THE INFLUENCE OF ISLAM ON BANK FINANCIAL REPORTING

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This paper discussed the evolution of Islamic banks and their financial reporting practices. The paper reflected on religious justifications for establishing banks. In addition, a comparison between Islamic and commercial banks was provided.

INTRODUCTION

In the last two decades, many Islamic countries with crude oil resources, following the 1970 rise in oil prices, experienced a tremendous growth in their economies. Their governments have become major spenders on development projects (such as roads, airports, agriculture, housing, hospitals, and other infrastructural projects) aimed at improving the quality of life of their people.

The earnings from the sale of crude oil were often surplus to the immediate needs of these countries for internal capital and recurrent spending. In addition, the surge of domestic capital expenditure led to an increase in the currency in circulation and commercial activity. These led to the development of a locally-based and locally-owned banking industry and the investment of funds in enterprises abroad.

Parallel with the growth in the wealth of these Islamic countries and their people, is the growth in religious fervour. The current academic and business interest in Islamic banking and finance is a product of a considerable amount of Islamic resurgence leading to movements for reforms and return to basic

Islamic principles, in many Islamic and Arab countries.

By the early 1990s, 54 Islamic banks had been established in 26 Islamic and non-Islamic countries. These had either emerged as part of the process in some countries of moving to a total Islamisation of the economy (e.g. Iran, Pakistan) or had been established to compete with traditional banks by providing either trading banking, or investment and holding banking opportunities that accord with Islamic principles. Examples of Islamic trading banks are Faisal Islamic Bank of Egypt and Tadamon Islamic Bank of Sudan. Examples of Islamic investment and holding banks operating at the national or international level are Dar Al-Maal Al-Islami, Bahamas and Albaraka Investment Bank, Bahrain.

In an attempt to identify the significance of the Islamic banks in the countries in which they operate, a comparison of the assets held by Islamic banks and the assets held by private banks in a number of Arabic and Islamic countries was undertaken. The results of this comparison are reported in Table 1 and reveal a wide variation in the significance of Islamic banks. For example, in Sudan, the ratio of assets held by Islamic banks to assets held by private banks was 1:1.1, whereas the equivalent rate in the UAE was only 1:17.04. The equivalent rate to the average for all of the countries sampled was 1:5.91.

Table 1 shows variations in the proportion of assets held by the Islamic banks to the country's total private banks' assets. The proportion ranges from over 90% in Bahrain and Sudan to less than 20% in UAE and Saudi Arabia.

The idea of Islamic banking crystallised to meet the desire of the Islamic movements in conducting financial activities in accordance with Islamic Sharia'h principles. In this respect, Abdel-Magid (1986) demonstrates the appearance of Islamic movements leading to three major developments in Islamic countries:

1. A tendency to call for a unified Islamic political and economic system that could have a significant impact on the patterns of international trade.
2. A tendency to create a "pure" Islamic system in the Islamic countries.
3. A tendency to adopt Islamic Sharia'h law as the foundation for business transactions.

TABLE 1
Comparison of the Islamic Banks Assets and the Country's Private Banks Assets

Country*	Islamic Banks	Average Assets Between 1989-1994** (US $000)	Country's Private Banks Average Total Assets Between 1989-1994*** (US $000)	Average Islamic Banks Assets/ Country's Private Banks Average Total Assets (%)
Bahrain	Albaraka Islamic Investment Bank Bahrain Islamic Bank (9 June) Faysal Islamic Bank of Bahrain	178,333 820,231 1,563,008 2,561,570	36,795,000	1:14.43
Bangladesh	Islamic Bank Bangladesh	226,177	404,048	1:1.78
Egypt	Faisal Islamic Bank of Egypt Islamic International Bank for Investment and Development	2,690,643 360,095 3,050,738	10,833,266	1:3.55
Jordan	Jordan Islamic Bank & Investment	424,286	1,294,833	1:3.05
Kuwait	Kuwait Finance House	4,148,035	7,971,350	1:1.92
Malaysia	Bank Islam Malaysia Behrad	684,426	3,119,167	1:4.56
Qatar	Qatar Islamic Bank	664,225	2,269,380	1:3.42
Saudi Arabia	Al-Rajhi Banking & Investment	5,474,314	30,902,250	1:5.64
Sudan	Islamic Bank for Western Sudan Tadamon Islamic Bank Albaraka Bank of Sudan Faisal Islamic Bank of Sudan El-Gharb Islamic Bank Islamic Co-operative Development	55,523 64,464 35,400 107,078 44,138 117,573 424,176	466,000	1:1.10
Turkey	Albaraka Turkish Finance Faisal Finance Institution Kuwait Turkish EVKAF Finance House	452,530 395,480 322,201 1,170,211	5,805,350	1:4.96
UAE	Dubai Islamic Bank Islamic Investment Co. for the Gulf	1,013,125 30,860 1,043,985	17,779,300	1:17.05
Total		19,912,143	117,639,944	1:5.91

* It is assumed that the Islamic Banks Assets of countries like Pakistan and Iran, who Islamised their financial institutions, represent 100% of the total private banking assets. Therefore, they are not included in the table.

** The Islamic Banks' annual reports was used to calculate the bank's assets. The exchange rate at each reporting date was taken from the datastream and the IMF statistics for the period between 1989-1994 to convert the bank's assets from the local currency to the American dollar. The average Islamic Bank's asset for the period between 1989-194 was computed and compared with the country's average private banks assets for the same period.

*** Each country's total private banks assets was taken from the datastream for the period between 1989-1994.

These tendencies, coupled with the increase in the wealth of some Islamic countries, have implications for the growing business of taking care of assets belonging to third parties. For example, the concept of public shareholding grew in popularity. Therefore, stewardship and accountability are important to ensure that investor confidence is not eroded.

The requirement for organisations to provide regular financial reports is widely accepted as having an important part to play in satisfying accountability. Many examples of regulatory frameworks, which specify the form and frequency of financial reports, and attempts to harmonise accounting measurement and disclosure practice, exist at both national and international levels. Although Islamic banks may adopt similar financial instruments (market-similar products) and observe the rules of Sharia'h in their treatment of returns from investments, only recently, attempts to bring about some form of regulation of the financial reporting practices have been introduced with the establishment, in 1990, of the Financial Accounting Organisation for Islamic Banks and Financial Institutions (FAOIBFI). The FAOIBFI has the responsibility of setting accounting standards which have the objective of harmonising the financial reporting practices of the Islamic banks and financial institutions.

