- (i) When the bank enters into significant financing transactions on behalf of its managed funds, it may not be able initially to obtain sufficient off-balance sheet funds to invest in the transaction. Consequently, the bank may initially provide the funds to cover the financing shortfall and subsequently repay itself as and when off-balance sheet funds for the particular transaction become available.
- (ii) From time to time, the Islamic bank may lend to its managed funds in order to cover temporary shortfalls arising from investor withdrawals.
- (iii) The bank may also lend to its managed funds under the scenario envisaged in (iii) above, whereby it may borrow funds from off-balance sheet investors wishing to invest in low-risk, liquid instruments and invest the funds in relatively high-risk, off-balance sheet transactions.

The following issues may arise as a result of borrowing from and lending to managed funds:

- (i) Borrowing from and lending to the bank's managed funds may have the effect of inflating an Islamic bank's balance sheet, particularly if such borrowing and lending reaches significant proportions. The resultant inflation of an Islamic bank's balance sheet may have adverse effects on its financial position, particularly in relation to capital adequacy issues.
- (ii) Borrowing by an Islamic bank from its managed funds may raise certain arm's length issues, particularly in respect of the rate at which it borrows these funds from its off-balance sheet investors. Since Islamic banks are prohibited from receiving or paying interest, in respect of which comparative market rates are readily available, it may be difficult to compare the rates of return paid by the bank on borrowing from its managed funds with the rates of return which the investors would have obtained in respect of alternative Islamically acceptable instruments and it is almost certain that at some stage the practice may be challenged accordingly.
- (iii) Islamic institutions which rely to an extent on obtaining funds from their off-balance sheet investors to finance their own assets may be exposed to potential liquidity problems, particularly in the event of a significant level of withdrawal of investors' funds. In the event of non-payment of such debts, the institution will almost certainly encounter legal problems with respect to fulfilment of its fiduciary duties towards the investors.
- (iv) On the other hand, Islamic banks may also face liquidity issues in respect of potentially long-term commitments arising from financing off-balance sheet transactions for which the Islamic bank may be unable to attract sufficient investor funds to replace its own initial financing. Such a situation may also be construed to prejudice the interests of the shareholders of the bank, who, in substance, predominantly bear the responsibility of supporting the bank's managed funds in view of the *Sharia* restrictions placed on Islamic banks in respect of raising external sources of funds to finance their managed funds.

- (v) As a corollary to (iv) above, Islamic banks may expose themselves to credit risks which are disproportionate to their corporate size and consequently may incur potentially large financing losses.

b) Fiduciary issues

Other issues arising from the treatment of managed funds off-balance sheet may have certain fiduciary connotations. It would, therefore, be appropriate at this juncture to perhaps elaborate on the concept of "fiduciary" before dealing with the issues associated therewith.

One of the most important responsibilities of an Islamic bank is the diligent performance of its fiduciary duties and obligations to its investors.

Investors place a great deal of trust in Islamic institutions, since they provide funds at their own risk and without recourse to the Islamic bank. Quite often the investor permits the Islamic bank to invest his funds at the sole discretion of the bank.

Islamic banks, therefore, have an onerous duty to their investors and are thus required to perform their fiduciary role to the best of their ability and in the best interests of their investors. The fiduciary responsibility of an Islamic bank extends to include the exercising of due care and diligence to ensure that customer funds are invested in accordance and in compliance with the Islamic *Sharia*

Following are some of the potential fiduciary issues which may arise:

- (i) Islamic banks, in order to remain competitive with other conventional banks, may attempt to provide their investors with returns on investments which appear to be consistently comparable to prevailing market rates. In order to achieve this, some Islamic banks may establish off-balance sheet provisions or reserve accounts. When managed investments yield returns in excess of market rates, this provision account may be credited with such excesses, thereby aligning actual yields with market-comparable rates of return.

During leaner times, when the yields on investment fall below market rates of return, the provision account may be utilised to

release funds sufficient to cover the shortfall, thereby artificially inflating returns to investors. The use of such techniques may result in the Islamic bank potentially compromising itself in the performance of its fiduciary duties, since investors may be under the misconception that their funds are actually yielding market rates of return. The situation might deteriorate if the provision account had been fully utilised, thus resulting in a decline in actual rates of return. Such a situation may reflect adversely on the reputation of an Islamic bank and consequently may cause investors to doubt its competence as a *mudarib*.

Another related issue arises when provisions are required to be established in respect of non-performing, off-balance sheet investments. The creation of such provisions off-balance sheet may have an adverse impact on investor return, which, as a consequence, may tend to decline.

In order to avoid such a situation, Islamic banks may adopt the route of establishing equivalent provisions on-balance sheet and assign such provisions to cover the off-balance sheet shortfall in provisions. On the other hand, Islamic bank may be reluctant to establish even on-balance sheet provisions to cover such shortfalls.

The adoption of such a treatment has the effect of masking the true quality and performance of the assets in which customers have invested their funds and may therefore potentially result in the bank breaching its fiduciary duties.

The allocation of on-balance sheet surplus provisions to cover the off-balance sheet shortfall in provisions may have wider implications, since this treatment may effectively reduce returns to the shareholders of the bank and may therefore be detrimental to their rights and interests.

Another example whereby the interests of shareholders may be adversely effected is when managed funds are not performing satisfactorily and the bank, in its capacity as *mudarib*, waives its management fees in order to maintain adequate returns to its investors. This practice may have a negative impact on the profitability of the bank itself and consequently may prejudice the interests of its shareholders.

- (ii) Islamic banks are under constant pressure to maintain adequate returns to both their shar-eholders and their investors. this may result in the bank resorting to the transfer of assets either from, or to, its managed funds, sometimes at values other than the fair value of the asset. This practice is undesirable and could result in a breach in the performance of the bank's fiduciary duties as well as jeopardise the interests of both its shareholders and investors.
- (iii) Islamic banks, as a rule, enter into standard agreements with their off-balance sheet customers. These agreements, which require to be approved by the bank's Religious Supervisory Board, formalise the relationships between the bank and its investors and set out the terms and conditions, as well as the rights and obligations, of both the bank and the investor. These agreements generally protect the interests of the bank and tend to provide the bank with a free hand in the investment of funds, obviously without recourse to itself.

