

ACCOUNTING STANDARDS FOR ISLAMIC BANKS

PAPERS AND REPORTS OF COMMITTEES
FOR ACCOUNTING STANDARDS FOR
ISLAMIC BANKS

VOLUME **1**

ISLAMIC DEVELOPMENT BANK (IDB)
JEDDAH

ACCOUNTING STANDARDS FOR ISLAMIC BANKS

VOLUME ONE

PAPERS/REPORTS PREPARED FOR ISTANBUL ANNUAL MEETING OF
IDB BOARD OF GOVERNORS ON 27 MARCH 1987 UP TO THE WORKSHOP
HELD ON 7-8 SEPT. 1987

ISLAMIC DEVELOPMENT BANK (IDB)

DHU AL QADA 1410

JUNE 1990

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FOREWORD

The remarkable growth of Islamic Banks and other financial institutions operating in conformity with Shariah in the last decade has led to the recognition that the development of financial accounting standards reflecting the unique features of Islamic Banking is imperative.

To sustain the momentum of their rapid expansion Islamic Banks need to maintain a high degree of credibility with those who rely on financial statements in making decisions affecting their relationships with those banks. Credibility requires that the financial statements of all Islamic Banks should contain information which is relevant, reliable and comparable and is perceived as such by those who use that information in making decisions. Therefore, the need is for accounting standards for Islamic Banks, their clients, auditors and regulatory agencies to assure the relevance, reliability and comparability of financial information.

The need for accounting standards for Islamic Banks was pointed out to the IDB Management by the IDB's auditor Br. Abdul Aziz Al-Rashed. The IDB referred this matter to the Islamic Banks' meeting on the occasion of the IDB's Board of Governors annual meeting in Istanbul in 1407H. With the encouragement and active involvement of the Islamic Banks, coordinated by the IDB, work in this important area has been ongoing for over three years.

Although the task has only begun, the various committees composed of Islamic bankers, practicing accountants, Shariah scholars, academicians and representatives of other relevant institutions have generated a considerable amount of research on the subject. In view of its topicality, relevance and growing interest from researchers, academicians, auditors, Islamic Banks and others it was considered desirable to publish the main papers and reports for wider usage.

Many institutions and individuals, too numerous to mention by name, have contributed generously to this effort. However, the IDB would like to take this opportunity to once again express its thanks to the members of the Steering Committee, Follow-Up Committee and Preparatory Committee for Accounting Standards for Islamic Banks who have given so generously of their time and effort. The work of this various committees would have been incomplete without the significant contributions of Br. Abdul Aziz Al-Rashed, Br. Abdul Gadir Banaga and Br. Samir T. Badawi who have been the driving force behind all the committees on Accounting Standards for Islamic Banks.

May Allah Almighty bestow success on us.

Dr. Ahmad Mohamed Ali
President
Islamic Development Bank

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3. PAPER "AN APPROACH TO ESTABLISHING ACCOUNTING STANDARDS FOR ISLAMIC BANKS" BY ABDUL AZIZ AL-RASHED, DR. SABRY HEAKAL AND DR. ABDULLAH AL-FAYSAL

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Members of the Steering Committee:

- | | |
|--------------------------------|-------------|
| o Abdul Aziz Rashed Al-Rashed, | Chairman |
| o Dr. Siddiq Al-Darir | Member |
| o Dr. Abdul Halim Ismail | " |
| o Dr. Riffaat A. Abdul Karim | " |
| o Dr. Abdullah M. Al-Faisal | " |
| o Irtiza Hussain | " |
| o Abdelgadir Banaga | " |
| o Samir T. Badawi | " |
| o Dr. Khalid M. Boodai | " |
| o Dr. Abdul Monem Mahmood | " |
| o Dr. Sami Hamoud. | " |
| o Shamshad Nabi | " |
| o Farooq Azam | Coordinator |

Consultants:

- o Dr. Sabry Heakal

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Members of the Follow-Up Committee:

| | |
|-------------------------------|-------------|
| o Abdul Aziz Rashed Al-Rashed | Chairman |
| o Abdel Gadir Banaga | Member |
| o Samir T. Badawi | " |
| o Dr. Khalid M. Boodal | " |
| o Shamshad Nabi | " |
| o Dr. Ausaf Ahmed | " |
| o Irtiza Hussain | " |
| o Dr. Siddiq Al Darir | " |
| o Dr. Sami Hamoud | " |
| o Dr. Rifaat Abdul Karim | " |
| o Musa Abdul Aziz Shihadeh | " |
| o Ismail Hassan Mohammed | " |
| o Mohamed Towfiq | " |
| o Moncef Cheikh Rouhou | " |
| o Abdel Hamid Abu Musa | " |
| o Dr. Abdul Halim Ismail | " |
| o Dr. Ahmed Kamal A Al Magd | " |
| o Kazim Raza Awan | Coordinator |

Consultants:

- o Dr. Sabry Heikal
- o Dr. Abdullah Bin Mohamed Al-Faisal
- o Dr. Abdul Rehman Ibrahim Al-Humaid

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Members of the Preparatory Committee:

| | |
|------------------------------------|-------------|
| o Ousmane Seck, Vice President-IDB | Chairman |
| o Abdul Aziz Rashed Al-Rashed | Member |
| o Samir Badawi | " |
| o Abdul Gadir Banaga | " |
| o Faisal Abdul Aziz Al Zamil | " |
| o Dr. Siddiq Al Darir | " |
| o Dr. Abdul Halim Ismail | " |
| o Irtiza Hussain | " |
| o Abdel Hamed Abu Musa | " |
| o Shamshad Nabf | " |
| o Dr. Hassan Mirghanf | " |
| o Kazim Raza Awan | Coordinator |

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- a) Introduction
 - b) Historical Background
 - c) Recommendations
 - d) Commentary on Recommendations
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VOLUME FIVE (contd.)

Members of the Executive Committee:

| | |
|------------------------|-------------|
| o Ousmane Seck | Chairman |
| o Abdul Aziz Al-Rashed | Member |
| o Samir T. Badawi | " |
| o Abdulgadir Banaga | " |
| o Abdul Hamid Abu Musa | " |
| o Shamshad Nabi | " |
| o Kazim Raza Awan | Coordinator |

5.1 EXECUTIVE SUMMARY OF THE REPORT OF THE EXECUTIVE COMMITTEE FOR FINANCIAL ACCOUNTING STANDARDS FOR ISLAMIC BANKS TO THE FIRST MEETING OF THE SUPERVISORY COMMITTEE FOR FINANCIAL ACCOUNTING STANDARDS FOR ISLAMIC BANKS - ALGIERS 26 FEBRUARY 1990 (ARABIC & ENGLISH)

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II Agenda for the First Supervisory committee

Appendices:

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VI Summary of bases followed in proposing the constitutions of the Supervisory Committee and Standards Board

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Report - Workshop on Accounting Standards for Islamic Banks

Introduction

A workshop on accounting standards for Islamic banks was organised by the Treasury and Finance Department of the IDB and the Training Division of IRTI. The workshop was held at the IDB headquarters in Jeddah for two days, 14-15 Muharram 1408H [7-8 September 1987]. Finance for the workshop was provided from IRTI's budget.

Objectives

The objectives of the Workshop were to:

- (I) Provide an experts' forum consisting of Islamic Scholars and Accountants with the opportunity of exchanging in depth the ideas and views regarding the need and rationale for having accounting standards for the Islamic Banks.
- (II) Analyse the various steps that need to be undertaken in order to set up the infrastructure for providing accounting standards for Islamic Banks.
- (III) Explore the organisational and financial implications of creating an Accounting Standards Board dealing exclusively with the modes of finance undertaken by the Islamic Banks.

Methodology and Contents

Given the emerging and nascent nature of the topic, the workshop was limited to a small group of experts. Two main papers were presented & three additional notes were also discussed, all focussing on the major issues related to the subject of accounting standards for Islamic banks. The main workshop sessions were

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held over two days, the details are given below.

PROGRAMME

14 MUHARRAM 1408H, MONDAY [07 SEPTEMBER 1987]

- 08:30 : Registration
- 09:00 : Recitation of Holy Quran
- 09:15 : Address of Welcome by the Acting President
of the Islamic Development Bank
- 09:45 : Announcements
- 10:00 : Refreshments
- 10:15 : Introduction: Shariah basis of Accounting - Dr Sami Hammoud
- 10:30 : Paper - I: Chairman and Discussant : Samir T. Badawi
"The Need and Rationale for Setting up of Accounting
Standards for Islamic Banks" by Fuad Hashmi
[Read by Shamshad Nabi]
- 12:30 : Prayer and Lunch
- 02:30 : Additional material on the subject
by Abdul Qadir Banaga
Chairman: Dr Sami Hammoud
- 03:00 : Discussion
- 04:00 : Refreshment and prayers
- 04:30 : Discussion : (Continued)
- 05:00 : Recommendation Committee meeting

15 MUHARRAM 1408H, TUESDAY [08 SEPTEMBER 1987]

- 09:00 : Paper - II: Chairman and Discussant: Irtiza Hussain
"An Approach to Establishing Accounting Standards for
Islamic Banks" by Abdul Aziz Al Rashid.
- 10:30 : Refreshments
- 11:00 : Additional material on the subject - Irtiza Hussain
Chairman: Dr Abdul Monem Mahmood
- 12:30 : Prayer and Lunch given by Acting President
- 03:00 : Recommendation Committee meeting
- 03:45 : Prayers

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- 05:00 : Presentation of recommendations to the workshop followed by discussion.
Chairman: Abdul Aziz Al Rashed
- 06:00 : Conclusion of Workshop
- 06:45 : Prayer
- 07:00 : 1st Meeting of Steering Committee for Standard, established by Workshop participants.

16 MUHARRAM 1408H, WEDNESDAY [09 SEPTEMBER 1987]

07:00 [PM] : Trip to Makkah

17 MUHARRAM 1408H, THURSDAY [10 SEPTEMBER 1987]

08:00 [AM] : TRIP TO MADINAH

Participants

The Workshop was attended by leading Auditors of Islamic banks, Professional Accountants, Islamic Bankers, Academicians specializing in Accounting and Shari'ah Scholars.

A detailed list of participants together with the Organizing Committee is given at Annexure II.

Resolutions

At the conclusion of the workshop, the participants approved a detailed set of recommendations [Please see Annexure I for details]. A Steering Committee was set up, from among the participants, to implement the decisions of the workshop.

It was agreed that there is an urgent need for the development of accounting standards for Islamic banks. For this purpose, an independent and representative body has to be set up.

The methodology for developing standards in conformity with Shari'ah was spelt out and a plan of action has been outlined. The workshop elected 11 members to function as a Steering Committee which would do the needful towards setting up a permanent accounting standards body for Islamic banks. The Steering Committee would endeavour to complete its initial terms of reference [please see Annexure I, Point 5] before the annual meeting of the IDB Governors scheduled for March 1988.

Finally, the participants recorded their thanks to the IDB and IRTI for giving them the opportunity to discuss an urgent and serious problem facing Islamic banks.

Resolutions of the Workshop on Accounting
Standards for Islamic Banks held on
13-15 Muharram 1408H (7-8 Sept. '87)
at Islamic Development Bank, Jeddah

The Members of the Workshop were very encouraged with the papers discussed during the two days of the Workshop. There was a consensus of agreement by all Members (Shariah experts, Islamic Bank Executives, Professional Accountants and Scholars) to adopt the following approach for the development of financial accounting standards for Islamic Banks:

1. There is an urgent need for the development of accounting standards for Islamic Banks. The standards will make information included in financial statements more relevant, reliable and comparable.

2. Creating and developing a body with the following characteristics:
 - a) The body must be independent.
 - b) The constituent affected by the promulgated standards should be represented. This should include:
 - i) Participating banks and financial Institutions;
 - ii) Professional Accountants Bodies;
 - iii) Academicians;
 - iv) Fuqahas;
 - v) Capital Market Organization;
 - vi) Government regulatory agencies;

- c) Due process to be fair and is perceived as being fair.
 - d) It must be adequately funded.
 - e) Its authority from inception should be recognized by those who have to comply with the promulgated standards.
3. The following methodology for development of a conceptual framework for financial accounting and promulgation of standards should be adopted in conformity with Shariah:
- i) The objectives of financial statements of Islamic Banks should be defined. This should take into account the decision makers who rely on financial statements of Islamic Banks, the common attributes of information needed to make decision and the types of financial accounting information that can be produced.
 - ii) Defining the basic concepts, principals and assumptions of financial accounting for Islamic Banks. Establish the basic features of financial accounting for those Banks.
4. Establishing the due process for the promulgation of financial accounting standards for Islamic Banks.