This paper provides, first of all, a brief outline of the influence that religion has had on shaping the distinctive characteristics of Islamic banks. An analysis of financial reporting practices disclosed by a sample of Islamic banks in an attempt to assess the extent of variability in practices follows. The paper, then, considers the impact that differences in the application of Sharia'h principles have on financial reporting and examines the implications of the requirements for a religious audit.

THE INFLUENCE OF RELIGION

The influence of Quoran on the corporate reporting practices of Islamic banks is fundamental, as Gambling and Karim (1991: 3) assert:

> As for accounting, the Quoran directs traders to keep proper records of indebtedness. Apart from that, the general prohibition on both waste and avarice, and unfair trading practices, imply a

need for records which demonstrate what a business person has done. Finally, the [Quoran] enjoins the payment of a religious tax (zakah) which is assessed, in part, on wealth and trading profits.

The condemnation of usury is part of the general condemnation of market abuse, such as the exploitation of weaker members of society by deceit, manipulation, or restriction. Although some Islamic scholars (e.g. Ahmad 1989: 132), still consider that the payment and receipt of normal interest - but not usury - is a legitimate reward for debt financing, the condemnation of usury is generally interpreted as extending to the condemnation of normal interest charges on loanable funds, and this has contributed to the growth of Islamic banks.[1]

Instead of paying depositors or charging customers interest, Islamic financial institutions share profit or losses with both. Thus, the profits made by a customer of an Islamic bank are shared with the banks financing them while depositors of an Islamic bank share in the profits of the bank itself in accordance with the size and tenure of their deposits. Essentially, in place of a fixed and determinable rate of return (interest), Islamic banks adopt a variable and indeterminable rate of return (profit sharing scheme) for transactions with their customers. In short, Islamic banks do not lend money to individuals except for benevolent purposes (when they are interest-free - Quard Hassan); rather they seek to make profits by helping their clients through the purchase of commodities or by undertaking joint venture businesses with them. A summary of the principal forms of Islamic bank transactions is produced in Table 2.

One reason for believing the Islamic law on usury can extend to normal interest can be traced to the Islamic position on property rights and its conception of economic justice. In Islam, property rights arise from assets obtained through individual effort and labor. The lending of money releases property rights to a borrower who has not worked for the money; the borrower rather than the lender then uses the money to create further wealth or to purchase consumable commodities. According to Islamic rules, because the lender has not used the money to create wealth personally, the lender cannot claim more than the amount of money lent. Thus, interest is considered as representing an unjustified creation of instantaneous property rights. Interest is unjustified, because it is a property right arising outside the religious Islamic framework for creating property rights, and is instantaneous, because a right to the borrower's property is created for the lender as soon as the money is released to the borrower.

TABLE 2
Patterns of Islamic Bank Financing for Various Customer Activities

	Patterns of	Financing		
Type of Activity	**Equity Participation ***	**Term Financing****	**Trade Financing*****	**Investment******
1. Trade and commerce: Commodity operations including import and export	Yes	Yes	Yes	No
2. Trade in Equities and securities and futures	No	No	No	Yes
3. Industry:				
Fixed Capital	Yes	Yes	No	No
Working Capital	No	No	Yes	No
4. Agriculture & fisheries				
Short term	No	No	Yes	No
Medium & long term	Yes	Yes	No	No
5. Housing:				
Building Society	Yes	Yes	No	No
Individual owners	No	Yes	No	No
6. Personal Advances:				
Consumer durables	No	Yes	No	No
Consumption	No	No	Yes	No

* Equity participation takes the form of Musharakah (Joint-venture profit-sharing) and Mudarabah (trustee profit-sharing).
** Term finance includes Bai Bithaman Ajil (deferred sale); Adjure (Leasing) and Carat Hassal (Interest-free or benevolent loan)
*** Trade finance includes Wakalah (Agency), Murabahah (Cost-plus trade), Musharakah (Joint-venture profit-sharing).
**** Investment refers to the application of Musharakah (Joint-venture profit sharing) scheme to the purchase and sale of equity, securities, options and futures.

An Islamic bank contributes to development in so far as its approach to finance and banking is geared toward the sharing of risks and profits (as and when they arise) with borrowers and depositors instead of only financing the borrowers on the basis of interest alone. Depositors of funds with Islamic banks do not expect a fixed amount of interest regardless of the performance of the funds employed by the bank. Contrary to the reports on the characteristic behavior of some Islamic banks (Bashier 1983, Nienhaus 1985, and Karim and Ali 1989), recent financial products of Islamic banks suggest they are not unwilling to finance, over relatively long periods, newcomers or innovative enterprises since they are not pressed to earn profits within a short-term to remunerate depositors. The latter (depositors), are willing to "wait" in the hope of receiving appropriate compensation in due course.

Islamic banks have similarities with the non-Islamic commercial banks in that both offer similar services and play a major role in the economic development of their societies. However, unlike non-Islamic banks, Islamic banks operate within the boundaries of the Islamic Sharia'h which strictly emphasizes the following in addition to the prohibition of interest:

1. Because the Holy Quoran prohibits the consumption of alcohol and pork, Islamic banks do not deal with organisations dealing in these products.
2. Avoidance of any involvement with gambling. However, it is important to recognise that this specifically relates to direct exposure to casinos, horse racing, and betting and not to the taking of business risks as in dealing with stocks and shares on the stock market.
3. Directing of most operating activities toward the financing of socially productive activities.

