Appendix (12)

Objectives and Concepts of Financial Accounting, Presentation and General Disclosure Standard and Information about the Organization

FINANCIAL ACCOUNTING STANDARDS BOARD

of the Financial Accounting Organization for Islamic Banks and Financial Institutions

Jumada I 1415 H - October 1994

Objectives and Concepts of Financial Accounting, Presentation and General Disclosure Standard, and Information About the Organization

Financial Accounting Standards Board
of the
Financial Accounting Organization for Islamic Banks and Financial Institutions

Jumada I 1415 H - October 1994

Volume Contents

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In The Name Of Allah, The Beneficent, The Merciful

Volume Preface

We thank Allah and offer prayers and peace upon our Prophet, his relatives, companions and followers.

The Financial Accounting Organization for Islamic Banks and Financial Institutions aims to develop accounting thought in the field of Islamic banking, preparing, issuing and amending accounting standards for such banks and institutions. It consists of the "Supervisory Committee", and the "Financial Accounting Standards Board" (1).

The organizational structure and work procedures of the Organization have been adopted after several studies (2) conducted by a consulting firm and specialized experts. Those studies which were financed by the Islamic Development Bank (IDB), started in 1408H (corresponding to 1987G) and took three years to complete. The studies were discussed and analysed in seminars and also by four different committees comprising several Shari'a and accounting scholars, officials from Islamic banks, representatives of regulatory agencies, certified public accountants, and other parties interested in the field of Islamic banking.

The studies and their recommendations emphasized that since the human behaviour of all Muslims is regulated by the revealed doctorines of Allah and the directives of His messenger (may the blessing and peace of Allah be upon Him), the objectives, concepts and standards of financial accounting must be in full compliance with the Islamic Shari'a, the comprehensive system abiding to all Muslims. This is consistent with the view that accounting is a social science which is affected by its environment. The Islamic bank's environment would encompass Shari'a, legal, economic and social requirements, as well as the development of accounting thought and practices.

The studies revealed that the lack of approved standards to be followed by Islamic banks has a negative effect on the confidence of the users of their financial statements and the information contained therein. This is reflected in a negative attitude towards dealing with Islamic banks and a hesitation in investing, depositing and exchanging services with them. The studies and recommendations (3) also concluded that there is a pressing need for issuing accepted accounting standards for Islamic banks and financial institutions. Among the reasons given are:

1. Accounting standards established in various parts of the world, were developed and issued to cope with the environment of the issuing country. Among the factors which influence the environment of Islamic banks are the Shari'a requirements related to the activities of banks.

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(1) Part -D of the Volume presents information about the Organization.

(2) The work of the committee was documented in five volumes under the title of "Accounting Standards for Islamic Banks". They were deposited in the library of the Islamic Research and Training Institute (IRTI) in Jeddah. The volume's reference number is (ISL332/121021) and it contains studies and comparisons of the mechanisms and the basic techniques for preparing standards throughout the world. The volumes also include the recommendations reached by the four committees in this regard and a brief history of how the four organizational structures and the work procedures of the organization have been adopted.

(3) See footnote No. (2) above. More details are provided in the *Statement of Objectives of Financial Accounting for Islamic Banks* (Part-A of the volume).

2. There are major differences between Islamic banks and traditional banks, with which Islamic banks are compared, the most important of which are Shari'a requirements and the different economic substance of many of its important operations.

3. The information needed by users of financial statements of Islamic banks is different from that is needed by users of financial statements of traditional banks.

4. The standards being used by the Islamic banks and financial institutions themselves are different from one country to another, from one bank to another in the same country, and sometimes from one year to another for the same bank.

The Chairmen and Presidents of Islamic banks signed the "AGREEMENT OF ASSOCIATION OF THE ORGANIZATION" (Part-F of the Volume) in their meeting held in 1410H (1989G) in the Islamic Development Bank Jeddah, and pledged to apply the standards issued by the Organization. They also approved the recommended constitution of the Supervisory Committee and the constitution of the Board with some modifications.(4) The Supervisory committee then adopted the two constitutions on 1.8.1410H (26.2.1990G). The Organization was registered in the State of Bahrain under registration No. 24524 dated March 27th, 1991 as a not-for-profit organization.

The constitutions of both the Supervisory Committee and the Board adopted the conclusions of the above mentioned studies and recommendations regarding the reasons for the success of the preparation process of standards (adoption & application). The most important of these studies and recommendations is the separation between the agency responsible for financing, follow-up, and control; and the body in charge of preparing standards.

The major responsibilities of the Supervisory Committee are mentioned in Article IX of its constitution. Its most important duties are to appoint the board members, select the Chairman and Vice Chairman of the Board, arrange for financing the activities of the Board, periodically review the activities and accomplishments of the Board, appoint an external auditor. These responsibilities should be carried out without interfering in the direction of the Board's role in preparing, approving and issuing the standards in any way.

The responsibilities of the Board are mentioned in Article IV of its constitution. These include setting, modifying, and interpreting standards and practice guidelines of financial accounting. The constitution established the basis for the independence of the board in issuing standards from the users of the financial statements. This independence was apparent in the way the constitution charged the Board with the responsibility of issuing the standards in a specific manner, and in the composition of the Board and its work procedures.

The Board has considered several approaches to the preparation, approval and issuance of standards. Two workable approaches have emerged in this regard. The first is to develop accounting standards from the principles of Shari'a and its teachings, and then adopt and implement them. The second approach is to review the standards which have been developed

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(4) The two constitutions were modified to include the changes made by the Supervisory Committee in its second meeting held on 16.06.1413H (11.12.1992G).

(5) All studies conducted after the establishment of the Organization on this subject and on other subjects mentioned in this volume can be obtained through the Organization's headquarters in Bahrain.

by prevailing accounting thought, test them against Shari'a, then adopt those which are consistent with the Sharia and exclude those which are not. After in-depth studies of Shari'a and accounting aspects(5), it was decided to adopt the second approach.

The Board then moved to develop the objectives and concepts of financial accounting and accounting standards for Islamic banks and financial institutions.

Financial statements (e.g. statement of financial position, income statement, cash flow statement) are among the most important outputs of financial accounting. One of the prime objectives of these statements is to provide users with information to help them make decisions relating to Islamic banks. Such requirements and needs are enormous and sometimes differ and contradict each other. It is impossible therefore to provide all these requirements and needs in a useful, efficient and cost effective manner. Accordingly, the Board decided to study the requirements and needs of each category of user of financial statements, to examine what can be achieved through financial accounting and the approach necessary to achieve a balanced selection of these needs. These are used as a main source in determining the objectives which will guide the process of preparing financial accounting standards for Islamic banks and financial institutions.

In studying the information needs and requirements of users of financial statements the Board opted for the approach commonly known in accounting thought(6) for the development of accounting standards. The *Statement of Objectives of Financial Statements* (Part 'A' of the volume) addresses the information needs of the major users of financial standards. The following presents part of the analysis made about users of financial statements, and the Board's role. Users of financial statements are divided into three categories:

1. **Users of financial statements from within the bank :**
   This category includes officials of different levels working within the bank. These officials can obtain all reports they need through internal executive orders. They are limited only by their evaluation of the need for the report and its relative cost.

2. **Regulatory agencies:**
   This category includes regulatory agencies such as central banks and Zakat and tax agencies. It is important to differentiate between the two types of requirement in this category:

   Type I: Requirements for preparing financial statements of Islamic banks published for the public:
   This includes the requirements which the concerned agencies issue regarding the standards to be followed by the banks in measuring, recording and preparing their external financial statements for the public (the standards). The bank has to follow those standards as a minimum requirement for the preparation of its financial statements.

(6) Footnote (2) on page (1)

Accordingly, the Board during the course of its preparation and approval of the statement of objectives, the statement of concepts, and the standard of presentation and general disclosure has given consideration to the regulatory and accounting requirements that are used by these agencies regarding the preparation of published financial statements. This will allow the banks to comply with those requirements, and at the same time present and disclose the requirements of the standards issued by the Board in an appropriate manner.

Type II: Regulatory requirements:
This includes the requirements issued by regulatory agencies for the purpose of control and for any other purposes. These requirements are usually more detailed because they are directed towards specific purposes such as drawing attention to specific aspects of the bank's operation in order to examine its validity, as is required by central banks or to request detailed information about certain elements of the financial statements for the purpose of calculating Zakat and taxes required by Zakat and tax agencies.

3. **Users with no direct regulatory or administrative authority**
This category includes existing and potential shareholders and investment account holders, parties dealing with the bank either through sales and purchases or through exchange of services. It also includes financial analysts and researchers, non-authoritative government agencies (including studies and research centres). Since this category has no regulatory or administrative authority to obtain the information it may need, it relies heavily on the financial statements published for the public as its main source of information.

The above analysis shows that :

- Standards which the Board issues respond to the requirements for preparing financial statements published for the public use.

- The category which uses the financial statements published for the public most is the third category which has no regulatory nor administrative authority to obtain the information. These financial statements are the main source of information available about the bank.

- The Board has taken into consideration the regulatory and accounting requirements issued by the concerned authorities, so that banks can comply with them, and at the same time, present and disclose, in an appropriate manner, the requirements of the Board's standards.

The *Statement of Objectives* (Part A of the volume), the *Statement of Concepts* (Part B of the volume) and the *General Presentation and Disclosure Standard,* issued by the Board, have been prepared and approved in accordance with the environment which influences Islamic banks, namely Shari'a requirements. They have been prepared following several comprehensive and in-depth studies.[7] They were reviewed by the Executive Committee for Planning and Follow-up [8] (which consists of members of the Board) and were then approved

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(7) Footnote (5) on page 3
(8) The committee held 33 meetings up to Shawal 1414 H corresponding to March 1994

by the Board. The *General Presentation and Disclosure Standard* (Part C of the volume) has been prepared in accordance with both the objectives and the concepts.

The approach adopted in the preparation and approval of the standards (Part E of the *volume*) makes it possible to benefit from the objectives, concepts, and standards already developed in accounting thought. At the same time, the approach takes into consideration the differences between such objectives, concepts and standards due to the environment in which they were developed. Such an approach requires a scientific methodology to ensure that the studies are conducted by qualified experts with sufficient education and experience to enable them to determine what suits the environment of Islamic banks with regard to aspects of Shari'a, accounting theory and practice, auditing, Islamic banking, and the information requirements and needs of users of financial statements.

The importance of adopting this approach in preparing and approving the standards is derived from the fact that acceptance of standards and their application depends on:

- Their fulfilment of the needs and requirements of the users of the financial statements, and of those who prepare them.
- Their preparation according to a conceptual framework which leads to the establishment of consistent standards, and reduces the possibility of contradictions within the standards and with their environment.
- The information resulting from the application of those standards having specific qualitative characteristics, including relevance, reliability, comparability, consistency, and understandability [9].
- The impartiality of the body that issues those standards in assessing the needs and requirements of users of financial statements.

The *Statement of Objectives*, the *Statement of Concepts*, and the *Presentation* and *General Disclosure Standard*, are the first publications of the Organization. Approval and publication of three more accounting standards: (Murabaha, Mudaraba, and Musharaka) will follow within a short period of time *Insha Allah*. The preliminary studies for preparing those three standards have been accomplished.

It is our hope that what has been issued by the Board along with what will be issued in the future, will help:

- Islamic banks in measuring, recording and preparing financial reports containing information which is relevant, comparable, reliable, understandable and cost-effective. This will hopefully result in strengthening the relationship between those banks and their clients.

- The regulatory agencies in countries in which Islamic banks operate, by providing them with their information requirements and by assisting them in applying their control measures to benefit society, improve the performance of those banks and help them grow.

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(9) These are defined in part (B) of the volume

- Agencies responsible for promulgating and developing accounting standards which take into consideration the environment in which Islamic banks operate. The Board's publications will provide these agencies with an important source of information concerning the objectives, concepts and standards of financial accounting for Islamic banks. If the preparation, adoption and promulgation of such publications were conducted by a single authority in each country in which Islamic banks operate, it would be very costly for all in many ways and include the possibility of issuing inconsistent standards.

This work could not have been accomplished without the blessing of Allah first, then the efforts of the members of the Supervisory Committee, the Board, and its subcommittees. They all worked hard, volunteering their time, effort, and sometimes their money as well. Islamic banks and financial institutions provided the financial support for the activities of the Organization. The Executive Committee for Planning and Follow-up, its Shari'a advisers, accounting and auditing experts, officials working for Islamic banks, other bank-related interested parties, and the staff of the Organization's Office in Bahrain have all contributed to this accomplishment. May Allah bless and reward them all.

Allah is our desired end, and we seek His support and guidance.

Financial Accounting Standards Board
of the
Financial Accounting Organization for Islamic
Banks and Financial Institutions

Statement of Financial Accounting No. 1

Objectives of Financial Accounting for Islamic Banks and Financial Institutions

Financial Accounting Standards Board

of the

Financial Accounting Organization for Islamic Banks and Financial Institutions

Jumada I 1414 H - October 1993

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1. Preface

The emergence of Islamic banks and financial institutions [1] as relatively new organizations and the great challenge they face to successfully serve the societies in which they operate, have led them, together with specialists in Islamic Shari'a and in accounting, to seek the most appropriate means through which accounting standards could be developed and implemented in order to present adequate, reliable, and relevant information to users of the financial statements of such organizations. The presentation of such information is critical to the economic decision making process by parties who deal with Islamic banks and would also have a significant effect on the distribution of economic resources for the benefit of society. **(para 1)**

The principles of Islamic Shari'a strike a balance between the interests of the individual and society. It is known that investment is the foundation of economic activities in any society. However, not every individual is capable of directly investing his own savings. Accordingly, Islamic banks play an important role by acting as a vehicle to attract the savings of individuals and investing those savings for the benefit of the individual and society. **(para 2)**

Islam clearly encourages investment and spending. Indeed, when Islam imposed Zakah, it required that wealth should be invested, otherwise it would be exhausted by Zakah over a period of time. It has been reported that the Prophet (may the blessing and peace of Allah be upon him) said *"Trade in orphans wealth (property) lest it would be exhausted by Zakah"* [2].

However, to induce individuals to invest through savings with their Islamic banks, it is essential that such individuals develop a trust in the ability of Islamic banks to realize their investment objectives. In the absence of trust in the ability of Islamic banks to invest efficiently and in full compliance with Islamic Shari'a, many individuals may refrain from investing through Islamic banks. One of the pre-requisites for the development of such trust is the availability of information that assures the investing public of the ability of Islamic banks to achieve their objectives. Among the important sources of such information are the financial reports of Islamic banks which are prepared in accordance with standards that are applicable to Islamic banks. However, in order to develop such standards it is essential to define the objectives and concepts of financial accounting for Islamic banks. In this respect, it is not harmful to begin where others have ended, if what has been developed by others is beneficial and does not contradict the Islamic Shari'a. **(para 3)**

The interest in developing financial accounting standards for Islamic banks started in 1987. In this respect, several studies have been prepared. These studies have been compiled in five volumes and deposited in the Library of the Islamic Research and Training Institute of the Islamic Development Bank. **(para 4)**

1. Referred to herefafter as Islamic bank or Islamic banks
2. Related to al-Tabarani on the authority of Anas-Ibn-Malik from the Prophet (may the blessing and peace of Allah be upon him). A good Hadith as stated by al-Hafiz Ibn Hajar. Also related to al-Baihaqi on the authority of Umar (may Allah be pleased with him) and it is a good Hadith. (*Faied al-Qadeer*, al-Munawi, Vol. 1 p. 108).

The outcome of these studies has been the formation of the Financial Accounting Organization for Islamic Banks and Financial Institutions (the Organization) which was registered as a not-for-profit organization in the State of Bahrain in 12/9/1411H corresponding to 27/3/1991. Since its inception the Organization has continued the efforts to develop accounting standards. Periodic meetings of the Executive Committee for Planning and Follow Up (the Committee) have been held with the aim of implementing the plan approved by both the Supervisory Committee (the supreme authority of the Organization) and by the Financial Accounting Standards Board for Islamic Banks and Financial Institutions (the Board). In this respect, the Committee has retained the service of several consultants on Shari'a, experts and practitioners of accounting and bankers. **(para 5)**

2. Introduction

Al Hamdo Lillah (praise be to Allah) Who said "**We shall set up justice scales for the day of judgment, not a soul will be dealt with unjustly in the least. And if there be (no more than) the weight of a mustard seed, We will bring it (to account); And enough are We to take account**" (excerpt from chapter 21: verse 47), and peace and blessing of Allah be upon Prophet Mohammed who said "*Acquisition of a Muslim Wealth (property) is not permissible without his consent.*" (3)

Accounting in Islam deals with, among other things, recognition, measurement and recording of transactions and the fair presentation of rights and obligations. Allah said "**O ye who believe! When ye deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing**" and "**Let a scribe write down faithfully as between the parties**" (Chapter 2: verse 282). He also said "**O ye who believe! Stand out firmly for justice**" (excerpt from chapter 4: verse 135). Allah also said, "**Woe to those that deal in fraud - those who, when they have to receive by measure from men, exact full measure, but when they have to give by measure or weight to men, give less than due**" (Chapter 83: verses 1-3). Allah also said in the sacred Hadith "*O My servants, I have forbidden oppression for Myself and have made it forbidden amongst you, so do not oppress one another.*" (4) There is no doubt that variance from the fair determination of rights and obligations is unjust and not acceptable in Islam. Allah has decreed that a Muslim should be fair and above board in his dealings. He says "**Allah commands justice, the doing of good**" (excerpt from chapter 16: verse 90). **(para 6)**

The fear of Allah in private and in public is one of the reasons for establishing justice, and empowering the rightful owner to know, demand and receive his rights. Allah says "**O ye who believe! Fear Allah, and (always) say a word directed to the right**" (excerpt from chapter 33: verse 70). Allah also says "**Allah doth command you to render back your trusts to those to whom they are due and when ye judge between man and man that ye judge with justice**" (excerpt from chapter 4: verse 58). Accordingly, the fear of Allah should deter those concerned with financial accounting from being imprecise and from failing to disclose relevant information, particularly that which contradicts with the precepts of Islamic Shari'a - for example, usurious interest and prohibited investment activities. The fear of Allah should also help those concerned with financial accounting to fairly present the financial position of the accounting entity and the results of its operations. **(para 7)**

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3 Related by ad-Daraqutni on the authority of Anas Ibn-Malik and also related by al-Baihaqi and Ibn-Heian and al-Hakim on the authority of Ibn-Hamid al-Saidie (see *Niel al-Awair* for al-Shawkani 5/316).

4 Related by Muslim on the authority of Abu Dharr al-Ghifari (may Allah be pleased with him) from the Prophet (may the blessing and peace of Allah be upon him) is that among the sayings he relates from his Lord (may he be glorified). This is a Hadith qudsi (sacred Hadith) i.e. one in which the Prophet reports what has seen revealed to him by Allah, though not necessarily in these actual words.

Financial accounting in Islam should be focused on the fair reporting of the entity's financial position and results of its operations, in a manner that would reveal what is halal (permissible) and haram (forbidden). This is in compliance with Allah's instructions to co-operate in performing good deeds. Allah says, **"Help ye one another in righteousness and piety. But help ye not one another in sin and rancour"** (excerpt from chapter 5: verse 2). This means that financial accounting in Islam has objectives which the financial accountant in Islam should be aware of and comply with. He should not enter this field without a conscious and clear understanding of the objectives of financial accounting. This is in accordance with the word of Allah Who said **"Let a scribe write down faithfully as between the parties"** (excerpt from chapter 2: verse 282)[5]. Khalifa Umer Ibn al-Khatab (may Allah be pleased with him) asked of merchants in the market to be knowledgeable of halal and haram. He said "Nobody should sell in our market unless he is knowledgeable in religion otherwise he would enter voluntarily or involuntarily into usurious transactions"[6]. Hence, those in charge should, therefore, establish for financial accounting the necessary rules which protect the rights and obligations of individuals, and ensure adequate disclosure. **(para 8)**

Islamic banks have been established to assist Muslims and Islamic societies in using money in a beneficial manner consistent with the principles of Islamic Shari'a. These banks have now become an important means of attracting deposits whose owners wish to invest in ways and means consistent with the rules and principles of Shari'a. Such ways and means are characterized by many features, including the prohibition of interest, profit sharing and other investment vehicles, and the avoidance of activities that Allah has forbidden. Accordingly, the attractiveness of Islamic banks to the Muslim stems mainly from their compliance with Shari'a in their dealings, whether with shareholders, depositors, or others with whom such banks invest their funds. **(para 9)**

On the other hand, the Muslim's choice of investing or depositing funds in or dealing with one Islamic bank versus the other, is predicated on his evaluation of and confidence in the bank's ability to maintain its capital at a level sufficient to provide safety for depositors funds, and its ability to realize rates of returns for both its owners and the holders of investment accounts commensurate with the assumed investment risk. Lack of such confidence might cause Muslims to stop dealing with the Islamic banks. Such confidence, however, cannot be developed without several important measures, one of which is the communication of relevant information to assist its users in evaluating the bank's compliance with Shari'a principles and its ability to maintain capital at a sufficient level and realize reasonable rates of return on invested funds for its owners and the holders of investment accounts. **(para 10)**

Financial accounting plays an important role in providing the information which users of the financial statements of Islamic banks depend on in assessing the bank's compliance with the precepts of Shari'a. However, to perform this role effectively, accounting standards need to be developed and complied with by Islamic banks. The development of such standards must be based on clear objectives of financial accounting and agreed upon definitions of its concepts. **(para 11)**

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5. One of the explanations of this verse is that the adverb faithfully relates to the scribe himself as a person who is entrusted with what is written and who knows what is expected from him (Alzamakshari Vol. 1, p. 304).
6. Imam Al-Gazali, *Ihia Ulum Al-Din*, Vol. 2, p. 64).

3. A brief on financial accounting, its processes, general objectives and limitations

Accounting encompasses several areas, generally agreed to include financial accounting, managerial accounting, cost accounting, and accounting for non-for-profit organizations. We are concerned here only with financial accounting.

3/1 Financial accounting

Financial accounting has developed over time for many practical considerations relating to the need of entities[7] to determine their financial rights and obligations, and results of operations, and to inform present and potential parties concerned with the affairs of the entity of its financial position, the results of its operations and its cash flows. This information is intended to assist those parties in making suitable decisions with respect to the entity. Thus financial accounting plays an important role in directing economic resources in society to different entities as a result of the decisions made by the parties concerned with the affairs of those entities. These decisions are based, among other things, on information available to them through financial accounting which ranks as one of the important sources of the basic information required for decision making. During the period of its development, a number of rules and principles have been accumulated which specify the processes of financial accounting, its general objectives and limitations. **(para 13)**

3/2 The financial accounting processes

Financial accounting consists of the following processes:

(a) Accounting recognition of an entity's financial rights and obligations as of a given date and changes in those rights and obligations resulting from consummated transactions and other events during a given period.

(b) Measurement of the financial effect of consummated transactions and the impact of other events during a given period.

(c) Classifying the financial effect of consummated transactions and other events for the purpose of determining the entity's results of operations and other changes in its financial position including its cash flows.

(d) Preparing periodic reports about the entity's financial position as of a given date and the results of its operations and cash flows during a given period. **(para 14)**

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7. An entity is defined as an economic unit which is separate from those parties involved in or dealing with such entity. An entity has its own financial position and results of operations with which financial accounting is concerned. An Islamic bank is an example of an entity.

3/3 The general objectives of financial accounting

The main objective of financial accounting is to provide information, through periodic reports, about the entity's financial position, its results of operations and cash flows, to assist users of such reports in making decisions. The financial statements (statement of financial position, income statement, the statement of cash flows, and related notes) are the main type of reports provided by financial accounting.

Financial accounting also provides important information which assists the entity's management in directing available economic resources. Accordingly, it facilitates management efforts in planning, directing and supervising the entity's activities. It also facilitates the roles of governmental agencies responsible for supervising the national economy and for collecting tax based on the financial information which it produces. **(para 15)**

3/4 Limitations of information provided by financial accounting

Financial accounting does not provide all the information required by those who need to make decisions about the entity. This is so because of many reasons, including those related to the nature of the financial accounting processes, and those related to cost and benefit considerations. The following are some aspects of the limitations of information produced by financial accounting and the reasons for such limitations. **(para 16)**

3/5 Limitations resulting from the nature of the financial accounting processes

(a) Financial accounting is concerned mainly with measuring the financial effect of transactions and other events on the entity's financial position, results of operations and cash flows. Accordingly, financial accounting is not usually able to produce information to assist in the evaluation of the entity's ability to achieve objectives that are not capable of financial measurement in an objective manner.

(b) Financial accounting does not differentiate, through its processes, between the entity's performance and that of its management. Although management ability is one of the important factors that affect the entity's performance, there are other factors beyond management control which affect the entity's performance such as natural disasters and external political and economic changes. Accordingly, it is not currently possible for financial accounting to provide information which can assist in evaluating management performance aside from the entity's performance.

(c) The information currently provided by financial accounting is historical in nature which may or may not be indicative of the future. Yet, decisions made by those who need this information are concerned with the future impact of alternative courses of action.

(d) Financial accounting relies to a very great extent on estimates when measuring the financial effect of transactions and other events on the entity's financial position and the results of operations; for example, depreciation of fixed assets, doubtful receivables, etc. Such estimates are based on assumptions determined by management which may or may not turn out to be accurate. **(para 17)**

3/6 Limitations resulting from cost and benefit consideration

The information which financial accounting produces has costs associated with its preparation, presentation and usage. Accordingly, cost considerations affect the information produced by financial accounting. One of the results of cost considerations is the emphasis in financial accounting on the production of general purpose financial reports to serve the common information needs of multiple external users. **(para 18)**

4. The importance of establishing objectives of financial accounting for Islamic banks and financial institutions

4/1 The importance of establishing objectives

Human experience proved that any work which does not have clear objectives encounters limitations, conflicts and blurred vision in its implementation. Financial accounting and financial reporting are no exception to this precept. Accounting scholars and practitioners alike have found that the process of developing financial accounting standards without establishing objectives leads to inconsistent standards which may not be suitable for the environment in which they are expected to be applied.

