REGULATION OF FINANCIAL REPORTING
BY ISLAMIC BANKS

by

ANWAR KHALIFA IBRAHIM AL-SADAH

A thesis submitted in part-fulfilment of the requirements for the award of the Degree of MPhil

1999
SUMMARY

This thesis attempts to test the hypothesis that since IASs were not drafted so as to deal with the specificities of Islamic banks, the adoption of IASs by Islamic banks had rendered the financial statements of these banks non-comparable. To test this hypothesis, this thesis examines some of the accounting practices of Islamic banks.

As a first step the thesis conducted a pilot survey on the accounting practices of some Islamic banks in order to determine the similarities, differences and level of disclosure among Islamic banks operating in different countries and which are subject to different accounting regulations.

In order to gain a deeper understanding of the accounting differences and level of disclosure that existed among Islamic banks. The thesis conducted case studies on two of the Islamic banks operating in Bahrain.

Based on the findings of the two case studies, the thesis supports the research hypothesis.
# LIST OF CONTENTS

## CONTENTS

<table>
<thead>
<tr>
<th>List of Figures</th>
<th>vii</th>
</tr>
</thead>
<tbody>
<tr>
<td>List of Abbreviations</td>
<td>viii</td>
</tr>
<tr>
<td>Acknowledgments</td>
<td>x</td>
</tr>
</tbody>
</table>

## CHAPTER 1: INTRODUCTION

1.1 Background  
1.2 Problems of Accounting & Financial Reporting  
1.3 The Research Hypothesis  
1.4 Emergence of AAOIFI  

## PART I: BACKGROUND AND REVIEW OF LITERATURE

## CHAPTER 2: THE REGULATION OF FINANCIAL REPORTING

2.1 The History of Accounting Regulation  
2.2 The Arguments for Accounting Regulation  
2.3 The Arguments against Accounting Regulation  
2.4 The Differences between Disclosure Regulation and Measurement Regulation  
2.5 Conclusions
CHAPTER 7: MOHAMMED BANK

7.1 Introduction 96
7.2 Types of contracts governing the bank’s relations with IAH 98
7.3 Accounting practices of the bank 100
7.4 Role of the Shari’a Supervisory Board (SSB) 107
7.5 Role of the external auditors 108

PART III: ANALYSIS AND CONCLUSIONS

CHAPTER 8: COMPARISONS, ANALYSIS AND CONCLUSIONS OF THE CASE STUDIES 111

8.1 Comparisons of Case Studies 111
8.2 Analysis of Ahmed Bank’s Case 114
8.3 Analysis of Mohammed Bank’s Case 124
8.4 Concluding Remarks 130

CHAPTER 9: CONCLUSIONS 134

9.1 Pre-AAOIFI State of Accounting Regulation 134
9.2 Post AAOIFI State of Accounting Regulation 137
9.3 AAOIFI Implications for the Islamic Banking Industry 140

APPENDICES

Appendix 1 Positions of persons that were interviewed from Ahmed Bank, Mohammed Bank and Khalifa Bank. 143

Appendix 2 Interview questions with Ahmed Bank and Mohammed Bank. 144
Appendix 3  Positions of persons that were interviewed from the External Auditors.  147

Appendix 4  Interview questions with the External Auditors.  148

Appendix 5  Positions of persons that were interviewed from the Shari’a Supervisory Boards.  150

Appendix 6  Interview questions with the Shari’a Supervisory Boards.  151

Appendix 7  Illustration that highlights the differences between the straight-line and the reducing balance methods  153

BIBLIOGRAPHY  155
## LIST OF FIGURES

<table>
<thead>
<tr>
<th>Figure</th>
<th>Description</th>
<th>Page No.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fig. (1)</td>
<td>Evolution of Total Assets</td>
<td>77</td>
</tr>
<tr>
<td>Fig. (2)</td>
<td>Evolution of Shareholders’ Funds</td>
<td>77</td>
</tr>
<tr>
<td>Fig. (3)</td>
<td>Evolution of Funds Under Management</td>
<td>79</td>
</tr>
<tr>
<td>Fig. (4)</td>
<td>Evolution of Assets</td>
<td>96</td>
</tr>
<tr>
<td>Fig. (5)</td>
<td>Evolution of Shareholders’ Funds</td>
<td>97</td>
</tr>
</tbody>
</table>
# LIST OF ABBREVIATIONS

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAOIFI</td>
<td>Accounting and Auditing Organization for Islamic Financial Institutions</td>
</tr>
<tr>
<td>AF</td>
<td>The Total Amount of Facility</td>
</tr>
<tr>
<td>AICPA</td>
<td>The American Institute of Certified Public Accountants</td>
</tr>
<tr>
<td>APB</td>
<td>Accounting Principles Board</td>
</tr>
<tr>
<td>ASC</td>
<td>Accounting Standard Committee</td>
</tr>
<tr>
<td>ASP</td>
<td>Account Share in the Profit</td>
</tr>
<tr>
<td>ASSC</td>
<td>Accounting Standards Steering Committee</td>
</tr>
<tr>
<td>BMB</td>
<td>Bank Islam Malaysia Berhad</td>
</tr>
<tr>
<td>BP</td>
<td>Bank's Profits</td>
</tr>
<tr>
<td>CAP</td>
<td>Committee on Accounting Procedure</td>
</tr>
<tr>
<td>CCAB</td>
<td>Consultative Committee of Accountancy Bodies</td>
</tr>
<tr>
<td>DM</td>
<td>Murabaha Duration in Years</td>
</tr>
<tr>
<td>DP</td>
<td>Down Payment</td>
</tr>
<tr>
<td>FASB</td>
<td>Financial Accounting Standards Board</td>
</tr>
<tr>
<td>GAAP</td>
<td>General Accepted Accounting Principles</td>
</tr>
<tr>
<td>GMF</td>
<td>General Mudaraba Fund</td>
</tr>
<tr>
<td>IAH</td>
<td>Investment Account Holders</td>
</tr>
<tr>
<td>IAS</td>
<td>International Accounting Standards</td>
</tr>
<tr>
<td>IASC</td>
<td>International Accounting Standards Committee</td>
</tr>
<tr>
<td>IAWFP</td>
<td>Investment Accounts with Fixed Period</td>
</tr>
<tr>
<td>ICAEW</td>
<td>The Institute of Chartered Accountants in England and Wales</td>
</tr>
<tr>
<td>IOSCO</td>
<td>The International Organization of Securities Commission</td>
</tr>
<tr>
<td>JIB</td>
<td>Jordan Islamic Bank</td>
</tr>
<tr>
<td>KFH</td>
<td>Kuwait Finance House</td>
</tr>
<tr>
<td>MR</td>
<td>Mudarib Profit Share Rate</td>
</tr>
<tr>
<td>NAV</td>
<td>Net Assets Value</td>
</tr>
<tr>
<td>NSB</td>
<td>Nasser Social Bank</td>
</tr>
<tr>
<td>OBCA</td>
<td>Outstanding Balance of the IAH's Account</td>
</tr>
<tr>
<td>PIA</td>
<td>Perpetual Investment Accounts</td>
</tr>
<tr>
<td>PIB</td>
<td>Percentage deemed to be Invested by the bank on behalf of IAH, after</td>
</tr>
<tr>
<td>Abbreviation</td>
<td>Description</td>
</tr>
<tr>
<td>--------------</td>
<td>-------------</td>
</tr>
<tr>
<td>PIP</td>
<td>Private Investment Portfolio</td>
</tr>
<tr>
<td>PPL</td>
<td>Provision for Potential Losses</td>
</tr>
<tr>
<td>RM</td>
<td>The Rate of Murabaha Per Annum</td>
</tr>
<tr>
<td>RMF</td>
<td>Restricted Mudaraba Fund</td>
</tr>
<tr>
<td>SA</td>
<td>Saving Account</td>
</tr>
<tr>
<td>SEC</td>
<td>Securities and Exchange Commission</td>
</tr>
<tr>
<td>SIC</td>
<td>Specific Investment Certificate</td>
</tr>
<tr>
<td>SSB</td>
<td>Shari'a Supervisory Board</td>
</tr>
<tr>
<td>TA</td>
<td>Total Assets</td>
</tr>
<tr>
<td>TP</td>
<td>Total Profit</td>
</tr>
<tr>
<td>UIA</td>
<td>Unrestricted Investment Accounts</td>
</tr>
<tr>
<td>UIAH</td>
<td>Unrestricted Investment Account Holders</td>
</tr>
</tbody>
</table>

deducting certain percentage for liquidity
ACKNOWLEDGEMENTS

At the beginning, I would like to show gratitude to ALLAH Almighty for his generosity, sympathy and mercy, which allowed me to complete this thesis.

I would like also to express my sincere appreciation and gratitude to my supervisors Professor. Simon Archer and Professor. Rifat Ahmed AbdulKarim for their guidance and encouragement throughout the preparation of this thesis.

I would like to avail myself of this opportunity to thank H.E. Abdulla Hassan. Saif, the Governor of Bahrain Monetary Agency for his continues support and to Sheikh. Abdulla Al-Khalifa, the Deputy Governor and Dr. Khalid Ateq, Executive Director of Banking Control at the Bahrain Monetary Agency.

Thanks are also due to some of my colleagues at the Bahrain Monetary Agency who provided me with technical assistance during the preparation of this thesis, namely, Mr. Yousif Al-Fadal, Director of Computer Services and Mr. Abdul-Aziz Abdul-Razaq and Mr. Tariq Al-Alawi. I would like to thank also Mr. Bernadette Dole, Legal Advisor at the agency for editing the thesis.

I would also like to express my sincere thanks to my secretary, Mrs.Kholood Bu-Ali, for helping me in typing this thesis.

Last but not least, my great gratitude and thanks to my family, especially my wife and my children for their love, encouragement and prays.
CHAPTER 1
INTRODUCTION

1.1 BACKGROUND
Islamic banks are a new type of (religious) business organisations that were established primarily to meet the needs of those who adhere to their faith in their financial transactions. It is generally believed that Islamic banking started to take off in the aftermath of the boom in the oil prices in 1973-1974 (Wilson 1997, Moore, 1997). So far, in Iran, Sudan and, to some extent, Pakistan the whole banking system has been transformed to comply with Islamic Shari’a. The growth of this industry has been remarkable. It is reported that in 1997 the total assets of the 176 Islamic financial institutions reached US$147 billion (1).

Islamic banks are truly different from non-Islamic banks in that financial products involving riba(2) are strictly avoided. As an alternative to the receipt and payment of riba, which is strictly prohibited, inter alia, by the Shari’a, Islamic banks use the Mudaraba financial instrument to mobilise funds in investment accounts. Mudaraba is a profit sharing contract (described in detail later on) derived from the Shari’a. It includes detailed accounting rules that are also derived from Islamic jurisprudence and explicitly takes into consideration the economic welfare of the fund provider (Karim, 1996).

In the Mudaraba contract, the Islamic bank acts as Mudarib (entrepreneur), and cannot guarantee the capital of Investment Account Holders (IAH). In case of loss that is not due to negligence or misconduct, the IAH will share in the loss in proportion to their capital. Such Investment Accounts did not exist in the conventional banks and, hence were not addressed by either accounting standard setters or banking supervisors.

---

(1) The International Association of Islamic Banks (1997).

(2) Riba is translated strictly as usury, but interpreted by modern Islamic scholars as being equivalent to interest (see Mallet, 1988; Saleh, 1992; Taylor and Evans, 1987).
In a way, these investment products offered by Islamic banks are similar to those of mutual funds (un-guaranteed funds). Both institutions manage the funds on behalf of their investors, and in case of loss not due to negligence, the investors will bear such loss. On the other hand, an Islamic bank is entitled to receive its Mudarib share of profits only when the IAH funds generate profits; in contrast, fund managers receive typically their management fee based on the net assets value (NAV) and regardless whether the funds generate profits or not.

Quoting a 1997 IASC Insight Report, Karim (1999) state that most of the countries in which Islamic banks operate either look directly to International Accounting Standards (IAS) as their national standards or develop national standards based primarily on IAS. These countries include Bahrain, Kuwait, Sudan etc. Malaysia develops its own national standards, which are based primarily on IAS. Despite the adoption of IAS by Islamic banks in the preparation of their financial statements major differences continued to exist among them that rendered these financial statements non-comparable.

The fact that Islamic banks accepts funds on profit sharing basis, raises accounting issues, in particular regarding the recognition of profits and their allocation between shareholders and IAH, which are not addressed by accounting standards (whether national or international) drawn up with conventional financial institutions in mind. This has arguably given rise to a lack of effective accounting regulation of Islamic banks, with consequences as such outlined below.

1.2 PROBLEMS OF ACCOUNTING AND FINANCIAL REPORTING

Adopting the IAS for Islamic banks gave them a wide range of options to use accounting treatments which would meet their individual objectives. Such accounting differences relate to measurement and disclosure policies adopted by Islamic banks, as well as the presentation of their financial statements. For example, some Islamic banks use the front-end loading in recognising their profits from Murabaha (instalment sale) transactions; other banks use the accrual basis by dividing the profits over the period of the instalments.
In addition, some banks treat their investments in *Musharaka* (partnership or joint venture) financing as long term investments, while others treat them as an investment in associated company by applying the equity method. (*Murabaha* and *Musharaka* are explained in more detail in chapter 3).

Differences were noted in the accounting policies relating to real-estate held for investment. Some banks value their real-estate by using the historical cost method with provision for any decline (other than temporary) in value, other Islamic banks use the lower of cost and market price. Also there are other Islamic banks which re-appraise their real-estate at market value investments, and any excess of appraised value over cost is allocated between IAH and shareholders.

On the liability side, accounting differences were also noted in the presentation of IAH on the banks' balance sheet. Some Islamic banks present their IAH as a liability in the liability section of the balance sheet. Other Islamic banks reflect IAH as funds under management by reflecting them as off-balance sheet item.

Furthermore, none of the Islamic banks disclose their *Mudarib* share of profit or their accounting policies on profit allocation between shareholders and IAH.

The above differences suggest that the existing framework for accounting regulation in adopting IAS for Islamic banks did not achieve accounting harmonisation among them mainly because IAS were not prepared to cater for such institutions.

### 1.3 THE RESEARCH HYPOTHESIS

This thesis attempts to test the hypothesis that because IASs were not drafted so as to deal with the specificities of Islamic banks, the adoption of IASs by Islamic banks had neither prevented their financial statements being non-comparable in important ways nor led to an acceptable level of disclosure. To test this hypothesis, this thesis examines and analyses certain accounting practices of Islamic banks in Bahrain during the early to mid 1990s, with a view to determining the degree of comparability of their financial statements, and the extent to which the accounting standards to which some of them were subject were effective from the standpoint of the
comparability of their financial statements and of adequate disclosure. The accounting standards in question were the IAS issued by the International Accounting Standard Committee (IASC).

The evidence emerging from the case studies that were carried out supports the research hypothesis.

1.4 EMERGENCE OF AAOIFI
Because IAS or other accounting standards did not cater for Islamic banks, Islamic banks realised the importance of establishing a self regulatory body which would be responsible for issuing accounting standards that consider the nature of Islamic banks.

Therefore, in 1991, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), a private-sector standard-setting body, was established in Bahrain to promulgate accounting standards for Islamic financial institutions based on Shari’a precepts. AAOIFI has so far issued 18 standards (12 accounting, 5 auditing, and one code of ethics). Islamic banks operating in Bahrain and Sudan are required by their supervisory authorities to adhere to AAOIFI’s accounting standards. In addition, international rating agencies have started to take into consideration AAOIFI’s standards in rating Islamic banks (Karim, 1999).

The thesis examines the ways in which AAOIFI’s standards address the loopholes resulting from the reliance on IASs for the accounting regulation of Islamic banks.

The thesis is structured as follows:

Part I provides background and review of literature. It includes three chapters. Chapter two reviews the literature on the regulation of financial reporting. Chapter three examines the general principles of commercial transactions in Islam. Chapter four discusses the accounting issues that relate to concepts and practices in Islamic banking.
Part II addresses the research objectives, methodology and the case studies carried out. This part includes three chapters. Chapter five discusses the research objectives and methodology. In chapter six and seven the case study of Ahmed Bank and the case study of Mohammed Bank are presented respectively.

In part III the analysis and conclusions are presented. This part comprises two chapters. In chapter eight, the comparison, analysis and conclusions of the case studies are discussed. The overall conclusions of the thesis are stated in chapter nine.
CHAPTER 2
THE REGULATION OF FINANCIAL REPORTING

This chapter discusses the arguments for and against accounting regulation. It is an introduction in which the researcher highlights the development of accounting regulation in the USA and the UK and the establishment of the IASC (International Accounting Standards Committee). Then, it analyses the arguments for and against regulating financial reporting. It ends by noting the differences between measurement standards and disclosure standards. Thus, the chapter is divided into five main sections:

1. The History of Accounting Regulation.
2. Arguments for Accounting Regulation.
3. Arguments against Accounting Regulation.
4. The Differences between Disclosure Regulation and Measurement Regulation.
5. Conclusions

2.1 THE HISTORY OF ACCOUNTING REGULATION

Arrangements for accounting regulation differ between countries. The possibilities cover a wide spectrum. They range from a system that depends mainly on statute, for example in France and Germany, through a balanced mixture of statutory and self-regulatory approaches (Australia and Canada), to regulation that relies mainly on self-regulation by the accounting profession or more precisely, by “the business and financial community” (Armstrong in FASB, 1976). The United Kingdom, especially prior to the Companies Act of 1981 (Consolidated in the 1985 Act, which enacted the Fourth Directive of the European Community into British Law), and the United States provide examples of this last system (Bromwich, 1992).

Taylor & Turley (1986, p. 3) stated that “there are four broad approaches to regulation. The first is regulation by the accounting profession through convention, precedent and training. This is potentially the most informal and least stringent means of regulation. A second approach is regulation by private sector regulatory institutions. Such institutions
may be associated with the accountancy profession (e.g. the Accounting Standards Committee (ASC), or may exert an influence over accounting as part of their other activities (e.g. the Stock Exchange). The third approach involves public sector regulation. This can be through governmental bodies (e.g. the Department of Trade in the UK or the Securities and Exchange Commission (SEC) in the USA) or through company law. Fourthly, a mixed system involving aspects of some or all of the other three approaches may be adopted.”

2.1.1 Accounting Regulation in the United States
Prior to 1936, financial accounting and reporting was dominated by a *laissez faire attitude* (Hendriksen, 1977, p. 76), in which companies and auditors were left to decide upon appropriate financial accounting practices for themselves. This period was characterized by much disparity amongst companies in their reporting practices, and relatively few important items were disclosed (Gaa, 1988).

Beginning in the late 1920s, the New York Stock Exchange became interested in the quality of the financial disclosures made by listed companies (Zeff, 1972, 1984). By 1930, after the stock market crash, the Exchange was concerned with both the inadequacy of specific firms’ accounting practices, and with the variety of accounting practices used by different corporations.

Later, the Securities and Exchange Commission (SEC) was established to regulate the securities markets under the Securities Acts of 1933 and 1934. These statutes gave the SEC a broad statutory power over accounting and auditing practices. The main concern of the SEC was to reduce the variety of accepted accounting principles (Gaa, 1988). The SEC is empowered to specify the content of financial reports submitted to it under various acts. The SEC Commissioners and Chief Accountants have been reluctant to go beyond this statutory requirement, by having the SEC itself promulgating financial reporting standards for SEC regulated firms. However, while the decision of the SEC not to involve itself in the standard setting process still stands, it has the legal power to intervene should it choose to.
The accounting profession and the business community were eager to keep all aspects of financial accounting and reporting under their control. The result was that in 1938 the SEC effectively delegated the responsibility for standardization to the Committee on Accounting Procedure (CAP), which was established by the professional organization of CPAs (the American Institute of Accountants, later renamed the American Institute of Certified Public Accountants - AICPA). In Accounting Series Release (ASR) No. 4, it announced that reports filed with the SEC would be presumed to be misleading or inaccurate (and therefore subject to regulatory sanctions) unless the accounting principles used have "substantial authoritative support" or are the subject of a specific ruling by the SEC. In so doing, therefore, the SEC largely delegated the task of recommending preferred accounting practices to the accounting profession itself (Hendriksen, 1977; p. 69; Zeff, 1972).

The CAP had two objectives: to "narrow down the range of choices in accounting procedures", and to establish a more carefully selected and better integrated body of accounting principles or practices (3). This tendency toward uniformity and systematization has persisted to the present day (Gaa, 1988).

The transfer of authority in 1959 from the CAP to the Accounting Principles Board (APB) was essentially no more than a transfer from one senior committee of the AICPA to another, with a change of name but little change of substance. Both bodies consisted exclusively of members of the AICPA, who therefore had to be CPAs, mostly in public practice. In summary, the activities of the CAP and APB may be regarded as having been part of the self-regulatory aspect of a professional group. At the same time (as the SEC's actions over time have consistently indicated) it has also been accepted that the profession should retain this responsibility only as long as its actions are regarded by non-professionals as being "in the public interest" (Gaa, 1988).

---

When the setting of accounting standards was examined in 1971-1972 by the AICPA’s study on Establishment of Accounting Principles (the Wheat Committee), these characteristics of the APB were seen as weaknesses, and they led the committee to propose a substantially different kind of body to replace the Board. The Wheat Committee reported in March 1972, its proposals were quickly approved by the Council of the AICPA, and the new body that the committee had proposed, to be called the Financial Accounting Standards Board (FASB), came into being on July 1, 1973 (Solomons, 1986).

The Wheat committee summed up its views in these words “It may at some time become clear beyond question that standard-setting cannot be left in private hands. But that time is not yet. Until it is shown without doubt that this task must be entrusted to government, we strongly prefer to keep it where it is. There are two prerequisites for the success of such an undertaking in the private sector. These are the existence of a tradition of standard setting and the participation, at the core of the process, of a well-organized profession anxious to make the process work. In the field of accounting, these two prerequisites are satisfied” (Solomons, 1986).

Zeff (1995, p. 56) argued that “the authorization given to the FASB by the SEC should not lead to the conclusion that the SEC has been a passive bystander, since the SEC has kept a close watch over the issues, agendas, priorities, and tentative positions of the standard setter and has not been reluctant to intervene.”

The next section highlights the role of the regulatory bodies in the UK.

2.1.2 Accounting Regulation in the United Kingdom
In the UK throughout the nineteenth century there were no mandatory accounting and audit regulations in the Companies Acts, notwithstanding the fact that railways, banks and public utilities were subject to much greater regulation (Parker, 1990). During the twentieth century, the rules in the Acts have greatly increased in quantity and complexity. Nobes and Parker (1991) claimed that a notable landmark in the accounting regulations is
the introduction of the Companies Act 1947 (consolidated as the 1948 Act), which made group accounts compulsory, introduced many disclosure requirements and required directors to prepare financial statements which were ‘true and fair’. The 1948 Act remained the principal Act for around forty years but was amended by a series of Acts in 1967, 1976, and 1981. All these acts were consolidated in the 1985 Act. The accounting and auditing provisions of the Act were amended and restated by the Companies Act 1989, in which the seventh and eighth Directives of the EC were incorporated.

It was not until late 1969 that the accounting profession in the UK started to play a role in developing consistent accounting principles. Taylor and Turley (1986) reported that in December 1969, The Institute of Chartered Accountants in England and Wales (ICAEW) took the initiative and published a Statement of Intent on Accounting Standards in the 1970’s. In January 1970, The Accounting Standards Steering Committee (ASSC) was created to develop definitive standards of financial reporting. To begin with, the ASSC was a committee of the ICAEW alone, but its representatives as a professional body grew quickly by the joining of other accounting professional bodies. In February 1976 the ASSC was reconstituted and the word ‘steering’ was dropped from the title to leave the Accounting Standards Committee (ASC).

There was much dissatisfaction with the ASC as regards its slow approach to developing accounting standards. Accounting Standards Committee standards were eligible for issuance based on a two-thirds vote of its 21 members. However, the ASC had to obtain the approval of the six member bodies of the Consultative Committee of Accountancy Bodies (CCAB) before a standard could be issued. The ASC was also criticized for failure to use a conceptual framework and for the lack of compliance by many companies with its standards (Collins & Bloom, 1997).

Although the ASC had produced twenty-five standards by 1991 there was also criticism that it was not adequately staffed, that it had no ground plan and that it was reactive rather than proactive. Therefore, a fairly radical reform of the standard-setting process was introduced in 1990, following a report sponsored by the accountancy profession (The Dearing Report, 1988) which recommended the setting up of the Accounting Standards
Board (ASB), with a salaried staff comprising accountants responsible for issuing standards (Elliott & Elliott, 1993). The Accounting Standards Board (ASB) was established in the United Kingdom in 1990, replacing the ASC. An independent Financial Reporting Council oversees the ASB. Unlike the ASC with its dependence on the CCAB, the ASB is authorized to issue its standards directly rather than in consultation with other bodies (Collins & Bloom, 1997).

The Companies Act 1989, as part of this process of setting up a more authoritative standard-setting body in the United Kingdom, did place a duty on corporate directors to follow accounting standards. This was the first mention of accounting standards in United Kingdom legislation. Both the profession and the Dearing Committee wanted a stronger statutory backing to be given to accounting standards. Bromwich (1992) claims that “the government refused to give additional authority on the grounds that it would amount to giving statutory backing to accounting standards setting in UK and attenuating the desired self-regulatory character of the standard setting.”

The degree of intervention by the accounting profession in accounting regulation is a notable feature in countries like the US, UK, Canada and Australia, as compared to continental European countries. However, the strength of the profession varies from country to country (Nobes & Parker, 1991).

Archer and Karim (1997, p. 103) claim that “self-regulation is prevalent in the English-speaking countries with their tradition of common law and corresponding lack of a comprehensive commercial code, and less prevalent in the countries of Continental Europe where comprehensive commercial codes and ‘accounting law’ are the norm. In the case of the United Kingdom, France, The Netherlands, and the other member states of the European Union, the broad framework of accounting law is governed by the various Accounting Directives of the EU Commissions, which are enacted into national law.”
While the United States has many accounting standards tightly written in a legalistic style, the traditional approach in the United Kingdom has been to have far fewer written standards, and even these, by and large, are guidelines rather than rigid rules (Collins & Bloom, 1997).

The US and UK accounting regulations are either directly or indirectly influenced by their respective legal systems and governmental enforcement mechanisms. The next section highlights the role of the IASC in regulating accounting standards in a way which does not have legal backing.

### 2.1.3 The Establishment of the International Accounting Standards Committee (IASC)

For the last twenty five years, the IASC (which was established in 1973), has been developing accounting standards with the objective of working “generally for the improvement and harmonization of regulations, accounting standards and procedures relating to the presentation of financial statements” (IASC, 1998). In the late 1980s, the IASC began a project to reduce the number of options within its standards. This was part of a major campaign to increase the adoption of IAS (International Accounting Standards) internationally, especially for securities listing purposes. Nevertheless, there is probably some IASC influence in continental European countries. The most obvious example is in Italy, where listed companies are required to follow IAS in the absence of a relevant national standard (Nobes & Parker, 1991). The governments of France and Germany are also considering draft laws which would allow group accounts to use certain ‘foreign’ accounting rules, perhaps IAS, US rules, or both (Nobes, 1996).

The IASC can be commended for its part in the effort to reduce the number of differences between national accounting standards. Although differences between national accounting standards remain, there is greater comparability between the different national sets of accounting standards. In July 1995, in order to enhance its global role, the IASC reached an agreement with IOSCO (The International Organization of Securities Commissions), in which it was decided that, if the IASC completed a set of high-quality accounting standards that covered a number of key areas, IOSCO would consider
recommending those ‘core standards’ for endorsement by its members for cross-border filings (Bloomer, 1997).

For most cross-border purposes, the users of accounting data must live with these accounting differences. This leads to expense in various ways (IASC, 1996):

- Investors, lenders, etc., steer clear of some profitable investments because they do not understand or trust the financial data relating to them.
- Some investors, lenders, etc., do not realise the nature of the accounting differences, so they make the wrong financial decisions.
- Other investors, lenders, etc., spend time and money adjusting accounting data so that it can be used comparably across borders.

Gray and Maunder (1980) suggested that the divergence in accounting methods was caused by the orientation of different groups of users. For example, in the UK and the USA financial reporting is oriented toward the equity investors who are mainly interested in the profits of the firm, whereas the orientation in France and Germany is towards the creditors, and the interest is therefore in the ability of the firm to meet its obligations, including its interest payments.