Consequently, the Islamic bank also considers any business operation relating to the first two issues as unholy and so seeks to avoid them. Therefore, the purpose of Islamic banks is to employ funds in accordance with the Islamic Sharia'h towards the development of the societies (Islamic and non-Islamic) where they operate. According to Siddiqui (1985), compared to non-Islamic commercial banking, Islamic banking seeks a just and equitable distribution of resources. In a non-Islamic commercial bank, if a borrower makes a loss on a project financed by a bank loan, the borrower is obliged to pay all interests due on the loan. On the other hand, if the interest rate falls and the borrower secures a high profit, other savers in the commercial bank will not benefit from such a profit. This element of speculation, one of the non-Islamic banking principles, is against the tenets of Islam. A further distinguishing characteristic of Islamic Banks is their role as an intermediary between those willing to make benevolent offers through Zakah and their unknown beneficiaries. From the above discussion several essential differences between Islamic and non-Islamic banks are clear and these are summarised in Table 3. Since these differences are likely to have influenced financial reporting practices, differences are expected in financial disclosure and accounting measurement. The paper attempts to ascertain the extent of these differences in a few key areas of financial reporting. The results of our survey of current practices are reported in the following section.

FINANCIAL REPORTING PRACTICES

The sample of banks whose accounts were examined included those identified by The Banker as the Top 100 Arab Banks and other significant Islamic banks placed in countries with a high proportion of Muslim population (Bangladesh, Iran, Malaysia, Pakistan, Bahamas and Turkey). In addition, Islamic banks from western countries (UK, Switzerland and Denmark) were used in the survey. The list of the thirty Islamic banks whose annual reports are examined is given in Table 4. The English language version of the annual accounts was used in all cases. All banks are integrated companies engaging in trading and investment transactions, and in all cases, the operations of the banks transcend national boundaries.

VARIATION IN ACCOUNTING PRINCIPLES OF ISLAMIC BANKS

The variation in financial reporting of Islamic banks is due not only to the flexibility provided by the conventional accounting system but it also arises from the variation in the application of the Sharia'h principles to the banking activities as interpreted by different schools of thought and Olama (Muslim

TABLE 3
Comparison Between Islamic and Non-Islamic Banks

Dimension of Comparison		Islamic	Non-Islamic
Funding Characteristics			
1.	Ownership of Banks	Predominantly share-holder-owned except in Iran and Egypt where all banks are nationalised	Predominantly share-holder-owned. Although in some countries such as Italy and France large banks are owned by the government.
2.	Leverage: Bonds and Loans	No: because it is interest-based	Yes
3.	Receipt of deposit	Yes on profit/loss sharing basis. All deposits (except specific investment deposits) are fungible.	Yes- interest bearing and non-interest bearing types. All deposits are fungible.
4.	Main sources of Income	Share of profit/loss from musharakah, murabahah and commission from services.	Interest and commission.
Application of Funds			
5.	Granting of loans: interest-based interest-free benevolent loans	No Yes	Yes: main activity No
6.	Investment in non-equity securities	Yes (excluding fixed interest securities)	Yes (all types)
7.	Investment in equities	Yes- for example, Kuwaiti Investment House owns approximately 20% of British Petroleum	Yes, but banks are not allowed to invest in equities in some countries
8.	Trading in commodities (mudarabah) leasing (ijarah)	Yes Yes	No No (but non-bank subsidaries can and often do)
9.	Participation in clients' businesses: - Profit/loss sharing (musharakah) - profit sharing with clients and loss borne by the bank (murabahah)	Yes (main field)	No (except some banks in Germany)
10.	Investment in foreign currencies	Yes	Yes

Services Rendered		
11. Social	Collection and management of zakah fund on a regular basis. This is guided by Sharia'h	Ad-hoc services as collection points for contribution in response to mass appeal for donations by charitable organisations
12. Current account	Yes	Yes
13. Credit cards	Yes (no overdrafts)	Yes
14. Collection of cheques for customers	Yes	Yes
15. Collection and payment of bills for clients	Yes	Yes
16. Investment in securities for clients	Yes (excluding fixed interest securities)	Yes
17. Sale and underwriting of securities	Yes	Yes, but in some countries (e.g., Japan, South Korea and the United Kingdom) commercial banks are prohibited by law from engaging in this type of business. Only investment banks or securities brokerage houses can undertake this type of business in these countries
18. Letters of credit	Yes (100% down payment)	Yes
19. Letters of guarantee	Yes	Yes
20. Purchasing for clients on a pre-agreed profit basis (murabahah)	Yes (main field)	No
21. Futures and arbitrage	No	Yes
22. Discounting of bills	No	Yes
23. Leasing of safe deposit boxes	Yes	Yes
24. Carrying out feasibility studies	Yes (for bank projects and clients)	Yes (for bank projects only)
25. Providing advice to clients	Yes on normal business and Islamic matters relating to clients' businesses	Yes on normal clients' businesses only
26. Foreign exchange transactions	Yes (provided no interest is charged)	Yes
Accounting Matters		
27. Valuation of fixed income securities	No such problem as these are interest-based investments	Valuation methods vary widely

28.	Valuation of marketable securities	Market value is preffered to lower of cost or market value basis	Majority of banks value method or market
29.	Allowances for losses and provision for bad and doubtful debts	Amount reserved vary from Nil to about 10% of assets at risk. In many cases, directors use their discretion.	Fixed by law in some countries (e.g., Canada, Hong Kong, Japan, South Korea, Germany and some other European countries). Not fixed in some (e.g., Australia, Malaysia, Singapore, South Africa and the United Kingdom). In the United Kingdom, this requires the approval of the Bank of England.

TABLE 4
Islamic Financial Institutions Studied

1.	Bank Islam Malaysia	
2.	Alrajhi Banking	+
3.	Faisal Finance Institution	
4.	Islamic Bank for Western Sudan	
5.	Al Baraka Islamic Investment	+
6.	Bank Melli Iran	
7.	Masraf Faysal Al Islamic (Bahamas)	
8.	Dar Al Maal Islamic	
9.	Bahrain Islamic Bank	+
10.	Dubai Islamic Bank	+
11.	Islamic Bank Bangladesh	
12.	Muslim Commercial Bank	
13.	Habib Bank	
14.	Jordan Islamic Bank	+
15.	Islamic Investment Co. Of the Gulf	
16.	Kuwait Finance House	+
17.	Faisal Islamic Bank of Egypt	+
18.	Faisal Islamic Bank of Bahrain	+
19.	Kuwait Turkish EVKAF Finance House	
20.	Al-Baraka Turkish Finance House	
21.	Islamic Bank International	
22.	Tadamon Islamic Bank	
23.	Islamic Co-operation Development Bank of Sudan	
24.	Faisal Islamic Bank of Sudan	
25.	Allied Bank of Pakistan Ltd.	
26.	Qatar Islamic Bank	+
27.	El Gharb Islamic Bank	
28.	Bankers Equity Limited	
29.	National Bank of Pakistan	
30.	Al-Baraka Bank of Sudan	

+ Listed as one of the Top 100 Arab Banks by The Banker (November 1995: 75).

