Routledge Studies in Accounting

ACCOUNTING AND AUDITING STANDARDS FOR ISLAMIC FINANCIAL INSTITUTIONS

Mohd Ma'Sum Billah

ROUTLEDGE

Accounting and Auditing Standards for Islamic Financial Institutions

While accounting and audit functions are significantly regulated and standardized in conventional financial industries and activities through the implementation of International Accounting Standards and International Financial Reporting Standards, as well as other international, regional, and local regulations, this is not the case for all Islamic financial organizations. Rather than having their own set of comprehensive accounting or auditing standards or policies, these are based, in some cases, on the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Islamic Financial Services Board (IFSB)'s standards, and *Shari'ah*-based local policies.

This book is a timely and comprehensive overview of accounting and auditing standards based on the doctrine of *Shari'ah*. It contributes significantly to the field in the form of a wealth of technical know-how. It analyzes Islamic accounting and auditing both in theory and practice and from a distinctly international perspective. The chapters are arranged in a systematic and logical manner making them readable and engaging.

The book evaluates the existing standards and widens the scope of the discourse to include *Maqasid al-Shari'ah* and Islamic accounting and audit models and standards as well as offers practical policy recommendations. The author presents a *Shari'ah*-justified solution to Islamic Accounting and Audit issues and offers guidance on overcoming the challenges to implement Islamic Accounting and Auditing Standards.

The book is a unique and exhaustive guide and, as such, will be an invaluable resource for academics, researchers, students, policymakers, as well as practitioners in accounting and auditing firms and financial institutions.

Mohd Ma'Sum Billah is Senior Professor of Finance, Insurance, FinTech and Investment at the Islamic Economics Institute, King Abdulaziz University, Kingdom of Saudi Arabia.

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Accounting and Auditing Standards for Islamic Financial Institutions

Mohd Ma'Sum Billah

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This book is, dedicated to the remembrance of my most beloved parents *Allamah Mufti Nur Mohammad (r)* and *Ustazah Akhtarun Nisa' (r)* also my beloved parents-in-law *Tuan Haji Nawawi Bin Mat Din (r)* and *Puan Hjh Basariah Binti Mat Lia (r)* who have nourished us with their love and wisdom. May *Allah (swt)* shower them with His Love and Mercy and grant them *Jannat al-Ferdaus*. I would also like to dedicate this book to my lovely wife Dr. Khamsiah Binti Nawawi (Head, OSHE-Hospital UKM) and our heart-touching kids Dr Ahmad Mu'izz Billah (HCTM), Ahmad Mu'azz Billah (Pursuing his BSc Honors in Artificial Intelligence, UPNM), Ahmad Muniff Billah (Pursuing his BSc Honors in Aviation Management and Piloting, MSU), and Akhtarun Naba' Billah (Pursuing her Foundation Leading to LLB Honors, IIUM) for their continuous supports and sacrifices.

May all be blessed with *Muwaddau Wa Rahmah*, *Qurratu A'yun*, and *Mardhaati Allah (swt)* in the life and the next.

This book is also dedicated to the *Ummah* and the whole of humanity.

Mohd Ma'Sum Billah, PhD
Islamic Economics Institute
King Abdulaziz University
Saudi Arabia

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There is no strength and power except in Allah (swt), To Him comes the praise, the Savant, the Wise, the Omniscient, the most beautiful names belong to Him. May the blessing of Allah (swt) and peace be upon Muhammad (saw) and all the Prophets (aws) from the first to the last.

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Mohd Ma'Sum Billah, PhD
Islamic Economics Institute
King Abdulaziz University
Saudi Arabia

About the author

Mohd Ma'Sum Billah, DBA, PhD, MBA, MCL, MMB, LLB (hons)

Senior Professor of finance, insurance, finTech and investment, Islamic Economics Institute, King Abdulaziz University, Kingdom of Saudi Arabia. He is also currently the Member of the Audit Board of ACIG (approved by the Saudi Monetary Authority/Central Bank of Saudi Arabia), Saudi Arabia. Billah has been earlier affiliated with University of South Australia as Adjunct-Professor. Billah had been serving and contributing both academic as well as corporate industries and international organizations for more than 25 years with management, teaching, research, solution proving and sharing of strategic and technical know-how towards the advancement of Islamic finance, finTech, business, investment, capital market and insurance (*Takaful*) besides *Halal* standard. Billah has published 36 books and chapters in books besides more than 200 articles in internationally reputable journals and social media. Most of his books were published by world top publishers namely; Thompson Reuters, Sweet & Maxwell, Palgrave Macmillan, Springer, Routledge, Edward Elgar, and others. Most of his books and articles are used as among the lead references (solutions to reality) by universities, industries, professional firms, governments, policy makers, regulators, NGOs, academia, researchers, and students of higher learning in different parts of the contemporary world. He had been presenting in more than 300 conferences, seminars, executive workshops, professional development workshops, and industrial trainings in different parts of the world. In addition, he had also been affiliated with corporate, academic, and financial industries including central banks, international corporate organizations, governments, and NGOs in his capacity as a member in boards, director, advisor, strategic decision-maker, transformer, and reformer with strategic solutions and technical know-how. Among the areas of his interest and contributions are: Islamic finance, insurance (*takaful*), crowdfunding, investment, *Zakat, Waqf*, capital market (*Sukuk*), social finance, SDGs, petroleum finance, trade, fintech, e-Commerce, Crypto-asset, cryptocurrency, industrialization, privatization, national entrepreneuring models, standards, policies strategies, and technical know-how.

Foreword

بِسْمِاللَّهِالرَّحْمَٰنِالرَّحِيمِ

All praise be to Allah, the Lord of the worlds, and Allah's blessings and peace be upon Prophet, Muhammed (PBUH), his family and his companions.

I feel honored and thankful to **Prof Dr Mohd Ma'Sum Billah** for inviting me to write the foreword of this book. This publication, "*Accounting and Auditing Standards for Islamic Financial Institutions*," is a praiseworthy work toward building a consensus on the specific needs for determining the appropriate basis of accounting and auditing for Islamic financial institutions (IFIs). This is a very important topic and still has not grabbed the attention of the scholars and experts, and so a student and researcher on these topics are unable to have any access to adequate knowledge resources. Accordingly, in my humble opinion, it is a timely and very significant contribution to the field of Islamic accounting and auditing as it inculcates a constructive discourse and provides valuable information for further research in this field. The book in this respect provides insights into various aspects of accounting in a way that is aimed to reflect true and fair reporting, recognition, measurement, and disclosure of Islamic financial transactions in the financial statements of IFIs.

With the rapid growth of the Islamic finance industry around the globe, especially after the global financial crisis of 2007–08, there has been a growing demand for a uniform set of accounting practices and standards for the stakeholders of the Islamic finance industry. And it is gradually being recognized as an important component of *Shari'ah* compliance of an IFI to enjoy trust of various stakeholders as well as to demonstrate transparency in reporting and disclosing facts to its stakeholders.

Islamic finance accounting abides by the *Shari'ah* principles and rules and assesses an IFI in its dealings whether the objectives of the organization are being met, including socioeconomic factors, religious activities, and transactions. It provides the foundation for the recording and reporting of Islamic finance transactions in a manner, whereby the rights and obligations as well as the profits and costs accruing to different parties and stakeholders are determined in accordance with *Shari'ah* principles and rules. Additionally, the Islamic finance accounting ensures that the recording of transactions provides adequate transaction trails recorded in line with the *Shari'ah* requirements relating to the execution and sequencing of the transactions, reflecting the risks profiles of different elements of financial statements in line with their true characteristics.

It is also worth noting that the information needs of users of financial reports increase and vary with the increase in the categories of users – for example investors including equity and investment account holders, creditors including current accountholders, debtors, employees of the IFI, and those who deal with it in any other manner.

It needs to be reemphasized that Islamic finance products and services are different in principle and shall be construed as such as well as shall be implemented and executed in a manner consistent with their legal form. This, however, does not mean or intend to reinvent the wheel by proposing a whole new set of standards of accounting and auditing for IFIs, unless there is a gap that needs to be filled in. Accounting for IFIs holds prominence especially when (IFRS or) generally accepted conventional principles of accounting fall short of recognizing those unique and specific information needs of the users of financial reports of IFIs, and, accordingly, the financial reports of such entities do not reflect the nature of the relationships established with such entities and the transactions, events or conditions involving such entities. The gap in this area is filled in by the AAOIFI Financial Accounting Standards (FASs).

It is worthwhile to mention that AAOIFI's FASs are the globally accepted standards in this respect, which are adopted fully, partially, as guidelines, as supplementary reporting, or as a basis for local regulations/standards in more than 43 regulatory jurisdictions in more than 36 countries. I am pleased to note that although not all, but a major part of the accounting treatments and principles defined in this book are driven from or are principally in line with the AAOIFI FASs.

AAOIFI in the recent past has made its FASs more conceptual and principle-based in an attempt to make them as practicable, adoptable, and implementable as possible by the industry stakeholders, including streamlining its approach in line with international standards. In doing so, AAOIFI has revised many standards, as well as has issued (and is continuously issuing) new ones that are closer to and aligned with international best practices. This is of course without compromising on principles and rules of *Shari'ah* and addressing specific characteristics of Islamic finance transactions, including issues of Islamic social finance. The need of the hour for the industry is to have a uniform set of accounting practices across jurisdictions and to have and maintain top quality standards.

AAOIFI's Conceptual Framework of Financial Reporting (revised 2020) helps in better understanding of accounting information included in general-purpose financial reports and, in turn, enhances confidence in IFIs. Additionally, it promotes harmonization by providing a basis for selecting the most appropriate accounting treatment permitted by the FASs. A very important aspect covered by the new framework is the linkage of the *Shari'ah* principles and rules with the accounting principles applicable on Islamic finance. This linkage, if referred to by the readers of this book, may significantly enhance their understanding of the rationale for such accounting treatments.

This book covers important areas of accounting and auditing for IFIs, including different practices with a significant focus on Malaysian market (as a very mature Islamic finance market), which provides an opportunity for other jurisdictions to gain from their experiences. A further study on comparison of accounting practices of IFIs in different regions and/or jurisdictions of Islamic finance would be highly beneficial.

Case studies discussed in the book provide a good source of information and learning to the readers and will hopefully enhance their understanding of the concepts explained in the book. The discussion on *Shari'ah* audit has been well elucidated. Future publications on this could research and expand its scope and purview of coverage, including explanations of external *Shari'ah* audit standard of AAOIFI and ISAE 3000.

The book also touches upon AAOIFI's code of ethics that is one of the important areas that guides the Islamic finance industry. However, it is worth noting that AAOIFI has issued a revised code of ethics for Islamic finance professionals that superseded the two codes of ethics previously issued. The purpose of developing a new code is to provide Islamic finance professionals with a better and more comprehensive understanding of the concept of ethics; structure it in a simple and easy-to-understand format; and, most importantly, accommodate the industry needs, expectations, and requirements. This enhanced code can be discussed in the next edition(s) of the book. The new code of ethics, however, is a highly recommended reading for the readers of this book.

While the publication is an excellent read both for industry practitioners and academia alike in understanding accounting for IFIs, it is also recommended to refer to AAOIFI conceptual framework, AAOIFI FASs, and AAOIFI's publication on "IFRS and the *Shari'ah* Based Reporting: A Conceptual Study," in addition to study texts of CIPA professional qualification. These will complement a great deal of information provided in this book and will enable the reader to understand the Islamic finance accounting and auditing practices in more detail.

Accounting and accountancy profession, both conventional and Islamic, is ever evolving and needs timely updates and renewing of concepts at regular intervals. Therefore, I firmly believe that the need of this type of book at this juncture cannot be overemphasized, and the same needs to be updated at regular intervals through revised and improved editions.

I wish all the best of luck for this publication and hope it achieves its desired objective(s) in the time to come.

Peace be upon you with the mercy and blessings of Allah (swt).

Omar Mustafa Ansari
Secretary General, Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)

Preface

Islamic Accounting and *Shari'ah* Auditing are among the holistic paradigms to ensure systematic activities of Islamic finance and corporate functions within *Maqasid al-Shari'ah*. Islamic Accounting and *Shari'ah* Auditing are not a mere technical component that help in facilitating financial and corporate activities, but they also are about the eco-justice for both entrepreneurs and customers leading toward a sustainable balanced economy and development for the benefit of individual, family, corporate, society, government as well as globally toward corporate justice and efficiency. There are many write-ups on Islamic accounting and *Shari'ah* audit, but no comprehensive and organized literature or textbook yet is there that can help students and researchers to follow as their needful direction. It is time to contribute with a comprehensive solution in the form of a guide for students, researchers, academia, professionals, and industrialists to build up themselves with accounting and auditing professionals within the *Shari'ah*-justified models. Thus, an attempt is made in this book to contribute with core solutions to *Islamic Accounting and Shari'ah Auditing* in their holistic sustainable capacity as a technical vehicle with mechanisms in today's world in meeting the goals of financial and corporate activities with accuracy in accordance with the *Maqasid al-Shari'ah*. The book, *Accounting and Auditing Standards for Islamic Financial Institutions* can be listed among the pioneers on the subject by addressing a series of core and specialized issues, which is in ***two parts*** with ***27*** specialized chapters besides an introduction and an index.

Part I provides a chemistry of ***Shari'ah Standard of Accounting***, which consists of 21 chapters addressing different core issues of *Islamic Accounting*. *Chapter 1* contributes on *Islamic Accounting System*. *Chapter 2* provides a paradigm of the *Islamic Accounting Policies*. *Chapter 3* focuses on Islamic Accounting Procedures. *Chapter 4* analyzes *Islamic Accounting versus Mainstream Accounting*. *Chapter 5* analyzes the *AAOIFI's Accounting Standard*. *Chapter 6* presents a paradigm of *Islamic Accounting Standard*. *Chapter 7* goes on analyze the *MASB's Accounting Standard*. *Chapter 8* analyzes the *Shari'ah Compliance to MASB's Standard*. *Chapter 9* analyzes *Functions of Account under Islamic Law*. *Chapter 10* focuses on *Types of Account Adapted in Islamic Banks*. *Chapter 11* provides an account on *Financial Accounting and Reporting for the Islamic Financial Institutions*. *Chapter 12* discusses *al-Mudharabah Investment Deposit (Fund)*.

Chapter 13 advocates on *Accounting for al-Musharakah Venture Capital*. *Chapter 14* presents *Accounting for al-Murabahah*. *Chapter 15* discusses the topic of *Accounting for al-Bay Bithaman al-Ajil (BBA) Financing. Chapter 16* provides an account on *Accounting for al-Ijarah*. *Chapter 17* analyzes the *Accounting for al-Wakalah Financial Arrangement. Chapter 18* focuses on *Accounting for al-Rahnu Financial Arrangement. Chapter 19* discusses *Accounting for Islamic Trade Financing*. *Chapter 20* analyzes *Accounting Treatment of Takaful Products. Chapter 21* contributes on the topic of *Accounting for al-Zakat*.

Part II**,** consisting of six chapters, focuses on the manner in which ***Shari'ah Audit Standard*** functions. *Chapter 22* contributes on *Corporate Understanding of Islamic Audit and Shari'ah Compliance*. *Chapter 23* provides a comprehensive analysis of the *Essence of Islamic Audit*. *Chapter 24* analyzes the *Shari'ah Auditing Standard*. *Chapter25* discusses the *AAOIFI's Audit Standard*. *Chapter 26* analyzes the *Islamic Ethics of an Auditor*. *Chapter 27* contributes on *Role and Responsibilities of an Auditor in the Islamic Financial Institutions*.

Needless to say that the idea of *Islamic Accounting and Auditing Standards* and their emergence are capturing the attention and appreciation of all levels of Islamic financial and Halal corporate organizations across the contemporary world; yet no significant or comprehensive research with applied solutions to *Islamic Accounting and Auditing Standards* as a textbook or lead reference is available to be used as a reliable resource for continuing academic or industrial research in meeting the demand of practical market niche and develop further with technical know-how of *Islamic Accounting and Auditing Standards*, with jurisprudential thoughts and *Shari'ah* guidelines by AAOIFI and others available in the academic or corporate library and or as occasional research or in the social media. Thus, this title (*Accounting and Auditing Standards For Islamic Financial Institutions*) is expected to be among the pioneers with organized and comprehensive applied solutions to *Islamic Accounting and Auditing Standards*, which may be a guide to academia, researchers, financial institutions, corporate organizations, practitioners, decision-makers, programmers, professionals, and students for their technical know-how, future research, and development of *Islamic Accounting and Auditing Standards*. It is not impossible for the book containing any shortcoming. We are, thus, humbly requesting all readers to notify us should any shortcoming be noticed for a further improvement of the book.

Mohd Ma'Sum Billah, PhD
Islamic Economics Institute
King Abdulaziz University
Saudi Arabia

Introduction

Accounting and auditing are an essential part of the core engineering system of financial industries and their activities. The prime functions of accounting are collection, accuracy, recording, analysis, presentation, and performance of a business, organization, or company's financial operations and activities. Thus, an accountant plays a key role primarily in financial data collection, entry and report generation, and accurate financial performance. The general objective of auditing on the other hand is to ensure the accuracy of the compliance function of the company or the business activities within the law and policies that the company and its activities are based on. Thus, the key role of an auditor is to assess the level of compliance and duly conformity of the company to government's rules, regulations, general orders, policies, procedures, guidelines, standards, and practices accurately. In addition, an auditor in the financial organization is supposed to screen through and examine the financial transactions, records, and activities of the company by ascertaining whether they were relevant, accurate, complete, and fairly presented. Furthermore, the role of an auditor is to provide users with information on the policies, laws, principles, accounting practices, and presentation of financial statements with accurate paradigm and highlight the clear and complete financial position and financial performance of the company and its activities.

It has been closely observed that the accounting and audit functions in facilitating conventional financial industries and their activities are significantly regulated and standardized by the International Accounting Standard (IAS); International Financial Reporting Standard (IFRS) and other international, regional, and local laws; policies; guidelines; manuals; and standards of every jurisdiction accordingly. But the same *locus standi* has not been realized among the Islamic financial organizations and their activities across the world. Accounting and audit functions for the Islamic financial industries of the world are in some situations based on the AAOIFI, the Islamic Financial Services Board (IFSB)'s standards, and *Shari'ah*-based local policies, for example Malaysian Accounting Standard Board Islamic (MASBi). Under some circumstances, the accounting and audit functions of Islamic financial industries rely on Fatwa (Juristic opinions) and the views of *Shari'ah* Supervisory Council of respective jurisdiction or company. Moreover, the Islamic financial institutions in some circumstances (in the absence of accurate

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solutions to *Shari'ah*-compliant accounting or audit standard) for their accounting and audit functions rely on the conventional standards and policies, perhaps on the ground of necessity (*Dharurah*), by customizing one within the broad principles of *Maqasid al-Shari'ah*. It is, thus, submitted that the Islamic financial institutions of the global environment do not really have their own comprehensive accounting or audit standards or policies ready yet in hand to be absolutely relied on. Furthermore, there are several research works (books, articles, papers, views, and Fatwa) available on the issues of Islamic accounting and audit models and standards, which are mostly on conceptual knowledge with some empirical studies, but there are no comprehensive solutions to *Shari'ah* accounting and auditing standards for Islamic financial institutions except the ongoing standards of AAOIFI.

It is, thus, time to comprehend and duly contribute to the academics, research, professional and Islamic financial environments with a comprehensive solution to accounting and audit standards within the principles of *Shari'ah*. Thus, this book is a humble effort in contribution of possible solutions to Islamic Accounting and Audit Standards within the principles of *Maqasid al-Shari'ah*. The book therefore, aims at meeting the possible market demands in the form of a detailed guide to Islamic Accounting and Audit Standards as a resource for the academia, researchers, students, professionals, policy makers, accounting and audit firms, and financial and corporate industries.

Part I

Shari'ah standard of accounting

1 Islamic accounting system

Introduction

Islam is a religion of truth and comprehensive. Islamic teachings cover all aspects of human life and the universe. Islam also provides guidelines and principles to be followed by both Muslims and non-Muslims to the right path and better way. Besides fulfilling our responsibilities as slaves of Allah, we also need to accomplish our responsibilities toward other people especially when dealing with them. As stated in the holy Qur'an:

> "*O you who believe! When you deal with each other, in transactions involving future obligations in a fixed period, reduce them to writing*."
>
> (*al-Baqarah*: 282)

As dealing with money, goods, and properties is the most common of our daily activities, it would be the reason why a proper measurement and recording system is required for fair presentation of rights and obligations. A systematic and accurate financial accounting system that had originated and applied since the time of Prophet is an effort to fulfill this requirement. This financial accounting system had been developed and improved occasionally to satisfy the users of information needs. Islamic institutions have been established to assist Muslim societies to spend money in a beneficial manner in line with *Shari'ah* principles. Islamic institutions such as the Islamic banks play their important roles in introducing and attracting depositors and investors to invest their properties according to the Islamic *Shari'ah*. Further on, the financial accounting system emphasizes on the conceptual framework and *Shari'ah* requirements that have been adopted by Islamic financial institutions across the world.

Accounting system

Accounting system in financial industries is a set of structured frameworks to record business transactions in a proper manner with certain rules and principles, and those transactions should be recorded in monetary term. The system is necessary especially for businesses and profit-making organizations or companies to

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record daily transactions and to define and classify the financial effects of consummated transactions. Besides, the system is supposed to prepare financial statements as a final report of all transactions during a period. The financial statements are to report profit or loss, cash flow and changes in equity of the company every year. The system is also expected to evaluate the organization's performance as well as enable the Board of Directors to forecast future income and expenses for the future years. The system has also been adopted and practiced in Islamic financial institutions of Malaysia. The accounting system applied by the institutions is conventional and like what has been practiced by other non-Islamic financial institutions, but the only different aspect is that the system takes into consideration the *Shari'ah* requirements and other Islamic conceptual frameworks. It means the accounting system applied by the Islamic financial institutions follows the *Shari'ah* guidelines as well as the conceptual frameworks.

Conceptual framework

Conceptual framework is defined by FASB (1976) as "*A constitution, a coherent of inter-related objectives and fundamentals that can lead to consistent standards and that prescribe that nature, function and limits of financial accounting and financial statement*." Conceptual frameworks can be considered as the basic guidelines, and they are meant to assist the development of accounting standards and principles. There are some groups of authorities involved in developing accounting standards and principles like Financial Accounting Standards Board (FASB), Accounting Principles Board (APB), and the "Trueblood Committee" under AICPA. These authorities mainly focus on the formulation of objectives of financial statements. The most important purpose of financial statements is to provide a true and fair view on the business financial positions. Besides, the statements also report the performance of the company in order to estimate the earning potential as well as to show the changes in the financial resources of the company. The conceptual frameworks take into consideration the reliability, accuracy, going concern standard, verifiability, and other qualitative objectives of financial accounting system. The frameworks that have been adopted by Islamic financial institutions follow the basic concepts of asset valuations, liabilities, equity, earning, gain and losses, financial maintenance, and physical maintenance, which have been proposed by the conventional accounting system.

Shari'ah requirement

Shari'ah requirements are the Islamic principles and guidelines generally stated in the Holy Qur'an. The *Shari'ah* requirements are compulsory for every Muslim to follow. In the case of the Islamic financial institutions, they need to take into consideration the *Shari'ah* requirements and conceptual frameworks to be applied in conjunction with the conventional accounting system. The *Shari'ah* principles are the main reference in the operations of the Islamic financial institutions to ensure lawful transactions and avoid unlawful transactions. Islamic *Shari'ah* has highlighted the guidelines and principles due to several reasons, which are to ensure just and fair treatment to all parties involved in the transactions with the institutions and to protect the rights and interests of the parties. These facts prove that the *Shari'ah* requirements are essential to be obeyed to ensure the blessing and mercy from Allah. *Shari'ah* principles were explained in general in the holy Qur'an. Among the requirements and principles highlighted is the prohibition of *Riba'* (interests). Interests are to be considered as unjust income generated in which it does not involve risks, while the risk is essential in any business contract in order for the income to be considered as lawful. Rifaat Ahmed Abdel Karim (1990) stated in his article that:

> *As an alternative to interest, Islamic banks use various mechanisms in their mobilization and uses of funds. Two of these mechanisms (Al-Musharakah and Al-Mudharabah) are based on the concept of profit and loss sharing while the others are similar to cost plus margin of profit (Al-Murabaha), leasing financing (Al-Ijarah) and hire-purchase financing (Al-Ijarah-wa-igtina).*

Underlying principles

The financial accounting system that is adopted by the Islamic financial institutions follows the *Shari'ah* requirements highlighted in the Qur'an. The Islamic banks, Takaful companies, and *Zakat* institutions are the examples of the Islamic financial institutions, which conduct their daily activities according to the *Shari'ah* requirements as well as the conceptual frameworks. Among those practices are explained as follows.

Al-Murabahah *(sale by deferred payment)*

Al-Murabahah is a financing instrument, which involves the exchange of goods. It is a sale of goods with an agreed mark-up price on cost as ruled by the *Financial Accounting Standards* (FAS) 2. Islamic bank buys goods from a seller and sells them back to the customer. There are terms and conditions to be followed in which the Islamic banks should disclose the cost of the goods to the customer, the contract should be valid, and the contract must be free from interest and the need to disclose any fault or destruction of the goods to client.

Al-Mudharabah *(co-partnership)*

Al-Mudharabah is a contract in which one party provides capital (*rabbul mal*), and the other party provides work or efforts (Mudharib) (FAS3). Normally, the Islamic bank enrolls as Mudharib while the investors are considered as the contributors of funds or the *rabbul* mal. The Islamic banks receive the capital or deposits from the depositors, or the capital providers and the funds are to be managed or invested in businesses or projects. The profits are shared between the two parties based on the profit-sharing ratio agreed in the contract, but the losses are borne by the capital providers unless there is misconduct or violation on agreement on the part of the Islamic bank. The practice follows the *Shari'ah* guideline in which Islam emphasizes that a contract ('*aqd*) must have the "offer and acceptance" ('*aqd*). The ('*aqd*) must exist and should be agreed between the two parties. Another *Shari'ah* principle applied is that the concept of truthfulness. It is considered relevance since the bank must disclose the cost and the mark-up price to the customer. The disclosure should not defeat the customer, and this shows how the bank follows the guideline of the *Shari'ah* principles.

Al-Musharakah *(partnership)*

Al-Musharakah is a form of partnership between the Islamic bank and its clients in which the two parties are supposed to contribute capital of either cash or kind. The parties are the owner of the capital on a permanent or declining basis (FAS4). The profits are shared based on the profit-sharing ratio as agreed during the contract while the losses are shared according to the capital contribution ratio. The concept of *Al-Musharakah* financing replaces the loan-based financing as practiced by most of the Conventional Banks. Thus, the Islamic banks offer this type of financing in order to avoid interests (*Riba*'), which is clearly prohibited by Islam.

Zakat *(mandatory alms)*

The conceptual frameworks that have been proposed and applied in accounting treatments related to *Zakat* include the determination of *Zakat* base, measurement of items, and disclosure of *Zakat* in financial statements of Islamic banks. *Zakat* is determined by 2.5 percent per year based on either two methods – net asset or net invested fund methods (FAS9). The percentage is based on *Zakat* portion according to *nisab* (amount) that has been stated in *Shari'ah* principle. Another important entity is the *Haul* or principle of the period of one full year that the properties should be owned for. Calculation of *Zakat* based on net asset is as follows:

> Assets subjected to *Zakat* – (liabilities due during the year + equity of unrestricted investment account + minority interest + equity owned by government + equity by endowment fund + equity owned by charity + equity of non-profit-organization exclude owned by individuals).

Calculation based on net invested fund

Calculation of *Zakat* based on Net Invested Fund is as follows:

Paid-up capital + reserves + provisions + retained earnings + net income + liabilities not due to be paid during the year – (net fixed asset + investment not required for trading [e.g., real estate for rent] + accumulated losses). Some Islamic institutions like Bank Islam Malaysia Berhad (BIMB) usually calculates *Zakat* on income, trading, or shares on behalf of the customer. So, the income received by the customer is short by the deducted amounts of Employees' Provident Fund (EPF) and *Zakat*, and the same goes to *Zakat* on trading.

Islamic unit trust

Islamic unit trust fund offered is also managed according to the *Shari'ah* principles. Islamic unit trust is a type of collective long-term investment scheme where investors pool their savings into a fund, and then the fund is diversified into portfolio of equities, fixed income instruments, and other permitted assets by a professional fund manager. Islamic Unit Trust operation allows to include only permissible properties and Halal stocks in accordance with Islamic principles. *Shari'ah* advisor is responsible to advise the manager on the compliance of the fund with the *Shari'ah* law, including preparing true and fair accounting system and the selection of Halal counters in which the fund is to be invested. Besides, the *Shari'ah* advisory is responsible to advise the manager regarding the concept, models, and operation of Islamic unit trust products.

Accounting for equity investment

Equity of unrestricted investment account holders shall be recognized when the bank receives the amount, and it is measured at the time of contracting. At the end of financial period, the equity is valued at its book value. The profits of an investment shared between the bank and the unrestricted investment account holders is allocated based on capital contribution. In the case of losses, if the loss has resulted from normal trading, the loss is deducted from the respective equity shares in the joint investment of the Islamic banks and the unrestricted investment account holders based on their contributions. In cases where the loss is due to misconduct or negligence of the bank, the loss should only be borne by the bank (FAS6). The treatment of the loss is to ensure justice and fair practices to be applied to all parties involved in the contract. The contract of the shared investment does not stipulate the predetermined rate of return in terms of percentage on their investment since it is prohibited in Islam.

Salam and parallel Salam (sale by deferred delivery)

Capital of Salam financing and parallel Salam is measured based on the amount paid at the time of contracting (FAS7). While the capital provided in kind or benefit shall be measured at the fair value. The contract of Salam, which is the advance payment contract, is allowed in Islam, but it should be put in written agreements. This type of financing is also considered a financing instrument, which follows the *Shari'ah* requirements.

Conclusion

Shari'ah principles are important to be adopted in conjunction with the conventional financial accounting system in order to provide a true and fair view of business performance, as the *Shari'ah* principles are divine regulations that have been formulated traditionally based on al-Qur'an and *as-Sunnah*. In the later times, the principles have been developed by Islamic scholars to make them relevant to certain conditions and situations due to new arising challenges but are still based on the concepts that are highlighted in Islam. Besides, the *Shari'ah* requirements should be the main reference for the Islamic financial institutions in order to practice justice and to protect the interests of all parties involved in the business activities and contracts. Islamic financial institutions play big roles in introducing and practicing the Islamic financial concepts and principles besides the conventional accounting system. These *Shari'ah* principles should be adopted and practiced in all Islamic financial institutions, especially when dealing with Muslim properties besides to satisfy the needs of the Islamic society.

2 Islamic accounting policies

Introduction

Islamic Accounting Model is based on macroeconomics. The main source for the development of Islamic Accounting Model are Islamic laws. Bank Negara Malaysia has a long-term objective to develop the Islamic banking system so that the Islamic Banks can operate in parallel or side-by-side with the Conventional Banks. Bank Negara Malaysia established the Islamic Banking in 1983 and later introduced the Interest-Free Banking Scheme on 4th March 1993. Under that scheme, Conventional Banks can provide the Islamic Banking products and services, but they are required to:

- Establish an Islamic Banking Unit (IBU).
- Create an Islamic Banking Fund (IBF).
- Open separate current accounts for Islamic Banking operations with Bank Negara Malaysia (BNM).
- Register as indirect members under the wholesale payments system, SPEEDS (now known as RENTAS).
- Observe a separate check-clearing system for Islamic Banking.
- Maintain a separate general ledger for their Islamic Banking operations.

Besides, the Conventional Banks are encouraged to appoint at least one *Shari'ah* consultant to advise them on their day-to-day Islamic Banking operations. The major development in Islamic Banking sector was the establishment of Islamic Money Market on 3rd January 1994 to smoothen the function of Islamic Banking system. Bank Negara Malaysia decided to implement Islamic Money Market based on the concept of Al-Mudharabah. In December 1993, Bank Negara Malaysia issued specific guidelines to ensure a smooth implementation and running of the market. Islamic Money Market consists of trading of Islamic financial instruments, Al-Mudharabah inter-bank investments (MII), and Islamic check-clearing system (ICCS).

The Association of Islamic Banking Institutions Malaysia (AIBIM) was established in June 1995 to promote an efficient Islamic Banking system with cooperation of and in consultation with Bank Negara Malaysia and other

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regulatory bodies. In October 1996, Bank Negara Malaysia issued the Specimen Financial Statements known as GP8 to prescribe the minimum standards on the disclosure of SPI banking operations. Bank Negara Malaysia established the National *Shari'ah* Advisory Council on Islamic Banking and Takaful (NSAC) on May 1, 1997 as the highest *Shari'ah* authority on Islamic Banking and Takaful in Malaysia. On December 1, 1998, Bank Negara Malaysia replaced the SPTF with Islamic Banking Scheme, which did not portray the correct picture with respect to the Islamic Banking operations undertaken by the bank. Under Islamic Banking Scheme, the participating banks are required to disclose the Islamic Banking operations, that is balance sheet and profit and loss account, as additional items under the notes to the accounts. Islamic Banking Unit (IBU) was upgraded to Islamic Banking Division (IBD) on 2nd January 1999. It is responsible on all Islamic Banking operations such as retail banking, commercial banking, corporate banking, trade or international banking, treasury operations, corporate planning, and branch operations. The Islamic Financial Services Board (IFSB) was established on 3rd November 2002. It is an association of central banks and monetary authorities of several Islamic countries with Islamic Development Bank (IDB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and is supported by International Monetary Fund (IMF). Bank Negara Malaysia issued two guidelines for two Islamic Banking products:

- Guidelines on Islamic Accepted Bills (IAB) in March 1993 to enhance the trading activities in the Islamic Money Market.
- Guidelines on Islamic Negotiable Instruments (INI) in December 1998. These guidelines comprised two Islamic deposit-taking products that are Negotiable Islamic Debt Certificate (NIDC), which is based on BBA, and Islamic Negotiable Instruments of Deposits (INID), which is based on Al-Mudharabah.

There are more than 40 Islamic Financial products that may be offered by the banks to the customers. The Islamic Banks and Conventional Banks that provide the Islamic Financial products may offer some of the facilities such as *Al-Wadi'ah* (guaranteed custody or safekeeping), which is a deposit-taking product, that is current deposits and savings deposits; *Bai' Bithaman Ajil* (sale by deferred payment), which is a trade financing product; *Al-Murabahah* (cost-plus trade financing product); *Al-Istisna'; Bai' Al-Dayn* (sale of debt); '*Aqd as-Sarf* (monetary exchange); *Salam;* Al-Mudharabah*;* and also *Al-Ijarah*.

Al-Wadiyah

Al-Wadi'ah is something put under the custody of people other than the owner. According to Hanafi School, it is an empowerment to someone for keeping the owner's wealth explicitly or implicitly, but, according to the Shafi'e and Maliki Schools, it is a representation of keeping possession of respectable private goods in a specific way. The trustee keeps the money for the owner, and it is to be returned to him when he requests. Trustee has no liability on the money unless there are issues of mishandling, negligence, mixing *al-Wadi'ah* with others, and loss when he refuses to return the money on owner's request. In the investment of *al-Wadi'ah*, the profits from the commercial activities are Halal, and the expenses of keeping *al-Wadi'ah* are borne by the owner. *Allah (swt)* said in the Qur'an:

> *Allah does command you to render back your trusts to those to whom they are due.*[1]

Prophet Muhammad (saw) said in a Hadith:

> *Render trust to whom has put his trust to you. Do not betray those who betrayed you.*

According to the Al-Ijma', Al-Wadi'ah is permissible since people need it, and it is a necessity. There are two types of Al-Wadi'ah – Wadi'ah Yad Al-Amanah and Wadi'ah Yad Al-Dhamanah.

Wadi'ah Yad Al-Amanah is based on *amanah* (trust) where it is charitable and rewarded. The liability is incurred according to the rulings of liability. The hand keeping is basically a trust to keep. *Wadi'ah Yad Al-Dhamanah* is a contemporary practice used in Islamic Banking System where the deposits are the source of funds for the bank. These funds are used for banking investment activities. The hand getting the deposits has a liability to give back since the deposits have been used for investment activities. They may be considered as loan to the bank. The bank may give *hibah* (gift) at its discretion.

Bai' Bithaman Ajil[2] **(sale by deferred payment)**

Bai' Bithaman Ajil (also known as BBA) is a sale of an object against an obligation to provide payment on a future date. It is a contract of exchange, where the commodity exchanged is delivered immediately, and the price is paid by installments. It is an Islamic trade financing product where people choose to buy house, land, consumer goods, etc. The bank provides medium and long-term financing to the customer. The assets to be financed by the bank must be lawful (Halal). *Bai' Bithaman Ajil* is widely used for house financing. When a customer wants to buy an asset using *Bai' Bithaman Ajil*, he can write an application to the bank and request the bank to purchase the asset. The bank will negotiate the period and the manner of payment with him. The customer does not have to inform the bank about the asset that he wants to purchase in details, and the bank is free to purchase the asset from any developer or supplier. But, if the customer informs the bank about the details of the asset, the bank must purchase the asset according to what he requested. Then, the bank will sell the asset to the customer at the actual cost along with the bank's profit margin. The customer must settle the payments by installments within the period and in the manner as agreed between both before.

> *Oh you who believe! When you contract a debt to a fixed term, record them in writing.*
>
> (Surah al – Baqarah: 282)

Al-Murabahah (sale by deferred payment)

Al-Murabahah is a trust sale (*Amanah* sale). It is a type of sale or trade where the bank acts as a partner that provides the finance for purchasing goods. The actual cost price or purchase price of the good must be disclosed before it is sold. The cost price includes insurance premium, transportation cost, import duty, etc. When the goods purchased are sold to the customer, the bank will share the profit based on the percentage markup, which has been agreed between the bank and the partner, to be added to the actual cost. This kind of sale involves smaller items and is valid for a short period of less than 6 months or less than 12 months (unlike *Bai' Bithaman Ajil*). The object of the sales must exist at the time of the contract and physically owned by the seller. The application of *al-Murabahah* in modern Islamic banking is to finance the acquisition of working capital such as stock and inventories, spares and replacement, or semi-finished goods and raw materials. The bank will purchase or appoint the customer as an agent to purchase the goods. The bank subsequently sells the goods at the purchase price along with profit margin for settlement on a deferred term.

> *The customer requests from the bank letter of credit (LC) and requests the banks to purchase or import the goods indicating that he would be willing to purchase the goods from the bank on their arrival on the principal of al-Murabahah. The bank will issue the LC and pays the proceeds to the negotiating bank. The bank sells the goods to a customer at a sale price comprising its cost and a profit margin.*[3]

Al-Istisna' (manufacturing)

Al-Istisna' is a contract of obligation for making a product in collaboration with a manufacturer. It comprises the purchase of a good that is manufactured by a manufacturer where he provides the labors and the materials. Both the manufacturer and purchaser can terminate the contract before the purchaser gets the manufactured goods. But when the purchaser has seen the goods, he may or may not accept the goods if he is not satisfied with the quality, while the manufacturer has no right on the goods anymore at that time. The payment is paid in advance such as deposit or down payment. The transaction can be canceled before the payment has been made. The contract can be for a long period as there is no specific duration. The bank acts as the middle person as it becomes the first purchaser who purchases the goods from the manufacturer or developer, and then the purchaser (second purchaser) deals with the bank to purchase the goods. Based on Qiyas (analogy), *Al-Istisna'* is not valid because it is selling something that is non-existent. According to the Juristic Preference or suspension of general rule, since the people are unanimous in practicing it, it becomes permissible. Prophet Muhammad (saw) said in a Hadith:

> *My ummah will never be unanimous to be astray*.

As *al-Istisna'* can be applied in modern Islamic Banking as a mode of financing, *al-Istisna'* can be used to finance a house under construction. Is it suitable in terms of payment and rules of sales? The bank can enter into a parallel contract of *al-Istisna'* with a third party or may hire services of a manufacturer. The payment of installment may start during or after the construction of the house.

Bay' Al-Dayn **(debt sale)**

Bay' Al-Dayn is a trade of debt that arises from deferred sale or other exchange contracts. Generally, *Shari'ah* prohibits this type of sale because the debt is an intangible property or wealth (*mal hukmi*), and, when it is traded, the risk (*Gharar*) is high for the buyer to win it and the seller to deliver it. But, the sale of debt to the debtor is totally allowed by the *Shari'ah*. The scholars differ in the sale of debt to the third party. According to Hanafi School, the transaction is not allowed, but, according to the Shafi'e School, the transaction is allowed if the debt is guaranteed and sold in exchange for physical good that must be delivered immediately. According to Ibn Qayyim, the transaction is permissible as Maliki School agrees that the transaction is allowed but with some conditions as follows:

- Expediting the payment of the purchase.
- The debtor confirming the debt.
- The debt cannot be created from the sale of currency to be delivered in the future.
- The debt should be on goods that are saleable.

'Aqd as-Safr **(exchange)**

'Aqd as-Sarf is a sale of money with money either of the same monetary value or different kind or mode – for example gold with gold, gold with silver, and notes with coins. Similar monetary value can be got by exchanging equal amount of gold with gold and silver with silver. Different monetary values can be got by exchanging different amounts. The sale of different kind such as gold with silver is allowed but the amount of gold must be less than silver. If the amount of gold and silver is equal or silver is more than gold, then *Riba' al-Fard* (*Riba'* of exchange) is

occurred. The exchange must be done on the spot. There should be no lapse of time as it is *Riba' an-Nasiah*. Prophet Muhammad (saw) said in a Hadith:

> *Do not exchange gold with gold except similar with similar, do not reduce one over the other. Do not exchange the absent with the present (on the spot present)*.[4]

'Aqd As-Sarf is valid if it fulfills the conditions. It becomes invalid if any option is attached to it or it involves a deferred exchange.

Takaful (Islamic insurance)

Takaful is a scheme of insurance. It is based on the concept of trusteeship and cooperation according to the Islamic teachings. The Task Force was formed in 1982 to study the establishment of an Islamic Insurance Company in Malaysia. In 1984, the Parliament enacted Takaful Act to provide for registration and regulation of takaful business in Malaysia. It also provides that the Articles of Association of a Takaful operator must have a provision for the establishment of a *Shari'ah* Supervisory Council to advise the operator on its Takaful operations and to ensure that the operator is not involved in any elements which are contradictory to the *Shari'ah*. Bank Negara Malaysia regulated and supervised Takaful operations since 1988 as the Government entrusted it. The Governor of Bank Negara Malaysia has been appointed as the Director-General of Takaful. In this scheme, the participants have agreed to provide financial help to the other participants against loss or damage. It is not a buying and selling contract and is not like the conventional insurance. Conventional insurance involves the elements of uncertainty (*al-Gharar*) in the contract of insurance, gambling (*al-Maisir*) as the consequence of the presence of uncertainty, and usury (*al-Riba'*) in the investment activities of the conventional insurance companies, which contradict the rules of *Shari'ah*. Muslim jurists generally accept the Takaful. The Takaful policyholders purchase the insurance from the insurer and pay the price in the form of insurance premium. In return, the policyholders receive monetary benefits as compensation from the insurer when there is a loss or damage. Under profit-sharing principle, the most appropriate accounting policy would be on cash basis. The profit gained is to be shared based on the actual sum. The operation of Takaful in Malaysia is confined within the *Tijari* or is commercial based on the Islamic principles of al-Takaful, al-Mudharabah, and *al-Tabarru'*. Takaful operation can be concluded as a profit-sharing business venture between the Takaful operator and the individual members or participants who desire to guarantee each other against any loss or damage that may occur to anyone of them.

Bay al-Salam (sale by deferred delivery)

Bay' al- Salam refers to an agreement of sale of an object that not available at the time of the completion of the sale but is delivered in the future on a fixed date. The price in *Bay' al- Salam,* however, is paid immediately during the signing of the contract. When there is a proposed sale of a determinate thing for an agreed price between two parties with immediate payment, and it must be delivered in the future on a fixed date, the process is called '*Bay' al- Salam*. "*The Bay' al Salam is a sale of the unavailable goods which has been allowed based on the Hadith of the Prophet which allowed the sale of future goods*." The jurists allowed such thing because the public needed it and was customarily practiced in the commercial sector. *Bay' al-Salam* is actually bounded by the specific rules and condition. It is necessary that the subject matter of the sales is specified and known, besides knowing the amount, measurement of the subject matter, and the date to deliver the subject matter. *Sales of Salam* are lawful in relation to the goods, which can be weighted or measured or counted by number. The sales are unlawful if there is no similarity in the counted numbers, because it cannot specify and describe units, and it may involve excessive uncertainty. "*According to the Hanafi School, another condition for the validity of the sales of Salam is that the delivery of the goods should be postponed to a future date and immediate delivery renders such sale invalid*." However, Shafi'i School maintains that the delivery of the goods in the sale of Salam is not necessarily to be postponed to a future time but it can be immediate. It is because the future delivery of the goods is to be authorized in order to facilitate the seller to acquire the subject matter of the sale and deliver it to the purchaser. Hanafi provided two reasons to support their view upon this point. First is Hadith of the prophet:

> *Whosoever enters a sale of with you, let him stipulate a define weight and measurement and a definite period of delivery*.

The other Hadith narrated by Ibn Abbas is:

> *O you who believed! When you contract a debt to fixed term, record them in writing*.

The Malikis and Hanbalis are of the opinion that the *Salam* sale should be allowed on the non-existent subject matter. It is not important whether it is available at the time of the completion of the sale or not. The sale is valid if the subject matter would be available at the time of delivery or it would come from a place known to have been capable of producing such goods, because the possibility of *Gharar* in such situation is remote. *Salam* is applied in Islamic Banking nowadays when the bank, after paying the advance payment of *Salam*, may enter into a parallel contract of *Salam* with another prospective buyer. The period of *Salam* in the second Salam contract is shorter, thus the price may be a little bit higher. The difference between these two prices is the profit. The rule is that the shorter the period, the higher the price and the greater the profit.

Al-Mudharabah

As a pre-Islamic commercial system, al-Mudharabah continued to be an acceptable economic practice during the Islamic era. The major reason of al-Mudharabah's acceptance was the resulting ease and efficiency achieved in functioning of the economic system. Al-Mudharabah is a special kind of contract of partnership based on the risk and profit sharing in which a party provides funds (*Rabb al-mal*) and the other provides work and management (mudharib). According to the Majjala article 1404, al-Mudharabah is defined as a type of partnership where one party supplied the capital and the other supplied the labor. From this definition, we know that there are two elements constituting al-Mudharabah, which are contracting parties and capital. Taqi Uthmani give his opinion that al-Mudharabah is a special kind of partnership where one partner gives money to another for investing in the commercial enterprise. The investment comes from a partner who is called (*rab al-Mal*), while the management and work are the exclusive responsibilities of the other partner who is called (*mudharib*). Based on the Hadith of the Prophet (saw), it is practiced by the companion.

> *Reported that the prophet SAW before his prophet hood at attaining went to Syria (Shams) for trade with Siti Khadijah's merchandise on a basic of al-Mudharabah on sharing.*

It also reported that Uthman bin Affan (r.a.) practiced al-Mudharabah by depositing some of his saving with Aisyah (r.a.) who lent him on the al-Mudharabah for business purposes. Al-Mudharabah can be divided into two types: absolute al-Mudharabah and al-Mudharabah *muqayyadah*. Absolute al-Mudharabah occurs when there is no limitation as to the time or place or any time of commerce or any render or purchaser. In other word, it is the one in which the investor (*Rabb al-mal*) authorizes the agent (*mudharib*) to act completely at his own discretion in all business matters. Al-Mudharabah *Muqayyadah* is a limited al-Mudharabah. It occurs where there is a limitation on time, place, persons, business, and so on. For example it is stipulated in the al-Mudharabah agreement that property shall be sold or bought at a certain time or place or should be a certain type or that business shall be carried out with certain persons as the inhabitants of a certain place. The issue is whether the limitation of certain place, time, and specified person is valid or not. According to the Hambali and Hanafi schools, the limitation is permissible, but Maliki and Shafi'i do not agree with the condition giving the explanation that the condition is invalid. There are essential elements and conditions in al-Mudharabah. According to the Hanafi, there are two elements of al-Mudharabah, which are offer and acceptance. But according to the Jumhur, there are three elements which are sighah (offer and acceptance), contracting parties (*rab al- mal and mudharib*), and *al-'aqd* (capital and working profit). The issue of *re*-al-Mudharabah is that there is a critical question as to on what basis a bank is entitled to a profit as it does not provide any capital or work. The capital is derived from the depositors. To this effect, types of contract while Maliki and Hanafi have allowed it. Probably, due to this reason, the contemporary practice of Islamic banks, particularly in Malaysia, is only applicable at the first level between the bank and not at the second level.

***Al-Ijarah* (lease)**

It literally means to give something on rent. Technically, it refers to employing the services of a person on wages given to him as a remuneration of his hired services. Alwi Hassan on his opinion defines *Al-Ijarah* as a contract of proposed and known usufruct with a specified and lawful return of amount or compensation for the effect of work, which has been expended. The legality of *al-Ijarah* is based on the al-Qur'an, Hadith, and Ijma'. According to the Hadith of the holy Prophet (saw):

> *Give the employee his wages or salary before his sweat dried.*

And, Qura'nic verses Surah Al-Qasas verse 26:

> *Said one of the (damsels) "Oh my (dear) father! Engage him on wages: truly the best of men for thee to employ is the (man) who is strong and trusty.*

Transferring the usufruct of a particular property to another person on a rent claimed from him, the difference between sale (bay) and *Al-Ijarah* is the transfer of ownership verses the transfer of usufruct (*manfa'at*). There two types of *Al-Ijarah*: *al-Ijarah al – 'Ayn*, which is used for physical immovable property such as land and house and *al-Ijarah al-Dhimma* for hire or purchase of personal services of people such as doctors, lawyers, and teachers. The rules of *Al-Ijarah* are as follows:

- The leasing subject must have a valuable use.
- The lease given for rent and the hired amount should be fully known to both parties.
- The corpus of the leased property remains in the ownership of the lessor; all the liabilities emerging from the ownership shall be borne by the lessor; but liabilities referable to the use of the property shall be borne by the lessee.
- The lessee is liable to compensate the lessor for harm caused by any misuse or negligence of the lessee.
- The rental must be determined for the whole period of lease at the time contract.
- The lessor cannot increase the rent unlaterally, and any agreement to the contrary is void.

The application of *Al-Ijarah* in Modern Islamic Banking is a direct leasing financing process where under this contract, the lessee is required to pay the amount equivalent to the purchase price of the object as the lease rent. Hire purchase finance happens when the bank rents the assets to the customer who promises to purchase the asset within a special field period. The rental payment could be a fixed amount or a percentage directly related to the cash flow or the project and consists of the bank's share in the net profit plus the rental charges. Accordingly, when the total rental charge equals the cost of the asset, the asset ownership is transferred to the customer.

Conclusion

Islamic Financial system was developed in Malaysia over the last 20 years. Malaysia is the first country to have a full-fledged Islamic Banking system that can compete with Conventional Banking system, implementing dual banking system successfully. The development of Islamic Financial system would include the Islamic Banking industry, Islamic Money and Capital Markets, and Takaful Market. Takaful industry acts as an important institutional investor that represents the important component in overall Islamic Financial system. Its challenge is to expand a dynamic Takaful industry within Islamic Financial system. It is the role of the Government to provide the necessary infrastructure through a comprehensive set of legal and regulatory frameworks for Islamic Banking and Finance. Bank Negara Malaysia, which is the central bank in Malaysia, regulates and introduces schemes, rules and regulations, guidelines, requirements, and standards to the banks and other financial institutions. All banks and financial institutions must follow the standards that have been centralized by Bank Negara Malaysia including the guidelines for exercising the Islamic Financial system. Bank Negara Malaysia has been instrumental in developing the Islamic Accounting, Banking, and Financial systems in Malaysia, owing to the fact that the Conventional system involves elements that are contradictory to the *Shari'ah* principles. Besides, the Islamic Financial system is less risky and provides more benefits to the banks and the customers. The development of Islamic Financial system will encourage other Islamic countries to invest in Malaysia, and it will meet the demand of the Islamic investors. According to the *Shari'ah*, principles alone are not enough for the development of Islamic Finance. In the long term, customers and businesses expect product and service qualities that Islamic Finance offers. There is a need for a greater collaboration among the *Shari'ah* scholars, practitioners, and researchers to make further studies and to do adequate research to come up with more Islamic Financial products. Bank Negara Malaysia also has established two Islamic Banks which are Bank Islam Malaysia Berhad (BIMB) and Bank Muamalat Malaysia Berhad (BMMB), in addition to the Islamic Financial system that it has introduced. Today, Islamic Money Market is an important part of Islamic Financial system with instruments included such as Government Investment Issues (GII), Bank Negara Negotiable Notes, Islamic Accepted Bills (IAB), and Islamic private debt securities.

Notes

1 Surah An-Nisa': verse 58.
2 A past experience, though it is no longer appreciated.
3 Bank Islam Malaysia Bhd, 1994, pp. 41, 102.
4 Riwayah Al-Bukhari.

3 Islamic accounting procedures

Introduction

Luca Pacioli has been acknowledged as the first major contributor to the development of accounting records and reports. However, the specific source of Pacioli's books in 1494 is still anonymous. The outline by Pacioli in 1494 were like the narration of the Muslim civilization, historical evidence conserved in Turkey and Egypt indicates that accounting records and reports were developed in the early Islamic states. The growth of accounting books in the Italian Republics was also influenced by commercial links between Muslim traders and their Italian counterparts (Majdi, 2001). Several accounting records and reports used in the different parts of Islamic states are comparable to the modern-day accounting books and reports. According to Shaari Hamid in his paper "Book keeping and Accounting" in the tenth century, Muslim Administrative Office suggested evidences that some modern-day practices like book keeping and accounting control procedures may have been practiced in an integrated accounting system that existed in Muslim Administrative Office of the tenth century. He found that the following evidences: the modern-day accounting practices were introduced into Europe through the Muslim Arab influences of the Moors in Spain. The principal argument is the use of Arabic rather than Roman numerals to explain accounting. Italian traders acquired the knowledge of sophisticated business methods from their Muslim counterparts across Mediterranean (Lieber, 1968). An example is Leonardo Fibonicci of Pisa, author of *Liber Abbaci* (1202), a historical accounting figure who was an official notary to the Muslim merchants and had used the Arabic numerals extensively in his book.[1] The accounting practices in the Muslim Administrative Office also offered insight drifts of accounting practices in Italy. In a book by Al Khawarizmi, *Mafatih Al Ulum* (Key of Sciences), chapter 4 provided an encyclopedic compilation of technical terms relevant to the activities of a secretary. It thus provides a skeletal description of an elaborate accounting system. The technical terms refer to those terms employed in the Dimans, which pertain to record, registers, and financial documents. Al Khawarzmi list 26 different types of official registers used for recording financial and military transactions.[2]

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Objective of Islamic accounting

The objective of Islamic accounting is to provide information about a company's transaction and operations to society in general and to the shareholders. An organization should be transparent enough to inform all interested parties that the company runs its operation in a lawful way. The information also should be used to enhance an organization's efficiency, reduce waste, promote goodness, and ensure that only Islamically permitted economic activities are carried out to achieve socioeconomic justice and to have an equitable distribution of wealth among the society. Former Prime Minister of Malaysia, Dato Seri Abdullah Ahmad Badawi, had raised this issue in which he requested all the companies to provide true and fair information to the public. As stated in the Qur'an:

> *O You who believe! When you contract a debt for a fixed period, write it down. Let a scribe (accountant?) write it down in justice between you. . . . .Let him who incur the liability dictate . . . And get two witnesses out of your own men. . . . You should not become weary to write it down whether it be big or small . . . that is more just with Allah, more solid as evidence and more convenient to prevent doubts among yourselves, save when it is a present trade which you carry on, on the spot among yourselves, then there is no sin on you if do not write it down*.[3]

Bookkeeping

Bookkeeping is very crucial for a corporation to implement and practice. It is a process of recording business transactions and events accurately and systematically.[4] The recording process must be in accordance with Islamic accounting principles and rules and in line with the *Shari'ah*. Corporation needs bookkeeping records in order to show the results of the business operations. For instance, business profit or loss must be shown in the bookkeeping so that the corporation knows their outstanding performance. On the other hand, bookkeeping records ascertain the financial position of the business in the form of assets and liabilities. It also helps the management team in the decision-making process – for example by looking at the financial position, the corporation may decide whether to expand the business or not. A corporation should possess a good accounting system by implementing a systematic bookkeeping process. This is because the corporation will know the flow of their activities, where are they leading to, and get other important information from it. Besides that, it is important for a corporation to assign a right person to do the bookkeeping. For instance, the management should appoint a person who is dedicated, reliable, and responsible and possess both conventional and Islamic accounting knowledge. Therefore, it will help the management to produce accurate, reliable, and relevant economic information to the users and at the same time enhance the performance of the corporation.

Islam emphasizes that any transaction that has occurred must be recorded or put into writing. The main purpose of recording business transactions is to avoid disputes and harms among the parties who are involved in the transaction. At the same time, it also protects the rights of the parties and assists them in decision-making process. In the following verse, Allah says that if a transaction took place, we should write down whatever matters or agreements between both parties took place. If the parties do not have capabilities to do the transactions, their guardian should represent them. This shows the importance of bookkeeping system as a proof of business transactions of a corporation.

> *O ye who believe! When ye deal with each other, in transactions involving future obligations in a fixed period of time, reduce the to writing, let a scribe write down faithfully as between the parties: let not the scribe refuse to write: as God has taught him, so let him write. Let him who incurs the liability dictate, but let him fear his Lord God, and not diminish aught of what he owes. If they party liable is mentally deficient, or weak, or unable himself to dictate, let his guardian dictate faithfully, and get two witnesses, out of your own men, and if there are not two men, then a man and two women, such as ye choose, for witnesses, so that if one of them errs, the other can remind her.*[5]

Records must be maintained so that accountability in the form of financial statement can be provided. Therefore, we should apply the principles of a double entry system where each transaction is entered twice.

Accounting concept

A corporation should adopt several accounting concepts underlying the financial accounting in terms of preparation and interpretation. Even though we are discussing about the Islamic accounting procedures, which are different from Conventional accounting procedures, this does not mean that it needs different sets of accounting standards. There are several accounting concepts under the Islamic accounting, which are like the Conventional ones but with different views according to Islamic principles. Eltagani Abdul Gader Ahmed has also discussed several accounting concepts. Following are the basic or major accounting concepts that a corporation should adopt.

Going concern

This concept implies that the organization will continue in existence for the foreseeable future. If it is assumed that the business would not continue, then there would be a need to write down the assets on the balance sheet with their selling prices they would need in a forced sale situation.[6]

Consistency

This concept helps to provide more useful and accurate information because each accounting treatment is consistent within each accounting period. In addition, it helps to produce a financial statement with a fair and true view. If a corporation fails to maintain this concept, it will derive a profit, which is not realistic. This will then affect the calculation of *Zakat* and distribution of available profits to the shareholders. Therefore, this concept is acceptable in Islam.

Matching

The matching concept is acceptable in Islam because it reflects justice and fairness, and it protects the rights of users. For instance, it allocates expenses to their related revenues, and it provides justice and fairness to the shareholders of the corporation. Allah says in the following verse that justice is important in our daily life, and we should not betray or manipulate it for our self-interest. Allah hates those who are ignorant and against justice.

> *O ye who believe! stand out firmly for justice, as witnesses to God, even as against yourselves, or your parents, or your kin, and whether it be (against) rich or poor: for God can best protect both. Follow not the Lusts (of your hearts), lest ye swerve, and if ye distort (justice) or decline to do justice, verily God is well-acquainted with all that ye do.*[7]

Cost

In a Conventional accounting system, the valuation is based on a historical cost concept. The problem with this concept is that it does not reflect the true value or current market value of the assets. It may cause injustice to certain parties who are involved in the transaction. When the valuation is based on historical cost during the inflation period, it conflicts with the principles of fairness and justice. Therefore, in the Islamic accounting, we use current cost accounting for the valuation because it indicates the value that people are willing to pay for the assets. For example in the case of valuing a building, which has been bought 5 years ago, a corporation should base the valuation according to the current value or market value of the building.

Realization

In the Islamic accounting, profit is realized when goods are passed to the customer or services are already rendered and when the cash receipt takes place. Therefore, revenue cannot be recorded if the transaction has not occurred and a cash receipt does not prove it.

Time interval

Accounting information should be prepared at the end of a defined and regular period.[8] It is the same for both Islamic and Conventional accounting systems.

Disclosure

This concept is mainly for the purpose of presenting the financial statement with a fair and true view and adequate disclosure. The management should provide the public with the true information needed in order to assist them in making sound decisions.

Accounting theoretical

Islam supports organizations to implement Proprietary Theory. According to Proprietary Theory, an entity is the agent representative through which the individual entrepreneurs or shareholders operate. The viewpoint of the proprietor group as the center of interest is reflected in the ways in which accounting records are kept and financial statements are prepared. The primary objective of the Proprietary Theory is the determination and analysis of the proprietor's net worth.

The accounting equation used in Proprietary Theory is as follows:

Asset − Liabilities = Proprietors' equity

In other words, the proprietor owns the asset and the liabilities. The Proprietary Theory may be said to be asset-centered and balance-sheet-oriented. Assets are valued, and balance sheet is prepared to measure the changes in the proprietary interest or wealth. Revenues and expenses are considered to increase and decrease respectively in proprietorship, which do not result from proprietary investments or capital withdrawals by the proprietor. Thus, net income on debt and corporate income taxes are expenses, while dividends are withdrawals of capital (Belkaoui, 2000). The entity theory as practiced in conventional accounting views the entity as something separate and distinct from those who provide capital to the entity.

Accounting techniques

Cash is clearly the means of survival of an organization. Cash accounting recognizes only cash inflows and cash outflows. The resulting final accounts are summarized in cashbooks. If there is no balance sheet, it means there are no assets and liabilities. It is because the sales are only recognized when cash is received, so there are no debtors. On the other hand, purchases are only recognized when cash is paid, so there are no creditors and no stock adjustments. Cash flow accounting is usually used in many public sector and non-profit organizations. This accounting method is certainly simple, very easy to understand and interpret, and costs less in terms of administration and accounting expertise. Cash accounting does not involve any subjectivity matters as there are no adjustments or provisions being made. It also reduces the ability of managers of manipulating the owners of capital.[9]

However, in real application, cash accounting might be quite difficult to implement. It is because not every transaction can be made in terms of cash. For instance, utilities bills for services such as electricity are usually being paid 1 month after the usage of electricity. Therefore, an organization can adopt modified cash accounting in which this method will record its transaction partly in cash accounting and partly in accrual accounting (Jones & Pendlebury, 2000). Accrual accounting practiced by conventional accounting principles is the process where earnings are generally taken to mean that invoices have been issued and costs are incurred when services are received. Transaction in this process occurs one step earlier than under cash accounting. The main differences between accrual and cash accountings are in the calculation of income and capital and the accruing of receipts and payments.

Accounting valuation

According to the current cost accounting, all assets and liabilities are revalued at their net realizable values. Net realizable values for nonmonetary assets are generally obtained from market quotations and therefore correspond to the quoted sales prices on the market demand. Whenever net realizable value cannot be estimated directly from the demand market, two alternatives may be considered, which are as follows:

- The sales price indices computed externally by external sources or internally by the firm.
- The use of appraisals by external appraisers or management.[10]

For instance, land is shown in its current market value while a depreciable asset is shown at its current cost by deducting any depreciation. Stocks are also shown at their current value. Monetary asset and liabilities are also shown at historical cost, where usually the current cost would be the same as the historical cost for monetary items. Implementing current cost accounting rather than historical cost accounting provides several advantages that are as follows:

- Current price provides relevant and necessary information on the basis of which to evaluate the financial adaptability and liquidity of a firm.
- Provides a better guide for the evaluation of the managers in their stewardship functions because it reflects current sacrifices and other choices.
- Eliminates the need for arbitrations in cost allocation for the estimated useful life of an asset.
- Accounting becoming more accepted when the financial statement is produced using current cost.

(Belkaoui, 2000)

In conventional accounting practices, historical cost accounting is used in which capital is measured as the initial capital invested. Land is shown at its historical cost in the balance sheet. A depreciable asset would be shown at its cost deducted by any depreciation.

Income determination

According to Islamic Perspectives, an organization should adopt an asset-liability approach. This approach, which is also called balance sheet or capital maintenance view, holds that revenues and expense result only from changes in assets and liabilities. Revenues are nothing but increase in assets and decrease in liabilities, meanwhile expenses are decrease in assets and increase in liabilities. Assets and liabilities should be defined clearly to match principles between revenues and expenses. It focuses on the presentation of financial position. Assets are the economic resources of a firm in which it represents the future result from an effective operation of the organization. The economic resources are as follows:

- Productive resources
- Contractual rights to productive resources
- Products
- Money
- Claims to receive money[11]

Liabilities are the obligation of the firm to transfer the economic resources to other entities in future. However, this does not represent the binding obligations to transfer economic resources to other entities. As in the conservative accounting principles, organizations are adopting the revenue–expense approach for income determination. This approach primarily emphasizes on measuring the earnings of the firm and not on the increase or decrease of the capital (Belkaoui, 2000).

Financial reporting

According to the FASB, the main objective of financial reporting is:

> *Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions. The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence.*[12]

Under the Islamic accounting procedures, financial reporting is crucial for a corporation because it provides information for investors, creditors, and other users. For instance, as investors' and creditors' cash flows are related to corporation cash flows, it is important to have financial reporting where it helps assess the amounts, timing, and uncertainty of prospective net cash inflows to the related corporation (Hermanson, Edwards and Salmonson; 1980). A corporation that uses Islamic accounting procedures should provide information about their past performance and focus on earnings but at the same time should consider the welfare of the society. Besides that, it should also provide information that is accurate, relevance, reliable, and understandable by the users. Financial reporting of a corporation should also provide information about the economic resources of the corporation, business activity transactions, and so on. Islam prohibits any manipulation of the information presented to the users.

Zakat

Zakat is a special tax that is levied only upon the Muslim members of the state and is paid by them as a religious duty.[13] *Zakat* is very important as it is one of the pillars of Faith (*Iman*), which must be fulfilled by every Muslim. The duty to pay *Zakat* is emphasized in the Qur'an, but the types of assets that are subject to *Zakat* are not determined. Thus, properties in the early days of Islam which were applicable for *Zakat* are not the same as today's properties, because the type of properties has changed now.[14] *Zakat* was the common factor that influenced the Islamic states and individual Muslims in the development of accounting records and reports. The calculation and payment of *Zakat* requires the maintenance of adequate record and the preparation of accounting reports to discharge the religious financial responsibility of paying *Zakat*. The calculation of the *Zakat* demands a careful recording and proper observation of the date of occurrence of transactions.[15]

Fairness in accounting

Fairness occupies an important role in accounting to the users and in the market in which it provides the guarantee that the accountant and the auditor have tried their best to be fair. A guarantee reflects a diligence and care in the preparation and verification of the financial statement and adequate presentation of the financial affairs of the firm. Fairness is also understood as the expression of neutrality on the part of the accountant in the preparation of financial reports. It implies that the accountants who provide accounting information have acted in good faith and employed ethical business practices. Information is fair if it is objective and neutral. Fairness becomes a necessary criterion of information in managerial accounting to ensure the integrity and accuracy of decision-making. The fairness concept implies that accounting statement has not been subject to undue influence or bias.