Agreement on the objectives of financial accounting for Islamic banks would achieve many benefits:

(a) The objectives will be used as a guide by the Financial Accounting Standards Board for Islamic Banks and Financial Institutions when developing financial accounting standards. This should assure consistency in developing standards.

(b) The objectives will assist Islamic banks, in the absence of accepted accounting standards, in making choices among alternative accounting treatments.

(c) The objectives will be available as a guide and a regulator of subjective judgment made by management when preparing the financial statements and other financial reports.

(d) The objectives, when properly defined, should increase users' confidence and understanding of accounting information and, in turn, their confidence in Islamic banks.

(e) Establishing objectives should lead to the development of accounting standards which are likely to be consistent with each other. This should increase users' confidence in the financial reports of Islamic banks. **(para 19)**

4/2 Differences between the objectives of financial accounting and financial reports for Islamic banks and objectives of financial accounting for other banks

Financial accounting is mainly concerned with providing information to assist users in making decisions. Those who deal with Islamic banks are concerned, in the first place, with obeying and satisfying Allah in their financial and other dealings. Allah says **"O ye people! eat of what is on earth. Lawful and good; and do not follow the footsteps of the Evil One, for he is to you an avowed enemy"**. (Chapter 2: verse 168). The objectives of financial accounting for other banks have, for the most part, been established in non-Islamic countries. It is natural, therefore, that there should be differences between objectives established for other banks and those to be established for Islamic banks. Those differences stem mainly from differences in the objectives of those who need accounting information and, therefore, in the information they need. This does not mean, however, that we should reject all the results of contemporary accounting thought in non-Islamic countries. This is so because there are common objectives between Muslim and non-Muslim users of accounting information. For example, Muslim and non-Muslim investors share in their desire to increase their wealth and to realize acceptable returns on their investments. This is a legitimate desire which has been recognized in Shari'a consistent with Allah's saying "**It is He Who has made the earth manageable for you, so traverse ye through its tracts and enjoy of the sustenance which He furnishes**" (excerpt from chapter 67:verse 15). **(para 20)**

In addition to the above, there are other reasons why different objectives of financial accounting should be established for Islamic banks. Those are:

(a) Islamic banks must comply with the principles and rules of Shari'a in all their financial and other dealings.

(b) The functions of Islamic banks are significantly different from those of traditional banks who have adopted the Western model of banking.

(c) The relationship between Islamic banks and the parties that deal with them differs from the relationship of those who deal with traditional banks. Unlike traditional banks, Islamic banks do not use interest in their investment and financing transactions, whereas traditional banks borrow and lend money on the basis of interest. Islamic banks mobilize funds through investment accounts on the basis of Mudaraba (i.e. sharing of profit between the investor who provides the funds and the bank which provides the effort) and invest these funds on the basis of Mudaraba, profit and loss sharing mechanisms, or deferred payments methods consistent with the Shari'a. **(para 21)**

Hence, accounting standards developed for traditional banks may not be relevant to Islamic banks. Nevertheless, in developing accounting standards for Islamic banks, the Board may be guided by clear objectives and concepts which are appropriate for other banks provided they are in compliance with the Shari'a precepts. **(para 22)**

5. The approach to establishing objectives of financial accounting for Islamic banks and financial institutions

Two approaches to establishing objectives have emerged through the discussion which took place at different meetings of the committees established by the Board. These are:

(a) Establish objectives based on the principles of Islam and its teachings and then consider these established objectives in relation to contemporary accounting thought.

(b) Start with objectives established in contemporary accounting thought, test them against Islamic Shari'a, accept those that are consistent with Shari'a and reject those that are not. **(para 23)**

In order to test each approach and select an appropriate one, a Shari'a scholar was requested to prepare a working paper on the objectives of financial accounting for Islamic banks consistent with the first approach, and an accounting scholar was requested to prepare a separate working paper consistent with the second approach. In addition, a joint working paper was prepared by a Shari'a expert and an accounting expert. Several joint meetings were held to present and discuss those working papers. It was agreed that one of the Shari'a scholars who attended the meetings prepare a paper summarizing the results of those discussions and the views presented in the working papers. This last paper was presented and discussed at a meeting of the Committee attended by several Shari'a and accounting scholars. Based on the results of those efforts, it was agreed that the second approach, described above, should be adopted to establish objectives of financial accounting for Islamic banks and financial institutions. **(para 24)**

5/1 The major users of financial reports

Financial reports include not only financial statements but also other means of communicating information that relates, directly or indirectly, to the information provided by financial accounting.

The objectives of financial accounting determine the type and nature of information which should be included in financial reports, in order to assist users of these reports in making decisions. Therefore, the objectives of financial accounting should focus on the common information needs of users of financial reports. In addition, the objectives should focus on the common information needs of those users who do not have the authority or ability to directly obtain the information they need, or access to such information. This focus stems from two reasons, namely the ability of other users to directly obtain from the entity the information they need to make decisions; and the need for accountants to make a choice among a variety of contending information needs of different users because of the limited nature of what could be included in financial reports. This does not mean, however, that financial reports which are focused on the common information needs of users with limited access to information will not be useful for others. **(para 25)**

The main categories of users of external financial reports for Islamic banks whose information needs are addressed in this statement include:

(a) Equity holders
(b) Holders of investment accounts
(c) Other depositors
(d) Current and saving account holders
(e) Others who transact business with the Islamic bank, who are not equity or account holders
(f) Zakah agencies (in case there is no legal obligation for its payment)
(g) Regulatory agencies **(para 26)**

5/2 Common information needs of users of financial reports who do not have the authority or ability to obtain additional information from the Islamic bank

The information needs of users of financial reports increase and vary with the increase in the categories of users, for example investors including equity and investment account holders, creditors including current depositors, savings depositors, debtors, employees of the Islamic bank, other financial and banking institutions, and those who deal with the Islamic banks in any other manner.

Government agencies have the power and authority to directly obtain the types of information that best serve their needs. On the other hand, other external users are limited to the information contained in the Islamic bank's financial reports. Accordingly, it is essential that the common information needs of these categories of users be the focus of financial reports. It should be emphasized, however, that financial reports, because of cost considerations, cannot be expected to provide for every possible information need of these categories of users, particularly those needs that are not common to all users. **(para 27)**

It is possible to summarize the common information needs of users as follows:

(a) Information which can assist in evaluating the bank's compliance with the principles of Shari'a in all of its financial and other dealings.

(b) Information which can assist in evaluating the bank's ability in:

1. Using the economic resources available to it in a manner that safeguards these resources while increasing their value, at reasonable rates.

2. Carrying out its social responsibilities, and in particular those that have been specified by Islam, including the good use of available resources, the protection of the rights of others and the prevention of corruption on earth.

3. Providing for the economic needs of those who deal with the bank.

4. Maintaining liquidity at appropriate levels.

(c) Information which can assist those employed by the bank in evaluating their relationship and future with the Islamic bank, including the bank's ability to safeguard and develop their rights and develop their managerial and productive skills and capabilities.

(d) It is assumed that the types of information described above represent the minimum required to satisfy the common information needs of external users of financial reports. **(para 28)**

5/3 Other financial reports

Financial reports which are intended to provide for the common information needs of external users have been divided into the following categories:

(a) Those that are currently produced by financial accounting in the form of financial statements and related notes.

(b) Those that could be produced by financial accounting or other information systems of Islamic banks in the form of other financial reports, which are not currently being produced. **(para 29)**

The distinction between these two categories of reports is essential at this stage of the Board's efforts for the following reasons:

(a) The first category of reports, i.e. the financial statements and related notes, is the main output of financial accounting. In addition, they are generally known and are prepared in accordance with standards that provide reasonable assurance of fairness in the presentation of the financial position, results of operations and cash flows.

(b) The second category of reports lacks a generally accepted definition and there is no assurance that they would contain reliable and fair presentations of information required by those who deal with Islamic banks for a variety of reasons, including the limitations of the financial accounting processes. **(para 30)**

Notwithstanding the above, objectives will be established for all financial reports as a group to guide the development of accounting standards for Islamic banks. The future plans of the Board will address the specific objective(s) of each report and its concept and develop the standards for its preparation to assure its accuracy. **(para 31)**

Examples of these types of other financial reports for Islamic banks include:

(a) Analytical financial reports about sources of funds for Zakah and their uses.

Although the financial statements of Islamic banks will disclose the liability for Zakah and the amount that has been disbursed, users of financial statements might be interested in additional analysis of sources of funds for Zakah, methods of its collection including controls to safeguard these funds and their uses.

(b) Analytical financial reports about earnings or expenditures prohibited by the Shari'a

It is our intent for the financial statements to disclose income earned by the Islamic bank from prohibited transactions or sources and expenditures prohibited by the Shari'a and how those earnings were disposed of. However, users of the financial statements may be interested in detailed financial reports. Such reports may include information about the causes of such earnings, their sources, how they were disposed of and procedures established to prevent entering into transactions prohibited by the Shari'a.

(c) Reports concerning the Islamic bank's fulfillment of its social responsibilities

Islam has always been concerned with the concept of social responsibility whether that responsibility be for the welfare of society or the prevention of harm. Indeed, this can be clearly observed in the Quranic verses, the sayings and deed of the Prophet (may the blessing and peace of Allah be upon him), and Islamic jurisprudence. For example, Allah said **"But seek with the (wealth) which Allah has bestowed on thee, the Home of the Hereafter, nor forget thy portion in this world: but do thou good, as Allah has been good to thee and seek not (occasions for) mischief in the land; for Allah loves not those who do mischief"**.(Chapter 28: verse 77). The Prophet (may the blessing and peace of Allah be upon him) said *"The most loved by Allah among the people are those helpful to others"*[8]. The Prophet also said *"There should be neither harming nor reciprocating harm"*[9]. Hence, Islam prohibits the Muslim from causing harm to himself, to others, his environment or society in the pursuit of material returns. This shows that Islam spearheaded this concept which did not develop in the West except recently.

(d) Reports about the development of the Islamic bank's human resources

Those reports may contain information about and the bank's efforts to develop its human resources whether with respect to their knowledge of Shari'a or economics. In addition it would include the bank's efforts in encouraging its employees to be effective and efficient. **(para 32)**

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8. Related by al-Tabarani in his three volumes and the Hadith includes a poor chain of authorities. Also related by Abdullah ibn Ahmad ibn Hanbal in his father's *Zawaied Ktab al-Zuhd* with a poor chain of authorities, (al-Haitham, *Muojam al Zawaied* Vol. 8, p. 191; al-Munawi, *Faied al-Qadeer*, Vol. 1, p. 174)

9. Related by Ibn Majah and ad-Daraqutni on the authority of Abu Said al-Khudri. An-Nawawi said it is a good Hadith (An-Nawawi's *Forty Hadith*, No. 32).

6. Objectives of financial accounting and financial reports for Islamic banks and financial institutions

6/1 Objectives of financial accounting

(a) To determine the rights and obligations of all interested parties, including those rights and obligations resulting from incomplete transactions and other events, in accordance with the principles of Islamic Shari'a and its concepts of fairness, charity and compliance with Islamic business values. **(para 33)**

(b) To contribute to the safeguarding of the Islamic bank's assets, its rights and the rights of others in an adequate manner. **(para 34)**

(c) To contribute to the enhancement of the managerial and productive capabilities of the Islamic bank and encourage compliance with its established goals and policies and, above all, compliance with Islamic Shari'a in all transactions and events. **(para 35)**

(d) To provide, through financial reports, useful information to users of these reports, to enable them to make legitimate decisions in their dealings with Islamic banks. **(para 36)**

6/2 Objectives of financial reports

Financial reports, which are directed mainly to external users, should provide the following types of information:

(a) Information about the Islamic bank's compliance with the Islamic Shari'a and its objectives and to establish such compliance;[10] and information establishing the separation of prohibited earnings and expenditures, if any, which occurred, and of the manner in which these were disposed of[11]. **(para 37)**

(b) Information about the Islamic bank's economic resources and related obligations (the obligations of the Islamic bank to transfer economic resources to satisfy the rights of its owners or the rights of others), and the effect of transactions, other events and circumstances on the entity's economic resources and related obligations. This information should be directed principally at assisting the user in evaluating the adequacy of the Islamic bank's capital to absorb losses and business risks; assessing the risk inherent in its investments and; evaluating the degree of liquidity of its assets and the liquidity requirements for meeting its other obligations. **(para 38)**

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10. This objective stems from the basic idea behind the existence of Islamic banks as well as the objectives of those who transact business with them.

11. This objective is incidental since it is assumed that earnings of an Islamic bank are from legitimate transactions and sources consistent with the Shari'a precepts. However, illegitimate earnings may occur inadvertently because of factors outside the control of management such as when the bank operates in a country that does not apply Shari'a and is asked to deposit funds with the central bank as reserves and is paid interest on those funds or because of erroneous judgment by the management of the bank.

(c) Information to assist the concerned party in the determination of Zakah on the Islamic bank's funds and the purpose for which it will be disbursed.([12]) **(para 39)**

(d) Information to assist in estimating cash flows that might be realized from dealing with the Islamic bank, the timing of those flows and the risk associated with their realization. This information should be directed principally at assisting the user in evaluating the Islamic bank's ability to generate income and to convert it into cash flows and the adequacy of those cash flows for distributing profits to equity and investment account holders. **(para 40)**

(e) Information to assist in evaluating the Islamic bank's discharge of its fiduciary responsibility to safeguard funds and to invest them at reasonable rates of return, and information about investment rates of returns on the bank's investments and the rate of return accruing to equity and investment account holders. **(para 41)**

(f) Information about the Islamic bank's discharge of its social responsibilities. **(para 42)**

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12. The giving of Zakah is one of the pillars of Islam and is a personal obligation of the Muslim who is financially capable towards the poor and others who are entitled to Zakah. However, some Shari'a scholars, according to the first conference on Zakah held in Kuwait in 1985, are of the opinion that the entity can fulfill the Zakah obligation either because it is a governmental requirement, a requirement in its articles of incorporation or by-laws, a decision by a general assembly or as a consequence of its owners appointing it as their agent with respect to their Zakah obligation.

7. Adoption of the Statement

The *Statement of Objectives of Financial Accounting for Islamic Banks and Financial Institutions* was adopted by the Board in its meeting No. 5 held in Jumada I 1414H corresponding to October 1993.

Members of the Board:

1-	Abdel Aziz Rashed Al-Rashed,	Chairman
2-	Dr Abdelgadir Banaga,	Deputy chairman
3-	Ibrahim Al-Subeil	
4-	Irtiza Husain	
5-	Anwar Khalifa Sadah	
6-	Hazim Hassan*	
7-	Huseyin Cahit Ozcet	
8-	Dr Khaled Boodai	
9-	Dr Rifaat Ahmed Abdel Karim	
10-	Samir Tahir Badawi	
11-	Abdel Hamid Abu Musa	
12-	Sheik Abdullah Bin Sulaiman Al-Maneei	(Absent due to sickness)
13-	Professor Abdullah Al-Faisal	
14-	Dr Omer Zuhair Hafiz	
15-	Farooq Azam	
16-	Professor Mohamed Al-Siddiq Al-Darir	
17-	Mohammed Alawi Thiban	
18-	Mohammed Mukhtar Al-Sallami	
19-	Musa Abdel Aziz Shihadeh*	
20-	Mian Mumtaz Abdullah	
21-	Dr Yousuf Al-Qaradawi	

* Did not attend the Board's meeting no. 5

Statement of Financial Accounting No. 2

Concepts of Financial Accounting for Islamic Banks and Financial Institutions

Financial Accounting Standards Board

of the

Financial Accounting Organization for Islamic Banks and Financial Institutions

Jumada I 1414 H - October 1993

Contents

1. Preface

The emergence of Islamic banks and financial institutions[1] as relatively new organizations and the great challenge they face to successfully serve the societies in which they operate, have led them, together with specialists in Islamic Shari'a and in accounting, to seek the most appropriate means through which accounting standards could be developed and implemented in order to present adequate, reliable, and relevant information to users of the financial statements of such organizations. The presentation of such information is critical to the economic decision making process by parties who deal with Islamic banks and would also have a significant effect on the distribution of economic resources for the benefit of society. **(para 1)**

The principles of Islamic Shari'a strike a balance between the interests of the individual and society. It is known that investment is the foundation of economic activities in any society. However, not every individual is capable of directly investing his own savings. Accordingly, Islamic banks play an important role by acting as a vehicle to attract the savings of individuals and investing those savings for the benefit of the individual and society. **(para 2)**

Islam clearly encourages investment and spending. Indeed, when Islam imposed Zakah, it required that wealth should be invested, otherwise it would be exhausted by Zakah over a period of time. It has been reported that the Prophet (may the blessing and peace of Allah be upon him) said " *Trade in orphans wealth (property) lest it would be exhausted by Zakah*"[2].

However, to induce individuals to invest through savings with Islamic banks, it is essential that such individuals develop **a** trust in the ability of Islamic banks to realize their investment objectives. In the absence of trust in the ability of Islamic banks to invest efficiently and in full compliance with Islamic Shari'a, many individuals may refrain from investing through Islamic banks. One of the pre-requisites for the development of such trust is the availability of information that assures the investing public of the ability of Islamic banks to achieve their objectives. Among the important sources of such information are the financial reports of Islamic banks which are prepared in accordance with standards that are applicable to Islamic banks. However, in order to develop such standards it is essential to define the objectives and concepts of financial accounting for Islamic banks. In this respect, it is not harmful to begin where others have ended, if what has been developed by others is beneficial and does not contradict the Islamic Shari'a. **(para 3)**

The interest in developing financial accounting standards for Islamic banks started in 1987. In this respect, several studies have been prepared. These studies have been compiled in five volumes and deposited in the Library of the Islamic Research and Training Institute of the Islamic Development Bank. **(para 4)**

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1. Referred to hereafter as Islamic bank or Islamic banks.
2. Related to al-Tabarani on the authority of Anas-Ibn-Malik from the Prophet (may the blessing and peace of Allah be upon him). A good Hadith as stated by al-Hafiz Ibn Hajar. Also related to al-Baihaqi on the authority of Umar (may Allah be pleased with him) and it is a good Hadith. (*Faied al-Qadeer*, al-Munawi, Vol. 1 p. 108).

The outcome of these studies has been the formation of the Financial Accounting Organization for Islamic Banks and Financial Institutions (the Organization) which was registered as a not-for-profit organization in the State of Bahrain in 12/9/1411H corresponding to 27/3/1991. Since its inception the Organization has continued the efforts to develop accounting standards. Periodic meetings of the Executive Committee for Planning and Follow Up (the Committee) have been held with the aim of implementing the plan approved by both the Supervisory Committee (the supreme authority of the Organization) and by the Financial Accounting Standards Board for Islamic Banks and Financial Institutions (the Board). In this respect, the Committee has retained the services of several consultants on Shari'a, experts and practitioners of accounting and bankers. **(para 5)**

2. Introduction

This statement of concepts of financial accounting for Islamic banks has been prepared to express basic principles of financial accounting. These concepts or basic principles are consistent with the broader view of Islamic principles - a view which does not require that a concept need always to be derived from the Shari'a. Islamic thought accommodates principles not specifically stated in the Shari'a, provided that such principles are beneficial or harmless to society and do not violate any precept of Shari'a. **(para 6)**

2/1 The approach used in developing this statement

The approach used in developing this statement consists of the following:

(a) The identification of accounting concepts which have been previously developed by other institutions that are consistent with the Islamic ideals of accuracy and fairness. It is unlikely that anyone would dispute the adoption of such concepts, for example those relating to defining the characteristics of useful accounting information such as relevance and reliability.

(b) The identification of concepts which are used in traditional financial accounting but are inconsistent with Islamic Shari'a. Such concepts were either rejected or sufficiently modified to comply with the Shari'a in order to make them useful. An example of such concepts is the time value of money as a measurement attribute.

(c) The development of those concepts defining certain aspects of financial accounting for Islamic banks that are unique to the Islamic way of transacting business. The development of these concepts was particularly emphasized in this statement. Examples include concepts based on the Islamic laws defining the risks and rewards associated with business transactions, and the incurrence of costs and earnings of profits. **(para 7)**

2/2 Functions of Islamic banks

Islamic banks were developed on a foundation that does not permit the separation between temporal and religious matters. That foundation requires compliance with Shari'a as a basis for all aspects of life. This covers not only religious worship but also business transactions which should comply with Shari'a precepts. For example, one of the most notable aspects of Islamic teaching is the prohibition of usury and the perception of money as a medium of exchange and a means of discharging financial obligations, but not a commodity. Indeed, money does not have a time-value aside from the value of goods that are being exchanged through the use of money, in accordance with Shari'a. Accordingly, Islamic banks are founded on the concept of sharing profits and losses consistent with the Islamic concept of "profit is for that who bears risk" . Islamic banks reject interest as a cost for the use of money and loans as an investment vehicle. **(para 8)**

In conducting their investments, Islamic banks make sure that their funds and those available to them for investment generate earnings that are both compatible with Shari'a precepts and beneficial to society. Islamic banks accept funds on the basis of a Mudaraba contract which is a form of an agreement between the provider of funds (investment account holders[3]) and the provider of effort (the bank). In conducting business on the basis of Mudaraba, the bank declares its willingness to accept funds to invest on behalf of its owners, divides profits according to a predetermined percentage and makes it known that losses will be borne solely by providers of funds, absence of negligence or breach of contract. **(para 9)**

Islamic banks have numerous functions including the following:

(a) Investment management:
Islamic banks may perform this function based on either a Mudaraba contract or an agency contract.

According to the Mudaraba contract, the bank (in its capacity as a *Mudarib* i.e. the one who undertakes the investment of other parties' funds) receives a percentage of the returns only in case of profit. However, in case of loss the bank receives no reward for its effort and the provider of funds (*rabb-al-mal*) is allocated the losses.

According to the agency contract, the bank receives either a lump sum or a percentage of the invested amount irrespective of whether or not a profit is realized. **(para 10)**

(b) Investment:
Islamic banks invest funds placed with them (owners funds as well as investment account funds) using investment vehicles consistent with the Shari'a. Examples would include Murabaha contracts, leasing, joint ventures, Mudaraba contracts, Salam or Istisna' contracts, formation of enterprises or the acquisition of controlling or other interests in existing enterprises, trading products, and investment or trading in publicly traded shares or real estate. The returns are divided between the contributors of funds after the bank receives its Mudarib share of profit which must be agreed upon between investment account holders and the bank before implementation of the contract. **(para 11)**

Investment accounts may be divided into unrestricted (i.e. unrestricted Mudaraba) or restricted (i.e. restricted Mudaraba).

Unrestricted Investment Accounts [4]
With this type of account, the investment account holder authorizes the Islamic bank to invest the account holder's funds in a manner which the Islamic bank deems appropriate without laying down any restrictions as to where, how and for what purpose the funds should be invested. Under this arrangement the Islamic bank can commingle the investment account holder's funds with its own funds or with other funds the Islamic bank has the right to use (e.g. current accounts). The investment account holders and the Islamic bank generally participate in the returns on the invested funds. **(para 12)**

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3. The term investment accounts is used instead of investment deposits to reflect their nature of sharing in profits and losses.
4. Unrestricted participating investment bonds and any other accounts that are of similar nature are equivalent to unrestricted investment accounts.

Restricted Investment Accounts [5]

With this type of account, the investment account holder imposes certain restrictions as to where, how and for what purpose his funds are to be invested. Further, the Islamic bank may be restricted from commingling its own funds with the restricted investment account funds for purposes of investment. In addition, there may be other restrictions which investment account holders may impose. For example, investment account holders may require the Islamic bank not to invest their funds in installment sales transactions or without guarantor or collateral or require that the Islamic bank itself should carry out the investment rather than through a third party. **(para 13)**

(c) Financial services:

Islamic banks also offer a variety of other financial services for a fee based on an agency contract or a rental. Examples include letters of guarantee, wire transfers, letter of credit, etc. **(para 14)**

(d) Social Services:

The concept of Islamic banking requires that Islamic banks perform social services whether through the Qard (good faith loan) fund or the Zakah and charity fund consistent with Islamic teachings. Furthermore, the concept of Islamic banking also requires Islamic banks to play a role in the development of its human resources and to contribute to the protection and development of the environment. **(para 15)**

It is obvious that the functions of Islamic banks and their methods of doing business vary significantly from the functions of traditional banks and their methods of doing business. It is essential, therefore, to develop concepts that are specifically tailored for Islamic banks since the concepts developed by traditional financial accounting do not cater to the functions of Islamic banks. **(para 16)**

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5. Restricted participating investment bonds and restricted participating investment units in mutual funds formed by the Islamic bank and any other accounts that are of similar nature are equivalent to restricted investment accounts.

3. Definition Of financial statements

Defining an appropriate set of financial statements for an Islamic bank requires consideration of their functions and the consequences of performing those functions on the rights and obligations of the Islamic bank and other parties. In addition, consideration should also be given to the common information needs of the users of those financial statements. The common information needs of the users of the financial statements of Islamic banks have been defined in the *Statement Of Financial Accounting No. 1: Objectives Of Financial Accounting For Islamic Banks And Financial Institutions.* **(para 17)**

Based on those considerations, the proposed set of financial statements for Islamic banks is as follows:

(a) Financial statements that reflect the Islamic bank's function as an investor and its rights and obligations, irrespective of the Islamic bank's objective from its investment being economic (achieving the maximum return through means approved by Shari'a) or social, the investment mechanisms used being limited to a few or are encompassing all those that are approved by the Shari'a, or the type of investment. Thus financial statements include:

- Statement of financial position.
- Statement of income.
- Statement of cash flows.
- Statement of retained earnings or statement of changes in owners' equity. **(para 18)**

(b) A financial statement reflecting changes in restricted investments managed by the Islamic bank for the benefit of others whether based on a Mudaraba contract or an agency contract. Such a statement will be referred to as "Statement of changes in restricted investments". **(para 19)**

(c) Financial statements reflecting the Islamic bank's role as a fiduciary of funds made available for social services when such services are provided through separate funds:

- Statement of sources and uses of funds in the Zakah and charity fund.
- Statement of sources and uses of funds in the qard fund. **(para 20)**

4. Definition of the basic elements of financial statements

4/1 Statement of financial position

The basic elements of this statement include assets, liabilities, equity of unrestricted investment account holders and their equivalent, and owners' equity. **(para 21)**

The definitions of these basic elements are as follows:

4/1/1 Assets

An asset is anything that is capable of generating positive cash flows or other economic benefits in the future either by itself or in combination with other assets which the Islamic bank has acquired the right to as a result of past transactions or events. However, to be reflected as an asset on the Islamic bank's statement of financial position, the asset should have the following additional characteristics:

(a) It should be capable of financial measurement with a reasonable degree of reliability.