5. Steering Committee.

- 1) Establishing a Steering Committee to prepare the required instruments for the suggested body to set up the accounting standard for Islamic Banks, taking into account points 2, 3 & 4 above.

- ii) The Terms of Reference of the Steering Committee will be as follows:
 - a) The organizational structure
 - b) Membership
 - c) Funding
 - d) Internal regulations
 - e) To hire temporary technical and secretariat assistance
 - f) To draft by-laws for the permanent body
 - g) To do everything within its power to complete the task well before the time, i.e. annual meeting of the IDB Governors scheduled to be held in March 1988.

- iii) Membership -

The Steering Committee should consist of 11 Members with the power to co-opt additional Members as it may consider necessary. The selection of Members should take into account the discipline and regional representation in the following order:

 - a) Shariah Scholars (Fuqhas)
 - b) Bankers
 - c) Professional Accountants
 - d) Academicians

The selected Members of the Committee are:

1. Abdul Aziz Al-Rashed, Chairman
2. Dr. Siddig Al-Darir
3. Dr. Abdul Halim Ismail
4. Dr. Rifaat A. Abdel Karim
5. Dr. Abdullah Al-Faisal
6. Irtiza Hussain
7. Abdul Gadir Banaga
8. Samir T. Badawi
9. Dr. Abdul Monem Mahmood
10. Dr. Sami Hamoud
11. Shamshad Nabi

Farooq Azam has been selected as Co-ordinator for the Steering Committee.

6. We would like to take this opportunity of recording our thanks to our gracious hosts the Islamic Development Bank who made it possible for us to get together and discuss a serious problem in a very congenial and friendly surrounding. Our thanks are due to the organizers of this Workshop. I hope these sentiments will be conveyed to the President and the Vice President.

FA:ras

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ANNEXURE II

LIST OF PARTICIPANTS

1. Abdul Aziz Al Rashed

Presenting Paper II "Procedures for setting up of an Accounting Standard for Islamic Banks"

Abdul Aziz Al Rashed has his own Auditing Firm of Al Rashed & Co. CPA, Auditor, Islamic Development Bank.

2. Dr. Abdullah El Faisal

Co-writer with Abdul Aziz Al Rashed for Paper II from Riyadh University.

3. Dr. Abdul Monem Mahmood

Professor, Cairo University. Ph.D. in Audit. At present Chairman of Accounting Standards Committee in Egypt.

4. Dr. Abdul Halim Ismail

Managing Director, Bank Islam Malaysia Berhad. Has inside knowledge of Islamic Banking and problems faced in the accounting field. Involved in setting up the accounting manual for the Bank.

5. Abdul Gadir Banaga

Managing Partner, Jeddah office of auditors Baeshan and Banaga. With accounting background and experience. Auditor of Islamic Development Bank and Sudanese Islamic Bank.

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6. M. Azizul Haq

Executive Vice President, Islami Bank Bangladesh Ltd. Has written several papers on Islamic Banking and responsible for setting up an Accounting Manual for Islami Bank Bangladesh. Last paper written in May 1986 entitled "Islamic Banking in Malaysia".

7. Irtiza Hussain, FCA.

Qualified Chartered Accountant. EX-President of Institute of Chartered Accountants of Pakistan. Presently Chairman of Law Authority of Pakistan, responsible for corporate laws in Pakistan.

8. Dr. Rifaat A. Abdel Karim

Lecturer in Accountancy in Kuwait University. Has written several papers on Islamic Banking.

- i) Islam and Social Accounting
- ii) Determinants of the financial strategy of Islamic Banks.
- iii) The Shariah and its implications for Islamic Financial Analysis. An opportunity to study interactions between society organisations and accounting.
- iv) Towards an understanding of the use of Islamic Banks' Financing Mechanism.

9. Dr. Sami Hamoud

General Manager, Al Baraka Bank, Bahrain. Scholar and has written a book on Islamic Banking.

10. Samir T. Badawi

Managing Partner, Jeddah Office of auditors Whinney, Murray. Has accounting background and involved in two seminars in London and Zurich on Islamic Banking. He has written a paper on 'Comparison of accounting policies used in Islamic Banks'.

11. Dr. Sidig Al-Darir

Extensive knowledge of shariah with accounting background. Chairman of Shariah Board for Faisal Islamic Bank, Khartoum. Board Member of other Islamic Banks in Sudan.

Observers

1. Mustapha Hamat
Chief Accountant
Bank Islam Malaysia Berhad
2. Dr. A. R. Lababidi
Treasury & Finance Dept., IDB
3. Durmus Cavdar
Treasury & Finance Dept., IDB
4. El Mubarak El Tayeb El Amin
Treasury & Finance Dept., IDB
5. Dr. Husain Ali Al Bounny
Treasury & Finance Dept., IDB
6. Dr. Hasan Al Amin, IRTI
7. Dr. Ausaf Ahmad, IRTI

WORKSHOP_ORGANISING_COMMITTEE

| | |
|---|---------------|
| SHAMSHAD NABI ACTING TREASURER, IDB | COORDINATOR |
| DR. ASLAM NIAZ HEAD OF TRAINING DIVISION, IRTI | CHAIRMAN |
| EL-MIGDAD HAMID EL RASHID HEAD OF ACCOUNTS SECTION, IDB | VICE CHAIRMAN |
| FAROOQ AZAM, ACCOUNTS SECTION, TREASURY AND FINANCE DEPARTMENT | SECRETARY |
| DR. JELLOUL SACI INTERNAL AUDIT DEPARTMENT | MEMBER |
| KAZIM RAZA AWAN, IRTI | MEMBER |

RECOMMENDATION COMMITTEE:

Abdul Aziz Al Rashed (Chairman)

Samir T. Badawi

Shamshad Nabi

Irtiza Hussain

Dr. Sami Hamoud

Dr. Abdul Monem Mahmood

Farooq Azam (Secretary)

LETTER TO ISLAMIC BANK

Assalamo Alakum Wa Rahmatullah Wa Baraktuh

Subject: WORKSHOP ON ACCOUNTING STANDARDS FOR ISLAMIC BANKS ON
7-8TH SEPTEMBER, 1987 AT ISLAMIC DEVELOPMENT BANK JEDDAH

The above workshop was held under the patronage of Islamic Development Bank (IDB) Jeddah. As this was an exploratory meeting, unfortunately not all Islamic Banks representatives could be invited. The participants who were finally invited represented bankers of Islamic Banks, accountants and auditors, academicians, Government regulatory institutions and experts in Sharia. The papers presented at the workshop (copies are enclosed) raised considerable interest on accounting techniques and Sharia issues related to Islamic Banks.

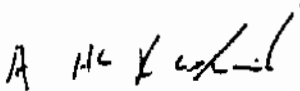
The workshop participants agreed that there is a need for accounting standards for Islamic Banks within the Sharia framework and formed a Steering Committee whose members are from various disciplines mentioned above. The list of Steering Committee members with brief details is enclosed for your information. The IDB Management has agreed (subject to the approval of the Board Executive Directors of IDB) to support financially the work of the Steering Committee. The work of the Steering Committee will suggest a framework for promulgating accounting standards for Islamic Banks. The final recommendation will include a draft of a document for an accounting standard setting body for the Islamic Banks including:

- a) Composition of setting up of an accounting standard setting body;
- b) Internal organization;
- c) By-laws, including due process;
- d) Methodology for the development of objectives, concepts and standards;

This will be presented to the Islamic Banks at the annual IOB meeting in Tunis on 7 & 8 March 1988.

Your interest and support in this pioneering work is needed. I would appreciate if the enclosed form with your last annual report is sent to the Steering Committee. If you have any thing to discuss I would be most pleased to hear from you.

Best regards,



Abdul Aziz Rashed Al-Rashed
Chairman
Steering Committee

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ISLAMIC DEVELOPMENT BANK

WORKSHOP ON ACCOUNTING STANDARDS FOR ISLAMIC BANKS

14-15 MUHARRAK 1408H (7-8 SEPTEMBER 1987)

ADDRESS OF WELCOME BY THE ACTING PRESIDENT
OF THE ISLAMIC DEVELOPMENT BANK

The Acting President on behalf of the President of IDB, Dr. Ahmad Mohamed Ali, who was away from Jeddah welcomed all the participants and guests attending the workshop. He said that the importance of accounting in the economic and financial activities is well known the world over. An Accountant supplies to decision makers and the owners of the capital global and standards data which are necessary for them for the purpose of accounting. Each firm has its own methods and procedures clothed in particular terminologies. Interpretations of these terminologies are made differently by different units and that is the reason why the accounting method and procedure as well as the language used should be unified, standardised and financially codified. This has been done in all other sectors of economy except the Banking. Many of the regional or sub-regional firms/institutions have already standardized and codified their accounting language and terminologies but such a standardisation does not yet exist for Islamic Banks. He said that about 2 years back, the Bank's External Auditors, Mr. Abdul Aziz Al Rashid while submitting the Accounts of the Bank to the Board of Executive Directors came forward with an idea of standardisation or setting up Islamic concepts of accounting. This rich idea was accepted and studied and the Bank's Management as well as IRTI have found it necessary that this issue be studied more in depth by the

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specialists in accounting in Islamic Banks. This idea was submitted to the meeting of the Islamic Banks in Istanbul last march. All the participants in that meeting showed keen interest in the subject and suggested that it should be studied urgently more in depth. The President, IDB, therefore, suggested that a seminar or a workshop be urgently organised and a group of specialists in Islamic Banks invited to study this question. He requested the specialists present in the meeting to find out the method, terminology and concept that should be informally adopted and standardised. The Acting President suggested that their efforts should not be directed merely towards interpretation of accounting principles which are already know but something new will have to be laid down. He stated that it was a huge and challenging tasks which, perhaps, might not be resolved in three days' meetings. This workshop, he said, should lay down a standard system of Islamic accounting.

With these observations, the Acting President declared open the Workshop.

**WORKSHOP OF ACCOUNTING STANDARDS
FOR ISLAMIC BANKS**



ORGANISED BY:

- **ISLAMIC DEVELOPMENT BANK**
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JEDDAH

**14 16 MUHARRAM, 1408H
(07 09 SEPTEMBER, 1987)**

The need and rationale for setting up of
Accounting Standards for Islamic Banks

Paper to be presented
at Islamic Development Bank Workshop
Jeddah - 7,8,9 September 1987

By
Fuad Azim Hashimi

**Accounting Standards &
Fundamental Accounting Concepts**

**Application of Accounting Standards &
The Revenue Recognition Principle**

Islamic Economic Environment

- Development of Islamic Banks
- Islamic Modes of Financing

**Accounting problems associated with
Islamic Modes of Financing**

**Need and Rationale of Setting up
Accounting Standards for Islamic Banks**

Accounting Standards & Fundamental Accounting Concepts

We accountants, being unscientific, validly think and project accounting as a mystic art. Keeping this in mind, it would be close to impossible to define accounting in terms which would be acceptable to all. Some of the several definitions which have been published are *'Accounting is the art of recording, classifying, and summarising in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof' and **'The process of identifying, measuring, and communicating economic information to permit informed judgments and decisions by users of the information.' But most of us would not disagree if we were to refer to accounting as a 'pragmatic art' with its primary objective being usefulness.

The goal of usefulness obviously raises questions as to who are the principal users. This list of users of accounting data is an evergrowing tree. Each user may have his own specific need, which may require a special type of data or a specific accounting treatment. However, in order to produce general purpose financial statements, one must fairly balance the information needs of all interested parties and apply it consistently from situation to situation. Hence, the need for Accounting Standards arose, which would help in uniform application of rules, and produce results which would not be biased by the objectives of only one group of users.

Accounting Standards may be defined as rules which it is widely accepted should be followed in accounting for measuring, analyzing, interpreting and communicating economic data. These Standards are based on certain concepts identified as underlying the theories and practice of accounting as applied to periodic financial accounts of business enterprises. Accounting literature refers to these concepts as Fundamental Accounting Concepts. These concepts are a result of our understanding of the current business and economic environment. All the major accountancy bodies in the world recognise these concepts and have developed accounting standards based on these concepts.

* (American Institute of Certified Public Accountants, Committee on Terminology, Accounting Terminology Bulletin No.1, para.9, August 1953, repeating a definition formulated in 1941.)