However, certain investors stipulate the parameters within which they wish to invest their funds and accordingly specify the type and tenor of the investment in which they wish to place their funds.

The Islamic bank is, therefore, under a fiduciary obligation to comply with the terms and conditions of the agreement as well as any restrictive covenants which the investor may stipulate. Accordingly, if the Islamic bank failed to comply with the terms and conditions of the agreement, as well as with the specific instructions of the investor, it would breach its fiduciary obligations to its off-balance sheet investors.

- (iv) Islamic banks offer a wide range of *mudarabas* in which off-balance sheet customers may wish to invest their funds. Each *mudaraba* is structured differently and its salient features include the tenor of the *mudaraba* and the underlying assets in which customer funds will be invested. The Islamic bank is therefore under a fiduciary obligation to its customers to ensure that funds are invested in accordance with the objectives and the tenor of the *mudaraba*. Fiduciary issues arise when customer funds are invested in a manner which may be inconsistent with the stated objectives and the tenor of the *mudaraba*.

c) Sharia compliance issues

Having discussed fiduciary issues which arise mainly from the relationship between the Islamic bank and its off-balance sheet investors, it would be logical to proceed to *Sharia* compliance issues which external auditors of Islamic banks may be required to deal with. However, it should be noted that Islamic banks are required to comply with the covenants of the *Sharia*, irrespective of whether investment accounts are classified on-or off-balance sheet.

External auditors may come across *Sharia* compliance issues which may arise from the following situations:

(i) Post facto review by the Religious Supervisory Board

In the recent past, Islamic financial institutions have structured and developed innovative Islamic financial instruments and transactions bearing in mind the compliance requirements of the *Sharia*. These institutions strive to obtain the approval of their in-house Religious Supervisory Boards before entering into new transactions or marketing new instruments.

However, at times, due to commercial considerations, approval for these transactions and instruments may be sought on a *post facto* basis and as a result it may be too late to address *Sharia* compliance issues which may arise from the review of these transactions and instruments by the Religious Supervisory Board.

(ii) Inadequate or incomplete submissions to the Religious Supervisory Board

Financing instruments and transactions may be submitted to the Religious Supervisory Board in their legal and commercial forms without sufficient details and explanations in respect of the underlying substance of these transactions. Consequently, the instruments and transactions may be approved by the Religious Supervisory Board without a full appreciation of the *Sharia* issues and implications associated therewith. These issues and implications, therefore, come to light at a later stage, most often during the course of the external audit. Management, then, have to address these issues to the Religious Supervisory Board in order to have them regularised.

(iii) The concept of the *Sharia* audit

An Islamic bank found to be in breach of its fiduciary duties, or in contravention of the covenants of the *Sharia* could potentially expose itself to litigation from its investors as well as from third parties. The external auditor of an Islamic bank, therefore, has an “unwritten” duty to verify that the Islamic bank is properly discharging its fiduciary functions as well as complying with the covenants of the *Sharia* and is consequently required to report upon any breaches which may occur.

In order to ensure that Islamic banks comply with the requirements of the *Sharia* as well as in the performance of their fiduciary duties and obligations, close co-operation is required between Religious Supervisory Boards and external auditors. Currently, there are no formal rules and regulations to ensure compliance in these respects.

The introduction of the concept of the “*Sharia* audit” would ensure *Sharia* and fiduciary compliance and would also assign formal responsibility to ensure such compliance.

The *Sharia* audit could be performed either by the Islamic bank’s external auditors or by its Religious Supervisory Board.

The performance of the *Sharia* audit by the bank’s external auditors would ensure that adequate independence was maintained. However, the external auditors would require to have the necessary competence and expertise to deal with *Sharia* and fiduciary compliance issues.

On the other hand, if the in-house Religious Supervisory Board of an Islamic bank were to carry out a *Sharia* audit, it would have to be sufficiently independent in order to ensure an effective audit. Additionally, the Religious Supervisory Board would also require the requisite skills and expertise to address and resolve the resultant accounting issues and implications. However, it should be noted that some Islamic banks have “*Sharia* internal auditors” who are also members of the bank’s Religious Supervisory Board. These “auditors” monitor *Sharia* and fiduciary compliance on an on-going basis and report their findings to the Religious Supervisory Board.

Under either of the above scenarios, an Islamic bank’s Religious Supervisory Board and its external auditors will require to liaise closely with each other on an on-going basis in order to ensure that

potential *Sharia* and fiduciary compliance issues, which the Islamic bank may be exposed to, are addressed and resolved on a timely basis.

The establishment of rules and regulations as well as a code of practice, for the performance of a *Sharia* audit would go a long way in effectively ensuring that Islamic banks comply with the covenants of the *Sharia* as well as perform their fiduciary duties and obligations to their investors.

The Accountant's Role in The Islamisation of The Economy

Ebrahim Sidat

Introduction

The judgement of the Federal *shariat* Court of Pakistan which decreed the giving or taking of interest to be repugnant to the injunctions of the Holy Quran and Sunna is a decision which we accountants can ignore only at great risk, not only to our profession as a whole but also to our wellbeing as individual believers in a religion which gives us a complete code to live by. The Islamisation of the economy is so important that we, as members of an enlightened and accountable profession, should not allow ourselves to sink into apathy about it, which would show indifference to our professional and ethical ideals.

A host of practical problems arise when we try to change the economic system in accordance with the tenets of the *sharia*. We must therefore try first to understand what the fundamental concepts and principles of an Islamic economy are, what the transitional problems are which are likely to arise and the role which we will be called upon to fill in this emerging situation.

The concept and philosophy of an Islamic economy

The economic systems which have been prevalent throughout history and still exist leave a lot to be desired, to say the least. The greed for material wealth alone and its moral and social consequences -

poverty, hunger, grief and gloom among the less fortunate - bear testimony to the appalling state of affairs to which mankind has been brought by ignoring religion in his economic systems.

In this chapter, I intend to give an overview of significant Islamic economic principles and doctrines, as set down in the *Sharia*, so as to enable the reader to get a better comprehension of the issues involved.

The goal of an Islamic economy and, indeed, of every human endeavour, is the establishment and maintenance of the wellbeing of a human society, a concept enshrined throughout the Holy Quran. This concept is inherently so comprehensive that it covers all aspects of spiritual, cultural, political, social and economic wellbeing.