Scholars). Hence, variation in application of Sharia'h principles is expected to have different accounting implications.

A review of the 1993/1994 accounts of some Islamic banks suggests that the accounting principles, which form the basis of their annual accounts, vary widely.

Recognition of Income

Income is received from four main sources - equity participation, term financing, trade financing and investments (see Table 2). Income recognition problems, similar to those associated with long-term contracts and insurance contracts, are likely to occur when investments cover more than one year. The selected examples of accounting policies on income recognition revealed that income recognition practices vary from one Islamic bank to the other. Income from *musharakah* and *mudarabah* contracts is recognised in the following ways: on cash basis; on an accrual (time proportion, such as sum-of-digits) basis; on the finalisation of the contracts; or a combination of these three. For example, Tadamon Islamic Bank, Sudan, and Qatar Islamic Banks recognise income on musharakah and mudarabah on the actual results after the finalisation of the contract, after the investment operations have been completely settled. Bank Islam Malaysia and Jordan Islamic Bank for Finance and Investment recognise income as cash is received. Dubai Islamic Bank and Alrajhi Banking and Investment Corporation Bank recognise income on musharakah and mudarabah on an accrual basis, while Dar Al-Maal Al-Islami Bank, Albaraka Islamic Investment Bank, Faysal Bank of Bahrain and Bahrain Islamic Bank combine both cash and accrual basis in their recognition of income. A summary of income recognition approaches used by the sample banks used in this study is presented in Table 5.

It can be seen from Table 5 that, in most cases, the precise income recognition method used by the sample banks is not clear with as many as eleven out of a sample of thirty banks failing to include the method used. However, where information was given, the accrual basis method was the most widely used, but as many as four banks used a cash basis and a further four did not recognise income until the underlying contract had been finalised. Clearly, with such distinctly different practices being used, the ability to compare the financial performance of different banks becomes seriously impaired.

TABLE 5

Summary of income recognition policies employed by the surveyed Islamic Banks

Bank	Not Given	Cash Basis	Accrual Basis	On the Finalisation of the Contract	Combination of Accrual Basis & Cash Basis
Bank Islam Malaysia		√			
Alrajhi Banking			√		
Faisal Finance Institution			√		
Islamic Bank for Western Sudan	√				
Al Baraka Islamic Investment			√		
Bank Melli Iran			√		
Masraf Faysal Al Islamic (Bahamas)	√				
Dar Al Maal Islamic					√
Bahrain Islamic Bank					√
Dubai Islamic Bank			√		
Islamic Bank Bangladesh					√
Muslim Commercial Bank	√				
Habib Bank	√				
Jordan Islamic Bank		√			
Kuwait Finance House			√		
Faisal Islamic Bank of Egypt	√				
Faisal Islamic Bank of Bahrain		√			
Kuwait Turkish EVKAF Finance House	√				
Al-Baraka Turkish Finance House	√				
Islamic Bank International	√				
Tadamon Islamic Bank.				√	
Islamic Co-operativ Development Bank			√		
Faisal Islamic Bank of Sudan			√		
Allied Bank of Pakistan Ltd.	√				
Qatar Islamic Bank				√	
El Gharb Islamic Bank	√				
Bankers Equity Limited				√	
National Bank of Pakistan	√				
Islamic Investment Co. of the Gulf		√			
AL-Baraka Bank of Sudan				√	
Total	**11**	**4**	**8**	**4**	**3**

In an attempt to shed more light on the income recognition methods used by the sample banks, a series of examples taken from the banks annual reports are shown below.

<u>Selected examples of accounting policies on income recognition</u> for the 1993/1994 annual reports:

Bank Islam Malaysia	Income is accounted for on the cash basis of accounting in accordance with the principles of Shariah. Receipts in advance are treated as liabilities in the balance sheet. Income from financing of customers [is] recognised on the actuarial method. However, income from financing granted prior to 1 July, 1991 are recognised on the sum of the years digits method.

Alrajhi Banking & Investment Corporation	Revenue and expenses are recognised on the accrual basis.
Islamic Bank Bangladesh	The profit is shared between the bank and depositor at the rates as determined by the management.
Kuwait Finance House	Income from Murabaha and Istisna is recognised on a time proportion basis. Income from leased assets is recognised on a pattern reflecting a constant periodic return on the net investment outstanding. Rental income and income from government debt bonds are recognised on an accrual basis. Dividends income is recognised when earned.
Dar Al-Maal Al-Islami	Income arising from fund management and services comprises revenues earned from management of the funds in the Modarabas accrued on the basis of the terms and conditions of the related management agreements. Where profits arising from short-term investments and from projects and trade can be reasonably determined in advance, they are accrued over the life of the investment. In other cases they are included in the Consolidated Statement of Profit and Loss when realised.
Dubai Islamic Bank	Income from murabaha, musharakah, and property rental is recognised on a time proportion basis. Income from Mudaraba is recognised when advised by Mudaraba manager.
Bahrain Islamic Bank	Profit on financing contracts is recognised when deals are concluded, except for credit contracts which extend beyond one financial period where the profit is distributed on a pro-rata basis of the period of the contracts in order that each financial period is allocated with its appropriate share of the profit. Other categories of income are recognised when received.
Faysal Islamic Bank	Fees arising from the management of mudarabah investment funds and Private Portfolio investment accounts are accrued as income on the basis of the bank's entitlement to receive such revenue as defined in the bank's contract with the investor. Commissions earned on letters of credit and letters of guarantee issued are taken to income when earned. Dividend income is accounted for when received or dividends are declared.
Tadamon Islamic Bank	Revenue generated from direct investments via musharakah and murabaha has been calculated on actual basis i.e. after investment

	operations were completely settled. Return on foreign exchange transactions and affiliate companies represents the actual profit realised and due by the end of the particular year.
Qatar Islamic Bank	Income from musharakah and mudarabah contracts is recognised on the finalisation of the contracts. Income from mudarabah and musawamah (bargaining) contracts is recognised on a time proportion basis. Income from investments is accounted for when the dividends are received.