Today there is increasing interest in international accounting standards (IAS). Some are interested because greater acceptance of international accounting standards will lead to pressure in the local country to enhance the quality of local financial reporting. Others are interested because the direction of the development of international accounting standards is fundamentally different from the type of standards currently used locally. The fact is that by enhancing the quality of international accounting standards, there will be a greater degree of interest in those standards around the world (Wyatt, 1997).

The IASC has no legal power to enforce its standards and therefore it relies on its members “who are members of the International Federation of Accountants” to support its standards and to use their best endeavours to ensure that published financial statements
comply with the standards; to ensure that auditors enforce them; and persuade
governments, stock exchanges and other bodies to back the standards (IASC, 1983).

As indicated above, in practice this means that financial reporting is a regulated activity,
at least partially. However, there are some arguments against accounting regulation.
Hence, the next section of this chapter will analyse the arguments for and against the
regulation of financial reporting.

2.2 THE ARGUMENTS FOR ACCOUNTING REGULATION

2.2.1 Monopoly Control of Information by Management

Quoted in Watts and Zimmerman (1986, p. 159) Leftwich (1980) argued that “corporate
accounting reports are often claimed to be the main source of information available to
investors, and, as consequence, it is argued that managers are able to manipulate stock
prices to their own advantage. In an efficient market, the stock price adjustment to an
accounting report is unbiased and, therefore, managers cannot systematically mislead the
stock market.” It is to be noted that “efficient market” refers in this context to “semi­
strong form efficiency” like that of US and UK markets where only the publicly available
information are reflected in the securities prices and not the private information. Fama
(1970) delineated three major forms of market efficiency, weak, semi-strong, and strong:

i) The market is efficient in the weak form if prices fully reflect information regarding the
past sequences of prices. This form of market efficiency has obvious implications for
technical analysis, and it includes the random walk theory of stock prices. The
implications for accounting for marketable equity securities are discussed in Beaver

ii) The market is efficient in the semi-strong form if prices fully reflect all publicly
available information, including financial statement data. Trading strategies based
upon published financial statement data will not lead to abnormal returns.
iii) The market is efficient in the strong form if prices fully reflect all information, including inside information. Hence, even having access to non-published inside information will not lead to strategies promising abnormal expected returns.

Proponents of regulation claimed that if the management has more information in an efficient market than is available via other sources, but does not provide the information to the market, it can be argued that the market cannot discriminate between efficient and less efficient firms as accurately as it otherwise might. Hence, governmentally enforced disclosure improves the ability of the capital market to discriminate between firms and to allocate capital appropriately (Watts and Zimmerman, 1986).

According to Wolk et al (1992, pp. 81-82) "With accounting regulation, the argument is that it is better to force mandatory reporting rather than to have individuals competing to buy information privately and at monopolistic prices. In other words, mandatory public disclosure is a cost-effective method of getting firm-specific information to those demanding it. It is a waste of social resources for everyone to be buying the same private information about firms. The production costs of mandatory reporting requirements may be quite small since most of the basic information is produced as a by-product of internal accounting systems. If marginal information production costs are low, then the social costs associated with mandatory financial reporting requirements may be small."

Beaver (1989, pp. 186-187) argued that "the argument for disclosure regulation is that management has incentives to suppress unfavourable information. While there may be a general awareness of this potential among investors, investors would not know specifically the nature of the suppressed information. As a result, investors will be unable to distinguish quality differences among common stocks to the same extent they would under fuller disclosure. Hence, security prices will not fully reflect quality differences among stocks, and there will uncertainty about the quality of each stock. There may be a tendency for lower-quality stocks to be selling at a higher price than would prevail under fuller disclosure and conversely for the higher-quality stocks. This can lead to a phenomenon known as 'adverse selection' in which the management (and investors) of poorer quality stocks have greater incentives to offer additional shares for sale than the
management of higher-quality stocks. The anti-fraud provisions issued by the SEC can be viewed as requiring firms to provide disclosure warranties to investors. Presumably, the legal liability reduces the incentives of management to suppress unfavourable information.”

2.2.2 Uninformed Investors
Lev (1988, p. 6) claimed that “the traditional view, often espoused by policymakers and accountants, that there is a need to protect the "small" (presumably uninformed) investor was probably derived from genuine concerns about inequities in capital markets. However, the call for regulation to redress such inequities was generally phrased in vague, naïve and somewhat paternalistic terms suggesting that uninformed investors were at the mercy of market insiders. This rather unconvincing plea for regulation, emphasizing fraud as the major hazard to investors, effectively dampened the interest of modern accounting and economic researcher in equity issues.” A typical example is Ross (1979) quoted in (Lev, 1988, p. 6) dismisses equity considerations in disclosure regulation because they are based on such “defenseless investor” arguments “The equity benefits of [disclosure] legislation- as between insiders and out-siders- are more difficult to identify. The case for such benefits seems to rest on the traditional view that outsiders are at the mercy of insiders, and need to be protected from them.”

Lev (1988, p. 7) argued that “uninformed investors can defend themselves by minimizing trading with informed investors, that is by buying and holding well-diversified portfolios for the long run. Alternatively, the uniformed can identify specific groups of insiders, such as managers, and prohibit them, by legal or contractual arrangements, from trading in the securities of their own firms. At the extreme, suspecting gross investors asymmetries, uninformed investors may quite rationally withdraw from the stock market altogether. A massive withdrawal of uninformed investors from the market will strip the informed of the benefits of their costly-acquired information (thereby decreasing incentive for information production), and will deprive the economy of the allocational and risk sharing benefits of large and efficient capital markets. Herein, therefore, should lie our concern with inequity in capital markets. It stems form the adverse social effects
brought about by the defensive measures taken by uninformed investors who perceive significant inequity.”

Lev (1988) also claimed that the most effective remedy to alleviate the adverse consequences of inequity in capital markets (4) is to remove the major source of inequity, namely the informational advantage held by informed investors. This advantage could be decreased by instituting a policy mandating regular and timely public disclosure of information.

2.2.3 The Alleged Market Failures (5)

A market failure exists when the quantity or quality of an item produced in a free market differs from the supposed social optimum. The social optimum is the output that maximizes some social welfare function. The optimum is attained only if the prices of particular goods equal their social marginal costs. In a private market, individuals maximize their own utility and equate their private marginal benefits and costs. If an good’s private costs are less than its social cost, too much of the good is produced in a free market, there is over-production of the good. Conversely, if good’s private benefits are less than its social benefits, too little of the good is produced there is under-production of the good. The ‘over-’ or ‘under-’ production is relative to the production level chosen by a benevolent, social welfare-maximising dictator.

---

(4) Inequity in capital markets, according to Lev (1988) as inequity of opportunity or the existence of systematic and significant information asymmetries across investors, leads to adverse private and social consequences: high transaction costs, thin markets, lower liquidity of securities, and in general, decrease gains from trade.

(5) The following analysis of the alleged market failures draws heavily on a summary by Leftwich (1980).
The market failures argument suggests that social welfare can be improved in a 'Pareto' sense by government regulation moving the private output closer to the social optimum. The ability of the government to increase welfare in a Pareto sense means it can induce an output change that makes at least one person better off without making anyone worse off. An accounting market failure is alleged to exist because the output of information in accounting reports in the absence of regulation is non-optimal in a Pareto sense. Alternatively, an accounting market failure exists because the resource allocation resulting from the market for financial information is inequitable, that is, "unfair" to some groups or individuals (e.g. Burton, 1974; Lev, 1988).

2.2.4 The Public Good Problem

The distinguishing feature of a public good is that one person's consumption of it does not reduce the quantity available for others to consume. A traditional example of a public good is national defence. By contrast one person's consumption of a private good does reduce the quantity available for others.

The public good attribute of information need not lead to a market failure per se. The failure comes about if the private producers cannot exclude non-purchasers of the good from using it or cannot effectively price-discriminate between purchasers. In the case of corporate financial statements, it is claimed that corporate managers cannot exclude non-purchasers (Gonedes and Dopuch, 1974). Investors who do not hold securities in the firm can obtain the information in the firm's report without paying anything toward the information's production. Because they are not paid for the use of information by non-purchasers (e.g., non-shareholders), corporate managers do not take the value of the information to those non-purchasers into account when determining the quantity of information to produce (private benefits are less than public benefits). Hence, the managers "underproduce" information in the absence of regulation. Thus, there is an alleged market failure.

2.2.5 The Signalling Problem (Also called the 'Screening' problem)

A problem arises when one party to a potential transaction has more information than another; that is, there is information asymmetry. The problem relates to corporate
disclosure because corporate managers have more information about the value of the
corporation than do outside investors. Those firms whose share prices are undervalued
have an incentive to expend additional resources on providing financial information to
signal that fact. The remaining, overvalued, firms implicitly signal that fact by not
providing additional information and the value of their share drops to the average value
for the overvalued group. Now some of those firms’ shares are indeed ‘undervalued’ and
they therefore expend resources to provide additional information. The process continues
until only the very worst-performing firms do not signal. This principle is known as the
“signalling hypothesis” to refer to the proposition that signalling motivates corporate
disclosure, thus mitigating potential market failure.

Clearly, the expenditure of resources on information in our corporate example improves
the allocation of capital and increases output (i.e., the most efficient firms receive more
capital). However, part of the expenditure is related to past performance and may not be
related to future performance and hence not yield any social benefits. To that extent,
signalling may cause an over-production of information of doubtful relevance in
accounting reports.

2.3 THE ARGUMENTS AGAINST ACCOUNTING REGULATION

2.3.1 Trading of Information in an Efficient Market

In competitive unregulated markets, managers do not earn an abnormal rate of return by
withholding and trading on information, because the manager’s equilibrium
compensation is reduced by the amount of profits he is expected to earn from insider
trading (Manne, 1966). In an efficient market, the firm’s price is such that investors
outside the firm (from whom the managers earn their insider trading profits) earn a
normal rate of return. Thus, the effect of insider trading is to lower the firm’s stock price
without increasing (on average) the manager’s compensation. To the extent that insider
trading interferes with the manager’s production/investment and financing decisions, it
lowers the market value of the firm even further (Watts and Zimmerman, 1986).

(6) This subsection draws heavily on Watts and Zimmerman, 1986.
By providing information, managers can persuade the market that they will engage in less insider trading, and that they can increase the firm's market value and, given that their compensation depends on the market value, their own welfare. Consequently, managers have incentives to voluntarily disclose the information and will do so if the costs of disclosure are less than the effect of the disclosure on the value of the firm (Watts and Zimmerman, 1986).

2.3.2 Incentives for Managers to Produce Adequate Information
Taylor and Turley (1986) state that opponents of regulation have argued that both the suppliers and the consumers of accounting information experience sufficiently strong incentives to trade in information to ensure that trading will take place in the absence of regulation or compulsion. On the demand side, users bid for information, which is relevant to their decisions; while on the supply side, management has strong incentives to provide adequate and reliable information in order to attract resources and to ensure beneficial effects on economic indicators such as share prices. Enterprises not providing information deemed useful by users, or not conforming to generally accepted standards of disclosures, would not attract or keep resources.

A second reason for trading in information is provided by the relationship between managers and shareholders in enterprises. A number of writers have applied agency theory to this relationship (Jensen and Meckling, 1976; Watts and Zimmerman, 1978; Leftwich, 1980). They concluded that mutual benefits are received by management and shareholders from the disclosure of audited financial information. According to an agency theory view, management (the agent) possesses superior information about the enterprise, and shareholders (the principal) cannot directly observe management behaviour. This asymmetry of information supply creates the problem of 'moral hazard'. According to Taylor and Turley (1986), moral hazard is related to the potential which the agent has for engaging in activities which are not in the best interests of the principal, such as fraud or consumption of excessive perquisites. In order to solve the problem of moral hazard, the principal may seek to ensure that the agent's objectives are congruent with those of the principal by offering incentive schemes, such as profit sharing or share
option schemes. Alternatively, the principal may seek information with which to monitor the agent’s behaviour. The generation of information is a costly exercise and the agent has comparative advantage in its production.

Watts and Zimmerman (1978) argued that agents have an interest in providing information in order to reduce the cost of monitoring the agent-principal relationship. In addition, they will wish to provide such information in order to reduce the principal’s reliance on incentive schemes, which may involve the agent in undesirable risk taking. For similar reasons, the agent will favour an external independent audit (Watts, 1977).

The audit of an agent’s financial report to principals, both actual and potential, provides a signal to principals regarding the quality of the agent’s services, and thereby helps to distinguish the superior agent from the inferior. In the absence of such authenticated discriminatory information there is a tendency for only the services of inferior agents to be traded (Akerlof, 1970).

Wolk et al (1992, p. 78) claimed that “agency theory posits a conflict between owners and managers that is mitigated to some extent by financial reporting. Routine financial reporting is one means by which owners can monitor employment contracts with their managers.”

2.3.3 Private Contracting Opportunities

Another argument in favour of unregulated markets for financial information is the presumption that anyone who genuinely desired information about a firm would be able to obtain it, even in the event that unregulated markets resulted in less free and public disclosure. Any party could privately contract for information with the firm itself, with the firm’s owners, or indirectly with information intermediaries, such as stock analysts. If information were truly desired beyond that which is publicly available and free of charge, private individuals would be able to buy the desired information. In this way market forces should result in the optimal allocation of resources to the production of information. Because of private opportunities for contracting additional information, the argument is that regulatory intervention in the form of mandatory disclosure rules becomes unnecessary (Wolk et al, 1992).
2.4 THE DIFFERENCES BETWEEN DISCLOSURE REGULATION AND MEASUREMENT REGULATION

Although it can be inferred from 2.2 above that there are strong justifications for accounting regulation, it is important to highlight the differences between disclosure regulation and measurement regulation. According to Archer and Karim (1997, p. 101) they state that “The objectives of accounting standards are concerned with the amount of information disclosed and the formats used to do so (disclosure standards), and also with the accounting methods used to calculate the numbers disclosed (measurement standards). Measurement issues comprise those of recognition (e.g., of income) and valuation (e.g., of assets).”

Beaver (1989) argued that if the capital market is semi-strong form efficient there is a prima facie reason for requiring more disclosure because that will enable the intermediaries and analysts to do their job more effectively because they will be provided with more information, therefore more information will be reflected in the stock prices. That argument does not apply to measurement regulation, as the measurement regulation is more concerned with the information processing costs of correcting for the effects of different accounting principles, e.g. the private costs of different analysts doing it are likely to be greater than the cost of making firms comply with measurement standards. The costs of the firms setting up systems to comply with these standards will arguably, be less than the costs of the users having to cope with heterogeneous information.

2.5 CONCLUSIONS

Although the benefits of accounting regulation remain a matter of debate, there are sound theoretical reasons in favour of both disclosure standards and measurement standards. History suggests that, with regard to disclosure, the signalling incentive for the production of financial reporting information is insufficient to overcome the tendency to market failure. For example, UK companies did not disclose their sales turnover figure until required to do so by the 1967 Companies Act. The argument that measurement standards permit scale economies in information processing is also persuasive.
Before discussing the issue of accounting regulation for Islamic banks, it is necessary to review the characteristics of the transactions and financial instruments with which they are involved (ch.2), and then to examine the specific accounting issues which these raise (ch.2 and 3). As will be seen conventional accounting regulation (including International Accounting Standards) generally fails to address these issues (ch.6).
CHAPTER 3
GENERAL PRINCIPLES OF COMMERCIAL TRANSACTIONS IN ISLAM

The chapter is divided into three sections. Section One reviews the history of *riba* since the early civilisation and how various laws and religions dealt with the *riba/usury* question. Section Two highlights the early experiments in establishing Islamic banks and their development. Section Three discusses some of the current accounting differences between Islamic banks.

3.1 BACKGROUND ON THE HISTORY OF RIBA/USURY

3.1.1 Definition of Riba/Usury
*Riba* is variously translated as 'increase', 'excess', 'usury' or 'interest' (Pryor, 1985). Parker (1988), quoting Pope Clement in 1312, defined usury as any accrual, great or small, above the principal of the loan. Dorph (1990) defined usury as exorbitant interest over and above a morally prescribed limit. However, the term *riba* is interpreted as any pre-determined increase over the principal, from verses quoted in the Holy Quran: "You see the land life less but when we make water fall on it, it shakes and grows" (Surat Al-Hajj Verse No. 5). The term (Rabat) in the Arabic version of this verse means 'raised' or 'increased'.

3.1.2 History of Usury
Usury has been in existence ever since lending began in the early civilisations. The law of Hamurabi (18 century BC) dealt with lending to ensure efficiency, equity and control as compound interest was forbidden (Dorph, 1990). In 594 BC Solon cancelled all private and public debts when he reformed the Athenian constitution. In 340 BC Lex Genuica prohibited the charging of interest in republican Rome, and two centuries later Julius Caesar limited the rate of interest to 12% (Anwar, 1987).
Taylor and Evans (1987) claim that the views of two philosophers had particular significance in the consequent treatment of usury. The two philosophers were Seneca, a Roman, and Aristotle, a Greek. Seneca considered the practice of usury to be wrong on moral grounds since the return is linked to time and not to any natural wealth increase. Aristotle distinguished between wealth of two kinds, namely, 'natural' wealth, which he felt to be the result of man producing in conjunction with raw materials, and 'unnatural' finance. Finance was seen as an evil art and its most evil form was usury. Money was supposed to act as a medium of exchange and, therefore, any other role for it was contrary to its objectives. Aristotle claimed that money is an unproductive instrument and, therefore, it should not bear any interest.

3.1.3 The Church Position on Usury

In 4 AD, during the time of the Roman Empire, the church announced the prohibition of interest to the clergy, and in the fifth century the prohibition of interest was extended to the laity. In the eighth century interest became a criminal offence (Anwar, 1987). In the Middle Ages Roman civil laws differentiated between usury and interest according to whether they were *res fungibilis* or *res non fungibilis*.

*Res fungibilis* refers to a commodity that is exactly replaceable in kind, and *res non fungibilis* to an item not replaceable in kind. The law recognised money as 'fungible' and hence justice was seen to be done if the same amount of money was returned to the lender by the borrower. However, to establish fairness and justice for the lender, modifications in the laws were introduced to deal with events under which the lender may experience losses as a consequence of default by the borrower. Such events allowed the lender to receive a return considered as usurious interest in case of certain risks, including:

- termination or foregoing of gains.
- [the risk of] non-payment.
- [penalty clause against] late re-payment.
Less defensible was the *trinus contractus*, the notorious triple contract theory, which (Anwar, 1987) claims gave legitimacy to usury in the name of interest. It was discovered that the kind of loan which was condemned by the church and in which the creditor claimed interest from the beginning of the loan was allowed under triple contract theory. This theory is based on three separate agreements, each of which was lawful if considered separately; namely, a sleeping partnership, an insurance against the loss of the principal, and an insurance contract against fluctuations in the rate of profit. It was therefore assumed that if 'A' entered into these three separate agreements, then there was no reason why he could not combine the three contracts into one.

In the sixteenth century, as trade flourished, moneylenders in Europe played a critical role in the financial sector until the emergence of the modern banking system. (Moneylenders were generally despised for centuries because they were practising usury. This was particularly so when the debt in question was onerous.) Christians were prominent in moneylending activities, a matter of concern to the religious authorities as Christianity expressly condemned usury and any legitimisation of usury was seen as heresy.

By contrast, Taylor and Evans (1987) claim that *commenda* (the original form of *Mudaraba* contract in general use by Italian and other merchants in the late Middle Ages and early modern times) was permissible provided the investing partner genuinely shared the risk. Thus a partner needed to do no more than entrust his money to a trader or craftsman at his own risk and on that account was entitled to a share of the profit or was liable for his share of the loss (Bryer, 1993).

According to Bryer (1993, p. 119), "to avoid ecclesiastical condemnation, the sea-loan was increasingly replaced by *commenda*. However, according to Parker (1988, p. 140) de Roover claims that "the introduction of the bill of exchange was to circumvent the ban on usury. In Italy where the bill of exchange was introduced, it involved interest not overtly but indirectly as interest included in the rate of exchange since the bill of exchange at that time was used between merchants in different countries."
3.1.4 The Views of Judaism on Usury

Under Judaism, Israelites were forbidden to demand any increase on amounts lent to Israelites but were allowed to charge interest to gentiles. According to many scholars of Judaism, the reason for this distinction was that there was no law among gentiles that prohibited the charging of interest. Therefore, they claimed that it would be unfair to prevent Jews from charging interest to gentiles (Zindo 1994).

In Europe, the Jews came under strong pressure during Napoleon's reign (the early nineteenth century) to cease distinguishing between Jews and non-Jews as regards the charging of interest. Such pressure led Jewish notables to argue that such a distinction was no longer viable in the Diaspora, and the charging of interest within the Jewish community was therefore permitted (Dorph, 1990).

3.1.5 Islamic Position on Riba/Usury

The most noteworthy investment practices in the pre-Islamic period were Musharaka (partnership) and Commenda (Qirad or Mudaraba). Rayner (1991) claims that these investment methods were based on the assumed honesty of the merchant (Mudarib), who would invest the monies of the investors (Rab al Mall) in trade. The results of the investments would be shared as profits or losses in proportion to the investors' share in such investment, while the merchant would be entitled to a certain percentage as a commission if there was a profit. In the case of no profit or loss, he would receive nothing and thus lose his efforts. If the merchant combined his/her capital with the investors' funds (bilateral commenda), both the investors and the merchant would share the loss or profit in proportion to their capital.

In pre-Islamic days riba (usury) was practised in Mecca (the holy city of Muslims). Al-Fakr Al-Razi described the dealing on riba which prevailed in pre-Islamic days as follows: Arabs used to pay the money on loan and receive each month a certain sum leaving the principal sum intact; when the debt matured the lender claimed the principal from the borrower. If it was not possible on the part of the debtor to pay, then the lender used to increase the principal sum and extend the time (Naqvi, 1993).
The emergence of Islam drastically changed the behaviour of the inhabitants of Mecca, as new rules were established which included the prohibition of riba. Indeed, the largest verse in the Quran was devoted to the condemnation of riba Allah says that "Those who eat riba will only rise from their graves just like the rise of a person who has been inflicted with mental instability by the devil and that is because they said that trading is like riba and God has allowed trading and banned riba; he who receives a sermon from his God and desists (from eating usury) shall have what he had already taken (prior to the ban) and his absolution rests with God, and those who recommit usury are residents of hell where they are eternal.

God shall strip riba of all the blessings and increase the alms and double the merit; God does not like sinful renegades (who make riba legitimate). Those who believed, have performed benevolences, performed prayers and paid Zakah will be rewarded by God and there is no fear for them nor shall they be grieved. Oh ye believers fear God and abandon what remained of riba, if you are (real) believers. If you fail to do so be advised that God and his Messenger will wage war on you; if you repent you may recover your capital without taking an increase or recovering less than the capital sum; he who is in financial straits, let him wait for better times and if you give alms (discharge the liability of an insolvent) it would be better for you, if you know it is good" (Surat Al Baqara, Verses Nos. 275 - 280).

Also, Allah said of riba "Oh ye who have believed do not eat riba which multiplies and fear God that you may thrive" (Surat Al-Omran, Verse No. 130).

In his last pilgrimage sermon Prophet Mohammed (peace and blessings of Allah be upon him) said. "However, every usury of pre-Islamic days is abolished, you are entitled to take your capital so that you do not oppress nor be oppressed" (Naqvi, 1993).

The verses of the Quran and the saying of the Prophet categorically prohibited and condemned riba, which in the context of present day financial practices is universally interpreted to mean 'interest'. However, the condemnation of interest is not strictly adhered to by all Muslims or observed in the majority of Islamic countries.
Exceptions are Sudan, Iran and Pakistan, where a process of Islamization of the banking system has been adopted (7).

Riba is sometimes interpreted as compound interest, but is better understood as a *pure return on money* as opposed to the provision of *asset-based finance* (e.g., Murabaha and Ijara).

### 3.2 THE EMERGENCE OF MODERN ISLAMIC BANKING

Despite the legitimisation of interest in Islamic countries, it is well known that a number of pious Muslims do not deposit their savings in banks because they wish to strictly observe the Islamic prohibition of interest. It is incumbent on Islamic banks, therefore, to completely eschew all such practices which involve any element of interest, so that the trust placed in them by the depositors with regard to the return paid on their deposits being completely free of interest is duly discharged (Ahmed 1989). Therefore, since the nineteenth century, when interest-based banking was introduced in the Islamic countries, there has been a need to establish interest-free banks as well.

There are now over fifty Islamic banking institutions operating in a number of different countries and encompassing both most of the Muslim states and some non-Islamic states. The major international Islamic banks are the Dar Al-Mall Al-Islami Trust, the Al-Baraka Group, Kuwait Finance House and Al-Rajhi Banking & Investment Corporation.

The first recorded experiment to establish interest-free banks began in 1920 in a rural village in Egypt in the form of a peasant co-operative financial society. Following this experiment efforts were made to repeat it elsewhere. The following sections review some countries' experiences in developing Islamic banking.

---

3.2.1 Islamic Banking in Egypt
The first attempt to introduce Islamic banking into the Egyptian economy could be said to have started with the establishment of the Mit Ghamr local banks in 1963, and latter more Islamic banks were established. The main Islamic financial institutions include the Nasser Social Bank and the Faisal Islamic Bank of Egypt (Al-Ashker, 1990).

3.2.2 Mit Ghamr Local Savings Bank
This bank was established in 1963 in a provincial rural centre in the Nile Delta, Mit Ghamr. The bank was owned by the public sector because at that time all financial institutions in Egypt were owned by the state. Abdeen and Shock (1984) claim that the purpose of this experiment was to attract savings of low income peasants and to mobilise them for development investment, no interest was paid or charged on the bank's transactions. The activities of the bank covered five areas: deposit accounts, loan accounts, equity participation, direct investments and social services.

Deposit accounts were classified as savings accounts, which bear no interest but were intended to develop the savings habit amongst small savers such as students and blue collar workers, with investment accounts based on profit and loss sharing.

Loans were divided into two main types: non-investment loans were provided on humanitarian grounds, but only if the borrower maintained a savings account with the bank. Investment loans were provided on the basis of profit and loss sharing. The loans were mainly directed to small enterprises and craft workers who had the requisite skills but were short of funds.

The Mit Ghamr Savings Bank suffered from a lack of government support (Abdeen and Shock, 1984). However, other factors played a part in the failure of the bank, particularly once the bank had been placed under the direct control of the state administration and had therefore lost its operational autonomy.
3.2.3 Nasser Social Bank (NSB)

The experiment of the Mit Ghamr Savings Bank encouraged pious Muslims to try again. Mr. Ahmed Al-Najar, a well-known Islamic banker, was behind the idea of both the Mit Ghamr and the NSB (Abdeen & Shock 1984).

Some Islamic banks were established between the 1970s and early 1980s in order to attain social objectives. These included the NSB. Abdeen & Shock (1984) stated that the main factors behind the revival of the Mit Ghamr experiment:

i) The decline in the number of the depositors and deposits after putting the Mit Ghamr Bank and its branches under the control of a commercial bank which operated an interest-based system.

ii) The changes in the government administration under the late president, Anwar Al-Sadat.

The NSB took over the Mit Ghamr Savings Bank, thereby benefiting from the popularity of the latter bank but committing itself to meeting all of that bank's outstanding obligations. The bank was very successful but, due to the need for governmental financial support, which meant putting the bank under the Government's control, the public became suspicious and the bank lost the trust of its clients.

3.2.4 Faisal Islamic Bank of Egypt

In 1977 the Egyptian government took a leading step in supporting the Islamic banks when it issued a special act authorising the establishment of the Faisal Islamic Bank of Egypt. This was followed by the setting-up of two more Islamic banks.

The authorised capital was set by the Act as US$5 million, divided into 80,000 shares of US$100 per value per share. The Act states that the Egyptian participation in the capital is 51 per cent, while Saudi participation is 49 per cent.
The bank's capital was subsequently increased to US$40 million in 1977 and in 1984 the authorised capital increased to US$500 million. The issued capital was subsequently raised to US$100 million (Al-Ashker, 1990).

Besides compliance with the Shari'a ruling in its operations, the bank offers all banking operations including the normal banking services of commercial banks, accepting deposits on a profit and loss sharing basis.

### 3.2.5 Islamic Banking in Pakistan

Pakistan was created in the name of Islam in 1947, and the demand for Islamization of the country's economic life was, according to Anwar (1987), voiced as early as the first year of the country's independence.