(b) It should not be associated with a non measurable obligation or a right to another party.

(c) The Islamic bank should have acquired the right to hold, use or dispose of the asset. **(para 22)**

4/1/2 Liabilities

A liability is a present obligation to transfer assets, extend the use of an asset or provide services to another party in the future as a result of past transaction(s) or other events(s). However, to be reflected as a liability on the Islamic bank's statement of financial position, the obligation must have the following additional characteristics:

(a) The Islamic bank must have an obligation to another party and the Islamic bank's obligation must not be reciprocal to an obligation of the other party to the bank.

(b) The Islamic bank's obligation must be capable of financial measurement with a reasonable degree of reliability.

(c) The Islamic bank's obligation must be capable of being satisfied through the transfer of one or more of the Islamic bank's assets to another party, extending to the other party the use of the Islamic bank's assets for a period of time, or providing services to the other party. **(para 23)**

4/1/3 Equity of unrestricted investment account holders and their equivalents

Unrestricted investment accounts refer to funds received by the Islamic bank from individuals and others on the basis that the Islamic bank will have the right to use and invest those funds without restrictions, including the Islamic bank's right to commingle those invested funds with its own investment in exchange for proportionate participation in profits and losses after the Islamic bank receives its share of profit as a Mudarib. **(para 24)**

The relationship between the Islamic bank and holders of unrestricted investment accounts and their equivalent is based on an unrestricted Mudaraba contract because the Islamic bank has the right to commingle funds received from holders of unrestricted investment accounts with owners' equities. The Islamic bank also has the right to use those funds unconditionally and without any restrictions imposed by holders of investment accounts.

Hence, unrestricted investment accounts are considered as one of the elements of the financial position of the Islamic bank. This is in conformity with the Shari'a precepts which permit the Islamic bank to commingle its own assets with those which the Islamic bank has the right to use or dispose of. On the other hand, restricted investment accounts and their equivalent are not considered an element of the Islamic bank's financial position because the Islamic bank does not have unconditional right to use or dispose of these funds. **(para 25)**

Equity of unrestricted investment account holders and their equivalent refers to the amount remaining, at the date of the statement of financial position, from the funds originally received by the Islamic bank from the account holders plus (minus) their share in the profits (losses) and decreased by withdrawals or transfers to other types of accounts. **(para 26)**

Unrestricted participating bonds and other accounts of similar nature are equivalent to unrestricted investment accounts. Unrestricted participating bonds have a face amount and are issued by the Islamic bank in the names of those who subscribe to them on the basis that the Islamic bank will use those funds to finance its investment activities. Profits are allocated between holders of these bonds and the Islamic bank, based on the relative amount of funds invested by each, after the bank has received its share of profits as a Mudarib. Losses are allocated between the Islamic bank and holders of these bonds based on the relative amount of funds invested by each. **(para 27)**

Holders of unrestricted investment accounts and their equivalent receive their share of profits according to what is agreed in their contract with the Islamic bank and bear their share of loss based on the relative contribution of their invested funds. **(para 28)**

Equity of unrestricted investment account holders and their equivalent is not considered a liability for the purpose of financial accounting. This is because the Islamic bank is not obligated in case of loss to return the original amount of funds received from the account holders unless the loss is due to negligence or breach of contract. Likewise, equity of unrestricted investment account holders and their equivalent is not considered part of the ownership equity in the Islamic bank since the holders of these accounts and their equivalent do not enjoy the same ownership rights , for example voting rights and entitlement to profits realized from investing funds provided by current and other non-investment accounts. Current accounts and other non-investment account are guaranteed by owners' equity and not by the equity of investment account holders or their equivalent. This is in accordance with the hadith of the Prophet (may the blessing and peace of Allah be upon him) which says "*Profit is for that who bears risk*".[6] **(para 29)**

4/1/4 Owners' equity

Owners' equity refers to the amount remaining at the date of the statement of financial position from the Islamic bank's assets after deducting the bank's liabilities, equity of unrestricted investment account holders and their equivalent and prohibited earnings, if any. That is why owners' equity is sometimes referred to as the owners' residual interest. **(para 30)**

4/2 Income statement

The basic elements of this statement include revenues, expenses, gains, losses, return (profit or loss) on unrestricted investment accounts and their equivalent and net income or net loss. **(para 31)**

The definitions of these basic elements are as follows:

4/2/1 Revenues

Revenues are gross increases in assets or decreases in liabilities or a combination of both during the period covered by the income statement which result from legitimate investment, trading, rendering of services and other profit oriented activities of the Islamic bank like investment management of restricted investment accounts.

To be considered revenues, the gross increases in assets or the gross decreases in liabilities should have the following characteristics:

(a) The gross increases in assets or the gross decreases in liabilities should not be the result of investment by or distribution to owners, deposits or withdrawals by unrestricted investment account holders or their equivalent, deposits or withdrawals by current or other non-investment account holders or the acquisition of assets.

(b) The gross increases in assets or the gross decreases in liabilities should have the same characteristics of assets and liabilities, respectively.

(c) The gross increases in assets or the gross decreases in liabilities should relate to the period covered by the income statement. **(para 32)**

4/2/2 Expenses

Expenses are gross decreases in assets or increases in liabilities or a combination of both during the period covered by the income statement which result from legitimate investment, management of investments, trading and other activities of the Islamic bank, including the rendering of services.

To be considered expenses, the gross decreases in assets or the gross increases in liabilities should have the following characteristics:

(a) The gross decreases in assets or the gross increases in liabilities should not be the result of distribution to or investment by owners, withdrawals or deposits by

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6. This is a good Hadith related to a number of Hadith reporters.

- unrestricted investment account holders or their equivalent, or withdrawals or deposits by current or other non-investment account holders .

(b) The gross decreases in assets or the gross increases in liabilities should have the same characteristics of assets and liabilities.

(c) The gross decreases in assets or the gross increases in liabilities should relate to the period covered by the income statement. **(para 33)**

4/2/3 Gains and losses

A gain is a net increase in net assets which results from holding assets that appreciate in value during the period covered by the income statement or from incidental legitimate reciprocal and non-reciprocal transfers, except for non-reciprocal transfers with equity owners or holders of unrestricted investment accounts and their equivalent. **(para 34)**

A loss is a net decrease in net assets which results from holding assets that depreciate in value during the period covered by the income statement, or from incidental legitimate reciprocal and non-reciprocal transfers, except for non-reciprocal transfers with equity owners or holders of unrestricted investment accounts or their equivalent. **(para 35)**

Not all gains and losses result from the same causes. Some gains and losses result from exchanges between the Islamic bank and other entities, for example gains and losses from the sale of fixed assets that were not acquired for sale in the normal course of business. Other gains or losses result from non-reciprocal transfers (one sided transactions), for example donations received by the Islamic bank or penalties imposed on the bank by the central bank. In addition, the bank may incur other losses which result from involuntary conversions of assets, for example loss of assets due to theft, destruction of assets due to flood. Other gains or losses may result from holding assets while their value changes during the period covered by the income statement. **(para 36)**

4/2/4 Return on unrestricted investment accounts and their equivalent

Return on unrestricted investment accounts and their equivalent is the share allocated to the holders of those accounts out of investment profits and losses as a result of their participation jointly with the Islamic bank, in the financing of investment transactions during the period covered by the income statement. The return on unrestricted investment accounts and their equivalent is not considered an expense (in case of profit) or a revenue (in case of loss). Rather, it is considered an allocation of the investment profits and losses accruing to the holders of unrestricted investment accounts from their participation in investment activities carried out jointly with the Islamic bank. **(para 37)**

4/2/5 Net income (net loss)

Net income (net loss) for the period covered by the income statement is the net increase or decrease in owners' equity resulting from revenues, expenses, gains, losses, after allocating the return on unrestricted investment accounts and their equivalent, for the period. It is the result of all ongoing profit oriented operations of the bank and other events and circumstances affecting the value of assets held by the Islamic bank during the period covered by the income statement. Net income (net loss) includes all legitimate changes in equity during the period covered by the income statement except those resulting from investments by owners and distributions to owners. **(para 38)**

The basic elements of the income statement may be combined in different ways to obtain intermediate measures of the Islamic bank's performance during a specific period of time. Examples of such intermediate measures are income (loss) from investments, income (loss) after return on unrestricted investment accounts, income before Zakah and tax. Those intermediate measures are, in effect, sub-totals of net income (net loss). **(para 39)**

4/3 Statement of changes in owners' equity or statement of retained earnings

4/3/1 Statement of changes in owners' equity

The basic elements of a statement of changes in owners' equity include net income, investments by and distributions to owners. **(para 40)**

The definitions of these basic elements are as follows:

(a) Net Income (Net Loss) (as defined in para 38).

(b) Investment by owners is the amount of increase in owners' equity resulting from the transfer of assets or the performance of services to the Islamic bank or the assumption or payment by owners of an obligation of the Islamic bank for the purpose of increasing their equity in the bank.

(c) Distributions to owners is the amount of decrease in owners' equity resulting from transfer by the Islamic bank to the owners of assets or the performance of services or the assumption or payment by the Islamic bank of an obligation of the owners for the purposes of reducing their equity in the bank. **(para 41)**

Hence, investments by owners and distribution to owners are non-reciprocal transfers (one sided transactions) between the Islamic bank and its owners as *owners.* This is different from reciprocal and non-reciprocal transfers between the Islamic bank and its owners as *non owners.* **(para 42)**

4/3/2 Statement of retained earnings

The basic elements of a statement of retained earnings include net income (net loss), dividends and transfers to other owners' equity accounts. **(para 43)**

The definitions of these basic elements are as follows:

(a) Net Income (Net Loss) (as defined in para 38).

(b) Dividends are one type of distributions to owners described in para 41.

(c) Transfer to other owners equity accounts is a decrease in retained earnings resulting from their transfer to legal or other reserves or to the owners' capital accounts. **(para 44)**

4/4 Statement of cash flows[7]

The basic elements of this statement include cash and cash equivalent as of a given date, cash flows from operations, cash flows from investing activities and cash flows from financing activities. Cash flows include inflows and outflows **(para 45)**

The definitions of these basic elements are as follows:

4/4/1 Cash and cash equivalent

Cash and cash equivalent include local and foreign currency and deposits with the central bank and other institutions which the Islamic bank can withdraw in full on demand. Cash and cash equivalent do not include gold, silver or other precious metals. This is because the purpose of this statement is to report sources and uses of cash and cash equivalent items that are available immediately as a means of transacting business. **(para 46)**

4/4/2 Cash flows from operations

Cash flows from operations refer to cash inflows or outflows during the period as a result of transactions and other events whose effects are reflected in the Islamic bank's statement of income as revenues, expenses, gains and losses, except for gains and losses resulting from the sale of assets acquired by the bank for its own use. **(para 47)**

4/4/3 Cash flows from investing activities.

Cash flows from investing activities refer to cash outflows as a result of the acquisition of assets for investment including investment for the Islamic bank's own use and/or cash inflows as a result of the sale of assets previously acquired by the bank for investment or/and for its own use. **(para 48)**

4/4/4 Cash flows from financing activities

Cash flows from financing activities refer to cash inflows as a result of investment by owners, deposits by holders of unrestricted investment accounts and their equivalent, and deposits by current, savings and other similar accounts and/or cash outflows resulting from distributions to owners or withdrawals by holders of unrestricted investment accounts and their equivalent, and withdrawals by current, savings and other similar accounts. **(para 49)**

4/5 Statement of changes in restricted investments and their equivalent

The basic elements of this statement include restricted investments as of a given date, deposits and withdrawals by holders of restricted investment accounts and their equivalent, restricted investment profits and losses before the investment manager share in investment profits as a Mudarib or his compensation as an investment agent, and the investment manager share in investment profits or compensation during the period ending at that date. **(para 50)**

The definitions of these basic elements are as follows:

4/5/1 Restricted investments

Restricted investments are assets acquired by funds provided by holders of restricted

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7. Cash flows refers to the inflow or outflow of cash.

investment accounts and their equivalent, and managed by the Islamic bank as an investment manager based on either a non-participating Mudaraba contract or agency contract. Restricted investments are not assets of the Islamic bank and should not be reflected on the bank's statement of financial position since the bank does not have the right to use or dispose of those investments except within the conditions of the contract between the Islamic bank and holders of restricted investment accounts and their equivalent. **(para 51)**

4/5/2 Deposits and withdrawals by holders of restricted investment accounts and their equivalent

Deposits by holders of restricted investment accounts and their equivalent are funds received by the Islamic bank, as an investment manager or agent, from holders of such accounts who agree that the Islamic bank invests their funds for a share in investment profits as a Mudarib or for a fee as an agent. Withdrawals by holders of restricted investment accounts and their equivalent are funds received by such holders out of the proceeds of restricted investments that reduce the holders' share in restricted investments. **(para 52)**

The following transactions are equivalent to withdrawals:

(a) The transfer of all or part of the balance of the holder of a restricted investment account to an unrestricted investment, a current account or any other account with the bank.

(b) The transfer of all or part of the balance of the holder of a restricted investment account from one restricted investment portfolio (or a mutual fund) to another restricted investment portfolio managed by the same bank. Such transfer is considered a withdrawal from the first portfolio and a deposit in the second portfolio.

(c) The reacquisition by a mutual fund of investment units previously issued by the fund. **(para 53)**

4/5/3 Restricted investment profits (losses) before the investment manager share in profits as a Mudarib or compensation as an investment agent

Restricted investment profits (losses) before the bank's share in investment profits as a Mudarib or compensation as an agent is the amount of net increase (decrease) in restricted investments other than increases (decreases) resulting from deposits and withdrawals by holders of restricted investment accounts and their equivalent. **(para 54)**

4/5/4 The investment manager's share in restricted investment profits as a Mudarib or its compensation as an investment manager

The relationship between the bank as an investment manager and holders of restricted investment accounts and their equivalent may be based on a Mudaraba contract or an agency contract. In the first case, the bank's compensation, as an investment manager, takes the form of a percentage of investment profits. No compensation would be due to the bank, as investment manager, in the case of investment losses when the bank's arrangement is based on a Mudaraba contract. However, the bank's invested funds would bear its share of investment losses. In the second case, the bank's compensation, as an investment manager, takes the form of a fixed fee regardless of the investment results. **(para 55)**

4/6 Statement of sources and uses of funds in the Zakah and charity fund

When an Islamic bank establishes a Zakah and charity fund, the bank acts as a fiduciary of that fund if the bank is responsible for the collection and distribution of all or part of Zakah and charity funds. The basic elements of this financial statement include sources of funds in the Zakah and charity, uses of funds in the Zakah and charity fund during a period and the fund balance as of a given date. **(para 56)**

The definitions of these basic elements are as follows:

4/6/1 Sources of funds in the Zakah and charity fund

Zakah is a fixed religious obligation calculated by reference to net assets (including cash) that have appreciated or have the capacity to appreciate in value over a specific period of time except for assets that have been acquired for consumption or use in the production of revenues[8]. Zakah is a religious obligation on wealth which every Muslim, including a child or an insane person, must meet provided his net assets are liable for Zakah. However, unlike Zakah, charitable contributions are discretionary.

The first Zakah conference held in Kuwait in 1984 concluded that in the case of a company that is considered, legally, a separate entity (e.g. limited liability companies and corporations) Zakah should be determined based on the company's net assets as if the company was subject to Zakah. The total amount of Zakah, so determined, would then be divided between owners to enable each owner to meet his religious obligation personally. However, in the following four cases the company is required to satisfy its Zakah obligation on behalf of its owners.

(a) When the law requires the company to satisfy the Zakah obligation as an entity.

(b) When the company is required by its charter or by-laws to satisfy the Zakah obligation as an entity.

(c) When the general assembly of shareholders passes a resolution requiring the company to satisfy the Zakah obligation as an entity.

(d) When individual owners authorize the company to act as their agent in satisfying the Zakah obligation.

In addition, holders of investment accounts and other accounts as well as other parties may ask the Islamic bank to act as an agent in meeting the Zakah obligation on their interest in the bank. The bank may also receive charitable contributions from owners, depositors and others for distribution on their behalf. **(para 57)**

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8. For example fixed assets of the bank or real estate owned by it.

4/6/2 Uses of funds in the Zakah and charity fund

Uses of funds in the Zakah and charity fund include the eight purposes for which they are distributed as set forth in the following verse "**Alms are for the poor and the needy, and those employed to administer the (funds); for those whose hearts have been (recently) reconciled (to the truth); for those in bondage and in debt in the cause of Allah and the wayfarer. (Thus is it) ordained by Allah, and Allah is full of knowledge and wisdom** (Chapter 9: verse 60)". **(para 58)**

4/6/3 Fund balance in the Zakah and charity fund

The fund balance refers to funds in the Zakah and charity fund which have not been distributed as of a given date. **(para 59)**

4/7 Statement of sources and uses of funds in the Qard fund

The basic elements of this financial statement include, sources of funds and uses of funds during a period and the fund balance as of a given date. **(para 60)**

The definitions of these basic elements are as follows:

4/7/1 Qard

The fiqh definition of Qard is that it is a non-interest bearing loan intended to allow the borrower to use the loaned funds for a period of time with the understanding that the same amount of the loaned funds would be repaid at the end of the period. An Islamic bank may organize a fund for Qard as a means of achieving social objectives. **(para 61)**

4/7/2 Sources of funds in the Qard fund

Sources of funds in the Qard fund represent the gross increase in funds available for lending during the period covered by the statement. Sources of such increase may be external or internal. External sources include funds provided to the fund by the bank from current accounts at the bank, funds provided to the fund by owners of the Islamic bank and proceeds of prohibited earnings which the Islamic bank may make available to the fund on a temporary basis until such proceeds are properly disposed of. Internal sources include collections of loans during the period or funds deposited in the fund by individuals on a temporary or permanent basis. **(para 62)**

4/7/3 Uses of funds in the Qard fund

Uses of funds in the Qard fund represent the amount of gross decrease in funds available for lending during the period covered by the statement. Uses include new loans granted during the period, reimbursement of funds made available to the fund by the Islamic bank from current accounts and/or prohibited earnings, if any, and repayment of funds previously provided to the fund by individuals on a temporary basis. **(para 63)**

4/7/4 Fund balance in the Qard fund

Fund balance in the Qard fund refers to the outstanding collectible loans and the other funds not loaned or used for other purposes. **(para 64)**

5. The accounting assumptions

5/1 The accounting unit concept

Islamic Fiqh (jurisprudence) include original applications which recognize the entity as a separate unit of accountability. Examples include waqf (trust foundation), the mosque and dar al-mal (treasury). Recent Fiqh thinking has extended that concept to companies and other similar entities, including an Islamic bank[9]. This recent thinking means that an Islamic bank is considered an accounting unit separate from its owners or others who have provided the bank with funds. **(para 65)**

The accounting unit concept requires the identification of economic activities that are associated with the Islamic bank as a separate entity and can be expressed as the bank's assets, liabilities, revenues, expenses, gains and losses, net income and net loss. **(para 66)**

This separation also includes the separation of the bank's liability from that of its owners because "There is no objection in Shari'ah to setting up a company whose liability is limited to its capital for that is known to the company clientele and such awareness on their part precludes deception."[10]. **(para 67)**

On the other hand, some activities with which the bank is associated are the activities of other accounting units and should be reflected as such. For example, the bank may manage a restricted investment portfolio for the benefit of other parties, manage a Zakah and charity fund or manage a Qard fund. Similarly, the bank itself as an accounting unit may be part of a bigger accounting unit. In this case, in addition to the bank producing its own financial statements as an accounting entity, the preparation of financial statements reflecting the activities of the bigger accounting unit may be appropriate. **(para 68)**

5/2 The going concern concept

Mudaraba and Musharaka contracts are for specific periods, however, these are assumed to continue until one or all of the parties involved decide to terminate such contracts. Hence, investment accounts managed by an Islamic bank that are based on Mudaraba contracts are assumed to continue until they are terminated by their owners or the bank. Similarly the concept of Islamic banking is based on Mudaraba contracts, which are assumed to continue until there is evidence to the contrary. **(para 69)**

On other hand, Islamic Fuqaha divide wealth into money and goods. Goods are divided into those that are available for sale and those that are not available for sale. The latter are used for longer periods (e.g. buildings and equipment) which imply that the entity would continue in operation[11]. **(para 70)**

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9. See, for example: al-Khafeef, *Al-Sharikat fi al-Fiqh (Companies in Islamic Jurisprudence)*, (Cairo: Arab Countries League, 1962); al-Kayat, Abdul Aziz, *al-Sharikat fi al-Shari'a al-Islamia Walganoon al-Wadie (Companies in Islamic Shari'a and Company Law)* Part II, Second Edition, (Beirut 1983); Abdullah, Ahmed Ali, *Al Shaqseea al-ietbariah fi al-fiqh al-Islami: Dirasa Mogarana (The Legal Entity in Islamic Jurisprudence: A Comparative Study)*, (Khartoum: Al-dar al-Sudania Lelktub, 1986).
10. Para 12, Resolution No. 65/17, Seventh Session of the Council of the Islamic Fiqh Academy, Jeddah, 7-12 Dhul Qi'da 1412H corresponding to 9-14 May 1992.
11. See Abie Ubaid, *Al-Amwal (Wealth)*, 1975; Al-Qaradawi Y., *Fiqh al-Zakah (Zakah Jurisprudence)*, 1977; Shehata, S., *Mouhasbat al-Zakah (Zakah Accounting), 1987.*

In the absence of persuasive evidence to the contrary, financial accounting assumes the continuation of an entity as a going concern. This means that in preparing the entity's financial statements it is assumed that there is no intention or necessity to liquidate the entity. In addition, the going concern concept has an important bearing on financial accounting and the financial statements of the accounting unit. In so far as the entity is conceived of as a continuous stream of activities, it is the task of financial accounting to make the most significant measurements possible of the continuous flow of the entity activities. Under this concept, the most significant measurements possible of the continuous flow of the entity activities are those pertaining to allocating its efforts and accomplishments as between the present and future and matching those efforts and accomplishments. **(para 71)**

Breaking up these continuous streams of activities into periodic streams between the present and the future severs many real connections and tends to give an impression of high degree of certainty with respect to the figures presented in the financial statements. In reality, what the financial statements present as of a given point in time is dependent to a very great extent on the future direction of events and circumstances that affect the entity's activities. The financial statements of a period, even under the most favourable circumstances, are tentative in character. The complete picture of the entity is never entirely discernible prior to final liquidation. **(para 72)**

The going concern concept has an important implication to an Islamic bank. Assumptions are made about the continuity of the bank's activities in the future, including its investment activities. However, the relationship between the bank and owners of investment accounts may not continue until the liquidation of investments, when actual results become known. It may, therefore, be appropriate to measure investments during the life of such investments at their cash equivalent values in order to achieve equity in determining the rights of holders of investment accounts who wish to withdraw their funds before the actual liquidation of investments. **(para 73)**

5/3 The periodicity concept

Islam assigns certain rights to money and wealth and associates such rights with periods of time to ensure that obligations pertaining to such rights are fulfilled on a timely basis. For example, Zakah is due on the amount of money and wealth that have reached a certain level one year after reaching that level. It is reported that the Prophet (peace be upon him) has said "*No Zakah on wealth (property) until a year passes*" (12). **(para 74)**

Consistent with this concept in Islam, there is an obligation on Islamic banks to present periodic reports reflecting their financial positions as of a given date and the results of their operations during a specific period in order to disclose the rights and obligations of the bank and those of interested parties. **(para 75)**

Hence, the periodicity concept means that life of the Islamic bank should be broken into reporting periods to prepare financial reports that provide interested parties with information or directions by which they can evaluate the performance of the accounting unit. This assumption also indicates the need to relate the activities of the accounting unit through the entirety of its life to the appropriate reporting periods as necessary. **(para 76).**

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12. Related to al-Daraqutni and al-Baihagi on the authority of Ibn Umar from the Prophet (may the blessing and peace of Allah be upon him). It is a poor Hadith. Also related to al-Daraqutni on the authority of Umar which is the most correct on (*Al-Talkees Al-Habeer*, Ibn Hajar. p. 175).

5/4 The stability of the purchasing power of the monetary unit

Financial accounting uses monetary units of a given currency as a common denominator to express the basic elements of financial statements. The use of monetary units as a means of expressing the basic elements of financial statements is a prerequisite for measuring the financial position, results of operations and other changes in the financial position of an accounting entity during a specific period. **(para 77)**

The use of monetary units as a means of expressing the basic elements of financial statements may raise a question regarding the stability of the measurement unit in view of a change in its purchasing power. For example, the purchasing power of a monetary unit decreases during a period experiencing an increase in the general price level (inflation) and increases during a period experiencing a decrease in the general price level (deflation). **(para 78)**

There are two schools of thought in Islamic Fiqh(13) with respect to the effect of changes in the purchasing power of money on financial rights and obligations. One school of thought believes that changes in the purchasing power of money should be taken into account when settling financial rights and obligations. The other school of thought believes that changes in the purchasing power of money should be ignored when settling financial rights and obligations.(14) (15) **(para 79)**

For purposes of financial accounting for Islamic banks, the stability of the purchasing power of the monetary unit is assumed. **(para 80)**

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13. For an excellent review see the work of the famous Muslim scholar Ibn Abdeen, *Tanbeeh al-Regood ala Masail al-Nigood*, 558/2-67.
14. The Islamic Fiqh Academy reviewed this issue in its meeting held in Kuwait in December 1988. It concluded that debt should be satisfied by an equivalent number of monetary units regardless of the change, if any, in the purchasing power of the monetary unit to avoid any implications of payment of *riba*.
15. See Shehata, op.cit.