Basis of Valuation

Shariah principles do not specify the basis of valuation that should be used by Islamic banks. However, the requirements for the calculation of Zakah, indicate the need for annual revaluation of assets, because the Zakah calculation is based on the change of wealth over time. This might be regarded as a requirement that all fixed assets should be regularly revalued and therefore point to the use of modified historic cost. Only 5 of the surveyed banks used the modified historic cost convention. The vast majority of the surveyed banks (17) have adopted the pure historic cost principle without modification. The remainder of the sample were either silent or used a different sort of modification. For example, the 1993 Dubai Islamic Bank annual report indicated that only one specific asset is revalued as can be seen from the following extract:

> **Accounting Convention**
>
> The financial statements are prepared under the historic cost convention modified by the revaluation of land granted to the bank by His Highness The Ruler of Dubai.

Similarly, Dar Al Maal Al Islami bank recorded all fixed assets at cost less depreciation except for land and building which are recorded at *"appraised value"* based on periodic valuation conducted by a professional expert. The 1993 annual report states, "adjustments arising from these appraisals are recorded in trust capital after taking account of any corresponding tax and hedge effects and are included in the consolidated statement of profit and loss only upon disposal".

Of the five banks that revalued their fixed assets under the modified historic cost basis, four of them (Faisal Financial Institution, Dar Al-Maal Al-Islami, Dubai Islamic Bank and Kuwait Turkish

EVKAF Finance House) included the revaluation surplus in the stockholders' equity section of the balance sheet. However, the fifth bank (Habib Bank Ltd.) reported the difference on "other liabilities" account. Under the significant accounting policies section of the 1993 annual report, the bank disclosed the following:

Basis for Presentation

These accounts have been prepared under the historic cost convention except for revaluation of properties at an overseas location and the accounting and reporting guide-lines prescribed by the banking regulatory authority. The surplus arising on revaluation of fixed assets is included in branch adjustments account under "other liabilities."

To note, Habib Bank's treatment of surplus arising on revaluation of fixed assets does seem somewhat surprising, is important. A surplus arising on revaluation of fixed assets would normally be credited to revaluation reserves, which is clearly part of the equity of a company. Perhaps the treatment adopted by Habib Bank reflects their belief that changes in the value of fixed assets is due to property value fluctuations that are to some extent fortuitous, and therefore, should be treated as a separate item in the accounts.

Depreciation

The vast majority of the surveyed sample banks (21) used the straight line method of depreciation, with the remainder disclosing no information. From the information that was disclosed, it was clear that there were inconsistencies in disclosure. Eleven banks indicated they calculated depreciation by dividing cost minus residual value over the useful life of assets, but gave no information on either the useful life or residual value. Five banks provided the depreciation rate for each type of fixed assets. Two banks provided information on the useful life of each of each type of fixed asset. One bank indicated somewhat vaguely the useful life of fixed assets ranged from 3 to 10 years.

Long-Term Investment

The terminology used to report long term investment varied among the sample of surveyed banks. This is illustrated by fifteen banks reporting their long term investments at cost minus any permanent diminution in value while six banks appearing to adopt the same approach, but using different phrases such as: "net realizable value based on periodic appraisal of performance by management"; "cost minus accumulated balance for bad and doubtful investments"; "cost adjusted to amortization premium and corrected for discount less permanent diminution in value." However, eight banks disclosed no information.

All Islamic banks tend to differentiate between special investment funds and general depositors' funds. Investment funds are long-term funds available to the banks for investment in specified activities whereas depositors' funds are fungible. Because of the long-term nature of investment funds, they tend to carry a higher rate of return than depositors' funds. Income which the bank earns from the use of the two types of funds (less directly attributable expenses) is apportioned on an agreed basis or a basis determined by the bank and the depositors. Figure 1 provides a descriptive framework of an Islamic bank's profit sharing operations.