Stewardship and accountability

Stewardship

Stewardship means a duty to provide and account for the use(s) to which the resources entrusted to a steward have been put.[16] The main function of stewardship is to establish social responsibility. The informational role of accounting is crucial to the efficient allocation of society's resources for individual, corporations, and government. Therefore, a corporation should adopt the concept of decision-usefulness as the objective of accounting and then involve in social welfare through the following processes.

The process explained earlier is justified by the Qur'anic principle in its *Surah al-Hashr* as to the effect:

> *That which Allah gives as spoil unto His messenger from the people of the townships, it is for Allah and His messenger and for the near of kin and the orphans and the needy and the wayfarer, so that it may not become a commodity between the rich among you. And whatsoever he forbids, abstain (from it). And keep your duty to Allah. Surely Allah is stern in reprisal.*[17]

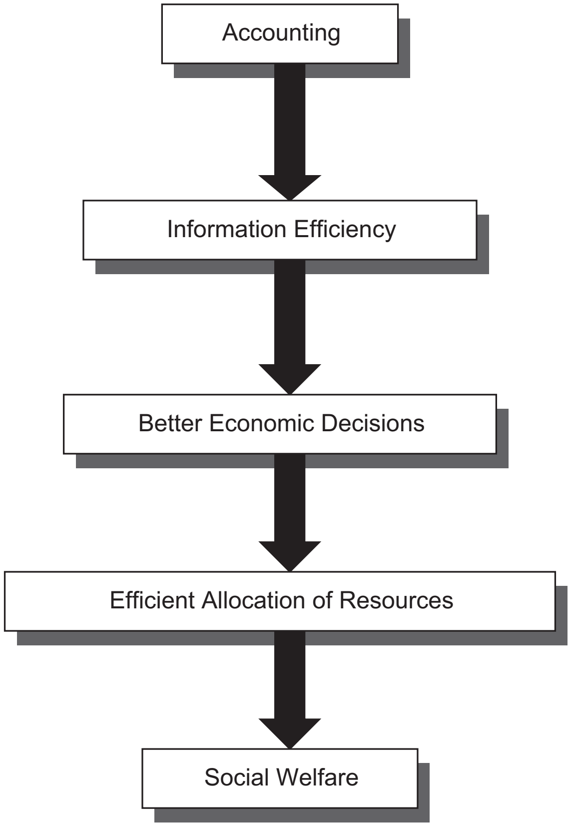

Figure 3.1 Accounting Route to Social Welfare

In the aforementioned verse, *Allah (swt)* emphasizes in establishing a social welfare fund to help the poor and needy people. It shows that Allah is concerned about social welfare. A corporation should emphasize the welfare and goodness of the community. In Islam, stewardship means equitable distribution of wealth in an Islamic economy, equal distribution in the communist system, and concentration of wealth to the ones who make use of opportunities in the capitalist system.[18] As a conclusion, a corporation should implement stewardship in its accounting procedures because Conventional accounting does not lead to social welfare and emphasizes on material sense only.

Accountability

Accountability refers to taking responsibility for our actions to someone else. Accounting is concerned with financial accountability in addition to some aspects of economic accountability.[19] The main purpose of Islamic Economic System is to achieve *falah (success)*. Therefore, a corporation should conduct its business activity in order to achieve *falah*. Since Islam has comprehensive ethical principles for business, accounting should support this activity by providing information to achieve *falah*.[20] However, accounting cannot directly achieve *falah*. It can be achieved only by directing behavior toward proper activities, and therefore, there is a need for intervening variable which Islamic accounting is based on. In addition, Islamic accountability, which is the extension of the concept of accountability, can help rationalize *falah* in the socioeconomic arena.

Conclusion

It is submitted that all the accounting procedures for a corporation should be based on Islamic principles. Bookkeeping is the main Islamic accounting procedure because without it, a corporation will have no means to refer to in the case of any arising problems. It also acts as a proof for the corporation because the occurred transactions are recorded systematically according to double entry system. On the other hand, accounting concepts practiced by a corporation should also be based on Islamic principles and *Shari'ah* law. For instance, the prudence concept is not allowed in Islam because it is not suitable for the Islamic environment, and it may cause harm to the society. Stewardship and accountability are the two characteristics that are important for an Islamic accounting. It helps the corporation to enhance its performance and at the same time is concerned with the social welfare. Financial reporting should provide adequate information disclosures for the users in order to assist them in decision-making processes. Therefore, the reporting should be in accordance with the teaching of al-Qur'an and *sunnah*. Accounting technique, accounting valuation, accounting theory, and income determination method proposed by Islamic accounting are the best among all the alternatives available. Therefore, an organization which adopts the cash accounting techniques, current costing valuation, Proprietary Theory, and asset-liability approach will have the best accounting procedures.

Notes

1 Hafiz Majdi, *Introduction and Evolution of Accounting Theory*, p. 8.
2 Ibid., p. 9.
3 Surah Al-Baqarah: 282.
4 Noraini Mohd Ariffin, "Financial Accounting 1," *International Journal of Economics, Management and Accounting*, vol. 19, no. 3 (2011), pp. 1–2.
5 Al-Qur'an: (2:282).
6 Noraini Mohd Ariffin, "Financial Accounting 1," pp. 5–6.
7 Surah Al Nisa': 135.
8 Noraini Mohd Ariffin, "Financial Accounting 1," p. 7.
9 Jones & Pendlebury, Public Sector Accounting, p. 161.
10 A. Belkaoui, *Accounting Theory*, 4th edition, Business Press, 2000, p. 406.
11 www.geocities.com/interfads2001.htm

12 Roger H. Hermanson, Roland F. Salmonson, and James Don Edwards, *Accounting Principles*, Dallas, TX: Business Publications, 1980, p. 372.
13 www.takaful-malaysia.com/article.php?sid=33
14 Ibid.
15 Hafiz Majdi, *Introduction and Evolution of Accounting Theory*, p. 9.
16 Shahul Hameed, The Need for Islamic Accounting, Perceptions of Its Objectives and Characteristics by Malaysian Muslim Accountants and Accounting Academics.
17 *Al-Qur'an*: *Surah al-Hashr*: 7.
18 Shahul Hameed, The Need for Islamic Accounting, Perceptions of Its Objectives and Characteristics by Malaysian Muslim Accountants and Accounting Academics.
19 Jones & Pendlebury, Public Sector Accounting, p. 131.
20 Shahul Hameed, The Need for Islamic Accounting, Perceptions of Its Objectives and Characteristics by Malaysian Muslim Accountants and Accounting Academics.

4 Islamic accounting versus mainstream accounting

Introduction

It is believed that accounting reflects a culture as accounting is a record of business activities. It is natural that accounting should reflect the sociocultural environment in which the business activities are carried out. Therefore, one can read cultural features and social system of a society to which an accountant belongs, if he or she is looking through an accounting book. Moreover, bookkeeping conventions themselves vary from culture to culture. During Abbasid period, Islamic society developed its special way of accounting. The medieval Islam way of accounting is not being practiced any longer in the medieval Islamic world owing to the fact that Western method of accounting has been dominant throughout the world. But we can still observe the excellent features indigenous to Islamic culture in account books of Muslim accountants. The Islamic accounting idea is not as familiar as the modern accounting, so it makes people continuously asking if there is any type of bookkeeping in Islamic world. However, this chapter does intend to compare the different features between the unique accounting procedures in the Islamic world and the modern Western world. Although there are many similarities in the skills of accounting practices that were and are practiced in the business field today, but, there are still differences between the two methods of bookkeeping. After we went through some reading, we arrived at a conclusion that both methods are different as far as the view and the application being in the line of religion are concerned.

As regards the modern accounting applied by Western accounting, which is practically a privately controlled system and since many alternatives are accepted as sound accounting producers, it is used for income control by the management. The accounting figures as merely an illusion, in turn, affect the society and the enterprise itself through the stock exchange market. Against the neoclassical economic accounting which had been developed in America, critical accounting started in England – that is the accounting that has tried to develop the n-dimensional accounting to explain the n-dimensional reality and the accounting which values the societal role of it. The covariance between accounting and society is strongly evident. It is meaningless to discuss the difference on the surface alone when we are discussing accounting in the Middle East. In this section,

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I will explain the emergence of Islamic accounting and its standpoint. Influenced by the Islamic fundamental movement, the scholars of accounting began to explain accounting from the Islamic point of view. Though the conventional Western accounting has been dominant even in the Middle East, they thought it should be reformed along with their economic requirement. At the same time, it should be evaluated by the Islamic law. Islamic accounting concept analyzes the Arabic word *Muhasabah*, which means accounting, and the Arabic word *Muhtasib, which* means market inspector. After that I am going to discuss accounting for *Zakat*. *Zakat* is one of the pillars of Islamic life. Here, I would like to concentrate on *Zakat* of the business enterprise. In the first chapter, I had explained the general characteristics of *Zakat* and a later section explains the treatment of *Zakat* fund account in the Islamic bank.

In reference to modern accounting, so long as modernization cannot be separated from westernization, it is natural for Islam to be prudent about taking on the modernization policy. That is why some people might say that Islamic countries got way behind modernization because they denied Westernization, and because if modernization means Westernization, they had no choice but to deny modernization itself. Islam completely separated modernization from Westernization. Some of the elites in the Islamic countries who attempted to introduce Western technologies into the legal and economic systems, without doubt, had to be isolated now due to the fact that the intelligence of the modern Middle East gave up capitalism and socialism, and they begin to seek a third way. However, their destination has been unclear so far.

Let us define the term "accounting." According to Western definition, it is something that affects people in their personal lives just as much as it affects very large businesses. We all use accounting ideas when we plan what we are going to do with our money. We plan how much of it we will spend and save. We may write down a plan, known as a budget, or we may simply keep it in our minds. However, when people normally talk about accounting it means the type used by businesses and other organizations. They cannot keep all the details in their minds, so they must keep records of it. They will not only record cash received and paid, but also they will record goods bought and sold, items bought to use rather than to sell, and so on. This part of accounting is usually called the recording of data. Accounting reflects culture. Many accountants have mentioned it, and it is a well-known common knowledge. It is so true to guess that before the Western (double entry) bookkeeping or accounting conventions spread almost all over the world; through colonization throughout the world previously. In addition, the accounting procedures were different from place to place, according to regions.

In the Islamic world, it is known that accounting in the public sector, which was developed under the control of the financial division of the government named *bay'i al-mal*, formed a very sophisticated bookkeeping system and accounting information network.[1] However, if accounting as to what it was, is reformed historically and is discussed how it had the improved system from the modern point of view, then it cannot be evaluated beyond the framework of today's accounting. Accounting cannot and should not be evaluated except in the context of the society where it is practiced. For example we can raise the question concerning what it is "to account." We might consider that to account is useful; however, it means conversely not only that things which cannot have any useful method to think about the things we cannot account. Therefore, it should be ignored or be reformed in the way by which we can account practically. In contrast, accounting practiced today looks universal as one might be saying that accounting was simply a function of middle management, such as production scheduling or credit control, dealing with self-evident facts which could be carelessly and even fraudulently stated, but which could be checked quickly once in possession of the good.

Emergence of Islamic accounting

In the fifteenth century, since the Arabs had gone out of the European view till the very recent days, Islam had not come to the center of world history. The Europeans, in turn, have dominated world history, particularly after the industrial revolution, and they intervened in the Middle East, Asia, and Africa under the name of imperialism. At that time, for the middle Eastern elite who were proud of the cultural tradition that had been more rich than that of Europe, political defeat to the Western countries was crucial so as to injure them identify deeply. Because of the fact of overwhelmingly inferior feeling to the West, they chose Westernization. As a result, the sector concerned with management like national finance, commerce, or banking in the occupied area was institutionally destroyed and reconstructed to meet the needs of the occupying countries. Their institution was capitalism, but they were subject to the so-called big countries. The Middle East formally could be independent after the World War, but politically and economically they have been still dependent on the Western system. Looking at the way the Western people deal with the Middle East, they have taken the dependence of Middle East on the West for granted, and they thought that they could control the Middle East because Middle Easterners cannot do anything by themselves. That is the so-called superpowers controlled and managed the world and have dominated the international relationships. In this sense, the covering of the surroundings by the center has been successful.

Accounting in the Islamic society

Islamic accounting is a part of the society, and it cannot be separate from Islamic law. In this section, I would like to explain how the commercial actions are recognized basically in Islam, because accounting theory in Islamic thoughts is based on this view. Next, I would like to explain the implicit meaning of the Arabic word *Muhasabah*, which means accounting. I will discuss the meaning of *Muhasabah* and what it reminds Muslims of, after explaining its root and its derivations. When Muslims think of *Muhasabah*, it means more than just a numerical calculation. *Muhtasib* refers to the Muslim world before the occupation of the West. The word *Muhtasib* is also derived from the root *H.S.B*. It is usually translated as a market inspector, but his duties were connected not just with the economic affairs. Al-Qur'an says the following to the effect:

> *Islam is perhaps the only religion that gives a high and positive value to lawful economic activity. The gain from economic activity is considered a bounty from Allah.*[2] *M. Watt says Islam is the religion of the merchants, though it is neither the religion of the desert nor the farmers. During the time of Prophet (SAW), he himself was a leader of the caravan of Khadijah, who later became of his wives. Moreover, Mecca was the center of trade and banking, where Islam became known first. In the Holy Quran, there are many verses using the terms of commerce.*
>
> *Lo! Those who read the Scripture of Allah, and establish worship, and establish worship, and spend of that which We have bestowed on them secretly and openly, they look forward to imperishable gain.*[3]

Jihad, which is sometimes translated as holy war, is originally understood as any effort for the preservation and propaganda of Islam, and good trade is explained to be a part of them.[4] In the Mecca period, the Prophet warned about the unlawful transactions.[5] In the Medina period, he gave preference on having faith in God and he prohibited trade on Fridays, which is the day of prayer.[6] He encouraged commerce, but he strictly prohibited the usury.[7] What is the most interesting are the phrases which tell us of the liquidation of the acts of a person on the Judgments Day – accounting of acts. To believe in the day of Judgment is one of the six pillars of Iman.

> *There is none in the heavens and the earth but cometh unto the beneficent as a slave. Verily He knows them and numbered them with (right) numbering. And each one of them will come unto Him on the Day of Resurrection, alone.*
>
> (*al-Qur'an* Ch19:93–95)

Two angels follow every Muslim to record full accounts of his words and acts.

> *Lo! There are above you guardians, Generous and recording, who knows (all) that ye do.*
>
> (*al-Qur'an;* 82:10–12)

His acts are audited and recorded by these angels.

> *When the two Receivers receive (him), seated on the right hand and on the left, He uttered no word but there is with him an observer ready.*
>
> (*al-Qur'an* 82:10–12)
>
> *Here in this book his acts are recorded in full account and the book is placed, and thou sees the guilty fearful of that which and they say: What kind of a book is this that leave not a small thing nor a great thing but hath counted it! And they find all that they did confronting them, and thy Lord wrong no one.*
>
> (*al-Qur'an* 18:50)

In Islam, the pursuit of the happiness of the human beings is a supreme must. The supreme situation, that is the supreme bliss, exits in the hereafter, and this world is the trial ground to decide one's destiny in hereafter. In this world, one should make his/her good and bad deeds weighed in the balance *(Mizan) and* measured through the unique view of the values of Islam.

> *And We set a just balance for the day of resurrection so that no soul is wronged in aught. Though it is of the weight of a grain of mustard seed, we bring it. And We suffice for reckoners*.[8]
>
> *The weighing on that day is the true (weighing). As for those whose scale is heavy, they are the successful. And as for those whose scale is light: those are they who lose their souls because they disbelieved Our revelations*.[9]

As a conclusion, the believer who goes along the road of faith will be handed the book recording his acts in the right hand, and the unbeliever who indulges in the bad things will be handed it in the left hand.

Then, as for him is given his record in his right hand, he will say: Take, read my book!

> *Surely, I knew that I should have to meet my reckoning*
> (*Hisabiyah*)

Then he will be in blissful state in high Garden Whereof the clusters are in easy reach. (And it will be said unto those therein): Eat and drink at ease for that which ye sent on before you in past days.

> *But as for him who is given his record in his left hand, he will say: Oh, would that I had not been given my book. And knew not what my reckoning*
> (*Hisabiyah)*![10]

Surely, a man who is devoted and faithful, the door to the heaven will be opened, but to the ungodly man the door to the hell will be opened.

> *Then those whose scales are heavy; they are the successful. And those whose scales are light are those who lose their souls, in hell abiding*.[11]

Moreover, the knowledge of accounting has been revealed by *Allah (swt)* through His Prophet that, each single act of human being will be accounted for and liquidated on the judgment day. In the holy Qur'an, there are many theories on the nature of accounting, its aim, ideology and principles, the theories on the accounting indices, and data collection, with its circulation and its feedback system, for the purpose of indicating the financial situation at the end of an accounting period. *Shari'ah* does not check asset evaluation or the result of the profit and loss measurement of an economic unit in a period. *Shari'ah* gives us a special accounting system that accuses the human beings and records all of the acts (*'Alam*) of the life of the creatures on the earth, and it has interests in the situations and acts during a certain period, that is the accounting period or the period God defines.[12]

Islamic accounting cites the *Sari'ah* and *Shari'ah* include the calculation of the human acts. "God illustrates supremely, and there is no god besides *Allah (swt)*.[13]

Accounting of *Zakat*

In the previous slide, I mentioned that Islamic accounting (accounting from the Islamic point of view) is included in Muslim accountant's consideration under the Islamic fundamental movement. It does not merely describe it as a part of the Islamic society. It is societal although the subject of accounting is a business enterprise. In other words, Islamic accounting exists for the society. In this sense, it contrasts with the Western conventional accounting that exists for the business entity.

This is one of the practices of Islamic accounting. I would like to pick out the problem of *Zakat* accounting. The reasons are as given as follows:

- It has not been made clear as to what is Islamic accounting because it has just started recently.
- *Zakat* accounting implies the Islamic view of value in it from the beginning, because *Zakat* is an institution which started at the same time when Islam started. The important concepts in accounting are included in it, and it is suitable to think that it is in accordance with Islamic accounting since it is applied only to Muslims.

First, I will discuss the general characteristics of *Zakat*. Second, I will discuss what is required in the practice of *Zakat* accounting. The unique principles in Islamic accounting are shown. In this section, I would like to narrow down to the problem of *Zakat* of the business enterprise, because the common problems existing are those of evaluation of assets and measurement of costs and revenue. The concept discussed here is agreeable with the aim of Islam. I would like to mention the view of the business enterprise in Islam derived from *Zakat* calculation and *Zakat* payment. At the end, I would like to explain *Zakat* accounts in the banks (the Islamic banks). Noninterest bank which was established with the object of being in the van of establishing the ideal society of Islam has *Zakat* accounts which are reserved from the deposit. The religious supervisory board in the banks is working for this fund. *Zakat* gives the banks an Islamic role.

General characteristics of *Zakat*

Zakat has the following characteristics, which prove *Zakat* is not an ordinal tax.

- It is one of five pillars of Islam, which are:
  - *Shahadah*, which is to witness their faith as Muslims.

- *Salat*, which is to pray five times a day.
- *Zakat*, which is to pay alms.
- *Sawm*, which is to fast during the month of *Ramadhan*.
- *Hajj*, which is to make a pilgrimage to Mecca whoever can afford it.

Zakat* is closely linked with other pillars. For example while *Salat* (prayer) is the obligation of the body, *Zakat* is the obligation of the wealth. Therefore, *Salat* and *Zakat* are inseparable for the purification of bodies and wealth. *Zakat* is tightly connected with other fundamental aspects of Islamic belief.

- The proceeds of *Zakat* should be spent in a certain manner as specified in the Qur'an.[14] Beneficiaries are as follows:

    - The poor (*Fuqara'*).
    - The needy (*Masakin*).
    - *Zakat* officials (*'Amileen*).
    - Those who reconciled to Islam (*Mua'llafatu Qulubahum*).
    - The liberation of captives and slaves (*Riqab*).
    - The debtor (*Gharimeen*).
    - In the cause of God (*Fi Sabilillah*).
    - The wayfarers (*Ibn-al-Sabil*).

- *Zakat* rate is fixed by the definition of traditions (Hadith), though the rate is different according to the type of economic activities.
- It is levied only on Muslim individuals because it is the religious foundation of Islam. Though joint-stock company has its own juristic personality independent from the shareholders, it may be subject to *Zakat*.
- Debt is exempted from *Zakat* base. That is *Zakat* is imposed on the net accumulated wealth (net asset).
- The wealth subject to *Zakat* should be more than the minimum level (*Nisab*) as stipulated in Hadith. This is the necessary amount of assets the income of which provides the basic needs of the owner and his family.
- The assets subject to *Zakat* should be possessed over one full (lunar) year.

Accounting standards of *Zakat*

Reflecting on the aforementioned characteristics of *Zakat*, the main topics of accounting standards for *Zakat* might be as following:[15]

- The evaluation of the current exchange value or the market value:

  Most of the scholars of *Shari'ah* maintain that the assets which the enterprise has at the time of calculation of *Zakat* should be evaluated at the current (market) value. I would like to discuss what is implied by this evaluation principle later.

- One-year rule:

  To measure the value of assets, the lunar calendar should be adopted except for *Zakat* agriculture. These assets should be possessed over one full year.

- Independent rule:

  This rule is related with that given before. *Zakat* calculated is subject to the wealth of the year end. The credit receivable or the carried over income is not included.

- Realization rule:

  The increasing amount is recognized in that year whether the transaction is complete or not. That is the credit should be included in *Zakat* base.

- Taxable rule:

  Nisab should be calculated according to the Hadith that *Zakat* is not collected from Muslims who are not wealthy.

- Net total (gross) income but net income:

  After 1 full year, expenses, debts, and family use should be deducted from income subject to *Zakat*.

- Nationality of assets:

  Irrespective of the fact that whether a country is Islamic or not, if the owner is a Muslim, then his wealth should be subject to *Zakat* and *Nisab*.

Treatment of *Zakat* account in the Islamic banks

Zakat is disbursed by Muslims as an obligation. In the early period, Islamic states collected *Zakat* through the regular officials and administered it from the national treasury to support the poor among the community, built mosques and defrayed government expenses. However, after the disintegration of the purely Islamic state, *Zakat* was again left to *Molem*'s conscience. According to Ibn Tamiyah, Muslims do not necessarily pay *Zakat* to the ruler if he is not just or if he does not spend *Zakat* revenue on its purpose beneficiaries. Muslims have a right to hand it directly to them.[16] Experiencing of today's situation, there are few states that are completely Islamized. The states that are not Islamized economically have no authority or obligation to collect *Zakat*. However, as I mentioned, *Zakat* is paid by Muslims. Though it is not clear where Muslims pay *Zakat*, the Islamic Bank could be one of the institutions where they pay *Zakat*. Hundred questions and 100 answers on Islamic Banks say:

> A *Zakat* fund must therefore be established in each bank. In the countries where the ruler takes charge of collecting alms (*Zakat)*, the Islamic Bank can then play the role of a technical organization that assists the government. In case the ruler of a country has nothing to do with the ordinance of *Zakat*, it is up to the Islamic Bank to call upon Muslims to do this ordinance. It collects the *Zakat* and administers its funds in the legal ways.[17]

As is generally known, the Islamic Bank was born as an organization to establish the Islamic economy in the Islamic fundamental movement. It naturally coincides with the idea of *Shari'ah* and their fundamental principles that are:

- The complete elimination of interest in any form from the banking system.
- The use of several forms of profit-sharing (PLS) plans as the backbone of Islamic banking practices.

The normal operations of banks are opening current and savings accounts and purchasing and selling gold bullion and foreign currency and drafts in such changes and so on. Of course, this operation should be free from interest because Islam strictly prohibits it. As-Sadr thinks that because the Islamic Banks operate in a society where the other banks accept the interest, they should oppose each other.

In addition to the normal operations, according to Abdel-Magid, to collect contributions for *Zakat* fund and to dispense the fun according to the Islamic *Shari'ah* is one of the objectives of Islamic banks. As he says, "the most interesting accounting aspects of Islamic banking is that the Islamic bank is a legal entity comprising the accounting entities of the *Zakat* fund, normal banking operations, investment deposits, and general investments.[18]

The Islamic bank operates the *Zakat* funds separately from the other deposits, and to operate this fund it has a special board, namely, the religious supervisory board.

Religious supervisory board

The religious supervisory board is the institute that ensures that the bank's dealings and activities are consistent with the *Shari'ah*. It is formed by the articles. For example the Albaraka Islamic Investment Bank defined it in the article 58–60 as the *Shari'ah* Legal Advisors. Dar al-Maal al-Islami trust has the religious supervisory board too. The members consist of those who are selected from among the Islamic scholars and jurists of comparative law and are highly knowledgeable and proficient in *Shari'ah* related to financial transactions. They can give advice concerning the application of *Shari'ah*. They can request a special meeting of the board of directors to explain their view on *Shari'ah*. Moreover, they prepare a religious auditing report as a part of the annual report. This board certifies that the bank's operations are carried on in accordance with the *Shari'ah*. In the bank's annual report, the member's names are published with the name of financial auditors. Conversely, the financial auditor should report that he has seen the religious auditing report and that the bank's operations have been satisfactory in accordance with the *Shari'ah*.

The act of the religious supervisory board might be seen for us is only a religious approval. However, in the Islamic society, to obtain a religious approval means that the economic act concerned is recognized as a just act and that it belongs to category of the auditable economic act. For example the interest (*Riba'*) is forbidden by the Qur'an.[19] Moreover, if such an act with interest is done, it means deviant behavior and then accounting does not have to deal with it. In other words, the auditing act by the religious supervisory board could be thought of as the subject of accounting. The satisfaction of the religious matter is also required as one of the accounting information in the Islamic society. It proves that Islamic society never separates the religion from the economic matter.

Examples of *Zakat* accounting

In this appendix, I will show the numeral examples that I translated from *Accounting of the Company and the Bank for the Islamic Organization* by M. K. Atiya (1984, pp. 260–263)

Example 1

The balance sheet of an unlimited stock company of industry is shown as follows:

- Fixed Assets

Goodwill	50,000	
Land	180,000	
Buildings	250,000	
Machines	700,000	
Vehicles	300,000	
Furnitures and Installations	120,000	1,600,000

- Current Assets

Cash	100,000	
Bond	15,000	
Materials	200,000	
Merchandise	400,000	
Work-in-process	500,000	1,700,000
Agent	300,000	
Bills Receivable	200,000	
Bank Deposit	100,000	
Funds	200,000	
Organization Expense	15,000	
Securities	10,000	
Paid in Advance	2,000	
Accrued Revenues	8,000	2,150,000
Total Assets	3,750,000	

- Capital and Income

Common Stocks	650,000	
Preferred Stocks	350,000	1000,000
General Reserves	115,000	

Reserved Surplus	35,000
Reserved Income	150,000
Income General	100,000
Carried-over Income	200,000
Stocks	650,000
Allocation to Buildings	80,000
Allocation to Machines	250,000
Allocation to Vehicles	80,000
Allocation to Furniture	50,000

- Current Liabilities

Tax Allocated	10,000
Depreciation funds	15,000
Reserved for Bad Debts	7,000
Reserved for Allowed Discount	8,000
Bank Credit	200,000
Notes Payable	20,000
Accrued Expenses	30,000
Capital and Liabilities	1,190,000
Total	3,750,000

The shares of the Muslims are 10,000 common stocks and 6,000 preferred stocks. Sixty percent of the general income is subject to distribution. Calculations of the Muslim shares and that of *Zakat* base are given in the following:

Increasing capital = 2,560,000 – 1,600,000
Or = 2,150,000 – 1,190,000
= 960,000 (guinea)

Amount of *Zakat* payable:

$$= \frac{960{,}000 \times 2.5 \text{ percent} \times 16{,}000}{20{,}000}$$

= 19,200 (guinea)
Distribution Income = 100,000 × (60/100)

Distribution to non-Muslims per share

= 60,000/20,000
= 3 (guinea)

Amount of *Zakat* per share

= 19,200/16,000
= 1.6 (guinea)

Distribution to Muslims per share
= 3–1.6
= 1.4 (guinea)

Journalizing:

(Certification of Distribution and *Zakat*)	
(Dr.) Distribution to the Aforementioned	60,000
(Cr.) Muslims' Share	28,800
Non-Muslims' Share	12,000
Zakat Requirement	19,200
(Accrued *Zakat*)	
(Dr.) *Zakat* Funds	19,200
(Cr.) *Zakat* Payable	19,200

The balance sheet describes here is shown in the reporting form due to the limitation of space, but in the original text it is described as the account form. The details of the debtors are written on the left side like the English conventional form and unlike the general form. Some reasons are worth considering. (1) Because Arabic is written from the left side to the right side, it is convenient to fill in the Arabic's letters. (2) The English form was imported directly because England dominated the world commerce at that time. (3) Though they imported the general form, they conversed the table of balance sheet as well as the other tables because Arabic should always be opposite in their mind.

Zakat rate of the industry is 2.5 percent.

Example 2

Accounting data of a petro-drilling nonpublic company in an Islamic country on December 30, 1403 (Hijra calendar) is as following:

Fixed assets	600,000 (riyal)
Current assets	500,000 (riyal)
Current liabilities	100,000 (riyal)
General income	200,000 (riyal)
Fixed liabilities	750,000 (riyal)

Due *Zakat* of the aforementioned company in 1403 is:

$$\begin{aligned} \text{Increasing Capital} &= 750{,}000 + 200{,}000 - 600{,}000 \\ \text{Or} &= 500{,}000 - 150{,}000 \\ \textit{Zakat}\text{ Payable} &= 350{,}000 \times 10 \text{ percent} \\ &= 35{,}000 \end{aligned}$$

Conclusion

Islamic accounting is society oriented. Accounting is not only a tool for translating economic phenomena in monetary terms but also a method of describing how the economic phenomena are working in the Islamic society. It is different from the distinction between descriptive accounting and normative accounting, because the latter aims to offer a suitable accounting for a certain purpose is different, naturally the norm is different. Because of this nature, Western accounting (particularly in America) has as many normative alternatives as the number of interest groups concerned. In other words, accounting is separated from the society where it is practiced. Alternatives of accounting procedures are considered as rules to measure profit. The rule that controls these rules is unclear. If I can call such a rule a meta-rule, our accounting has lost the clarity of the first rule. As a result, the business enterprises are acting separately from both the society and individual. Islamic accounting has one aim – that is accounting should obey the teachings of Islam because of the oneness of Islam. In this sense, all Islamic accounting can be said to be normative. However, it is correct to say that in a society, like the Islamic one, "such attractive distinction as positive or normative and such a fundamental dichotomy as facts or values, which are typical of, and adapted to a kind of knowledge could now in a way methodical obstacles for accounting studies (on Islamic accounting)." The assets of the company for the Muslim accountants should be measured by the saleable value. As far as the Islamic interpretation of the assets is concerned, its difference from conventional accounting does not matter.

Of course, there might be different opinions to one economic phenomenon. The argument concerning the characteristic of *Zakat* is one example. It does not matter how the enterprise saves money or the government collects tax, but the problem is determining what is best for understanding Islam. The following sentences are available for Islamic accounting. Necessity is always driving the Islamic society to amend and revise the codes. What is exercise at that time is not the legislative power but interpretative power.[20]

Islamic accounting may not deny the opinion that accounting adjusts the interest groups. However, Islamic accounting deals with economic problems, the political problems as well as the accounting problems. In other words, it functions as a part of the *Shari'ah* and in that sense it would be justified that Islamic accounting plays a role to adjust the interest groups in the society. I would like to mention again that Islamic accounting is learnt as an accounting system and at the same time, it is interpreted as management, economics, law, politics and religion. The *Zakat* fund in Islamic accounting is audited by the religious supervisory board. This treatment naturally comes into sides of Islamic accounting. In short, religious justice is regarded as a problem of accounting. I do not see the *Shari'ah* committee as an organized inner auditing institution except as the religious supervisory board in the Islamic bank today, but it could be thought of as the one where the individual enterprise consults with Islamic jurists for its problems or it has the religious board as an institution. Islamic accounting includes issues that we are not accustomed to think of in accounting. The acts of human beings are liquidated on the day of the judgment. Accounting should be considered as one of the derivations of *hisa'b* that prompts what is proper and forbids what is bad (*Amar bil Ma'ruf wa Nahi 'anil Munkar*). *Zakat* accounting shows the processes where the properties earned lawfully by the enterprise are justified. It is one of the examples of derivation of *hisa'b* which belongs to the ambit of accounting. The derivation belonging to the political matter is *al-hisb* and its officer, *Muhtasib*.

Notes

1 Shauqi Isumail Shahata, *Financial Accounting from the Islamic Point of View*, Cairo: Al-Zahra Al-Alam Al-Arabi, 1987, p. 15.
2 A.A. Islahi, *Economic Concepts of Ibn Taymiyah*, London: Islamic Foundation, 1988, p. 151. and refer to the verse of Qur'an. (3:174).
3 Qur'an: (35:29).
4 Qur'an: (61:10).
5 Qur'an: (55:7–8), (83:1–3), (6:152), (7:85).
6 Qur'an: (62:9–10).
7 Qur'an: (3:130).
8 Al-Qur'an: (21:47).
9 Al-Qur'an: (7:8–9).
10 Al-Qur'an: (69:19–26).
11 Al-Qur'an: (23:102–103).
12 Shahata, *Financial Accounting from the Islamic Point of View*, 1987, p. 13.
13 Ibid., p. 15.
14 Al-Qur'an: (9:60).
15 M.K. Atiya, *Accounting of the Company and the Bank for the Islamic Organization*, 1984, pp. 210–211.
16 Islahi, *Economic Concepts of Ibn Taymiyah*, p. 216.
17 *100 Questions & 100 Answers on Islamic Banks*, edition by International of Islamic Banks, 1987, p. 41.
18 Abdul-Magid, p. 99.
19 Qur'an: (2:275).
20 Miyoko Kuroda, "Individual and Law: In Sharia" Maydan, No. 17 Niigata: The Institute of Middle Eastern Studies, International University of Japan, 1989, p. 3.

5 AAOIFI's accounting standard

Introduction

In the task given, we are going to analyze the *Accounting and Auditing Organizations for Islamic Financial Institutions* (AAOIFI)'s accounting standards. Before we discuss further in detail about this topic, it is crucial for us to really understand what AAOIFI is all about. The organization's name itself gives us some ideas of what AAOIFI is all about. AAOIFI is a nonprofit-making organization, which was established for the purpose of developing, implementing, and promoting accounting and auditing thoughts in accordance with the teachings of Islam. AAOIFI in its early establishment was formerly known as *Financial Accounting Organization Institution for Islamic Banks and Financial Institutions*. The organization was founded by Islamic financial institutions in accordance with the Agreement of Association on 26th February 1990 (1 Safar 1410H). Later, on 27th March 1991 (11 Ramadhan 1411H), the organization changed its name to AAOIFI. Throughout this chapter, we will explain the general ideas of AAOIFI Accounting Standards. It includes the objectives of AAOIFI, reasons for standards' setting, and methods used in standards' setting process.

Objectives of the AAOIFI's establishment

Behind the establishment of every single organization, there are objective(s). Regardless of whether it is a profit-seeking entity or nonprofit organization, an entity must clearly determine their objective(s) in order to make their existence beneficial. The word beneficial here is not necessarily in terms of money, but it may include other benefits as well like social benefit. As stated in Article 4 of AAOIFI statute, the main objective of AAOIFI establishment is to develop accounting, auditing, and banking practices. The term "develop" here can be realized either by creating new methods (which can't be found in the conventional system) or by modifying the conventional methods to suit with the Islamic *Shari'ah* principles. After the developing stage, the organization aims at spreading the thoughts through various means such as conducting seminars and training and producing publications. The organization itself never gives up

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reviewing and makes amendments when necessary in order to be updated in both accounting and auditing fields. Indeed, the aim for every change they make is to harmonize the accounting and auditing practices in line with the Islamic principles.

Rationale outlook of AAOIFI's accounting standards

The reason why there is an existence of AAOIFI Accounting Standards is the emergence of Islamic banks and financial institutions, which offer products' compliance with the Islamic *Shari'ah*. Thus, appropriate accounting standards are needed in order to disclose reliable, adequate, and relevant information to related parties. Related parties here refer to investors, creditors, government, and probably public who need the information on the Islamic banks and financial institutions' activities as reference. Therefore, AAOIFI accounting and auditing standards are helpful for Islamic banks and financial institutions in preparing their financial statements. *Tawheed* is the most important part in every Muslim life. As it governs all human actions, it becomes a driving force for a Muslim in doing and avoiding something. In each action they want to undertake, Muslims must think carefully about the goodness and the evil of a particular action. In Islamic accounting, a Muslim must avoid doing something, which is beneficial to him but not permissible in the eyes of God. This means that God's orders take the first preference in their decision-making process. Thus, the process of measuring and recording accounting information should be performed in accordance with the *Shari'ah* guidelines. In the contrary, in conventional accounting, they aim to satisfy their self-interest first regardless of whether it is beneficial or not to him and other people in the long run. Normally, they aim to maximize their short-term profits rather than thinking about the effects of their actions in future. For example creative accounting is probably common to a Western accountant in maximizing shareholders' wealth, but for a Muslim accountant, it is a nonethical action that must be avoided. Similarly, usury and *Gharar* elements are not permitted in Islam as they will harm the society at large. *Allah (swt)* mentioned in one verse:

> *There's a boundary (which Allah creates for you), and do not go beyond it.*

One special feature embedded in Islamic teaching is the establishment of justice. Islam prohibits its followers to gain something at the expense of others. Any kind of manipulation including creative accounting is strongly prohibited in the eyes of God. Allah mentioned in one Qur'anic verse:

> *We shall set up justice scales for the Day of Judgment, not a soul will be dealt with unjustly in the least. And if there be (no more than) the weight of a mustard seed, we will bring it (to account); And enough are We to take account.*
> (21:47)

In this verse, it is clearly mentioned that man is responsible in upholding justice in whatever circumstances. They are responsible for every action they undertake, and they will be questioned for their own actions on the Day of Judgment. In another verse, *Allah (swt)* said:

> *O ye who believe! When ye deal with each other, in transaction involving future obligations in a fixed period of time, reduce them to writing let a scribe write down faithfully as between the parties let not the scribe refuse to write: as Allah has taught him, so let him write. Let him who incurs the liability dictate, but let him fear his Lord God, and not diminish aught of what he owes. If they part liable is mentally deficient, or weak, or unable himself to dictate faithfully, and get two witnesses, out of your own men, and if there are not two men, then a man and two women, such as ye choose, for witnesses, so that if one of them errs, the other can remind her. The witnesses should not refuse when they are called on (for evidence), Disdain not to reduce to writing (your contract) for a future period, whether it be small or big: it is just in the sight of God, more suitable as evidence, and more convenient to prevent doubts among yourselves but if it be a transaction which ye carry out on the spot among yourselves, there is no blame on you if ye reduce it not to writing. But take witness whenever ye make a commercial contract; and let neither scribe nor witness suffer harm. If ye do (such harm), it would be wickedness in you. So, fear God; for it is God that teaches you. And God is well acquainted with all things. If ye are on a journey, and cannot find a scribe, a pledge with possession (may serve the purpose). And if one of you deposits a thing on trust with another, let the trustee (faithfully) discharge his trust, and let him fear his Lord conceal not evidence; for whoever conceals it, – his heart is tainted with sin. And God knows all that ye do. If ye on a journey, and cannot find a scribe, a pledge with possession (may serve the purpose). And if one of you deposits a thing on trust with another, let the trustee (faithfully) discharge his trust, and let him fear his Lord. Conceal not evidence; for whoever conceals it, – his heart is tainted with sin. And God knows all that ye do.*
>
> (2: 282–283)

From the verse, it is understood that every business transaction must be well recorded and fairly presented. This is to ensure the rights and obligations of all parties involved are well preserved. Accounting information must be in an understandable manner in order not to deceive or decrease the users' understanding, which finally may lead them in taking wrong decisions. In addition, Islam prohibits its followers to cheat and deprive others. Allah (swt) says:

> *Let them bear, on the Day of Judgment, their own burdens in full, and (something) of the burdens of those without knowledge, whom they misled. Alas, how grievous the burden they misled.*
>
> (16:25)

The role of Muslim accountants does not stop there. They are also responsible to be transparent in giving proper information regarding permissible and forbidden matters. Islam emphasizes this issue in one Qur'anic verse:

> *Help you one another in righteousness and piety. But help you not one another in sin and rancor.*
>
> (5:2)

By giving adequate information, there's no room for an entity to hide anything, and, as a result, nobody will involve evil doings.

Standards' setting process

AAOIFI has set up some general policies and guidelines to be used in standards' setting process. The general rule in Islam is applied here where everything is made permissible unless there is a prohibition stated in the Qur'an and *Sunnah*. If there's no single verse governing an issue, general principle or idea will be extracted from both the Qur'an and *Sunnah*. Besides, Islam gives priority to the community at large, not individual interest. Therefore, a principle can be used even if it is not stated in the *Shari'ah*. For instance, a principle probably can be adopted from the conventional system, if it doesn't contradict with the teaching of Islam and not cause any harm to the society. Three approaches have been recognized by AAOIFI to derive accounting concepts and principles for Islamic banks and financial institutions.[1] Here, conventional accounting theory and principles are used as benchmarks. First, any accounting concepts that are consistent and not contradicting any Islamic principles will be directly adopted by AAOIFI in their accounting standards. The simplest example is to include relevance and reliability in the definition of useful accounting information. There are two possibilities for any concepts that are not *Shari'ah* compliant – either to reject or modify them to suit with the *Shari'ah* requirements. An example of such concept is time value of money as a measurement attribute. Last, for accounting concept that cannot be found in the conventional accounting and is only applicable to Islamic banks, AAOIFI will develop it through a continuous effort. This includes the definition of risks and rewards associated with business transactions.

Role of Islamic banks

AAOIFI in its accounting standards has also described roles and duties placed on the shoulders of Islamic banks. The functions played by Islamic banks are not the same as other banks. Behind the profit-seeking motive, there are limitations and obligations that must be observed by Islamic banks. They shouldn't separate between the religious and temporal matters as Islam is considered to be a comprehensive way of life. Therefore, they must make sure that their products and transactions are *Shari'ah* compliant. The best examples are the prohibition of usury and the perception of money as a medium of exchange and a means of discharging financial obligations, instead of a commodity. Investment is the most important instrument for every bank to survive. If they fail to manage their investment properly, they will not be able to compete in the industry. Although banks have their own investment strategies, there are some limitations for Islamic banks. Islamic banks must monitor carefully their investment activities. Meaning to say that Islamic banks must ensure that their sources and returns both meet the *Shari'ah* requirements and are beneficial to the community at large. Al-Mudharabah is the basis for Islamic banks to finance their investment activities. In this kind of contract, the bank will declare their willingness to accept and manage the funds on behalf of capital provider (depositor).

Roles and functions of Islamic banks[2]

Investment management

There are two alternatives for Islamic banks in managing their depositors' money, either by involving in Al-Mudharabah contract or agency contract. In Al-Mudharabah contract, Islamic bank will act as Mudharib (the one who manages the funds), and depositors will act as *Rabb al-mal* (capital provider). In case where the investment is profitable, both will share the profit based on agreed ratio. However, if the bank incurs losses, they will not be rewarded for their efforts.

Investment

With enough capital available in hand, Islamic banks can start thinking about the type of investments they want to jump in. There are several options for them to utilize the depositors' (*Rabb al-mal*) money. Some activities, which they may get involved in are:

- *Al-Murabahah* contract.
- *Al-Ijarah* (leasing).
- Al-Mudharabah contract.
- *Al-Musharakah* (joint ventures).
- *Salam* contract.
- *Al-Istisna'* contract.
- Formation of enterprises.
- Companies' acquisition.
- Trading products.
- Trading or investment in public listed shares or real estate: however, they must get the depositors' consent before entering into any contract. The best way is by splitting into two accounts – Unrestricted Investment Accounts and Restricted Investment Account.

Financial services

Under this service, Islamic banks may earn some income by involving in agency contracts or rental services.

Social services

Al-qard (loan), *Zakat,* and *Tabarru'at* (charity) fund are among social responsibilities to be performed by Islamic banks. In addition, the development of human resources, protection of workers, and existence of good working environment also are considered essential for Islamic banks.

Conclusion

Based on our understanding, the accounting concepts and principles stated in the AAOIFI Accounting Standards comply with the *Shari'ah* requirements. *Tawheed* is the foundation in developing AAOIFI Accounting Standards. The duty of Islamic banks and financial institutions is to ensure that their accounting information is relevant, reliable, comparable, consistent, and understandable in assisting the users of financial statements. Their works must be transparent and should be able to give a true and fair view regarding their financial position. In fact, Islam prohibits its followers from cheating and deceiving others. Therefore, there's no room for Islamic banks and financial institutions to manipulate accounting information for their own sake and benefits.

Notes

1 Please refer to Appendix I.
2 Please refer Appendix II.

6 Islamic Accounting Standard – An Experience With BIMB and MASBi

Introduction

As far as the regulatory authority that governs the operations of all banks and other financial institutions in Malaysia is concerned, the *Banking and Financial Institutions Act* 1989 (BAFIA) came into force on 1st October 1989. BAFIA was introduced to provide for an integrated supervision of the Malaysian financial system and to provide the power to speedily investigate and prosecute, if necessary, any illegal activities to reduce white-collar crimes to the Central Bank. However, Section 124 of BAFIA 1989 provides that BAFIA shall not apply to an Islamic bank. In fact, the Islamic Banking Act was approved in 1983, and it defined the Islamic banking as "banking business whose aims and operations do not involve any element which is not approved by the religion of Islam." At the international level, Accounting and Auditing Organizations of Islamic Financial Institutions (AAOIFI) standards were established, effective since 1st January 1996. They are a sort of guidelines for the practice of Islamic banks and other Islamic financial institutions worldwide. Nevertheless, most of the Islamic countries found that AAOIFI could not be fully applied in their countries due to the existence of local regulatory authorities. Malaysia was one of those countries whereby it could not simply apply AAOIFI standards as it is. This is because the operations of all banks and other financial institutions in Malaysia are governed by the Central Bank. This would also be the reason why there is a need for accounting standards for Islamic banks and other Islamic financial institutions, particularly for the purpose of regulating financial accounting and reporting in order to achieve a high degree of comparability. From that, through our survey, we are trying to investigate one of the newly established standards that govern the presentation of financial statements of Islamic banks and other Islamic financial institutions in Malaysia, namely, Malaysian Accounting Standards Board-Islamic (MASBi-1). A sample has been taken, that is Bank Islam Malaysia Berhad (BIMB), to see how transparent they are in the presentation of their financial statements according to the requirements laid down in the MASBi-1. However, the BAFIA is replaced by the *Islamic Financial Services Act* 2013 (for Islamic financial industries) and the *Financial Services Act* 2013 (for Conventional financial industries).[1]

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Methods of the survey

Basically, we have been conducting a survey on the practice of Bank Islam Malaysia Berhad (BIMB) to analyze its financial statements. As far as the methods of survey are concerned, the first and foremost step taken was to determine the population from which a sample would be taken to conduct the survey. The population comprised all Islamic banks and other Islamic financial institutions in Malaysia, and we picked up the sample that was the annual report of Bank Islam Malaysia Berhad (BIMB), the International Islamic University Malaysia branch. BIMB was selected to be our sample primarily because it was the first to lead other Islamic banks and other Islamic financial institutions in Malaysia in adopting both the AAOIFI standards as well as those conforming to MASBi-1. Throughout the analysis, it compared between the information disclosed in the annual report and the requirements of the MASBi-1 as regards the presentation of the financial statements. The research continued to discuss about any necessary information not discovered in the annual report and any matter that we could not understand while comparing between the annual report and the MASBi-1. After finishing with that, we reached a conclusion from the analysis of the comparison between the BIMB's annual report and the MASBi-1. Besides, we searched for some relevant statutory provisions and cases in the books of law in order to support our findings. We subsequently tried to relate the outcomes of our survey to such statutory provisions and cases that we had collected. At the end, we found that, based on our findings, the BIMB's presentation of the financial statements was approximately 83 percent in compliance with the standards of MASBi-1.

Addressing of major issues

Throughout this survey, we identified one major issue which centered on the matter of "presentation and disclosure of financial statements" by the Bank Islam Malaysia Berhad (BIMB). In order to facilitate ourselves in our attempt to tackle as well as to help the readers understand the issue, we had broken this major issue up into several parts. This was meant to find out as to whether or not the BIMB complies with the MASBi-1, to what extent does it comply with the MASBi-1, whether the BIMB needs to comply with the MASBi-1 alone or it should be in coexistence with the old MASB, whether there was any conflict between the pronouncements set out in the current practice of the BIMB and the ones laid down in the MASBi-1 in respect of the presentation of its financial statements, and whether the BIMB disclosed any additional accounting policies that are distinctively used as compared to other Islamic banks and other Islamic financial institutions in Malaysia in its annual report.

Upon comparing the current practice of the BIMB for the presentation of its financial statements with the requirements laid down in the MASBi-1, it may be

Table 6.1 Analyzing the Survey on the MASB-I's Accounting Standard and Its Application

MASB-I	*Comply (Yes) / Not Comply (No)*	*Remarks*
Para 12 A complete set of financial statements include the following components: (a) balance sheet; (b) income statement; (c) statements showing either (i) all changes in equity, or (ii) changes in equity other than those arising from capital transactions with owners and distributions to owners; (d) cash flow statement; and (e) accounting policies, explanatory notes, and appendices.	Yes	The BIMB has a complete set of financial statements
Para 14 Financial statements should present fairly the financial position, financial performance, and cash flows of an IFI. The appropriate application of MASB Standards, with additional disclosure, results in virtually all circumstances in financial statements that achieve a fair presentation.	Yes	The BIMB has presented fair financial statements in its annual report
Para 15 An IFI whose financial statements comply with MASB Standards should disclose that fact. Financial statements should not be described as complying with MASB Standards unless they comply with all the requirements of each applicable accounting standard and any other technical pronouncement issued by the MASB.	No	The BIMB did not disclose the fact that its financial statements comply with MASB standards since it did not 100% comply

Para 17 In the extremely rare circumstances when management concludes that compliance with a requirement in a Standard would be misleading, and therefore that departure from a requirement is necessary to achieve a fair presentation, an IFI should disclose: (a) that management has concluded that the financial statements fairly present the IFI's financial position, financial performance, and cash flows; (b) that they have complied in all material respects with applicable MASB Standards and that they have so departed in order to achieve a fair presentation; (c) the Standard from which the IFI has departed, the nature of the departure, including the treatment that the Standard would require, the reason why that treatment would be misleading in the circumstances and the treatment adopted; and (d) the financial impact of the departure on the IFI's net profit or loss, assets, liabilities, equity, and cash flows for each period presented.	No	An example would be the use of cash basis in the revenue recognition of the BIMB. By right the management of the BIMB should have disclosed the reasons and impacts of such departure to avoid any misleading information to the users.
Para 18 When, in accordance with specific provisions in that Standard, a MASB Standard is applied before its effective date, that fact should be disclosed.	No	There is no such disclosure that the BIMB has applied the MASBi-1 Standard before its effective date since it did not fully apply the Standard yet.
Para 19 Management should select and apply an IFI's accounting policies so that financial statements comply with all MASB Standards where relevant and other technical pronouncements issued by the MASB. Where there is no specific requirement, management should develop policies to ensure that the financial statements provide information that is: (a) relevant to the decision-making needs of users; and (b) reliable in that they: (i) represent faithfully the results and financial position of the IFI; (ii) are neutral, that is free from bias; (iii) are prudent; and (iv) are complete in all material respects.	Yes	The requirement of MASBi-1 is that the revenue recognition must be on accrual basis. On the contrary, the BIMB still accounted for its revenue on cash basis. However, the BIMB has made it clear to the users by disclosing this fact in the notes to the financial statements.

(*Continued*)

Table 6.1 (Continued)

MASB-I	*Comply (Yes) / Not Comply (No)*	*Remarks*
Para 21 When preparing financial statements, management should assess an IFI's ability to continue as a going concern. Financial statements should be prepared on a going concern basis unless management either intends to liquidate the IFI or to cease trading or has no realistic alternative but to do so. When management is aware, in making its assessment, of material uncertainties related to events or conditions, which may cast significant doubt upon the IFI's ability to continue as a going concern, those uncertainties should be disclosed. When the financial statements are not prepared on a going concern basis, that fact should be disclosed, together with the basis on which the financial statements have been prepared and the reason why the IFI is not considered to be a going concern.	Yes	The BIMB has prepared its financial statements on a going concern basis.
Para 22 An IFI should prepare its financial statements, except for cash flow information, under the accrual basis of accounting unless otherwise approved by the National *Shari'ah* Advisory Council of BNM.	No	Even though the BIMB still uses the cash basis, it has disclosed in the notes to the financial statements that it is in accordance with the principles of *Shari'ah* as advised by the Group's *Shari'ah* Supervisory Council.
Para 23 The presentation and classification of items in the financial statements should be retained from one period to the next unless: (a) a significant change in the nature of the operation of the IFIs or a review of its financial statement presentation demonstrates that the change will result in a more appropriate presentation of events or transactions; or (b) a change in presentation is required by a MASB Standard and technical pronouncements issued by the MASB or other directive or regulation.	Yes	Since there was neither significant change in its operation nor MASB requirement as to the change, the BIMB used the same presentation and classification of items in its financial statements.
Para 24 Each material item should be presented separately in the financial statements. Immaterial items should be aggregated with amounts of a similar nature or function and need not be presented separately. Where immaterial items are deemed significant to users, such information should be presented separately on the face of or in the notes to the financial statements.	Yes	Basically, the BIMB disclosed each material item separately in its financial statements. Immaterial items have been combined into one item. For example *other receivables* .

Para 25 The nature of immaterial information should be disclosed if it is for purposes of compliance with *Shari'ah* rulings.	Yes	In the case of the BIMB, it did not disclose the nature of immaterial information as such information has nothing to do with *Shari'ah* rulings. By right, the nature of immaterial information should be disclosed if it is important so that the users will be well informed as to whether it is following *Shari'ah* rulings.
Para 26 Assets and liabilities should not be offset unless there is a religious and/or legal right and/or when permitted by another MASB Standard.	Yes	The BIMB did not offset its assets and liabilities.
Para 28 Items of income and expenses should be offset when and only when: (a) a MASB Standard requires or permits it; or (b) gains, losses, and related expenses arising from the same or similar transactions or events are not material. Such amounts should be aggregated in accordance with paragraph 24.	Yes	The BIMB did not offset between the items of income and expenses as it presented them separately in its income statements.
Para 29 Unless a MASB Standard permits or requires otherwise, comparative information should be disclosed in respect of the previous period for all numerical information in the financial statements. Comparative information should be included in narrative and descriptive information when it is relevant to an understanding of the current period's financial statements.	Yes	Beside the descriptive information, the BIMB also explained certain information in narrative form to give users a better understanding of such information and help them make a wise decision.
Para 30 When the presentation or classification of items in the financial statements is amended, comparative amounts should be reclassified, unless it is impracticable to do so, to ensure comparability with the current period, and the nature, amount, and reason for any reclassification should be disclosed. When it is impracticable to reclassify comparative amounts, an IFI should disclose the reason for not reclassifying and the nature of the changes that would have been made if amounts were reclassified.	Yes	There was no amendment made by the BIMB to the presentation and classification of items in its financial statements.

(*Continued*)

Table 6.1 (Continued)

MASB-I	*Comply (Yes) / Not Comply (No)*	*Remarks*
Para 31 The form and classification used in the financial statements should ensure the fair presentation of their content. Assets and liabilities need not be classified between current and non-current in the balance sheet but should be broadly presented in the order of liquidity.	Yes	The BIMB did not classify between current and non-current as for assets and liabilities, but instead it listed them down according to the order of liquidity. The reason for not classifying the items is that it is difficult to do so in banking transactions and the items were presented in the order of liquidity because it will guide users to capture the most favorable information therefrom.
Para 33 Financial statements should be clearly identified and distinguished from other information in the same published documents.	Yes	Other information such as director's report and auditor's report have been properly identified and distinguished from its financial statements in the annual report.
Para 34 Each component of the financial statements should be clearly identified. In addition, the following information should be prominently displayed and repeated to provide a proper understanding of the information presented: (a) the name of the IFIs; (b) whether individual or group financial statements are presented; (c) the balance sheet date or the period covered by the financial statements, whichever is appropriate to the related component of the financial statements; (d) reporting currency; and (e) the level of precision used in the financial statements.	Yes except for (b)	The BIMB should display as to whether the financial statements are for individual or group on every single page so that the users would not lose track while studying the annual report.

Para 36 Financial statements should be presented at least annually. When, in exceptional circumstances, an IFI's balance sheet date changes and the annual financial statements are presented for a period longer or shorter than a year, the IFI should disclose, in addition to the period covered by the financial statements: (a) the reason for a period other than one year being used; and (b) the fact that those comparative amounts for the income statement, changes in equity, cash flows, and related notes are not comparable.	Yes	The BIMB presented its financial statements every year since there was no changes in its balance sheet date, that is 30th June.
Para 38 The balance sheet of an IFI should include the IFI's assets, liabilities, and equity. These elements should be presented separately such that they present the IFI's financial position fairly.	Yes	The assets, liabilities, and equity of the BIMB were presented separately in its balance sheet to make the users clear about the financial position and financial performance of the BIMB.
Para 39 Additional line items, headings and sub-totals, should be presented on the face of the balance sheet when a MASB Standard requires it, or, when such presentation is necessary in order to present the IFI's financial position fairly.	Yes	The BIMB complied with this requirement.
Para 45 Separate disclosure of assets, liabilities, and equity should be presented in the notes to the financial statements,	Yes	The BIMB complied with this requirement.
Para 50 The income statement of an IFI should include income, expenses, and net profit or loss for the period. These elements should be presented separately such that they presented fairly the results and performance of an IFI's operations	Yes	This is important for the users to understand the operations of the BIMB.
Para 51 Additional line items, headings and subtotals, should be presented on the face of the income statement when a MASB Standard requires it, or, when such presentation is necessary for the result and performance of the IFI's operations to be fair.	No	Even though the BIMB merely put the totals of the items in its income statement, it then disclosed the details in the notes to the financial statements.

(*Continued*)

Table 6.1 (Continued)

MASB-I	*Comply (Yes) / Not Comply (No)*	*Remarks*
Para 55 An IFI should present in the notes to the financial statements, an analysis of income according to types of investments and financing of customers.	Yes	This requirement is to be given a great emphasis to help users understand the types of investments and financing of customers provided by the BIMB.
Para 56 An IFI should present in the notes to the financial statements, an analysis of expenses using a classification based on either the nature of expenses or their function.	Yes	This would tell the users as to where the BIMB has expensed its money.
Para 57 An IFI should disclose, either on the face of income statement or in notes to the financial statements, the number of dividends per share, declared or proposed for the period covered by the financial statements	Yes	Such disclosure would be very helpful for the users in making decision as to whether to invest in the BIMB or not.
Para 59 An IFI should present, as a separate component of its financial statements, a statement of changes in equity showing: (a) the net profit or loss for the period; (b) each item of income and expenses, gain or loss which, as required by other MASB Standard, is recognized directly in equity and the total of these items; and (c) the cumulative effect of changes in accounting policies and the correction of fundamental errors dealt with under MASB 3, Net Profit or Loss for the Period, Fundamental Errors. and Changes in Accounting Policies. In addition, the IFI should present, either within this statement or in the notes: (d) capital transactions with owners and distributions to owners; (e) the balance of accumulated profit or loss at the beginning of the period and at the balance sheet date and the movements for the period; and (f) a reconciliation between the carrying amount of each class of equity capital, share premium and each reserve at the beginning and the end of the period, separately disclosing each movement.	Yes	The BIMB presented each item of each equity separately and stated the opening balance, the movements of the equity within that accounting period as well as the closing balance of each equity.

Para 61 An IFI's cash flow statement should report cash flows during the period classified by operating, investing, and financing activities.	Yes	The BIMB complied with this requirement.
Para 62 Additional line items, headings and subtotals, should be presented on the face of the cash flow statement when a MASB Standard requires it or when such presentation is necessary in order to present fairly the cash flows of an IFI.	Yes	This was meant to give a clear information to the users as to what activities the movement of the cash belonged to.
Para 64 The notes to the financial statements of an IFI should: (a) present the information about the basis of preparation of the financial statement and the specific accounting policies selected and applied for significant transactions and events; (b) disclose the information required by MASB Standards, which is not presented elsewhere in the financial statements; and (c) provide additional information which is not presented on the face of the financial statements but that is necessary for a fair presentation.	Yes	All narrative information was disclosed in the notes to the financial statements instead of in the financial statements (i.e. balance sheet, income statement, statement of changes in equity and cash flow statement) themselves since it was more proper to present figures only in the financial statements. This is to provide ease to the users in reading the financial statements.
Para 65 The notes to the financial statements should be presented in a systematic manner. Each item on the face of the balance sheet, income statement, statement of changes in equity, and cash flow statement should be cross-referenced with any related information in the notes to the financial statements.	Yes	Each item stated in the balance sheet, income statement, statement of changes in equity, and cash flow statement of the BIMB was cross-referenced with the related information in the notes to the financial statements. Each of these items was marked by numbers.
Para 66 The accounting policies section of the notes to the financial statements should describe the following: (a) the measurement basis (or bases) used in preparing the financial statements; and (b) each specific accounting policy that is necessary for a proper understanding of the financial statements.	Yes	The BIMB disclosed in the notes to the financial statements each accounting policy that it has been using.

(*Continued*)

Table 6.1 (Continued)

MASB-I	*Comply (Yes) / Not Comply (No)*	*Remarks*
Para 67 An IFI should disclose the following if not disclosed elsewhere in information published with the financial statements: (a) the domicile and legal form of the IFI, its country of incorporation, and the address of the registered office (or principal place of business, if different from the registered office); (b) a description of the nature of the IFI's operations and its principal activities; (c) the name of the parent of the IFI and the ultimate parent enterprise of the group; and (d) either the number of employees at the end of the period or the average for the period.	Yes	This information was disclosed in note number 1 of the notes to the financial statements.
Para 71 An IFI should disclose the role and authority of the *Shari'ah* advisor or board in monitoring the IFI's activities pertaining to the *Shari'ah* matters.	Yes	The BIMB disclosed the role and authority of the *Shari'ah* advisor or board in monitoring the BIMB's activities pertaining to the *Shari'ah* matters.
Para 72 An IFI should also disclose, where applicable, its responsibility toward payment of *Zakat* on behalf of depositors, shareholders, and others.	No	Even though the BIMB disclosed the *Zakat* payable, it did not disclose its responsibility toward payment of *Zakat* on behalf of depositors, shareholders, and others. Such disclosure is very important so that the users would know that their *Zakat* obligation has been discharged.
Para 74 Disclosure should be made in the financial statements of any significant concentrations of its assets invested or deposited in the following ways: (a) by geographical areas; (b) by customer group; (c) by industry sectors; or (d) other concentrations or risk that are appropriate.	Yes	It was disclosed in note number 7 of the notes to the financial statements.

Para 75 Disclosure of concentrations of sources of investment accounts and their equivalent and other accounts should be made in the financial statements.	Yes	The BIMB disclosed the customers' financing modes – for example *al-al-Ijarah, al-inah*, and al-Mudharabah
Para 76 Disclosure of the distribution of investment accounts and their equivalent and other accounts in accordance with respective periods to maturity should be made in the financial statements.	Yes	This is significant especially to investors so that they would know the progress of their investments.
Para 77 Disclosure of the distribution of assets in accordance with respective periods to maturity or expected periods to cash conversion should be made in the financial statements.	Yes	The BIMB disclosed the distribution of assets according to the period of maturity.
Para 78 Disclosure of commitments and contingencies should be made in the financial statements of the IFIs and include: (a) the nature and amount of commitments that are irrevocable; and (b) the nature and number of contingencies arising from off-balance sheet items including direct credit substitutes, transaction-related contingencies, sales and repurchase agreements, and other contingencies of similar nature.	Yes	It was disclosed in note number 34. It said that the BIMB made various commitments and incurred certain contingent liabilities with legal recourse to their customers. However, no material losses are anticipated as a result of these transactions.
Para 79 The disclosure requirements as per MASB 3, Net Profit or Loss for the Period, and Fundamental Errors and Changes in Accounting Policies should apply to an IFI. In addition, any accounting effect on the investment account should be disclosed.	No	By right, it should disclose any accounting effect on investment account because this disclosure is helpful to investors to make judgment.
Para 80 An IFI that comingles various types of deposits into a single pool of funds should disclose the method of allocation of income among various categories of deposits.	Yes	Since the BIMB did not comingle its deposits from customers, it need not disclose the method of allocation of income.

(*Continued*)

Table 6.1 (Continued)

MASB-I	*Comply (Yes) / Not Comply (No)*	*Remarks*
Para 81 An IFI should disclose the distribution of profit derived from the investment of depositors' funds at gross level, after deducting expenditure to the extent that they are directly attributable to the investment of those funds.	Yes	The distribution of profit derived from investment of depositors' funds should be disclosed so that the depositors know the return of their investment.
Para 84 An IFI should comply with MASB 8, related party disclosures.	Yes	The BIMB complied with this requirement
Para 86 Any profit or loss of the specific investment account should be separately disclosed. They should not be offset with other types of the IFI's profit or loss.	Yes	The BIMB presented the profit of the specific investment account separately from other types of the BIMB's profit.
Para 88 This standard becomes operative for annual financial statements of an IFI covering periods beginning on or after January 1, 2003. Earlier application of the Standard is encouraged.	No	The BIMB still did not fully apply the MASBi-1 because its financial year-end for 2002 was on 30th June 2002, while the effective date for applying the MASBi-1 is 1st January 2003.

concluded that the BIMB was approximately 83 percent in compliance with the MASBi-1. As for the issues not discovered throughout the analysis, it is noted that the BIMB needs to comply with both the old MASB and the MASBi-1 to the extent that the new MASBi-1 should be taken as a guideline for the presentation of the financial statements. Since the annual report under discussion was for the year ended on 30th June 2002, any conflict between the current practice of the BIMB and the requirements of the MASBi-1 is considered irrelevant. This is because the BIMB is yet to fully apply the MASBi-1 as its effective date is on or after 1st January 2003. For instance, the cash basis of accounting used by the BIMB in its revenue recognition is contrary to the requirement of the MASBi-1 that advises to use the accrual basis of accounting. Hence, such clash will only be taken into consideration once the BIMB has fully applied the MASBi-1 standard.

Statutory provisions

As required by the Companies Act 1965, some provisions require that the management of every company prepares its balance sheet and profit and loss accounts as well as that they must give a true and fair view as showed out in the provisions given as follows:

> **Section 169 (1)**
>
> The directors of every company shall at some date not later than eighteen months after the incorporation of the company and subsequently once at least in every calendar year at intervals of not more than fifteen months lay before the company at its annual general meeting a profit and loss account for the period since the preceding account (or in the case of the first account, since the incorporation of the company) made up to date not more than six months before the date of the meeting.
>
> **Section 169 (3)**
>
> The directors of every company shall cause to made out, and to be laid before the company at its annual general meeting with the profit and loss account required by subsection (1) a balance sheet as at the date to which the profit and loss account is made up
>
> **Section 169 (14)**
>
> Every balance-sheet referred to in subsection (3) shall give a true and fair view of the state of affairs of the company as at the end of the period to which it relates and every profit and loss accounts referred to in subsection (1) shall give a true and fair view of the profit and loss of the company for the period of accounting as shown in the accounting and other records of the company, and without affecting the generality of the foregoing, every such

balance-sheet and profit and loss account shall comply with the requirements of the Ninth Schedule so far as applicable thereto.