In practical terms, this concept implies a society in which:

1. Individuals are provided with opportunities for being gainfully employed within the dictates of the *Sharia*.
2. Individual dignity is not only recognized but manifested in actions.
3. Freedom from want and adherence to moral and social values for the elevation of the spirit and the attainment of material benefits is accorded the highest priority by both the individual and the state.
4. Individuals and groups are safeguarded from all forms of exploitation.

To accomplish all this demands that we observe one of the fundamental teachings of the Quran, namely, that society be governed on the two strong pillars of justice and beneficence.

Thus the foundations of an Islamic economic system may be seen to be based on justice, equity, human dignity, freedom of enterprise, and a fair relationships between individuals and society with a view to reaping the benefit of the vast potential underlying the human and material resources of society in a planned, orderly and harmonious manner.

The fundamental premise is the supreme concept that "absolute ownership of everything belongs to God alone". yet it is the virtue and strength of the Islamic economic system that despite God's exclusive ownership of everything in the universe, the utilisation and enjoyment

of wealth by individuals and groups is not only recognized but safeguarded by society. In fact, earning one's living without exploiting others by lawful and legitimate means is one of the obligations ordained for every person by the *Sharia*, which recognizes the right of all sections of society to share in the wealth of the society.

From this emerges yet another fundamental doctrine - the emphasis on keeping resources in constant circulation by using them in productive and profitable channels so that wealth does not accumulate in any one section of society. This obligation is observed both through legal sanctions and, perhaps more importantly, by securing the voluntary compliance of the people. This combination of legal sanctions and voluntary compliance permeates the entire fabric of the Islamic social system.

From the foregoing overview of the ethos of the Islamic economic and social system, the principal features which emerge are:

1. An individual has the right to seek his economic wellbeing, provided he shows conscientious and due regard for what is permitted (*halal*) and what is forbidden (*haram*)
2. No economic activity, either individually or collectively, is permitted which is, in form, extent or manner, morally or socially injurious to mankind.
3. In the matter of spending, too, it is obligatory to act judiciously and in accordance with the *Sharia*. By implication, it can be seen that there is also the obligation not to hoard wealth, nor to keep it idle and certainly not to squander it.

With regard to surplus wealth, the Islamic economic system has propounded a unique system. The margin of surplus has to be reasonable and must be utilized for the wellbeing of the community as a whole, particularly its less fortunate subjects, the destitute and deprived. Thus came into being the concept of an organized system of *zakat* (alms), to which everyone must contribute. This is one of the five basic tenets of the *Sharia*.

Another way in which Islam curbs the worst consequences of the tendency of wealth to accumulate among a few to the detriment of society as a whole is by following the well structured and equitable laws of inheritance found in the Quran (4:11-12)

To sum up, the Islamic economic system, as envisaged by the Quran and the *Sunna*, aims for social justice as its fundamental objective without in the least inhibiting individual enterprise. This requires a delicate balance to be kept, so that the quest for individual wealth does not become collectively perilous, which would in any case also be destructive for the individual.

The Elimination of Interest—a Fundamental Imperative

As a set of principles emerging from the Divine Revelation, the Islamic economic framework embraces all aspects of human life and conduct. While it is true that the elimination of interest from banking and financial transactions will not, in itself, change the conventional financial system to an Islamic one, it nevertheless occupies a key position in the transformation. Charging and paying interest must be replaced by participation in profits and losses for all involved.

Islamisation of the Economy in Pakistan

It is noteworthy that the Council of Islamic Ideology (CII) has laid strong emphasis on the concept of profit-and-loss-sharing as the fundamental premise of financial intermediation. In consonance with this recommendation, the Islamic instruments of *musharaka* and *mudaraba* have been permanently recognised as not only the most truly Islamic modes of financing but also the most preferred ones if meaningful progress is to be made towards an interest-free economy.

Other modes of financing such as mark-up, hire purchase, leasing, etc. have been given qualified approval by the CII, but with a strong caution that such modes should be kept to a minimum.

Twelve approved modes of long-and short-term financing formulated by the State Bank of Pakistan (SBP) were introduced, the principal ones being:

1. Mark-up
2. Leasing
3. *Mudaraba*
4. Term Finance Certificate (originally called Participation Term Certificates (PTCs))

5. *Musharaka*

6. *Murabaha and bay-muajjal*

Let me make so bold as to say that many of the measures initiated up to now suffer from conceptual, structural and legal deficiencies of a very serious nature. Such forms of interest-free banking are merely cosmetic.

In all fairness, I must say that if this admittedly half-hearted approach, however deficient, had not been taken over the last decade or more, we would not, perhaps, be discussing this subject today. What is regrettable is that having introduced these substantially questionable forms of interest-free financing, there is now a great deal of apathy on the part of government, banks, financial institutions and businesses to go any further towards genuine Islamic modes in the form of PLS.

More than a decade has now elapsed since the adoption in Pakistan of various measures to transform the economy into a system truly in accord with the *Sharia* injunctions, yet we are today far from the realisation of this goal.

The reasons are complex and varied and, to my mind, the crucial cause has been the cosmetic nature of the reforms and the lack of commitment on the part of all concerned (accountants included) to approach the problem so as to realise the objective of a true transformation.

No measure was initiated in Pakistan to put in place an institutional mechanism or framework for an overseeing function which would review and evaluate the new banking and financing arrangements as to whether they conformed, in letter and spirit, to the dictates of interest-free financing as enunciated by the *Sharia*.

For instance, the so-called *musharakas* as presently conducted raise significant issues of serious concern as to propriety and deviation from *Sharia* -mandated course of action.

Most of the contracts for financial arrangements of various types which we come across in our professional practice invariably give an impression that not only in substance, but also in form, our banking and financial system has hardly made any departure from the interest-based system we have been witnessing over the years.

The interest-based orientation on the part of banks and financial institutions and their reluctance to share genuine business losses with their clients (all in the name of safeguarding the interest of the deposit-holders) has raised the cost of financing to as high as over twenty two per cent and perhaps even more in many instances.

The continuing and perhaps increasing lack of credence of entrepreneurs in financial institutions has resulted substantially from less than full financial disclosure of the institutions' results of their operations and this has struck an almost fatal blow to the system, not only in its nascent stages but even continuing today.