** (American Accounting Association, A Statement of Basic Accounting Theory (Evanston, Ill, 1966), p.1.)

International Accounting Standard 1 issued by the International Accounting Standards Committee, recognises the following as fundamental accounting assumptions:

Going concern - The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations. Thereby it is concluded that an entity will have a continuing existence and does not have the intention nor the necessity of liquidation.

Consistency - It is assumed that accounting policies are consistent from one period to another. Thereby it is concluded that consistency in application of accounting methods from year to year is necessary to avoid confusing the reader and to enable proper evaluation of trends.

Accrual - Revenues and costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate. Thereby it is concluded that accounting is to be based on recording the effect of transactions on financial conditions and income when the transactions take place, and not merely when they are settled in cash.

There is an added concept of Prudence, which the International Accounting Standard 1, however, regards as one of the important considerations governing the selection and application of appropriate accounting policies by a reporting entity, rather than a fundamental accounting assumption.

Application of Accounting Standards & The Revenue Recognition Principle

Financial reporting is not an end in itself but it is intended to produce information which will be useful in making business and economic decisions. The objectives of financial reporting are a product of various factors including economic, social, political and legal environment. In applying the accounting standards which have been developed by the accounting profession, the basic aim of financial reporting is to provide a true and fair (one can say reasonable in the given circumstances) presentation of the results of objectively verifiable transactions.

Traditionally, information provided by financial reporting largely reflects the financial effects of transactions and events that have already taken place.

The Financial Accounting Standards Board (FASB) in its Statement of Financial Accounting Concepts No.1 has identified three primary objectives of financial reporting:

- It should provide information that is useful to investors and creditors in making investment and credit decisions.
- It should provide information that is useful to investors and creditors in assessing the cash flow prospects of any entity and
- It should provide information about the economic resources of an enterprise, the claims to those resources and changes in them.

From the above discussion it can be seen that one of the most important concerns in a business environment is the initial recognition of transactions in the accounts and the measurement of the amounts of such transactions. In other words, Revenue Recognition has a critical role to play in the accounting principles or the rules and regulations, methods and procedures of accounting.

The accounting profession has developed comprehensive principles of Revenue Recognition. Based on the economic environment today and the nature of transactions in the business world, the fundamental concept of accrual accounting and the application of the principle of conservatism in financial reporting, has greatly influenced the accounting rules and regulations for recognising revenue.

However, with the growth of an Islamic economic environment in general, and Islamic banking in particular, the fundamental concepts or basic assumptions on which accounting principles have developed, are being challenged and there is a need for setting up Standards for Islamic business transactions.

Before we take up the task of analysing the Islamic economic environment and its implications on accounting standards, it will be useful to highlight the general principles of Revenue Recognition found in accounting literature today.

Transactions may be divided into the following groups:

- (a) Sale of goods
 - (b) Rendering of services
 - (c) Financial transactions - where entity receives funds from issue of debt obligations or equity capital, or conversely repays or redeems debt or capital previously issued.
- or
- Investment transactions - where entity acquires investments to be held for production of income.

For (a) and (b) type of transactions, revenue is recognized generally at the earlier of:

- performance by purchaser (i.e. payment)
- performance (or partial performance) by the vendor provided that at the time of performance it is not unreasonable to expect ultimate collection.

For (c) type of transactions the critical point is the date of legal commitment, or the contract or value dates when no significant uncertainty as to measurability or collectibility exists. Interest income is recognised with the passage of time, dividend income being recognised only when a legal right to dividend arises.

The accounting principles as enunciated in International Accounting Standard 18 on Revenue Recognition may be summed up as follows:

- the amount of revenue must be measurable,
- there must be no significant uncertainty as to ultimate collection, and
- there must be no significant uncertainty as to the costs yet to be incurred by the vendor of the goods or the services.

Where any of the above conditions are not met, the recognition of revenue is deferred till the actual receipt of cash or the completion of the business transaction.

Islamic Economic Environment

- Development of Islamic Banks

The acceleration of Islamic movement throughout the muslim world has perforce demanded complete restructuring of the socio-economic set-up in accordance with Islamic Shariah. On the economic front, the demand for abolishing interest (Riba) from the financial system has been most pressing.

A notable feature of this current awareness to Islamic values is the fact that a number of groups of muslim bankers have started incorporating or re-organizing banks in line with Islamic principles, and at the same time they have continued their demands for a national prohibition on interest-based banking. The emergence of private Islamic banks has reflected a strong desire for such institutions and helped in dispelling doubts typically cast on the viability of such operations.

Though a number of privately owned Islamic banks had emerged during the late sixties the real thrust came in early and mid-seventies, when each year saw the establishment of at least one Islamic bank. This trend is still continuing though at a slower pace.

At present there are some 40 Islamic banks operating throughout the world. These banks are geographically diversified as they are based in 17 muslim countries. Some of the banks are also based (mainly for fiscal and other strategic reasons) in non-muslim countries such as Switzerland, Luxembourg, The Bahamas, Denmark and England. However, there are some 27 muslim countries where an Islamic bank has yet to be established. This information is reported in Annexure-I.

Besides these banks, there are some 20 Islamic finance companies engaged in quasi-banking operations. A number of traditional banks have also opened up their branches which operate along the lines of Islamic banking.

Islamic banks have been established in different areas of banking specialization. The areas of specialization include commercial banking, investment banking, development finance, merchant banking and special purpose banking - such as, for social objectives. The ownership structure of these banks is also varied. It consists of private ownership, public ownership and multilateral ownership.

The operational basis of Islamic banks is different from the basis found in conventional banks. Unlike conventional banking, which revolves around a pre-determined cost of funds and yield approach, the Islamic banks are organized on the principle of profit and loss sharing on both sides of their operations.

On the 'sources of funds' side, almost all Islamic banks have relied on the mobilization of deposits from common savers. Though in some types of accounts the principal is guaranteed, in general the depositors are not entitled for a fixed return on their deposits. Except for the absence of interest, Islamic banks provide most of the conventional banking facilities to their customers ranging from checking accounts to the opening of letters of credit. Normally such banking facilities are provided against a service charge.

On the 'uses of funds' side, Islamic banks have adopted a number of non-interest based modes of financing. The short-term financing needs are largely met through the mark-up instrument which stipulates a given profit margin on the cost of underlying transaction. This is only a deferred sale and the mark-up is not tied to the length of time. In case of default there is no compounding, though a small penalty can be imposed. Banks can acquire collateral to protect their investments. The long-term investment financing is provided on the basis of Mudaraba and Musharika. These are alternative modes based on the principle of profit and loss sharing. Besides these two modes, leasing, buy-back and hire-purchase are also used for financing medium and long-term investment projects.

Islamic banks basically operate by participating in profits with borrowers, on the uses side, and in turn by sharing these profits with depositors, on the sources side. This constitutes an operational basis for running a banking system. The performance of Islamic banks, their growth and a firm standing in the profession, are sufficient indicators of not only the viability of the system but also that the system can efficiently, and with greater stability, compete with the conventional banking system.

A distinct feature of the Islamic movement related to the restructuring of the financial system has been that in two countries of the muslim world, namely Pakistan and Iran, interest-based operations have been eliminated from their banking systems. This has provided a strong impetus and encouragement to privately owned Islamic banks and to other countries in the Islamic world to further their efforts for Islamization.

The Islamic economic environment is visible and now stands on a firm operational basis.

- Islamic Modes of Financing

The conventional banking system operates on the basis of a pre-determined cost of capital. Accordingly, the entire financing is charged an appropriate cost which is given by the relevant interest rate. Though this rate is determined by market forces like any other price, it remains fixed once a financing arrangement is finalised. Islam does not allow for any fixed cost of capital. Under Islamic financing arrangements, capital can qualify for a reward only if it also participates in losses. Thus all capital in an Islamic financial system must be risk capital.

Islamic jurists have formulated a number of financing arrangements that can effectively substitute the existing arrangements under the conventional banking system. In what follows, some of these financing modes are briefly discussed and distinguished from those operative in an interest-based system.

Mudaraba: Under a Mudaraba financing two parties initiate a business with distinct provision of resources. One party, called Rab-ul-Maal or principal, supplies capital for the business whereas the other party, called Darib or agent, supplies effort to manage the business. In an Islamic legitimate form of such arrangement, losses are borne by the principal as they basically accrue on capital whereas profits are shared in predetermined proportion with the agent. Evidently the agent would also share in losses because of lost efforts.

This type of arrangement is extremely useful in promoting the skill of those who lack the needed capital in undertaking a profitable venture. An interest-based system cannot promote it as vigorously because of its unwillingness to share in losses, though currently, venture capital companies have come into vogue.

Musharika: This is a partnership arrangement where two or more parties could be involved. Each party subscribes to the capital of the business. However, not every partner is required to actively participate in the operations. The losses are shared in strict proportion to the capital employed. Profits, on the other hand, can be shared in whatever proportions as may be agreed by the mutual consent of partners.

There are variants of this arrangement which are particularly useful for long-term industrial financing. For instance, partners could be retired after a suitable time. Thus under a retirement provision, musharika can effectively substitute the debentures and other debt instruments used by companies in raising long-term industrial finances.

Bai-Mu'ajjal (Deferred Sale): In this financing arrangement a mark-up can be charged over the sales price of goods financed. Since this mode closely resembles interest-based financing, two important conditions must be met before it qualifies as an acceptable mode of financing. First, the financier must take physical possession of the goods which are being financed for the borrower (so that there is some risk exposure). Second, the rate of mark-up should not be tied to the length of time except for specifying the date on which payment is due (i.e. there should absolutely be no mark-up on mark-up, nor any provision of lost income recovery in case there is a delay in payment).

This mode of financing is particularly suited to meet the short-term working capital requirements. At the same time it also relieves the borrower of compounding interest which could prove fatal in recessionary periods.

Ijara (Leasing): Under this type of financing arrangement the financier (Lessor) acquires the ownership of relevant productive assets and leases it out to the borrower (Lessee). A fixed rental is charged for a given interval until the useful life of the asset is completed. It is required that any damage to the leased asset during currency of the leasing agreement will be the responsibility of the lessor (this essentially ensures risk exposure to the lessor).

In recent years leasing has assumed an important position as a financial instrument in the conventional banking world. However, these leasing arrangements carry features of interest-based financing. Leasing under an Islamic financial system will involve profit or loss sharing as the financier-owners are made responsible for damages to assets while properly in use by the borrower-lessee.

There are other modes of financing such as Buy-Back and Hire-Purchase. Both of these involve financing of a given productive asset. However, the general principle of financing remains the same. Some type of risk-exposure is required for the financier implying that there is no fixed cost of capital known for all times.

Of necessity, in Islamic banking, the cost of borrowed funds should be 'zero' as it is a derivative of profits dependent on a pre-determined formula of sharing. Theoretically the provider of funds, except where his principal is guaranteed, could be called upon to 'seed' rather than to earn a return on his monies - a concept which is alien to conventional banking.

The diversity of instruments pronounced by Islamic jurists as available under Islamic banking is a reflection of their suitability under contemporary conditions.

Accounting problems associated with Islamic Modes of Financing

For purposes of an accounting study the Islamic modes of financing can be categorized into two basic groups:

- the first group consisting of
 - a) Murabaha or 'mark-up' finance and
 - b) Leasing

- the second group consisting of
 - a) Mudaraba and
 - b) Musharika

Presently, Murabaha which is a short-term financing instrument, enjoys the majority role as an Islamic mode of financing. Due to the nature of this type of financing - which is not much different from traditional lending - it is considered by many scholars to represent the negative side of Islamic banking.

In both Murabaha and Leasing transactions the accounting problem revolves around the timing of recognition of profit, the amount of profit being generally known.

In the second group consisting of Mudaraba and Musharika the accounting problems can be found at both levels of revenue recognition i.e. the transaction measurement, or the amount of revenue to be recognised, and the timing of revenue recognition.

In a truly Islamic mode of financing, based on sharing of risk and profits, there will always be an element of uncertainty in the measurability of revenue and the ultimate collectibility.

Both these elements would tend to negate the fundamental accounting concept of accrual accounting and suggest the need for alternate revenue recognition guidelines.

While financial accounting is concerned with both the legal and economic effects of transactions and many of its conventions are based on legal rules, the economic substance of a transaction is usually emphasised when substance differs from legal form.