The late Zahid Hussain, the first governor of the Central Bank, announced in his opening statement on July 1, 1948, his intention to reform the banking system to operate in line with Islamic principles, including the elimination of interest from the banking system. In 1959 the State Bank of Pakistan (The Central Bank) set up an Islamic economic section within the research department of the bank to carry out research regarding the elimination of interest from the banking system. During the 1950s, several prominent scholars, including M. N. Siddiqi and Mohammed Uzqin, had proposed an Islamic banking system based on Mudaraba, but the government did not take serious steps in that direction (Anwar, 1987).

However, Zindo (1994) claims that the process of Islamization of the Pakistani economy was initiated following a declaration by the late President Zia ul Haq in February 1979, that the government planned to remove interest from the economy within a period of three years. He also claims that a decision had been taken to begin moving in this direction, commencing with the elimination of interest from the operations of the House Building Finance Corporation, the National Investment Trust and the Mutual Funds of the Investment Corporation of Pakistan.
On the other hand, Gieraths (1990) claims that pronounced official attempts to Islamize Pakistani society started in July 1977, following General Zia's coup. The determination to eliminate *riba* from the economy turned out to be the major field of activity in Islamizing the economy and has led to a number of changes in the banking system, a system inherited from British colonial times.

The conversion of the operations of commercial banks to a non-interest basis took longer. This process began in January 1981 with the setting-up of separate counters for accepting deposits on a profit and loss sharing basis in all the domestic branches of the five nationalised commercial banks. As from July 1, 1985 all banks were required to accept deposits on a profit and loss basis, except foreign currency deposits which continued to earn interest and current accounts on which no interest or profit was given since the principal amount is guaranteed (Zindo 1990).

In 1980, a law was promulgated under which banks and other financial institutions can register themselves as *Mudaraba* companies and mobilise funds through the issuance of *Mudaraba* certificates. Funds obtained through a *Mudaraba* can only be used in such business as are permitted under *Shari'a* and need prior clearance from the Religious Board established by the government. On the other hand, to safeguard the banks against delays and defaults in repayment by parties obtaining finance, a law called the Banking Tribunals Ordinance was promulgated in 1984 (Zindo 1990).

However, Zindo (1990) claims that the Islamization of the banking system has certain deficiencies in that no institutional mechanism exists for a continuous scrutiny of the operating procedures of banks and other financial institutions from a *Shari'a* point of view. Also, deposits originally based on the principle of profit and loss sharing between depositor and bank, turn out to be limited to profit sharing since the Government guarantees all deposits.
3.2.6 Islamic Banking in Turkey

In Turkey, perhaps the most drastic move was in 1928 when the country decided to follow a path of complete secularism. Even today, the government seeks to 'separate' religion from politics and other areas of public life despite the fact that 99 per cent of Turkey's population is Muslim. Since Atatürk, various governments have made concessions to Islam, including the establishment of Islamic banking in Turkey. However, the establishment of Islamic banks in Turkey was controversial and the decision to allow their opening was criticised by both the conventional bankers and the secularists.

Several Islamic banks, together with numerous foreign conventional banks, have been established in Turkey since 1980. Although the role of Islamic banks, or "special finance houses" as they are called in Turkey, is still fairly limited, they have nevertheless managed to attract a sizeable number of investors. These finance houses are obliged to generate their income from fees for services, profit sharing from equity participation, trading in commodities and foreign exchange, the building and management of industrial and agricultural businesses, leasing operations and other transactions that involve risk and do not violate Islamic principles (Boldwin 1990).

There are strict and detailed rules governing the operations of Islamic banks or 'special finance houses' in Turkey. No where should the words 'Islam' or 'Shar'ia' appear, as the authorities intend to avoid an open conflict with the aims and principles contained in the secular constitution. Permission to set up "a special finance house" needs to be obtained from both the Central Bank and the Council of Ministers.

So far, four Islamic banks have been established in Turkey. One is called Al-Baraka Turk Ozel Finans Kurumu, with the majority shareholder being the Al-Baraka Investment and Development Corporation of Jeddah, whose chairman is Sheikh Saleh Kamel. The second is Faisal Finans Kurumu, whose main shareholder is Prince Mohammed Al-Faisal Al-Saud of Dar Al-Mall Al-Islami Group. The third is Kuwait Turkish, which is half-owned by the Kuwait Finance House. The fourth is the Anadolu Finance Institution, which is wholly owned by Turkish individuals nationals.
The banking services offered by the Islamic banks in Turkey are generally similar to those of the conventional banks, but exclude the granting of loans or the acceptance of deposits at fixed or varying rates of interest.

The finance houses may also offer leasing facilities and carry out commodity trading. The finance houses offer three types of account: current, participation and special investment. Current accounts are payable on demand. These accounts are operated and recorded separately from all other accounts and the finance houses are also required to keep funds in local and foreign currency separate from each other.

The finance houses also accept deposits in the form of participation or profit and loss sharing accounts and invest the deposited funds on behalf of the depositors in economic sectors or projects whose operations conform to Shari'a principles (Boldwin 1990).

Despite the fact that the market share captured by the finance houses is steadily increasing, it appears that this is a result of these institutions offering financial products which appeal to customers, not as a result of direct competition with riba banks. According to Boldwin (1990, p. 56), "overall, the Islamic finance houses have shown that they operate successfully in a very competitive financial sector and that they complement rather than compete with conventional banks. The finance houses are obliged to act prudently to earn goodwill and customer loyalty and to maintain their good reputation.

3.3 DIFFERENT ACCOUNTING PRACTICES
The accounting practices of Islamic banks in most countries are partially regulated, as in Bahrain, Kuwait and Jordan. However, in spite of such regulation, significant accounting differences among Islamic banks can be observed. These accounting differences can be observed between Islamic banks operating in the same country (as in the case of a certain Middle Eastern country in which the Mohammed Bank, the Khalifa Bank and the Ahmed Bank all operate), and between banks that belong to the same group (such as the Ahmed Bank and the Sarah Bank). Accounting differences
can also be noted between Islamic banks operating in different jurisdictions, such as in the case of the Aysha Bank, the AbdulGhafoor Bank and Fatima Bank \(^{8}\). It is worth noting that the Mohammed Bank, the Khalifa Bank and Ahmed Bank all adhere to International Accounting Standards (IAS).

The differences in accounting practices were noted in reviewing the bank's financial reports and in some cases from interviews held with the banks' senior management, auditors and members of their SSB.

**The Following Section Highlights The Differences In The Accounting Practices Among Islamic Banks:**

3.3.1 Different Presentations of Financial Statements

_i) Financial Statements:_ Islamic banks differ in their presentation of Investment Account Holders’ Funds in their balance sheet, as some banks present them as a liability while others treat IAH as an “off balance sheet items “funds under management.” This difference is found between: 1) banks operating in the same country, such as the Mohammed Bank and the Ahmed Bank; 2) banks that belong to the same group, such as the Ahmed Bank and the Sarah Bank; as well as 3) banks belonging to different groups and operating in different countries, such as the AbdulGhafoor Bank and the Fatima Bank.

Every one of the above groupings has its own argument for its method of presentation. Banks that present IAH under the liabilities section of the balance sheet argue that this presentation fairly reflects the size of the balance sheet. They argue this, despite the fact that IAH represent no liability for the bank, i.e., the bank is not obliged to return on maturity the initial amounts of the invested funds in case of losses (except when the bank has violated the terms of the agreement or acted with gross negligence.) They also believe that Islamic banks have a moral obligation to invest these funds prudently.

---

\(^{8}\) These are fictitious names for a number of Islamic banks located in and outside of Bahrain.
The auditors of these banks have supported their clients' views in favour of reflecting IAH under the liabilities section of the balance sheet. This is because they believe that Islamic banks should be able to meet the demand of the IAH to withdraw their funds at any moment in time in order to preserve the bank's credibility in the market. Therefore, this presentation is considered a fair one since it is thought to truly reflect the financial position of the bank.

In this regard, some supervisory authorities, like those in Jordan and Egypt, have instructed their Islamic banks to reflect IAH in the liabilities section of the balance sheet.

It is expected that this presentation of IAH by such groups of banks may strengthen the claims of some supervisory authorities that Islamic banks should be treated similarly to conventional banks. Examples, are the calculation of the cash reserve requirements, and the gearing ratio (a ratio between the share capital and deposits).

Banks that treat IAH as funds under management claim that it is unfair to reflect IAH in the liabilities section of the balance sheet, as these funds represent no liability for the bank. Also, whilst the relationship that governs the bank and IAH is based on a Mudaraba contract, the relationship in the conventional bank is governed by fiduciary contracts. Under a Mudaraba contract, the Islamic Bank will not be entitled to receive any remuneration from the IAH unless a profit is made. However, under a fiduciary contract, the bank's management fees are normally collected regardless of whether the investments earned profits or losses, e.g., as a percentage of the value of the assets managed. The fiduciary relationship in conventional banks is similar to the agency contract that is also permissible in Islamic fiqh.

However, the Statement of concepts of financial accounting standards of Islamic banks and financial institutions issued by the Accounting and Auditing Standards Organization (AAOIFI) for Islamic Financial Institutions has come up with a reasonable treatment for both Restricted and Unrestricted Investment Account Holders (UIAH). It is stated that "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 restriction, including the Islamic bank's right to commingle those invested funds with its own investments in exchange for proportionate participation in profits and losses after the Islamic bank receives its share of profit as Mudarib" (para. 24, p. 42). "The relationship between the Islamic banks and holders of 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 UIA with owners equities. The Islamic bank also has the right to use those funds unconditionally and without any restrictions imposed by holders of UIA. Hence, UIAH 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" (para. 25, p. 42).

It is expected that this presentation may encourage some supervisory authorities that have not yet developed separate regulations for Islamic banks to reconsider their position.

On the other hand, according to the Statement of Concepts (para. 25, p. 42), "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 an unconditional right to use or dispose of these funds."

**ii) Income Statement:** Islamic banks differ in the way they present their income statement and in the types of information that they disclose in it. For example, the Mohammed Bank presents its income statement much as a conventional bank would, by reflecting all of the bank's expenses (and not distinguishing between the expenses to be borne by the shareholders and those to be borne by IAH).

The revenues represent the income generated from investing the shareholders' and IAH funds, as well as the bank's income from its other operations. It is also noted that the bank reflects the amount of profits allocated to IAH as an expense (i.e., a deduction in arriving at net profit).
Khalifa Bank reflects in its income statement only those expenses which are borne by the shareholders, such as operating expenses etc., while IAH bear those expenses which are directly related to their investments. The profit and loss account reflects only those expenses that are attributed to the shareholders and no information is shown about the expenses that are borne by IAH.

Ahmed Bank reflects in its income statement only those expenses and revenues that are related to the assets and liabilities of the bank, as well as the profits received by the bank, as Mudarib. However, the income statement reflects no information on the expenses and revenues related to the funds under management (IAH). Similarly, AbdulGhafoor Bank reflects in its income statement only those expenses and revenue that are attributed to the shareholders. The income statement, however, shows no information on the expenses that are borne by the IAH. The bank does not reflect in the income statement the profits attributed to IAH.

It can be observed from the above analysis that significant differences exist in the income statement among the above-mentioned Islamic banks, which effectively render their income statements non-comparable.

3.3.2 Differences in the Level of Information

In order for the financial statements to be clearly understandable and comparable, an adequate level of information needs to be disclosed by all banks (Islamic and non-Islamic). To achieve this objective, Islamic banks operating in countries like Bahrain, Kuwait and Jordan were required to comply with IASC standards (IASs). AbdulGhafoor Bank’s financial statements state that it complies with the IASs only if these standards do not violate the Shari’a (as required by the bank’s by-laws).

This section examines the differences in the level of information disclosed by Islamic banks in their financial reports, and the implications regarding the need for regulating the information that should be disclosed therein. For this purpose, the financial statements of a number of Islamic banks operating in Bahrain, Kuwait, Jordan and Sudan are reviewed.
It should be noted that although the disclosure of the bank's policy regarding the allocation of profits between shareholders and IAH is essential for users of financial statements, none of the financial statements of Islamic banks which have been reviewed discloses this information.

Unlike conventional banks, Islamic banks use different policies for the charging of expenses to IAH. For example, Khalifa Bank transfers some of the expenses (such as legal consultants' fees and the fees of the external auditors) to the Mudaraba pool, i.e. the pool consisting of the banks' own funds and those of UIAH. The expenses charged to the pool are deducted from the profits of the Mudaraba pool and are not shown on the income statement, whereas general expenses (e.g. staff salaries, rents, etc.) are borne only by shareholders and are therefore shown in the bank's income statement. The expenses charged to the restricted IAH are also not shown on the bank's income statement.

On the other hand, it was noted from private interviews held with Khalifa Bank, Ahmed Bank and AbdulGhafoor Bank, that all of them transfer the profits on investing excess current account funds, to their shareholders, on the grounds that shareholders of these banks guarantee the amounts placed on current account. However, none of these banks discloses such information, despite the fact that it is important to the shareholders.

3.3.3 Different Measurement Practices

i) Assets Valuation: Differences are noted between Aysha Bank, Mohammed Bank and Khalifa Bank in their accounting policies relating to real estate held for investment. Mohammed Bank uses the historical cost method, with provision for any decline other than temporary in value, where necessary (1996 audited accounts), while Khalifa Bank uses the lower of cost and market price (1996 audited accounts). Therefore, although Mohammed Bank and Khalifa Bank both adhere to IASs, each of them treats investment in real estate differently. However, the 1996 audited accounts of Aysha Bank states that, “investments in properties were re-appraised and any excess of appraised value over cost has been allocated between IAH and
shareholders.” In the latter bank, the shareholders’ share of unrealised profit is taken to the shareholder’s equity, while the IAH share of profit is shown on the liabilities side ‘under Mudaraba accounts’ as a revaluation reserve for IAH.

**ii) The Effect of the Accounting Policies on the Profits Paid to Shareholders and IAH:** Mohammed Bank uses the historical cost basis and creates a provision in case of permanent decline in the value of the real estate held for investment. The provision has up to the present time been borne entirely by shareholders, despite it being stated in the contract with the IAH that the bank can charge their share of the amounts of provisions to the IAH. Therefore, the profits of the shareholders will be particularly affected by the size of the provision.

Khalifa Bank re-values real estate held for investment on the basis of the lower of cost and market value. This method is more conservative than the historical cost because, if the value of real estate in the market is below its cost price, and even if the decline is not permanent, a provision will be created. Whereas, under the historical cost basis, the bank creates provisions only if the decline is permanent.

Khalifa Bank’s accounting policy is to charge provisions on real estate entirely to shareholders. Therefore, the level of provisions will not affect the profits allocated to IAH. It is worth noting that the Mudaraba contract between the bank and IAH is silent on the party that will bear the provisions.

Unlike the Mohammed and Khalifa Banks, Aysha Bank recognises appreciation on the value of the real estate by adopting the market selling price (“marking to market”). This is similar to the position adopted by AAOIFI in its first exposure draft of the statement of concepts (AAOIFI 1993), which states that "... equitable allocation of the results of unrestricted investments between the holders of UIA who have provided or withdrawn funds at different points of time during the lives of those investments, on the other hand, and between such account holders as a group and owners of the Islamic bank on the other hand" (AAOIFI 1993d, para. 92). "... 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 these investments. Likewise, inequities would occur in the distribution of unrestricted investment results between the holders of UIA as a group and owners of the Islamic bank" (para. 93).

Karim (1995) argued that AAOIFI changed its position on adopting the cash equivalent value to the historical cost basis because the latter has attracted strong resistance from some eminent Shari’a scholars. Furthermore, it is worth mentioning that the majority of Islamic banks represented in the AAOIFI’s Accounting Standard Board strongly rejected adopting the cash equivalent value approach. This would, after all, exert pressure on the banks to pay out a higher level of profits to the shareholders and IAH if the bank started recognising the unrealised gains in its income statement.

The accounting practices of Islamic banks and their basis in Islamic Shari’a are further analysed in the following chapter, in order to highlight matters relevant to the issue of the accounting regulation of Islamic banks.
CHAPTER 4
ACCOUNTING ISSUES: CONCEPTS AND PRACTICES IN
ISLAMIC BANKING

In addition to the accounting differences that have been highlighted in the previous chapter, this chapter intends to concentrate on some other accounting practices and, in particular, their juristic aspects. Prior to the development of accounting standards for Islamic banks, in some Islamic countries (e.g., Egypt, Kuwait and Bahrain) Islamic banks were required by their national supervisory bodies to adopt the International Accounting Standards (IAS). Similarly, Islamic banks in Malaysia are required to comply with the Malaysian Accounting Standards (Ahmed and Hamat, 1992), which are based on IAS. A survey was conducted by the researcher to highlight accounting differences between some Islamic Banks operating in Bahrain, namely Khalifa Bank, Mohammed Bank and Ahmed Bank (9).

The survey was carried out by conducting interviews with senior staff members that were responsible for setting accounting policies in each bank and with each bank's external auditors. The survey also included an examination of the annual reports of each bank.

The survey was extended to incorporate Islamic banks outside Bahrain, namely, the Jordan Islamic Bank (JIB), the Kuwait Finance House, the Faisal Islamic Bank of Sudan and Bank Islam Malaysia Berhad (BIMB). However, no interviews were conducted with the staff of the latter groups of banks and the survey was limited to an examination of their annual reports.

(9) These are fictitious names for a number of Islamic banks operating in Bahrain.
4.1 MURABAHA FINANCING

4.1.1 The Juristic Aspects of Murabaha Transactions

Under normal Murabaha, the bank buys the goods for the purpose of selling them without any promise or commitment to purchase made to the bank by a client. Another type of Murabaha financing, which is widely practised by almost all Islamic banks, is the Sale by Murabaha to the Purchase Order. This type of Murabaha usually involves more than two parties. For example, A will make a promise to B that he will buy from A certain type of goods at a pre-determined price. B will then order the goods from C on the basis of the promise made by A to buy the goods from B. B’s profit is the difference between the purchasing price and selling price. Islamic scholars have discussed whether this type of Murabaha involves a commitment by A to purchase the goods from B. Since Islamic banks follow different Shari’a rulings, some Islamic banks are of the opinion that the client is committed to meet his promise, whilst other Islamic banks adopt the Shari’a view and see no commitment on the client to meet his promise. Both Shari’a views are supported by prominent Shari’a scholars. Under both types of Murabaha financing the client will usually make the payment by instalments over the period of the contract.

Murabaha financing with a commitment to buy allows the bank to deduct from the amount paid by the client, as down payment, any damages the bank suffers following the client’s refusal to accept the goods. If the amount paid by the client is less than the amount of damages caused, the bank should treat such a difference as an account receivable. On the other hand, under Murabaha financing with no commitment to buy, the bank will have no right to recover from the down payment made by the client the damages it has suffered following the client’s refusal to accept the goods. In this case the bank cannot retain any of the down payment made by the client (AAOIFI (10), 1997).

---

(10) Accounting and Auditing Standards Organization for Islamic Financial Institutions.
This amount of down payment is different from hamish gedyyah which is also paid by the client but it is considered an obligation on the Islamic bank and shall be treated as a liability unless the Shari‘a supervisory board of the Islamic bank decides otherwise (Murabaha and Murabaha To The Purchase Orderer, AAOIFI 1996.)

**Murabaha** financing is legitimate only if it satisfies the following conditions (Karim and Abdullah 1995):

i) The seller should inform the buyer about the actual cost of the asset and his profit.

ii) The contract should not involve any element of *riba*.

iii) The bank should inform the client about any defect/damages of the goods in advance.

It is worth noting that all Islamic banks that have been surveyed have met the above conditions on the legitimacy of the *Mudabara*.

Since *Murabaha* entails a fixed, pre-determined, rate of return to the Islamic bank, arguments have been raised as to its similarity to conventional interest. Imtiaz (1994) claims that Islamic banks deal in goods and not documents and thus bear several risks. *Murabaha* financing is widely practised by Islamic banks since it has a relatively low risk (the only risk it carries is credit risk and, in some cases, cancellations risk) and the return is highly predictable.

However, due to the non-existence of an Islamic inter bank market, Islamic banks are compelled to maintain a higher level of liquidity than their conventional counterparts. This is one of the reasons why a large part of Islamic banks’ financing portfolio comprises short-term and relatively liquid *Murabaha* (Imtiaz, 1994).

The contract normally caters for the short-term financing requirements of clients through legitimate trading practices. Without the financing from the Islamic bank, it would not be possible for the client to undertake his trading activities to his required or planned level. In addition it caters for consumer credit and also for certain kinds of trade credit.
It has been noted that Islamic banks use different accounting treatments for profit recognition relating to Murabaha financing. The following highlights some of these accounting treatments as practised by some Islamic banks.

4.1.2 Recognition of Profit on Murabaha Financing

In profit-sharing (i.e. Mudaraba) contracts, the rules used for profit recognition affect the returns credited, in respect of such a contract, to Investment Account Holders the duration of whose investment differs from the duration of that contract. Consider, for example, a credit sale for an item that the bank acquires for US$10,000 and then sells on to its customer for US$12,000, to be paid in 24 monthly instalments of US$500. There are at least five different methods of profit recognition that may be applied. (Methods 1, 2, 3, and 5 are each used, or have been used, by at least one major Islamic bank.)

i) The gross profit of US$2000 is recognised when the customer takes delivery of the item.

ii) The gross profit of US$2,000 is recognised pro rata on the dates on which the monthly payment is due. That is, one-sixth or US$83.33 of each monthly payment is recognised as profit when it falls due.

iii) The gross profit of US$2,000 is recognised pro rata on the receipt of the monthly payment. That is, one-sixth or US$83.33 of each monthly payment is recognised as profit when it is received.

iv) The gross profit is recognised once the capital of US$10,000 has been recovered. That is, the final four payments of US$500 are treated as profit.

v) The gross profit is recognised once all the payments have been received (and the transaction is liquidated).

With methods 1, 4, and 5, an investor (IAH) who placed money in an investment account for 18 months starting (say) two months after the customer took delivery would receive no share of the profit. With methods 4 and 5, an investor who placed money in an
investment account for the last four months of the contract would receive a share of the profit proportionate to the time the funds had been invested, i.e., a 1/6th share. (Archer and Karim, 1997). It is worth noting that in addition to the five methods mentioned above, Faysal Islamic Bank of Bahrain uses the reducing method may either or similar to the ‘actuarial method’. Under this method as the balance of capital outstanding is reduced, so is the proportion of each installment recognised as income is reduced.

It is also important to note that the Jordan Islamic Bank practises method 1; all the Islamic banks in Bahrain employ method 2; and Bank Islam Malaysia Berhad uses method 3. The researcher is unaware of any Islamic bank using method 4, but method 5 is adopted by all banks in Sudan.

4.2 MUSHARAKA FINANCING

The origin of the word Musharaka is the Arabic root ‘Sharika’ to ‘share’. Musharaka is a participation in the project capital. Such participation may be in the capital of a joint venture or investment in a short-term financing. In Musharaka, the partner may or may not participate in the management of the project (Dorph, 1990).

4.2.1 There are two types of Musharaka Financing

i) Constant Musharaka: In this type of Musharaka financing, the shares of the partners in the capital will remain unchanged during the lifetime of the Musharaka.

ii) Declining Musharaka: In this type of Musharaka one of the partners agrees to sell his share in the Musharaka to the other partner by instalments.

4.2.2 The Juristic Conditions of Musharaka Financing

i) There must be acceptance of the terms, and an intention by the partners, to enter into a Musharaka financing agreement.

ii) The terms and conditions of the agreement should be clear.
iii) Each partner’s share of the capital should be paid up in money. However, some Islamic jurists, under certain conditions, allow partners to pay up their shares in the capital with non-monetary assets.

iv) The contract should clearly state the role that the management of the venture will undertake.

4.2.3 Profit Recognition on Constant Musharaka Transactions from the Shari’a Point of View

Shahatta (1995) stated that accounting treatments may be adopted on profit recognition:

i) The bank (Partner) may recognise the profit only when the contract is liquidated and the bank receives its capital back; or

ii) The bank (Partner) may re-value the Musharaka periodically.

Furthermore, Shahatta (1995) argues that most Islamic scholars state that no profits should be recognised before the capital is recovered. Therefore, in order to comply with this Shari’a opinion, undistributed profits should not be recognised by the bank as investor (Rab al Mall). Therefore, IAH will only receive their profits when the Musharaka is liquidated and the bank has recovered its capital.

4.2.4 The Profit Recognition on Declining Musharaka from Shari’a Point of Views

Some Islamic banks recognise profits on declining Musharaka when the deal is liquidated and the bank has recovered its initial investment.

The above accounting treatment is accepted from the Shari’a point of view since the majority of Islamic scholars have stressed that no profits should be recognised before liquidating the investment. Other Islamic jurists have allowed periodic re-valuation of the Musharaka, because they believe IAH may receive their share of profits before the capital is recovered.
4.2.5 The Accounting Treatments of Musharaka Transactions as Practised by Islamic Banks

Khalifa Bank and Mohammed Bank use the declining Musharaka. They use Musharaka to acquire a building with another partner. The share of the bank in the Musharaka declines gradually while the share of the other partner increases. The payment made by the client to acquire the bank’s share in the Musharaka includes part of the initial investment and part of the profit. The bank measures its share in the Musharaka at cost since it has no control over the management of the Musharaka. Both banks adopt IAS25, which states that "Long-term investments are usually carried at cost. However, when there is a decline, other than temporary, in the value of a long-term investment, the carrying amount is reduced to recognise the decline."

Ahmed Bank applies the constant Musharaka, which involves entering into a contract with another partner through participating jointly in a specific project. The share of the partners in the Musharaka remains unchanged until the partners decide to liquidate the joint venture or sell it to a new investor. However, before transferring the ownership of the Musharaka to the new investor, the latter should promise to pay a certain amount to the old partners of the Musharaka either immediately or through deferred instalments.

Although the bank’s participation in the Musharaka is usually not less than 50 per cent, and it exercises management control, it treats its share in the Musharaka as an investment in an associated entity and uses the equity method to recognise its share in the Musharaka.

4.2.6 The effect of the Musharaka Accounting Policies on Profit Allocation to IAH

The profit allocated to IAH depends upon the accounting policies used for Musharaka financing. As stated above, some Islamic banks like the Khalifa Bank and the Mohammed Bank, measure their share in Musharaka at cost, while Musharaka profit is not recognised in the income statement until a right to receive payment is established. They claim that these accounting treatment is in line with IAS18. IAH who terminate
their relationship with the bank before the bank receives the profit or obtains the right to receive the payment may not receive a proportionate return on the investment financed by their funds, but may receive a share of the return on an investment financed by other IAH funds received in the past.

Ahmed Bank uses the equity method to recognise its share in the Constant Musharaka. Adopting this accounting treatment allows the bank to recognise its share of the profit when the partners in the Musharaka declare quarterly the result of the Musharaka. Therefore, IAH who terminate their relationship with the bank before the partners declare the result of the Musharaka may not receive a proportionate return on the investment financed by their funds, but may receive a share of the return on an investment financed by other I.A.H funds received in the past. However, if the assets of the Musharaka are of a type whereby a periodical return is received (e.g., property), such an effect is mitigated.

4.3 MUDARABA FINANCING

4.3.1 The Juristic Aspects of Mudaraba Transactions

Mudaraba is an agreement between the Rab al Mall (the bank) and the Mudarib (client), in which the bank as a provider of funds agrees to finance the Mudarib with a certain amount of money, the purpose being to invest it in an activity stipulated in the Mudaraba agreement. The capital should be provided in cash. However, it is considered permissible by some jurists that the capital of a Mudaraba be provided in the form of trading assets (e.g., inventory). At the time of contracting, the value of such assets or their historical cost will be considered as the Mudaraba capital.

It is important to mention that such a Mudaraba contract is reflected in the assets section of the bank’s balance sheet. However, in the Mudaraba contract (that is presented on the bank’s balance sheet between the liability section and owners’ equity AAOIFI 1993), the bank plays the role of the Mudarib and IAH play the role of Rab al Mall.
4.3.2 The Capital Terms and Conditions

i) The capital should be known to both parties.

ii) The capital cannot be in the form of a debt (due from a third party or the Mudarib).

iii) The share of both the capital provider (Rab al Mall) and the Mudarib in the profits must be specified.

iv) The share of both the capital provider and the Mudarib in the profits should be proportional, for it cannot be specified as a specific sum.

v) The capital provider should bear any financial loss in full, while the Mudarib loses only his effort.