PTCs, which accorded more closely to the *Sharia* principles of financing, were promptly dispatched to the archives and replaced by TFCs on a mark-up basis, which action was, in my personal view, a highly retrograde step which has reversed whatever modicum of progress we had made in the field of interest-free financing.

Savings schemes of various sorts in highly fashionable forms, all based on a fixed periodical return and blatantly contrary to the *Sharia* injunctions continue unabated. What is more, some of the *mudaribs* are to be heard openly demanding that they be allowed to issue fixed-return investment securities for the mobilisation of funds.

Issues For Consideration Of The Accounting Profession

I would most humbly submit that to my mind the most crucial responsibility which a truly Islamic economic system, observed in letter and spirit, casts on us as accountants, whether in public practice or industry, is to recognize, with total conviction, that interest has been totally forbidden by Allah and, therefore, we should strive to assist in the process of the transformation of the system in accordance with *Sharia* principles.

In order to achieve this primary objective, we need to broaden the horizon of our knowledge of the fundamental principles of Islamic economic in general and interest-free banking and financing in particular. It is, therefore, inevitable that at individual and institutional levels, we should endeavour to acquire a thorough understanding of the truly Islamic modes of financing which may be used for funding long-and short-term business needs.

There is an urgent need to realise that the operational basis of Islamic banking and finance has to be, in concept and practical implementation, different from the conventional interest-based arrangement which has, as its so-called immutable basis, a fixed, determined cost of funding. This conventional approach to banking and finance emanates from a time-value concept of money, as perceived culturally, legally and financially. It is a way of life and of doing business under the Western system, as opposed to the principle of profit-and-loss-sharing, both on the liabilities and deposits side of banking and on the assets side, in term of the utilisation and application of funds.

The concept of risk-capital as the fundamental plank of Islamic financial arrangements needs to be implemented so that capital is not rewarded if there are no profits from the relevant business operations and so that losses are equitably shared according to the extent of the investment provided by various sources, including the entrepreneurs and the financial intermediaries, be they banks, financial institutions or *mudarabas*.

I need not emphasise that *musharaka* and *mudaraba*—by a universal consensus of juristic opinion—are considered to be, if properly operated according to the tenets of the *Sharia*, not only the most significant but perhaps the most preferred forms of interest-free financing in its true spirit. In our professional practice as accountants, we come across various forms of financial arrangements which are claimed to be interest-free, but which are true only in form, while in substance and reality, they smack grossly of the interest-ridden system.

We, as accountants, need to be reasonably knowledgeable to evaluate a financial arrangement concluded between a fund user and a bank or financial institution and determine whether it stands the test of scrutiny on the basis of *Sharia* injunctions or not, and then to deal accordingly while preparing financial statements or reporting upon them.

One peculiar feature inherent about most of the existing so-called interest-free financial arrangements practised over the years is that banks and financial institutions participating in such arrangements appear to be apprehensive in outlook and over-cautious in approach.

This inevitably makes a mockery of the economic system all in the name of Islam.

Let me readily concede that this state of affairs stems from the hard facts of life in our commercial world, where morality and adherence to the requirements of full disclosure leaves much to be desired. In this context, allow me to revert to the important subject of the credibility of, and the degree of reliance placed on, the financial statements with which we, as accountants, have an inextricable relationship and obligation.

Interest-free modes such as *musharaka* and *mudaraba* lean heavily on a reliable set of financial statements with full, proper and objective disclosure as the basis for a participatory arrangement on a profit-and-loss-sharing basis.

In the context of interest-free financial arrangements, the effect of the oft-repeated allegations of lack of credibility and the resultant allegedly concocted financial statements has been that *musharakas* in the true sense remain an unattained goal.

It is often contended by the concerned quarters that this weakness or limitation is a factor which can put the whole banking and financial system into a state of perilous upheaval. Most reports and formal discussions on the subject recognise this lack of credibility as the principal impediment thwarting our progress towards a transformation to an interest-free system in the true sense of the term.

I, therefore, wish to emphasise that the "comfort level" on the part of institutional finance is so terribly low that the accounting profession, on most occasions, is hard put to it to defend themselves against allegations. I, therefore, visualise the role of the accounting profession, in the context of the Islamisation of the economy, as being to do, and to be seen to be doing, everything possible not only to dispel the allegation of being a party to, or having abetted, the alleged manipulations, but also to take concrete steps to restore and reinforce the credibility of our "attest" function through audit as a recognised institution in the "corporate-compact".

As we are aware, financial accounting is not intended to add economic substance that is not already established by the risks and rewards associated with a transaction or an extent or a set of circumstances.

Rather it is intended to capture, express and reflect those risks and rewards suffered or enjoyed by an entity as a result of its transactions, events and circumstances. Despite this reality, while auditing financial statements, we should not be oblivious of the compelling need to reflect a financial arrangement, be it a *musharaka* or any other mode, according to the true substance of the transaction or financial arrangement rather than its form. This is a requirement of International Accounting Standards as well and it is now all the more incumbent upon us, while performing audit, to be duly conscious of this obligation.

This brings me to yet another role which we as a profession are required to discharge in the context of interest-free banking and financing. This is the need to review current accounting standards so as to ensure that interest-free financial transactions are properly accounted for and disclosed in the financial statements.

Accounting principles for revenue recognition and accrual have a critical role to play in the context of interest-free modes of financing, and I feel that there is an urgent need to review conventional accounting principles in this regard.

Similarly, the treatment and disclosure of profit/loss to be shared under interest-free forms of financial intermediation also need to be reviewed. To continue to treat these as "financial charges" or correspondingly as "income" in the conventional sense would, in my view, be a blatant misrepresentation.

Buying and selling under *murabaha* and *bay-muajjal* require special consideration for accounting treatment and financial statement disclosures. It would be naive to accord an accounting treatment to these regardless of the commercial substance and reality of the transaction.

Definitions of the shareholder's or owner's equity and of the reserves of an enterprise may need to be given a different connotation compared to the past when it comes to sharing profit/losses under an interest-free system. This is again an aspect we can hardly ignore in our consideration and review of the existing accounting principles and standards.

While the list of such issues cannot be exhaustive, and mine is certainly not, another aspect with serious practical implications is that

of at what point the ownership and title in the goods should be seen to change hands in a variety of complex interest-free transactions. Since aspects related to property and title in the goods have a strong bearing on appropriate accounting treatment and disclosure, to disregard such aspects would be tantamount to shirking our responsibility as professional accountants.