6. Accounting recognition and measurement concepts

6/1 Accounting recognition and measurement defined

Accounting recognition refers to recording the basic elements of the financial statements. The concepts of accounting recognition define the basic principles that determine the timing of revenue, expense, gain and loss recognition in the bank's income statement and, in turn, the basic principles that determine the timing of assets and liabilities recognition. The concepts of accounting recognition also determine the timing of recognizing profits and losses resulting from restricted investments in the statement of changes in restricted investments. **(para 81)**

Accounting measurement refers to the determination of the amount at which assets, liabilities and, in turn, equity of the holders of unrestricted investment accounts and their equivalent and owners' equity are recognized in the bank's statement of financial position. It also refers to the amounts at which restricted investments and, in turn, equity of the holders of restricted investment accounts and their equivalent are recognized in the statement of changes in restricted investments. Accounting measurement concepts define the broad principles that determine the amount or amounts at which those elements are recognized. **(para 82)**

6/2 Accounting recognition

6/2/1 Revenue recognition

The basic principle for revenue recognition is that revenues should be recognized when realized. Realization of revenues takes place when the following conditions are met:

(a) The bank should have earned the right to receive the revenue. This means that the earning process should be complete or virtually complete. The point at which the earning process is complete may differ for different types of revenues. For example, the earning process for revenues from services is compete when the bank delivers the service; the earnings process for revenues from the sale of goods is complete upon delivery of those goods; and the earning process for revenues from allowing others the use of the bank assets (e.g. leasing real estate) is completed through the passage of time.

(b) There should be an obligation on the part of another party to remit a fixed or a determinable amount to the bank.

(c) The amount of revenue should be known and should be collectible with reasonable degree of certainty, if not already collected. **(para 83)**

6/2/2 Expense recognition

The basic principle for expense recognition is realization either because the expense relates directly to the earning of revenues that have been realized and recognized or because it relates to a certain period covered by the income statement. The recognition of expenses that relate directly to the earning of revenues that have been realized and recognized is founded on the Islamic concept of assigning the responsibility for the cost to the recipient of the benefit.

Expenses that have no direct relationship to revenues but do have a direct relationship to the periods during which revenues are recognized fall in two categories:

(a) Expenses representing costs that provide a benefit in the current period but are not expected to provide reasonably measurable benefits in the future. Examples include management compensation and bonuses and other administrative expenses which are difficult to allocate directly to specific services performed for others by the bank or specific assets acquired by the bank. Accordingly, such expenses should be recognized when incurred.

(b) Expenses that represent a cost incurred by the bank which is expected to benefit multiple periods. Such cost should be allocated in a rational and systematic manner to the periods expected to receive the benefit. An example of such expenses is depreciation of fixed assets which represents an allocation of the cost of fixed assets to the periods that benefit from the use of such assets. **(para 84)**

6/2/3 Gain and loss recognition

The basic principle for gain and loss recognition is their realization as a result of:

(a) The completion of a reciprocal or a non-reciprocal transfer resulting in the gain or loss. An example of reciprocal transfer is the consummation of the sale of fixed assets as a basis for the recognition of gains (losses). An example of a non-reciprocal transfer is the occurrence of an event such as a natural disaster which results in a loss.

(b) The availability of sufficient competent evidential matter indicating reasonably measurable appreciation or depreciation in the values of recorded assets or liabilities as a result of changes in supply and demand. Such gains and losses are estimated unrealized gains and losses resulting from revaluation of assets and liabilities, where applicable. **(para 85)**

6/2/4 Recognition of restricted investment profits and losses

The basic principles governing the recognition of gains and losses also govern the recognition of restricted investment profits and losses. Restricted investment profits and losses may consist of two types, namely realized profits and losses resulting from reciprocal and non-reciprocal transfers, and estimated unrealized profits and losses resulting from the revaluation of restricted investments, where applicable. **(para 86)**

6/3 Concepts of accounting measurement

6/3/1 The matching concept

The bank's net income (net loss) for a period of time should be determined by matching revenues and gains with expenses and losses that relate to that period of time in accordance with the basic principles of accounting recognition. Likewise, restricted investments' net profit or net loss for a period of time should be determined by matching restricted investment revenues and gains with restricted investment expenses and losses that relate to the period of time in accordance with the basic principles of accounting recognition. The matching concept is supported by the Islamic concept of assigning the responsibility of the cost to the recipient of the benefit. **(para 87)**

6/3/2 Measurement attributes

Measurement attributes refer to the attributes of assets and liabilities that should be measured for financial accounting purposes. For example, asset attributes that may be selected for measurement in financial accounting may include the acquisition cost of the asset, the net realizable or cash equivalent value of the asset as of a given date, the asset's replacement cost as of a given date or any other attribute whose measurement would result in relevant information.

The choice of the attribute(s) that should be measured for financial accounting purposes should be guided by the relevance, reliability, understandability and comparability of the resulting information provided to users of financial statements. **(para 88)**

6/3/3 Attributes that should be measured

6/3/3/1 The cash equivalent value expected to be realized or paid

The cash equivalent value expected to be realized is the number of monetary units that would be realized if an asset was sold for cash in the normal course of business as of the current date. The cash equivalent value expected to be paid is the number of monetary units required to settle an obligation as of the current date such as a Salam or Istisna' obligation.

When all of the conditions required for the measurement of this attribute are present (i.e. relevance, reliability and understandability of the resulting information), measurement of this attribute would be suitable as a basis for accounting measurement for an Islamic bank whether as:

(a) an investor of the funds available to it from its owners and holders of unrestricted investment accounts on the basis of an unrestricted Mudaraba contract

(b) an investment manager of restricted investment accounts either on the basis of a restricted Mudaraba or agency contract. **(para 89)**

In both cases, information resulting from the measurement of this attribute is particularly relevant to present and potential holders of unrestricted or restricted investment accounts or their equivalent. Present and potential holders of investment (restricted or unrestricted) accounts and their equivalent need information to evaluate the bank's ability in achieving their investment objectives. In addition, holders of investment accounts and their equivalent need information to evaluate alternatives available to them whenever they can change their relationship with the bank. **(para 90)**

In both respects, the investment account holder's evaluation needs to take into consideration, among other factors, the cash equivalent value he expects to realize from the funds he has provided or expects to provide to the bank to finance restricted or unrestricted investments. The value the holder of an investment account expects to realize from his funds is substantially dependent upon the cash equivalent value expected to be realized from investments if the investments were to be sold as of the current date. **(para 91)**

Another important factor that calls for the measurement of this attribute, is the equitable allocation of the results of unrestricted investments between the holders of unrestricted investment accounts who have provided or withdrawn funds at different points of time during the lives of those investments, on the one hand, and between such account holders as a group and owners of the Islamic bank on the other hand. **(para 92)**

Unlike owners of the Islamic bank, holders of investment accounts and their equivalent may withdraw their funds at the end of their contract. This means that if unrestricted investments were to be measured at their acquisition (historical) cost, inequities would occur in the distribution of investment results between holders of investment accounts who provide or withdraw funds at different points of time during the lives of those investments. Likewise, inequities would occur in the distribution of unrestricted investment results between the holders of unrestricted investment accounts as a group and owners of the Islamic bank. **(para 93)**

This consideration is also relevant with respect to holders of restricted investment accounts or their equivalent who have provided or withdrawn funds at different points in time during the life of restricted investments. The results of investments (profits and losses) do not occur at a given point in time. Rather, such results are earned over the life of those investments even though the ultimate result is not certain until the investments are liquidated. If restricted investments were to be measured at their acquisition costs until liquidated, investment results would only be recognized during the period when the investments are liquidated. Should this be the case inequities would arise between holders of restricted investment accounts who have provided or withdrawn funds at different points in time during the life of those investments. **(para 94)**

6/3/3/2 Revaluation of assets, liabilities and restricted investments at the end of the accounting period

Measurement of the cash equivalent expected to be realized or paid require the periodic revaluation of outstanding assets, liabilities and restricted investments. However, the resulting information must be reliable and comparable. To assure reliability and comparability, it is imperative that the management of the Islamic bank adheres to all of the following broad principles during the revaluation of assets, liabilities and restricted investments:

(a) To the extent available, outside indicators (such as market prices) should be used.

(b) All relevant information whether positive or negative should be utilized.

(c) Logical and relevant valuation methods should be utilized.

(d) Consistency in the use of valuation methods should be adhered to.

(e) To the extent appropriate, experts in valuation should be utilized.

(f) Conservatism in the valuation process by adhering to objectivity and neutrality in the choice of values. **(para 95)**

6/3/3/3 Applicability of revaluation of assets, liabilities and restricted investments

Notwithstanding the relevance of revaluing assets, liabilities and restricted investments whenever investments are financed by holders of investment accounts, this concept will not be adopted at the present time. It is not evident that adequate means are currently available to apply this concept in a manner that is likely to produce reliable information. **(para 96).**

It is permissible, however, to apply this concept for the purpose of presenting supplemental information which may be relevant to an existing or a prospective holder of an investment account. Presentation of such supplemental information does not necessarily obligate the Islamic bank to distribute unrealized investment results. Distribution of investment results and the nature of the results to be distributed is generally based on the contractual relationship between the Islamic bank and the holder of the investment account and the laws and regulations governing that relationship. **(para 97)**

6/3/3/4 Alternative measurement attributes to the cash equivalent value

Historical Cost

The historical cost of an asset refers to its fair value at the date of its acquisition including amounts incurred to make it usable or ready for disposition. Fair value at the date of acquisition refers to the price paid by the Islamic bank to purchase the asset in an arm's length transaction. When an asset is acquired through a non-reciprocal transfer to the Islamic bank, fair value refers to the market price at which a similar asset is exchanged in an arm's length transaction between unrelated parties at the date of the transfer.

The historical cost of a liability refers to the amount received by the Islamic bank when the liability was incurred or the amount at which the liability will be settled when it is done. **(para 98)**

7. The qualitative characteristics of accounting information

7/1 Meaning of the qualitative characteristics of accounting information

The qualitative characteristics of accounting information refer to the qualities of useful accounting information and the basic principles that should be used to evaluate the quality of such information. Definition of these qualities should assist those responsible for setting accounting standards, as well as those responsible for the preparation of financial statements in evaluating financial information produced by alternative accounting methods and in differentiating between necessary and unnecessary disclosures. **(para 99)**

The usefulness of accounting information must be evaluated in relation to the objectives of presenting financial statements which are focused on helping their main external users make decisions involving Islamic banks. The interest of accountants should be directed to such users and to the preparation of financial statements that aid users in their decision making. **(para 100)**

The decision making objective of presenting financial statements leads to the overriding criterion by which the alternative accounting methods or disclosure choices can be evaluated. Given a choice from among alternative accounting methods or given a number of disclosure choices, the method that should be chosen or the disclosure that should be made is the one that produces the information that is most useful for decision making by the main external users of financial statements. **(para 101)**

To say that a choice from among alternative accounting methods or disclosure alternatives should be based on the usefulness of the resulting information for decision making is not sufficient guidance to those who have to make the choice. The specific characteristics that would make the information useful for decision making need to be discerned and defined. **(para 102)**

7/2 Relevance

Relevance refers to the existence of a close relationship between the financial accounting information and the purposes for which this information is prepared. To be useful, financial accounting information should be relevant to one or more decisions of users of that information.

The main users of financial statements have many courses of action under consideration. Some of these courses of action may involve a particular Islamic bank but others do not. Financial accounting information of a particular bank can only be relevant to evaluating an outcome of the course of action that relates to that bank. Accordingly, the financial statements of the bank in which an investor has an equity interest can not be expected to provide him with information about the outcome from the immediate sale of his interest - a quotation from a willing buyer is needed for that - or information about the outcome from investing elsewhere. For this reason, the role of the financial statements of a particular bank in the evaluation of outcomes of different courses of action must be related to the evaluation of the outcome from holding an equity interest in that bank or starting a particular relationship with a specific bank. **(para 103)**

On this basis relevance may be defined as follows:

> Accounting information is relevant if it helps the main users of financial statements evaluate the potential outcomes of maintaining or establishing relationships with

the Islamic bank provided that information meets the other criteria of useful information. **(para 104)**

Relevance of accounting information requires that the information has the following three qualities:

(a) Predictive value
This means that the information should enable the user to predict the potential outcome of a current or a new relationship with the bank. For example, net income resulting from the revaluation of assets and liabilities at their cash equivalent value would provide a better basis for predicting future cash flows than their valuation at historical cost. **(para 105)**

(b) Feedback value
This means that the information should enable the user to verify the accuracy of his prior prediction and make adjustments. For example the reporting of net income would help equity owners to confirm their earlier predictions about cash flows or to correct those predictions. **(para 106)**

(c) Timeliness
This means that if information is not available when it is needed or becomes available only so long after the reported events then it becomes of little use in making decisions. Timeliness alone cannot make information relevant because there are other factors which also make information relevant. However, lack of timeliness reduces the value of information or detracts from it usefulness. **(para 107)**

Timeliness of accounting information requires consideration of two aspects:

(a) The frequency of financial statements issued by the Islamic bank. i.e., the length of the time period for which financial statements are prepared and issued. In this respect, the longer the period for which financial statements are prepared the less useful the information contained therein. On the other hand, the shorter the period for which financial statements are prepared the less reliable the information contained therein. Information contained in financial statements prepared for a very short period of time are likely to be affected by seasonal or random factors which might cause the information to be misleading or at least not worth the user's time. But if the reporting period is too long, the user is required to wait too long before obtaining and using the information included in the financial statements. By then it might be too late for the information to make a difference in the user's assessments of the outcome of different courses of action under consideration. **(para 108)**

(b) The time-period that elapses between the end of the period for which the financial statements are prepared and the date of their issuance. The longer the period during which the financial statements are being prepared for issuance, the greater the loss of the information value contained therein. It the responsibility of the Islamic bank to prepare its financial statements in the earliest possible time that is reasonable. **(para 109)**

Optimal frequency and minimal lag are, therefore, important criteria of useful accounting information. They apply primarily to the reporting function rather than to the accumulation and measurement of financial accounting data. **(para 110)**

7/3 Reliability

Users of financial accounting information prefer that such information has a high degree of reliability. Reliability is the characteristic which permits users to depend upon information with confidence. However, reliability does not mean absolute accuracy since accounting information by necessity reflects estimates and judgments. Rather, reliability means that based on all the specific circumstances surrounding a particular transaction or event, the method chosen to measure and/or disclose its effects produces information that reflects the substance of the event or transaction. Estimates and judgments in applying accounting methods are not inconsistent with Shari'a principles which permit the use of persuasive evidence in the absence of conclusive evidence. **(para 111)**

Reliable accounting information should have the following qualities:

(a) **Representational faithfulness.**
This means that the information should reflect a faithful representation of what it purports to represent. That is, there is close correspondence between such information and reality. However, there is no general rule to permit the evaluation of different methods of accounting based on this quality of accounting information. Whether a particular method of accounting will produce information that is more representationally faithful than information produced by another method depends on the facts and circumstances of each case. **(para 112)**

(b) **Objectivity**
This means that the results reached by a person can be substantially duplicated by another independent person using the same measurement and/or disclosure methods. Hence, to verify financial accounting information means to substantiate the information. However, the process of measuring and disclosing financial information can never become completely scientific because its factual materials can never be determined with complete and conclusive objectivity. The Islamic bank's business does not lend itself to scientific experiments and its activities do not follow mathematical formulae. Accordingly, accounting information is not always conclusively objective or completely verifiable. Nevertheless, the usefulness of accounting information is enhanced if it is verifiable, that is, if the measurement and/or disclosure methods used provide results that can be substantially corroborated by independent measures. **(para 113)**

To summarize, reliability means that the measurement and/or disclosure methods selected to produce and present the information are appropriate to the specific circumstances and have been applied in a manner that can be substantially replicated by independent measures. It also means that the information presented is a faithful representation of the underlying events and does not contain material errors or distortions. **(para 114)**

(c) **Neutrality**
Neutrality to or lack of bias against any group is a concept fully endorsed by

Islamic principles. Allah says "**O ye who believe! Stand out firmly for Allah, as witnesses to fair dealing, and let not the hatred of others to you make you swerve to wrong and depart from justice. Be just; that is next to piety; and fear Allah. For Allah is well acquainted with all that ye do** (Chapter 5: verse 8). This means that accounting information should serve the common information needs of its users without bias or unfair information advantage given to one group of users at the expense of others. **(para 115)**

Lack of neutrality affects the reliability of accounting information. Biased information is not reliable information. Neutral financial accounting information is directed towards the common needs of external users and is independent of presumptions about particular needs of specific users of the information. Neutral financial accounting information is fair information and is free from bias towards predetermined results. **(para 116)**

Neutrality of accounting information, therefore, creates a special duty on the part of those responsible for promulgating accounting standards as well as those who prepare financial statements. In both cases, there is duty to make choices among alternative measurement and/or disclosure methods on the basis of achieving two objectives; relevance of the resulting information and reliability of that information. **(para 117)**

7/4 Comparability

Comparable financial accounting information allows users to identify real similarities and differences in the bank's performance in relation to its own performance over time and in relation to the performance of other banks. The usefulness of financial accounting information is, therefore, enhanced by the use of similar measurement and/or disclosure methods to similar events. While there is some overlap between comparability, reliability and relevance, the many aspects of comparability are so important in providing useful financial accounting to users that a separate consideration seems to be warranted. **(para 118)**

7/5 Consistency

An Islamic bank should be consistent in its application of accounting measurement and disclosure methods from one period to another. However, this does not mean that the bank should keep using the same measurement and disclosure methods for the same transaction if there is a genuine reason to use other methods . For example, the management of the bank may decide to change the depreciation method if there were justifications that warrant the use of a different method. However, the change and its effect should be disclosed in the financial statement. **(para 119)**

7/6 Understandability

The Prophet (peace and blessing of Allah be upon him) has ordered Muslims to address people according to their ability to understand. Information can not be useful to users who can not understand it. Understandability depends on the nature of the information contained in the financial statements, the way the information is presented as well as the background and abilities of external users. It is , therefore, important for those who promulgate accounting standards and those who prepare financial statements to be aware of the abilities and limitations of those for whom accounting information is provided. **(para 120)**

This is one of the concepts that requires careful attention by those who promulgate accounting standards as well as those who prepare financial statements. The former group should realize that accounting standards are not produced only for the benefit of those who prepare financial statements. Rather, standards are prepared for users of financial statements to revaluate the outcome of alternative courses of action under consideration. Accordingly, the strengths and limitations of users of financial statements should be as important a consideration as anything else when preparing financial accounting standards. Likewise, those who prepare financial statements should realize that the statements are not produced for the benefit of other accountants. Rather, they are prepared for the benefit of external users who may have a limited knowledge, if any, of financial accounting of Islamic banks. Hence, the strengths and limitations of those users should be taken into consideration when designing financial statements and writing the notes accompanying them. **(para 121)**

The following should contribute to the understandability of financial accounting information:

(a) Use of classifications that are meaningful to users of financial statements and not just to accountants
(b) Information headings
(c) Juxtaposition of related data
(d) Presentations of net figures which the users typically want to know. **(para 122)**

8. Preparation and presentation of accounting information

8/1 Materiality

The principles of Islamic jurisprudence include rules that regulate priorities and classifications of human needs, namely daruriyat (necessities), hajiyat (needs) or tahsiniyat (commendables) matters. Among these principles is the principle of gharar (uncertainty of price quality, quantity or time of delivery in a contract) and the principle of choosing the least detrimental alternative. **(para 123)**

In preparing financial statements, the common information needs of users should always be taken into consideration with respect to the qualitative and quantitative importance of the information contained in those financial statements. *Statement of Financial Accounting No. 1: Objectives of Financial Accounting for Islamic Banks and Financial Institutions* defines the primary users as well as their common information needs. Information that is qualitatively or quantitatively important (material) should be presented. Conversely, information that is not material need not be presented. **(para 124)**

Materiality and adequate disclosure are interrelated and relate also to the concepts of relevance and reliability. Materiality and adequate disclosure are interrelated because if the information is material it should be disclosed and at the same time, information that is not disclosed is presumed to be immaterial. Materiality and adequate disclosure relate to relevance and reliability because information which is not relevant to the objectives of financial statements or which cannot be relied upon should not be disclosed. Financial accounting as a process of measurement and communication frequently involves judgments. In making these judgments, considerations of materiality play an essential role. Materiality in financial accounting is a state of relative importance. Importance may depend on quantitative or qualitative characteristics or a combination of both. **(para 125)**

In general, an item is regarded material if its omission, non-disclosure or misstatement would result in distortion of the information being presented in the financial statements, and thereby influence users of the statements when making evaluations or decisions. In deciding whether an item is material, its nature and its amount should both be taken into consideration, although in particular circumstances, either one may have to be recognized as the decisive factor. **(para 126)**

Qualitative materiality considerations include:

(a) The inherent importance of the transaction, event or circumstance which an item reflects, e.g., whether usual or unusual, expected or unexpected, recurring or non-recurring, in compliance with Shari'a or not in compliance with Shari'a, legal or illegal, etc.

(b) The inherent importance of the item as an indicator of the probable course of future events whether the item is indicative of new activities, represents substantive changes in current activities or changes in the bank's practices. **(para 127)**

Quantitative materiality considerations include:

(a) The amount of the item relative to normal expectations.

(b) The magnitude of the item in relation to an appropriate base. For example, income statement items in relation to net income after deducting the share of unrestricted investment accounts, or the average operating income for a number of past years; or statement of financial position items in relation to total assets, total investment accounts or owners' equity. **(para 128)**

8/2 Cost of information

Information, like any other commodity, has a cost either for the Islamic bank or society as a whole. The information provided by financial accounting involves a cost for its provision and use, and generally the cost of information provided should be expected not to exceed the benefits to users of financial accounting information in their decision making either at the individual level or the society level. **(para 129)**

8/3 Adequate disclosure

Adequate disclosure means that the financial statements should contain all material information necessary to make them useful to their users. This requires the disclosure of information which is expected to be useful to users of financial statements in their decision making whether that information is included in the financial statements, the notes accompanying them or in additional presentations. **(para 130)**

There are two aspects to adequate disclosure: optimal aggregation of accounting data and appropriate descriptions and clarifications.

(a) With respect to optimum aggregation of accounting data, the financial statements should provide sufficient details to meet the users' need for information about various categories of assets, liabilities, equity of holders of unrestricted investment accounts and their equivalent, owners' equity, revenues, expenses, gains, losses, cash flows, changes in owners' equity, changes in equities of holders of restricted investments accounts and their equivalent, sources and uses of funds in the Zakah and charity fund, sources and uses of funds in Qard fund. However, too much details can contribute to confusion, especially if the user is required to study many lines of data that are not helpful in order to find the few that are needed. Furthermore, as excessive detail can cause the user to overlook the significant data, immaterial items should not be separately stated. **(para 131)**

(b) With respect to written descriptions and clarifications, the headings, captions and amounts must be supplemented by enough additional descriptions and explanations so that their meaning is clear but not by so much information that important matters are buried in a mass of trivia. Notes accompanying the financial statements are always necessary both to provide users of financial statements with information that helps them in evaluating the bank's performance and its management, and in explaining the limitations of the financial statements. This, however, depends partly on the ability of users of financial statements. **(para 132)**

Whatever the circumstances, those who promulgate financial accounting standards and those who prepare financial statements must aim at adequate disclosure as a significant step towards providing useful information, particularly the information stated in the *Statement of Financial Accounting No. 1: Objectives of Financial Accounting for Islamic Banks and Financial Institutions.* **(para 133)**

9. Adoption of the Statement

The *Statement of Concepts of Financial Accounting for Islamic Banks and Financial Institutions* was adopted by the Board in its meeting No. 5 held in Jumada I 1414H corresponding to October 1993. Some members qualified their assent to the adoption of the statement with respect to the provision of para 96 as explained in the minutes of the meeting and shown below.

Members of the Board:

1- Abdel Aziz Rashed Al-Rashed, Chairman
2- Dr Abdelgadir Banaga, Deputy chairman
3- Ibrahim Al-Subeil
4- Irtiza Husain
5- Anwar Khalifa Sadah
6- Hazim Hassan*
7- Huseyin Cahit Ozcet
8- Dr Khaled Boodai
9- Dr Rifaat Ahmed Abdel Karim
10- Samir Tahir Badawi
11- Abdel Hamid Abu Musa
12- Sheik Abdullah Bin Sulaiman Al-Maneei (Absent due to sickness)
13- Professor Abdullah Al-Faisal
14- Dr Omer Zuhair Hafiz
15- Farooq Azam
16- Professor Mohamed Al-Siddiq Al-Darir
17- Mohammed Alawi Thiban
18- Mohammed Mukhtar Al-Sallami
19- Musa Abdel Aziz Shihadeh*
20- Mian Mumtaz Abdullah
21- Dr Yousuf Al-Qaradawi

* Did not attend the Board's meeting no. 5
(para 134)

Reservations

Some members qualified their assent to the adoption of the statement with respect to the provision of para 96, which does not require the revaluation of assets at their cash equivalent value at the present time, because fairness and safeguarding the rights of investment account holders and owners of the Islamic bank - as a Mudarib - require the use of the expected cash equivalent value in the revaluation of assets. Furthermore, the use of historical cost may cause unfairness both to holders of investment accounts and owners of the Islamic bank - as a Mudarib - if the assets appreciated or depreciated in value. The claim that it is difficult to estimate the cash equivalent value does not justify the use of other accounting measurement attributes.

The majority of the members of the Board were of the opinion that although holders of investment accounts provide or withdraw funds at different points of time during the lives of the investments financed by them which makes it relevant to revalue these investments at their cash equivalent value, it is not evident that adequate means are currently available to apply this concept in a manner that is likely to produce reliable information. It is permissible, however, to apply this concept for the purpose of presenting supplemental information which may be relevant to an existing or a prospective holder of an investment account. Further, in revaluing assets at their cash equivalent value, the management of the Islamic bank should give consideration to the broad principles for such revaluation that have been set and should disclose them. **(para 135)**

Financial Accounting Standard No. 1

General Presentation and Disclosure in The Financial Statements of Islamic Banks and Financial Institutions

Financial Accounting Standards Board

of the

Financial Accounting Organization for Islamic Banks and Financial Institutions

Jumada I 1414 H - October 1993

Contents

Preface

The emergence of Islamic banks and financial institutions[1] as relatively new organizations and the great challenge they face to successfully serve the societies in which they operate, have led them, together with specialists in Islamic Shari'a and in accounting, to seek the most appropriate means through which accounting standards could be developed and implemented in order to present adequate, reliable, and relevant information to users of the financial statements of such organizations. The presentation of such information is critical to the economic decision making process by parties who deal with Islamic banks and would also have a significant effect on the distribution of economic resources for the benefit of society.