For Murabahas and Leasing it is imperative that the transactions be viewed in terms of their economic substance rather than legal form. These transactions are essentially financing arrangements, not much different from traditional bank lending and the accounting treatment should reflect the underlying economic basis of these transactions. In the case of Leasing, the major accountancy bodies have in issue comprehensive guidelines as well as International Accounting Standard 17 on leasing. It will be seen that the Islamic concept of Leasing of 'Ijara' is not much different than what would be termed 'operating' or 'true' leases.

The more complicated accounting problem relates to the second group of financing modes where the following options exist as a solution:

- to defer recognition of revenue till actual receipt of monies.
- to accrue for revenue on lines similar to 'percentage of completion basis' of accounting commonly found in the construction or service industry.
- to recognise revenue in anticipation of expected profitability or return of the project or the entity as envisaged when the decision to create the revenue generating asset or provable debt was taken - suitably modified by change in the factual elements.

There can be no set of given answers to the accounting problems foreseen in the Islamic economic environment of today. If the pronouncement of our revered Islamic jurists were accepted for incorporation in Accounting Standards for Islamic Banks as sacrosanct, then that would be a beginning for we accountants to put our heads together and eventually evolve Accounting Standards with the paramount objective of their usefulness. It would, however, still be necessary in such a case to view business transactions in terms of their economic substance rather their legal form. This would then become the Achilles' heel for the accountants, as they would find that in practice the Islamic Banks in developing and implementing the financial instruments under the Islamic modes of financing do not necessarily follow the pronouncements of Islamic jurists and Shariah. We could end up in a debate or controversy over basic understanding of Shariah which would be quite unparadonable.

To highlight the matter at hand, why should the returns to depositors of Islamic Banks who may be guaranteed the principal but not the returns, be regarded as an expense and shown 'above the line' in the profit and loss account when these are mostly received on the basis of sharing in the eventual profit or loss of the entity? Can we not regard these as preferential dividends before the equity shareholders distribute profits to themselves? Should the gearing ratio in an Islamic bank be 10:1 or 1:1 ?

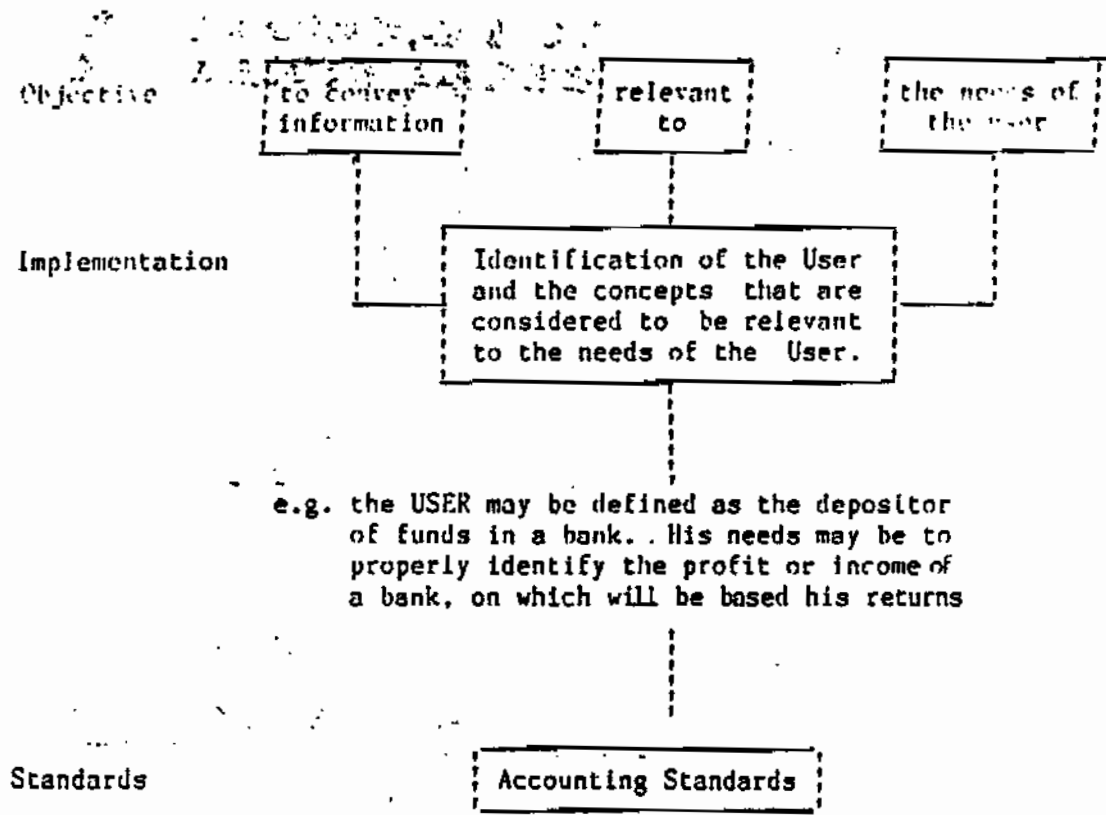
On the other side of the scale, what is wrong in traditional lending when the mere crediting of fixed return to the income account of an entity, may not of itself disqualify it from the precincts of Islamic banking. It is known that before the last day of an accounting period when the profit or loss can truly be determined, the entity has to perforce reduce such income amount by the usual or necessary provisions for bad and doubtful debts or suspense some earlier credits. Can it therefore be said that the contribution to profit of the entity in respect of that particular borrower was pre-determined or fixed ??

Another thought related to the income cycle for determination of profits to be shared. Should what local and fiscal laws dictate to be an accounting period, normally a calendar year, be a desirable period for Islamic Banks ? Could it be shorter or longer by relationship to the income cycle in the particular circumstances of each banking entity ?

Be it suffice to say that banking, after all, whether conventional or Islamic, is the art of gauging risk, deciding whether a client has plans or dreams and then approving or denying a loan. Thereafter, everything is a fiction created mostly by lawyers and accountants, but we accountants would still want rigid regimentation of Standards to measure the success or otherwise of comparable operations and see what is true and fair!

**Need and Rationale of Setting up
Accounting Standards for Islamic Banks .**

The earlier discussions and the need for development of Accounting Standards for Islamic Banks and the objectives of such Standards can best be summarised in the given below flow chart:



e.g. the USER may be defined as the depositor of funds in a bank. His needs may be to properly identify the profit or income of a bank, on which will be based his returns

The principles of accounting to be evolved must have the following characteristics:

- | | | | |
|-----------------|------------------------|---|---|
| Concepts | Reliability | - | verifiability measurability true and fair |
| | Communicability | - | free from bias, disclosure, simplicity, timely reporting |
| | Practicability | - | Cost/benefit justification |
| | Conformity | - | Islamic Laws and Shariah |

Progress in the establishment of Islamic Banks

Annexure - I

| | | | Bahrain | Bangladesh | Egypt | Guinea | Iran | Jordan | Kuwait | Malaysia | Mauritania | Niger | Qatar | Saudi Arabia | Senegal | Sudan | Tunisia | Turkey | U.A.E. | Others |
|-------|----|--|---------|------------|-------|--------|------|--------|--------|----------|------------|-------|-------|--------------|---------|-------|---------|--------|--------|--------|
| 1972 | 1 | Nasser Social Bank, Cairo | | | 1 | | | | | | | | | | | | | | | |
| 1973 | 1 | Philippine Amanah Bank | | | | | | | | | | | | | | | | | | 1 |
| 1975 | 2 | Islamic Development Bank, Jeddah; Dubai Islamic Bank, Dubai | | | | | | | | | | | | 1 | | | | | 1 | |
| 1977 | 3 | Faisal Islamic Bank, Egypt; Faisal Islamic Bank, Sudan Kuwait Finance House, Kuwait | | | 1 | | | | 1 | | | | | | | 1 | | | | |
| 1978 | 2 | Jordan Islamic Bank, Jordan; Islamic Finance House Universal Holding, Luxembourg | | | | | | 1 | | | | | | | | | | | 1 | |
| 1979 | 2 | Bahrain Islamic Bank, Bahrain; Iran Islamic Bank | 1 | | | | 1 | | | | | | | | | | | | | |
| 1980 | 1 | Islamic International bank, Cairo, Egypt | | | 1 | | | | | | | | | | | | | | | |
| 1981 | 4 | Dar-Al-Mal Al-Islami, Switzerland; Islamic Finance House, England; Jordan Finance House, Jordan; Islamic Bank of Western Sudan, Sudan | | | | | | 1 | | | | | | | | 1 | | | | 1 |
| 1982 | 3 | Islamic Bank Bangladesh, Bangladesh Kibris Islamic Bank, Kibris; Islamic Investment House, Jordan | | 1 | | | | 1 | | | | | | | | | | | | 1 |
| 1983 | 10 | Qatar Islamic Bank, Qatar; Tadamon Islamic Bank, Sudan; Islamic Bank, Bahrain; Bank Islami, Malaysia; Faisal Islamic Bank, Guinea; Faisal Islamic Bank, Senegal Islamic Bank International, Denmark; Faisal Islamic Bank, Niger; Sudanese Islamic Bank, Sudan; Bank Al-Baraka Al-Sudani, Sudan | 1 | | | 1 | | | | 1 | | | 1 | | | 1 | | | | 1 |
| 1984 | 5 | Al-Baraka Bank, Bahrain; Islamic Finance House, Jordan; Bait-Al-Tamwil Al-Saudi Al-Tunisi, Tunis; Al-Baraka Turkish Finance House, Turkey; Faisal Finance Institution, Turkey | 1 | | | | | 1 | | | | | | | | 1 | | | 1 | 1 |
| 1985 | 1 | Al-Baraka Islamic Bank, Mauritania | | | | | | | | | 1 | | | | | | | | | |
| Total | 35 | | | 3 | 3 | 1 | 1 | 4 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 5 | 1 | 2 | 1 | 6 |

Source: Muslim World, Development & Problems of Islamic Banks, Islamic Research & Training Institute, Islamic Development Bank, Sudan

WORKSHOP ON ACCOUNTING STANDARDS FOR ISLAMIC BANKS



ORGANISED BY:

- ISLAMIC DEVELOPMENT BANK
- ISLAMIC RESEARCH & TRAINING INSTITUTE

JEDDAH

**14 16 MUHARRAM, 1408H
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محاسبون ومراجعون قانونيون

ترخيص رقم ٥٠

No.

Date

الرقم

التاريخ

AN APPROACH TO ESTABLISHING
ACCOUNTING STANDARDS FOR
ISLAMIC BANKS

Prepared by:

Abdul Aziz Al-Rashed
Dr. Sabry Heikal
Dr. Abdullah Al Faisal

Riyadh
August 1987

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INTRODUCTION

The introduction and expansion of Islamic banking institution over the past few years is a very desirable phenomena. Yet, without concerted efforts on several fronts to prevent pitfalls which tend to raise questions about the credibility of those institutions, their viability might be at risk. On the financial accounting front, it is essential that all Islamic banks maintain a high degree of credibility with those who rely on financial statements in making decisions affecting their current or future relationships with those banks. Maintenance of that degree of credibility, requires that the financial statements of all Islamic banks should contain information that is relevant, reliable and comparable and is perceived as such by those who use that information in making decisions. The essential role of accounting standards is to assure the relevance, reliability and comparability of financial information. It is imperative, therefore, that such standards be developed for Islamic banks.

The purpose of this paper is not to suggest any specific financial accounting standards for Islamic Banks. Rather, its purpose is to recommend an approach to the development of such standards. The paper is divided into five parts.

The first part is an introduction to the function of Financial Accounting Standards.

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The second part addresses the need for an organized and effective approach from a historical prospective. It draws on the comparative study conducted in 1401-1402H by Al-Rashed CPAs on behalf of the Kingdom's Ministry of Commerce as a part of the Accounting Profession Development in Saudi Arabia. The study addressed the development of Accounting Profession in three countries (Tunisia, United States of America and West Germany). The study has demonstrated that the experience of the United States in developing accounting standards is more comprehensive than the experience of other countries. As a result, the United States' experience is used to highlight the major features to be considered in selecting an approach to the development of accounting standards. We hope that this part will show the importance of reaching an agreement on an organized and effective approach to the development of financial accounting standards for Islamic Banks.

The third part describes the essential elements of an organized and effective approach to the development of Financial Accounting Standards.

The fourth part focuses on the proposed approach to the development of financial accounting standards for Islamic Banks. It includes suggestion for the creation of a body to promulgate financial accounting standards for Islamic Banks and describes a recommended methodology for their promulgation. The fifth part of this paper contains the conclusion.