Financial statement disclosures need a fresh hard, look from the perspectives of both the fund-using entity and the provider of funds. A more objective presentation and harmonization in the treatment and disclosure of interest-free financial intermediation is inevitable if we are to render comparability of financial statements more meaningful. This is an important consideration which cannot be disregarded if we are to assist the decision-making process by infusing greater confidence in the various users of financial statements, and more importantly, in banks and financial institutions who may expect to participate on a profit-and-loss basis, both on the assets side as also with the depositors.

The evaluation of the current audit approach, procedures and techniques to determine their adequacy in the context of Islamic modes of financing is an aspect of no less significance. Both while conducting individual audits as also in our professional work as a whole, we need to be conscious of adopting audit procedures and techniques not mechanically, with a procedure-driven approach, but with a risk-driven one, with a deliberate realization of the fact that the profit or loss, is now to be shared not only by the conventional owners of capital but also by the banks and financial institutions which may have provided finances.

Coming to the raising of funds through public flotation, the publication of a prospectus with full, realistic and true disclosure occupies a very crucial position. The auditors' report to be embodied in the prospectus therefore requires more than usual attention in terms of observing "due care and diligence". Some consideration should now be given to projected financial statements, with an auditors' opinion thereon, so that the prospectus becomes more meaningful.

Finally, on the question of the appointment of auditors — and their independence — it is often alleged, especially in recent years, in many informal and formal discussions at official forums, that auditors owe their allegiance to corporate managements or to sponsor directors,

with little or perhaps no regard for the shareholders who legally and technically appoint them. On many occasions, it is vigorously argued, with great feeling, that auditors' independence is a myth rather than a reality. It is a question of conflicting loyalties and demands that we carry out a sincere soul-searching exercise.

The establishment of a system of self-regulation of the profession if we are to survive and progress in the national and international marketplace as a respected profession worthy of being trusted and relied upon is a matter which requires considerable and well-directed institutional efforts.

In this context, the profession's quality control (QC) procedures, both within the professional firms and through the oversight function of the professional accounting body and QCR, also needs to be reinforced and strengthened.

Adherence to the code of ethics of the accounting profession needs to be given more attention and any aberrations therefrom strictly disciplined if we, as a profession, are to be seen supervising the profession and safeguarding public interest as one of our dominant concerns.

Conclusion

Having captured my humble thoughts on the subject, let me reiterate that while the road to the ultimate goal of a truly conceived interest-free economic system, substantially in accord with the immutable dictates of the Holy Quran and the *sunna*, is long and thorny, given belief, commitment and perseverance on the part of all concerned, the impediments, both real and perceived, will give way ultimately to a sound and vibrant system.

Once the interest-free system makes appreciable progress, there will be, in the society, a growing desire for greater accountability and we, as a profession, should reinforce our professional and ethical standards not only out of a craving for a higher degree of professional excellence, which should always be paramount, but more as our religious commitment to the goal of making the interest-free economic system a success.

I have repeatedly said, and would once again reiterate, that in a large measure, the success of an interest-free economic system depends upon the degree of public confidence and the vitality of audit as an institution which lends credibility to audited financial statements. Apart from professional competence, integrity and independence, we need to be conscious of a multitude of practical problems which will keep cropping up in a dynamic environment while we tread the path towards an interest-free economy.

I am reminded of a saga of a pilgrim quoted in the book *unaccountable accounting* by A.J. Briloff, who aptly narrates, "A pilgrim set out on a long quest in search of the ultimate answer to the enigma of men's role on earth. After a tortuous road, he discovered that the answer was within the 'self'. and it is there that one is constrained to search for it". The issues in the context of the Islamic economy are ethical, not technical or legal and, therefore, the success of the system demands integrity and commitment. For our part, as accountants, we should not fail to respond to the need of the hour.

The Role of Sharia Supervisory Boards in Setting Accounting Policies in Islamic Banks

Ahmed Ali Abdallah

Since the inception of Islamic banks, *Sharia* Supervisory Boards (SSBs) have developed rich and varied experiences in regard to both the form and substance of *Sharia* supervision and control. Different types of SSBs, as well as different levels of jurisdiction, have also taken shape, namely:

- (a) a *Sharia* consultant;
- (b) a *Sharia* Supervisory Board;
- (c) a Department of *Fatwa*¹ and Research: (DFR) and
- (d) a Central Higher *Sharia* Supervisory Board.

Some Islamic banks have opted to appoint only one person versed in the *Sharia* to supervise and ensure that the bank activities are being pursued and actually carried out in compliance with *Sharia* rules. This model was piloted by the Al-Baraka group of Islamic banks and was later adopted by other Islamic financial institutions.

However, the majority of Islamic banks have opted for a *Sharia* Supervisory Board. The SSB comprises at least three persons knowledgeable in the *Sharia*. The membership of SSBs may also include other specialists, for example, economists, lawyers and bankers.

Both an SSB and a *Sharia* consultant carry out their duties on a part-time basis. They usually convene weekly, fortnightly or monthly meetings with the concerned departments and/or staff of the bank.

1. *Fatwa* is a ruling on the *Sharia* and issued by a competent scholars(s).

The department of *fatwa* and research (DFR) is an innovation of the Sudanese. At least three banks in the Sudan are presently adopting this type of supervision, namely the Tadamon Islamic Bank, the Bank of Khartoum and the Omdurman National Bank. Unlike the other two models, the staff of the DFR are full-time and the department discharges its functions on a daily basis and in collaboration with all organs of the bank.

The experience of *Sharia* supervision and control has further developed into another, higher tier of control. The first development manifested itself in the establishment of the Higher *Sharia* Supervisory Board (HSSB) by the International Association of Islamic Banks² (IAIB) in 1983.

The second development took place in the Sudan, when the Minister of Finance issued a ministerial decree for the establishment of the Higher *Sharia* Supervisory Board. This is an independent body having its seat at the Bank of Sudan (the Central Bank). It supervises and controls the banking system, including the Bank of Sudan as well as other financial institutions in the Sudan.

The main objectives of the two HSSBs are to provide a higher tier of control and to serve as an appellate forum for the *Sharia* supervisory bodies at the individual bank level.