As for the contents of the financial statements issued by the BIMB, there is a long list enumerated in the Ninth Schedule of the Companies Act 1965. However, we have selected some of them to be stated as supports for our findings. Among others, the Ninth Schedule of the Companies Act 1965 provides that:

Profit and loss accounts

There shall be shown in respect of the period of accounting:

- Sales or other operating revenues, stating the basis on which they are determined;
- The net balance of profit or loss on the company's trading;
- The gross income before the deduction of income tax from investments in subsidiaries of the company.

Balance sheet

There shall be shown as at the end of the period of accounting:

- So far as the information is not given in the profit and loss account, any share capital on which interest has been paid out of capital during the financial year, and the rate at which interest has been so paid.
- Income or gain carried forward to subsequent periods of accounting, and by way of note, specify the basis for carrying that income or gain.

Statement of changes in financial position

There shall be annexed to every profit and loss account and balance sheet a statement of changes in financial position showing separately:

- The funds provided from and used in the operations of the company; and
- Other sources or uses of funds of the company, except that in respect of consolidated accounts of holding and subsidiary companies as required by paragraph 5 of this Schedule the statement of changes in financial position shall be the consolidated statement of changes in financial position of the holding and subsidiary companies and the statement relating to the holding company alone need not be so annexed.

Supporting case

In the case of Haw Par Brothers International Ltd., Haw Par has accumulated a large amount of profit. In order to avoid disclosing such profits, the directors of Haw Par formed a unit trust, named Melbourne Unit Trust. They sold two subsidiary companies to the trust. The issues raised in this case centered on the nondisclosure by the directors as to:

- The sale of Grey Securities Limited to Legis Ltd. (the trustee of Melbourne Unit Trust) which caused Grey to carry on its business operations in the name of the trust (i.e. Melbourne),
- The formation of Melbourne and the information related to it, and
- The unusual realized profits made by Grey from the sale to Melbourne.
- By right, this fact should have been disclosed since it was of an unusual nature of transaction. In other words, such a sale was not in the normal course of Grey's business, and, thus, the shareholders should be informed.

By not disclosing the sale, the directors have violated the requirements of section 169(6) Paras (o) and (p) which provide that:

> **169(6)(o)**
>
> Whether at the date of the report the directors are aware of any circumstances not otherwise dealt with in the report or account which would render any amount stated in the accounts misleading and, if so, giving particulars of the circumstances.
>
> **169(6)(p)**
>
> Whether the results of the company's operations during the financial year were, in the opinion of the directors, substantially affected by any item, transaction or event of a material and unusual nature and, if so, giving particulars of that item, transaction or event and the amount or the effect thereof, if known or reasonably ascertainable.

It should be taken as a matter of fact that the trust was not consolidated with the parent company, and, hence, the profits were hidden. In addition, the ignorance of the directors to consolidate the profits made by the subsidiary company with the parent company was clearly contradictory to section 169(14) which provides that:

> Every balance-sheet referred to in subsection (3) shall give a true and fair view of the state of affairs of the company as at the end of the period to which it relates and every profit and loss accounts referred to in subsection (1) shall give a true and fair view of the profit and loss of the company for the period of accounting as shown in the accounting and other records of the company, and without affecting the generality of the foregoing, every such balance-sheet and profit and loss account shall comply with the requirements of the Ninth Schedule so far as applicable thereto.

It was also believed that the purpose of the nondisclosure was to transfer the profits to the holding company in case it was found to be less profitable in any

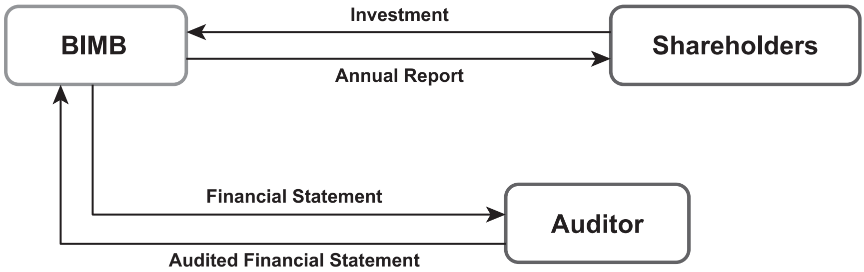

Figure 6.1 Structure of the Bank and Shareholders' and Auditor's Relationship

following year. The act of the directors was against section 169(5) of the Companies Act 1965 which provides that:

> The directors of a company shall cause to be attached to every balance-sheet made out under subsection (3) a report made in accordance with a resolution of the directors and signed by not less than two of the directors with respect to the profit or loss of the company for the financial year and the state of the company's affairs as at the end of the financial year and if the company is a holding company also a report with respect to the state of affairs of the holding company and all its subsidiaries.

The shareholders in Figure 6.1 represent the principal while the BIMB represents the agent. As far as the agency theory is concerned, the shareholders invest their money in the BIMB to be circulated in its business operations, and they expected certain amount of return at the end of the day. In order to avoid the BIMB from breaching its responsibility toward the shareholders, the Companies Act 1965 requires that the BIMB should present the annual report to the shareholders at the end of each financial year. The presentation of the financial statements contained in the annual report shall be in compliance with the MASBi-1 and the old MASB. As for the annual report presented to the shareholders, the financial statements contained therein shall be audited beforehand. Once the financial statements have been audited by the auditor and if there is no material misstatement detected, the auditor will issue an unqualified auditor's report.

Conclusion

As a conclusion, it is a requirement set out in the Companies Act 1965 for every company to prepare its financial statements at the end of each accounting period. In addition, the presentation of the financial statements of every Islamic financial institution as well as that of Conventional Banks and other financial institutions that provide Islamic Banking Scheme (IBS) or the like shall be in line with the requirements of the MASBi-1. Such compliance with the MASBi-1 is greatly important mainly to present a true and fair view of the financial statements. In the case of a conventional financial institution that offers IBS, the requirement to separate out the Islamic and non-Islamic transactions will really help the users identify as to which activities are Islamic and vice versa. The compliance with the MASBi-1 is also to avoid the disclosure of any misleading information to users on which they probably will base their decisions afterwards. Another significance would be to render the financial statements "comparable" in that every company uses the same manner of presentation such as the same accounting basis (i.e. accrual basis) and, therefore, "reliable" in the sense that users can rely on the financial statements presented in order to make judgments. Thus, even though the BIMB has not fully complied with the MASBi-1 with respect to the presentation of its financial statements, it is still something we should be happy about as the BIMB is trying to apply the requirements of the MASBi-1 bit by bit, though the effective date was actually on 1st January 2003.

Note

1 Refer to the *Islamic Financial Services Act* 2013 (for Islamic financial industries) and the *Financial Services Act* 2013 (for Conventional financial industries).

7 Analyzing the MASB's Accounting Standard

Introduction

Malaysia Accounting Standard Board (MASB) is an independent authority that is legally bound having to carry out a duty or is responsible to develop and issue the accounting and financial standard in Malaysia. It was established under the Financial Reporting Act 1997. There are two main mission of MASB: first is to develop accounting standard and financial reporting standard and the second one is to promote high quality of accounting and financial reporting standard in Malaysia especially. At the same time, it also to ensure that all those are consistent with international best practices. To achieve those missions, MASB is working together with the Financial Reporting Foundation (FRF). It is by creating the part of the new structure that gives shape and support for financial reporting in Malaysia which comprises an independent standard setting structure with representation from all relevant parties in the standard setting process. They are also referring to the relevant parties in the standard-setting process including the preparers, users, supervisory bodies, and accountancy profession to develop the new framework.

According to the *Financial Reporting Act* 1997, it is stated that the function and power of MASB are to issue new accounting standard and review, revise, or adopt existing accounting standards as approved accounting standards. It is also stated that MASB has the function to issue statement of principles for financial reporting, as the sponsor and for undertaking the development of possible accounting standard. Another function of MASB is to conduct public consultation in order to determine and evaluate the content and change of the proposed accounting standard. The act also stated that the responsibility of MASB is to perform functions as prescribed by the Minister of Finance. There are eight members of MASB, and all of them are appointed by the Minister of Finance. The members are MASB Chairman, Accountant General, and six knowledgeable and experienced in the matter of financial and reporting members. Besides that, there are also three advisors from Central Bank of Malaysia, the Security Commission, and the Registrar of Companies, who are appointed to support the eight members of MASB.[1] It is mandatory for all companies in Malaysia that lodge their financial statement with Securities Commission, the Central Bank of Malaysia, and the Registrar of Companies to follow MASB Standard when preparing annual financial statement. To

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entail the perfection, the Securities Commission, the Central Bank, and the Registrar of Companies ensure the companies to follow the MASB Standard.

Introduction to accounting standard

Accounting standard is the standard which was proved and agreed by Malaysia Accounting Standard Board (MASB) to be implemented in the financial statements of many companies and enterprises. Financial statements are prepared based on the number of fundamental accounting concepts. However, as there are numerous procedures, methods, bases, and rules that can be adopted to record a transaction or to value an asset, there will be variations in practice regarding the treatment of a particular transaction or event. This gives rise to difficulties in comparing financial statements of different enterprises. On the other hand, there could be a deliberate attempt to manipulate the accounts in order to arrive at the desired operating result or financial position.

The International Accounting Standards Committee (IASC)[2] was set up in 1973 in order to narrow down the choice of accounting treatments and make the financial statements of different enterprises reasonably comparable. IASC is now renamed as International Accounting Standard Board (IASB). One of the objectives of the IASB is to formulate and publish in the public interest, standards to be compared to in the presentation of audited financial statements and to promote their worldwide acceptance and observance. To date, the IASB has issued over 40 Accounting Standards. In 1989, the IASC issued the Framework for the Preparation and Presentation of Financial Statements. The framework is not an accounting standard but a framework within which future International Accounting Standards will be issued. IASB believes that further harmonization in the regulation, accounting standards, and procedures relating to the preparation and presentation of financial statements can be promoted by focusing on financial statements that are prepared for the purpose of providing information that is useful in making economic decisions, that is to meet the common needs of most users.

In Malaysia, in 1997, the Financial Reporting Act was approved. The Malaysian Accounting Standards Board (MASB) has been set up under this Act. MASB is the body that issues the accounting standards. Prior to the setting up of the MASB, members of Malaysian Institute of Accountants (MIA) and Malaysian Association of Certified Public Accountants (MACPA) were required to comply with the requirements of the International Accounting Standards (IAS) as and when the standard is adopted by these accounting bodies by ensuring that published financial statements comply with the IASs. Therefore, where a public company does not comply with AIS, the auditors must issue a qualified report, which may have dire consequences for listed companies.

The IAS as issued by the IASC were not automatically adopted in Malaysia. The accounting bodies of member countries adopted them after review – that is the standards become effective only when the accounting bodies adopt them. For example IAS 22 on Accounting for Business Combinations was not adopted in Malaysia. So was IAS 15. In Malaysia, the MACPA and the MIA had issued to date seven accounting standards or the Malaysian Accounting Standards (MAS). These standards were issued to fill up the gap created by the lack of standards in certain areas (e.g., MAS 1 on Earnings per Share) or for specific industry (such as two standards of Accounting for Insurance) or to meet local reporting needs (such as MAS 2 on Accounting for Business Combinations). Financial Reporting Foundation (FRF) and the MASB were established by the Financial Reporting Act 1997. Briefly, under section 4 of the Act, there are three major functions of the FRF. First is to be responsible for all the financing arrangements for the operations of the MASB, second is to review the performance of the MASB, and third is to provide its views on any matter that the MASB seeks to implement or undertake. As mention earlier, the MASB is an independent statutory body and its aim is to continually improve the quality of external financial reporting in Malaysia and to contribute directly to the international development of financial reporting. The MASB to date has issued 29 standards and has adopted some of the International Accounting Standards and 5 Malaysian Accounting Standards as extant standards. At the same time, MASB initially adopted 24 of the extant International Accounting Standards (IASs) and Malaysian Accounting Standards (MASs) issued prior to the creation of the MASB by the Councils of the MIA and the MACPA. As a result of the adoption by the MASB, IASs and MASs got the status of approved accounting standards2. This status will apply until each IAS or MAS is amended, rescinded, or replaced by a new MASB standard.

Accounting standards issued by the MASB are then known as MASB Standards. The extant IASs and MASs approved by the MASB will continue to be known as IASs or MASs until each standard is amended, rescinded, or replaced by a[3] new MASB Standard. It is the function of the MASB to issue accounting standards, and it is also[4] a requirement that if financial statements are required to be prepared or lodged under any law administered by the Securities Commission, the Central Bank (Bank Negara Malaysia), or the Registrar of Companies, such financial statements shall be prepared in compliance with MASB Standards.

Structure

Accounting standards are formed and issued against the background of a business environment that evolves over time. MASB is, therefore, receptive or, in other words, quick or ready to comment on accounting standards and to recognize that a substantial period may be needed before the intended result of some accounting standards can be judged, while in other cases there may be special reasons why an earlier review is necessary. However, the MASB chooses and uses the view that it will normally be appropriate to allow a period. As a result, there will be some new accounting standards which will become established and used before commencing a formal post-issue review process.

The legal framework of the accounting standards is not set in isolation or is not to put or kept aloof from others. In its deliberations on any accounting topic, the MASB initially makes a careful consideration and discussion to develop its views by considering how the principles of accounting presented in the proposed framework apply to possible accounting options available for that topic. However, in deciding the most appropriate treatment, the MASB will also consider the environment in which its standards are to be applied under. Any legislation with which reporting enterprises must comply forms an important part of that environment. MASB standards also are drafted in the context of the current Malaysian statutes and in the guidelines of other Malaysian regulatory bodies accordingly. The purpose of doing so is to make sure the consistency between accounting standards and the law is maintained.

The objective of MASB is to commensurate the harmonization with International Financial reporting practice. Regarding this matter, MASB Standards are formulated with due regard to international developments. The MASB supports the International Accounting Standards Committee in its aim to harmonize international financial reporting. As part of the approach to harmonization, each MASB Standard contains a section outlining the level of comparability that exists in respect of the International Accounting Standard (IAS) dealing with the same topic. In most cases, a compliance with MASB Standards inherently ensures compliance with the relevant IAS.

Status

In Malaysia, fulfillment with the MASB standard means the authorization by law. All companies that lodge their financial statements with the regulatory agencies such as Securities Commission, the Central Bank of Malaysia, and the Registrar of Companies are required under the *Financial Reporting Act* 1997 to prepare their annual financial statements in compliance with the MASB Standard. All these regulatory agencies then ensure that all companies that lodge their Financial Statement with them act in accordance with the MASB Standard. When a new accounting standard is issued, the question that normally arises is whether its provisions should be applied to transactions that took place prior to the promulgation or a new law of the standard. The general policy of the MASB is that the provisions and preparation of accounting standards should be applied to all material transactions. The application however is made irrespective or regardless of the date upon which they occurred. The selective exemption of certain transactions may lead to similar transactions being accounted for differently in the same set of accounts. When a similar transaction is accounted for differently while it is in the same set of accounts, it would therefore hinder the comparability of the accounts of one entity with another. In a few instances or example, the application of the provisions of a new accounting standard to past transactions will entail a considerable amount of work. It also may result in disordered information which is difficult for the users of accounts to interpret. In such cases, the MASB will consider incorporating exemptions or transitional provisions for transactions that took place prior to the promulgation of the standard. In this case, incorporating exemptions is refer to the exemption which been made by all the effected body. It is where the affected body becomes integrated in one group into the design for the exemption. While the transitional provision is the changing from one provision or set of circumstances to another.

In some instances, a new standard may have unforeseen or unexpected consequences where financial statements are used to monitor the compliance and doing what is asked or ordered with contracts and agreements, for example in relation to covenants contained in banking and loan agreements that may impose limits on measures such as net worth or gearing as shown in the borrower's financial statements. The MASB considers that the developing nature of accounting requirements is a long-established fact that would be known to the parties when they enter into the agreement. It is the responsibility of the affected parties to determine whether the agreement should be insulated or separated from the effects of any future accounting standard or not. If not, it might be renegotiated to reflect changes in reporting rather than changes in the underlying financial position. The MASB, therefore, has no general policy of exempting transactions that occur before a specific date from the requirements of new accounting standards.

Every new accounting standard is drafted before issued to be applied. An exposure draft is issued for comment and is subject to revision. Until the contents of any draft documents are issued as an approved accounting standard, the requirements of any existing approved accounting standard remain in force. Some companies or other reporting enterprises may wish to provide additional information reflecting proposals in an exposure draft.[5] In the Board's views, there are two ways that this can be achieved:

- In so far as the information does not conflict with existing accounting standards, it could be incorporated into the financial statements. It should be remembered, however, that the proposals may change before forming part of an accounting standard and the consequences of a change to the proposals should be considered; or
- The information could be provided in supplementary form.

Due process

The MASB's Standards are framed with due consideration of the balance between the benefit and cost of providing information. To balance between benefit and cost, the MASB may grant exemptions to selected enterprises from either the whole or nominated sections of a MASB pronouncement. The due process in the issuance of MASB Standards will start by identifying topics that become the subject of MASB Standards by the MASB either from its own research from external sources (e.g., International Accounting Standards) or from submissions by interested parties. When a topic is identified by the MASB as potentially requiring the issue of a MASB Standard, the MASB will appoint its staff to undertake a program of investigation. This program involves consultation and consideration of the relevant conceptual issues; any pre-existing pronouncements and practices both in Malaysia and overseas; and the economic, legal, and practical implications of the introduction of accounting requirements. When the relevant issues have been identified, a working group chaired by a member of the MASB and comprising a project manager, representatives from industry, auditors, and regulatory authorities is appointed by the MASB to debate on the issues. Following research and deliberation, a draft document, either in the form of a Draft Statement of Principles or an Exposure Draft, is presented to the MASB for review or then presented to the FRF for comments. When the issues require a more discursive treatment, a Discussion Paper may be published or circulated to other parties who have registered their interest with the MASB. The Draft Statement of Principles or the Exposure Draft is then published to allow an opportunity for interested parties to comment on the proposals and for the MASB to determine the appropriateness and level of acceptance of those proposals.

An exposure draft may be amended in the light of feedback resulting from the period of public exposure. In some circumstances, there may be a further period of public or selective exposure prior to the issue of an MASB Standard. The ultimate content of an MASB Standard must be determined by the MASB's own judgment based on research, public consultation, and careful deliberation as to the benefits and costs of providing the resulting information.[6] The MASB is conscious of the need to operate with maximum possible consultation and to be transparent in its deliberations. For this reason, the MASB's due process is based upon consultation with preparers, users, industry representatives, auditors, regulatory authorities, and other interested parties. In addition, the due process provides opportunities for interested parties to make input to any proposed pronouncement at several stages. Further, the pronouncements of the MASB may take several forms as it may issue discussion papers and prepare statements of principles and exposure drafts before an approved accounting standard is finally issued. The MASB will, where considered appropriate, publish statement of principles or technical releases on individual topics as necessitated by circumstances.

The process of adoption of extent of the accounting standard is started with review made by the IAS and MAS. In this stage, MASB will identify the topic that becomes the subject of MASB standard. This is either from their research by external sources or from the submission by interested parties. Then a working group of MASB staff will be appointed to investigate the program based upon the identified topic. This program involves consultation and consideration of the relevant conceptual issues; any pre-existing pronouncements and practices both in Malaysia and overseas; and the economic, legal, and practical implications of the introduction of accounting requirements. Then, the outline or exposure draft from the investigation will be submitted to FRM for review. Within 14 days, FRM will return it with their comments. After comments have been made by FRM, the MASB draft will be refined based on FRM comment and their research and observation. Next, they will publish the exposure draft so that the interested parties can comment on the proposals and for MASB to gauge the appropriateness and level of those proposals. The publication will sometimes depend on the situation in order to collect the feedback. In the meantime, the working group will compare and examine the comments from the publication, summarize, and analyze them for the preparation of the MASB standard. Although the MASB weighs carefully the views of interested parties, the ultimate content of an MASB Standard must be determined by the MASB's own judgment based on research, public consultation, and careful consideration as to the benefits and costs of providing the resulting information.

After that, the proposed MASB standard will be prepared, and it will be sent to FRM for review and analysis which may take 14 days to be processed. At this stage, the proposed MASB standard will be kept in the consideration of MASB. When FRM returns the proposed MASB standard, it will be updated by MASB and published to the public as it has been approved.

Conclusion

In the development an MASB standard, several stages of process will be conducted. Like the process for the adoption of extent accounting standard, developing MASB standard is started with an identification and review of the emerging issues. A working group as appointed in the previous process will find the important facts about the issue. It will be discussed by the working group, and they will prepare the discussion paper if it is necessary. They will keep the discussion paper under consideration, while it is sent to FRM for review. Within 14 days, the paper will be returned to MASB with comments on it. Next, the working group will do refinement to the paper based on the comments. Then they will publish the paper to the interested parties to collect some feedback or comments from them. According to the data collected, they will analyze and summarize it to develop a Draft Statement of Principle (DSOP). This DSOP once again will be submitted to FRM for review. After it has been returned, the working group will refine it and release it to interested parties to get their feedback and comment. Next the working group will analyze the comment to develop the exposure draft, and the process for consideration of the exposure draft is conducted. After the process has been completed, the MASB standard will be approved for publication.

Notes

1 Section 29 of *Financial Reporting Act* 1997.
2 Currently, the *International Financial Reporting Standards* (IFRS) 2017 (ought to be with enforcement in 2023) is expected to replace IAS and all other relevant existing ones.
3 Section 7 of the Financial Reporting Act 1997.
4 Section 27 of the Financial Reporting Act 1997.
5 Company Accounts and Reporting, Jane Lazar and Tan Lay Leng, 5th edition.
6 www.masb@gov.my

8 *Shari'ah* compliance to MASB's standard

Introduction

Accounting standard is important as a guideline to follow in order to produce reliable financial reports. There are many standards that are used by many countries in the world, for example International Accounting Standard Board (IASB) in UK and Financial Accounting Standard Board (FASB) in the United States. Standard can be defined as an acknowledged measure of comparison for quantitative value, criterion, and model.[1] Ordinarily, the word is used as a reference for comparing two or more items or things. But an accounting standard is not a measure of comparison. The term accounting standard refers to accounting guidelines to specific issues in financial accounting and reporting.[1] In Malaysia, Malaysian Accounting Standard Board (MASB) is an established statutory body, governed under the Financial Reporting Act (1997), which has an authority to set legally binding accounting standards. The Security Commission (SC) had identified a need for a specific accounting standard to ensure a high level of financial reporting and disclosure for corporate sectors. Due to this finding, the SC recommended the establishment of MASB. The Government received this recommendation as they realized that there is a requirement to develop a framework for accounting standard setting. MASB provides accounting standards for various segments in businesses that cover many areas especially in accounting treatment. This chapter, however, focuses on MASB standards' compliance by all companies in Malaysia in performing their business operations as a part of requirement imposed by the regulatory body of Malaysia.

List of MASB standards

1. MASB 1: Presentation of Financial Statement
2. MASB 2: Inventories
3. MASB 3: Net Profit or Loss for the Period, Fundamental Changes in Accounting Policies
4. MASB 4: Research and Development Costs
5. MASB 5: Cash Flow Statement

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6 MASB 6: The Effect of Changes in Foreign Exchange Rates
7 MASB 7: Construction Contracts
8 MASB 8: Related Party Disclosures
9 MASB 9: Revenue
10 MASB 10: Leases
11 MASB 13: Earning Per Share
12 MASB 14: Depreciation Accounting
13 MASB 15: Property, Plant, and Equipment
14 MASB 17: General Insurance Business
15 MASB 18: Life Insurance Business
16 MASB 19: Events after the Balance Sheet Date
17 MASB 20: Provisions, Contingent Liabilities, and Contingent Assets
18 MASB 21: Business Combination
19 MASB 22: Segment Reporting
20 MASB 23: Impairment of Assets
21 MASB 24: Financial Instruments: Disclosure and Presentation
22 MASB SOP 1: Exempt Enterprises
23 MASB SOP 2: Interim Financial Reporting
24 Foreword to MASB Standards and other Technical Pronouncements
25 MASB Technical Release TR1 (Revised): Share Buyback – Accounting and Disclosure
26 MASB Technical Release TR2 (the year 2000 Issues): Accounting Disclosure

Type of accounting standard implemented

The company being talked about is one of the subsidiary companies of the DRB HICOM Sdn. Bhd. It follows its holding company in term of type of accounting standard applied. Generally, starting from March 31, 2003, it follows the MASB standards number 1 to number 25, with some exceptions. It does not follow the MASB standards 7, 11, 13, 16, 17, 18, 21, and 22 because they are not related to its nature of business. Meanwhile, the company has not yet implemented the MASB standards number 26 to 30.

Action taken to ensure compliance

There are several actions taken by this company in ensuring the compliance with the MASB standards. One of the actions is that every year, there is an internal auditor from the headquarters to review the level of compliance of the company. The internal auditor will analyze whether the company follows the MASB standard as followed by its holding company. The other action is that the holding company requires all the Chief Financial Officers (CFOs) and managers of the subsidiary companies to attend seminars and conference on accounting standard. It is to ensure that they are fully equipped with the latest information regarding any changes or additions in MASB standards.

Current level of compliance

The company currently is 100 percent compliant with all the MASB standards that are related to the operation of the company. The management consistently keeps track with the level of compliance of the holding company.

Monitoring the standard compliance

The financial controller of this company is responsible for monitoring the level of compliance with the MASB standards. They develop adequate control plans, procedures, and guidelines that should be followed by the management to ensure the company is following the MASB standards. However, the ultimate responsibilities lie with the Chief Executive Officer and Chief Financial Officer of the company to govern the overall treatments of accounting practices to ensure compliance to standards. They send relevant personnel of the company to attend seminars and workshops on MASB standards.

Mechanism in implementation of standard

There are several mechanisms used by the company in adopting the standards. For instance, in following MASB 23: Impairment of Asset, which includes requirements for identifying an impaired asset, measuring its recoverable amount, recognizing or revising any resulting impairment loss and disclosing information on impairment losses or reversal of impairment losses. This company used corporate asset approach in treating the damaged asset as the mechanism in following MASB 23. The assets are grouped together and are evaluated in total whether it can generate sufficient cash flow to the company or otherwise it will be considered as impaired. This indicates that the value in use of the asset is less than the net selling price. For other MASB standard mechanisms, this company used other approaches, which are relevant to the nature of business.

Problems faced in adopting the standard

The company did not face many problems in order to pursue the standard because it mainly depends on its parent company. One of the major problems that currently is faced by this company is in following MASB 23: Impairment of Asset. It is because the company has many assets, so it is difficult to identify the value of each asset in order to recognize its imparity as preferred by the standard. The company has to apply corporate asset approaches as the alternative. The company also faced difficulty in adopting going concern standard. This is because the company has negative shareholder fund position that needs letter of support from the parent in order not to be deemed as an unprofitable company. The company's going concern principle is highly dependent on the holding company. In order to survive in the industry, the company has to generate more sales to increase profit and try to make cost reduction in certain areas in the company. The company also can source for alternative of more than one supplier as a preparation to face tough competition, as Asian Free Trade Area (AFTA) will be implemented in 2005.

Significance of compliance to standard

The compliance of standard was very significance to this company as it was a subsidiary of public listed company. Failure to comply with the standard would affect the group of the company in terms of gaining investors' confidence and securing the company image publicly. Legally, noncompliant company would be contradicted to the Section 27 of Financial Reporting Act 1997 and Section 166A of Companies Act 1965.

Effectiveness of the standard to the company

The standard would affect the company in standardizing the accounting practices by both parent and subsidiary. For example the company adopted FIFO method in the valuation of its assets like the practice of the parent. It facilitated the inventory management and disclosure purposes where information was not distorting. It also assisted the parent company to prepare consolidated financial statement because the subsidiary and the holding companies had same basis of accounting practices.

Drawbacks of compliance to the standard

There are several drawbacks as well due to adherence to the accounting standard. In this company, it can be seen in following the standard regarding inventory valuation. The company that used FIFO method would sell the inventory that they purchased earliest. At the end of the period, the remaining inventories are those that are most recently purchased or produced. This method is not suitable for this company, which incurs slow-moving stock in its business operation. It is because it does not reflect the actual cost of consumption where the cost of purchasing the stock for the current period is the cost incurred in the previous period.

Expectation of the standard

The accounting standards are moving and keep changing due to growth of business industry. This company also has its own expectation regarding the standards, especially MASB standards. The company anticipated that accounting standards in Malaysia are becoming more specific year by year – for instance, the development of standards in Islamic Companies, services industry, and insurance. The company also realizes that the standard is becoming more detailed in providing guidelines especially for the presentation of financial statement. The format may require ample information to be provided by the management. It will become a challenging task for the financial statement to totally comply with the standard.

Relevancy of the standard in future

Accounting standards in Malaysia are constructed based on IAS standards and the needs of the country's business industry that are growing and expanding continuously. Due to this reason, the standards are easily modified to suit the current need and the earlier format will become obsolete in a short time and no longer relevant to be implemented.

Major issues on accounting standard

Nowadays, several issues have surfaced among the companies worldwide regarding the implementation of accounting standards. We are going to highlight the major issues that can be considered as significant to be analyzed in this title. Among the major issues are given as follows.

Political influence

Political aspect can be a reason contributing to emerging issues on the compliance with the accounting standards. A segment of political people may misuse their power to influence the presentation of certain elements in the financial statements. For example in order to cover the actual state of the company, the company's management can be pressed by political people to manipulate certain things and produce amounts that are pleasant to be viewed. This company always reported higher earnings in its financial statement, and its share price keeps increasing year after year. It is because this kind of company, especially a big company, had financially supported the political campaign of a politician so in turn they have to ensure that company always displays good performance in the eyes of their shareholders. In the current situation, we can illustrate this issue giving the example of Enron Company, an energy company that used hundreds of off-balance sheet partnership to hide billions of dollars in the form of debt. The firm also sold doubtful assets to these partnerships at high prices to create fake income. The board of directors of the company also used the company's money to financially support the political lobbying of some politicians in the United States. The company also cooperated with its auditor, Arthur Andersen, to hide all the misconduct of the company from the public. In this situation, the company went against both the accounting standards as well as the legal requirements.

Impairment of asset

The other issue that can be highlighted is associated with MASB 23: Impairment of Assets. This standard requires that the recoverable amount of an asset should be estimated whenever there is an indication that the asset may be impaired. In order to make such an indication, a company should estimate the value of the asset. The problem arises when the forecast value is not accurate as compared to the actual figure. This leads to improper decision-making by the management, especially in determining which asset can be considered as damaged. Besides that, this standard also preferred the asset to a company to be valued item by item and this will be a complicated and difficult task for a company that has very large number of assets. For instance, we referred the sample of companies that we had interviewed where they faced major challenge in order to value their numerous assets, and they used corporate asset approach that groups the assets together rather than values them one by one. In this case, they did not ultimately follow the standard prescribed.

Disclosure

The other issue is on disclosure. The MASB standards require companies in Malaysia to follow certain level of disclosure on their financial matters for the ease of users of financial statements such as investors, shareholders, and regulatory agencies. This becomes a sensitive issue when a company has certain factors that are not suitable to be disclosed, as they would reveal unfavorable aspects of the company – for example low Earning per Share (EPS). Besides, sometimes companies refuse to disclose certain information because it will expose valuable data to their competitors. As we can see in a contemporary example of the world's largest media company, AOL Time Warner Company, which allowed a British company to buy advertising instead of paying negotiation award in a large dispute. It made false and misleading statements about the company's business and financial conditions, and this generated advertising and commercial revenue as a result of unusual transactions.

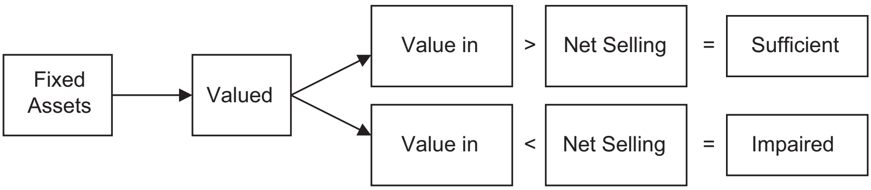

Figure 8.1 Structure of Impairment of Asset

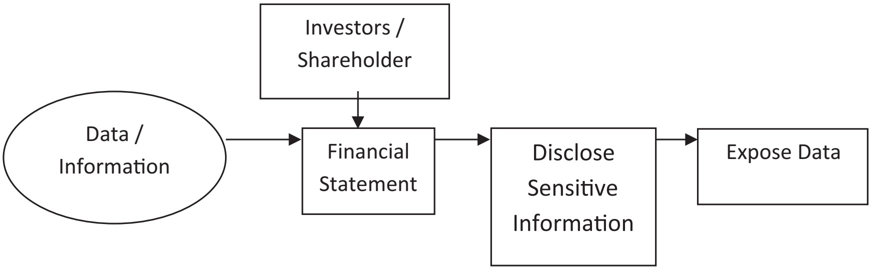

Figure 8.2 Structure of Disclosure

Accrual–allocation-based historical cost accounting basis

The next issue is regarding the accrual–allocation-based historical cost on the basis of accounting whether it is relevant to be used in decision-making process or not. The present business enterprises prepare their financial statements except for cash flow information using the accrual–allocation-based historical cost accounting. Accrual basis refers to a method where transactions and dealings and revenue or expense in nature are recognized when they occur, and they are recorded in the financial statement of the related period. An issue of how far this current practice is relevant in decision-making has arisen in the financial statements prepared worldwide. The reason given is that the accrual-based and allocation-based historical cost accounting increases the tendency of misdeeds in accounting practices. The management has opportunity to mislead giving information regarding depreciation, amortization of preliminary expenses, goodwill, discount on issues of shares and bonds, and other non-cash items in order to arrive at a favorable amount of earning. The real situation is that the companies are having difficulty with their liquidity aspect where insufficient cash had been generated through business operation. Even though the company has a high earning per share which can be considered as a sign of doing well in business, but somehow, they are unable to meet cash requirement for paying current liabilities. Using accrual–allocation-based historical cost accounting, investors, creditors, and other financial users are provided with unrealistic accounting information, which is not useful in making decisions on matters such as investment. It is because in the investment-related decisions, the primary factor that to be considered is the liquidity or cash flow from operation of a company rather than its earning per share. Due to this reason, the financial statements prepared all over the world view that the existing accrual–allocation-based historical cost basis should be replaced with cash flow basis of accounting as it is a better measure of liquidity and profitability of a company.

Revenue recognition and expense determination

Among major issues in accounting practices nowadays include the matter regarding revenue recognition and determination of expenses. The MASB standards require companies to identify revenue or expenses based on accrual basis at the time the revenue is earned or the expenses are incurred. Due to this, a company can manipulate the standard by overstating its revenue earned in the financial statement to increase the profit figure. On the other hand, based on the same accrual basis, a company can deflate its expenses in its financial statement by recognizing

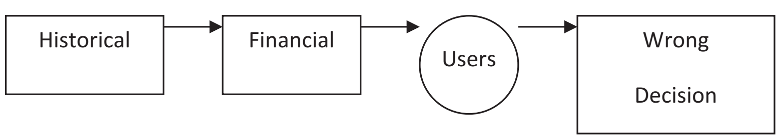

Figure 8.3 Structure of Accrual Method

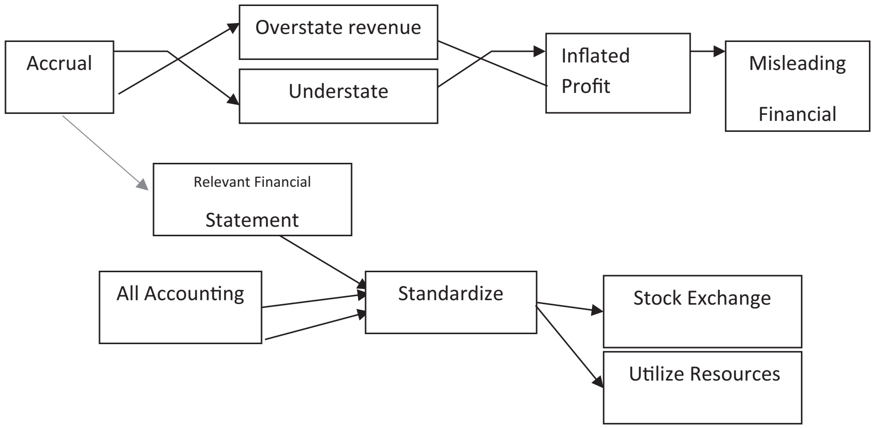

Figure 8.4 Method Structure of Revenue Recognition and Expense Determination

lower than the actual amount incurred as expense. A company also can commit fraud by transferring the expenses to capital account rather than record them as operating expenses in the profit and loss statement of the company. By doing that, a company can minimize its operating expenses leading to higher earnings. One of the examples of a company that committed misdoings in the determination of expenses is WorldCom company, which is a giant company that had wrongly listed US$ 7.1 billion of expenses as capital expenses. The other example is Qwest Company, a communication company that sells long-term fiber-optic capacity and equipment. It had recognized a booked sale of more than $ 1 billion as revenue before it received payment or before the fiber was delivered to the buyer.

Harmonization of accounting standards

The other issue is regarding harmonization of accounting standards. This issue arises due to the fact that businesses nowadays are moving toward globalization in their operational activities. They are expanding their commercial activities to different countries all over the world, which apply diverse types of accounting standards. It may cause difficulties because the accounting treatment might be differing from one country to another and some of the treatments may not relevant to be applied according to local accounting standards. Due to this reason, there is a need to develop a single accounting standard that should be followed for preparing financial statements all over the world. Since current accounting standards applied in preparing financial statements is not similar in all countries, uniformity in accounting standards seems to provide a lot of advantages. A standardized accounting standard will facilitate in business operations of companies where if all the countries apply the same standard, it would be easier for a company to be listed on the stock exchanges of different countries. It is because at present time, in order to be listed on the stock exchanges of other countries, a company has to restate its financial statement according to the local accounting standard or it has to provide reconciliation between the original financial statements with the local accounting standard. Adopting a similar basis of accounting standard not only increases the relevancy of financial statement to be applied in the international level, but it also helps a company to utilize economic resources efficiently by providing proper flow of the resources to the company.

Ethical issues in accounting

Ethical aspect of accounting is given less priority in today's business activities. It can be seen through the examples of several companies that they are involved in unethical accounting procedures as well as misconduct in business operation is increasing over the years. The major unethical issues in accounting include situations where a company is not adhering to the accounting standards and principles. According to a recent survey, most of companies that are involved in fraudulent activities are doing well in business by reporting high earning every financial year. They are also having high share price that is able to satisfy all the investors. Unfortunately, due to unjust intentions to keep enjoying a luxurious lifestyle with huge income, some of the higher authority that include Chief Executive Officer (CEO) and Chief Financial Officer (CFO) of the company start practicing creative accounting method. They refuse to adhere to the existing accounting standard that required them to be fair and justice and disclose accounting information to the users. They are involved in off-balance sheet transaction where some of unethical accounting treatment is being hidden from the knowledge of shareholders, investors, and regulatory agencies. It means that they do not produce a true and fair view of financial statement that is to be used as a crucial measurement to determine the performance of a company.

They also take advantage over the accounting standard; for instance, in term of revenue recognition where they overstate the revenue in the financial statement of the company. Hence, the company wrongly reports higher earning. When the earning of the company is higher, it also increases its share price since the investors are confident of the performance of the company. During this time, the unethical authorities sell their personally held stocks at a high price and gain a lot of profit. By the time the true condition is revealed to the public, the respective company automatically incurs a huge loss because its share price drops significantly, and the share is quoted at a very low price. It is a kind of injustice to the shareholders as well as to the employees where they will lose their job if the company is declared as bankrupt.

Inventory valuation

There are many issues related to accounting standard governed by MASB on the inventory valuation. One of the issues is on the requirement of MASB 2 that inventory must be stated in lower of cost and net realizable value. The net realizable

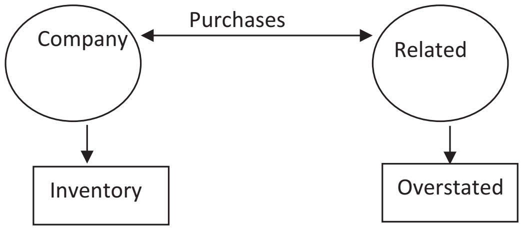

Figure 8.5 Method Structure of Inventory Valuation

value is the estimated selling price less the estimated cost of completion and the estimated cost to make the sale. In some cases, a company does not value its inventory using the valuation method required by the standard. For example in related party transaction, the company may purchase raw materials from supplier company controlled by its Chief Executive Officer at prices in excess of market value. The issue that arises here is the value of inventory will be overstated and cash will have been misappropriated from the entity.

Relevant statutory and cases

Relevant statutory regarding the compliance to approved accounting standard. The approved accounting standard in Malaysia that is developed by Malaysian Accounting Standard Board (MASB) is governed under Companies Act 1965 and Financial reporting Act 1997 where both acts mandate companies to comply with the standards. The compliance to the approved accounting standards is stated by virtue of section 166A of Companies Act 1965. Section 166A (2) stresses on the need of companies, including holding companies and their subsidiaries, to follow the approved accounting standards. Section 166A (2) of Companies Act states that:

> The approved accounting standards shall apply to the accounts of a company or the consolidated accounts of a holding company if, at the time when the accounts or consolidated accounts are made out, the approved accounting standards:
>
> (a) apply in relation to the financial year of the company or the holding company to which the accounts or consolidated accounts relate; and
> (b) are relevant to those accounts or consolidated accounts.

Meanwhile Section 166A (3) of Companies Act emphasizes on the role of the directors of a company in ensuring the company is compliance with approved accounting standards.

Section 166A (3) states:

> Without prejudice to the generality of the provisions of this Division, the directors of a company shall ensure that the accounts of the company and, if the company is a holding company for which consolidated accounts are required, the consolidated accounts of the company, laid before the company at its annual general meeting are made out in accordance with the applicable approved accounting standards.

The Financial Reporting Act 1997 also requires companies to comply with approved accounting standards by virtue of section 27 that states:

> Where financial statements are required to be prepared or lodged under any law administrated by the Securities Commissions, the Central Bank or the Registrar of Companies, and approved accounting standards have been issued or adopted by the Board under subsection 7(1), such financial statements shall be deemed not to have complied with the requirement of such law unless they have been prepared and are kept in accordance with the approved accounting standards.

Relevant case

The following case is the example of some accounting standards that might be manipulated by certain companies in order to report good business performance to the public. For instance, accrual basis accounting may lead to a tendency of misleading of information in financial statement. This matter will be more illustrated in the following case:

> This case is mainly about the bankruptcy of W.T. Grant company in 1975 and others in early 70s, which showed that the working capital concept of funds, based on accrual basis in recognition of revenue, was not a good indication of business performance as compared to the cash flow basis. This company had reported positive net working capital and positive net income in its financial statements during 1966–1974. But, somehow, it had negative cash flows during the 9-year period (except 1968 and 1969). The company later went bankrupt because of its inability to generate cash flows from operation even though it reported higher earnings over years.

Application of the standard: possibilities and mechanism

Possibilities of application

The MASB technical pronouncements are developed around both local and international treatments and within the framework of the law and the standards prescribed in MASB standards and other statements issued by the MASB. It provides guidelines for the application of generally accepted accounting principle to the issues. As we know, the directors or owners of companies established under the Companies Act 1965 are required to ensure that the profit and loss statement and balance sheet for the companies are prepared at the end of every financial year with a true and fair view. In accordance with this matter, MASB technical pronouncements are applicable to financial statement of a company in order to show its financial position, performance, and changes in financial position for the financial period. MASB expects every Malaysian professional accountancy bodies and their members to comply with any technical pronouncements issued by MASB until they are replaced by MASB standards or withdrawn. These technical pronouncements can be applied to Malaysia group financial statements.

Mechanism of application

The process of the development and issuance of the MASB technical pronouncements is like that of the MASB accounting standards. The topics to be developed as technical pronouncements are procured and selected by the MASB by research conducted by internal sources (IAS) and submission by interested parties. When the topic has been decided as potential technical pronouncement, the MAB assigns its staffs to construct a program of research and consultation. This program discusses on the relevancy of conceptual issues, pre-existing pronouncements and practices both in Malaysia and overseas, and the economic and practical implications of the introduction of accounting requirement. When the issue is confirmed, it is debated by the group. Following this research of the issues, a draft of intended pronouncements is presented to MASB for review and then presented to Financial Reporting Foundation (FRF) for comments, after which it is published. The draft may be amended as a result of the public exposure. The MASB pronouncements must be determined by the MASB's own judgment based on research, public consultation, and a careful consideration of benefit and cost of providing the resulting information. The technical pronouncements get effective from the date in the published pronouncement and are regarded as accepted practices in the area in question. The companies are required to confirm to the technical pronouncement principle, if necessary, by changing previous adopted accounting practices unless consensus states otherwise.

Islamic accounting standards

Businesses in Islamic countries are moving toward implementation of Islamic aspects in their operations. This is due to the awareness of the advantages and significance of adopting the Islamic tools and mechanism. In order to be in line with these rapid changes, MASB also has taken necessary steps to develop Islamic accounting standard. The step begins with the development of the first draft of financial statement of Islamic Banks and similar financial institutions. As this standard is said to be the beginning of their efforts, they will continue to develop the Islamic Accounting within the region. The standards developed

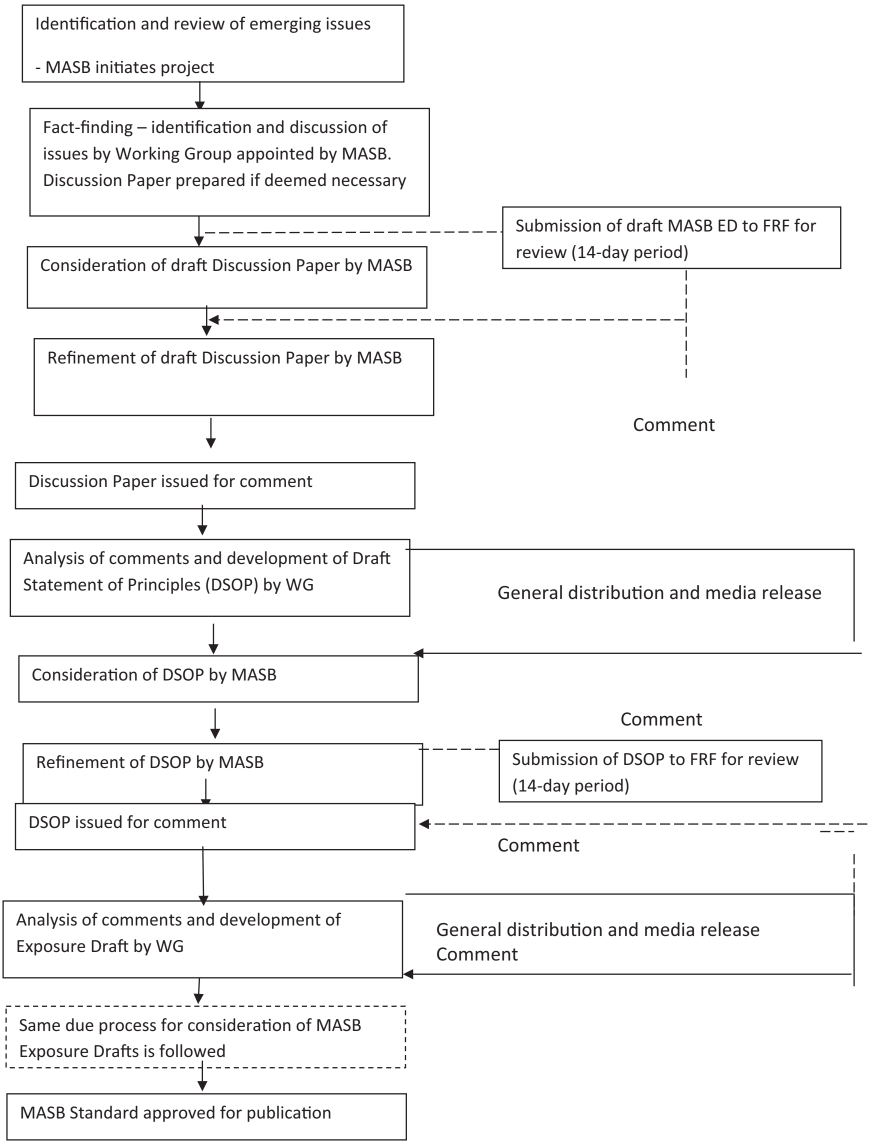

Figure 8.6 Process for the Development of MASB Standards

Source: Foreword to MASB Standard and Other Technical Pronouncements

might be adopted from Middle East standards; however, they will be customized according to the economic requirement of the country and region. The establishment of accounting standards will be focused initially on the Islamic Banking and financial institutions and then will be move to other conventional and commercial institutions. The challenges faced by MASB in developing the Islamic Accounting are mainly about the lack of expertise both in accounting issues and *Shari'ah* principles. This issue might be overcome by collaborating with other Islamic bodies such as *Shari'ah* Advisory Council and recruiting *Shari'ah* scholars and professionals with accounting knowledge. However, MASB acts as a statutory board only so the enforcement of the standards will rely on the Security Commission, Bank Negara, and Registrar of Companies. Indeed, the effort to develop the standards is a very important step toward the Islamization of business trade in Malaysia. Muslims who are involved directly or indirectly in the establishment of the standards should support this effort, as it is an obligation for them. Islam always stresses on the ethical aspects of every inches of its revelation that comprises all matters in our life. So, the establishment of the Islamic standard will enable the ethical presentation of financial reports being produced by the companies as long as they are following the standards as a whole.

Conclusion

As a conclusion, it is importance for companies to adhere to the accounting standards – MASB standards, for example in performing their operation to avoid any undesirable consequences. Even though the standard had provided detailed guidelines, but somehow it needs to be improved from time to time to increase its efficiency in fulfilling its objectives. Nowadays, it is a need to have a uniform standard of accounting practices worldwide in order to facilitate preparation of financial statements for all users. The existing standards might be applicable to certain country only and it may be difficult to be adopted by other country that differs in term of economic and political conditions. It is also important to emphasize on ethical aspect in providing a true and fair picture of accounting information to the users. The standard should be developed in a way that could not be manipulated by certain parties for their own benefits. It is also significant to stress on Islamic perspectives in developing accounting standards to be adopted by Muslim entrepreneurs. Owing to the fact that current accounting practices are deviating from *Shari'ah* principle, the establishment of an Islamic standard is necessary to be a starting point in overcoming those problems, and it can be a general guideline for the accounting practices.

Note

1 H. K. Porwal, "Generally Accepted Accounting Principles in Malaysia," *Akauntan Nasional*, November 2002.

9 Functions of account under Islamic law

Introduction

Since the evolution of Islamic banking system worldwide, it has played an essential role on guiding depositors and investors in making appropriate investment decisions that are free from any element of interest, uncertainty, and other doubtful matters. In Malaysia, the pioneer financial institution to be based on Islamic principle would be *Tabung Haji*. Established in 1969, the main purpose of this organization is far from profit seeking but was to collect money from people whom would be pilgrims and organize the accommodation and transportation of pilgrims in Mecca and Medina. The collection is then being invested under policies that the organization feels fall under the requirement of Islamic *Shari'ah*. This scenario triggered the development of Bank Islam Malaysia Berhad in 1983, the first bank that provided Islamic banking system, since which most of the eastern Islamic countries such as Egypt, Iran, and Jordan have long established Islamic banks. The legal system of Malaysia also supports this development as two enforcements were formulated in the form of the Islamic Banking act and Investment act. These two acts regulated the system as they prohibited Islamic banks in investing the money to prohibited business such as gambling, liquor, and that operating with the involvement of interest. From these baby steps, we could now happily see that in less than 20 years, most of the major banks in Malaysia have followed this step as they realize the potentials of Islamic banking system.

Most of the banks have now offered wide variety of services such as banking and financing based on Islamic principle such as *al-Wadiyah,* al-Mudharabah, and *Bai-Bithaman Ajil* (BBA). However, most scholars and Muslim at large were apprehensive of this system, as there are possibilities of exploitation of the sacred system. It might be used as a cover to attract people or investors to invest money but still may involve doubtful or prohibited business activities. This chapter will examine in detail the types and function of accounts which normally are provided by the banks. Normally, this will fall under banking services rather than financing services. Certain banks also classify this service as deposit services. Banking or deposit services normally serve the public by investing their money to use as capital in appropriate business activities. It would also be useful to guide people on how to manage their money in line with their needs and target.

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Central idea

Types of accounts under Islamic Banking can be classified into three major components: deposit account, investment account, and financial statements' accounts.

Deposits accounts

Bank deposits under the principle of *al-Wadiyah* are classified into two different accounts, which are current account deposits and savings account deposits. Both accounts are based on the *al-Wadiyah yad Dhamamah*, which means guaranteed custody.[1]

Al-Wadiyah current accounts

Current accounts are virtually the same as in all Conventional Banks. In current accounts, depositors are guaranteed repayment of their funds. It is essentially the application of *al-Wadiyah yad Dhamamah* concept or safekeeping. The arrangement has been made between two parties, the depositors and the banks, where the former can withdraw their money at any time whereas the banks are permitted to use depositors' money for investments. The application of current account by Islamic banks slightly differs from the Conventional Banks. The important features of this account are described as follows:

- The bank will guarantee the repayment of full amount of deposits from depositors and depositors are not paid for any profit from the deposits.
- The bank will be authorized to use depositors' funds for investment purpose, provided that the risk will be borne by the banks. Therefore, any profit or loss incurred from the investment will be borne by the banks.
- Depositors can deposit any amount into their account as well as withdraw their funds at any time without any condition imposed on them regarding the deposits and withdrawals. However, some banks may require depositors to maintain a certain amount of balance in their account for the operational purposes.
- The bank usually will provide the facilities of checkbooks and other usual services connected to current accounts such as bank drafts, bills of exchange, travelers' checks, and so on to its depositors.

Al-Wadiyah savings accounts

Operating under the same principal of *al-Wadiyah*, savings account is quite similar to current accounts. Depositors put their money in the bank for the purpose of profit generation. Bank will use their funds for investment purposes. Depositors of savings account will earn depositor income depending on the performance of the bank. Bank will reward the depositors by returning a portion of the profits generated from the use of their funds known as *al-Hibah* (gift) at its discretion.[2] Concept of *al-Wadiyah* was applied based on the Islamic rulings.

Return or give back the trust to one who had entrusted you and never betrays whoever betrays you.

In principle, *al-Wadiyah* is not compensated for, except if the loss or damage of the subject matter is due to the negligence of the depository. Generally, it was based on these justifications:

Whoever is entrusted with al-Wadiyah, there is no consumption on his part.

Nevertheless, compensations will be given under the condition that the loss is not due to the shortcoming of depository. Referring to the lectures given by Mr. Mustafa Omar Mohammad, compensations due to the shortcomings of the depository may include situations such as:

- Negligence or inefficiency in taking cares *al-Wadiyah*.
- Entrusting *al-Wadiyah* to a third party (other institutions) other than the family members (or company branches). Exception is given in the case of *Darurah* (necessity).
- Utilizing the services from *al-Wadiyah* (in case of machines, vehicles, etc.)
- Changing location of the *al-Wadiyah* without a prior consent from the depositor.
- Violating the terms of the depositor.

Investment accounts

Another type of account is investment account, which in the common practice of Conventional Banks would be like a fixed account. Basically, in normal practice of banking services of Islamic banks, they further divide the investment account into four categories: joint/general investment account, specific investment account, limited period investment account, and unlimited period investment account.

Joint–general investment account

Normally, investment account is being operated under the al-Mudharabah principle in Islamic banks. Fixed amount is required to be deposited and cannot be withdrawn before the maturity date. In this case, depositor will be the *Sahibul Mal,* and the banks act as *Mudharib*. What distinguishes Islamic banks from Conventional Banks would be that this type of account is neither considered as a liability nor equity fund but as a financial instrument.[3] Bank will later invest the money into appropriate business that is not in contradiction with Islamic principle. Later, the outcome of investment in the form of profit or loss will be distributed according to the pre-agreed ratio. The capital contributed will only be redeemable after the maturity date and not before the stated date. However, depositors may have the right to continue to invest with the bank, meaning that the capital along with the profit or the capital only can be used for further investment. This depends on the depositors for such action.

Specific investment account

This type of investment account is like the general investment account but what differentiates these two investments would be the choice of business that is intended to be invested in. Other terms like the period of maturity are quite similar. In GIA, depositors will deposit the money and totally trust the banks to invest money. No interference is allowed as this contradicts with the principle of al-Mudharabah. Depositors have no rights or say on the investment made. However, there are slight differences in SIA, where depositors have the option to choose which investment they wanted to be involved in. For example a depositor may choose to invest between construction business and restaurant business. This gives some degree of freedom to the depositors to indulge in business he/she felt is more profitable. However, once they choose specifically the business they wish to invest in, no interference is allowed in order to ensure the smoothness of operation.

Limited period investment account

This type of account operates under a scheme where the banks and depositors mutually agree on the length of time of deposit. The contract is terminated at the said date, but the profits are distributed at the end of the financial year.[4]

Unlimited period investment account

What differentiates unlimited period investment account from the previous accounts is that the time of deposit is not specified here. The deposit account will be automatically renewed unless a notice of 3 months is given in order to terminate the contract. Depositors are not allowed to withdraw or add any money during the contract; however, flexibility is given as customers can open more than one account. Overall, these four investment accounts are based on al-Mudharabah principle. Under Islamic *Shari'ah*, al-Mudharabah involves a business that is based on trust, meaning that capital contributor has given full trust to the Mudharib to organize their fund. Therefore, interference is not allowed in investment account. Based on *Usul al-Fiqh*, when two parties enter into an al-Mudharabah contract, the profits are being shared accordingly, and losses are borne by the *Sahibul Mal* (contributor of capital). The *Mudharib,* however, gains zero benefit and loss by this effort in this situation. This also applies to investment accounts. Before entering to the agreed contract, depositors should clearly understand the terms, condition, and consequences in order to avoid any misunderstanding. In case of any losses, depositor should understand that they are liable for any losses.

Financial statements accounts

Financial statements accounts are further divided into income statement and balance sheet.

Income statement

The main function of income statement is primarily to provide useful information to present and potential investors, creditors, etc., in order to enable them to make proper decision for their best interest. Income statement, which normally consists of revenue and expenses information, may also help users in assessing the company's performance, capabilities, and uncertainty of their prospect. In an income statement, information disclosed should be relevant and reliable. It should be relevant in the sense that it must be timely, contain feedback value pertaining to action already taken, and can be used for performance measurement and evaluation. An ideal income statement should also have a predictive value to the future and should be enhanced by information about the past. Reliability is the quality that assures that the information disclosed is reasonably free from any error and truthfully represents the true situation. Therefore, it must be verifiable, faithful, and neutral.[5] From an Islamic point of view, the revenue and expense account or income statement should be recorded in a way that it satisfies the following characteristics:; conformity with *Shari'ah* principle, relevance and reliability, understandable and faithful representation.[6]

Conformity with **Shari'ah** *principle*

It means that the measurement and recording the information are in accordance with *Shari'ah* guidelines. For example the revenue of Islamic company should not include any amount derived from usury; thus, investors or potential investors will be satisfied with the performance of the company in maintaining its revenue. As stated in the Holy Qur'an 2:279,

> *If you do not give up (interest) then be warned of war against God and His messenger, and if ye repent, then ye shall have your principal (without interest); neither ye wrong nor be wronged.*

Relevance and reliability

As explained before, the information in income statement should be reliable and relevant because as Muslims, not only we have individual responsibility but social responsibility as well. The clear example would be in the case of *Zakat*. If appropriate amount is not disclosed, there are possibilities that the calculation of the profit is inappropriate especially to the *Zakat* payers and beneficiaries. As stated in the Al-Qur'an 9:60,

> *Verily the sadaqat (taxes on Muslim) are only for the needy, and the poor and those who work for these (taxes) and those heart are to be reconciled and to free the neck (i.e. slaves and prisoner of wars) and heavily indebted and in the path of God and for the way fearer – and duty imposed by God, God is Knower, Wiser.*

Understandability

Information disclosed in income statement should be disclosed in a manner that is understandable and is not for the purpose of deceiving the user, thus saving them from taking wrong decisions. For example company might use bombastic words with the intension to deceive the users. In Islam, this is not allowed as stated in 16:25,

> *Let them bear, on the day of judgement, their own burden in fall and something of the burden of those without knowledge, whom they wisled. Alas, how grievous the burden they will bear.*

Faithful representation

All activities in an organization should be recorded and disclosed truthfully, and every detail of transactions taking place in a particular year should also be included. This is very important as organizations especially banks expect the public to act in the most honorable way by trusting them.

Balance sheet

Balance sheet is the overall presentation of event occurring in a company, an indicator of firm financial decisions taken within a specific time. This presentation has been categorized into three major parts: assets, liabilities, and shareholder equity. Financial Accounting Standards Board (FASB) has defined these three entities of balance sheet in Statements of Financial Accounting Concept No. 6 as follows in the subsequent sections:

Assets

As the economic resources of the firm, they represent future benefits that are expected to result directly or indirectly in a net cash inflow.[7]

Liability

> *Probable future sacrifices of economics benefits arising from present obligation of a particular entity to transfer assets or provide services to other entity in the future as a result of past transactions or events.*

The definition has laid down several characteristics of liability, which are

- The obligation must exist at the present time from the occurrence of past events or transactions.
- It is a constructive obligation to make payments as to maintain a good relationship in business transactions.
- There should be little or no option to avoid future sacrifices.
- The amount should be determinable.
- The payee would be known.

Equity

It is a residual interest of the assets of an entity that remains after deducting its liabilities. In a business enterprise, the equity is the ownership interest.[8]

Balance sheet, like the income statements, is like a tool for the user for decision-making since it shows the performance of the firm whether the firm is going concern (i.e. surviving) or not. Therefore, from the Islamic viewpoint, the presentation of the balance sheet should be in line with *Shari'ah* principles and display the truth.

Compliant to **Shari'ah** *principles*

It means that the measurements and recorded information shown in the balance sheet is in accordance with *Shari'ah* guidelines. For example the measurements used either in estimation or any allowances previously known as provisions set out in the balance sheet must be precise, that is all the evaluation must be in just. The Qur'an has emphasized the importance of just measurement used in business dealings.

> *And come to night to the orphan's property, except to improve it, until he attain the age of full strength; give measure and weight with (full) justice; – no burden do We place on any soul but that which it can bear:- whenever ye speak, speak justly, even if a near relative is concerned: and fulfil the covenant of Allah, thus doth He commend you, that ye may remember.*[9]
>
> *To the Madyan People (We sent) Shu'aib, one of their own brethren: he said: "O my people! worship Allah. Ye have no other god but Him. And give not short measure or weight: I see you in prosperity, but I fear for you the penalty of a day that will compass (you) all around." And O my people! give just measure and weight, no withhold the people the things that are their due: commit not evil in the land with intent to do mischief.*[10]

Truthful presentation

All the events or transactions that have taken place in a particular year should be recorded and disclosed truthfully. This issue has been emphasized in Islam as Allah says:

> *O ye who believe! When ye deal with each other, in transactions involving future obligation in a fixed period of time, reduce them to writing Let a scribe*

write down faithfully as between the parties: let not the scribe refuse to write as Allah Has thought, so let him write. Let him who incurs the liability dictate, but let him fear His Lord Allah, and not diminish aught of what he owes. If they party liable is mentally deficient, or weak, or unable Himself to dictate, Let his guardian dictate faithfully, and get two witnesses, out of your own men, and if there are not two men, then a man and two women, such as ye choose, for witnesses, so that if one of them errs, the other can remind her. The witnesses should not refuse when they are called on (For evidence). Disdain not to reduce to writing (your contract) for a future period, whether it is small or big: it is juster in the sight of Allah. More suitable as evidence, and more convenient to prevent doubts among yourselves but if it be a transaction, which ye carry out on the spot among yourselves, there is no blame on you if ye reduce it not writing. But take witness whenever ye make a commercial contract; and let neither scribe nor witness suffer harm if ye do (such harm), it would be wickedness in you.

So, fear Allah. For it is Good that teaches you. And Allah is well acquainted with all things. If ye are on a journey, and cannot find a scribe, a pledge with possession (may serve the purpose). And if one of you deposits a thing on trust with another, let the trustee (faithfully) discharge his trust and let him Fear his Lord conceal not evidence; for whoever conceals it, his heart is fainted with sin. And Allah Knows all that ye do.[11]

If ye are on a journey, and cannot find a scribe, a pledge with possession (may serve the purpose). And if one of you deposits a thing on trust with another, Let the trustee (Faithfully) discharge His trust, and let him fear his Lord. Conceal not evidence; for whoever consists it, – His heart is tainted with sin And Allah Knows all that ye do.[12]

***Shari'ah* rulings**

There are four main principles of Islamic banking:

- Predetermined interest or *Riba'* is forbidden. Islam strictly reminds us that wealth should be but put to productive use so that others can share its benefits, not to use it as a power of one party. It is, therefore, wrong to charge for the use of money as money is not a commodity but rather a medium of transaction. Essentially, owners of capital must bear any losses and share the profits from the said investment.
- Islamic law, or *Shari'ah*, does not allow uncertainty or *Gharar* in contracts. This counts out, for example a contract in which someone undertakes to insure or indemnify another or allows him or her the option to sell or buy an asset. The Prophet SAW prohibited sales involving *al-Gharar*.
- Speculation or gambling (*Maisir)* is also unacceptable. This refers to insurance and dabbling in futures and options. Islamic banks will not finance projects involving products, which are *haram* or forbidden under *Shari'ah*, the most obvious examples of which are pork and alcohol.[13]

- Before concluding an al-Mudharabah contract, each party must know about the investment period, that is the maturity date of investment and the profit-sharing ratio which distributes the result to each parties and no interference is allowed by the *Sahibul Mal* as he has no rights or say toward the investment since this is trust-based contract.
- *Referring to the lectures delivered by Mr Mustafa Omar Mohammad, capital should be in the form of money, that is.. gold, silver etc., must be in liquid form, not in the form of debt, its amount must be specified, known to both parties, and it must be delivered or handed over to the Mudharib. However, there is an issue whether it can be in the form of merchandize or goods. For the situation where the merchandise itself was taken as capital, fuqahah disallowed it because it involves price fluctuations, and hence profit would be affected. Nevertheless, Hanafi and Hanbali agreed that merchandise can be used as capital provided that the Mudharib sell the merchandise first and use the proceeds as capital. But, according to Shafie and Maliki, they disagreed for the reasons of price fluctuation and the element of gharar involved. Besides, capital owner is giving extra responsibility to liquidate the merchandise first. Another issue raised is whether the capital can be in the form of debt or not. Jumhur disallowed that the debt can be used as capital since it involves issue of gharar that is the capability to recover the debt and Riba al-nasiah that is anything that gives extra burden to the debtor. Debt also cannot become al al-Wadiyah or safekeeping.*

Practical scenario

In most of the eastern Islamic countries, these Islamic-based deposit accounts have been implemented for quite some time. However, in most Asian countries, the implementation of these banking services is still yet to be initialized. In Malaysia, for example the banking services have recently been booming since 1983; however, 3 to 4 years back, they started to boom as more banks realized their potential and developed these facilities that would enable both Muslims or non-Muslims to invest money in appropriate way without the involvement of *Riba'*. Banks like OCBC, Hong Leong bank, and Bumiputra Commerce have offered public services such as *al-Wadiyah* accounts, investment accounts, and other Islamic alternatives in modes of financing. Bank Negara Malaysia, for example has implemented this banking service system as they realized the potential of Islamic banking. Particularly in banking services, Bank Negara Malaysia has provided seven types of deposit services that enable depositors or investors to open an account that would give returns without the involvement of interest or usury. Listed here the seven types of services provided and the applicable concept of Islamic Economic.