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I THE FUNCTIONS OF FINANCIAL ACCOUNTING STANDARDS

Financial accounting involves the processes of identifying, recognizing, and measuring the economic events and circumstances affecting the financial position and results of operations of an entity and communicating information about its financial position and the results of its operations.

The financial accounting processes are carried out to provide information about an entity that would be useful in making economic and other decisions by interested parties. These decisions involving an Islamic Bank, and other institutions, require, among other things, information that is relevant reliable and comparable. Without these attributes, information provided through the financial accounting processes will not be useful. To enhance the usefulness of financial accounting information, it is generally recognized that standards need to be established to assure that:

- a) Similar economic events and circumstances affecting the financial positions and results of operations of different Islamic Banks will be identified, recognized and measured similarly;
- (b) Disclosures regarding similar economic events and circumstances will be comparable between Islamic Banks;

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- (c) The measurements and communication of the effects of economic events and circumstances will be focused on those attributes that are relevant to economic and other decisions involving Islamic Banks; and
- (d) The measurement methods utilized will produce reliable information.



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II - THE NEED FOR AN ORGANIZED APPROACH

A) HISTORICAL PERSPECTIVE

It is generally recognized that the United States has currently one of the most organized and effective approaches to the development of financial accounting standards. This has not always been the case. The road to the current state of affairs is filled with many attempts. Many of those attempts missed the mark. Accordingly, a brief overview of the experience of the United States would be very helpful in terms of avoiding many of the pitfalls encountered in developing financial accounting standards.

This overview is not intended as a complete history of every effort toward the development of financial accounting standards in the United States. Nor is it intended to suggest that the experience of the United States is the only experience worth studying.

1) RECOGNIZING THE NEED FOR FINANCIAL ACCOUNTING STANDARDS IN THE UNITED STATES

It is generally agreed that one of the contributing factors to the 1929 stock market crash in the United States was the lack of financial accounting standards, and the inadequacy of available disclosures about the performance of investment alternatives.

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The lack of such standards made it difficult for current and prospective investors, including creditors, to have available relevant, reliable and comparable information about the performance of investment alternatives. Further, the lack of such standards made it difficult to maintain comparable score of performance of different managements during the same period as well as the same management from one period to another. Under these circumstances investment decisions were often made without careful assessment of their potential.

While, it is true that the need for financial accounting standards was felt before the 1929 stock market crash, there is general agreement that the crash itself demonstrated their importance and accelerated the efforts toward their development. Accordingly, several major steps were taken to assure that relevant, reliable and comparable information was made available to investors about alternative investments. Those steps resulted in:

- 1) The enactment of the 1933 Securities Act;
- 2) The enactment of the 1934 Security Exchange Act;
- 3) The creation of the Securities Exchange Commission (SEC) as the regulatory agency empowered with the authority to enforce the provisions of the 1933 and 1934 Acts.



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The 1933 and 1934 acts contain many provisions designed to protect current and prospective investors from being provided with misleading or inadequate information about Public Companies. Notable among those provisions, is the authority given to the SEC to establish generally accepted accounting standards to assure relevant, reliable and comparable information about public companies. Although the SEC was given the legal authority to establish generally accepted accounting standards, it has delegated that authority to the private sector (primarily the accounting profession).

The following is a brief overview of the private sector's efforts from 1938 till the present time at establishing generally accepted accounting standards. This overview will focus on the nature of those efforts, together with our views regarding the reason(s) why those efforts were or were not effective. Our objective from this overview is to distill the essential elements of an organized and effective approach to the development of financial accounting standards for Islamic Banks.

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2) ATTEMPTS AT AN ORGANIZED AND EFFECTIVE APPROACH TO THE DEVELOPMENT OF FINANCIAL ACCOUNTING STANDARDS IN THE UNITES STATES:

a) The American Institute of Certified Public Accountants' (AICPA) Committee on Accounting Procedures (1938-1959)

The first notable attempt was the creation in 1938 of the AICPA Committee on Accounting Procedures. The Committee was charged with the responsibility of narrowing alternative accounting practices. The Committee consisted primarily of practicing CPA's. It issued fifty one (51) Accounting Research Bulletins. Each Bulletin addressed one or a set of related subject matters. Those bulletins defined generally accepted accounting principles (standards) for several subject areas ranging from depreciation to business combinations.

An analysis of the composition of the AICPA Committee on Accounting Procedures, its approach to the promulgation of generally accepted accounting principles, its methodology, and the accounting principles it has promulgated, leads to the following observations:

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- 1) The Committee did not achieve sufficient acceptance by those who had to comply with its pronouncement due to:
 - (i) lack of explicit recognition of its authority by the SEC and other interested parties;
 - (ii) lack of representation on the Committee by those who have to prepare financial statements (i.e., managements of the Public Companies) and those who use the information provided by the financial accounting process (e.g., investor groups, creditor groups, etc.); and
 - (iii) lack of a well-defined due process that would have assured that those who are affected by its pronouncements had ample opportunity to be heard before the issuance of those pronouncements. As a result, its pronouncements were taken into consideration but not necessarily always followed by those who prepared financial statements.

- 2) The Committee lacked either a direct or an indirect enforcement authority to assure compliance with the pronouncements;

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- 3) The Committee did not constitute sufficient commitment of resources. Members of the Committee were either full-time practicing CPA's or academicians appointed to the committee on a part time basis. As a result not enough time was devoted to a thorough considerations of the subject matters addressed by the Committee; and
- 4) The Committee's pronouncements did not rest on an adequate conceptual foundation or framework which defined the objectives and concepts of financial accounting. The lack of such foundation resulted in some inconsistencies between pronouncements. This, in turn, contributed to the lack of sufficient acceptance of those pronouncements. The Committee's approach is best described as providing solutions to specific problems without a conceptual frame of reference. Accordingly, there was no assurance that the solution to one problem would always be conceptually consistent with prior solutions to other problems.

- b) The AICPA Accounting Principles Board (APB)
 1959-1973

In 1959 the AICPA replaced the Committee on Accounting Procedures with the APB in an attempt to improve the process of establishing generally accepted accounting

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standards. The APB consisted of 18 part-time members. Except for one or two members representing the academic community, all other members were practicing CPA's. Members served on the board on a part time basis. Among other things, the APB was charged the responsibility of developing a conceptual framework as a foundation for establishing generally accepted accounting standards. In connection with the establishment of the ABP, the AICPA created an accounting research division. It was the responsibility of the Accounting Research Division to conduct the necessary research for the subject matters being addressed by the APB and for the APB to promulgate the standards based, among other things, on considerations of the conducted research. Further, the APB adopted a due process for the promulgation of the standards to assure considerations of the views of those who are affected by the promulgated standards. The APB issued 31 standards (APB opinions) and 4 conceptual statements. An analysis of the composition of the APB, its approach to the promulgation of accounting standards; its methodology and the accounting standards it has promulgated, leads to the following observations:

- 1) Although the APB achieved better acceptability than the Committee on Accounting Procedures, it's total acceptability was still lacking due to:

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- (i) lack of explicit recognition of its authority by the SEC and other interested parties;
- (ii) lack of representation on the board by those who have to prepare financial statements and those who use the information provided by the financial accounting process; and
- (iii) a due-process that was perceived to be inadequate by those for whom the process was intended.

2) The APB lacked either a direct or an indirect enforcement authority to assure compliance with its pronouncements;

3) Although one of its charges was the development of a conceptual framework as a foundation for financial accounting standards, the APB did not develop the necessary framework on a timely basis. Further, what was developed was not comprehensive enough to provide the necessary foundation. As a result conceptual inconsistencies crept into the promulgated standards. This contributed, in turn, to the

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general dissatisfaction with several promul-
 gated standards.

- c) The Financial Accounting Standards Board (FASB) -
 1973 - Present time.

Considerations of the experience with the promulgation of accounting standards from 1938 to 1973 lead to the creation of the FASB as an independent full time board, supported not only by the AICPA and the SEC but also by organizations representing those who prepare financial statements and those who use the information provided through the financial accounting process. The FASB consists of seven members. Members are appointed by a board of Trustees in a way that assures that not only practicing CPA's will be represented but also preparers and users of financial statements. The FASB is advised by an advisory board consisting of representatives of many organizations affected by the promulgated standards. Further, the FASB is assisted in the discharge of its responsibilities by a large full time staff which conducts the research and analysis necessary for the promulgation of the standards. In addition, the by-laws of the FASB established a due-process that provides reasonable assurance that interested parties are given ample opportunity to

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express their views and that those views are adequately and carefully considered by the board before reaching any conclusions.

In connection with the establishment of the FASB, the SEC explicitly recognized its authority for the promulgation of accounting standards. In addition, members of the AICPA adopted an article in the code of professional ethics requiring compliance with standards promulgated by the FASB as well as those that have been previously promulgated by the Committee on Accounting Procedures and the APB until superseded by the FASB.

The initial agenda of the FASB contained seven items. One of those items was the development of a conceptual framework for financial accounting from which accounting standards can be derived. Prior experience with the promulgation of accounting standards demonstrated the urgent need for a conceptual framework. It was felt that accounting standards need this framework for the same reason a country needs a Constitution to guide the development of its laws (although the accounting framework does not have the legal force of a Constitution). Without it, debate over the issues involved in promulgating a standard bogs down because arguments would be

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based on individual frames of reference that are rarely made explicit, with no common basis for analysis.

In 1985, the FASB completed the construction of a conceptual framework for financial accounting. This framework is currently being used by the FASB to guide the promulgation of accounting standards. In addition, since its inception, it has promulgated over 100 standards.

A review and analysis of the work of the FASB since its inception lead to the following observations:

- 1) there is general acceptance of the FASB's authority to promulgate financial accounting standards;
- 2) the following elements have contributed to the general acceptance of the FASB's authority:
 - o Its independence;
 - o The adequacy and fairness of its due process;
 - o The significant improvement in the relevance, reliability and consistency of the promulgated standards.

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o The enforcement authority provided indirectly by the SEC, the AICPA, and several other organizations through their recognition of the FASB as the only body authorized to promulgate generally accepted accounting standards.

3) The general acceptance of the FASB's authority lead to significant improvement in compliance with the promulgated standards. This, in turn, has enhanced the credibility of financial reporting.

8) RECAPITULATION

The experience of the United States indicates that certain pitfalls should be avoided in developing a structure and a methodology for the promulgation of accounting standards. It emphasizes that the acceptability of the promulgated standards is essential for the credibility of the information presented in the financial statements. The acceptability of accounting standards suffers when the body promulgating those standards is perceived to be lacking independence (i.e. perceived to be biased toward one point of view at the expense of other points of view). Likewise, the acceptability of the standards suffers when they are perceived not to be based on firm conceptual foundation that articulates the objectives and the essential characteristics of financial accounting. Lack of explicit recognition of the authority

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of the body promulgating the standards also diminishes their effectiveness in improving the quality of financial statements. These pitfalls must be avoided in selecting an organized approach for the promulgation of accounting standards for Islamic Banks.

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III - THE ESSEDNTIAL ELEMENTS OF AN ORGNAIZED APPROACH

We believe that an organized and effective approach to the development of accounting standards should consist of two main elements as follows:

(a) A body to promulgate the standards:

In order for this body to achieve a degree of authority sufficient to assure compliance with the standards it promulgates, it has to have the following characteristics:

- (1) It must be independent;
- (2) It must represent all constituents affected by the promulgated standards;
- (3) It must adopt a due process that is fair and is perceived as being fair;
- (4) It must be adequately funded;
- (5) Its authority from inception must be recognized by those who have to comply with the promulgated standards.

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(b) A methodology for the promulgation of the standards that assures their relevance and consistency:

Accounting standards must be derived from a conceptual framework which defines the objectives of the financial statements and the basic concepts of financial accounting. Without a well-constructed conceptual framework, accounting standards will run the risk of being irrelevant and/or inconsistent. Irrelevant and/or inconsistent standards are apt to be not complied with, which in turn, reduces the credibility of financial statements.