Objectives and Functions of the SSBs

This section provides a brief and an exemplary account of the objectives and functions of some *Sharia* supervisory bodies, with special reference to the Sudanese experience.

The SSB of the Faisal Islamic Bank —Sudan

The SSB of the Faisal Islamic Bank, Sudan, was established to perform the following functions:

- (a) (i) Draft and approve, in collaboration with other concerned departments and officials, model contracts and agreements to govern and regulate all the bank's activities and dealings.

2. The International Association of Islamic banks was founded in 1977 to reinforce the ties and links amongst Islamic financial institutions and to promote mutual cooperation and coordination.

- (ii) Update and improve the developed models to conform with *Sharia* principles, rules and spirit (*maqasid*).
- (b) Study and decide on, from a *Sharia* point of view, issues and problems submitted by the board of directors and/or the general manager.
- (c) Provide advice and/or instructions to the management of the bank.
- (d) to carry out its above duties, the SSB has been entrusted with the authority to inspect the bank's operations, examine the necessary documents, and summon any official of the bank.
- (e) Present, whenever necessary, reports to the general manager and the board of directors conveying the SSB's views and observations on the bank's activities.
- (f) Submit to the general meeting of shareholders an annual report containing, among other things, the SSB's opinion on the compliance of the bank's operations with *Sharia* precepts.

In addition, the SSB has the following rights:

- (a) To regulate its meetings and spell out the procedures to be followed in arriving at decisions and recommendations. Such regulations are proposed by the SSB and are approved by the general meetings of shareholders.
- (b) The chairman of the SSB has the right to attend the general meeting of shareholders. He may choose to submit any issue for discussion, yet he has no right to vote in the meeting.⁽³⁾

The Department of Fatwa and Research

The Tadamon Islamic Bank was the first Islamic financial institution to spearhead the development of the model of the DFR. This development was the result of a thorough examination of the pros and cons of the experience of the prevailing SSBs in 1982.

A DFR usually comprises three corelated disciplines, namely *Sharia*, economics and law. The department performs its duties in a different

3. *The Fatawa of the Sharia Supervisory Board*, (Khartoum: Faisal Islamic Bank- Sudan,), vol. 1, pp. 13-15.

manner from that of an SSB because it is very much involved in the daily operations of the bank. Such involvement manifests itself in the membership of the DFR in the higher executive committee, investment committees at the headquarters and the branches. All the financial reports, including the bank's annual report, are examined by the department.

The rationale behind the evolving of the DFR emanates from the manner through which the *Sharia* rules are derived. The induction of a *Sharia* rule requires two complimentary types of knowledge, knowledge of the *Sharia per se* and knowledge of the present state of affairs of a discipline that needs to be regulated by the *Sharia*, for example, banking, finance and/or accounting. The right application of the *Sharia* knowledge to well-defined state of affairs in a discipline should produce the appropriate *Sharia* principles and rules through the process of *ijtihad* (debate).

At present, it seems that those who are well-versed in the *Sharia* are not necessarily knowledgeable about the present state of affairs in banking, finance or accounting. Similarly, those who are versed in the latter are not necessarily knowledgeable in the *Sharia*. Hence, one may need a model like that of a DFR to complement knowledge of the *Sharia* with other relevant disciplines. This process may finally lead to the emergence of persons versed in the two types of knowledge (*faqih*).

This is, therefore, a built-in model of *Sharia* control, similar to the internal audit department. However, the DFR would usually have more authority than the internal audit department, and this would enable it to maintain its independence and to differ even with the executive management.

The relevant provisions for *Sharia* control in the Article of Association of the Tadamon Islamic Bank read as follows:

- 3 This bank is necessarily an Islamic bank. It shall, therefore, be governed by the laid down rules of the *Sharia* and shall be guided in respect of conducting all its activities by the provisions, principle and spirit-*maqasid* - of Islam.
60. There shall be established within the bank a specialized department to be known as the department of *fatwa* and research, whose

manager shall be appointed by the board of directors. The department shall be charged with the following duties:

- (a) to see to it that all the bank's business and dealings shall fully conform to the rules and precepts of the *Sharia*;
 - (b) to participate in the designing and drafting of all the forms which are used for contracts, agreements and operations related to all the bank's business dealings and transactions so as to ensure compliance with the rules of the *Sharia*;
 - (c) to conduct research and publish journals in the field of Islamic banking and all other aspects of Islamic economic studies;
 - (d) to supervise both the economic and legal affairs of the bank's business: and
 - (e) to perform any tasks referred to it by the board of directors and/or the general manager.
61. The department shall submit regular reports to the board and the general manager. Such reports shall express the views and comments of the department on any matter of the bank's business, whenever the need arises.
62. The department shall submit to the meeting of the general assembly an annual report embodying its views and observations as to whether, and to what extent, the bank's business has been conducted in conformity with the rules and precepts of the *Sharia*.
63. In case of any disagreement between the general manager and the department of *fatwa* and research concerning the Islamic legality of any business transaction carried out by the bank, the matter shall be put before the board, which may consult any authority on the issue.
64. The following issues shall be passed by a two-thirds majority of the members present at a legal meeting of the board;

THE ROLE OF SHARIA SUPERVISORY BOARDS

- (a) the election of the chairman of the board, the definition of his functions and jurisdiction;
- (b) the appointment of the general manager and his deputy, the manager of the Department of *Fatwa* and Research and the defining of their functions and jurisdiction. (Tadamon Islamic Bank, 1983)

Higher *Sharia* Supervisory Bard (HSSB)

The HSSB was established by the IAIB and entrusted with the following duties:

1. To study and scrutinize the *fatwas* of the SSBs in Islamic banks and financial institutions enjoying the membership of the Association. The reason for such scrutiny is to ensure its conformity with *Sharia* principles and rules.
2. To supervise and control bank's operations as well as those of financial institutions to guarantee their compliance with the *Sharia*, on the one hand, and to draw the attention of the management concerned to any irregularities, on the other hand.
3. To provide the *Sharia* point of view with respect to any issue referred to it by the member institutions, the individual bank's SSB or the Secretary-General of the IAIB.
4. To provide the *Sharia* point of view with respect to any issue related to bank operations and financial dealings referred to it, even from institutions not enjoying membership in the IAIB.
5. Decisions and verdicts passed by the HSSB are binding to member institutions as long as they have been unanimously passed. However, a member institution shall have the right to request the Board to reconsider its decision or verdict. Such a request should mention the reasons for the review. Member institutions are not bound by decisions and verdicts arrived at by a majority. Hence, each member is free to follow the majority or the minority point of view except where the Board agrees that the public interest necessitates the adoption of the decision or verdict of the majority.