To look more on other banks such as Al-Rajhi bank of Saudi Arabia, the service provided is wider as they have been long established. Although the principle or

Table 9.1 Classes of Accounts Adapted in the Islamic Financial Institutions and Their Governing Instruments/Principles

Product/Services	*Applicable Concept*
Saving Account	*Al-Wadiyah Yad Dhamamah*/Al-Mudharabah
Current Account	*Al-Wadiyah Yad Dhamanah*/Al-Mudharabah
General Investment Account	Al-Mudharabah
Special Investment Account	Al-Mudharabah
Specific Investment Account	Al-Mudharabah
Negotiable Islamic Deposit Certificate	*Bai' Bithaman Ajil (BBA) – a Past Experience*
Islamic Negotiable Instrument of Deposit	Al-Mudharabah

concept of banking services around the world is the same, but they subdivided these banking services into private banking, international banking, and so on. Moreover, they even provide banking services particularly for women according to their needs.

Current accounts

There are two types of loans being implemented reflecting from the current accounts concept. The two types of loans are trust accounts (*amanah*) and interest-free loan current accounts (*Qard al-hasan* current accounts).

Trust accounts (*amanah*)

To begin with, this concept was first applied by Jordan Islamic Bank. The depositors put their cash deposit into the bank, whereas the bank is authorized to use their funds for investment purposes. The bank can use the funds at its own risk and must be held responsible for any profit or loss incurred.[14] Under this concept, depositors give the bank amount of money to be kept as a trust or *amanah* and the bank cannot use the money unless there is an authorization given to them to do so. From *Shari'ah* point of view, when *al-Wadiyah* is accompanied by the permission to use, it becomes a loan.

Qard al-Hasan current accounts

Iranian Islamic Banks have adopted this type of current account. In this case, the money deposited by depositors in current account is considered as interest-free loan or *Qard al-hasan*.[15] In other words, depositors give loan without interest to the bank. Applying the concept of *Qard* (loan), there is no need for the debtors to get a specific permission from creditors to use the funds that have been borrowed. Hence, bank as a debtor is free to utilize the money at its own risk without obtaining authorization from the depositors as creditors. Bank also is free to use the funds for investment purpose without give any return to the depositor except the principal amount only.

Savings accounts

As an example, Bank Islam Malaysia operates the savings account in the following manner. The bank accepts cash deposits from its customers for keeping a safe custody of their funds. Depositors also feel convenience in their use and bear in mind the possibility of getting some profit in the form of saving under the principle of *al-Wadiyah*. If the funds remain with the bank, the bank requests permission to use it. On the other hand, depositors can deposit or withdraw their funds at any time they want, and the bank guarantees to refund of all such balances. All profits generated from the usage of the funds by the bank belong to the bank. However, in contrast to the current account, under its absolute discretion, the bank may reward the depositors by giving them some portions of profits generated from using their funds from time to time.[16]

Investment accounts

As all the accounts mentioned operate under the principle of al-Mudharabah, each related party needs to understand completely how the system works and the consequences in order to maximize the benefits to each party. According to ALM Ghafoor in his article entitled "Al-Mudharabah *based investment and benefits,*" there are certain issues that must be encountered before implementing the system. The implementation requires the cultivation of new attitude on the part of the participant.[17]

This means that each of the participants must know their responsibilities, rights, and their positions. In today's scenario, the al-Mudharabah implementation may involve banking and financing simultaneously or what they called two tiers of al-Mudharabah. It involves two parties, and the bank acts as the "middle person" of these situations. This could be simplified to the following:

Table 9.2 Two tiers of al-Mudharabah

Depositor	Bank	Entrepreneur
Deposit	money Financing	
Depositor is the *Sahibul Mal*	Bank is the *Sahibul Mal*	
Bank is the *Mudharib*	Entrepreneur is the *Mudharib*	

Each party must well understand that this is the current practice which is normally done by the banks. This information is very crucial especially to the depositors as originally the *Fiqh* prohibits one party to enter into two contracts of al-Mudharabah simultaneously. However, this is allowed with the consent of *Sahibul Mal*, that is the depositors. Each party, especially the depositors and entrepreneur, must both be aware that they are giving/receiving the fund to/from a party that they do not know at all. However, the 100 percent of fund does not necessarily come from the depositor, but 75 percent of the fund might come from the depositors and 25 percent from the bank. Depositor should also be aware that in any cases of losses, they should take the consequences of bearing the loss. The entrepreneur is also required to retain a full bookkeeping and accounts so as to avoid any misunderstanding. This is because al-Mudharabah work is based on trust; therefore, all parties should act in the most decent and honest way.

Conclusion

There are certain that could be done by both parties in order to beautify the contract. First, consultancy could be made available to public from third party, which acts on the best interest of the client. Although the establishment of Islamic banking has been booming tremendously since a few years, investor or potential depositor may have a lack of knowledge in organizing their fund. If there is a consultancy that provides services and advice to people on how to best undertake the contract or which account or investment suits their needs, the riskiness of the investment could be reduced, as the consultancy may provide legal and economic advice. For example they might discuss with clients on topics of their target or the aim of their fund. If they seek for investment that has low risk and want to ensure that their capital will be safeguarded, they should go for something that has low return such as savings accounts or current accounts. However, this applies differently to depositors who wish to have rapid growth of fund, involving high risk, then they should enter a contract of investment accounts.

In today's scenario, banks are keen in short-term investment rather than long-term investment, as the inflow of short-term investment is faster than the long-term investment, and therefore "money" will move around quickly. In order to achieve this purpose, it seems to be wise decision if the banks or contributor of capital create a joint venture with entrepreneur with skills. For example let us say that as people are now keen on using stenciling rather than using wallpaper due to low maintenance, banks and contributors of capital may take this advantage by hiring a skillful worker preferably with high art skill to achieve this purpose. The joint venture may last 3 to 6 months until the "season" passes. However, this recommendation requires both parties to be sensitive to changes of customer preference. In addition, it would also be helpful if the owner of capital could provide capital not necessarily in money but in kind. According to *Usul Fiqh*, the majority of schools have allowed this to happen. However, the ratio of profit should be done accordingly with reference to the value of the equipment or goods.

In order to avoid any exploitation of the Islamic banking system, it might be appropriate to establish an authority that will ensure that all financial institutions practicing the Islamic banking principle observe the rules and regulation as stated in the Islamic banking Act. The authority would also observe that the businesses that the banks are investing in are allowed and do not contradict with the Islamic *Shari'ah* such as gambling, liquor, prostitution, and pork. This is feared to happen if in any cases, banks act for their interest only to gain profit without looking deeply into the type of business that they invested in. It would also be recommended that banks establish a committee for each investment made. The committee should consist of four to five people with different backgrounds in order to ensure that they can view the investment from different angles. For example if a bank has ten major investments, a committee should be established for every two or three investments, and they should consist of people from different backgrounds such as accounting, marketing, and engineering. Thus, the investment could be viewed in its technical form, cost and return form, and expandability form. Therefore, profit from the investment could be maximizing not only to the banks but to the depositor as well.

To put in a nutshell, the evolvement of Islamic banking system has opened the eyes of many countries, either modern, developed, or third world countries, for its prospects which may become the major financial features in the economic structure. The success of Islamic bank in the opposite environment is more significant, when the challenges of its successfulness toward Islamic environment materialize after being ruled by interest domination of the monetary system (i.e. conventional system) for generation. Thus, its participate toward the process of Siamization of the economic system. In Malaysia, Islamic bank was born after the burst of the Islamic monetary system in the East Asia in accordance with the *Shari'ah* principle. It was designed to promote savings and investments while being interest free, that is the difference between conventional with Islamic bank maintained. Conversely, there are a lot of disputes between the jurists regarding the practice of the Islamic banking system. I end this chapter with the hope that the fallacy will transform to be a greater and firm Islamic banking system and be the starting point toward Islamic way of life.

Notes

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10 Types of account adapted in Islamic Banks

Introduction

Islamic Bank was established as an institution that promotes the interest of the *Ummah* and the principle of *Shari'ah*. Meanwhile, as a profit-making institution, Islamic Bank serves the society by being the safe keeper and the guarantor of the savings. Besides that, Islamic Bank actively plays its role in being the agent that channels capital to entrepreneurs to ensure a proper, systematic, and continuous circulation of money in the economy. Economic theory says that keeping money idle distorts economic development. Realizing this fact, Islamic Bank adopts various types of accounts to encourage all levels of society to save and invest their money with the bank. Acting as an agent that guarantees the money, Islamic Bank utilizes the money in the *Shari'ah*-permissible investment. Then the bank distributes the profit among depositors based on al-Mudharabah principle or as a gift (*al-Hibah*). This cooperation between Islamic Bank institutions and the society at large will bring prosperity to the economy of the nation and at the same time bring a development process that will build up human beings. An attempt is made in this chapter to analyze types of accounts adopted in an Islamic Bank as the means in realizing its objective.

Current account

Islamic bank offers current account facility to individuals above 18 years old, industries, clubs, and societies whose activities are in-line with the *Shari'ah*. The practice of this account is based on *al-Wadiyah Yad Dhamanah* principle. Basically, *al-Wadiyah* principle refers to a contract in which a depositor leaves his properties to a depository for safekeeping based on trusteeship (*al-Amaanah*). However, if the depository uses the deposits, in this case, the Islamic bank uses the money for investment; the trusteeship becomes a guarantee (*al-Dhamanah*). Therefore, the bank is responsible for assuring the safety of the deposits and for returning them upon request. The depositors keep their money in this account, mainly for transaction motives, that is to preserve its liquidity to assure the settlement of cash payment. Moreover, the bank provides the depositors with checkbooks that allow them to transfer money from their current account to the payee

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account. Upon utilization of the deposits, the bank does not promise any fixed dividend to be given to current account holders. However, they may get some amount of money as a gift (*al-Hibah*) at the discretion of the bank.

As the motive of having a current account is to maintain a safe liquidity level of the depositors, a safety portion of money is reserved to fulfill the depositors' requirement. Meanwhile, the bank will allocate some portion for interest-free loan facilities. The loan operates on the principle of Qardh al-Hasan. The principle says that the borrower must return the principal amount of the borrowed fund on a specified time, without any additional profit (interest). Then only the bank will utilize the other portion for short-term investments. The utilization on this investment will then generate profit that can cover the administration cost of the current account. Therefore, the Islamic bank will be able to lower its service costs charged to the account holder. With a minimum deposit of $ 1,000.00, the account holders will enjoy convenient transactions with the help of checkbook facilities without having to carry cash around. Furthermore, they can make interbranch transactions, and they can have a joint account with their partner.

Savings account

Bank Islam Malaysia Berhad (BIMB) offers five types of savings accounts that are *al-Wadiyah*, al-Mudharabah, *al-Wadi*, *al-Ijarah*, and Pewani. *Al-Wadiyah* savings account operates under *al-Wadiyah Yad Dhamanah* principle. Under this principle, the depositor is not entitled for the profit generated by the bank. However, he may get a gift (*hibah*) at the discretion of the bank. On the other hand, al-Mudharabah, al-Wadi, *al-Ijarah*, and Pewani savings accounts operate on the basis of al-Mudharabah principle. Under this principle, the bank will provide a fixed profit-sharing ratio between the bank and the depositor. These four types of accounts are basically of the same ground in the principle sense. However, the features are different between each other in terms of customer target group, profit sharing ratio, benefits the account holder will get, etc. The following discussion will analyze each of these five savings accounts.

Al-Wadiyah savings account

Al-Wadiyah savings account operates based on *al-Wadiyah* principle. It is a contract between the depositor and the bank (depository) for safekeeping. The default principle of *al-Wadiyah Yad Amaanah*[1] then becomes *al-Wadiyah Yad Dhamanah* when the bank utilizes the deposits for any activities permitted by *Shari'ah*. Therefore, the bank is acting as a safe keeper and a guarantor to the deposits. The basis of *al-Wadiyah* comes from three sources: Al-Qur'an*, as-Sunnah,* and *al-Ijma'* (consensus):[2]

> *Indeed, Allah commands you to render trusts to whom they are due and when you judge between people to judge with justice. Excellent is that which Allah instructs you. Indeed, Allah is ever Hearing and Seeing.*
>
> (An-Nisa': 58)

Rasulullah (saw) said,

> *Render trust to who has put his trust to you. Do not betray those who betrayed you.*

According to the majority of scholars,

> *Al-Wadiyah is permissible because of its necessity for public interest.*

As the guarantor of the deposits, the bank must be responsible to return the deposits upon request by the depositor. This concept is parallel to Surah Yusuf verse 66:

> *(Yaacob) said, "Never will I send him with you until you give me a promise (i.e., oath) by Allah that you will bring him (back) to me, unless you should be surrounded (i.e., overcome by enemies)." And when they had given the promise, he said, "Allah, over what we say, is Witness."*

In this verse, Prophet Yaacob demanded guarantee from his sons to safeguard their stepbrother, Prophet Yusuf. They promised to him and with Allah as the Witness that they were fully responsible to bring their brother back safely. This account is open for all and is categorized into three types of accounts. First type is an individual account that is opened to individuals aged 12 and above. Second, entrust account for children below 12 years old and the account must be opened together with an individual adult. At the end, joint account can be opened for clubs, societies, and partners. For all the three types of accounts mentioned before, Bank Islam Malaysia Berhad (BIMB) specifies the minimum of $ 10 for initial deposit. Meanwhile, Muamalat Bank (MB) restricts a minimum deposit of $ 30 for entrust account and a minimum deposit of $100 for individual and joint accounts. Depositing money in this account does not promise the depositor a fixed return. However, at the discretion of the bank, the depositor may earn some amount of return as a token (*al-Hibah*). Apart from earning the token, account holder will also get a free savings book, ATM Smart Card, salary crediting facility, and standing instruction facility. Moreover, the bank will facilitate the Muslim depositor for his *Zakat* payment on savings. Salary-crediting facility refers to the facility that bank provides for employer to credit the salary to employees' *al-Wadiyah* account. It is done through employer's current account or through the check the employer presents to the bank. In this case, the employer will need to pay service charges.

Meanwhile, standing instruction facility is for someone like a graduate who got scholarship for higher education (PTPTN) and wants to pay back the loan. She can approach BIMB. She needs to fill in a specific form saying that she empowers BIMB to transfer some constant amount of money, say $200, from her account to PTPTN account at the first day of every month for a period of 30 years. However, she must ensure that at the date she specified, the money is available in her account or otherwise the bank cannot process her instruction. Besides that, the bank will transfer the money on the following day if let's say the date that she specified falls during a holiday.

Al-Mudharabah savings account

As the name indicates, Al-Mudharabah savings account operates under al-Mudharabah concept of profit sharing. It is basically an investment account that has been altered a little bit to combine with savings account. Depositors deposit their money, and then the bank invests the money in businesses that are conducted in line with *Shari'ah*.

Allah (swt) said in the Qur'an:[3]

> *There is no blame upon you for seeking bounty from your Lord.*
>
> (An-Nisa: 198)

This verse did not mention the word al-Mudharabah. However, the translators (mufassirin) translated the sentence of seeking bounty from your Lord as part of al-Mudharabah concept. Different from *al-Wadiyah* savings account, deposits of this account are purposely for investment with an agreed profit-sharing ratio between the bank and the depositors. The ratio is 50 percent to the bank and 50 percent to the depositors. Meanwhile, this account differs from investment account in the sense that the investment account has a maturity date of 1 to 60 months. To deposit in this account, one must be 65 years old or younger. An initial deposit of minimum $ 100 is required to open this account. ATM card is available for this account. Different from *al-Wadi, al-Ijarah*, and Pewani savings account, al-Mudharabah savings account holder can withdraw money at any time subject to a minimum saving of $25. Three types of accounts are available: personal account for those aged 15 years or above, joint account, and entrust account for children younger than 15 to open the account with an adult individual. Foreigners can also open this account.

Al-Wadi savings account

BIMB adopts Wadi savings account specially for children aged 12 years and younger. This is an entrust account in which the children must open a joint account with their mother, father, or their guardian. This account is an encouragement to children to start saving in a convenient way. With an initial deposit of only $1, the depositors can enjoy benefits offered in this account. This account, which operates under Al-Mudharabah concept, provides profit sharing ratio of 50: 50 between the depositor and the bank. Apart from a high profit ratio, depositors may get a membership of Wadi Club at selected schools. In addition, depositors will get a free Group Family Takaful Plan with a maximum amount of benefit up to $5,000 depending on the monthly average daily balance of at least $250. Benefit of this takaful coverage is payable to the beneficiaries upon the demise of the account holder. All profits will be credited monthly into depositors' account with an exemption of withholding tax to eligible depositors. In addition, the bank will pay *Zakat* on savings on behalf of the depositors.

Al-Ijarah savings account

Bank Islam's *Ijarah* savings account is unique and highly profitable in many ways. This account is opened to customers aged between 13 and 18 years. That is this account is specified for all youths or secondary school students. This account came up as a result of suggestion of Bank Negara Malaysia. Besides inculcating the spirit of savings among teenagers, it is designed to give them an exposure about the workings of bank, especially, Islamic Banking. Ijarah savings account is based on the concept of al-Mudharabah. According to the normal principle of Bank Islam Malaysia Berhad (BIMB), if the account is under Al-Mudharabah concept, the customer must have a deposit of $100. But, in this case, for the purpose of encouragement, the minimum initial deposit is only $1. Meanwhile, the account holders can only perform withdrawal transaction once a month. It is not so difficult to open an Ijarah savings account. The one who is interested must go to the nearest Bank Islam branch or if there is Ijarah Club in school. Anyone who has become Ijarah account holder, he is automatically entitled to be a member of 'Bankers' Club (*Ijarah* Club). The member will enjoy a lot of benefits in the form of receiving indirect education and exposure through special Islamic Banking talks by Bank Islam. As the result, the member can learn from and participate in an internationally successful banking principle. One of the main benefits from this savings account is high profit ratio. Normally, the profit is credited at the end of month with 50:50 fixed profit distribution ratios to the depositor's account. The Ijarah holder also will get Takaful (insurance) coverage which is a free group Family Takaful Plan. The maximum amount insured by Takaful is $5000, but it depends on the holder's minimum monthly average daily balance of $250. The benefit will be paid to the beneficiary upon the death of the account holder. The other benefits that will be given are the exemption of withholding tax to those who are eligible. Normally, the individual whose the monthly account balance is less than $100,000 has not to worry about the payment of *Zakat* (tithes) because the bank on the savings pays it.

Pewani savings account

While *Ijarah* savings account is especially for teenagers from 13 to 18 years old, Pewani savings account is uniquely for women aged 18 and above. The required initial deposit is $50, and the depositors can only withdraw their money once in a month. No ATM card service is provided for this account. Pewani Savings Account offers three types of accounts: individual account, joint account, and account for nonresident individual. For joint account, a male depositor can open the account only if the account's primary holder is a female. This account has two profit-sharing ratios depending on the monthly average daily balance. If the monthly average daily balance is at least $5,000, 60 percent of the profits go to the depositors, while the rest 40 percent is for the bank. However, if the monthly average daily balance is less than $5,000, the ratio applicable is 50: 50. Depositors are also eligible to get Takaful Hawa coverage up to $25,000, subject to the monthly average daily balance of $50,000. Besides that, they are also entitled to receive benevolent endowment in the case of death, hospitalization, annual cancer check-ups, and many more. Like *Wadi* savings account, all profits will be credited monthly to depositors' account, and the bank will pay *Zakat* on savings for the Muslim depositors.

Investment account

Investment account operates under al-Mudharabah concept. This concept refers to an agreement between the party who provides the capital (capital owner) and the other party who manages the capital. Both parties will share the profit, and the loss will be borne by the capital owner. However, as the practice of Islamic bank, if some amount of capital is loss and it is not caused by either party, that is if it is the risk faced by the business itself, the loss capital will be offset against the profit.[4] Meanwhile, if the investment incurs loss, capital owner (the depositor) will bear the loss while the managing party will suffer efforts and time spent on the operation. This investment account is quite like fixed deposit as practiced by Conventional Banks. The difference between fixed deposit and BIMB investment account is in the profit-sharing ratio. In Conventional Banks, the percentage of profit sharing fluctuates as set by the bank. For example the bank sets 4 percent of the profit for customer. Then, for a 7 percent profit the bank gets, the 4 percent goes to customers and the rest 3 percent is for the bank. Say, the bank sets a 3 percent return to customers, with a 7 percent profit, then 4 percent will be the bank's profit portion. Looking at these scenarios, there is a probability that one party may get lower return than what they got before. This uncertainty is what the Islamic bank is trying to avoid. In Islamic bank, the bank sets a fixed profit sharing ratio of 70:30. This means that every time customers get 70 percent of the total profit, the bank will earn the rest 30 percent. Therefore, each party gets a constant rate thus eliminating the element of uncertainty.

BIMB offers two types of investment accounts of general and special with the terms ranging from 1 to 60 months. The bank will invest all deposits in all types of projects approved by *Shari'ah*. This refers to general investment. For special investments, the bank is responsible to carefully observe and value specific projects to be developed. Then the bank will open the projects to general. However, profits from these investments are viewed separately from those of general investment. This investment account differs from al-Mudharabah savings account (MSA) in the sense that depositors of MSA can withdraw their money at any time without the need to change the initial agreement. However, withdrawal from investment account is subject to a change in the investment certificate due to the amount and maturity date of the investment certificate.

Sakinah investment account

Sakinah investment account is based on the concept of Al-Mudharabah in which the profit-sharing ratio is 70 percent for customer and 30 percent for bank. This account requires a minimum of $50,000 deposit. It is opened to individuals aged 18 and above, especially retired people who have extra money (reserve) to invest. The minimum tenure to this investment account is 12 months and the maximum 60 months, and it is renewable. The monthly interim profit will be credited directly to investor's saving or current account. Among the benefits that investor will get from this account is the coverage of "Funeral," in which the amount obtained is $1,000 upon investor's death. Moreover, the investor is eligible for consumer financing products including personal financing, umrah and tour package financing, education financing, vehicle financing, home financing, and Bank Islam Card. For all consumer-financing products, the margin of financing is equal to the amount of investment in Sakinah, and the selling price (total repayment amount) is known and fixed even though it fluctuates in the market. Profit margin is lower than regular for all financing products except for vehicle financing; for example Baiti Home Financing has the profits competitive and attractive whereas, the profit margin for Bank Islam Card is 1.5 percent per month. Fortunately, there is no processing fees and security deposit for all financing. If we compare with the conventional system, the selling price is changed according to the Base Lending Rate (BLR), which is stated by Bank Negara and it charges processing fees for administrative fees.

Consumer financing

Personal financing

In order to fulfill our cash need, Bank Islam, the Bank for all, offers personal financing facility. Basically, this facility is the combination of *Qardh al-Hasan* (benevolent loan) and Bai Sarf (monetary exchange) contract, a method of sale with deferred payment to ease financial problems of customers.[5] Meaning of *Qardhul Hasan*, literally, is part. The example is a part of wealth. Technically, this is a contract where wealth is given to someone and the same wealth is returned. The concept of *Qardh al-Hasan* sits parallel to the Quranic verse:

> *Who is it that would loan Allah a goodly loan so He will multiply it for him and he will have a noble reward.*
>
> (al-Hadeed:11)

In reference to a *Sunnah* of the Prophet (saw),

> *In the night of Lailatul Qadr (the night of fate), the Prophet (saw) saw the door of paradise, the rewards of "sadaqah" is 10 and the reward of 'qardh' is 18 times.*

According to the majority of scholars[6],

> At all times allows *Qardh* as it is a form of charitable act to help others. *Allah (swt)* will ease someone in the Hereafter who eases someone in this world.

Meanwhile, *Bai' as-Sarf* (monetary exchange) literally means extra as in Hadith[7]:

> *Technically, sale of money is either of the same kind or different.*

In reference to a Hadith,

> *Do not exchange gold with gold except similar with similar, do not reduce 1 over the other. Do not exchange silver with silver except similar with similar, do not reduce 1 over the other. Do not exchange the absent with the present.*
>
> (Narrated by Bukhari in the topic of sale)

For the personal financing, the maximum amount that can be financed is \$25,000, but it can be up to 10 times of the gross salary. The repayment period is up to 55 years of customer's age or maximum to 7 years, whichever is earlier. For example if the customer is 50 years old, the maximum repayment period is only 5 years. Personal financing is opened to national citizen or permanent resident who is 18 years or above and earns a minimum fixed income of RM 1,500 per month. If the financing amount is \$10,000 or less, the applicant will need only one guarantor, but if it is more than \$10,000, two guarantors are needed. The applicant and guarantor must be a confirmed employee in government sector or in statutory bodies or in recognized private company. At the same time, they must participate in either Group Family Takaful Plan or Mortgage Takaful Plan from Takaful Malaysia Berhad.

Education financing

The purpose of this financing is to finance the customer in terms of education; it doesn't matter whether a local or overseas colleges or universities or other institutions of higher learning offer the course. But the most important matter is that the relevant authorities must approve a full-time or part time course. This financing is offered to national citizen or permanent resident aged 18 or above, and the applicant and/or guarantor must be a continued employee in government sector or statutory bodies or recognized private company. Only one guarantor is needed if the financing amount is less than \$10,000. But for the amount ranging from \$10,000 to \$25,000, two or one guarantors are needed if the consumable income is more than \$3,000 per month. Meanwhile, collateral is needed if the amount is RM 25,000 and above, The applicant and guarantor must participate in either Group Family Takaful Plan or Mortgage Takaful Plan from Takaful Malaysia Berhad. The repayment period for education financing is due to the amount of financing. It will be maximum 3 years of repayment period if the amount is \$5,000 or less. The maximum period for the amount to be loaned from \$5,000 to \$10,000 is 6 years. The applicant must repay within 15 years if the amount is \$10,000 and more. The margin of financing is subject to terms and conditions. But normally, it is like up to 100 percent inclusive cost of purchasing a computer and learning fees offered by the institution as a package.

Baiti home financing

Baiti Home Financing gives us an opportunity to own our dream home or renovate or refinance our old home. It is a home-financing scheme based on the *Bai' Bithaman Ajil* (BBA) contract if it is provided by BIMB. Meanwhile, home financing for Bank Muamalat is based on Bai' *Al-Istisna*' because the house is still under construction. *Bai' Bithaman Ajil* (BBA) is a method of sale with a deferred payment plan by monthly installments. It can reduce our risks against interest fluctuation Base Lending Rates (BLR) and other risks we can do without. It includes "Long-Term House Owners Takaful" and "Takaful Mortgage Plan." Long-Term House Owners Takaful is a long-term takaful policy to protect our homes from disaster during the financing period, and Takaful Mortgage Plan is a guarantee in paying the outstanding financing amount in the case of death or permanent disablement of financier. This financing is offered to Malaysian citizens aged 18 years old and above who have source or income in order to pay back the financing amount. He must also execute selling and purchase agreement with the developer of the house or duly accepted purchase of property from the developer. If the customer involves with this financing, there is no need for him to worry because there are no processing fees, security deposits, or hidden charges. Moreover, there is a flexible repayment scheme because it puts the budget according to financier's ability, and he enjoys special discounts for the first 24 months as well as special rebates if he can settle the payment earlier. The repayment period is up to 32 years inclusive of 2 years' grace period or maximum age of 65 years, whichever is earlier.

Vehicle financing

Bank Islam provides vehicles' financing, buying and selling concept based on the *Shari'ah* contract of *Bai' Bithaman Ajil*, which is a deferred payment plan by monthly installments. For this financing, it has its own terms and conditions. It is offered to individuals aged 18 years above with fixed or stable income. In terms of type of vehicles, new passenger vehicles including cars and multipurpose-wheel drive vehicles are entitled to get this financing. Margin of financing is 90 percent for national and nonnational models. The profit margin is fixed. Meanwhile, the customer has maximum 84 months to pay back the financing amount. If he settles the payment earlier, rebate will be given.

Naqad (overdraft) facility

Bank Islam offers *Naqad* overdraft facility for financial needs. This facility is under the *al-Bai Bithaman Ajil* principle (sale with deferred payment). It is open for individuals and business organizations. But the applicant must own a property such as house, land, commercial building and others as collateral to the bank. Amount of financing is up to the collateral's forced sale value. There is no fix amount to be repaid. Moreover, it is flexible according to the applicant's capability. The repayment period is up to 5 years, and the installment can be paid monthly, quarterly, or others, as agreed by both parties.

Bank Islam Card

Bank Islam Card is same as credit card. But the main different is that this card is *Shari'ah*-based card, which means it is free from *Riba'* (interest) and *Gharar* (uncertainty). Bank Islam Malaysia Berhad assures the user absolute transparency of usage. So, there are no hidden costs or obscure clauses to the user's finances. Furthermore, no annual fee, joining fee, and profit on cash withdrawal are charged. The cardholder will have Free Group Family Takaful Plan for "credit shield" coverage, which saves around 1.6 percent per annum.

Ar-Rahnu *Scheme*

Pertaining to *ar-Rahnu* Scheme, Bank Islam offers Qardh al-Hasan to applicants. The applicant must be Malaysian resident aged from 18 to 65 years. For this scheme, the applicant gives jewelery as mortgage of the debt (money). This scheme is practiced according to Islamic rule because the scholars say that *Ar-Rahnu*[8] technically is detention of something due to rights where right fulfilling the right can be fulfilled or obtained from it. For example making physical wealth with financial value according legal perspective to be security of debt, which can be used to settle the debt. Physical wealth is detained due to debt (right), and the right can be fulfilled or obtained from the physical wealth. According to the *Sunnah*,

> *Aishah reported that the prophet (PBUH) bought goods from a Jew and use his iron Armour as rahn (mortgage).*[9]

Bank Islam guarantees the security of the jewelry, which is kept under *al-Wadiyah Yad Dhamanah* contract. But it will get charged on the mortgage. *Ar-Rahn* is the product as a result of the cooperation between BIMB and *Yayasan Pembangunan Ekonomi Islam Malaysia* (YPEIM), which is assumed to be the best choice to get immediate cash. For *Ar-Rahnu*, the maximum loan is up to RM 5,000 or not more than 60 percent of gold market value.

Conclusion

Even though the Islamic banks in Malaysia are quite new as compared to the Conventional Banks, the Islamic banks have succeeded in attracting categories of investors, which did not previously have dealings with banks. So, the Islamic banks have thus contributed toward raising the level of national savings in our countries.

Notes

1 Samsuri Sharif, *Fiqh for Economist II*, Kuala Lumpur: IIUM Printing, p. 66.
2 Ibid., p. 64.

3 Sobri Salamon, *Bank Islam*, p. 93.
4 Ibid., p. 95.
5 Sharif, *Fiqh for Economist II*, p. 67.
6 Ibid., p. 68.
7 Ibid., p. 54.
8 Ibid., p. 71.
9 Ibid., p. 72.

11 Financial accounting and reporting for the Islamic financial institutions

Introduction

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is known as Financial Accounting Organization for Islamic Banks and Financial Institutions. It was established in accordance with the Agreement of Association, and it was registered on 27 March 1991. The primary purpose for establishing AAOIFI is to enhance the confidence of users in the financial statements of the Islamic financial institutions and ultimately to promote Islamic financial institutions. In fact, there are several objectives of AAOIFI, among which the first objective is to develop accounting and auditing thought relevant to Islamic financial institutions. Besides that, AAOIFI was established to review and amend accounting and auditing standards for Islamic financial institutions. The other objective is to disseminate accounting and auditing thought relevant to Islamic financial institutions and its applications through training, seminars, publication of periodical newsletters, carrying out and commissioning of research, and other means. Other than that, the objective of AAOIFI is also to prepare, promulgate, and interpret accounting and auditing standards for Islamic financial institutions. As far as the objectives of AAOIFI are concerned, it carries out these objectives in accordance with the precepts of Islamic *Shari'ah* that represents a comprehensive system for all aspects of human life and in conformity with the environment in which Islamic financial institutions have developed.

General objectives of financial accounting

Financial statements defined by MASB 1 are a structured financial representation of the financial position and the transactions undertaken by an enterprise.[1] The general purpose of financial statements is to meet the needs of users who are not in a position to demand reports tailored to meet their specific information needs.[2] It requires that those are presented separately or within another document such as an annual report or a prospectus. The main objective of financial accounting is to provide information about the financial position, performance, and cash flows of an enterprise that is useful in order to help users in making economic decisions. Financial statements provide user the information about an enterprise's assets,

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liabilities, equity, income, and expenses, including gains and losses, and cash flows. According to Nabil Baydoun and Roger Willet in their article titled "Islam and Accounting: Ethical Issues in the Presentation of Financial Information," in preparing the Islamic corporate report, two general objectives should be underlying. The two general objectives mentioned are social accountability and full disclosure.[3] Thus, in order to be in line and consistent with *Shari'ah* procedures, some Western accounting practices should be modified.

The *Shari'ah* specifies the meaning and the way of achieving accountability. God makes all the resources especially for humans, based on trust. Thus, it depends on humans themselves to create and to use the resources given in an appropriate way. In business, the management and the capital provider are accountable for their actions. Both must ensure that they are consistent with the teaching of *Shari'ah*. One of the main objectives of Islamic accounting is to provide information which discharge those involved in firms from their accountability to the ummah. The concept of social accountability is related to the principle of full disclosure. There is an obligation to disclose everything that it is believed is 'of important to Islamic users for purposes of serving God. This does not mean that the preparer of account must disclose everything to every detail of individual transfers. The purpose of financial statements for Islamic banks and financial institutions basically focus on the importance of the relationship between religion, human behavior, and accounting. According to McClelland (1970), he argued that some religions are an important source of the development in economic growth.[4] Gilkey also argued that

> every society has a religious substance which it shares and expenses in all aspects of its cultural life and in which we participate insofar as we are members. Culture and religion have always been closely interrelated. Every religion expresses itself in the form of its cultural settings, and cultural reflects a "religious substance," that is, exists out of an ultimate point of view or sets of beliefs.

Islam does not recognize any separation between business and religion. The most common approach, which refers to the differentiation in accounting policy and financial report among the various countries, has emphasized the cultural dimensions. According to Hofstede, there are four main features, which might relate to cultural influence in any institutions and organization: power distance, uncertainty avoidance, individualism, and masculinity.[5] The features mentioned might influence the presentation of the financial reports especially for Islamic banks and financial institutions. Power distance reflects to which a culture believes, how institutional and organizational power should be distributed, and the decisions of the power holders should be viewed. Uncertainty avoidance is a fundamental issue involving how a society responds to the fact that the future is unknown. Individualism discusses the degree to which a culture relies on and has allegiance to the self or the group. The issue of masculinity versus femininity relates to the division of roles between sexes in a society. Masculinity stands for a preference in society to show personal pride through achievement, heroism, assertiveness, financial success, and material success. Femininity, on the other side, stands for a preference for relationships, humility, caring for the weaker, the equality of life, and preservation of the environment. The financial reports for the Islamic banks and financial institutions must show the fair and true view information in line with the *Shari'ah* procedures. Al-Qur'an requires followers to keep proper records especially for their indebtedness and prohibits *Riba* and any unfair trading. This is because *Riba* is increasing in value which can make the rich become richer and the poor become poorer. The prohibition of *Riba* is necessary because it involves unjust transactions between societies. Al-Qur'an recommends writing down anything with faithful manner:

> O ye who believe! When ye deal with each other, in transactions involving future obligations in a fixed period, reduce them to writing let a scribe write down faithfully as between the parties. Let not the scribe refuses to write as God has tough him, so let him write.
>
> (2: 282)[6]

Obviously, there are certain requirements that Islamic banks and financial institutions must follow in order to be in line with the way of Islam. Some of the existing principles of accounting and the presentation of financial reports must be modified for the benefits of its variety of users and for the benefit of Muslim society.

Rational outlook

There are two approaches of establishing objectives of financial accounting for Islamic banks and financial institutions. These two approaches have appeared through discussion in two different meetings by the committee of the Board. The first approach is "*establish objectives based on the principles of Islam and its teachings and then consider these established objectives in relation to contemporary accounting though*."[7] The second approach is the contradiction of the first approach, that is, "*start with established in contemporary accounting though, test them against Islamic Shari'ah, accept those that are consistent with Shari'ah and reject those that are not*."[8] The first approach is basically starting with creating new objectives that are totally based on the principles of Islam and after that it relates those objectives with the contemporary accounting thought. For the second approach, the existing accounting thought will be tested aligned with Islamic *Shari'ah* and those that are consistent will be accepted.

In order to choose the best approach for establishing objectives of financial accounting for Islamic banks and financial institutions, a working paper consistent with the first approach was prepared by a *Shari'ah* scholar. In addition, an accounting scholar prepared a separate working paper based on the second approach. At the same time, both *Shari'ah* expert and accounting expert set up a joint working paper. After conducting several meetings, they came into conclusion and agreed that the second approach should be the approach to establish objectives of financial reporting and financial reports for Islamic banks and financial institutions. The approach selected is basically not to make the presentation of financial statement for Islamic bank absolutely different from the existing Western banks. The procedures based on *Shari'ah* are basically the addition to what we have in common procedures.

Figure 11.1 illustrates that the objectives of financial accounting can be viewed by two different perspectives which are Islamic and Western. For Islamic perspective, the objectives can be determined by AAOIFI. However, for Western perspective, the objectives can be determined by business enterprises and non-business organizations. These objectives then can be categorized further according to two different categories which are financial accounting and financial reporting. The following section will discuss in detail the objectives of financial accounting and reporting.

According to AAOIFI, there are several objectives of financial accounting for Islamic banks and financial Institutions which include:

- To provide useful information to users of these reports through financial reports in order to enable them to make legitimate decisions in their dealings with Islamic banks.
- To safeguard the Islamic bank's assets, its rights, and the rights of others in the proper and adequate manner.
- To contribute to the enhancement of the managerial and productive capabilities of the Islamic bank and encourage compliance with its established goals

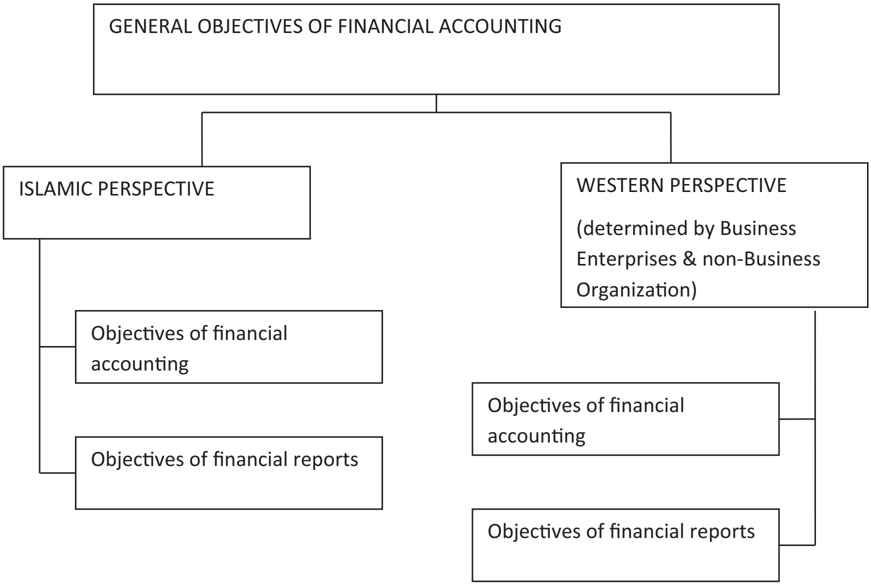

Figure 11.1 Objectives of Financial Accounting

Figure 11.2 Mind-Mapping Financial Accounting

and policies and, above all, encourage compliance with Islamic *Shari'ah* in all transactions and events.

- To determine the rights and obligations of all interested parties which include those rights and obligations resulting from incomplete transactions and other events in accordance with the principles of Islamic *Shari'ah* and its concepts of fairness, charity, and compliance with Islamic business values.

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

- Information about the Islamic bank's compliance with the Islamic *Shari'ah* and its objectives and to establish such compliance[9] as well as information

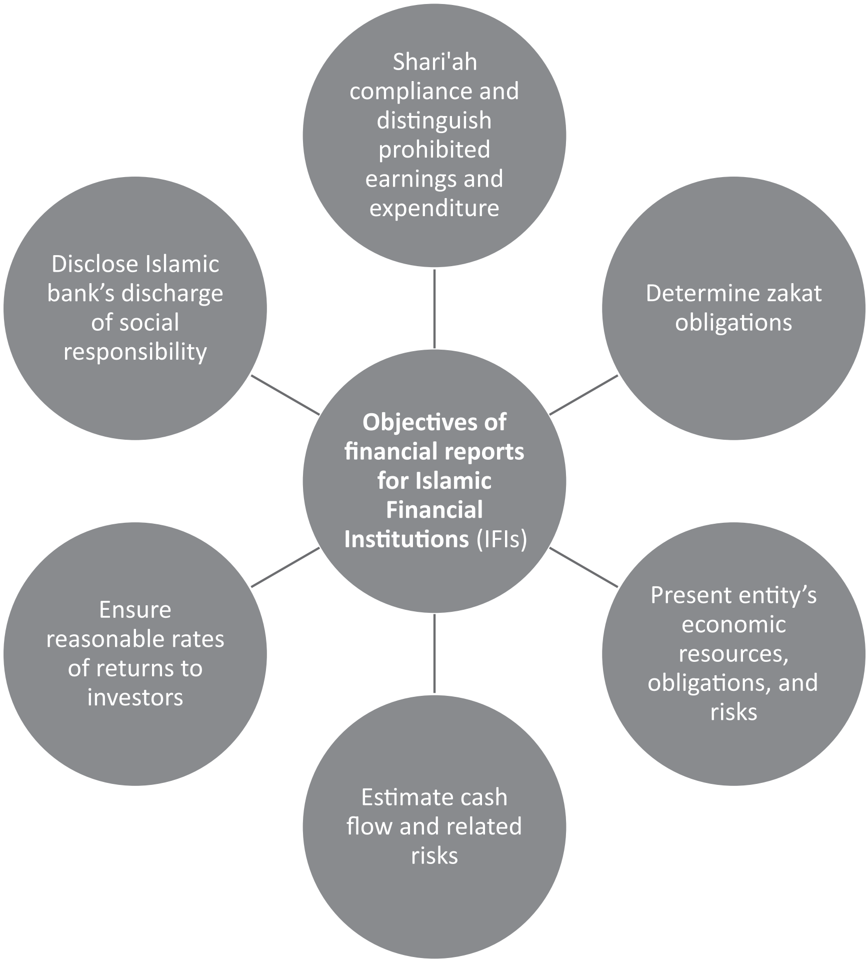

Figure 11.3 Objectives of Financial Reports

on the separation of prohibited earnings and expenditures, if any, which occurred, and of the manner in which these were disposed of.

- Information to assist in evaluating the Islamic bank's discharge of its fiduciary responsibility to safeguard funds and to invest them at reasonable rates of return, and information about investment rates of returns on the bank's investment and the rate of return accruing to equity and investment account holders.
- Information to assist in estimating cash flows that might be realized from dealing with the Islamic bank, the timing of those flows, and the risk associated with their realization. This information should be directed principally at assisting the user in evaluating the Islamic bank's ability to generate income

and to convert it into cash flows and the adequacy of those cash flows for distributing profits to equity and investment account holders.

- Information about the Islamic bank's economic resources and related obligations to transfer economic resources to satisfy the rights of its owners or the rights of the others and the effect of transactions, other events, and circumstances on the entity's economic resources and related obligations. This information should be directed principally at assisting the user in:

  I Evaluating the adequacy of the Islamic bank's capital to absorb losses and business risks.
  II Assessing the risk inherent in its investment.
  III Evaluating the degree of liquidity of its assets and the liquidity requirements for meeting its other obligations.

- Information to assist the concerned party in the determination of *Zakat* on the Islamic bank's funds and the purpose for which it will be disbursed.[10]
- Information about the Islamic bank's discharge of its social responsibilities.

Objectives of financial reporting by business enterprises versus nonbusiness organizations

Objectives of financial reporting by business enterprises

There are three main objectives as recommended by Belkaoui, which are:

- Financial reporting should provide useful information to existing and potential investors and creditors and other users in making rational investment, credit, and similar decisions.
- Financial reporting should provide information to help present, potential, and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts (from dividends and interests) and proceeds (from sale, redemption, or maturity of securities and loan).[11]
- Financial reporting should provide information about the economic resources of an enterprise; the claims to those resources; and the effects of transactions, events, and circumstances that change its resources and claim to those resources. This objective encompasses several subsidiary objectives which are:

  i Financial reporting should provide information about financial performance and earnings for a certain period.
  ii Financial reporting should provide information about the factors that may affect an enterprise's liquidity and solvency, with questions about how enterprise obtains and spends cash, borrowing and repayment of loans, and so on.
  iii Financial reporting should provide information about how the management of an enterprise has discharged its stewardship responsibility to stockholders for the use of the resources entrusted to it.

iv Financial reporting should include explanations and interpretations to help users understand the financial information provided.

Objectives of financial reporting by noncommercial organizations

According to Belkaoui, there are several objectives of financial reporting by nonbusiness organizations, which are as follows:

- Financial reporting should provide information to resource providers in making rational decisions about the allocation of resources.
- It should provide information to the present and potential resource providers in assessing the services provided and the ability to provide such services in the future.
- It should provide information for assessing the managers' stewardship functions and other aspects of their performance.
- It should provide information on the performance of the nonbusiness organizations.
- It should provide information on the organization's liquidity.
- It should include explanations and interpretations to help resource providers and other users understand the information provided.

Objectives of financial accounting for Islamic financial institutions

Financial accounting and financial reporting which do not have clear objectives encounter limitations, conflicts, and misleading implementation as proved by human experience. Accounting scholars and practitioners alike have found that process of developing financial accounting standards without establishing objectives leads to inconsistent standards which may not be suitable for the environment in which they are expected to be applied. However, according to AAOIFI, the agreement on the objectives of financial accounting for Islamic banks would achieve many benefits which are as follows:

- The objectives will be used as a guide by the Standards Board for Islamic Banks and Financial Institutions when developing financial accounting standards.[12]
- The objectives will assist Islamic banks, in the absence of accepted accounting standards, in making choices among alternative accounting treatments.
- The objectives will be available as a guide and a regulator of subjective judgment made by management when preparing the financial statements and other financial reports.
- The objectives should increase users' confidence in Islamic banks when properly defined.
- Establishing objectives should lead to the development of accounting standards that are likely to be consistent with each other.[13]

Objectives of financial accounting and reporting for Islamic banks and Conventional Banks

Financial accounting is mainly concerned with providing information in order to assist users in making reasonable decisions. Those who deal with Islamic banks are concerned in the first place with obeying and satisfying Allah in their financial and other dealings as stated in the Qur'an:

> *O ye people! Eat of what is on earth. Lawful and good: and do not follow the footsteps of Evil One, for he is to you an avowed enemy.*
>
> (2: 168)[14]

Mostly, the objectives of financial accounting for other banks have been established in non-Islamic countries. It is natural, therefore, that there should be differences between objectives established for Islamic banks and that of other than Islamic banks. Those differences stem mainly from differences in the objectives of those who need accounting information. However, this does not mean that we should reject all the results of contemporary accounting thought in non-Islamic countries. This is so because there are common objectives between Muslim and non-Muslim users of accounting information such as Muslim and non-Muslim investors share in their desire in order to increase their wealth and to realize acceptable returns on their investments. This is a legitimate desire which has been recognized in *Shari'ah* consistent with Allah (swt)'s saying:

> *It is He who has made the earth manageable for you, so traverse ye through its tracts and enjoy of the sustenance which He furnishes.*
>
> (67: 15)[15]

Furthermore, AAOIFI has suggested other reasons why different objectives of financial accounting should be established for Islamic banks which are:

- Islamic banks must comply with the principles and rules of *Shari'ah* in all their financial and other dealings.
- The functions of Islamic banks are significantly different from those of traditional banks, which have adopted the Western model of banking.
- The relationship between Islamic banks and the parties that deal with them differs from the relationship of those who deal with traditional banks. Unlike traditional banks, Islamic banks do not use interest in their investment and financing transactions, whereas traditional banks borrow and lend money based on interest. Islamic banks mobilize funds through investment accounts based on al-Mudharabah[16] and invest these funds based on al-Mudharabah, profit and loss sharing mechanisms, or deferred payments methods consistent with the *Shari'ah*.

Therefore, accounting standards which have been developed for traditional banks may not be relevant to Islamic banks. Nevertheless, in developing accounting standards for Islamic banks, the Board may be guided by clear objectives and concepts which are appropriate for other banks provided they are in accordance with the principles of *Shari'ah*.

Conclusion

Objectives of financial accounting and financial reports for Islamic banks and financial institutions are very important for transforming financial information into reports for economics decision. The objectives will guide in maintaining compliance with *Shari'ah* perspectives. The flexibility allowed by the accounting convention and the *Shari'ah* in adopting different accounting methods for the treatment of certain issues leads to different results being presented in the financial reporting. As discussed, the information needs of an Islamic society are quite different from those of a capitalist society. However, this does not mean that Islamic banks must come out with different accounting standards for their financial reports. Based on the approach of establishing objectives of financial accounting and financial reporting, the standards set for Islamic banks are from the existing standards and test against the Islamic law. Thus, it proves that Islamic standard is also consistent with the conventional standards because the basic is from the existing standards. Furthermore, the objectives also will assist Islamic banks in making correct decisions and choices. When all the accounting standards are based on the established objectives, the consistency between one and another will itself develop the accounting standards. In addition, the most significant is the true and fair picture of financial accounting and financial reports for both Islamic banks and non-Islamic banks. This is not only to increase users' confidence in the financial reports for Islamic banks and non-Islamic banks, but also it is a must and the basis for the financial reporting. The goal of accounting must be to ensure that the financial reporting rules are consonant with the economic realities on which proper commercial decisions are based. For the Islamic banks, it is surely to be consistent with the *Shari'ah* procedures as mentioned earlier.

Notes

1 Malaysian Accounting Standards Board (MASB) Standard 1, p. 6.
2 Ibid., p. 4.
3 Baydoun and Willett: Islam and Accounting: Ethical Issues in the Presentation of Financial Information, vol. 1, no. 1, 1997, p. 1.
4 Ibid., p. 2.
5 S. Gray, "Towards a Theory of Cultural Influence on the Development of Accounting Systems Internationally," *Abacus*, vol. 24, no. 1 (1988).
6 Al-Qur'an: (2:282).
7 Accounting and Auditing Standards for Islamic Financial Institutions (AAOIFI), p. 24.
8 Ibid.

9 This objective stems from the basic idea behind the existence of Islamic banks and the objectives of those who transact business with them.
10 In fact, the payment of *Zakat* is one of the pillars of Islam and a personal obligation of the Muslim who is financially capable to help the poor and others who are entitled to *Zakat*.
11 This objective stresses on the importance of cash flow information, particularly with respect to predicting future cash flows.
12 This should assure consistency in developing standards.
13 This should increase users' confidence in the financial reports of Islamic banks.
14 Quran, Al- Baqarah, verse 168.
15 Quran, Al- Mulk, verse 15.
16 Sharing of profit between the investor who provides the funds and the bank which provides the effort.

12 Al-Mudharabah investment deposit (fund)

Introduction

In general, al-Mudharabah is a contract in which one party provides capital (*sahib al-maal* or capital provider) and the other party provides work (mudharib or entrepreneur). Here, each party shares profit according to pre-determined profit-sharing ratio. Whereas the loss is borne by the capital provider if there is no misconduct or negligence on behalf of the capital provider. As far as al-Mudharabah investment deposit fund is concerned, it is a type of activity operated by the Islamic banking nowadays. Since Islamic bank acts as an intermediary between depositors who have excess of money and borrowers who are in shortage, the funds deposited by the investment account holders will be managed according to Al-Mudharabah principles by the Islamic bank. In this principle, bank acts as an entrepreneur to invest funds deposited by depositors into profitable ventures, either sales, financing, or investments. Then, the profit derived from the investments will be shared between Islamic bank and the depositors. The profit-sharing ratio must be determined at the time of contract. Other principles of al-Mudharabah are: there must be an offer and acceptance between the depositor and acceptance on behalf of Islamic bank on money deposited. Then, the capital should not be in the form of debt. For example the bank cannot give loan to a person for the purpose of investing the money in al-Mudharabah account.

There are two types of al-Mudharabah, which are restricted al-Mudharabah (al-Mudharabah *al-Moqayyadah*) and unrestricted Al-Mudharabah (al-Mudharabah *al-Mutlaqah*). The first type of al-Mudharabah is known as specific investment, where investment account holders will impose certain restriction on types of investment, where, when, and other project specifications that are supposed to be invested in using their money. The Islamic bank also restricts commingling its own fund with investment account funds for the purpose of investment.[1] The latter type of Al-Mudharabah investment fund is also known as general investment where Islamic bank is allowed to commingle its fund with the fund of investment for the purpose of investment. The bank can invest the fund appropriately on its own discretion without any restriction as to where, how, and for what purpose the fund should be invested. This means that there should be no work interference made by the capital provider. With regards to unrestricted al-Mudharabah,

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the timing or period of investment to maturity period varies according to depositors' preferences and it can be either 1 month, 3 months, 6 months, 9 months, 12 months, 15 months, 18 months, 24 months, 36 months, 48 months, or 60 months which is equivalent to 5 years and more. As far as different periods of maturity are concerned, the longer the period, the more return in terms of profit will be distributed. The purpose is to compensate the depositors for the capital provided.

In practice, the number of al-Mudharabah contracts undertaken in Islamic bank is small because it is a risky contract and it is difficult to find a trustworthy entrepreneur. The main idea is to help the entrepreneur to make money by using capital providers' fund. Thus, it promotes the spirit of brotherhood through profit-sharing contract. The concept of al-Mudharabah contract had been practiced during pre-Islamic era between Prophet Muhammad and Khadijah, where Prophet Muhammad conducted the business while Khadijah was the capital provider. This story of Prophet Muhammad and Khadijah can be read from Chapter 93 (*Ad-Dhuha*), verses 6 to 8 of the holy Qur'an:[2]

> Verse 6: *Did He not find thee an orphan and give thee shelter (and care)?*
> Verse 7: *And He found thee wandering, and He gave thee guidance.*
> Verse 8: *And He found thee in need and made thee independent.*

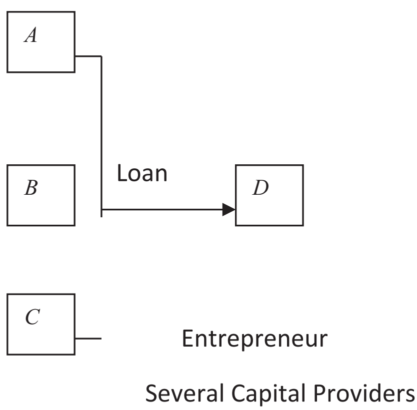
Categories of al-Mudharabah and their relationship with investment accounts

There are four issues or elements to be discussed under this topic, namely multiplicity of al-Mudharabah parties, timing to determine profit, ownership of the funds invested in al-Mudharabah operations, and limits of the *Mudharib*'s actions.[3] There are two types of *al-Mudharabah*: single al-Mudharabah and compound Al-Mudharabah. Single al-Mudharabah or bilateral al-Mudharabah refers to a contract between one mudharib and only one capital provider whereas compound al-Mudharabah, which is commonly used by Islamic bank, is based on multiplicity of parties involved in the contract. It can either be "*several mudharibs and several providers of funds, several mudharibs and a single provider of fund or several providers of funds and a single mudharib*."[4] In modern banking practice, the commonly used terms are multilateral and two-tier al-Mudharabah. The timing of profit determination in al-Mudharabah contract can be classified into two categories that are limited term al-Mudharabah and continuous al-Mudharabah.[5] Profit-sharing ratio between the parties involved must be stated in the al-Mudharabah contract in the form of percentage and not in a fixed amount. In the first category, profit is accounted for at the liquidation of the project or investment. In other words, it will be given in lump sum amount after the project is finished. At that point in time also capital will be returned to the providers of funds. Second, in continuous Al-Mudharabah, profit will be paid periodically during the lifetime of the project invested by the Islamic bank. However, for this type of al-Mudharabah, capital will not be returned to the providers of funds, and it requires mutual consent from all parties involved in the contract to be implemented.

There are two forms of ownership of the funds invested in al-Mudharabah contract. The first category is called non-commingled al-Mudharabah where the invested capital comes from providers of funds only. Another type of ownership is called commingled al-Mudharabah where the invested capital comes from both mudharib and providers of funds while the work is performed by mudharib only. The last issue is pertaining to the limits of mudharib's actions in al-Mudharabah operations. For unrestricted al-Mudharabah, the providers of funds make their own decision and judgment about the investment to be made to mudharib. However, the decision made must be at the best interest of both parties. Conversely, for restricted Al-Mudharabah, providers of funds restrict Mudharib, where the providers of funds specify the project to be invested in. More elaboration on restricted and unrestricted al-Mudharabah will be given in the next section.

Illustration on forms of al-Mudharabah transactions

Multilateral Al-Mudharabah



Re-al-Mudharabah (two tier); in the modern banking system

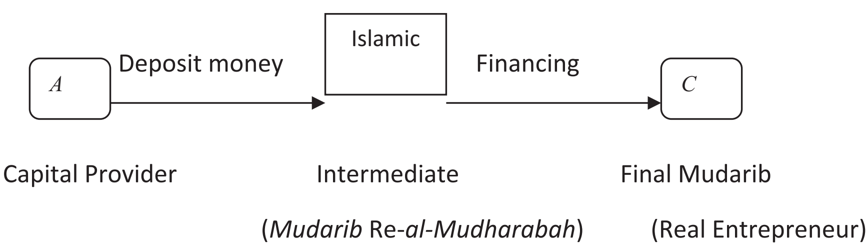


Figure 12.1 Bilateral (Simple) al-Mudharabah

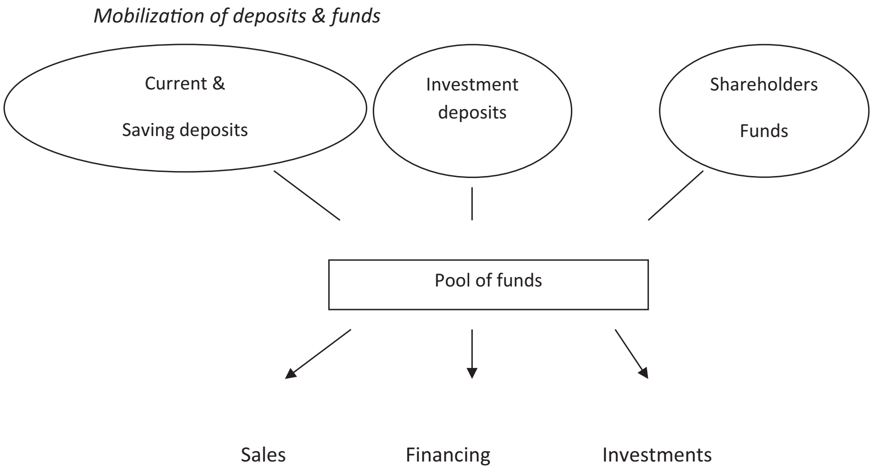


Figure 12.2 Mobilization of Deposits and Funds

Equity of investment account holders and their equivalent

Financial Accounting Standard No. 6 on Equity of Investment Account Holders and Their Equivalent scoped the discussion on the accounting rules with regards to the treatment of funds received by Islamic Bank for investment, whether by Islamic Bank discretion (unrestricted) or subject to certain restriction (restricted).

For unrestricted investment account holders and their equivalent:

- Fund received by the Islamic Bank will be recognized once it is received from depositors. Then, this fund will be recorded in the current account before the Islamic Bank decides to invest the fund after certain date.
- The fund received is then measured by the amount received by the Islamic Bank in terms of monetary value during the time of contracting.
- However, at the end of financial period, the amount is measured at book value. This is to reflect the true value of financial position of the investment.
- For the profit of investment, it must be allocated according to the contribution made by each party, either work or capital contribution.
- In the case of loss incurred during the period, the treatment is done according to situation. If loss incurred is as a result of ordinary course of business, then if the amount of loss is more than distributed profit, the loss must be deducted from the provision for investment loss. Then the remaining loss will be deducted from respective equity share according to parties' contribution. However, if the loss is occurred due to the negligence or misconduct on behalf of Islamic bank, the loss amount will be deducted from the profit of Islamic Bank. If the loss amount is more than the profit shared, the difference is deducted from its equity share or recognized as due from the Islamic Bank.

For restricted investment account and their equivalent technique

- The assets and liability of restricted investment account holders are treated separately from Islamic bank's assets and liability. This is because Islamic Bank is not allowed to commingle the assets or fund owned by depositors with its own fund.
- The equity of investment account holders will be recognized when the Islamic Bank receives it.

Juristic rules of equity of investment account holders and their equivalent

There are several juristic rules of equity of investment holders under Al-Mudharabah contract explained in Financial Accounting Standard No. 6 (FAS No. 6) of AAOIFI under the topic of Equity of Investment Account Holders and Their Equivalent. The equity of investment account holders is used as capital for al-Mudharabah contract between Islamic bank and investment account holders. The investment account holders are the capital providers while Islamic bank is the entrepreneur or mudharib who will invest the capital into profitable ventures. Profits arising from the investment will be shared between them, that is Islamic bank and capital provider according to predetermined profit-sharing ratio. On the other hand, current accounts and other funds received by Islamic bank not based on al-Mudharabah contract are considered from *Shari'ah* perspective as loan from holders. Here, Islamic bank uses the principal of guarantee for all deposits received from those funds. The holders of these accounts have no financial relationship with the holders of investment account and have no right to receive any revenue from investment made by Islamic bank.

Another issue of al-Mudharabah contract stated in FAS No. 6 is to make the contract contingent on a future event where "al-Mudharabah *contract will not become effective until certain possible event in the future has taken place*."[6] For instance, when bank specifies certain amount on the al-Mudharabah fund before it can be invested, until the fund reaches its targeted amount, it cannot be used as capital for any investment by the Islamic bank. In another situation, according to Hanafis and Hanbalis, if there is any addition to the investment fund, the profit to be shared to that additional investment will be deferred to future date. However, this practice is not allowable by Shafis and Malikis. Another issue on a similar case as mentioned before is if one provider of fund enters into al-Mudharabah contract and gives the capital to one Mudharib to be invested, he can add additional amount to be invested together with the first amount on the condition that the profit-sharing ratio specified to the mudharib remains equal for the two amounts.[7]

In addition, deposit received in the unrestricted investment accounts in the current month is allowable to be invested in the following month. In other words, it is not necessary to be used immediately. The same rule applies to restricted investment accounts where the deposit received is kept as in the current account and is guaranteed by the bank before it is used as capital in the investment. In the issue of period of al-Mudharabah contract, majority of jurists are of the opinion that it is inappropriate to specify any time limit to the contract of al-Mudharabah as the contract can be terminated at any time as wished by any party. All *fuqaha* or jurists agree that money can be used in al-Mudharabah contract. On the other hand, only Hanafis allow the use of non-monetary assets as a contribution in al-Mudharabah contract while majority of *fuqaha* do not give approval on this issue. Additionally, the possession of al-Mudharabah funds should be positioned at the disposal of mudharib either in terms of cash or bank transfers to the *mudharib*'s account. It will help the mudharib to use the funds when needed. All the aforementioned issues are discussed in detail in FAS No. 6 of AAOIFI.

Commingling of al-Mudharabah fund

There are two ways to commingle al-Mudharabah fund:

- The first type applies to unrestricted investment accounts where the entrepreneur or mudharib will commingle al-Mudharabah funds received from Islamic bank with his own funds after obtaining consent from the providers of the funds. The first allocation of profit will be between mudharib's funds and the funds of investment account holders. Second, the portion of profit for Islamic bank as another mudharib will be deducted from the share of profit of the investment account holders.[8] This is an example of two-tier al-Mudharabah.
- Second type applies to the commingling of al-Mudharabah funds with each other or multiplicity of providers of funds with one mudharib. The condition for this type of commingling is that the mudharib must be able to invest both funds.[9]

Juristic aspects relating to losses

According to al-Mudharabah contract, mudharib will not bear any portion of losses incurred in the normal conduct of business. On the other hand, the mudharib or entrepreneur must bear the responsibility if the losses are due to his misconduct, negligence, or violation of the terms of the Al-Mudharabah contract. The losses incurred will normally be setting off against profits earned from other transaction, and it shall not be considered as a decrease in the capital of al-Mudharabah.[10]

Disclosure in financial statements

Financial Accounting Standard No. 5 has discussed on Disclosure of Bases for Profit allocation Between Equity Holders and Investment Account Holders. Among the issues involved are discussed as follows.

Unrestricted investment account

For the unrestricted investment account, disclosure should be made in notes relating to significant accounting policies between the owners' equity and investment account holders. It includes:

- Basis in the allocation of profit: This allocation can be determined between parties based on mutual agreement during the contracting period – for example by using weighted average method. The longer period the money is deposited in the account, the more profit allocation will be given.
- For charging expenditure: Expenses must be directly attributable to the investment on al-Mudharabah investment account.
- Charging provisions and the parties that they revert once they are no longer required: According to MASB *i* -1, Islamic financial institutions (IFI) should apply the provision outlined in MASB 3, Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies.[11]
- Total administration expenditure and brief description on the major components that are materially significant: Meaning, the components of administration expenditure should be ranked according to the most important to the least important.
- Percentage for profit allocation in the current financial period: To ensure justice between parties, the profit sharing is not necessarily according to capital contribution ratio. But it is based on their agreement. Normally, the capital provider will receive more portion than the entrepreneur, which is Islamic bank.
- If there is any increase in percentage of profit as mudharib: This is important to be disclosed in the notes to avoid any disputes, after fulfilling certain *Shari'ah* requirements.
- Whether Islamic bank has included any unrestricted investment account in sharing of revenue from operation: For example Islamic bank might use the fund from the investment account holders to perform various operations for the Islamic banks such as sales, financing, and other investments. Therefore, these activities will generate revenues, and it must be disclosed in the notes.
- Whether Islamic bank has included unrestricted investment account in sharing of profit from investment in other types of fund (other than al-Mudharabah contract): For example if there is any investment in *al-Ijarah*, *al-Wadiyah*, and so on by using funds of unrestricted investment account holders.
- If the Islamic bank is unable to utilize all funds available for investment: Disclosure should be made on the possible reasons for the excess of fund available. Maybe it is caused by less financing activity made by the Islamic bank.