4.3.3 The Profit Terms and Conditions

i) The profits should only be shared between Rab al Mall and the Mudarib.

ii) The profit shares are determined as percentages of the profits, or percentage of the capital.

iii) The losses incurred should be borne by Rab al Mall provided the loss is not due to the misconduct or negligence of the Mudarib.

4.3.4 Rulings Pertaining to Profit

i) Recognition of Profit: This takes place at the time at which it can be established that profit is achieved in a Mudaraba. According to the Islamic Fiqh Academy, “profits are due when realised by declaration or re-evaluation and become payable only upon distribution” (11).

(11) Islamic Fiqh Academy resolution No. 5 para. 7, issued in respect of Muqaradah bonds and investment certificates in the fourth session of the Academy held in Jeddah during the 18-23 Jumada 11, 1408H corresponding to 6-11 February 1988.
**ii) Entitlement to Profit:** Hanafis \(^{(12)}\), and some Shafis, say that profit should be recognised on a realisation basis, whereas the Malikis, and some Hanabalis, believe that profit should be recognised only when it is distributed between the two parties, i.e., on a cash basis (*Mudaraba Standard*, AAOIFI 1996).

### 4.3.5 Ruling Pertaining to Losses

1. **Net losses at the time of winding up the Mudaraba** are considered as a decrease in the *Mudaraba* capital, and the Mudarib is required to return the balance to Rab al Mall.
2. **Periodic losses in the Mudaraba** shall be set off against previously earned profits.
3. **Losses that cannot be set off against undistributed profit** in the case of a continuing *Mudaraba* shall be held in suspense until profits are realised hereafter.

### 4.3.6 The Two Types of Mudaraba

1. **Unrestricted Mudaraba:** Unrestricted *Mudaraba* refers to funds received by the Mudarib from the Rab al Mall on the basis that the Mudarib will have the right to use and invest those funds without restrictions. This includes the Mudarib’s right to commingle those invested funds with its own investment for proportionate participation in profits and losses after the Mudarib receives its share of profit as Mudarib (*Mudaraba Standard*, AAOIFI, 1996).

2. **Restricted Mudaraba:** Restricted *Mudaraba* refers to funds received by the Mudarib from the Rab al Mall on the basis that the Mudarib should follow the Rab al Mall’s instructions on matters such as the type of investment, the level of risk and the commingling of its own investment with the Mudarib funds (*Mudaraba Standard*, AAOIFI, 1996).

---

\(^{(12)}\) The Four Sunni Schools of Islamic Law are Shafis, Malikis, Hanafis and Hanbalis, see Wael Hallaq, “A History Islamic Legal Theories” published, 1988.
4.3.7 The Accounting Treatment of Mudaraba Financing where the Islamic Bank Plays the Role of Rab al Mall

Ahmed Bank uses this type of Mudaraba contract to provide its clients with the required funds to be invested in a certain asset or project. In this case Ahmed Bank plays the role of Rab al Mall and the client is the Mudarib. The Mudaraba financing appears in the bank's balance sheet as an asset. The parties to the Mudaraba must agree on the ratio of allocation of profit before any business is undertaken. The bank's share is measured at cost at the end of a financial period and any appreciation in the value of the bank's share is not recognised. In the case of a permanent decline in the value of the bank's share a provision is created against such decline and the bank's balance sheet will reflect the net amount after deducting the provision. The bank recognises its share in the profits of the Mudaraba only when they are distributed or declared as distributable by the Mudarib (client). This type of Mudaraba contract is different from the other type of Mudaraba contract where the IAH places its funds with the bank where the IAH plays the role of Rab al Mall and the bank acts as Mudarib. Under the latter type of Mudaraba contract, the IAH funds appears in the liability section of the balance sheet.

Khalifa Bank offers two types of Mudaraba financing. Namely, (a) General Mudaraba, and (b) Specific Mudaraba.

Specific Mudaraba involves an amount of money provided by Khalifa Bank (Rab al Mall) to another bank (Mudarib) to manage funds on behalf of Khalifa Bank. Khalifa Bank must know the type of investment involved. Usually, Khalifa Bank treats an investment as Specific Mudaraba when it participates in a large syndication and the bank's (Khalifa Bank) share of the profit can be determined.

Khalifa Bank's balance sheet reflects the initial amount of the Mudaraba financing plus its annual share of the profit. Since the bank's share of the profit can be determined it uses the accrual basis to recognise its share of the profit on a pro rata basis.
In the General Mudaraba, Khalifa Bank provides an amount of money to be used by the client for a certain investment specified in the agreement. Usually, the bank will use the cost method to recognise its share of the investment. Since the bank's share of profit cannot be determined, it recognises its profit when it is received or agreed between the bank and the client.

4.3.8 The Effect of the above Accounting Treatment on IAH

As stated above, Ahmed Bank recognises its share of profit of the Mudaraba only when distributed or declared as distributable by the Mudarib (client). Therefore, IAH who terminate their relationship with the bank before the profit is received or declared by the Mudarib may not receive a proportionate return on the investment financed by their funds. However, they may receive a share of the return on an investment financed by IAH funds received in the past. However, if the assets of the Mudaraba are of a type whereby a periodic return is received (e.g., property) such an effect is mitigated.

In any event, Khalifa Bank recognises its share of the profit of the Specific Mudaraba when the instalment is due (accrual basis). This accounting method is intended to match the revenue with expenses and provide the IAH with a share of the profit before they terminate their relationship with the bank. This accounting method has been criticised for two reasons:

i) It represents a violation of Shari'a principles in the opinion of some Islamic scholars who state that "the sharing of profit before the capital is recovered is not valid."

ii) If any loss occurs it may be related to a transaction that occurred in the past. It should therefore be borne by investors who were IAH at that time some of whom have terminated their relationship with the bank. At the same time this accounting treatment may be unfair for future IAH who will bear losses that are related to transactions that occurred in the past before become IAH.
On the other hand, Khalifa Bank uses the cost method to measure its share in the General Mudaraba, and it recognises its share of the profit when the profit is received or agreed between the bank and the client. Therefore, IAH who terminate their relationship with the bank before the profit is received or agreed between the bank and the client may not receive a proportionate return on the investment financed by their funds. They may, however, receive a share of the return on an investment financed by IAH funds received in the past.

4.4 PROFIT ALLOCATION

In Islamic banks there are various factors that affect the allocation of profits, which include the following:

4.4.1 Rate of Investment

In most Islamic banks the sources of funds include shareholders’ equity, investment accounts holders, saving accounts and current accounts. The bank’s rate of investment is the amount available for investment (i.e., that not required to be held in liquid form without any remuneration.) This rate varies from one bank to another and from one type of account to another.

In determining the rate of investment, some Islamic banks (e.g., Mohammed Bank) take into consideration the level of liquidity to be maintained on each type of account to meet investors’ withdrawals. The level of liquidity is influenced by the liquidity requirements imposed by the regulatory agencies on Islamic banks. These requirements include the cash reserve maintained with the central bank, the maturing period of the investor’s funds (e.g., an investor’s accounts for a period exceeding one year would require a lower liquidity percentage, while savings accounts would require a higher liquidity percentage because holders of these accounts have the right to withdraw them at any time), and the withdrawal behaviour of the investors.
Mohammed Bank maintains different liquidity ratios based on the maturity period of the investor's funds. For example, in the case of savings accounts the bank invests only 50 per cent for the benefit of the investors, while the remaining 50 per cent will be considered to be held for liquidity purposes. Any profit generated on investing the amount ‘for liquidity’ will be for the benefit of the shareholders. The bank’s contract states that Investors are entitled to at least 75 per cent of the profits earned on their funds after deducting 10 per cent for provisions. The bank’s share as *Mudarib* is the remaining 25 per cent. Mohammed Bank would invest around 95 per cent of the funds deposited in investment certificates since the maturity period of such accounts is more than a year.

However, other Islamic banks use different liquidity systems. For example, Khalifa Bank invests 100 per cent of the investor’s funds maintained with the bank. No percentage is deducted from the investor’s funds for liquidity purposes. The bank’s strategy is to use the current accounts as the liquidity cushion for satisfying unexpected withdrawals in investment accounts. This tends to have implications for the investment of the balances in current accounts which are expected not to be withdrawn within a certain period. This is because any returns earned on the current accounts are for the benefit of shareholders since they guarantee these accounts.

Furthermore, Ahmed Bank treats investment accounts as funds under management and the bank maintains separate liquidity ratios for each of its funds. The bank invests at least 20 per cent of the fund’s assets in short-term investments. Any profits earned on these funds belong to IAH after deducting any direct expenses related to the fund, a fixed percentage as contribution to the reserve fund, and the bank’s share as *Mudarib*. The level of liquidity may vary depending on the investors’ withdrawal behaviour and the maturity period of the investors’ accounts. The bank’s current accounts are shown on the balance sheet as a liability. These accounts are guaranteed by the shareholders, therefore, any returns generated on them are for the benefit of the shareholders. The bank invests only 10 per cent of its current accounts, with 90 per cent being held as liquidity reserves.
It is worth noting that some Islamic banks allow IAH to receive part of the profits earned on investing the surplus funds of current accounts, as in the case of Kuwait Finance House (KPH), according to Karim (1995) that this is done either by way of donation from the shareholders' share or it is known to the I.A.H at the time of contracting that they will participate in the profits of investing the surplus of current accounts in return for their participation in compensating the holders of current account in the event of loss.

4.4.2 Rate of Profit Allocation

According to the rules of the Mudaraba contract, the profit allocation ratio between the Rab al Mall and the Mudarib should be specified. However, any loss is solely borne by the Rab al Mall. The Shari'a stipulates that profits to be earned by both parties to the Mudaraba contract should be specified as a percentage of the profits earned on investing the IAH's funds. In case the percentage of profit sharing is revised in the future, the Mudarib should notify the IAH about the amendment in advance (Karim 1995). In this regard, Faisal Islamic Bank of Sudan states that amendment of the terms governing the Mudaraba contract is possible at any time whether with respect to the percentage in which profits will be shared or otherwise, since this alteration will only take place with the consent of both parties and provided that the newly added term is within the accepted Shari'a rules. This will then be valid even if it was not contained in the original contract.

If the bank is of the opinion that there is some benefit in including a term in the Mudaraba contract that allows for reassessment of the share of the profits at the end of each operation or at the end of each year with the consent of the parties to the contract then that is possible and there is no uncertainty about this. Alteration of the percentage of profits in the Mudaraba contract can be effected with the consent of the parties even before the end of the operation.
Khalifa Bank agrees with the Unrestricted Investment Account Holders (UIAH) on a 20 per cent *Mudarib* rate on their profits, while it charges different rates on restricted investment accounts (3-15 per cent). The bank claims that, generally, the amount of funds placed with the bank under restricted investment accounts are larger than those placed under unrestricted investment accounts. This suggests that the bank had adopted a strategy of attracting more funds to be placed under restricted investment funds by charging them lower *Mudarib* rates compared with the rates charged on unrestricted investment accounts. The bank’s financial statements make no reference to the actual *Mudarib* rate received by the bank.

On the other hand, Mohammed Bank’s contract document makes no reference to the percentage charged as *Mudarib* rate. Therefore, the bank has full discretion to decide on its *Mudarib* rate. This does not comply with the Shari‘a ruling which requires that the *Mudarib* rate should be known in advance to *Rab al Mall* (IAH). The bank claimed that the *Mudarib* rates differ from one account to another. The bank’s financial statements make no reference to the actual *Mudarib* rate received by the bank.

### 4.4.3 Revenues and Expenses

Khalifa Bank divides the expenses and revenue between shareholders and Unrestricted Investment Account Holders. The shareholders bear 50 per cent of the overall expenses excluding staffing costs. The latter is borne by the shareholders alone. Any specific provisions in respect of unrestricted investment accounts are borne by the shareholders.

In return, the shareholders receive profits earned on their own funds as well as the bank’s share as *Mudarib*. In addition, shareholders are entitled to receive income generated from providing normal banking services, such as custody services, and from investing of surplus funds in current accounts, etc.
Unrestricted investment accounts are entitled to the return on their investments after deducting 50 per cent of all expenses (excluding the staffing costs which are borne by the shareholders), 5 per cent as a general provision, and 20 per cent as the bank's share as Mudarib. The bank does not disclose information in its financial statements on profit allocation. The bank's income statement (13) does not reflect the bank's share of profit as Mudarib.

Unlike unrestricted investment accounts, where the bank has the discretion to select the appropriate investment opportunities on behalf of these investors, in the case of restricted investment accounts the bank is obliged to follow the instructions of the account holders in selecting a suitable investment. The bank is entitled to a percentage of the profit as its Mudarib fee, which is shown in the income statement under the bank's share as Mudarib.

Unlike unrestricted investment accounts, where 50 per cent (excluding staffing costs) of the bank's expenses are borne by the account holders, no expenses are borne by the restricted investment accounts. It is worth noting, however, that in the income statement the bank's share as Mudarib received from profits relating to unrestricted investment accounts is not separated from that which relates to restricted investment accounts.

Mohammed Bank allows IAH and shareholders to participate jointly in the revenues and expenses of the bank, except profits earned on investments financed exclusively from current accounts and the bank as Mudarib. The latter types of return belong to the shareholders only. The financial statements make no reference to the bank's policy on profit allocation.

(13) This analysis was carried out on the bank's financial statements from 1991 audited accounts to 1996.
Ahmed Bank separates the expenses and revenue of the bank from the expenses of the IAH. The bank’s corporate books show its own balance sheet and income statement. The balance sheet reflects the assets of the bank that have been financed by the shareholders equity, the current accounts, and other liabilities. This does not include funds received from IAH as these are treated as funds under management. However, the income statement reflects the revenue earned on the bank’s assets, the bank’s Mudarib share which it earns for managing IAH funds, and revenue from providing banking services, etc. The expenses represent those that relate to the bank’s own assets such as provisions, bank operating expenses, etc. However, the bank maintains an income statement for each fund it manages.

4.4.4 Prudential Reserves (Provisioning Policy)

In conventional banks, it is usually the practice that at the end of the financial year the management of the bank, in consultation with their auditors, determines the amount of provisions to be charged to the profit and loss account. In Islamic banks, the provisioning policy tends to differ from one bank to another. For example, Khalifa Bank charges what it calls a general provision to unrestricted investment accounts by deducting 10 per cent from their profits. Any specific provisions are charged to the shareholders. The bank’s provisioning policy is not clearly stated in the bank’s financial statements. It is worth noting that no provisions are deducted from the profits of the restricted Investment Account Holders. This provisioning policy was endorsed by the bank’s SSB (Shari’a Supervisory Board).

Before the deduction of the Mudarib share, Mohammed Bank sets aside 10 per cent of the IAH profits to create what it calls a provision “to meet any potential losses on the bank’s investments.” Although it is clearly stated in the contract with IAH that the bank has the right to deduct 10 per cent of the investor’s (IAH) profits as ‘general provisions’, the bank has thus far not exercised this right.
As stated above, the Khalifa Bank and the Mohammed Bank create what they call 'provisions' from the deduction made on the investor's net profits and they are not charged to the bank's profit and loss account. This suggests that these are reserves rather than provisions.

Ahmed Bank creates a reserve for each fund it manages by deducting a certain percentage from the profits of the fund. This is primarily used to cover future potential losses, and in case of a decline in the investor's profits. The bank may use it to cover such a shortfall. If the fund does not generate what the bank considers to be sufficient profits on its managed funds, any shortfall in the amounts required for the reserve fund will be borne by the bank and is considered to be a donation to the fund. The reserves maintained by the bank for each fund are not shown in the bank's financial statements. Furthermore, the bank creates provisions to cater for a permanent decline in the value of its own assets as well as for its own non-performing assets. Such provisions are disclosed in the bank's financial statements. The bank creates its own reserves, which are appropriated out of the bank's net profits. In its audited financial statements the bank discloses the amounts provided by the shareholders' funds.

The above suggests that Mohammed Bank does not allocate (what it calls) provisions between shareholders and IAH, but in practice charges them entirely against the shareholders' share of the profits. The bank reflects the outstanding amounts of provisions in the balance sheet. Khalifa Bank, on the other hand, allocates provisions on investments financed by IAH (both Restricted and Unrestricted Investment Account Holders) against the unrestricted account holders' share of the profits. Ahmed Bank also allocates the reserves maintained on its managed funds on investments financed by IAH (restricted and Unrestricted Investment Account Holders) in this way.

The financial statements of Khalifa Bank reflect the amounts of provisions, while the Ahmed Bank's financial statements do not include the reserve fund (prudential reserves) created on those investments financed by IAH, but reflect only the provisions created
against the bank's own assets. It is worth noting that both Mohammed Bank and Khalifa Bank refer to the amounts deducted from the profits of the IAH as provision, which, according to IAS 30, is a reserve. A provision is an asset valuation account whereas a reserve is an appropriation of profit.

4.5 INVESTMENT VALUATION

As already noted, Islamic banks accept funds from Investment Account Holders (IAH) on the basis of the Mudaraba contract either on a discretionary (unrestricted) or a non-discretionary (restricted) basis. The profits earned on such investments should be paid to IAH after deducting other expenses relating to the investment, and the result of the profit is shared between the bank (as Mudarib) and IAH. Based on the contractual relationship between the bank and Investment Account Holders, the bank should pay to Investment Account Holders the amount earned on their investments subject to various deductions as discussed above. The amounts paid to IAH could certainly be affected by the accounting treatments applied to its investments. For example, assuming that the bank uses the asset revaluation method, if the value of the assets increases it may allow the bank to allocate higher profits to IAH. If there is a decline in the value of the asset the IAH may receive lower profits or may lose their investments altogether. This suggests that the bank's profits and the profits paid to IAH will fluctuate from one financial year to another, based on the result of the valuation of the assets and also variations in the income earned on those assets.

This matter was discussed by AAOIFI (Statement of Concepts, 1993). AAOIFI decided that asset revaluation would be the ideal solution in order to measure the real value of the investments. However, for the present, Islamic banks were recommended to apply the historical cost basis. This would not, though, prevent banks from presenting supplementary information based on the revaluation method in order to assist the user of their financial reports in their economic decision making.
4.6 THE SHARI'A SUPERVISORY BOARD

The main purpose for establishing Islamic banks is to allow Muslims to conduct their financial transactions in accordance with Shari'a precepts. In order to give credibility and to satisfy the ethical expectations of their customers, the majority of Islamic banks have developed a control process in the form of in-house religious advisers, commonly called the Shari'a Supervisory Board (SSB). The membership of the SSB is drawn exclusively from very knowledgeable Shari'a Scholars (Gambling et al, 1993).

The members of the SSB are supposed to be appointed by the bank's shareholders. They have the right to attend the annual general meeting of the bank, and perform all or some of the following duties (Karim, 1990):

1- Design and approve the bank's contracts for its basic activities and issue religious rulings in response to requests by the staff.
2- Advise the external auditors and the management of the bank on the accounting treatments which require departure from generally accepted accounting principles in order to comply with Shari'a precepts.
3- Ensure that the bank's practices conform to the spirit as well as the letter of Islamic teaching.
4- Prepare a religious [compliance] report which is regarded as part of the annual report, in which it [attests as to] whether the bank's operations are in conformity with the Shari'a.

Briston and Al-Asliker (1986) claim that the functions of a SSB, which are usually spelt out in the articles of association of the bank, lie in three main areas. These are ex ante compliance (e.g., the checking of contracts in advance of their use), ex post compliance (e.g., checking that the approved forms of contracts or transactions have been used or observed), and the calculation of Zakah. Karim (1990b) claims that the SSB is involved in determining the income that should be distributed amongst the bank's shareholders and
Investment Account Holders. SSB also advises the bank on the expenses that the former must bear alone and on those which the latter can share.

Unlike external auditors, members of the SSB may be employees of the bank and on its payroll. However, the SSB has a right of access to any source of information and, at the end of the financial year, it issues a special report that is published with the external auditor's annual report. The SSB religious [compliance] report in which it [attests as to] whether the bank's operations are in conformity with the Shari'a. It also states whether or not SSB members had access to all the documents and records that they deemed necessary to carry out their duties. Such a report is meant to give credibility to the information in the financial statements from a religious perspective.

Karim (1990b) claims that it is not mandatory that each bank should have its own SSB. This is because an SSB is perceived as a control process developed voluntarily by Islamic banks to satisfy the moral expectation of their customers.

However, in certain countries (such as the United Arab Emirates and Malaysia) it is a legal requirement for Islamic banks to establish an SSB. The Malaysian Islamic Banking Act (1983) states that "the Central Bank shall not recommend the grant of a license, and the Minister shall not grant a license, unless the Central Bank or the Minister, as the case may be, is satisfied that there is, in the articles of association of the bank concerned, provision for the establishment of a Shari'a Supervisory Board to advise the bank on the operations of its banking business in order to ensure that they do not involve any element which is not approved by the Religion of Islam."

64
The accounting practices of the surveyed Islamic banks tend to suggest that they have great freedom in choosing their accounting policies. This possibility will be analysed in the next chapter by reference to the case studies. This will enable us to identify the potential consequences of more effective regulation and the extent to which regulation may be considered beneficial both to the users of the financial statements and to the banks themselves.
CHAPTER 5
RESEARCH OBJECTIVES AND METHODOLOGY

5.1 OBJECTIVES OF THE EMPIRICAL STUDY
As was noted in chapter 1, this thesis examines and analyses certain accounting practices of Islamic banks in Bahrain during the early to mid 1990s, with a view to determining the degree of comparability of their financial statements, and the extent to which the accounting standards to which some of them were subject were effective from the standpoint of the comparability of their financial statements. The accounting standards in question were the International Accounting Standards (IASs) issued by the International Accounting Standards Committee (IASC). While one of these (IAS 30) is a disclosure standard for banks, neither it nor other IASs applied by Islamic banks in Bahrain had been drafted so as to deal with the specificities of the financial instruments used by Islamic banks and the contents of their financial statements. The effectiveness of such accounting standards in the context of the financial reporting of Islamic banks is therefore an important issue, unless one takes the view that accounting regulation is unnecessary since market forces and private contracting are sufficient (Watts and Zimmerman, 1986). This question is discussed in chapter 2 of this thesis, where the arguments that market forces and private contracting cannot be relied upon to result in adequate financial reporting are accepted as persuasive.

In the light of conclusions regarding the degree of comparability of their financial statements and effectiveness of IASs for the accounting regulation of Islamic banks, the objective of the thesis is then to evaluate the potential contribution of a set of accounting standards specifically drafted for Islamic banks, namely those issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

5.2 RESEARCH METHODOLOGY
A review of the literature on accounting regulation was carried out in order to develop a broad theoretical proposition to guide the research. This would provide an understanding the advantages and disadvantages of regulation and enable one to gain
an initial insight into their relevance for Islamic banking. According to Hussey and Hussey (1997, p. 87) “The literature review is a written summary of the findings from literature search. It is an important part of any research activity and should provide the background to and justification for the research project.”

### 5.2.1 Pilot Survey

A pilot survey was conducted on the accounting practices of some Islamic banks in order to establish the similarities, differences and level of disclosure among Islamic banks operating in different countries and which are subject to different accounting regulations. For this purpose, three banks were selected from Bahrain and one Islamic bank from each of Kuwait, Jordan, Malaysia and Sudan.

The above countries were selected because Islamic banks in Bahrain and Kuwait are required to adhere to IAS. In Jordan, the financial statement of Jordan Islamic Bank (which was the only Islamic bank in Jordan until 1996), state that it complies with IAS only if these standards do not violate the *Shari'a* (as required by the bank’s by-laws). In Malaysia, all banks, including Bank Islam Malaysia Berhad, are required to comply with the Malaysian Accounting Standards, which are based on IAS. In Sudan, all banking systems have been Islamized and banks are required to adopt the IAS. However, the inclusion of Sudan in the survey was because of the strong intervention of the *Shari'a* in the accounting practices of the banks there, which was as a result of the Islamization of the banking sector.

The survey of Islamic banks operating outside Bahrain was limited to examining their financial statements for the 1996 financial year because the survey of these banks was intended to compare the similarities and differences and level of disclosure based on their audited accounts.

The survey of the Bahrain banks was intended to find out the similarities, differences and level of disclosure, comparing the Islamic banks in Bahrain and those that operate outside Bahrain. In addition, analyses were conducted on the three banks operating in Bahrain to find out the similarities, differences and level of disclosure among them despite the fact that they are subject to the same accounting regulation. Therefore,
carrying out this exercise requires one not only to analyse the bank’s financial statements (from 1991 to 1996) but also to review their contracts with IAH and the memorandum and articles of association of the three banks.

Interviews were also held with the senior management of the three Bahrain banks to ask them about their accounting treatments and disclosures of specific issues (e.g. provisions, disclosure of the basis of profit allocation between IAH and shareholders.) (enclosed as appendix 1, is the positions of the persons interviewed from Ahmed Bank, Mohammed Bank and Khalifa Bank.) To check on the information received from the senior management of the banks, more than one interview was held with them. If more clarifications were needed, discussions with the bank’s auditors were held, in the case of an accounting matter, and with the SSB when the point related to Shari‘a.

Furthermore, to avoid misunderstanding and to ensure accuracy of information provided, each bank was invited to comment on the part written in the thesis related to that bank. It is worth noting that the analysis of Islamic banks operating outside Bahrain was limited to examining their financial statements.

In order to gain a deeper understanding of the accounting differences and level of disclosure that existed among Islamic banks operating in the same country, and which were subject to the same regulations by adhering to IAS standards, an in-depth analysis of the accounting policies adopted by Islamic banks was required.

To achieve the above, it was decided to use the case study method to study in greater depth two Islamic banks operating in Bahrain. Given the lack of available research on the accounting practices of Islamic banks, it was decided that the case study method was the appropriate tool for this purpose. This is particularly so since very little information on accounting policies is disclosed in the annual reports of Islamic banks as was apparent from the pilot survey.
Hussey and Hussey (1997) identifies the following characteristics of case study research:

- The research aims not only to explore certain phenomena, but to understand them within a particular context;
- The research does not commence with a set of questions and notions about the limits within which the study will take place; and
- The research uses multiple methods for collecting data, which may be both qualitative and quantitative.

5.2.2 Advantages of the use of Case Studies

The case study approach is supported by Yin (1983, p. 1) who argued that “case studies are the preferred strategy when ‘how’ or ‘why’ questions are being posed, when the investigator has little control over events, and when the focus is on a contemporary phenomenon within some real-life context.” Yin (1983, pp. 3-4) also argued that “the case study has been a common research strategy in psychology, sociology, political science, business, social work, and planning.”

Quoted in Yin (1994, p. 6) Lupo et al, (1971) stated that “how” and “why” questions call for explanatory answers which may benefit from the adoption of case studies. This is because such questions deal with operational links needing to be traced over time, rather than mere frequencies or incidence.

The case study is preferred in examining contemporary events, when the relevant behaviour cannot be manipulated. The case study relies on many of the same techniques as a historian, but it adds two sources of evidence not usually included in the historian’s repertoire: direct observation and systematic interviewing. Again, although case studies and histories can overlap, the case study’s unique strength is its ability to deal with a full variety of evidence - documents, artifacts, interviews, and observations-beyond what might be available in a conventional historical study (14).

(14) This and the following section draw heavily from Yin (1994) chapters 1 and 2.
Furthermore, the essence of a case study, the central tendency among all types of case study, is that it tries to illuminate a decision or set decisions, why they were taken, how they were implemented, and with what result (Schramm, 1971).

5.2.3 Limitations of the use of the Case Studies

Yin (1994, p.9) argued that “Although the case study is a distinctive form of empirical inquiry, many research investigators have disdain for the strategy. To put it another way, as a research endeavour, case studies have always been viewed as a less than desirable form of inquiry than either experiments or surveys. Perhaps the greatest concern has been over the lack of rigour of case study research. Too many times, the case study investigator is accused for being sloppy and to have allowed equivocal evidence or biased views to influence the direction of the findings and conclusions.”

The possibility also exists that people have confused case study teaching with case study research. In teaching, case study materials may be deliberately altered to demonstrate a particular point more effectively. In research such a step would be strictly forbidden. Every case study investigator must work hard to report all evidence fairly. Bias can also enter into the conduct of experiments (Rosenthal, 1966) and the use of other research strategies, such as designing questionnaires for surveys (Sudman & Bradburn, 1982) or conducting historical research (Gottschalk, 1968). The problems are not different, but, in case study research, they may have been more frequently encountered and less frequently overcome.

Quoted in (Yin 1994, p. 10) Kennedy, (1976) stated that another limitation of the case study method is that case studies provide limited basis for scientific generalization.