The principles of Islamic Shari'a strike a balance between the interests of the individual and society. It is known that investment is the foundation of economic activities in any society. However, not every individual is capable of directly investing his own savings. Accordingly, Islamic banks play an important role by acting as a vehicle to attract the savings of individuals and investing those savings for the benefit of the individual and society.

Islam clearly encourages investment and spending. Indeed, when Islam imposed Zakah, it required that wealth should be invested, otherwise it would be exhausted by Zakah over a period of time. It has been reported that the Prophet (may the blessing and peace of Allah be upon him) said "*Trade in orphans wealth (property) lest it would be exhausted by Zakah*" [2] .

However, to induce individuals to invest through savings with their Islamic banks, it is essential that such individuals develop a trust in the ability of Islamic banks to realize their investment objectives. In the absence of trust in the ability of Islamic banks to invest efficiently and in full compliance with Islamic Shari'a, many individuals may refrain from investing through Islamic banks. One of the pre-requisites for the development of such trust is the availability of information that assures the investing public of the ability of Islamic banks to achieve their objectives. Among the important sources of such information are the financial reports of Islamic banks which are prepared in accordance with standards that are applicable to Islamic banks. However, in order to develop such standards it is essential to define the objectives and concepts of financial accounting for Islamic banks. In this respect, it is not harmful to begin where others have ended, if what has been developed by others is beneficial and does not contradict the Islamic Shari'a.

The interest in developing financial accounting standards for Islamic banks started in 1987. In this respect, several studies have been prepared. These studies have been compiled in five volumes and deposited in the Library of the Islamic Research and Training Institute of the Islamic Development Bank.

The outcome of these studies has been the formation of the Financial Accounting Organization for Islamic Banks and Financial Institutions (the Organization) which was registered as a not-for-profit organization in the State of Bahrain in 12/9/1411H corresponding to 27/3/1991. Since its inception the Organization has continued the efforts to develop accounting standards. Periodic meetings of the Executive Committee for Planning and Follow Up (the Committee)

1. Referred to hereafter as Islamic bank or Islamic banks.
2. Related to al-Tabarani on the authority of Anas-Ibn-Malik from the Prophet (may the blessing and peace of Allah be upon him). A good Hadith as stated by al-Hafiz Ibn Hajar. Also related to al-Baihaqi on the authority of Umar (may Allah be pleased with him) and it is a good Hadith. (Faied al-Qadeer, al-Munawi, Vol. 1 p. 108).

have been held with the aim of implementing the plan approved by both the Supervisory Committee (the supreme authority of the Organization) and by the Financial Accounting Standards Board for Islamic Banks and Financial Institutions (the Board). In this respect, the Committee has retained the services of several consultants on Shari'a, experts and practitioners of accounting and bankers.

This standard defines the financial statements that should be periodically published by Islamic banks to satisfy the common information needs of users of financial reports set forth in the *Statement of Financial Accounting No. 1: Objectives of Financial Accounting for Islamic Banks and Financial Institutions.* This standard also establishes the general principles for the presentation of information and defines certain information that should be disclosed in the financial statements of Islamic banks in order to achieve the objectives of accounting and financial reports within the limitations of financial accounting.

Statement of Standard

1. Scope of the Standard

This standard is applicable to the financial statements published by Islamic banks to meet the common information needs of the main users of such statements. This standard is applicable to all Islamic banks regardless of their legal form, countries of incorporation or size. Should the requirements of this standard contradict the bank's charter or the laws and regulations of the country in which it operates, a disclosure should be made of the contradiction and the impact of promulgated standards on the relevant elements of the financial statements. **(para 1)**

2. General provisions

2/1 The Complete set of financial statements

The complete set of financial statements that should be published by Islamic banks should consist of the following:

(a) A statement of financial position (balance sheet)

(b) An income statement

(c) A statement of cash flows

(d) A statement of changes in owners' equity, or a statement of retained earnings.

(e) A statement of changes in restricted investment

(f) A statement of sources and uses of funds in the Zakah and charity fund (when the bank assumes the responsibility for the collection and distribution of Zakah)

(g) A statement of sources and uses of funds in the Qard fund

(h) Notes to the financial statements

(i) Any statements, reports and other data which assist in providing information required by users of financial statements as specified in the *Statement of Objectives.* **(para 2)**

2/2 Comparative financial statements

An Islamic bank should publish comparative financial statements which should include, as a minimum, the financial statements of the comparable prior period. The presentation methods and disclosures in published financial statements should enable the user to differentiate between actual changes in the Islamic bank's financial position, its results of operations, its cash flows, the restricted investments managed by the bank, the sources and uses of funds in the Zakah and charity fund, and the sources and uses of funds in the Qard fund, from accounting changes during the periods covered by the financial statements. **(para 3)**

2/3 Rounding amounts presented in the financial statements

Amounts presented in the financial statements and related notes should be rounded to the nearest monetary unit. **(para 4)**

2/4 The form and classification of the financial statements and the terminology used therein

The form of and the classification used in the financial statements should ensure a clear presentation of their content. In addition, the terminology used to express the content of the financial statements should enable their users to understand and comprehend the information contained therein. Assets and liabilities should not be classified between current and non-current in the statement of financial position. **(para 5)**

2/5 Numbering of pages

Pages containing the financial statements and the related notes should be numbered consecutively. Notes to the financial statements should be given clear and distinct titles and should be cross referenced to the related items in the financial statements. **(para 6)**

2/6 Notes are an integral part of the financial statements

The following statement should appear on the bottom of every page containing a financial statement:

> "Notes to the financial statements from number - to number - are an integral part of the financial statements".

In addition, notes should be set forth immediately after the last page containing a financial statement. **(para 7)**

3. General disclosures in the financial statements

3/1 Adequate disclosure of material information

The financial statements should disclose all material information that is necessary to make those financial statements adequate, relevant and reliable for their users. **(para 8)**

3/2 Disclosure of basic information about the Islamic bank

The financial statements should disclose, to the extent applicable, the following information about the bank:

(a) The name of the Islamic bank.

(b) The country of incorporation.

(c) Formation date and legal form.

(d) Location of headquarters and number of branches in each country where the bank operates.

(e) The nature of the activities the bank is authorized to carry out by its charter and the major banking services it provides.

(f) The names of the bank's subsidiaries whose financial statements are consolidated with those of the bank, the countries of their incorporation, the bank's ownership percentage in each subsidiary and the nature of their activities.

(g) The names of the bank's subsidiaries whose financial statements are not consolidated with those of the bank's, the countries of their incorporation, the bank's ownership percentage in each subsidiary, the nature of their activities, and the reasons for excluding their financial statements from the consolidated financial statements of the bank.

(h) The name of the holding company and the names of other affiliates. An entity is considered an affiliate of another if they are controlled by an entity that owns not less than 51 percent of the shares of each entity.

(i) The role of the Shari'a adviser or the Shari'a board in supervising the bank's activities and the nature of the adviser's or board's authority in accordance with the bank's by-laws and in actual practice.

(j) The agency responsible for supervising the bank's activities and the agency responsible for supervising the holding company.

(k) The bank's responsibility towards Zakah.

(l) The tax treatment in the country of incorporation and in other countries where the bank has operating branches. If the bank enjoys a tax holiday in the country of incorporation and in other countries, the period of the tax holiday and the remaining period thereof. **(para 9)**

3/3 Disclosure of the currency used for accounting measurement

(a) The financial statements should disclose the currency used for accounting measurement, if not otherwise evident from the contents of the financial statements.

(b) The financial statements should disclose the accounting method used for translating foreign currency balances and transactions.
(para 10)

3/4 Disclosure of significant accounting policies

(a) Definition of accounting policies
Accounting policies refer to the accounting principles, bases, rules and methods which have been adopted by the Islamic bank's management for the preparation and publication of the financial statements. **(para 11)**

(b) The accounting policies that should be disclosed
The financial statements must contain a clear and precise description of the significant accounting policies used for the preparation and publication of the financial statements. This disclosure should include, as a minimum, the significant policies in the following circumstances:

1. Accounting policies that represent a choice among acceptable alternative accounting methods (e.g. the depreciation method used).

2. Accounting policies adopted by the management of the Islamic bank but which are not consistent with the concepts of financial accounting for Islamic banks, if any.

3. Accounting policies adopted by the management of the Islamic bank for revenue, gain and loss recognition.

4. The accounting policy adopted by the Islamic bank's management for the recognition and determination of doubtful receivables and the policies of writing-off debts.

5. The policies, bases and methods adopted by the bank's management for the revaluation of assets, liabilities and restricted investments to their cash equivalent value, if applicable.

6. The use of historical cost as a basis of determining equity of owners of unrestricted investment accounts and their equivalent (or restricted investment accounts or their equivalent) if the revaluation of assets, liabilities, and restricted investments to their cash equivalent value, is not mandatory.

7. The accounting policy adopted by the Islamic bank's management for the consolidation of the financial statements of subsidiaries, if any. **(para 12)**

(c) Method of disclosing significant accounting policies
Significant accounting policies should be disclosed in one note and should be shown as either the first or second note of the notes to the financial statements. **(para 13)**

3/5 Disclosure of unusual supervisory restrictions

The financial statement should disclose any unusual supervisory restrictions imposed on the Islamic bank by any regulatory or supervisory agency after due consideration with respect to any regulations regarding the disclosure of such restrictions. A supervisory restriction should be considered unusual if it either restricts management's ability to make decisions necessary to manage the bank, or if it prevents the bank from carrying out some of the activities it has been authorized to carry out by its charter. **(para 14)**

3/6 Disclosure of earnings or expenditures prohibited by Shari'a

The financial statements should disclose the amount and nature of earnings that have been realized from sources or by means which are not permitted by Shari'a. Likewise, disclosures should be made of the amount and nature of expenditures for purposes not permitted by Shari'a. The Islamic bank should also disclose how it intends to dispose of the assets generated by the prohibited earnings or acquired through prohibited expenditures. **(para 15)**

3/7 Disclosures of concentrations of asset risks

Disclosure should be made in the financial statements of the magnitude of assets invested, deposited or used in any of the following concentrations.

(a) An economic sector (e.g. the agriculture sector, the service sector, the manufacturing sector, the real estate sector, etc.)

(b) A customer, including another bank or a financial institution without stating the customer's name

(c) A domestic geographical area with unique economic characteristics

(d) Foreign countries **(para 16)**

3/8 Disclosure of concentrations of sources of unrestricted investment accounts and their equivalent and other accounts

Disclosure should be made in the financial statements of the magnitude of balances of all unrestricted investment accounts and their equivalent and other accounts by type in foreign countries. **(para 17)**

3/9 Disclosure of the distribution of unrestricted investment accounts and their equivalent and other accounts in accordance with their respective periods to maturity

Disclosure should be made in the financial statements of the distribution of unrestricted investment accounts and their equivalent and other accounts, by type, in accordance with their respective periods to maturity, from the date of the statement of financial position. The Islamic bank's disclosure should differentiate between demand accounts and other accounts. With respect to non-demand accounts, the bank should use for the purpose of this disclosure, maturity periods designed to disclose liquidity requirements during the next period and liquidity requirements during the following periods. Maturity periods should be consistently used and changes in the maturity periods used by the bank should be disclosed. **(para 18)**

3/10 Disclosure of the distribution of assets in accordance with their respective periods to maturity or expected periods to cash conversion

Disclosure should be made in the financial statements of the distribution of assets in accordance with their respective periods to maturity or expected periods to cash conversion from the date of the balance sheet. The Islamic bank's disclosure should differentiate between cash and other assets. With respect to other assets, the Islamic bank should use, for the purpose of this disclosure, maturity or conversion periods designed to disclose expected sources of liquidity during the next period and the following periods from outstanding assets at the statement of financial position date. Maturity or conversion periods should be used consistently and changes in the maturity or conversion periods should be disclosed. **(para 19)**

3/11 Disclosure of compensating balances

Disclosure should be made in the financial statements of any amounts the Islamic bank is obligated to deposit with others as compensating balances. **(para 20)**

3/12 Disclosure of risk associated with assets and liabilities which are denominated in foreign currency

Disclosure should be made in the financial statements of the net assets (net liabilities) by type of foreign currency, as of the statement of financial position date, which are denominated in foreign currency. **(para 21)**

3/13 Disclosure of contingencies

Disclosure should be made in the financial statements of contingencies existing as of the statement of financial position date including those resulting from the issuance of letters of credit or guaranty, documentary credit and similar instruments. **(para 22)**

3/14 Disclosure of outstanding financial commitments as of the statement of financial position date

Disclosure should be made in the financial statements of the nature and amounts of outstanding significant financial commitments as of the statement of financial position date which the Islamic bank cannot cancel without significant cost or penalty. **(para 23)**

3/15 Disclosure of significant subsequent events

Disclosure should be made in the financial statements of any event subsequent to the date of the statement of financial position which might have a significant effect on the Islamic bank's financial position or results of operations, including those events which may cause significant change in the bank's activities or size, or which may restrict management's ability to take action. Such disclosure should be made after due consideration to regulatory requirements imposed by the supervisory agencies. **(para 24)**

3/16 Disclosure of restricted assets or assets pledged as security

Disclosure should be made in the financial statements of the nature and amounts of any assets which are restricted for a particular use or used as a collateral for the Islamic bank's obligations. **(para 25)**

3/17 Disclosure of accounting changes

Disclosure should be made in the financial statements of the nature and effects of the following accounting changes:

(a) Change in an accounting policy
Disclosure of a change in an accounting policy should include the following:

1. Description of the change and its justification.

2. The effect of the change on net income for the current period and prior periods presented for comparative purposes and on retained earnings as of the beginning of the first period presented for comparative purposes.[3]

(b) Change in a non-routine accounting estimate[4]
Disclosure of a change in a non-routine accounting estimate should include the following:

1. Description of the change and the reasons thereof.

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3. If the change relates to restricted investments, disclosures should be made of the effect of the change on both the investment profits (losses) for the current period and for the prior periods presented for comparative purposes, and the balance of restricted investments at the beginning of the first period presented for comparative purposes.

4. Non-routine accounting estimates refer to those estimates management makes in order to allocate the recorded amount of an asset or deferred revenues to future periods or in order to estimate the expected amount of a liability that should be given accounting recognition. These do not include estimates management makes at the end of each period in order to determine the results of that period (for example, estimate of uncollectable receivables).
The financial statements should also disclose the investment returns for each type of account.

2. The effect of the change on net income or profits (losses) from restricted investments for the current period.

(c) Correction of an error in prior period financial statements
Disclosure of a correction of an error should include the following:

1. Nature of the error and the prior period(s) affected by the error.

2. The effect of the error correction on net income or profits (losses) from restricted investments for the period(s) affected by the error and the current period. **(para 26)**

3/18 Disclosure of the method used by the Islamic bank to allocate investment profits (losses) between unrestricted investment account holders or their equivalent and the Islamic bank as a Mudarib or as an investment manager whether or not participating in the investments with its own funds.
Disclosure should be made in the financial statements of the method(s) used by the Islamic bank to determine the share of unrestricted investments in the profits (losses) of the period. Disclosure should also be made of the returns of each type of investment accounts and their rate of return. **(para 27)**

3/19 Disclosure of related party transactions

3/19/1 Definition of related parties
Related parties mean the following:

(a) Members of the Islamic bank's board of directors, its external auditor, its Shari'a adviser or members of its Shari'a Board, its general manager and his deputies and equivalent.

(b) Relatives of those mentioned in (a) above, to the second degree provided there is vested interest between the two parties.

(c) Any natural person or entity which directly or indirectly owns a percentage (to be determined by the Islamic bank) of the banks voting ownership units and relatives of the natural person to the second degree. Changes in the percentage used by the Islamic bank should be disclosed.

(d) Any entity in which any person in (a), (b) or (c) above either directly or indirectly owns the percentage referred to in (c) above of its voting ownership units or is a member of its board of directors.

(e) Subsidiaries and other affiliates of the Islamic bank. An entity is considered an affiliate of another if they are controlled by an entity that owns not less than 51 percent of the shares of each entity.

(f) Any entity in which the Islamic bank directly or indirectly owns a sufficient percentage of its voting ownership units to enable the bank to influence its operations. **(para 28)**

3/19/2 Contents of the disclosure of related party transactions

Disclosure of related party transactions should include the following:[5]

(a) The nature of the relationship between the bank and the related party.

(b) The nature and amount(s) of the transaction(s) consummated with the related party during the period.

(c) Balances due from or due to the related party as of the statement of financial position date. **(para 29)**

4. Presentation and disclosure in each statement

4/1 The statement of financial position

The date of the statement of financial position should be disclosed. **(para 30)**

The statement of financial position should include the Islamic bank's assets, its liabilities, equity of its unrestricted investment account holders and their equivalent, and its owners' equity. **(para 31)**

Assets should not be set-off against liabilities[6] and liabilities should not be set-off against assets unless there is a religious or legal right and an actual expectation of set-off. **(para 32)**

Significant items of assets, liabilities, unrestricted investment accounts and their equivalent or owner's equity should not be combined on the face of the statement of financial position without disclosure. **(para 33)**

The amount of any allowance established to cover expected losses should be disclosed. **(para 34)**

Assets and liabilities should be combined into groupings in accordance with their nature and those groupings should be presented in the statement of financial position in the order of the relative liquidity of each group. The statement of financial position should present separate totals for assets, liabilities, unrestricted investment accounts and their equivalent, and owners' equity. **(para 35)**

Assets and liabilities should not be classified between current and non-current. **(para 36)**

Disclosure should be made on the face of the statement of financial position or the notes to the financial statements of the following assets with separate disclosures of assets jointly financed by the Islamic bank and unrestricted investment account holders and those exclusively financed by the Islamic bank:

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5. In case of executive managers, disclosure should be limited to amounts in excess of the maximum limits, if any, established by law or regulatory authorities for transactions between the bank and its executive managers.

6. Accounting provisions are not considered as liabilities.

(a) Cash and cash equivalent
(b) Receivables:
    Murabaha receivables
    Salam receivables
    Istisna' receivables
(c) Investment securities
(d) Mudaraba investments
(e) Musharaka (participation and joint ventures) investments
(f) Investments in other entities
(g) Inventories (including goods purchased for Murabaha customers prior to consummation of Murabaha agreement)
(h) Investment in real estate
(i) Assets acquired for leasing
(j) Other investments with disclosure of their types
(k) Fixed assets with disclosure of significant types and related accumulated depreciation
(l) Other assets with disclosure of significant types **(para 37)**

Disclosure should be made of the net realizable value of an asset if such value is less than the asset's recorded amount. However, all expected losses should be recognized when reasonably measurable. **(para 38)**

Disclosure should be made of the historical cost of assets or the historical amounts of liabilities which are reflected in the statement of financial position at their estimated cash equivalent values, when the revaluation of assets and liabilities to their estimated cash equivalent value is utilized. **(para 39)**

Disclosure should be made of changes during the period in the allowance for doubtful accounts receivable as follows:

(a) Provision charged to income statement during the period.

(b) Receivables written-off during the period.

(c) Receivables collected during the period which were previously written-off.

(d) The balance of the allowance for doubtful receivables as of the beginning and end of the period. **(para 40)**

Disclosure should be made in the statement of financial position or the notes to the financial statements of the following liabilities:

(a) Current accounts, saving accounts and other accounts, with separate disclosure of each category of accounts.

(b) Deposits of other banks.

(c) Salam payables.

(d) Istisna' payables.

(e) Declared but undistributed profits.

(f) Zakah and taxes payable.

(g) Other accounts payable. **(para 41)**

Unrestricted investment accounts and their equivalent should be disclosed and presented in the statement of financial position as a separate item between liabilities and owner's equity. **(para 42)**

A consolidated statement of position should disclose the minority interest and that interest should be shown on the statement as a separate item between unrestricted investment accounts and owner's equity. **(para 43)**

Disclosure should be made in the statement of financial position, and/or the statement of retained earnings or the statement of changes in financial position, and/or notes to the financial statements, as appropriate, of the following:

(a) Authorized, subscribed and paid-in capital.

(b) Number of authorized ownership units (shares), number of issued ownership units, number of outstanding ownership units, par value per unit and premiums on issued units.

(c) Legal reserve and discretionary reserves at the beginning and end of the period and changes therein during the period.

(d) Retained earnings at the beginning and end of the period and amount of retained earnings resulting from the revaluation of assets and liabilities to their cash equivalent values, where applicable, and changes therein during the period including distribution to owners and transfers to or from reserves.

(e) Other changes in owners' equity during the period.

(f) Any restrictions imposed on the distribution of retained earnings to owners. **(para 44)**

The rights, conditions and obligations of each type of unrestricted investment account and its equivalent and other deposit accounts shown in the statement of position should be disclosed. **(para 45)**

4/2- The income statement

The period covered by the income statement should be disclosed. **(para 46)**

Investment revenues, expenses, gains and losses should be disclosed by type. **(para 47)**

The nature of material revenues, expenses, gains and losses from other activities should be disclosed. **(para 48)**

Where applicable, estimated gains and losses from the revaluation of assets and liabilities to their cash equivalent values should be disclosed including the general principles used by the Islamic bank in the revaluation of assets and liabilities. **(para 49)**

To the extent applicable, the following information should be disclosed in the income statement with separate disclosures of investment revenues, expenses, gains and losses jointly financed by the Islamic bank and unrestricted investment account holders and those exclusively financed by the Islamic bank:

(a) Revenues and gains from investments.
(b) Expenses and losses from investments.
(c) Income (loss) from investments.
(d) Share of unrestricted investment account holders in income (loss) from investments before the bank's share as a Mudarib.
(f) The Islamic bank's share in income (loss) from investments.
(g) The Islamic bank's share in unrestricted investment income as a Mudarib.
(h) The Islamic bank's share in restricted investment profits as a Mudarib.
(i) The Islamic bank's fixed fee as an investment agent for restricted investments.
(j) Other revenues, expenses, gains, and losses.
(k) General and administrative expenses.
(l) Net income (loss) before Zakah and taxes.
(m) Zakah and taxes (to be separately disclosed).
(n) Net income (loss). **(para 50)**

The Zakah base should be disclosed whenever the Islamic bank is obligated to pay such Zakah on behalf of all owners. **(para 51)**

The minority interest (pertaining to companies whose financial statements are consolidated with those of the Islamic bank) in net income (loss) should be disclosed in the consolidated statement of income as a separate item before net income (loss). **(para 52)**

4/3 Statement of cash flows

The period covered by the statement should be disclosed. **(para 53)**

The statement of cash flows should differentiate between cash flows from operations, cash flows from investing activities and cash flows from financing activities. In addition, the statement should disclose the main components of each category of cash flows. **(para 54)**

The statement of cash flows should disclose the net increase (decrease) in cash and cash equivalent during the period and the balance of cash and cash equivalent at the beginning and end of the period. **(para 55)**

Transactions and other transfers that do not require the payment of or do not result in the receipt of cash and cash equivalent should be disclosed, for example bonus shares or the acquisition of assets in exchange for shares in the equity of the Islamic bank. **(para 56)**

The Islamic bank's policy with respect to the components of cash and cash equivalent used as a basis for the preparation of the statement of cash flows should be disclosed. **(para 57)**

4/4 The statement of changes in owners' equity or the statement of retained earnings

The period covered by the statement of changes in owners' equity or the statement of retained earnings should be disclosed. **(para 58)**

The statement of changes in owners' equity should disclose the following:

(a) Paid-in-capital, legal and discretionary reserves separately, and retained earnings as of the beginning of the period with separate disclosure of the amount of estimated earnings resulting from the revaluation of assets and liabilities to their cash equivalent values, where applicable.

(b) Capital contribution by owners during the period.

(c) Net income (loss) for the period.

(d) Distributions to owners during the period.

(e) Increase (decrease) in legal and discretionary reserves during the period.

(f) Paid-in-capital, legal and other discretionary reserves and retained earnings as of the end of the period with separate disclosure of the estimated amount of retained earnings resulting from the revaluation of assets and liabilities to their cash equivalent values, where applicable. **(para 59)**

The statement of retained earnings should disclose the following:

(a) Retained earnings at the beginning of the period with separate disclosure of the amount of estimated retained earnings resulting from the revaluation of assets and liabilities to their cash equivalent values, where applicable.

(b) Net income (loss) for the period.

(c) Transfers to legal and discretionary reserves during the period.

(d) Distribution of profits to owners during the period.

(e) Retained earnings at the end of the period with separate disclosure of the amount of estimated retained earnings resulting from the revaluation of assets and liabilities to their cash equivalent values, where applicable. **(para 60)**

4/5 Statement of changes in restricted investments

The period covered by the statement of changes in restricted investments should be disclosed. **(para 61)**

The statement should segregate restricted investments by source of financing (e.g. those financed by restricted investment accounts, investment units in restricted investment portfolios.) In addition, the statement should segregate investment portfolios by type. **(para 62)**

The statement of changes in restricted investments should disclose the following:

(a) The balance of restricted investments at the beginning of the period with separate disclosure of the portion of the balance resulting from the revaluation of restricted investments to their cash equivalent values, where applicable.

(b) The number of investment units in each of the investment portfolios and the value per unit at the beginning of the period.

(c) Deposits received or investment units issued by the Islamic bank during the period.

(d) Withdrawals or repurchase of investment units during the period.

(e) The Islamic bank's share in investment profits as a Mudarib or its fixed fee as an investment agent.

(f) Allocated overhead expenses, if any, from the Islamic bank to restricted investment accounts or portfolios.

(g) Restricted investment profits (losses) during the period with separate disclosure of the amount resulting from the revaluation of restricted investments to their cash equivalent values, where applicable.