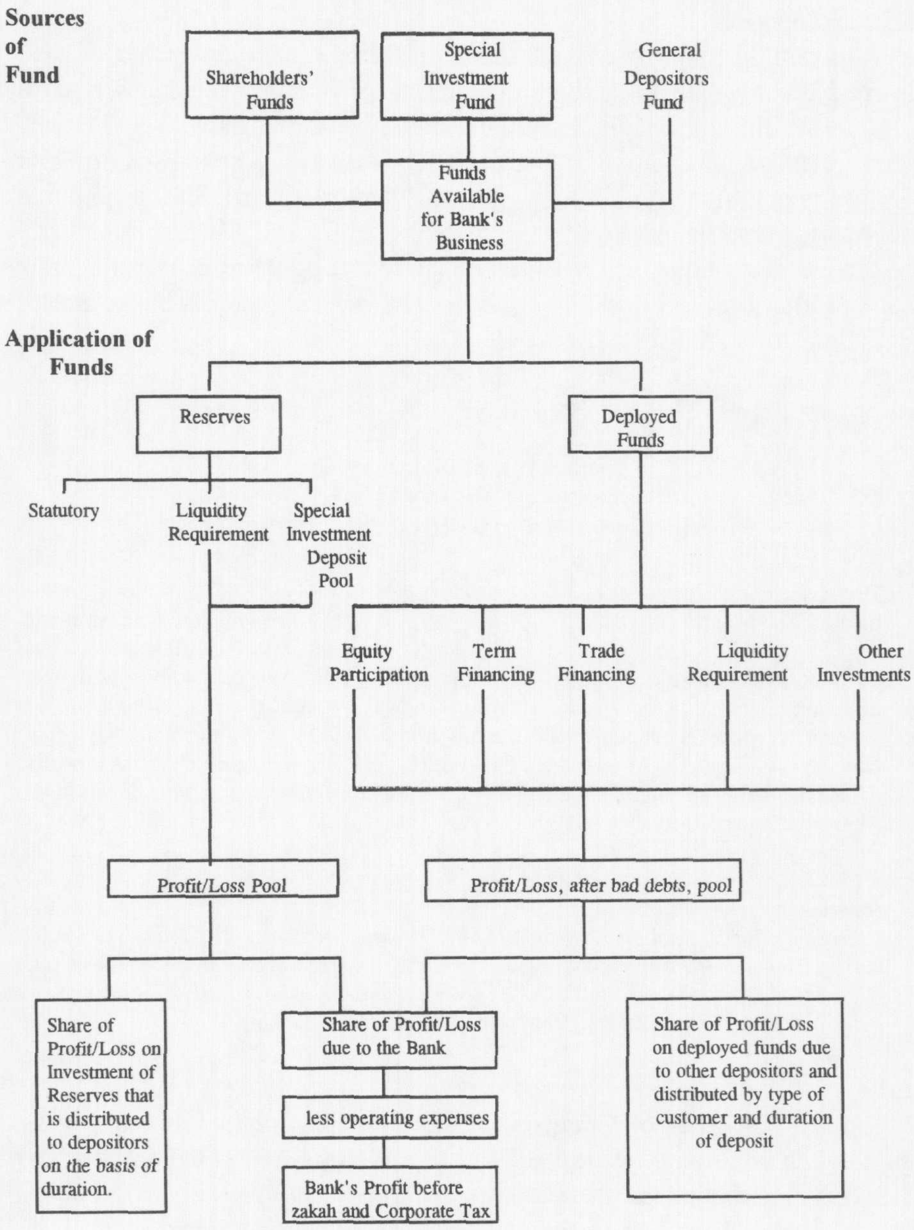
Some Islamic banks, in addition to financing customers' businesses on the basis of their financial products, carry on commercial transactions (such as import and export business and management of housing estates) on their own, but do not distinguish this sort of trading activity from the income from their financing activities. Thus, inventories on the balance sheets of these banks are found. It would seem essential that Islamic banks should either distinguish their independent trading activities from their financing activities and report the results of the two separate operations accordingly, or at least produce a separate line of business segmental analysis to help users disaggregate the consolidated results.

Disclosure practices also vary in respect of the rate of returns granted to owners of different deposit accounts. In most cases the rates are not mentioned.

SHARIAH PRINCIPLES AND SOCIAL OBLIGATIONS

The social obligations of Islamic banks in accordance with Sharia'h include the granting of interest-free loans to the needy and the management of

FIGURE 1
A Framework of an Islamic Bank's Operations



the zakah fund.

Interest-free loans

Although the majority of the banks in the sample were perceived to have performed their social obligations in granting of interest-free loans (Quard Hassan) only Jordan Islamic Bank and Bahrain Islamic Bank B.S.C. bank presented detailed information of their role in this regard. Jordan Islamic Bank gave information on the sum of loans granted from Al Quard Alaska fund and the number of beneficiaries.

The extract below, from 1992 annual report of Bahrain Islamic Bank B.S.C. presents a revealing picture of the extent to which Islamic banks accept the principles of social responsibility.

Extract from Bahrain Islamic Bank B.S.C. 1994 Annual Report

FINANCIAL REPORT OF
GOOD FAITH LOAN FUND
AS AT 30TH THUALALHIJA, 1413 HIJRI

To the shareholders,
Bahrain Islamic Bank continues to undertake its pioneering role in serving the community through payment of shariaa prescribed Zakat (alms) and Good Faith Fund. This fund provides financial assistance for persons planning to get married, to customers wishing to undertake house repairs, and to others in need of educational and medical treatment services. A growing number of applications are received by Bahrain Islamic Bank from customers wishing to enjoy its benefit. Hence it requires financial backing through others' participation in these noble community services. Therefore, the bank accepts donation and contributions to this fund as follows:
- Personal one-time donation
- Fixed-term loans for no less than three years after which the amount in question is returned to the lender.

Initially the fund's total amount was BD 50,000 (Bahraini Dinars fifty thousands) which was paid by the bank from its own fund. Then, this amount was raised in two stages each by a sum of BD 25,000 (Bahraini Dinars twenty five thousands). Thus, the total amounts contributed by the bank to the Fund have now reached BD 100,000.

Zakah

Zakah is a pillar of Islam. It is the obligation of the wealthy to the needy. Zakah is a social insurance "tax" payable by Muslim individuals, not business entities, though these entities are allowed to set up and manage zakah funds. Such funds are financed through zakah collected from their shareholders, customers, suppliers, and employees. Only businesses set up on Islamic principles, with Muslims holding majority equity shares, can set up and manage zakah funds.

Sharia'h suggests that zakah is payable as follows:

(1) 2.5 percent annually of a person's capital (or savings) above a specified amount including any income derivable from the use of that capital by other people (i.e., unearned income);
(2) 5 and 10 percent of irrigated and un-irrigated land under a person's control;
(3) 2.5 percent of total annual sales of an industrialist or a trader;
(4) 20 percent of the wealth from mines and buried treasures;

The proceeds of zakah should be spent on (a) the poor (Faqir), (b) the needy (miskin), (c) the administrators of Zakah (al'amilin aliha), (d) those who reconciled with Islam (al-mo'alafa qulubahum), (e) the liberation of captives and slaves (fako reqab), (f) helping debtors settle their debts (gahrimeen), (g) the cause of Allah (fe sabil allah), and (h) wayfarers (bn-al-sabil) (Quoran Chapter 9: 60).

Money invested with Islamic banks such as equity interests and deposits including returns accruing on them are considered to be accumulated wealth of their owners exceeding that necessary for personal use and consumption, and so are liable to zakah at 2.5 percent. In accordance with Sharia'h, the majority of the Islamic banks whose accounts were examined operated a zakah fund and collected, at source, zakah due from their shareholders before paying them dividends. However, variations exist on the way the banks account for the fund in their accounts. Some banks recorded the fund as part of the bank's assets and include any unspent balance among the list of its assets. Some other banks treat the zakah fund as a separate and independent activity in the form of a trust fund and provide separate fund accounts and auditor report in their annual accounts (e.g., Faisal Islamic Bank of Egypt). Some banks did not even provide information relating to zakah collected or distributed (e.g., Jordan Islamic Bank for Finance and Investment).