Quoted in Yin (1994, p.10) Lipset et al (1956) argued that “Case study, like the experiment, does not represent a 'sample', and the investigator's goal is to expand to generalized theories (analytic generalization) and not to enumerate frequencies (statistical generalization). Or, as three notable scientists describe in their single case study, the goal is to do a 'generalizing' and not a 'particularizing' analysis.”
Quoted also in Yin (1994, p. 10) Freagin et al (1991) claimed that “case studies take too long, and they result in massive, unreadable documents. This complaint may be appropriate, given the way case studies have been done in the past, but this is not necessarily applicable to case studies done in the future.”

5.2.4 Selection of the Case Studies

From the three Islamic banks operating in Bahrain, two of them were selected for the case studies. The reason for choosing Ahmed Bank and Mohammed Bank and not Khalifa Bank is because each of the first two is in contrast to each other as indicated in the case studies e.g. Mohammed Bank reflects IAH in the liability section of the balance sheet, while Ahmed Bank reflects IAH as off balance sheet under funds under management. Khalifa Bank, on the other hand, treats IAH similarly to the accounting treatments of Mohammed Bank e.g. Khalifa Bank also reflects IAH in the liability section of the balance sheet.

Moreover, conducting two case studies rather than one case study will provide better understanding of the accounting policies of Islamic banks and will strengthen the argument as to whether there is a need to regulate the accounting practices of Islamic banks by a set of accounting standards other than IAS.

One of the selected Islamic banks, Ahmed Bank, treats IAH as funds under management, offers higher risk investment with higher return, while the other selected Islamic bank, Mohammed Bank, treats IAH in the liability section of the balance sheet and offers lower risk investments with lower return. The role of the SSB in the two banks is also different and both of them claim that they follow IAS as required by their supervisory body. Furthermore, while Ahmed Bank is part of a larger group operating in number of countries, Mohammed Bank is a smaller bank with no presence outside Bahrain. These different characteristics of the two banks provide a good opportunity to study their despite their claim of adhering to the same set of accounting standards, IAS.
It is to be noted that the use of multiple case studies in research is supported by numerous authors. For example, Frestone & Herriott (1983) claims that the evidence from multiple cases is usually believed to be more compelling, and the overall study is therefore regarded as being more robust.

The research uses “embedded case studies” by conducting cross sectional comparison between the two banks rather than taking each case study separately. Furthermore, since the case studies mainly focused on the accounting treatments of the bank, analysing subunits (Yin, 1990) within the bank, rather than looking to the bank as a whole, the “embedded case studies method” become more relevant. Yin (1990) also argued that analysing subunits allow significant opportunities for extensive analysis.

5.2.5 Steps Adopted in Developing the Case Studies

1. Examining both banks’ financial statements (from 1991 published accounts to 1995)

This was intended to gain a better understanding of the banks’ accounting policies and the level of information published in their financial statements and to establish whether this information was in accordance with IAS and to establish the similarities and differences in the accounting treatments between the two banks and their respective levels of disclosure. Examining the financial statements was also intended to lead to an understanding of the nature and size of the operations carried out by the bank, the size of the bank in terms of its own capital and IAH funds.

2. Reviewing Banks’ Memorandum and Articles of Association

This was intended mainly to ensure that the objectives of the two banks were to operate in accordance with the Islamic principles and to determine the responsibilities of the SSB in carrying out their duties. Furthermore, examining the Memorandum and Articles of Association was intended to establish whether setting up the banks’ accounting policies was solely the responsibility of the management and whether the SSB could participate in the setting up of these polices.
3. Reviewing the Banks' Contracts with IAH

This was intended mainly to evaluate (a) the level of information given in these contracts; (b) whether the contracts disclose the bank's share as Mudarib; (c) the bank's policy of allocation of profits between the bank and IAH including the percentage to be set aside for liquidity, which represents a liability of the bank; (d) whether the contracts disclose the expenses that are borne by the IAH including the percentage deducted from them for the "Reserve Fund".

4. Conducting Interviews with Banks' Senior Management

One of the methods to collect data is through face to face interviews. One of the main sources of information which was essential for this thesis was the interviews held with the two banks’ senior management (enclosed as appendixes 1 & 2, are the positions of the persons interviewed from Ahmed Bank, and Mohammed Bank and the questions that were asked). Due to the complexity of the case studies and the low level of information published in each bank’s financial statements, the interviews were very rewarding since they allowed the thesis to address issues relating directly to the banks’ accounting policies which are not disclosed in the banks’ financial statements.

Questions were prepared in advance in order to obtain as much relevant data as possible from the interviewee. To check the accuracy of responses, more than one interview was held sometimes to repeat the same questions or to ask for more clarifications on the responses. An audio recorder was used in all interviews.

Using the face to face interviews has its strengths and weaknesses. Hussey and Hussey (1997, p. 163) argued that “this method of face to face is an expensive method and time consuming, particularly if conducted in a location which is the choice of the interviewee. At the same time, it offers the advantage that response rates tend to be high and comprehensive data can collected. It is often very useful if sensitive or complex questions need to be asked.” They added that (1997, p. 157) “interviewees may have certain expectations about the interview and therefore give what they consider to be a ‘correct’ or ‘acceptable’ response.”
Quoted in Hussey and Hussey (1997, p. 157) Lee (1993) indicated another limitation of face to face interview that “it is difficult to predict or measure potential bias, but the interviewer should be alert to the fact that it can distort the data and hence the findings.”

5. Conducting Interviews with the Banks’ External Auditors

More than one interview was held with both banks’ external auditors by conducting face to face interviews through questions prepared in advance (enclosed as appendix 3 & 4, the positions of the persons interviewed from the External Auditors, and the questions that were asked.) The interviews were meant to understand the role of the auditors in advising the bank on the accounting policies to be adopted, and whether the procedures adopted in auditing Islamic banks were the same as those used in auditing conventional banks.

Furthermore, the interviews with the auditors were intended to check some of the issues that were raised with the senior management of the banks. These issues were brought up with the auditors to check the accuracy of the information given to the interviewer by senior management.

6. Conducting Interviews with the SSB of Each Bank

One interview was held with one member of the SSB of Mohammed Bank and one interview was held with two members of the SSB of Ahmed Bank. The interviews of the two banks were conducted separately and were face to face through questions prepared in advance (enclosed as appendixes 5 & 6, the positions of the persons that were interviewed from the Shari’a Supervisory Boards and the questions that were asked.)

The interviews held with the SSBs’ members also inquired whether the SSB played a role in setting up the banks’ accounting policies.
7. The Comparison of the Two Cases Studies

A comparison of the two case studies was carried out to determine the similarities and differences on the accounting practices of the two banks and their level of disclosure. This was intended to test the hypothesis that because IASs were not drafted so as to deal with the specificities of Islamic banks, the adoption of IASs by both banks had neither prevented their financial statements being non-comparable in important ways nor led to an acceptable level of disclosure.

If this hypothesis is supported by the findings of the research, this in turn will lend support to the development of accounting standards that specifically cater for the characteristics of financial instruments used by Islamic banks in the mobilization and application of funds (Karim, 1999).

The case of Ahmed Bank is presented in the next chapter.
CHAPTER 6

AHMED BANK

The case study is divided into the following sections:

1- Introduction.
2- Types of contracts governing the bank’s relation with Investment Account Holders.
3- Accounting practices of the bank.
4- Role of the Shari’a Supervisory Board (SSB).
5- Role of the external auditors.

6.1 INTRODUCTION

Ahmed Bank was granted a banking license in the early 1980s with paid-up capital of US$20m. It is worth noting that the first management of the bank had wide experience in banking and fund management. The bank is a subsidiary of a large financial group that holds 53 per cent of the capital, the remainder being held by individual investors. The group operates in number of countries including Bahrain, Pakistan, Bangladesh, Egypt, and Turkey. It also operates in Europe.

The bank’s Articles of Association state that it will “promote, foster and develop the applications of Islamic principles, laws and traditions to the transaction of financial, banking and related business affairs including the investment of funds.”

6.1.1 Assets of the Bank

Figure (1) shows that the bank’s assets, excluding assets pertaining to funds under management, increased by almost 100 per cent during the period 1991-1995. The increase was mainly due to an increase in shareholder funds, which reached US$101m in 1995, compared to a level of US$62m in 1991. The other major increase was in the current accounts, which reached US$57m in 1995, compared to a level of US$30m in 1991.

(15) This is a fictitious name for one of the Islamic banks.
The Total Assets of the Bank

Fig. (1) Evolution of Total Assets

Short-term assets reached US$72m in 1995 compared to US$54m in 1991. This item includes short-term liquid funds and investment in the bank's managed funds (the bank's investments on behalf of the shareholders in its funds under-management, e.g., bilateral Mudaraba.) Funds due from related companies have shown a surge from US$0.097m to US$36m over the same period. Income receivable and the item on the bank's balance sheet labelled 'other assets' increased substantially as it reached US$54m in 1995 compared to US$17m in 1991.

Fig. (2) Evolution of Shareholders' Funds
6.1.2 Shareholders' Funds

Figure (2) indicates that shareholders' funds increased from US$61.5m in 1991 to US$100.8m in 1995, an increase of 64 per cent, mainly attributable to retained profits.

The movement of shareholders' funds

<table>
<thead>
<tr>
<th></th>
<th>Millions.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening shareholders' funds at 31/12/1991:</td>
<td>US$61.5</td>
</tr>
<tr>
<td>+ Right issues cash</td>
<td>US$003.0</td>
</tr>
<tr>
<td>+ Retained profits</td>
<td>US$040.8</td>
</tr>
<tr>
<td>+ Assets' revaluation surplus</td>
<td>US$000.7</td>
</tr>
<tr>
<td>Less foreign exchange translation adjustments</td>
<td>US$004.8</td>
</tr>
<tr>
<td></td>
<td>US$100.8</td>
</tr>
</tbody>
</table>

The ratio of shareholders funds to total funds under management (Investment Account Holders or 'IAH'), which appear in the bank's balance sheet as off-balance sheet items, rose from 1:18 (5.5 per cent) in 1991 to 1:10 (10 per cent) in 1995. This indicates a strategy to strengthen the bank's capital base in relation to its funds under management. It is worth noting that up to 1995, all IAH were reported as funds under management.

The rights of the shareholders of Ahmed Bank include the following:
1- The appointment of members of the board of directors.
2- The appointment of the external auditors following the boards' recommendation.

The main responsibilities of the board of directors are to formulate the overall policies of the bank and to appoint the management and the Shari'a Supervisory Board.
Furthermore, the bank's net profits increased in 1995 to US$12.6m from US$9m in 1991. During the same period the return on owners' equity declined from 14.7 per cent in 1991 to 13.5 per cent in 1995 despite the increase in the bank's net profit. The decrease was mainly attributed to the increase in the owners' equity from US$61.5m in 1991 to US$100.7m in 1995 due to the dilution effect of the increase in equity. It is worth noting that funds under management declined slightly in 1995 in relation to 1991.

6.2 TYPES OF CONTRACTS GOVERNING THE BANK'S RELATION WITH IAH

6.2.1 Funds Under Management

Fig. (3) Evolution of Funds Under Management

Funds under management represent the funds of Investment Account Holders (IAH) which are mobilised on a Mudaraba basis (profit sharing). The bank indicated that its role is like that of fund managers who invest the investors' funds on their behalf with no liability on the managers' part to return the investors' funds in case of loss, provided that the loss was not due to negligence or breach of contract. The bank is entitled to a certain fee called the Mudarib share, which is calculated as a percentage of the IAH's profits.

The bank offers specialised funds for investors. Each Fund has its own terms and conditions. The bank maintains separate accounts for each fund. The Mudaraba funds can be broken down into two types: discretionary (unrestricted) accounts and non-discretionary (restricted) investment accounts.
6.2.1.1 Discretionary Accounts (Unrestricted Investment Accounts)

As regards discretionary accounts, the bank is permitted to employ IAH funds in investment opportunities that the bank deems appropriate without recourse to the investors. The discretionary accounts are of two types: General Mudaraba Fund (GMF) and Private Investment Portfolio (PIP). The bank maintains separate balance sheets and income statements for each of these funds.

However, if any of the funds is in need of liquidity, it may borrow from another fund provided that the terms and conditions of that fund permit it. The deal between the funds will be carried out on an arms-length basis, which means that the rates that are used between the funds are the same rates as those used by the bank in dealing with another entity.

i) The General Mudaraba Fund (GMF): The bank imposes no conditions on the amounts to be placed under GMF, unlike the Private Investment Fund where a minimum amount is required. The GMF invests in relatively low risk investments (savings-type products). Hence, the profits paid to investors in this Fund may be lower than the rate of profits distributed by other Funds. Investors in this Fund place their funds for periods not exceeding one year.

Investors in the GMF are allowed to withdraw their funds at short notice. Due to its relatively high liquidity, this affects the level of the profits paid to them. The bank claims that managing the investors' funds under GMF involves higher costs and a higher percentage of liquidity to meet investors' withdrawals of funds than for other types of fund. Accordingly, the banks' Mudarib percentage share is higher than for other accounts. Savings accounts fall under the same terms as the GMF.
The Main Terms and Conditions of the Unrestricted Investment Accounts' Contract

Cost of Operations
Ahmed Bank (Mudarib) bears all costs of banking operations and the cost of managing the assets of the fund. Brokerage fees paid to parties during the course of business for the purpose of acquisition of assets for the fund are in principle borne by the fund and not by the bank. However, although the bank has the right to transfer such expenses to the fund, they are usually borne by the bank.

Asset Valuation and Recognition of Profit
According to the terms of the banks' contract for Unrestricted IAH:
“all assets pertaining to Investment Accounts of any kind whatsoever may be commingled. These assets are evaluated at the end of every Gregorian month. Profit realised and accrued for the month is credited to the investor's account at the end of each pertinent month.”

The Bank’s Share of the Profit
The bank is entitled to a share of profit as Mudarib only if the Fund generates a profit.

The following are the ceilings for Mudarib’s share of profit:

- Undetermined Term (Savings Account) 33.33%
- 7 days (1 week) 25.00%
- 90 days (3 months) 20.00%
- 180 days (6 months) 17.50%
- 360 days (12 months) 15.00%

Reserve Fund
According to the banks’ contract:
“the bank is allowed to deduct up to a maximum of 10 per cent from the fund’s net profit for reserve fund (hidden reserve) as Takafol (mutual provision) among investors in the fund.” This reserve fund is determined after deducting any direct expenses relating to the
fund and before the Mudarib share, and is used primarily to meet losses in respect of the assets of the fund. It is also used to pay the investors' profits during a period of decline in the fund's profitability (income smoothing). The amount of this reserve fund is not shown in the financial statements or by way of a note to the accounts.

**ii) Private Investment Portfolio (PIP):** Each investor's funds under PIP are managed separately. This service is offered to high net worth investors who place large amounts with the bank. Although this is a discretionary account, the investor can give general instructions to the bank regarding such matters as the level of risk he/she is willing to accept and the type of investment.

**Cost of Operations**
The same terms and conditions of GMF also apply to PIP.

**Asset Valuation and Calculation of Profit**
According to the banks' contract "the bank is authorised to invest the investor's funds in a portfolio managed by the bank or investment opportunities through the assets of the bank. The investor also allows the bank to invest his funds in other investment opportunities without any obligation on part of the bank. If the bank was able to achieve profits in addition to the expected profits (the profits achieved by the bank in excess of the expected profits, as indicated to the investors at the commencement of the contract), the investor agrees that the bank will deduct up to 50% of the additional profits as remuneration."

**The Bank's Share of the Profit**
The bank's share of the profit as Mudarib is equal to 10 per cent of the profits earned from investing the investors' funds; however, the bank does not get any reward for its efforts if no profits are achieved. The bank's contract states that "the bank at its sole discretion may forgo part of its share of profits in favour of the investor."
The Reserve Fund

The investor permits the bank to deduct up to 5 per cent from the fund's realised profits to meet any losses in respect of the funds' investment and to pay the investors' profits during a period of decline in the fund's profitability (income smoothing). The bank deducts the amount at the end of each month before the bank receives its share as Mudarib and the payment of investors' profits. As in the case of the GMF, the amount of the reserve is not shown in the financial statements or notes and thus constitutes a hidden reserve.

6.2.1.2 Restricted Mudaraba Fund (RMF)

Under a Restricted Mudaraba Fund (RMF) the investor (IAH) authorises the bank to use the investor’s funds according to the conditions specified by the investors, e.g., in a specified investment such as real estate or agriculture. Restricted Investment Accounts are targeted at high net worth investors who usually place their funds for over a year. The investment in these funds (investment products) will typically carry higher risk and higher profits when compared to the General Mudaraba Fund. Usually, the type of investment is stated in the agreement with the investor. The bank maintains separate accounts for each of these funds, including a separate balance sheet and profit and loss account. RMF funds are like open-ended funds where the investors change during the life of the fund.

In order not to liquidate the fund’s investments before its maturity, at its discretion the bank may play the role of market maker and buy the units of those investors who would opt to withdraw their funds before the liquidation of the fund until new IAH join the Fund. The bank will in this case be entitled to receive its share of the profits, as an investor, on an arms-length basis besides its share as Mudarib.

The liquidity maintained in these funds is less than in the GMF because investors place their funds for a longer period. This enables the bank to invest a higher percentage of the funds available in longer investments. Accordingly, the profits generated on these funds are expected to be higher than for GMF. As a result, investors in RMF are expected to receive higher profits than those who invest in the GMF.
The bank's contract states that the bank may use IAH funds for investments other than those specified in the contract. The reason given for incorporating such a provision is that in some cases the bank, for example, may receive funds from investors to be invested in purchasing an aircraft a few days before launching the deal. Hence, in order not to keep investors' funds idle the bank may invest them in short-term assets before launching the fund. The bank mentioned that it had obtained the SSB's consent to use the investors' funds for investments other than those specified in the contract. The bank determines on a monthly basis the profits on each fund and credits the investors' accounts with their share of the profits after deducting 10 per cent for the reserve fund as well as its share as Mudarib.

**The Main Terms and Conditions of the Restricted Investment Accounts Contract**

**Fund Management and Administration**

According to the bank's contract:

1) "The bank acts as manager and administrator of the fund. All relevant decisions regarding the fund are taken at the discretion of the bank (Mudarib). The bank may delegate all or part of its duties to a third party as the bank deems suitable."

2) "The investor authorises the bank to identify further investment opportunities, whether relevant to new or existing assets and services, to achieve a profit/gain over and above the projected profit, from the fund managed by the Mudarib. The investor hereby authorises the Mudarib, in its sole discretion and without any obligation, to take such steps as the Mudarib may consider are reasonably necessary to exploit such opportunities and, in consideration of the Mudarib taking such steps, the investor agrees that the Mudarib may credit to its own account, in payment by way of a special fee, an amount to the maximum of 50 per cent of the net amount of any profit/gain over and above the projected profit, so achieved after payment of fees, charges and/or any other amounts that the Mudarib may have paid to any third parties for the purpose."
The Mudarib’s Share of Profit

1- The bank is entitled to receive up to 33 per cent of the total profits as remuneration for its role as Mudarib. If no profits have been generated during any given month, the bank will receive no remuneration. If there is a profit, the bank may give up part or its entire share to the investors at its full discretion.

2- The bank may charge to the fund any direct expenses paid by the bank on behalf of the fund, e.g., fees related to a feasibility study prepared for the fund.

Investment Risks

The investor declares that he is fully aware of the potential risk in his investments and that the fund may incur losses. The Mudarib does not indemnify the investor for any loss suffered and the bank cannot guarantee the investor any returns or the return of the principal sum invested. The liabilities and obligations relating to the fund are to be borne by the investors except in the case of the bank’s negligence or breach of the contract.

Transaction Fees

The bank shall bear general expenses not directly related to any specific fund. Brokerage and other commission paid to third parties in the ordinary course of managing the fund are charged directly to the fund’s Profit and Loss account.

"Redemption" Facility

The bank acts as a market maker by replacing investors who withdraw their funds at maturity. The bank plays this role in the absence of an organised Islamic capital market. The bank determines its share of profits on an arms-length basis (this mean that the bank’s rate of profit will be the same rate of profit paid to other investors in the fund.) The bank’s policy is to sell its share in the fund to new investors willing to join the fund so as to avoid conflict of interest, after determining the net assets value (NAV), i.e., total assets inclusive of accrued profits less total liabilities. The bank uses the historical cost or mark to market where applicable to determine the value of the fund’s assets. For example, the bank uses the historical cost basis for Islamic financing such as Murabaha, Musharaka and Mudaraba and it uses mark to market for quoted securities. The bank
determines the net asset value (NAV) of the fund monthly, which is also checked periodically by the bank's auditors.

**Reserve Fund**

According to the contract, the bank is allowed to deduct up to a maximum of 10 per cent from the fund’s net profits for a reserve fund (hidden reserve) as Takafol (mutual provision) among investors in the fund. This reserve fund is determined after deducting any direct expenses relating to the fund and before the Mudarib share is taken. It is used primarily to meet losses in respect of the assets of the fund and to pay the investors' profits during a period of decline in the fund's profitability (income smoothing). However, the bank may exercise its discretion as to whether it makes such a deduction.

**Special Syndication**

This is a specialised operation where the bank acts as lead manager and is responsible for sourcing, structuring and arranging the deal. It also acts as Mudarib for managing the deal on behalf of the investors. For example, the bank enters into a deal whereby it purchases a commodity and appoints an agent to sell the product on behalf of the bank.

Usually, the bank invites financial institutions to participate in the deal to spread the risk. Normally, the bank uses its own funds only to replace investors wishing to sell their share before the liquidation of the deal. The bank recognises its fee as lead manager when the deal is concluded.

**6.3 ACCOUNTING PRACTICES OF THE BANK**

The accounting of the bank is divided into two main divisions:

1- Corporate Books (The Bank's Book).
The bank claims that its main reason for separating the corporate books from those of the investors' accounts is to identify the rights and obligations of the bank separately from those of the investors (IAH).

6.3.1 Corporate Books
In the corporate books the bank maintains a separate balance sheet and income statement. The balance sheet reflects the assets of the bank that have been financed by the capital and reserves of the bank, the current accounts, and other liabilities, excluding the funds received from IAH as these are treated off the balance sheet as funds under management.

The income statement reflects the profits earned on the bank’s assets, the bank’s share of profits as Mudarib for managing the IAH’s funds, and fees for providing banking services, etc. The expenses side represents those expenses which are related to the bank’s own expenses including provisions against the assets of the bank, expenses not related to any specific fund, etc.

The bank states that it applies the same accounting policies to both its financial statements (corporate books) and the books of IAH (funds under management).

6.3.2 The Investment Account Holders Books (funds under management)
The bank states that it treats investment accounts (both restricted and unrestricted) as funds under management, since they are not liabilities of the bank. In case of loss neither due to the bank's negligence nor to a breach of contract, the IAH will share in that loss in proportion to their contribution to the investments. The bank stated that its role as Mudarib is similar to the role of a fund manager who manages mutual funds.

The bank maintains separate accounts to determine the rights and obligations of the IAH in each fund. The bank believes “this accounting treatment is fairer to shareholders and Investment Account Holders compared to other accounting treatments applied by other Islamic banks.”
The bank argued that it does not publish separate financial statements for its managed funds because this is not required under IAS 30. However, the bank mentioned to the researcher that it would provide such information to IAH at their request.

6.3.2.1 Profit Allocation

The profit allocation of Ahmed Bank has the following characteristics:

1) The shareholders of Ahmed Bank are entitled to all profits earned on their investments plus the profits earned by the bank as Madarib and any other fees/commissions collected by the bank for banking services provided to its customers.

2) As the shareholders are the owners of the bank, all liabilities and commitments of the bank are to be borne by the shareholders to the extent of their contribution to the capital of the bank plus any unpaid calls on shares.

3) The relationship governing current account holders and the bank is a debtor/creditor relationship, which means that holders of current accounts make their funds available to the bank at a zero return. In return, the bank guarantees the payment of these funds. In case of loss, the bank pays the current account holders from shareholders’ funds. Revenues earned from investing the excess of current account funds that are not required to be held as liquid cash are credited to shareholders.

4) The bank's accounting system was developed to enable it to determine the profit/loss of each fund at any specific time and allows the bank to review its investment policies from time to time. The bank’s policy is to credit each IAH’s account at the end of each month with their share of profits after deducting the following:

- the IAH’s share of the contribution to the reserve fund (Takaful);
- any direct expenses to be borne by the IAH; and
- the bank’s share as Madarib.
The bank indicated that Islamic *Shari'a* permits the bank to reduce its *Mudarib* rate without informing the IAH, but it cannot charge a higher rate than that stated in the contract without first obtaining the IAH's consent. However, up to 1995 the financial statements do not disclose the actual *Mudarib* rates collected by the bank as this is not required under IAS 30.

6.3.2.2 The Accounting Treatments Adopted by Ahmed Bank

i) *Murabaha* to the Purchase Orderer: Ahmed Bank offers *Murabaha* Financing Upon The Order Of The Buyer, whereby the bank buys the goods at the request of the client who, according to the *Shari'a* ruling of the bank's SSB, is obliged to buy the goods from the bank when the latter acquires them. The difference between the cost of purchase and the selling price to the client represents the profit of the bank. Until 1993, the bank used the straight-line method of income recognition, whereby it divided the profits equally over the period of the *Murabaha*. In 1994, the bank started to use the reducing balance method for the major transactions of the *Murabaha*, though small transactions remained subject to the straight-line method. The bank states that such changes were not mentioned in the notes to the bank's financial statements because they had no material effect on the accounts. The external auditors supported this view. However, in 1996, the audited accounts stated that the bank used both the reducing balance and the straight-line method. The bank's auditors stated that it was important to indicate this in the published accounts because it had a material effects on the accounts of the bank. In 1997, the bank stopped using the straight-line method. It should be noted that the reducing balance method might be either similar or identical to the 'actuarial method'. This method assumes a constant ratio of income to capital outstanding and apportions each instalment between capital and income according to this ratio, thus notionally 'repaying' the capital. As the balance of capital outstanding is reduced, so is the proportion of each instalment recognised as income, and the effect of this method is therefore to recognise income sooner than with the straight-line method (for illustration see appendix 7).
The bank claimed that using the reducing balance method would provide the following advantages:

1- It provides for a constant return on investment over time.
2- It complies with the matching concept.
3- It provides a fair method for profit allocation to all investors.

In addition, using the straight-line method will have the following disadvantages:
1- It leads to distortion in profit recognition.
2- It does not provide a fair method for profit distribution.

**ii) Musharaka Financing:** Ahmed Bank applies the Fixed Musharaka, which means there will be no change in the partner’s share during the life of the Musharaka. The Musharaka will be terminated when the partners decide to liquidate it or sell it to a third party.

The bank treats its share in the Musharaka as an investment in an associated company, by using the equity method to record its share in the Musharaka. In most cases the bank’s participation in the Musharaka will not be less than 50 per cent of the amount of the Musharaka.

The bank claims that although its share in the Musharaka will be more than 50 per cent, and it exercises management control over the Musharaka, it treats its share as an investment in an associated entity and not as an investment in a subsidiary. This is because the Musharaka that the bank finances is in the form of a specific transaction (trade project) and not a legal entity.

**iii) Mudaraba Financing:** The bank as Rab al Mall provides the capital to the client (Mudarib) who invests it according to the terms of the contract. The bank’s share in Mudaraba is accounted for using the cost method. Thus, any appreciation in the value of the bank’s share will not be recognised, while in case of a permanent decline in the value
of the bank's share a provision will be created against such decline and the bank's balance-sheet will reflect the net amount after deducting the provision. The bank recognises its share in the profits of the Mudaraba only when it is distributed or declared as distributable by the Mudarib.

**iv) Leasing Transactions:** Most of the leasing transactions entered into by the bank are of the type that is known as Ijara wa Iqtina (or Ijara Muntahia Bittamleek), which means that the title in the leased asset will be transferred from the bank to the lessee at the end of the contract.

This type of leasing is somewhat similar to a finance lease, with the exception that with the latter (according to IAS17) the lessor transfers the obligations of ownership (maintenance, insurance, etc.) to the lessee together with most of the rights of ownership - even before the transfer of ownership takes place. In Ijara wa Iqtina, the lessor remains responsible for maintenance, insurance, etc., until the transfer of ownership takes place. Also, under Ijara wa Iqtina the lessor is responsible for any permanent impairment of the leased asset's value before the title is transferred to the lessee if the impairment was not due to the negligence of the lessee.