6. The HSSB shall have the right to express its views on new economic issues, particularly those affecting and/or serving the interest of the community.
7. In order to discharge these duties, the board shall have the right to examine the laws, by-laws and circulars governing the activities of the member institutions. While exercising this duty, the board has a duty to keep the secrets of its member institutions⁽⁴⁾.

Higher *Sharia* Supervisory Board, Sudan (HSSBS)

The HSSBS was established in 1992 to look after the financial sector, act as an adviser to the Minister of Finance and, more specifically, to achieve the objectives and perform the duties stated below:

Objectives:

1. to ensure the strict adherence to the principles and rules of the *Sharia* by the Bank of Sudan, commercial banks and other specialized banks and financial institutions.
2. To eliminate usurious dealings, fraudulent and all other practices which are repugnant to the *Sharia* principles and rules.
3. To cooperate with other concerned institutions to define the financial goals in Islam and to choose the appropriate and effective modes of finance and means of control to achieve such goals.

Duties:

1. to revise the laws, by-laws and circulars establishing, organizing and governing the activities of:
 - (a) the Bank of Sudan
 - (b) the banking sector
 - (c) financial institutions

Such revision, which must be carried out with the cooperation of the concerned bodies in these institutions, is meant to free the laws and by-laws and circulars from any inconsistency with *Sharia* precepts.

2. To supervise and ensure that the operations and dealings of the banking system, including the Bank of Sudan and other financial

institutions, are in conformity with the principles of the *Sharia* and to advise the Governor of the Bank of Sudan with respect to issues arising therefrom.

3. To study from a *Sharia* point of view issues and problems facing the banking system and other financial institutions and to suggest practical solutions.
4. To respond to relevant queries and decide upon any relevant disputes brought to its notice from all these institutions as well as from the public at large in their dealings with these institutions.
5. to collaborate with the legal department in the Bank of Sudan to design contracts, agreements and forms to regulate the operations of the banking system and other financial institutions.
6. to train and assist the department of control in the Bank of Sudan to widen its scope of control to cover the adherence of the banking system and other financial institutions to the *Sharia* precepts. In addition, the HSSBS reviews the reports issued by the department of control and arranges for rectifying any irregularity.
7. To carry out researches and studies which would improve upon the performance of its functions.
8. to furnish the Minister of Finance with an annual report, in which it expresses views on whether, and to what extent, the banking sector and other financial institutions have been discharging their activities in accordance with *Sharia* precepts.

Powers

In order to be able to perform its duties, the HSSBS has been entrusted with the following powers:⁽⁵⁾

1. The *fatwa* resolutions of the HSSBS are binding on all concerned parties.

4. Faisal Islamic Bank - Egypt, Annual Report, 1984.

5. Ministry of Finance, "*Establishment of the Higher Sharia Supervisory Board*," The Ministerial Decision No. 184, 1992, Khartoum, Sudan.

2. To inspect the activities of the Bank of Sudan, and other banks and financial institutions to ensure their compliance with *Sharia* precepts.
3. To examine the documents, records and dealings of the bank of Sudan, and other banks and financial institutions whenever it deems necessary.

The Role of SSBs in Setting Accounting Policies

It is evident from the preceding sections that SSBs have been charged with a wide spectrum of objectives, duties and powers, so much so that their role covers the supervision and control of almost all the activities of an Islamic bank with respect to adherence to the *Sharia* and the issues arising therefrom.

How far SSBs actually measure up to these legislative expectations is a different matter altogether. However, the performance of some of these bodies, that I personally know, seems to be more than satisfactory, especially that of the Faisal Islamic Bank, Sudan, the DFRs in the three banks in Sudan, and the HSSBS. I believe that some other SSBs are of the same calibre. On the other hand, some SSBs are extremely weak. The main function of most such SSBs has been to sanction the practices of the management of the bank, including even their follies, or at least to keep silent about them.

The DFRs, which are part and parcel of the bank, perform their duties on a daily basis. They are, therefore, more familiar with the work of the banks and the problems arising out of it. This characteristic would tend to enable them to carry out their duties more closely and effectively.

Other SSBs perform their duties on a part-time basis. They do not really involve themselves in the daily activities of the banks. The proponents of this model of the SSB profess that their form of constitution gives them more independence than DFRs, which may fall under the grip of the banks' management. There is indeed some element of truth in this argument. Yet, the fact remains that the *fatwa* verdict of a DFR is binding on the management. If, however, the general manager has any reservation with respect to a certain *fatwa*, the issue has to be raised with the board of directors, which would usually seek the opinion of a third party well versed in the *Sharia*. To the best of my knowledge, no such conflict has so far occurred.

SSBs have been entrusted with such objectives, duties and powers because of the following:

1. The Islamic banking system is different from the usurious banking system. Areas of similarities and dissimilarities can be recognized with certainty through SSBs.
2. Whereas the usurious banking system depends largely on the rate of interest in governing the bank's operations and services, the Islamic banking system prohibits a rate of interest in any banking operation.
3. The Islamic banking system is governed by the principle of *ghunm bil-ghurm*⁶ which, contrary to the usurious mode of finance, is a risk-bearing principle. This principle governs the mechanism of the Islamic modes of finance, which are different from those of the rate of interest in almost all respects.

Ex ante and *Ex post* Sharia Audit

The role and duties of the above SSBs indicate that all of them should perform *ex ante* Sharia audit of all the transactions in terms of designing contract agreements and forms. Others, like DFRs, also perform their *Sharia* audit during the process of the transaction. This includes audit of the conclusion of the contract and the execution, as well as the follow-up, of the implementation of the terms of contract until liquidation.

However, none of the above SSBs tends to perform full *ex post* *Sharia* audit. Rather, they tend to audit random samples of the transactions. In the Sudan, the HSSB has decided to train the staff of the internal audit department in Islamic banks to perform the necessary *ex ante* and *ex post* *Sharia* audit. The result of the audit will be reported to both the management of the bank and its SSB. The training of the staff to discharge this duty has already started.