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IV - A PROPOSED APPROACH TO THE DEVELOPMENT OF FINANCIAL ACCOUNTING STANDARDS FOR ISLAMIC BANKS

The proposed approach deals with the structure for the promulgation of accounting standards; and the recommended methodology for their promulgation as follows:

A) CREATION OF AN INDEPENDENT BODY TO PROMULGATE ACCOUNTING STANDARDS FOR ISLAMIC BANKS

The Islamic Banks are unique institutions. It is assumed that their philosophies and modes of business activities make it difficult to simply adopt financial accounting standards developed in other countries for commercial banking institutions. Accordingly, a standard setting body needs to be established to promulgate standards suitable for Islamic Banks. Yet, Islamic banks are not unique to one country. As a result they are subject to different laws and regulations. This is an important issue to be considered. It also emphasizes that the body established to promulgate standards for Islamic banks be recognized by all Islamic banking institutions as the sole body authorized to promulgate accounting standards for Islamic Banks.

If this idea were to be accepted, the organization, membership, funding, internal regulations including the due process etc. should be considered by the participants.

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B) PROPOSED METHODOLOGY FOR THE PROMULGATION OF FINANCIAL ACCOUNTING STANDARDS FOR ISLAMIC BANKS.

The proposed methodology consists of four major steps as follows:

1) Defining the objectives of financial statements of Islamic banks

This paper started by suggesting that standards should assure, among other things, that information presented in the financial statements of an Islamic Bank must be relevant to those who need the information to make decisions. For the standards to provide this assurance, they must be promulgated based on a clear and concise statement of the objectives of the financial statements of Islamic banks. Articulation of those objectives involves:

- a) Identification of the major groups of decision makers who rely on the financial statements of Islamic banks in making decisions;
- b) Analysis of the nature of the decisions that are being made in reliance on the financial statements;

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- c) Identification of the type(s) of information that can be produced through the financial accounting process which would be most helpful in making decisions;
- d) Analysis of the common attributes of information needed to make decisions; and
- e) Focusing the objectives of the financial statements of Islamic banks on the common information needs of the major groups of decision makers who rely on those financial statements.
- 2) Defining the basic concepts of financial accounting for Islamic banks.

To assure consistency of the promulgated standards, they must be based on a well-defined set of basic concepts. A concept is a statement that defines a basic term and provides broad guidelines for the use of that term. A term is basic when repeated reference to it is necessary, either explicitly or implicitly, when standards are being promulgated. In this manner, standards that deal with different types of assets would be consistent with each other.

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Identifying and defining the basic terms of financial accounting for Islamic banks, establish the basic features of financial accounting for those banks. Those basic features must be maintained when standards are promulgated.

Generally, the concepts of financial accounting for Islamic banks will fall into three groupings as follows:

a) The elements of financial statements of an Islamic bank:

This group of concepts define the basic characteristics of assets, liabilities, owners equity, revenue, expense, gains, losses, and net income.

b) Recognition and measurement concepts:

This group of concepts provide broad guidelines for the following issues:

- o When should revenues, expenses, gains, losses and income be recognized?.
- o What attribute(s) of assets, liabilities, equity should be measured?
- o What unit of measurement should be used?

c) Qualitative characteristics of accounting information:

This group of concepts provide operational guidelines for

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the standard setting body as well as those who prepare financial statements for evaluating alternative proposals for standards and practices. Terms such as relevance, reliability, materiality, conservatism, and adequate display and disclosure would be defined.

- 3) Establishing an agenda for the promulgation of financial accounting standards for Islamic banks

This step in the proposed methodology requires the following:

- a) Developing an inventory of investing, financing and other types of transactions that Islamic banks enter into, such as lease financing, option trading, futures, purchase and resale agreements, sale and repurchase agreements, credit sales, etc.
- b) Developing an inventory of the accounting practices currently in use by Islamic banks to account for transactions identified in (a) above.
- c) Analyzing the economic substance of transactions identified in (a) above.
- d) Identifying problem areas. Those would include:

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- o Similar transactions that are being accounted for differently by different banks.
 - o Accounting practices currently in use which appear to be inconsistent with the objectives and basic concepts of financial accounting for Islamic banks; and
 - o Accounting practices currently in use which seem not to reflect the economic substance of transactions.
- e) Establishing priorities for the promulgation of standards to deal with problem areas.

4) Identifying and evaluating alternative solutions

Guided by the conceptual framework for financial accounting for Islamic banks (see steps 1 and 2 in the proposed methodology), this step requires the standard setting body to identify and evaluate alternative standards developed in other countries to deal with problem areas identified in the previous step. One of three possibilities might exist for each problem area. These are:

- a) A standard promulgated in another country might be considered, without adaptation, to be consistent with the conceptual framework. In this case, the standard should be adopted for Islamic banks.

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- b) A standard promulgated in another country might be considered, with some adaptation, to be consistent with the conceptual framework. In this case, the standard should be adapted to fit the unique characteristics of financial accounting for Islamic banks as reflected in the conceptual framework.
- c) No standard promulgated in another country might be considered to be consistent with the conceptual framework. In this case, the standard setting body should develop and promulgate its own standard consistent with the requirements of the conceptual framework.

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V - CONCLUSION

As stated at the beginning of this paper, the introduction and expansion of Islamic banking institution over the past few years is a very desirable phenomena. Yet, without concerted efforts on several fronts to prevent pitfalls which tend to raise questions about the credibility of those institutions, their viability might be at risk. On the financial accounting front, it is essential that all Islamic banks maintain a high degree of credibility with those who rely on financial statements in making decisions affecting their current or future relationships with those banks. Maintenance of that degree of credibility, requires that the financial statements of all Islamic banks should contain information that is relevant, reliable and comparable and is perceived as such by those who use that information in making decisions. The essential role of accounting standards is to assure the relevance, reliability and comparability of financial information. It is imperative, therefore, that such standards be developed for Islamic banks.

The corner stones of the proposed approach are:

- 1) The creation of an independent standard setting body to promulgate financial accounting standards for Islamic banks; and
- 2) The adoption of a methodology for the promulgation of the standards which focuses the initial efforts of the standard

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setting body on the development of a conceptual framework for financial accounting for Islamic banks. Once developed, this conceptual framework should serve as a basis for evaluating alternative solutions for problem areas for which standards need to be promulgated.

WORKSHOP ON ACCOUNTING STANDARDS FOR ISLAMIC BANKS



ORGANISED BY:

- ★ **ISLAMIC DEVELOPMENT BANK**
- ★ **ISLAMIC RESEARCH & TRAINING INSTITUTE**

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Baeshen & Banaga

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Dear brothers in Islam:

It is an honour and my pleasure to be a participant in this workshop. The question under discussion to my mind is not so much just the need for accounting standards for Islamic banks, since we accountants are already familiar with the various accounting standards which we follow in our professional life on an almost daily basis and as such the need for such standards. The question that should be addressed in my view is what is so special or unique about Islamic banks that we require separate accounting standards for these banks.

This presentation essentially draws its strength from the paper already presented by Mr. Hashmi and is being made with the specific environment of a workshop in mind, i.e. the need to raise questions, encourage discussions rather than presenting cut and dried solutions. However, on issues where I had some thoughts on possible alternatives, I have noted down my suggestions which are offered only as points for discussions and not as inflexible standards.

This presentation is arranged in four sections. The first section discusses the need and form of a banking institution in Islam. The second section addresses some of the basic concepts in Islamic banking which need clarification. In the third section, I have briefly described certain specific accounting problems encountered by some Islamic banks. In the last section I have attempted to present a suggested approach for regulating Islamic banking which is a prerequisite before development of specific accounting standards.

I. NEED AND FORM OF A BANKING INSTITUTION IN ISLAM

One basic issue which should not be ignored at the outset is that we have taken for granted that a banking institution, on the lines found in the conventional banking system, is an integral part of the Islamic system of finance. The basic concept of an Islamic financial institution is still arguable, whether it should be an investment bank or should it be similar to a conventional commercial bank. The correct way to decide on this issue might be to firstly examine the total financing needs at the level of individuals; businesses; corporations; countries, etc.; develop appropriate financing modes; and then decide on the most appropriate type of enterprise or enterprises needed for these activities.

It should be borne in mind that the conventional banks are primarily profit oriented and, in practice, their services are restricted to the rich or to the influential and privileged class. On the other hand, Islamic institutions, though not charitable enterprises, should have wider social responsibilities of serving the small savers and the poor with entrepreneurial skills. In addition, an Islamic financial institution of this nature should play its part in relieving distress caused by natural catastrophes like floods and famines by providing the much needed finance and administrative skills.

II. SOME PROBLEMS IN THE BASIC CONCEPTS OF CURRENT ISLAMIC BANKING

In my opinion, most of the problems in the basic concept emanate from the following two reasons:

- A. A study of the current Islamic Banking practices will indicate that Islamic banks have generally retained the broad pattern of banking followed by the conventional banks even though the concepts underlying the transactions are significantly different.
- B. With the exception of Iran and Pakistan, where the respective Governments have assisted in developing Islamic Banking on an economy-wide basis, most other Islamic financial institutions have come into being as a result of the individual efforts of entrepreneurs. As a result, the systems evolved sometimes differ between the banks in both concept and practice.

Also, most Islamic banks have internal Fatawa committees which are charged with the responsibility of overseeing the operations of the banks for compliance with Islamic Shariaa. It has been observed that on many issues the banks follow different and sometimes contradictory practices because of differences in the interpretation of the Shariaa.

I now highlight some specific problems in the basic concepts of current Islamic banking.

Surplus funds

Islamic banks have been successful in obtaining substantial funds from dedicated Muslims and, as a result, deposits have persistently grown. On the other hand, the banks are not readily prepared to invest in risky

ventures, therefore, they have accumulated substantial unutilized funds. Further, in some countries banks are subject to overall investment limits by the regulatory agencies, which has also resulted in surplus funds. It would appear that if a substantial portion of resources remain unutilized, the rate of return to the depositors will be low.

In view of the above, a system needs to be developed for investing surplus funds in an Islamic manner. One possible answer to the problem highlighted above would be to limit the funds obtained to those required for actual investment or in other words, strict resourcing of investment requirement of varying maturities with matching funds. Alternatively, surplus funds could be deposited with a Central Islamic Bank as discussed below.

Temporary cashflow shortfalls

Procedures need to be established on how, from where, and at what cost an Islamic bank might obtain temporary financial accommodation in the event of unusually large withdrawals. One possible solution might be to set up an International Central Islamic Bank.

Guidelines are also needed on how best can an Islamic bank keep a balance between its short, medium and long-term financing, and to manage its portfolio so as to be always in a position to arrange a steady cash-flow. Run on liquidity can also be avoided if the investment deposit certificates were made negotiable instruments.

In so far the depositors' share in the risks of the banks, a question arises, should there be a requirement for Islamic banks to maintain cash margin accounts with the central banks?

Relationship with the conventional banks

Relationship of Islamic banks with the conventional banks in financing multilateral trade transactions in an international environment on non-interest basis needs to be examined; and a mutually satisfactory method should be evolved in this respect.

Further, there is a need to develop opportunities for cooperation between the western and Islamic financial institutions.

Operating in non-muslim countries

In non-muslim countries, the regulatory agencies have stringent rules for guaranteed protection of deposits, therefore, Islamic banks are finding it increasingly difficult to open deposit taking branches in these countries. One feasible method to operate in non-muslim countries may be to implement a deposit insurance scheme through an independent Islamic insurance company. Another possibility that may be considered is to restrict employment of the funds from ordinary deposits in relatively risk free financing like mark-up or leasing, etc. Both the suggested methods should be examined for conformity with Islamic Shariaa.

Amana accounts (guaranteed current and savings accounts)

Certain banks have resolved to pay voluntary rewards on deposits held on current and savings accounts (essentially in the form of Amana accounts). The main criticism for this practice comes from the fact that if such practice is repeated regularly, it might become a settled custom and thus constitute a return on guaranteed deposits, which may be construed as Ribaa.

However, there may be a valid case for allocating a portion of the bank's income to the Amana accounts if it could be demonstrated that the bank had invested such deposits in profitable ventures. This could be easily demonstrated by comparing the total amounts invested with the sum total of bank's equity and investment deposits. Any excess amounts invested would represent amounts utilized out of the Amana accounts.

Further, it is argued that in order to compensate for the fall in the purchasing power of money due to inflation, such Amana accounts (also Qarde Hasan) should be subject to indexation. The concept of indexation has been discussed at several forums in the past but no firm decision has emerged on acceptability of this concept in Islamic banking.

Another point which requires clarification is the classification of saving accounts; certain banks classify savings accounts as Amana account while others classify them as regular profit and loss sharing deposits.