The bank treats this type of leasing as a finance lease by reflecting the initial amount of the lease under accounts receivable and not under fixed assets. The income from the lease is recognised in accordance with the actuarial method. Thus, lease instalments are apportioned between capital and income as illustrated in the appendix under Murabaha, and the bank's share in the leased asset decreases at an accelerating rate.

**v) Prudential Reserves:** The difference between reserves and provisions is that reserves are part of equity and are constituted by appropriations out of the net profits of the entity. If there is no profit, no reserve is created. ("Entity here may mean the bank or one of its managed funds.) Provisions, on the other hand, are charged as an expense in arriving at the entity’s profit or loss. The bank maintains two types of reserves. These are:
1) Fund Reserves
The bank creates a reserve for each fund it manages by deducting a certain percentage from the profits of that fund, which are to be used primarily to cover future potential losses. The fund’s financial statements reflect the assets after deducting the reserves, which means that, in effect, these reserves are treated from a balance-sheet point of view as provisions or contra-assets. In the case of a loss, it is charged against the ‘reserve’ and not against current profits; however, if the reserve is insufficient, the bank will provide finance to make good the deficit and this is considered by the bank as a donation to the fund and is charged in the bank’s profit and loss account.

The balance of reserves is referred to as Takafol (mutual provision) between investors in the fund. The bank’s contract states the percentage that is deducted from the investors’ profits. Although the reserve is primarily set aside in case of possible losses, the bank may use the reserve to pay the investors' profits during a period of decline in the fund's profitability (income smoothing). The bank states that this is legitimate because these reserves belong to the investors and it has obtained the SSB’s approval. The balance of the reserves is not disclosed in the financial statements or in the notes thereon. Hence, they are ‘hidden reserves’.

2) The Bank’s Own Reserves and Provisions
The banks’ own reserves are appropriated out of the bank’s net profit. In addition, the bank creates provisions against a permanent decline in the value of its assets, and against non-performing facilities, as contra-assets against the assets of the bank. Such provisions are disclosed in the bank’s financial statements. The bank also discloses in its audited financial statements the amount of reserves provided from shareholders' funds.

vi) The bank's investments in the fund: The bank stated that when it replaces investors in any of its managed funds, it treats its share as an investment in an associated entity, since it has management control over these funds. Hence, equity accounting is used.
The Policy Of The Bank In Determining Its Share Of Profits As Mudarib And The Profits Of The IAH

The bank’s accounting policy is to recognise its share of profit as Mudarib in a closed-ended fund when the transaction is liquidated. In the case of an open-ended fund, where investors are changing, the bank values the performance of each fund at the end of every month to determine the profit of each fund by employing the historical cost plus or minus any accrued profits. This allows the bank to determine the investors’ profit and its share as Mudarib, which is recognised on a monthly basis.

6.4 THE ROLE OF THE SHARI’A SUPERVISORY BOARD

The bank’s Articles of Association state that “the Shari’a Supervisory Board shall have general responsibility to ensure that the company’s investments and activities (and those of its subsidiaries or controlled affiliates) are in accordance with Islamic principles.”

The members of the SSB consist of four Shari’a scholars (including a chairman). According to the Articles of Association, the board of directors is responsible for appointing the members of the SSB. The bank states that the SSB is independent of the management.

In order to ensure that the bank has adopted its fatwas and instructions, the SSB appoints one of its members to review the operations and documents of the bank. The appointed member is required to present a report to the SSB on his review. The report is discussed among the committee members before it is submitted to the management of the bank for their response and before the SSB publishes that report as part of the annual report of the bank.

(16) The memorandum and articles of association of Ahmed Bank are more specific regarding the role of the SSB, compared with those of Mohammed Bank.
Occasionally, the SSB also holds meetings with the investment committee of the bank to discuss the committee’s investment policies and investment documents. This is with a view to checking whether or not the bank’s investments are in accordance with Shari’a precepts and to ensure that the bank has adhered to its instructions.

Despite the importance of the SSB’s participation in the setting up of the accounting policies of the bank to ensure that they are in accordance with the Shari’a precepts, the accounting policies were actually agreed between the bank and its external auditors. In this respect it is important to mention that the SSB considers the bank as Mudarib and the Investment Account Holders as Rab al Mall (provider of funds).

6.5 VIEWS OF THE EXTERNAL AUDITORS

The external auditors of Ahmed Bank stated that they have been appointed by the shareholders upon the recommendation of the board. The auditor’s report is, therefore, addressed to the shareholders only. The auditors argued that since they are appointed by the shareholders, their main duty is to protect the interest of the shareholders.

The auditors stated that the audit procedures that they apply to Ahmed Bank are the same procedures as those applied to conventional banks. In both cases the auditor’s duty is to protect the interests of the shareholders. Hence, they carry out a full audit of the assets and liabilities of the bank, while, with regard to funds under management (which are treated as an off balance-sheet item), they perform a review rather than a full audit. This suggests that, although a review may bring significant matters affecting the accounts to the auditor’s attention, it does not ensure that the auditors are aware of all the significant matters that would be disclosed in a full audit. This is because the scope of conducting a review is substantially less than an audit. Therefore, the auditors’ review report gives less assurance than that of an audit opinion.

It is worth noting that the only additional work that the auditors of Ahmed Bank carry out when they audit an Islamic bank is that in some cases they may require the management of the bank to obtain the SSB’s approval for certain transactions.
With regard to the accounting policies of the bank, the auditors stated that they were developed at the request of the bank. They supported the bank's treatment of Investment Account Holders as funds under management because they are not liabilities of the bank. In addition, the auditors of the bank supported the need for accounting standards for Islamic banks. This was due to the special nature of certain operations carried out by Islamic banks.

The auditors of the bank claimed that separating the Investment Account Holders into restricted and unrestricted investment accounts as suggested in the AAOIFI's presentation and disclosures accounting standard will not achieve a standardisation of the financial statements of Islamic banks. They argued that Islamic banks will change their contracts so as to be in line with the definition of a Restricted Investment Account in order to avoid reflecting the equity of Investment Account Holders as a balance-sheet item until the AAOIFI's Discussion Memorandum and Exposure Draft Statement on Capital Adequacy appeared, the auditors might have thought that by treating IAH as an off balance-sheet item they would not subject IAH to capital adequacy requirements.

The next chapter will analyse the second case.
CHAPTER 7

MOHAMMED BANK

The analysis of Mohammed Bank is divided into the following sections:
1- Introduction.
2- Types of contracts governing the bank’s relations with Investment Account Holders.
3- Accounting practices of the bank.
4- Role of the Shari’a Supervisory Board (SSB).
5- Role of the external auditors.

7.1 INTRODUCTION

Mohammed Bank was granted a banking license in the late 1970s with a paid-up capital of US$15.1m. The bank was established to carry out banking and other trading activities in accordance with the teachings of Islam (Mohammed Bank’s Articles of Association). The past experience of the bank’s senior management was in conventional banks and insurance companies.

7.1.1 Assets of the Bank

Fig.(4) Evolution of Assets

(17) This is a fictitious name for one of the Islamic banks.
The growth in the bank's assets from 1411H (corresponding to 1991 according to the Gregorian Calendar) to 1415H (corresponding to 1995) show an increase of almost 37 per cent. The increase was mainly due to the calling of the remaining un-called capital, which amounted to US$15.1m. Also, a major increase was observed in the holdings of Investment Account Holders, which reached US$303m in 1415H compared to US$220m in 1411H. Current accounts reached US$30m in 1415H from US$20m in 1411H.

During the same period, Murabaha financing increased substantially as it reached US$332m in 1415H compared to US$226m in 1411H, an increase of 47 per cent.

Fig. (5) Evolution of Shareholders' Funds

Millions

![Bar chart showing evolution of shareholders' funds from 1411H to 1415H.]

7.1.2 Shareholders' Funds

Figure (2) indicates an increase in the shareholders' fund in 1413H (corresponding to 1993), the year in which the bank called the remaining part of its capital, which was fully subscribed by the shareholders. The increase in capital increased the ratio of shareholders' funds to total assets from 1:17 in 1411H to 1:11 in 1413H. This indicates that the bank strengthened its capital base.

Furthermore, it is important to mention that the bank's overall return on assets increased by just over one-third, from 0.73 per cent in 1411H to 1 per cent in 1415H. Meanwhile, the return on shareholders' equity was 10.7 per cent in both 1411H and
1415H, as the bank’s share capital had increased by a similar proportion, from US$19.0m in 1411H to US$30.6m in 1415H.

7.1.2.1 Rights of the Bank’s Shareholders
The rights of the shareholders’ of Mohammed Bank include the following:
1- Appointment of members of the Board of Directors.
2- Appointment of the external auditors.

7.2 TYPES OF CONTRACTS GOVERNING THE BANK’S RELATIONS WITH IAH
It was observed from the discussion held with the management of the bank that the bank is authorised to invest the IAH’s funds in investments managed by the bank or through agents appointed by the bank. In addition, it was noted that all the bank’s contracts with IAH state that IAH are entitled to receive 75 per cent of the profits generated from their funds, after deduction of 10 per cent of such profits as provision against unexpected losses. The bank mentioned that, despite its right to deduct 10 per cent, thus far all provisions created have been charged to the bank’s profit and loss account and shown in the balance sheet under ‘other liabilities’.

7.2.1 Savings Account (SA)
The bank stated that the contractual relationship governing the bank and the holders of savings accounts (sight deposits) is based on the Mudaraba contract. However, the bank’s contract states that “50% of the funds available in the savings account (sv) will be invested in the bank’s portfolio and the holders of the saving accounts are entitled to at least 75% of the profits generated on the 50% after deducting 10% of the profits for provisions against potential losses.”

This is illustrated by the following formula:

\[
\text{Balance available in SV} \times 50\% \times [75\% - 10\%] = 32.5\% \text{ of balance}
\]
The bank’s policy is to pay the account-holders their share of profits at the end of the financial year, even if the IAH’s funds matured before the end of the financial year. The bank indicated to the researcher that it calculates the IAH’s share of profits from the date of placing the fund with the bank until the maturity date (this applies to all types of accounts).

The bank argued that this policy is adopted because an IAH who withdraws his funds before the end of the financial year will not, therefore, share in any subsequent losses. However, paying an IAH his share of profits at the end of the financial year will allow the bank to determine the profits or loss attributed to the IAH in respect of the duration of his investment.

7.2.2 Investment Accounts With Fixed Period (IAWFP)
Under this type of account, an IAH can choose to place his funds with the bank for one month, three months, or one year. The bank specifies the minimum amount to be deposited with the bank. The bank’s contract states that “75% of the funds available on IAWFP will be invested in the bank’s portfolio and the holders’ of this type of account are entitled to at least 75% of the profits generated on the 75%, after deducting 10% of the profits for provisions against potential losses.” This is illustrated by the following formula:

\[ \text{Balance available in IAWFP} \times 75\% \times [75\% - 10\%] = 48.75\% \text{ of balance} \]

The IAH receives his share of profits at the end of the financial year. The bank mentioned that it renews the deposit only if the investor has approached the bank expressing his consent to this.

7.2.3 Perpetual Investment Accounts (PIA)
Holders of this type of account are asked to deposit their funds with the bank for three years. The bank’s contract states that “80% of the funds available on PIA will be invested in the bank’s portfolio, and the holders’ of this type of account are entitled to at least 75% of the profits generated on the 80%, after deducting 10% of the profits for provisions against potential losses.” This is illustrated by:

\[ \text{Balance available in PIA} \times 80\% \times [80\% - 10\%] = 56\% \text{ of balance} \]
Balance available on PIA \( x \) 80\% \( x \) \([75\% - 10\%]\) = 52\% of balance

It is worth noting that with this type of account, the bank will pay the profits to IAH at the end of the financial year.

7.2.4 Specific Investment Certificate (SIC)

The account holder deposits a fixed amount with the bank. The total proportion invested in this type of account is higher than with the other types of deposits. The bank accepts deposits for short periods, such as three months.

As stated by the bank, in order to attract high net worth IAH the bank pays the IAH their share of profits at maturity, not at the end of the financial year. The bank mainly invests these funds in international commodities. The bank’s contract states that “90\% of the funds available on SIC will be invested in the bank’s portfolio, and the holders’ of this type of account are entitled to at least 75\% of the profits generated on the 90\%, after deducting 10\% of the profits for provisions against potential losses.” This is illustrated by:

\[
\text{Balance available on SIC} \times 90\% \times 75\% - (10\%) = 58\% \text{ of balance}
\]

The Relationship Between the Bank and Current-Account Holders

The bank considers the funds maintained under current accounts as a free loan (Qard Hassan) provided to the bank by the current account holders. The shareholders guarantee the amount of the principal. The bank invests the excess funds and at the end of the year adds the income it earns to its overall profits.

7.3 Accounting Practices of the Bank

When it was established in the late 1970s, banks in the country in which Mohammed Bank operates were not required to follow a specific set of accounting standards. Therefore, at that time, banks (both Islamic and non-Islamic) followed accounting practices which they, together with their auditors, believed gave a fair presentation of the bank’s financial position and the results of its operations. In 1992 all banks,
including Mohammed Bank, were required by the regulatory authority to adopt the International Accounting Standards (IAS).

7.3.1 The Accounting Treatments of Islamic Financing

i) Murabaha Financing: The bank states that it measures its Murabaha financing receivables at cost to the client. It creates specific and general provisions against Islamic financing assets. The amounts of Murabaha financing are shown in the balance sheet as part of Islamic financing assets, and the notes do not show the amounts of each type of Islamic financing separately.

Before 1410H (corresponding to 1990 according to the Gregorian Calendar) the bank applied the up-front method of income recognition, which meant all profits on Murabaha were recognised immediately after concluding the deal with the client. In 1410H the bank changed this accounting treatment following instruction from the regulatory authority to recognise profits on a pro rata basis for Murabaha contracts exceeding one financial year.

The following formula is used to determine the bank’s profits from Murabaha financing:

\[(af - dp) \times rm \times dm = bp\]

(af) The total amount of facility
(dp) Down payment
(rm) The rate of Murabaha per annum
(dm) Murabaha duration in years
(bp) Bank’s profits for the year

Note that Mohammed Bank does not calculate the profits on a monthly basis, unlike Ahmed Bank.
The auditors of Mohammed Bank claim that this accounting treatment was taken from IAS 18, which states that “interest revenue which is the difference between the revenue from the sale of goods or rendering of the service and the nominal amount of the consideration, is recognised on a time proportion basis.”

**ii) Musharaka Financing:** Most of the bank’s Musharaka financing is of the declining Musharaka type. This means that the bank’s share in the Musharaka declines while the share of the other partner increases. For example, if the total amount of the Musharaka is US$100 and is invested in a building, and the bank’s initial share is $50, the bank will sign an agreement with the other partner stating that the bank will recover its initial share in the investment by adding 10 per cent to its initial share. Therefore, at the end of the Musharaka the bank will recover the cost of its initial share (US$50) plus US$5. This is in addition to the returns which the bank will receive in the form of rent. The latter will decline as the bank’s share in the real estate declines.

The payment will include part of the initial investment and part of the profits, and this will decrease the bank’s share in the building. The client would usually manage the building and the bank monitors the behaviour of the client and reserves the right to intervene if the client breaches the contract. This implication here is that the bank acts as a sleeping partner.

The bank measures its share in the Musharaka at cost, and at the end of the financial period any permanent decline in the value of the Musharaka would be reflected by the creation of a provision. This treatment is in line with IAS25 (para. 24), which states that “long term investments are usually carried at cost unless in the case of permanent decline.”

**iii) Investment in Properties:** The property is valued at cost, and in case of a permanent decline in the value of the property, a provision is created for such decline.
This treatment is in line with IAS 25 (para. 23A), which states that “investments classified as long-term assets should be carried in the balance sheet at either:
1- cost;
2- re-valued amount; or
3- in the case of marketable equity securities, the lower of cost and market value determined on a ‘portfolio basis’.

7.3.2 The Contractual Relationship between Investment Account Holders and Mohammed Bank

Mohammed Bank reports equities of Investment Account Holders (IAH) as a liability on the balance-sheet, although the contractual relationship between the bank and IAH is based on the Mudaraba contract. The bank argues that this is a fair presentation because it is responsible for managing the investor’s funds in a prudent and professional manner, even though the bank does not guarantee the returns or the capital of these funds.

The management of Mohammed Bank claims that reporting IAH off balance-sheet as funds under management does not protect the interest of the IAH. Rather, it protects the management from any responsibility in cases of negligence by the bank. The bank’s treatment of IAH reflects its attitude that IAH represent a commercial obligation, i.e., it is in substance a fixed obligation on the bank similar to a deposit in conventional bank. In other words, the management believes that IAH effectively represent a commercial liability on the bank in the sense that, if a loss were incurred relating to IAH funds, the bank would transfer the loss to the shareholders. This would then be met from their profits, rather than deducted from the IAH funds, in order to avoid losing its IAHs’ confidence.

By contrast, AAOIFI’s Statement of Concepts (1993) requires Islamic banks to present equities of unrestricted investment accounts as a separate item in the balance-sheet, which is part of neither shareholders’ funds nor liabilities.
The bank stated that no losses relating to IAH have ever been borne by the 
shareholders from their profits, because all investment accounts have achieved profits.
The researcher is of the opinion that the bank, thus far, have not followed this practice 
of transferring losses. It is to be noted that the bank is not required to disclose any 
such information in their financial statements. On the other hand, the bank may also 
deduct part of the shareholders’ profits (share of Mudarib) to increase the IAH’s 
profits during a period of decline in the IAH’s profitability.

The bank mentioned that it commingles shareholders’ funds with those of the IAH. 
The result is shared between the two parties in proportion to their participation in the 
investments. The bank’s management indicated that all income, including that from 
banking services, is allocated between the shareholders and IAH.

The bank claimed that its reputation in the market is to a large extent influenced by 
the funds received from IAH and the adequacy of its capital. For example, if the bank 
wants to open a letter of credit with another bank, the correspondent bank will carry 
out an assessment report that will take into consideration the level of deposits. Hence, 
in order for the bank to act in a fair manner, both the shareholders and the IAH should 
share in all of the bank’s profits.

It is worth noting that the management of the bank claims that the Board of Directors 
act as Mudarib since it is responsible for setting-up the overall policies of the bank, 
and the IAH are the Rab al Mall (provider of funds). This begs the question as to the 
status of the shareholders. A typical view would be that the bank is the Mudarib.

7.3.3 The Bank’s Provisioning Policy
The bank’s provisioning policy is to create specific provisions where losses are 
expected to arise on Islamic financing contracts. The bank also creates a general 
provision on its financing portfolio. The bank’s accounting policy is to reflect the 
amounts of provisions in the income statement and to show provisions in the balance 
sheet as part of ‘other liabilities’.
However, the bank would also create provisions against investments in properties and securities when there is a permanent decline in the value of such investments. The amount of such provisions is also charged to the income statement.

Although the IAH authorise the bank to deduct 10 per cent of their profits to create provisions against losses (the bank’s contract), the bank has not used this right thus far. The bank’s provisions are charged to the profit and loss account and it credits specific provisions, which appear under the heading ‘other liabilities’ in the balance sheet.

7.3.4 The Bank’s Liquidity Policy
The bank adopts a conservative approach in managing its liquidity. The 1415H (corresponding to 1995) and 1416H (corresponding to 1996) financial statements show that short-term assets (up to 3 months) exceed its short-term IAH of similar maturities by BD57m and BD31m, respectively. The bank’s financial statements show this ‘surplus’ is mainly invested in short-term commodities.

This policy tends to allow the bank to sell its commodity contracts in a short period if it faces any shortage in liquidity and at the same time earn some profits by investing in commodities transactions.

7.3.5 Profit Allocation
This method of profit allocation is designed to determine the IAH’s share of profits from the bank’s portfolio. The following method is applied to all types of IAH accounts:
Although the bank states that this is a general formula, nevertheless, in the case of a decline in the IAH’s share of profit, the bank may follow one or all of the following options in order to mitigate the fall:

\[
ASP = \frac{OBCA \times (TP - PPL)}{TA \times 100 \times 100} \times 100 - MR\%
\]

1. transfer part of the shareholders profits to IAH in the form of a ‘donation’ as it is permissible under Islamic Jurisprudence for the Rab al Mall to give up part or all of his share of profit as Mudarib; plus
2. decide that the provisions are to be borne only by the shareholders; or
3. reduce its Mudarib rate to maintain the rate of the investors’ profits at the desired level.

This is intended to preserve the IAH’s confidence in the bank. As mentioned earlier, the transfer of profits from the shareholders to IAH is not disclosed in the bank’s financial statements. It is worth noting that neither the shareholders nor the SSB have approved the practise of transferring profits from shareholders to IAH. (As already noted, the bank states that no such transfers have ever been made.)

(18) With regard to PPL, although this appears in the bank’s formula, in practice it appears not to be used.
The bank deducts from the amounts deemed to be invested in respect of each IAH’s type of account, a certain percentage for liquidity. This will not be included in calculating the allocation of profits when determining the IAH’s share of profits. However, the bank may invest part of these ‘liquidity’ amounts in short-term investments after making provision for its short-term commitments, thereby generating additional profits for shareholders.

7.4 ROLE OF THE SHARI’A SUPERVISORY BOARD (SSB)

The SSB consists of six members. The meetings of the SSB take place at the management’s request and to respond to Shari’a matters. The members of the SSB are not appointed by the shareholders. No chairman has been appointed for the SSB.

Lately, the SSB extended its role to meeting with the staff of the bank. This is intended to educate the staff of the bank about issues relating to Shari’a matters.

Furthermore, the SSB reviews the annual financial statements of the bank before publication. This review is in order to ensure that the bank’s profits have been generated only from investments permitted by the Shari’a. The SSB also ensures that the items appearing in the financial statements have been explained clearly. This procedure is supposed to ensure that the operations of the bank are in accordance with Islamic Shari’a.

Although the SSB was not involved in setting up the accounting policies of the bank, it issued a Fatwa two or three years after the establishment of the bank, to the effect that IAH and shareholders should be treated as partners (Shuraka) in the bank. This Fatwa was issued following a request to this effect made by the management of the bank to the SSB.

With regard to the bank’s method of profit recognition on Murabaha financing, the SSB member whom the researcher interviewed objected to the bank’s initial treatment of recognising all the profits when the contract is concluded between the bank and the
client (up-front income recognition). However, despite the SSB's objection, the bank continued using the up-front recognition of profits approach.

Therefore, it can be argued that the Fatwas issued by the SSB are not treated as binding by the bank. Indeed, it is worth noting that the bank's Articles of Association state that the SSB will play a 'consultative' role in such matters.

Nevertheless, every member of the SSB signs its annual report. The report states the following: “The SSB has reviewed the balance sheet of Mohammed Bank and discussed its items with the bank’s management. Continuous contact was maintained between the officials of the bank and the SSB to examine the contracts and matters undertaken by the bank or dealt with, while undertaking its business activities. Religious opinions were expressed with respect to such questions and matters. The SSB committee, being thankful to Allah for its success, expresses its appreciation to the bank’s management for their keen interest in understanding and applying the provisions of true Islamic Shari’a.”

7.5 ROLE OF THE EXTERNAL AUDITORS
The auditors of Mohammed Bank stated that their auditing procedures for an Islamic bank are similar to those for a conventional bank. In addition, the auditors believe that there is a necessity to develop Islamic accounting standards for Islamic banks, although a number of IAS standards can be applied to Islamic banks. In this respect, the auditors mentioned that the issue of Islamic financing, including Murabaha financing and Musharaka financing, has not been addressed by IAS.

With regard to the bank’s presentation of IAH’s as liabilities in the balance-sheet, the auditors of Mohammed Bank argued that Islamic banks claim that IAH represent no legal liability for these banks. This is because the contractual relationship is based on the Mudaraba contract, whereby, in the case of loss relating to IAH’s funds these would be borne by IAH provided the loss was not due to the bank’s misconduct or negligence.

108
It is worth noting that this treatment of IAH is similar to the treatment of another Islamic bank that was established before Mohammed Bank and is audited by the same accounting firm.

However (as the auditors indicated to the researcher), Islamic banks usually prefer to transfer any losses to the shareholders rather than charging them to IAH. The auditors believe that if Islamic banks charged the losses to IAH, they might lose their reputation in the market.

The auditors also stated that, in the absence of accounting standards for Islamic banks, differences would continue to exist between Islamic banks.

The auditors believe that they would accept the treatment of IAH as funds under management only if the bank strictly separated the accounts of shareholders from those of IAH, and the bank strictly adhered to the principles of Mudaraba (e.g., the bank does not transfer losses on IAH funds to shareholders’ share of profits.) In other words, the auditors seem to concur with the bank in treating IAH accounts as in-substance (or constructive) liabilities.

The auditors of Mohammed Bank indicated that they established the accounting policies of the bank in consultation with the management. With regard to the level of information disclosed by Islamic banks, the auditors believe that the present level of information disclosed by Mohammed Bank is in accordance with IAS. However, the auditors mentioned that, due to the nature of Islamic banks, more information needs to be disclosed in the bank’s financial statements, and this may be achieved when Islamic banks adopt the Islamic accounting standards issued by AAOIFI.

The auditors stated that the bank’s profits from Murabaha are now recognised on a pro-rata basis over the period of the contract in order that each financial period is allocated its proportionate share of profits.
The auditors argued that this accounting treatment of income recognition is more prudent than other accounting treatments used by some other Islamic banks. Recognising the profits pro-rata allows the IAH to receive an appropriate share of profits on their investments even if they decide to withdraw their funds before the liquidation of the investments. The auditors claimed that since *Murabaha* is a sale of goods, it falls within the scope of IAS 18, which states that "... interest revenue which is the difference between the revenue from the sale of goods or rendering of the service and the nominal amount of the consideration is recognised on a time proportion basis."

The auditors of Mohammed Bank pointed out that they are responsible to the shareholders because they were appointed by them. Therefore, if the auditors' report is incorrect or it has ignored a major liability of the bank, the shareholders would have the right to take the necessary actions against them.

The auditors of Mohammed Bank believe that banks which treat IAH as funds under management should be required to disclose more information than that which is required under IAS 30. Such information should include the amounts of provisions created against IAH's investments, and the profits or losses earned on these funds.

The next chapter will discuss the comparison, analysis and conclusions of the case studies.
CHAPTER 8

COMPARISONS, ANALYSIS AND CONCLUSIONS OF THE
CASE STUDIES

This chapter provides an analysis of the two case studies by casting light the casting similarities and differences and level of disclosure between Ahmed Bank and Mohammed Bank. The reason for choosing these two banks for conducting the case study was that both banks operate in the same country and are therefore subject to the same supervisory regulations. In addition, each bank pursues different investment policies. For example, Ahmed Bank offers higher risk investments with higher returns, while Mohammed Bank offers low risk investments with, consequently, lower returns. The role of the SSB in the two banks is also different. Although both banks claim that they follow IAS, it appears from the transactions that were examined that each bank has a different accounting treatment for the same transaction.

The chapter is divided into the following sections:
1- Comparisons of Case Studies.
2- Analysis of Ahmed Bank’s Case.
3- Analysis of Mohammed Bank’s Case.
4- Concluding Remarks.

8.1 COMPARISONS OF CASE STUDIES

Although the above indicates differences between the two banks in terms of their size and the complexities of their operations, whether these differences help to explain the differences in their accounting policies is a matter which is discussed below. This section will highlight the main accounting differences, which were discussed in more details in the individual case studies.

8.1.1 The Accounting Treatment of Investment Account Holders

The contractual relationship governing the two banks and IAH is based on the Mudaraba contract. However, the accounting treatments of IAH differ between them,
pending the implementation of AAOIFI standards. Ahmed Bank treats IAH as funds under management (off balance sheet), while Mohammed Bank presents IAH under the liabilities side of the balance sheet.

The differences in accounting treatments between the two banks have resulted in non-comparable financial statements. This will be discussed in more details in the case studies.

8.1.2 Disclosure of Information

i) Profit Allocation: Ahmed Bank allocates the investors’ share of the profits on a monthly basis after it determines the profits achieved on each fund. However, before making the payment, and before deducting its Mudarib share, the bank deducts from the profits a fixed percentage for ‘reserve fund’.