Extracts from Islamic Banks 1993 annual reports are following:

Dar Al-Maal Al-Islami	In 14/11/12 H, The Trust paid zakat of $2,810 thousands on behalf of equity participants. The corresponding amount for the previous year was $2,774 thousands.
Bahrain Islamic Bank	Zakat is calculated on the balance of statutory, general reserves and retained earnings of the financial year.
Faisal Islamic Bank of Egypt	The zakat legitimately due on the banks fund (shareholders) is considered among the costs of realized profits and not for distribution as stipulated in Article (3) of the Law No. 48 for 1977 establishing the bank. hence it appears in the profit and loss account and disappears in the appropriation.
Dubai Islamic Bank	Zakat is calculated and paid under the direction of Shariah supervisory board on profits retained in the bank's records and the long term liabilities. Zakat on share capital and distributed profits is to be paid by each individual shareholder.
Bank Islam Malaysia Behrad	Zakat represents tithe payable by the bank and its subsidiaries to comply with the principles of Syariah and as approved by the Syariah Supervisory Council.
Tadamon Islamic Bank	Usually the amount subject to zakat composes of ["capital + net profit] + reserves minus [fixed assets + equity shares in other institutions].

Nevertheless, the value of capital on which zakah is payable is indeterminate. It is generally believed that capital refers to any unemployed wealth and accordingly zakah is calculate on the basis of the paid capital which is unemployed in the form of fixed assets and investments in other institutions. For example, Tadamon Islamic Bank reported, because the paid capital was fully utilised in fixed assets, the amount of zakah payable by its shareholders was confined to 2.5 percent of the net profit before tax.

Provision for Bad and Doubtful Debts

Speculating on the method of measuring the capital base on which zakah is based and quoting Al-Qaradawi (1981), Gambling and Karim (1991) stated:

> A debt is not excluded from the base on which zakah is calculated until it is established that it cannot be collected. This would mean that only specific bad debts should be deducted from accounts receivables in the calculation of zakah, and

allowances for doubtful debts would not be deductible.

Evidence from the sample Islamic banks does not support this speculation. All the banks deducted bad and doubtful debts from the profit figure which formed the basis of their zakah computation and almost all the banks have both general and specific provisions for bad and doubtful debts. However, three banks deducted bad and doubtful debts before arriving at the capital on which zakah is based.

THE RELIGIOUS AUDIT OF ISLAMIC BANKS

The external auditor's function is to provide a basis for the credibility (on secular grounds) of the financial statements produced by an Islamic bank. In addition, the audit report may indicate whether the reporting client company has complied with banking regulations of the country in which the company is located.

Islamic banks are, however, expected to pursue their business activities in accordance with the pronouncements of the bank regulatory authorities and Islamic principles. A financial report of an Islamic bank that fails to assure its readers that the transactions which formed its basis are in line with Islamic principles would be incomplete. To provide such an assurance, every Islamic bank has come to adopt a system of parallel audit by which it exposes itself to the surveillance of a body of persons, appointed by the bank, to indicate whether the bank has complied with Islamic principles in its day-to-day transactions[3]. The "modifier" indicating the function of the Sharia'h committee or council varies from "Control" to "Supervisory" to "Advisory" Committee or Council. In this paper, the committee or council is referred to as Sharia'h Advisory Committee (SAC).

The SAC may be appointed by the bank's management or its shareholders. Its members are on the payroll of the bank. The SAC is set up to advise the bank's management on how to conduct its business along Sharia'h principles, to ensure that its banking activities do not violate Islamic rules and to provide a report which would assure customers (depositors and borrowers), government, and the people that the bank has adhered to the Sharia'h. According to Gambling and Karim (1991: 31), although the SAC is an in-house institution, it is similar to the hisbah (accountability to Allah) created in the early Muslim state "to ensure that the market-traders conformed to the Sharia'h in their dealings." Empirical evidence indicates the SAC may be both in-house and external to the bank. An examination of the annual accounts suggests some banks do not have "in-house" SACs (e.g., Tadamon Islamic Bank), while some others do (e.g., Islamic Bank Bangladesh). Out of those without in-house SACs, some have constituted their SACs in a manner similar to the workings of the audit committee, now a common feature of Western enterprises. Members of such SACs are religious authorities who are otherwise independently employed either as clerics or as academics and act on a part-time basis as consultants to the bank. Some other banks with no in-house SACs and those with in-house SACs also maintain a list of reputed Olamas (Islamic scholars) and clerics to be consulted as the need arises. Those banks with in-house SACs do offer religious advice to clients interested in ensuring that their businesses are also conducted on Islamic principles.

Because the Muslim law predates events of the present day, the status and duties of the SAC are not well specified in it or in the literature. In general, the duties of the SAC usually include:

1. To advise the bank management on the Sharia'h principles underlying normal and emerging banking transactions.

2. Ex ante and ex post auditing of transactions for compliance with Islamic principles and the checking of the calculation and payment of zakah (Briston and El Ashker 1986; Karim 1990a).

3. To advise the external auditor and bank management on the accounting treatment of issues which require departure from generally accepted accounting principles in order to comply with the Sharia'h (Karim 1990a: 300) and the allocation of profits earned by the bank between its shareholders and depositors (Karim 1990b: 35).

4. To issue a report to users of financial statements certifying that the bank has adhered to Islamic precepts in all its financial transactions (Karim 1990b: 34).

Looking at the surveyed sample banks, the 1993 annual reports of 15 banks did not contain the Sharia'h Supervisory Committee's report. However, in another case (Alrajhi Banking and Investment Corporation) the bank referred to the activities of the SSC in the Board of Directors Report without including the committee's religious report.