(h) The balance of restricted investments at the end of the period with separate disclosure of the portion of the balance resulting from the revaluation of restricted investments to their cash equivalent values, where applicable.

(i) Number of investment units in each of the investment portfolios at the end of the period and the value per unit. **(para 63)**

Notes to the statement of changes in restricted investments should disclose the following:

(a) The nature of the relationship between the Islamic bank and owners of restricted investments either as a Mudarib or investment agent.

(b) The rights and obligations associated with each type of restricted investment account or investment unit. **(para 64)**

4/6 Statement of sources and uses of funds in the Zakah and charity fund

The period covered by the statement of sources and uses of funds in the Zakah and charity fund should be disclosed. **(para 65)**

Disclosure should be made of the Islamic bank's responsibility for the payment of Zakah and whether the bank collects and pays Zakah on behalf of owners of unrestricted investment account holders. **(para 66)**

Other sources of funds in the Zakah and charity fund should be disclosed. **(para 67)**

Disclosure should be made of the funds paid by the Islamic bank from the Zakah and charity fund during the period and of funds available in the fund at the end of the period. **(para 68)**

4/7 Statement of sources and uses of funds in the Qard fund

The period covered by the statement of sources and uses of funds in the Qard fund should be disclosed. **(para 69)**

The balances of Qard outstanding and funds available in the fund at the beginning of the period should be disclosed by type. **(para 70)**

The amounts and sources of funds contributed to the fund during the period should be disclosed by source. **(para 71)**

The amounts and uses of funds during the period should be disclosed by type. **(para 72)**

The balances of Qard outstanding and funds available in the fund at the end of the period should be disclosed. **(para 73)**

5. Treatment of changes in accounting policies

The following are not considered changes in accounting policies:

(a) The adoption of a new accounting policy because of a clear difference in the substance of certain transactions and events compared to similar transactions and events in the past.

(b) The adoption of a new accounting policy because of transactions or events that are occurring for the first time or have occurred in the past but were immaterial.

(c) Changes in the classification of items in the financial statements of the current period compared to their classification in prior period financial statements. However, items in prior period financial statements, when presented for comparative purposes, should be reclassified to conform to their current classifications. **(para 74)**

If the management of the Islamic bank decides to change an accounting policy, the new policy should be applied retroactively by restating the financial statements for the last period presented unless it is not practicable to obtain the data necessary for the restatement or the data is not available. **(para 75)**

If the data necessary for restating one or more of the prior periods' financial statements are not available or not practicable to obtain, retained earnings[7] as of the beginning of the current or a prior period, as appropriate, should be restated to reflect the cumulative effect of the change in the accounting policy on the prior periods which are not restated. The amount of that cumulative effect should be disclosed. **(para 76)**

The balance of retained earnings[8] at the beginning of the first period presented should be adjusted to reflect the cumulative effect of the change on the periods which are not presented. That cumulative effect should be disclosed. **(para 77)**

7. If the change relates to restricted investments, the balance of restricted investment at the beginning of the period should be adjusted.

8. If the change relates to restricted investments, the balance of restricted investments at the beginning of the first year presented should be adjusted.

Disclosure should be made as to whether prior periods presented have been restated to reflect the effect of the change. **(para 78)**

The effect of the change in an accounting policy on unrestricted investment accounts owners' share in income (loss) from investments and on net income (loss)[9] for the current period and for each prior period presented should be disclosed. **(para 79)**

The effects of multiple changes in accounting policies should not be netted and should be disclosed separately. **(para 80)**

A change in accounting policy should be disclosed even when its effect is not material either in the current or prior periods when it is expected to have a material effect on future periods. **(para 81)**

6. Treatment of changes in non-routine accounting estimates

The effect of a change in a non-routine accounting estimate should be reflected in:

(a) The period of the change if the effect of the change is limited to that period.

(b) The period of the change and future periods if the change affects the current and future periods.

The effect of the change in a non-routine accounting estimate on unrestricted investment account holders share in income (loss) from investments and on net income (loss) for the current period should be separately disclosed [10]. **(para 82)**

7. Treatment of a correction of an error in prior period financial statements

An error in prior period financial statements should be corrected retroactively by restating the financial statements for all prior periods presented which have been affected by the error. Disclosure should be made as to whether such an error affects the rights and obligations of the Islamic bank towards others. **(para 83)**

Retained earnings[11] at the beginning of the first period presented should be adjusted to reflect the cumulative effect of the correction of the error on the periods which are not presented but which were affected by the error. That cumulative effect should be disclosed. **(para 84)**

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9. If the change relates to restricted investments, the effect of the change on restricted investment profits (losses) for the current period and for each prior period presented should be disclosed.

10. If the change in non-routine accounting estimates relates to restricted investments, the effect of the change on restricted investment profits (losses) and on the Islamic bank's share in the profits of restricted investments as a Mudarib should be separately disclosed.

11. If the error relates to restricted investments, the balance of restricted investments at the beginning of the first year presented should be adjusted.

8. Effective date

This standard shall be effective for financial statements for fiscal periods beginning 1 Muharram 1417 H or 1 January 1996. **(para 85)**

Adoption of the standard

The presentation and general disclosure standard was adopted by the Board in its meeting No. 5 held in Jumada I 1414H corresponding to October 1993.

Members of the Board:

1- Abdel Aziz Rashed Al-Rashed, Chairman
2- Dr Abdelgadir Banaga, Deputy Chairman
3- Ibrahim Al-Subeil
4- Irtiza Husain
5- Anwar Khalifa Sadah
6- Hazim Hassan*
7- Huseyin Cahit Ozcet
8- Dr Khaled Boodai
9- Dr Rifaat Ahmed Abdel Karim
10- Samir Tahir Badawi
11- Abdel Hamid Abu Musa
12- Sheik Abdullah Bin Sulaiman Al-Maneei (Absent due to sickness)
13- Professor Abdullah Al-Faisal
14- Dr Omer Zuhair Hafiz
15- Farooq Azam
16- Professor Mohamed Al-Siddiq Al-Darir
17- Mohammed Alawi Thiban
18- Mohammed Mukhtar Al-Sallami
19- Musa Abdel Aziz Shihadeh*
20- Mian Mumtaz Abdullah
21- Dr Yousuf Al-Qaradawi

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* Did not attend the Board's meeting no. 5

Appendices

Appendix A: Brief history on the preparation of the standard

The Committee commissioned a number of consultants to conduct field studies on the objectives and standards of financial accounting and the role of governmental, professional and private organizations in preparing accounting standards in countries where Islamic banks operate. The studies have shown that there were differences in the methods of presentation and disclosure of Islamic banks.

The standard is prepared from several preliminary studies which include the views of a number of consultants in Islamic Shari'a and in accounting, practicing accountants, officials in central banks and Islamic bankers.

The Committee commissioned two accounting consultants to prepare a preliminary discussion paper on the requirements of presentation and general disclosure in financial statements. The study was developed by another team comprising an accounting consultant and a Shari'a consultant who prepared another discussion paper on the presentation and general disclosure in the financial statements of Islamic banks. An accounting consultant was then asked to prepare a first exposure draft on the standard. The job of finalizing the first exposure draft was assigned by the Committee to a study team consisting of two consultants in Shari'a and two consultants in accounting. The team was supported by meetings attended by other consultants of the Committee and its members who include specialists in Shari'a and in accounting, officials in central banks and Islamic bankers. It is worth noting that the charters, by-laws and published financial statements of Islamic banks were taken into consideration in the various stages of preparing the studies.

The first exposure draft was issued in Rabi I 1413H corresponding to September 1992 and discussed in the third meeting of the Board held on 13 Jumada I 1413H corresponding to 8 November 1992 which was attended by the consultants of the Committee. The first exposure draft was distributed to various parties for discussion in a seminar held in the State of Bahrain on 18-19 Jumada II 1413 corresponding to 12-13 December 1992. The seminar was attended by 124 individuals from various countries representing Islamic banks, central banks, international and local certified public accountants, associations of certified public accountants, international accounting standard-setting organizations, Shari'a scholars, academics, users of financial statements of Islamic banks. In addition to the comments that were expressed in the seminar, the Committee also received written comments.

The Committee and its consultants studied the comments received on the first exposure draft and made the changes which were considered appropriate. The Committee then issued the second exposure draft in Dhu Al Qa'da 1413H corresponding to April 1993 and distributed it to various parties. The Committee held two seminars in the State of Bahrain attended by representatives of Islamic banks to discuss the second exposure draft. The first seminar was held in Dhu Al Hajja 1413H corresponding to May 1993 and the second seminar was held in Rabi II 1414H corresponding to September 1993.

Following are the main comments submitted on the three exposure drafts but which were not accepted by the Committee.

(a) The classification of assets and liabilities into current and non-current.

The Committee decided that such classification is not relevant for Islamic banks. The standard requires that assets and liabilities should be combined into groupings in accordance with their nature and those groupings should be presented in the statement of financial position in order of their relative liquidity of each group.

(b) Not to disclose earnings or expenditures prohibited by Shari'a.
The Committee decided that this contradicts the objectives of financial reports in the *Statement of Financial Accounting No. 1: Objectives of Financial Accounting of Islamic Banks and Financial Institutions* which require that the financial reports of Islamic banks should provide information about the Islamic bank's compliance with the precepts of the Islamic Shari'a in its operations and dealings.

Appendix B: Reasons for the standard

The Committee commissioned a number of consultants to carry out field studies to identify the objectives and standards of financial accounting and the role of governmental, private, and professional organizations in preparing accounting standards in countries in which Islamic banks and financial institutions operate. These field studies included a comparison of methods of presentation and the adequacy of disclosure in the financial statements of a number of Islamic banks. The studies have shown that there were differences in the methods of presentation and adequacy of disclosure in the financial statements of Islamic banks. They also confirmed the need to disclose in the financial statements of Islamic banks additional important information related to matters that may affect the way users of the financial statements of these institutions make use of such statements as a basis for investment decisions in a manner that would benefit them in accordance with the Shari'a precepts.

A Muslim shareholder, depositor or customer chooses an Islamic bank in preference to other Islamic banks because of his confidence in the performance of the Islamic bank and in its ability to achieve his economic objectives in accordance with the precepts of Islamic Shari'a. However, this confidence comes only out of a number of factors, at the top of which is the disclosure of adequate information that enables users to evaluate the performance of the Islamic bank and its ability to achieve their economic objectives. A Muslim evaluates the performance of an Islamic bank mainly by comparing it with that of other similar banks. No doubt, the ability to compare the performance of various Islamic banks depends to a large extent on the adequate disclosure of information in its published financial statements, the methods of presenting the information in these statements and the clarity of the information presented.

In view of this, it is evident that there is a need to promulgate a standard which defines the information that should be disclosed in the financial statements of Islamic banks and the acceptable methods of presentation in these statements.

Appendix C: Basis for conclusions

The conclusions reached by this standard mainly emanate from the objectives of financial reports and the concepts of financial accounting for Islamic banks and financial institutions. Such objectives being geared to the needs of the categories of the users of such reports as are specified in the *Statement of Financial Accounting No. 1: Objectives of Financial Accounting for Islamic Banks and Financial Institutions* and the *Statement of Financial Accounting No. 2: Concepts of Financial Accounting for Islamic Banks and Financial Institutions* (referred to hereafter as the *Statement of Objectives and the Statement of Concepts*).

The *Statement of Objectives* states that financial reports should provide information about the Islamic bank's compliance with the precepts of Islamic Shari'a in its dealings and operations, and should also provide information to assist in separating earnings and expenditures prohibited by Shari'a, if any, and in verifying that prohibited earnings are spent on charitable purposes. Accordingly, the standard requires that financial statements should disclose the nature of the activities carried out by the Islamic bank, the major banking services it renders, the role of the Shari'a adviser or Shari'a Board in supervising the operations of the Islamic bank and the nature of the powers vested in the Shari'a adviser or Shari'a Board supervising these operations. The standard also requires the disclosure of any gains generated from sources or methods prohibited by Islamic Shari'a, expenditures on activities prohibited by Shari'a, and how the Islamic bank disposes of the funds generated from earnings prohibited by the Shari'a.

The *Statement of Objectives* states that financial reports should provide information to assist in the determination of Zakah on the Islamic bank's funds and where it will be spent. Accordingly, the standard requires that financial statements should disclose the Islamic bank's responsibility of paying and distributing Zakah on behalf of shareholders and investment account holders. The standard also requires that the full set of published financial statements should include a statement of sources and uses of the funds of the Zakah and charity fund and to disclose the Zakah base, the Zakah due for the financial period, and the Zakah declared but not yet distributed.

The *Statement of Objectives* states that financial reports should disclose information that assists in evaluating the adequacy of the Islamic bank's capital to absorb losses and business risks, assessing the inherent risk in the Islamic bank's investments, evaluating the degree of liquidity of the Islamic bank's assets, and the liquidity requirements of its other obligations. Accordingly, the standard requires that financial statements should disclose owner's equity and to separate it from the equity of unrestricted investment account holders and their equivalent, changes in owner's equity, the concentration of risk in both assets and the distribution of those assets in accordance with their respective periods to maturity or the estimated periods to actual conversion to cash, the concentration of the sources of unrestricted investment accounts and other accounts and their distribution in accordance with their respective periods to maturity, foreign currency risks, unrecorded contingencies in the statement of financial position, outstanding financial commitments, assets restricted for particular purposes including compensating balances with others, subsequent events, unusual supervisory restrictions imposed on the activities of the Islamic bank and valuation allowances established to cover expected losses. This standard also requires the grouping of assets and liabilities in accordance with their nature and the presentation of these grouping in the order of their relative liquidity. Finally, the standard requires that the full set of financial statements should include a statement cash flows.

The *Statement of Objectives* states that financial reports should provide information that assists in estimating cash flows that might be realized from dealing with the Islamic bank, the timing of those cash flows, the risk associated with their realization, the adequacy of such cash flows for the Islamic bank's operations including the distribution of return to holders of unrestricted investment accounts and shareholders. In addition to the requirements provided for in the former paragraph, the standard also requires that Islamic banks should publish comparative financial statements and that such statements should disclose cash flows and to distinguish between cash flows according to the activities which generated them or in which they were used. The standard also requires that the income statement should distinguish between the revenues and expenses of investments jointly financed by the Islamic bank and unrestricted investment account holders and those exclusively financed by the Islamic bank and the revenues, expenses, gains and losses resulting from other activities of the Islamic bank. Finally, the standard requires a number of disclosures relating to the revaluation of the Islamic bank's assets and liabilities at their cash equivalent value, if applicable, and the distribution of the Islamic bank's assets according to their respective periods to maturity or their estimated periods to actual conversion to cash.

The *Statement of Objectives* states that financial reports should provide information to assist in evaluating the Islamic bank's discharge of its fiduciary responsibility to safeguard funds and to invest these at reasonable rates of return, and information about investments' rates of returns and the rates of returns distributed to shareholders and owners of investment accounts. In addition to the requirements provided for in the latter two paragraphs, the standard also requires the disclosure of investments revenues and expenses, the nature of material revenues, expenses, gains and losses from other activities, the profits (losses) of restricted investments and the method which the Islamic bank employs in distributing the profits (losses) between holders of unrestricted investment accounts and owners' of the Islamic bank and the return on each type of account. The standard also requires the disclosure of the investment of available funds according to the nature of the assets in which the Islamic bank invested these funds.

The *Statement of Objectives* and the *Statement of Concepts* refer to the role of the Islamic bank in fulfilling its responsibility towards society. The *Statement of Objectives* states that financial reports should provide information about the Islamic bank's discharge of its social responsibilities. Accordingly, the standard requires that financial statements should disclose the uses of the funds of the Zakah and charity fund and the funds of the Qard fund. The standard also requires that financial statements should disclose the distribution of the Islamic bank's assets between domestic and foreign investments according to the economic sectors in which the investments are made, the nature of investments, and the concentration of the unrestricted investment accounts of the Islamic bank. Such disclosures serve a number of purposes, including indicators, though indirect, about the Islamic bank's discharge of its duties towards society. There is no doubt that there may be other indicators of the discharge of the Islamic bank's social responsibilities which may not be appropriate for inclusion in the General Presentation and Disclosure Standard because this may entail accounting measurements which are outside the scope of this standard.

In order to facilitate comparison by the user of financial statements of the Islamic bank's performance over a period of time and with similar Islamic banks, the standard includes a number of provisions which are aimed mainly at assisting users of financial statements to distinguish between the real changes and accounting changes in the Islamic bank's financial position and the results of its operations and in differentiating, on the other hand, between significant and insignificant changes in the performance of the Islamic bank in relation to other Islamic banks. Therefore, the standard requires that financial statements should disclose a number of basic pieces of information about the Islamic bank, the currency used for accounting purposes, significant accounting policies, and accounting changes and their effects. The standard also includes provisions to standardize the accounting treatment of accounting changes.

Appendix D: Glossary

Istisna'

A contract whereby the purchaser asks the seller to manufacture a specifically defined product using the seller's raw materials at a given price. The contractual agreement of Istisna' has a characteristic similar to that of Salam in that it provides for the sale of a product not available at the time of sale. It also has a characteristic similar to the ordinary sale in that the price may be paid on credit; however, unlike Salam, the price in the Istisna' contract is not paid when the deal is concluded. A third characteristic of the contractual agreement of Istisna' is similar to *Ijarah* (employment) in that labour is required in both.

Murabaha

Sale of goods with an agreed upon profit mark up on the cost. Murabaha sale is of two types. In the first type, the Islamic bank purchases the goods and makes it available for sale without any prior promise from a customer to purchase it. In the second type, the Islamic bank purchases the goods ordered by a customer from a third party and then sells these goods to the same customer. In the latter case, the Islamic bank purchases the goods only after a customer has made a promise to purchase them from the bank.

Musharaka

A form of partnership between the Islamic bank and its clients whereby each party contributes to the capital in varying degrees and agrees upon a ratio of profit fixed in advance. However, losses are shared according to the contribution of capital.

Mudaraba

A contract in which one side (investment account holders) provides capital and the other side (Islamic bank) provides work. The profits are to be shared in the proportion agreed before the implementation of the contract. In the case of loss, investment account holders bear all net loss provided that there has been no violation of the stipulated contract or neglect on the part of the Islamic bank.

A Mudaraba contract may also be concluded between the Islamic bank as a provider of capital on its behalf and on behalf of investment account holders, and business owners and other craftsmen, including farmers traders etc.

Salam

Sale of a deferred commodity against a present cash price. The seller undertakes to deliver a certain commodity with defined specifications at a certain date. There are five elements of Salam contract: text of the contract, *al-Musalam* (purchaser), *al-Musalam ileihi* (seller), *al-Musalam fihi* (commodity sold) and *Rasumal al-Salam* (price).

Appendix E: Example of the financial statements and disclosures therein

Notes:

The purpose of this example is to illustrate the application of some of the provisions of the standard. The example is not intended to illustrate the only acceptable methods for the presentation of or the disclosure in the financial statements. Furthermore, the example does not reflect all the requirements of the standard.

(Name of bank or institution)
Consolidated statement of financial position
As at xxx year xxx (last year)

	Note	xxx (year) Monetary unit	xx (last year) Monetary unit
Assets:			
Cash and cash equivalents	8	95,041,890	51,281,906
Sales receivables	9	3,804,889	875,556
Investments:			
Investment securities	10	14,850,000	15,000,000
Mudaraba investments	11	10,000,000	1,500,000
Musharaka investments	12	-	5,000,000
Participations	13	102,500,000	102,500,000
Inventories	14	-	2,000,000
Investment in real estate	15	58,500,000	71,750,000
Assets for rent	16	89,000,000	94,500,000
Istisna'	17	-	1,000,000
Other investments			
-		-	-
-		-	-
-		-	-
Total investments	18	274,850,000	293,250,000
Other assets	19	322,000	15,510,000
Fixed assets (net)	20	24,870,500	26,070,000
Total assets		398,889,279	386,978,462

(Paras 30,38, of the standard)

The attached notes from No. ( ) to No. ( ) form an integral part of the financial statements (para 7 of the standard)

(Name of bank or institution)
Consolidated statement of financial position
As at xxx year xxx (last year)

	Note	xxx (year) Monetary unit	xx (last year) Monetary unit
Liabilities, unrestricted investment accounts, minority interest and owners' equity			
Liabilities:			
Current accounts and saving accounts	21	18,550,000	15,400,000
Current accounts for banks and financial institutions		1,200,000	1,200,000
Payables	22	936,112	133,611
Proposed dividends		5,000,000	5,000,000
Other liabilities	23	5,069,750	2,192,321
Total liabilities		30,755,862	23,925,932
Unrestricted investment accounts (Para 42 of the standard)	24, 34	7,838,500	6,572,000
Minority interest (Para 43 of the standard)		3,450,600	3,240,550
Total liabilities, unrestricted investment accounts, and minority interest		42,044,962	33,738,482
Owners' equity			
Paid-up capital	25	350,000,000	350,000,000
Reserves	26	3,368,864	1,649,796
Retained earnings		3,475,453	1,599,184
Total owners' equity (Para 44 of the standard)		356,844,317	353,248,980
Total liabilities, unrestricted investment accounts, minority interest and owners' equity		398,889,279	386,987,462

(Paras 41 to 44 of the standard)

The attached notes from No. ( ) to No. ( ) form an integral part of the financial statements (Para 7 of the Standard)

(Name of bank or institution)
Income statement
For the year ended xxx (year) xxx (last year)

	Note		xxx (year) Monetary unit		xx (last year) Monetary unit
Income					
Deferred Sales	(29A)		97,500		36,389
Investments	(29B)		5,120,000		4,168,000
	28,29		5,217,500		4,204,389
Less					
Return on unrestricted investment accounts before the Bank's share as a Mudarib		551,480		455,673	
Bank's share as a Muarib		(110,296)		(91,135)	
Return on unrestricted investment accounts before Zakat			(441,184)		(364,538)
Bank's share in income from investment (as a Mudarib and as fund owner)			4,776,316		3,839,851
Bank's income from its own investments	29B		12,000,000		10,000,000
Bank's share in restricted investment profits as a Mudarib			158,000		140,000
Bank's fee as an investment agent for restricted investments			528,000		400,000
Revenue from banking services			2,000		1,000
Other revenues	30		3,000		2,000
Total Bank revenue			17,467,316		14,382,851
Administrative and general expenditures			(3,890,000)		(2,468,000)
Depreciation			(2,089,500)		(2,030,000)
Net income (loss) before Zakat and tax			11,487,816		9,884,851
Provision for Zakat			(2,887,479)		(1,632,871)
Net income before minority interest			8,600,337		8,251,980
Minority interest			(5,000)		(3,000)
Net income			8,595,337		8,248,980

(Paras 46 to 52 of the standard)

The attached notes from No. ( ) to No. ( ) form an integral part of the financial statements (para 7 of the standard)

(Name of bank or institution)
Statement of Cash Flows
For the year ended xxx (year) xxx (last year)

	Note	xxx (year) Monetary unit	xx (last year) Monetary unit
Cash flows from operation			
Net income (loss)		8,595,337	-
Adjustments to reconcile net income			
Net cash provided by operating activities			
Depreciation		2,089,500	-
Provisions of doubtful accounts		10,000	-
Provision for Zakat		2,887,479	-
Provision for taxes		-	-
Zakat paid		(200,000)	-
Taxes paid		-	-
Return on unrestricted investment accounts		441,184	-
Gain on sale of fixed assets		-	-
Depreciation of leased assets		8,750,000	-
Provision for decline in value of investment securities		150,000	-
Bad debts		(6,000)	-
Purchase of fixed assets		(890,000)	-
Net cash flows provided by operations		21,827,500	-
Cash flows from investing activities			
Sale of rental real estate		-	-
Purchase of rental real estate		-	-
Sale of real estate		15,000,000	-
Acquisition of investment securities		-	-
Increase in Mudarba investments		(8,500,000)	-
Sale of inventory		2,000,000	-
Sale of Istisna'		1,000,000	-
Net increase in receivables		(2,933,333)	-
Net cash flows from (used in) investing activities		6,566,667	-

The attached notes from No. ( ) to No. ( ) form an integral part of the financial statements (para 7 of the standard)

(Name of bank or institution)
Statement of Cash Flows
For the year ended xxx (year) xxx (last year)

	Note	xxx (year) Monetary unit	xx (last year) Monetary unit
Cash flows from financing activities			
Net increase in unrestricted investment accounts		825,316	-
Net increase in current accounts		3,150,000	-
Dividend paid		4,800,000	-
Increase in credit balances and expenses		805,501	-
(Decrease) in accrued expenses		(10,050)	-
Increase in minority interest		210,050	-
Decrease in other assets		15,188,000	-
Net cash flows provided by financing activities		15,365,817	-
Increase (decrease) in cash and cash equivalent		43,759,984	-
Cash and cash equivalent at beginning of year	(37)	51,281,906	-
Cash and cash equivalent at end of year		95,041,890	-

(Paras 53 to 57 of the standard)

The attached notes from No. ( ) to No. (0 form an integral part of the financial statements (para 7 of the standard)

(Name of bank or institution)
Statement of Changes in Owners' Equity
For the year ended xxx (year) xxx (last year)

Description	Paid-up Capital	Reserves (NOTE 25)		Retained Earnings	Total
	Monetary unit	Legal Monetary unit	General Monetary unit	Monetary unit	
Balance as at xxx (year)	350,000,000	–	–	–	350,000,000
Issue of ( ) shares					
Net income				8,248,980	8,248,980
Distributed profits				(5,000,000)	(5,000,000)
Transfer to reserves		824,898	824,898	(1,649,796)	-
Balance as at xxx (year)	350,000,000	824,898	824,898	1,599,184	353,248,980
Net income				8,595,337	8,595,337
Distributed profits				(5,000,000)	(5,000,000)
Transfer to reserves		859,534	859,534	1,719,068	-
Balance as at xxx (year)	350,000,000	1,684,432	1,684,432	3,475,453	356,844,317

(Paras 58 to 60 of the standard)

The attached notes from No. ( ) to No. ( ) form an integral part of the financial statements (para 7 of the standard)

(Name of bank or institution)
Statement of Changes in Restricted Investments
For the year ended xxx (year) xxx (last year)