On the other hand, Mohammed Bank uses the following formula, which reflects the commingling of IAH funds with the shareholders’ funds in financing Total Assets:

\[
\text{ASP} = \frac{\text{OBCA} \times \text{TP} - \text{PPL}}{\text{TA} \times 100} \times 100
\]

- (ASP) Account Share in the Profit
- (OBCA) Outstanding Balance of the IAH’s Account
- (TA) Total Assets
- (TP) Total Profit
- (PIB) Percentage Invested by the bank on behalf of IAH after deducting a certain percentage for liquidity (i.e. the ‘Investment Rate’)
- (PPL) Provision for Potential losses
- (MR) Mudarib Rate

Although the contractual relationship between the two banks and their IAH is in both cases based on the Mudaraba contract, each bank uses a different method for allocation of profits. Such a difference can be attributed to the differences in their
investment policies, i.e., Ahmed Bank separates the funds of the shareholders from those of IAH, while Mohammed Bank, conversely, commingles the funds of the shareholders with those of IAH.

ii) Transparency of information: In the absence of a specific disclosure standard issued on profit allocation by the IASC, or a clear direction from the regulatory authority, the two banks were not obliged to disclose information on their allocation of profits. For example, they were not obliged to disclose the actual Mudarib rate received by them, the profits generated on investing their IAH’s funds, any amounts transferred from the shareholders to the IAH or vice versa, or amounts transferred from one fund to another.

8.1.3 Islamic Financing

i) Murabaha Financing: Until 1993, Ahmed Bank used to adopt the straight-line method of income recognition on an accrual basis. It then adopted the so-called 'actuarial' or declining balance method, under which income is recognised pro rata to the balance of capital deemed to be outstanding. The bank recognises its share as Mudarib in the profits when the instalment is due.

Until 1989, Mohammed Bank used to adopt the up-front basis, whereby it recognised all the profits when the contract was concluded with the client. After 1989, the bank adopted an accrual basis using the straight-line method. The bank recognises its share of profits as Mudarib when the instalment is due.

ii) Musharaka Financing: Ahmed Bank uses the Fixed Musharaka, and, therefore, its share in the Musharaka will not be less than 51 per cent of the capital. Ahmed Bank treats its share in the Musharaka as an investment in a joint venture (IAS 31). On the other hand, Mohammed Bank applies the declining Musharaka and it uses the cost method by applying IAS 25 to Musharaka as a long-term investment. This is accepted under GAAP (General Accepted Accounting Principles) because the bank has no influence over the Musharaka (being a sleeping partner).
This accounting difference is due to the fact that each bank uses a different type of Musharaka and plays a different role. In the case of Ahmed Bank, the bank always maintains a majority in the Musharaka, and under IAS this allows the bank to treat its share in the Musharaka as investment in a joint venture (using the equity method as permitted by IAS31), with recognition of undistributed profits. By contrast, Mohammed Bank treats its share as a long-term investment (IAS25), since it has no influence in the Musharaka as long as the other partner has not violated the agreement.

8.1.4 The Duties of the SSB
The SSB of Ahmed Bank has a larger role than the SSB of Mohammed Bank, possibly because the scope of its responsibilities is greater. In this context, the SSB of Ahmed Bank conducts a Shari’a audit on the bank’s operations through the use of a Shari’a staff. While the role of the SSB of Mohammed Bank is no more than a consultative committee to the management.

8.2. ANALYSIS OF AHMED BANK’S CASE
This section analyzes the following accounting aspects of Ahmed Bank:

1- The Accounting Treatment of Investment Account Holders.
2- Disclosure of Information.
3- Islamic Financing.
4- The Duties of the SSB.

8.2.1 The Accounting Treatment of Investment Account Holders
In the main, Ahmed Bank offers to IAH various investment funds (portfolios). The funds of IAH are maintained in different portfolios according to the type of investments, the level of risk, and the level of discretion given to the bank. Usually the IAH’s funds will be invested separately from the bank’s own funds.
The case study indicated that the bank treats investment accounts as accounts managed on a fiduciary basis, since in the case of a loss the bank will not be liable to compensate the investors (IAH) unless the loss were due to the bank's negligence or breach of contract.

The bank's auditors stated that the bank's role as Mudarib is like that of a fund manager who manages the investors' funds on their behalf. Therefore, the funds of IAH should be treated as funds under management, i.e., as types of fiduciary accounts. A fiduciary service is a service offered by a bank/financial institution acting in a position of trust to administer assets on behalf of another party. Fiduciary services include safe deposit rental boxes, trustee services, and funds management. Trustee and other fiduciary services include the holding or placing of assets on behalf of individuals, and, as these assets are not assets of the bank, they should therefore not be reflected in its balance sheet (IAS 30). This means that, because assets held on behalf of fiduciary accounts are not considered assets of the bank, the related funds should not be reflected in the liabilities section of the bank's balance sheet.

As mentioned earlier, the management of Ahmed Bank claims that its role is similar to that of a fund manager in the Western model. Treating IAH as funds under management avoids subjecting the investment accounts to the capital adequacy requirements. Hence the bank is allowed to maintain lower capital. This may be a reason why this treatment is favoured by management.

**Researcher's Comments**

It is true that IAH are not a liability of the bank and should therefore not be reflected as a liability in the balance sheet. However, there are significant differences between fiduciary accounts and Mudaraba contracts. These are stated below:

1-In exchange for the service provided by the fund manager, the latter is entitled to a fixed management fee. In the case of an Islamic bank (Mudarib), the bank is entitled to a Mudarib share only if the IAH’s funds are generating profits. The accounting treatment of IAH has implications from the auditors' points of view, as well. Treating IAH as an off balance-sheet item reduces the assets and
liabilities to be audited by the auditors of Ahmed Bank, as funds under management represent no risk to the shareholders. This is because, if there are losses on IAH arising in the normal course of business, they will be borne by the IAH. This apparently allows the auditors to carry out a limited review of funds under management rather than a full audit. Hence, the auditor's opinion does not cover funds under management. This suggests that the interests of IAHs may be inadequately reflected in both the scope of the audit work and the auditor's final report.

2- Under the conventional banking system, a 'Chinese wall' is established to prevent the bank from transferring depositors’ funds, which are expected to be invested in a low risk, low return assets, to mutual funds. These mutual funds would be managed by the same bank and invested in higher risk assets, in order to generate higher profits to be “creamed off” while paying a low rate of return to the depositors. It is worth noting that a Chinese wall is established to protect the depositors’ funds and to match the investors’ funds with their risk preferences.

Dale (1996, chap. 2) argued that the separation of a bank’s securities business from the rest of the bank will not protect the depositor’s funds, as the rules stipulated in the EU’s Capital Adequacy Directive of 1993 permit the bank to fund its securities business from its own liabilities. He also argued that in order to avoid, or at least alleviate, such a risk the funding rules should prevent or limit the use of deposits to support a bank’s trading book.

A Chinese wall is not established in an Islamic bank since the interest of the shareholders will be treated the same as those of IAH (if we assume that the bank commingles the shareholders funds with those of IAH, as in the case of unrestricted IAH), and the results of the investments will be shared between the shareholders and IAH. However, this logic cannot be applied to the case of restricted IAH, and this raises the question of how far the contractual terms for restricted IAH provide protection similar to that of a Chinese wall.
3- In the case of conventional banks, mutual funds are separated from the bank’s retail operations; therefore, the bank will maintain two sets of accounts, one for the banks’ assets and another for the mutual funds.

This raises the further question as to whether Islamic banks which treat IAH as funds under management (with no commingling) should be subject to all regulatory controls including the liquidity ratio and single borrowing limit (similar to universal banks). A positive answer to be indicated, because the role of the supervisory authority is not only to reduce the risk attaching to the bank’s own capital, but also to reduce the risk borne by the IAH’s funds as well^{19}.

In addition, because the bank acts as a market maker for those investors (IAH) who withdraw their funds before the liquidation of the fund, the bank must maintain adequate liquidity for this purpose. However, to encourage IAH not to withdraw their funds prior to liquidation, if one of the funds incurs losses the bank may prefer to transfer the losses to its own income statement rather than deducting them from the investors’ accounts.

Furthermore, in the case of proven negligence in managing the investors’ funds, the bank’s capital may also be affected. This would subject the capital of Ahmed Bank to various risks.

In Islamic banks, which commingle their own funds with the IAH’s funds, the assets of the bank include those that are financed by both the shareholder’s funds and IAH. Hence, the assets of the bank are pooled with the assets financed by the IAH.

The above also recognises the importance of including the investors’ accounts (Restricted IA and Unrestricted IA) in the calculation of the capital adequacy.

^{19} It is worth noting that the Basle Accord on capital adequacy is silent on the issue of funds under management. See Dale (1996) for more detailed analysis on this issue.
It is worth noting that, due to the absence of accounting standards for Islamic banks, the bank had no choice but to adopt existing international accounting standards as required by the regulatory authority. It can be also inferred from the case study, however, that Ahmed Bank intended to reflect IAH as funds under management to avoid subjecting the bank to various supervisory controls, including capital adequacy and liquidity control.

The findings emerging from the case study are that the financial statements of Ahmed Bank do not disclose adequate information to Investment Account Holders (IAH). However, according to IASC (1997, pp. 42-43), “The users of the financial statements include investors, shareholders, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies, and the general public.” IAH are not mentioned amongst the ‘users’ of financial statements and, therefore, this indicates that the International Accounting Standards Committee has not considered the type of information needed by the IAH.

Treating IAH as funds under management does not reflect the nature of the contractual relationship between the bank and IAH. This treatment reflects the fact that the IAS did not address the Mudaraba contracts in its accounting standards. The case also suggests the need to regulate the bank’s contracts with IAH to ensure that the bank discloses the necessary information which IAH need to know before signing the contracts. This would reduce the 'information asymmetry' between the parties involved and help to make these contracts more transparent.

The adoption of IAS seems to have had two contrasting impacts on financial statements. Firstly, it may indicate to the users of the financial statements that the bank is adhering to accepted international accounting practices, which will give the users of the financial statements more confidence in the bank’s accounting policies. Secondly, it allows the bank to avoid disclosing important information in those financial statements.
8.2.2 Disclosure of Information

According to IAS 30 (1997, p. 530) "if the bank is engaged in significant trust activities, disclosures of that fact and an indication of the extent of those activities is made in its financial statements." This indicates that IAS 30 requires the bank to publish general information, which is appropriate for fiduciary services but not (for the reasons given above) adequate for Mudaraba contracts. The Investment Account Holders require additional information to that required under IAS 30, e.g., the profits generated from managing the investors' funds, and the expenses charged against the investors' profits. In addition, in case of loss, IAH would expect to obtain information that explains the reasons for the loss.

Although the bank discloses more information than the minimum required under IAS 30, including information on the gross income generated from managing the investors' funds, the total amounts of funds under management, the types and amounts of Islamic financing which are financed by the investor's funds, etc., the level of information disclosed in the bank's financial statements is still not sufficient to assist the investors in the bank to make their investment decisions. This is because important information is not disclosed in the financial statements about the profitability of each fund, the amounts received by the bank for acting as Mudarib, and the amounts of 'reserve funds' maintained by each fund. It is worth noting here that because the bank is not required by the law to publish a separate financial statement for each fund, the bank does not prepare them.

i) Transparency of Information: Ahmed Bank creates a separate 'reserve fund' for its General Mudaraba Fund and Restricted Mudaraba Fund. In case any of these funds achieves profits lower than initially expected, which would effect the IAH's profits, the bank can then use the 'reserve fund' by releasing an amount to enhance the IAH's i.e. for 'income smoothing' purposes. The bank believes that such action is legal because IAH are the real owners of this 'reserve fund'. These arrangements were approved by the bank's SSB. It is worth noting that the bank's contract makes no reference to the income smoothing arrangements (neither to the right to deduct the percentage nor the release to enhance the profit.)
Furthermore, any direct expenses related to a specific fund should be charged to that fund. IAS 30 does not require any information to be published in the banks' financial statements regarding those expenses. This suggests that adopting the IAS would enable the Islamic bank to avoid disclosing important information in the financial statements.

**ii) Allocation of Profits:** No financial statements are published by the bank for the managed funds, despite the importance of these statements in helping investors to evaluate the bank's performance in managing their funds. Although the bank's contracts state the *Mudarib* rate, this is in effect a maximum rate, as the bank may charge lower rates during a period of decline in the profitability of the managed funds. The bank may increase the rate actually applied back to (or forward) the 'maximum' when the profitability of the funds improves. In neither case does the bank need to disclose the actual *Mudarib* rate it collected in the financial statements.(20)

This suggests that publishing inadequate information in the financial statements of the bank has made it easy for the bank to use 'income smoothing' without this being apparent. This would lead investors to believe that the profits reported represent the actual profits generated on their investments.

The theme emerging from this section is that IAS 30 does not require Islamic banks to disclose adequate information in their financial statements regarding funds under management, given that *Mudaraba* contracts are different from the funds under management as practised by conventional banks. It is worth noting that AAOIFI has developed an accounting standard that deals with disclosure requirements for profit allocation between owners' equity and IAH (FAS No. 5 standard 1997).

---

(20) This analysis is based on the bank's financial statements from the period of 1991 to 1995.
8.2.3 Islamic Financing

i) Murabaha to the Purchase Orderer: It can be argued that the reducing balance method allows the bank to link the outstanding balance of the facility with the amount of profits. It is observed from the example in the case that, when the outstanding capital decreases the profit decreases, while, under the straight-line method, the profits are unchanged despite the decrease in the outstanding capital balance.

Compared to the straight-line method, the reducing balance method is a form of profit recognition, which tends to make profit more sensitive to changes in the bank's level of activity in funds management. This is a problem that may be mitigated by use of the income smoothing technique already mentioned (hidden reserves).

It can be suggested from the above that more information should, therefore, needs to be disclosed regarding Murabaha financing, including the profits/loss generated on Murabaha financing. However, the bank discloses no such information since it is not required under IAS.

However, the new AAOIFI standard on Murabaha allows this method of income recognition. (Plus recognition when instalments are received, when based on a decision by the SSB of the Islamic bank, or if the supervisory authorities require it.)

ii) Musharaka Financing: The bank has argued that it adopts IAS 28 (i.e. the equity method) to re-value its share in Musharaka, bearing in mind that this standard is established to deal with investment in associates. However, IAS 28 only addresses investment in associates when the enterprise holds not less than 20 per cent of the voting power of the associates, i.e., it is presumed that the enterprise maintains significant influence over the associates. The bank's share in the Musharaka is usually not less than 50 per cent of the capital, and if they has a controlling interest or joint control. Thus it might be more accurate to say that the bank has adopted the equity method permitted as an alternative to proportionate consolidation according to IAS31.
However, *Musharaka* and its accounting treatments as set out in AAOIFI’s FAS No. 4 do not correspond with any of the three types of joint ventures described in IAS 31. Unlike jointly-controlled operations and jointly-controlled assets, *Musharaka* controls its assets, generates its revenue, and incurs its expenses and liabilities. Each party to the contract is allocated his/her share of profit or loss. Each party also has the right to know the details of the assets, liabilities, revenues, and expenses of the *Musharaka*.

In *Musharaka*, capital is measured at cost (the amount which was paid or at which the asset contributed was value at the time of contracting) and recorded under the title *Musharaka* Financing, in the Islamic bank’s statement of financial position. The Islamic bank’s share of profit, resulting from partial or final settlement between the Islamic bank and the partner, is recognised in the Islamic bank’s income statement to the extent that the profit is being distributed. Unlike the equity method in IAS28 and IAS31, the retaining of profit does not normally lead to adjustments in the Islamic bank’s capital in the *Musharaka*, which remains unchanged until the activity is liquidated. The capital of *Musharaka* may only be increased/decreased before the activity is liquidated, provided the parties to the contract agree to do so. This is important because, whilst profits may be shared according to whatever ratios the Islamic bank and its partner agree upon, losses are shared in proportion to the capital contributed by each party. Losses are recognised in the Islamic bank’s accounts to the extent that such losses are being deducted from its share of the *Musharaka* capital.

It is to be noted that AAOIFI’s FAS No. 4 (AAOIFI, 1997) does not require any consolidation procedures for *Musharaka* transactions. An Islamic bank’s consolidated financial statements would therefore include the same amounts as its separate financial statements. Therefore, neither the proportionate consolidation preferred by IAS 31 for jointly-controlled equities nor the equity method permitted as an alternatives, is suitable for *Musharaka* transactions.

By contrast, FAS No. 4 (para. 12, p. 181) states that “in the case of *Musharaka* that continues for more than one financial period, the Islamic bank’s share of profit for any period, resulting from partial or final settlement between the Islamic bank and the
partner, shall be recognised in its accounts for that period to the extent that the profit is being distributed.” FAS No. 4 thus takes account of the contractual nature of Musharaka, whereas IAS31 does not.

**iii) Mudaraba Financing:** The 1995 audited accounts reflect no assets based on Mudaraba financing. This may be because Mudaraba financing involves a higher risk than other modes of financing. This argument is justifiable since the bank (provider of funds) will have no say in the management of the project/investment, while the client (Mudarib) has control of the management of the project/investments.

Therefore, in order for the bank to provide Mudaraba financing it would require a very detailed assessment of the client (Mudarib). This would involve additional expenses that would be added to the original cost of the Mudaraba.

Although the 1995 audited accounts show no Mudaraba deals carried out by the bank, the management stated that the bank applies the cost method to value its share in the Mudaraba when it exists.

The bank’s approach of applying the cost method to value its share in the Mudaraba, seems appropriate since the bank (Rab al Mall) will have no significant influence over the management of the investment/project. It is also consistent with the AAOIFI standard No. 3.

**8.2.4 The Duties of the SSB**

The SSB of Ahmed Bank has a larger role than the SSB of Mohammed Bank, possibly because the scope of its responsibilities is greater. In this context, the SSB of Ahmed Bank conducts a Shari’a audit on the bank’s operations through the use of a Shari’a staff. This staff submits its report to the SSB, which also holds frequent meetings with the bank’s management. The level of responsibility that has been given to the SSB of Ahmed Bank was tended to enhance the bank’s credibility among the users of the financial statements about its compliance with the Shari’a precepts.
Despite the importance, in principle, of the SSBs' participation in deciding the accounting policies of the bank, in the case of Ahmed Bank the SSB did not participate in setting its accounting policies. This suggests that the management may have viewed the role of the SSB as limited to verifying the bank's contracts, and ensuring that the profits are generated from sources acceptable to Islamic Shari'a.

It can be argued that the SSB never realised the importance of their participation in setting the accounting policies until the AAOIFI was established in 1991. If so, this case study indicates the importance of the AAOIFI's role in regulating the SSB in order to enable it to play a more effective role in the bank's operations.

**8.3 ANALYSIS OF MOHAMMED BANK'S CASE**

This section analyses the following accounting aspects of Mohammed Bank:

1- The Accounting of Treatment of Investment Account Holders.
2- The Information Disclosure.
3- Islamic Financing.
4- The Duties of the SSB.

**8.3.1 The Accounting Treatment of Investment Account Holders**

Mohammed Bank allows IAH to maintain accounts similar in someways to normal deposit accounts, and the bank will invest the shareholders funds together with those of IAH. Mohammed Bank operates more like a conventional bank in commingling the shareholders' funds with those of other investors (IAH).

Presenting IAH as a liability in the balance sheet indicates to the users of financial statements that IAH represent a liability for the bank similar to any other liability. This treatment misrepresents the contractual relationship governing the bank and IAH. Presenting IAH under the liability section of the balance sheet has the (presumably international) result of showing the bank with a more impressive balance sheet. However, this could equally be well achieved by showing IAH on the liabilities and equity side, but not as a liability, (i.e. as a separate liability between shareholders equity and liabilities.)
On the other hand, reflecting IAH as a normal deposit (liability) in the balance sheet allows the bank to claim it is complying with IAS 30 in disclosing the same level of information as required for conventional deposits under IAS 30. The bank is not required under IAS 30 to disclose important information relating to IAH, such as the actual Mudarib rate received by the bank. Such a practice thus helps the bank to claim to the users of the financial statements that it is disclosing adequate information.

This treatment of IAH conflicts with the AAOIFI standards which require Islamic banks to present Unrestricted Investment Accounts on the balance sheet (but not as a liability), and with the AAOIFI treatment of Restricted Investment Accounts, which requires Islamic banks to present them as an off-balance sheet item.

It can be inferred from the above that the adoption of IAS 30 will suggest to the users of the financial statements that the level of information published in the financial statements is adequate. At the same time, it allows the bank to avoid disclosing important information in its financial statements including the bank’s actual share as Mudarib and its accounting policies regarding its allocation of profits.

Furthermore, Mudaraba has no equivalent in Western financial instruments. The management of the bank, and their auditors, tended to interpret IAS to mean what they thought would be appropriate, given the bank’s accounting objectives. This interpretation seems to have served the bank’s objectives in improving its balance sheet footing. The inadequacy of IAS to cater for Mudaraba gave the bank a wide degree of discretion as regards disclosures.

The auditors of Mohammed Bank claimed that they are responsible to the shareholders because it is they who appointed them. If the auditor’s report is incorrect, (i.e. it has ignored a major liability of the bank), the shareholders can take legal action against their auditors if they suffer losses as a result.
It seems that Mohammed Bank’s external auditors’ global is to advise its clients to treat IAH as a liability item in the balance sheet. This would appear to be the case because this treatment of IAH is similar to the treatment adopted by another Islamic bank that is audited by the same accounting firm. This means that the external auditors will carry out a full audit of all operations of the bank, regardless of who bears the losses on the investments.

8.3.2 Disclosure of Information

i) Profit Allocation: The bank’s profits allocation method suggests that IAH are entitled to the profits generated from investing their funds only after setting aside a certain percentage for liquidity (via the Investment Rate) and subject to the deduction of the Mudarib rate. Income from other activities, including fees and commissions generated from offering banking services, is also allocated between shareholders and IAH.

It is highly likely that the bank will invest a higher percentage than the Investment Rate that which is stated in the contract, in income-producing and less liquid assets. However, the additional income will be for the benefit of the shareholders and the whole of the “liquidity amounts” is treated as an interest free loan (Qard Hasan).

As indicated in the case study of Mohammed Bank, the bank’s contracts state that it invests a specific percentage of the IAH funds’ placed with the bank, and the holders of the accounts are entitled to at least 75 per cent of the profits generated on their invested funds, after deducting 10 per cent of the profits for what it calls provision against potential losses. The bank indicated to the researcher that the bank’s Mudarib rates equal 25 per cent of the profits on all types of IAH.

It is important to note that, if the profit allocation resulted in profits for IAH lower than the profits paid by other banks operating in the same market, the bank might decide to reduce its Mudarib rate. As was indicated to the researcher by the management, although the bank has the right to deduct 10 per cent of IAH’s profits for provisions, the bank has so far not used that right.
If the bank sets the percentage of IAH investment to be deemed as held in non-income producing assets too high (i.e. it sets the Investment Rate too low), it may find itself obliged to transfer some of the ‘shareholders’ profits back to IAH in order to be competitive in the market. Such a transfer is considered a form of voluntary ‘donation’ by the bank to the IAH. The financial statements disclose no information regarding the practising of this by the bank, as this is not required under IAS 30.

It is worth noting that paying IAH (except the holders of Specific Investment Certificates) their profits at the end of the financial year enables the bank to re-invest the IAH’s profits during the year for the benefit of the shareholders. At the same time, it gives the bank a better picture of the level of profits paid by other banks so as to decide accordingly on the appropriate rate of profits for its IAH.

The profit allocation method indicates that the Mudarib rate of profits is deducted from the IAH’s profits and paid to the shareholders and not to the Board of Directors. This implies that the Mudarib is the bank, and not, as the management stated, the Board of Directors.

The bank’s argument that the Board of Directors is the Mudarib is difficult to comprehend, since in case of misconduct or breaching of contracts, the bank as an entity will be responsible rather than the Board of Directors or the management generally. It seems unlikely that directors or members of management are personably liable for tortious acts (as opposed to criminal ones).

The transfer of profits from the shareholders to IAH may show that the shareholders are giving up part of their profits for the benefit of IAH. In fact, the truth is that the method of profit allocation is drafted to be in favour of the shareholders (not only because of the Mudarib share but also due to the low Investment Rate.) Hence, in order to sustain the bank’s confidence in the eyes of IAH, the bank may transfer some of the ‘shareholders’ profits back to IAH.
Researcher's Comment:
The researcher believes that if the bank were required to disclose any transfer of profits (as discussed above) in the financial statements, this might negatively affect its credibility in the market. The lack of information transparency can be attributed to the lack of accounting regulations, including the general inapplicability of IAS 30 to Islamic banks.

The bank is not required under IAS to disclose any information regarding its allocation of profits. This seems to have led to the transfer of profits between the shareholders and IAH without the IAH or the shareholders being aware of this practice on the part of the management.

ii) Provisioning Policy: Under IAS 30, banks are not required to separate the amounts deducted from the shareholders' profits, from those which are deducted from the IAH's profits. This is because, in the case of conventional banks, the provisions are directly deducted from the income statement, which will affect only the shareholders.

Mohammed Bank stated that it is permitted to deduct the amounts of provisions from the profits of the IAH only. It would therefore seem logical that the notes to the financial statements should disclose the actual amounts deducted from the profits of the IAH, which Mohammed Bank does not do.

Researcher's Comment:
In order to enhance the transparency of the financial statements, it is necessary for Islamic banks to separate the amounts of provisions deducted from the IAH's profits from those provisions that have been borne by the shareholders.

8.3.3 Islamic Financing

i) Murabaha Financing: The theme emerging from this section is that the differences amongst Islamic scholars regarding income recognition lead to different accounting results. Some Islamic scholars' views were to stick to the initial concept of income
recognition, which is to recognise the profits only after recovering the capital. Others allowed the recognition of income before the full recovery of the capital.

Furthermore, the IAS did not address certain accounting issues relating to Murabaha, such as the insolvency of the client, provision for doubtful debts, and the failure of the client to fulfil his promise after making the down payment (in Arabic *hamish gedyyah*, which is considered an obligation on the Islamic bank and is to be treated as a liability unless the *Shari’a* supervisory board of the Islamic bank decided otherwise.)

However, the new AAOIFI standard on Murabaha allows this method of income recognition. (as well as recognition when instalments are received, if based on a decision by the SSB of the Islamic bank, or if the supervisory authorities require it.)

**ii) Musharaka Financing:** The Musharaka is similar to a joint venture since it involves partners. Hence, treating Musharaka as a long-term investment is acceptable under IAS25, as the bank has no influence over the Musharaka provided it is a sleeping partner, which is the case with Mohammed Bank. Therefore, this accounting treatment fairly reflects the actual contractual arrangement between the bank and the client under the Musharaka.

The bank states in its standard contract that it could deduct 10 per cent of the IAH’s profits as a provision against potential losses.

In the notes, the bank discloses the total provisions it has created. The balance sheet will show the net Islamic financing after deducting the provisions. However, the bank is not required to disclose the actual amounts deducted from IAH’s profits in a specific financial year.

**iii) The Duties of the SSB:** The case indicated that the SSB has a very limited role in controlling the activities of the bank. Even the meetings of the SSB take place at the request of the management.
On the other hand, it can be inferred from the role of the SSB of Mohammed Bank that it is not independent from the management, and that its role is to act as a consultative committee to the management. The decision of the bank's management was to treat its relationship with the IAH as based on Mudaraba, while the SSB's Fatwa stated that IAH should be treated as partners similar to shareholders (Shuraka). This illustrates the limited influence of the SSB on the management of the bank. Furthermore, the absence of a chairman for the SSB, and the holding of its meetings upon the request of the management, raises doubts about the independence of the SSB.

8.4 CONCLUDING REMARKS

1- The themes emerging from analysing the two case studies suggest that the use of IAS as a basis for the accounting of regulation of Islamic banks has been ineffectual. It has left the financial statements of the two banks non-comparable, and has resulted in an inadequate level of disclosure. For example, consider the treatment of investment accounts (IAH). Ahmed Bank treats IAH as funds under management, off-balance sheet; Mohammed Bank shows IAH as a liability item in the balance sheet. IAS30 gives no guidance as to which is the appropriate treatment.

2- It can be argued that the accounting differences have emerged because neither the national authority nor the IASC had any specific accounting standard for Mudaraba contracts. Furthermore, the Mudaraba has a unique feature (being neither equity nor a liability in the conventional senses), and this is ignored in the IAS standards. The banks were thus able to 'comply' with the IAS in the vacuous sense of not actually 'contravening' them, whilst adopting accounting treatments for Mudaraba of their own choosing. It is worth noting that during the early 1990s almost all parties, including the national authorities that regulate Islamic banks, Islamic banks themselves and the external auditors of Islamic banks, did not realise the need to standardise the accounting treatments for Mudaraba contracts. This only occurred when AAOIFI started issuing its standards. Later, these
standards received significant support when one of the rating agencies criticised the treatment of IAH by an Islamic bank, despite the fact that such treatment was claimed by the bank and their auditors to be in line with IASC standards.