Basically, the reason for disclosure by the Islamic bank is to ensure transparency in terms of every action taken by the Islamic bank. Therefore, it will avoid elements of *gharar* or uncertainty in both parties either Islamic bank or depositor.

Restricted investment account

- In allocation of profit.
- Basis for charging provision and parties whom they revert once they no longer required.
- Percentage for profit allocation.

Basically, they are the same as for unrestricted investment account.

Incentive profit

If the profit, either from restricted or unrestricted investment account fund is materially significant, Islamic banks should disclose bases applied to determine the incentive profit.

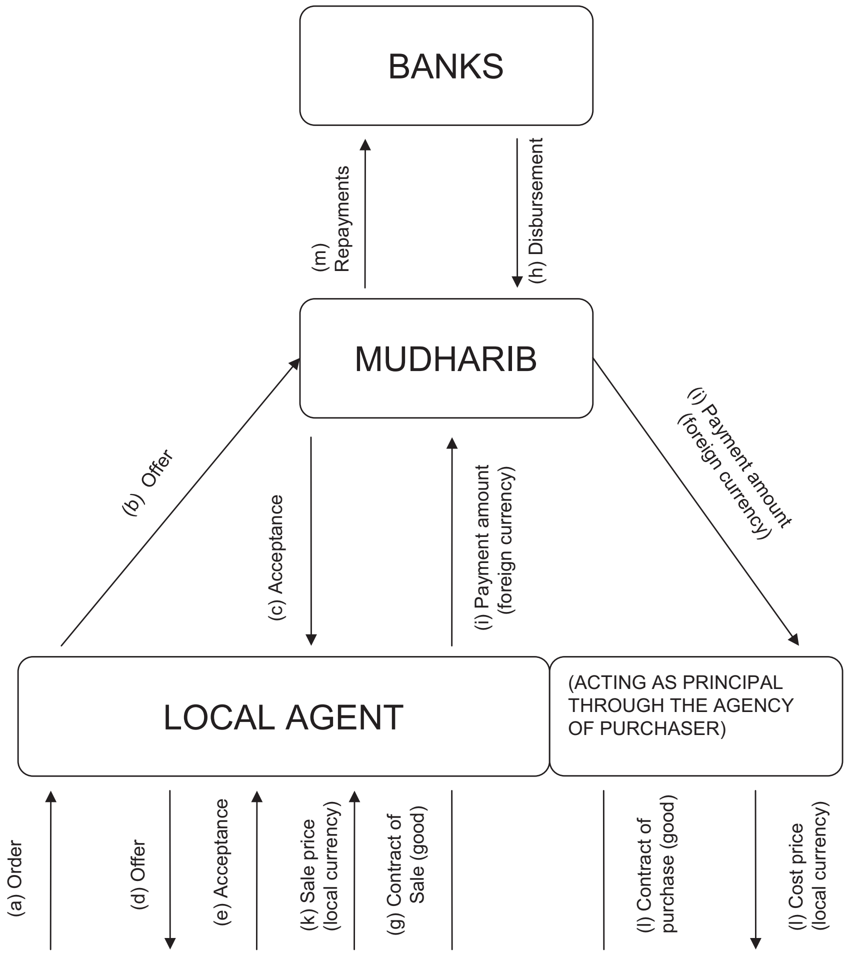


Figure 12.3 Mind-Mapping

General disclosure requirement

According to Financial Accounting Standard No 1 on General Presentation and disclosure in the Financial Statements of Islamic Financial Banks and Financial Institutions, there are many requirements that should be observed, such as disclosure on basic and material information, currency used, and accounting policies.

Conclusion

al-Mudharabah investment deposit (fund) is a type of product offered by Islamic banking. It is a type of partnership between two parties which are depositors (*rabbul-mal*) and entrepreneur (mudharib). The profit will be shared between them according to predetermined profit-sharing ratio, while loss will be borne by the capital provider unless it is due to misconduct or negligence of the mudharib. There are two types of al-Mudharabah that are restricted (al-Mudharabah *al-Moqayyadah*) and unrestricted (al-Mudharabah *al-Mutlaqah*). The distinction between these types of al-Mudharabah is that, for the first type, the rabbul-mal will specify the type of investment and when and where to invest. The bank also cannot commingle its own fund with restricted al-Mudharabah fund. While for the latter, the Islamic bank will invest the money according to its own discretion and the bank can commingle al-Mudharabah fund with another fund. The purpose of al-Mudharabah is to help those who do not have any capital to start up their businesses. Thus, it promotes the spirit of brotherhood. al-Mudharabah is a risky type of investment. Therefore, Islamic bank is not allowed to offer this product. This is because it is difficult to find trustworthy entrepreneur, and if any problem arises, it will affect the bank as well as depositors' money.

Notes

1 FAS6-Equity of Investment Account Holders and Their Equivalent (1993), p. 228.
2 The Holy Quran, Text and Translation.
3 FAS6-Equity of Investment Account Holders and Their Equivalent, p. 221.
4 Ibid.
5 Ibid.
6 Ibid., p. 220.
7 Ibid., p. 223.
8 Ibid.
9 Ibid.
10 Ibid., p. 224.
11 MASB I – 1, Presentation of Financial Statements of Islamic Financial Institutions, para 87.

13 Accounting for *al-Musharakah* venture capital

Introduction

The chapter contributes in analyzing *al-Musharakah* venture capital. *Al-Musharakah* venture capital is an Islamic mode of financing. It is an alternative for the business owner to finance their business. This mode of financing is more suitable for small and medium scale businesses. Although public awareness about this type of financing (*al-Musharakah* venture capital) is limited, but this concept is not a new phenomenon for the users of financing scheme. Nowadays almost every bank provides windows for the Islamic Banking that emphasizes more on non-interest-based banking system. For example Bank Islam Malaysia Berhad, Bank Muamalat, and Maybank provide the alternatives for the user of financing mode. The Association of Merchant Bank in Malaysia believes that through *al-Musharakah* venture capital a small and medium scale company can be nurtured and developed into a large and more sophisticated business.[1] In this chapter, some examples have been derived based on the case study that is appropriate to be used in this chapter. This example is taken either from the Malaysian Islamic Bank that provide this mode of financing or from other foreign countries.

The chapter is also a forecast on whether *al-Musharakah* can be applied and accepted by the public as an alternative for the existent modes of financing. The Government gave its firm support in order to establish the Islamic modes of financing. This will encourage the growth of the enterprises in Malaysia to expand their company nationwide and after that worldwide. This will penetrate export market with more different, innovative, and sophisticated products rather than the usual product being marketed in the community. The income of the Malaysian people will increase as the economics of the country will take a boost. Not much can be said about *al-Musharakah* as it is based on the Islamic concept of mutual co-operation where those who have the capability should help those in need without having any hidden intention beside it. But to be applied in modern world, the concept should be altered a little bit so that it can suit the needs of people nowadays. In a world where we know people would not give anything for free, this kind of financing mode is suitable as the capital provider can also earn benefit. This is far more better than the interest-based modes of financing, as it does not cater to the need of enterprise as although they face losses, they still must pay for the interest.

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But in this venture, the losses are borne together. The chapter may contribute to the need of people who do not understand much of *al-Musharakah* to have a clear view on this subject.

Idea of *al-Musharakah*

Al-Musharakah or *shirkah* means sharing, participating, partaking, or co-partnership. But, legally, *al-Musharakah* means that a property belongs to many owners due to the allotment of shares to them.[2] There are differences of opinions pertaining to the technical meaning of *al-Musharakah*. Hanafi defined *al-Musharakah* as an agreement between two parties who come together to combine their capital and share of profit. On the other hands, Shafi'e viewed that *al-Musharakah* is the right of ownership of something by two or more people.[3] In the sense of business transaction, *al-Musharakah* can be defined as a form of partnership where two or more persons combine either their capital or labor together to share profit and enjoy similar rights and liabilities. As stated in the Qur'an, where prophet Musa asked her brother Harun to be his companion,

> *And make him share my task. That we celebrate thy praise without stint*[4].

From the Islamic point of view, the model of *al-Musharakah* is very close to the venture capital of conventional financial system. Venture capital is a form of active investment through equity-based instruments, and it is very similar to equity financing (*sharikah al-inan*).[5] Although the details of practices of existing venture capital are not consistent with Islamic rules, a few accounting basic principles are reliable to both *al-Musharakah* and conventional of venture capital.

Fundamental characteristics of *al-Musharakah*

Like the other Islamic Financial systems, there are a few conditions that partners of *al-Musharakah* should fulfill. It is necessary to treat *al-Musharakah* as a separate legal entity from the individuality of the shareholders. Thus, partners cannot be held liable for more than the amount of capital they have invested.[6] It also agreed with the conventional effects of incorporation as been stated in the *Salomon v Salomon & Co Ltd*.[7] The case basically explained that although the business's organization and operation was managed by Salomon solely, in law he and the company were separate entities. This distinction is the result of the incorporation of a company, even if one person effectively owns and controls it. Second, all the partners should anticipate to contributing to the capital or management, and this is in agreement with the conventional venture capital concept. In addition, the capital of *al-Musharakah* must consist of money or assets that can be measured with money.[8] It may include plant, machinery, or equipment, and no fixed amount can be imposed to any partners of *al-Musharakah*. The third characteristic of *al-Musharakah* is that at least two or more persons must get involved in the business.[9] Partners should decide how many proportions of profit will be distributed the first time they sign the *al-Musharakah* contract ('*aqd*). On the other hand, if business is suffering losses due to the unintentionally carelessness, partners must borne the losses to the proportion of capital or shares invested. The holy Prophet Muhammad (saw) said:

> *Profit is upon contract agreed and loss is upon capital had invested*[10].

Logically, this is because the partner who holds more shares will be able to pay more losses. Besides, partner who is liable to perform *al-Musharakah* project has the right to do whatever he likes if it is lawful in the eyes of *Shari'ah*. This is different than conventional venture capital where there are no limitations on businesses of casino or liquor for investment purpose. Furthermore, *al-Musharakah* venture capital must be free from any issue of uncertainty (*gharar*).[11] The examples of *gharar* transaction are used the property of company for personal use or make an agreement with the third party without the consent of other partners. If an individual partner commits the aforementioned crime, his responsibility will change from trust to guarantee. Last, the partner can withdraw from *al-Musharakah,* provided he had fulfilled his liabilities as a partner. He also can sell his shares to any person desirous of becoming a shareholder of that company. Apart from that, the contract of an individual partner will be terminated if the partner is dead or becomes insane.[12]

Classes of modern *al-Musharakah* and its conditions

Al-Musharakah is partnership, which is regulated under: partnership rules as being framed by the government[13]

In order to increase the number of participants using *al-Musharakah* venture capital, the government has introduced a new scheme named Public Enterprise Scheme Act 1995. The scheme is particularly about the Government al-Mudharabah and *al-Musharakah* Scheme. This scheme provides rules and guideline to govern the al-Mudharabah and *al-Musharakah* modes of financing. This is in order to protect the small- and medium-scale enterprises, which are the main users of the alternative modes of financing.

Central idea

Nazmi Ghazali in his thesis entitled "Government al-Mudharabah and *al-Musharakah* Shares Scheme" has defined the government *Al-Musharakah* Scheme and its framework.[14] According to him, the *al-Musharakah* Shares Scheme exists when subsist relationship between government and public exists. In this relationship, the government will act as a manager and the majority shareholders, that is the public, act as the minority shareholders. As majority shareholders, government has the authority to manage the company without any interference. The public as a minority shareholder only has the aim of earning profit at its maximum.

How does it operate?

The government will run the enterprise and resume the position as *al-Amil*. The management either will be managed by the government itself or it may delegate it to the other government agency (which will act as *Wakalah* for the government).

Problem faced

The most controversial issue is that there are injustice and unfair distribution of shares. Most of the time, the shares will be distributed among those who have a good relation or a connection with the certain people such as ministers or the Very Important Persons (VIPs) who hold a good governmental position themselves.

Solutions

So, in order to eliminate the problem a new act *Government Investment Act* was introduced in 1983. From an Islamic perspective, we can see that in order to form the public–government enterprise, we should combine for concept of Islamic Muamalah. The four concepts are

- *al-Musharakah*
- al-Mudharabah
- *al-Amanah*
- *al-Hibah*

This will ensure the fair and just distribution of the nation's wealth. Allah's proclaim in one of the verses saying that[15]

Thus, have We made of you an Ummah justly balanced that ye might be witnesses over the nation; And the Apostle a witness over yourselves[16]

Example

The banks that provide this kind of scheme are Bank Islam Malaysia Securities Sdn. Bhd, RHB Securities Sdn. Bhd., and Arab-Malaysia Security Sdn. Bhd.

Business practices as has been prevailing in the business community

Banking

A lot of banks provide windows for Islamic banking modes of financing, and the *al-Musharakah* venture capital is one of the main investment modes introduced by them. A bank may join other entities to set up a joint venture in the various aspects of project in varying degrees.

Central idea

The bank always defines *al-Musharakah* as a profit and loss sharing or a joint venture between the bank and the small- and medium-scale company. This joint venture is in accordance to the agreed profit ratio or markup determined by the bank itself. This can be said as the opportunity lost for the bank as it gave the enterprise money to be used to finance their company. In the event of loss, both the parties will share the losses based on their equity participation.[17]

How does it operate?[18]

The company will ask the bank about its *al-Musharakah* venture capital scheme. Then they will consult the officer on duty about how, when, and what can be done in order to obtain the finance. The officer in charge will do an investigation to see whether they are eligible for the financial investment or not. After that only the bank will reveal how it calculates the markup and the agreed ratio or proportion that it will take.

Problem faced

The public often is confused on how the Islamic Bank determines the agreed ratio or markup and is fearful of the bank of deceit. Hasanuz Zaman in his book[19] mentioned that how bank can claim any competence in trading or entrepreneurship which is necessary for signing *Al-Musharakah* and al-Mudharabah contracts with all the limitations or it can act as the owner of the assets obtained through the joint venture period.

Solutions

A lot of writers in their books have attempted to show that Islamic Banking *al-Musharakah* venture capital scheme is superior as compared to the conventional ways if we see it from different angles and view. The modern shareholders have already adopted this financing mode.[20]

Corporate financing[21]

It has two forms: equity financing and joint venture. In corporate financing, the bank becomes one of the shareholders in the company, which is similar to the other venture capital investment, and selects a relevant and suitable project as the bank will not invest in any business that is inappropriate according to *Riba*' or is based on prohibited products such as liquor and gambling.

Central idea

It is an agreement or contract of partnership where each body contributes capital, and both profit and loss are shared between those parties.

How does it operate?

The other difference is that the bank is represented on the board of the company. The company either is a newly set-up company or an existing company. The selected project is financed by the bank, and the profit and losses are shared based on the pre-agreed ratio and, to be more specific, the losses are according to the percentage held by a specific party in the company. Both parties provide the capital in terms of money or other valuable assets. The bank then gets the result in return in the form of dividend or disposal of shareholdings at the appropriate time. Both parties jointly own the pools of the assets.

Limited company

This type of *al-Musharakah* is governed by the statutory rules framed by the government mainly focused on the commercial activities that are being influenced by the business practices (*'urf*).

Cooperative societies

Cooperative societies are also being governed by the statutory rules, but the commercial activities are influenced by the practices prevailing in the business community. It is almost similar to partnership of a business that prevails in the community.

Principle and computation of profit and loss in *al-Musharakah*

In order to determine the return by Bank Islam Malaysia Berhad's financing, a few policies should be considered, which comprise combining capital and labor by both bank and *Sharikah* (partnership entity).[22] Usually, the main scope of labor that is managed by the bank is bank administration and financial management. But *Sharikah* must display skills, internal control, and its own administration matter. Furthermore, bank will not accept *Sharikah* that contributes only to labor resources without contributing a capital. It is to make sure that *Sharikah* is proved affordable to return the borrowing capital by the bank. At the end, the partner of *Sharikah* will bear all the losses if it is due to his own carelessness or mistake – for instance, he does not find a reliable supplier or does not inspect the quality of the product. This condition makes the partner of *Sharikah* work hard to enjoy the profit in the investment.

An example of *al-Musharakah* financing by bank

A, B, C, and D are depositors that invest their money according to *al-Musharakah* system to enjoy the profit from Islamic Bank. Their deposit amounts are \$ 10000, \$ 20000, \$ 30000, and \$ 40000, respectively. At the end of financial year, bank noticed that their period of savings is 10, 8, 6, and 2 months, respectively. On the other hand, here are the details about investors:

Table 13.1A Examples of *al-Musharakah* Financing by Bank

Project	*Investor*	*Total Investment Amount ($)*	*Investment Rate (%)*	*Profit Rate (%)*	*Profit or Loss*
1	J	$ 10,000	100%	30%	($ 400)
2	K	$ 30,000	50%	50%	$ 4,000
3	L	$ 30,000	40%	20%	($ 3,600)
4	M	$ 80,000	85%	60%	$ 48,000

Table 13.1B Examples of *al-Musharakah* Financing by Bank

Investment Amount ($)					*Investment Rate (%)*		*Profit Rate (%)*		*Loss Amount ($)*			*Profit Amount ($)*		
	Name	*I**	*B**	*Total*	*I*	*B*	*I*	*B*	*I*	*B*	*Total*	*I*	*B*	*Total*
1	J	–	1000	10000	–	100	70	30	–	**400**	400	–	–	–
2	K	15000	15000	30000	50	50	50	50	–	–	–	4000	**4000**	8000
3	L	18000	12000	30000	60	40	80	20	5400	**3600**	9000	–	–	–
4	M	12000	68000	80000	15	75	40	60	–	–	–	32000	**48000**	80000
∑		45000	105000	150000					5400	4000	9400	36000	52000	88000

*I, Investor.
*B, Bank.

Table 13.1A explains that J, K, L, and M invest the total amount that had been agreed by both bank and investors in Islamic Bank. The investment rate is the proportion of capital that had been contributed by bank. It means that the investment rates of investors is 0 percent, 50 percent, 60 percent, and 85 percent, respectively, and profit rate, are 70 percent, 50 percent, 20 percent, and 60 percent, respectively. A computation of distribution of profit and loss between investors and bank is shown in Table 13.1B.

As per previous information in the first project, bank contributes all the capital. Thus, bank will bear all the loss incurred. On the other hands, in the second project, J and bank share an equal profit and loss as they contribute 50 percent of the capital, respectively. In the third project, L and bank bear the losses as the following computation:

$$\text{Investor L bears loss} = 18000/30000 \times 9000 = 5400 \qquad \text{Bank bears loss} = 12000/30000 \times 9000 = 3600$$

Last, in the fourth project, M and bank enjoy the profit as per the following computation:

$$\text{Investor M enjoys profit} = 40 \text{ percent} \times 80000 = 32000 \qquad \text{Bank enjoys profit} = 60 \text{ percent} \times 80000 = 48000$$

Depositors will obtain the return as the transaction shown here:

Table 13.2 Depositors' Transaction

INVESTMENT ACCOUNT			
LOSS-PROJECT 1	400	PROFIT-PROJECT 2	4000
LOSS-PROJECT 3	3600	PROFIT-PROJECT 4	48000
GENERAL & ADMIN	18000		0
BAL C/D	**30000**		
	52000		52000
			0
TO DEPOSITORS	**13929**	BAL B/D	**30000**

Table 13.3 Distribution of Return to Depositors

Depositors	*Dep. Amount ($)*	*Period (Mth)*	*Monthly Dep. Amount ($)*	*Return ($)*
A	10000	10	100000	2679
B	20000	8	160000	4286
C	30000	6	180000	4821
D	40000	2	80000	2143
Total	**100000**		**520000**	**13929**
Bank	50000	12	600000	16071
			1120000	**30000**

It has been noticed that, in the investment account, return on investment is $ 30,000. Thus, we can compute the return to depositors in a computation as shown:

= Monthly deposit amount/
(Total deposit amount + Bank proportion) × Return on investment
Return on A = 100,000/1,120,000 × 30,000
= 2679

According to Table 13.4, we can conclude that *al-Musharakah* financing stood at the lowest level for the prior years 1998 and 2000 compared to other types of investment. We may come out with the question that is it the banking institution that was imposed a tight requirement for the *al-Musharakah* financing or investors were not getting exposed enough with the policies and benefits. As an Islamic finance practitioner, there are few ways to encourage the investors to invest in *al-Musharakah* scheme – first is the advancement in research and development (R&D). When R&D had been accelerated, products and services more by both customers and bankers.[23] In the future, it can be envisioned that not only Muslims but also non-Muslims are indulging in *al-Musharakah* financing as they will be attracted with the systematic system of Islamic financing. Second, an effective legal framework should be implemented to ensure the speed in getting results. As we know, in *al-Musharakah*, the investment risk is more than that of a

Table 13.4 Incentives Toward Enhancement of *al-Musharakah* Financing (Some Past Experiences)

	1997	*1998*	*1999*	*2000*
Bai Bithamin Ajil	$ 1,840,895	$ 2,320,577	$ 2,428,325	$ 2,883,697
Al-Ijarah	$ 132,708	$ 130,129	$ 136,148	$ 279,389
Al-Musharakah	$ 20,464	$ 12,980	$ 20,751	$ 17,517
Al-Mudharabah	$ 18,434	$ 18,468	$ 18,774	$ 219,939
Al-Murabahah	$ 483,823	$ 867,248	$ 1,228,331	$ 1,156,849
Qard al-hasan	$ 24,574	$ 90,323	$ 105,217	$ 210,016
Staff financing	$ 45,174	$ 52,926	$ 56,787	$ 34,711
Total	$ 2,566,072	$ 3,494,649	$ 3,996,332	$ 4,804,118

Source: Annual Report BIMB Holding Berhad 1998 & 2000.

conventional or interest-based bank, thus, it is necessary that interest-free banks or Islamic Banks deal on the basis of a just profit and loss margin.[24] Last, Islamic Banks should initiate the networking in *al-Musharakah* financing. Networking intensive means that Islamic Banks create the market for demand and supply of product within the network.[25] For example BIMB can create its own networking that includes its loyal customer base by providing a special service.

Conclusion

It is thus submitted that *al-Musharakah* venture capital is an alternative mode of financing where two or more persons or parties both jointly can combine their capital or labor together. This joint venture or profit or loss-sharing schemes are established with the view of earning maximum profit. The profit is shared together between the financer of the capital and the owner of the small and medium-sized enterprise based on the ratio that has been agreed by both party before forming the capital venture. However, the losses occurring in the business will be borne in accordance to the portion that they contribute. Fundamental of *al-Musharakah* venture capital should be regarded as a legal entity different from that of the individuality of the shareholders. Second, the partner should contribute something in the venture capital be it in the form of money, assets, or in the form of management and administration. After that the venture capital should consist of two or more person who is together formed the *al-Musharakah* venture capital. Last, the partners should be allowed to withdraw from the *al-Musharakah* venture capital if they had fulfilled their liability and obligation. Types of *al-Musharakah* being applied in the modern days are also talked about in this chapter. They are in forms of partnership, limited company, and cooperative society. These types of *al-Musharakah* are all governed by the certain statutes that are formed by the government to protect the interest of both parties in association with the venture capital. For it to be a success, we also must know about the computation of the profit and loss. As far as we are concerned, the bank will provide capital and labor. The enterprise cannot solely depend on the bank to provide the capital, and they also must contribute their own capital. If not from the very beginning the bank

Warren Edwardes, CEO of Delphi Risk management,[26] said that we should replace the Arabic terminology of *al-Musharakah* as equity financing. Why we must do so? In order to be accepted worldwide, as people who do not know the Arabic would have difficulties in understanding its meaning. Changing the name cannot be associated with changing the Islamic ruling of Islamic financing modes. The *Al-Musharakah* mode of financing should not be neglected as a temporary phenomenon that is being used according to the season.[27] It provides a better framework as compared to the conventional way of financing, as there is no interest being associated with it. As far as we are concerned, some of the small- and medium-sized business are facing difficulties to expand their business, but using the a*l-Musharakah* mode of financing, they can easily obtain money, provided that they really have a good initiative to expand the company. Perhaps, the selected projects being funded should become the responsibility of both parties associated with the *al-Musharakah* venture capital as both the profit and loss depend on them. If they want more profit, then they should work more. If before the bank will have earned interest regardless whether the enterprises are facing loss or profit but now, they also will bear the loss. They will evaluate the project frequently to ensure the progress of the project. *Al-Musharakah* will not only provide the capital to those who need it but also something that appear alongside. Both the involved parties can share their experience and expertise in order to ensure the success of the project. But after all, as many banks are providing the window of alternative modes of financing, they are strictly subject to follow and be in compliance with the *Shari'ah* ruling.

Notes

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2 Sales and Contract in Early Islamic Commercial Law, p. 104.
3 Mudarabah and Musharakah Principle under Shari'ah: A Comparative Study Partnership under English and Malaysian Law, p. 51.
4 Surah Taha: 32–33.
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6 http://www.ibf.com
7 Salomon V A Salomon & Co. Ltd [1897] AC 22.
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9 Lindley LJ in Badaley V Consolidated Bank [1988] 38 Ch.D238, p. 258.
10 Perakaunan Syarikat & Bank Menurut Sistem Islam, p. 70.
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14 Nazmi Ghazali Azmi, *Government Mudharabah and Musharakah Shares Scheme*, Malaysia: IIUM PJ, 1995.
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22 Perakaunan Syarikat & Bank Menurut Islam, p. 229.
23 http://www.cert.com.my/CONTRACT.PDF
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14 Accounting for *al-Murabahah*

Introduction

Al-Murabahah (markup sale by deferred payment) originates from the root word *Rabah* meaning profit. It is also defined as selling commodity for its purchase price plus specified markup price or profit agreed between parties. The markup can be in lump sum or a certain percentage of the purchase price. It also trusts transaction. If the seller is guilty of any deception, the purchaser is free to reject the thing and take the stipulated full price back. This type of sale to the purchase order mentioned under Islamic *Shari'ah* and the basis are from the Qur'an, Hadith, and the scholars.

Types of *al-Murabahah*

The promise of the purchaser in *al-Murabahah* may or may not be binding. *Shari'ah* scholars agree that the purchases should not be bound to fulfill his promise. *Shari'ah* scholars also explain that this does not force the person to sell or to perform acts that are prohibited in Islam. There are two types of *al-Murabahah* that are explained in the next section.

Al-Murabahah ***sale to purchaser with obligation and its rules***

- If purchaser accepts, a valid contract is signed between purchaser and seller. It is a binding mutual promise between them.
- If the seller offers the assets, the purchaser should accept it and establish sale contract.

Al-Murabahah *sale to purchaser without obligation and rules*

- The purchaser asks the other party to buy an asset and promises that he will purchase the asset at a price including markup. This action considered as willingness to buy and not an offer.
- If purchaser accepts its, he proceeds to purchase the asset under valid sale contract between him and seller.

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Condition for *al-Murabahah*

There are five most important conditions that should be satisfied in an *al-Murabahah* sale:

- Purchaser should know the original price of the commodity including all the expenses that were incurred in selling the assets.
- Seller must declare the profit to buyer whether it is a certain fixed amount of money or just a percentage of the original price.
- The first sale must be legitimate from the point of view of *Shari'ah*, and if not, the contract of *Al-Murabahah* will be cancelled.
- If the commodity was damaged by defects, the seller must inform the purchaser, because *al-Murabahah* sale is a sale based on trust, and the seller should not betray his purchaser.
- *Al-Murabahah* is not allowed when associated with *Ribawi* properties. Example if buying commodities that could be measured or weighed should be like for like and on the spot. *al-Murabahah* increase is not allowed. Any increase in *Ribawi* commodities are usury or *Riba*.

Statement of the standard

Scope of the standard

- These conditions are applied to the assets available for sale by *al-Murabahah* – that is the revenue, expense, gain, and losses attributable to the assets.
- Whether Islamic bank buys the assets from its own funds or from restricted investment account.

Accounting treatment of al-Murabahah

Measurement of assets' value or acquisition by Islamic bank:

- Bank purchases the asset desired by purchaser and sells them to the customer at agreed price with specified margin of profit to the bank.
- Payment is settled by the customer at agreed time and either the purchaser is paid in lump sum or in installments.

Measurement of assets' value after acquisition by Islamic Banks:

- Case of *al-Murabahah* where purchaser is obliged to fulfill his promise. Assets should be measured at historical cost. If the assets' value decreased because of damaged or destruction of the assets at the end of the financial period.
- Case of *al-Murabahah* where purchaser is not obliged to fulfill his promise.

If the Islamic Bank finds that is an indication of possible non-recovery of the costs of goods available for sale based on *al-Murabahah*, the assets shall be measured at the cash equivalent value. Creating provision for decline for the asset value that reflect different between acquisition costs and the cash equivalent value.

- Potential discount to be obtained after the acquisition of the assets.
  Discount shall not be considered as revenue for an Islamic Bank, but the costs of the relevant goods shall be valued by the amount of the discount. Consideration should be given on both profit of the period and deferred profit. Discount may be treated as revenue for an Islamic bank if it is decided by the *Shari'ah*. Revenue shall be identified in the income statement.

Al-Murabahah *receivables*

- Either short or long term, *al-Murabahah* shall be recorded at the time of its face value.
- It is measured at the end of financial period at its case equivalent.

Profits' recognition

- Profits are recognized at the time that contracting sale of assets either cash or credit that not more than financial period.
- If on credit sale, it will be paid either by payment due after current financial period or by installments.

Early statement with deduction of a part of profit

- *Deduction of a part of profit at the time of settlement:* If client paid on installment, the Islamic bank may deduct a part of the profit that is agreed between them. It shall be credited to *al-Murabahah* receivable and excluded from the profit recognized in respect of the installment.
- *Deduction of a part of profit after settlement:*
  If a client paid on installment, Islamic bank does not allow the client a deduction of the profit but ask the client to pay in full amount.
- *Procrastination in payment by or insolvency of the client*.
- *Procrastination:* Failure to pay a due debt without having any excuse or being insolvent, that is being a delinquent debtor shall be treated as
  - Revenue to Islamic bank or
  - An allocation to charity fund or
  - Insolvency.
- If *client nonpayment was due to insolvency*, then the Islamic bank cannot ask the client to pay the amount of installment.

Failure of the purchase order to fulfill the promise

Amount paid is considered as an obligation on the Islamic bank and treated as a liability.

- *In the case of non-binding promise*. The amount is returned in full even if the asset is sold to another client at lower price as agreed by the first client.
- *In the case of binding promise*. Amount of loss shall be deducted from *Hamish gedyyah*, as Islamic banks shall not carry any losses. If *Hamish gedyyah* is not adequate or not available, any loss of Islamic bank shall be recorded as amount due from the client.

Disclosure requirements

The bank should disclose in the notes accompanying in the financial statement whether it considers promise made in *al-Murabahah*. The disclosure requirement stated in Financial accounting Standard No. 1: General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions should be observed.

Nature of asset-based financing transactions

Al-Murabahah or *Bai Bithamin Ajil* financing is involving the exchange of goods *as-Salam* and *al-Istisna'*. There are two types of *Al-Murabahah*:

- *Al-Murabahah*.
- *Al-Murabahah* to the Purchase Order.

Al-Murabahah

Al-Murabahah is defined as the sale of goods at cost plus markup which is agreed upon. The seller should inform the buyer of the price at which he purchases the product and stipulate an amount of profit in addition to the cost price in order to protect the buyer.

Nature of *al-Murabahah* to the Purchase Order

Al-Murabahah to the Purchase Order involves three entities, namely, the purchase order, the purchaser, and the seller. It is a sale in which two or more parties negotiate and promise each other to execute an agreement in which the order will ask the buyer to purchase an asset of which the latter will take legal possession. The Purchase Order promises the buyer to purchase the asset from him and give the ordered a profit there on. The parties may conclude the sale after the possession of the ordered asset. However, the purchase order may or may not conclude the sale. *Al-Murabahah* to the Purchase Order involves intermediary due to a lack of expertise or need for credit facility.

Principles of *al-Murabahah* financing

- The cost of capital or financing should be disclosed. There must be a disclosure of mark-up price in *al-Murabahah* financing. In *Bai' Bithamin 'Ajil*, there is no disclosure of mark-up price in the contract, but it is being accepted only by Mazhab of Shafi'e.
- Activities in *al-Murabahah* financing must be free from usury.
- *Al-Murabahah* financing involves a transparency of facilities.
- The orderer or purchaser has the right to have recourse to the seller or cancel the contract. But, in *Bai' Bithamin 'Ajil,* financing the purchaser does not have that much of right.
- The advance payment or deposit is allowed in *al-Murabahah* financing.
- *Al-Murabahah* with obligation to purchase:
    - The customer will bear any risk for nonreceipt of the goods (delivery) if it is a deferred payment sale.
    - In *Bai' Bithamin 'Ajil*, it is involving *Al-Murabahah* to the Purchase Order in which the customer is obliged to purchase.
- *Al-Murabahah* without obligation to purchase:
    - The total risk will be borne by the bank for nondelivery of the goods.

General rules of *al-Murabahah* financing

- Assets can be collateral to the financing amount.
- Early settlement is required if assets have been pledged as collateral.
- Any form of procrastination (failure to pay back) by a solvent debtor such as the purchaser; can be liable for legal actions.
- *Al-Murabahah* financing provides ease of payment to insolvent debtor.
- The bank is prohibited to buy back his asset from the purchaser.
- Any price discount obtained by the bank could benefit the purchaser.

Al-Murabahah financing asset

- Upon acquisition of assets.
- With obligation.
- Asset should be measured at lower of historical cost or impaired value. (Not to over value in order to prudence and protect the purchaser).
- Without obligation.
- Assets should be measured at cash equivalent value. This means that it reflects current value and protects the bank or financier.
- A provision should reflect any decline between the acquisition cost and cash equivalent value.
- Price discount, if obtained after acquisition, should not be treated as revenue but a means to reduce the cost of the relevant goods unless agreed by SSB.
- Upon financing the customer.

- *Al-Murabahah* receivables should be recorded (by the bank) at face value (cash equivalent value) less provision of doubtful debt.

Income recognition of *al-Murabahah* financing assets

- Profits are recognized at time of contracting for cash or credit transaction not exceeding the current financial period.
- If credit period is more than one financial period with a single or several installment payments, the recognition methods are:
    - Accrual basis method.
    - Cash basis method.

Accrual basis method

It recognizes profits based on a proportionate allocation of profits whether cash is received or otherwise.

Cash basis method

It recognizes profits as and when the installments are received and require the approval of SSB. The following are its features:

- Principle of matching expenses with income applies.
- Deferral profits (unearned) shall be offset against *al-Murabahah* receivables in the statement of financial position.
- Settlement amount is based on outstanding financial amount (accrual basis).

Policies on penalty

- Penalty imposed on any procrastination (failure to repay) in payment (mutual agreement or court action) is a form of revenue or allocation to charitable fund.
- In the case of insolvency, the bank has no authority to ask client to pay for a penalty.

Accounting issues

Revenue recognition (expenses)

- IAS (ought to be replaced by IFRS 17 with its implementation in 2023) recognizes revenue even it is not received yet. So, therefore it should be under the accrual basis. For example every month, the bank should recognize an income of \$ 2500[1]; even though it is not surely received.
- AAOIFI[2] argues that revenue should be recognized after it is received. So, therefore it should be under cash basis not the accruals. Mazhab of Shafi'e

follows the same argument. Therefore, BIMB uses cash basis in recognizing the revenue.

Asset recognition (liability)

- IAS (ought to be replaced by IFRS in 2023) argues that bank could not recognize the asset as it is not the real owner of the asset. Instead, the customer is the real owner of the asset.
- However, the customer may also argue that he could not recognize the assets too as the assets will only be in possession after the last installment's payment. But the bank will not look deeper into it as the bank follows the IAS (ought to be replaced by IFRS in 2023) argument. The bank will not bear any risk borne by the customer as the asset is in their possession. This is the first issue why BIMB uses IAS (ought to be replaced by IFRS in 2023) argument in recognizing the assets.

Workings

Islamic Banks provide a financing	– $ 100,000
Rate of return	– 10 percent
Period of payment	– 5 years (annually)
Installment payment	– $ 30,000 per year[3]

Unearned Income for Year 0

= 5($ 30,000) – $ 100,000
= $ 150,000 – $ 100,000
= $ 50,000

Unearned Income for Year 1

= 4[4]($ 30,000) − ($ 100,000 − $ 20,000)[5]
= $ 40,000

Unearned Income for Year 2

= 3($ 30,000) − ($ 80,000[6] − $ 20,000)
= $ 30,000

Table 14.1 Balance Sheet Extract

Year	*Year 0*	*Year 1*	*Year 2*	*Year 3*	*Year 4*	*Year 5*
Monetary unit	*$*	*$*	*$*	*$*	*$*	*$*
Al-Murabahah financing	150,000	120,000	90,000	60,000	30,000	0
Unearned income	(50,000)	(40,000)	(30,000)	(20,000)	(10,000)	0
Net receivables	100,000	80,000	60,000	40,000	20,000	0

Unearned Income for Year 3

= 2($ 30,000) − ($ 60,000 − $ 20,000)
= $ 20,000

Unearned Income for Year 4

= 1($ 30,000) − ($ 40,000 − $ 20,000)
= $ 10,000

Income Statement Extract
Al-Murabahah Income $ 10,000[7]

Table 14.2 Journal Entries

	Descriptions	*Money ($)*
DR	*Al-Murabahah* Financing	150,000
CR	Unearned Income	50,000
	Cash	100,000
DR	Cash	30,000
CR	*Al-Murabahah* Financing	30,000[8]
DR	Unearned Income	10,000
CR	Profit and Loss	10,000[9]

Figure 14.1 Mind-Mapping: *Al-Murabahah* Financing

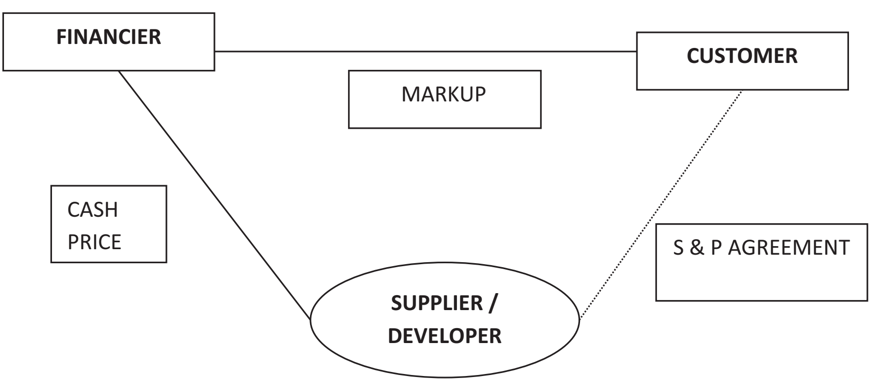

Figure 14.2 Mind-Mapping: *Al-Murabahah* to the Purchase Order

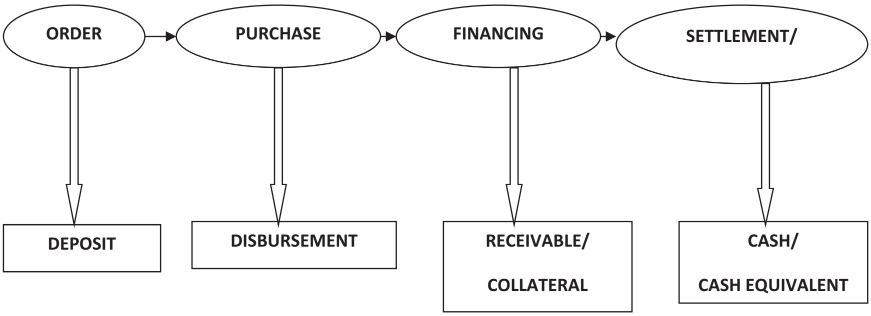

Figure 14.3 Mind-Mapping: Recognition of *al-Murabahah* Financing

Notes

1 \$ 150,000/5 × 12 = \$ 2500. Annual installment payment is \$ 2500 × 12 months = \$ 30,000.
2 Accounting and Auditing Organization for Islamic Financial Institutions.
3 Each year, we pay \$ 20,000 which is from the financing; \$ 100,000 that is amortized over 5 years plus the Murabahah income \$ 10,000. That is why our installment payment each year is \$ 30,000.
4 The number of years will be reduced as we calculate the installment payment for each year.
5 \$ 100,000/5 years = \$ 20,000 in a year (each year \$ 20,000 will be deducted from the balance of amount of financing).
6 The amount of financing of \$ 100,000 reduced by \$ 20,000.
7 10% × \$ 100,000 = \$ 10,000.
8 Each year Murabahah financing: RM 150,000 will be reduced by RM 30,000.
9 Each year unearned income will be reduced by RM 10,000.

15 Accounting for al-Bay Bithaman al-Ajil (BBA) financing (a past experience)

Introduction

The almighty *Allah (swt)* revealed to man on earth with an authentic source of law, that is al-Qur'an and its interpretation *al-Sunnah* (Hadith) as guidance to mankind. Islam is the most complete religion because it governs every aspect of human life, such as social, economics, and politics. In the terms of trade and financial matters, there is a lot of guidance provided in the Qur'an and Hadith. The tremendous changes today need religion experts to interpret the Qur'an and Hadith clearly and in detail, so that the Muslim community can practice the Islamic *Shari'ah* in trade. In the field of trade and finance, Qur'an directed traders to keep records of indebtedness, as a need to demonstrate what business a person has done. Moreover, it also emphasizes on the prohibitions on waste, trading '*haram*' products, unfair trading practices, and so on. Bank or finance company is the most importance part of trade which is responsible in managing the money and finance in trade. In Malaysia, Bank Islam Malaysia Berhad (BIMB) is most famous Islamic bank that provides facilities which is in accordance to the *Shari'ah* principles. In the project financing, BIMB used two methods to finance the acceptable projects which are known as al-Mudharabah and *al-Musharaka*. For property financing, BIMB applied the principles of *Al-Murabahah, Bai Bithaman Ajil, Al-Ijarah,* and *Qard al-Hassan*.

Hence, we are going to be focused on the principle of *Bai Bithaman Ajil*. *Bai Bithaman Ajil* (BBA) is defined as a deferred payment sale, whereby the Bank will finance customers who wish to acquire an asset but want to defer the payment for the asset for a specific period or want to pay by installments. The concept of *Bai Bithaman Ajil* is that the bank purchases the asset first and then subsequently sells the relevant asset to the customer at a price, which comprises the actual costs along with the profit margin.

Rational outlook of BBA financing

BBA principle of financing is the most common type of Islamic financing as people can afford to buy a house, land, consumer goods, and other things on cash terms. Basically, bank or finance company utilizes BBA to provide customers with medium- and long-term financing to acquire items such as the following:

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- Houses and shop lots
- Land
- Motor vehicles
- Consumer goods
- Shares
- Overdraft facility
- Education financing package
- Personal financing
- Other acceptable or Halal goods

The contract of financing can also be utilized for refinancing an asset for the purpose of redemption, construction, renovation, or other purposes, and the assets to be financed must be lawful.[1] Unlawful assets are forbidden by Islam, as in Hadith of Al-Bukhari it is mentioned that: "*Allah and His Prophet has forbidden the trade of liquor, which dies of itself, swine and idols*" (Bukhari). Therefore, financing premises that involve selling the liquor is forbidden in Islam.

Application of BBA

Under BBA principle, the finance company or bank will purchase the assets that is requested by the customer (refer to Figure 15.1A) at a cost price and then sell it to the customer at a selling price – cost price plus profit margin (refer to Figure 15.1B). The selling price shall be agreed upon by both parties, that is customer and the finance company/bank and will remain unchanged until the end of the repayment period. The customer can defer the repayment of the selling price until a certain period installment basis. The fixed total monthly installments are determined by the selling price and the repayment period. The assets purchased in this agreement will be under the finance company's or bank's claim and will be handed over to the customer upon full payment due.

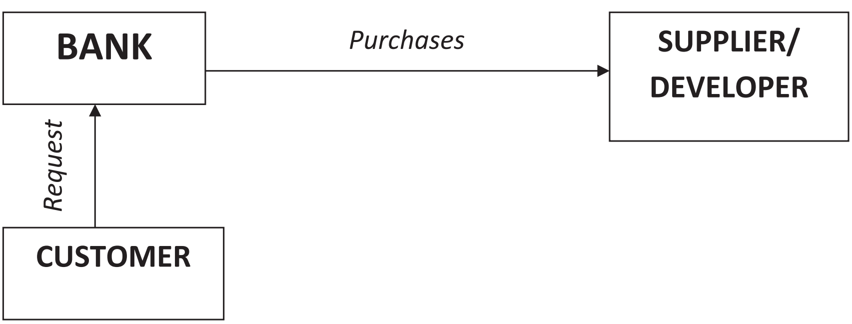

Figure 15.1A Mind-Mapping 1

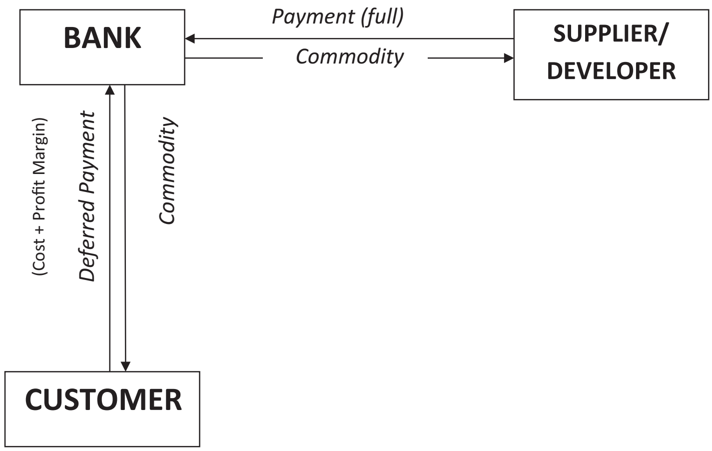

Figure 15.1B Mind-Mapping 2

Types of BBA financing

The Islamic financing based on *Bai Bithaman Ajil* principles enables financing for the following purposes:

- House financing facility, which may be extended for the purchase of a new house, an existing completed house, for building a house on the customer's land, renovations, or as a refinancing facility;
- Financing for the acquisition of immovable assets such as landed properties and movable assets such as machineries and transport equipment. The facility may also be extended to finance working capital requirement of the company by way of refinancing of assets.

The general concepts involve the finance company or bank purchasing the asset and resell the asset to the customer within the stipulated terms including selling price, period of financing, repayment amount, repayment frequency, and grace period.

BBA home financing

BBA Home Financing is advisable for homebuyers who prefer fixed and equal monthly installments. Fixed payment means that the customers know exactly how much they need to pay throughout the tenure, whether by a single installment sum or in-line with the multi-tiered rates. It is useful for those working on a monthly budget. Practically, in the contract of BBA, the bank sells the house to the customer at a mark-up price, which consists of the cost price plus a profit margin that is to be paid over a specified financing period, for example 15 years.

The contract of BBA should not include the sale transaction between bank and the developer. It should be separated from the BBA contract since the bank is supposed to purchase the house from the developer and claim the legal ownership of the house before it is put on for sale. Thus, the BBA contract should only deal with the installment sale between the bank and the customer. The process of BBA home financing is started from the identification of a house or property by the customer who wishes to purchase that house. Then, the bank or finance company will determine the requirement of the customer in relation to the financing period and amount of repayment. After being approved, the bank will purchase the specified house or property from the developer. Subsequently, bank sells the house or property to the customer at an agreed price, which constitute the actual cost of the house or property and the profit margin[2] of the bank. The customer needs to make the repayment by equal monthly installments throughout the specific financing period. BBA home financing is open to both Muslims and non-Muslims, and it can be applied by individuals who are aged 18 and above but do not exceed 60 years of age at the end of the financing period. The applicant must be a Malaysian citizen or a permanent resident of Malaysia with monthly income at least three times that of the monthly repayment. If the application is by more than one person, the joint applicants are allowed involving the immediate family members.[3]

BBA home financing-I

The new feature under GPS is that the customers can buy their ideal house which ordinarily they may not afford. But they can buy the property based on their

Table 15.1 Standard BBA Home Financing

Tenor	*Profit Rate*	*Financing Tenor*	*Margin of Financing*
Year 1	2.88%	Up to 30 years or age 60, whichever is earlier	90% without MT/HBT/MRTA*
Year 2	6.5%		95% with MT/HBT/MRTA*
Years 3–10	7.50%		
Years 11–20	8.00%		
Years 21–30	8.50%		

Note: The rates are irrespective of property price and only applicable until December 31, 2003.[4]

Table 15.2 BBA Financing Graduated Payment Scheme (GPS)

Tenor	*Profit Rate*	*Financing Tenor*	*Margin of Financing*
Up to 10 years	Single rate:	Up to 30 years or age 60, whichever is earlier	90% without MT/HBT/MRTA*
Up to 20 years	7.50%		95% with MT/HBT/MRTA*[5]
Up to 30 years	8.00%		
	8.50%		

Table 15.3 BBA Home Financing (Experience)

Types of Properties	*Profit Rate*	*Financing Tenor*	*Margin of Financing*
Shop house (Irrespective of value) 1. Completed properties 2. Under Construction (selected projects)	• Own Occupation 1st year – 4.25% 2nd year – 6.00% Thereafter – 7.75% • Investment 9.00%	• Individual Up to 20 years • Company Up to 15 years	• Own Occupation 80% • Investment 70%
Vacant Bungalow Lot (Irrespective of value)	9.50%	Up to 10 years	65%
Construction of Bungalow	Per rates applicable for residential properties under BBA Home Financing-i	Up to 30 years or age 60, whichever is earlier	80%

current income. Under GPS, it is recognized that the customer's income is going to grow in the future by giving higher margin of financing for their property at a fixed rate for 30 years. The initial installment[6] is subject to an annual increment of between 1 percent and 5 percent.

Properties financing

The thereafter profit rate for shop house is always to be calculated based on 50 basis points above BLR + 1.25 percent. For shop houses Under Construction in other projects end financing by the Bank not deemed eligible for the new profit rates, the profit rate is 9.00 percent for both own occupation and investment properties.

BBA vehicles financing

In the contract of vehicles' financing, the condition for the type of vehicle is a new passenger vehicle that includes cars, multi-purpose and four-wheel drive vehicles. The margin for financing national and nonnational models of vehicles is 90 percent. Individuals aged 18 years and above can apply to this financing, and he/she must have a stable and fixed income. This is important for ensuring that the applicants make the installment payment when it comes due. As the vehicle is a movable asset, the non-Malaysian citizen can afford to apply to this kind of financing. The repayment period has a limitation for 84 months, and there is a rebate for an early settlement of the repayment. Profit margin might be competitive or fixed and net. There is no security deposit applied, and there is fast approval with additional comprehensive Takaful (Islamic insurance) coverage. These are the benefits of BBA vehicle financing.

Calculation in BBA financing

Selling price

There will be two calculations for selling price.

Contracted selling price

- This is the maximum selling price quoted in the offer letter.

Actual selling price

- This actual selling price is calculated based on the prevailing profit rate.
- This option may be used for staff financing as well as floating rate financing.

Therefore, the difference between the "contracted" monthly installment (calculated based on the contracted Selling Price) and the "actual" monthly installment (calculated based on the Actual Selling Price) is the monthly rebate.

Margin of profit

The system will determine the margin of profit by taking into account the period of financing, the pattern of disbursement, and the mode of repayments. This enables the Bank to quote the selling price to the customer.

Computation of installment

The computation of installment will be based on the required Constant Rate of Return (CRR), cost of financing (i.e. principal amount), period of financing, frequency of repayments (i.e. monthly, quarterly, half-yearly, or annually) as well as grace period, if any.

Grace Period Profit (GPP)

The system caters for grace period profit for progressive release financing. Three methods of calculation are provided, which are given here.

Average financing amount

GPP = Cost of Financed × Rate × Grace Period (in years) × 2

- Drawdown Schedule

  The calculation of GPP will be based on the drawdown schedule

- Full Financing Amount

  GPP = Cost of Financing × Rate × Grace Period (in years)

Legal documentations of BBA

BBA legal documentation must reflect the true nature of sale (*al-bay*') contract. The terms and conditions of *al-bay'* such as the purchase and selling prices, the rights and duties of a seller and buyer, and consideration must be included. Any uncertainties about the principles of a sale contract can cause a contract to be rendered null and void. Likewise, the terminologies used in the sale contract must reflect the rules and principles governing it; expressions such as loan and fixed returns must be strictly avoided. The main purpose of a sale contract is to transfer ownership from the seller to the buyer. As such, this is the basic consideration that the buyer is getting in return to the money he has paid to the seller. The ownership should be unqualified; any attempts to qualify it could make the sale contract invalid at the option of the buyer. In addition, seller and buyer should be liable to each other, and they must comply with their respective rights and obligations. *Shari'ah* advocates the principle of equal bargaining power whereby all the contracting parties are deemed to be equal at the eyes of *Allah (swt)* and the transaction they are involved in. As such, legal documentation should be able to translate all the principles of *al-bay'* in conformity to *Shari'ah*. The rule of construing and interpreting the provision must be obvious and clear.

There are three legal documentations of BBA financing in Malaysia which are:

- Property Purchase Agreement (PPA)
- Property Sale Agreement (PSA)
- Charge Document (Form 16A and Annexure)

PPA is the agreement between the supplier or developer and bank wherein the bank purchase the property from the supplier for the purpose of immediately thereafter selling the same property to the customer upon deferred terms under the *Shari'ah* principles of BBA. The PPA provides that:

- The customer is the beneficial owner of the property pursuant to the Sale and Purchase Agreement.
- In pursuance thereof the Bank agrees to sell, the customer agrees to purchase the property subject to the terms and conditions herein contained.

PSA is the agreement that is executed immediately after the execution of PPA to reflect the act of reselling the same property to the customer upon deferred payment (cost plus profit margin). This agreement also states that the bank is fully covered and in a secured position. Charge Document (Form 16A and Annexure) is an agreement made between the bank and the customer whereby the latter agrees to assign all his rights and interest over the property to the former as a security for the financing granted.

Advantages of *Bai Bithaman Ajil* (BBA)

Financing

- The total cost of the property purchased is determined as the time of contract or "*Aqad*"
- There are no additional elements of uncertainties of *Gharar* (which is an exchange in which there are elements of deception either through ignorance of goods, the price, or through faulty description of the goods).

- Customer will know exactly when the financing will end, so that he/she can make a budget out of their financial position.
- There will be no compounding of arrears and penalty charges; this will reduce the burden of the poor.
- The repayment is not subject to fluctuation, and it is fixed throughout the financial period.
- BBA allows for a better financial planning.

Conclusion

Currently, many types of financing are provided in every bank or finance companies. It is a better practice for Muslim investor or consumer to finance in Islamic way by using the BBA financing that is provided in the bank, which provides Islamic banking system. Islam prohibits the Muslims to be involved in *Riba, Gharar, Misir,* and so on. The Conventional Bank finances their customer with interest payment which contradicts with Islamic financing. The holy Qur'an condemns in the terms: "*Those who devour usury will not stand except as one whom the Evil One by his touch has driven to madness. That is because they say, 'Trade is like usury' but Allah has permitted trade and forbidden usury*" (al-Qur'an 2:275–276). The Conventional Bank charges interest to a customer, and the customer is willing to pay for it. Both are considered involved in *Riba*, and both are considered sins. In Malaysia, Bank Islam Malaysia Berhad (BIMB) and Bank Muamalat are Islamic banks that provide BBA financing to Muslims as well as the non-Muslims. Thus, Muslims should take the opportunities to avoid paying interest by using the Islamic system as provided by the Islamic banks.

Notes

1 Lawful means goods that are allowed in Islam which is Halal. Financing forbidden (Haram) services/goods such as construction of casinos, massage centre, and pub are strictly illegal.
2 The profit margin is varying according to the value and type of the house or property.
3 Immediate family members are such as spouse, father, mother, son, daughter, brother, sister, and sister in-laws.
4 www.maybank2u.com.my/business/other_services/islamic_banking/maybank/bba_financing_rates.shtml
5 * Mortgage Takaful/Homebuilding Takaful/Mortgage Reducing Term Assurance,
6 Initial installment should at least cover the monthly profit.

16 Accounting for *al-Ijarah*

Introduction

> *The mothers shall give suck to their children for two whole years, (that is) for those (parents) who desire to complete the term of suckling, but the father of the child shall bear the cost of the mother's food and clothing on a reasonable basis. No person shall have a burden laid on him greater than he can bear. No mother shall be treated unfairly on account of her child, nor father on account of his child. And on the (father's) heir is incumbent the like of that (which was incumbent on the father). If they both decide on weaning, by mutual consent, and after due consultation, there is no sin on them. And if you decide on a foster suckling-mother for your children, there is no sin on you, provided you pay (the mother) what you agreed (to give her) on reasonable basis. And fear Allah and know that Allah is All-Seer of what you do.*
>
> (*al-Qur'an* 2:233)

This verse of al-Qur'an is one of the verses related to the basis of *al-Ijarah* financing. Thus, the idea of *Al-Ijarah* financing can be derived from this verse. By assuming foster-mother as service provider (wet-nurse) who gives something to gain something, that is rent. Therefore, *al-Ijarah* financing is not a new term that we can hear nowadays, but it had already been practiced during the period of Prophet Muhammad (saw) and Companions. The concept of *Al-Ijarah* had being applied since long time ago. The basic idea and its concept are quite similar with leasing, which had been in practice to this modern day. Basically, this concept of financing focuses on two counter parties that are involved in transferring the benefit with an exchange of payment. For example when a person acquires an expensive fixed asset in order to continue his business, this concept of financing becomes very useful. As an illustration, Encik Ahmad wants to buy car, and he knows that he cannot give full price for that car at one time. By using this concept, he now can get the car with certain payment and duration. Regarding this, there was a Hadith about *Al-Ijarah* financing:

> *Narrated Muhayyisah ibn Ka'b: Muhayyisah asked permission of the Apostle of Allah (peace be upon him) regarding hire of the cupper, but he forbade*

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> *him. He kept on asking his permission, and at last he said to him: Feed your watering camel with it and feed your slave with it.*[1]

Again, men were born with the fault of forgetfulness. Hence, this concept became forgotten from time to time due to our negligence. Therefore, the objective of doing this research and chapter are to calculate and integrate back the teaching of Islam, as we believe that Islam is perfect and governs all aspects of life. This chapter covers the concept of *al-Ijarah*. Finally, it is hoped that at least this chapter can give some basic understanding and explanation about the topic that been discussed. We hope this chapter becomes very useful in order to get the information and knowledge about the topic based on our understanding in relating with *Shari'ah*.

Central idea of *al-Ijarah* financing

Understanding al-Ijarah

Basically, *al-Ijarah* mean giving something, whether in term of benefit of good or services, on rent. It is referred to the amount paid to a person in consideration of the services rendered by him/her or rent on benefit of the good. This form of *al-Ijarah* includes every transaction where someone else hires the services of a person. It may be a doctor, a lawyer, a teacher, or any other person who can render some valuable services. For example a manager hires an employee; the employee gets payment known as salary due to their job for that manager. Professional workers such as auditors gain revenue from their service by auditing the financial statement of a company under other people. To differentiate, person who paid for services is known as '*Musta'jir*' and the person who received payment is called "*Ajir"* in Islamic terms.[2] Not only services, this concept also can be used for transaction between two parties where one party gives good for its benefit and the counter party has to pay the rent for that benefit. The lessor is called "*Murj,"* the lessee is called "*Mustajir*", and the rent payable to the lessor is called "*Ujrah*."[3] For example Ali gives car to Abu for certain time of period. In return, Abu gives some payment to Ali as consideration for getting benefits by using that car.

In the context of Islamic banking, *Al-Ijarah* can be defined as a process by which "*usufruct of a particular property is transferred to another person in exchange for a rent claimed from him or her*." In many respects, *Al-Ijarah* resembles leasing as it is practiced in today's commercial world.

Conditions of *al-Ijarah* financing

To be in consonance with the principles of Islamic finance governing financial transactions, every *al-Ijarah* transaction must meet these conditions:

- The object leased must not be perishable or consumable. The subject matter must be durable. For example a car, which can be used for ride.
- The subject of the contract must actually and legally be attainable.

- The lessee must ensure that the asset is used for the purpose it is made for. The lessee shall comply with the provisions of the contract. The lessee also shall not benefit from the asset in a way more than what has been agreed upon. Other than off agreement shall not appear unless get permission from its owner. For example in agreement, the car was supposedly to be used as riding vehicle, but the lessee had used it as a delivering vehicle.
- The lease contract must state the lease period clearly.
- The rental must be money. The lease rent falls due from the receipt of the asset by the lessee, not the date the contract is signed.
- The amount and timing of the lease payments should be agreed in advance. However, the agreed schedule and amount of those payments need not be specific.
- It is permissible for the two parties to agree during the lease period to review the lease period or the rental or both – for example the agreement between Singapore and Malaysia on water agreement.
- The asset for lease should be fully identified by the parties.
- The lessor bears the liabilities when leasing the asset such as damage to the asset.

Phenomenon of *al-Ijarah* financing

An important feature of financial leases is that after the expiry of the lease period, the corpus of the leased asset is normally transferred to the lessee.[4] The corpus here means the ownership. If the lessor already recovers any cost with an additional profit thereon the lessor has no further interest in the leased asset. The arrangements of *al-Ijarah* potential for securitization may help create a secondary market for the financiers based on *al-Ijarah*. As quoted by Muhammad al-Bashir Muhammad al-Amine, Ph.D scholar at IIUM, "*al-Ijarah* bond, on the other hand are securities of equal denomination of each issue, representing physical durable assets that are tied to an *al-Ijarah* contract as defined by *Shari'ah*."[5] For example to elucidate on this matter, Proton was producing cars, but the machine to make the car was got by using money from investment of the shareholders. Even if the money was got from shareholders, it does not mean that the shareholders owned that machine.

As the lessor in *al-Ijarah* owns the leased asset, the assets can be sold in whole or in part to a third party. This party would then purchase it and replace the seller in the rights and obligations of the lessor about the purchased aspect of the asset. This is the practicality of '*Al-Ijarah* wa iqtina' concept. This concept is based on two conditions:

- The agreement on separate agreement.
- The promise by unilateral not by both sides: '*Al-Ijarah wa iqtina'* approved that when the term of leasing was already done with, it can be continued as sale product or as a gift to the lessor but by another contract and not by the same contract. The promise should be highlighted by one party, usually by

the lessee. For example Ali leased the car from Abu. Ali wants to use it for a couple of months for delivering. After the term ended, Ali gives back the car to Abu, and this time Abu wants to make a new agreement with Ali. Abu makes suggestion to sell the car to Ali with a new contract. Ali agreed that the new contract will be valid.

Termination of the *al-Ijarah* financing

In this scope, the termination of the contract could be arrived at from many different perspectives. The contract could be terminated by either party or it can be happening because of the subject matter itself. If the lessee breaches any term of the agreement, the lessor has a right to terminate the lease contract unilaterally. However, if there is no contravention on the part of the lessee, the lease cannot be terminated without mutual consent, like for example if there is no more benefit received from the asset leased. The leased contract also can be terminated because of the contract itself, for example the option by the lessee stated in that contract. For example the contract stated that the owner of the house can terminate the contract after 2 years without any reason. If the lessor had paid the rent, the lessee must give back the balance from that amount. This concept contradicts with the *Shari'ah*, but it is being used because it needs to protect the asset and lessee's position from paying any contingent to the lessor – as an example the car with depreciation. The second condition why the contract can be terminated could be because of the subject matter itself. For example A rents the house beside the hill. Suddenly, the house collapsed, as a result, it is permissible for that contract to be terminated, and it is automatically terminated because there is no more benefit from that asset can be received by the lessor.

Benefit of lessor and lessee in *Al-Ijarah* financing

There is a lot of benefit the lessor and lessee can gain from the leasing or *al-Ijarah* financing system. The two situations can be described here. The first situation is where the employer receives the services of a person with exchange of wages given to him as a consideration for his hired services. In the first situation of *al-Ijarah* financing, the employer is called '*Mustajir*' and the employee is called '*Ajir*'. For example Siti is the owner of his company or '*Mustajir*', and she has employed Ali (*Ajir*) as an account clerk and he receives wages by services given to Siti. The second situation is where the usufruct of a particular property is removed to another person in exchange for rent claimed. In other words, it means the property or asset remains in the ownership of lessor (*Mujir*), and the lessee (*Mustajir*) can enjoy the usufruct of the property. The rent of the property or assets can be fixed when the total cost that incurred in the purchase of these assets is calculated and added to the agreed profit margin. For example the company A leases a photostat machine from company B, and company B demands a rent for $ 2,000 per month. The amount includes the cost and the profit of the leasing.

All the liabilities emerging from the ownership shall be borne by the lessor, but the liabilities referable to the use of the property shall be borne by the lessee.

The leased asset shall remain in the risk of the lessor throughout the lease period. Any harm or loss caused by factors beyond the control of the lessee shall also be borne by the lessor. However, the lessee is liable to compensate the lessor for any damage to the asset caused by any misuse or negligence on the part of the lessee. The lessor cannot increase the rent unilaterally, and any agreement to this effect is void. The rent or any part thereof may be paid in advance before beginning of the lease, and the amount collected by the lessor shall remain as 'on account' payment and shall be adjusted toward the rent after it is due. However, the determination of rental on the basis of the aggregate cost incurred in the purchase of the asset by the lessor, as normally done in financial leases, is permissible according to the rules of *Shari'ah*, but it is only applicable if both parties agree and all other conditions of a valid lease prescribed by the *Shari'ah* are fully adhered to. The lease period shall commence from the date on which the leased asset has been delivered to the lessee. If the leased asset no longer is functional for what it was leased out as, the lease shall be terminated on the day on which such loss has been caused. However, if the loss is caused by the misuse or by the negligence of the lessee, then the liability for compensation for the depreciated value of the asset falls onto the lessee.

In long-term lease agreements, there are two options that shall be followed:

- To contract the lease with a condition that the rent shall be increased according to a specified proportion (e.g., 5 percent) after a specified period (e.g., 1 year).
- To contract the lease for a shorter period, after which the parties can renew the lease on new terms by mutual consent. When both parties have full liberty to refuse the renewal, the lessee is bound to leave the leased property and return it back to the lessor.

If the lessee contravenes any term of the agreement, the lessor has a right to terminate the lease contract unilaterally. However, if there is no contravention on the part of the lessee, the lease cannot be terminated without mutual consent. In some agreements of the 'financial lease', the lessor has unrestricted power to terminate the lease unilaterally according to his sole judgment. This is contrary to the principles of *Shari'ah* and the principles of equity and justice. The logical consequence of the termination of lease is that the asset should be returned to the lessor. Similarly, in some such agreements a condition to the effect that in case of the termination of lease, even at the option of the lessor, the lessee shall pay the rent of the remaining lease period, has been found. The lessee should pay the rent due up to the date of termination. If the termination has been affected due to the misuse or negligence on the part of the lessee, the lessee should compensate the lessor for the loss caused by such misuse or negligence. According to the principles of *Shari'ah*, the asset shall be the sole property of the lessor. After expiry of the lease period, the lessor shall be at liberty to take the asset back or to renew the lease or to lease it out to another party or sell it to the lessee. If after the lease period expires, the lessor wishes to give the asset to the lessee as a gift or to sell it to him, he can do so by his free will. However, the lessee cannot force that the asset is sold on at a nominal price or can such a condition be imposed on the lessor in the lease agreement. The leased property can be sold to a third party by the lessor, establishing a relationship of lessor and lessee between the new owner and the lessee. If the lessor, after entering *al-Ijarah*, wishes to recover the cost of purchase of the asset with a profit thereon, the leased asset wholly or partly can be sold onto either to one party or to several individuals. As the asset is already leased to the lessee, the lease will remain with the new owners, while each holder of the *al-Ijarah* certificate will have a right to enjoy a part of the rent according to the proportion of ownership in the asset.