Description	Units of restricted investment portfolio (1)							
	Marketable Equity Securities Portfolio		Real Estate Trading Portfolio		Murabaha Portfolio		Others	
	xxx (year) Monetary unit	xxx (last year) Monetary unit	xxx (year) Monetary unit	xxx (Last year) Monetary unit	xxx (year) Monetary unit	xxx (Last year) Monetary unit	xxx (Year) Monetary unit	xxx (Last year) Monetary unit
Investment at beginning of year	6,000,000		15,000,000		10,000,000		31,000,000	
Number of investment units at beginning of year	6,000		15,000		10,000			
Unit value at beginning of year	1,000		1,000		1,000			
Deposits and issues	4,000,000		–		–		4,000,000	
Repurchased investment units and withdrawal	–	–			(2,000,000)		(2,000,000)	
Investment profits (losses)	1,800,000		750,000		880,000		3,430,000	
Administrative expenditures	(2,200)		(1,500)		(2,500)		(6,200)	
Bank's fee as an agent (1)	(360,000)		(150,000)		(176,000)		(686,000)	
Investments at end of year	11,437,800		15,598,500		8,701,500		35,737,800	
Number of investment units at end of year	1,000		15,000		8,000		–	
Unit value at end of year	1,143		1,039		1,087		–	

(Paras 61 to 64 of the standard)

The attached notes from No. ( ) to No ( ) form an integral Ppart of the financial statements (para 7 of the standard)

(1) Or the Bank's share in investment profits as a Mudarib if the relationship between the bank and the holders of restricted investment accounts is based on the Mudaraba Contract (Note 43)

(Name of bank or institution)
Statement of Sources and Uses of Zakat and Charity Funds
For the year ended xxx (year) xxx (last year)

	Note	xxx (year) Monetary unit	XX (last year) Monetary unit
Sources of Zakat and charity funds (See notes 6 & 7)			
Zakat due from the bank (institution)		2,887,479	-
Zakat due from accounts holders		893,445	-
Donations		200,500	-
Total sources		3,981,424	-
Uses of Zakat and charity funds			
Zakat for the poor and the needy		206,280	-
Zakat for the wayfare		203,000	-
Zakat for the heavily indebted and freedom of slaves		73,945	-
Zakat for new converts to Islam		350,000	-
Zakat for the cause of Allah		330,000	-
Zakat collection and distribution to staff (administrative and general expenditure)		130,720	-
Total uses		1,293,945	-
Increase (decrease) of sources over uses		2,687,479	-
Undistributed Zakat and charity at the beginning of year		1,632,871	-
Undistributed Zakat & charity funds at end of year		4,320,350	-

(Paras 65 to 68 of the standard)

The attached notes from No. ( ) to No ( ) form an integral part of the financial statements (para 7 of the standard)

(Name of bank or institution)
Statement of Sources and Uses of Qard Fund
For the year ended xxx (year) xxx (last year)

	xxx (Year) Monetary unit	xx (Last year) Monetary unit
Opening balance		
Good loans	xxx	xxx
Funds available for loans	xxx	xxx
Sources of Qard fund		
Allocation from current accounts	xxx	xxx
Allocation from earnings prohibited by Shari'a	xxx	xxx
Source outside the bank	xxx	xxx
Total of sources during the year	xxx	xxx
Uses of Qard fund		
Loans to students	(xxx)	(xxx)
Loans to craftsmen	(xxx)	(xxx)
Settlement of current accounts	(xxx)	(xxx)
Total uses during the year	(xxx)	(xxx)
End-of-year-balance		
Good loans	xxx	xxx
Funds available for loans	xxx	xxx

(Paras 69 to 73 of the standard)

The attached notes from No. ( ) to No. ( ) form an integral part of the financial statements (para 7 of the standard)

(Name of bank or institution)

Notes

1. Incorporation and activities

The (name of the bank) was established as a (joint stock or with limited liability) company in (bank's country of incorporation) on (date of incorporation) in pursuance of the (State reference ________) of (date of the reference ________). (Reference ____________) authorized the bank to carry out all banking, financial and trading activities, investment transactions, setting up manufacturing, economic development, construction of projects and acquiring equities therein inside the country and elsewhere in conformity with the precepts of Islamic Shari'a. The bank may, in particular, carry on the following business activities:

a) Opening current accounts

b) Accepting unrestricted investment accounts and commingle the same with those of the bank and investing them in accordance with Islamic Shari'a.

c) Managing the investment of other parties' funds as an agent for a fixed fee or as a Mudarib and any other banking activities not contravening the provisions of the noble Islamic Shari'a.

d) Industrial, commercial and agricultural business activities, etc. either directly or through companies it may establish, or in which the bank may acquire shares.

e) Leasing and purchasing lands and constructing buildings and renting out thereof.

f) Spot foreign exchange dealings.

The bank carries out its business activities through its Head Office in (name of city) and its branches totalling (number of branches) in (name of the domicile country) and (number of branches in other countries, if any) and the following affiliated companies:

Company's Name	Country of Incorporation	Equity Percentage	Nature of Business
International Islamic Investment Company	British	99%	Financial investments

(Para 9 of the standard)

2. Major accounting policies

a) General:
The bank uses the historical cost concept and accrual basis in recording its assets, liabilities, revenues and expenses.

b) The Consolidated Financial Statements:
The consolidated financial statements include the (Bank's) financial statements and the financial statement of its local affiliates in which the Bank's equity total ______% or more of their voting capital. The effects of the transactions between the bank and its affiliates whose financial statements have been consolidated with those of the bank have been eliminated. Transactions among affiliates have also been eliminated. The bank's investments in the affiliates whose financial statements have not been consolidated because they are foreign companies are shown at (....*)

(Para 12 of the standard)

c) Recognition of Revenues:

1. Murabaha:
The profits and losses which result from Murabaha transaction (including long term, local and international Murabaha) are recognized (....*)

2. Salam contracts:
Profits and losses from delivery contracts are recognized (....*)

3. Istisna' contract:
Profits and losses from manufacturing contracts are recognized (...*)

4. Leasing
Revenues from the lease of buildings, real estate and other property are recognized (...*)

5. Income from equity participation
The Bank's share in the dividends of companies in which the bank has invested its funds including the affiliated companies whose financial statements have not been consolidated with those of the bank is recognized (...*)

6. Mudaraba contracts
Profits and losses resulting from Mudaraba contracts are recognized (...*)

7. Musharaka contracts
Profits and losses resulting from Musharaka contracts are recognized (...*)

8. Participation
Profits and losses resulting from participation are recognized (...*)

---

* State the accounting policy adopted by the bank

9. Investment securities
   Profits and losses resulting from investment securities are recognized (...*)

(Para 12 of the standard)

d) Transactions and Balances in Foreign Currencies:
Transactions in foreign currencies are recognized (in local currency) at the prevailing exchange rate at the date of the transaction. Assets and liabilities in foreign currency are converted at the date of the statement of financial position to (the local currency) at the prevailing exchange rate at the date of the statement of financial position. All gains (losses) resulting from the conversion of foreign currencies are recognized as profits or losses in the income statement.

(Para 10 of the standard)

e) Receivables and Investments:
Receivables are shown in the statements of financial position net any provision for doubtful receivables. Investments are shown in the statement of financial position less provision for the decline in investment value.

f) Provision for Doubtful Receivables:
The bank's management examines the accounts receivables and investments on an annual basis to estimate the losses expected as a result of a debtor's insolvency or inability to settle the whole or part of his outstanding balance, or as a monthly decline in the investment value. Accordingly, the bank's management shall make a special accounting provision for other receivables and investments, and consider the uncollectible amounts as bad debts.

(Para 12 of the standard)

g) Mudaraba investments:
Mudaraba investments are shown in the statement of financial position at (....*)

h) Musharaka investments:
Musharaka investments are shown in the statement of financial position at (...*)

i) Participation:
Investment in participation are shown in the statement of financial position at (....*)

j) Inventories:
The inventories are shown in the statement of financial position at (....*)

k) Investment in real estate:
Investment in real estate is shown in the financial position at (...*)

l) Rental from real estate:
Rental from real estate is shown in the statement of financial position at (...*)

---

* State the accounting policy adopted by the bank

m) Investment securities:
Investment securities are shown in the statement of financial position at (...*)

n) Statement of Changes in Restricted Investments:
The statement of changes in restricted investments include the investments which have been financed from funds received by the bank from restricted investment accounts holders or as a result of the issue of investment units in investment unit portfolios. The bank manages restricted investments, including the investment unit portfolios (specify portfolio) as an agent for a fixed fee and does not participate in the investment results. Restricted investments, restricted investment accounts or investment unit owners' are not shown in the bank's statement of financial position. Restricted investments in the statement of changes of restricted investments are shown at (....*)

o) Revenues, Gains, Expenses and Losses Prohibited by Shari'a:
The bank records revenues, gains, expenses and losses prohibited by Shari'a in a special account included in the amounts of credit balances which appear on the statement of financial position. Funds spent from this account is done according to (.... disclose relevant rules).

p) Depreciation:
Fixed assets held by the bank for its use are depreciated on (specify method) and over the following estimated useful lives

Buildings:	Years	(specify estimated useful lives)
Furniture	Years	
-		
-		
-		
Stationery	Years	
Vehicles	Years	
Computers	Years	

Buildings, machinery and equipment owned by the bank for leasing purposes are also depreciated on (specify method) over their estimated useful lives (state estimated useful lives)

q) Cash and cash equivalent:
The elements of cash and cash equivalent are determined on the basis of the balance in cash and with bank both in local and foreign currencies (the bank should state the basis of determining cash and cash equivalent)

3. Changes in accounting policies

The accounting policy regarding (state the accounting policy which was changed if any) has been changed. As a result, (state the impact on the elements of the financial statements which were changed).

(Para 74 to 82 of the standard)

* State the accounting policy adopted by the bank

4. Supervision of the regulatory agency

The bank's business activities are subject to _________ (state the regulatory laws for supervision to which the bank is subjected).

(Para 14 of the standard)

5. Shari'a board

The bank's business activities are subject to the supervision of Shari'a Board consisting of (number of the Shari'a Board members) appointed by the general assembly for a period of (specify period). The Shari'a Board has the power....(state the powers and responsibilities of the Shari'a Board).

(Para 14 of the standard)

6. Zakat and tax treatment

The Bank is subject to the Zakat and tax treatment prescribed by (state the rules and regulations that govern the Zakat and tax treatment). (para 9/L of the standard)

7. Zakat base

The Zakat base and Zakat due from the Bank as a legal entity for the years ended xxx xxx consists of the following:

	xxx (year) Monetary unit	xx (last year) Monetary unit
Year's profits	-	-
Capital	-	-
Reserve (legal and carried forward)	-	-
Carried forward proposed dividend for distribution	-	-
Carried forward retained earnings	-	-
	-	-
	-	-
Less		
Net fixed assets	-	-
Rental real estate	-	-
Investment in real estate	-	-
Musharaka and participation	-	-
------------------------	-	-
------------------------	-	-
	-	-
	-	-

Zakat due from the bank totalled (state amount) and is considered one of the items of expenditures included in the income statement. Zakat from unrestricted investment accounts holders and other accounts, totalled ______ . The Bank should disclose whether it is responsible for the collection and disposition of Zakat and should disclose the accounting treatment of Zakat. The Bank should disclose if it levies taxes on unrestricted amount holders and the amount levied, if any.)

(Para 51 of the standard)

8. Cash and cash equivalents

	xxx (year Monetary unit	xx (last year) Monetary unit
Details should be stated according to materiality of items	-	-
	-	-
	-	-
	-	-
Total	95,041,890	51,281,906

9. Sales receivables

	Total		Jointly financed [(1)]		Self financed [(2)]	
	xxx (year)	xx (last year)	xxx (year)	xx (last year)	xxx (year)	xx (last year)
	(Monetary unit)	(Monetary unit)	(Monetary unit)	(Monetary unit)	(Monetary unit)	(Monetary unit)
Details should be stated according to materiality of items	-	-	-	-	-	-
	-	-	-	-	-	-
	-	-	-	-	-	-
Total	3,838,889	905,556	2,138,889	355,556	1,700,00	550,000
Provision for doubtful receivables (see note 32)	(34,000)	(30,000)	(22,000)	(20,000)	(12,000)	(10,000)
Total	3,804,889	875,556	2,116,889	335,556	1,668,000	540,000

(1) Investments jointly financed by the Bank and unrestricted investment accounts
(2) Investments exclusively financed by the Bank.

10. Investment securities

	Total		Jointly financed (1)		Self financed (2)	
	xxx (year)	xx (last year)	xxx (year)	xx (last year)	xxx (year)	xx (last year)
	(Monetary unit)	(Monetary unit)	(Monetary unit)	(Monetary unit)	(Monetary unit)	(Monetary unit)
Details should be stated according to materiality of items	-	-	-	-	-	-
	-	-	-	-	-	-
	-	-	-	-	-	-
Total	14,850,000	15,000,000	4,485,000	4,550,000	10,365,000	10,450,000

11. Mudaraba investments

	Total		Jointly financed (1)		Self financed (2)	
	xxx (year)	xx (last year)	xxx (year)	xx (last year)	xxx (year)	xx (last year)
	(Monetary unit)	(Monetary unit)	(Monetary unit)	(Monetary unit)	(Monetary unit)	(Monetary unit)
Details should be stated according to materiality of items	-	-	-	-	-	-
	-	-	-	-	-	-
	-	-	-	-	-	-
Total	10,000,000	1,500,000	7,000,000	1,000,000	3,000,000	500,000

(1) Investments jointly financed by the Bank and unrestricted investment accounts
(2) Investments exclusively financed by the Bank.

12. Musharaka Investments

	Total		Jointly financed (1)		Self financed (2)	
	xxx (year)	xx (last year)	xxx (year)	xx (last year)	xxx (year)	xx (last year)
	(Monetary unit)	(Monetary unit)	(Monetary unit)	(Monetary unit)	(Monetary unit)	(Monetary unit)
Details should be stated according to materiality of items	-	-	-	-	-	-
	-	-	-	-	-	-
	-	-	-	-	-	-
Total	-	5,000,000	-	3,000,000	-	2,000,000

13. Participations

	Total		Jointly financed (1)		Self financed (2)	
	xxx (year)	xx (last year)	xxx (year)	xx (last year)	xxx (year)	xx (last year)
	(Monetary unit)	(Monetary unit)	(Monetary unit)	(Monetary unit)	(Monetary unit)	(Monetary unit)
Details should be stated according to materiality of items	-	-	-	-	-	-
	-	-	-	-	-	-
	-	-	-	-	-	-
Total	102,500,000	102,500,000	67,500,000	67,500,000	35,000,000	35,000,000

(1) Investments jointly financed by the Bank and unrestricted investment accounts
(2) Investments exclusively financed by the Bank.

14. Inventories

	Total		Jointly financed [1]		Self financed [2]	
	xxx (year)	xx (last year)	xxx (year)	xx (last year)	xxx (year)	xx (last year)
	(Monetary unit)	(Monetary unit)	(Monetary unit)	(Monetary unit)	(Monetary unit)	(Monetary unit)
Details should be stated according to materiality of items	-	-	-	-	-	-
	-	-	-	-	-	-
	-	-	-	-	-	-
Total	-	2,000,000	-	2,000,000	-	-

15. Investment in real estate

	Total		Jointly financed [1]		Self financed [2]	
	xxx (year)	xx (last year)	xxx (year)	xx (last year)	xxx (year)	xx (last year)
	(Monetary unit)	(Monetary unit)	(Monetary unit)	(Monetary unit)	(Monetary unit)	(Monetary unit)
Details should be stated according to materiality of items	-	-	-	-	-	-
	-	-	-	-	-	-
	-	-	-	-	-	-
Total	58,500,000	71,750,000	58,500,000	61,750,000	-	10,000,000

(1) Investments jointly financed by the Bank and unrestricted investment accounts
(2) Investments exclusively financed by the Bank.

16. Assets acquired for leasing

	xxx (year)			xxx (last year)		
	Cost	Accumulated depreciation	Net book value	Cost	Accumulated depreciation	Net book value
	(Monetary unit)	(Monetary unit)	(Monetary unit)	(Monetary unit)	(Monetary unit)	(Monetary unit)
Details should be stated according to materiality of items	-	-	-	-	-	-
	-	-	-	-	-	-
	-	-	-	-	-	-
Total	100,000,000	(11,000,000)	89,000,000	100,000,000	(5,500,000)	94,500,000
Jointly financed	-	-	-	-	-	-
Self financed	-	-	-	-	-	-
Total	100,000,000	(11,000,000)	89,000,000	100,000,000	(5,500,000)	94,500,000

17. Istisna' Contracts*

	Total		Jointly financed (1)		Self financed (2)	
	xxx (year)	xx (last year)	xxx (year)	xx (last year)	xxx (year)	xx (last year)
	(Monetary unit)	(Monetary unit)	(Monetary unit)	(Monetary unit)	(Monetary unit)	(Monetary unit)
Details should be stated according to materiality of items	-	-	-	-	-	-
	-	-	-	-	-	-
	-	-	-	-	-	-
Total	-	1,000,000	-	1,000,000	-	-

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* Investment in Istisna' contracts represents the cost of goods being manufactured. When amounts become receivable they are shown at the sale price in Sales Receivables.

(1) Investments jointly financed by the Bank and unrestricted investment accounts

(2) Investments exclusively financed by the Bank.

18. Investments

	Total		**Jointly financed (1)**		**Self financed (2)**	
	xxx (year)	**xx (last) year)**	**xxx (year)**	**xx (last year)**	**xxx (year)**	**xx (last year)**
	(Monetary unit)	**(Monetary unit)**	**(Monetary unit)**	**(Monetary unit)**	**(Monetary unit)**	**(Monetary unit)**
Details should be stated according to materiality of items	-	-	-	-	-	-
	-	-	-	-	-	-
	-	-	-	-	-	-
Total	274,850,000	293,250,000	199,485,000	205,800,000	75,365,000	86,450,000

19. Other assets

	xxx (year) Monetary unit	**xx (last year) Monetary unit**
Details should be stated according to materiality of items	-	-
	-	-
Total	322,000	15,510,000

(1) Investments jointly financed by the Bank and unrestricted investment accounts
(2) Investments exclusively financed by the Bank.

20. Net fixed assets

	xxx (year)			xxx (last year)		
	Cost	Accumulated depreciation	Net book value	Cost	Accumulated depreciation	Net book value
	(Monetary unit)	(Monetary unit)	(Monetary unit)	(Monetary unit)	(Monetary unit)	(Monetary unit)
Details should be stated according to materiality of items	-	(-)	-	-	(-)	-
	-	(-)	-	-	(-)	-
	-	(-)	-	-	(-)	-
	-	(-)	-	-	(-)	-
	-	(-)	-	-	(-)	-
Total	28,990,000	(4,119,500)	24,870,500	28,100,000	(2,030,000)	26,070,000

21. Current accounts and savings accounts

	xxx (year) Monetary unit	xx (last year) Monetary unit
Current accounts*	-	-
Savings accounts*	-	-
(details should be stated according to its materiality)	-	-
	-	-
Total	18,550,000	15,400,000

(para 41 of the standard)

22. Payables*

	xxx (year) Monetary unit	xx (last year) Monetary unit
Details should be stated according to materiality of items	-	-
	-	-
Total	936,112	133,611

(*) The rights, conditions and obligations of each type should be disclosed (Para 45 of the standard)

23. Other liabilities

	xxx (year) Monetary unit	xx (last year) Monetary unit
Undistributed declared profits		
Accrued undistributed Zakat		
Other accrued expenditures		
(Details should be stated according to materiality of items)	-	-
	-	-
Total	5,069,750	2,192,321

24. Share of unrestricted investment accounts in income (loss)

The share of unrestricted investment account holders (and their equivalent) and the bank's share in the net income (loss) from investments and other trading transactions are calculated on the basis of (state the Bank's policy in the calculation of the share of unrestricted investment accounts in net income and the returns of each type of investment accounts and their rate of return.)

(Para 27 of the standard)

25. Authorized and paid up capital

	xxx (year) Monetary unit	xx (last year) Monetary unit
Authorized and paid up capital:		
3,500,000 ordinary shares. Each share valued 100 (monetary unit) issued and fully paid up	350,000,000	350,000,000
	350,000,000	350,000,000

26. Reserves

In accordance with (state the legal reference), ______% of the net income every year must be transferred to (name the legal reserve) until its balance reaches the percentage of the paid-up capital as prescribed by (state the legal reference and determine what is to be done with the reserve). As for other kinds of reserves (state other reserves and their regulations).

	xxx (year)			xx (last year)		
	Reserve xxx	**Reserve xxx**	**Total**	**Reserve xxx**	**Reserve xxx**	**Total**
	(Monetary unit)	**(Monetary unit)**	**(Monetary unit)**	**(Monetary unit)**	**(Monetary unit)**	**(Monetary unit)**
Balance brought forward	-	-	-	-	-	-
Transfer from net income for the year	-	-	-	-	-	-
Current balance:	1,684,432	1,684,432	3,368,864	824,898	824,898	1,649,796

27. Financial commitments and contingencies

Financial commitments:
Outstanding financial commitments for the following items (state the items) are as follows:

	xxx (year) Monetary unit	**xx (last year) Monetary unit**
Details should be stated according to materiality of items		
Total	15,000,000	6,000,000

(para 23 of the standard)

Contingencies:
The Bank contingencies resulting from (state items) totalled ..... countered by commitments by customers for the same amounts as follows:

	xxx (year) Monetary unit	**xx (last year) Monetary unit**
	-	-
	-	-
Total	5,000,000	3,000,000

(Para 22 of the standard)

28. Net assets (liabilities) in foreign currencies

The net assets (liabilities) in foreign currencies at the end of ——— were as follows:

	xxx (year) Monetary unit	xx (last year) Monetary unit
Details should be stated according to materiality of items	xxx	xxx
	xxx	xxx
	xxx	xxx
Total	xxx	xxx

(Para 21 of the standard)

29. Income (loss) from receivables and investments

	xxx (year)			xx (last year)		
	Revenue/ Gains	Expenses	Net income	Revenue/ Gains	Expenses	Total
	(Monetary unit)	(Monetary unit)	(Monetary unit)	(Monetary unit)	(Monetary unit)	(Monetary unit)
a) Receivables [1]						
Details should be stated according to materiality of items	-	(-)	-	-	(-)	-
	-	(-)	-	-	(-)	-
	-	(-)	-	-	(-)	-
	-	(-)	-	-	(-)	-
Total	3,900,000	(3,000,000)	900,000	1,250,000	(1,080,000)	170,000
Deferred profits from previous year [2]			14,167			-
Deferred profits for next year [3]			(816,667)			(133,611)
Total			97,500			36,389
Income from jointly financed receivables			97,500			36,389
Income from self financed receivables			-			-
			97,500			36,389

(Notes for [1], [2] and [3] on the following page)

b) Investments:

Details should be stated according to materiality of items	-	-	-	-	-	-
	-	-	-	-	-	-
	-	-	-	-	-	-
	-	-	-	-	-	-
Total	26,290,000	(9,170,000)	170,120,000	23,220,000	(9,052,000)	14,168,000
Income from jointly financed investment	(7,826,500)	(2,706,500)	5,120,000	6,831,000	(2,663,000)	4,168,000
Income from self financed investment	18,427,500	(6,463,500)	12,000,000	16,389,000	(6,391,000)	10,000,000
	26,290,000	9,170,000	17,120,000	23,220,000	(9,052,000)	14,168,000

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(1) Revenue represents the sales value of completed transactions while expense represents the cost of those transactions. Accounts which are not received until the end of the year are included in the receivable items.

(2) State the investment profits deferred from previous year which belongs to that year.

(3) State investment profits from receivables which took place during the year but belong to next period (example profits from salam sales which are being calculated for each year according to the installments due).