An elaborate example of a report by the SAC is supplied in the 1993 Annual Report of Islamic Bank Bangladesh Ltd. The following is an extract from this report:

> Activities of the Sharia'h Council
>
> During the year 1993 the Sharia'h Council of the Bank discussed different operational issues including those referred to it by the Board and the management of the Bank in its meetings held from time to time, expressed views and gave necessary suggestions thereon. The Council inspected number of branches during the year, participated and deliberated on Shariah issues in different formal and informal get-together of the Depositors, Clients and well-wishers.
>
> The Shariah Council had examined the Shariah Inspection Report, Balance Sheet, and the Profit and Loss Account for the year 1993 and observed as under:
>
> 1. The accounts of the current year have also been finalised on accrual basis. However, the Bank management has assured to continue efforts for switching over to Actual method of Accounting.
>
> 2. Al-Hamdulillah, the Bank has achieved remarkable progress in implementing Shariah Principles in conducting Foreign Trade. Progress in implementing Shariah Principles, particularly in respect of investment made under Hire-Purchase Shirktul Meelk, is satisfactory.
>
> 3. The Bank has achieved noticeable progress in following Shariah Principles in Bai-Murabaha and Bai-Muazzal modes of investment, through buying and selling goods could not be ensured in number of cases. During the current year also, the bank could not fully implement the principles of Islamic Sharia'h in foreign trade operations.

A further interesting point appearing in the SAC report can be seen from the following extract :

> The council further expects that the Bank Management will take more effort than before in implementing Shariah Principles in all its activities.

This seems to indicate that the bank in the past, been only partially successful in adopting the Shariah principles.

At present, whether the authority of the SAC is superior to or subordinate to that of the external auditor in situations where each has arrived at a conflicting opinion about the validity of a bank's transaction, is not clear. Since the SAC operates from within, it sometimes, vets a transaction before it is entered into (ex ante auditing), and is therefore more familiar with the bank's activities than the external auditor. The SAC also issues a report which seeks to give credibility to the annual report and to assure the users of the annual reports that the financial statements, which form part of them, are prepared in compliance with the Sharia'h. Thus, the SAC performs a dual (if contradictory) function. It helps set the accounting policies on the basis of Sharia'h law and at the same time, monitors the bank's business affairs and resulting financial reports to determine whether or not they have been conducted and prepared according to these policies.

The financial reporting system of Islamic banks seems to be facing two major problems. In the first place, the lack of principles or standards to underline the preparation of financial reporting. Secondly, the in-house SACs that can be considered as resembling internal auditors that may not be independent of the bank's management even though it may try hard to be independent (Karim 1990b). Following Pratt (1986), one may suggest that if the SAC does lack independence then its effectiveness as an auditor is seriously diminished, because independence is essencial in the audit of business transactions involving parties with potentially conflicting interests. A more important issue is the danger that members of the SAC may be ignorant of the true implications of the very complex financial products and transactions brought before them. To investigate both the necessity of regulating the financial reporting of the Islamic banks and the role of the SAC as an internal audit mechanism independent of the bank's management is important.

CONCLUSION

This paper has reported the result of a study of the financial reporting practices of Islamic banks. At a time when Islamic banks and financial institutions across the world are setting themselves up for harmonising their accounting and corporate reporting principles, the study has hopefully contributed to the necessary groundwork for potential standard-setters in identifying items of information, measurement, and valuation problems on which there is no consensus. Auditors, professional accountants, and Olama may use the results of such a study to determine preferred accounting and corporate reporting policies for Islamic banks and to advise their clients and organisations on improvements to their financial reports.

Evident, from the foregoing discussion, are the difficulties faced by the Islamic banking system in many areas. The absence of a well-defined set of accounting procedures and rules based on generally accepted Islamic and secular principles would most probably affect the comparability of the financial report of Islamic banks. Since the Islamic Sharia'h principles are so broad, more likely are Islamic banks to proceed differently on similar transactions based on differing advice from their SACs.

Because accounting and corporate reporting need to respond to their environment, and because the operational circumstances of Islamic banks are different from those of non-Islamic banks, to expect Islamic banks to produce financial reports similar to those of non-Islamic banks and to recommend that Islamic banks should adopt the accounting standards of non-Islamic banks is advisable. In the light of the above arguments, arrangements should be made by those in a position to do so for the harmonisation of the financial information which Islamic banks are disclosing in their annual reports.

A major problem in the accounting and operation of Islamic banks is the lack of precision in the application of Sharia'h principles to Islamic banking. The Sharia'h does not refer directly to banking or its accounting, but to broad issues relating to the prohibition of the paying and receiving of interest, transactions relating to pork, gambling, speculation, etc.. Therefore, for Islamic countries to operate, in a practical manner, the application of Sharia'h principles to the accounting and operations of Islamic banks is important. This requires the development of a conceptual framework for the understanding of Islamic banks operations and accounting. The conceptual framework should provide a clear definition of Islamic bank practices including accounting period, loans, investments, deposits, measurement, and allocation of profit between the bank and its depositors. This task can be undertaken by a committee made up of Islamic scholars drawn from countries with Islamic banks, by a committee of regulatory bodies from these countries; by a committee of Islamic banks from different countries (a sort of regulatory club), or by a combination of two or more of the earlier three, such as a committee made up of regulatory bodies, Islamic banks, and Muslim scholars. However, Islamic banks from many countries have chosen to form a regulatory board. The Financial Accounting Organisation for Islamic Banks and Financial Institutions (FAOIBFI), located in Bahrain, is moving in the direction of harmonising accounting and corporate disclosure matters of Islamic banks. The first accounting standard of the FAOIBFI "General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions," published in October 1993, is expected to become effective in 1996. The impact of this and future accounting standards in the harmonisation of financial reporting by Islamic banks will be observed closely.

NOTES

1. Interest has been defined by the Oxford dictionary as "money paid for use of money lent or for forbearance of debt". Usury has been defined by the Oxford dictionary as "an excessive rate or amount of interest, or a higher interest than is allowed by law. The equivalent to usury in Islam, is riba. Riba defined by Haque (1982) "as an interest or excess (fadl) which in exchange or sale of commodity, accrues to the owner (lender) without giving in return an equivalent counter value of recompense (iwada) to the other party". The forbidding of interest is not the only major issue that affect Islamic banking. Islam sets great store on legitimacy, ownership and responsibility. For example, capital leasing is not very acceptable to Islam.

2. This does not apply to murabahah transactions, which relate to the purchase of commodities on behalf of clients at an agreed profit.

3. The notion of a parallel audit does not mean that the Islamic auditors fail to interact with the secular (external) auditors.

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