Some issues

Determination of the rental or leasing

Rent or leasing is determined at the time of contract for whole period.

Example 1

A house was rented for 5 years. For first year, the rent for that house was $ 2,000. For the subsequent years, the rental was increased by 10 percent as compared to the previous year. All these conditions were stated in the agreement.[6] From an Islamic perspective, this agreement was valid because i) it was stated in the agreement and ii) there was certainty about the payment condition. Logically, why the rental keeps increasing is because the purchasing power of the money would not be same in year 1 as compared with year 5.

Example 2

We have same situation as the first one. But this time, the condition of payment changes: for the first year, the rent was still $ 2,000 and for the rest of the payment was to be a fixed amount until the owner determines a new rate (optional due to the owner). In Islamic terms, this type of contract is void because there was uncertainty in this agreement (*Gharar*) in term of i) period and ii) rate of payment. Nowadays, this is happening. Due to this reason, people tend to give the reason that they must do it because of an increasing of cost for living.

Financial leasing

Today, people know about the Islamic banking. One of the products they provide is financial leasing in accordance with the *Shari'ah*.[7] In *Shari'ah*, the income over the leasing should be fixed due to the product. The rate that Islamic Bank charges to the lender should be fixed, for example 4 percent fixed for 1 year. As for illustration, A wants to take loan from the bank. The Conventional Bank charges based lending rate (BLR) plus 2 percent for their interest payment as for their profit. The Islamic Banking charges fixed 5 percent rate for their profit. Due to *Shari'ah*, when there is uncertain (*gharar*) in the agreement, the contract is void. The reason behind this is that the uncertainty will make either each party hard to perform the transaction completely. From this illustration, if A adopts the system from Conventional Bank, the payment of interest will be uncertain because based lending rate (BLR) will follow the interest rate. Interest rate will not always be in fixed condition, and it always fluctuates from time to time. For example if the interest rate increases, that means the BLR also will increase, price of money will go down, and for that result A must pay more. If this happen, it is hard for A to pay. It only gives benefit to the lender if the interest rate was decreasing. But if A adopts Islamic Banking system, A already knows the rate he must pay to the bank.

Comparison with conventional financing

As we mentioned about *Al-Ijarah* financing in the previous page, we can see that *al-Ijarah* financing is different from conventional leasing. It is because *al-Ijarah* is treated in the Islamic teaching where it is accepted by the rule of *Shari'ah*. Meanwhile, the conventional leasing does not follow the rule of *Shari'ah*. Here, we will show how different the *Al-Ijarah* is from conventional leasing. According to the article about *al-Ijarah* in *www.islamic-finance.com*, it represents an exchange transaction in which a known benefit arising from a specified asset is made available in return for a payment but where the ownership of the asset itself is not transferred. *Al-Ijarah* contract is essentially of the same design as an installment leasing agreement. Where fixed assets are the subject of the lease which can return to the lessor at the end of the lease period, in which case the lease takes on the features of an operating lease, and thus only a part amortization of the leased asset's value results. In an alternative approach, the lessee can agree at the outset to buy the asset at the end of the lease period in which case the lease takes on the nature of a hire purchase known as *Al-Ijarah* wa iqtina (literally, lease, and ownership). Some jurists do not permit this latter arrangement on the basis that it represents a guaranteed financial return at the outset to the lessor, in much the same way as a modern interest-based finance lease. The terms of *al-Ijarah* are flexible enough to be applied to the hiring of an employee by an employer in return for a rent that is a fixed wage. Some generally agreed conditions for *al-Ijarah* are as follows:

- The leased item should be transferred to the lessee on completion of the lease agreement and should be of a condition that is fit for performance of the required tasks. The lessor should transfer the leased items to the lessee in their completed form.
- The usufruct of the leased item should have value.

- The amount and timing of the lease payments should be agreed in advance, though the agreed schedule and amount of those payments need not be uniform.
- The lease payment schedule becomes active upon complete acquisition of the usufruct of the leased goods, whether such usufruct is in fact enjoyed by the lessor or not.
- The period of the lease must be specified.
- The conditions of usage of the leased items must be stated.
- The lessor must have full possession and legal ownership of the asset prior to leasing it.
- The leased asset must continue to exist throughout the term of the lease. Items which are consumed in the process of usage, ammunition for instance, cannot be leased.

In contrast with most conventional finance leases, the responsibility for maintenance and insurance of the leased item under *al-Ijarah* remains with that of the lessor throughout. Then the price cannot be predetermined for the sale of the asset at the expiry of the lease. However, lessor and lessee may agree about the continuation of the lease or the sale of the leased asset to the lessee under a new agreement at the end of the initial lease period. In the event of late payment of rental, *al-Ijarah* may be terminated immediately. The lessor may claim compensation for any damage caused to the leased assets as a result of negligence on the part of the lessee.

Conclusion

After a long discussion about this topic, obviously we can see that *al-Ijarah* financing really gives an option to our present economic situation. By its own unique concept, condition, and benefits, *al-Ijarah* financing offers better method of financing. Besides that, *al-Ijarah* financing offers an easy way to be adopted and doesn't burden any side of parties. Again, this refers to its main objective, which focuses on helping any parties who face difficulties. The changing situation of the time of the Companions with ours calls for a great systemization of application and extension of the details about this topic in order to implement back in our current economic situation. It is an advantage for us, as our country pays a lot of attention in order to bring back the values of Islam, realizing that the teaching of Islam is not only suitable for the Muslim but also for the non-Muslim. Besides that, Islamic economy also receives large number of demands from the non-Muslims as they also feel very comfortable with the way the economy is being practiced and are attracted to the profit that they will receive at the end. In the end, this chapter suggested that detailed research about this topic need to be done. In addition, the commitments from the Muslims themselves play a significant role in order to support the Islamic economy and making sure that *al-Ijarah* financing is successful.

Notes

1 www.usc.edu/dept/MSA/fundamentals/hadithsunnah/abudawud/0.23.sat.html – wages (kitab al-ijarah).
2 www.usc.edu/dept/MSA/fundamentals/hadithsunnah/abudawud/0.23.sat.html
3 Ibid.
4 Accounting for Islamic Banks, Department of Accounting, ENMS, IIUM, *Ijarah and Ijarah Muntahia Bittamleek*, 1998, p. 259.
5 www.islamic-finance.net
6 www.usc.edu/dept/MSA/fundamentals/hadithsunnah/abudawud/0.23.sat.html
7 Ibid.

17 Accounting for *al-Wakalah* financial arrangement

Introduction

Al-Wakalah (agency) is known as one of Islamic modes or instruments which are used mostly in dealing with economic and business transactions and contracts. Later, we can see the use of *al-Wakalah* in the contracts of *al-Ijarah thumma al-bai'*, *al-Murabahah*, and *al-bai' bithaman ajil*.

Disposition of wakill (agent)

In sale and purchase contract

- *Al-Mutlaqah* (unlimited): Scholars are in different views on the issue. Hanafi school views that, the agents are in liberty to act while majority of the schools rule out that, the agents shall follow the common practice.
- *Al-Muqayyadah* (limited): agent abides by the limitation.
- Acting against the limit will hold the disposition, pending on the approval of the principal agent.

In brokerage deal

- Act of dealing as a mediator between two parties in sale and purchase
- Normally the sale/purchase conducted in auction
- The fee is based on Ju'alah (reward) where it is paid after the completion of the mediating process.

Al-Murabahah (mark up sale by deferred payment)

Al-Murabahah is the contract sale between one party and another party for the sale of good at a price and profit agreed by the both parties. As a financing technique, the client requests financer to purchase the good. Then the client purchases the good from financer with price and markup. The manner of payment is stated in the agreement – for example installment. *Al-Murabahah* is the frequently used instrument to finance purchases of goods or equipment. It is used in

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similar circumstances in Conventional Bank loans for the purchase of goods or equipment.

The stages of the *al-Murabahah* transactions are as follows:

- Purchaser submits order to local agent for required goods.
- Local agent informs mudharib about the principal of the proposal.
- Mudharib agrees to finance the purchase of proposed goods or equipment.
- Local agent passes the information through an offer.
- Purchaser accepts the offer through a contract to purchase the goods or equipment.
- Acting through the purchaser, the local agent buys the good or equipment from supplier.
- The purchaser acting for itself buys goods or equipment from the local agent.
- Banks make their contribution to the *mudharib*.
- Mudharib passes the funds to the local agent.
- Local agent pays the supplier.

Many of these steps are done simultaneously. The transaction is completed until the repayment to the bank by mudharib is done between 6 and 12 months.

- The purchaser then pays the deferred sale prices, being the purchase plus costs, to the local agent as agent to mudharib.
- The local agent pays the amount, deducting its fees to the *mudharib*.
- The mudharib sends to the bank the term of *al-Murabahah* agreement.

Next, this chapter will indulge into the trade of financing instruments offered by bank that uses the combination of *wakalah* and *al-Murabahah* contracts.

Letter of credit[1]

The letter of credit (LC) is used to facilitate local or foreign purchases of material and equipment. A deferred sale contract, which is *al-Murabahah,* can be applied to this instrument. Here, the bank as the wakeel issues the LC and purchases the goods from supplier using their funds. Then the goods are sold to the purchaser who pays the deferred price which he will pay by installment or in a lump sum. The bank gets the profit from the difference of selling price and cost price of the goods. The bank determines the selling price by markup from the cost price. The formula is:

Markup + (cost of goods × profit rate per month × number of months) /100
Selling price + cost of goods + mark-up.

Bankers' acceptance or Islamic Accepted Bills (IAB)[2]

The bank is appointed by the customer as agent (wakeel) to purchase goods at the cost the payment is guaranteed by bank through proper documentation. The bank sells the goods to customer where the credit should be paid at a certain time, for example 100 days. Selling price is:

Selling price = Cost of goods + (cost of goods × annual of profit × tenor)/36500

Then the bank draws the bill to customer who gets the bill at the mark-up price. The bank can sell the bill to a third party at a price not less than cost price based on *ba'y al-dayn* contract. In the case of *al-Murabahah*, the relationship between *al-Murabahah* and *wakalah* instruments exists. It is because the purchaser represents the bank or someone to purchase goods by his money. Then, the purchaser buys the goods from the wakeel at the mark-up price.

Bai-Bithaman Ajil financing (BBA) – *a past experience*

BBA is the most popular instrument in Malaysian Islamic banking. It is a deferred sales contract similar to *al-Murabahah*, the payment being done by installments. BBA is applied in almost all the financial instruments which involve customer and trade financing. It is an important component in corporate finance for the issuance of Islamic debt securities. BBA still fulfills the principles and condition of a sale contract, which consist of wakeel of contract, the objective of contract, the object of contract, and offer and acceptance. In spot sale, the price refers to the current market price, but in BBA, the offer price includes the element of time. It is because the payment is made in future time. The Islamic jurists agree to set credit price higher than the current market price. So, the profits generated from BBA follow the *Shari'ah* law, because it is derived from trade rather than debt. In the BBA sales, no loan is offered to the customer. Instead, the bank purchases the property direct from the developer or vendor at the current market price. Then, bank sells it back to the customer at the mark-up price. The determination of selling price is dependent on the bank annual profit. When the rate of profit and period of financing is specified, the selling price is calculated by using annuity factor table.

> *Those who devour usury will not stand except as stands one whom the evil one by his touch hath driven to madness. That is because they say: trade and forbidden usury. Those who after receiving direction from their Lord, desist, shall be pardoned for the past; their chase is for Allah (to judge); but those who repeat (the offence) are companions of the fire; there will abide therein (forever).*
>
> (al-Baqarah:275)

BBA is the alternative to the conventional loan. It is because BBA offer the fixed rate of charges compared to the conventional loan use the volatile rate. The Islamic banking should improve BBA. This is because the loan rate incurred in Malaysia is lower. So, the demand for BBA will decrease, and Bank Negara Malaysia should take on their role to inform the way of Islamic financing and how BBA can best serve consumers. The BNM only focuses on banking while the issue of consumer welfare takes a backseat. Islam desires to protect public interest, and consumer welfare must be given equal consideration. Today, the rate of financing in Malaysia is low, so in the future we have two possibilities where the rate either will go up or go down. When the people expect the rate to fall, they prefer conventional loan as it will save their money. The BBA demand will down. If the rates go up, the demand of BBA is up. Islamic bank should reduce the dependency on BBA and try to introduce new product(s) which can eliminate the loss from the volatile interest rate movement.

Calculation for BBA (*past experience*)

For example

Present value = \$ 1000
Monthly interest = 10 percent / 12 = 0.8333 percent
N = 36
Payment = \$ 32.27

(0.8333 percent × 1000)

Table 17.1A Calculation for BBA (Past Experience)

Period	*Beg. Bal.*	*Payment (Pmt)*	*Interest*	*Principal*	*End. Bal.*
1	1000.00	32.27	8.33	23.94	976.06
2	967.06	32.27	8.13	24.14	957.92
3	957.92	32.27	7.93	24.34	927.58

(1000–23.94)

Islamic Banking:

Present value = \$ 1000
Monthly Profit Rate = 10 percent /12 = 0.8333 percent
N = 36
Payment = \$ 32.27

Table 17.1B Calculation for BBA (Past Experience)

Period	*Begin. Bal.*	*Pmt*	*Profit*	*Profit Bal.*	*Principal*	*End. Bal.*
0	0			161.72		1000
1	1000.00	32.27	8.33	153.39	23.94	976.06
2	976.06	32.27	8.13	145.16	24.14	951.92
3	951.92	32.27	7.93	137.13	24.31	927.31

The BBA financing uses *wakalah* instrument for their services. The concept of BBA is same as the *al-Murabahah* in which someone represents purchaser to buy goods, and then purchaser buys it from representative. But the difference is that while *al-Murabahah* is used for the short-term financing, BBA is used for long-term financing.

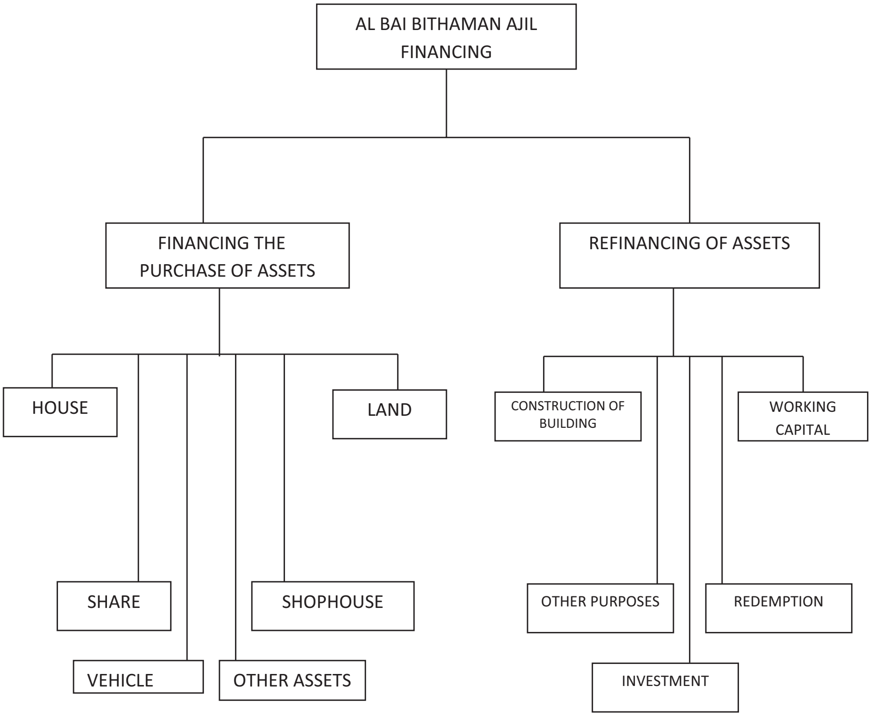

Figure 17.1 Al-Bai Bithaman Ajil Structure (Past Experience)[3]

Further analysis of *al-Ijarah*[4]

In Fiqh, *al-Ijarah* means “to give something on rent.” Literally, *al-Ijarah* means substitute, compensation, recompense, indemnity, consideration, return, or counter-value. Technically, it has different meanings according to different schools of laws. According to Hanafi school of law, it means contract of benefits with return or exchange. According to the school of Shafie, it is a contract of determined permissible benefits which are known to be utilized where it is allowed with return/exchange. Whereas according to Maliki and Hanbali schools, it is a contract of possessing benefits of something permissible in known period with return or exchange.

Normally, consumer will seek bank financing to purchase a car or any related goods and do a hire-purchase agreement with the bank. In this agreement, the term and charges (interest payable by hire) are calculated as if the transaction is based on a facility or debt agreement where the element of *Riba*’ is implicated. For Muslims, *Riba*’ is prohibited as *Allah (swt)* mentions in the Qur’an*,” Allah has made trade or commerce lawful but made Riba’ unlawful*” (al-Baqarah: 275). So, an alternative to the conventional hire-purchase, a commercial contract in

Islam known as *al-Ijarah* or leasing is used. However, *al-Ijarah* alone may not be an accurate contract as an alternative to conventional hire-purchase, and as alternative, Islamic jurists today have introduced an Islamic version on hire-purchase known as *al-Ijarah thumma al-bai'* (AITAB) or leasing ending with sale.

AITAB is a contract of lease with an obligation on the part of the lessee to buy the asset. It also can be used to describe the process of converting an *Al-Ijarah* contract into a sale contract. Transactions in AITAB involves the following steps:

- The bank will purchase the product, for example a car from the dealer.
- Later, the bank will lease the car to the customer according to the term and conditions specifying market rental values and leasing period.
- Customer will make lease payments to the bank according to the agreement.
- The transfer of ownership from the bank to the customer exercises the option to buy the goods.

In the contract, the customer acts as an agent for the bank to take the car from the car dealer after the bank has purchased the car. Later, the customer must pay the leasing amount as what he has agreed to the bank, and at the end of the leasing period, the ownership of the car will be transferred to the customer.

Conclusion

The instrument of *wakalah* is popularly used in trade financing. This instrument is always used by banks to finance their customers to purchase something from someone. *Al-Murabahah*, BBA, and *al-Ijarah thumma al-bai* are the examples of Islamic instruments which use *wakalah* in their process. *Wakalah* instrument can help people who do not have any links to purchase goods to represent someone who has the link and experience to perform the transaction process on behalf of them.

Notes

1 Saiful Azhar Rosly, *Islamic Project Financing in Malaysia*, Kuala Lumpur: IIUM Printing, n.d.
2 Ibid.
3 Saiful Azhar Rosly, *Al-Bai-Bithaman Ajil Financing: Impacts on Islamic Banking Performance*, Kuala Lumpur: IIUM Printing, 1997.
4 Sharif, *Fiqh for Economist II*.

18 Accounting for *Al-Rahn* financial arrangement

Introduction

From the linguistic point of view, *Ar-rahn* is derived from an Arabic word which means stable and permanent. Technically, four Islamic schools (Shafie, Hanafi, Maliki, and Hambali) have some slight differences in interpreting *Ar-rahnu*. According to Shafie, it means, "*Making physical wealth security of debts in case the debts are unable to be settled*." However, as per Hanafi, "*Detention of something due to rights where right fulfilling the right can be fulfilled or obtained from it*." Hambali its interpretation as, "*Ar-rahnu happened when wealth which is used as security of debts in cases the debts is unable to be settled*." And according to Maliki, it means something financial taken from the owner, which is used as security in the actual debt.[1] From the perspective of Islamic law, when someone gives his property that is moveable or immovable and can be sold as security to his debt, it is called *Ar-rahn*. According to The Mejelle, *Ar-Rahn* was defined as, "to make property a security in respect of right of claim, the payment in full of which from that property is permitted."[2] Whereas, under civil law system, when a person gives his moveable property (chattel) to another person for some valid reason, it is said to have a contract called bailment. But if a person gives his chattels due to security of payments, the contract is called pledge. Otherwise, if he gives immovable property (like land), it is considered as a mortgage.[3] As a conclusion,

> *Ar-rahnu* is the principle, which refers to something that you own (such as gold ornaments) used as a surety against a loan. In practice, the bank will retain the gold as collateral, charging for safekeeping service. The gold will be valued at the current market price. The bank will give a loan which represent the amount that slightly lower than the market value of the gold. The safekeeping period is predetermined and agreed by both parties. At the end of this period, the borrower must repay the loan to the bank and the collateral reclaimed. No interest is charged, but if the loan is not repaid within the agreed period, the bank retains the right to seize or hold the gold used as collateral.
>
> (Shan Saeed, 2003)[4]

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Basis of *Ar-Rahnu*

There are a few verses in al-Qur'an that mention about *Ar-Rahnu* or Islamic pawn broking. For example *Allah (swt)* said in al-Qur'an 2: 283:

> *If ye are journey, and cannot find a scribe, a pledge with possession (may serve the purpose). And if one of ye deposits a thing on trust with another, let the trustee (faithfully) discharge his trust, and let him fear his Lord. Conceal not evidence; or whoever conceals it, his heart is tainted with sin. And God knoweth all that ye do.*

In a Hadith, narrated by Aisyah (r.a.), *the Prophet was reported to have some foodstuff on credit from a vendor and had mortgaged his armour for it.*[5]

From the aforementioned sources, which are from al-Qur'an and Hadith, it is clearly agreed between Islamic scholars that *Ar-Rahn* is not an obligatory, but it is an acceptable and recommendable instrument.

Contract of *Ar-Rahnu*

In order to understand *Ar-Rahn*, one needs to know the terms used in the contract. There are terms like:[6]

Marhun/Rehn	:	The property being pledged.
Rahin	:	The person who gives a rehn (pledgor)
Murtahin	:	The person who takes a rehn (pledgee)
'Adl	:	The person with whom the pledgor and pledge have deposited and delivered the pledge.

How does it work? First, to make *Ar-Rahn* contract become valid, there must be an offer of an acceptance made by both parties of pledgor and pledgee. But the pledgor has the right to cancel of the contract if the property being pledged (*rehn*) is not transferred to pledgee yet. Second, there must be an existence of '*aqd* between pledgor and pledgee and it must be done in words as evidence to an agreement. For instance, if the pledgor said, "*I give this thing as pledge to my debt*", the pledgee will reply, "*I have accepted*."

And there is no requirement of pledgor or pledgee to state the word "rehn" to make this contract to be valid. This means that the contract can be extended as long as both parties have the intention and say the '*aqad* using their own words. For example if someone buys something in a bulk, he gives the seller his property and says "keep this thing until your money is paid," and automatically the property is considered as a pledge. To make it become easier to be understood, let us go through to the complete example given here.

Hamad has a financial problem and needs immediate cash in order to overcome his problem. Then he goes to the bank to borrow some money. As he does not have a permanent job, he is not able to take a loan as the bank is not sure about

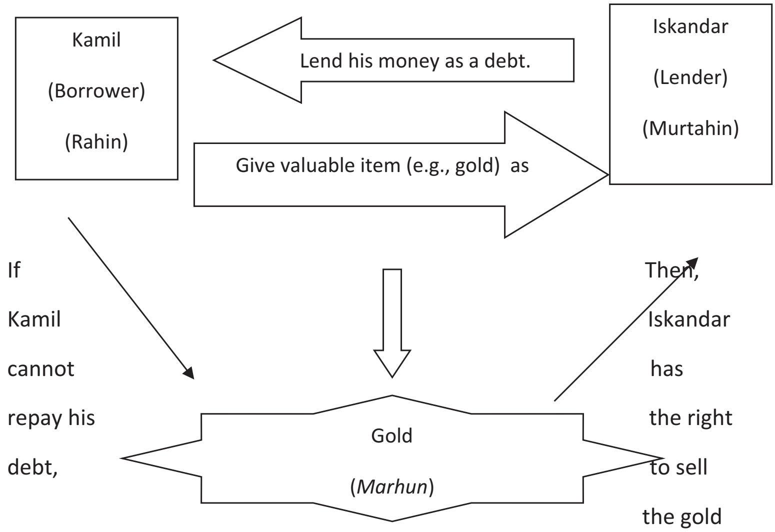

Figure 18.1 Mind-Mapping

his ability to repay back the loan. Then, the bank officer asks him whether he has any valuable property like gold ornaments, land, or house because if he does, he can take a loan under *Ar-rahnu* (pawn broking) scheme. Let us say, if he has gold worth $ 60,000, he will get a loan which is less than RM 60,000 (let us consider it is $ 50,000). Then, the bank will provide him information about the terms and conditions about the repayment period and other related matters. After it has been agreed by both parties, then the contract is said to be concluded. But, if Hamad cannot repay his debt during the agreed period, the bank has the right to sell the gold in order to settle his debt after receiving an approval from the court. Any surplus amount got after deducting his debt will be returned to him.[7]

Conditions for the validity of the contract

In order to perform an *Ar-Rahnu* transaction, there are some conditions and guidelines that need to be followed by the performers. First, related to the performers of Ar-Rahn, both rahin and murtahin must be able to take correct decisions (have good sound of mind) but not necessarily to be baligh. Therefore, children who are mumaiyiz can do and accept Ar-Rahn contract. Second, the pawned object must be capable of being sold and exist at the time of contract. In the other word, it must be valuable and can be handed over within the agreed time.

Pledge as security (*Marhun*)

According to what *fuqaha* already has agreed, the conditions related to *Marhum* are equivalent to conditions related to things that can be sold. It is believed that the pledge will be disposed to settle the principal amount after a given time. Abdul Halim El-Muhammady in his book, entitled *Undang-undang Muamalat and Aplikasinya kepada produk-produk Perbankan Islam*, states the terms of *Marhum*:

> The subject matter must exist and is able to deliver.
> It is a valuable thing, not a dead animal.
> The pledge must be known clearly by both parties.
> The pledge itself must be free from any rights.
> The pledge item must be won by pledgor.

But there are different opinions among scholars about the ability of the non-owner in making pledge. According to Hanafi, it is valid to pledge other's property without permission. For example the contract is valid if the father pledges his son's property. Unlike Hanafi, Shafie and Hambali have a different view, which state that it is not permissible to make a pledge by having or involving other people's property. According to a book entitled *the Mejelle*, it is stated that the pledged properties also include the things that are not mentioned. For instance, if a building site is pledged to you, automatically all fruits and trees and the things planted and sown are included in *Ar-Rahn* contract. Furthermore, it is quite sometimes that we face the situations where we need to back the thing being pledged for any reason like in emergency or we love that thing very much. For example you have pledged your necklace to pledgee and after sometime you informed him/her to exchange the necklace with other diamonds. Here, the exchange between one pledge and another is allowed. If someone finds that the amount of pledge is not enough, there are two ways that one can increase the value of debt.

Increase the thing pledged

It is permitted to do so even after the agreement is signed up. The additional things are still attached to original contract as we assume that the contract represents two things.

Increase of debt-allowance

For instance, consider that you pledge your necklace worth RM 50,000 to secure your debt of $ 25,000. Here, you can increase the debt up to RM 50,000 only with condition that the increase is secured by the pledge.

Essence of *Ar-Rahnu* product

There are advantages of *Al-Rahn* as compared to the others (conventional systems or other financing products in the markets). After doing research in this topic, we find that *Ar-Rahnu* has a good future and prospect in banking products not only in Malaysia but throughout the world. Our belief and assumption are not simply because we support the Islamic products blindly due to our religion, which is Islam, but it was cemented by our knowledge which was gained through the reading process. First, as compared to conventional pawnshop, Islamic pawnshop only charge a minimum cost (due to safe keeping) because this scheme is more like a charitable concept rather than commercial, which helps needy people who need immediate cash. But it was not neglecting the rights of pawnbroker to get the benefit from this transaction. As far as conventional system is concerned, it charges a high interest rate even up to 2 percent per month or 24 percent annually. As the customers of this product are mostly from the low-income bracket, the figure of the interest rate can be considered as high enough and will not overcome their financial problem in the future. As for the basic calculation in experiencing of *Al-Rahnu* product offered by Bank Rakyat, it is stated that if the pawned value is $ 1666.67 and the borrower got the loan amount of $ 1000.00, the fee/charge is RM8.33 per month. This means that one needs to pay the principal amount of owing (of which the total has been spread over the period agreed by both parties) along with the fee for every month until the duration is over. For conventional pawnshop, if someone gets the loan amount of $ 1000.00, he needs to pay the interest (let's say it charges for 2 percent) which amounts to $ 20.00. Therefore, the borrower needs to pay the amount owing plus the interest for every month.

In mathematical equation form, it can be seen like this:

$$\text{Monthly payment}\left(\text{Islamic pawnbroking scheme}\right)=\frac{\left(\$1000+\$8.33\right)}{y}$$

$$\text{Monthly payment}\left(\text{conventional pawnbroking scheme}\right)=\frac{\left(\$1000+\$20.00\right)}{y}$$

Given that y = repayment period.

The example given before might differ due to formula adopted by each pawnbroker.

Based on the calculation given before, it was proven that conventional pawnshop charges high interest rate, while Islamic pawnshop only charges for an amount that rises due to safekeeping. The second advantage that can be gained by doing *Ar-Rahnu* transaction is in term of cash amount that would be given based on the value of pawned items. In *Ar-rahnu* scheme, most of the pawnbrokers offer a high amount of cash (even up to 60 percent as offered by Bank Rakyat nowadays) while under the conventional scheme, usually it gives lower amount as compared to Islamic scheme. For example if you bring your gold that has the market value of $ 1666.67, under *Ar-rahnu* scheme, you are eligible to get cash of value of $ 1000 (60 percent × $ 1666.67). But you might get lesser than $ 1000 if you bring the same gold to the conventional pawnshop. Third, if the borrower fails to repay his/her debts within the repayment period, under *Ar-Rahnu* scheme, the pawnbroker has the right to sell the pawned item, but he must take only the balance of debt amount. Any gain or surplus after the deduction of debt must be returned to the borrower. But if someone is having a transaction under conventional system, the pawned items will totally belong to the pawnbroker (he/she has the right to hold or sell the item), and any gain after deducting the debts will not be given back to the borrower. Let us say Ali needs to pay back $ 1,000 to the pawnbroker. But, under some circumstances he cannot pay back his debt. Before this, he has settled a portion of his debt amounting to $ 800. Based on this case, if the pawnbroker sells the pawned item with the selling price of $ 500, under *Ar-rahnu* scheme, Ali will get back $ 300 [$ 500 – ($ 1000 – $ 800)]. But, under the conventional scheme, Ali will not get anything. Another advantage of *Ar-rahnu* is that it helps a Muslim who has an intention to run a business but is lacking in capital. *Ar-Rahnu* gives immediate cash without any delay in processing time.[8] If we look at the economic perspective, *Ar-Rahnu* encourages Muslims in running their business because if we look at the scenarios in Malaysia today, most of Muslim businessmen are having trouble in gaining their capital even though it is an important and critical element in the business world. As a conclusion, we can say that the Islamic scheme gives more advantages as compared to conventional system. Conventional system seems to be rejecting benefitting other people and tries to manipulate the profit individually. It always creates chaos in society, and it was proved by statistical data compiled by Bahagian Pengawasan Dan Penguatkuasaan, KPKT in 2002, which mentioned about some problems due to conventional pawnshop system.

Customer reports of past experiences

Customer report was received by Pawnshop License Department of Malaysia for the year 2002[9].

Therefore, by looking at the advantages of *Ar-rahnu*, we are sure that *Ar-rahnu* has a bright future and prospect in order to compete with other banking products not only in Malaysia but also in the world.

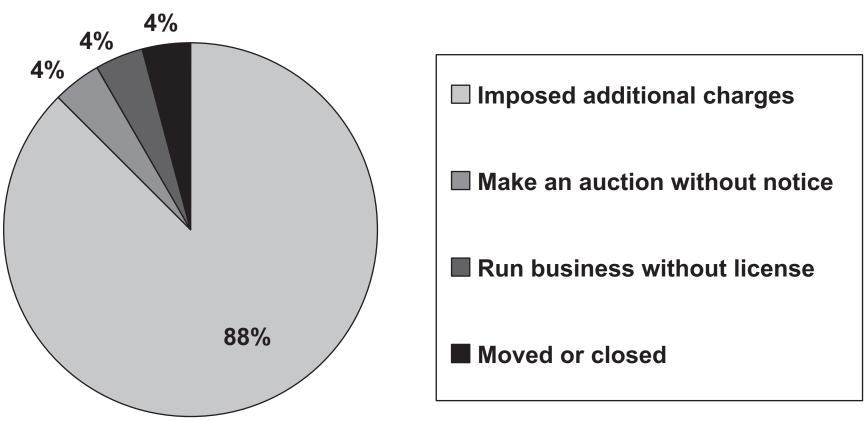

Figure 18.2 Customer Reports of Past Experiences

Application of *Ar-Rahnu*

Shari'ah-based pawn-broking or *Ar-Rahnu* is one of the micro-credit and financial instruments or products available to all Muslims, especially those from the lower income groups. In Malaysia, there are about 140 Islamic pawn-broking branches helping the lower-income groups in order to obtain quick and easy access to cash. In the early 1990s, a few Islamic pawn-broking institutions were established in Malaysia. The first Islamic pawn-broking institution, Mu'assasah Gadaian Islam Terengganu (MGIT), was set up by the Majlis Agama Islam dan Adat Istiadat Terengganu in January 1992. MGIT is not a fully corporate body but more like a charitable one in order to help needy persons by offering them a loan for a given time period to repay back their debts. In order to obtain the loan, one needs to provide their jewelery (gold) as collateral to their debts. Since it was introduced, this institution got a full support from all Muslims living in Terengganu as it was realized that conventional system was still practicing and adopting the *Riba* transaction. In March 1992, Kedai *Al-Rahn* (KAR), a subsidiary of Permodalan Kelantan Berhad, commenced its operations. On 21 August 1993, the Minister of Finance announced the introduction of a scheme, known as Skim *Al-Rahnu* (SAR), through the collaboration of three institutions, namely, Bank Negara Malaysia, Yayasan Pembangunan Ekonomi Islam Malaysia, and Bank Kerjasama Rakyat Malaysia Berhad. Later, on 27 October 1993, the first phase of SAR was launched at six branches of Bank Rakyat.[10] Then, around 50 locations introduced and offered this Islamic scheme to public as a whole throughout the country as reported by ICT Department of JAKIM in September 2003. And this number will keep increasing from time to time (see Appendix for further information).[11]

Application of **Ar-Rahnu** *scheme by Bank Rakyat*

In order to involve in *Ar-Rahnu* scheme, one need to fulfill certain criteria by Bank Rakyat:

- The person should be a Malaysian citizen.
- Age must be 18 years and above (but not exceeding 65 years at the end of financing repayment period).
- Only genuine gold products are pawned.
- Pawned items must belong to you or your spouse.
- A copy of IC is mandatory.

After that you will be taken to a special room called "*Ar-Rahnu Room*." There your gold will be examined by the staff in order to know its weight and whether if it is genuine or not. After all, after the completion of the process, you will get a form that contains all information about your pawned item (see Appendix for the original form). According to the explanation made by the Head of Credit Department at Petaling Jaya Branch, Bank Rakyat will offer you cash up to 60 percent of the pawned items and the calculations of the gold price, amount of loan, and safekeeping fees are as follows.

If the pledgor pawns his/her 22K gold which weighs 50 gram, the value of pawned item (marhun) is calculated as follows:

Value of pawned items = Weight × Recent price
= 50 × $ 35.80
= $ *1790*
Loan amount = Value of pawned item × 60 percent
= $ 1790 × 60 percent
= $ 1074
= $ 1070 (rounding up)

Safekeeping charge has been divided into two categories that are mentioned here.

For safekeeping, calculation is based on the given example as follows:

$$= \frac{\text{Value of pawned item}}{100} \times \text{Safekeeping charge} \times \text{Repayment period}$$

$$= \frac{\$1790}{100} \times \$0.60 \times 6 \text{ months}$$

= $ *64.44*

What will happen if the pledgor fails to pay his debt within the repayment period? Here, Bank Rakyat will extend the duration for 2 months. If he/she still cannot repay back his debt, he/she will get another extra 2 months. If he/she still fails to do so, the bank will make an auction. Any person who bids for the highest price will get the privilege to buy that pawned item. After the process has been completed, the bank will deduct the balance amount of debt, and any surplus amount will be given back to the pledgor.

Notes

1 Shamsuri Shariff, *Figh for Economist II*, p. 71.
2 *The Mejelle*, translated by C.R. Tyser B.A.L., Kuala Lumpur: The Other Press, 2007, p. 106.
3 Law of Charges, Rahn Comparative Study, by Ledchumiah Ramamoorthy, p. 59.
4 The news, Business & Finance review, Re-emergence of an alternative system.
5 Sahih Al-Bukahari, Hadith no. 686, p. 414.
6 *The Mejelle*, p. 107.
7 Prinsip and Operasi Perbankan Islam, by Sudin Haron, p. 78.
8 Sistem Kewangan Islam by Nor Mohamed Yakcop, p. 122.
9 www.kpkt.gov.my
10 www.bnm.gov.my
11 www.islam.gov.my

19 Accounting for Islamic trade financing

Introduction

Islamic view on accounting theory and policy is nothing but the importance of the concept of "accountability" in Islam, and it also stresses on the importance of writing and arithmetic in Islam. Islamic Accounting Theory is purely deductive; thus it is the main difference between Islamic Accounting and Western Accounting. Accounting is defined by Committee of Terminology, AICPA, as an art of the recording, classifying, and summarizing in a significant manner and in terms of money, transactions, and events which have in part, at least, a financial character, and interpreting the results thereof. However, AAA (American Association of Accountants) provides a broader definition of Accounting as the process of identifying, measuring, and communicating economic information to permit informed judgments and decisions by users of the information. The definitions given before suggest that accounting has the following stages that the transactions of business activities that have, at least in part, a financial character. In this chapter, an analysis is made on the types of Islamic trade financing modes which were offered by Islamic banks such as *al-Murabahah, al-Musharakah,* al-Mudharabah*, al-Ijarah, Qard al-Hasan, al-Istisna', Bai' al-Salam, al-Kafalah, and al-Wakalah*. This is because these services differ from the practices in the Conventional Banking. Second, a discussion on accounting standard is specific. There are two organizations or boards which set up accounting standards for Islamic trade financing. The objectives and concepts of Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and Islamic Financial Services Board (IFSB) are elaborated. Third, Islamic Accounting Standard since it differs from Western. And last, we also discuss broadly the Islamic versus Western economics in term of *Zakat* concept and interest-free banking, which greatly differ between these two.

Islamic trade financing

There are many types of Islamic trade financing modes offered by Islamic banks such as *al-Murabahah, al-Musharakah,* al-Mudharabah*, al-Ijarah, Qard al-Hasan, al-Istisna', Bai' al-Salam, al-Kafalah,* and *al-Wakalah*.

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Al-Murabahah *(letter of credit)*

In *al-Murabahah* agreement, bank will fund the purchase of a given asset by changing a markup for the goods. *Al-Murabahah* involves the sale of goods against deferred payments (*Bay al-mu'ajjal*), and which according to Umer Chapra has been used in the same sense as *Al-Murabahah*. For example a customer engaging either in trading or manufacturing may require purchasing merchandise or raw materials during his business. In this case, the customer requires *al-Murabahah* facility. Any *al-Murabahah* transaction will involve several steps:

- The purchaser or client submits an order to the bank to purchase goods they require.
- The Bank agrees to finance the purchase of the proposed goods.
- The Bank prepares and sends an offer to purchase to the client.
- The purchaser accepts the offer, which binds it contractually to purchase the goods.
- The Bank pays the supplier and purchases the goods using spot payment.
- The purchaser, acting for itself, enters into a contract to buy the goods from the Bank.
- The Bank agrees with purchaser for the selling price and the markup.
- The purchaser purchases the goods from the Bank for the immediate delivery with deferred payment.
- On the due date, the purchaser then pays the *Al-Murabahah* deferred sale price, which is the purchase price plus the markup.

Depositors in Islamic bank have an opportunity to share in the profits made as a result of *Al-Murabahah* financing mode through profit share mechanism, which is usually described as an investment account.

Al-Musharakah

Al-Musharakah means sharing and is used to describe joint business enterprises in which the partners share the profit or loss of the venture. *Al-Musharakah* also can be translated as partnership. In this concept or technique, two or more financiers provide finance for a project. All partners are entitled to a share in the profits resulting from the project in a ratio, which is mutually agreed upon. However, the losses are to be shared exactly in the proportion of capital proportion. There is no guaranteed rate of return on the investment, as income is based on the profit earned by the joint venture and may possibly result in a loss. Partners also have a right to participate in the management of the project. However, they also have a right to transfer the right of participation to any specific partners or persons. There are two types of *al-Musharakah*, which are permanent *al-Musharakah* and diminishing *al-Musharakah*.

Al-Mudharabah

Al-Mudharabah is a form of business contract in which one party brings capital (owner), and the other party (worker or agent) runs the business. The proportionate share in profit is determined by mutual agreement. But the loss, if any, is borne only by the owner of the capital in which case the entrepreneur gets nothing for his labor. The investor is known as the *Rabb al-Mal,* and the other partner, who manages the investment (entrepreneur), is known as the *Mudharib*. As a financing technique adopted by Islamic banks, it is a contract in which all the capital is provided by the Islamic bank while the business is managed by the other party. However, owner does not have a right to interfere into the management of the business, which is the sole responsibility of the agent. But, he (owner) has a right to specify any condition that would ensure a better management of his money.

Al-Ijarah *(leasing)*

Al-Ijarah is a contract where the bank or financier buys and leases equipment or other assets to the business owner for a fee. Under this term, also investor or lessor would purchase equipment from a manufacturer and lease it on to the company or lessee for an agreed period. During the pre-determined period, the title or the ownership will remain in the hands of lessor, whereas the actual possession and usage of the asset would be for the benefit of the lessee. Over the life of the asset, lessee would pay the agreed rentals to the lessor according to what is stated in the agreement.

Qard al-Hasan

Qard al-Hasan or also known as interest-free loan or benevolent loan.

Al-Istisna'

Al-Istisna' is defined by Islamic Banks as a contract for the acquisition of manufactured goods by specification or order, where the price is paid gradually in accordance with the progress of the job.[1] This used for house under construction, where the builder is paid at the specific stages of the building process. The specifications on the *Istisna*' sale have to be very clear as to type, size, materials used, delivery date, and place.

Bai' al-Salam

This term refers to advance payment for goods, which are to be delivered later. This sale of goods whose specifications are determined at the time of the contract, for a cash price paid in advance, and whose delivery will be at a future date. The seller of the goods must make delivery of the goods of determined specification on the definite future due date. The goods need not be already manufactured (on in final form) at the time of the sale contract.

Al-Kafalah

Al-Kafalah or letter of guarantee is a contract made between bank and another party, whereby the bank agrees to discharge the liability of the third party in the case of default by the third party.

Al-Wakalah

Al-Wakalah or agency is a contract, which is bank acts as the Agent of the customer.

Accounting standards

There are two organizations or boards which set accounting standards for Islamic trade financing. These two are AAOIFI and IFSB.[2] AAOIFI, based in Bahrain, plays an integrating or harmonizing role in terms of accounting and auditing practices and norms. Reference should also be made to the IFSB, whose headquarters is in Kuala Lumpur. Basically, IFSB is seen as an association of institutions charged with the regulation and supervision of the Islamic financial services industries that would undertake research and provide training and technical assistance. The concept of developing financial accounting standard came out in 1987 when a working paper was presented by the Islamic Development Bank during the annual meeting of its Board of Governors in Istanbul in March 1987. Previously, AAOIFI was known as Financial Accounting Organization for Islamic Banks and Financial Institutions (FAOIBFI), which was registered as a nonprofit organization in Bahrain on 27 March 1991. FAOIBFI changed its name to AAOIFI in order to reflect the expanded scope of its work to include the preparation of auditing standards for Islamic banks and financial institutions.[3] The objective of AAOIFI is to develop accounting and auditing standards relevant to Islamic financial institutions; to disseminate accounting and auditing thought relevant to Islamic institutions and its applications through training, seminars, publication of periodic newsletters, carrying out and commissioning research, and other means; to prepare, promulgate, and interpret accounting and auditing standards for Islamic banks and financial institutions; and to review and amend accounting and auditing standards for Islamic banks and financial institutions.[4] Those objectives only affect to Islamic banks and financial institutions, and do not cover takaful companies.

Development of financial accounting standards and auditing standards

Statements of Financial Accounting (SFA)

- Objectives of Financial Accounting for Islamic Banks and Financial Institutions (SFA 1)
- Concept of Financial Accounting for Islamic Banks and Financial Institutions (SFA 2)

Financial Accounting Standards (FAS)

- General Presentations and Disclosure Standards in Financial Statements of Islamic Banks and Financial Institutions (FAS 1)
- *Al-Murabahah* and *Al-Murabahah* to the Purchase Ordered (FAS 2)
- Al-Mudharabah Financing (FAS 3)
- *Al-Musharakah* Financing (FAS 4)
- Disclosure of Bases for Profit Allocation Between Owners, Equity and Investment Account Holders (FAS 5)

Auditing Standards for Islamic financial institutions (ASIFI)

- Objectives and Principles of Auditing (ASIFI 1)
- The Audit Report (ASIFI 2)

Distinctions between FAS And IAS in respect of the treatment of investment accounts[5]

Even though there are objectives and concepts in SFA 1 and SFA 2 which are like the framework of IAS (International Accounting Standards), but there are some differences between the concepts as stated in SFA 2 and those in the preparation of financial statements under IAS. FAS 1 and FAS 5 also require the financial statements of Islamic banks and financial institutions to make certain disclosure, which are not required under the IAS, since the disclosure is only relevant to Islamic banks and financial institutions. Another distinction or difference between FAS and IAS is the treatment of investment accounts. FAS categories investment accounts are divided into unrestricted investment account and restricted investment account. Unrestricted investment accounts are defined as those where fund is received by an Islamic bank from individuals and others based on al-Mudharabah contracts which state that Islamic banks have the right to use and invest those funds without any restrictions. However, although investment accounts are treated as a part of financial position of an Islamic bank, such accounts are treated separately from liabilities and equity of Islamic bank, because according to FAS in the event of losses, Islamic bank is not responsible to return the original amount of funds received from its investment account holders unless the loss is due to the breach of contract or so on. This account is also not considered as part of the equity of an Islamic bank because the holders do not enjoy the same ownership right as the shareholders of an Islamic bank. The treatment of unrestricted investment accounts is same as is mentioned in the definition of an asset under SFA 2 but differs from the definition of an asset under IAS. According to IAS, a resource is an asset for an enterprise only if its control results in a flow of future economic benefits to the controlling enterprise. Under FAS, asset is defined as anything that can generate positive cash flows or economic benefits in the future but does not specify whether the future economic benefits should flow to the enterprise controlling the asset. Under IAS, the future economic benefit needs to flow to the controlling enterprise. FAS defined restricted investment as assets acquired by funds provided by holders of restricted investment account and managed by an Islamic bank as an investment manager on the basis of either on non-participating al-Mudharabah contract or an agency contract. Restricted investments are not the investments of the Islamic banks. Therefore, they should not be treated as a part of Islamic bank's financial position. Islamic bank does not have the right to use or dispose of these investments except within the conditions of the contract between the Islamic bank and the holders of restricted investment accounts. FAS 3 and FAS 5 indicate that if Islamic bank is restricted from co-mingling its funds with that of the investment account holder for the purpose of investment, the investment account would be characterized as restricted and reflected off balance sheet.

FAS's treatment of restricted and unrestricted investment accounts is based on the form of the al-Mudharabah contract which is consistent with the *Shari'ah* which does not recognize the concept of substance over form since a contract in Islam is binding and all pervasive. Unlike IAS, the qualitative characteristics of financial statements, as set out in SFA 2, do not specifically state that the concept of substance over form is an element of reliability that is a characteristic of financial statements. The reliability characteristic as described in SFA 2 refers to substance in the context of stating that reliability means that, based on all the specific circumstances surrounding a particular transaction or event, the method chosen to measure and/or disclose its effect produces information that reflect the substance of the event or transaction.[6] However, the framework of IAS recognizes the concept of substance over form as one of the elements of reliability characteristic of financial statement. Under the framework, if information is to represent faithfully the transactions and other events that is purports to represent, it is necessary that they are accounted for and presented in accordance with their substance of transaction or other events are not always consistent with that which is apparent from their legal or contrived form. IAS 30 (Disclosure in the Financial Statements of Banks and Similar Financial Institutions) states that if banks act as trustees and in other fiduciary capacities that result in the holding or placing of assets on behalf of individuals, institutions, and others, these assets, provided the trustee or similar relationship is legally supported (the Al-Mudharabah contract in the case of Islamic banks), are not assets of the bank and, therefore, are not included in its balance sheet. IAS 30 further states that if the bank is engaged in significant trust activities, which is the principal activity of most Islamic banks, disclosure of that fact and an indication of the extent of those activities are made in its financial statements because of the potential liability of its fiduciary duties.[7] Under FAS and IAS, the return on unrestricted investment accounts is also treated differently under the two financial reporting frameworks. For example FAS does not consider the return on unrestricted investment accounts as an expense (in case of profit) or revenue (in case of loss). It is considered as an allocation of the investment profits and losses accruing to the holders of unrestricted investment accounts from their participation in the investment activities carried out jointly with the Islamic bank. The return included a part of the gross income of the Islamic bank and then deducted net of the Islamic bank's share as a mudharib in order to arrive at the total revenue of the Islamic bank. Meanwhile, under IAS,[8] only the Islamic bank's share as a mudharib would be reflected in the statement of income.

Disclosures specific to the requirements of Islamic banks and financial institutions

FAS requires the financial statements of such institutions to make certain specific disclosures, which are not addressed under traditional financial reporting frameworks. These disclosure requirements are mainly set out in FAS 1 (General Presentation and Disclosures Standard in Financial Statement of Islamic Banks and Financial Institutions) and FAS 5 (Disclosure of Bases for Profit Allocation Between Owners' Equity and Investment Account Holders). A set of financial statements under IAS comprises the following:

- Balance sheet (statement of financial position)
- Statement of income
- Statement of cash flows
- Notes to the financial statements setting out disclosures required under IAS

In addition, FAS 5 requires the complete set of financial statements of Islamic banks and financial institutions to include the following:

- Statement of changes in restricted investments
- Statement of sources and uses of funds in the *Zakat* and charity funds (when the Islamic bank assumes the responsibility for the collection and distribution of *Zakat*)
- Statement of sources and uses of funds in the *Qard* fund

Statement of changes in restricted investment

The statement of changes in restricted investments should segregate restricted investments by source of financing as well as by the type of investment portfolios and disclose the period covered by the statement. The disclosure includes details of movements during the period, the Islamic bank's share in investment profits as a Mudharib or its fixed fee as an investment agent, allocated overhead expenses, if any, by the Islamic bank to restricted investment accounts and restricted investment profits or losses during the period.

Recording of business transactions from an Islamic perspective

Underpinning the Islamic belief is the requirement that doubt and uncertainty are to be removed from inter-personal engagement. Therefore, in the business affairs, all the parties' rights and obligations should be well documented for verification.

This issue of the importance of recording transactions has been highly stressed in Islam as Allah says in al-Qur'an:

> If ye are on a journey, and cannot find a scribe, a pledge with possession (may serve the purpose). And if one of you deposits a thing on trust with another, let the trustee (faithfully) discharge His trust, and let him fear his lord. Conceal not evidence; for whoever conceals it, – His heart is tainted with sin. And Allah knows all that ye do.[9]

These verses place an emphasis on recording material credit loans and transactions and advise debtors to sign these transactions (to acknowledge their indebtedness and the amount of the loans). These transactions should be more important to be put in writing for the verification purposes. Also, precise measurement in business affairs (i.e. evaluating everything with justice) and not measuring high than the true worth are the focus of the verse 11: 84–85. Allah says (meaning):

> To the Madyan People (We sent) Shu'aib, one of their own brethren: he said 'O my people! Worship Allah. Ye have no other God but Him. And give no

Figure 19.1 Accounting Principles

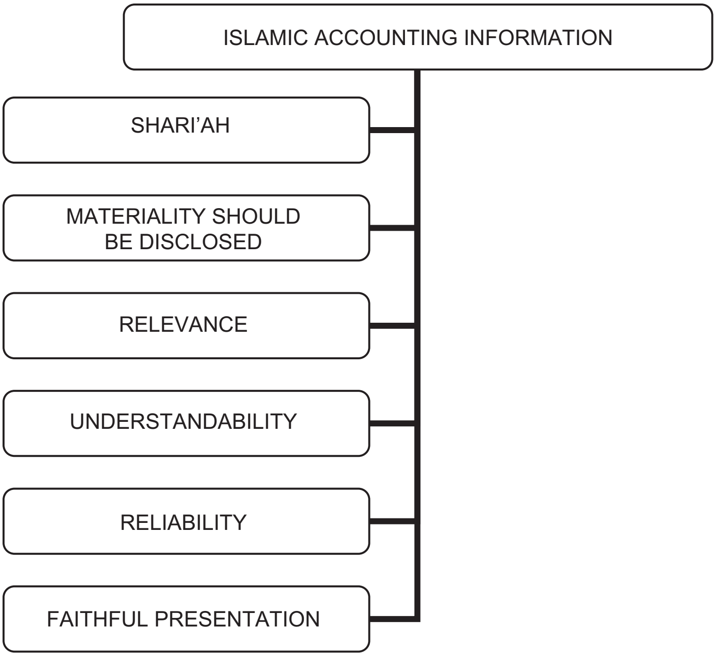

Figure 19.2 Islamic Accounting Information

> short measure or weight: I see you in prosperity, but I fear for you the penalty of a day that will compass (you) all rounds. 'And O my people! Give just measure and weight, nor withhold from the people the things that are their due: commit not evil in the land with intent to do mischief.

Accounting standards

Accounting standards usually comprise of three parts:

- A description of the problem
- A discussion of the solutions to the problem
- The prescribed solution

Reasons for establishing accounting standards are to provide the users of information with a set of information regarding a firm's performance and also provide guidelines and rules of regulation such as taxation and the regulation of the companies for the planners of the financial statements such as accountants. Finally, it also generates more interest in the accounting principles and theories among those who are interested in the issues.[10]

Islamic accounting standards

In recent years, there has been an emphasis in the accounting world to develop international accounting standards in response to the increasing globalization of markets and economies. Some argue that international standards will increase comparability and understandability of financial statements, save time and money, ease interpretation, and improve the credibility of the financial reporting process and profession (Choi & Mueller, 1992). This standard setting is dominated by the practice of the United States. So, this practice is not suitable for the Islamic purposes as it is based on the Western economies and not Islamic economies.

Islamic versus Western economies

Islamic economies are based on *Shari'ah*, the Islamic law, which governs secular[11] as well as religious activity. The basic objective of *Shari'ah* is to ensure general human well-being and socioeconomic justice. Islamic economics is part of *din*, which deals with production, consumption, and distribution activities of human beings according to Islamic worldview. It makes choices according to Islam which comprise the description, analysis, and prescription from the Islamic perspective. All these are derived from the sources of Islam, that is al-Qur'an and *as-Sunnah*. This is the main difference between Islamic and Western economics. It teaches that all wealth belongs to Allah, and that humans are merely trustees of this wealth.[12] Islamic vision on property ownership is Allah as an absolute owner whereas man as khalifah and 'abd has relative and conditional ownership. Man is responsible to society and accountable to Allah for his property. Both private and public properties are legitimate kinds of property in Islam. In Western materialistic economies, the individual has unconditional and absolute rights over wealth and is allowed to use it as he or she pleases.[13] The individual's main aim or objective is to maximize this wealth, so they called "*maximization of profits and minimization of loss*." It contrasts with the Islamic economics because the individuals do not have absolute right over their wealth. Although they have been granted ownership over wealth, this is as trustee only, and they must use it only according to the instructions given by *Allah (swt)*. They must not wastefully consume their wealth, and they must give to others their due. The holy Qur'an states: "*In their wealth there is a known right for those who ask for it and those who have need for it*." Thus, wealth maximization is not the main objective of economics in Islam. One of the main aims of Islamic economics is that wealth, instead of becoming concentrated in the hands of few, should be allowed to circulate in society as widely as possible, so that the distinction between the rich and poor is narrowed down as far as is natural and practicable.[14] Certain institutions are put in place to achieve this aim, for instance, the imposition of *Zakat*, a kind of mandatory religious tax levied on the rich to give to the poor and needy, and the prohibition of *Riba*, or fixed interest. These institutions differ greatly from the prevailing practice in Western countries.

Zakat

Zakat is one of the fundamental pillars of Islam: the second most important duty of Muslims. The word *Zakat* means, literally, purity, growth, and increase (religious merit, property grows by giving, purifies soul and cleanses property). It means to donate alms (*sadaqah*) from their property in order to purify or cleanse them (from their sin).[15] Its purposes are to eliminate poverty by redistributing wealth from the richer or relatively well to the poor and needy. *Zakat* is not a charity but something that rightly belongs to the poor and needy. Thus, *Zakat* keeps wealth constantly circulating in society. It creates a society based on mutual assistance and, if properly developed, guarantees a minimum level of living to all people in the Islamic society.[16] This ensures that the distribution is really from the relatively rich, and it is payable only from surplus wealth not the wealth which is in use. In Western countries, tax is regarded as an evil, something to be avoided. Accountants are charged with making the tax expense as low as possible without breaking the law for their clients. Paying *Zakat*, on the other hand, is an important religious duty, an act of worship. Muslims are encouraged to be generous with their wealth. *Zakat* is to be regarded as a loan to Allah, which He will repay many times over in the world Hereafter.

Concept of conservatism

In the United States, the concept of accounting follows the concept of conservatism[17] or prudence. It states that an extra care should be taken to ensure that assets and revenues are not overstated, and liabilities and expenses are not understated. This means that there are two given possible valuations for an asset, and which would choose the lower. This, however, is inconsistent with the concept of *Zakat*. Understating assets would mean less *Zakat* liability, but Islam encourages Muslims to be generous with their wealth. Therefore, they must be careful to not understate their assets or overstate their liabilities, and thus concept of conservatism is not applicable for assessing *Zakat*. It is clear then that there is much difference between accounting for *Zakat* and general accounting practice in the west. Its accounting standards would not therefore be appropriate for *Zakat* purposes.

Interest-free banking

Literally, *Riba*' means increased, excess, or fixed interest. Hukm has given in al-Qur'an and Hadith is haram. However, not all kinds of increase are haram; in fact, only 'unjust increases' are haram, that is *'bi'l batil*.[18] Interest is one of the main factors in creating an unequal distribution of wealth. A fixed interest rate guarantees a profit on money contributed, regardless of whether the borrower has made a profit or a loss. Thus, it is possible that labor and hard work may go unrewarded while lending of capital, which entails no exertion or effort on the part of the lender and is not eroded or reduced in value by its use, is guaranteed remuneration. Those who already have money are provided with an easy way of increasing it, while those who are in need of money may not be able to break out of the poverty cycle, because they are obliged to make interest payments, whether they can reasonably afford to or not. Islam considers this to be unfair.[19]

Conclusion

Indeed, Islamic economics use a framework derived from the divine text. This framework is sacred and absolute. However, from the mainstream economics, it undergoes changes. Second, Islamic economics builds ethical values such as justice, moderation, and caring for others for doing an analysis of behavioral parameters – for instance, as we discussed before in the *Zakat* and interest-free banking approach. In contrast, Western economics do not concern about ethical values on their judgments. Third, Islamic economics asks questions, which are different from those, as asked by the Western economics. It is concerned with the *falah* of man and with creating the social and institutional conditions, which maximize *falah* in a society. In Western economics, they do research for the sake of knowledge. While in Islamic economics, all knowledge has a purpose. That purpose is derived from the overall worldview of Islam. Therefore, there are many aspects of the Islamic economy that differ greatly from Western economies. Their accounting techniques cannot be readily applied in Islamic economies, and, thus, international accounting standards based on such techniques would create difficulties for Muslims around the world. For this reason, it is important for Muslim accountants to develop accounting standards which are specially adapted to Islamic needs, and for Muslim countries to ensure that these are considered by international accounting standard-setting bodies such as AAOIFI and IFSB.[20] Islamic banking should use all the concepts derived from the *Shari'ah* boundary. They should not apply half Islamic concepts and half conventional concepts.

Notes

1 Philip Moore, *Islamic Finance a Partnership for Growth*, 1997, p. 42.
2 Perhaps the modified *International Financial Reporting Standard* (IFRS 17) with *Shari'ah* compliance may be additionally adapted by Islamic financial industries to contribute to the need effective from 2023.
3 Moore, *Islamic Finance a Partnership for Growth*, p. 98.
4 Ibid, pp. 98–99.
5 Perhaps the modified *International Financial Reporting Standard* (IFRS 17) with *Shari'ah* compliance may be additionally adapted by Islamic financial industries to contribute to the need effective from 2023.
6 Moore, *Islamic Finance a Partnership for Growth*, p. 103.
7 Ibid, p. 103.
8 Perhaps the modified *International Financial Reporting Standard* (IFRS 17) with *Shari'ah* compliance may be additionally adapted by Islamic financial industries to contribute to the need effective from 2023.

9 Al-Qur'an: (2:283).
10 A. Belkaoui, *Accounting Theory*, 4th edition, Australia: Business Press, 2000.
11 Secular means here (time) now (place).
12 Al-Qur'an: (57:7).
13 M. Shafi, *Distribution of Wealth in Islam*, Karachi: Ashraf Publications, 1979.
14 http://islamic-finance.net/
15 Dr. Mohamed Aslam, Unpublished.
16 http://islamic-finance.net/
17 This concept refers to the "need to exercise care when dealing with uncertainties."
18 Al-Qur'an: (2:188), (4:29).
19 http://islamic-finance.net/
20 Perhaps the modified *International Financial Reporting Standard* (IFRS 17) with *Shari'ah* compliance may be additionally adapted by Islamic financial industries to contribute to the need effective from 2023.

20 Accounting treatment of Takaful products – an experience

Introduction

Takaful Insurance is an Islamic transacting policy of mutual cooperation, solidarity, and brotherhood against unpredicted risk or catastrophes in which the parties involved are expected to contribute genuinely. The nature of the principles of Takaful is fundamentally different from the principle of conventional insurance. Takaful insurance provides Islamic insurance to society, which practices based on the Islamic principles. In Malaysia, there are two companies which are conducting Takaful operation, and they are Takaful Malaysia Berhad (TMB) and MNI Takaful Sdn Bhd (MINT). An actuary is an expert who calculates insurance risks and payments by studying the mobility rates. However, pricing refers to the value of the policy and the number of premium rates that need to be contributed by the participants as a result of calculating the insurance risk by the actuaries' people. Therefore, there is a department called actuary and pricing department in Takaful Company that specializes on this field. The objective of this department is to provide quality products at good rates. Therefore, the product and its pricing need to fill some criteria before it can be considered as quality product:

- There is a mutual cooperation existing between the participant and the operator in managing the fund.
- The profit that is created from the al-Mudharabah fund is lawful.
- The product can serve the ummah and provides benefits in line with *Shari'ah* principles.
- The product can provide protection and coverage to the participants in a reasonable premium rate.

The sentence means that Allah has encouraged and permitted in trade and commerce and prohibited '*Riba'* in practices. This verse is related with the concept of the pricing in Takaful, which is the responsibility of the actuary and pricing department in preparing the costing for the Takaful product that does not contain any elements of '*Riba'* or '*gharar*'. Takaful also emphasizes the cooperation between participant and operator. The participant contributes certain amount in the Takaful plan, as a result the operator provides the coverage accordingly. In

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a similar way, in the Al-Mudharabah fund, the profit and lost will be divided into a portion that is agreed by the participant and operator at the beginning of the contract. Therefore, there is no issue of misallocation of fund or breach of trust. The concept of the cooperation and helping each other is stated in the holy Qur'an at *Surah al-Mai'dah*:2. In responding to this verse, the actuary and pricing department is responsible to prepare costing for the new product by looking into mobility rates and morality rates as a consideration. The morality rates and mobility rates should come from the primary sources or originally result from the research which was done by the marketing department in Takaful itself. It is due to emphasizing that pure and quality products are offered to the society. However, the way that the fixed the price must be also influenced by the profit of company as well as the welfare of society.

Products

Every product has its own objectives, characteristics of participants, amount of contribution (premium rate), maturity period, benefits and type of payment as well as allocation of the fund and application form. The actuary and pricing department takes all information that is provided by the marketing department to determine the pricing for each Takaful plan. For example in fixing the rates of claim that can be made by the participant, the department needs to refer to mobility rates and morality rates. The mobility rate refers to the average rate of accident in Malaysia, and the morality rate is referring to the average people expiring at a certain time. The statistical and data collection also may be useful in calculating the cost of the Takaful plan. Therefore, primary sources are much more important in order to get an accurate and quality result. In the family Takaful plan for example the contribution made is related to the maturity period that is chosen by the participants and can either be 10 years or 50 years. The longer the maturity period, the participants takes the more percentage of contribution, which will be credited into "Tabbarru" fund. The rational is the longer the participant takes the policy, the higher the risk will be faced as well as the coverage.

We experience that the type of coverage that is offered to the participants depends on the type of policy. For example "Takaful Rawat" is purposely to help

Table 20.1 Services Offered by Takaful Company

Family Takaful Scheme	*General Takaful Scheme*
▪ Family Takaful Plan	▪ Motor Takaful
▪ Family Takaful plan for Education	▪ Accident Takaful
▪ Ma'asyi Takaful Plan	▪ Engineering Takaful Marine Takaful
▪ Siswa Takaful Plan	▪ "Rumah Desa" Takaful scheme
▪ Hawa Takaful Plan	▪ Pilgrimage Takaful scheme
▪ Annuity Scheme of Takaful KWSP	▪ Basic Fire Takaful scheme
▪ Health Takaful	
▪ PTKB Takaful Plan	

the participants in paying the cost of treatment in the hospital; for example if there are accidents or illnesses happening in the family. However, "Takaful Sihat" is purposely to provide coverage in term of money if the participant has any critical illness that is determined by Takaful. Similarly, in term of claim, the longer the participant contributes in the plan, the higher coverage they will receive from the Takaful Company.

Shari'ah rulings

The whole law is permeated by religious and ethical consideration, where each institution, transaction, or obligation is measured by the standard of religious and moral rules – for instance, the prohibition of interest and uncertainties, the concern for the equality of the two parties, and the concern for the just average (*mithl*). The basic rule of *Shari'ah* ruling of Takaful is based on mutual cooperation between two parties as is stated in the *Qur'anic ayah*, *al-Maidah*: 2;

> *And co-operate each ye one another in righteousness and piety, and do not co-operate in sin and rancor.*

From the aforementioned verse, the Takaful relates to the morality risk, which requires appropriate protection from re-takaful. Therefore, it shows the implication of mutual co-operation between both parties. As an Islamic insurance, all activities in Takaful are prevented from *Riba*'. In other words, it is a prohibition of interest as *Riba'* in the contractual agreement as well in determining the pricing of Takaful. Allah had said in *surah al-Baqarah*, 278; "*Allah had permitted trade, but not allowed Riba*."