30. Other revenues

	xxx(year) Monetary unit	xx (last year) Monetary unit
Details should be stated according to materiality of items	-	-
	-	-
Total	3,000	2,000

31. Administrative and general expenditures

	xxx (year) Monetary unit	xx(last year) Monetary unit
Details should be stated according to materiality of items	-	-
	-	-
Total	3,890,000	2,468,000

32. Provisions

a) Provision for doubtful receivables (Note 9).

	xxx (Year) Monetary unit	xx (Last year) Monetary unit
Balance at beginning of year	-	-
Amounts written off during the year	(-)	(-)
Amounts collected during the year	-	-
Provision for the year	-	-
Balance at end of year	34,000	30,000

b) Provision for decline in investment value

(Note 18)

	xxx (year) Monetary unit	xx (Last year) Monetary unit
Balance at beginning of year	-	-
Amount deducted during the year	(-)	(-)
Provision for the year	-	-
Balance at end of year	150,000	-
Jointly financed investments	-	-
Self financed investments	-	-

33. Related party transactions

The value of major transactions with the related parties are as follows:

Related party	Type of relationship	Type of transaction	Balance at beginning of year	Movement during year	Balance at end of year
(State related party)	(specify the relat-ionship)	Mudaraba	-	-	-
		Guarantees	-	-	-
		Murabaha			
-		-	-	-	-
-		-	-	-	-

(Para 29 of the standard)

34. Assets, liabilities and unrestricted investment accounts according to their respective periods to maturity or expected periods to cash conversion

	Balance at the end of year	Maturity period
Assets		
Cash and cash equivalents	-	(determine the period according to its nature Example: monthly instalment for ( ) months.
Receivables	-	
(Details should be stated according to materiality of items)	-	
Investments		
(Details should be stated according to materiality of items)	-	
Total	373,696,779	
Liabilities		
(Details should be stated according to materiality of items)		
Total	23,619,750	
Unrestricted investment accounts	-	
(Details should be stated according to materiality of items)	-	
-	-	
-	-	

35. Concentration of asset risks

a) Economic sectors

	Sectors						
	xxx Monetary unit	xxx Monetary unit	xxx Monetary unit	xxx Monetary unit	xxx Monetary unit	xxx Monetary unit	xxx Monetary unit
Assets							
Cash and cash equivalent	-	-	-	-	-	-	-
Receivables	-	-	-	-	-	-	-
(Details should be stated according to materiality of items)							
Investments	-	-	-	-	-	-	-
(Details should be stated according to materiality of items)							
Total	106,200,000	62,854,889	4,050,000	10,000,000	95,550,000	-	-

b) Geographical areas:

	Geographical areas		
	xxx Monetary unit	xxx Monetary unit	xxx Monetary unit
Assets			
Cash and cash equivalent	-	-	-
Receivables	-	-	-
(Details should be stated according to materiality of items)	-	-	-
Investments (Details should be stated according to materiality of items)	-	-	-
Total	222,155,779	151,541,000	373,696,779

(Para 16 of the standard)

c) Customers

	Customers (No names)				
	Governmental Monetary unit	Financial Institutions Monetary unit	Individuals Monetary unit	xxx Monetary unit	xxx Monetary unit
Assets					
Receivables	-	-	-	-	-
(Details should be stated according to materiality of items)	-	-	-	-	-
Investments (Details should be stated according to materiality of items)	-	-	-	-	-
Total	95,031,890	1,700,000	2,104,889	10,010,000	-

(Para 16 of the standard)

36. Concentration of sources of unrestricted investment accounts

	Domestic	Foreign	Total
Unrestricted investment accounts	-	-	-
(Details should be stated according to materiality of items)	-	-	-
-	-	-	-
-	-	-	-
(Para 17 of the standard)	-	-	-

37. Disclosure of significant subsequent events

After the end of the year (mention any significant event which took place after the end of the year) and resulted in (state the financial effect on the Bank as a result of the event).
(Para 24 of the standard)

38. Earnings and expenditures prohibited by Shari'a (if any)

Earnings realized during the year from transactions which are not permitted by Shari'a amounted to (state transactions and their amounts). The balance at the beginning of the year was (state amount) and the amount spent during the year totalled (state how the amounts were). The remaining balance at the end of year is (state amount).
(Para 15 of the standard)

39. Disclosure of compensating balances

The bank has deposited the amount (state the amounts) with (state institutions with which the bank was obligated to deposit the amounts) as compensating balances (state the compensating balances).
(Para 20 of the standard)

40. Restricted assets or assets pledged as security

Assets which are restricted for (mention the uses and the values of the assets to be used).
(Para 25 of the standard)

41. Estimated cash equivalent value of assets and liabilities compared to historical value

Following is the estimated cash equivalent value of assets and liabilities compared to their historical values (state details) if revaluation of assets and liabilities can be measured on the basis of the principles stated in para 95 of the *Statement of Financial Accounting No.2: Concepts of Financial Accounting for Islamic Banks and Financial Institutions.*
(Para 39 of the standard)

42. Rights, obligations and conditions related to unrestricted investments and their equivalents

Rights related to unrestricted investments and their equivalents totalled (amount and currency). Related obligations totalled (amount and currency).

43. Relationship between the bank and holders of restricted investments accounts as a Mudarib or an agent

The bank has invested funds of holders of restricted investment accounts as a (state the status of the Bank as a Mudarib or as an agent). Rights of holders of restricted investments accounts realized from their investments totalled (amount and currency) and the related obligations totalled (amount and currency).

44. Reciprocal transactions and non-reciprocal transfers which do not require payment or receipt of cash

During the course of the year, reciprocal transactions (state transaction conducted and non-reciprocal transfers were conducted but did not require payment or receipt of cash (state the transfers conducted). Following is a statement that explains each transaction (state the transactions and transfers and their amounts).
(Para 56 of the standards

45. Social responsibility

During the period, the bank has discharged its social responsibilities (state how the bank has discharged its social responsibilities, the amounts that were spent in these activities and their impact if possible.

Financial Accounting Organization for Islamic Banks and Financial Institutions

Information about the Organization

Jumadi II 1413 H - December 1992

The Organization's objectives and establishment

The Financial Accounting Organization for Islamic Banks and Financial Institutions aims at developing the accounting thought on Islamic banks and financial institutions and preparing, promulgating, and adjusting accounting standards for these banks and institutions.

Preparing, adopting and promulgating accounting standards used in the preparation of financial reports for Islamic banks and financial institutions is a process that should undergo a lengthy and in-depth study in order to become viable, fulfil the requirements expected from them and win approval and endorsement. For this reason, before the Organization was established, intensive efforts were made on administrative and technical levels, beginning with the working paper that was presented by the Islamic Development Bank (IDB) during the annual meeting of its govemors in Istanbul (March 1987). This was followed by a discussion workshop in which representatives of Islamic banks and members of government regulatory bodies, accounting experts, practising accountants and Shari'a experts took part. Thereafter, many committees were formed to examine the appropriate methods of preparing accounting standards. These committee made a number of research projects, studies and reports which were complied in five volumes and were lodged in the library of the Islamic Research and Training Institute (IRTI).

Those studies led to the establishment of the Financial Accounting Organization for Islamic Banks and Islamic Institute which was officially established under its Agreement of Association signed on 30.3.1410H corresponding to 29.10.1989 by a number of Islamic banks and financial institutions. Regulations were laid down to organize its activities and resolutions were adopted to realize its objectives. Clause (1) of the Agreement of Association provides as follows:

> "The signatories below have agreed to establish a non-profit organization of juristic entity called 'The Financial Accounting Organization for Islamic Banks and Financial Institutions'. They also agreed to apply the financial accounting standards it will issue. The Organization shall consist of a Supervisory Committee and a Board to prepare financial accounting standards in accordance with their constitutions attached to the Agreement of Association."

Registration of the Organization and joining it
The Organization was registered in the State of Bahrain on 27.3. 1991 as a not-for-profit organization, with the possibility of opening offices outside Bahrain, if need be. Any Islamic bank or financial institution may accede to the Agreement, by virtue of Clause (4) which provides as follows:

"Any Islamic bank or financial institution may accede to this Agreement and the wish to do so may be expressed by writing to the Chairman of the Supervisory Committee and signing the original copy of this Agreement which is lodged in the Organization's Head Office"

Need to prepare accounting standards for Islamic banks and financial institutions
The financial reports of economic and business establishments are not a means *per se*, but their purpose is to provide information used in the economic decision-making process. Such financial reports, which are prepared in accordance with financial accounting standards approved by a recognized authority, should help in reflecting the financial position and the results of business operations in a fair manner. Accounting standards consist of rules which should be followed in the process of measuring, recording and presenting the establishment's

economic data. Because accounting standards govern these operations, they stem from the nature of activities which differ in Islamic banks and financial institutions from those of traditional banks. In addition, the relationship of the parties taking part in the activities of Islamic banks differs from the financing relationship of traditional banks. The relationship governing Islamic banks eschews the most important element of traditional banks, namely the charging of interest on loans. Islamic banks exclude interest from investment vehicles and instruments and replace it with the profit and loss-sharing element. In addition, the difference in the philosophy and functions of Islamic banks from those of traditional banks necessarily requires setting accounting objectives, concepts and standards which are suitable to the nature of Islamic banks' operations and philosophy.

Despite the positive response and approval given to the establishment of Islamic banks and financial institutions and the expansion of these banks and institutions, the survival and continuation of these banks in performing the role required from them is contingent upon their continuing to meet the needs, fulfilling the requirements of their customers and winning their approval and confidence through a high degree of credibility among those who rely on their financial statements in taking their economic decisions. These statements must include suitable and reliable information which can be compared with other statements, taking into consideration the requirements and capabilities of the users of such statements. This prompted the need to prepare accounting standards for Islamic banks and financial institutions.

Organization's administrative sturcutre

Article (1) of the Organization's Agreement of Association provides that the Organization shall consist of the Supervisory Committee and the standards setting Board. Article (2) also provides that the Organization shall conduct research projects and studies, sign contracts with experts, convene seminars and do that which would realize its objectives in accordance with the clauses of the Agreement of Association and the Constitutions of the Supervisory Committee and the Financial Accounting Standards Board attached therewith.

Supervisory Committee

The Supervisory Committee consists of (17) members in specializations closely related to Islamic banks and financial institutions. Among its duties are: forming the Financial Accounting Standards Board and appointing its members, finding financial resources for the Organization and reviewing the Board's activities and achievements. During its first meeting held on 1.8.1410H corresponding to 26.2.1990, the Committee elected Dr. Ahmed Mohamed Ali, President of Islamic Development Bank, as its Chairman. HE Ousmane Seck, IDB Vice President, acted on his behalf.

Financial Accounting Standards Board

The Board consists of (21) members representing parties interested in financial accounting for Islamic banks and financial institutions, and fuqahas. Among its functions are: approving and promulgating statements of financial accounting standards for Islamic banks and financial institutions and guidelines for using them, circulating such statements to Islamic banks and financial institutions, organizing administrative activities related to the to the establishment of the Organization and appointing members of the Shari'a Committee and the Executive Committee for Planning and Follow-up.

The Shari'a Committee consists of (4) fuqahas who are members of the Financial Accounting Standards Board. Its function is to ensure that Shari'a precepts are complied with in the Organization's activities and achievements. The Executive Committee for Planning and Follow-up consists of (5) members who are elected from amongst the Standards Board and its functions are to organize technical work, prepare the work plan, follow up the implementation of the Board's resolutions and prepare the issues presented to it.

Due process for the preparation of financial accounting standards
The Constitution of the Financial Accounting Standards Board for Islamic Banks and Financial Institutions includes the rules pertaining to the preparation of the statements of financial accounting standards in article (8) thereof, as follows:

Section 8-1
The objectives of statements of financial accounting standards shall be to explain the bases for the establishment and development of the standards of financial accounting and the standards' texts.

Section 8-2
Before a statement of financial accounting standards is approved a draft thereof shall be circulated to banks and financial institutions to obtain their observations and the public shall have the right to have access to such observations.

Section 8-3
Draft and final statements of financial accounting standards shall include:

a) The proposed alternatives of the standards considered and the final standards approved and reasons for their selection.
b) The standards date of effectiveness and the methods of application thereof.
c) Background information in connection with the bases of the establishment and development of the standards.
d) A summary of the more significant observations and comments communicated to the Board on the particular draft statement of the standards.

The Standards Board has approved the regulations governing the due process of preparing financial accounting standards for Islamic banks and financial institutions. According to these regulations, the preparation of a standard passes through eight phases the details of which are outlined in a separate booklet.

The Organization's activities and future plan
During its first meeting, the Financial Accounting Standards Board decided that the Organization's activities will begin by preparing the objectives and concepts of financial accounting for Islamic banks and financial institutions and the general presentation and disclosure standard. Most of the studies necessary for the preparation of these statements have been completed and these studies have yielded in the following projects:

- Exposure draft of the statement of objectives of financial accounting for Islamic banks and financial institutions.
- Exposure draft of the statement of concepts of financial accounting for Islamic banks and financial institutions.
- Exposure draft of the general presentation and disclosure standard in the financial statements of Islamic banks and financial institutions.

These statements will be used after the Board adopts them, together with the findings of the field survey conducted by the Organization in countries in which Islamic banks operate as a basis for the preparation of all financial accounting standards in the future.

In addition, a plan has drawn up to promulgate three accounting standards, in pursuance of the resolution adopted by the Standards Board during its third meeting held during the period ending on the last day of 1993, namely:

- Mudaraba standard
- Murabaha standard
- Musharka standard

The Organization is currently engaged in building two databases; the first on the studies and research projects related to its activities, and the second on the professional experts in its field of specialization, in order to enhance the efficiency of the process of preparing standards. It would also be publishing studies conducted by it and convening study and training workshops and seminars on the standards to be issued by it.

Supervisory Committee

1.	HE. Dr. Ahmed Mohamed Ali President of the Islamic Development Bank	Chairman
2.	HRH Prince Mohamed Al Faysal Al Saud	Member
3.	Shaikh Saleh Abdulla Kamel	Member
4.	Shaikh Sulayman Al Abdul Aziz Al Rajhi	Member
5.	Shaikh Ahmed Baziegh Al Yassin	Member
6.	Dr. Abdul Haleem Ismael	Member
7.	Mr. Mohamed Zaki	Member
8.	Mr. Datoo Haneefa Haj Ahmed	Member
9.	Professor Najatulla Siddiqi	Member
10.	Dr. Abdul Aziz Hejazi	Member
11.	Mr. Mohamed Abdul Haleem Mohamed	Member
12.	Mr. Ismael Mohamed Amin	Member
13.	Mr. Abdul Jaleel Al Gharaballi	Member
14.	Mr. Ayyuob Sabri	Member
15.	Shaikh Saleh Al Husayn	Member
16.	Shaikh Abdulla Al Mutawwa	Member
17.	Mr. Abdul Malik Al Hamar	Member

Financial Accounting Standards Board for Islamic Banks and Financial Institutions

1.	Mr. Abdul Aziz Rashed Al-Rashed	Chairman
2.	Dr. Abdelgadir Banaga	Deputy Chairman
3.	Mr. Ibrahim Al-Subeil	Member
4.	Mr. Irtiza Husain	Member
5.	Mr. Anwar Khalifa Sadah	Member
6.	Mr. Hazim Hassan	Member
7.	Mr Huseyin Cahit Ozcet	Member
8.	Dr. Khaled Boodai	Member
9.	Dr. Rifaat Ahmed Abdel Karim	Member
10.	Mr. Sameer Tahir Badawi	Member
11.	Mr. Abdel Hamid Abu Musa	Member
12.	Sheik Abdullah Bin Sulaiman Al-Maneei	Member
13.	Professor Abdullah Al-Faisal	Member
14.	Dr Omer Zuhair-Hafiz	Member
15.	Mr. Farooq Azam	Member
16.	Professor Mohamed Al-Siddiq Al-Darir	Member
17.	Mr. Mohammed Alawi Thiban	Member
18.	Mr. Mohammed Mukhtar Al-Sallami	Member
19.	Mr. Musa Abdel Aziz Shihadeh	Member
20.	Mr. Mian Mumtaz Abdullah	Member
21.	Dr. Yousuf Al-Qaradawi	Member

Due process for the preparation of financial accounting standards for Islamic banks and financial institutions and requirements for the development of each standard.

Due process for the preparation of financial accounting standards for Islamic banks and financial institutions

1. Introduction

The due process of preparing accounting standards for Islamic banks and financial institutions aims to provide interested parties with an active role in the various stages of the preparation of standards.

The due process was prepared in the light of the Constitution of the Financial Accounting Standards Board for Islamic Banks and Financial Institutions. Article 8 of the Constitution, which relates to the statements of financial accounting standards, states:

Section 8-1
The objectives of statements of financial accounting standards shall be to explain the bases for the establishment and development of the standards of financial accounting and the standards' texts.

Section 8-2
Before a statement of financial accounting standards is approved a draft thereof shall be circulated to banks and financial institutions to obtain their observations and the public shall have the right to have access to such observations.

Section 8-3
Draft and final statements of financial accounting standards shall include:

a) The proposed alternatives of the standards considered and the final standards approved and reasons for their selection.
b) The standards date of effectiveness and the methods of application thereof.
c) Background information in connection with the bases of the establishment and development of the standards.
d) A summary of the more significant observations and comments communicated to the Board on the particular draft statement of the standards.

2. Phases of the due process

The Board has approved the due process of preparing accounting standards for Islamic banks and financial institutions which comprises the following phases:

2.1 Phase 1: Preparation of study

2.1.1 The consultant shall prepare a study which shall comprise:

2.1.1.1 Theoretical aspects of the standard from all sources, particularly:

- Fiqh rules governing transactions and companies based on reference approved by the books of Fiqh.
- Objectives and concepts of financial accounting for Islamic banks and financial institutions which are to be prepared.
- A comparative note on matters related to standards from the prevailing accounting literature from a number of authorities responsible for preparation of accounting standards in Islamic countries and elsewhere.

2.1.1.2 A note on the current application in force in general and of five Islamic banks where the standard shall be applied when it is approved.

2.1.1.3 Details on the need for preparing the standard and the problems expected upon implementation.

2.1.1.4 Review of the legislative, procedural, technical and other anticipated problems related to the standard and a preliminary statement of possible options which may be considered as solutions prior to their discussion by the Board and formulation of tentative projections for solving them as guidance in the implementation of subsequent phases.

2.1.1.5 Review of alternative standards and methods of their applications.

2.1.2 The technical unit shall go through the study referred to above and refer it to the Executive Committee for Planning and Follow-up with its views.

2.2 Phase 2: Discussion of the Standard by the Executive Committee for Planning and Follow-up and Approval of the Initial Principles

2.2.1 The study and the technical unit memorandum shall be distributed to the Executive Committee for Planning and Follow-up for study and comments.

2.2.2 The Executive Committee for Planning and Follow-up shall meet to consider the findings of the study, adopt resolutions on issues which might have been raised and lay down a plan of action for the post study phase.

2.2.3 The consultant shall make a summary of research undertaken in the previous phases comprising what is contained in Phase 1. He shall also make a summary of the resolutions adopted by the Executive Committee for Planning and Follow-up.

2.2.4 The results of phase 1 and 2 shall be presented in detail to the Board to discuss them and approve the resolutions.

2.3 Phase 3: Views of specialists and interested parties

2.3.1 The technical unit shall distribute the summary referred to in 2.4 above, after it is approved by the Board, among specialists including Fuqahas, university professors, officials of Islamic banks and other interested parties. They shall be requested to participate as appropriate in the field of the standard.

The technical unit shall prepare a form for this purpose and the instructions for its use by those wishing to reply to it in order to facilitate its analysis at a later stage. This shall be presented to the Executive Committee for Planning and Follow-up for approval.

2.3.2 The technical unit shall receive the replies and keep the original. It shall prepare detailed procedures to receive it and keep it to ensure safely and easy reference. It shall give a copy to the consultant.

2.4 Phase 4: Classifications and study of views of specialists and internal parties

2.4.1 The consultant shall classify the replies in a scientific way so as to facilitate comparison and easy reference. He shall study and analyse them and submit the classification together with his study, analysis, findings and proposals to the technical unit. Neither the consultant nor the technical unit may disregard any views for any reason whatsoever.

2.4.2 The technical unit shall study the classification, analysis and findings received from the consultant (4.1) and submit them with the views to the Executive Committee for Planning and Follow-up for decision on issues on which the consultant require guidance from the Executive Committee for Planning and Follow-up.

2.4.3 The memorandum referred to in (4. 2) shall be discussed at a meeting attended by members of the Executive Committee for Planning and Follow-up and any other interested party the Executive Committee for Planning and Follow-up may deem appropriate to convene.

2.4.4 The consultant shall prepare a summary record of the meeting referred to in (4.3), highlighting the main points and showing whether they are useful or not, giving his reasons for that. He shall submit his proposals to the technical unit.

2.4.5 The technical unit shall study the summary referred to in (4.4) and submit it to the Executive Committee for Planning and Follow-up with its views.

2.4.6 The summary mentioned in (4.5) shall be sent to the Board members who shall submit their views to the technical unit.

2.4.7 The Board shall meet to take the appropriate decision. It may call the consultant for discussions.

2.4.8 The technical unit shall give the consultant the Board's decisions to implement them.

2.5 Phase 5: Preparation of a draft statement of the Standard

2.5.1 The consultant shall prepare a statement of the standard and submit it to the technical unit. The statement shall include provisions listed in section 2 of the details which the statement of the standard should contain.

2.5.2 The consultant shall give the statement of the standard to the technical unit which, in turn, shall study it and submit to it the Executive Committee for Planning and Follow-up for approval.

2.6 Phase 6: View of Specialists and Interested Parties

2.6.1 After the Executive Committee for Planning and Follow-up approves the draft statement of the standard, the technical unit shall send the statement to specialists and interested parties for their observations. The replies received shall be classified by the consultant in the way referred to in (4.4) and submit his recommendations to the technical unit.

2.6.2 What is contained in 6.1 shall be submitted to the Executive Committee for Planning and Follow-up.

2.7 Phase 7: Preparation of the statement of the Standard and its approval by the Board

2.7.1 The technical unit send to the consultant the views of specialists and interested parties which the Executive Committee for Planning and Follow-up decides to adopt. The consultant shall prepare the text of the final statement and forward it to the technical unit.

2.7.2 The draft statement of the standard shall be submitted to the Board for approval as a final standard.

2.8 Phase 8: Extent of adherence to the Standard

2.8.1 The Executive Committee for Planning and Follow-up shall study examples of financial statements after the issue of the standard to determine the extent to which adherence is made to it and submit a report to the Board.

2.8.2 The Board shall receive from all interested parties and specialists, observations or problems met during the implementation period. These shall be made to the standard if necessary. Unless otherwise indicated, procedures governing modification shall be similar to those regarding the preparation of the standard.

Requirements for the development of each accounting standard to be prepared by a consultant

1 Basic information

1.1 Reasons for preparing the standard.

1.2 Brief note on details related to the standard comprising:

1.2.1 Fiqh rules of transactions and Zakat based on references approved by the Books of Fiqh.

1.2.2 Current practice in Islamic banks and the ways in which the consultant has come to this.

1.2.3 Detailed presentation on the feasibility of the standard in achieving the objectives of financial accounting for Islamic banks.

1.2.4 Texts of related systems and regulations in countries where Islamic banks operate, in particular the system applied by regulatory authorities on commercial and Islamic banks.

1.3 Definition of concepts related to standards and their relationship to concepts whose definition is approved by the Board.

1.4 Comparative note on the standard from prevailing accounting thought and a number of issuing institutions responsible for the preparation of financial accounting standards in Islamic countries and elsewhere.

1.5 Brief note on the current practice in general in five banks which shall apply the standard when it is approved.

2. Details which the statement of the standard should contain

2.1 Introduction

2.1.1 Summary of basic information in (1) above to be determined according to the nature of the standard.

2.1.2 Impact of the standard on financial statements like:

- Statement of financial position (comparative example).
- Income statement (comparative example)

2.1.3 Economic impact of the standard on:

- Islamic banks
- Shareholders
- Zakat institutions

2.2 The Standard

2.2.1 Text of the standard

2.2.2 Procedures related to its application

2.2.3 Accounting methods (s)

2.2.4 Procedures related to disclosure

2.2.5 Limits of application

2.2.6 Dates of effectiveness

General requirements for preparation of standards

The general requirements for the preparation of standards are as follows (whatever is not covered by these requirements, should be referred to the *Due Process for the Preparation of Financial Accounting Standards for Islamic Banks and Financial Institutions:*

1. Offer application

a) An individual consultant can apply to prepare only one standard

b) A team of consultants or an institution can apply to prepare more than one standard. However, the following should be considered:
   - A separate application is needed for each standard and the name of the person who would be in charge of preparing the standard should be mentioned.
   - Each standard should be prepared by one consultant. One consultant cannot prepare more than one standard.
   - The Executive Committee for Planning and Follow-up has the right to assign one or more standards to a team or an institution.

2. Research and professional background of the consultant

a) An individual consultant should submit a brief resume together with a copy of all his published and unpublished work.

b) A team of consultant should submit a brief resume of each member of the team and a copy of the published and unpublished work of each member.

c) An institution should submit a statement of the standards it has prepared and the names and qualifications of its consultants

3. Fees and work hours

a) The applicant should submit budgeted work hours for each standard and his fees for preparing the standard.

b) A budgeted time table for the preparation of each standard.

4. Contract time and follow up

a) The standards should be completed within the time span specified in (3) above.

b) The consultant should submit to the Executive Committee for Planning and Follow-up a detailed time table for the preparation of the standard within one month of signing the contract. The Executive Committee for Planning and Follow-up shall study and approve the time plan within one month.

c) A progress report should be submitted to the Executive Committee for Planning and Follow-up every three weeks. Such a report should be submitted within three days after the end of the report period. The report should indicate the work completed at the end of the report period and the work expected to be completed within the following three weeks and the unused budgeted hours.

5. Use of Research for Other Purposes

The consultant may, in consultation with the Executive Committee for Planning and Follow-up, use the research conducted in relation to the standard for other purposes. However, under all circumstances, the consultant should indicate that the research was originally conducted for the Financial Accounting Standards Board for Islamic Banks and Financial Institutions. In addition a copy of the research should be submitted to the Executive Committee for Planning and Follow-up before it is used for other purposes.

6. General Requirements About the Standard

a) The consultant shall address in detail all items of the standard as specified in the *Requirements for the Development of each Standard.* The Executive Committee for Planning and Follow-up welcomes any additional details. These should be included in the application.

b) The selected consultant shall thoroughly research all items of the standard in a scientific manner. The subject matter of the standard shall also be covered in a detailed and comprehensive manner indicating the research methodology to be adopted.

c) The consultant shall fully document all references and sources used in the preparation of the standard in a manner that can easily be referred to. He should also be conversant with recent publications related to the standard and should use up-to-date references including reliable Shari'a sources.

Agreement of Association
of the
The Financial Accounting Organization for Islamic Banks and Financial Institutions

Agreement of Association
The Financial Accounting Organization for Islamic Banks and Financial Institutions

ARTICLE 1

Establishment of the Organization

The undersigned agreed to establish a not-for-profit judicial organization which shall be known as "The Financial Accounting Organization for Islamic Banks and Financial Institutions." They agreed to apply the financial accounting standards issued by the said Organization. The Organization shall be composed of a Supervisory Committee and a Financial Accounting Standards Board in accordance with the constitutions thereof attached hereto.

ARTICLE 11

Objectives of the Organization

The Organization aims at developing accounting thought in the field of Islamic banks and financial institutions, preparing, issuing and amending the Accounting Standards for such banks and institutions. In achieving its objectives the Organization shall have the right to conduct researches and studies, contract the services of experts, convene seminars and undertake all measures leading to the achievement of its objectives in accordance with the provisions of this Agreement and the Constitutions of both the Committee and the Board.

ARTICLE 111

The duration of this Agreement is unlimited and it shall be effective as of Rabi Al Awal 1410 corresponding to 29 October 1989.

ARTICLE 1V

Any Islamic bank or Islamic financial institution may join this Agreement. A letter of intent to this effect may be sent to the Chairman of the Supervisory Committee and thereon the original copy of the Agreement lodged in the Headquarters of the Organization may be signed.

ARTICLE V

The Headquarters of the Organization shall be in the city of ________________________
in the ______________. The Organization shall have the right to establish branches or offices in the other countries.

Name	Signature	Address
________________	______________	______________