Loans and calculation of service charges thereon

Some Islamic banks provide loans to individuals and government agencies. Such loans differ from Qarde-Hasan in so far that the banks charge a service fee for providing the finance based on the administrative cost of the bank.

Clear guidance is needed whether such loans are acceptable under Islamic Shariaa. If these loans are considered acceptable, guidance will also be required on calculation of service charge. At present, the administrative costs used for calculating the service charge exclude losses

from bad debts and tax expenses.

Funds for assisting the needy (Qarde-Hasan)

Different views have been presented on how Islamic banks should allocate funds for cost free loans to the needy. Such funds may be set up by the following methods:

- o Obtain specific funds from depositors and/or partners for charitable purposes. (This method is, however, likely to raise many administrative and practical problems.)
- o Allocate a percentage of the total profits of the bank, before or after allocation of profits to the investment depositors.

Guidance is needed on whether the above methods are acceptable under Islamic Shariaa. Alternatively, other appropriate methods should be formulated in this respect.

Al-Murabaha

Murabaha is still considered by many scholars to represent the negative side of Islamic banking. This mode of financing raises the following questions of conceptual nature:

- o At what point the property/title to goods passes to the customer? Legally, the title to the goods passes on delivery of goods.
- o On what basis the mark-up may be determined in advance?
- o Are prompt payment rebates (cash discounts), as offered by certain banks, in line with Islamic Shariaa?

- o When the bank has financed a large consignment, can the bank insist that the entire consignment should be purchased by the customer on the same date?
- o How to ensure that trade-related operations are not oversimplified for convenience so that these are reduced to paper transactions and lose their credibility as instruments of Islamic banking?

Some of the concerns raised above may be resolved, if the banks adhere to the strict principles of Murabaha. For example, Murabaha principles stipulate that a customer can refuse to purchase the goods financed if he felt that, in view of subsequent market conditions, it may result in a loss. In this event, loss on unsold goods should be the responsibility of the bank. Many Islamic banks do not follow this principle.

Further, under this mode of finance, the bank must insist on full settlement of the accounts due as soon as the customer has sold the goods or the date for payment specified in the agreement, whichever is earlier. Again, many Islamic banks do not follow this principle.

Al Murabaha mode of finance is frequently used to finance working capital needs of enterprises. If strict compliance with Murabaha principles is not considered practicable then the working capital needs may be financed by either of the following methods:

- a. By providing total finance on the basis of Musharaka; or
- b. By financing the trade on the basis of an agreed percentage in the gross profit margin of the trader. In the event of loss, the bank should also share in the loss.

Al Musharaka

This mode generally provides for payment of management fees out of profits, and distribution of the remaining profits in predetermined ratios. In some countries, the predetermined ratios and fees may be altered based on actual results; clear guidelines need to be established in this regard to ensure conformity with Islamic Shariaa.

Leasing (Ijara)

This mode of finance carries many features of conventional financing. In particular, the rental charge is not linked to the ultimate results of the lessee. In the event of a loss, lessee is still obliged to pay the fixed amount of rent. It is argued that prohibition of predetermined positive return only applies to provider of capital in a purely financial transaction. Leasing is not considered to be a purely financial transaction because the entrepreneur does not receive liquidity or money but real asset, i.e. machinery. Assuming that this mode of finance is in strict conformity with Islamic Shariaa, full supporting evidence in this respect should be made available and efforts should be made to educate and gain acceptance with the public at large.

Sale and buy back arrangements

In this mode of financing, if the initial sale price by the customer and the buy back purchase price (which is fixed in advance) are not related to market, I do not see how these arrangements can be described as fair and equitable and thus fall within the ambit of Islamic Shariaa.

Collateral and guarantees

In Islamic modes of financing, to my understanding, no form of collateral or guarantees may be obtained by the banks to secure the amounts invested. The only form of guarantees which may be obtained are to cover for negligence on the part of the investee. In practice, however, certain banks obtain collateral or guarantees to secure their overall line of credit. Clear guidelines are needed in this respect to ensure compliance with Islamic Shariaa.

III. SOME ACCOUNTING PROBLEMS IN CURRENT ISLAMIC BANKING

Islamic banking is a unique concept in the present commercial environment. The concept of sharing of profits and losses on an equitable basis instead of fixed guaranteed returns to financiers is alien to the conventional banking system. Similarly, the mode of financing adopted by Islamic banks to give effect to the Islamic basis do not have parallels in conventional banking. It should also be acknowledged, and indeed this fact has already been discussed at some length, that in order to introduce Islamic concepts into banking, many Islamic banks have adopted practices and based their activities on concepts that still require some fundamental clarifications.

In view of the above, it is obvious that accounting for Islamic banks, like the related banking practices, will have to be formulated on different bases from the present generally accepted accounting principles. Such new accounting standards will have to develop some fundamental accounting concepts as well as operational standards.

Mr. Hashmi's paper has already drawn our attention to some of the basic accounting problems with reference to the revenue recognition problems. Now, I would like to further reinforce the argument for the need of new accounting standards by highlighting some other specific problems currently faced by Islamic banks.

Relationship of the depositors with the bank

In conventional banking, the relationship between the bank and its customer is essentially that of a creditor and debtor. In Islamic banking, however, the bank may either be a partner with the depositor and the ultimate user of the finance or the bank may in theory merely

act as an intermediary between the depositor and the ultimate user.

Creditor and debtor relationship is, however, still relevant in the case of Amana accounts and Qarde Hasan.

If the relationship of the bank with the depositor is that of a partner, with the bank acting as an independent profit enterprise, then returns related to the depositor should be shown below the line as an appropriation of profit. The question which then arises is, should the depositor share in the profit of the bank before transfers to reserves or in the profit after Zakat and taxes and transfers to reserves.

In case the relationship of the bank to a depositor is that of an agent, for example as in the case of a mutual fund, then the whole accounting will be that of a special purpose fund whereby the income related to the fund will be directly credited to the depositor after deducting the share of the bank.

Sharing of the bank's profit and loss with the depositors

Funds available with a bank for the purposes of business broadly comprise:

- o Equity funds including paid-up capital; reserves and unappropriated retained earnings
- o Investment deposits
- o Amana accounts (savings and current)
- o Call accounts including interbank deposits

Where the bank is acting as an independent profit enterprise and there is no specific matching of resources of different maturities with corresponding investments, or trade-related finance provided by the

bank, clear guidance should be provided on how the bank might share its profit or loss with the depositors.

In practice, Islamic banks use different bases for this purpose. For example, in Sudan, some of the banks before allocating profits between the bank and the depositors allocate a certain percentage of revenues to cover expenses of the bank. In Pakistan, however, net profits from profit and loss investments (after deducting proportionate costs) are distributed by a system of weightage for various types of sources of finance. The manner in which these weightages (some of which are variable) were initially worked out and its practical applications are, however, not made public.

The ultimate exact profit of a bank for a particular transaction or an investment can only be determined after the bank has made full recovery of the amounts advanced and its share of profit. So there may be a case for deferment of recognition of profit until such time that all cash is collected. If the banks were to follow the accrual basis in both determination of their revenues and depositors' share of profit, it may result in serious accounting difficulties in matching revenues with corresponding funds.

Another area of contention might be whether the depositors should share in revenues derived by the banks from sundry banking services?

Al Murabaha

There are several questions concerning the accounting of Murabaha transactions:

- o How should unsold inventory be valued in the books of the bank, if

purchase and sale are not simultaneous? International Accounting Standards require that inventories should be valued at the lower of cost and net realizable value.

- o How should transactions for purchase and sale of goods be presented in the bank's profit and loss account? International Accounting Standards require that revenues and costs should be shown gross.
- o At what point should income be recognized? Generally speaking, income should be recognized as soon as sale is made. Certain banks defer recognition of income and loss until receivables are collected in full. In my view, this practice is unacceptable. Full provision (if considered acceptable in Islamic Shariaa) should be made for anticipated losses on collection as soon as these are known.
- o One related accounting problem is the recording of purchases by the customer. The question which arises is should the customer record the purchase at original cost plus mark-up or exclude the mark-up? In the latter case, mark-up would be shown as a financing cost.

Mudaraba and Musharika

The paper by Mr. Hashmi raises the following questions regarding the revenue recognition for Mudaraba and Musharika:

- o Should the recognition of revenue be deferred until cash is received?
- o Should revenue be recognized on lines similar to the "percentage of completion" method, which is commonly found in the construction and service industries?

- o Should revenue be recognized on the basis of expected profitability or return that was envisaged when the decision to participate in the business was made?

I would like to raise the following additional questions:

- o What should be the basis for valuation of underlying venture assets at balance sheet date and treatment of the resulting gains and losses?
- o How should revenues be recognized where the ultimate user's financial year-ends are not co-terminus with the bank or where there are delays in calculation of profit or loss?
- o In the case of long-term relationships, can losses be carried forward, or should results be calculated each year separately or on a cumulative basis?

It would appear that the timing of the recognition of income from these two types of financing modes is dependent upon the bank's accounting for its investment/partnership interest in such ventures. A discussion of the alternative methods of accounting for each of these financing modes follows.

A. Mudaraba

One method of accounting for Mudaraba would be for the bank to apply the cost method prescribed by U.S. APB 18. Under the cost method the bank should record the amounts invested in the venture at cost. Subsequently, the bank should recognize 100% of the venture's net losses, as incurred, in the relevant accounting

period and should record a corresponding reduction in its investment in the venture. If it appears likely that the venture will sustain continued net losses and there is evidence of permanent impairment in the bank's investment, the bank should write down its investment to reflect that impairment and should recognize a corresponding loss in the period the investment is written down. If the amount of future net losses cannot be reasonably estimated, but their occurrence and the resultant impairment in the bank's investment appears likely, disclosure of this fact should be made in the footnotes to the bank's financial statements.

In the event that the venture sustains continuous net losses and is unable to meet its obligations to its other creditors, what are the bank's obligations to the venture's creditors? If the bank is liable to the venture's creditors for such obligations, should the bank record a provision (e.g. over and above the operating losses it has already recorded) to reflect its liability to the venture's creditors for such amounts? The answer to this question would seem to depend upon the bank's legal and moral obligations in these circumstances. If the bank is liable to the venture's other creditors, then the bank should record such a provision at the time it becomes apparent that such a liability will be incurred and the amount can be reasonably estimated. If the amount of the loss that the bank will sustain as a result of its liability for the venture's obligations to creditors cannot be reasonably estimated, disclosure of the potential loss should be made in the footnotes to the bank's financial statements.

When the venture is profitable the bank should not recognize its agreed proportional share of the venture's net income until such profits are distributed to the bank in the form of a cash dividend or distribution.

As an alternative to accounting for the bank's investments in these ventures under the cost method, consideration could be given to presenting consolidated financial statements for the bank and its investments in these ventures.

Provisions for losses and risks and presentation of consolidated financial statements should be examined for conformity with Islamic Shariah.

B. Musharika

For this type of financing mode it would appear that the bank's investment/partnership interest in the venture could be accounted for using either the equity method or the cost method. These alternative methods are discussed below.

- o Equity method - Under the equity method (the existing accounting principles which are embodied in U.S. APB 18) the bank should record the amount invested to the borrower as its equity investment in the venture. The bank should then recognize its share of the venture's net income or loss for the relevant accounting period as an increase in its investment, in the case of net income, or as a reduction of its investment, in the case of net losses. The bank would not recognize losses beyond the total amount of its original investment in the venture, unless there is a legal or moral obligation on

the part of the bank for its share of the venture's obligations to other creditors. (See discussion above under Mudaraba regarding such obligations to other creditors.) If the venture appears likely to sustain continuous net losses and there is evidence of permanent impairment in the bank's investment in the venture the bank's investment should be written down to reflect this impairment, and a corresponding loss recognized by the bank at that time. (See discussion above under Mudaraba regarding the disclosure in these circumstances if such amounts cannot be reasonably estimated.)

Although the venture may generate net income, the bank's equity share of that net income should only be recognized when there is no uncertainty regarding the ultimate realization of that income in the form of a cash distribution.

- o Cost method - Under the cost method (also described in APB 18), the bank should record its investment in the venture at the amount invested. The bank would record income only when received in the form of a cash dividend or distribution of net income. In this case, there is no need to evaluate the collectibility of amounts due to the bank. However, if the venture sustains continuous net losses and it appears that there has been a permanent impairment of the bank's investment, the bank's investment should be written down to reflect that impairment and a corresponding loss recognized, at that time. (See discussion above.)