Takaful policy

In Takaful policy, the actuary plays an important role in determining the pricing for the Takaful plan as well as the rate and morality rate in preparing the costing. There is also involves projector investor return or in conventional insurance, it most familiar with the name of investment rate. Actuary department in expecting the return of profit uses this projector investment return. The mobility rate is used for measure the critical illness and medical expenses. The morality rate is most used in '*Khairat*'. Similarly, as with other conventional insurance, Takaful also recognizes time value of money in order to measure the expected return for the company. However, the rate of interest in time value of money is considered as profit margin in Takaful practices which is lawful in Islam. The Bank Negara Malaysia is only providing the guidelines to all insurance companies in preparing the cost for new product. Only after the approval from the BNM, the product can be launched. The BNM does only a part of filing the documents. If the Takaful Company plans to create a new Takaful plan, the marketing department does a research based on the company need which emphasizes customer's need and preference, request by the society, and the competitors' challenge. After gathering the data, the marketing department transfers the information to the actuary department. The actuary department will prepare the costing based on the marketing information, morality rate, and mobility rate. They need to make comparison regarding the amount with the statistical and existing rate. The proposal is submitting to the management department for the approval. After the approval, the proposal will be submitted to the accuracy by the consultant company. The Takaful Company hires the consultant company. Finally, after getting an approval from Bank Negara, the IT department prepares system for the new products.

Roles of actuaries

The role of actuary in Takaful is recognized under the Islamic Insurance (Takaful) regulation, which contains three main areas as discussed as follows.

Appointed actuary

A Takaful operator must have an appointed actuary who has responsibility to report to the Bank Negara should he/she fail to take the necessary steps to address the issues that may expose the company to undue risk of being insolvent.

Product certification

A Takaful operator is required to submit the regulatory authority (Bank Negara) certification by an actuary who certifies that the premium basis of any life insurance product or as the Takaful contribution basis of any product of the Family Takaful Business is based on sound principles.

Actuarial valuation

A Takaful operator is required to submit yearly to Bank Negara an actuary report on the actuarial investigation of the financial condition of the life insurance found, as well as part of Family Takaful Business specifically allocated for the payment of the Takaful benefit.

Practical scenario involved in pricing procedures

Thirty-year-old Abdullah, for example wants to buy an insurance policy from authorize agencies. He indulges in Family Takaful Plan, and the maturity period ends in 25 years. In the contract stated, the proportion between al-Mudharabah fund and At- Tabbarru' fund is 91.7: 8.3. His policy amount is $ 50,000.

Issue arises

- What is the monthly premium?
- How much amount is allocated in *al-Tabbarru'* and Al-Mudharabah funds?

Calculation

Total fund = \$ 50,000 /(25 years × 12 months)
= \$ 166.67 per month

Al-Tabbarru' Fund = \$ 166.67 × 8.3 percent
= \$ 15.00

Al-Mudharabah Fund = \$ 166.67 × 91.7 percent
= \$ 150.02

If Abdullah passes away in the age of 40, what is the total amount of money that can be claimed by his beneficiary? Abdullah has already contributed the money in first 10 months.

Calculation

Al-Mudharabah = \$ 166.67 × 10 years × 12 months
= \$ 20,000.4

If the profit in 10 years is about \$ 2,500, and the contribution ratio is 60:40, the participant will get 40 percent from the underwriting investment, which is \$ 1000.

Total fund = \$ 166.67 × 20 remaining years
= \$ 3333.4

Therefore, the claimed amount that should be given to the Encik Hamdan beneficiary is

= \$ 20000.4 + \$ 1000 + \$ 3333.4
= \$ 24333.8 (will be distributed according with faraidh).

The issues of prefer ability in choosing Insurance policy. Why many people like to buy conventional policy insurance rather than Takaful insurance?

Practically, the transaction in conventional insurance is based on buy and sale agreement. The company will be the seller while the participant will be the buyer. When talking about claim in this contract, the policyholders will have the full right to claim whole amount from the company. This is one attractive attribute that makes people buy policy from conventional insurance company. People may blur and doubt about why they can't claim whole amount in Takaful practice. The main reason is that the Takaful has two accounts. One account is personal account, and the other is participant special account. Both accounts are treated as Al-Mudharabah and Tabbarru' accounts, respectively. In this case, the participant can only claim the amount in participant account.

This has been stated in pricing procedure of Takaful, which in line with *Shari'ah* principle:

If anyone desires a system other than Islam never will it be accepted from him.

The issue of claim at the end of period

If someone doesn't make any claim during the policy period, what should they receive at the end of maturity? In this case, Takaful practice provides such benefit to the participants. Each Takaful product has their own pricing procedures, and the Takaful Company tries the best on serving them the best. Basically, there are two types of benefits that can be received by the policyholders.

No Claim Benefit (NCB)

The regulation in all countries already stated that for those who do not face any risk within risk period, they can claim NCB.

There is a Hadith, which provides a justification for NCB:

> *Muslim bound with the conditions, if it exceed the condition, Muslim is permitted.*

Bonus

This will be given to the Takaful holder at the end of maturity. Basically, this money belongs to Takaful operator. It indicates the appreciation that the companies show toward customers.

The basic calculation in computing bonus is as follows:

= Surplus − (General Expenses + Management Cost) − *Zakat* = *Net Profit*The bonus also can be treated as *sadaqah*. As mentioned in the holy Qur'an,

> *God will deprive usury of all blessing, but will give increase for deeds of charity, for he loveth not creatures ungrateful and wicked.*

Family Takaful scheme

How to calculate the amount of insurance in Family Takaful Scheme?

There are several guidelines that should be adhered to by the policyholders in order to determine the insurance amount. The steps are like as follows:

Step 1: Determine the group of age.
Step 2: Refer to the rate given in Takaful scheme in Family Takaful Schedule.
Step 3: Calculate the amount based on the percentage found in the schedule.

The final amount derived from this step will be divided into two accounts – personal account and participants' special account.

An example of a practical situation

Abdullah, for example is bought a Family Takaful Plan, and the maturity period is 30 years. His age right now is 25 years, and he contributes about $ 16.90 in his Takaful account. This account can function as his back up in case of an unpredicted scenario. But, Encik Halim is still vague about the allocation of fund, and this raises the question why it is different from the conventional practice. Generally, the payment made by the policyholder in conventional insurance will be credited into the general insurance account. However, it is different with Takaful operation. The money collected will be allocated between al-Mudharabah and Tabbarru' funds. Abdullah in this case can be considered as Takaful participant, and the company where he buys the policy is known as Takaful operator. The money that the company received will be segmented into different channels. The main channels are:

- Management Cost
- Risk Fund
    - IBNR
    - Reserved claim
    - Unearned premium
    - Re-Takaful
- Special Security Fund (SSF)
- Surplus

IBNR (*Incurred But Not Recorded*)

This is one type of Risk Management fund that exists in life and family Takaful scheme. The IBNR fund is a reserved fund for the occurrences that happen out of policy period. The fund is known as IBNR reserved. The fund is compulsory for all Takaful operators. In other words, Takaful operator should establish this fund for the convenience of Takaful participants. The rate of contribution in this fund is 2.5% based on the actuaries' computation. Example that can be used to explain detailed about IBNR fund is a s follows:

Abdullah, for example buys a Takaful policy for 1 month. He buys it from Takaful National with an amount of \$ 10000. During the policy period, En. Nor meets an accident and his body become handicapped. His beneficiary does not log a report to the related parties (Insurance Company, police, etc.). After several months (out of policy period), En. Nor claims his right from the Takaful company. The company will not give the money from Tabbarru' account because the money raised there belongs to other participants. Therefore, the company will extract some money reserved for him under the IBNR fund.

Claim reserve

The claim make by the participants in the policy period originates from "claim reserved." This is the reserve that is collected from participant premium contribution every stated period. This contribution can be done using several ways like from the deduction of salary and individual pocket money. The participant can claim this benefit from the Takaful operator if they had faced several difficulties like accident, injury, loss of damages, and other unpredicted risks. So, the company tends to put high rates on this fund for the purpose of gaining more funds as well as for the benefit for the participants. As far as this fund is concerned, the main objective is to strive for the satisfaction of policyholders.

Unearned premium

The participants should contribute certain amount of money in the Takaful fund. This amount can be contributed monthly or quarterly depending on the contract agreed. Sometimes, participants tend to contribute unequal amount throughout the policy period. This practice is not wrong, but it tends to get low in amount in the fund. Alternatively, Takaful Company has provided one special fund known as unearned premium fund. This fund serves as a backup for the participants who do not contribute equally in their premium payment. Here is an illustration to elaborate more about the unearned premium fund. Consider the cash flow given in Table 20.2.

Based on this cash flow, the participants do not contribute similar amounts in the whole 4 months. So, the company tries to make it same-value premium in each month. Therefore, the company extracts some money from the unearned premium fund for covering the shortage. This fund is from the participant account in which they had put extra amount than needed in the premium.

Re-Takaful

Re-Takaful is one type of risk management fund. The fund is needed for the Takaful company for its risk (Takaful Company risk). The company can buy the policy from other companies for the sake of helping them when the company in is an unpredicted situation. In Malaysian context, the re-Takaful practice has been supervised and done by ASEAN Takaful Group (ATG)[1] and ASEAN Re-Takaful International Labuan Limited (ARIL).[2] Re-Takaful refers to transaction make by one Takaful company to another Takaful company for the joining responsibilities and solidarity. There are two types of re-Takaful natures. The natures are:

Facultative: this type of re-Takaful nature reflects the insurance by product. In other words, this nature goes products by products. For instance, the marine Takaful only can be re-Takaful by its own-based product (marine with marine). This is optional to the Takaful company, and there are no strict regulations on it.

Treaty: this is compulsory for all Takaful operators, and has been made the law by the government. This nature reflects that all Takaful products can be re-Takaful under one roof. There are no restrictions imposed on the products. Under this nature, it can be classified according to compulsory and non-compulsory.

Table 20.2 Cash Flow

Month	Jan	Feb	Mar	Apr
Premium	$ 100	$ 80	$ 90	$ 150

All the risk management funds mentioned before are treated based on At-Tabbarru' principle. This principle refers to gifts or donation which are given by one person to others sincerely without asking any reward in return. The funds are mainly for needy and helpless people for their security, survival, and happiness. Based on Hadith, this fund will not be returned or claimed by participants unless they face any unknown risk. Prophet Muhammad (saw) said:

> *A person who contribute his/ her money and then claim it back is like a dog that eat and then vomit, and it eat its own vomit.*

The new item that will be included in the distribution of Takaful premium is Special Security Fund (SSF). What is SSF? Special Security Fund is a fund that will save Takaful Company from facing insolvency or bankruptcy. The establishment of this unique fund requires big funding and capital to set up. The capital requisite is around RM 10 million up to 50 million. This fund is based on *Shari'ah* principles for sharing the burden between concerned parties. Basically, Prophet encouraged people to share the difficult part and try to make it lighter. Prophet said:

> *Whosoever alleviate the difficulties of believers, Allah (swt) will alleviate his difficulties in this world and in the hereafter.*

The mechanism suggested in Special Security Funds is basically based on mutual cooperation between participants and Takaful operator. Both need to contribute equal proportion of money in the fund. For example the participants should contribute 2 percent in the fund, and the operator also must put 2 percent in account for each participant. This amount can be accumulated in specific period, and with that amount, operator can cover or back up it from loss. The amount that is already for use can be distributed or reimbursed to the operator in a lump sum basis. The principle implied here is Qard Al-Hassan. This term refers to benevolent loan to the specific party. There is no additional charges and interest imposed. By right, the company is able to manage the fund for protect from bankruptcy or loss. The extra amount derived from the loan should be used for charity and welfare purposes like helping the needy build welfare center and cater or manage orphanage. Hopefully, this fund can be realized and approved by Central Bank of Malaysia. Viewing it as a part of the development of Islamic finance, it also tends to avoid Islamic institutions from suffering from unexpected risks. As short, the benefit from establishing the Special Security Fund (SSF) may be shared by both contributing parties.

As regards the management cost, should the company bear all the expenses, or should they take part of premium as the cost? The establishment of company like Takaful company faces several problems especially in terms of budget and expenses. Even though it involves a lot investment and other financial activities, Takaful company still needs support or other sources for survival. One of its sources is from the participants' premium contribution. This contribution is already channeled into different sorts of fund for their future benefits. Management cost is different than the premium. Bear in mind that this cost is crucial for activities in Takaful practice. Without proper management, the Takaful Company may not serve the participants' demand and fulfill their need. At the end, the Takaful Company may end up with poor quality and, low service expectations, and the worst part is that participants may leave the Takaful and find other reliable insurance companies for their risk coverage. From the management point of view, this cost is used for the payment of salaries as well as the utilities used. The proportion may not be big as in risk management fund. In practice, the Takaful operator may deduct about 5 percent to 10 percent of premium for management fund purposes. Example, if the premium is RM 150, the management cost is only $ 7.50 per participant. Looking at this matter from an Islamic point of view, every work or task should be done with justice. Islam does not encourage seeking material gains in return of doing a sincere job. But it is matter of appreciation with the task done. Prophet Muhammad (saw) said:

> *For every service must be charged before the sweat dry.*

The commission, salary, bonus, and wages should be commensurate with the task or work done. In this issue, Islam has clearly stated that the charge should be imposed, and the participants should understand the reason behind it. The extra premium after deducting and allocating into various funds is known as *surplus*. The issue arises that to whom surplus should go. Surplus can be considered as underwriting income for a company or, in the simple words, known as the gain of the Takaful company. This gain originates from the participants' extra contribution. The distribution of surplus toward the participant account is known as ex-gratia or *ihsan*. Given in the next section are Ulama' opinion regarding the surplus, and the differences between life policy and family Takaful policy.

Life policy

- It should go back to the risk management fund and allocated it equally.
- The extra money should be returned back to the participants who do not make any claims during the policy period. The contribution should be based on the contribution ratio.
- The surplus gains should be shared by both parties of participants and operator on the presumption that the operator put a lot of effort in managing it.

Family policy

- It should go back to the policyholder who does not make any claim during the stated period.
- It should be put back into Participant Special Account (PSA).

Actuary, underwriter, and loss adjuster

Public is usually confused about who evaluates the price of policy insurance. Is it actuary or underwriter or loss adjuster? The correct answer is actuary. They is the important people behind Takaful industry. For clarifying further, here is information pertaining to these three Takaful-related jobs.

Actuary

Based on the definition of the human resource, actuary is a combination of business executive, mathematician, financier, sociologist, and investment manager. They are the problem solvers who use actuarial science to define, analyze the financial, economic, and other business applications of future events. Mainly, they define the risk within country boundaries and define it based on the damages like accident and fire. An actuary is trained to analyze uncertainty, risk, and probability. They also create and manage programs, which reduce the adverse financial impact of the expected and unexpected things that happen to people and businesses. Here are several responsibilities of actuary:

- Investigating the effects of medical impairments on long life
- Applying mathematical models to insurance company problems
- Participating in various aspects of corporate planning
- Calculating a fair price for new products
- Identifying the benefits a new insurance contract will cover
- Preparing company's financial statement

Underwriter

The underwriter is involved with review and processing of application for participants' compensation insurance. Here are several functions of an underwriter under certain Takaful companies:

- Reviews and evaluates applications for participants' compensation Takaful and determines appropriate classifications based on the types and nature of work performed.
- Determines appropriate premium rates and codes based on classification assigned.
- Interprets policies and explains coverage and changes to interested parties; responds to inquiries concerning rules and regulations.
- Conducts interviews with applicants to gather information to prepare policies or determine classifications or rates.
- Processes renewal policies and adjusts payroll, rates, and premium; prepares certificates of insurance.
- Gathers and prepares reports.

Loss adjuster

Who is a loss adjuster? In terms of Human Resource, loss adjuster is an independent expert in the handling and settlement of insurance claim. It means that the loss adjuster is an entity for investigating any damages and launches a report for claiming purposes. Basically, here are several roles played by a loss adjuster in Takaful industry:

- Investigates the circumstances of the loss and ascertains facts of the case.
- Determines policy liability.

- Quantifies loss within the terms and conditions of the policy.
- Seeks recovery against the any negligent party.
- Advises policyholders on loss mitigation and risk improvement.

Example of contribution of premium

Table 20.3 Takaful Rawat: Ehsan Package

Age	*Plan Number 1*	*Plan Number 2*	*Plan Number 3*
Up to 17 years	$ 378	$ 278	$ 193
18 to 35 years	$ 522	$ 384	$ 265
36 to 45 years	$ 666	$ 490	$ 336
46 to 55 years	$ 942	$ 689	$ 462
56 to 60 years	$ 1405	$ 1026	$ 685

Table 20.4 Takaful Siswa Plan

Monthly Contribution	*$ 20*	*$ 30*	*$ 50*
Participants:			
a) Death	$ 1000 + PA	$ 1000 + PA	$ 1000 + PA
b) Disable	$ 1000	$ 1000	$ 1000
c) Accident	$ 10000	$ 15000	$ 25000
Guardians:			
a) Death	$ 1000 + ($ 20 × duration up to 18)	$ 1000 + ($ 30 × duration up to 18)	$ 1000 + ($ 50 duration up to 18)
b) Disable	$ 1000 + ($ 20 × duration up to 18)	$ 1000 + ($ 30 × duration up to 18)	$ 1000 + ($ 50 duration up to 18)

Table 20.5 Takaful Dana Pekerja Plan

	Contribution	
Coverage scopes	$ 40	$ 50
Death	$ 8000 + PA	$ 10000 + PA
Accident	$ 20000	$ 25000
Permanent disables	PA + $ 200 per month up to maturity	PA + $ 250 per month up to maturity
Personal khairat	$ 1000	$ 1000
Family khairat		
a) Spouse	$ 1000	$ 1000
b) Children	$ 500	$ 500
c) Parents	$ 400	$ 400
Medical expenses (accident only)	1. Repayment up to $ 500 2. Daily allowance RM 20 up to 52 weeks (at least 2 times hospitalized)	1. repayment up to $ 500 2. daily allowance $ 25 up to 52 weeks (at least 2 times hospitalized)
Drawing for education purpose	Year 2: 50% Year 5: 70%	Year 2: 50% Year 5: 70%

Table 20.6 Takaful Hawa Plan: Package A

Benefit	*$*
Cash benefit	
1. Cancer	$ 20,000
2. Additional cash benefit for other parts effected by cancer	$ 20000
3. Operation on breasts (each side)	$ 10000
4. Khairat for death	$ 4000
Cash allowances for hospital ward	
1. Due to cancer	$ 150
2. Additional cash benefit for other parts effect by cancer	$ 150
Yearly cancer test	
Reimbursement on the "pap smear" and breast test (check for cancer)	$ 100

Table 20.7 Al-Mudharabah Rate Stated

Month/Business	*General Takaful Business*	*Family Takaful Business*
January	26.95	23.63
February	26.56	23.63
March	25.77	23.26
April	25.58	23.16
May	25.59	23.01
June	25.81	22.43
July	25.6	22.22
August	25.61	23.16

The figure from September onwards is not available yet due to unfinished analysis done

Al-Mudharabah rate stated

Takaful already determines the rate that should be fulfill in order to separate the contribution into al-Mudharabah account. Table 20.7 is extracted from Takaful Malaysia Berhad for al-Mudharabah rate from January 2003 to August 2003[3] (expressed in percentage).

Management expenses are not charged on the contribution premium

Participants of the Takaful business would have the opportunity to enjoy 'free cover'. Perhaps it may sound strange, as it would imply that Takaful is just like another charitable organization. No business would give away its products or services for free except on special events. From the context of insurance, it looks more awkward because the core activity of insurance after all is to provide financial guarantee in order to compensate against loss or liability in the event of a misfortune. What is more, the quantum of guarantee may exceed the premium paid in the first place in the event of a huge misfortune. Nevertheless, through the profit-sharing contract of al-Al-Mudharabah, as provided by Takaful, such an opportunity is no more a dream. Taking the performance of Takaful Malaysia as an example, where participants have been enjoying a rate of profit averaging at around 35 percent p.a. for the general Takaful business over the last 5 years, participants who have been sticking to Takaful in terms of their insurance needs would fully appreciate the meaning of 'free cover'. With the total aggregate of the 3 consecutive years' profit, it would obviously be more than enough to pay for the fourth-year renewal contribution (premium), assuming that the amount of contribution each year has been the same throughout. But profit is something that cannot be guaranteed or assured.

On the other hand, whether such level of profit rate could be sustained would depend on the claim experience as well as the accounting practice adopted by a Takaful operator. Certainly, in the event of big claims, the financial benefits paid from the Takaful fund would be correspondingly high. This would decrease the balance of the fund, and hence would affect its underwriting results. Should the number of claims exceed contributions, the underwriting performance would suffer a deficit. Hence, there would be no profit. From the technical standpoint, Takaful, to all intents and purposes, is no different from insurance. It therefore follows that the art of evaluating or underwriting a risk would also be no different from the principles commonly and universally practiced by insurance, so long as these principles do not contravene the *Shari'ah* Rules. After all, Islam calls for good governance and excellent management, particularly in a situation where one is entrusted as a custodian or trustee to manage and handle money. In a contract, the parties involved must uphold certain obligations and responsibilities to ensure fairness, transparency, and equitability. Honesty and sincerity are essential hallmarks to check one side from taking undue advantage at the unfair expense of the other resulting in unjust loss and injury not only to the other side, but others as well who at the same time may be having a joint financial interest in the same contract. This is where the "*utmost good faith,"* a doctrine strongly advocated in Islam, should strictly be adhered to as a way to prohibit all parties in a Takaful contract not to conceal any material fact either at the point of inception of the contract or upon the happening of a misfortune leading to claim.

Since it in the best interest of the parties concerned to safeguard the Takaful fund from any undue exposure due to unwarranted practices, it would rest upon the shoulder of the Takaful operator to see and ensure that proper professional management is in place. After all, the fund which is built from the al-Tabarru' or donation portion of the contributions paid by the participants is for their common benefit. Together with the operator as trustee and manager on the one hand, and the participants as the "insurers" and "insured" at the same time on the other must protect the Takaful fund from undesired claims. Toward this end, every strategy adopted in ensuring good management of an insurance company would also be relevant in ensuring good management of Takaful. If insurance requires professional skills and strong technical know-how in the areas of underwriting, risk management, and claims' evaluation, so would Takaful. However, in the case of Takaful, an appreciation of *Shari'ah* would help to enhance a better understanding of its operation.

The accounting practice adopted is also a critical factor in determining the profit. For practical reasons, *Shari'ah* generally accepts that cash accounting would be a suitable basis for any contract. Although it is not strictly an issue of *Shari'ah*, it is however argued that any profit to be shared must be based on actual or realized figure. To distribute profit which has been not realized is simply not practical. In this respect for the type of Takaful operation with profit-sharing arrangement, as practiced by Takaful Malaysia, for example the most appropriate accounting policy would be on cash basis. By this policy, only the recognition of income is on cash basis, but liabilities and expenses are accrued.

Following this practice, participants who pay their Takaful contributions early, ideally on the day the Takaful contract is incepted, would have the opportunity to receive relatively higher amount of profit from late paymasters. Profit is calculated from the day contribution was paid. Therefore, any delay in the settlement of the contribution would mean an opportunity lost due to relatively less amount of actual profit received. For example a participant who pays the contribution on the same day the Takaful commences would enjoy a full-year profit upon the expiry of cover. On the contrary, if payment is made 3 months later, the amount of profit distributed would be equivalent only to three-quarters of the full year's profit. The other critical feature commonly adopted as part of the accounting policy under Al-Mudharabah practice is on the treatment of the operator's management expenses. In this respect, a distinction must be made between costs of Takaful, such as payments of claim, re-Takaful, and reserve which are borne by the Takaful fund, from the management expenses of the operator which are charged to the shareholders' fund. In terms of the Takaful contract, participants of general Takaful agree that the operator would pay on their behalf claims to their aggrieved fellow participants and other related costs including re-Takaful and reserve as al-Tabarru' or donation from their contributions. Like insurance, due to the nature of general Takaful, al-Tabarru' amount can only be got when a misfortune occurs. For the purpose of profit sharing, therefore, the contribution recognized as al-Mudharabah capital would be the balance left after deducting the *al-Tabarru'* amount. And investment profit will be added back to the capital.

Conclusion

All the issues and problems arising should be clarified and clearly stated to all especially to those who have interest in buying a Takaful policy. The company will work as per the convenience of the policyholders even though the valuation of certain policies is quite rigid. At the same time, the company should put a lot of effort in providing the necessary information to future clients. The computation, segmentation, and evaluation of policy must be made transparent to public. This vital information can open the eyes of all to the beauty of *Shari'ah* principle in transactional and insurance activities. The actuary also plays the critical responsibilities in making such information available. On the other hand, they also tend to promote the Takaful product to all. The procedures in estimating and approximating should be done keenly and decently. As a matter a fact, the pricing may be the core element in attracting a client. Therefore, the interactive and two-way direction of communication can be a suitable mechanism in transmitting the valuation ideas. The Takaful company and other qualifying authorities should collaborate and cooperate in marketing and revealing the pure *Shari'ah* concept in the Takaful products. The brand name, purposes, benefits, and the calculation of claim should be main ingredients in Takaful brochure, websites, kiosks, and other promotion tools. By relying on traditional activities, the company may not get huge feedback from the public.

Perhaps, the government and other financial institutes should lend their hands to Takaful industry. This implies that the commitment by other concerned parties will make the Takaful product possible, and the prospective clients can generally accept its pricing procedure. Nevertheless, the effort and exertion that the company put on this pricing procedure may become a benchmark for other companies. In short, the pricing procedure should serve as primary information in marketing the Takaful products. And this mechanism can't work alone and need support by various organizations to realize it. Actuaries do the pricing procedure. This is the vital role in insurance field. The valuation should be done in appropriate manner, and in Takaful's case, it should be based on Islamic jurisprudence. The actuary department is responsible for calculating new product's cost in light to mobility rates, mortality rates, projector investment return, and information from marketing research and providing value to the company. At the last stage, the approval should be verified by the central bank. The process of pricing in Takaful starts with conducting research on the need of the society by the marketing department. The purpose of the costing is used in determined the right pricing rate for the new product. After getting the approval, BNM will fill the documents and approving the proposals. The IT will create system for the new product before it is launched in the market. The pricing regulation in Takaful is based on mutual cooperation, and it has been defined in al-Qur'an. This procedure may not involve *Riba'* and other usury elements as prohibited by Islam.

Notes

1 A past experience.
2 Ibid.
3 An example of past experience.

21 Accounting for *al-Zakat*

Introduction

Zakat is one of the pillars of Islam. Literally, *Zakat* means purification. Technically, it is a tax on the wealthy to provide social justice.[1] The collection of *Zakat* will be distributed to eight categories of recipients (asnaf) who are qualified to receive *Zakat* money. It has been mentioned in the Qur'an regarding to this 8 asnaf.

> *To spend of your substance, out of love for Him, for your kin, for orphans, for the needy, for the wayfarer, for those who ask, and for the ransom of slaves; to be steadfast in prayer, and practice regular charity*.[2]

When Muslims pay *Zakat*, they purify their soul and become closer to Allah s.w.t. Allah said in the al-Quran: "*those who believe, and do deeds of righteousness, and establish regular prayers and* ***regular charity****, will have their reward with their Lord: on them shall be no fear, nor shall they grieve*."[3]

Zakat does not only ensure benefits to the poor but also to the rich. When the richest spend their money on the poor, they help the poor with any type of financial problem. Allah loves those people who spend their money for Him in seeking rewards in the world and in the Hereafter. Also, it strengthens the relationship between them (concept of brotherhood among Muslims).

> *Your (real) friends are (no less than) God, His Apostle, and the (fellowship of) believers, those who establish regular prayer and regular charity, and they bow down humbly (in worship)*.[4]

Generally, *Zakat* is charged on agricultural products, mineral, treasures, gold and jewelry, livestock, money, etc. However, in the modern context, there are many items that are being subjected to *Zakat*. For example individual income, business wealth, dividends, shares, bonds.

> *On the day when that 9hoarded wealth) shall be heated in the fire of hell and their foreheads and their sides and their backs branded therewith, (those*

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> *sinners shall be told;) These are the treasures which you have laid up for yourselves! Taste, then, the evil of) your hoarded treasures!*
>
> (At-Taubah:35)

The chapter focuses on corporate *Zakat*, which will consist of business wealth, bonds, and shares. This topic is very important in this century because there are many people not aware about it, and there are many issues arising because of this. We also include some examples to further elaborate.

Zakat on business wealth

The Muslim should realize that they have an obligation to pay *Zakat*. The amount of *Zakat* paid not only applies to individual Muslim, but also Muslim- owned company. The Muslim obey Allah when they are paying *Zakat*. *Zakat* is the third pillar of Islam. The amount of *Zakat* is collected from the Muslim wealth and income which are payable annually. In the modern context, many new items have been charged for *Zakat*– for example business wealth, dividends, shares, and bonds. In Malaysia, most of the *Zakat* is collected from Islamic financial institutions (e.g., Bank Islam, Tabung Haji, Takaful). Other business entities such as companies do not pay *Zakat* on the behalf of their shareholders. Even the standards have been developed specifically for Islamic financial institutions (Financial Accounting Standard 9 which was issued by AAOIFI), but other business entities can refer to this standard as their guideline.

Conditions of governing *Zakat*[5]

Conditions of governing *Zakat* are as follows:

- *Islam* – Only Muslims need to pay *Zakat*. In a business company where ownership is shared between a Muslim and a non-Muslim, only the Muslim's share of the business is subjected to *Zakat*.
- *Full ownership* – *Zakat* is payable on the shared capital or company shares owned by the owner minus any money borrowed to purchase the shares.
- *Intention* to do business.
- *Haul* is completed – Wealth must remain for a full year in the possession of the person before it is liable to *Zakat*. Normally, the haul follows the financial year.
- **Nisab** is reached – Must exceed the value of 85 gram of gold according to market value.

Illustration on core issues

- *Zakat* base rate
- Methods of *Zakat* measurement

- Valuation of assets
- Treatment of *Zakat* in the financial statement
- Disclosure requirements

Zakat base rate

Basically, the company should pay *Zakat* based on *Urud at-TAl-Ijarah* (trade goods) which is paid once a year at the rate of 2.5 percent for a lunar calendar year and 2.5775 percent for a solar calendar year.[6] For others, it should attain the nisab of 85 grams of gold.

Methods of *Zakat* measurement

There are three methods that can be used in measuring *Zakat*. FAS 9 determines that *Zakat* can be computed by using Net Current Asset and Net Invested Fund (Net Owner's Equity) method.[7] However, there is another method called Net Growing Capital Method which has been proposed by El-Badawi and Al-Sultan (1992).[8]

Net Current Asset method

The business wealth is subject to *Zakat*, which includes cash and cash equivalent, debtors (after deducting provision for doubtful debts), and assets acquired for trading (inventory, marketable securities, etc.). While trade liabilities should be deducted from the asset, only the net will be subjected to *Zakat* – for example the total Net working capital will be subjected to *Zakat*.

Net owner's equity method

This method includes all the owner's equities such as paid-up capital, reserves, retained earnings, and profit for the year. While for the net fixed assets, investment not acquired for trading and loss for the year are excluded. Then, the net will be subjected to *Zakat*.

Net growing capital method

According to El-Badawi and As-Sultan, this method is used to improve the deficiency on the Net Current Asset method. The way is by adjusting the Net Current Asset at the end of the year, and then adding back to the item such as short-term debt used to finance fixed assets to pay off long-term debt or reduce capital stock and subtracting long-term debts used to finance current assets.

Valuation of assets

Zakat should be based on market value (cash and cash equivalent value) and not at historical cost.[9]

Treatment of *Zakat* in the financial statement

Zakat is to be treated as a nonoperating expense and should be included as a deduction from net income. While unpaid *Zakat* should be treated as a liability for the company.

Disclosure requirements

For the disclosure requirements, it should be consistent with applicable standards in Malaysia which are conforming to Malaysian Accounting Standard Board (MASB) and International Accounting Standard (IAS). By referring to the AAO-IFI, FAS 9, only certain are applicable, which are[10]

- the method of *Zakat* measurement used.
- the ruling of *Shari'ah* Supervisory Board on matters pertaining to *Zaka*t.
- the obligation of *Zakat* due from the subsidiaries.
- the disclosure requirements of MASB IAS 1 (General Presentation and Disclosure Requirements) to be complied with.

Example 1

Illustration describing how to determine the *Zakat* base:

Excellent Sdn Bhd

Balance Sheet as of 31 December 2003 (a Past Experience)

	$'000	$'000
Fixed Assets		
Fixtures and Fittings (NBV)	17,300	
Equipment	70,500	
Motor Vehicles	5,000	92,800
Current Assets		
Cash at Bank	28,000	
Stock	9,000	
Debtors	23,500	
	60,500	
Current Liabilities		
Creditors	15,000	
Other payables	2,000	
	17,000	43,500
		136,300
Financed by:		
Capital		100,000
Reserve		50,800

Long Term Loan	6,000	
	156,800	

Answer

Net Asset Method

		$'000	$'000
Asset Subject to *Zakat:*			
Cash at Bank		28,000	
Stock		9,000	
Debtors		23,500	60,500
Less:	Liabilities		
	Creditors	15,000	
	Other Payables	2,000	17,000
Net Current Assets			43,500
Subject to *Zakat* 2.5 percent			1,088

Net Owner's Equity Method

		$'000	$'000
Total Owner's Equity:			
Capital		100,000	
Reserve		50,800	
		150,800	
Add:	Long Term Liabilities		
	Long Term Loan	6,000	156,800
Less:	Fixed Asset		
	Fixtures and Fittings (NBV)	17,300	
	Equipment	70,500	
	Motor Vehicles	5,000	92,800
			64,000
Subject to *Zakat* 2.5 percent			1,600

Net Growing Capital Method

		$'000	$'000
Net Current Asset			43,500
Add:	short-term debt used to:		
	finance fixed asset	15,000	
	pay off long-term debt	11,500	
	reduce capital stock	17,000	43,500
			87,000
Less:	long-term debt used to finance current asset		12,000
			75,000
Subject to Zakat 2.5 percent			1,875

Zakat on financial securities

The scopes that will be included in this topic are *Zakat* on shares and *Zakat* on bonds. Both types of shares (preference or ordinary) are liable to pay *Zakat* even though some people say that they are haram. So, there are many issues arising in this area. In order to overcome this problem, we will refer to works of some scholars.

Characteristics

There are two views

- Some scholars consider financial securities to be treated like *Zakat* on trade which must achieve nisab, haul, and at the same rate. *Zakat* due will be based on the percentage of shares' ownership in the firm charged on the Net Current Assets of the company at the end of the financial year.

Computation

$$\text{Net Current Assets} \times \frac{\text{Number of shares owned}}{\text{Total number of shares in the company}}$$

- Some scholars consider financial securities as a commodity like gold. So, *Zakat* will be charged based on the market current value of shares at the end of the financial year.

Zakat on shares

Condition of zakatability:
Haul: The shareholders must own the shares more than a year.
Nisab: The value of shares must exceed the market current value of 85 gram of gold.
Rate: 2.5 percent

There are two ways of computation of *Zakat* on shares, which are given as follows.

Long-term investment

If the shareholders acquired the shares for long-term investment or to control the company capital, or as a participant in the company's capital, the shares are considered as fixed assets. So, only its income generated (dividend) will be subjected to *Zakat*. The rate is 10 percent as is the case with agriculture produce.

Short-term investment

If the shareholders acquired the shares for trading activity or short-term investment, it is considered as current assets. The *Zakat* will be imposed both on its value and income (dividend). The rate is 2.5 percent, as is the case with *Zakat* on business wealth. The *Zakatable* amount can be computed based on the company's financial statement at the end of the period.

Example 2

In June 1999, Syafiqah has purchased \$ 5,000 worth of ordinary shares of Abdul Malik Berhad. The market value of shares at December 31, 2000 was \$ 4. Absul Malik Berhad did not pay *Zakat* on behalf of its shareholders. The following is the summarized balance sheet of Abdul Malik Berhad as of December 31, 2000.

Fixed Assets	800,000
Current Assets	450,000
	1,250,000
Ordinary Shares' Capital (Fully Paid @ \$ 2.5)	100,000
Current Liabilities	330,000
Retained Earnings	820,000
	1,250,000

Net profit for the year for Abdul Malik Berhad was \$ 950,000, and 60 percent of this year's profit has been distributed as dividends to the shareholders.

Answer

Short-term Investment

$$(\text{Net Current Assets} + \text{Dividend}) \times \%\ \text{shareholders} \times 2.5\%$$

$$= \left[(450,000 - 330,000)\ +\ 570,000\right] \times \frac{5,000}{100,000} \times 2.5\%$$

= \$ 862.50

Long-term investment

$$\text{Dividend} \times \%\ \text{of Shareholders} \times 10\%$$

$$= 570,000 \times \frac{5,000}{100,000} \times 10\%$$

= \$ 2,850

Treated as a commodity

$$\text{Market Value of shares} \times \text{Number of units of shares owned} \times 2.5\%$$

$$= \text{RM}\ 4 \times \frac{5,000}{2.50} \times 2.5\%$$

= \$ 200

Zakat on bonds

Bond is one type of contract debt. It represents a promise made by the company that issued it to repay the amount of debts at a certain date in the future subjected at a fixed rate of interest.[11] The condition of *zakatability* is same with Zakat on shares.

There are two opinions to calculate *Zakat* on bond, which are given as follows.

Sheikh Shaltoot and Sheikh Abu Zahra (Egypt)

Bonds are traded in the market. Therefore, they should be subjected to *Zakat* on trade at the rate of 2.5 percent of their market value when they reach the nisab after 1-year possession. According to this opinion, both assets and income should be subjected to *Zakat*.

There are two ways to compute it.

Long-term investment

If bonds are considered as fixed assets, it will be treated as a long-term investment. *Zakat* will be imposed only on its interest (income) earned. The rate charged is 10 percent of the market value of bonds.

Short-term investment

If bonds considered are considered as short-term investment, the rate is 2.5 percent. *Zakat* will be imposed both on assets and income.

First conference for *Zakat* held in Kuwait 1404H/1984

Normally, bonds come with *Riba'* (usury), and *Zakat* should be paid according to *Zakat* on money where its rate is 2.5 percent on the market value of bonds. The interest received from bonds is not subjected to *Zakat*. That income is considered haram, and the Muslims should not use it. However, the interest money received can be spent for the benefit of the general public in order to get rid of the money.

Example 3

Abdullah has bought interest-based government bonds of 100 units of $ 500 each, more than a year ago. He already received his first annual dividend of 15 percent on the face value last month.

View of Sheikh Shaltoot and Sheikh Abu Zahra (Egypt)

LONG-TERM INVESTMENT

Dividend × 10 percent

= (100 × $ 500 × 15 percent) × 10 percent
= $ 750

SHORT-TERM INVESTMENT

[(Number of bonds × Value) + Dividends] × 2.5 percent
= [(100 × $ 500) + (100 × $ 500 × 15 percent)] × 2.5 percent
= $ 1,437.50

First conference for *Zakat* was held in Kuwait 1404H/1984. In reference to the

Number of bonds × Value × 2.5 percent
= 100 × $ 500 × 2.5 percent
= $ 1,250

Issues

Muslim shareholders

If the companies are not wholly owned by the Muslim shareholders, the amount of business wealth subjected to *Zakat* must be computed based on the percentage of Muslim shareholders. For example considering that the company has 7 out of 10 shareholders, who are Muslims (70 percent of Muslim shareholders),

By using Net Current Asset method showing in *Example 1*.
Net Current Assets subjected to *Zakat* =
$ 43, 500,000 × 2.5 percent × 70 percent: $ 761,250

Zakat versus taxation

The company should not be burdened with *Zakat* and at the same time should be paying tax. While *Zakat* is obligatory toward Allah, tax is a Muslim responsibility to the government. So, if the company had paid *Zakat*, they can reduce the burden of taxes with the amount of *Zakat*. The company needs to show the evidence of *Zakat* paid to the tax authority.

Method of *Zakat* measurement

This issue had been raised by El-Badawi and As-Sultan.[12] First, they thought that the net current will be undervalued if short-term debt is used to finance fixed asset, pay off long-term debt, or reduce capital stock, and overvalued if long-term debt is used to finance current assets. In order to face this problem, they proposed a new method called Net Growing Capital Method which has been discussed earlier. However, they were also skeptical that this new method does not work well, especially if the company does not have proper accounting system and record of business transaction. It is difficult for *Zakat* authority to compute *Zakat* when the company does not have complete disclosure requirements.

No act to govern the *Zakat*

There is no act to govern *Zakat* like tax. Tax is governed by Income Tax Act 1967 (Act 53) with selected regulations and rules. So, nobody can avoid it. As we know, *Zakat* is obligatory for Muslims, but there are some people who ignore it. So, with the act, it will make them aware of that obligation and force them to give the portion which belonged to another person. As we know, the money that is collected from *Zakat* will be distributed to 8 asnaf.

Conclusion

All Muslims are obliged to pay *Zakat*. It is a social responsibility of Muslims in order to help the poor with the wealth of the rich. Since the Prophet Muhammad's time, the Muslims, especially in agricultural activities such as paddy farming, have been subjected to *Zakat*. However, in the modern time, many conflicts have arisen. The farmers argued why they are should pay *Zakat,* but the business entity which is even more richer than them is not paying *Zakat*. For example the farmer could only get $ 5,000 per harvest as compared to the company that might contribute more than $ 5,000 profit semiannually. Muslims need to be more aware on this matter. Now, Islamic authority bodies such as Majlis Agama Islam Selangor and Pusat *Zakat* need to resolve this issue. Moreover, new standard should be proposed to complement FAS 9 which only concentrates on Islamic financial institution. This new standard can be applied by all business entities such as companies and partnerships. *Zakat* on company is charged on the business wealth, its shareholders shares, dividends, and bonds. This means that they cannot avoid paying *Zakat*. But there is no act to govern the *Zakat* as tax even though *Zakat* is one of Muslims' obligations. While this act will give a brief information about it and punish people who do not perform it.

Notes

1 Shaikh Mahmud Ahmad, *Economics of Islam*, Adam Publishers, 2014, p. 78.
2 The *Qur'anse*: 177.
3 The *Qur'an*: 2:277.
4 The *Qur'an*: 5:55.
5 www.muis.gov.sg
6 AAOIFI, Financial Accounting Standard 9 (Zakah), p. 283.
7 Ibid., p. 283.
8 El-Badawi, M.H., and Sultan, S.M., pp. 69–85.
9 AAOIFI, Financial Accounting Standard 9 (Zakah), p. 297.
10 Abdul Rahim Abdul Rahman, *Zakat Accounting, Creating Business Wealth*, UPM Press, 2005, p. 16.
11 Nur Barizah Abu Bakar, Lecture note on Accounting for Zakat.
12 El-Badawi, and Sultan, pp. 69–85.

Part II

Shari'ah audit standard

22 Corporate understanding of islamic audit and *Shari'ah* compliance

Introduction

An auditor and audit regulatory frameworks are basically provided in Malaysia under *the Companies Act* 1965, which required that all the companies registered and incorporated under Registrar of Companies to have their account audited by professional auditors. Different types of audits are included to give a brief idea about wide scope of the audit profession. In addition, the most common type of audit, that is the audit of the financial statement, with little of details of the work done by a typical audit firm, is included. This chapter, however, discusses the differences between modern auditing and *Shari'ah* standard. We will explain that both types of auditing are different. We have divided this chapter into two sections. The first part will discuss the modern or current auditing system, and the other part will explain the main criteria of *Shari'ah* (Islam) standard. We also will include the real time cases involving auditors' fraudulent practices. Among the most famous, naturally, are the conflicts involving auditor clients. Other types of liabilities to the auditors include the damage to the parties and very rare criminal charges. The recent Enron case, which awakens the accounting industry, is included with a discussion on the collapse of the giant audit firm Author Anderson. It will conclude with some recommendations how to improve the regulatory frameworks to solve some of the existing problems or issues in the industry. Obviously, a very noble profession like the auditing will totally depend on the up keeping of the professional ethical conduct by the auditors. Regulatory frameworks are mere guidelines to keep the auditors in the right place.

Modern auditing

In Malaysia, *Companies Act* 1965 stipulates that every company incorporated under the act is required to have its financial statement audited annually, which is called the statutory audit.

Section 172(1) of Companies Act 1965 states:

> *At any times before the first annual general meeting of the company, the director of the company may appoint, or (if the director do not make an*

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> *appointment) the company at a general meeting may appoint, a person to be the auditor of the company and any auditor or auditor so appointed shall, subject to this section, hold office until the end of the first annual general meeting.*

The same act section 169(4) states that:

> *The profit and loss account and the balance sheet shall be duly audited before they are laid before the company at its general meeting as required by this section.*

The companies act rigorously requires any company incorporated in Malaysia to audit its account annually before its annual general meeting. It is also of worth to highlight the importance of auditors at the annual general meeting. For the first year of audit, the auditor can be appointed by the director, however, as from the first annual general meeting onwards the auditors must be appointed at the AGM for the following year. Although the company might not change the auditor, the auditor is being required by the Companies Act 1965 to be re-appointed every year. With this requirement of the companies act, an induced demand is created for the profession. People specialize in field. Every qualified accountant must be registered in the Malaysian Institute of Certified Public Accountant (MICPA). Malaysian Institute of Accountants (MIA) is a statutory body that is requiring by the Account Act 1967. MIA keeps the accountants updated with the code of ethic for the profession. The codes of ethics are the by-laws of the profession, and all institutes should abide by the rules. The importance of auditing is unquestionable. Auditing provides economic benefit to the society. Auditors including external auditors and government auditor assist companies in improving the operation and internal controls. An auditor often makes suggestion to management that ultimately reduces the cost by promoting operational efficiency and reducing errors and fraud.

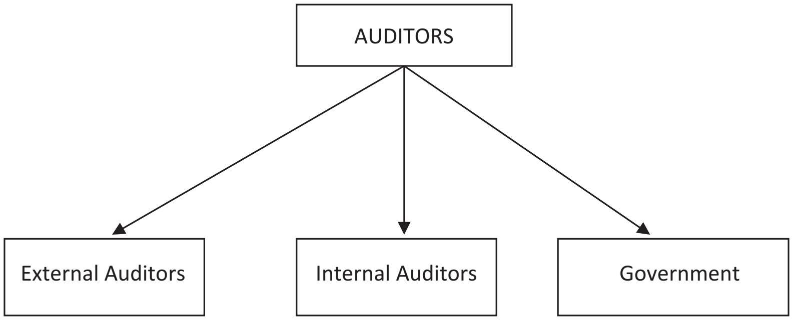

Figure 22.1 Structures of Auditing Process

What is auditing?

According to Arens, A.A. et al., auditing is the accumulation and evaluation of evidence about information to determine and report on the degree of correspondence between the information and the established criteria, and an independent person should do the auditing. This definition very clearly explains what an auditor does. Auditor basically verifies the financial statement provided by the management. He collects the evidence and checks whether the accounts have been prepared in accordance with approved accounting standards in Malaysia – specifically, the Malaysian Accounting Standards. Companies are required to prepare the account in accordance with these standards. What the auditor does is they verify it. In order to have a standard practice and explaining how the audit should be done, audit standards are established. These are the basically the mechanisms that the auditor should adopt in analyzing the financial statement.

Once the auditor is appointed, he examines the records by accumulating and evaluating evidence. Then the year-end financial records are compared with accounting standards and the provisions of the *Companies' Act* 1965. The auditor is required to plan and perform the audit in accordance with established auditing standards in Malaysia to give timely, reliable, and easily understood information to the investors and all the stakeholders of the company at large.

Types of audit

There are different types of audit. Most famous and voluminous audit is that of the financial statement. This is simply because any incorporated company in Malaysia is statutorily required to audit their financial statement annually. Financial statement audit is conducted to determine whether the overall financial statements are stated in accordance with established accounting standards. Financial statement commonly includes balance sheet, profit and loss account, and the statement of cash flows, including the complying notes to the accounts. The second type of audit is the operational audit, and an operational audit is a review of any part of an organization's operating procedures and methods for the purpose of evaluating effectiveness. Normally at the end of the operational audit, some recommendation is made to the management. This is the final stage of the operational audit. An example of an operational audit would be evaluating the efficiency and accuracy of the payroll processing transaction in a newly installed computer system. The third type of audit that is going to be discussed in this chapter is the compliance audit. The purpose of the compliance audit is to determine whether the auditee is following specific procedures, rules, or regulations set down by a higher authority. A compliance audit for a business organization could include determining whether the accounting personnel are following the procedures prescribed by the company controller or examining the contractual agreement with the bankers and lenders to be sure that company is complying with legal requirements. In the audit of government and statutory bodies, there is an extensive compliance auditing due to extensive regulation by higher government authorities.

Shari'ah standard of audit

Nature of Shari'ah *Supervisory Board*

Islamic financial institutions (IFIs) need to comply with the *Shari'ah* requirements in their organizational structure, information flow and channels of communication, operating procedures and controls, etc. Therefore, the institute's *Shari'ah* Advisory Unit acts to advise financial institutions on these matters and can advise and assist them to create a reliable system for the conduct of business in compliance with the provisions of the *Shari'ah*. It uses recognized consulting procedures and practices in dealing with clients' requirements. Besides, saying that competition is always in favor of the most proper and efficient can counter the claim that traditional financial institutions desire to unfairly compete with Islamic financial institutions. This kind of competition may prompt Islamic financial institutions to exercise more diligence and care to introduce better-quality products and conduct their activities more efficiently. This is in fact evident in many nations where competition exists. Therefore, *Shari'ah* Supervisory Board (SSB) should be established, and it should take a drastic action to control and consult the company's current and future performance in line with Islamic principles and standards.

There should be a *Shari'ah* Supervisory Board for any Islamic financial institutions or investment body, and that Board should consist of trustworthy scholars who are highly qualified to issue fatwa[1] (religious rulings) on financial transactions. Moreover, they must have considerable experience with knowledge of modern dealings and transactions. The Articles of Association, prospectuses, or statutes should provide for the existence of a *Shari'ah* board, whose fatwa and resolutions should be binding upon the financial institution's management. Sheikh Nizam suggested that it should be independent and free to give opinions on proposed contracts and transactions. The role of the *Shari'ah* Supervisory Board should be concurrent with that of the financial institution itself in the sense that it should be formed from the moment the financial institution is incorporated and that it should provide continued supervision and permanent checking of contracts, transactions, and procedures. This should be provided for in the Articles of Association or the prospectus.

Types of *Shari'ah* Supervisory Board

Most the Islamic financial institutions (IFIs) today, especially for Islamic banks, have their own in-house advisers called *Shari'ah* Supervisory Boards (SSBs).

According to Abdallah (1984), there are many types of SSBs which can be referred to as follows:

- *Shari'ah* Consultant
- *Shari'ah* Supervisory Board
- Department of Fatwa and Research (DFR)
- Central Higher SSB

In fact, the SSBs should have at least three knowledgeable people in the *Shari'ah* or in other professional fields (i.e. economists, lawyers, and bankers). They work on part time basis and always conduct meetings every week and month with the related parties in the bank. Meanwhile, the Department of Fatwa and research (DFR) is like an internal auditor who works full time and functions daily in the entire bank. The International Association of Islamic Banks (IAIB)[2] has developed the Higher *Shari'ah* Supervisory Board (HSSB) as higher tier of control in 1983, and the purpose is to supervise and control the banking system in Sudan.

Functions of SSBs

Shari'ah *Supervisory Board (SSB)*

According to H.J. and Sinning (1982), the SSB is also known as external auditor, but it has been regulated in Islamic perspectives whereby the religious audit and the financial audit are conducted simultaneously. Some of SSB's functions are as follows:

- Making a draft and then getting the approval in collaboration with the related department and officials.
- Analyzing the issues and problems from an Islamic point of view.
- Working as a consultant to the bank management.
- Inspecting the bank's operations and examining the required documents.
- Giving assurance and opinion upon the annual report that complies with the *Shari'ah* standards.

Department of Fatwa and Research (DFR)

In fact, DFR is same as an internal auditor of conventional system, who is much involved in the daily operations of the bank. This department usually makes examination of all the financial reports. Based on the Article of the Tadamon Islamic Bank (1983), every Islamic bank should have a specialized department (DFR), whose manager shall be appointed by the board of directors. Based on Article (60) of Tadamon Islamic Bank, given here are some duties of DFR:

- To ensure that all the bank's business and activities are in accordance with the *Shari'ah* principles.

- Making and drafting of all the forms such as contracts, agreements, and operations of the bank activities and to ensure that comply with the Islamic principles.
- Observe the economics and legal activities of the bank's business.

Higher Shari'ah *Supervisory Board (HSSB)*

Following there are some roles of HSSB:

- Scrutinize the fatwas that are in conformity with the *Shari'ah* principles and rules.
- To direct, observe, and control bank's activities and other IFIs that are related to the *Shari'ah*.
- Give specific views based on Islamic principles and rules against any issues by its members.

Reasons of SSB's existence and establishment

Some reasons why SSB was established to meet the objectives and perform such duties were the following:

- The different practices between Islamic and Conventional Banking system. SSB could identify similarities and differences.
- The dependency of Conventional Banks on interest, since there is a prohibition of interest charged by Islamic banking system.
- The difference between Conventional Banks that imply the risk-bearing principle, but the Islamic banking practice is based on the principle of *ghunm bil-ghurm*.[3]

Ex-ante and Ex-post Shari'ah *audit*

All the SSBs should perform ex ante *Shari'ah* audit on all transactions in terms of designing contract agreements and forms. These audit activities should be performed during the process of the transaction. The processes include the contract and the execution, follow-up, the implementation of the terms of contract until liquidation. In other hand, R.E. and Karim (1986) identifies that there are no SSBs that are supposed to conduct full ex-post *Shari'ah* audit. They rather tend to audit random samples of the transactions. For example in the Sudan, first HSSB must train the staff of the internal audit department in Islamic banks to conduct the ex-ante and ex-post *Shari'ah* audit. As a result, the staffs must report to the management of the bank and SSB.

Comparison between SSB and the conventional auditor

According to R.E and Karim (1986), there are some differences between the roles of SSB and conventional auditor, and they are:

- SSB auditors must perform certain functions that the conventional auditors do not always do or practice. For instance, normally the conventional auditors perform their audit based on the samples irrespective of whether the transactions are Halal or not; in contrast, before SSB made further report, it has to ensure that all transactions which have been made by the bank have to comply with the *Shari'ah* standard.
- The SSB auditor independence is based on the morals of beliefs and obligations to other community interests. The higher commitment to religious values and ethics could provide its members with strong incentives to be independent. However, the conventional auditor's independence is governed by legal rules and professional codes of ethics.
- Normally, the SSB has to focus on the compliance of IFIs to the Islamic percepts to ensure that the result would reflect a high commitment to Islamic business principles, while conventional auditors are focused on their compliance with accounting standard to ensure that they could fairly report upon the economic situation of the company.
- The SSB auditor independence is much influenced by moral values; however, the conventional auditors are affected by economics factors.

Compliance of Islamic financial institutions with AAOIFI standards

The AAOIFI has issued and published several accounting and auditing standards that all Islamic financial institutions should comply with and implement. The AAOIFI's activities are considered a fundamental for Islamic banking activities by keeping them away from individual and personal reasoning. The collective personal reasoning (*ijtihad)* of the AAOIFI is highly important in this fundamental aspect of Islamic economic life. Therefore, these standards deserve strict adherence. Several government authorities and central banks in certain countries have circulated these standards and obliged other financial institutions to comply with them. That is why any party wishing to incorporate or set up an Islamic financial institution should be required to conform to these standards in order to avoid confusion, misunderstanding, and uncertainty and to seek clarity in business activities.

Enron case

This case highlights the damage one can do to a profession. One of the problems in the case was that the same audit partner was engaged in the audit of Enron for many years, and, worst of all, the same audit was providing business advisory for the company. It was a big lesson for other audit firm and countries.

Conclusion

Even though there are some sliding differences in modern auditing and *Shari'ah* standard, we cannot reject both. What we hope that one day, the *Shari'ah* standard will be combined with the modern auditing system so that we can really feel and practice the Islamic practice perfectly in our country Malaysia. We are one of the Islamic countries, therefore, we must start to use *Shari'ah* standard in all over countries. It will give a big impact in an ethic manner. It also will anticipate cases like Enron case that happened in real life.

Notes

1 Fatwa is a ruling on the *Shari'ah* and issued by competent scholars(s).
2 The International Association of Islamic Banks was found in 1977 to reinforce the ties and links among IFIs and to promote mutual cooperation and coordination.
3 Al-ghunm means consideration, benefit, and profit. Al-ghurm means loss. The phrase in this context denotes that the Islamic mode of finance may not per se guarantee to the contracting party either capital or any expected profit.

23 Essence of Islamic audit

Introduction

An auditor is a person who is responsible to audit the account of the company and to report to the members of the company on the account. In addition to these, an auditor is also obliged to exercise reasonable care and skill in the performance of his duties. However, an auditor is not an ensurer and does not guarantee that the company's book shows the time position. In the manual of Company Law, s174 stated that there are six rights of auditors:

- To report whether the accounts show a true and fair view.
- To attend general meeting and speaking on any business that concerns them.
- To receive notice of all such meetings and any other communication sent to the members in connection with them.
- To have access to the book, account, and vouchers of the company.
- To require from the officer of the company all info and explanation thought necessary for the performance of their duties.
- To obtain information about a company's subsidiaries where this is necessary for the fulfillment of their duties as auditors of the company.

Meanwhile, from the Islamic point of view, there are certain criteria which Islamic auditors should have, where, for example, the auditor should have Islamic value which is essential in order to differentiate between Islamic and conventional auditors. At the same time, an Islamic auditor should comply with *Shari'ah*. They must not violate any of the constraints set by the *Shari'ah*.

Characteristic and importance of Islamic auditing

Muhammad Akram Khan (1989) from his article, "A beginner's introduction to auditing," page 1, discusses about the origin of auditing which shows that it is an old profession in checking and cross-checking of public accounts in the ancient Egyptian, Greek, and Roman civilizations the evidence of which truly exists. During seventh to thirteenth centuries when Muslims flourished, they developed the concept of public auditing further. There is recorded evidence showing that

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the Muslim caliphs established separate accounting and auditing departments. It shows that Islamic economic environment previously had emphasized on the procedures of auditing to have a proper collection and use of resource in true and fair view. In general, Macmillan Dictionary of Accounting states that,

> Auditing is an independent examination for an expression of opinion on the financial statements of an enterprise by an appointed auditor in pursuance of that appointment and in compliance with relevant statutory obligations. It is a mechanism within the process of accountability whereby the performance of those in control of the resources of an organization is checked or monitored by or on behalf of interested parties.

Precisely, from the definition that had been stated, there are some key phrases that show the importance or the roles of auditors in dealing with their work with full responsibility.[1]

The most important characteristic of being an auditor is independence. In Islam, the independence of auditors is stressful because humans get too easily influenced if they don't have faith and are always thinking of self-interest. Such person cannot be a good an Islamic auditor because it can occur big circumstances toward the society. As we know, in Islamic teaching, *Khilafah* refer to the role, status as well as the mankind's responsibilities to themselves and to the ummah. This point is interrelated with the independent issues, which strive to the base of the man itself. According to *Abdalati* (1994), Khilafah are relationships among man and god, man and his fellows, man and the other elements, and creatures of the universe man and his innermost self. It means that every human being has the responsibility toward all Muslims for whatever deeds they have done with regards to the sources that God (Allah) has given to him or her. In this kind of situation, Islamic auditors should understand their roles in the society, as it is important for them to persuade the other people to refrain from any fraud and inappropriate transaction in their business activities and help them to manage the performance of company within the Islamic *Shari'ah* and ethical conduct rules. It shows that indirectly, the Islamic auditors should become the role model in the organizations for the harmonization aspect. It is mentioned in al-Qur'an (2:30):

> *Behold, thy Lord said to the angels: "I will create a vicegerent on earth." They said: "Wilt Thou place therein one who will make mischief therein and shed blood? Whilst we do celebrate thy praises and glorify thy holy (name)?" He said: "I know what ye know not.*

This verse means the human being principally has been assigned to safeguard this world, which belongs to Allah. It is understandable that the Islamic auditors play a great role in preventing human corruptions and to give the whole satisfaction to the parties involved so that there is none of unhealthy competitors in the economic environments such as what happened in the case of Arthur Andersen with Enron that is one of the biggest accounting firms in the world, downgraded by the corruption of their auditors. We should avoid something like this to happen again therefore in the capacity as an Islamic auditor; we should implement the Islamic values in our daily life. It implies universal brotherhood, trustees for God's resources with humble lifestyles, and human freedom in Islam. Regarding the independence, based on the Mautz and Sharaf analysis, there are three specific areas of practitioner independence, which must be upheld. First is the technical independence, in which the auditor is free of any controls or pressures concerning his audit techniques and procedures and the extent of their applications.[2] From my point of view, this kind work ethics can help auditors to come out with their own decision and true and fair view without any interruption from other parties, which can lead to independence problems. Second is the investigative independence that the auditor is free from any attempted restrictions on matters that he may want to examine during the audit, and no source of information can be considered closed to the auditors. In the end, the auditor must not be having any personal interest, which might cause him to be tempted to limit his examination. This specifies that the auditors also should make sure that the full examination should be made without any self-interest. All transactions should be incurred in the procedures of auditing to get the true and fair view financial statements. The third area is reporting independence, which requires the auditor to be free from any pressures to suppress facts revealed by his examination or to modify his method of expression. It can be said that the auditors are required to carry out the examination for any or all the following types of audit: truth and fairness of accounts, compliance to rules and regulations, propriety of transactions, and value for money.

Furthermore, it is important for the Islamic auditors to emphasize the value of the professional ethics because their profession is one of the professional levels. Individually, the Islamic auditors should have the accountability in the same line that Muslims believe that they will be accounted for whatever they do in this world and in the hereafter. In Islam, Muslims verily must fulfill the will of *Allah (swt)* in order to seek his pleasure and the promised rewards in the hereafter. Thus, it requires that every deed and word by them in this world must be in line with the Islamic teachings. They must follow the Islamic teaching framework carefully in whatever tasks or work that they are being imposed to, so the issue of accountability is there without any interference. The importance of accountability in a man's life also has been manifested by the prophet of Islam as: "*Each one of you is a guardian and each guardian is accountable to everything under his care*." From this, we know that the responsibility of every person is in being accountable for any job in this life. As far as Islam is concerned, the auditors should perform their professional duties with the objective of satisfying the needs of the shareholders and showing acknowledgment to Allah as well. Therefore, auditor must avoid the issue of fraud or material misstatement for example exist in the company if this concept could be internalized and could be reflected in theirs conduct. In the process of accountability, there will be certain steps to be followed that the participant organization should be identified with, therefore the auditors will know and really be clear with the transactions that being made. After that, the identification of objectives is needed to achieve the accountability process as the auditors will follow the stated objectives. In the end, the provision of relevant information to monitor the objective if there any circumstances would happen therefore the preparation can be made in the earlier stage to control any corruption occur.[3]

Everything that is being discussed here can be adapted in today's economic environment. As we know, during regime of Tun Abdullah Ahmad Badawi, the former Prime Minister of Malaysia, the government implemented Islam *hadhari* method that emphasizes on the value of Islamic teachings in any area of the work being done. Therefore, the Islamic auditors today have a bigger role in the economic environment to make sure the system that being used is applicable and in the line with Islamic *Shari'ah*. The example of the process that will lead to the Islamic auditors is the issue of who should audit *Zakat* account. In the auditing of *Zakat*, the responsible people are those who are in the *Zakat* department, State Islamic Religious Council (SIRC) and Shari'ah Advisory Body (SAB) and we can see that academics do not seem to favor the involvement of religious scholars in the auditing of *Zakat*. The purpose of SIRC and SAB are to provide an assurance that the company and bank will operate within *Shari'ah* Islamiyah principle. The important thing that should be highlighted by the auditors is diminishing *Riba*' although it is unseen, but still if it exists it means that the transactions are not in favor of Islamic teaching; therefore, the Islamic auditor is accountable to diminish it. Next, is the avoidance of gambling and speculations that are very important to control them from being held as, in Islam, it is prohibited to gamble and speculate any information in the business transaction specifically or do any activity which is similar.

Furthermore, the auditors also must make sure the avoidance of any contracts or trade in prohibited products. It means that anything regarding the business activities should be in accordance of Islamic teaching. The concept of Halal and *haram* are being emphasized in dealings with any trader. It is important for the auditors to make sure that the resources or raw materials that are being used also are permissible. They also must check the company in providing guidance on documentation, transaction, and business in the line of *Shari'ah* Islamiah principles and must prepare a religious auditing report which is very important in clarifying their auditing process.

The concept of transparency is also important regarding the importance of Islamic auditors. *Allah (swt)* had mentioned in the following ayah: "*O you who believe! When ye deal with each other, in transactions involving future obligations in a fixed period, reduce them to writing. Let a scribe write down faithfully as between the parties*" (Al-Baqarah 282, Beginning of the Ayah). Auditors are responsible to a wide spectrum of auditing matters, and their aims should not only focus strictly on monetary values but also on social responsibility to the ummah. Applying the concepts of transparency, auditors should emphasize on undertaking the audit process of a company by disclosing information regarding its policy, activities undertaken, contribution to the community, use of resources, and the protection of environment.

In addition, the concept of trustworthiness is also important for Islamic auditors to uphold their roles in the society. *Surah Al-Anfal* (Verse 27) states: "*O ye who believe! Betray not the trust of God and the Apostle, nor misappropriate knowingly things entrusted to you*." It shows that trustworthiness is of paramount importance in auditing work which is most emphasized in keeping the confidential information of a company carefully and avoid any fraud and speculation between the subordinates in accordance with their self-interest. Trustworthiness is also parallel with the concept of accountability whereby man in his judgment toward his action is influenced by the fear that he will be accounted to *Allah (swt)*.

This is one of the highly regarded virtues in Islam, and every individual within an organization is required to subscribe to ethical and moral practices while carrying out their commercial activities. Stewardship sense will lead all to utilize the possessions entrusted upon them by *Allah (swt)* to the best of their abilities as a form of submission to Him. The religious belief can be considered as the system of shared values and beliefs through which people within an organization interact. If Islamic auditors find any violation of the Islamic principles in the operation of an organization, this should be reported in the organization's financial statement as in the case of an external auditor reporting their opinion on the true and fair view of the organization's performance.

Shari'ah auditing in the Islamic business organization

The objectives and operations of Islamic and Muslim organizations should be different from non-Islamic organizations where it should follow *Shari'ah* ethical principles and promote social welfare rather than concentrate on profits. However, it should not perceive the need to forgo the profit maximization objective if the *Shari'ah* constraints are fulfilled. Islamic organizations must carry out their financing, investing, and operating activities according to the *Shari'ah*. Besides, profit maximization or wealth maximization is not the ultimate rationale for the existence of Islamic business organizations. Instead, earning a reasonable rate of return according to the risk undertaken should suffice Muslim investors who should always keep the success of the hereafter in mind. Hence, the equitable treatment of other groups and the general social well-being of the community should be more important to the Muslim businessmen than profit.