6. *Al-ghunm* means consideration, benefit and profit. *Al-ghurm* means loss. The phrase in this context denotes that the Islamic mode of finance may not *per se* guarantee to the contracting party either the capital or any expected profit. Rather, it exposes the parties to an opportunity of profit or loss. Unlike the usurious loan, the Islamic mode of finance is necessarily risk-bearing. It is for the parties themselves, through their expertise, to try to minimize risk.

The department of supervision and control in the Bank of Sudan is presently performing some *ex post Sharia* audits with respect to commercial and other specialized banks. They have been trained by the HSSB to perform this duty. They report to both the Governor of the Bank of Sudan and the HSSB. Their reports have highlighted a number of *Sharia* violations. The decisions taken by HSSB in some of these cases, after verification, included the forfeiting of unlawful profits. Such gains were disposed of in charitable activities.

Debtor and Creditor Relationship Vs Capital and Labour Relationship

The establishment of an Islamic bank is based on the contract of *mudaraba* ⁽⁷⁾. Unlike the debtor and creditor relationship in usurious banks, the contractual relationship between investment account holders and an Islamic bank is based on a *mudaraba* mode of finance can be restricted (*muqayyada*) or unrestricted (*mutlaqa*).

The unrestricted *mudaraba* contract enables the bank, in its capacity as a *mudarib* (entrepreneur), to commingle the funds of investment account holders with its equity funds and any other funds available to the bank. The bank is then free to invest the pool in whatever manner it deems fit.

In restricted *mudaraba*, on the other hand, the bank must invest the funds available to it from investment account holders in the manner determined by the latter for example, in shares, real estate, the agricultural sector, etc.

According to the rules of the *mudaraba* contract, the providers of funds share the profit with the bank, in its capacity as a *mudarib*, according to a predetermined ratio; however, the providers of funds bear the full risk of loss.

The SSB in each bank usually determines the formula by which the profits should be shared by the two parties to the *mudaraba*. Furthermore, they determine the revenues and expenses that should be borne by each party⁸.

7. *Mudaraba* is a type of partnership whereby one person or a group of persons provides the capital while the other person or group of persons provides the expertise and management. It is a cooperation between capital and labour.

8. For more details, see Abdallah (1984, 1994), Karim (1993).

Revenue Recognition of Islamic Modes of Investment

Another area in which the views or advice of the SSB plays an important role in setting accounting policies in Islamic banks is the accounting treatment of the Islamic modes of investment, for example *murabaha sales*⁹.

Based on the advice of SSBs, Islamic banks have different accounting treatments for *murabaha* transactions. Some Islamic banks recognize the revenue of these transactions on an accrual basis. Others use different cash accounting methods, such as the instalment method or upon complete liquidation of the transaction.

Examination of Financial Statements of Islamic Banks

The SSB of each bank usually examines the financial statements of the bank. In its examination, the SSB gives special attention to the following:

- (a) It ensures that the formula for allocating profits between shareholders and investment account holders is fair and just and in accordance with what, if anything, has been prescribed by the SSB.
- (b) It ensures that the bank's revenues are from lawful transactions. Any earnings marked by the SSB as unlawful should not be included in the profits allocated between shareholders and investment account holders, but disclosed and dispensed of in charitable causes.
- (c) It ensures that the *zakah* fund has been properly calculated, disclosed in the financial statements and distributed to the prescribed beneficiaries.
- (d) Some SSBs examine the financial statements of the bank and express an opinion on whether or not the bank has played its proper social role in the community.

9. *Murabaha* is an investment mode of finance based on a contract of sale. The buyer asks the bank to arrange to buy a commodity which the bank does not own. He also promises to buy the goods from the bank at cost plus an agreed-upon mark-up. According to the preponderant view in Islamic jurisprudence, the buyer has the option whether or not to honour his promise to buy the goods when the bank has bought them and offers to sell them to him.

The SSBs' Contribution in the Work of the Financial Accounting Organization for Islamic Banks and Financial Institutions (FAOIBFI).

Some members of SSBs contributed to the preliminary discussions, studies and seminars which led to the establishment of the FAOIBFI. Moreover, some members of SSBs have been invited to join the membership of the various bodies of the FAOIBFI after its establishment in 1991.

A number of *Sharia* consultants have also collaborated on a part-time basis with other experts in accounting and banking to undertake theoretical and field studies and hold seminars and group discussions at different stages of preparing accounting standards. It is worth noting that the FAOIBFI has so far published three statements, namely:

- (a) *Financial Accounting Statement No. 1: Objectives of Financial Accounting for Islamic Banks and Financial Institutions.*
- (b) *Financial Accounting Statement No. 2: Concepts of Financial Accounting for Islamic Banks and Financial Institutions.*
- (c) *Financial Accounting Standard No. 1: General Presentation and Disclosure Standard in the Financial Statements of Islamic Banks and Financial Institutions.*

Some *Sharia* experts are involved in the development of the three accounting standards on *mudaraba*, *musharaka* and *murabaha* currently being developed by the FAOIBFI.

Concluding Remarks

In this chapter, I have attempted to outline some of the activities through which SSBs contribute directly or indirectly to the setting of accounting policies. However, while some SSBs have been fully and deeply involved in this process, thereby helping Islamic banks to achieve their stated goals and provide useful information that reflects a fair view of their financial statements, other SSBs might not be widely cognizant of accounting issues or relevant issues in other disciplines.

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A sound accounting system plays an important role in the management of a business enterprise. The prevailing accounting system has developed over centuries within the socio-economic framework of the capitalist system. As such, its concept, values, rules and procedures are defined by the characteristics of the capitalist system.

Islam's Socio-Economic System, its culture, its values and its objectives differ from the capitalist system in several important ways. Basically, it is a value-oriented system which must operate within the principal and guidelines of *Shariah*. The principle objective of the Islamic Economic Order is the establishment of a society based on equity and justice and welfare of the society as a whole. These and other features peculiar to the Islamic Financial System necessitate the development of an accounting system tailored to the needs of Islamic Banking. In this book leading Economists, Bankers, Accountants and Islamic Scholars examine various aspects of this urgent need.