3- This situation seems to have allowed Islamic banks and their auditors to interpret IAS standards in a manner that suits their accounting objectives. Another example to illustrate the inadequacy of the IAS for Islamic banks is the case of what they call provisions. Due to their nature, Islamic banks follow different investment policies, as in the case of Ahmed Bank and Mohammed Bank. This implies that there should be certain minimum disclosures regarding provisions in order to harmonise the information published in the financial statements by Islamic banks.

It should be noted that IAS 30 does not require Islamic banks to disclose important information, such as the percentages deducted in arriving at the IAH’s profits in respect of provisions, and the amounts which have been transferred back from provisions to enhance the level of profits to be distributed to IAH. This is because IAS 30 was not designed to apply to Islamic banks, specifically as regards accounting for IAH.

4- The above suggests that, even in a regulated accounting environment, differences may continue to exist if the regulations are not geared toward the special characteristics of the institutions that will adopt them, as in the case of Islamic banks. Hence, what matters is not the existence of regulation, but the type and appropriateness of regulation.

5- Another issue that emerges from the comparison of the case studies relates to the responsibility of the external auditors. Thus far in Islamic banks the prime responsibility of the external auditors would be to protect the interest of the shareholders in ensuring that the management operates within the overall policies that they have approved by the shareholders. The auditors address their report to the shareholders because they have been appointed by them. This suggests that auditors are mainly liable to the shareholders. For example, the auditors of Ahmed
Bank take the position that, since they are appointed by the shareholders, their audit and their opinion should be limited to the bank's accounts, which would not include funds under management. However, although in Mohammed Bank the audit covers the bank's financial statements including the assets financed by the IAH, and the audit opinion covers all the bank's operations, it is not clear whether the auditors have responsibilities to IAH. In any event, the auditors do not recognise any such responsibilities.

Mohammed Bank and Ahmed Bank were established in the 1970s and 1980s, respectively. The rules at that time allowed an Islamic bank to operate either as a fund manager or like a conventional bank. This suggests that, due to the flexibility of the existing rules, each bank adopted the 'role' that met its objectives. This seems to have resulted in each bank providing different banking services, i.e., Ahmed Bank manages its investor's funds like a fund manager, Mohammed Bank commingles the shareholders' funds with the investors 'depositors' funds like a conventional bank might do.

Such a setting may be acceptable in the case of conventional banks, where deposits represent a liability to the banks and shareholders face a higher risk compared to depositors. However, in the case of Islamic banks, the IAH, like the shareholders, may lose their investments and, therefore, consideration should be given to the possibility of involving them, together with the shareholders, in the appointment of the auditors. This would result in broadening the scope of the auditor's responsibilities to cover the interests of the IAH. It also highlights the need to standardise the role of the external auditors in auditing Islamic banks. This is an issue of corporate governance, which deserves further research (see Archer, Karim and Al-Deehani, 1998).
6- Due to the absence of a specific standard, each bank specifies the role of its SSB. Therefore, differences arise between Islamic banks regarding the role of their SSBs. This suggests that there is a need for a standard on the role of the SSB; with the aim of standardizing the role of the SSB, preserving the confidence entrusted in them by the shareholders and IAH, and to avoid any interference by the management of the bank.

The next chapter will discuss the overall conclusions of this thesis.
CHAPTER 9
CONCLUSIONS

Islamic banks were established in the 1970s to carry out their activities in accordance with Islamic Law. Their main difference from conventional banks is that Islamic banks are not permitted to deal in interest (by either accepting funds or providing financing on an interest-bearing bases) since it is prohibited by Islamic law.

This thesis has attempted to examine and analyse certain accounting practices of Islamic banks in Bahrain during the early to mid 1990s, with a view to determining the degree of comparability of their financial statements, and the extent to which the accounting standards to which some of them were subject were effective from the standpoint of the comparability of their financial statements and of adequate disclosure. The accounting standards in question were the IASs issued by the IASC.

In particular, the thesis endeavoured to establish the hypothesis that the adoption of IASs by Islamic banks had neither prevented their financial statements being non-comparable nor led to an acceptable level of disclosure.

To test this hypothesis, the research conducted case studies on two Islamic banks in Bahrain to understand in more depth their accounting differences and their level of disclosures, and the cause of such differences. The findings of the case studies support the hypothesis, which in turn supports the need to develop accounting standards which specifically cater for the characteristics of Islamic banks.

9.1 PRE-AAOIFI STATE OF ACCOUNTING REGULATION

Most of the countries that have been reviewed in this thesis either directly adopted the IAS as their national standards or developed national standards based primarily on IAS. For the reasons analysed in chapter 8, this failed to render the financial statements of Islamic banks comparable, thereby departing from the concept of comparability which is considered in the IASC Framework as one of the four qualitative characteristics that make the information provided in the financial statements useful for users. The above suggests that the demand to adhere to the IAS
by Islamic banks in order to achieve comparability is questionable to say the least (Karim, 1999).

IAS are designed for conventional organisations and conventional banks, e.g. IAS30. The following highlights some of the accounting practices which made IAS of little positive effect for Islamic banks:

1) The Mudaraba contract that governs the relationship between the IAH and the Islamic bank is neither a financial liability nor an equity instrument (AAOIFI, 1993). Unlike holders of equity instruments, IAH can withdraw their funds at maturity; Islamic banks could refuse to pay IAH until the results of the investments financed by IAHs' funds are determined.

Unlike a debt instrument, investment accounts are not a liability of the bank because in case of loss (not due to negligence or misconduct) IAH will bear the loss. Therefore, IAH have a claim on the bank's earnings or assets, which ranks pari passu with that of the shareholders (Archer et al., 1998).

Furthermore, neither IAS nor the EC directives address the unrestricted investment accounts or the restricted investment accounts in any of their standards, which gave the Islamic banks the discretion to treat them either under the liability section of the balance sheet or as funds under management. Hence, this option allowed Islamic banks to choose an accounting treatment that met their individual accounting objectives.

2) In the absence of a Murabaha standard, some Islamic banks recognise profits on Murabaha over the period of the instalments, by applying an interpretation of IAS 18, which states that "interest revenue which is the difference between the revenue from the sale of goods or rendering of the service and the nominal amount of the consideration is recognised on a time proportion basis." However, the Murabaha is a sale of goods on credit.
Furthermore, none of the Islamic banks discloses in its accounts the type of Murabaha its practices (either obligatory Murabaha or non-obligatory Murabaha), although each type has different accounting implications.

3) Applying the equity method in the Musharaka financing by Islamic banks is not allowed by the Shari‘a, because of the implications of using the equity method for measuring the share which each partner should bear in case of loss. This highlights the need to develop a specific standard which takes into account the special juristic characteristics of the Musharaka. Islamic precepts stipulate that loss should always be divided between the partners in proportion to their respective shares in the capital, while profit (and hence retained earnings) may be shared on a different basis by agreement. Under the equity method, this could lead to the proportions of capital being changed in a way which is inconsistent with the rules for Musharaka.

4) Islamic banks are not required under IAS30 to disclose important information in their financial statements such as the basis applied by the Islamic banks in the allocation of profits between IAH and shareholders, the amount charged as expense to unrestricted investment accounts before allocating their share of profits, etc.

5) On the issue of Shari‘a compliance, the limited role of the SSB in some Islamic banks has allowed the management to take decisions without obtaining the SSB’s approval, e.g., transfer of profits from the shareholders to IAH. This highlights the need to regulate the role of the SSB. One possible solution is through a governance structure which gives more responsibilities to the SSB by mandating that their appointment and removal should be the responsibility of the shareholders. In addition, the bank could be required to establish terms and conditions specifying the responsibilities of the SSB. Such terms and conditions could be presented to the shareholders for their approval. Furthermore, it could be made a requirement that the report of the SSB on the bank’s compliance with Shari‘a be presented to the shareholders after discussion with the management of the bank.
9.2 POST AAOIFI STATE OF ACCOUNTING REGULATION

Islamic banks realised the importance of establishing some form of regulation to create accounting harmonisation between them. Karim (1995) argued that not only Islamic banks but other interested parties like the regulatory bodies and auditing firms supported establishing an external self-regulating body.

In 1991, AAOIFI, a private self regulatory, standard-setting body, was established in Bahrain to promulgate accounting standards for Islamic banks based on Shari'a precepts. Included as members (in addition to Islamic banks), representative of central banks, accounting firms and academics. The appointment of members of the Accounting and Auditing Standards Board, the raising of funds, and promoting the role of AAOIFI are the main functions of the Board of Trustees (Karim 1995).

Following the establishment of AAOIFI, one of the main challenges it has faced in harmonising the accounting policies of Islamic banks is the treatment of investment accounts. AAOIFI has addressed this in Statement of Financial Accounting No.2: Concepts of Financial Accounting for Islamic Banks & Financial Institutions, Financial Accounting Standard No. 5: Disclosure of bases for profit allocation between owners equity and investment account holders, and Financial Accounting Standard No. 6: Equity of investment accounts and their Equivalent (see points 1 and 4 in sub-section 9.1 above).

Statement of Financial Accounting No. 2, classifies investment accounts into two types. Unrestricted investment accounts refer to funds accepted by the Islamic banks from the public on the basis that such funds will be invested without recourse to the investors. The bank also has the right to commingle the funds of the shareholders with unrestricted investment accounts. AAOIFI requires that equity of unrestricted investment account holders appear on the “liability” side of the balance sheet as a separate item (neither under the shareholders equity, nor under other liabilities.) Restricted investment accounts 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. AAOIFI requires Islamic banks to publish a separate statement for restricted investment accounts along with the bank’s annual report.
Financial Accounting Standard No. 5 requires Islamic banks to disclose the bases which they applied in the allocation of profits between IAH and shareholders. The standard also requires among other things, disclosure of the basis applied by Islamic banks for charging expenses to IAH.

Financial Accounting Standard No. 6 sets out the accounting rules to be followed by Islamic banks for recognising and measuring the transactions relating to IAH.

In order to harmonise the accounting practices for Murabaha (see points 2 is subsection 9.1 above), AAOIFI issued Financial Accounting Standard No. 2: Murabaha and Murabaha to the Purchase Orderer, (AAOIFI, 1996). The standard requires that “Profits of a credit sale which will be paid for either by means of one payment due after the current financial period or by instalments over several future financial periods shall be recognised by using one of the following two methods:

i) Proportionate allocation of profits over the period of the credit whereby each financial period shall carry its portion of profits irrespective of whether or not cash is received. This is the preferred method.

ii) As and when the instalments are received. This method shall be used based on a decision by the SSB of the Islamic bank or, if it is required, by the Supervisory authority. In both of the above methods, revenues and costs of goods sold shall be recognised at the time of concluding the sale contract, subject to the deferral of profits” (AAOIFI, para. 8).

As a disclosure requirement, the standard requires the Islamic bank to disclose in the notes accompanying the financial statements whether it considers the promise made in the Murabaha to purchase orderer as obligatory or not.

AAOIFI also issued a Musharaka Standard (see sub-section 3 in 9.1 above). This standard produced a new treatment on the measurement of the Islamic bank’s share in Musharaka capital after contracting at the end of a financial period. It states that “The constant Musharaka capital shall be measured at the end of the financial period at
historical cost (the amount which was paid or at which the asset was valued at the time of contracting)” (AAOIFI, *Musharaka Standard*, 1996, para. 7).

In the case of diminishing *Musharaka*, the *Musharaka* standard states that “The Islamic bank’s share in the diminishing *Musharaka* shall be measured at the end of a financial period at historical cost after deducting the historical cost of any share transferred to the partner (such transfer being by means of a sale at fair value.) The difference between historical cost and fair value shall be recognised as profit or loss in the Islamic bank’s income statement” *Musharaka Standard*, AAOIFI, 1996, para. 8).

Furthermore Financial Accounting Standard No. 3 states that “profits or losses in respect of the Islamic bank’s *Musharaka* financing transactions that commence and end during a financial period shall be recognised in the Islamic bank’s accounts at the time of liquidation” (AAOIFI, 1996 para. 11). However, “in the case of a constant *Musharaka* that continues for more than one financial period, the Islamic bank’s share of profits for the period, resulting from partial or final settlement between the Islamic bank and the partner, shall be recognised in its accounts for that period to the extent that the profits are being distributed; the Islamic bank’s share of losses for any period shall be recognised in its accounts for that period to the extent that such losses are being deducted from its share of the *Musharaka* capital” (AAOIFI, 1996 para. 12). With regard to diminishing *Musharaka* the treatment stated in para. 12 above should be applied after taking into consideration the decline in the Islamic bank’s share in the *Musharaka* capital and its profits or losses.

To regulate the role of the SSB (see sub-section 5 of 9.1 above), in 1997 and 1998 AAOIFI issued two standards respectively: Auditing standard for Islamic Financial Institutions No. 4: Shari’a Supervisory Board: Appointment, Composition and Report and Auditing Standard for Islamic Financial Institutions No. 5: Shari’a Review. To ensure its independence, ASIFI 4 states that members of the SSB should be appointed by the shareholders in their annual general meeting upon the recommendation of the board of directors. Also a dismissal of an SSB member should be approved by the shareholders during the bank’s annual meeting.
ASIFI 4 also states that at all times the SSB shall consist from at least three members and they have the right to seek the service of consultants if they wish to do so. The standard prohibits bank’s directors or who is considered as a significant shareholders of an Islamic bank from becoming a member of the SSB of the same bank.

ASIFI 5: Shari’a Review was established to provide guidance to assist bank’s SSB in performing their Shari’a review to ensure compliance with Islamic Shari’a Rules and Principles as reflected in the Fatwas issued by them.

Recently AAOIFI also established a new Shari’a board consisting of 9 Islamic scholars, which will be responsible for issuing Fatwas. This is a positive step to harmonise the Fatwas issued by Islamic banks, and which will tend to have implications on the accounting standards that will be promulgated by AAOIFI.

9.3 AAOIFI IMPLICATIONS FOR THE ISLAMIC BANKING INDUSTRY
At present, like the IASC, AAOIFI has no legal powers to enforce its standards. The decision to implement AAOIFI’s standards lies with the concerned bodies in the countries in which Islamic banks operate. This is a major challenge for AAOIFI. However, unlike the IASC, AAOIFI’s scope is confined to Islamic financial institutions. This may make the task of AAOIFI easier because it would need to focus its efforts mainly on persuading the following to implement its standards: (a) Islamic banks’ regulators in the countries in which they operate; (b) market players that are interested in the work of Islamic banks (e.g. rating agencies) and (c) stock exchange regulatory bodies.

However, the efforts needed to persuade Islamic banks’ regulators and market players should not be underestimated. One major problem that may make AAOIFI task difficult to achieve is that the adoption of AAOIFI’s standards may highlight some of the weaknesses of Islamic banks. This may deter some regulatory bodies from adopting AAOIFI standards. For example, Islamic banks that treated investment accounts as funds under management used to record them as an off-balance sheet item. Reporting the unrestricted part of these accounts on the balance sheet as required by AAOIFI’s standards would tend to have an impact on the calculation of the capital
adequacy of these banks as well as on their liquidity requirements. Furthermore, AAOIFI’s standards require disclosure of much more information than would be disclosed when Islamic banks adhere to IASC. This may also unearth information that may be perceived by some regulatory bodies as detrimental to the stability of their banking system.

However, AAOIFI can learn the lessons that may be derived from a similar challenge that seems to facing IASC. Keegan (1999, p.82) observes that “Many of us strongly support the development and use IASs. But we must remember than an international regulatory culture around IASs has yet to develop. Standard setters do not-and should not – work in isolation from the markets for which they are writing the rules of communication”.

Another challenge that may face AAOIFI in persuading regulatory authorities to adopt its standards is that some countries may be reluctant to adopt AAOIFI’s standards and abandon their national standards as this may be considered by these countries as giving up their own sovereignty to foreign powers.

Nevertheless AAOIFI should attempt to persuade the regulatory authorities that the adoption of its standards will not only enhance harmonisation and comparability (Karim, 1999), but also will enhance transparency, which will allow both national and international agencies to play a more effective role in safeguarding the soundness and stability of Islamic financial institutions.

Cox (1995, p. 8) supports this claim. She argues that “The final implementation of a uniform set of accounting practices for Islamic banks will also be a welcome development and the research efforts of organisations such as AAOIFI are to be applauded.”

AAOIFI would greatly benefit from the support it receive from market players such as international rating agencies, as they can play an instrumental role in putting pressure on the regulatory authorities to adopt AAOIFI’s standards. A case in point is the qualification given to Faysal Islamic Bank of Bahrain by Capital Intelligence (one of the rating agencies that rate Islamic banks), which states in its report that
"Due to the large degree of uncertainty concerning the effect the transfer of off-balance sheet unrestricted investment accounts to the balance sheet (in compliance with the introduction of [AAOIFI's] Islamic Financial Accounting standard (IFAS) No. 1), would have on the bank’s liquidity and capital adequacy ratios.”

The rating agency further claims that, in its opinion “the supplementary information [presented by FIBB based on AAOIFI’s standards] enables one to form a more accurate picture of the financial health of FIBB. For example, under the new accounting treatment (including unrestricted investment accounts on balance sheet)...profitability ratios such as return on average assets become more meaningful (2.06% opposed to 6.4% using IAS). Thus in analysing the composition of FIBB’s asset structure, we have assumed unrestricted investment to be part of the Bank’s balance sheet, since they have a direct effect on the bank’s liquidity and profitability and give a more accurate reflection of the magnitude of business operations.”

However, the fact that the regulatory authorities in both Bahrain and Sudan have asked Islamic banks to implement AAOIFI’s standards in preparing their 1998 financial statements, and that major market players have started to recognise AAOIFI’s standards, indicates that the support for AAOIFI is in the ascending. These developments also provide support for the hypothesis advanced in this thesis regarding the regulatory gap affecting accounting of Islamic banks.
APPENDIX 1

POSITIONS OF PERSONS THAT WERE INTERVIEWED FROM
AHMED BANK, MOHAMMED BANK AND KHALIFA BANK

Ahmed Bank
- Chief Executive Officer
- Executive Vice President, Commercial Banking
- Senior Vice President, Capital Market

Mohammed Bank
- The General Manager
- Assistant General Manager
- Director of Accounts

Khalifa Bank
- The General Manager
- Director of Accounts
APPENDIX 2
INTERVIEW QUESTIONS WITH AHMED BANK AND MOHAMMED BANK

1) What is the contractual relationship between shareholders, investment account holders and the bank?

2) What are the differences between restricted investment accounts and unrestricted investment accounts?

3) What is the contractual relationship between saving account holders, current account holders and the bank?

4) Does the bank invest the excess liquidity of the current account and saving account? If the answer is yes, which account holders receive such returns?

5) What are the bases for choosing the existing accounting policies?

6) What are the bases for the existing balance sheet presentation of the investment account holders?

7) Was the SSB consulted on the accounting treatment of investment account holders? What are the factors you have taken into consideration for this treatment e.g. prudence, fairness to investment account holders?

8) To what extent are the international accounting standards applicable for Islamic financing like Murabaha, Musharakah, Mudaraba etc?

9) Was the external auditor of the bank consulted in choosing the accounting policies adopted by the bank and why?
10) Was the Shari'a Supervisory Board consulted in choosing the existing account policies and why?

11) Did the bank review other accounting policies before adopting the existing accounting policies?

12) What factors you had taken into consideration in choosing the existing accounting policies?

13) Are the funds of investment account holders and shareholders invested in the same pool or different pool?

14) Does the bank's accounting policy segregate between the funds of shareholders and investment account holders and why? Please explain the reasons for choosing the existing accounting treatments?

15) Who is given priority in investment over the other: shareholders funds or investment account holder funds?

16) What are the bank's accounting policies (asset valuation, profit recognition) of the following assets:
   - Murabaha financing
   - Musharakah financing
   - Mudarabah financing
   - Real estate for investment
   - Commodity investment

17) What are the factors determining the allocation of profit between shareholders and investment account holders, including the percentage of profit sharing between shareholders and investment account holders?

18) What are the bank's policies regarding expenses and revenues that are borne by investment account holders and those that are exclusively borne by shareholders?
19) What steps the bank undertakes to adjust the profit sharing between investment account holders and the bank?

20) Does the bank contribute part of the shareholders profits to investment account holders in order to be competitive in the market?

21) Do you think Islamic banks should disclose more information than conventional bank since Islamic bank do not guarantee investment accounts in case of loss?

22) Does the bank credit a higher profit rate (= return on capital) to shareholders than investment account holders and why?

23) Who are entitled to receive the amount of unused provisions and why?

24) What is the bank's policy on recognition, measurement and disclosures of provisions?

25) What is the structure of the SSB?

26) What is the role and duties of the SSB?

27) What are the reasons for appointing the SSB?

28) What are the reasons for the accounting differences among the Islamic banks?

29) What are the relationship between the SSB and the external auditors?
APPENDIX 3

POSITIONS OF PERSONS THAT WERE INTERVIEWED FROM THE EXTERNAL AUDITORS

- Partner – Price Waterhouse Coopers (Bahrain).
- Director – Price Waterhouse Coopers (Bahrain).
- Managing Partner – Ernst & Young (Bahrain).
- Executive Manager – Ernst & Young (Bahrain).
APPENDIX 4

INTERVIEW QUESTIONS WITH THE EXTERNAL AUDITORS

1) Are the role and duties of the external auditor of an Islamic bank different from those of conventional banks? Why?

2) Was your firm involved in setting up the accounting policies of the bank? If yes how and if no why?

3) What is the relationship between the investment account holders, shareholders and the bank?

4) Do the accounting treatments reflect the bank's contracts? And what steps you take to insure such compliance?

5) Do you think that the international accounting standards are applicable to Islamic banks? If yes how and if no why?

6) Investment account holders are not addressed by international accounting standards. What are the factors that you have taken into consideration to come up with the existing presentation of the investment account holders? Have you taken into consideration factors like prudent, fairness and reliability of financial reports? Also did you review other accounting standards for this purpose?

7) What are the factors determining the allocation of profits between shareholders and investment account holders?

8) What is your relationship with the SSB?

9) What are the bank policies for provisions and expenses? Which account holders bear the amounts of provisions and expenses?
10) Does the bank segregate the investments of shareholders from those investment account holders and why?

11) What are the bank's accounting policies on profit recognition and measurement of the following items:
Murabaha Financing, Musharkah Financing, Mudaraba Financing, Real Estate Investment and Leasing.

12) What is the bank's policy on recognition, measurement and disclosures of provisions?

13) Do you review the bank's compliance with the SSB rulings?

14) Do you review the accounting policies of the subsidiaries/branches of the bank in order to maintain accounting consistency?

15) Do you review the SSB rulings of the bank's branches and subsidiaries to ensure consistent with shari'a rulings?

16) Are you satisfied with the level of information disclosed in the bank's financial reports compared to the presentation and disclosure standard of the AAOIFI?

17) What are the reasons for the accounting differences among Islamic banks?
APPENDIX 5

POSITIONS OF PERSONS THAT WERE INTERVIEWED FROM
THE SHARI'A SUPERVISORY BOARDS

- Two members from the SSB of Ahmed Bank
- One member from the SSB of Mohammed Bank
APPENDIX 6
INTERVIEW QUESTIONS WITH THE SHARI'A SUPERVISORY BOARDS

1) What are the rules and duties of SSB?

2) To what extent has the SSB been involved in setting up the accounting policies of the banks?

3) What are the steps that the SSB undertakes to ensure that the management complies with the shari'a rulings?

4) What is the relationship between the shareholders, investment account holders and the bank?

5) To what extent do the accounting treatments reflect the bank's contracts?

6) What are the factors that the bank has taken into consideration in the allocation of profits between shareholders and investment account holders?

7) Which accounts bear the amounts of provisions and expenses?

8) Should the profit sharing rate of mudaraba be fixed and why?

9) Can the bank commingle the investments of the funds of the shareholders and investment account holders? And why?

10) Who is entitled to receive the amounts of unused provisions?

11) What is the relationship between the SSB and the external auditors?
12) What are the bases on which the SSB prepares its report on the bank's compliance on sharia rulings?

13) Are your views enforceable? If yes do the terms of reference of the SSB stated that?

14) Does the SSB verify the accounting policies of the bank to ensure that the bank has implemented its sharia rulings?

15) Do you think that the promulgation of accounting standards for Islamic banks will strip-away some of the duties of the SSB?
APPENDIX 7

The following illustration highlights the differences between the straight-line and the reducing balance methods:

Allocation of Murabaha Income

Comparison of Methods

Example
A Murabaha for US$10,000m was allowed for 4 years at 5 per cent flat profit (i.e., US$2,000m). Murabaha will be repaid in four annual equal instalments, payable at the end of each year.

Consider the computation according to:

- **Method 1** Allocation of profit on reducing balance (i.e. actuarial method); and
- **Method 2** Allocation of profit on time basis.

Results

- **Method 1** Return per annum is 7.71385 per cent throughout the period of Murabaha (This is the ratio of income to capital).
- **Method 2** Return per annum fluctuates between 5-20 per cent.

**Method 1** Allocation of Profit on Reducing Balance

<table>
<thead>
<tr>
<th>Year</th>
<th>Instalment No.</th>
<th>Instalment USS</th>
<th>Profit USS</th>
<th>Capital USS</th>
<th>Outstanding Capital USS</th>
<th>Return Per Annum %</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>1</td>
<td>3,000</td>
<td>771.38</td>
<td>2,228.62</td>
<td>7,771.38</td>
<td>7.71385%</td>
</tr>
<tr>
<td>1</td>
<td>2</td>
<td>3,000</td>
<td>599.47</td>
<td>2,400.53</td>
<td>5,370.85</td>
<td>7.71385%</td>
</tr>
<tr>
<td>2</td>
<td>3</td>
<td>3,000</td>
<td>414.29</td>
<td>2,585.71</td>
<td>2,785.14</td>
<td>7.71385%</td>
</tr>
<tr>
<td>3</td>
<td>4</td>
<td>3,000</td>
<td>214.86</td>
<td>2,785</td>
<td>0</td>
<td>7.71385%</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>12,000</td>
<td>2,000</td>
<td>10,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Return Per annum 7.71385%
Flat Profit 5.0000%
### Method 2) Allocation of Profit on Time Basis

<table>
<thead>
<tr>
<th>Year No.</th>
<th>Instalment</th>
<th>Profit US$</th>
<th>Capital US$</th>
<th>Outstanding Capital US$</th>
<th>Return Per Annum %</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td></td>
<td></td>
<td></td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>1</td>
<td>3,000</td>
<td>500</td>
<td>2,500</td>
<td>7,500</td>
</tr>
<tr>
<td>2</td>
<td>2</td>
<td>3,000</td>
<td>500</td>
<td>2,500</td>
<td>5,000</td>
</tr>
<tr>
<td>3</td>
<td>3</td>
<td>3,000</td>
<td>500</td>
<td>2,500</td>
<td>2,500</td>
</tr>
<tr>
<td>4</td>
<td>4</td>
<td>3,000</td>
<td>500</td>
<td>2,500</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>12,000</strong></td>
<td><strong>2,000</strong></td>
<td><strong>10,000</strong></td>
<td><strong>10,000</strong></td>
<td></td>
</tr>
</tbody>
</table>

**Return Per annum Variable**

- **Flat Profit** 5.0000%

---

Note that in our example, with the declining balance method, total profit of US$1370.85 is recognised by the end of the year two, as compared with a total profit of US$1000 by the end of year two using the straight-line method.
BIBLIOGRAPHY

(A) ARTICLES IN JOURNALS


**Financial Accounting Standards Board**, 1976, Scope and Implications of the Conceptual Framework Project, Stamford, Conn.: FASB.


**B) BOOKS**


Orderer, in Accounting and Auditing Standards for Islamic Financial Institutions. Bahrain.


Accounting and Auditing Organization for Islamic Financial Institutions, (1997), Auditing Standard No.4, Shari's Supervisory Board: Appointment, Composition and Report, in Accounting and Auditing Standards for Islamic Financial Institutions, Bahrain.


International Accounting Standards Committee, 1997, Users and their information needs in the International Accounting Standards Committee, London.

International Accounting Standards Committee, 1998, the objectives of IASC as set out in its Constitution, in the International Accounting Standards Committee, London.


Islamic Banking Act (ACT), 1983: Malaysia.


**(C) CHAPTERS IN BOOKS**


(C) TECHNICAL REPORTS