Given the socioeconomic principles under which Islamic and Muslim business operate, the information that is required may vary from what conventional accounting is attuned to provide, as characteristics and consequences of conventional accounting do not make it a suitable information tool for Muslim users and organizations. This inappropriateness can be categorized into three aspects:

- Conventional accounting may, in effect, direct Muslim users toward un-Islamic behavior.
- Conventional accounting may not provide appropriate information for Muslim users (various stakeholders and organizations).

- The concepts of conventional accounting such as historical cost and monetary measurement concept may be unsuitable for adoption by Islamic organizations.

Once the auditors understand the concept of accounting principle used by the business organization, they can easily trace their task. When assigning their duty, they should not forget to implement their Islamic ethic in all aspects. For example an "*Islamic accountability*" is the main objective of Islamic auditors. Further, they have social and environmental objectives where the auditor must make sure that the organization should function in an environmentally friendly manner. Islamic religious auditing provides an institution to solicit advice and to monitor performance so that a company operates as a strictly Islamic concern. The Islamic percepts highlight the difference between Islamic and Western business practices. For instance, the Islamic *Shari'ah* prohibits, among other things, the payment and receipt of *Riba* or usury, gambling or *Misir*, hoarding, and speculation.

Riba or Usury *(al-Qur'an 2:275 and 276)*

> *Those who swallow usury cannot rise up save as he ariseth whom the devil hath prostrated by (his) touch. That is because they say: Trade is just like usury; whereas Allah permitted trading and forbiddeth usury. He unto whom an admonition from his Lord cometh, and (he) refrauneth (in obedience thereto, he shall keep (the profit of) that which is past, and his affair (henceforth) is with Allah. As for him who returneth (to usury) Such are rightful owners of the Fire. They will abide therein. Allah hath blighted usury and made alms giving fruitful. Allah loveth not the impious and guilty.*

Gambling or Misir *(al-Qur'an 5:90)*

> *O ye who believe! Strong drink and games of chance and idols and divining arrows are only an infamy of Satan's handiwork. Leave it aside in order that ye may succeed.*

Hoarding *(al-Qur'an 9:34)*

> *O ye, who believe! Lo! Many of the (Jewish) rabbis and the (Christian) monks devour the wealth of mankind wantonly and devar (men) from the way of Allah. They who hoard up gold and silver and spend it not in the way of Allah, unto them give tidings (O Muhammad) of a painful doom.*

Speculation *(Qureshi 1976)*

Besides that, Islam also forbids any investing or dealing in alcohol, pork, and other activities which are considered unlawful from an Islamic perspective. The need for religious audit stems from the requirement that organizations should comply with the *Shari'ah*. If religious auditors find any violation of the Islamic principles in the operation of an organization, this should be reported in the organization's financial statement as in the case of external auditors reporting their opinion on the true and fair view of the organization financial position. Moreover, the businesses are also social institutions having a responsibility to *Allah (swt)*, their stakeholders, and environment. As such, externalities, especially negative consequences, irrespective of financial considerations, should be reported by an Islamic accounting system. The system should also provide nonfinancial information concerning employee–employer relationships, discharge of contract, details of prohibited transactions under Islamic law (if any, and their reasons), environmental and communal responsibilities undertaken, and the amount of *Zakat* payable and paid. The nonfinancial information is especially relevant to Muslim users of Islamic organizations because the user requires assurance that the organizations have conducted their activities within the *Shari'ah*.

In addition, the auditor could also contribute to the corporate ethics program by conducting ethics-related activities and by serving as models of ethical conduct. Although many large corporations have made a start in instituting ethics codes, there are risks that such codes may not or permeate the corporate culture. Considerable training may be necessary to improve employee sensitivity. Hopefully, auditors could play a role, especially if their skills have been vetted by service with transnational companies. Internal auditors are well positioned to play an important part in installation, monitoring, and evaluation of the corporate ethics program and in the related training. Auditors should be comfortable in ethic-driven activity, given their transnational perspective and the circumstances that moral and ethical values are similar throughout the world. Management should take immediate advantage of the credibility that internal auditors could bring to the ethics program.

Conclusion

Shari'ah compliance auditing can be upgraded to the level of professional ethics in today's economic environment. It is important for Malaysia specifically to have such Islamic auditor- oriented companies with certain restrictions being imposed from now on for the future benefits as nowadays there are so many cases regarding the corruption of financial position in companies by the auditors themselves because of the lack of auditor independence. This kind of attitude should be abolished before it becomes worst. There are few recommendations to improve auditor's work to be more efficient and effective. Auditors should be working independently of the interference of the managing directors of the company being audited, and they should be more responsible in reporting to a third party if they suspect that the managing directors are involved in fraud or other illegal acts. Next, the auditors also should be accountable to a wide range of stakeholders and be financially liable if they fail in their duties. Therefore, in the line of implementation system of Islam Hadhari that was being stressed by our former Prime Minister, Malaysia can come out with many talented and worthy Islamic auditors by adding additional syllabus in the high education institutions for students who take accountancy in auditing system in Islamic perspectives as a subject and give more training to existing Muslim auditors to excel in implementing Islamic values and *Shari'ah* Islamiyah in the process of auditing in any business area. Therefore, the standards of auditing in Islamic principles according to, for example AAOIFI, can be more applicable and be upgraded in conjunction with today's economic environment that stresses on globalization and we should be fully prepared in dealing with whatever circumstances that happen in the future.

Notes

1 Muhammad Akram Khan, *A Beginner's Introduction to Auditing*, Cataloguing in Publication Data, 1989, p. 5.
2 Michael Sherer, and David Kent, *Auditing and Accountability*, Pitman Publishing Inc., 1983, p. 25.
3 Ibid., p. 9.

24 *Shari'ah* auditing standard

Introduction

Annual audit is mandatory for every company, regardless of size, that is registered under the *Malaysia Companies Act*, *1965*. For this reason, the term "auditing" is most associated with the statutory audit of a company's accounts or financial statements as provided under the Act.[1] The Act also stipulates that an external independent auditor referred to in the Act as "approved company auditor" must perform a company's annual audit.[2] An audit of financial statements increases the reliability of financial information for users (e.g., managers, investors, creditors, and regulatory agencies). An auditor plays an important role in this process by providing objective and independent reports on the reliability of information.[3] By adding the audit function in the business environment, the users of the financial statements have reasonable assurance that the financial statements do not contain material misstatements or omissions. The auditing profession is currently operating in a very dynamic environment as numerous forces are affecting the responsibilities and activities of the public accountants. Lately, critics have charged that the current audit system has failed to meet user expectations (e.g., Enron case). Therefore, it is important for the profession to reflect to the nature and ethics of auditing in the hope that by practicing ethically, this will restore the confidence of the public. The purpose of this chapter is to explore auditing under the *Shari'ah* guidelines. Perhaps the best answer to give to the critics is by developing an auditing standard and guidelines in compliance with the *Shari'ah* rulings.

Essence of auditing

Annual audit has been made compulsory for every company that is registered under the *Companies Act*, *1965*. In contrast, a business registered as a sole proprietorship or partnership is not required to audit its annual statements annually. In addition, the act also requires that company's annual audit must be performed by an external independent auditor. This is where the credibility of an auditor is enhanced through the public reliance on the professionalism of audit profession. Traditionally, the essence of auditing is to provide financial control and risk management. Auditor is deemed to work on the interest of shareholders by which

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he/she needs to carry out a systematic process with the objective of accumulating and evaluating evidences regarding the management assertions contained in the financial statements.[4] Hence, an auditor's assurance depends on the level of collaborative evidences found during the audit process. However, there is an increase in audit needs since the corporate sector expanded in parallel to the changes in business activities. Thus, audit provides not only a control on financial aspects but also furnishes the top management with analysis, appraisals, recommendations, and advices regarding the company's performance and profitability as well.[5] Moreover, it identifies business opportunities, which will then contribute to adding value across the business. Hence, the most important aspect is that audit serves as a method of corporate governance since audit analytical procedures provide an extensive control on the correspondence between management assertions, its authenticity and financial reporting framework.[6]

Objective of auditing

Auditing plays an important role in the process of providing objective and independent reports on the reliability of information. Generally, by adding the audit function in business activity, the users of the financial statements have a reasonable assurance that the financial statements do not contain material misstatement. Hence, the users can rely on the assertions made by the manager, while making any judgments or decisions. As mentioned earlier, auditing profession is operating in a very dynamic environment. There are many forces that influence the responsibilities and activities of an auditor. Thus, complying to general accounting and auditing standards in Malaysia as well as rulings issued by *Shari'ah Supervisory Board* while providing a reasonable assurance to the financial statements become the most important objectives of an audit. Apart from complying with the aforesaid standards, there are some other standards that an auditor must keenly keep under observation: that is the standards conforming to *National Accounting Standard & Practice and AAOIFI*.[7] This is to ensure that the activities carried are not in breach of the *Shari'ah* requirements. Ultimately, an audit on financial statements enhances the reliability of management assertions and enables an auditor to communicate his true and fair opinion on the financial statement to the interested users or parties.

Responsibilities of an auditor

Auditing plays an important role in the principal–agent relationship, where an auditor has a responsibility of determining whether the financial reports prepared by the manager conform to the approved accounting standards and in compliance with *Companies Act, 1965*. In general, an audit process is to enable the auditor "to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework." This is stated in *ISA 20*, "Objective and General Principles Governing an Audit of Financial Statements" (Para. 2).[8] Thus, auditor's opinion toward the financial statements adds credibility to the report. Auditing requires an auditor to engage in a systematic

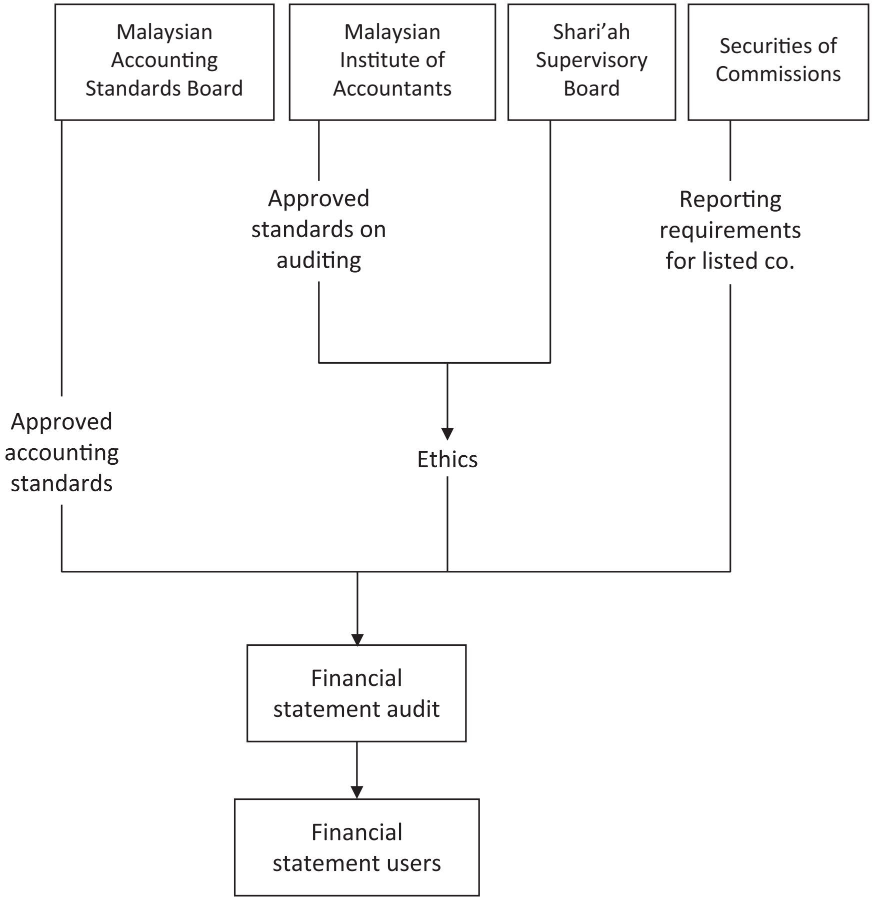

Figure 24.1 Organizations Affecting the Financial Statement Audit

process of accumulating and evaluating evidences, which relate to the management assertions in the financial statements. Auditor's reliance on collaborative evidences will influence the auditor's opinion toward the financial statements. Performing professional duties entails a lot of ethical procedural activities. It requires some commitments toward the responsibility that is shouldered by an auditor. Serving clients to the best and offering management some valuable advices have been highlighted as being the primary responsibilities of auditors. This includes a discussion on the current system used by the client. Auditor, who observes and evaluates the management system and controls used, may provide value-added advices to his client. For instance, auditor may suggest the use of *UBS* or *MYOB* accounting software to the client who is using manual accounting system. To maintain the perception that auditors are credibly reliable in their profession, they should observe ethical values in their duty apart from providing the highest level of trustworthiness, integrity, and truthfulness. All information should be disclosed and communicated to the related parties so that it will not reflect any wrong judgments. In addition, auditors should avoid themselves from taking any advantages of the client's confidentiality of information, either for personal or third party's interest.

The question of complying with professional ethics depends on the principle of religious legitimacy. Responsibility toward God should be put as the priority in one's consideration followed by responsibility toward society, profession, superiors, client, and to himself. Commitment toward Allah generates good ethical appearance and diligent and proper work with high quality, which comply with *Shari'ah* Rules and Principles. This applies especially to the auditor, who is Muslim in religion. The emphasis on *Shari'ah* adherence ensures good audit work with sincerity while performing professional duties. Seeking Allah's satisfaction becomes a due to good job fulfillment by way of being conscious to the accountability before *Allah (swt)* and the Day of Judgment. For instance, a good auditor will refrain himself from committing any corruption or convicting to any fraudulent activities such as accepting gift, favor, or hospitality that would influence his judgment on the assertions contained in the financial statement.

Moreover, an auditor is responsible to preserve his independence in both facts (mind) and appearance. Auditor should maintain his mental attitude of being fair and portray his independency. The *Malaysian Institute of Accountant (MIA) By-Law* on *Professional Independence* stated that, "A member of public practice should be and be seen to be free of any interest that might detract from objectivity."[9]

This indicates that independence can be in terms of mind as well as appearance. The earlier type of independence includes freeing an auditor's mind from any factors, which may influence or affect his professional judgment. While the latter type of independent refers to holding an official position, which disqualifies a person from being the auditor for that company as stated in *Section 9(1) of the Company Act*, *1965*.[10] Also, holding financial interest or having a family relationship in the client's company will disregard one to be the auditor of that company. In addition, an auditor should adhere to general accounting and auditing standards in Malaysia while conducting any audit work, even up to the process of evaluating evidences and providing reasonable assurance to the financial statements. Besides, auditors should maintain their competency and due care in the profession. It can be attained through updating his technical services every now and then and keeping his knowledge up to date. Indeed, in the expansion of audit profession, an auditor should continuously be aware and be conscious of his function and responsibility toward God, society, profession, and client in providing a true and fair view on the financial statements. An auditor should be serving client to the best and with the most ethical conduct, which would not contravene to the underlying principles.

Hence, auditor's responsibilities include:

- Determining whether the financial reports prepared by the manager conform to the approved accounting standards and complied with *Companies Act*, *1965*.
- Adding credibility to the report of financial statements.
- Engaging in a systematic process of accumulating and evaluating evidences, which relate to the management assertions in the financial statements.

- Serving clients to the best and offering management valuable advices.
- Observing ethical values in their duty, apart from providing the highest level of trustworthiness, integrity, and truthfulness.
- Putting an emphasis on *Shari'ah* adherence to provide good audit work with sincerity while performing professional duties.
- Preserving independence in both facts (mind) and appearance.
- Adhering to general accounting and auditing standards in Malaysia while conducting any audit work, even up to the process of evaluating evidences and providing reasonable assurance to the financial statements.

An auditor, therefore, shall continuously be aware and observe his function and responsibility toward God, society, profession, and client in providing a true and fair view on the financial statements through serving client to the best and with the most ethical conduct.

***Shari'ah* rulings – ethical principles**

Islam is a comprehensive religion. It provides guidance in all aspects of life including economics, social, political, and cultural. Accounting and auditing are parts of economy, which are professions that are required by *Shari'ah as Fard kifayah*. Both accounting and auditing provide the concept of fairness as they show where the resources have been allocated. The realization of this concept is closely related to the code of ethics for accountants in performing their professional duties and responsibilities. From the Islamic point of view, the ethics of accountants and auditors depend primarily on the principles of Islamic faith and *Shari'ah*. As ethics are integral part of Islamic *Shari'ah*, therefore, Islam strongly emphasizes on that and considers them as one of the objectives of legislation. In short, Islamic *Shari'ah* provides some foundations of auditors and accountants' ethics. The major *Shari'ah* foundations of auditors and accountants' ethics are given in the subsequent sections.

Integrity[11]

Integrity is an act of honesty and having strong moral principle. In Islam, integrity is highly valued as it governs all acts. It requires accountants and auditors to perform their duties and responsibilities with competency and adequacy. Allah said in the Qur'an,

> *Truly the best of men for the thee to employ is the man* who is strong and trusty. (*Surah Al- Qasas:* 26)

Principle of vicegerency of humanity on earth[12]

Man is the best creation of *Allah* (*swt*), and He (swt) bestowed us with mind (*al-'aql*). Thus, we serve as vicegerent of *Allah (swt*). We are entrusted to develop the earth. However, it is important to be aware that the supreme authority belongs to *Allah (swt)*, and that man's ownership of property is not absolute. We must always observe the orders and prohibitions of *Allah* (*swt*) regarding

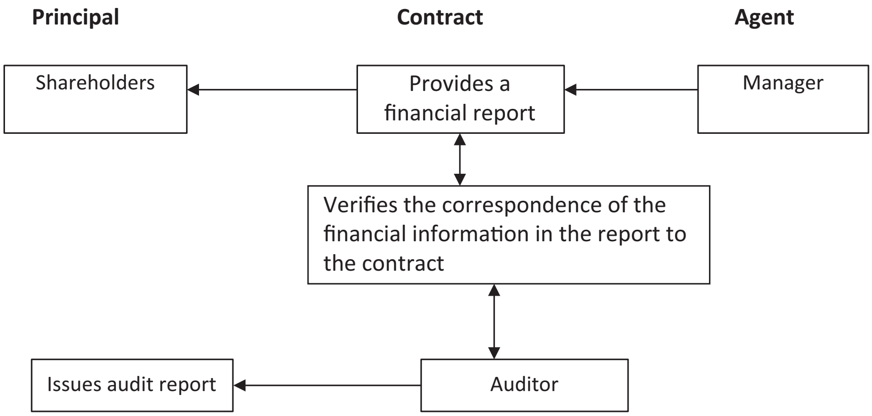

Figure 24.2 Overview of the Agency Relationship Leading to the Need for Auditing

Source: Auditing and Assurance services in Malaysia, William F. Messier, Jr. Margaret Boh, McGraw Hill, Malaysia Edition, 2002, pg 16

property. Objectives in *Shari'ah* are pervasive, and these include property. Thus, auditors have big roles in ensuring that property and funds are not squandered and wasted uselessly or used in prohibited matters (e.g., usurious transactions) or traded unjustly or by denying the rights established in it for *Allah (swt)*. Anything that is prohibited in *Shari'ah* should not be given either verbal or documentary support in anyway whatsoever. *Allah (swt)* said in the Qur'an:

> *Behold, thy Lord said to the angles: "I will create a vicegerent on earth.*
> (*Surah Al Baqarah:* 30)

> *It is He who halt made you (His) agents, inheritors of the earth.*
> (*Surah Al An'am:* 165)

Sincerity[13]

The Qur'an and *Sunnah* stress that we must have good intentions in whatever we do. Good intentions will lead to good performances and commitments in work as they also promote sincerity and avoid hypocrisy. Auditors are not to perform work because of fame, flattery, and boasting. Instead, he should regard his work as a religious commitment as well as a performance of his professional duty. This will eventually turn his duty into a form of worship. This is in line with the fundamental established in *Shari'ah* that good intention turns a habit into worship. Subsequently, the auditor becomes worthy of reward from *Allah (swt)*.

Piety[14]

Piety refers to a strong belief in religion. It means fearing Allah to protect oneself from adverse consequences by following the rules of *Shari'ah*. This is done by observing Allah's commandments and forbidding oneself from His prohibitions. Therefore, auditor must fear Allah in performing his duty especially when dealing with property as it diverts man's attention and leads him into transgression. *Allah (swt)* said:

> *Let there arise out of you a band of people inviting to all that is good, enjoying what is right and forbidding what is wrong*.
>
> (*Surah Al- Imran:* 104)

Then the Holy Prophet also mentioned that,

> *Fear Allah wherever you are, and follow the evil with good to obliterate it, and deal with people in good conduct*.

Righteousness and making one's work perfect[15]

According to this principle, one should perform his duties that have been assigned to him in the best manner, and that is to attain perfection in his work. This can be achieved through academic qualifications, practical experience, and acquisition of religious knowledge. Therefore, auditors must always strive to acquire the aforementioned. *Allah (swt)* promotes this principle in the following verse:

> *And spend of your substance in the cause of God and make not your own hands contribute to (your) destruction; but do good, for God Loveth those who do good*.
>
> (*Surah Al Baqarah:* 195)

Besides that, Prophet also mentioned that,

> *Allah likes when someone performs his work to do it perfectly and Allah has described righteousness in everything*.

Allah-fearing conduct in everything[16]

This implies that *Allah (swt)* is constantly watching the acts of His servants. Therefore, it is Allah that the auditors should be afraid of regardless of the opinion of other people, which includes his superiors. This principle is absolute and will never change from time to time. Hence, auditors should always practice self-monitoring. And this may weaken unless it is tied to both faith and feeling that one is being observed by *Allah (swt)*. Allah said,

> *Allah ever watches over you*
>
> (*Surah Al Nisa'*: 1)

"For verily He knoweth what is secret and what is yet more hidden." (Surah Taha: 7)

Men's accountability before *Allah (swt)*[17]

As *Allah (swt)* is observing all the acts of auditors, therefore, they will be accountable to Him on the Day of Judgment for all their deeds. Thus, auditors should always be aware and to avoid doing things that may incur Allah's punishment. The auditor should always remember that he is accountable before Allah and before his society, profession, superiors, and finally before himself.

> *Then shall anyone who has done an atom's weight of good, see it. And anyone who has done an atom's weight of evil, shall see it.*
>
> (*Surah Al Zalzalah*: 7–8)

Shari'ah code of ethics in auditing

Auditing is one of the branches of accounting. It is associated with an examination of accounting data. It is a professional service which people put high reliability on. Hence, audit needs to be performed in the most ethical manner as the auditors provide reasonable assurance to the company's stakeholders. Therefore, based on the ethical principles highlighted in the Qur'an and *Sunnah*, the certain ethical principles for accountant and auditors are derived, which are explained in subsequent sections.[18]

Trustworthiness

Accountants and auditors should be trustworthy and honest in conducting their professional duties. However, they are said to be trustworthy by conducting their responsibilities with a high degree of integrity and honesty. One way to show their integrity is by protecting their client's interest, which is related to the confidentiality of the information of the clients. For example they cannot use such confidential information for their personal gain and for any third party. Besides that, the auditors must present and provide factual and truthful report so that others can rely on the information while making accurate judgment and decision.

Legitimacy

Besides being truthful and honest, auditors also must comply with certain legal requirements and procedures including the *Shari'ah* Rules and Principles. They must act and conduct according to the guidelines of *Shari'ah* principle. Moreover, they also must comply with standards provided by professional bodies such as *MASB*.

Objectivity

In conducting an audit work, auditors must be objective. They must perform their professional duties in fair, impartial, and unbiased ways. They also must be free from any conflict of interest in order to ensure their independence. As independence is a fundamental characteristic and a key point of the auditing profession, auditors should be independent in both mind and appearance. If the auditor is a member of the board of directors of the auditee company, then he should not perform or conduct any audit work for that company. This is because he could be involved in providing biased information, as now he is no longer an independent party.

Professional competence and diligence

As auditing is a professional service, it should be conducted in professional ways. Therefore, auditors should show their credibility in realizing these duties. To ensure work is done in proper manner, they should be professionally competent and well-equipped in carrying out the task assigned. Hence, professional competence can be achieved or obtained through ways like achieving formal education, training, experience, and professional education. Besides that, they must be due diligent in discharging their responsibilities as they are not only responsible to the stakeholders but ultimately also to *Allah (swt)*.

Faith-driven conduct

Auditors should behave and conduct their duties in line with the faith values derived from *Shari'ah* Rules and Principles.

Auditor's report

The auditor's report is the expression of opinion of the auditor whether the financial statements audited have been prepared in accordance with the auditing standards and applicable accounting principles. It is also important to note whether the financial statements comply with the statutory requirements.

The auditor's report consists of title, addressee, introduction, scope, opinion, auditor's address and signature, and the date of report.[19]

Title

This refers to the main subject, for example reports of the auditors.

Addressee

The report should be addressed mainly to the shareholders/members of the company audited (as required by the engagement and laws).

Introduction

The report needs to identify the pages of financial statements that have been audited as well as the date and period covered. There should also be statements regarding the responsibilities of the management and the auditors. The management's responsibility is toward the preparation of the financial statements. Meanwhile, the auditor's responsibility is to express an opinion on the financial statements.

Scope

The reports should narrate that the audit was conducted in accordance with the relevant auditing standards and accounting principle, which do not contravene the *Shari'ah* Rules and Principles. The report should also indicate that the audit was planned and performed to obtain reasonable assurance and not an absolute one. The audit also evaluates the overall financial statement presentation.

Opinion

The auditor's report must state the auditor's opinion as to whether the financial statements give a true and fair view in accordance with the appropriate standards and that they do not contravene with the *Shari'ah* Rules and Principles and statutory requirements.

Auditor's address and signature

The report should name the audit firm, personal name of auditor, and address of the audit firm. The report should be signed.

Date of report

The auditor should date the report on the date when the audit was completed. The date should not be earlier than the date when the statements were signed or approved by management.

Shari'ah ethics

Principle of trustworthiness

An auditor should refrain oneself from engaging in any activity that would jeopardize the attainment of the institution's religious and ethical objective. Therefore, an auditor should present and communicate favorable as well as adverse information honestly with complete transparency. He should not disclose confidential information acquired while performing his professional duties unless required to do so by the law. He also should not use the information acquired during his duties for the advantage of himself or third parties.

Principle of religious legitimacy

An auditor should always remember his responsibilities toward Allah and toward his society, profession, superiors, and himself. Therefore, it is his responsibility to verify the religious legitimacy of everything relating to his duties. He should be aware of *Shari'ah* Rules and Principles relating to jurisprudence of financial transactions. Thus, he should receive formal and adequate training in jurisprudence of financial dealings. He must make sure that he performs his duties in conformity with such rules and principles. Anything that is not in conformity with *Shari'ah* should be considered illegitimate by him.

Maqasid al-Shari'ah

An auditor should be independent in fact as well as appearance. Therefore, he should not involve himself in a situation whereby there is a conflict of interest. This is because it will threaten his judgment in expressing his opinion. He should also avoid from being influenced by others to ensure he could present information truthfully. In his course of duties, he should refuse any gifts or favors. Contingent fees (defining the fees as a percentage of the income number) should also be avoided as it might affect the independence and objectivity of the auditors.

Professional competence and due diligence

An auditor has a responsibility to possess an appropriate level of academic and professional competence. He should uphold his competence by going through courses of skill development constantly and keeping himself updated with the new developments in the auditing as well as accounting profession. Most importantly, he should acquire enough working knowledge of *Shari'ah* aspects relating to financial transactions.

Principle of good faith

An auditor's behavior should always be in line with religious values derived from *Shari'ah* Rules and Principles. Particularly, he should consistently do self-monitoring (i.e., always be aware of the existence of *Allah (swt)*). He should be conscious that he is accountable before Allah on the Day of Judgment. Therefore, in his course of duties, he should be seeking Allah's satisfaction and not to submit to the pressures of others. He also should show love and brotherhood as well as be merciful to the rest of the staffs and whomever he deals with.

Conclusion

It is a common critic opinion that the current audit system has failed to meet user expectations. It is important for the profession to reflect the nature and ethics of auditing in the hope that by practicing ethically, this will restore the confidence of the public. In order to uphold the integrity of auditors, a separate body should govern ethical principles for checking the auditor's professional responsibilities. Therefore, the best solution is to form the *Shari'ah* Supervisory Board to govern the ethics of auditors. The ethical principles that should be included are as follows:

- *Integrity*
- *Trustworthiness*
- *Confidentiality*
- *Professional Behavior*
- *Honesty*
- *Righteousness*
- *Fairness*
- *Objectivity*
- *Professional Competence*
- *Due Care*
- *Independence*

The question of complying with professional ethics depends on the principle of religious legitimacy. Responsibility toward God should be put as the priority in one's consideration. Commitment toward Allah generates good ethical appearance and diligent and proper work with high quality, which complies with *Shari'ah* Rules and Principles. The emphasis on *Shari'ah* adherence provides good audit work with the sincerity while performing professional duties. Seeking Allah's satisfaction becomes a due to good job fulfillment by way of being conscious to the accountability before Allah and the Day of Judgment.

Annual audit is mandatory for every company, regardless of size, which is registered under the *Companies Act*, 1965. Auditing plays an important role in this process by providing objective and independent reports on the reliability of information. Traditionally, the essence of auditing is to provide financial control and risk management. Auditor is deemed to work on the interest of shareholders for which he/she needs to carry out a systematic process with the objective of accumulating and evaluating evidences regarding the management assertions contained in the financial statements. However, there is an increase in audit needs since the corporate sector expanded in parallel with the changes in business activities. Thus, audit provides not only a control on financial aspects but also furnishes top management with analysis, appraisals, recommendations, and advices regarding the company's performance and profitability as well. Thus, complying to general accounting and auditing standards in Malaysia as well as rulings issued by *Shari'ah* Supervisory Board while providing a reasonable assurance to the financial statements become the most important objectives of an audit. This is to ensure that the activities carried out are not in breach of the *Shari'ah* requirements. Ultimately, an audit on financial statements enhances the reliability of management assertions and enables an auditor to communicate his true and fair opinion on the financial statement to the interested users or parties. To maintain the perception that auditors are credibly reliable in their profession, they should observe ethical values in their duty apart from providing the highest level of trustworthiness, integrity, and truthfulness.

Notes

1 Companies Act 1965, Malaysian Law Journal, Reissue, 1999, p. 61.
2 Ibid., p. 59.
3 William F. Messier, Jr., and Margaret Boh, *Auditing and Assurance Services in Malaysia*, McGraw Hill, Malaysia Edition, 2002, p. 3.
4 Ibid., p. 14.
5 R. Gray, D. Owen, and K. Maunders, *Accountability, Corporate Social Reporting and the External Social Audit*, edited by C.R. Lehman, vol. 4, Advances in Public Sector Accounting, 1991, p. 21.
6 Ibid., p. 23.
7 Accounting and Auditing Organization for Islamic Financial Institutions, 1999, p. 16.
8 International Standards on Auditing (ISA), ISA 20, Para 2.
9 Malaysian Approved Standards on Auditing, Malaysian Institute of Accountants, 1998.
10 Companies Act 1965, Malaysian Law Journal, Reissue, 1999, p. 61.
11 Accounting and Auditing Organization for Islamic Financial Institutions, 1999, p. 5.
12 Ibid., p. 5.
13 Ibid., p. 6.
14 Ibid.
15 Ibid., p. 7.
16 Ibid.
17 Ibid.
18 Ibid., pp. 8–9.
19 Messier, and Boh, *Auditing and Assurance Services in Malaysia*, p. 503.

25 AAOIFI's audit standard

Introduction

This chapter focuses on AAOIFI's audit standards in a nutshell. It is analyzed in each guidelines of the Auditing Standard for Islamic Financial Institutions (ASIFIs). In ASIFI No 1, it focuses on the objective and principles of auditing. As far as Islamic financial institutions are concerned, the *Shari'ah* Rules and Principles are the major reference of the standard. The Auditor's Report has been discussed in detail in ASIFI No 2. Being discussed in this chapter are the points of modified report and the matters that do not affect the auditor's opinion. Furthermore, this chapter analyzes the terms of audit engagement that is being demonstrated in ASIFI No 3. In ASIFI No 4, the discussions are focused more on the testing for compliance with *Shari'ah* Rules and Principles by an external auditor. Therefore, the auditors who get an opportunity to audit Islamic financial institutions should possess enough knowledge about Islamic *Shari'ah* Rules and Principles, and this chapter will provide some evidence on how important they are in the process of completing the entire audit task.

Analysis of Auditing Standard for Islamic Financial Institutions

Objective and principles of auditing

A question should be raised: why do the Islamic financial institutions require an audit? As we know, Islamic financial institutions are operating their systems in conformity with Islamic *Shari'ah* Rules and Principles. Therefore, one of the reasons for conducting an audit of them is as stated in Auditing Standard for Islamic Financial Institutions (ASIFI) No 1: *to enable the auditor to express an opinion as to whether the financial statements are prepared, in all material respects, in accordance with the Shari'ah Rules and Principles*. (Auditing Standard for Islamic Financial Institutions Board, 1996, p4). As far as the Islamic financial institutions are concerned, most of the theoretical work of them is based on profit sharing equity participation. That is normally involving a principal–agent relationship, which will create a natural conflict of interest[1] as an outcome of information asymmetry that exists between the provider of fund and the provider of work

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and management of that fund. Here, the accounting and auditing play an important role to avoid manipulation of records that may be made by the management who is responsible for reporting them. The auditor's role here is to determine whether the financial reports have been prepared in compliance with contract provision. Point of scope of an audit is also taken into consideration in ASIFI No. 1. Each and every audit procedure should refer to Islamic *Shari'ah* Rules and Principles, ASIFIs, relevant professional bodies, legislation, and regulations that do not contradict Islamic Rules and Principles to achieve audit objectives.[2] If there is an issue discovered that is not covered in detail by ASIFI, then International Standards on Auditing (ISAs) will be referred to. The important point is that the scope covered in ISAs must not contravene with Islamic Rules and Principles. Besides that, this chapter also discusses the issue of an auditor providing reasonable assurance. Reasonable assurance is being provided when the financial statements are free of material misstatements that could influence the economics decisions of users. Audit procedures such as thorough examination, observation, test basis, and glancing through the supporting documents can be the means to achieve reasonable assurance. Normally, in the real world, absolute assurance cannot be attainable. Additional thing in ASIFI No. 1 is the satisfactory work done on each transaction when it is in compliance with Islamic *Shari'ah* Rules and Principles.

As far as the financial statement is concerned, that is the responsibility of the management for preparing and presenting it. In Islamic financial institutions, each item presented must be in compliance with Islamic *Shari'ah* Rules and Principles, besides relevant legislation and regulation. The auditor is only accountable for forming and expressing an opinion on that financial statement. Foremost thing is that the objective of all human activities should be accordance with the Qur'an to seek the pleasure of *Allah (swt)*. Therefore, ethics that is compliant with the "*Code of Ethics for Professional Accountants*" that is issued by the AAOIFI and the International Federation of Accountant should be taken into consideration by the auditor. This also can help to ensure the objective of an audit is being achieved besides the self-satisfaction of the auditor for the worldly and hereafter life.

Analysis of Auditing Standard for Islamic Financial Institutions

Auditor's report

In this chapter, the discussion will be focused on the written analysis of the audit that has been performed by an auditor on the financial statement, which is auditor's report. The Auditing Standard for Islamic Financial Institution (ASIFI) No. 2 has provided its users the details for assistance on preparing the auditor's report for Islamic financial institutions that is effective for the financial periods since January 1, 1998. ASIFI No. 2 has drawn up its basic elements of the auditor's report, which are almost similar to the basic elements that obtainable in the International Standards on Auditing (ISA) 700 – "*The Auditor's Report on Financial Statements.*" Table 25.1 represents the list of comparison on details of the basic elements of the auditor's report on the financial statement, according to both ASIFI No. 2 and ISA 700. The major point that is common between both standards is that one of ASIFI's reference for the auditor to issue an opinion is including the *Shari'ah* Rules and Principles. If there is a situation arising for the financial institution, which did not comply to one of the rules of *Shari'ah*, it can affect the opinion of an auditor on its financial statement.

As far as the auditor's report is concerned, the issuance of unqualified report by an auditor for Islamic financial institutions is taken place when all those situations have been fulfilled; the sufficient evidence have been gathered, the audit has been performed in accordance with Auditing Standard for Islamic Financial Institutions, besides referring to relevant national regulations and standards, and also the financial statement is being prepared in accordance with the Financial Accounting Standard No 1: General Presentation and Disclosure in the Financial Statement of Islamic Banks and Financial Institutions. Besides, the issuance of modified report can happen in cases when i) the auditor's opinion is not affected and ii) the auditor's opinion is affected. The matters that do not affect auditor's opinion, such as going concern problem, significant uncertainty, and so on, emphasizes of matter paragraph will be added. But that does not affect the auditor's opinion. Therefore, it is still unqualified report. The matters that do affect the auditor's opinion will depart unqualified report to modified report other than qualified.

The basic reasons that an unqualified report is issued are as follows:

- scope limitation – in other words, difficulty to gather information needed, and
- disagreement – that is when the issue of disagreement of views between auditor and management arises, besides the disagreement on accounting policies.

Two reasons are not so material and persistent, and the qualified opinion will be expressed. If the scope of limitation issue is so material as the auditor has not been able to obtain information, the disclaimer opinion will be derived. If the disagreement issue is so material and pervasive, the adverse opinion will be expressed out. All those should bring to a clear description in except for paragraph. The adverse and disclaimer opinion would bring out the statement that the financial statements do not give a true and fair view.

Analysis of Auditing Standard for Islamic Financial Institution

Terms of audit engagement

The overall discussions on this standard mainly focus on terms of engagement that the auditor deals with the Islamic financial institution as their client and the auditor's report to a demand by the client to alter the term of an engagement to one that provides a lower level of assurances. The term of audit engagement means that both parties which include the auditor and the client agree to the condition that they hold and require to be recorded in an audit engagement letter other than an appropriate form of agreement. Basically, the contents of the engagement letter as set by the AFISI comprise the engagement letter documents and confirm the auditor's acceptances of the appointment, the objective, the scope of audit, the extent of the auditor's

Table 25.1 Comparison on Details of Basic Elements of an Auditor's Report Between Auditing Standard for Islamic Financial Institutions (ASIFI) **No. 2 and International Standards on Auditing (ISA)** 700

Auditing Standard for Islamic Financial Institutions (ASIFI) No. 2	*International Standards on Auditing (ISA) 700*
a) Title – Should be appropriate – "Auditor's Report"	a) Title – Should be appropriate – Distinguished from report issued by other top management
b) Addressee – Should be appropriate, as required by the circumstances and local laws and regulations	b) Addressee – It should be addressed to the shareholders of the company, as required in Company Act 1965
c) Opening or Introductory Paragraph – Identify the financial statements that have been audited, and period covers by the financial statements – a statement that the financial statements and the financial institution's undertaking to operate in accordance with Islamic *Shari'ah* Rules and Principles are the responsibility of the financial institution management. – auditor's responsibility to express an opinion on the financial statements	c) Introductory Paragraph – Comprises three important facts: ❖ an audit has been conducted and the period covers by the financial statements ❖ a statement that the financial statements are the responsibility of management ❖ auditor's responsibility to express an opinion on the financial statements
d) Scope Paragraph – explain the scope of the audit by stating that the audit was conducted in accordance with ASIFIs and relevant national standards or practice as appropriate which do not contravene the *Shari'ah* Rules and Principles – include a statement that the audit was planned and performed to obtain reasonable assurance; disclose that an audit involves examining evidence on a test basis, an assessment of accounting principles used and significant estimate, and an overall evaluation of financial statement presentation – include a statement that the audit provides reasonable assurance	d) Scope Paragraph – things that are involved in an audit: ❖ indicate that the audit was conducted in accordance with the auditing standard ❖ emphasized the fact of reasonable assurance that is provided by the audit ❖ disclose that an audit involves examining evidence on a test basis, an assessment of accounting principles used and significant estimate, and an overall evaluation of financial statement presentation

(*Continued*)

Table 25.1 (Continued)

Auditing Standard for Islamic Financial Institutions (ASIFI) No. 2	*International Standards on Auditing (ISA) 700*
e) Opinion Paragraph – Auditor's opinion whether the financial statement gives a true and fair view in accordance with the Islamic *Shari'ah* Rules and Principles – statement whether the financial statement complies with statutory requirements	e) Opinion Paragraph – Auditor's opinion whether the financial statements "give a true and fair view" (s174 of Companies Act) in accordance with approved accounting standards
d) Name and Signature of the auditor – Signed in the name of the audit firm and the personal name of audit partner responsible for the engagement.	f) Name and Signature of the Auditor – Signed in the name of the audit firm and the personal name of audit partner responsible for the engagement. – s8A (5) of Companies Regulations 1966 requires that the Firm Number of the audit firm and the Approval Number of the auditor should be stated.
g) Address – Should name a specific location, normally the city where the auditor maintains the office that has responsibility for the audit.	g) Address – Should name a specific location, normally the city where the auditor maintains the office that is responsible for the audit.
h) Date – Should be dated on the date of the completion of the audit	h) Date – It is dated on the day when the auditor has completed all significant auditing procedures.

responsibilities to the clients, and form of any report to be provided by the auditor. When the auditor confirms to set a prior arrangement with the client, it means that the auditor is showing his/her consent to audit the client's company. The objective stated by the ASIFI is similar to the general principle of audit standard that the auditor is accountable to express their opinion whether the financial statement gives a true and fair view in all material aspects, in accordance with fatwas, rulings, and guidelines issued by the SSB, AAOFI, and all the operations of IFI or not. The audit work that is conducted by the auditor must be in line with ASIFI. Auditor can also make use of the International Standard on Auditing and national standards if those standards do not breach the Islamic *Shari'ah* Rules and Principles. A better understanding of the accounting system would aid the auditor to evaluate its adequacy in preparing the financial statement of the client's company. In order to represent a reasonable conclusion, the auditor is needed to find more relevant and reliable evidences. Procedures that are applied by the auditor are different than that applied by the internal auditor. Other scope of the audit work that could be covered by the auditor is to detect any material misstatement of client's financial statement, and the auditor should realize that the unavoidable risk can be detected during the audit work.

The engagement letter refers to the form of report which is also associated with results of the engagement stated by the auditor in the statutory reports. A statutory report is given to the equity holders – for example a report to management on any weaknesses of material or observations on the accounting by internal control systems. Auditors have unlimited access to records, documentation, and other information requested in link with the audit, and this should be stated in the engagement letter. ASIFI also provides the guidelines to the auditor regarding the situation based on which the engagement letter need to be revised or whether there is a need to change/modify the existing terms of the engagement. As stated in ASIFI No. 3 on this recurring audit, there are factors to be considered in order to send the new letter. The factors are as follows:[3]

- The objective and scope of the audit that expose any misunderstanding to the client.
- Any modified or special terms of the engagement.
- A current alteration of senior management, equity holders, members of the board of directors or in ownership – for example in a new holding Islamic financial institution.
- An important change in nature or size of the client's business.
- Legal requirement.

The auditor is subject to consider any change in the engagement which could provide a lower level of assurances if it is requested by the client prior or during the completion of audit work. If auditor does not agree to a change of the term of engagement or does not want to continue the existing engagement, the auditor should withdraw or cancel the engagement and needs to report to the board of the director or equity holder about the termination of the engagement. Therefore, when the changes have been made, it should be agreed by the both parties: auditor and client.[4]

Table 25.2 Comparison Between ASIFI No. 3 and the General Rules of Principles of Audit

Auditing Standards of Islamic Financial Institutions No. 3[5]	*General Rules and Principle of Audit6*
The auditor and the client should agree on the term of engagement that needs to be recorded in an audit engagement letter or other suitable form of contract.	The auditor and the client must agree on the term of engagement including the types, scope, and timing of the engagement.
Basic content of the engagement letter includes:	Principle content of audit engagement letter would normally include references to
1) the engagement letter documents and confirms the auditor's acceptance of the appointment 2) the objective of the audit of financial statement. 3) the scope of audit work. 4) the extent of the auditor's responsibility to the clients. 5) the form of any report to be provided by the auditor. 6) arrangement regarding the planning of the audit.	1) the objective of the audit of financial statement 2) management's responsibility for the financial statement 3) the scope of audit including appliance standards. 4) the form of report. 5) the inherent limitations of an audit and the material misstatement may be discovered.

Analysis of Auditing Standard for Islamic Financial Institution

Testing for compliances with Shari'ah Rules and Principles by an internal auditor

As an auditor, it is her/his responsibility to know the *Shari'ah* Rules by forming and expressing an opinion on the financial statements in accordance with Islamic *Shari'ah* Rule and Principle. Even though an auditor may not possess the same level of knowledge as that of the *Shari'ah* Supervisory Board (SSB) members, but it is not compulsory for an auditor to provide the interpretation of Islamic *Shari'ah* Rules and Principles. The auditor should consider the issues of fatwas, rulings, and guidance that have been determined by SSB as a basis for them to conclude whether the financial statements of the Islamic financial institutions have been prepared in accordance with Islamic *Shari'ah* Rules and Principles. Furthermore, the auditor should observe whether the processes of new or modified products offered by the Islamic financial institution (IFI) are using the appropriate procedures. The auditor is liable to assess the related documents in order to ensure that all types of products offered have been reviewed by SSB, and the most important is that the product is in compliance with Islamic *Shari'ah* Rules and Principles. The main objective of an audit should be ensuring that the basis of test, when examining each single transaction entered, is consistent with fatwas, rulings, and guidelines of the SSB.

As far as the audit opinion is concerned, all the outcomes generated by the Islamic Financial Institutions Management, internal auditor, and as set out in GSIFI No. 3 must take into consideration whether these outcomes have affected the nature, timing, or extent of the work during the auditor's preliminary field work and final audit task. Moreover, SSB draft their report on the IFIs before the auditor can make their report available, and both reports should be in compliance with Islamic *Shari'ah* Rules and Principles.[7] Auditing Standard for Islamic Financial Institution (ASIFI) No. 4 mentions from the beginning until the end of audit task that the auditor should have the professional competence especially on the *Shari'ah* Rules and Principles in order to give reasonable assurances to the Islamic financial institutions that have been audited.

Conclusion

The major purpose of the AAOIFI, that is narrowed down to Auditing Standard have set those standard to provide the guidelines to the auditor in preparing the report and expressing opinion according or inconsistence with Islamic *Shari'ah* Rules and Principles. Auditor is required to have a code of ethics of an accountant, which should not breach the *Shari'ah* in fulfilling their task as an auditor of Islamic financial institution. The basic elements in preparing the report and the term of the audit engagement also have been discussed in detail by the ASIFI. Therefore, it is the responsibility of an auditor to follow the standards. Finally, the auditor can make use of this standard in order to comply with the Islamic *Shari'ah* Rules and Principles.

Notes

1 F.M. William, and B. Margaret, "Auditing and Assurance Services in Malaysia" (2002), p. 3.
2 ASIFI No. 1, "Objective and Principles of Auditing" (1996), p. 5.
3 ASIFI No. 3, "Term of Audit Engagement" (1996), p. 28.
4 Summary of ASIFI No. 3, "Term of Audit Engagement" (1996), p. 29.
5 ASIFI No. 3, "Term of Audit Engagement" (1996), p. 25.
6 William, and Margaret, *Auditing and Assurance Services in Malaysia*, pp. 3120–3121.
7 Summary of ASIFI No. 4, "Testing for Compliance with Shari'a Rules and Principles by an External Auditor" (1996), pp. 38–39.

26 *Shari'ah* Code of Ethics of an Auditor

Introduction

Commonly, we experience the voice of ethical problems in our life. It seems like no one knows how to deal with ethical dilemma. For example there are a lot of scandals and corruptions in today's business world generally and in job profession specifically. Do auditors cannot really be completely trusted in giving opinions – just like the Enron case and a lot more? This is because there are several studies concerning the ethics in various aspects but very few studies focusing on Islamic moral conduct for the auditing profession. Therefore, in this chapter, an attempt is made to provide the Islamic ethics that the auditors should have in mind when performing their duties so as to minimize corruption in the business world. Before discussing the principles and ethics in Islam that an auditor should have, it is better for us to clarify what is the definition of ethics. Ethics as defined by Professor Felix Pomeranz comprises normative judgments about social conduct that involves matters of good and evil for the members of society. However, it may not be upheld by legal penalties. Islamic ethics must be based on Qur'an and *Sunnah* as guidance to Muslims' conduct. It provides us the guidance of what is right or wrong, giving us the confidence to follow and make ethical decisions. Islamic ethics can be described as "*akhlaq*." *"Akhlaq"* or moral means disposition, nature, temperament, behavior, and the character of human life. Imam al-Ghazali stated that "*akhlaq"* implies such consciousness which is ingrained deep in the heart and prompts certain acts. The reason why ethical conduct is very important in the business world nowadays in accordance with Professor Felix is because:

- High ethical standards create a psychologically healthy working environment.
- Trust is fundamental to efficient business transactions: a consistent ethical behavior is necessary to maintain that trust.
- Ethical firms develop trusting relationship with their clients and establish stable and profitable relationships.
- Ethical firm minimize the risk of scandals or disasters that destroy companies and careers.

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Therefore, the principles and ethics in Islam could minimize all the ethical problems in business especially in the auditing aspect itself. The Islamic ethics that we believe the auditor should have in conducting their job are justice, accountability, trustworthy, integrity, and competency.

Auditor

An auditor is a person who is trusted to audit financial statements of companies. The fundamental task of the auditors is to prepare, analyze, and verify financial documents in order to present the true company financial position to the investors, government, shareholders, and other persons who are interested in their company. The function of the auditors is to ensure:

- The company is run effectively and efficiently.
- Records of transactions are kept accurately.
- The tax is paid accurately and consistently by the taxpayers.

Other than that, an auditor's responsibility is to state and report whether the financial statement shows a true and fair view. True and fair view means that all the records have no material misstatements.

External auditors

An external auditor is a person who is from other companies to audit the financial statements of the client company. This means that the auditor is not working in the company being audited. External auditor was a member of Public Accounting Profession. Normally, the external auditors audit the financial records for public listed and private companies, partnerships, clubs and societies, and other types of entities. An external auditor should be competent, patient, and willing to work under pressure because these are the usual factors needed for working at the client company that an auditor must have.

Internal auditors

Internal auditor is a person who is working in the company being audited. These auditors are responsible to audit the financial statements of the company that they are working for. Normally, the internal auditors have a high position in the company they are working for. They must record and monitor all the transactions that have occurred in that company and ensure that all the transactions are true and supported with the references. At the end of a financial year, the external auditors will be called upon to audit the work of the internal auditors to make sure that the financial statements prepared by the internal auditors are in true and fair view.

Government auditors

Government auditor is a person who performs the audit work for the government which is called Office of the Auditor General (OAG). Auditor General is responsible to audit the financial statements of the Federation and that of all states as well as of the public authorities and public fund. The responsibilities to conduct the audit work are to ensure:

- The government fund is used effectively and efficiently.
- All the transactions of payment and receipt are authorized and supported by proofs.
- All the accounts and records are properly recorded and maintained.

Forensic auditors

Forensic auditors' function is to detect, investigate, and deter fraud and white-collar crimes. These auditors may be employed by corporations, government agencies, public accounting firm, or consulting and investigate services firms. All these four types of auditors are required to be independent. It means that all the auditors must not combine the personal and external interest with the profession work. The auditors should avoid all those things to maintain the independence objective. This is to prevent the auditors doing fraud and modifying the financial statements by changing certain figures in it to look nice or for maintaining the company name and reputation at the eyes of the clients.

Islamic ethics for auditor

Justice

The principle of justice is one of the basic facts of Islam. It is based on what had been revealed by *Allah (swt)* and needs to be carried out as a fulfillment of the Islamic creed (*aqidah*). It is not based on human reasoning and interpretation or in accordance with the need of an interested party. The term justice has been stated in Qur'an which says that:

> *Allah commands justice, the doing of good and liberality to kith and kin, and He forbids all shameful deeds and injustice and rebellion: he instructs you, that ye may receive admonition.*
>
> (*Al-Nahl*: 90)

From the aforementioned verse, we could see that *Allah (swt)* commands all human beings to uphold justice, enjoin good deeds, give assistance to the needy, and He forbids evil deeds and injustice. Thus, it can be concluded that the principle of justice and fairness governs all aspects of humanity from material to spiritual. Justice has been defined by Ibn Miskawayh as equality that consists in giving what is due, to whom it is due, and in the way it is due. The term equality implies fairness, impartiality, and right judgment. In other words, one should be justified in dealing with all kinds of people regarding any matter. Allah commands all Muslims to be just and equitable to all other citizens regardless of race, nationality, or religions even when it involves those opposed to them. Other than that, Imam al-Ghazali also describes justice as putting something in the right place or positioning it properly in its right perspective. Justice implies doing something with righteousness and accuracy without any elements of fraud. As Allah (swt) has reminded us to be just in measure as well as scale which is highlighted in the Qur'an:

> *Give full measure when ye measure and weight with a balance that is straight.*
> (*Al-Isra'*: 35)

This implies that any weight and measurements done should reflect the correct values of the assets and liabilities. Therefore, in auditing perspective, the auditor should be fair in conducting the auditing job and should be just and fair in giving his or her opinion on the financial report. If there in their duty, they face a situation where there is a conflict between the management or client and the public, for example then they must give full attention to public interest rather than the management or client. This principle will give them a clear guidance on how to act in any situation that they might face on the future. Therefore, by having this principle in their life, public interest will be protected and prevent the discrimination in business.

Accountability

Another Islamic ethics that the auditor should have is accountability. It is a fundamental concept in Islamic ethics. Man is accountable for every single action that is carried out under his supervision. He cannot run away from being answerable for the outcome of things that he has done before. He must bear all the consequences for any of his misconduct. Therefore, it is important for every Muslim to understand his role and responsibilities so that the task is completed with the best of one's ability.

The Prophet (saw) told to convey to the unbelievers,

> *I am accountable for my actions and you are for yours: you are not accountable for what I do. Every one of you is a shepherd and everyone is responsible for what he is shepherd of.*
> (*Sahih Bukhari and Muslim*)

Also, Muslims should realize that Allah will consider every single action they did. Therefore, they should be aware of their responsibilities and be alert of *Allah's (swt)* punishment if the task assigned is not performed in the best manner as stated in the Qur'an:

> *Do not think that Allah is unaware of the wrongdoer's action.*
> (*Ibrahim*: 42)

In the perspective of a Muslim auditor, he needs to be accountable not only in fulfilling his auditing obligation or in disclosing the financial information to the public, but he is also accountable in ensuring the public interest. For instance, in the case of pollution, even though in a legal term company is not obliged to account for the external costs, but the auditor should take into consideration this cost as well in providing information so as the society will not suffer from their action.

Trustworthiness

Being trustworthy is also important to the auditor in auditing the firm or client organization. It is an important value in business as a trustworthy person is an individual who is dependable and reliable. According to Imam al-Ghazali, a Muslim trader must be honest, truthful, and straightforward in all his business dealings. In other words, any person who is involved directly or indirectly in business not only has to be sincere or honest but also he should exercise trustworthiness.

As stated in the Qur'an:

> *Allah doth command you to render back your trust to those to whom they are due.*
>
> (*Al-Nisa'*: 58)

Therefore, in the perspective of an auditor, it is necessary to exercise trustworthiness to ensure that the auditor would not be biased in performing their jobs and give a just opinion on the audit reports because the wrong opinion given by the auditor could risk the interest of business people. For example the audit opinion is important for the investors since they rely on the audit report to invest on that company. In addition, the auditor should not have any biased interest in the organization that they audit. As well, the auditor should not reveal any information of the company for their own benefit such as trading the information of the organization to the outside parties and thus betray the trust bestowed on them. As stated in the Qur'an:

> *Ye that believe! Betray not that trust of Allah and the Messenger, nor misappropriate knowingly things entrusted to you.*
>
> (*Al-Anfal*: 27)

Integrity

Integrity means the quality of being honest and morally right. *Allah (swt)* says in the Qur'an:

> *O you who believe! Why say ye that which ye do not? Grievously odious is it in the sight of Allah that ye say that which ye do not.*
>
> (*Al-Saff*: 2–3)

Integrity requires a person to be honest and sincere in performing his duties so as to obey Allah's command. The Islamic principle puts great importance on honesty by telling the reality and not to hide any action or information which could harm the society. The auditors can maintain this profession only when they are honest. This is because when they are honest, many clients will employ them to audit the financial statement of their companies. From this, the public confidence and respects also will be gained by that auditor. According to al-Ghazali, integrity deals with the inner power at its source. It hinges on the capability of a man to guide, direct, and influence people based on moral principles and ethical values. It also reflects in one's ability to keep promises and trusts. The Prophet (saw) had personally proven that any businessman who practices honesty or integrity and cares about his customers can in fact earn more profits simply because he is doing his duty for the sake of obeying Allah. In relation to the auditing practice, to be sincere or honest means in auditing the financial report of a company, the auditor's report should disclose all the information without any misstatement or omission. Auditor should be free from being biased and other influences. Therefore, as an auditor, he must ensure that the information provided by them reflects the actual condition of a company and should not be used to deceive the users of the report. Such information should be detailed, true, and fair to enable the users to evaluate the impact on their decisions. Thus, the auditor should show integrity in performing their duty since it could help in the development of the country since the user can really rely on the auditor's opinion as to make an investment without any doubt.

Competences

Competences refer to the ability to serve the effective interpretation and implementation of Islamic principles. Even though the competence principle is ranked last, it is among the most important elements in Islamic ethics. An auditor must have the Islamic worldview in mind in providing the assurance of the audit's report because they must be aware of their duty to *Allah (swt)*. Therefore, the auditor should be competent in the *Shari'ah* because if the auditors show competence in the *Shari'ah* law, then they are able to make decisions or conduct ethically because they know exactly what is allowed or prohibited under the *Shari'ah* law.

Conclusion

Ethical observation is important in our life because it can lead us to behave in a good manner. There are many views regarding the definition of ethics which is based on a different situation. Therefore, ethics for the auditor is important because it will guide the auditor to perform their work effectively and efficiently. There are four types of auditors who must have the Islamic ethics irrespective of the type of organization they are working for. This is because the Islamic ethics could reduce the fraud, corruption, and manipulation in the business world. There are lots of Islamic ethics that the auditor should have in performing their duty, but the most important elements that the auditor should have are justice, accountability, trustworthiness, integrity or honesty, and competency. The auditor should know that they are responsible not only to the management or public but to Allah (swt) as well. Moreover, love and fear of Allah will help auditors to perform their jobs without indulging in any fraud or deceit.

27 Role and responsibilities of an auditor in the Islamic financial institutions

Introduction

In this contemporary era, Islamic countries have shown a good concern with the relationship between religion and the proper form of Islamic accounting. Islamic accounting can be concluded as an instrument for achieving justice in society. This is the reason why the auditor should provide a proper and reliable audit report as it influences the allocation of resources and distribution of income to the shareholders. The auditor should bear in mind that the auditing job not only affects the relationship between the auditor and the manager, but it also affects the relationship between themselves and *Allah (swt)*. Therefore, the auditor should be more responsible and honest to their selves by promoting good ethical conduct relating to Islamic ethics. There are no differences in the roles and responsibilities of the auditor between auditing the Islamic financial institutions and Western institutions. The auditor still needs to perform audit jobs as usual. The only difference is that the auditor should do the audit jobs in the lines of the *Shari'ah* Rules and to make sure that the activities performed by the institution conform to the Islamic *Shari'ah* as well.

Roles and responsibilities of the auditor

As an auditor of Islamic institutions, it is their responsibility to ensure that the institutions develop accounting, auditing, and ethical thought taking into consideration the international standards and practices which comply with the Islamic *Shari'ah* Rules. This standard has been set by the AAOFI. AAOFI standard is used so as to support the faith of Islam and as to strengthen the effectiveness of *Shari'ah* committee by assisting in the evaluation of financing instruments and by aiding in the implementation of Islamic ethics. The faith of Islam must be governed by the holy Qur'an, the deeds and sayings of the prophet, the interpretation of the scholars of the laws and rules as well as the personal attitude of the Muslims. Therefore, the auditor's roles and responsibilities are to conduct audit in accordance with certain standards so as to obtain a reasonable assurance about whether the financial statement is free from any material misstatement. An audit includes examining the evidence which supports the amounts and disclosures in

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the financial statement given to them. In other words, when auditing the organization, the auditor should take into consideration the regulatory bodies, Islamic financial and accounting and auditing firms in order to implement the standards as well as the statements and guidelines that are published by AAOFI.

In addition, the auditor should assess the accounting policies and procedures adopted by the Islamic financial institutions and see whether they are harmonized with the preparation and issuance of accounting standards and the interpretations to the institution. For example an audit also includes assessing the accounting principles used and significant estimates made by management as well as evaluating the overall financial statement presentation before giving their opinion on the financial report. The Islamic institution should not exercise any activity beyond their policies and procedures which could bring harm to the society so as to achieve their main objective. The accounting and reporting policy is very important because it affects allocation and distribution of wealth and demonstrates the firm's accountability to their investors so as to aid them in their decision-making. Furthermore, for the Islamic institution, the auditor is responsible for gathering the information needed to identify risks of material misstatement due to fraud, who assesses risks after considering an evaluation of the business activities and controls and responds to the result. Three conditions are present when fraud occurs as described in Figure 27.1.

If the auditor finds out about the fraud occurring in the institution, the auditor should discuss the matter and the approach an appropriate level of management for further investigations. Also, if there is an appropriate suggestion from the client, they can consult with their legal counsel.

An auditor shall adapt the process as described in Figure 27.2 in auditing the fraud risk assessment in both financial and nonfinancial sectors.

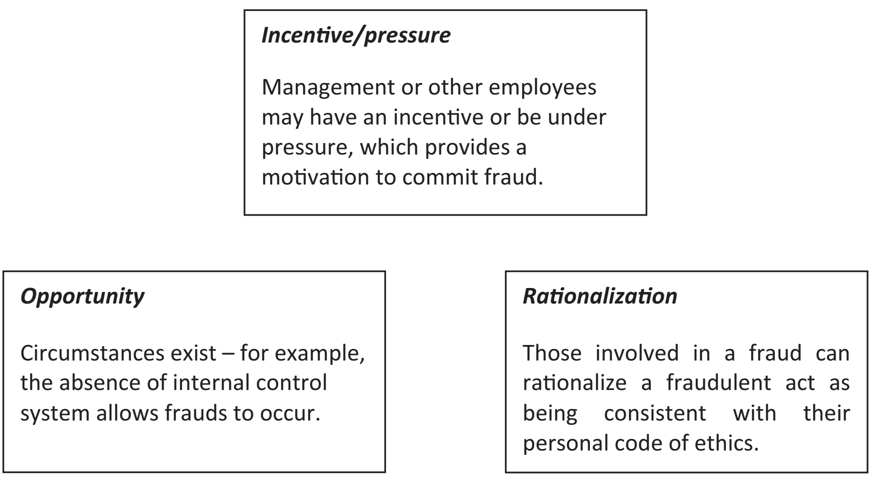

Figure 27.1 Conditions Present When Fraud Occurs

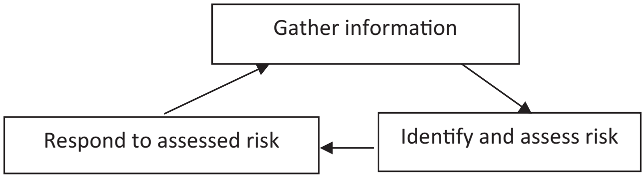

Figure 27.2 Fraud Risk Assessment Process

Another responsibility that auditor should bear in mind is that they must possess a skeptical attitude in auditing the Islamic financial institution. Skeptical attitude means that the auditor should always keep questioning and set aside past relationship and not assume that all clients are honest. The other responsibility of an auditor is to review with the aim of making additions, deletions, or amendments to any accounting, auditing, governance and ethical statements, standards and guidelines for Islamic financial institutions prepared by the Accounting and Auditing Board so as to aid the development in the activities of Islamic financial institutions in order to meet the needs of the users of the financial statements of that institution. Since the relationship of auditing is not only between the auditor and the manager but it is also between *Allah (swt)* and the auditor, therefore, so as to demonstrate that kind of responsibility and accountability, an auditor must promote good ethical practices in performing their job. Auditor must show good conduct and avoid getting biased when auditing certain company. The auditor should act in accordance to the MIA by-laws on Professional Code of Ethics as well as in accordance to the Islamic accounting ethics. Since the Islamic accounting ethics is based on al-Qur'an and *Sunnah*, therefore, it provides the stability guidance of what is right and what is wrong and gives confidence to the auditor to make correct decision. The roles and responsibilities of an auditor in accounting and financial reporting other than AAOFI standard is that the auditor is responsible to maintain the General Ledger (GL) of the company throughout the year. All the transactions occurring in the business during the day, week, month, and year should be recorded without fail to avoid the misstatement and frauds to happen. The GL should be maintained because it can show the flow of the business transactions (transactions that occurred during each day of the business). There is an advantage of the auditor maintaining the GL because it can be reviewed and can be proved to the management team of the company when they are unsatisfied or there is any doubt arising regarding the business transactions or the business flow.

A preparation of the annual financial report is also one of the responsibilities of an auditor. The purpose of preparing this annual financial report is to show the users of the financial report such as the employers, investors, taxpayers, suppliers, or people who are interested in this company, the performance of the company, whether the business of that company was running well or not or, in other words, to know whether the company was making a profit or loss. The preparation of this annual financial report is important because from this report, the users of this financial report will evaluate the performance of this company and make a decision whether they want to improve the company business, whether they want to invest in this company, or whether they want to supply to this company. So, to get the true result of the annual financial report, the auditor should be responsible to maintain the GL throughout the year. Besides that, the auditor is responsible to state his or her opinion regarding whether the financial statements have been properly drawn up or the accounting information, other records, and the registers of the company have been properly maintained in accordance with the provisions of the *Company's Act* 1965 and with applicable approved accounting standards. So, in conclusion, the auditor is responsible to give a true and fair view of the company's state of affairs and results of operations to prove that the companies being audited were operating under the rules that are being regulated, and they not contravening with the *Shari'ah* and government rules.

In auditing**,** the responsibilities of an auditor are to ensure the accuracy of accounting and budgeting information. The auditor should ensure that the accounts of the audit company are properly maintained, and the figures recorded are accurate with the actual transactions. Other than that, the auditor is responsible to ensure an efficient operation of the company. This is to make sure that the company was running the legal business that was not contravening with the *Shari'ah* and government rules. In addition, the auditor has the responsible to examine the books of the company for correctness. The auditor has the right to access the accounting documents and records of the company and its related companies at all reasonable times. The auditor is also entitled to obtain information and explanations that he or she requires for the purpose the audit from officers of the company and its related companies.

Conclusion

The role and responsibilities of an auditor are important in the working of Islamic institutions. There is no difference in the roles and responsibilities of an auditor of Islamic institutions and Western institutions. The important thing that we must remember is that the roles and responsibilities of the auditor are an *amanah* that is assigned to the human being by *Allah (swt)*. Those who perform well in this *amanah* show that they were good Muslims because to perform the roles and responsibilities of the auditor, they must have good ethics such as honesty, independence, good judgment, accountability, trustworthiness, and competency for us to be ensured that all the account and audit jobs were done properly and accurately in the lines of the *Shari'ah* Rules.

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