Leasing (Ijara)

The major accountancy bodies have issued comprehensive guidelines on leasing (FASB 13, as amended, in the U.S., and International Accounting Standard 17). It would seem that the Islamic concept of leasing (Ijara) is similar to what would be termed "operating" leases under these existing guidelines, and as such, may be accounted for in accordance with same. For purposes of discussing and formulating accounting standards for Islamic leasing transactions the following points should be addressed:

- o Should the bank record the cost of the asset at the time the leasing transaction is entered into? Under existing guidelines, it would appear that the bank should record the asset at cost when acquired.
- o How should the bank account for the costs incurred to place the asset in service, if such costs are incurred? Under existing guidelines, it would appear that the bank should defer such costs and amortize them over the term of the lease arrangement. Alternatively, consideration might be given to recognizing such costs as period costs.
- o Should the bank periodically depreciate the cost of the asset over the term of the lease? Under existing guidelines, the bank should depreciate the cost of the asset over the term of the lease arrangement, on a straight-line basis.
- o How should the salvage value, if any, of the relevant asset be accounted for by the bank? Given that there may be some uncertainty as to the determination of the salvage value of the relevant asset, or as to the bank's ability to realize that salvage value,

it would appear prudent and conservative for the bank to recognize any gain associated with the sale of the relevant asset for its salvage value at the end of the lease arrangement only when such gain is realized. (One of the questions to be answered in this regard is whether the bank is legally entitled to sell the relevant asset for its salvage at the end of the term of the lease arrangement.)

- o Should the bank recognize the costs of damage to the asset during the term of the lease as period costs? As such costs are to be borne by the bank, it would appear prudent and conservative to recognize such costs, when incurred, as period costs.
- o On what basis should revenue be recognized during the term of the lease? It would seem that revenue should be recognized as it is earned throughout the term of the lease. However, if there appears to be uncertainty as to the collection of amounts due the bank, provision should be made for such losses at the time the revenue is recognized, if in conformity with Islamic Shariah.
- o Should the profit be spread equally over the term of the lease agreement or should it be based on the implicit rate of return?

Term Finance Certificates (TFC)

Under this mode of financing, the bank buys and then sells capital equipment to customers and the cost of the equipment includes a mark-up (e.g. if the cost is SR 20 million and mark up SR 15 million with a prompt payment rebate of SR 1 million, the ultimate sale price would be SR 34 million). Further, the agreements generally provide no repayment in the first two or three years of operations on the basis

that no profit is made by the customer in the initial stages of installing the plant.

Problems

- a. At what value should the asset be recorded by the customer? Under the substance over form concept the cost of fixed assets is the invoice cost and not the one arrived at on the basis of financial arrangements. However, financing costs may be capitalized under certain circumstances (IAS 23).
- b. Some customers take the position that in periods where no payment (principal or profit) is due to the bank, an accrual in respect of the profit payable to the bank should not be made in their financial statements.
- c. Regarding the banks, a question arises whether the amount charged as profit should be spread evenly over the period of the agreement or be based on the implicit rate of return used by the banks in preparing the repayment schedule?
- d. Following the accounting method used by some customers (as discussed in b. above), if the banks do not accrue any profit in the years during which no repayment is due, the bank's financial statements may not show a fair position particularly since they would have to accrue expenses in respect of the funds used to finance TFCs.

IV. APPROACH FOR REGULATING ISLAMIC BANKS

In this context, I would like to make a few comments and give a few practical suggestions in the environment in which Islamic banking will have to operate to be successful.

The desire to introduce Islamic banking in the Islamic world is based not on any commercial or vested interests. It is part of the desire of Islamic Ummah to regulate their lives in all its aspects in accordance with the laws and tenets of Islam. To achieve Islamization in banking, as is indeed necessary in introducing new concepts and ideas in any walk of life, you need dedicated men. My first suggestion, therefore, for Islamic banks is that its management, its custodianship, its operations and indeed every aspect of its existence should be in the hands of men who are committed to the philosophy of Islamic banking; for it is the people who make or destroy any entity - be it a country or an organization - no matter how good the systems and the underlying theory might be.

Secondly, I would like to emphasize that a change-over to Islamic banking should only be undertaken after a careful study of the factors affecting such a change-over. Overnight changes are usually spectacular but are not always long lasting. Failures, for whatever reasons, could bring disenchantment with the whole concept.

The viability of Islamic banks in my view is dependent upon the following:

- o The ability of the Muslim scholars, jurists, bankers, accountants, and other relevant professionals to develop a banking system which is truly Islamic in letter as well as in spirit.

- o Training of management and other personnel in the working of Islamic banks.
- o Introduction of a regulatory framework which can monitor compliance with the basic conceptual framework and ensure adherence to prescribed standards (once developed).
- o Establishment of a supreme committee to overview and give advice on the fundamental concepts developed in accordance with the Shariaa and Islamic Jurisprudence. The committee should also try and narrow down differences on the main issues which may exist amongst the Muslim scholars. Such a supreme committee should also be provided with the necessary funds and resources to undertake independent research in financial and Islamic matters and for providing training and education to students in Islamic banking.
- o The supreme committee should also review the decisions to date of all individual Fatawa committees of Islamic banks and should rule on the acceptability of those decisions. Additionally, all future decisions of these Fatawa committees should be referred to the supreme committee prior to implementation.
- o In certain Muslim countries, some of the conventional banks have introduced Islamic banking in some of their branches only. These branches, however, operate under common management. Additionally, the funds of such branches also appear to be interchangeable. The supreme committee should examine the status of such Islamic branches of conventional banks from the viewpoint of Islamic Shariaa and, if these banks are considered acceptable, develop the regulatory structure to ensure that Islamic banking principles are not compromised.

- o Widespread recognition of Islamic banking as an effective alternative to conventional banking is dependent upon clear understanding of the basic economic concepts of Islam, and a supporting framework of laws to keep the emerging system on the right tracks.

Any attempt to develop specific accounting standards for Islamic banks before firstly critically reviewing the fundamental Islamic banking concepts and agreeing on a comprehensive framework would not be appropriate. Additionally, we would need to review all the accounting standards currently in issue, and to amend these as appropriate, to cater for the new banking concepts as they affect the providers and the ultimate users of finance.

It is not sufficient to just define the conceptual framework for Islamic banks. It would also be necessary to establish business and ethical standards for Islamic banks to ensure that the new financial institutions are properly equipped to cope with the new structure. Such standards might cover issues like:

- o Form of legal entity
- o Organization and infrastructure
- o Quality of personnel and personnel training needs
- o Marketing instruments, e.g. prospectus
- o Investment evaluation criteria and techniques
- o Strategic objectives
- o Code of ethics
- o Documentation, etc.
- o Draft legal contracts (models)
- o Delay penalties (if any)

Another set of standards should govern the relationship of Islamic banks with the central banks and other regulatory agencies.

Codification of the Shariaa laws and principles, in my views, is also required and should form the basis for the auditors to report on compliance with Islamic Shariaa.

Let us also not ignore that Islamic banking largely relies on the fiscal and moral integrity of the ultimate users of finance for determination of the bank's return; and, therefore, we should all work towards establishing a puritan form of Islamic business environment.

Finally, whilst maintaining our resolve for strict compliance with the Islamic Shariaa we should not close our ears to our critics in the west. No doubt most comments made would be biased and probably designed at undermining the stability of Islamic banks, we should encourage dialogue with the western economists and bankers and share our views with them, since reviewing some of the problems sheds more light on the issues and helps our efforts to achieve closer cooperation with our counterparts in the west.

In conclusion, I would like to say that although my presentation may seem excessively critical, the reason it is so designed is to evoke thought and seek resolution of problems in this important forum. However, I am appreciative and impressed with the efforts of all the people who have been involved in Islamic banks all over the world. They have achieved many successes in difficult circumstances and deserve our praise and congratulations and I would like to end my presentation with

acknowledgment of their efforts and with the best wishes in their future endeavours.

Presented by:

Abdelgadir Banaga
Workshop on Accounting Standards
for Islamic Banks
Sponsored by Islamic Development Bank
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WORKSHOP ON ACCOUNTING STANDARDS FOR ISLAMIC BANKS



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- **ISLAMIC DEVELOPMENT BANK**
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(07 09 SEPTEMBER, 1987)**

By
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Ex-Officio Secretary to Government of Pakistan
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1 Standard setting in the sphere of the rapidly advancing accountancy techniques is admittedly a time consuming, costly and labourious process. The development of internationally acceptable standards, difficult as it is in the face of differing environments and objectives for accounting in various countries, requires concerted efforts backed by in-depth research, extensive consultations and post-exposure debates. The task is challenging indeed - more so in regions faced with professional limitations, resource constraints and, above all, peculiar conditions arising out of innovative Islamisation of economic and financial systems. The challenge has to be accepted and the task accomplished in the larger public interest, especially for protection of investors and financiers, so as to bring about qualitative improvement in professional approach, harmonisation of recognised accounting principles and financial discipline.

2 As a matter of enlightened public policy, the application and observance of standards needs to be ensured on a "self-regulatory" basis though initially it might be necessary to have guidance and involvement of official regulatory organs. The long range aim must of course be on self-regulation. Unfortunately, experience in the UK on self-regulation has not been entirely satisfactory.

3 Funding of the project may have to be done by the Islamic Banks and Financial Institutions as a pioneering contribution in view of their vital interest in the quality of financial statements. They should rise to the occasion.

4 The work may be assigned to a Board, constituted for the purpose by the participating banks and financial institutions, consisting of representatives of the interests involved, namely users, preparers, auditors and concerned regulatory agencies. To be more specific, the Board should have representatives of:-

- (i) Participating Banks and Financial Institutions.
- (ii) Professional Accountants Bodies.
- (iii) Academicians including fu'quahas.
- (iv) Capital market organisations.
- (v) Government regulatory agencies.

5 One of the objects of the proposed Board should be to harmonize, so far as practicable, the diverse accounting and auditing standards, policies and practices of different countries. It should also adopt measures for securing observance of the approved standards. Where local regulations require deviation from the standards set by the Board, the standards should not over-ride the local regulations.

6 Standards should be a brief and simple statement setting out -

- (a) how certain items within the financial statements should be measured; and
- (b) what information should be disclosed as a minimum.

7 Certain statistics relating to Financial Accounting Standards Board (USA), International Accounting Standards Committee (UK) and Accounting Standards Committee (UK) about their respective annual budget and personnel are as follows:

| | <u>Year Formed</u> | <u>Standards Issued</u> | <u>Budget</u> | <u>Manpower</u> |
|----------|--------------------|-------------------------|---------------|---------------------|
| FASB USA | 1973 | 91 | | |
| IASC UK | 1973 | 26 | | 4 full-time persons |
| ASC UK | 1971 | 23 | | 3 full-time persons |

ASC Chairman feels that their budget requires to be increased by at least 2 to 3 times to enable the ASC to have adequate number of staff and related facilities.

8 During its fourteen years' existence FASB has issued over 91 statements of financial accounting standards and 6 statements of financial accounting concepts. They have 7 full time members of the Board consisting of Government officials (1), Academicians (1), Private business (1), Financial analysts (1), CPA (3) and a large number of technical hands. The size of the Board is justified by its output.

9 An important point to consider is who should do the ground work to set standards? It is felt that the UK ASC's reliance on part-time auditors and accountants to staff its projects did not produce effective rules, leading too often to compromises and lax in drafting. There is also a question about the independence of the people making decisions. Should the job of drafting standards be entrusted to the full time members of the Board on US's FASB model or a blend of part time members and full time professionals evolved? Ways and means position will obviously be the determining factor.

10 While structural outlines of the project can be evolved by the sponsors, details and implementation action may be best left to a well represented Steering Committee having requisite operational freedom and clear mandate.

11 They say old habits die hard! Having been an auditor for well-over two decades, I am used to giving unsolicited advice. I feel we should also think of formulating accounting standards for all the Islamic financial instruments as there is no literature available on the subject and for various reasons, these cannot receive the desired attention from the professionals wedded to the non-islamic well established financial system. It will indeed be a service to the cause of Islam and the financial world at large. Western financial world is watching us closely as to how do we deal with Islamic financial instruments for the purposes of recording and reporting of transactions arising from the "newly" developed financial instruments.

12 Before concluding, let me make it clear that my observations and suggestions are inevitably influenced by my long association with the International Accounting Standards Committee. I was a member of its Steering Committee, responsible for drafting of IAS-18 on the subject of "Revenue Recognition".